Yes, I'll Order that Trust Fully Loaded

By Jonathan Blattmachr, Mickey Davis, Steve Gorin, and Steve Trytten

Special Session II-B

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I. Overview

Dynasty trusts are an important element in many estate planning strategies because they have the potential to accomplish a number of different tax and non-tax objectives:

- Multi-generational transfer tax efficiency is fundamental to the design of a dynasty trust and, in some cases, the choice of trust situs.
- Protection of trust assets from the beneficiary's creditors can be an important non-tax objective for certain clients.
- Income tax efficiency is becoming more and more important as rates increase (including the 3.8% net investment income tax) and estate planners pay more attention to cost basis.
- "Stretch-out" of retirement plans[1] is another important objective, since more and more clients have significant balances in retirement plans.[2]
- State-specific objectives may also be in play. For example, the design of a trust may determine whether California property tax is reassessed.

Planning and drafting to accomplish any one objective may be difficult enough, but for the client who "wants it all," planning and drafting to accomplish multiple objectives can be particularly challenging.

Task Force – Materials as Practical Guide. A Task Force was formed by two substantive committees of the American College of Trust and Estate Counsel ("ACTEC").[3] The task was to compile sample forms illustrating how a dynasty trust can be drafted to accomplish different possible objectives, and to address coordination that may be needed when drafting to accomplish multiple objectives. These materials are the result.

These materials are intended as a practical guide to the experienced estate planner who is already familiar with the underlying concepts of the dynasty trust, particularly those related to estate, gift, and generation skipping transfer tax. The Task Force chose to devote more attention to some issues than others, focusing on current trends in the law. In particular, the Task Force gave emphasis to income-tax-related issues, since income tax efficiency is more important than ever.

These materials focus primarily on the design and drafting of dynasty trusts that will be formed during the grantor's life, but some of the discussion extends to dynasty trusts that may arise at death for two reasons.

First, even when dynasty trusts are established during life, additional assets may pass to dynasty trusts at death. See Chapter IX for discussion of coordinating lifetime and death-time transfers.

Second, retirement plan assets generally do not pass until death. But retirement plan issues should be considered when drafting an inter vivos dynasty trust since the trust may be designated as beneficiary of retirement plans. See Chapters X – XII for discussion of drafting considerations related to retirement plan issues.

Organization of Materials. In order to create reference materials that will be useful in a wide range of situations, the Task Force organized these materials as follows:

- Chapter II: *Sample Dynasty Trust.* Jonathan Blattmachr has graciously contributed an inter vivos, irrevocable dynasty trust template (the "template") generated from estate planning document assembly software marketed by

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[1] The term "retirement plan" is used broadly in these materials, and includes IRAs and Roth IRAs.

[2] "Stretch-out" refers to the ability to take minimum required distributions over the life expectancy of a younger heir, which in the context of a dynasty trust, is likely the primary beneficiary of the trust. Such a trust is often called a "see-through trust."

[3] The two committees are the Fiduciary Income Tax Committee and the Employee Benefits in Estate Planning Committee. The Task Force consists of Jonathan Blattmachr, Mickey Davis, Steve Gorin and Steve Trytten.

Interactive Legal Solutions.[4] As you will see, the template reflects a directed-trustee, Alaska dynasty trust that contemplates that neither the grantor nor the beneficiary will serve in any office of the trust.[5]

- Chapters III to 17: *Sample Clauses and Comments.* Sample clauses and commentary are provided that focus on 15 specific planning objectives.
- Appendix A: Planning For Charitable Contributions by Estates and Trusts, by Blattmachr, Boyle, and Fox
- Appendix B: Income Tax Trap - Reduction in Trust's S Corporation Charitable Deduction, by Gorin
- Appendix C: Trusts and the 3.8% Tax on Net Investment Income, by Gorin
- Appendix D: Selected Fiduciary Income Tax Issues, by Gorin
- Appendix E: Passive Loss Rules for Trusts, by Gorin
- Appendix F: Drafting See-Through Trusts, by Trytten

[4] Interactive Legal was co-founded in 2003 by Jonathan and Michael Graham.

[5] The beneficiary or the grantor can, however, act in certain positions, such as making investment decisions except for insurance on his or her life or, as to the grantor, voting stock that would be described in Section 2036(b). The provisions are not limited to Alaska governing law.

II. Sample Inter Vivos Dynasty Trust

IRREVOCABLE TRUST

THIS IS A TRUST AGREEMENT dated March _______, 2016, between Howard M. Zaritsky of Fairfield, Virginia (the "Grantor") and Steve Gorin as General Trustee, Big Trust Company of Alaska as Administrative Trustee, Mickey Davis as Distributions Trustee, and Steven Trytten as Investment Trustee (collectively, the "Trustee").

WHEREAS, the Grantor desires to create a trust; and

WHEREAS, the Trustee is willing to accept the trust hereby created and covenants to discharge faithfully the duties of a Trustee hereunder;

NOW, THEREFORE, the Grantor intends to transfer the property described in Exhibit A, attached hereto and made a part hereof, to the Trustee, IN TRUST, and the Trustee agrees to accept the property and to hold, manage and distribute the property under the terms of this Agreement.

ARTICLE I
Trust Name

This Agreement and the trust hereunder may be referred to as Irrevocable Trust.

ARTICLE II
Lifetime Trust

A. **During The Grantor's Life.** During the Grantor's life, the Trustee shall administer the trust (the "Lifetime Trust") pursuant to this paragraph:

1. The Distributions Trustee may, but shall not be required to, distribute as much of the net income and/or principal of the Lifetime Trust as the Trustee (excluding, however, any Disqualified Trustee) may at any time and from time to time determine to such one or more of the Grantor's Wife, Martha Washington Zaritsky, and the Grantor's descendants in such amounts or proportions as the Trustee (excluding, however, any Disqualified Trustee) may from time to time select for the recipient's health, education, maintenance or support in his or her accustomed manner of living.

2. The Distributions Trustee may, but shall not be required to, distribute as much of the net income and/or principal of the Lifetime Trust as the Trustee (excluding, however, any Interested Trustee) may at any time and from time to time determine to the Grantor's Wife and the Grantor's descendants in such amounts or proportions as the Trustee (excluding, however, any Interested Trustee) may from time to time select, for any purpose.

3. Any net income not so distributed shall be accumulated and annually added to principal.

4. The Lifetime Trust shall also be subject to the withdrawal rights set forth below.

B. **Separate Trusts for GST Purposes.** Although this Article speaks in terms of a single Lifetime Trust, the Lifetime Trust may instead be held as two trusts under the circumstances outlined in this paragraph if the Trustee (excluding, however, any Interested Trustee) in the Trustee's absolute discretion determines to do so.

1. The Trustee may hold as much of the property of the Lifetime Trust as the Trustee may determine in the exercise of discretion as a separate trust ("the GST Exempt Trust") and hold the balance of the trust property in another separate trust ("the GST Non-Exempt Trust"). The GST Exempt Trust and the GST Non-Exempt Trust shall have identical terms but shall be accounted for as separate trusts for which investments and distributions need not be the same. The Grantor anticipates this will be done in such manner that the GST Exempt Trust will have a zero inclusion ratio with respect to the Grantor and the Grantor's Wife as transferors for Federal generation-

skipping transfer tax purposes (to the extent either or both of them may be considered a transferor of property held under this Article for such purposes).

2. The GST Exempt Trust and the GST Non-Exempt Trust may be held and administered as if they were a single trust, *in solido*, and shall be treated as a single trust in applying the Crummey withdrawal rights defined below.

3. When additions are made to the Lifetime Trust, the Trustee may wait until there is sufficient information concerning what GST exemption has been allocated to the addition before allocating the added property to the GST Exempt Trust or the GST Non-Exempt Trust.

4. The Trustee (excluding, however, any Interested Trustee) is also authorized in the Trustee's absolute discretion to transfer property from the GST Non-Exempt Trust to the GST Exempt Trust. Without limiting the Trustee's discretion, the Grantor anticipates this will be done in conjunction with the allocation of additional GST exemption to the property. If the GST Non-Exempt Trust has more than one GST transferor and is therefore treated as separate trusts for GST purposes, then a transfer from the GST Non-Exempt Trust shall be deemed to come pro rata from such separate trusts comprised in the GST Non-Exempt Trust, unless the Trustee shall identify it in some other fashion. If the GST Exempt Trust also has more than one GST transferor, the transferred property shall be added to the separate trust for GST purposes having the same transferor.

5. The authority conferred by this Article to create separate GST Exempt and GST Non-Exempt Trusts may be exercised without any special notation on the trust records.

6. If no Trustee (other than an Interested Trustee) serves, or if it is established that no such division has ever been accomplished, all property contributed hereto shall be deemed to be GST Exempt, whether or not GST exemption is actually allocated to the property contributed hereunder.

C. **End of Lifetime Trust.** Upon the Grantor's death, if the Grantor is survived by the Grantor's Wife, any property of the Lifetime Trust that is included in the Grantor's gross estate shall be distributed to the Trustee of the Marital Trust hereunder, to be disposed of under the terms of that trust, and any property of the Lifetime Trust that is not included in the Grantor's gross estate shall be distributed to the Trustee of the Family Trust hereunder, to be disposed of under the terms of that trust. Upon the Grantor's death, if the Grantor is not survived by the Grantor's Wife, the property of the Lifetime Trust shall be set aside and divided, separately as to any GST Non-Exempt Trust and as to any GST Exempt Trust, into per stirpital shares for the Grantor's then-living descendants, and each share so set aside for a descendant shall be distributed to the Trustee of a Descendant's Separate Trust to be held as a separate trust and to be disposed of under the terms of the Descendants' Separate Trusts under this Agreement, the descendant for whom the share is set aside to be the Beneficiary of his or her own Descendant's Separate Trust.

ARTICLE III
Crummey Rights of Withdrawal

Immediately following each contribution (as defined below) to the trust, the Grantor's Wife and each of the Grantor's children (unless excluded as provided below) may withdraw from the trust a portion of the value of each contribution, the amount of which, and the limitations, rules and procedures applicable to which shall be set forth later in this Agreement.

ARTICLE IV
Family Trust

Property that is to be held as the Family Trust shall be held under this Article and all references to "Family Trust" shall be to the trusts held under this Article.

A. **Separate Trusts for GST Purposes.** If property passes to the Family Trust from separate GST Exempt and GST Non-Exempt Trusts of the Lifetime Trust, then the Family Trust shall likewise be held in separate GST Exempt and GST Non-Exempt Trusts. In that event, without limiting the Trustee's discretion, the

Grantor suggests that no distributions be made from the GST Exempt Trust until the GST Non-Exempt Trust is exhausted, unless there is a compelling reason to do so.

B. **During Wife's Life.** The following provisions shall apply during the Grantor's Wife's life:

1. The Distributions Trustee may, but shall not be required to, distribute to one or more of the Grantor's Wife and the Grantor's descendants as much of the net income and principal of the trust as the Trustee (excluding, however, any Interested Trustee) may at any time and from time to time determine, in such amounts or proportions as the Trustee (excluding, however, any Interested Trustee) may from time to time select, for any purpose; provided, however, that distributions to any descendant of the Grantor of such income and principal shall only be made in accordance with the provisions of the Supplemental Needs Trust below, and the descendant for whom such distribution would be made shall be treated as the Beneficiary of a Supplemental Needs Trust hereunder.

2. Any net income not so distributed shall be accumulated and annually added to principal.

3. Without limiting the Trustee's discretion, the Grantor suggests that no distribution of income or principal be made to the Grantor's Wife until the principal of the Marital Trust is exhausted, unless there is a compelling reason to do so.

4. Without limiting the Trustee's discretion, the Trustee may consider the needs of the Grantor's Wife as more important than the needs of the Grantor's descendants or any other beneficiary.

C. **Upon Wife's Death.** Upon the death of the Grantor's Wife, the property then held in the Family Trust shall be:

1. distributed to one or more persons out of a class composed of the Grantor's descendants on such terms as the Grantor's Wife may appoint by a Will or other signed writing that is acknowledged before a notary public specifically referring to this power of appointment; or, in default of appointment or insofar as an appointment is not effective;

2. set aside and divided, separately as to any GST Non-Exempt Trust and as to any GST Exempt Trust, into per stirpital shares for the Grantor's then-living descendants, and each share so set aside for a descendant shall be distributed to the Trustee of a Descendant's Separate Trust to be held as a separate trust and to be disposed of under the terms of the Descendants' Separate Trusts under this Agreement, the descendant for whom the share is set aside to be the Beneficiary of his or her own Descendant's Separate Trust.

ARTICLE V
Descendants' Separate Trusts

Property that is to be held in a Descendant's Separate Trust or the Descendants' Separate Trusts shall be held under this Article and all references to the "Descendant's Separate Trust" or the "Descendants' Separate Trusts" shall be to the trusts held under this Article.

A. **During The Beneficiary's Life.** The following provisions shall apply during the Beneficiary's life:

1. The Distributions Trustee may, but shall not be required to, distribute to any one or more of the Beneficiary and the Beneficiary's descendants as much of the net income and principal of the trust as the Trustee (excluding, however, any Disqualified Trustee) may at any time and from time to time determine, in such amounts or proportions as the Trustee (excluding, however, any Disqualified Trustee) may from time to time select for the recipient's health, education, maintenance or support in his or her accustomed manner of living.

2. The Distributions Trustee may, but shall not be required to, distribute to any one or more of the Beneficiary and the Beneficiary's descendants as much of the net income and principal of the trust as the Trustee (excluding, however, any Interested Trustee) may at any time and from time to time

determine, in such amounts or proportions as the Trustee (excluding, however, any Interested Trustee) may from time to time select, for any purpose.

3. Any net income not so distributed shall be accumulated and annually added to principal.

4. Without limiting the Trustee's discretion, the Trustee may consider the needs of the Beneficiary as more important than the needs of the Beneficiary's descendants or of any other beneficiary.

5. Without limiting the Trustee's discretion, the Grantor suggests that no distribution of principal be made from any trust for a Beneficiary that is exempt from Federal generation-skipping transfer tax ("GST Exempt Trust") until the principal of any trust that is not exempt from Federal generation-skipping transfer tax ("GST Non-Exempt Trust") for that Beneficiary is exhausted, unless there is a compelling reason to do so.

B. **Upon Beneficiary's Death.** Upon the Beneficiary's death, the property then held in his or her Descendant's Separate Trust shall be distributed as follows:

1. distributed to such one or more persons out of a class composed of the Beneficiary's descendants and surviving spouses of the Beneficiary's descendants on such terms as the Beneficiary may appoint by a Will or other signed writing that is acknowledged before a notary public specifically referring to this power of appointment; or, in default of appointment or insofar as an appointment is not effective;

2. With respect to the GST-Non-Exempt Trust, distributed pursuant to the Paragraph of this article titled "Special Provisions for GST Non-Exempt Trust;" and

3. With respect to the GST Exempt Trust, set aside and divided into per stirpital shares for the Beneficiary's descendants then living or, if there is no descendant of the Beneficiary then living and if the Beneficiary was a grandchild or more remote descendant of the Grantor, for the descendants then living of the Beneficiary's nearest ancestor who was a descendant of the Grantor, with descendants then living or, if there is no such descendant then living or if the Beneficiary was a child of the Grantor, for the Grantor's descendants then living, the share so set aside for a descendant to be distributed to the Trustee of the Descendants' Separate Trusts, to be held as a separate trust to be disposed of under the terms of this Article, the descendant for whom the share is set aside to be the Beneficiary of his or her own Descendant's Separate Trust.

C. **Special Provisions for GST Non-Exempt Trust.**

1. **Death of Beneficiary Whose Death Would Cause Generation-Skipping Transfer Tax.** Upon the death of the Beneficiary (referred to in this paragraph as the "Deceased Beneficiary"), if the death of such Deceased Beneficiary would cause the imposition of a generation-skipping transfer tax if the GST Non-Exempt Trust were distributable in the same manner as that provided herein for distribution of the GST Exempt Trust, then the GST Non-Exempt Trust shall be distributed as follows:

    a) **If any Grandchild or more Remote Descendant of the Deceased Beneficiary is Living.** If upon the death of the Deceased Beneficiary any descendant of the Deceased Beneficiary other than a child of the Deceased Beneficiary is then living, the GST Non-Exempt Trust, to the extent, if any, not effectively appointed by the Deceased Beneficiary, shall, upon his or her death, continue in trust until the fifth (5th) anniversary of the death of the Deceased Beneficiary and, until such fifth (5th) anniversary, shall be held in a separate trust for the benefit of those descendants of the Deceased Beneficiary living upon the death of the Deceased Beneficiary who are then assigned to the youngest generation from the Grantor for generation-skipping transfer tax purposes of the Code (hereinafter collectively the "Deceased Beneficiary's Youngest Descendants"). During the term of such trust, The Distributions Trustee shall distribute to one or more of the Deceased Beneficiary's Youngest Descendants as much of the net income and principal of the trust as the Trustee (excluding, however, any Interested Trustee) may at any time

and from time to time determine, in such amounts or proportions as the Trustee (excluding, however, any Interested Trustee) may from time to time select, for any purpose. Any net income not so distributed shall be accumulated and annually added to principal.

Upon the fifth (5th) anniversary of the death of the Deceased Beneficiary, the trust principal then held for the benefit of the Deceased Beneficiary's Youngest Descendants hereunder, as it is then constituted, together with any accrued, accumulated and undistributed income, shall be set aside and divided into per stirpital shares for the Deceased Beneficiary's descendants then living or, if there is no descendant of the Deceased Beneficiary then living and if the Deceased Beneficiary was a grandchild or more remote descendant of the Grantor, for the descendants then living of the Deceased Beneficiary's nearest ancestor who was a descendant of the Grantor with descendants then living or, if there is no such descendant then living or if the Deceased Beneficiary was a child of the Grantor, for the Grantor's descendants then living, the share so set aside for a descendant to be distributed to the Trustee of the Descendants' Separate Trusts, to be held as a separate trust to be disposed of under the terms of this Article, the descendant for whom the share is set aside to be the Beneficiary of his or her own Descendant's Separate Trust.

b) **If no Grandchild nor any more Remote Descendant of the Deceased Beneficiary is Living.** If upon the death of the Deceased Beneficiary either (i) no descendant of the Deceased Beneficiary other than a child of the Deceased Beneficiary is then living or (ii) no descendant of the Deceased Beneficiary is then living, but a descendant of the Grantor who is assigned to a generation for generation-skipping transfer tax purposes at least two generations younger than that of the Deceased Beneficiary is then living, the GST Non-Exempt Trust, to the extent, if any, not effectively appointed by the Deceased Beneficiary, shall, upon his or her death, continue in trust until the fifth (5th) anniversary of the death of the Deceased Beneficiary and until such fifth (5th) anniversary, shall be held in a separate trust for the benefit of those then living descendants who are then assigned to the youngest generation from the Grantor for generation-skipping transfer tax purposes of the Code of the ancestor of the Deceased Beneficiary of the closest degree of consanguinity to the Deceased Beneficiary which ancestor has descendants who are then living and which ancestor is (or was) a descendant of the Grantor or which ancestor is (or was) the Grantor (hereinafter collectively the "Youngest Collateral Relatives"). During the term of such trust, The Distributions Trustee shall distribute to one or more of the Youngest Collateral Relatives as much of the net income and principal of the trust as the Trustee (excluding, however, any Interested Trustee) may at any time and from time to time determine, in such amounts or proportions as the Trustee (excluding, however, any Interested Trustee) may from time to time select, for any purpose. Any net income not so distributed shall be accumulated and annually added to principal.

Upon the fifth (5th) anniversary of the death of the Deceased Beneficiary, the trust principal then held for the benefit of the Youngest Collateral Relatives hereunder, as it is then constituted, together with any accrued, accumulated and undistributed income, shall be set aside and divided into per stirpital shares for the Deceased Beneficiary's descendants then living or, if there is no descendant of the Deceased Beneficiary then living and if the Deceased Beneficiary was a grandchild or more remote descendant of the Grantor, for the descendants then living of the Deceased Beneficiary's nearest ancestor who was a descendant of the Grantor with descendants then living or, if there is no such descendant then living or if the Deceased Beneficiary was a child of the Grantor, for the Grantor's descendants then living, the share so set aside for a descendant to be distributed to the Trustee of the Descendants' Separate Trusts, to be held as a separate trust to be disposed of under the terms of this Article, the descendant for whom the share is set aside to be the Beneficiary of his or her own Descendant's Separate Trust.

2. **Death of Beneficiary Whose Death Would Not Cause Generation-Skipping Transfer Tax.** Upon the death of the Deceased Beneficiary, and if the death of such Deceased Beneficiary would

not cause the imposition of a generation-skipping transfer tax if the GST Non-Exempt Trust were distributable in the same manner as that provided herein for distribution of the GST Exempt Trust, then the GST Non-Exempt Trust shall be distributed in the same manner as that provided herein for distribution of the GST Exempt Trust.

D. **Disinterested Trustee May Confer Power.** The Trustee (excluding, however, any Interested Trustee) may at any time, prior to the death of the Beneficiary, by an instrument in writing (1) confer upon the Beneficiary a power exercisable only by Will to appoint all or part of the Trust to the creditors of the Beneficiary's estate (other than any taxing authority), and the instrument conferring such power upon the Beneficiary may require the consent of the Trustee (other than any Interested Trustee) to exercise the power, (2) revoke any such instrument previously executed, with or without executing a replacement instrument and/or (3) irrevocably relinquish the powers conferred under (1) and/or (2). Without limiting the Trustee's discretion, the Trustee may use the authority conferred by this paragraph to subject the trust property to estate tax instead of the generation-skipping transfer tax when it appears that it may reduce overall taxes to do so. If a power is conferred upon a Beneficiary by the Trustee in accordance with this paragraph, such power shall not be exercisable in any manner so as to postpone the vesting of any estate or interest in the appointed property or to suspend the absolute ownership or power of alienation of the appointed property for a period ascertainable without regard to the date of this Agreement, and the validity of any exercise shall be measured with respect to that date.

E. **Maximum Duration for Trusts.** Any trust under this Article still in existence upon the expiration of the Maximum Duration for Trusts as defined elsewhere in this Agreement shall thereupon terminate and the remaining trust property shall be distributed to the Beneficiary of the trust.

F. **Supplemental Needs Trusts.** Notwithstanding any other provision of this Article to the contrary, any distribution to such Beneficiary shall only be made in accordance with the provisions of the Supplemental Needs Trust hereunder, and such Beneficiary shall be treated as the Beneficiary of a Supplemental Needs Trust hereunder.

ARTICLE VI
Supplemental Needs Trust Provisions

Notwithstanding anything to the contrary, any property disposed of hereunder or any trust created hereunder that is directed to be held in this Agreement pursuant to the terms of a Supplemental Needs Trust shall be administered as a separate trust pursuant to the terms of this Article. The Grantor directs that such trust be administered as follows:

A. **Payment of Benefits.** The Trustee (excluding, however, any Interested Trustee and any Disqualified Trustee) may, at any time and from time to time, apply for the benefit of the Beneficiary, so much (even to the extent of the whole) of the income and/or principal of this trust as the Trustee (excluding, however, any Interested Trustee and any Disqualified Trustee) may deem advisable, subject to the limitations set forth below. The Trustee shall add to the principal of this trust the balance of net income not so applied.

B. **Intent of Trust.** It is the Grantor's intent to create a Supplemental Needs Trust. The Grantor intends that the trust assets be used to supplement and not supplant, impair or diminish, any benefits or assistance of any Federal, state, county, city, or other governmental entity for which the Beneficiary may otherwise be eligible or which the Beneficiary may be receiving. Consistent with that intent, it is the Grantor's desire that, before expending any amounts from net income and/or principal of this trust, the Trustee consider the availability of all benefits from government or private assistance programs for which the Beneficiary may be eligible and that, where appropriate and to the extent possible, the Trustee endeavors to maximize the collection of such benefits and to facilitate the distribution of such benefits for the benefit of the Beneficiary.

C. **No Reduction of Benefits.** Subject to the provisions of the paragraph entitled Discretionary Distributions, none of the income or principal of this trust shall be applied in such a manner as to supplant, impair or diminish benefits or assistance of any Federal, state, county, city, or other governmental entity for which the Beneficiary may otherwise be eligible or which the Beneficiary may be receiving.

D. **No Revocation or Assignment.** The Beneficiary does not have, and shall not be deemed to have, the legal authority or power: (i) to revoke or terminate the trust, or (ii) to compel or direct the use or distribution of the trust assets. Additionally, the Beneficiary cannot assign, encumber nor sell the Beneficiary's beneficial interest in the trust.

E. **Use of Income and Principal.** The trust income and principal may, in the sole and absolute discretion of the Trustee (excluding, however, any Interested Trustee and any Disqualified Trustee), be used to provide the Beneficiary with extra and supplemental care, maintenance, support and education and will not be made available to provide primary support for the Beneficiary, including, but not limited to, basic food, shelter or health care. The Trustee (excluding, however, any Interested Trustee and any Disqualified Trustee) is authorized to make trust distributions to or on the Beneficiary's behalf in such a manner that the Beneficiary's life will be enriched and made more enjoyable, including, but not limited to, recreational and vacation opportunities away from places of residence, expenses for traveling companions, if requested or necessary, entertainment expenses and social services expenses. The Trustee (excluding, however, any Interested Trustee and any Disqualified Trustee) is authorized to expend the trust property to obtain more sophisticated and/or extensive medical and/or dental treatment than may otherwise be available to the Beneficiary and to seek private rehabilitative and/or educational training. For purposes of this paragraph, basic "health care" shall not include health insurance premiums, and the Trustee is explicitly authorized to pay such premiums if the Trustee determines, in the exercise of sole and absolute discretion, that it is in the Beneficiary's best interest to do so. The Grantor desires that the Beneficiary be able to maintain contact with his or her children and other family members, and the Trustee (excluding, however, any Interested Trustee and any Disqualified Trustee) is authorized to expend trust income and/or principal for transportation costs for the Beneficiary or other family members to facilitate such contacts. The Grantor desires, but does not direct, that the Trustee exercises the discretionary powers conferred in this Article in such a manner as will provide flexibility in the administration of the trust, and, in exercising such powers, the decision of the Trustee shall be conclusive as to the advisability of any distribution of income and/or principal, and as to the person or persons to or for whom such distribution is to be made, and such decision shall not be subject to judicial or governmental review.

F. **Use of Residence.** To the extent consistent with a Supplemental Needs Trust, the Trustee may acquire, hold, and maintain any residence (whether held as real property, condominium, cooperative apartment or otherwise) for investment or for the use and benefit of the Beneficiary of this trust, as the Trustee (excluding, however, any Interested Trustee and any Disqualified Trustee) may, in the exercise of sole and absolute discretion, determine, including allowing the Beneficiary the exclusive right to occupy and use the real property and to permit members of the Beneficiary's family or friends or medical or household employees (including independent contractors) for the Beneficiary also to occupy the property with the Beneficiary. If the Trustee (excluding, however, any Interested Trustee and any Disqualified Trustee) determines that it would be in the best interests of the Beneficiary to maintain a residence for the use of the Beneficiary but that the residence owned by the Trustee should not be used for such purpose, the Trustee is authorized to sell said residence and to apply the net proceeds of sale, or a portion of such net proceeds, to the purchase of such other residence or residences or to make such other arrangements as the Trustee (excluding, however, any Interested Trustee and any Disqualified Trustee) may deem suitable for the purpose. Any proceeds of sale not needed for reinvestment in a residence as provided above are to be added to the principal of the trust and thereafter held, administered, and disposed of as a part thereof. The Trustee shall use the proceeds to pay all carrying charges of such residence, including but not limited to any taxes, assessments, and maintenance thereon, and all expenses of the repair and operation thereof, including the employment of household employees (including independent contractors), and other expenses incident to the maintenance of a household for the benefit of the Beneficiary of the trust, to make such improvements to the residence as the Trustee may, in the exercise of sole and absolute discretion, determine to be appropriate to make the residence suitable for the Beneficiary, and to expend such amounts as the Trustee (excluding, however, any Interested Trustee and any Disqualified Trustee) may determine to be appropriate to maintain the current life style of the Beneficiary, or to improve the life style of the Beneficiary, including, but not limited to, providing for the personal care and comfort of the Beneficiary in any manner.

G. **Discretionary Distributions.** Notwithstanding any other provisions contained in this Article, the Trustee (excluding, however, any Interested Trustee and any Disqualified Trustee) may make distributions to meet the Beneficiary's need for food, shelter or health care even if such distributions may result in an

impairment, diminution or elimination of the Beneficiary's receipt or eligibility for Government Benefits but only if the Trustee determines that (i) the Beneficiary's needs will be better met if such distribution is made, and (ii) it is in the Beneficiary's best interest to experience the consequent effect, if any, on the Beneficiary's eligibility for or receipt of Government Benefits; provided, however, that if the mere existence of the Trustee's authority to make distributions pursuant to this paragraph shall result in the Beneficiary's loss of Government Benefits, regardless of whether such authority is actually exercised, this paragraph shall be null and void and the Trustee's authority to make such distributions shall cease and shall be limited as otherwise provided elsewhere in this Article, without exception.

H. **Limited Power to Amend.** The Trustee (excluding, however, any Interested Trustee and any Disqualified Trustee) may, by an instrument in writing, amend this Trust in any manner required to protect the Beneficiary's eligibility for public benefits or assistance including Medicaid or SSI, or to meet any of the Grantor's intentions or objectives set forth in this Trust. This includes amending this Trust in order to conform the Trust to current federal or state law. No amendment under this paragraph may increase the class of beneficiaries. Any expenses in this regard, including reasonable attorneys' fees, shall be a proper charge to the Trust. No Trustee shall be liable for any loss of Trust assets by reason of the exercise or failure to exercise the authority under this paragraph, except for any loss caused by the Trustee's bad faith, wanton conduct or negligence.

I. **Death of Beneficiary.** Upon the death of the Beneficiary, the Trustee shall pay over and distribute the principal and undistributed income of such trust as otherwise provided in this Agreement as though the provisions of this Article had never applied to the trust.

J. **Definition of Beneficiary.** For purposes of this Article, the term "Beneficiary" shall mean the person for whose benefit the property was directed to be held in a Supplemental Needs Trust hereunder.

ARTICLE VII
Marital Trust

Property that is to be held as the Marital Trust shall be held under this Article and all references to the "Marital Trust" shall be to the trusts held under this Article.

A. **During Wife's Life.** The following provisions shall apply during the Grantor's Wife's life:

1. The Distributions Trustee shall distribute to the Grantor's Wife the net income of the Trust at least annually.

2. The Distributions Trustee may, but shall not be required to, distribute to the Grantor's Wife as much of the principal of the trust as the Trustee (excluding, however, any Interested Trustee) may at any time and from time to time determine, for any purpose.

3. Without limiting the Trustee's discretion, the Trustee may consider the needs of the Grantor's Wife as more important than the needs of the Grantor's descendants or any other beneficiary.

4. The Grantor's Wife may direct the Trustee to make any unproductive assets productive of income or to convert any unproductive assets to property that produces income, within a reasonable time, notwithstanding any provision of this Agreement or any applicable law otherwise authorizing the Trustee to retain unproductive property. The application of any specific provision of this Agreement to the Marital Trust shall in all events be construed so as to give the Grantor's Wife that degree of beneficial enjoyment of the trust property during his life which the principles of the law of trusts accord to a person who is the sole income beneficiary of a trust, and to ensure that the Marital Trust qualifies for the Federal estate tax marital deduction to the extent so elected.

B. **Upon Wife's Death.** The following provisions shall apply after the Grantor's Wife's death:

1. Unless the Grantor's Wife provides otherwise by specific reference to this paragraph in a Will or other writing, the Trustee shall pay any increase in death taxes payable upon the death of the Grantor's Wife caused by the inclusion of a marital trust or a portion of a marital trust in his gross

estate from the principal of the trust or portion so included. The Trustee may rely upon the written statement by the Grantor's Wife's Executor of the amounts thus payable.

2. The balance of the property then held in the Marital Trust shall be distributed to such persons out of a class composed of the Grantor's descendants, on such terms as the Grantor's Wife may appoint by a Will or other signed writing that is acknowledged before a notary public specifically referring to this power of appointment; or in default of appointment or insofar as an appointment is not effective.

3. The balance of the property then held in the Marital Trust shall be set aside and divided into per stirpital shares for the Grantor's then-living descendants, and the share so set aside for a descendant shall be distributed to the Trustee of a Descendant's Separate Trust to be held as a separate trust and to be disposed of under the terms of the Descendants' Separate Trusts under this Agreement, the descendant for whom the share is set aside to be the Beneficiary of his or her own Descendant's Separate Trust.

C. **Wife's Disclaimer.** If the Grantor's Wife disclaims any of his interest in the income and principal of the Marital Trust, the disclaimed property shall be added to the Family Trust under this Agreement to be disposed of under the terms of that trust; provided however that the Grantor's Wife shall have no power of appointment over the fractional share of the Family Trust consisting of disclaimed property, including any accumulated income of that share unless such right is limited by an ascertainable standard. If the Grantor's Wife disclaims all of his interest in the income of the Marital Trust or a portion of the income of the Marital Trust, he shall be deemed to have disclaimed his interest in all or a corresponding portion of the principal of the Marital Trust.

D. **Allocation of Management Expenses.** To the extent the following authorization does not cause any interest hereunder to fail to qualify, in whole or in part, for the Federal estate tax marital deduction which otherwise would so qualify, the Trustee is authorized to allocate management expenses within the meaning of Reg. §20.2056(b)-4(d)(1)(i) to any interest hereunder that qualifies for the Federal estate tax marital deduction.

ARTICLE VIII
Substance Abuse

The following provisions apply to all trusts created under this Agreement, except as expressly provided to the contrary in this Article entitled "Substance Abuse:"

A. **Dependence.** If the individual serving as Trustee reasonably believes that: (1) a beneficiary of any trust created under this Agreement (i) routinely or frequently uses or consumes any illegal drugs or other illegal chemical substance so as to be physically or psychologically dependent upon that drug or substance, or (ii) is clinically dependent upon the use or consumption of alcohol or any other legal drug or chemical substance that is not prescribed by a licensed medical doctor or psychiatrist in a current program of treatment supervised by that doctor or psychiatrist; and (2) as a result of such use or consumption, the beneficiary is incapable of caring for himself or herself, is likely to dissipate the beneficiary's financial resources; then the individual serving as Trustee must follow the procedures set forth below.

B. **Testing.** The individual serving as Trustee will request the beneficiary to submit to one or more examinations (including laboratory tests of hair, tissue, or bodily fluids) determined to be appropriate by a licensed medical doctor or psychiatrist selected by the individual serving as Trustee. The individual serving as Trustee will request the beneficiary to consent to full disclosure by the examining doctor or facility to the individual serving as Trustee of the results of all the examinations. The individual serving as Trustee shall disclose the results of all of the examinations to any corporate trustee. The Trustee shall maintain strict confidentiality of those results and will not, without the beneficiary's written permission, disclose those results to any person other than the beneficiary. The Trustee may totally or partially suspend all distributions otherwise required or permitted to be made to that beneficiary until the beneficiary consents to the examination and disclosure to the individual serving as Trustee.

C. **Treatment.** If, in the opinion of the examining doctor or psychiatrist, the examination indicates current or recent use of a drug or substance as described above, the beneficiary must consult with the examining doctor or psychiatrist to determine an appropriate method of treatment for the beneficiary. Treatment may include counseling or treatment on an in-patient basis in a rehabilitation facility. If the beneficiary consents to the treatment, the Trustee may pay the costs of treatment directly to the provider of those services from the income or principal otherwise authorized or required to be distributed to the beneficiary, if the Trustee otherwise determines that the funds are available to do so and it is in the best interests of the beneficiary to do so.

D. **Mandatory Distributions Suspended.** If the examination indicates current or recent use of a drug or substance as described above, all mandatory distributions and all withdrawal rights from the trust estate with respect to the beneficiary during the beneficiary's lifetime (including distributions upon termination of the trust for reasons other than the death of the beneficiary) will be suspended until:

1. in the case of use or consumption of an illegal drug or illegal substance, examinations indicate no such use; and

2. in all cases of dependence, until the Trustee, in the Trustee's judgment, determines that the beneficiary is fully capable of caring for himself or herself and is no longer likely to dissipate his or her financial resources.

E. **Discretionary Distributions.** While mandatory distributions are suspended, the trust will be administered as a discretionary trust to provide for the beneficiary according to the provisions of the trust providing for discretionary distributions in the Trustee's discretion (other than an Interested Trustee) and those provisions of the trust relating to distributions for the beneficiary's health, education, maintenance or support.

F. **Resumption of Mandatory Distributions and Withdrawals.** When mandatory distributions to and withdrawals by the beneficiary are resumed, the remaining balance, if any, of the mandatory distributions that were suspended may be distributed to the beneficiary at that time and the balance of any rights of withdrawal by the beneficiary shall be immediately exercisable by the beneficiary. If the beneficiary dies before mandatory distributions or rights of withdrawal are resumed, the remaining balance of the mandatory distributions that were suspended will be distributed to the alternate beneficiaries of the beneficiary's share as provided herein.

G. **Other Prohibitions During Mandatory Suspension of Benefits.** If mandatory distributions to a beneficiary are suspended as provided above in this Article, then as of such suspension, the beneficiary shall automatically be disqualified from serving, and if applicable shall immediately cease serving, as a Trustee, Trust Protector, or in any other capacity in which the beneficiary would serve as, or participate in the removal or appointment of any Trustee or Trust Protector hereunder.

H. **Exoneration Provision.** It is not the Grantor's intention to make the Trustee (or any doctor or psychiatrist retained by the Trustee) responsible or liable to anyone for a beneficiary's actions or welfare. The Trustee has no duty to inquire whether a beneficiary uses drugs or other substances. The Trustee (and any doctor or psychiatrist retained by the Trustee) will be indemnified from the trust estate for any liability in exercising the Trustee's judgment and authority under this Article, including any failure to request a beneficiary to submit to medical examination and including a decision to distribute suspended amounts to a beneficiary.

I. **Tax Savings Provisions.** Notwithstanding the provisions of the preceding subparagraphs or any other provision of this Agreement, the Trustee shall not suspend any mandatory distributions required for a trust to qualify, in whole or in part, for any Federal or state marital deduction or charitable deduction or as a qualified subchapter S trust, nor shall the Trustee suspend any rights of withdrawal necessary for qualification of a gift as a gift of a present interest. Additionally, nothing herein shall prevent a distribution mandated by the provisions hereof relating to the Maximum Duration of Trusts.

ARTICLE IX
Takers of Last Resort

The Trustee shall distribute any property that is not otherwise disposed of under this Agreement to the persons who would have inherited the Grantor's personal estate, and in the shares that they would have inherited it had the Grantor died a resident of the State of Florida, unmarried and without a valid Will, on the date on which expires the interest of the last beneficiary of the property under this Agreement.

ARTICLE X
Trust Without Current Beneficiaries

During a time when a trust hereunder has not terminated but no one is eligible to receive distributions of income from the trust, the Trustee may distribute as much of the net income of the trust as the Trustee (excluding, however, any Interested Trustee) may at any time and from time to time determine to such one or more persons as the Trustee (excluding, however, any Interested Trustee) may from time to time select out of a class composed of the persons who would then receive the trust principal under the terms of this Agreement were the trust then to terminate, determined without regard to the exercise of any power of appointment granted hereunder. Any income not so distributed shall from time to time be accumulated and annually added to principal. During such period, the Trustee shall not be required to make any such distributions and may accumulate all the trust's income and add it to principal.

ARTICLE XI
Maximum Duration for Trusts

A. **Maximum Duration for Trusts Defined.** The Maximum Duration for Trusts is the longest period that property may be held in trust under this Agreement under the applicable rules governing perpetuities, vesting, accumulations, the suspension of alienation and the like (including any applicable period in gross such as twenty-one (21) years or ninety (90) years). If under those rules the Maximum Duration for Trusts shall be determined (or alternatively determined) with reference to the death of the last survivor of a group of individuals alive upon the Grantor's death or the Grantor's Wife's death, or at such other time that the application of such rules limiting the maximum duration of trusts is deemed to begin, those individuals shall consist of those measuring lives described in the paragraph below entitled "Measuring Lives."

B. **Measuring Lives.** The measuring lives under the paragraph above entitled "Maximum Duration for Trusts Defined" shall consist of those of the following individuals who are living at the time that the application of such rules limiting the maximum duration of trusts is deemed to begin: the Grantor's Wife, all of the Grantor's descendants and any surviving spouse of a descendant of the Grantor.

C. **Powers of Appointment.** This Article shall also apply to a trust created by the exercise of a power of appointment conferred by this Agreement (unless the exercise of the power of appointment commences a new rule against perpetuities or similar rule that limits the time that property may remain in trust).

ARTICLE XII
Certain Income Taxes

The Trustee shall not reimburse the Grantor from assets of any trust hereunder for the Grantor's income tax (Federal, state, local, or foreign) on the amount (if any) of the gross income of such trust that is reportable directly on the Grantor's return under Code Sec. 671. The Grantor hereby waives any right or eligibility to be reimbursed for such taxes.

ARTICLE XIII
Spendthrift Provision

A. **No Assignment.** Each trust shall be a spendthrift trust to the maximum extent permitted by law and no interest in any trust hereunder shall be subject to a beneficiary's liabilities or creditor claims, assignment or anticipation. Additionally, the interest of a beneficiary of any trust hereunder may not be either voluntarily or involuntarily transferred within the meaning of Florida Trust Code § 736.0502. Notwithstanding the foregoing, no provision of this Article shall prevent the appointment of an interest in a trust through the exercise of a power of appointment.

B. **Protection from Creditors.** If the Trustee shall determine that a beneficiary (other than the Grantor's Wife with respect to any Marital Trust) would not benefit as greatly from any outright distribution of trust income or principal because of the availability of the distribution to the beneficiary's creditors, the Trustee shall instead expend those amounts for the benefit of the beneficiary. This direction is intended to enable the Trustee to give the beneficiary the maximum possible benefit and enjoyment of all the trust income and principal to which the beneficiary is entitled.

C. **Protection from Marital Claims.** All benefits granted to a beneficiary under this instrument shall be the separate and individual property of such beneficiary (as distinguished from marital property, community property, quasi-community property or any other form of property as to which such beneficiary's spouse might have a claim or interest arising out of the marital relationship under the law of any jurisdiction, domestic or foreign). All benefits granted to a beneficiary hereunder shall also be free of any interference from, or control or marital power of, his or her spouse. For purposes of this paragraph, the term "benefits" shall include real or personal property, tangible or intangible, and the provisions of this paragraph shall apply not only to benefits actually paid to any beneficiary but also to trust property allocated to a trust in which the beneficiary possesses an interest hereunder.

ARTICLE XIV
Payments to Minors

Whenever property becomes distributable to a person under twenty-one (21) years of age (described herein as the "Minor" regardless of the actual legal age of majority) for any reason, the Trustee may make the distribution in any way in which the Trustee shall deem appropriate, including (but not limited to) those enumerated in this Article:

A. **Distribution to Trust.** The Trustee may hold the property in a separate trust for the Minor until the Minor attains twenty-one (21) years of age. The Trustee may distribute to the Minor as much of the net income and/or principal of the trust as the Trustee may at any time and from time to time determine, for any purpose, annually adding to principal any undistributed net income. When the Minor reaches twenty-one (21) years of age, the Trustee shall distribute the property to the Minor. If the Minor dies before reaching twenty-one (21) years of age, then upon the Minor's death, the Trustee shall distribute the property held in trust for the Minor as follows:

1. to the Minor's descendants surviving the Minor, per stirpes; or if there are no such descendants then living, then

2. if the Minor was a grandchild or more remote descendant of the Grantor, to the descendants then living, per stirpes, of the Minor's nearest ancestor who was a descendant of the Grantor with descendants then living, or if there are no such descendants then living, or if the Minor was a child of the Grantor, then

3. to the Grantor's descendants then living, per stirpes.

Any trust under this paragraph entitled "Distribution to Trust" shall terminate upon the expiration of the Maximum Duration for Trusts as defined elsewhere in this Agreement, and the remaining trust property shall be distributed to the Minor in one of the other ways authorized in this Article.

B. **Distribution to Custodian.** The Trustee may distribute the property to a custodian or successor custodian under any state's version of the Uniform Transfers (or Gifts) to Minors Act, including a custodian selected by the Trustee. The Trustee may select any age for termination of the custodianship permitted under the Act, giving due consideration to selecting twenty-one (21) years of age if that is permitted, and may designate successor custodians.

C. **Distribution to Donee of a Power During Minority.** The Trustee may actually distribute the property to anyone serving as Trustee under this Agreement, in a manner so that it then vests in the Minor, to hold the same as donee of a power during minority, such donee to have all the powers of a Trustee under this Agreement (including the power to apply the property for the Minor) and to be compensated as if the property were a separate trust, but with no duty to account to any court periodically or otherwise.

D. **Distribution to a Guardian of a Minor's Property.** The Trustee may distribute the property to a Guardian of the Minor's estate.

E. **Distribution to a Minor's Parent.** The Trustee may distribute the property to a parent of the Minor even if the parent does not assume any formal fiduciary capacity concerning the property. Distributions shall be made to a parent of a beneficiary only if the parent either (1) is a descendant of the Grantor, or (2) was married to a descendant of the Grantor at the date of death of the descendant of the Grantor who was the spouse of the parent to receive the distribution.

F. **No Distribution to Grantor.** Nothing in this Article shall authorize distribution of any trust property to or for the benefit of the Grantor, either individually or in any fiduciary capacity.

G. **Exoneration of Fiduciary for Distributions for Minor.** The Trustee shall be free from any responsibility for the subsequent disposition of property following the disposition of such property by the Trustee in one of the ways specified in this Article.

ARTICLE XV
Payments to Incapacitated Persons

Whenever property becomes distributable to a person whom the Trustee reasonably and in good faith shall determine is experiencing substantial difficulty in managing financial matters and that such difficulty is not expected to be short-term (described herein as "an Incapacitated Person" regardless of whether a court of competent jurisdiction has determined such person to be incompetent and regardless of whether a guardian, conservator or other legal representative has been appointed for such person), the Trustee may make the distribution in any way in which the Trustee shall deem appropriate, including (but not limited to) those enumerated in this Article:

A. **Distribution to Trust.** The Trustee may hold the property in a separate trust for the Incapacitated Person until the Incapacitated Person is no longer incapacitated as defined above. The Trustee may distribute to the Incapacitated Person as much of the net income and/or principal of the trust as the Trustee may at any time and from time to time determine, for any purpose, annually adding to principal any undistributed net income. When the Incapacitated Person is no longer incapacitated, the Trustee shall distribute the property to the formerly Incapacitated Person. If the Incapacitated Person dies before the property is distributed to him or her, then upon the Incapacitated Person's death, the Trustee shall distribute the property to the Executor of the Incapacitated Person.

B. **Distribution to Incapacitated Person of a Power.** The Trustee may actually distribute the property to anyone serving as Trustee under this Agreement, in a manner so that it then vests in the Incapacitated Person, to hold the same as donee of a power during incapacity, such donee to have all the powers of a Trustee under this Agreement (including the power to apply the property for the Incapacitated Person) and to be compensated as if the property were a separate trust, but with no duty to account to any court periodically or otherwise.

C. **Distribution to a Guardian of Incapacitated Person's Property.** The Trustee may distribute the property to a Guardian of the Incapacitated Person's estate.

D. **Distribution to Incapacitated Person's Spouse or Parent.** The Trustee may distribute the property to a spouse or parent of the Incapacitated Person even if the spouse or parent does not assume any formal fiduciary capacity concerning the property.

E. **No Distribution to Grantor.** Nothing in this Article shall authorize distribution of any trust property to or for the benefit of the Grantor, either individually or in any fiduciary capacity.

F. **Exoneration of Fiduciary for Distributions for Incapacitated Person.** The Trustee shall be free from any responsibility for the subsequent disposition of the property if it is distributed in one of the ways specified in this Article.

ARTICLE XVI
Exercise of Powers Created Hereunder

A. **Form of Appointment.** A power of appointment conferred hereunder upon a person in his or her individual capacity (a "Non-Fiduciary Power") may be exercised in favor of one or more persons to or for whom the power may be exercised, in any proportions, in any lawful estates and interests, whether absolute or in further trust. Such a Non-Fiduciary Power may be exercised to create further Non-Fiduciary Powers which may be made exercisable in the same or a different manner. A limited power of appointment may be exercised to confer a limited or general power, including a presently exercisable limited or general power.

B. **Trustees under Appointment.** The Trustee under an appointment in further trust may be any person not prohibited from serving as Trustee under this Agreement and may be given fiduciary powers (including discretionary powers over distributions), exercisable, however, only in favor of permissible objects of the exercised power.

C. **Testamentary Power.** A Non-Fiduciary Power, if any, that is exercisable only by the powerholder's last will and testament, may also be exercised by a separate written instrument signed by the powerholder (other than the powerholder's last will and testament) if the powerholder's last will and testament contains a direction that the exercise in the other instrument be honored.

D. **Trustees Can Create Trusts.** The authorized Trustee (as defined in this paragraph) may, subject to the provisions set forth in this paragraph, exercise any power to invade the principal of the invaded trust by appointing (whether or not there is a current need to invade principal under any standard for invasion of principal set forth in the invaded trust) part or all of the principal of the invaded trust in favor of a trustee of another trust (referred to as the "appointed trust," and defined further below) for the benefit of one, or more or all of those beneficiaries for whom the principal of the invaded trust may be currently paid to the exclusion of any one or more of such beneficiaries. The exercise of the power to invade the principal of a trust under this paragraph shall be subject to the following additional provisions:

1. If all of the assets of the invaded trust are to be paid to the appointed trust under the applicable appointment, then the exercise of the power by the authorized Trustee under this paragraph shall apply both to (1) all of the assets currently comprising the principal of the invaded trust, including undistributed accumulated income, and (2) to all assets subsequently paid to or acquired by the invaded trust after the payment to the appointed trust, unless the authorized Trustee who so appoints the principal of the invaded trust provides otherwise in writing at the time of appointment. If only a portion of the trust assets of the invaded trust are to be paid over to the appointed trust under the applicable appointment, then subsequently discovered assets of the invaded trust or assets subsequently paid to or acquired by the invaded trust shall remain assets of the invaded trust, unless the authorized Trustee who so appoints the principal of the invaded trust provides otherwise in writing at the time of appointment.

2. The exercise of the power to invade the principal of a trust under this paragraph shall be by an instrument in writing, signed, and acknowledged by the authorized Trustee. The instrument exercising the power shall be maintained with the records of the invaded trust and may be filed in any court having jurisdiction over the invaded trust.

3. The exercise of the power to invade the principal of a trust under this paragraph shall not be treated as being prohibited by any provision in the invaded trust instrument that prohibits amendment or revocation of the trust or that constitutes a spendthrift clause.

4. The provisions of this paragraph shall not be construed to abridge the right of any Trustee to appoint property in further trust that arises under any statutory law or under common law, or as directed by any court having jurisdiction over the invaded trust.

5. Nothing in this paragraph shall be construed as creating or implying a duty on any Trustee acting hereunder to exercise a power to invade principal, and no inference of impropriety shall be made as a result of a Trustee not exercising the power conferred under this paragraph.

6. The authorized Trustee, acting pursuant to the authority granted by this paragraph, may not exercise a power to decrease or indemnify against a Trustee's liability or exonerate a Trustee from liability for failure to exercise the duty of care, diligence and prudence otherwise applicable to the Trustee or to make a binding and conclusive fixation of the value of any asset for purposes of distribution, allocation or otherwise.

7. The authorized Trustee, acting pursuant to the authority granted by this paragraph, may not exercise a power to increase the total compensation of any Trustee of the appointed trust, other than by reason of extending the period, as may be permitted hereunder, during which such Trustee will serve. No Trustee shall receive any paying commission with respect to property transferred pursuant to this paragraph.

8. If any contribution to the invaded trust qualified for the annual exclusion under Code Sec. 2503(b), the marital deduction under Code Sec. 2056(a) or 2523(a), or the charitable deduction under Code Sec. 170(a), 642(c), 2055(a) or 2522(a), is a direct skip whether or not a nontaxable gift under Code Sec. 2642(c), or qualified for any other specific tax benefit that would be lost by the existence of the authorized Trustee's authority under this paragraph for income, gift, estate, or generation-skipping transfer tax purposes under the Code, then the authorized Trustee shall not (1) have the power to invade the principal of a trust pursuant to this paragraph in a manner that would prevent the invaded trust from qualifying for or would reduce the exclusion, deduction, nontaxable gift or other tax benefit which was originally claimed with respect to that contribution, (2) have the power to make a change, including the grant of a power of appointment, that will result in (a) a change or modification of any standard of payment to or for one or more of the beneficiaries of the invaded trust or (b) a reduction, limitation or other change in any beneficiary's right to a mandatory distribution of income, a mandatory annuity or unitrust interest, a right annually to withdraw a percentage of the value of the trust or a right annually to withdraw a specified dollar amount provided that such mandatory or annual right has already come into effect with respect to the beneficiary. Notwithstanding the foregoing (2) but subject to (1), the authorized Trustee may pay to an appointed trust that is a supplemental needs trust.

9. The authorized Trustee exercising the authority granted by this paragraph may not make a change that will violate any rule against perpetuities or similar rule limiting the duration of trusts applicable to the invaded trust and may not make a change that will disqualify a trust which owns S corporation stock and is a permitted shareholder under Code Sec. 1361(c)(2) from being a permitted shareholder.

10. The current beneficiaries of the appointed trust shall be one, more than one or all of the current beneficiaries of the invaded trust and the successor and remainder beneficiaries of the appointed trust shall be one, more than one or all of the successor or remainder beneficiaries of the invaded trust. If a beneficiary includes a class of persons, such class shall include any person who falls within the class of persons after the payment to the appointed trust. The appointed trust may grant to one or more of the beneficiaries of the appointed trust a power of appointment.

11. The term "appointed trust" shall mean an irrevocable trust other than the invaded trust to which principal is appointed under this paragraph including, but not limited to, a new trust created by the authorized Trustee.

12. The standard for invasion in the appointed trust may be no greater than the standard for invasion of the invaded trust.

13. As used in this paragraph, the term "authorized Trustee" shall refer to the Trustee of any trust hereunder, provided, however, that with respect to any trust which provides that principal may be invaded for any reason other than support, maintenance, health and education within the meaning of Code Sec. 2041(b), the authorized Trustee of that trust shall exclude any Interested Trustee.

ARTICLE XVII
Irrevocability

This Agreement shall be irrevocable. The Grantor shall have no right to alter it or amend it in any way and, notwithstanding any other provision hereof, none of the principal and none of the income therefrom shall ever be payable to the Grantor or to discharge any obligation of the Grantor to the Grantor's creditors, to the Grantor's estate or to the creditors of the Grantor's estate. The authorization to distribute income or principal for a beneficiary's support does not include authority to make distributions that would discharge or substitute for any obligation of the Grantor to support the beneficiary. The Grantor intends that no distribution from a trust hereunder shall be deemed to discharge or substitute for the Grantor's obligation to support a beneficiary of a trust hereunder, and the Grantor directs that no distribution shall be made that would have that effect.

ARTICLE XVIII
Outright Transfers if Trust Already Terminated in Whole or Part

Where property is directed under this Agreement to be held in trust and the time for termination of such trust has been reached, then the property shall not pass in trust but rather shall pass as the remainder of such trust is directed to be transferred at the time for termination of such trust. In addition, if property is directed under this Agreement to be distributed to a trust, the terms of which direct a partial distribution of the assets of the trust upon the occurrence of a specified date or event (referred to in this Article as the "Distribution Event"), and the Distribution Event has occurred, the portion of such property subject to partial distribution shall not pass in trust but shall instead pass as such property is directed to pass upon the occurrence of the Distribution Event.

ARTICLE XIX
Trustees

A. **Appointment of General Trustee.** The Grantor appoints Steve Gorin to serve as the Initial General Trustee hereunder.

B. **Appointment of Administrative Trustee.** The Grantor appoints Big Trust Company of Alaska to serve as Administrative Trustee hereunder.

C. **Appointment of Distributions Trustee.** The Grantor appoints Mickey Davis to serve as Distributions Trustee hereunder.

D. **Appointment of Investment Trustee.** The Grantor appoints Steven Trytten to serve as Investment Trustee hereunder.

E. **Co-Trustees.** A Co-Trustee may be appointed by a then serving Trustee (the "appointing Trustee") at any time when only one trustee is serving. A Co-Trustee so appointed hereunder shall serve while the appointing Trustee serves, and shall continue to serve if the appointing Trustee fails or ceases to serve only if no successor has been named or identified by the Grantor or all successors named or identified by the Grantor are unable or unwilling to serve. Any appointment of a Co-Trustee hereunder shall be made by an acknowledged instrument delivered to any and all other Trustees who may then be serving.

F. **Number of Trustees.** There shall never be more than two Trustees serving as Trustee hereunder as to any type of Trustee.

G. **Successor Trustees.** If a specific successor Trustee is named to succeed a particular Trustee named in this Article, such specific successor Trustee shall serve as successor as appointed above. In all other cases, a Trustee (the "appointing Trustee") may appoint successor Trustees in accordance with this paragraph:

   1. If only one trustee is serving hereunder and if no successor trustee has been named or identified herein or has been otherwise named pursuant to the provisions hereof, such trustee may appoint a successor trustee to serve when the appointing trustee fails or ceases to serve as trustee.

2. If an appointing Trustee names a successor Trustee, and if the Grantor has also named or provided for the appointment of one or more successor Trustees herein, the appointments the Grantor has made herein shall take priority.

3. Any appointment of a successor Trustee shall be made by an acknowledged instrument delivered to any and all other Trustees who may then be serving.

H. **Acceptance of Appointment.** Each Trustee appointed hereunder shall accept the appointment by executing an acknowledged instrument filed with the trust records, within 60 days of the date such person is advised of the opportunity to become a successor Trustee hereunder.

I. **Trustee Exclusions.** None of the Grantor, the spouse or a former spouse of the Grantor, the spouse nor a former spouse of any beneficiary of any trust hereunder, and anyone who is married to any of the persons described above shall ever serve as Trustee. No successor Trustee or Co-Trustee appointed by a beneficiary shall be a person or entity that is related or subordinate to such beneficiary within the meaning of Code Sec. 672(c) and the Regulations thereunder.

J. **Age Requirements.** Notwithstanding anything contained in this Agreement to the contrary, no individual who has attained the age of 75 years shall become a Trustee hereunder and each individual serving as a Trustee hereunder shall cease serving as a Trustee hereunder upon attaining the age of 75 years.

K. **Filling Trustee Vacancies.** If there is neither an effectual appointment of a successor Trustee nor any effectual provision otherwise hereunder for the appointment of a successor Trustee, the Grantor's eldest then living descendant shall have the right to appoint an individual, corporation or other entity with fiduciary powers to replace the removed Trustee or whenever the office of Trustee becomes vacant.

L. **Compensation of Trustees.** Individual Trustees shall receive reasonable compensation in accordance with the law of the State of Florida in effect at the time of payment, unless the Trustee waives compensation; provided, however, that neither the Grantor's Wife nor any descendant of the Grantor who is named herein or otherwise appointed to serve as Trustee hereunder shall receive compensation for serving as Trustee hereunder. A corporate Trustee shall be compensated by agreement with the individual Trustee or, in the absence of such agreement, in accordance with its fee schedule as in effect at the time of payment. The Grantor authorizes a corporate Trustee to charge additional fees for services it provides to a trust hereunder that are not comprised within its duties as Trustee; for example, a fee charged by a mutual fund it administers in which a trust hereunder invests, a fee for providing an appraisal or a fee for providing corporate finance or investment banking services. The Grantor also recognizes that a corporate Trustee may charge separately for some services comprised within its duties as Trustee; for example, a separate fee for investing cash balances or preparing tax returns. Such separate charges shall not be treated as improper or excessive merely because they are added on to a basic fee in calculating total compensation for service as Trustee. In calculating any compensation based on the value of a trust, a policy of insurance on the life of a living person shall be deemed to have no value.

M. **Beneficiary.** For purposes of this Article, the term "beneficiary" shall mean any person who is named as a recipient of property under this Agreement or who is, or in the future may be, eligible to receive income or principal under any trust created hereunder, or have the right to use any property owned by any trust created hereunder. A person shall be considered a beneficiary for purposes of this Article even if his or her only interest is as a potential distributee or user of trust property under a discretionary power held by a Disinterested Trustee of any trust created hereunder, but shall not be considered a beneficiary for such purposes if his or her only interest hereunder is as a potential appointee under any non-fiduciary power of appointment held by another person which has not yet been exercised or the exercise of which can take effect only in the future, such as a testamentary power held by a living person.

N. **Appointment of Trust Protector.** The Grantor appoints Jonathan G. Blattmachr to serve as Trust Protector hereunder. The Trust Protector may be one or more individuals, corporations or other entities. Multiple Trust Protectors shall act by majority.

O. **Trust Protector Provisions.**

1. Anyone serving as Trust Protector may resign by acknowledged instrument delivered to the Trustee then acting hereunder.

2. No discretionary distribution shall be made from any trust that would discharge or substitute for a legal obligation of any person serving as Trust Protector even if such a distribution otherwise would be authorized under the terms of the trust.

3. To the extent not prohibited by applicable law, no Trust Protector shall be treated as acting under a fiduciary duty but, in all events, the Trust Protector must act in good faith. Furthermore, the Trust Protector shall be under no duty or requirement to monitor any Trustee hereunder and shall not be liable to anyone for failure to do so, and shall be under no duty or requirement to exercise the powers conferred upon the Trust Protector hereunder and shall not be liable to anyone for failure to do so.

4. If the Grantor is serving as the Trust Protector, then the Trust Protector shall not appoint an individual or corporation that is related or subordinate to the Grantor within the meaning of Code Sec. 672(c), unless that individual or corporation would be an Interested Trustee. Additionally, no Trust Protector shall appoint an individual or corporation that is related or subordinate to such Trust Protector within the meaning of Code Sec. 672(c) when such Trust Protector is an Interested Trustee, or would be an Interested Trustee if such Trust Protector were serving as Trustee, unless that individual or corporation would also be an Interested Trustee. If more than one person is serving as Trust Protector, the preceding sentence shall prohibit the appointment of any Trustee that could not be appointed by each such person or corporation if serving alone as Trust Protector.

5. The Trustee shall advise each person appointed as a Trust Protector hereunder of such appointment and each person so appointed shall accept such appointment by an acknowledged instrument delivered to the Trustee then serving within sixty (60) days of such notification. If a person so appointed shall fail to deliver such acceptance to the Trustee within that time frame, such person shall be treated as having renounced the appointment as Trust Protector, and the Trustee shall, by an acknowledged instrument, appoint as Trust Protector one or more individuals or entities other than any Trustee or successor Trustee named hereunder or any individual or entity that is related or subordinate (within the meaning of Code Sec. 672(c) and the Regulations thereunder) to any such Trustee or beneficiary hereunder.

P. **Compensation of Trust Protectors.** Each Trust Protector shall act as Trust Protector hereunder without compensation and shall, as a condition of appointment, execute an acknowledged instrument agreeing to act as Trust Protector hereunder without compensation.

Q. **Trust Protector Powers.** The Trust Protector shall have the following powers:

1. The power to appoint one or more individuals, corporations or other entities to be successor Trust Protector to take office upon such Trust Protector ceasing to act as such, and any such appointment may be changed prior to becoming effective.

2. The power to remove and replace any and all Trustees.

ARTICLE XX
Fiduciary Provisions

A. **General Provisions Regarding Changes in Fiduciaries.**

1. In the event that the sole Trustee of a trust is a beneficiary of the trust, the Trustee may appoint, but shall not be required to appoint, a Co-Trustee as provided herein. A beneficiary's interest shall not be merged or converted into a legal life estate or estate for years because the beneficiary is the sole Trustee. If this would still happen under applicable law, then a Co-Trustee shall be appointed in preference to such merger or conversion.

2. Separate trusts hereunder may have different Trustees.

3. To the extent not prohibited by applicable law, any Trustee may resign at any time without court approval, whether or not a successor has been appointed, provided the resigning Trustee complies with any applicable state law governing the resignation of the Trustee that may not be waived by a governing instrument. Such resignation shall be by acknowledged instrument executed by the resigning Trustee and delivered to any other fiduciary (and any Trust Protector) acting hereunder, or if none, to the Grantor's then living eldest adult and competent descendant (who, if a Trustee is resigning, is a beneficiary of the trust of which such Trustee is resigning), or if none, then to the guardian of the Grantor's then living eldest descendant (who, if a Trustee is resigning, is a beneficiary of the trust of which such Trustee is resigning), or, if such descendant is a minor and no guardian for such minor has been appointed and is acting, then to the parent of such descendant or other individual with whom such minor resides.

4. No individual fiduciary hereunder shall participate in any decision with respect to any tax election or option, under Federal, state or local law that could enlarge, diminish or shift his or her beneficial interest hereunder from or to the beneficial interest hereunder of another person. Any such tax election or option shall be made only by a fiduciary or fiduciaries that do not have a beneficial interest hereunder or whose beneficial interest could not be enlarged, diminished or shifted by the election or option. If the only fiduciary or fiduciaries who otherwise could exercise such tax election or option hold beneficial interests hereunder that could be so enlarged, diminished or shifted, another individual or a bank or trust company (but not an individual, bank or trust company that is related or subordinate within the meaning of Code Sec. 672(c) to any acting fiduciary hereunder) shall be appointed by the fiduciary or fiduciaries by an acknowledged instrument delivered to the person so appointed and the fiduciary so appointed shall alone exercise any such election or option.

5. If any Trustee is removed, resigns or otherwise ceases to act as Trustee of any trust hereunder, the Trustee shall deliver all records and trust property in the Trustee's possession with respect to such trust to the then acting Trustees or, if no other Trustee is then acting with respect to such trust, to the successor Trustee upon receipt of written notice of the designation of the successor Trustee from the person appointing such successor Trustee, or any other person entitled to the records or trust property within a reasonable amount of time after the Trustee ceases to act, and unless a Trustee is then acting with respect to such trust, the Trustee who ceases to act shall continue to have all of the duties of a Trustee and the powers necessary to protect the records and trust property until delivered as provided herein.

B. **Accountings and Other Proceedings.**

1. The Grantor directs that a trust hereunder be subject to independent administration with as little court supervision as the applicable state law allows. The Trustee shall not be required to render to any court annual or other periodic accounts, or any inventory, appraisal, or other returns or reports, except as required by applicable state law. The Trustee shall take such action for the settlement or approval of accounts at such times and before such courts or without court proceedings as the Trustee shall determine. The Trustee shall pay the costs and expenses of any such action or proceeding, including (but not limited to) the compensation and expenses of attorneys and guardians, out of the property of the trust. The Trustee shall not be required to register any trust hereunder except as required by law.

2. The Grantor directs that in any proceeding relating to a trust hereunder, service upon any person under a legal disability need not be made when another person not under a disability is a party to the proceeding and has the same interest as the person under the disability. The person under the disability shall nevertheless be bound by the results of the proceeding. The same rule shall apply to non-judicial settlements, releases, exonerations and indemnities.

C. **Fiduciary to Fiduciary Self-Dealing.** Except to the extent a restraint on self-dealing may not be waived under applicable local law by a governing instrument, the Grantor authorizes any Trustee acting hereunder, without court approval or notice, (i) to purchase or otherwise acquire assets from and (ii) to sell, transfer,

exchange or loan any assets to any trust of which such Trustee is acting as a trustee and/or any estate of which such Trustee is acting as an Executor in any manner, at any time or times, and upon such terms, credits and conditions as the Trustee may deem advisable notwithstanding that such participation otherwise may be an act of self-dealing under applicable state law.

D. **Required Release of Protected Health Information.** Each individual named herein or appointed pursuant to the provisions hereof as Trustee or Trust Protector, as a condition precedent to such person so serving or being appointed, shall execute a written statement (a) authorizing and directing all of his or her health care providers to release, to any person having an interest hereunder (herein "Information Recipient") any and all Protected Health Information (including, but not limited to, the results of any medical examination requested in accordance with the provisions of this paragraph) for purposes of allowing a determination of whether the individual lacks the required capacity to continue to so serve hereunder and (b) in a form sufficient to permit such release pursuant to 45 CFR 164.508 (or any successor thereto). The term Information Recipient shall include, but not be limited to, another Trustee or Trust Protector acting hereunder. Any individual who revokes such authorization shall thereupon be treated as resigning as Trustee or Trust Protector hereunder upon the date of discovery of such revocation by any Information Recipient; provided that, notwithstanding the foregoing, upon discovery of such revocation, such fiduciary shall not be treated as resigning if the requisite authorization described above is executed by such individual within twenty (20) days after notice of such discovery is given to such individual by any Information Recipient. In addition, each individual so serving who fails within a reasonable time to undergo a medical examination at the written request of any person having an interest hereunder (including, but not limited to, another Trustee or Trust Protector acting hereunder) for the sole purpose of determining if the individual lacks the required capacity to continue to so serve hereunder or fails to cause the results of such examination to be made available within a reasonable time to the person making the written request, shall be treated as resigning as such fiduciary, provided that there is reasonable basis to request the medical examination be undertaken and provided further that no such request may be made more than once every thirty-six (36) months. The cost of the medical examination shall be borne by the trust with respect to which such individual is acting as Trustee or Trust Protector.

E. **Continuation of Trustee's Powers.** Powers granted to the Trustee hereunder or by applicable law shall continue with respect to all property held hereunder to be exercisable by the Trustee until property is actually distributed to a beneficiary. By way of illustration and not by way of limitation, the Trustee may invest and reinvest and take all investment action with respect to property that has been directed to be distributed and notwithstanding any direction that the property be distributed "as it is then constituted" until such property is actually distributed.

F. **Additional General Provisions Regarding Fiduciaries.**

1. Under this Agreement, if two or more separate trusts with the same beneficiaries and same terms are created, either by direction or pursuant to the exercise of discretion, the Grantor intends that the separate trusts may but need not have the same investments and may, but need not, follow the same pattern of distributions. The Trustee's powers shall be exercisable separately with respect to each trust.

2. Except to the extent, if any, specifically provided otherwise in this Agreement, references to the Trustee shall, in their application to a trust hereunder, refer to all those from time to time acting as Trustee and, if two Trustees are eligible to act on any given matter, they shall act unanimously, and if more than two Trustees are eligible to act on a given matter, they shall act by majority. In the exercise of discretion over distributions, if this Agreement provides that certain Trustees may participate in distributions limited by an ascertainable standard while a different set of Trustees may participate in distributions for any purpose, and if the two sets of Trustees (each acting by its own majority) want to distribute the same item of income or principal to different recipients, then the distribution desired by the set of Trustees participating in distributions for any purpose shall prevail.

3. The Trustee shall be entitled to reimbursement for any out-of-pocket expenditures, with interest as appropriate, made or incurred in the proper administration of the trusts under this Agreement or in furtherance of his or her fiduciary duties and obligations.

4. No Trustee shall be liable to anyone for anything done or not done by any other Trustee or any beneficiary.

5. The fact that a Trustee is active in the investment business shall not be deemed a conflict of interest. Purchases and sales of investments may be made through a corporate Trustee or through any firm of which a corporate or individual Trustee is a partner, member, shareholder, proprietor, associate, employee, owner, subsidiary, affiliate or the like. Property of a trust hereunder may be invested in individual securities, mutual funds, partnerships, LLCs, private placements or other forms of investment promoted, underwritten, managed or advised by a Trustee or such a firm.

6. The Trustee may employ and rely upon advice given by investment counsel, delegate discretionary investment authority over investments to investment counsel and pay investment counsel reasonable compensation in addition to fees otherwise payable to the Trustee, notwithstanding any rule of law otherwise prohibiting such dual compensation. The Trustee may, but need not, favor retention of assets originally owned by the Grantor. The Trustee shall not be under any duty to diversify investments, regardless of any rule of law requiring diversification, and any such duty is hereby waived. The Trustee may retain and acquire property that does not produce income, subject to any restrictions or qualifications of this power set forth elsewhere in this Agreement.

7. The fact that a Trustee (or a firm of which a Trustee is a member or with which a Trustee is otherwise affiliated) renders legal or other professional services to a trust hereunder shall not be deemed a conflict of interest, and the Trustee may, if permitted by applicable state law, pay fees for such services to such Trustee or firm without prior approval of any court or any beneficiary, whether or not there is a Trustee to approve such payment. An attorney or other Trustee who also renders professional services shall receive full compensation for both services as a Trustee and the professional services rendered, except as specifically limited by law.

8. No state law restraint on acts of self-dealing by a fiduciary shall apply to a Trustee who is the Grantor's Wife or a descendant of the Grantor, except to the extent (but only to the extent) such restraint may not be waived under applicable local law by a governing instrument. Except when prohibited by another provision of this Agreement, such Trustee may enter into transactions on behalf of a trust hereunder in which that Trustee is personally interested so long as the terms of such transaction are fair to the trust. For example, such Trustee may purchase property from the trust at its then fair market value without court approval.

9. If the Grantor has given the Trustee discretion concerning distributions of income or principal, that discretion shall be absolute and uncontrolled and subject to correction by a court only if the Trustee should act utterly without reason, in bad faith, with reckless indifference to the purposes of the trust or the interests of the beneficiaries, or in violation of specific provisions of this Agreement. If the Grantor has set forth general guidelines (as opposed to directions or dollar limits) for the Trustee in making distributions, those guidelines shall be merely suggestive and shall not create an enforceable standard whereby a distribution could be criticized or compelled. It is the Grantor's strong belief that the Trustee will be in the best position to interpret and carry out the intentions expressed herein under changing circumstances. This paragraph shall not, however, apply to any standards framed in terms of health, education, maintenance or support (including support in an accustomed manner of living), as those words shall create an ascertainable standard for Federal tax purposes under Code Sec. 2041(b), when applied to a Trustee's power or a power held individually, although even in those cases the holder of the power shall have as much discretion as is consistent therewith. An Interested Trustee who is otherwise authorized to make distributions to himself or herself subject to an ascertainable standard may exercise such discretion, notwithstanding any contrary rule of law, unless such authorization would cause the trust property to be subject to the claims of the creditors of such Interested Trustee.

10. Notwithstanding any other provision of this Agreement, each Trustee is prohibited from making, voting on or otherwise participating in any discretionary distribution of income or principal from a trust that would discharge or substitute for a legal obligation of that Trustee, including the obligation to support a beneficiary of the trust. Further, notwithstanding any other provision of this Agreement, any Trustee authorized to distribute income or principal for his or her own health,

education, maintenance or support in his or her accustomed manner of living, as those words shall create an ascertainable standard for Federal tax purposes under Code Sec. 2041(b), shall consider all resources reasonably available to himself or herself. Subject to that, in exercising discretion over distributions, the Trustee may consider or disregard other resources available to any beneficiary.

11. A Trustee may irrevocably release one or more powers held by the Trustee while retaining other powers.

12. Any Trustee may delegate to a Co-Trustee any power held by the delegating Trustee, but only if the Co-Trustee is authorized to exercise the power delegated. A delegation may be revocable, but while it is in effect the delegating Trustee shall have no responsibility concerning the exercise of the delegated power.

13. Unless the Grantor has specifically provided otherwise, and subject to any ascertainable standard governing its exercise for Federal tax purposes under Code Sec. 2041(b), the Trustee's discretionary power to distribute income or principal includes the power to distribute all of such income and/or principal to one or more members of a class to the exclusion of others, whether or not the terms of the trust specifically mention that possibility.

G. **Waiver of Bond.** No Trustee shall be required to give bond or other security in any jurisdiction and, if despite this exoneration, a bond is nevertheless required, no sureties shall be required.

H. **Amending, Revoking or Modifying Instrument.** Notwithstanding any provision contained in this document or any statute or common law, the Grantor shall have no right, either alone or in conjunction with any other person(s) to revoke, amend or modify this Agreement or any trust created by it.

ARTICLE XXI
Governing Law and Trustee Powers

The interpretation and operation of the trust shall be governed by the laws of the State of Alaska. The Trustee may, without prior authority from any court, exercise all powers conferred by this Agreement or by common law or by any fiduciary powers act or other statute of the State of Florida or any other jurisdiction whose law applies to the trust. The Trustee shall have sole and absolute discretion in exercising these powers. Except as specifically limited by this Agreement, these powers shall extend to all property held by the Trustee until actual distribution of the property. The powers of the Trustee shall include the following:

A. **Powers of Investment Trustee**. In addition to any other power granted by applicable law or herein granted, and except as may otherwise be provided herein, the Investment Trustee shall have the sole and absolute authority (acting alone and without the consent or approval of any other Trustee acting hereunder) to execute documents or take other action regarding decisions about the investment of the assets of any trust hereunder including, but not limited to, the purchase, retention or sale of any assets held in any such trust. In addition to all investment powers conferred by law upon trustees, and all other powers herein granted to the Investment Trustee, the Investment Trustee is expressly authorized, in the exercise of sole and absolute discretion:

1. To purchase or otherwise acquire, and to retain, whether originally a part of the trust estate or subsequently acquired, any and all common or preferred stocks, bonds, notes or other securities, or any variety of real or personal property, whether within or without the United States, including, but without limitation, foreign real estate or foreign securities, securities of a corporation in which any Trustee is a director, officer, employee or shareholder, securities of any corporate fiduciary, interests in any business venture (incorporated or unincorporated), and interests in entities formed principally for the commingling of assets for investment, such as common trust funds, investment companies, mutual funds, real estate and other investment trusts, and interests in any partnership, limited liability company or other entity and including, but without limitation, acquiring or purchasing from the Grantor assets in exchange for a note bearing interest at the current applicable federal rate;

2. To sell, lease, pledge, mortgage, transfer, exchange, convert, grant options with respect to, or otherwise dispose of, any and all real or personal property or interest therein, at any time forming a part of any trust estate, in any manner, at any time or times, for any purpose, for any price and upon any terms, credits and conditions; and to enter into leases, mortgages or options which extend beyond the period fixed by law for leases and options made by fiduciaries or beyond the term of the trust;

3. To borrow money from any lender, including, but without limitation any individual or corporate fiduciary hereunder or any member of the Grantor's family, or any trust, corporation or association in which any one or more of the foregoing may be interested, for any purpose connected with the preservation or improvement of any trust estate, and to mortgage or pledge as security upon any terms and conditions any real or personal property forming a part of the trust estate;

4. To purchase from the legal representatives of the Grantor's estate or the estate of any beneficiary of any trust created under this instrument any property constituting a part thereof at its fair market value and to make loans for adequate consideration to the legal representatives of the Grantor's estate or the estate of any beneficiary of any trust created under this instrument, upon such terms and conditions as the Investment Trustee, in the exercise of sole and absolute discretion, may determine;

5. To vote in person or by general or limited proxy with respect to any shares of stock or other security; directly or through a committee or other agent, to oppose or consent to the reorganization, consolidation, merger, dissolution or liquidation of any corporation, or to the sale, lease, pledge or mortgage of any property by or to any such corporation; and to make any payments and take any steps proper to obtain the benefits of any such transaction;

6. To the extent permitted by law, to register any security in the name of a nominee with or without the addition of words indicating that such security is held in a fiduciary capacity; to hold any security in bearer or non-certificated form; and to use a central depository for securities; to employ a broker-dealer as custodian of all or part of the securities at any time held by any trust estate and to register such securities in the name of such broker-dealer;

7. To complete, extend, modify or renew any loans, notes, bonds, mortgages, contracts or any other obligations which may at any time form part of any trust estate or which may be liens or charges against any property of the trust; to pay, compromise, compound, adjust, submit to arbitration, sell or release any claims or demands of any trust estate against others or of others against any trust estate upon any terms and conditions, including the acceptance of deeds to real property in satisfaction of bonds and mortgages, and to make any payments in connection therewith;

8. To place and leave all or any part of the funds or securities at any time held by any trust estate in the care and custody of any bank or trust company, with no obligation while such securities are so deposited to inspect or verify the same and with no responsibility for any loss or misapplication by the bank or trust company or its nominee; to appoint such bank or trust company the agent and attorney of the Investment Trustee to collect, receive, receipt for and disburse any income, and generally to perform the duties and services incident to a so-called "custodian account"; and to allocate the charges and expenses of such bank or trust company to income or to principal or partially to income and partially to principal as the Investment Trustee may determine;

9. To continue the operation of any business, incorporated or unincorporated, which may be held or acquired by the Trustee, and any successor business thereto, and to purchase or otherwise acquire any business or interest in any business; to take part in the management of any business in which investment is retained or made hereunder and to delegate duties with respect to such management, with the requisite powers, to any employee, manager, partner or associate of such business, without liability for such delegation; to reduce, expand, limit or otherwise fix and change the operation or policy of any such business and to act with respect to any other matter in connection with any such business; to subject to the risks of any such business, any part or all of any trust estate, for such term or period as the Investment Trustee, in the exercise of sole and absolute discretion, may determine; to advance money or other property to any such business; to make

loans, subordinated or otherwise, of cash or securities to any such business and to guarantee the loans of others made to any such business; to borrow money for any such business either alone or with other persons interested therein, and to secure such loan or loans by a pledge or mortgage of any part of any trust estate; to select and vote for directors, partners, associates and officers of any such business; to act as directors, general or limited partners, associates and officers of any such business either individually or through an officer or officers if any Trustee is a corporation, and to receive compensation from such business for so acting; to enter into stockholders' agreements with corporations in which any trust estate has an interest and/or with the stockholders of such corporations; to liquidate, either alone or jointly with others, any such business or any interest in any such business; and generally to exercise any and all powers as the Investment Trustee may deem necessary with respect to the continuance, management, sale or liquidation of any such business;

10. To manage, insure against loss, subdivide, partition, develop, improve, mortgage, lease or otherwise deal with any real property or interests therein which may form at any time a part of any trust estate; to satisfy and discharge or extend the term of any mortgage thereon; to demolish, rebuild, improve, repair and make alterations from time to time in any of the structures upon any such real property; to plat into lots and prepare any such real property for building purposes; to construct and equip buildings and other structures upon any such real property and to make any and all other improvements of any kind or character whatsoever in connection with the development and improvement thereof; to execute the necessary instruments and covenants to effectuate the foregoing powers, including the granting of options in connection therewith;

11. To form or cause to be formed, alone or with others, such corporations, partnerships, limited partnerships and other business organizations organized under the laws of any state or country and to transfer and convey to such business organizations all or any part of the assets, real or personal, of any trust estate in exchange for such stocks, bonds, notes, other securities or interests of such business organizations as the Investment Trustee may deem advisable;

12. To delegate any duties or powers, discretionary or otherwise, to a co-fiduciary or any other person or institution for such periods and upon such terms and conditions as may be designated in an acknowledged, written instrument delivered to such co-fiduciary, other person or institution; and if such duties or powers are delegated to a co-fiduciary, the fiduciary so delegating any duties or powers hereunder shall have no further responsibility with respect to the exercise of such duties or powers so long as such delegation shall remain in effect; and any such delegation shall be revocable by a similar instrument so delivered at any time; provided, however, that no duties or powers described may be delegated to any person who is prohibited by the terms of this instrument from exercising any such duty or power;

13. To appoint, employ and remove at any time and from time to time any accountants, attorneys, investment or other expert advisers, agents, clerks and employees; and to fix and pay their reasonable compensation; and to delegate discretionary authority to make changes in investments to investment counsel;

14. To execute and deliver any and all instruments to carry out any of the foregoing powers, no party to any such instrument being required to inquire into the validity of any such instrument, and generally to deal with any trust estate created hereunder as in the judgment of the Investment Trustee the best interests of such trust may require.

B. **Powers of Distributions Trustee**. In addition to any other power granted by applicable law or herein granted, and except as may otherwise be provided herein, the Distributions Trustee shall have the sole and absolute authority (acting alone and without the consent or approval of any other Trustee acting hereunder) to execute documents or take other action regarding the exercise of, or decision not to exercise, any discretion over beneficial payments, distributions, applications, uses or accumulations of income or principal to or for the benefit of the beneficiaries of the any trust hereunder. In addition to all other powers herein granted to the Distributions Trustee, the Distributions Trustee is expressly authorized, in the exercise of sole and absolute discretion:

1. To purchase, acquire, hold and maintain any residence (whether held as real property, condominium or cooperative apartment) for the use and benefit of one or more of the beneficiaries of any trust, as the Distributions Trustee, in the exercise of sole and absolute discretion, may determine, and, if the Distributions Trustee, in the exercise of sole and absolute discretion, determine that it would be in the best interests of the beneficiaries of any trust to maintain a residence for the use of such one or more of the beneficiaries, but that the residence owned by the Trustee should not be used for such purposes, the Distributions Trustee are authorized to sell said residence and to apply the net proceeds of sale to the purchase of such other residence or to make such other arrangements as the Distributions Trustee, in the exercise of sole and absolute discretion, may deem suitable for the purpose, any proceeds of sale not needed for reinvestment in a residence as provided above to be added to the trust principal and thereafter held, administered and disposed of as a part thereof; to pay all carrying charges of such residence, including but not limited to, any taxes, assessments and maintenance thereon, and all expenses of the repair and operation thereof, including the employment of household employees (including those providing services as independent contractors) and other expenses incident to the maintenance of a household for the benefit of one or more of the beneficiaries of the trust as the Distributions Trustee, in the exercise of sole and absolute discretion, may determine; to expend such amounts to maintain the current life style of any one or more of the beneficiaries, as the Distributions Trustee, in the exercise of sole and absolute discretion, may determine, including, but not limited to, complete authority to provide for the personal care and comfort of any one or more of the beneficiaries in any manner whatsoever (and the power conferred upon the Distributions Trustee by this paragraph shall supersede the powers of the Investment Trustee to the extent the Distributions Trustee may direct in an acknowledged, written instrument delivered to the Investment Trustee acting hereunder);

2. To purchase, acquire, hold and maintain as a part of each trust created hereunder any and all articles of tangible personal property for the use and benefit of the beneficiaries of any trust, as the Distributions Trustee, in the exercise of sole and absolute discretion, may determine, whether such property is productive, underproductive or unproductive of income, and without any duty to convert such property to productive property; to pay the expenses of safekeeping of any such property, including insurance, and all expenses of the repair and maintenance of such property, and to sell such property and to apply the net proceeds of sale to the purchase of such other property as the Distributions Trustee, in the exercise of sole and absolute discretion, may deem suitable for the purpose (and the power conferred upon the Distributions Trustee by this paragraph shall supersede the powers of the Investment Trustee to the extent the Distributions Trustee may direct in an acknowledged, written instrument delivered to the Investment Trustee acting hereunder;

3. To permit any one or more of the beneficiaries of any trust hereunder, as the Distributions Trustee, in the exercise of sole and absolute discretion, determines, to occupy any real property and to use any tangible personal property forming part of the trust estate on such terms as the Distributions Trustee in the exercise of sole and absolute discretion, determines, whether for rent, rent-free, in consideration of payment of taxes, insurance, maintenance or ordinary repairs, or otherwise; (and the power conferred upon the Distributions Trustee by this paragraph shall supersede the powers of the Investment Trustee to the extent the Distributions Trustee may direct in an acknowledged, written instrument delivered to the Investment Trustee acting hereunder);

4. To divide the trust, into one or more separate trusts for the benefit of one or more of the beneficiaries (to the exclusion of the other beneficiaries) of the trust so divided, as the Distributions Trustee, in the exercise of sole and absolute discretion, determines and to allocate to such divided trust some or all of the assets of the trust estate for any reason including, but not limited to, enabling any such trust or trusts to qualify as an eligible shareholder of a Subchapter S corporation as described in section 1361(d)(3) of the Code, or for any other purpose as the Distributions Trustee, in the exercise of sole and absolute discretion, determines;

5. To grant a term of years interest or a life estate to any one or more of the beneficiaries of any trust created hereunder, as the Distributions Trustee, in the exercise of sole and absolute discretion, determines, and to terminate the same, retaining the reversionary interest in the trust or for the

benefit of any other beneficiary of the trust and to make any property of the trust available for the use and benefit of any beneficiary hereunder;

6. To make distributions from any trust in kind or partially in kind and to cause any distributive share to be composed of cash, property or undivided fractional shares in property different in kind from any other distributive share, and any property distributed in satisfaction of a distributive share shall be valued as of its date of distribution;

7. To guarantee the loans of any trust beneficiary (and the power conferred upon the Distributions Trustee by this subparagraph shall supersede the powers of the Investment Trustee to the extent the Distributions Trustee so direct in an acknowledged, written instrument delivered to the Investment Trustee acting hereunder);

8. To make such elections under the tax laws as the Distributions Trustee, in the exercise of sole and absolute discretion, may determine to be appropriate, regardless of the effect thereof on any interests in any trust created under this Agreement of Trust, and to determine whether or not any adjustment of such interests shall be made by reason of any such election;

9. To make or terminate elections with respect to S corporation stock, and to make such adjustments between income and principal to compensate for the consequences of the trust's ownership of S corporation stock as the Distributions Trustee shall deem just and equitable; provided, however, that if the trust holds S corporation stock, the Distributions Trustee shall immediately take such actions to insure that the trust qualifies as either an Electing Small Business Trust within the meaning of section 1361(e)(1)(A) of the Code or a Qualified Subchapter S Trust within the meaning of section 1361(d)(3) of the Code and (A) if the Distributions Trustee seeks to qualify the trust as an Electing Small Business Trust, the Distributions Trustee shall have the authority to exclude by an acknowledged, written instrument any person or organization from having any interest therein, and (B) if the Distributions Trustee seeks to qualify the trust as a Qualified Subchapter S Trust, the Distributions Trustee shall not make (and no other Trustee hereunder shall be authorized to make) adjustments that would have the effect of denying to the income beneficiary the net income of the trust to which the beneficiary must be entitled for the trust to qualify as a Qualified Subchapter S Trust under section 1361(d) of the Code; and no Trustee shall exercise any power conferred under this Article or under this instrument that would have the effect of denying to the income beneficiary the net income of the trust to which the beneficiary must be entitled for the trust to qualify as a Qualified Subchapter S Trust under section 1361(d) of the Code; and provided further, during the term of any trust created hereunder, (i) if the Trustee sell any interest in a corporation or if the assets of any entity constituting a corporation in which the trust has an ownership interest are sold, and (ii) if that corporation has made an election to be taxed under Subchapter S of the Code, then in the sole and absolute discretion of the Distributions Trustee, the Trustee may distribute to the income beneficiary such amounts of principal as shall be necessary to pay any income tax caused by that sale, if the income or gain attributable to that sale is taxed directly to the income beneficiary under applicable federal tax law;

10. To delegate any duties or powers, discretionary or otherwise, to a co-fiduciary or any other person or institution for such periods and upon such terms and conditions as may be designated in an acknowledged, written instrument delivered to such co-fiduciary, other person or institution; and if such duties or powers are delegated to a co-fiduciary, the fiduciary so delegating any duties or powers hereunder shall have no further responsibility with respect to the exercise of such duties or powers so long as such delegation shall remain in effect; and any such delegation shall be revocable by a similar instrument so delivered at any time; provided, however, that no duties or powers may be delegated to any individual who is prohibited therein from participating in the exercise of such duties or powers or who is not eligible to act as a Distributions Trustee hereunder, and no duties or powers may be delegated to the Grantor, a former spouse of the Grantor, or anyone who is related or subordinate within the meaning of section 672(c) of the Code with respect to any of the foregoing;

11. To keep assets held hereunder or the physical evidence of their ownership in any state or country whatsoever, and from time to time to move the same to any other state or country;

12. To allocate receipts and expenses between income and principal in such manner as the Distributions Trustee may determine, in the exercise of sole and absolute discretion; and

13. To execute and deliver any and all instruments to carry out any of the foregoing powers, no party to any such instrument being required to inquire into the validity of any such instrument, and generally to deal with any trust estate created hereunder as in the judgment of the Distributions Trustee the best interests of such trust may require and the Distributions Trustee may, by an acknowledged, written instrument delivered to the Investment Trustee, direct the Investment Trustee to make cash available for the implementation of any of the foregoing powers.

C. If more than one person is acting as Distributions Trustee of any given trust hereunder, decisions of the Distributions Trustee shall be made (i) by a majority vote if more than two (2) persons are so acting or (ii) by unanimous vote if only two (2) persons are so acting.

D. **Administrative Powers**. In addition to any other power granted by applicable law or herein granted, and except as may otherwise be provided herein, the Administrative Trustee is authorized to maintain books and records of the trusts created hereunder; prepare and file or to arrange for the preparation and filing of all tax returns required to be filed by any trust created hereunder; to the extent deemed appropriate by the Investment Trustee, to maintain custody of any assets of the trusts created hereunder (other than real property and other than tangible personal property which the Distributions Trustee, in the exercise of sole and absolute discretion, may determine to make available for the use of any beneficiary hereunder); undertake any other duties to assist the Investment Trustee as the Investment Trustee, in the exercise of sole and absolute discretion, may determine to be appropriate; implement without responsibility therefor any decisions of the other Trustee hereunder; appoint, employ and remove, at any time and from time to time, any accountants, attorneys, expert advisers, agents, clerks and employees in furtherance of fulfilling the responsibilities of Administrative Trustee hereunder, and to pay them such reasonable compensation for their services as approved by the Investment Trustee; place and leave all or any part of the funds or securities at any time held by any trust estate in the care and custody of any bank or trust company, with no obligation while such securities are so deposited to inspect or verify the same and with no responsibility for any loss or misapplication by the bank or trust company or its nominee; to appoint such bank or trust company the agent and attorney of the Trustee to collect, receive, receipt for and disburse any income, and generally to perform the duties and services incident to a so-called "custodian account"; and to allocate the charges and expenses of such bank or trust company to income or to principal or partially to income and partially to principal as the Trustee shall determine; and execute and deliver any and all instruments to carry out any of the foregoing powers, no party to any such instrument being required to inquire into its validity or to see to the application of any money or other property paid or delivered pursuant to the terms of any such instrument. If more than one person is acting as Administrative Trustee of any given trust hereunder, decisions of the Administrative Trustee shall be made (i) by a majority vote if more than two (2) persons are so acting or (ii) by unanimous vote if only two (2) persons are so acting.

E. **Powers of General Trustee.** In addition to any other power granted by applicable law or herein granted, the General Trustee, shall have the sole and absolute authority (acting alone and without the consent or approval of any other Trustee acting hereunder), in the exercise of sole and absolute discretion, to exercise all powers conferred by applicable law to the extent such powers have not been specifically granted exclusively to another Trustee or Trustees hereunder.

F. **Special Trustee Liability Provision.** Some persons may be hesitant to serve as Trustee hereunder because of a concern about potential liability. Therefore, with respect to any trust created hereunder (i) no Trustee shall incur any liability by reason of any error of judgment, mistake of law, or action of any kind taken or omitted to be taken in connection with the administration of any trust created hereunder if in good faith reasonably believed by such Trustee to be in accordance with the provisions and intent hereof, except for matters involving such Trustee's willful misconduct or gross negligence proved by clear and convincing evidence, (ii) no Trustee shall have any fiduciary responsibility to observe, monitor or evaluate the actions of any other Trustee and shall not be liable to any party for the failure to seek to remedy a breach of trust, or in a recurring situation to request instructions from a court having jurisdiction over the trust, even if a Trustee may be guilty of a gross violation of fiduciary duties hereunder, and (iii) each Trustee shall be fully indemnified by the trust estate against any claim or demand by any trust beneficiary or trust creditor, except for any claim or demand based on such Trustee's willful misconduct or gross negligence proved by clear

and convincing evidence. Expenses incurred by a Trustee in defending any such claim or demand shall be paid by the trust estate in advance of the final disposition of such claim or demand, upon receipt of an undertaking by or on behalf of such Trustee to repay such amount if it shall ultimately be determined that such Trustee is not entitled to be indemnified as authorized by this paragraph. In no event shall any Trustee hereunder be liable for any matter with respect to which he, she or it is not authorized to participate hereunder (including the duty to review or monitor trust investments).

G. **Negating Power of Appointment for Interested Trustee as Beneficiary.** Notwithstanding any other provision of this Agreement, no Interested Trustee who is a beneficiary of any trust created hereunder shall ever participate as Trustee of that trust in (i) the exercise, or decision not to exercise, any discretion over beneficial payments, distributions, applications, uses or accumulations of income or principal by the Trustee to or for any beneficiary other than pursuant to an ascertainable standard, if any, expressly set forth and authorized in this Agreement, or (ii) the exercise of any general power of appointment described in Code Sec. 2041 or 2514 (but this shall not apply to a general power of appointment, if any, granted in a non-fiduciary capacity). If any Trustee is under a duty to support a beneficiary or is acting as a guardian, conservator, or similar fiduciary of any person who is a beneficiary, such Trustee shall not participate in the exercise, or decision not to exercise, any discretion over beneficial payments, distributions, applications or uses of trust property in discharge of any obligation of support. No Trustee shall participate in the exercise of any discretion (including, but without limitation, any discretion which would constitute an "incident of ownership" within the meaning of Code Sec. 2042(2)) with respect to any insurance policy on his or her life held hereunder. In each case, the determination of the remaining Trustee or Trustees shall be final and binding upon the beneficiaries of such trust. In addition, no individual shall have any power of appointment over or power to direct the beneficial enjoyment of the fractional share of any trust hereunder consisting of disclaimed property, including any accumulated income of that share, unless such power to direct the beneficial enjoyment is limited by an ascertainable standard.

H. **Security Interests.** The Trustee may grant security interests and execute all instruments creating such interests upon such terms as the Trustee may deem advisable.

I. **Tax Elections and Allocations.** The Trustee may make all tax elections and allocations the Trustee may consider appropriate; provided, however, this authority is exercisable only in a fiduciary capacity and may not be used to enlarge or shift any beneficial interest except as an incidental consequence of the discharge of fiduciary duties. Tax elections and allocations made in good faith shall not require equitable adjustments.

J. **Investment Responsibility.** The Trustee may retain any property originally owned by the Grantor and invest and reinvest in all forms of real and personal property, whether inside or outside the United States, including, without limitation, common trust funds of a corporate Trustee, mutual funds, partnerships (including a partnership in which a Trustee is a partner) and other forms of joint investment (which may but need not be managed by, advised by or affiliated with a Trustee), without regard to any principle of law limiting delegation of investment responsibility by the Trustee.

K. **Compromise Claims or Debts.** The Trustee may compromise claims or debts and abandon or demolish any property which the Trustee shall determine to be of little or no value.

L. **Borrowings.** The Trustee may borrow from anyone, even if the lender is a Trustee under this Agreement, and may pledge property as security for repayment of the funds borrowed, including the establishment of a margin account. No Trustee shall be personally liable for any such loan, and such loan shall be payable only out of assets of the trust.

M. **Sale or Exchange of Property.** The Trustee may sell property at public or private sale, for cash or upon credit, exchange property for other property, lease property for any period of time and give options of any duration for sales, exchanges or leases. The Trustee may give such warranties or indemnifications as the Trustee may deem advisable.

N. **Participation in Mergers and Reorganizations.** The Trustee may join in any merger, reorganization, voting-trust plan or other concerted action of security holders and delegate discretionary powers (including investment powers) in entering into the arrangement.

O. **Allocate Gain to Income or Principal.** The Trustee (other than any Interested Trustee) may allocate within the meaning of Reg. §1.643(a)-3(b) to income or to principal, or partly to income and partly to principal, all or part of the realized gains from the sale or exchange of trust assets; provided, however, that, if income is defined under an applicable state statute as a unitrust amount and the trust is being administered pursuant to such statute, the allocation of gains to income must 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 Reg. §1.643(a)-3(b).

P. **Character of Unitrust Amount Paid.** The Trustee (other than any Interested Trustee) may, within the meaning of Reg. §1.643(a)-3(e), specify the tax character of any unitrust amount paid hereunder. The Trustee (other than any Interested Trustee) may take any action that may be necessary in order for such specification to be respected for tax purposes.

Q. **Distributions as Paid from Capital Gains.** The Trustee (other than any Interested Trustee and other than the Grantor) may deem, within the meaning of Reg. §1.643(a)-3(e), any discretionary distribution of principal as being paid from capital gains realized during the year. The Trustee (other than any Interested Trustee and other than the Grantor) may take any action that may be necessary in order for such deeming to be respected for tax purposes.

R. **Distributions in Cash or Kind.** The Trustee may, without the consent of any beneficiary, distribute in cash or in kind, and allocate specific assets in satisfaction of fractional shares or pecuniary sums among the beneficiaries (including any trust) in such proportions, not necessarily pro rata, as the Trustee may determine, even though a Trustee has an interest affected by the distribution and even though different beneficiaries entitled to the same sum or share may thereby receive different mixes of assets, possibly with different income tax bases, as long as the fair market value of property on the date of distribution is used in determining the extent to which any distribution satisfies a sum or share. The decision of the Trustee in dividing any portion of the trust property between or among multiple beneficiaries shall be binding on all persons.

S. **Application of Property.** The Trustee may apply to the use or for the benefit of any individual, any property whether principal or income, that otherwise would or could be distributed directly to such individual.

T. **Acquisition and Maintenance of Real Property.** The Trustee may acquire, hold and maintain any residence (whether held as real property, condominium or cooperative apartment) for the use and benefit of any one or more of the beneficiaries of any trust whenever that action is consistent with the terms of that trust, and, if the Trustee shall determine that it would be in the best interests of the beneficiaries of that trust (and consistent with the terms of that trust) to maintain a residence for their use but that the residence owned by that trust should not be used for such purposes, the Trustee may sell said residence and apply the net proceeds of sale to the purchase of such other residence or make such other arrangements as the Trustee shall deem suitable for the purpose. Any proceeds of sale not needed for reinvestment in a residence as provided above shall be added to the principal of that trust and thereafter held, administered and disposed of as a part thereof. The Trustee may pay all carrying charges of such residence, including, but not limited to, any taxes, assessments and maintenance thereon, and all expenses of the repair and operation thereof, including the employment of household employees (including independent contractors) and other expenses incident to the running of a household for the benefit of the beneficiaries of that trust. Without limiting the foregoing, the Trustee may permit any income beneficiary of any trust created hereunder to occupy any real property or use any personal property forming a part of that trust on such terms as the Trustee may determine, whether rent free or in consideration of payment of taxes, insurance, maintenance and ordinary repairs or otherwise. In the case of any trust created under this Agreement that qualifies for the marital deduction, such occupancy shall be rent free and any other condition shall be consistent with the intention that the Grantor's Wife have that degree of beneficial enjoyment of the trust property during life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust, so that the Grantor's Wife's interest is a qualifying income interest for life for purposes of the marital deduction.

U. **Acquisition and Maintenance of Personal Property.** The Trustee may acquire, hold and maintain as a part of each trust hereunder any and all articles of tangible personal property or any other property whether

productive, underproductive or unproductive of income, and without any duty to convert such property to productive property, subject, however, to any right of the Grantor's Wife to demand that any property held in a trust for him be made productive and pay the expenses of the repair and maintenance of such property, and sell such property and apply the net proceeds of sale to the purchase of such other property as the Trustee deems suitable for the purpose.

V. **Hold Trusts as Combined Fund.** The Trustee may hold two or more trusts hereunder as a combined fund (allocating ratably to such trusts all receipts from, and expenses of, the combined fund) for convenience in investment and administration, but no combination of trusts for this purpose may alter their status as separate trusts.

W. **Consolidation of Trusts.** After complying with any applicable state law, such as providing notice to all beneficiaries, the Trustee may consolidate any trust with another trust if the consolidation will not impair the rights of any beneficiary or adversely affect the achievement of the purposes of the trust and administer the two as one trust, provided that each portion of the consolidated trust shall terminate and vest in possession no later than the date required for the separate trust from which it came. Without in any way limiting the discretion of the Trustee granted by this paragraph, the Grantor envisions that the Trustee will not elect to consolidate two or more trusts with different inclusion ratios for generation-skipping transfer tax purposes.

X. **Division of Trusts.** After complying with any applicable state law, such as providing notice to all beneficiaries, the Trustee may divide any trust into two or more separate trusts and administer them as separate trusts, either before or after the trust is funded, to enable the GST Exemption to be allocated separately to one of the trusts, to enable the election under Code Sec. 2652(a)(3) to be made separately over one of them or otherwise to make possible a separate trust with a zero inclusion ratio because the trusts have different transferors for GST purposes or for any other tax or non-tax purpose, provided the division does not impair rights of any beneficiary or adversely affect the achievement of the purposes of the trust. Any such division shall be by fractional shares and each share shall participate pro rata in income, appreciation and depreciation to the time of division. Any relevant pecuniary amount (such as the obligation to pay an annuity, or the right to withdraw that amount referred to in Code Sec. 2514(e)(1) (currently, Five Thousand Dollars ($5,000)) shall be applied to the separate trusts based on the fractional shares into which they are divided. Any such division may be retroactive to an earlier effective date, and each separate trust created by the division shall be treated as a separate trust for all purposes from the date on which the division is effective. If a trust is divided pursuant to this paragraph into two trusts, one that is exempt from Federal generation-skipping transfer tax ("GST Exempt Trust") and one that is not exempt from Federal generation-skipping transfer tax ("GST Non-Exempt Trust"), then, without limiting the Trustee's discretion, hereunder the Grantor suggests that no distribution of principal be made from such GST Exempt Trust until the principal of such GST Non-Exempt Trust is exhausted, unless there is a compelling reason to do so.

Y. **Loans.** The Trustee may make loans to, may buy property from, and generally shall have the power to make contracts with the Grantor's estate or the Grantor's Wife's estate or the trustee of any trust subject to any wealth transfer tax upon either of their deaths, regardless of the fact that one or more or all of the persons serving as Trustee hereunder are also serving as a selling or borrowing or otherwise contracting Executor or Trustee; provided that such loans shall be for adequate interest and shall be adequately secured, and such purchases shall be for the property's then fair market value.

Z. **Reliance Upon Advice.** The Trustee may employ and rely upon advice given by accountants, attorneys, investment bankers, and other expert advisors and employ agents, clerks and other employees and pay reasonable compensation to such advisors or employees in addition to fees otherwise payable to the Trustee, notwithstanding any rule of law otherwise prohibiting such dual compensation.

AA. **Trustee as Agent.** Trustees serving in any jurisdiction in which a corporate trustee is unable to serve as Trustee may use such corporate trustee as an agent to perform any task that may lawfully be performed by such an agent in that jurisdiction, and may pay to such corporate trustee such compensation for its services as an agent as shall be agreed upon by all Trustees.

BB. **Additions to Trust**. The Trustee may accept or decline to accept additions from any source.

CC. **Administration of Multiple Trusts.** Whenever two trusts created under this Agreement are directed to be combined into a single trust (for example, because property of one trust is to be added to the other trust), whether or not the trusts have different inclusion ratios with respect to any common transferor or have different transferors for generation-skipping transfer tax purposes, the Trustee is authorized, instead of combining said trusts, to administer them as two separate trusts with identical terms in accordance with the provisions that would have governed the combined trusts. However, the Trustee may manage and invest such separate trusts *in solido*. If anyone (for example, the Grantor's Wife) adds or is deemed to add by gift or bequest property to a trust created under this Agreement, the Grantor authorizes the Trustee to hold the added property as a separate trust with terms identical to the trust to which it would have been added and the Trustee may manage and invest such separate trusts *in solido*.

DD. **Combining Trusts.** The Trustee is authorized to combine any one or more trusts with identical terms for an identical beneficiary or beneficiaries created under this Agreement as a single trust. The Trustee is also authorized later to divide such trust as provided above in this Article. Without in any way limiting the discretion of the Trustee granted by this paragraph, the Grantor envisions that the Trustee will not elect to combine two or more trusts with different inclusion ratios for generation-skipping transfer tax purposes.

EE. **Custodian Employed.** The Trustee may employ a custodian, hold property unregistered or in the name of a nominee (including the nominee of any bank, trust company, brokerage house or other institution employed as custodian), and pay reasonable compensation to a custodian in addition to any fees otherwise payable to the Trustee, notwithstanding any rule of law otherwise prohibiting such dual compensation.

FF. **No Portion of Trust Includible in Gross Estate.** It is the Grantor's intent that no portion of any trust hereunder be includible in the Grantor's gross estate or the gross estate of the Grantor's Wife for Federal estate tax purposes. Accordingly, and notwithstanding any provision herein contained to the contrary, this Agreement shall be construed and the trusts hereunder administered in accordance with and to achieve that intention.

ARTICLE XXII
S Corporation Stock

Before the date on which any "S Corporation Shares" (defined below) otherwise would pass to or be treated as held by an "Ineligible Trust" (defined below), the Trustee (excluding, however, any Interested Trustee) may elect to hold these S Corporation Shares in one or more separate trusts or shares as set forth in this Article. The Trustee (excluding, however, any Interested Trustee) may elect to hold such S Corporation Shares under the paragraph entitled "Qualified Subchapter S Trusts" or the paragraph entitled "Electing Small Business Trusts," as the Trustee (excluding, however, any Interested Trustee) shall deem appropriate, considering the changes that such provisions would require from the terms and conditions under which such shares otherwise would be held under this Agreement.

A. **Qualified Subchapter S Trusts.** Any S Corporation Shares held under this paragraph shall be on the following terms:

1. Each trust held under this paragraph shall be a separate trust or substantially separate and independent share, as defined in Code Sec. 1361(d)(3), held for the benefit of one beneficiary. Any reference in this paragraph to a beneficiary's separate trust shall refer equally to any substantially separate and independent trust share.

2. Until the "QSST Termination Date" (defined below), the Trustee shall annually distribute all the trust's "Net Income" (defined below) to the sole beneficiary of each trust held under this paragraph, together with as much of that trust's principal as is appropriate under the standard contained in the trust which otherwise would have held such S Corporation Shares. The Trustee shall not distribute income or principal to anyone other than the beneficiary to whom Net Income is distributable until the QSST Termination Date.

3. Upon the QSST Termination Date, the Trustee shall distribute the remaining trust assets to the beneficiary to whom Net Income was then distributable, if then living, or otherwise in accordance with the terms of the Trust which would otherwise have held such S Corporation Shares.

4. The Trustee shall notify the sole beneficiary of each trust held under this paragraph that he or she must timely and properly elect under Code Sec. 1361(d)(2) to cause such trust held to be treated as a Qualified Subchapter S Trust for Federal income tax purposes, and if the beneficiary fails or refuses to do so, the Trustee shall hold such S Corporation Shares under the paragraph entitled "Electing Small Business Trusts."

5. The Trustee (excluding, however, any Interested Trustee) shall administer any trust under this paragraph as a Qualified Subchapter S Trust, as defined in Code Sec. 1361(d)(3).

6. In the event there is more than one income beneficiary of an Ineligible Trust (defined below), the Trustee shall divide the S Corporation Shares that will be held under this paragraph into separate trusts, based on each beneficiary's interest in the income of the Ineligible Trust that otherwise would have held those shares. If no beneficiary was entitled to income of such Ineligible Trust at that time, the Trustee may divide the S Corporation Shares into separate trusts for the beneficiaries of such Ineligible Trusts in such manner as the Trustee (excluding, however, any Interested Trustee) shall deem appropriate.

B. **Electing Small Business Trusts.** Any S Corporation Shares held under this paragraph shall be held on the following terms:

1. The Trustee (excluding, however, any Interested Trustee) shall apportion to the trusts under this paragraph a reasonable share of the unallocated expenses of all trusts under this Agreement in a manner consistent with the applicable Internal Revenue Code and Treasury Regulations.

2. The Trustee shall make that election required by Code Sec. 1361(e)(3) to qualify the trust under this paragraph as an Electing Small Business Trust under Code Sec. 1361(e).

3. The Trustee (excluding, however, any Interested Trustee) shall administer each trust under this paragraph as an Electing Small Business Trust under Code Sec. 1361(e).

C. **Implementation.** The Trustee (excluding, however, any Interested Trustee) shall manifest its selection of the form in which it shall hold any S Corporation Shares by written notice to all persons who would be eligible or entitled at the time of such writing to receive income from the Ineligible Trust that otherwise would hold such S Corporation Shares.

D. **Definitions.** The following definitions apply for purposes of this Article:

1. "Ineligible Trust" means a trust whose ownership of any S Corporation Shares would cause the termination of that corporation's election to be taxed under subchapter S of the Code.

2. "Net Income" means income, as defined in Code Sec. 643(b).

3. "S Corporation Shares" means shares of any stock of a corporation that then operates or that the Trustee shall deem likely to operate in the future under an election to have its earnings taxed directly to its stockholders under subchapter S of the Code.

4. The "QSST Termination Date" means, separately, with respect to each trust held under the paragraph entitled "Qualified Subchapter S Trusts," the earlier of the date on which the beneficiary dies and the date on which the trust terminates.

ARTICLE XXIII
The Closely-Held Business

A. **Authority to Operate.** The Trustee may operate "the Business" (as defined below) and retain any equity interests in the Business, even if these interests otherwise would be a speculative or inappropriate investment for a trust. This authority shall not supersede the right of the Grantor's Wife to compel that certain trust assets be made productive. The Trustee may do all things related to the operation of the Business that the Grantor could have done if living, in a fiduciary capacity:

1. The Trustee may carry out the terms of any option or buy-sell agreements into which the Grantor may have entered.

2. The Trustee may sell or liquidate any of the Business interests at such price and on such terms as the Trustee may deem advisable.

3. The Trustee may arrange for and supervise the continued operations of the Business.

4. The Trustee may vote (in person or by proxy) as stockholder or otherwise and in any matter involving the Business on behalf of the trust.

5. The Trustee may grant, exercise, sell, or otherwise deal in any rights to subscribe to additional interests in the Business.

6. The Trustee may take any actions appropriate to cause the capital stock or securities in the Business to be registered for public sale under any state or Federal securities act; may enter into any underwriting agreements or other agreements necessary or advisable for this registration and sale; and may grant indemnities to underwriters and others in connection with such registration.

7. The Trustee may participate in any incorporation, dissolution, merger, reorganization or other change in the form of the Business and, where appropriate, deposit securities with any protective committees and participate in voting trusts.

8. The Trustee may delegate to others discretionary power to take any action with respect to the management and affairs of the Business that the Grantor could have taken as the owner of the Business.

9. The Trustee may invest additional capital in, subscribe to additional stock or securities of and loan money or credit to the Business from the trust.

10. The Trustee may accept as correct financial or other statements rendered by the Business as to its conditions and operations except when having actual notice to the contrary.

B. **Compensation.** The Trustee shall be entitled to additional reasonable compensation for the performance of services with respect to the Business, which may be paid to the Trustee from the Business, the trust, or both, as the Trustee may deem advisable.

C. **Conflict of Interest Waived.** The Trustee may exercise the authorities granted under this Article even if the Trustee shall own personally an interest in the Business.

D. **The "Business" Defined.** The "Business" means any interest the Grantor, the Trust, or both, shall own at the Grantor's death, representing, in the aggregate, at least five percent (5%) of the total equity interests in any actively-conducted trade or business, whether incorporated or unincorporated. The "Business" shall also include, but not be limited to, any five percent (5%) or greater equity interests in any corporations, general and/or limited partnerships as well as membership interests in any limited liability company or other business enterprise formed, operated or beneficially owned by the Grantor prior to the Grantor's death or participated in (to the extent of five percent (5%) or more) by the Grantor prior to the Grantor's death. The "Business" does not include any interests that are regularly traded on an established exchange or over-the-counter.

ARTICLE XXIV
Real Estate Investments

A. **Authority to Retain.** The Trustee may retain all interests that the Grantor, the Trust, or both, may own in any real estate that the Trustee shall determine to have been held primarily for investment at the Grantor's death, even if it otherwise would be a speculative or inappropriate investment.

B. **Authority to Manage.** The Trustee may lease any real estate on such terms and conditions as the Trustee may deem advisable, and these leases may extend beyond the term of the administration of the trust. For this purpose, the Trustee may make any instruments and grant such covenants and warranties as the Trustee may deem advisable.

C. **Environmental Issues.** The Trustee shall take into account any environmental law that may be relevant to any real estate included in the trust.

1. The Trustee may inspect property held directly or indirectly as part of the trust, including any interests in incorporated or unincorporated business entities, comply with environmental laws affecting this property and respond to a change in, or any actual or threatened violation of, any environmental law affecting property held as part of the trust.

2. The Trustee may appropriately respond to a change in, or prevent, abate or otherwise remedy any actual or threatened violation of any environmental law affecting property held as part of the trust, either before or after the initiation of an enforcement action by any governmental body.

3. The Trustee shall not be personally liable to any beneficiary for any decrease in value because of the compliance by the Trustee with any environmental law, including any reporting requirement. Neither the acceptance by the Trustee of property nor the failure by the Trustee to inspect property shall create any inference as to whether or not there is or may be any liability under any environmental law with respect to such property.

D. **"Environmental Law" Definition.** "Environmental law" means any Federal, state or local law relating to the protection of the environment or human health, and "hazardous substances" means any substances defined as hazardous or toxic or otherwise regulated by any environmental law.

ARTICLE XXV
The Farm or Ranch

A. **Authority to Retain.** The Trustee may retain and continue to operate the "Farm" (as defined below), even if it otherwise would be a speculative or inappropriate investment.

B. **Authority to Operate.** The Trustee may do all things related to the operation of the Farm that the Grantor could have done if living, all in a fiduciary capacity.

1. The Trustee may sell or liquidate any interest in the Farm at such price and on such terms as the Trustee may deem advisable.

2. The Trustee may arrange for and supervise the continued operations of the Farm.

3. The Trustee may participate in any incorporation, dissolution, merger, reorganization or other change in the legal form of the Farm and, where appropriate, deposit securities with any protective committees and participate in voting trusts.

4. The Trustee may operate the Farm with hired labor, tenants or sharecroppers; hire a farm manager or a professional farm management service to supervise operations; lease or rent the Farm for cash or for a share of the crops; and construct, repair and improve farm buildings of all sorts to the extent the Trustee may deem advisable.

5. The Trustee may use approved soil conservation practices in order to conserve, improve and maintain the fertility and productivity of the soil; protect, manage and improve any timber and forest on the Farm; and sell any timber and forest products.

6. The Trustee may ditch and drain damp or wet fields and areas of the Farm when and where needed, engage in livestock production and construct such fences and buildings and plant such pastures and crops as may be appropriate to carry on such a livestock program.

7. The Trustee may execute contracts, notes and chattel mortgages relating to agriculture with the Commodity Credit Corporation, the United States Secretary of Agriculture or any other officer or agency of the Federal or state governments; enter into acreage reduction agreements and make soil conservation commitments; and do all acts necessary to cooperate with any governmental agricultural program.

C. **Liabilities.** The Trustee shall satisfy any contractual and tort liabilities arising from the Farm first from its assets, and secondarily from the other assets of the trust. The Trustee shall have no liability to anyone for any loss arising from the operations, retention or sale of the Farm.

D. **Additional Compensation.** The Trustee shall be entitled to additional reasonable compensation for the performance of services with respect to the Farm, which may be paid to the Trustee from the assets of the Farm or from other assets under fiduciary administration, or both, as the Trustee may deem advisable.

E. **Conflict of Interest Waived.** The Trustee may exercise the authorities granted under this Article even if the Trustee shall own personally an interest in the Farm.

F. **The "Farm" Defined.** The "Farm" means any interest that the Grantor, the Trust, or both, shall own at the Grantor's death representing, in the aggregate, at least Five Percent (5%) of the total equity interests in any operating farm or ranch, whether incorporated or unincorporated.

ARTICLE XXVI
Crummey Rights of Withdrawal: Rules, Limitations and Procedures

The withdrawal rights created in the Article entitled "Crummey Rights of Withdrawal" shall be subject to the rules, limitations and procedures contained in this Article.

A. **Withdrawal Rights of Wife.** The Grantor's Wife shall have a right of withdrawal over an amount equal to the value of all contributions to the trust, subject to the limitations set forth below.

1. The maximum amount that the Grantor's Wife may withdraw with respect to all contributions made in any calendar year shall not, in any event, exceed the lesser of: (i) the Federal gift tax annual exclusion in effect at the time of each contribution, less the amount of prior gifts to the Grantor's Wife either outright or in trust, by the same donor during the same calendar year, which gifts were eligible for the Federal gift tax annual exclusion but not eligible for the Federal gift tax marital deduction; and (ii) the greater of that amount referred to in Code Sec. 2514(e)(1) (currently, Five Thousand Dollars ($5,000)) or that percentage referred to in Code Sec. 2514(e)(2) (currently, Five Percent (5%)) of the trust corpus out of which, or the proceeds of which, the exercise of this withdrawal right could be satisfied. Absent an express direction to the contrary by a donor at or before the time of a contribution, all gifts to the Grantor's Wife (other than gifts by the Grantor) that enter into the computation under this paragraph shall be treated as having been made equally by the donor and the donor's spouse if the donor was married when the gift was made and the gift was eligible for gift-splitting under Code Sec. 2513(a). The limitation on the amount of a contribution that may be withdrawn under this paragraph, with respect to contributions made by a donor who was married when the gift was made and which gift was eligible for gift-splitting under Code Sec. 2513, shall be separately calculated and applied as to each spouse's deemed half of the gift.

2. The amount withdrawable by the Grantor's Wife shall be noncumulative and shall lapse on the last day of each calendar year, or, if earlier, thirty (30) days after the contribution was made.

3. The Grantor's Wife's withdrawal right continues until it lapses. The Grantor's Wife's withdrawal right shall not terminate merely because of the termination of the Lifetime Trust, but shall continue with respect to all trusts under this Agreement until it lapses as described above. The Grantor's Wife's withdrawal right shall, upon termination of the Lifetime Trust, be exercisable first out of that portion of the Trust Fund that qualifies for the Federal estate tax marital deduction.

4. All other withdrawal rights granted under this Article shall be determined with respect to the difference between the value of the contribution to the trust and any amount that the Grantor's Wife could withdraw under this section as of the time of the contribution, even if the Grantor's Wife does not withdraw such amounts.

B. **Withdrawal Rights of Children.** Subject to the limitations set forth below, each of the Grantor's children (herein defined as "holders") shall have a right of withdrawal over an amount equal to the value of such holder's proportionate share of the Descendants' Withdrawal Amount. Such holder's "proportionate share" shall be determined by dividing the Descendants' Withdrawal Amount by the number of the then-living holders (not including any individual or individuals who may be excluded by the Grantor). The "Descendants' Withdrawal Amount" shall be an amount equal to all contributions made to the trust in any calendar year minus the amount over which the Grantor's Wife has a right of withdrawal.

1. The maximum amount that a child may withdraw with respect to all contributions made in any calendar year shall not, in any event, exceed the gift tax annual exclusion in effect at the time of each contribution, less the amount of prior gifts to the same child either outright or in trust, by the same donor during the same calendar year, which gifts were eligible for the Federal gift tax annual exclusion.

2. Absent an express direction to the contrary by a donor at or before the time of a contribution, all gifts that enter into the computation under this paragraph shall be treated as having been made equally by the donor and the donor's spouse if the donor was married when the gift was made and the gift was eligible for gift-splitting under Code Sec. 2513(a). The limitation on the amount of a contribution that may be withdrawn under this paragraph, with respect to contributions made by a donor who was married when the gift was made and which gift was eligible for gift-splitting under Code Sec. 2513, shall be separately calculated and applied as to each spouse's deemed half of the gift.

3. The amount withdrawable by any child shall be cumulative, and shall lapse on the last day of each calendar year, or, if earlier, thirty (30) days after the contribution to which it relates in an amount equal to the greater of that sum referred to in Code Sec. 2514(e)(1) (currently, Five Thousand Dollars ($5,000)) or that percentage referred to in Code Sec. 2514(e)(2) (currently, Five Percent (5%)) of the trust corpus out of which, or the proceeds of which, the exercise of this withdrawal right could be satisfied. Rights of withdrawal that do not lapse at the end of a calendar year shall continue to be exercisable by the child subject to this same limited annual lapse. Notwithstanding anything herein contained to the contrary, with respect to any contributions, no lapse of a power of withdrawal held by any individual hereunder shall occur with respect to any contributions until the later of the time specified above for such lapse to occur and thirty (30) days after notice of such right of withdrawal is given to such individual.

4. Withdrawal rights exercisable by a child under this section respecting a contribution made fewer than thirty (30) days before the end of a calendar year shall not lapse at the end of that calendar year but shall remain exercisable by the child until thirty (30) days after the date of the gift even though such period to withdraw extends into the following calendar year and notwithstanding any other provision of this section.

5. The withdrawal right of each of the Grantor's children shall continue until it lapses as described above and shall not terminate merely because of the termination of the Lifetime Trust but shall continue with respect to all trusts under this Agreement except as to any disposition to the Marital Trust of any trust property that is included in the Grantor's gross estate.

C. **Notice.** The Trustee shall promptly notify each competent adult who holds a withdrawal right under this Article of all contributions to which that person's withdrawal right relates. The Trustee shall notify a person who is under a legal disability, including (but not limited to) minority, by notifying:

1. the legal guardian or conservator of the individual's property, who is hereby authorized to exercise the withdrawal rights;

2. any living parent of the individual (excluding, however, with respect to any child of the Grantor, both the Grantor and any parent of the child who is not then married to the Grantor);

3. any other person taking care of the individual or with whom the individual resides; or

4. any other appropriate adult individual selected by the Trustee.

D. **Exercise of Withdrawal Right.** Withdrawal rights under this Article shall be exercisable by a writing delivered to the Trustee. The person to whom notice is properly given for a minor or disabled individual may decide whether to exercise that minor or disabled individual's withdrawal right, unless that person receiving notice is the donor of the contribution to which the withdrawal right relates, in which case the Trustee shall designate another appropriate adult individual to make such decision.

E. **Satisfaction of Withdrawal Right.** A withdrawal under this Article may be satisfied from the contribution itself or from other trust assets, as the Trustee shall choose. The principal of any GST Non-Exempt Trust must be exhausted in satisfying a withdrawal right before the principal of any GST-Exempt Trust may be used to satisfy a withdrawal right. A distribution under this Article may be made to the person who makes the withdrawal or who is, under this Article, entitled to act for the minor or disabled individual.

F. **Power to Exclude.** The Grantor may, by an instrument in writing executed before a contribution, exclude one or more individuals from having withdrawal rights over that contribution or any future contribution or both. The Grantor may not, however, limit or alter any rights resulting from prior contributions.

G. **Power to Amend.** The Trustee may, by an instrument in writing, amend this Article to the extent the Trustee shall deem it appropriate to assure that contributions to this trust qualify for the gift tax annual exclusion for Federal gift tax purposes. The Trustee may not amend the trust in any manner that would cause any portion of the trust funds to be included in the Grantor's gross estate, that of the Grantor's Wife, or that of any of the Grantor's children, to a greater extent than before such amendment. An amendment made in good faith shall be conclusive on all persons interested in the trust and the Trustee shall not be liable for the consequences of any amendment or for not having amended the trust. No amendment shall limit or alter the rights of a beneficiary in any trust funds held by the Trustee before the amendment. No Interested Trustee or Insured Trustee may participate in any action under this paragraph.

H. **Priority of Withdrawal Rights.** No Trustee may make any discretionary distributions of principal or income that would reduce the available trust principal below the total amount of the then-existing withdrawal rights without advance notice to each trust beneficiary who is entitled to make a withdrawal, or who is, under this Article, entitled to act for a minor or disabled beneficiary.

I. **Special Definitions and Rules.** The following definitions and rules apply for purposes of this Article:

1. "Contribution" means any cash or other assets transferred to the Trustee to be held as part of the trust funds, in a manner that constitutes a gift for Federal gift tax purposes. The amount of a contribution is its Federal gift tax value.

2. The amounts involved in a power to withdraw described as "an amount equal to the greater of that sum referred to in Code Sec. 2514(e)(1) (currently, Five Thousand Dollars ($5,000)) or that percentage referred to in Code Sec. 2514(e)(2) (currently, Five Percent (5%)) of the trust corpus" shall be measured after subtracting all other amounts that the same person could have withdrawn during the same calendar year from this or any other fund, to the extent that such powers must, under applicable Federal gift tax law, be aggregated in determining whether the lapse of the withdrawal power under this Article is a release of a general power of appointment.

3. If the Trustee shall incorrectly determine the amount that should be distributed to a beneficiary under this Article, then within a reasonable period after the correct amount is finally determined, the Trustee shall receive from the beneficiary, or the beneficiary shall receive from the Trustee, as the case may be, an amount equal to the difference between the amount that should properly have been distributed and the amount actually distributed.

4. All withdrawal rights with respect to a contribution to which this Article applies shall arise immediately upon such contribution to the Trust.

5. The Trustee may without liability assume that no prior gifts to any holder of a withdrawal power under this Article were made by a donor or a donor's spouse other than contributions to the trust, unless the Trustee shall have actual notice to the contrary.

ARTICLE XXVII
The Selector

The Grantor appoints Jonathan G. Blattmachr or other person while acting as a Trust Protector hereunder as the Selector. Until the Grantor's death, the Selector is authorized, acting in an individual capacity and not in a fiduciary capacity, at any time and from time to time, to add one or more of organizations described in Code Sec. 2055 to the class of beneficiaries of any trust under this Agreement; provided, however, that in no event may the Selector add the Selector to such class of beneficiaries; provided, further, that in no event may the Selector add to the class of beneficiaries of any trust hereunder which may qualify (by election or otherwise) for the Federal marital deduction.

Any Selector may cease to act as Selector by delivery of a written and acknowledged notice to the Trustee. If the Selector should cease to act for any reason without having fully released the power to add to the class of beneficiaries pursuant to this Article, the successor Selector shall be such individual (other than the Grantor or any person who may be added as a beneficiary pursuant to this Article or any person who is a related or subordinate party within the meaning of Code Sec. 672(c) with respect to the Grantor or any person who may be added as a beneficiary) as shall be designated by a written and acknowledged instrument executed by the Trustee. If at any time prior to the complete release of the power to add to the class of beneficiaries under this Article there is no Selector acting hereunder, the Trustee (but acting in an individual capacity and not in a fiduciary capacity) shall exercise the Selector's powers under this Article until the appointment of a successor Selector as provided in this Article.

The Selector may at any time during the Grantor's lifetime release such power, in whole or in part, by delivery of an acknowledged instrument in writing to the Grantor releasing such power. Any such release made by the Selector shall be irrevocable, and shall be binding upon all current and successor Trustee and the current and successor Selector and all persons interested hereunder, and no person shall thereafter have the power to add to the class of beneficiaries under this Article to the extent of such release.

ARTICLE XXVIII
Power to Substitute Property

The Grantor appoints Jonathan G. Blattmachr or other person while acting as a Trust Protector hereunder as the Substitutor. During the Grantor's lifetime, the Substitutor shall have the power, exercisable at any time and from time to time in a non-fiduciary capacity (within the meaning of Code Sec. 675(4)) without the approval or consent of any person in a fiduciary capacity within the meaning of that section, to acquire or reacquire any asset or assets forming part of the trust estate of any trust held under this Agreement (other than any direct or indirect interest in stock that would, by reason of such power of substitution, be included in the gross estate of the Substitutor for Federal estate tax purposes under Code Sec. 2036(b)) by substituting other property of an equivalent value, determined as of the date of such substitution. With respect to any such "2036(b)" stock described in the immediately preceding sentence, the Trustee shall appoint another individual, who is not a person in whose estate such stock would be so included if such person held the power, directly or indirectly, to vote such stock, to hold such power of substitution with respect to such assets, such person so appointed with respect to such assets being the "Substitutor" only with respect thereto. The Grantor directs that this power is not assignable, and any attempted assignment will make this power void. Without reducing or eliminating the fiduciary duties imposed on the Trustee hereunder or by applicable law, the Substitutor shall exercise this power to substitute property by certifying in writing that the substituted property and the trust property for which it is substituted are of equivalent value, and the Trustee shall have a fiduciary obligation to ensure the Substitutor's compliance with the terms of this power by being satisfied in advance of completing the substitution that the properties acquired and substituted are in fact of equivalent value, within the meaning of Revenue Ruling 2008-22. This power to substitute property cannot be exercised in a manner that can shift benefits among the trust beneficiaries. Without limiting the foregoing prohibition upon shifting benefits among trust beneficiaries, the Trustee shall have, with respect to any trust which is not being administered as a unitrust or the distributions from which are not limited to discretionary distributions of principal and income (so that the power to reinvest the principal of the trust and the duty of impartiality are not required in order to avoid this power of substitution potentially causing a shift of benefits among trust beneficiaries, all within the meaning of Revenue Ruling 2008-22), the power to reinvest the principal

of the trust and the duty of impartiality with respect to trust beneficiaries at all times while this power of substitution is in effect. The foregoing grant of a power of reinvestment and imposition of a duty of impartiality are included herein for compliance with Revenue Ruling 2008-22, and whenever such power and duty are not granted and imposed under this Article, the remaining provisions of this Agreement shall determine whether and to what extent such power and duty are granted and imposed. The Substitutor may at any time during the Grantor's lifetime release such power, in whole or in part, by delivery of an acknowledged instrument in writing to the Trustee. Any such release made by the Substitutor shall be irrevocable, and shall be binding upon all current and successor Trustees, the current and any successor Substitutor, and all persons interested hereunder, and no person shall thereafter have the power to substitute trust property under this Article to the extent of such release. Any Substitutor may cease to act as Substitutor by delivery of a written and acknowledged notice to the Trustee. If the Substitutor should cease to act for any reason without having fully released the power to substitute property as provided under this Article, and if no successor Substitutor has otherwise been named, the successor Substitutor shall be such individual as shall be designated by a written and acknowledged instrument executed by the Trustee. If at any time prior to the complete release of the power of substitution there is no Substitutor acting hereunder, the Trustee (but acting in an individual capacity and not in a fiduciary capacity) shall exercise the Substitutor's powers under this Article until the appointment of a successor Substitutor as provided in this Article.

ARTICLE XXIX
Power to Compel Trustee to Loan Without Adequate Security

The Grantor appoints Jonathan G. Blattmachr or other person while acting as a Trust Protector hereunder as the Loan Director. During the Grantor's lifetime, the Loan Director shall have the power, exercisable at any time and from time to time in a non-fiduciary capacity (within the meaning of Code Sec. 675) without the approval or consent of any person in a fiduciary capacity within the meaning of that section, to compel the Trustee to loan some or all of the trust property to the Grantor without adequate security within the meaning of Code Sec. 675(2) although with adequate interest within the meaning of that section. The Grantor directs that this power is not assignable. In the event that Jonathan G. Blattmachr or other person acting as a Trust Protector hereunder dies before the Grantor dies, the successor Loan Director shall be such individual (other than the Grantor, any person acting as a Trustee under this instrument or anyone who is an adverse party within the meaning of Code Sec. 672) whom Jonathan G. Blattmachr or other person acting as a Trust Protector hereunder shall have designated by instrument in writing. Any person other than Jonathan G. Blattmachr or other person acting as a Trust Protector hereunder acting as a Loan Director hereunder shall also have the power to name a successor Loan Director by an instrument in writing. In the event that no one else is acting as a Loan Director hereunder, the oldest individual acting as a Trustee hereunder (or if none, the corporation or other entity acting as Trustee hereunder) shall be the Loan Director but acting only in a non-fiduciary capacity.

The person acting as the Loan Director hereunder may at any time during the Grantor's lifetime release such power, in whole or in part, by delivery of an acknowledged instrument in writing to the Grantor releasing such power. Any such release made by the Loan Director shall be irrevocable, and shall be binding upon all current and successor Trustees and the current and any successor Loan Director and all persons interested hereunder, and no person shall thereafter have the power to compel the Trustee to make loans to the Grantor without adequate security.

ARTICLE XXX
Definitions and Miscellaneous Provisions

The following definitions and miscellaneous provisions shall apply under this Agreement:

A. **Children and Descendants.** References to "children" and "descendants" shall include children and descendants whenever born.

B. **Spouse**. An individual's "spouse" (other than with respect to the Grantor) is the person (if any) to whom that individual is married at any given time.

C. **Surviving Spouse.** The "surviving spouse" of an individual, other than with respect to the Grantor, is the person (if any) who survives that individual and who is married to and living with that individual as a married couple at the time of his or her death.

D. **The Grantor's Wife.** For purposes of this Agreement, any reference to the Grantor's Wife shall mean Martha Washington Zaritsky only, including if and when he becomes the Grantor's widower. However, Martha Washington Zaritsky shall be treated for all purposes hereunder (other than for purposes of

applying the Maximum Duration of Trusts provisions hereof) as though he died when he and the Grantor became legally separated or divorced or their marriage was annulled.

E. **Determining Descendants.** One's children and other descendants shall be determined according to applicable law, except to the extent modified by this Article or by other specific provisions of this Agreement.

1. A child adopted before he or she attains eighteen (18) years of age (but not after attaining that age) shall be treated under this Agreement as a child of his or her adopting parents and a descendant of their ancestors.

2. A biological child shall not be treated as a child or descendant of any biological parent of the child or as a descendant of the ancestors of such biological parent if the child has been surrendered for adoption with the consent of such biological parent and the child's adoptive parent substitutes for the consenting parent under applicable state law.

3. A biological child born out of wedlock shall be treated as a child of his or her biological parent who is a descendant of the Grantor and as a descendant of their ancestors.

4. Adoptions and marriages that are recognized under this Agreement shall not affect prior distributions or other interests that have previously vested in possession, but they shall enable a person to receive distributions from or remainder or other interests in a trust still in existence. The descendants of a person who is treated as a child or descendant under this Article shall also be treated as descendants of such person's ancestors. The descendants of a person who is treated as not being a child or descendant under this Article shall also be treated as not being descendants of such person's ancestors.

5. The term "child" or "descendant" (and any plural form thereof) in this Agreement shall include any biological child or descendant of the Grantor (who has not been adopted by a person who is not a descendant of the Grantor unless the adoptive parent is married to a descendant of the Grantor or unless the adoptive parent was married to a descendant of the Grantor who died prior to the adoption) whose conception has resulted from the use of a frozen gamete of a deceased descendant of the Grantor and gamete of the Grantor's deceased descendant's surviving spouse and that posthumously conceived descendant has been born or is in utero by the time of the determination of the descendants who would take property outright or for whom it would be placed into separate trusts for descendants of the Grantor under this Agreement; provided, however that proof that such posthumously conceived person is the biological child or descendant of the Grantor shall be established by DNA or equally reliable testing.

F. **Minor and Adult.** Whether an individual is a minor or an adult shall be determined under the laws of the individual's domicile at the time in question, except in cases when this Agreement has specifically defined "Minor" to mean a person under twenty-one (21) years of age.

G. **Code and Regulations.** References to the "Internal Revenue Code" or "Code" or to provisions thereof are to the Internal Revenue Code of 1986, as amended at the time in question. References to the "Regulations" and "Regs." are to the Regulations under the Code. If, by the time in question, a particular provision of the Code has been renumbered, or the Code has been superseded by a subsequent Federal tax law, the reference shall be deemed to be to the renumbered provision or the corresponding provision of the subsequent law, unless to do so would clearly be contrary to the Grantor's intent as expressed in this Agreement. A similar rule shall apply to references to the Regulations.

H. **Disqualified Trustee.** A "Disqualified Trustee" is an individual who has a Developmental Disability, Mental Illness or Persistent Disability (as such terms are defined below) and who is eligible to receive or is receiving Government Benefits, if such individual is an Interested Trustee (as such term is defined in this Agreement), or would be an Interested Trustee, if serving. Notwithstanding any other provision of this Agreement, no Disqualified Trustee shall ever make, vote on or otherwise participate in any discretionary distribution of income or principal from any trust under this Agreement.

I. **Interested Trustee.** With respect to any trust, an "Interested Trustee" is a Trustee who is (i) a transferor of property to the trust, including a person whose qualified disclaimer resulted in property passing to the trust; or (ii) a person who is, or in the future may be, eligible to receive income or principal pursuant to the terms of the trust. A Trustee described in (i) is an Interested Trustee only with respect to the transferred property (including income and gain on, and reinvestment of, such property). A person is described in (ii) even if he or she has a remote contingent remainder interest, but is not described in (ii) if the person's only interest is as a potential appointee under a non-fiduciary power of appointment held by another person which has not yet been exercised or the exercise of which can take effect only in the future, such as a testamentary power held by a living person. A Trustee who is not an Interested Trustee is a "Disinterested Trustee."

J. **Per Stirpes.** Property that is to be divided among an individual's surviving or then-living descendants "per stirpes" or in "per stirpital shares" shall be divided into as many equal shares as there are children of the individual who are then living or who have died leaving surviving or then-living descendants. A share allocated to a deceased child of the individual shall be divided further among such deceased child's surviving or then-living descendants in the same manner.

K. **Executor.** Whenever herein a reference is made to the Grantor's or another person's Executor, such reference shall be to those serving as the fiduciary of that person's estate, whether or not their title is Executor under applicable state law.

L. **Incapacitated Trustee.** A Trustee shall be deemed to be "incapacitated" (and while incapacitated shall not serve as a Trustee) if another then-serving Trustee or, if there is none, the next successor Trustee receives written certification that the examined individual is physically or mentally incapable of managing the affairs of the trust, whether or not there is an adjudication of incapacity.

1. This certification shall be valid only if it is signed by at least two (2) licensed physicians, each of whom has personally examined the Trustee.

2. This certification need not indicate any cause for the Trustee's incapacity.

3. A certification of incapacity shall be rescinded when a serving Trustee receives a certification that the former Trustee is capable of managing the trust's affairs. This certification, too, shall be valid only if it is signed by at least two (2) licensed physicians, each of whom has personally examined the Trustee.

4. No person is liable to anyone for actions taken in reliance on the certifications under this paragraph or for dealing with a Trustee other than the one removed for incapacity based on these certifications.

M. **Gross Estate.** "Gross estate" means the Grantor's gross estate as determined for Federal estate tax purposes (or for state death tax purposes where relevant).

N. **Terms Relating to Supplemental Needs Trust.** The technical terms contained in the Supplemental Needs Trust shall be defined as follows:

1. "Government Benefits" refers to any program funded with either local, state, or federal funds which is only available to individuals who meet certain means tested criteria, as a result of having attained a certain age or as a result of a Persistent Disability. This includes, but is not limited to, Medicaid programs, Medicaid waiver programs, and Supplemental Security Income. The term Government Benefits is not intended to include programs such as Social Security and Medicare. The Trustee shall, in the exercise of sole and absolute discretion, determine whether an individual is receiving or is eligible to receive Government Benefits, and may determine that an individual is eligible to receive Government Benefits regardless of whether the agency or agencies administering such Government Benefits has made a final determination as to such individual's eligibility.

2. "Developmental Disability" means a disability of a person which

a) is attributable to:

(1) intellectual disability, cerebral palsy, epilepsy, neurological impairment, familial dysautonomia or autism;

(2) any other condition of a person found to be closely related to an intellectual disability because such condition results in similar impairment of general intellectual functioning or adaptive behavior to that of intellectually disabled persons or requires treatment and services similar to those required for such person; or

(3) dyslexia resulting from a disability described in subparagraph (i) or (ii) of this paragraph.

b) originates before such person attains age twenty-two;

c) has continued or can be expected to continue indefinitely; and

d) constitutes a substantial handicap to such person's ability to function normally in society.

3. "Mental Illness" means an affliction with a mental disease or mental condition that is manifested by a disorder or disturbance in behavior, feeling, thinking or judgment to such an extent that the person afflicted requires care, treatment and rehabilitation.

4. "Persistent Disability" means a person:

a) with mental illness, developmental disability or other physical or mental impairment; and

b) whose disability is expected to, or does, give rise to a long-term need for specialized health, mental health, developmental disabilities, social or other related services.

O. **Change of Situs.** The situs of the property of any trust created hereunder may be maintained in any jurisdiction that is appropriate to the trust purposes and its administration, in the discretion of the Trustee (other than an Interested Trustee), and thereafter transferred at any time or times to any such jurisdiction selected by the Trustee (other than an Interested Trustee) in accordance with applicable state law, which may include court approval of the transfer or adequate notice to trust beneficiaries. Upon any such transfer of situs, the trust estate of that trust may thereafter, at the election of the Trustee (other than an Interested Trustee) of said trust, be administered exclusively under the laws of (and subject, as required, to the exclusive supervision of the courts of) the jurisdiction to which it has been transferred. Accordingly, if the Trustee (other than an Interested Trustee) of any trust created hereunder elects to change the situs of any such trust, said Trustee is hereby relieved of any requirement to qualify in any other jurisdiction and of any requirement to account in any court of such other jurisdiction.

P. **Certain Survivorship Rules.** A person (the "Non-Skip Person") shall not be deemed to have been alive on the date of any distribution from or any termination of any interest in a trust under this Agreement or any other event covered by Reg. §26.2651-1(a)(2)(iii) (or any successor thereto) for which date (the "Transfer Date") the date of the Non-Skip Person's death is relevant if (a) the Non-Skip Person actually was alive on the Transfer Date but is not actually alive on the date ninety (90) days following the Transfer Date, and (b) the existence of a condition of survivorship causes another person who otherwise would be assigned to a generation below that of the Non-Skip Person to be assigned to the generation of the Non-Skip Person for purposes of the Federal tax on generation-skipping transfers.

ARTICLE XXXI
Manifestation of Trustee's Actions

When a Trustee takes action that is authorized hereunder and such action does not involve the participation of another person with respect to such action, the Trustee may (but shall not be required to) execute, within a reasonable time of taking such action, an acknowledged, written instrument describing the action taken, which instrument shall be maintained

with the trust records and either filed in the court having jurisdiction over the trust or delivered to one or more of the adult and competent beneficiaries then eligible or entitled to distributions of income or principal of such trust or, if there is no such beneficiary, to one or more of the parent(s), guardian(s) of the person, conservator(s) or committee of the minor or incompetent beneficiaries then eligible or entitled to distributions of income or principal of such trust. Failure to execute or to file or deliver the instrument shall not make the action taken by a Trustee void, voidable or ineffective, and the Trustee or Trustees, as the case may be, shall not be subject to any liability or surcharge for failure to document such action.

ARTICLE XXXII
Savings Clause

Should any of the provisions or directions of this Agreement fail or be held ineffectual or invalid for any reason, it is the Grantor's desire that no other portion or provision of this Agreement be invalidated, impaired or affected thereby, but that this Agreement be construed as if such invalid provision or direction had not been contained therein.

ARTICLE XXXIII
Captions

The captions used in this Agreement are inserted only as a matter of convenience and for reference and in no way define, limit or describe the scope of this Agreement or the intent of any provision therein.

IN WITNESS WHEREOF, the Trustee and the Grantor have signed this Agreement, effective the day and year first above written and executed by each of them on the dates set forth below.

Dated: March _______, 2016

____
Howard M. Zaritsky, as Grantor

Dated: March _______, 2016

____
Steve Gorin, as General Trustee

Dated: March _______, 2016

ATTEST: Big Trust Company of Alaska, as Administrative Trustee

By: ___________________________________

____
Name

____
Title

Dated: March _______, 2016

____
Mickey Davis, as Distributions Trustee

Dated: March _______, 2016

____
Steven Trytten, as Investment Trustee

____
Signature of Witness

____
Name of Witness

____
Signature of Witness

____
Name of Witness

STATE OF NEW YORK)
)
NASSAU COUNTY)

I HEREBY CERTIFY that on March _______, 2016, before me, the subscriber, a Notary Public in and for Nassau County, New York, personally appeared Howard M. Zaritsky, as Grantor, personally known to me (or proved to me on the basis of satisfactory evidence) to be the person whose name is subscribed to the foregoing instrument, and acknowledged that the foregoing instrument was executed by Howard M. Zaritsky, as Grantor, for the purposes therein contained.

WITNESS my hand and notarial seal.

Dated: March _______, 2016

____
Notary Public

____
Print Name of Notary

My Commission Expires: _________________

We, Howard M. Zaritsky, the Grantor and ____________________ and ____________________, the witnesses, respectively, whose names are signed to the attached or foregoing instrument, having been sworn, declared to the undersigned officer that the Grantor, in the presence of witnesses, signed the instrument as the Irrevocable Trust, that the Grantor signed or directed another to sign for the Grantor, and that each of the witnesses, in the presence of the Grantor and in the presence of each other, signed the trust as a witness.

____
Howard M. Zaritsky, Grantor

____
Witness

____
Print Name

____
Witness

____
Print Name

Subscribed and sworn to before me by Howard M. Zaritsky, the Grantor, and ____________________ and ____________________, each of whom is a witness, who is personally known to me or who has produced a driver's license as identification on March _______, 2016.

____
Notary Public

____
Print Name of Notary

My Commission Expires: __________________

STATE OF NEW YORK)
)
NASSAU COUNTY)

I HEREBY CERTIFY that on March _______, 2016, before me, the subscriber, a Notary Public in and for Nassau County, New York, personally appeared Steve Gorin, as General Trustee, personally known to me (or proved to me on the basis of satisfactory evidence) to be the person whose name is subscribed to the foregoing instrument, and acknowledged that the foregoing instrument was executed by Steve Gorin, as General Trustee, for the purposes therein contained.

WITNESS my hand and notarial seal.

Dated: March _______, 2016

____
Notary Public

____
Print Name of Notary

My Commission Expires: ________________

STATE OF NEW YORK)
)
NASSAU COUNTY)

I HEREBY CERTIFY that on March _______, 2016, before me, the subscriber a Notary Public in and for Nassau County, New York, personally appeared ___________________, __________________ of Big Trust Company of Alaska, as Administrative Trustee and, being authorized to do so, acknowledged that the foregoing instrument was signed on behalf of Big Trust Company of Alaska, as Administrative Trustee, for the purposes therein contained.

WITNESS my hand and notarial seal.

Dated: March _______, 2016

____
Notary Public

____
Print Name of Notary

My Commission Expires: ________________

STATE OF NEW YORK)
)
NASSAU COUNTY)

I HEREBY CERTIFY that on March _______, 2016, before me, the subscriber, a Notary Public in and for Nassau County, New York, personally appeared Mickey Davis, as Distributions Trustee, personally known to me (or proved to me on the basis of satisfactory evidence) to be the person whose name is subscribed to the foregoing instrument, and acknowledged that the foregoing instrument was executed by Mickey Davis, as Distributions Trustee, for the purposes therein contained.

WITNESS my hand and notarial seal.

Dated: March _______, 2016

____
Notary Public

____
Print Name of Notary

My Commission Expires: ________________

STATE OF NEW YORK)
)
NASSAU COUNTY)

I HEREBY CERTIFY that on March _______, 2016, before me, the subscriber, a Notary Public in and for Nassau County, New York, personally appeared Steven Trytten, as Investment Trustee, personally known to me (or proved to me on the basis of satisfactory evidence) to be the person whose name is subscribed to the foregoing instrument, and acknowledged that the foregoing instrument was executed by Steven Trytten, as Investment Trustee, for the purposes therein contained.

WITNESS my hand and notarial seal.

Dated: March _______, 2016

____
Notary Public

____
Print Name of Notary

My Commission Expires: ______________

WAIVER OF ELECTIVE SHARE AND
COMMUNITY PROPERTY RIGHTS

I, Martha Washington Zaritsky, in exchange for good and valuable consideration, the receipt of which is hereby acknowledged, and the agreement of the Trustees named below to serve in such fiduciary capacity, do hereby waive any and all right, title and interest I may have or otherwise succeed to by reason of community property, equitable distribution, elective share, minimum share, or similar rights as a spouse in and to all property contributed by my Husband, Howard M. Zaritsky, to the irrevocable trust she intends to create soon between herself, as Grantor, and the Trustees named below. This is intended to be and shall constitute a third party beneficiary contract for the benefit of all the beneficiaries under the irrevocable trust and may be enforced by any of those beneficiaries and by the Trustees on behalf of the Trustees.

Dated: March _______, 2016

____
Martha Washington Zaritsky

Accepted by

____
Steve Gorin, General Trustee

____
Big Trust Company of Alaska, Administrative Trustee

____
Mickey Davis, Distributions Trustee

____
Steven Trytten, Investment Trustee

III. Flexibility to Distribute Income to Charity

Background: Assume it is contemplated that the trust's beneficiary will want to make charitable contributions from time to time, and that it is within the trust's purpose to assist in funding these contributions. The Trustee can make distribution to the beneficiary, who would then make the donation and claim a "below the line" deduction that may or may not offset "above the line" income dollar for dollar. Instead, it will probably be more income tax efficient for the trust to distribute the funds directly to charity, if the distribution qualifies for the charitable deduction under Code Section 642(c). Special drafting will be required to make these direct distributions possible. The sample clauses below illustrate three alternate approaches.

Sample Clauses Authorizing Trustee to Distribute Income to Charity:[6]

The following clause tracks the language of Code Section 642(c) that allows distribution of income for a "charitable purpose," and provides a veto power for the Beneficiary.

DISTRIBUTION OF INCOME FOR CHARITABLE PURPOSE
The Trustee may distribute from the gross income of the trust for a purpose specified in Code Section 170 (c) (defining charitable contributions) such amounts as the Trustee determines to be appropriate, taking into consideration the charitable objectives of the grantor[s] and the Beneficiary, as well as the possible income and transfer tax effects of any such distribution; provided, however, that (i) the Trustee shall notify the Beneficiary of the proposed distribution or distributions not less than thirty days prior thereto; and (ii) the Beneficiary shall have an absolute right to veto any such distributions, by providing written notice thereof to the Trustee within twenty days after receive such notice.

As an alternative, the following clause authorizes distributions to charitable organizations. This may not be as broad a standard as a "charitable purpose," but it may be broad enough, and it may be more comfortable and understandable to clients and other advisors.

DISTRIBUTION OF INCOME TO CHARITY
The Trustee may distribute from the gross income of the trust to such one or more organizations described in Code Section 170 (c) (defining charitable contributions) such amounts as the Trustee determines to be appropriate, taking into consideration the charitable objectives of the grantor[s] and the Beneficiary, as well as the possible income and transfer tax effects of any such distribution; provided, however, that (i) the Trustee shall notify the Beneficiary of the proposed distribution or distributions not less than thirty days prior thereto; and (ii) the Beneficiary shall have an absolute right to veto any such distributions, by providing written notice thereof to the Trustee within twenty days after receive such notice.

Sample Clause Granting Beneficiary Power to Appoint Income to Charity: [7]

The beneficiary, in the beneficiary's individual capacity, shall have the continuing discretionary power to Appoint all or any part of the gross income, as such term is used in Code section 642(c) and the regulations and pronouncements thereunder, to one or more Charities; however, no interest in a Benefit Plan or that Benefit Plan's proceeds may be Appointed in a manner that would change the identity of the individual whose life expectancy would otherwise apply under the Minimum Distribution Rules. The beneficiary may authorize his or her agent to exercise this power to Appoint.

Sample Clause Granting Beneficiary Broad Lifetime Power to Appoint That Could Be Used to Appoint Income to Charity: [8]

The beneficiary, while at least ___ years of age, in the beneficiary's individual capacity, shall have the continuing discretionary power to Appoint all or any part of the income, principal, or both of the trust to or for the benefit of any person, but may not increase the authority, if any, to make distributions to or for the benefit of the beneficiary, the beneficiary's estate, the beneficiary's creditors, or the creditors of the beneficiary's estate; however: (a) no interest in a Benefit Plan or that Benefit Plan's proceeds may be Appointed in a manner that would change the identity of the individual whose life expectancy would otherwise apply under the Minimum Distribution Rules, and (b) if the trust is an electing small business trust under Code section 1361(e)(1), the beneficiary may not exercise the power to Appoint in a manner that might cause the

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[6] Contributed by Mickey Davis.
[7] Contributed by Steve Gorin.
[8] Contributed by Steve Gorin. Steve also notes that one might want to expressly mention charities as included in the class of potential appointees.

corporation to violate Code section 1361(b)(1). Any such Appointment may be exercised either to effect immediate distribution to the appointee or to take effect upon the occurrence of a future event, such as the beneficiary's death.[9]

Task Force Comments. In some cases, a trust must be of a specific structure or must not contain certain provisions in order to qualify for certain tax or other special tax treatment. For example, a trust, transfers to which are intended to qualify for the marital deduction for estate and gift tax purposes, must, in general, require that all fiduciary accounting income be distributed to the spouse of the person creating the trust and for no one else during the spouse's lifetime. See Code Section 2056 and 2523.

However, many trusts not intended to qualify for the marital deduction, such as one for descendants, may be very flexible in allowing for the distribution of income and corpus (principal) to the beneficiaries. These trusts may and often should permit distributions to charity. That may be advantageous to the trust beneficiaries for four reasons.

First, under Section 170, individuals may never reduce their taxable income (technically, their adjusted gross income specially computed) by more than 50%. Trusts, under Section 642(c), may be allowed an unlimited deduction (so their taxable income can be reduced to zero) for their gross income paid for a charitable purpose if paid pursuant to the terms of the governing instrument (such as the will or trust agreement). (Nonetheless, it should be noted that¸ under Section 682, the Section 170 adjusted gross income limitations will apply to the trust to the extent the gross income paid to charity consists of unrelated business income.)

Second, the trust is entitled to the income tax deduction for the year such income is paid for a charitable purpose even if paid from income from prior years not previously paid to charity or deemed distributed to charitable beneficiaries pursuant to Sections 651 and 661.

Third, if a payment of gross income for a charitable purpose is made after the close of a tax year of the trust and before the end of the following tax year from gross income earned in the year preceding the year it is paid, the trust is entitled to elect pursuant to Section 642(c)(1) to treat the payment as having been made in such preceding taxable year (that is, the year in which the gross income was earned).

Fourth, an individual cannot reduce his or her net investment income for purposes of the net investment income tax imposed by Section 1411 by making a charitable contribution. However, a trust may reduce its net investment income by paying its gross income to the extent it is treated as consisting of net investment income pursuant to the terms of the trust's governing instrument for a charitable purpose.

Accordingly, it may be appropriate to authorize distributions of gross income to charity. Even though those payments are not mandated, they should qualify as paid pursuant to the terms of the governing instrument. Although it is beyond the scope of this discussion to present the matter in full detail, it may be possible to direct that the payments are first to come from gross income that is not unrelated business income.

The authorization to pay to charity could be granted to the trustee and/or one or more beneficiaries. Even if a beneficiary were deemed to have made the transfer for gift tax purposes, the payment should qualify as charitable gift for gift tax purposes as long as it is made to an organization transfers to which qualify for the gift tax charitable deduction.

When designing a trust that authorizes distributions of income to charity, consider whether checks and balances should be included to ensure the distribution makes sense to both the trustee and the beneficiary. For example, the first clause could be adjusted to require beneficiary consent, and the second clause could be adjusted to require trustee consent. Consent could be required in all cases, or only with respect to certain distributions or appointments (for example, only those made to charities other than public charities).

Depending on the trust purpose, a more restrictive approach (such as the trustee power) could apply until the beneficiary reaches a certain age and then a less restrictive approach (such as the beneficiary's special power of appointment) could apply.

Care should be exercised since the sample clauses shown above could interfere with other trust objectives. For example:

[9] The clause used here is intended to be used when the grantor would have distributed the entire trust outright but instead is leaving it in trust with maximum control given to the beneficiary.

- If creditor protection is one of the objectives of the trust, the trustee distribution approach (with someone other than the beneficiary as trustee) is preferred over granting a special power of appointment to the beneficiary.

- If the trust will be holding S corporation shares:

  - Neither clause is compatible with a QSST, since all income must be distributed to the primary beneficiary; and

  - With non-QSST trusts, consider including a limitation that prevents a distribution of S corporation shares to any charity or other person ineligible to hold S corporation shares.

- Care must be taken to ensure that clauses facilitating distributions to charity do not undermine stretch-out of retirement plans if that is one of the purposes of the trust, thus:

  - With a conduit trust, the clauses may not interfere with requirement that all plan distributions be distributed to the beneficiary.

  - With an accumulation trust, the clauses may not allow distribution of retirement plan assets or accumulations to any charity or other person that could shorten the deferral period.

It is not entirely clear whether or the extent to which the payment to charity must be traced directly to gross income actually received by the trust (or an estate). Compare the following cases with each other: *Old Colony Trust Co. v. Commissioner,* 301 U.S. 379 (1937); *U.S. v. Benedict,* 592 U.S. 692 (1950); *Crestar Bank v. Internal Revenue Service,* 47 F. Supp. 2d 670 (1999); *Van Buren v. Commissioner*, 89 T.C. 1101 (1987); *Riggs National Bank v. U.S.*, 352 F.2d 812 (1965); *Frank Trust of 1931 v. Commissioner of Internal Revenue*, 145 F.2d 411 (1944); *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); *Estate of Esposito v. Commissioner*, 40 T.C. 459 (1963), acq. 1964-1 CB (pt. 1) 4. In any case, it seems that some type of tracing of the contribution to gross income received by the trust (or estate) is required to support a deduction under section 642(c).

This might be problematic when a trust (or a decedent's estate) owns an interest in a "pass through" entity such as a partnership as many hedge fund investment entities are. Income may be imputed to the trust as a partner (or other owner) but without a corresponding receipt of gross income. Indeed, income of a pass through entity is deemed distributed to a partner (or other owner) even if not received and, if and when the income is distributed, it typically is treated as a receipt other than gross income. In any case, to try to establish that gross income from the pass through entity has been paid to charity, it may be appropriate for the trust (or estate) to make its investments in pass through entities through an entity, such as a partnership or LLC, it controls (the "Control Entity"). The Control Entity will be treated as receiving the income from the pass through investment entities. The trust (or estate) will be treated as receiving gross income from the Control Entity and, by funding the Control Entity with cash in addition to the pass through entity investments, it can distribute cash to the trust (or estate) as its partner (or owner) which should satisfy any requirement that the gross income can be traced to what the trust (or estate) in turn distributes to charity.

Please refer to Appendix A[10] for a detailed discussion that explores a number of other interesting and more advanced aspects of the 642(c) deduction, including:

- The 642(c) deduction is allowable from gross income, even if from prior year so long as not yet distributed.

- For a limited time period after close of year-end, an election is available to treat prior year gross income as if distributed to charity.

- The 642(c) deduction is allowed for distributions for charitable purpose, which is a broader standard than for individuals (to charitable organization described in Section 170(c)).

- The 642(c) deduction is generally not limited by percentage of AGI.

[10] *Blattmachr, Boyle, and Fox,* Planning For Charitable Contributions by Estates and Trusts, 2016

- The 642(c) deduction is generally not subject to substantiation requirements under Code section 170.

- Special rules and limitations apply to 642(c) deduction for gross income that is unrelated taxable business income ("UBTI").

- Section 170(f), which limits deductions for partial interests other than remainder in charitable remainder trust, does not apply to 642(c).

- Planning to utilize the 642(c) deduction may be helpful for individuals who live in states that limit or do not allow charitable deductions for purposes of individual state income tax.

Please refer to Appendix B[11] for a detailed discussion of specialized issues that arise with S corporation gross income, including:

- S corporation K-1 income does not support a Code § 642(c) deduction unless the S corporation distributes that income to the estate or trust.

- S corporations are sometimes treated less favorably than other pass-through entities under rules governing 642(c) deduction for gross income that is UBTI, but there are planning ideas that may help.

[11] Gorin, Income Tax Trap – Reduction in Trust's S Corporation Charitable Deduction, 2016.

IV. Flexibility to Allocate Items of Income and Gain Between Trust and Beneficiary

Background: The income tax rules that apply to trusts and individuals are very complicated. Trusts have a highly compressed rate structure, and income tax rates have risen in recent years. Computerized income tax projections may be need to be maintained to guide the trust and its beneficiary(ies) in implementing the distribution strategy that optimizes income tax (balanced, of course, against other purposes of the trust).

Dynasty trusts generally do not mandate distribution of income to the beneficiary. This provides greater flexibility in setting distribution strategy and may also support other trust objectives (for example, to support creditor protection, or to limit distributions that might not serve the trust's purpose).

Gains are allocated to trust accounting principal by default, although the trust can override this default. Including the ability to override this default may provide added flexibility in setting distribution strategy. Special drafting is required to accomplish this. The following sample clauses illustrate how this can be done.

Other techniques are also discussed in this section to increase flexibility in distribution strategy, such as segregating assets that produce one category of income in a separate trust, or allocating deductions more to one class of income than another.

Sample Clause Granting Non-Interested Trustee Discretion to Allocate Certain Gains to Income:[12]

A. **Allocate Gain to Income or Principal.** The Trustee (other than any Interested Trustee) may allocate within the meaning of Reg. §1.643(a)-3(b) to income or to principal, or partly to income and partly to principal, all or part of the realized gains from the sale or exchange of trust assets; provided, however, that, if income is defined under an applicable state statute as a unitrust amount and the trust is being administered pursuant to such statute, the allocation of gains to income must 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 Reg. §1.643(a)-3(b).

B. **Character of Unitrust Amount Paid.** The Trustee (other than any Interested Trustee) may, within the meaning of Reg. §1.643(a)-3(e), specify the tax character of any unitrust amount paid hereunder. The Trustee (other than any Interested Trustee) may take any action that may be necessary in order for such specification to be respected for tax purposes.

C. **Distributions as Paid from Capital Gains.** The Trustee (other than any Interested Trustee and other than the Grantor) may deem, within the meaning of Reg. §1.643(a)-3(e), any discretionary distribution of principal as being paid from capital gains realized during the year. The Trustee (other than any Interested Trustee and other than the Grantor) may take any action that may be necessary in order for such deeming to be respected for tax purposes.

Sample Clause Providing General Authority to Apportion Income and Expenses: [13]

SECTION . APPORTION INCOME AND EXPENSES.

The trustee is authorized to apportion any receipt or disbursement between principal and income, notwithstanding the apportionment that would apply under RSMo[14] 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.

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[12] See Article XXI, Sections O, P, and Q of sample trust contributed by Jonathan Blattmachr.
[13] Contributed by Steve Gorin.
[14] "RSMo" means the Revised Statutes of Missouri, including all amendments thereto and successor laws.

Sample Clause Providing General Authority to Allocate Between Principal and Income, and Additional Authorities to Non-Interested Trustee: [15]

1.1 Allocate Between Principal and Income. The Trustee is authorized to determine what is principal and income of the trust estate and what items shall be charged or credited to either. In making these determinations, the Trustee shall act reasonably and treat the beneficiaries impartially consistent with the Trustee's fiduciary duties, and the Trustee may not exercise these powers in any way that departs fundamentally from traditional principles of income and principal within the meaning of Treasury Regulations Section 1.643(b)-1. No inference of imprudence or partiality shall arise solely because the Trustee exercises the Trustee's discretion to determine what is principal and income in a manner that deviates from default rules of law that arbitrarily allocate fixed percentages of receipts to principal and income.

In addition to the powers vested in the Trustee in the foregoing provisions of this Section __, the Trustee, other than an Interested Person, is further authorized:

(a) To exercise the power to make adjustments between principal and income pursuant to California Probate Code Section 16336[16] (or comparable provision under any other applicable law), subject to the requirements or any further limitations of said Code Section (or comparable provision). For purposes of this Section __ only, the term "Interested Person" shall be deemed to also include a beneficiary of the trust within the meaning of California Probate Code Section 16336(b)(7) (or comparable provision under any other applicable law).

(b) To allocate, within the meaning of Treasury Regulations Section 1.643(a)-3(b), to income or to principal, or partly to income and partly to principal, all or part of the realized gains from the sale or exchange of trust assets; provided, however, that, if income is defined under an applicable state statute as a unitrust amount and the trust is being administered pursuant to such statute, the allocation of gains to income must 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 Treasury Regulations Section 1.643(a)-3(b).

(c) To specify, within the meaning of Treasury Regulations Section 1.643(a)-3(e), the tax character of any unitrust amount paid hereunder if an ordering rule is not provided under applicable state law or this instrument, and take any action that may be necessary in order for such specification to be respected for tax purposes.

(d) To deem, within the meaning of Treasury Regulations Section 1.643(a)-3(e), any discretionary distribution of principal as being paid from capital gains realized during the year and to take any action that may be necessary in order for such deeming to be respected for tax purposes.

1.2 Interested Person.[17] The term "Interested Person," with respect to a trust created hereunder, means: (a) a Settlor, (b) a Current Beneficiary of such trust or a person designated or appointed as an Officer of such trust by a Current Beneficiary unless such person is a Qualified Person with respect to such Current Beneficiary, (c) a Successor Beneficiary of such trust, and (d) a disclaimant of property held by such trust (but such disclaimant shall only be deemed to be an Interested Person with respect to the portion of such trust consisting of the disclaimed property).

1.3 Qualified Person. A person or entity is a "Qualified Person" with respect to an individual (the "Individual") if the person is a corporation, partnership, limited liability company or an individual qualified to act as a trustee in the United States or any other common law jurisdiction. However, a Qualified Person shall specifically exclude: (a) a Settlor, (b) the Individual, (c) a beneficiary of any trust created hereunder, and (d) a person who is a "related or subordinate party" (as such term is defined in Code Section 672) with respect to a Settlor, the Individual or a beneficiary of any trust created hereunder.

Task Force Comments. The clauses shown above illustrate tools that can be applied to optimize the aggregate income tax paid by the trust and its beneficiaries.

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[15] Contributed by Steve Trytten. This clause is similar to Jonathan's, but is more explicit about the scope of power held by an interested person serving as trustee.

[16] The clause integrates California's implementation of the "power to adjust" under the 1997 UPIA.

[17] Steve Trytten's definition of interested person is similar to Jonathan's, except it also generally includes any person designated or appointed as an officer of the trust by a current beneficiary.

To the extent a fiduciary exercises discretion to make (or not make) allocations, tax and non-tax consequences should be considered. A discussion of these potential consequences is beyond the scope the scope of this paper, but for more information see two leading articles in this area:

- Jonathan's article, "The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey," 18th University of Miami (Heckerling) Estate Planning Institute ¶ 1400 (1984).

- Dobris, "Equitable Adjustments in Postmortem Income Tax Planning: An Unremitting Diet of Worms," 65 Iowa L. Rev. 103 (1979).

It is widely believed that income taxes will be higher if an item of income is taxed at the trust level than at the individual level. This belief arises from the low exemptions and compressed income tax brackets that apply to trusts. However, if the individual beneficiary is already in the top income tax bracket, taxation at the trust level will not necessarily increase the overall income tax bill and might even reduce it.

There are many differences in the income tax rules that apply at the trust and individual levels, but as one example, trusts and estates are not subject to the "3% of AGI haircut" of itemized deductions (other than medical expenses, investment interest, casualty and theft losses, or gambling losses).[18]

This is particularly significant if the trust is receiving retirement plan distributions that qualify for the "IRD deduction" for estate taxes paid on the retirement plan.[19] If the trust accumulates the retirement plan distributions, it will benefit from the IRD deduction without application of the 3% haircut. On the other hand, if the trust distributes the retirement plan distributions to the beneficiary, the IRD deduction will follow the distribution, and will be subject to the 3% haircut in the beneficiary's hands.

If the beneficiary is already in the top income tax bracket, overall income taxes will probably be lower if the trust can accumulate the retirement plan distribution. Further, the beneficiary will have a lower AGI and may get better mileage out of his or her other deductions.

A lower AGI may also mean the beneficiary will pay less 3.8% net investment income tax ("NIIT"). Although retirement plan distributions are not directly subject to the NIIT, they can indirectly increase the NIIT pushing the individual beneficiary's modified adjusted gross income ("MAGI") above the threshold at which the tax begins to apply. On the other hand, the NIIT threshold for trusts is so low ($12,401 in 2016), that accumulating taxable retirement plan distributions is unlikely to result in any increase in the trust's NIIT.

Given these advantages related to the IRD deduction and the NIIT, it may make sense in many cases for trusts to accumulate retirement plan distributions (particularly Roth IRA distributions). However, when a trust receives more than one category of income (for example part retirement plan and part non-retirement plan), any distribution that carries income out to a beneficiary is generally considered to carry out a pro rata portion of each category of income. So if the beneficiary will be needing distributions, it may not be possible to accumulate all of the retirement plan distributions.

However, flexibility to accumulate retirement plan distributions is possible if retirement and non-retirement assets are segregated in separate discretionary trusts. Code Section 643(f) must be considered in designing the separate trusts. Under this section, two trusts are treated as one trust if (i) they have substantially the same grantors and primary beneficiaries; and (ii) a principal purpose of such trusts is the avoidance of income tax. This Section's original purpose of limiting multiple "bracket rides"[20] is less an issue now that trust brackets are severely compressed.

Section 643(f) shouldn't apply in this situation. This two-trust arrangement is not the abusive "multiple bracket ride" strategy that Section 643(f) was designed to curtail. The primary purpose in creating the separate retirement plan trust is to address specialized minimum distribution rules that apply to those assets. The separate retirement plan trust will be an accumulation see-through trust, which requires specialized drafting that should only apply to retirement assets and not to non-

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[18] IRC § 68.

[19] IRC § 691(c).

[20] Estelle Morris Trusts v. Comm'r, 51 TC 20 (1968), aff'd per curiam, 427 F2d 1361 (9th Cir. 1970) (twenty trusts for two beneficiaries recognized as separate trusts). The IRS succeeded in consolidating numerous multiple trusts in two earlier cases, Sence v. United States, 394 F2d 842 (1968) (nineteen trusts for a single beneficiary), and Boyce v. United States, 296 F2d 731 (5th Cir. 1961) (ninety identical trusts for one beneficiary).

retirement assets. For example, beneficiaries will be limited either by age or by class, as will the permissible appointees under any power of appointment. It will also be necessary to track accumulations that came from retirement plan distributions and treat them separately from other accumulations.

To assert that the two-trust arrangement has a principal purpose of avoiding income tax seems a tough hill to climb when one considers that part of the tax benefit of the two-trust arrangement is tax deferral (not avoidance) through stretched-out retirement plan distributions and possible reduction in the NIIT (which is not an income tax).

Whether or not a two-trust arrangement is used, it may also be helpful to focus on how indirect expenses (expenses that are not directly allocable to a particular asset or activity) are allocated among various categories of income. If a trust has tax-exempt interest income a portion of indirect expenses is deemed allocable to tax-exempt interest and is disallowed.[21] Otherwise, the trustee may allocate those expenses against various categories of income in any fashion.[22]

[21] IRC § 265; Reg. §1.652(b)-3(b).
[22] Treas. Regs. § 1.662(c)-4(e).

V. Maximizing "Above the Line" Deductions

Background: A trust is allowed "above the line" deductions for expenses incurred in connection trust administration that would not have been incurred if the property were not held in the trust.[23] The balance of the trust's expenses are likely to be treated as miscellaneous itemized deductions, deducted "below the line" and subject to a "2% of AGI floor" (and disallowed as a deduction for alternative minimum tax).

The rules for determining the expenses "that would not have been incurred if the property were not held in trust" were the subject a series of court cases and two sets or proposed regulations before they were finalized with final regulations issued in 2014.[24] Among other things, these regulations require that certain trustee, legal, or other fees need to be "unbundled" to determine the appropriate portion that can be deducted "above the line."

There is not much that can be done in the drafting of a trust to maximize "above the line" deductions, other than preserving flexibility in the trustee's ability to hire outside advisors and to receive compensation. For example, if an outside investment advisor is paid separately for the investment duties that would have been incurred even if the property were not in trust, then the trustee's fees may not get cut back.

[23] IRC § 67(e). "Above the line" deduction refers to a deduction taken from gross income to arrive at adjusted gross income ("AGI").

[24] TD 9664, 79 Fed. Reg. 26,616, adopting Treas. Regs. § 1.67-4 (May 9, 2014).

VI. Minimizing Exposure to 3.8% Net Investment Income Tax

Background: The 3.8% tax on net investment income[25] adds another layer of tax to trusts and beneficiaries. It also complicates the process of optimizing income tax between the trust and its beneficiary(ies) because the threshold at which the tax applies is much lower for trusts than it is for individuals.

Task Force Comments.

Please see Appendix C[26] for a detailed discussion of how the 3.8% tax on net investment income can impact trusts, including:

- How can a Trustee to satisfy the material participation requirements to avoid the tax, and what documentation is recommended.

- How distributions of gross income for a charitable purpose that qualify for the Section 642(c) deduction can reduce the 3.8% tax.

The 3.8% tax can be reduced by any expense that can be deducted "above the line," such as Trustee fees. From a drafting perspective, it will be helpful to avoid any blanket prohibition on trustee compensation. A beneficiary or other family member who might otherwise waive trustee fees might appreciate the flexibility to take fees if it produces net income tax savings.

However, in the absence of a blanket prohibition of fees, the trustee who prefers not to take fees needs to be mindful that there may be a limited time period for the fiduciary to waive fees without income or gift tax consequence.[27] It will also be helpful if the trust instrument addresses the manner in which a trustee waives fees.

Sample Clause Setting Trustee Compensation and Providing When and How Trustee Can Waive Fees: [28]

SECTION . COMPENSATION OF TRUSTEE.

(a) Individual Trustee. An individual trustee, other than my spouse or me while I am living, is entitled to receive compensation out of the assets of the trust estate. The amount of the individual's compensation shall be reasonable in view of the time required of the individual, the nature and value of the assets in the trust estate and the amount of compensation provided for comparable services for comparable trusts in the market where the trust is situated, under the published fee schedules of corporate trustees in effect at the time the individual trustee's services are rendered.

(b) Corporate Trustee. A corporate trustee shall receive such compensation for its services as trustee as provided for in its published schedule of fees in effect at the time such services are rendered, or such lesser amount as it may, from time to time, agree. Anything herein to the contrary notwithstanding, no corporate trustee shall be entitled to a termination fee, a distribution fee, or a fee resulting from the resignation or removal of such corporate trustee.

(c) Any Trustee. Any trustee may waive its compensation, either expressly or by implication, in whole or in part. Any trustee, whether individual or corporate, is entitled to be reimbursed for such expenses as may be incurred by the trustee in connection with the administration of the trust.

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[25] IRC § 1411.
[26] Gorin, Trusts and the 3.8% Tax on Net Investment Income.
[27] Rev. Rul. 66-167, 1966-1 C.B. 20; *Breidert v. Commissioner*, 50 T.C. 844, 848 (1968).
[28] Contributed by Steve Gorin.

VII. Grantor Trust Status

Background: Drafting to make an inter vivos irrevocable trust a grantor trust under Code sections 671-677 can be complicated. This section presents multiple sample forms for consideration.

Whether Swap Power is Held by Grantor or Third Party. The power, held in a non-fiduciary capacity, to reacquire trust property by substituting other property of equivalent value (the "swap power") plays a prominent role in many practitioners' grantor trust forms. There has been concern over the years as to whether this power could cause estate inclusion if it extends to life insurance on the grantor's life or to stock in a controlled corporation that is subject to Code Section 2036.

The IRS has conceded that a grantor's retained swap power does not result in inclusion of the assets subject to the power under Code Sections 2036 and 2038,[29] and does not result in inclusion of life insurance on the grantor's life under Code Section 2042(2).[30]

Could a grantor's retained swap power cause inclusion of voting stock in a controlled corporation under Code Section 2036(b)? Some practitioners believe that this is not a concern, but others are not so sure and think that the safest course is to vest the swap power in someone other than the grantor.[31] The first sample clause below illustrates a third party swap power.

Sample Grantor Trust Form (Third Party Holds Swap Power):[32]

ARTICLE XXVII
The Selector

The Grantor appoints Jonathan G. Blattmachr or other person while acting as a Trust Protector hereunder as the Selector. Until the Grantor's death, the Selector is authorized, acting in an individual capacity and not in a fiduciary capacity, at any time and from time to time, to add one or more of organizations described in Code Sec. 2055 to the class of beneficiaries of any trust under this Agreement; provided, however, that in no event may the Selector add the Selector to such class of beneficiaries; provided, further, that in no event may the Selector add to the class of beneficiaries of any trust hereunder which may qualify (by election or otherwise) for the Federal marital deduction.

Any Selector may cease to act as Selector by delivery of a written and acknowledged notice to the Trustee. If the Selector should cease to act for any reason without having fully released the power to add to the class of beneficiaries pursuant to this Article, the successor Selector shall be such individual (other than the Grantor or any person who may be added as a beneficiary pursuant to this Article or any person who is a related or subordinate party within the meaning of Code Sec. 672(c) with respect to the Grantor or any person who may be added as a beneficiary) as shall be designated by a written and acknowledged instrument executed by the Trustee. If at any time prior to the complete release of the power to add to the class of beneficiaries under this Article there is no Selector acting hereunder, the Trustee (but acting in an individual capacity and not in a fiduciary capacity) shall exercise the Selector's powers under this Article until the appointment of a successor Selector as provided in this Article.

The Selector may at any time during the Grantor's lifetime release such power, in whole or in part, by delivery of an acknowledged instrument in writing to the Grantor releasing such power. Any such release made by the Selector shall be irrevocable, and shall be binding upon all current and successor Trustee and the current and successor Selector and all persons interested hereunder, and no person shall thereafter have the power to add to the class of beneficiaries under this Article to the extent of such release.

[29] Rev. Rul. 2008-22, 2008-16 I.R.B. 796. Although the ruling holds that inclusion does not arise under § 2036, there is no analysis devoted to closely-held voting stock. Thus, the holding may not necessarily extend to § 2036(b).
[30] Rev. Rul. 2011-28, 2011-49 I.R.B. 830.
[31] See *Danforth* and *Zaritsky,* BNA Portfolio E,G&T #819-1st, Section XII.C.3. for a succinct argument supporting the position that a third party who is non-adverse may hold this power.
[32] See Articles XXVII - XXIX of sample trust contributed by Jonathan Blattmachr.

ARTICLE XXVIII
Power to Substitute Property

The Grantor appoints Jonathan G. Blattmachr or other person while acting as a Trust Protector hereunder as the Substitutor. During the Grantor's lifetime, the Substitutor shall have the power, exercisable at any time and from time to time in a non-fiduciary capacity (within the meaning of Code Sec. 675(4)) without the approval or consent of any person in a fiduciary capacity within the meaning of that section, to acquire or reacquire any asset or assets forming part of the trust estate of any trust held under this Agreement (other than any direct or indirect interest in stock that would, by reason of such power of substitution, be included in the gross estate of the Substitutor for Federal estate tax purposes under Code Sec. 2036(b)) by substituting other property of an equivalent value, determined as of the date of such substitution. With respect to any such "2036(b)" stock described in the immediately preceding sentence, the Trustee shall appoint another individual, who is not a person in whose estate such stock would be so included if such person held the power, directly or indirectly, to vote such stock, to hold such power of substitution with respect to such assets, such person so appointed with respect to such assets being the "Substitutor" only with respect thereto. The Grantor directs that this power is not assignable, and any attempted assignment will make this power void. Without reducing or eliminating the fiduciary duties imposed on the Trustee hereunder or by applicable law, the Substitutor shall exercise this power to substitute property by certifying in writing that the substituted property and the trust property for which it is substituted are of equivalent value, and the Trustee shall have a fiduciary obligation to ensure the Substitutor's compliance with the terms of this power by being satisfied in advance of completing the substitution that the properties acquired and substituted are in fact of equivalent value, within the meaning of Revenue Ruling 2008-22. This power to substitute property cannot be exercised in a manner that can shift benefits among the trust beneficiaries. Without limiting the foregoing prohibition upon shifting benefits among trust beneficiaries, the Trustee shall have, with respect to any trust which is not being administered as a unitrust or the distributions from which are not limited to discretionary distributions of principal and income (so that the power to reinvest the principal of the trust and the duty of impartiality are not required in order to avoid this power of substitution potentially causing a shift of benefits among trust beneficiaries, all within the meaning of Revenue Ruling 2008-22), the power to reinvest the principal of the trust and the duty of impartiality with respect to trust beneficiaries at all times while this power of substitution is in effect. The foregoing grant of a power of reinvestment and imposition of a duty of impartiality are included herein for compliance with Revenue Ruling 2008-22, and whenever such power and duty are not granted and imposed under this Article, the remaining provisions of this Agreement shall determine whether and to what extent such power and duty are granted and imposed. The Substitutor may at any time during the Grantor's lifetime release such power, in whole or in part, by delivery of an acknowledged instrument in writing to the Trustee. Any such release made by the Substitutor shall be irrevocable, and shall be binding upon all current and successor Trustees, the current and any successor Substitutor, and all persons interested hereunder, and no person shall thereafter have the power to substitute trust property under this Article to the extent of such release. Any Substitutor may cease to act as Substitutor by delivery of a written and acknowledged notice to the Trustee. If the Substitutor should cease to act for any reason without having fully released the power to substitute property as provided under this Article, and if no successor Substitutor has otherwise been named, the successor Substitutor shall be such individual as shall be designated by a written and acknowledged instrument executed by the Trustee. If at any time prior to the complete release of the power of substitution there is no Substitutor acting hereunder, the Trustee (but acting in an individual capacity and not in a fiduciary capacity) shall exercise the Substitutor's powers under this Article until the appointment of a successor Substitutor as provided in this Article.

ARTICLE XXIX
Power to Compel Trustee to Loan Without Adequate Security

The Grantor appoints Jonathan G. Blattmachr or other person while acting as a Trust Protector hereunder as the Loan Director. During the Grantor's lifetime, the Loan Director shall have the power, exercisable at any time and from time to time in a non-fiduciary capacity (within the meaning of Code Sec. 675) without the approval or consent of any person in a fiduciary capacity within the meaning of that section, to compel the Trustee to loan some or all of the trust property to the Grantor without adequate security within the meaning of Code Sec. 675(2) although with adequate interest within the meaning of that section. The Grantor directs that this power is not assignable. In the event that Jonathan G. Blattmachr or other person acting as a Trust Protector hereunder dies before the Grantor dies, the successor Loan Director shall be such individual (other than the Grantor, any person acting as a Trustee under this instrument or anyone who is an adverse party within the meaning of Code Sec. 672) whom Jonathan G. Blattmachr or other person acting as a Trust Protector hereunder shall have designated by instrument in writing. Any person other than Jonathan G. Blattmachr or other person acting as a Trust Protector hereunder acting as a Loan Director hereunder shall also have the power to name a successor Loan Director by an instrument in writing. In the event that no one else is acting as a Loan Director hereunder, the oldest individual acting as a Trustee hereunder (or if none, the corporation or other entity acting as Trustee hereunder) shall be the Loan Director but acting only in a non-fiduciary capacity.

The person acting as the Loan Director hereunder may at any time during the Grantor's lifetime release such power, in whole or in part, by delivery of an acknowledged instrument in writing to the Grantor releasing such power. Any such release made by the Loan Director shall be irrevocable, and shall be binding upon all current and successor Trustees and the current and any successor Loan Director and all persons interested hereunder, and no person shall thereafter have the power to compel the Trustee to make loans to the Grantor without adequate security.

Sample Grantor Trust Forms (Swap Powers for Single Grantor, Two Grantors, Swap Power by Third Party, and Community Property Clause):[33]

SINGLE GRANTOR SWAP POWER:

Notwithstanding any contrary provision, I may reacquire any of my grantor property from any trust created under this instrument by substituting other property of an equivalent value. For purposes of the preceding, my "grantor property" means the property (or portion of property) with respect to which I am the grantor for federal income tax purposes. I may irrevocably release this power in whole or in part by notice to the Trustee. I may exercise (or release) this power: (i) in a non-fiduciary capacity and without the consent of any person; and (ii) through a duly appointed guardian or a duly authorized attorney-in-fact. I hold this power in a non-fiduciary capacity, and may exercise it without the approval or consent of the Trustee or any other person. However, the Trustee, acting in a fiduciary capacity shall have a duty to ensure that the property substituted has equivalent value, and to that end, shall provide me with sufficient information regarding the assets of the trust to enable a suitable valuation of the assets to be performed. I intend that the trusts created under this instrument constitute "grantor trusts" for income tax purposes under the Code whenever (and to the extent that) this power exists but not otherwise; this instrument shall be administered and interpreted in a manner consistent with this intent and any provision which conflicts with this intent shall be deemed ambiguous and shall be construed, amplified, reconciled, or ignored as needed to achieve this intent.

TWO GRANTOR SWAP POWER:

Notwithstanding any contrary provision, each of us who is then living may reacquire any of his or her grantor property from any trust created under this instrument by substituting other property of an equivalent value. For purposes of the preceding, a person's "grantor property" means the property (or portion of property) with respect to which that person is the grantor for federal income tax purposes. Each of us may irrevocably release this power in whole or in part by notice to the Trustee. Each of us may exercise (or release) this power: (i) at any time and any number of times; (ii) in a non-fiduciary capacity and without the consent of any person; and (iii) through a duly appointed guardian or a duly authorized attorney-in-fact. Each of us holds this power in a non-fiduciary capacity, and may exercise it without the approval or consent of the Trustee, the other of us, or any other person. However, the Trustee, acting in a fiduciary capacity shall have a duty to ensure that the property substituted has equivalent value, and to that end, shall provide us with sufficient information regarding the assets of the trust to enable a suitable valuation of the assets to be performed. We intend that the trusts created under this instrument constitute "grantor trusts" for income tax purposes under the Code whenever (and to the extent that) this power exists but not otherwise; this instrument shall be administered and interpreted in a manner consistent with this intent and any provision which conflicts with this intent shall be deemed ambiguous and shall be construed, amplified, reconciled, or ignored as needed to achieve this intent.

SWAP POWER EXCISED BY THIRD PARTY:

Notwithstanding any contrary provision, the Administrative Agent named below may reacquire any of my grantor property from any trust created under this instrument by substituting other property of an equivalent value. For purposes of the preceding, my "grantor property" means the property (or portion of property) with respect to which I am the grantor for federal income tax purposes. The Administrative Agent may irrevocably release this power in whole or in part by notice to the Trustee. The Administrative Agent may exercise (or release) this power: (i) at any time and any number of times; (ii) in a non-fiduciary capacity and without the consent of any person; and (iii) through a duly appointed guardian or a duly authorized attorney-in-fact. The Administrative Agent holds this power in a non-fiduciary capacity, and may exercise it without the approval or consent of the Trustee or any other person. However, the Trustee, acting in a fiduciary capacity shall have a duty to ensure that the property substituted has equivalent value, and to that end, shall provide the Administrative Agent with sufficient information regarding the assets of the trust to enable a suitable valuation of the assets to be performed. I intend that the trusts created under this instrument constitute "grantor trusts" for income tax purposes under the Code whenever (and to the extent that) this power exists but not otherwise; this instrument shall be administered and interpreted in a manner consistent with this intent and any provision which conflicts with this intent shall be deemed ambiguous and shall be construed, amplified, reconciled, or ignored as needed to achieve this intent. For purposes of this instrument, the Administrative Agent shall be [Name of Administrative Agent], or if his/she fails to serve, [Name of Successor Administrative Agent]. Until the power conferred in this Section is wholly released, each Administrative

[33] Contributed by Mickey Davis.

Agent shall designate a successor Administrative Agent to act in the event that the person(s) named above die, resign, or otherwise cease to act.

COMMUNITY PROPERTY ISSUES IN GENERAL:

Character Of Beneficial Interests. All interests provided under this instrument (whether principal or income, and whether distributed or held in trust): (i) shall belong solely to the particular estate (not any beneficiary) prior to actual distribution, and (ii) upon distribution, shall be received as a gift from me to the beneficiary, and shall not be the community property of the beneficiary and his or her spouse.

Sample Grantor Trust Form (Swap Power; Grantor is Trustee):[34]

SECTION . **POWER TO EXCHANGE ASSETS.** During my lifetime, I, acting alone in my individual capacity and not in any fiduciary capacity, shall have the power, with respect to any trust created under this Agreement, to reacquire the trust corpus by substituting other property of an equivalent value. The power described in this Section may be exercised by me or by an agent of mine appointed under a durable power of attorney or through any other means, whose actions shall be conclusive and binding. Neither the consent of the trustee nor the consent of any other person shall be required. Upon exercise of this power, I shall notify the person designated in Section __ to succeed me as trustee, and such person shall serve as special trustee for purposes of this Section, ignoring any exercise by me of powers under Section __; my spouse shall hold all powers described in Section __ to change the person(s) designated to serve as this special trustee as if I were incapacitated; and, if there is a total vacancy that my spouse does not fill, then I shall appoint a special trustee who is not a related or subordinate party (as defined in Code section 672(c)) with respect to me. This special trustee shall comply with Rev. Rul. 2008-22 or Rev. Rul. 2011-28, as applicable, including satisfying himself or herself that the properties acquired and substituted pursuant to this Section are in fact of equivalent value and that the that the proposed substitution will not have the effect of shifting beneficial interests among trust beneficiaries. The power described in this Section may be released by a written statement executed by me or by an agent appointed under a durable power of attorney or through any other means (whose actions shall be conclusive and binding), and delivered to the trustee.

Sample Grantor Trust Form (Married Settlors Funded With Community Property): [35]

1.1 Grantor Trust Provisions. For purposes of this Section __, the term "Grantor Trust Rules" refers to Code Sections 671 through 679 and comparable rules of any applicable state or other jurisdiction.

(a) **Settlor's Grantor Portion**. A Settlor's "Grantor Portion" refers to that portion of the trust estate as to which such Settlor is the grantor. If the Settlors transferred property in trust that was owned by them as joint tenants with right of survivorship or as community property, then each Settlor is deemed to be the grantor as to a 50% portion of said property.

(b) **Substitution Power.** Subject to Section [Cross references our Controlled Corporation Stock provision] regarding Controlled Corporation Stock, each Settlor, acting in a non-fiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity, shall have the power to reacquire all or any part of his or her Grantor Portion of any trust created hereunder by substituting other property of equivalent value, determined as of the date of such substitution (such power vested in each Settlor is referred to in this instrument as a Settlor's "Substitution Power"), subject to the following:

(i) No Settlor's Substitution Power may be exercised in a manner that shifts benefits among the trust beneficiaries within the meaning of Revenue Rulings 2008-22 and 2011-28.

(ii) Without reducing or eliminating the fiduciary duties imposed upon the Trustee, a Settlor shall exercise this Substitution Power by certifying in a written instrument that the substituted property and the trust property for which it is substituted are of equivalent value, and the Trustee, other than a Settlor, shall have a fiduciary obligation to ensure, with respect to any exercise of the Substitution Power, that the properties acquired and substituted by such Settlor have equivalent value within the meaning of Revenue Rulings 2008-22 and 2011-28.

[34] Contributed by Steve Gorin.
[35] Contributed by Steve Trytten.

(iii) Each Settlor may, acting in a non-fiduciary capacity, irrevocably relinquish his or her Substitution Power. Any such relinquishment shall be made in a written instrument delivered to the other Settlor, if then living, and each then serving Trustee, and shall be effective as of the date of its execution.

(iv) Unless relinquished sooner, the Substitution Power with respect to a Settlor's Grantor Portion shall terminate at that Settlor's death.

(c) **Power to Vest Borrowing Power.** The Trust Protector shall have the power to vest each Settlor with the power to borrow all or some of such Settlor's Grantor Portion of any trust created hereunder without the requirement of adequate security notwithstanding any provision to the contrary in Section [Cross references to our Power to Lend provision] (the Trust Protector's power is referred to in this instrument as the "Power to Vest Borrowing Power"). The Power to Vest Borrowing Power shall be exercised by the Trust Protector in a written instrument delivered to each then living Settlor and each then serving Trustee. The Trust Protector may irrevocably disclaim or release the Power to Vest Borrowing Power in a written instrument delivered to each then living Settlor and each then serving Trustee, and such release or disclaimer shall be effective as of the date of its execution, unless a later date is specified in such written instrument.

(d) **Power to Add Charitable Beneficiaries.** Until the death of a Settlor, the Trust Protector shall have the power to designate one or more Charities as additional beneficiaries ("Power to Add Charitable Beneficiaries") of the principal and/or income of that Settlor's Grantor Portion of any trust created hereunder, and to specify prospectively what amounts or proportions of the income or principal (or both) of such Settlor's Grantor Portion, without limitation, shall be distributed to each such additional beneficiary or beneficiaries and the time or times for distributions. In addition, the Trust Protector shall have the power to change or terminate any prior designation made pursuant to the Trust Protector's Power to Add Charitable Beneficiaries. Any designation of a Charity as a beneficiary, change to such designation, or termination of beneficiary status of a Charity under this Section __ shall be effectuated by the Trust Protector in a written instrument delivered on or before the death of such Settlor to each Charity affected thereby, to each then living Settlor, and to each then serving Trustee. The Trust Protector may irrevocably disclaim or release the Power to Add Charitable Beneficiaries in a written instrument delivered to each then living Settlor and each then serving Trustee, and such release or disclaimer shall be effective as of the date of its execution unless a later date is specified in such written instrument.

(e) **Intention to Be Treated as Owner of Grantor Trust Portion**. For so long as any of the Substitution Power, the Power to Vest Borrowing Power, or the Power to Add Charitable Beneficiaries is in effect for all or any part of a Settlor's Grantor Portion of any trust created hereunder (such Settlor's "Grantor Trust Portion"), such Settlor intends that he or she be treated for income tax purposes as the owner (within the meaning of the Grantor Trust Rules) of such Grantor Trust Portion. *The Trustee is urged to consult with tax advisors as early as possible to determine the income tax reporting requirements for each trust created hereunder that is a grantor trust.*

2. Office of Special Agent. The provisions of this Section apply to the office of Special Agent.

2.1 Selection of Special Agent; Successors. The Settlors intend that the Trustee of each trust hereunder have the ability to appoint a Special Agent on an "as needed" basis whose only purpose would be to hold and have the ability to exercise the powers set forth below. A Special Agent who so serves shall serve solely for such purposes and shall serve in a non-fiduciary capacity.

The office of Special Agent shall be vacant at the time an irrevocable trust is first established. If at any time the office of Special Agent is vacant, the Trustee shall have the power to select one or more persons to so serve who are (a) Qualified Persons[36] with respect to each then living Settlor, each Current Beneficiary, and each Successor Beneficiary of such trust, and (b) not currently serving as a Trustee or Trust Protector.

Any such appointment shall be made in a written instrument delivered to the appointee and filed with the records of the trust. Said appointee assumes the office of Special Agent upon the delivery of written acceptance to the Trustee of such office and remains in office until said Special Agent resigns or is otherwise unwilling or unable to serve.

[36] Another provision not shown here provides that a person or entity is a "Qualified Person" with respect to an individual (the "Individual") if the person is a corporation, partnership, limited liability company or an individual qualified to act as a trustee in the United States or any other common law jurisdiction. However, a Qualified Person shall specifically exclude: (a) either Settlor, (b) the Individual, (c) a beneficiary of any trust created hereunder, and (d) a person who is a "related or subordinate party" (as such term is defined in Code Section 672) with respect to either Settlor, the Individual or a beneficiary of any trust created hereunder.

2.2 Non-Fiduciary Capacity. The powers vested in the Special Agent shall be held in a non-fiduciary capacity. Thus, the Special Agent is not a Trustee or a Fiduciary and has no duty to the beneficiaries of the trust. Further, the Special Agent is not liable or accountable as a Trustee or Fiduciary when performing or declining to perform the express powers granted to the Trust Protector under this instrument. The Settlors realize that pursuant to the terms of this instrument, an individual serving as Special Agent may be concurrently serving as a Trustee or (or in any other fiduciary capacity under this instrument), and as a result, may hold some powers in a fiduciary capacity and others in a non-fiduciary capacity, and intends this result.

2.3 Powers of Special Agent. The Special Agent shall have the following powers, which may be exercised (or not exercised) in the Special Agent's sole discretion:

(a) During any period that either Settlor is treated as the owner of all or any portion of the assets of a trust hereunder for purposes of Code Sections 671 through 679, the Special Agent shall have the power to vest divest, or revest the Trust Protector with the power, exercisable in the Trust Protector's sole discretion, to apply (or not apply), all, any portion, or none of said assets, to pay all, any portion, or none, of any personal income tax liability imposed on such Settlor under Code Sections 671 through 679 (or comparable provisions of any other state or jurisdiction) with respect to the income or other income tax attributes arising from said assets and from any disposition of any of said assets, subject to the requirement that any such payment must be made directly to the taxing authority and may not be made to such Settlor.[37] The Special Agent, Trust Protector, and Trustee are urged to consult with tax advisors in advance of vesting this power in the Trust Protector to evaluate any tax implications that might result from vesting this power in the Trust Protector, or from the Trust Protector's exercise of this power.

(b) The Special Agent shall have the power to revest the Trust Protector with any one or more of the powers as the Trust Protector may have previously relinquished or restricted; provided, however, that the Special Agent may not revest the Trust Protector with the Power to Vest Borrowing Power or the Power to Add Charitable Beneficiaries described in Section __ if the Trust Protector has relinquished such power.

Any exercise of said powers by the Special Agent shall be made in a written instrument delivered to the Trustee or otherwise filed with the records of the trust, and shall be effective as of the date of its execution.

2.4 Resignation. Each Special Agent shall have the right to resign by delivering written notice of his, her or its resignation to the Trustee.

2.5 Compensation. Each Special Agent shall be entitled to receive reasonable compensation for duties performed hereunder and shall be reimbursed for reasonable expenses incurred on behalf of the trust.

2.6 Advancement of Expenses; Indemnification of Special Agent. Expenses incurred by any Special Agent shall be advanced, and any Special Agent who is an individual, other than an individual who is a Professional Trustee (as defined in Section [Cross references our definition of Professional Trustee found in our Exoneration provision]), shall be held harmless and indemnified, in the same manner as if said Special Agent were a "Trustee" within the meaning of Section [Cross references our Exoneration provision], subject to the limitations contained therein.

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[37] The Special Agent is authorized to activate a so-called "tax reimbursement power," that would be held by the Trust Protector. The power is discretionary, consistent with the requirements of Rev. Rul. 2004-64, 2004-2 CB 7. However, caution is advised before activating such a power. Depending on the applicable state law, the existence of such a power may cause trust property to be reachable by the grantor's creditors. To the extent the grantor's creditors can reach the trust property, the property is includible in the grantor's estate, which is normally inconsistent with the estate planning objectives. To avoid estate inclusion, it may be possible to move the trust to a situs that will not allow creditors to reach the property.

VIII. Flexibility to Qualify as Eligible Trust to Hold S Corporation Shares

Background: Any trust that may hold S corporation shares needs flexible mechanisms to allow the trust to maintain compliance as an eligible S corporation shareholder as circumstances change.

Sample Clause Authorizing Non-Interested Trustee to Act to Preserve S Corporation Shareholder Status:[38]

ARTICLE XXII
S Corporation Stock

Before the date on which any "S Corporation Shares" (defined below) otherwise would pass to or be treated as held by an "Ineligible Trust" (defined below), the Trustee (excluding, however, any Interested Trustee) may elect to hold these S Corporation Shares in one or more separate trusts or shares as set forth in this Article. The Trustee (excluding, however, any Interested Trustee) may elect to hold such S Corporation Shares under the paragraph entitled "Qualified Subchapter S Trusts" or the paragraph entitled "Electing Small Business Trusts," as the Trustee (excluding, however, any Interested Trustee) shall deem appropriate, considering the changes that such provisions would require from the terms and conditions under which such shares otherwise would be held under this Agreement.

A. **Qualified Subchapter S Trusts.** Any S Corporation Shares held under this paragraph shall be on the following terms:

1. Each trust held under this paragraph shall be a separate trust or substantially separate and independent share, as defined in Code Sec. 1361(d)(3), held for the benefit of one beneficiary. Any reference in this paragraph to a beneficiary's separate trust shall refer equally to any substantially separate and independent trust share.

2. Until the "QSST Termination Date" (defined below), the Trustee shall annually distribute all the trust's "Net Income" (defined below) to the sole beneficiary of each trust held under this paragraph, together with as much of that trust's principal as is appropriate under the standard contained in the trust which otherwise would have held such S Corporation Shares. The Trustee shall not distribute income or principal to anyone other than the beneficiary to whom Net Income is distributable until the QSST Termination Date.

3. Upon the QSST Termination Date, the Trustee shall distribute the remaining trust assets to the beneficiary to whom Net Income was then distributable, if then living, or otherwise in accordance with the terms of the Trust which would otherwise have held such S Corporation Shares.

4. The Trustee shall notify the sole beneficiary of each trust held under this paragraph that he or she must timely and properly elect under Code Sec. 1361(d)(2) to cause such trust held to be treated as a Qualified Subchapter S Trust for Federal income tax purposes, and if the beneficiary fails or refuses to do so, the Trustee shall hold such S Corporation Shares under the paragraph entitled "Electing Small Business Trusts."

5. The Trustee (excluding, however, any Interested Trustee) shall administer any trust under this paragraph as a Qualified Subchapter S Trust, as defined in Code Sec. 1361(d)(3).

6. In the event there is more than one income beneficiary of an Ineligible Trust (defined below), the Trustee shall divide the S Corporation Shares that will be held under this paragraph into separate trusts, based on each beneficiary's interest in the income of the Ineligible Trust that otherwise would have held those shares. If no beneficiary was entitled to income of such Ineligible Trust at that time, the Trustee may divide the S Corporation Shares into separate trusts for the beneficiaries of such Ineligible Trusts in such manner as the Trustee (excluding, however, any Interested Trustee) shall deem appropriate.

[38] See Article XXII of sample trust contributed by Jonathan Blattmachr.

B. **Electing Small Business Trusts.** Any S Corporation Shares held under this paragraph shall be held on the following terms:

1. The Trustee (excluding, however, any Interested Trustee) shall apportion to the trusts under this paragraph a reasonable share of the unallocated expenses of all trusts under this Agreement in a manner consistent with the applicable Internal Revenue Code and Treasury Regulations.

2. The Trustee shall make that election required by Code Sec. 1361(e)(3) to qualify the trust under this paragraph as an Electing Small Business Trust under Code Sec. 1361(e).

3. The Trustee (excluding, however, any Interested Trustee) shall administer each trust under this paragraph as an Electing Small Business Trust under Code Sec. 1361(e).

C. **Implementation.** The Trustee (excluding, however, any Interested Trustee) shall manifest its selection of the form in which it shall hold any S Corporation Shares by written notice to all persons who would be eligible or entitled at the time of such writing to receive income from the Ineligible Trust that otherwise would hold such S Corporation Shares.

D. **Definitions.** The following definitions apply for purposes of this Article:

1. "Ineligible Trust" means a trust whose ownership of any S Corporation Shares would cause the termination of that corporation's election to be taxed under subchapter S of the Code.

2. "Net Income" means income, as defined in Code Sec. 643(b).

3. "S Corporation Shares" means shares of any stock of a corporation that then operates or that the Trustee shall deem likely to operate in the future under an election to have its earnings taxed directly to its stockholders under subchapter S of the Code.

4. The "QSST Termination Date" means, separately, with respect to each trust held under the paragraph entitled "Qualified Subchapter S Trusts," the earlier of the date on which the beneficiary dies and the date on which the trust terminates.

Sample Clause Authorizing Trustee to Act to Preserve S Corporation Shareholder Status: [39]

QSST SAVINGS LANGUAGE

1.1. Creation of S Trusts. If: (i) any trust created under this instrument (an "Original Trust") holds or is to receive any stock in a corporation eligible to be an S Corporation ("S Stock"); (ii) the Original Trust has a Current Beneficiary; (iii) the Current Beneficiary is a U.S. citizen or resident; and (iv) the Current Beneficiary elects or intends to elect to qualify the trust as a Qualified Subchapter S Trust ("QSST") under Code Section 1361(d), then, the Trustee is authorized to allocate the S Stock to a separate "S Trust" to be administered as provided in this Section. In addition to any distributions provided for in the Original Trust, whenever an S Trust holds any S Stock the Trustee shall distribute all the income of the S Trust to the Current Beneficiary in quarterly or more frequent installments. During the life of the Current Beneficiary: (i) the Current Beneficiary shall be the sole beneficiary of the S Trust; (ii) no distributions shall be made to anyone other than the Current Beneficiary; and (iii) if the S Trust terminates during the Current Beneficiary's life, the remaining property of the S Trust, if any, shall be distributed to the Current Beneficiary. If the Current Beneficiary dies before the complete distribution of the S Trust: (i) the trust shall terminate upon his or her death; (ii) the Trustee shall distribute any undistributed income of the trust to his or her estate; and (iii) the remaining property of the trust shall be disposed of pursuant to the terms of the Original Trust. In the case of any Descendant's Trust or Contingent Trust, the term "Current Beneficiary" means the child, other descendant or other beneficiary for whom the trust is named. In the case of the Marital Trust or the Bypass Trust, the term "Current Beneficiary" means the Surviving Spouse. The Trustee may amend an S Trust in any manner necessary for the sole purpose of ensuring that the S Trust qualifies and continues to qualify as a QSST. Each amendment must be in writing and must be filed among the trust records. We intend that every S Trust qualify as a QSST within the meaning of Code Section 1361(d)(3). This instrument shall be interpreted in a manner consistent with this intent and any inconsistent provisions shall be construed, amplified, reconciled, or ignored as needed to achieve this intent.

[39] Contributed by Mickey Davis.

Sample Clause Providing Trustee (or Trust Protector) With Authority to Act to Preserve Status as S Corporation Shareholder:[40]

<u>SECTION .</u> **<u>S CORPORATION</u>.**

(a) With respect to any separate trust established under this Agreement which may acquire or hold any stock in a corporation that qualifies for treatment under section 1361 et seq. of the Code as an "S corporation," the trustee may elect to treat the trust holding such stock as an "electing small business trust" or may, in the trustee's sole and absolute discretion, modify the trust in order to permit the primary beneficiary to elect to treat the trust as a "qualified subchapter S trust," any such modification being subject to the last two sentences of this subsection. The trustee may change such election from time to time in such manner as is authorized by the Code and the Treasury Regulations, as the trustee, in such trustee's sole and absolute discretion, determines is in the best interest of the trust and the beneficiaries thereof. If it is decided to make such trust eligible to be treated as a "qualified subchapter S trust" and such trust does not qualify as a "qualified subchapter S trust," then the following provisions shall apply:

(1) <u>Segregation of Stock</u>. The trustee shall segregate all such stock and hold such stock as a separate trust for the sole benefit of the individual who is the primary beneficiary of such original trust; provided, however, that if there is more than one primary beneficiary of the trust, the trustee shall segregate all such stock, pro rata, into separate shares of the trust and hold each such share as a separate trust for the benefit of each such primary beneficiary. Except as otherwise provided in this Section, each separate trust created hereunder shall be: (A) held, administered and distributed pursuant to the terms and conditions set out in the Article under which such trust was created; (B) held as a separate trust thereunder until the death of the beneficiary of the trust, regardless of whether such trust continues to be funded with S corporation stock; (C) if, upon the death of the beneficiary of the trust, such trust continues in trust for further beneficiaries and is funded in whole or in part with S corporation stock, such trust shall continue to be held, administered and distributed in accordance with this Section for such further beneficiaries; and (D) no person may exercise a power to Appoint to the extent that any such exercise would permit any distribution to any person other than the primary beneficiary during the primary beneficiary's life.

(2) <u>Distribution of Income and Principal</u>. Notwithstanding any other provision herein to the contrary, the trustee shall distribute the income of each such trust to the primary beneficiary of the trust, and no other person, in convenient regular installments, not less frequently than quarterly; however, if a QSST election is not in effect, a Qualified Trustee (as defined below) may eliminate this mandatory income requirement (effective no earlier than the beginning of the next calendar year) and instead the rules for distributions of income to the primary beneficiary (but not to any other beneficiary) that applied before the application of this Section shall be restored. The trustee's authority to use and apply principal of such trust granted to the trustee in the Article under which such trust was created is limited to the use of such principal for the beneficiary of such segregated share of the trust, and no other person.

(3) <u>Request to Beneficiaries</u>. The then current income beneficiary of any such trust, or his or her legal representative, is requested to enter into a consent to any election that may be required under the Code, in the time and manner provided therein, in order to qualify the trust of which he or she is the then current income beneficiary as a qualified subchapter S trust.

No primary beneficiary of any separate trust under this Agreement who is serving as trustee or co-trustee of such trust shall participate in the election authorized in this Section with respect to such trust, unless the primary beneficiary has a general power of appointment over the entire trust. Instead, such election shall be exercised exclusively by the primary beneficiary's co-trustee or co-trustees, who or which is a Qualified Trustee, or, if the primary beneficiary is serving as sole trustee, by the first person(s) designated to act under Section __ or Section __ who or which is a Qualified Trustee, then living, and not incapacitated. As used in this Section, a Qualified Trustee is a person who is either (i) a trustee not designated or appointed to serve as trustee by the primary beneficiary of the trust or (ii) a trustee who is designated or appointed to serve as trustee by the primary beneficiary of the trust and is not a related or subordinate party (as defined in Code section 672(c)) with respect to such beneficiary.

[40] Contributed by Steve Gorin.

[If Trust Protector is used, this paragraph replaces the preceding paragraph:]

No primary beneficiary of any separate trust under this Agreement who is serving as trustee or co-trustee of such trust shall participate in any decision whether to modify such trust, unless the primary beneficiary has a general power of appointment over the entire trust exercisable either currently or at death. Instead, such decision shall be made exclusively by the Trust Protector (and, if no Trust Protector is then serving, a Trust Protector shall be appointed by the person so authorized under Section __).]

(b) The following paragraphs apply upon the death of the beneficiary of a trust with respect to which a QSST election is in effect immediately before the beneficiary's death, if and to the extent not overridden by a power to Appoint:

(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 __ determines the sharing of the residue of my estate, because my will bequeaths my estate to the Revocable Trust and Article __ 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 revocable trust entitled to the reside of the beneficiary's estate, if any, otherwise 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), Section __ shall not apply, and the trusts for the beneficiaries will be amended under paragraphs (1) ___, (2) ___, and (3) of subsection (A) ___.

(c) If stock in any S corporation is specifically allocated to one or more persons and subsection (b) does not apply, see Section ___.

Sample Clauses at Start of Trust Highlighting Importance of S Corporation Shareholder Status and Compliance With Shareholder Agreements: [41]

1.1 Qualified S Corporation Shareholder. The property contributed by the Settlor to this trust includes shares in a corporation that qualifies for income tax purposes as an "S corporation" (as defined in Code Section 1361(a)(1)). The Trustee shall review Section __ regarding the Trustee's and Trust Protector's powers with respect to trusts that own shares in a corporation that seeks to maintain status as an S corporation, and the Trustee shall take appropriate action, if any, to ensure, if possible, that each trust created under this instrument satisfies the requirements to be an eligible shareholder of an S corporation under Code Section 1361 for so long as the trust holds shares in any corporation that seeks to maintain status as an S corporation. It is possible that the Trustee (or the beneficiary) may need to make a tax election upon the establishment or change in status of a trust, and that there may be a limited period of time to make said election.[42]

1.2 Compliance with Ownership Agreements. The Settlor anticipates that each trust created hereunder will become a shareholder, partner, member or beneficial or equitable owner in one or more companies or co-ownership arrangements. As such, each Officer of a trust created hereunder is hereby directed and authorized to exercise its respective powers and administer such trust in such a way as to comply to the extent reasonably possible with the provisions of any applicable agreement (including any shareholder's agreement, operating agreement, partnership agreement, or co-ownership agreement) in effect from time to time governing any such interest of the trust. This Section shall not be construed as altering any of the dispositive provisions of this instrument.[43]

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[41] Contributed by Steve Trytten.

[42] This clause can be included at the start of a trust for emphasis.

[43] This clause can also be included at the start of a trust when the trust is expected to own an interest in an entity that is subject to the terms of a shareholders, partnership, or operating agreement.

Sample Clause Authorizing Trustee or Trust Protector to Act to Preserve S Corporation Status: [44]

1.3 S Corporation Stock. The following powers are provided, consistent with the intention of the Settlor that any trust created under this instrument holding shares in a corporation that desires to maintain S corporation status (hereafter "S Corporation Shares") do so without jeopardizing the corporation's status as an S corporation:

(a) The Trustee, in the Trustee's sole discretion, is authorized to make tax elections (such as the Electing Small Business Trust election provided under Code Section 1361(e)) or to assist a trust's beneficiary in making tax elections (such as the Qualifying Subchapter S Corporation Trust election under Code Section 1361(d)) to qualify a trust as a qualifying S corporation shareholder or to change from one qualifying status to another;

(b) The Trustee, other than an Interested Person, in its sole discretion, is authorized to distribute S Corporation Shares to the beneficiaries as if the trust had terminated, while directing the Trustee to continue to hold any other property in such trust;

(c) The Trustee is reminded that the Trustee may, in the Trustee's sole discretion, exercise its powers to divide the trust under Section [Cross references Division Into Separate Trusts provision] to create two or more separate trusts;[45]

(d) The Trust Protector is reminded that the Trust Protector may, in the Trust Protector's sole discretion, exercise its powers to amend the trust (or the one or more separate trusts created upon any division of the trust by the Trustee) under Section [Cross references the provision in our trust granting the Trust Protector amendment powers], in any manner that is necessary to accomplish any of the following and that does not otherwise exceed the scope of the Trust Protector's power under Section [Cross references the same provision]:[46]

(i) cause a trust to qualify as an eligible S corporation shareholder (including amending a trust to cause it to become a grantor trust, or amending a trust to require distribution of income to one beneficiary and to prohibit distributions of corpus to anyone other than said beneficiary, as is currently required for a Qualifying S Corporation Trust under Code Section 1361(d));

(ii) cause a trust to change from one qualifying status to another; or

(iii) cause a reduction in overall taxes paid by a trust or its beneficiaries (including causing a trust to make charitable contributions in any given year in amounts not exceeding the trust's pro rata share of charitable contributions made by the one or more S corporations in which the trust has an ownership interest).

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[44] Contributed by Steve Trytten.

[45] The Division Into Separate Trusts provision includes an example for dividing trusts: "… to avoid jeopardizing the S corporation status of any corporation seeking to maintain S corporation status as to which the trust is a shareholder."

[46] The Trust Protector holds a power to amend, modify or terminate all or part of any trust in any manner that the Trust Protector determines is appropriate to carry out the purposes of the trust for its intended beneficiaries, which includes as an example of a reason to use this power: "to avoid jeopardizing S corporation status for any corporation seeking to maintain S corporation status as to which the trust is a shareholder." Further, all amendment powers held by the Trust Protector are restricted to ensure they do not "jeopardize the status of any trust created under this instrument as an eligible S corporation shareholder if such trust owns or is expected to own stock in a corporation seeking to maintain S corporation status." The Trust Protector holds these powers in a non-fiduciary capacity.

IX. Dynasty Trusts Formed at Death – Pour Over from Revocable Trust

Background. For a high net worth family that has engaged in multi-generational planning, the family organization chart can get cluttered with many different trusts and entities. To help control the overall number of trusts, it may make sense to provide that additional amounts passing at death be added to the existing inter vivos trusts, rather than new trusts arising under the client's Will or revocable trust.

However, one should allow for the possibility that future events such as creditors' claims, tax disputes, or other litigation might render the inter vivos trust unsafe for additional assets passing at the client's death. Under the sample form below, the default is that the Trustee is to form a new trust based on the terms of the inter vivos trust, but the Trustee in its sole discretion may choose to pour over to the existing trust, instead.

Sample Clause Pouring Over from Will or Revocable Trust: [47]

The following language appears in the Will or revocable trust directing how the assets passing at death are to be administered:

(iv) Any share so created under this Section [Cross references the provision dividing the trust estate into shares for descendants] for a descendant of the Settlor shall be allocated to a separate Descendant's Trust, to be held, administered, and distributed for the benefit of such individual upon the same terms and conditions as the Descendant's Trust established for such individual under the FAMILY IRREVOCABLE TRUST dated June 1, 2016 (the "Irrevocable Trust"), as it exists at the time of the execution of this instrument. All of the terms of the Irrevocable Trust as it exists at the time of the execution of this instrument are hereby incorporated into this instrument by this reference and shall govern said separate Descendant's Trusts for such individuals. Alternatively, the Trustee, in the Trustee's discretion, may distribute part of all of any share so established for such individual to the Trustee of an existing Descendant's Trust for such individual established under the Irrevocable Trust, to be held, administered, and distributed as a part thereof (this is referred to as the "Pour Over Option"). The Settlor included the Pour Over Option to allow avoidance of multiple trusts arising for the same beneficiary under multiple trust instruments. However, the Settlor requests that the Trustee consider using the Pour Over Option only when doing so would not produce a disadvantage (such as exposing such share to claims or liens that have arisen in the existing Descendant's Trust). In addition, if the Trustee chooses the Pour Over Option for all or any part of a share of the property passing under this Section, the Trustee, in the Trustee's sole and absolute discretion, may direct the Trustee of the recipient trust to segregate such property as a separate trust under the Irrevocable Trust, having identical terms and conditions as those then in existence for such trust. The Settlor suggests that the Trustee consult with outside tax and legal advisors in making any determination on the manner in which each share for a descendant of the Settlor is allocated pursuant to this Section.

The following language appears in the inter vivos trust:

If property is received subject to instructions that said property is to be allocated to the Descendant's Trust under this instrument for a particular descendant of the Settlor, the Trustee shall apply said property to create or augment a Descendant's Trust under this instrument for such individual's benefit. If such instructions require that the property be segregated in a separate Descendant's Trust hereunder for a particular descendant (rather than being commingled with property already held in a Descendant's hereunder for such descendant), the Settlor instructs the Trustee to comply with that instruction by creating a separate Descendant's Trust for such descendant for the purpose of holding such property. Each Descendant's Trust so created shall be held by the Trustee and distributed for the benefit of the individual for whom said trust was created.

1.1 Additions to Trusts. Unless otherwise specified in this instrument or in any instrument of transfer, the following shall apply with respect to any addition to a trust created hereunder:

(a) **General Rules Regarding Additions**. Any addition to a trust created under this instrument that is not yet in existence at the time of such addition shall establish such trust. Any addition to a trust that was divided into multiple trusts prior to such addition shall augment proportionately the trusts into which such trust was divided at the time of the division. Any addition to a trust that was wholly distributed prior to such addition shall be

[47] Contributed by Steve Trytten.

distributed to the beneficiary or beneficiaries to whom such trust was distributed, in shares proportionate to the shares of such trust received by such beneficiaries. If any beneficiary is deceased upon the occurrence of the event requiring such addition, such deceased beneficiary's share shall be distributed to the person or persons presumptively entitled to then next eventual interest in such deceased beneficiary's share as determined by the Trustee, in the Trustee's discretion, taking into account the terms of this instrument. Any addition to a trust that was partially distributed prior to such addition shall augment proportionately the distributed and undistributed portions of such trust.

(b) **Trustee's Authority to Create Separate Shares or Trusts With Additions to Trusts**. In the event property is added to any trust created hereunder from the Settlor's estate, any other trust created by the Settlor or any other person, or pursuant to the exercise of a power of appointment, the perpetuities period applicable to such property may be shorter than the perpetuities period that would otherwise apply to the trusts created under this instrument and such property may have a different transferor for GST Tax purposes or a different grantor for income tax purposes than the trusts created under this instrument. The Settlor intends that the current and future beneficiaries of the various trusts arising under this instrument enjoy the maximum estate, gift and GST Tax benefits available to them, and that each such trust be allowed to continue in trust for as long as possible under the maximum perpetuities period allowed under applicable state law. To that end, the Trustee of any trust created hereunder is authorized (but shall not be required) to create separate shares or separate trusts for the Current Beneficiary of such trust (using the principles set forth in Section [Cross references Division Into Separate Trusts provision]) for the purpose of segregating assets with different transferors for GST Tax purposes, with different grantors for income tax purposes, or with different perpetuities periods.

1.2 Combining Trusts. The Trustee of a trust hereunder may participate in a transaction that combines the trust, in full or in part, with one or more other trusts established by the Settlor and/or the Settlor's spouse, provided the Trustee determines that such a combination will not defeat or substantially impair the purpose of the trust hereunder (including grantor trust status and other tax considerations) or the interests of the beneficiaries of the trust hereunder (excluding any beneficiary whose beneficial interest in the trust, taking actuarial considerations into account, is worth less than 5% of the trust). In particular, the Trustee may not combine GST Exempt assets with GST Non-Exempt assets. If any one or more of the trusts to be combined contain specific provisions relating to Tax Advantaged Accounts (e.g., so-called "conduit provisions") and any one or more of such trusts do not contain such provisions, the Trustee of the trust hereunder may participate in a combination provided that the specific provisions relating to Tax Advantaged Accounts continue to apply after said combination to all or substantially all (measured by aggregate value of such accounts) of the Tax Advantaged Accounts to which said provisions applied prior to the combination.

Although the Settlor generally intends that each trust arising hereunder be allowed to exist for as long as possible, the Settlor recognizes that the Trustee of each trust arising hereunder may need flexibility to combine trusts with different perpetuities period to minimize the administrative effort of administering multiple trusts that are similar, even if doing so might shorten the potential duration of the combined trust. Accordingly, if the Trustee, other than an Interested Trustee, determines that combining multiple trusts with different perpetuities periods serves the best interests of the beneficiaries of the trusts and is consistent with the purposes of the trusts, said Trustee may either:

(i) combine said trusts and account separately or establish separate shares for the assets received from each trust, subject to the Settlor's request that the Trustee make distributions as much as possible from the assets with the shortest perpetuities period; or

(ii) combine said trusts and modify the provisions of the combined trust to direct termination of the entire trust no later than the end of the shortest of the perpetuities periods that governed the multiple trusts so combined.[48]

[48] This section provides the Trustee (other than an interested Trustee) authority to combine trusts with multiple perpetuities periods, and provides two alternative approaches for dealing with the multiple perpetuities periods.

X. Conduit See-Through Trust

Background. See Appendix F for a detailed discussion of the rules that govern trusts as beneficiaries of retirement plan assets subject to the minimum distribution rules.

As a general rule, trusts are not recognized as having a life expectancy for minimum distribution purposes. But there is an exception for trusts that meet certain specialized requirements. These trusts are sometimes called "See-Through Trusts." The life expectancy of a see-through trust is determined by looking through the trust to identify the trust beneficiaries and their respective measuring lives, and then applying the shortest measuring life.

One type of see-through trust is called a conduit trust. To qualify as a conduit trust, the trust must require that any distribution from the retirement plan to the trust must then be distributed from the trust to the trust's beneficiary. In other words, the trust may not accumulate amount distributed from retirement plans.

The next section will cover see-through trusts that accumulate.

Sample Conduit Trust Clause:[49]

ARTICLE I
Retirement Benefits

The following provisions concern Retirement Benefits payable or distributable to the Trustee under this Trust Agreement (whether directly or through the Grantor's estate) by reason of the Grantor's death. As used in this Trust Agreement, the term "Retirement Benefits" (of whatever type), includes any trust, contract, plan, benefit, account, annuity, or bond which arises out of an employer-employee relationship (or in the case of a self-employed person, is deemed or treated as if arising out of an employer-employee relationship), whether non-qualified, qualified under Code Sec. 401, an individual retirement arrangement under Code Secs. 408 or 408A, a tax-sheltered annuity under Code Sec. 403 or any other benefit subject to the distribution rules of Code Sec. 401(a)(9), as well as deferred compensation under any employment contract and other benefits normally considered as employee benefits. As used in this Trust Agreement, the term "Retirement Plan" shall mean any plan or agreement under which Retirement Benefits are payable.

The provisions of this Article are subject to any expressly contrary provisions contained in any beneficiary designation, Retirement Plan contract or agreement, or other controlling document.

A. **Disposition of Participant's Interest.** Retirement Benefits shall be disposed of in the same manner as the Grantor's Residuary Trust Fund under this Trust Agreement.

B. **Selection of "Payout Schedule."** The Trustee may exercise any right to determine the manner and timing of payment of Retirement Benefits that is available to the recipient of the benefits, but the Trustee must exercise such rights in a manner consistent with the Federal income tax rules governing required minimum distributions under Code Sec. 401(a)(9).

C. **Conduit Trust Provisions for Descendants' Separate Trusts.** The following provisions shall be applicable to each Descendant's Separate Trust held hereunder with respect to the Grantor's interest in any Retirement Benefits which are payable (either directly or by reason of the provisions above) to the Trustee thereof:

1. Each year, beginning with the year of the Grantor's death, the Trustee of such trust shall withdraw from any such Retirement Plan the Minimum Required Distribution for such Retirement Plan payable to such trust for such year, plus such additional amount or amounts as the Trustee (excluding, however, any Interested Trustee) deems advisable in the Trustee's sole discretion. All amounts so withdrawn (net of expenses) shall be distributed to the Beneficiary (as defined below in this paragraph) free of trust, if the Beneficiary is then living. If the Beneficiary is not then living, the Trustee shall instead distribute the amount which would have been distributed to the Beneficiary had the Beneficiary been then living, in the manner provided for the distribution of the principal of such trust upon the death of the Beneficiary.

[49] Contributed by Jonathan Blattmachr.

2. The following definitions shall apply in administering these provisions relating to such trust. The Minimum Required Distribution for any year shall be, for each Retirement Plan: (a) the value of the Retirement Plan determined as of the preceding year end, divided by (b) the Applicable Distribution Period; or such greater amount (if any) as the Trustee shall be required to withdraw under the laws then applicable to such Retirement Plan to avoid penalty. If the Grantor's death occurred before the Grantor's "required beginning date" with respect to such benefit, the Applicable Distribution Period means the life expectancy of the Beneficiary. If the Grantor's death occurred on or after the Grantor's "required beginning date" with respect to such benefit, the Applicable Distribution Period means the life expectancy of the Beneficiary, or if longer, the Grantor's remaining life expectancy.

3. Notwithstanding the foregoing, if the Grantor's death occurred on or after the Grantor's "required beginning date" with respect to such benefit, the Minimum Required Distribution for the year of the Grantor's death shall mean (a) the amount that was required to be distributed to the Grantor with respect to such benefit during such year, minus (b) amounts actually distributed to the Grantor with respect to such benefit during such year.

4. Life expectancy, and the meaning of "required beginning date" and other terms in this paragraph, shall be determined in accordance with Code Sec. 401(a)(9).

5. As used in this paragraph to define the person to whom amounts are to be distributed, the term "the Beneficiary" shall refer to the person who is the primary Beneficiary of the trust under the terms and provisions of the Descendants' Separate Trusts hereunder.

D. **Exclusion of Retirement Benefits from Creditors.** Anything to the contrary in this Trust Agreement notwithstanding, any Retirement Benefits payable to the Trustee under this Trust Agreement shall never be or become part of the Grantor's probate or testamentary estate hereunder, and nothing in this Trust Agreement shall be deemed to subject those proceeds to payment of the Grantor's debts or expenses.

Sample Conduit Trust Clause:[50]

CONDUIT PLAN BENEFITS TRUST

1.2. Plan Benefits Trusts. To the extent that the **Trustee** is designated as the beneficiary of any qualified benefit plan or individual retirement account or other Nonprobate Asset subject to the Minimum Required Distribution Rules (the "MRD Rules") (collectively "Plan Benefits"), the following provisions apply: (i) a Plan Benefits Trust corresponding to each trust provided for in this **instrument** is created; (ii) all Plan Benefits shall be allocated (A) in accordance with the directions, if any, contained in the beneficiary designation or other instrument of transfer; otherwise, (B) **[subject to Section ___ (allocating all income in respect of a decedent to the Marital Deduction Amount),]**to or among the trusts or individuals receiving my Remaining Property, substituting Plan Benefits Trusts for their corresponding trusts; (iii) each Plan Benefits Trust shall be irrevocable; (iv) each Plan Benefits Trust shall be identical to its corresponding trust except with regard to required distributions outlined below, and (v) the Trustee shall deliver a copy of this **instrument** or alternate descriptive information to the plan administrator in the form and content and within the time limits required by applicable statute and treasury regulations. For purposes of this Section, each year following my death, the Trustee of the Plan Benefits Trust shall withdraw from the Plan Benefits held by or payable to that trust an amount not less than the minimum amount required to be distributed pursuant to Code Section 401(a)(9) as applicable to those Plan Benefits (the "Minimum Required Distribution Amount"). **If the Current Beneficiary is serving as Trustee, any determination by the Trustee to withdraw more than the Minimum Required Distribution Amount in any year shall be treated as a discretionary distribution as described in Section** [**Cross reference to Section "Restrictions on Beneficially Interested Trustee**]. The Trustee shall distribute all amounts withdrawn (the "Withdrawn Amount") as follows: (i) the Withdrawn Amount shall be paid directly upon receipt to the Current Beneficiary of such trust; (ii) the Current Beneficiary shall be the sole beneficiary of the Withdrawn Amount; and (iii) no Withdrawn Amount shall be accumulated in the trust during the Current Beneficiary's lifetime for the benefit of any other beneficiary. In the case of any Descendant's Trust or Contingent Trust, the term "Current Beneficiary" means the child, other descendant or other beneficiary for whom the trust is named. **In the case of the Marital Trust or the Bypass Trust, the term "Current Beneficiary" means the Surviving Spouse.** I intend that the Plan Benefits Trust qualify as a conduit trust described in Treasury Regulation Section 1.409(a)(9)-5, A-7(c)(3), Example 2, and that except for persons whose interests are contingent solely upon the death of a prior beneficiary, only individuals eligible as designated beneficiaries (as defined in Code Section 401(a)(9) and

[50] Contributed by Mickey Davis.

applicable treasury regulations) for purposes of the MRD Rules shall ever be permissible distributees or appointees of Plan Benefits Trusts. This **instrument** shall be administered and interpreted in a manner consistent with this intent. Any provision of this **instrument** which conflicts with this intent shall be deemed ambiguous and shall be construed, amplified, reconciled, or ignored as needed to achieve this intent. The Trustee may amend the Plan Benefits Trust in any manner necessary for the sole purpose of ensuring that the trust qualifies and continues to qualify as a conduit trust described in Treasury Regulation Section 1.409(a)(9)-5, A-7(c)(3), Example 2. Each amendment must be in writing and must be filed among the trust records.

Sample Conduit Trust Clause Including Lifetime Power of Appointment: [51]

The first subsection (c) follows an example in the regulations under Code § 401(a)(9) for conduit trusts and limits benefits to the primary beneficiary. The alternative subsection (c) sprinkles among the primary beneficiary and the primary beneficiary's descendants and follows the regulations' spirit but is not referenced in the example.

(d) Benefit Plans. If the trust is the beneficiary of any Benefit Plan subject to Code section 401(a)(9) or comparable provisions (the "Minimum Distribution Rules"), the trustee shall withdraw from the Life Trust's portion of the Benefit Plan the amount required under the Minimum Distribution Rules and may make additional withdrawals for the purposes set forth in subsection (a). If and to the extent necessary to enable the Benefit Plan to use the beneficiary's life expectancy for purposes of applying the Minimum Distribution Rules without considering the identity or life expectancy of any other beneficiary (whether current or future, vested or contingent) of the trust, the trustee shall distribute to the beneficiary each withdrawal from a Benefit Plan, whether or not such withdrawal is required under the Minimum Distribution Rules.

[(c) Distribution from Benefit Plans. This subsection applies if the Life Trust is the beneficiary of any Benefit Plan subject to Code section 401(a)(9) or comparable provisions (the "Minimum Distribution Rules"). If and to the extent necessary to enable the Benefit Plan to use the beneficiary's life expectancy for purposes of applying the Minimum Distribution Rules without considering the identity or life expectancy of any other beneficiary (whether current or future, vested or contingent) of the trust, the trustee shall distribute each withdrawal from a Benefit Plan to the individual(s) to or for whom that withdrawal is being made, whether or not such withdrawal is required under the Minimum Distribution Rules. The trustee shall withdraw from the Life Trust's portion of the Benefit Plan the amount required under the Minimum Distribution Rules, and such amounts withdrawn shall be distributed in the following priority:

(1) for the purposes as described in subsection (a) [distributions for the primary beneficiary]; then

(2) for the purposes as described in subsection (b) [distributions for the primary beneficiary's descendants]; then

(3) to the beneficiary, but if and to the extent that the second sentence of this subsection does not require distributions to be made to one or more individuals, such amount may be accumulated in the Life Trust.

The trustee may withdraw such additional amounts from the Benefit Plan as the trustee shall deem appropriate for the purposes described in subsections (a) and (b), and shall distribute such additional amounts so withdrawn for such purposes. **]**

SECTION . **SPECIAL POWER OF APPOINTMENT WHILE LIVING.** The beneficiary, while at least <AGE 3> (___) years of age, in the beneficiary's individual capacity, shall have the continuing discretionary power to Appoint all or any part of the income, principal, or both of the trust to or for the benefit of any person, but may not increase the authority, if any, to make distributions to or for the benefit of the beneficiary, the beneficiary's estate, the beneficiary's creditors, or the creditors of the beneficiary's estate; however: (a) no interest in a Benefit Plan or that Benefit Plan's proceeds may be Appointed in a manner that would change the identity of the individual whose life expectancy would otherwise apply under the Minimum Distribution Rules, and (b) if the trust is an electing small business trust under Code section 1361(e)(1), the beneficiary may not exercise the power to Appoint in a manner that might cause the corporation to violate Code section 1361(b)(1). Any such Appointment may be exercised either to effect immediate distribution to the appointee or to take effect upon the occurrence of a future event, such as the beneficiary's death.

[51] Contributed by Steve Gorin.

Sample Conduit Trust Clause: [52]

1.1 Descendant's Trust is a "Conduit" for Distributions from Retirement Plans.

(a) To the extent the Trustee of a Descendant's Trust receives distributions (either Minimum Required Distributions or Excess Distributions)[53] from a Stretch-Out Retirement Account[54] as to which the Primary Beneficiary is the Stretch-Out Retirement Beneficiary, the Trustee shall distribute to or apply for the benefit of[55] the Primary Beneficiary all of said distributions (net of expenses, and net of income, estate, inheritance, generation-skipping transfer tax, or any other tax, to the extent said expenses and taxes are properly chargeable to either the distributions received or to the balance remaining in said Stretch-Out Retirement Account),[56] for as long as the Primary Beneficiary shall live[57] or until the earlier termination of his or her trust.

(b) Notwithstanding any other provision of this instrument or any power granted to the Trustee by law, for so long as the Primary Beneficiary of a Descendant's Trust is the Stretch-Out Retirement Beneficiary of a Stretch-Out Retirement Account, the Trustee's power to take Excess Distributions from that Stretch-Out Retirement Account may be exercised only by the Trustee, other than: (i) a Settlor; (ii) the Primary Beneficiary; (iii) any individual who made a qualified disclaimer of any interest in said Stretch-Out Retirement Account; and (iv) any individual who owes a legal obligation of support to the Primary Beneficiary.[58]

Here are selected provisions from the administrative sections of the trust instrument:

1. Trust as Beneficiary of Retirement Account.

1.1 Trusts to Benefit from Maximum Extended Deferral. The Settlor intends that each trust hereunder that owns an interest in a Retirement Account benefit from the maximum extended deferral period under the Minimum Distribution Rules that is available based upon the terms of such trust. Accordingly, the following shall apply:

(a) The Trustee of a trust so designated shall, within the time limit prescribed under the Minimum Distribution Rules, deliver documentation required under said rules to the respective administrators and custodians of each Retirement Account.

[52] Contributed by Steve Trytten. These clauses are designed for inclusion in a dynasty style trust (a "Descendants' Trust") to make it a "see-through trust" for minimum distribution purposes. Thus, retirement and non-retirement assets would be held in the same trust. This approach may be appropriate when the retirement plan is modest and simplicity is preferred over maximum tax efficiency. When maximum tax efficiency is preferred, consider using either the "age restriction" or "last one standing" approaches in the following modules to allow accumulations of retirement distributions, and consider creating separate trusts so that the respective trustees have more flexibility in deciding whether to distribute income from retirement or non-retirement assets.

[53] We've seen so many practitioners administer conduit trusts as if only the MRDs are required to be distributed, we've chosen to be very explicit in directing that all plan distributions must be distributed.

[54] We used the defined term "Stretch-Out Retirement Plan" to ensure that the conduit requirements are only imposed on plans that allow stretch-out over the current beneficiary's life expectancy (or the oldest member of a class to which the current beneficiary belongs). This safeguard may be particularly helpful if the Obama Greenbook proposal to limit post-death stretch-out to five years is enacted.

[55] The phrase "or apply for the benefit of" is included to give greater flexibility to the Trustee in applying amounts for a beneficiary when outright distribution may not be the best option. Although Treas. Regs. do not specifically address this issue, there is indirect support in the marital deduction area. See Reg. § 20.2056(b)-5(f)(4).

[56] Although Treas. Regs. do not specifically address this issue, it would be irresponsible to require distribution to the beneficiary of all amounts received from Stretch-Out Retirement Plans without allowing for expenses and taxes that would normally be charged against such amounts.

[57] This limitation is intended to avoid application of the conduit provisions any longer than necessary to qualify as a "see-through trust."

[58] When you combine the Trustee's power to take distributions from the Stretch-Out Retirement Plan with the conduit provision, you potentially create the equivalent of a general power of appointment, which should not be held by certain tax sensitive trustees, including an individual who has made a qualified disclaimer. This clause limits the Trustee's power to take distributions from the Stretch-Out Retirement Plan if any of these tax sensitive persons are serving.

(b) When the Trustee makes a distribution or an allocation of an interest in a Retirement Account to or for the benefit of a beneficiary of a trust hereunder, the Trustee is to assign all of the Trustee's interests in and powers over said Retirement Account interest (e.g., to direct investments and withdrawals) to said individual or trustee, as the case may be, and nothing under this instrument shall be interpreted as requiring the Trustee to arrange for the assets held in the Retirement Account to be withdrawn from said Retirement Account. The Settlor specifically intends that any such distribution or allocation of a Retirement Account shall be handled in a manner that (i) results in zero, or the minimum possible amount of income tax payable by either the trust, said individual, or said other trust, and (ii) results in no change, or the minimum possible amount of change, to the deferral period that applies to the Retirement Account.

(c) The administrators, custodians, or other fiduciaries of the respective Retirement Accounts shall incur no liability to the trust or to any of its beneficiaries for acting upon the written instruction of the Trustee pursuant to this Section __.

1.1 Power to Exercise Retirement Account Options. In addition to the powers granted to the Trustee by law or under other provisions of this instrument, the Trustee is authorized to exercise any power or right over a Retirement Account that is available to the Trustee as beneficiary or successor owner of such Retirement Account, including powers to (a) take distributions, make elections, or otherwise select payment options, (b) direct investments, and (c) direct tax-free rollovers from one Retirement Account to another (and to establish any new Retirement Account that is to receive the rollover, if applicable).

1.2 Excess Distributions. The term "Excess Distributions" means, with respect to an interest in a Stretch-Out Retirement Account, any distribution in excess of those amounts reasonably necessary to: (a) comply with the Minimum Distribution Rules; (b) provide for the beneficiary's health, education, and support; (c) comply with the legal obligation to pay income, estate, inheritance, GST Tax, or other taxes properly chargeable to distributions received from or the balance remaining in said Stretch-Out Retirement Account; and (d) provide for payment of trust expenses properly allocable to distributions received from or the balance remaining in said Stretch-Out Retirement Account.

1.3 Retirement Related Definitions.

(a) **Participant**. The term "Participant" means the employee, plan participant, or account owner of said Retirement Account as those terms are commonly used under the Minimum Distribution Rules.

(b) **Retirement Account.** The term "Retirement Account" means a Tax-Advantaged Account that is subject to the Minimum Distribution Rules.

(c) **Stretch-Out Retirement Account.** The term "Stretch-Out Retirement Account" means, with respect to a particular trust arising hereunder, an interest in a Retirement Account that satisfies the following conditions: (a) the interest in the Retirement Account (or a successor Retirement Account, e.g., an inherited IRA that receives a rollover from a qualified retirement plan) became part of the trust by reason of the death of the Participant; and (b) the provisions governing said Retirement Account (including any death beneficiary designation in effect at the Participant's death and any other relevant circumstances) permit the Trustee of the trust to take post-death distributions over a time period based on the life expectancy of an individual, assuming said trust otherwise qualifies to do so under the Minimum Distribution Rules. By way of explanation, if a trust with an interest in a Retirement Account that is a Stretch-Out Retirement Account ultimately terminates (e.g., upon the death of a beneficiary), and if as a result the remaining Retirement Account interest is then allocated to a successor trust (e.g., for a descendant of the deceased beneficiary), said remaining Retirement Account interest will not be considered a Stretch-Out Retirement Account with respect to said successor trust under this Section because said interest did not become part of said successor trust by reason of the death of the Participant.[59]

(d) **Stretch-Out Retirement Account Accumulations.** The term "Stretch-Out Retirement Account Accumulations" means, with respect to a particular trust arising hereunder, any amounts distributed from any one or more of said Stretch-Out Retirement Accounts to the trust that accumulate in the trust (including earnings thereon and net of any expenses or taxes allocable thereto). By way of explanation, if a trust with Stretch-Out Retirement Account Accumulations ultimately terminates (e.g., upon the death of a beneficiary), and if as a result said Stretch-Out Retirement Account Accumulations are allocated to a successor trust (e.g., for the descendants of the deceased

[59] The term "Stretch-Out Retirement Account" is important, in that it is used to limit see-through trust provisions to those plans that actually provide stretch-out. A plan might not allow stretch-out either because its own terms are more restrictive, or because the law has changed to curtail post-death stretch-out.

beneficiary), said accumulations will not be considered Stretch-Out Retirement Account Accumulations in the hands of said successor trust, because it was the prior trust and not the successor trust that received distributions from a Stretch-Out Retirement Account and accumulated them.[60]

(e) **Stretch-Out Retirement Beneficiary.** The term "Stretch-Out Retirement Beneficiary" means, with respect to a trust hereunder that owns an interest in a "Stretch-Out Retirement Account," the trust beneficiary whose life expectancy is or will be used in determining the timing and amount of post-death distributions (or whose life expectancy would have been so used if he or she was the oldest member of the group of individuals determined under the Minimum Distribution Rules to which he or she belongs).[61]

(f) **Tax-Advantaged Account.** The term "Tax-Advantaged Account" means any plan, contract, or other arrangement (other than a life insurance contract) that is allowed under the Internal Revenue Code to accumulate any part of its income in a tax-advantaged manner (e.g., income tax-deferred or income tax free) for the benefit of an owner, beneficiary, or successor, including a qualified or non-qualified annuity, a deferred compensation plan, or a retirement or individual retirement account arrangement established under Code Section 401, 403, 408, 408A, or 457. A plan account or arrangement that is otherwise a "Tax-Advantaged Account" and that owns one or more life insurance contracts among its assets is a "Tax-Advantaged Account." A plan, contract, or other arrangement that is reasonably believed to qualify for tax-advantaged treatment under the Internal Revenue Code is a "Tax-Advantaged Account" even if it is subsequently determined it did not so qualify.

We give the Trust Protector a broad amendment power to carry out the purposes of the trust for its intended beneficiaries, which includes as an example: "to enhance the overall after-tax valuation of any Tax-Advantaged Account in which the trust has an interest." However, we restrict the Trust Protector's broad amendment powers to protect see-through trust status:

(i) Notwithstanding any of the foregoing provisions of this Section, with respect to a trust created hereunder that holds an interest in a Stretch-Out Retirement Account as to which a Current Beneficiary is the Stretch-Out Retirement Beneficiary, diminishes such Current Beneficiary's interest in "conduit distributions."

In our Division Into Separate Trusts provision, we provide examples to divide related to see-through trusts:

(a) To enable Tax-Advantaged Accounts to be segregated from other trust assets;

(b) To avoid holding one or more Stretch-Out Retirement Accounts with other trust assets; provided, however, that Stretch-Out Retirement Account Accumulations therefrom stay with the Stretch-Out Retirement Account;

We emphasize the need to maintain the see-through trust provisions upon a combination with another trust by adding the following language to the end of our Combining Trusts provision:

"If any one or more of the trusts to be combined contain specific provisions relating to Tax Advantaged Accounts (e.g., so-called "conduit provisions") and any one or more of such trusts do not contain such provisions, the Trustee of the trust hereunder may participate in a combination provided that the specific provisions relating to Tax Advantaged Accounts continue to apply after said combination to all or substantially all (measured by aggregate value of such accounts) of the Tax Advantaged Accounts to which said provisions applied prior to the combination."

In our Distributions to Persons Under Age 21 or Incapacitated Persons provision, we add the following conduit provisions just in case:

(i) Notwithstanding the foregoing, to the extent the Trustee of a Simple Trust receives distributions from a Stretch-Out Retirement Account as to which the beneficiary is the Stretch-Out Retirement Beneficiary, the Trustee shall distribute to or apply for the benefit of the beneficiary all of said distributions (net of expenses, and net of income, estate, inheritance, generation-skipping transfer tax, or any other tax, to the extent said expenses and taxes are properly allocable to distributions received or to the

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[60] The term "Stretch-Out Retirement Account Accumulations" is not needed for a conduit trust, but is a very important addition for any accumulation trust (see next chapter).

[61] It is important in defining this term to allow for the possibility that stretch-out will be over the oldest member of a group, and that the trust's primary beneficiary is not necessarily the oldest member.

balance remaining in said Stretch-Out Retirement Account), for as long as the beneficiary shall live or until the earlier termination of his or her Simple Trust. Notwithstanding any other provision of this instrument or any power granted to the Trustee by law, for so long as the beneficiary is the Stretch-Out Retirement Beneficiary of a Stretch-Out Retirement Account, the Trustee's power to take Excess Distributions from that Stretch-Out Retirement Account may be exercised only by the Trustee, other than: (a) any individual who made a qualified disclaimer with respect to said interest in said Stretch-Out Retirement Account; and (b) any individual who owes a legal obligation of support to the beneficiary.

XI. Accumulation See-Through Trust

Background. See the prior chapter for discussion of conduit see-through trusts, and see Appendix F for a detailed discussion of the rules that govern trusts as beneficiaries of retirement plan assets subject to the minimum distribution rules.

This section discusses see-through trusts that can accumulate retirement plan distributions (and thus, cannot qualify as conduit trusts).

In some cases, there may be substantial non-retirement plan assets to make full use of available GST exemptions, and it may be most practical to simply include a conduit clause in the non-exempt dynasty trust and designate retirement plan assets to that trust.[62]

In other cases, a conduit clause may not be the solution. For example: (i) the asset mix may be such that it is not as clear whether retirement assets will be passing to the exempt dynasty trust, the non-exempt trust, or partly to each; (ii) the projected amount of distributions that would arise under a conduit clause may be too large in light of the projected needs of the beneficiaries; or (iii) the best tax strategy may be for retirement assets (particularly if a Roth IRA) to pass to and accumulate in the exempt dynasty trust. In cases like these, a non-conduit approach may be needed, as discussed next.

There are three approaches to drafting an accumulation see-through trust that commentators consider safe (discussed in detail in Appendix F):

- Outright to Next Level Beneficiaries (must pass outright to next level heirs after primary beneficiary's death).
- Age Restriction (trust cannot have any beneficiary or permissible appointee older than a specified age).
- Last One Standing (trust cannot have any beneficiary or permissible appointee outside a defined class of persons).

Exempt Retirement Assets. The choice of method may be more difficult for "exempt" retirement assets. The conduit trust approach generally is not the best choice for "exempt" retirement assets, as there may be valuable transfer tax benefits if plan distributions can be accumulated in the trust. An accumulating trust is likely to provide stronger creditor protection, as well.

Also, accumulating taxable distributions at the trust level does not always produce higher income tax than if distributed to the beneficiary, and in some cases the trust level income tax may be lower. Variables such as the alternative minimum tax can cause variations from year to year, and careful planning on a year to year basis to set the optimal level of distributions may produce the lowest combined income tax over time.

The "outright gift to 'second tier' beneficiary" approach usually is not the best choice for "exempt" retirement assets, either, as the dynasty trust is generally intended to continue for as long as possible, rather than terminate at the death of the initial beneficiary.

Thus, for most dynasty trusts, the two remaining alternatives are either the "age restriction" or the "last one standing" approaches.

The "age restriction" approach should be viewed as the default choice. Although this approach is more complex to draft, and could arbitrarily exclude certain contingent beneficiaries if they are too old, it provides greater overall flexibility.

The "last one standing" approach is less complex to draft, but it carries a significant disadvantage – the trust will terminate and distribute outright at such time that only one class member remains, regardless of the class member's age, health, or other circumstances. This outcome conflicts generally with the objective of continuing a dynasty trust for as long as possible, and could result in serious problems in specific situations involving young, disabled, or spendthrift beneficiaries. The problems of a young beneficiary can be mitigated somewhat with a provision for a UTMA account until age twenty-one, but this is obviously not a complete solution.

[62] However, the power of tax-deferred compounding is such that designating retirement plan assets to fund an "exempt" trust may produce a greater after tax benefit than selecting non-retirement assets.

A client with a large number of descendants may be so confident that there will always be more than one descendant that the "last one standing" approach will be best. But in most cases, the "age restriction" approach (using the oldest child's age as the "target age") will probably be best.

Non-Exempt Retirement Assets. Once the technique has been determined for "exempt" retirement plan assets, the next step is to assess whether to use the same or a different technique for "non-exempt" assets. This determination may vary with each case, and will reflect an overall comparison of the advantages and disadvantages of each option.

For example, some clients may prefer to use a standard conduit arrangement on "non-exempt" retirement assets even though it does not make sense for "exempt" retirement assets.

Generally, it is best to extend the same technique selected for "exempt" retirement assets to the "non-exempt" retirement assets, except when the disadvantage of doing so is significant enough to indicate that a conduit approach should be used instead. In that event, it is important to pay close attention to the coordination of retirement plan designations that is discussed next.

Coordinating Retirement Plans and Division Between Exempt and Non-Exempt Trusts. It is common for the instrument that provides for a dynasty trust to allow the trustee to subdivide the trust into an "exempt" and "non-exempt" dynasty trust, based on how the decedent's GST exemption is allocated.

If retirement assets will simply be designated to the dynasty trust, the exempt and non-exempt dynasty trusts should be drafted using the same see-through trust approach. There are two reasons for this.

The first reason has to do with the generation-skipping transfer tax. The division of the dynasty trust into exempt and non-exempt subtrusts is allowed for generation-skipping transfer tax purposes provided that the requirements of Regulation Section 26.2654-1(b)(1) are satisfied. These requirements are:

- Assets of the dynasty trust may be divided on a pecuniary basis only if required in governing instrument, with assets divided in a "fairly representative" manner and appropriate interest paid;
- Otherwise assets of the dynasty trust must be divided on a fractional basis and may be divided non pro rata based either on date of funding values or "fairly representative" manner; and
- The two new subtrusts may have differing provisions, so long as the terms in the aggregate provide for the same succession of interests and beneficiaries as provided in the original subtrust.

The second reason has to do with the see-through trust rules. If the dynasty trust is designated, it is the dynasty trust that will be analyzed on a pre-split basis under the see-through trust rules. If the exempt and non-exempt subtrusts use different see-through trust mechanisms, the dynasty trust as a whole will not qualify under any one mechanism and may fail to qualify as a see-through trust with the intended beneficiary as the measuring life.

When different techniques will be used, it is essential that the division of the retirement assets as between the exempt and non-exempt subtrusts is "hard-wired" in the death beneficiary designation or governing document of the retirement plan. This is a situation where a Trusteed IRA can be particularly helpful, as a custom-drafted Trusteed IRA document can contain a sophisticated formula clause governing the division of the IRA as between the exempt and non-exempt subtrusts.

The following sample clauses illustrate three Age Restriction versions and one Last One Standing version.

Sample Age Restriction Accumulation See-Through Trust Clause:[63]

ARTICLE II
Retirement Benefits

The following provisions concern Retirement Benefits payable or distributable to the Trustee under this Trust Agreement (whether directly or through the Grantor's estate) by reason of the Grantor's death. As used in this Trust

[63] Contributed by Jonathan Blattmachr.

Agreement, the term "Retirement Benefits" (of whatever type), includes any trust, contract, plan, benefit, account, annuity, or bond which arises out of an employer-employee relationship (or in the case of a self-employed person, is deemed or treated as if arising out of an employer-employee relationship), whether non-qualified, qualified under Code Sec. 401, an individual retirement arrangement under Code Secs. 408 or 408A, a tax-sheltered annuity under Code Sec. 403 or any other benefit subject to the distribution rules of Code Sec. 401(a)(9), as well as deferred compensation under any employment contract and other benefits normally considered as employee benefits. As used in this Trust Agreement, the term "Retirement Plan" shall mean any plan or agreement under which Retirement Benefits are payable.

The provisions of this Article are subject to any expressly contrary provisions contained in any beneficiary designation, Retirement Plan contract or agreement, or other controlling document.

A. **Disposition of Participant's Interest.** Retirement Benefits shall be disposed of in the same manner as the Grantor's Residuary Trust Fund under this Trust Agreement.

B. **Selection of "Payout Schedule."** The Trustee may exercise any right to determine the manner and timing of payment of Retirement Benefits that is available to the recipient of the benefits, but the Trustee must exercise such rights in a manner consistent with the Federal income tax rules governing required minimum distributions under Code Sec. 401(a)(9).

C. **Designated Beneficiary Status and Accumulation of Retirement Benefits in Descendants' Separate Trusts.** The following provisions shall be applicable to each Descendant's Separate Trust held hereunder with respect to all the Grantor's interest in any Retirement Plan from which Retirement Benefits (i) may be paid, under the terms of the plan or agreement applicable thereto, over the life expectancy of an individual beneficiary and (ii) are payable (either directly or by reason of the provisions above) to the Trustee of that Descendant's Separate Trust:

1. Each year, beginning with the year of the Grantor's death, the Trustee of such trust shall withdraw from any such Retirement Plan the Minimum Required Distribution for such Retirement Plan payable to such trust for such year, plus such additional amount or amounts as the Trustee deems advisable in its sole discretion. All amounts so withdrawn or which are otherwise paid or payable to the Trustee of that Descendant's Separate Trust, along with all income with respect thereto and all changes, increases and decreases thereof (collectively the "Descendant's Separate Trust Designated Beneficiary Portion"), shall be accounted for by Trustee, and shall be subject to the distribution and other provisions with respect to that Descendant's Separate Trust, both during the Descendant's Separate Trust Measuring Life's lifetime and at the Descendant's Separate Trust Measuring Life's death, provided that, notwithstanding anything to the contrary, none of such Descendant's Separate Trust Designated Beneficiary Portion shall ever be distributed, whether pursuant to the terms of that Descendant's Separate Trust, the terms of any trust to which property of that Descendant's Separate Trust passes following the death of any descendant of the Grantor, the exercise of any power of appointment, or any other provision (whether under this Trust Agreement or under applicable law of intestacy or otherwise), to anyone other than an individual who was born at the same time or after the Descendant's Separate Trust Measuring Life. The intent of these provisions is to cause the Descendant's Separate Trust Measuring Life to be treated as the designated beneficiary of such Retirement Plan for purposes of Code Sec. 401(a)(9) and the Regulations thereunder, so that the amount in such Retirement Plan may be paid over the life expectancy of the Descendant's Separate Trust Measuring Life, rather than being subject to the default payout rule under Code Sec. 401(a)(9)(B)(iii).

2. The following definitions shall apply in administering these provisions relating to such trust. The Minimum Required Distribution for any year shall be, for each Retirement Plan: (a) the value of the Retirement Plan determined as of the preceding year end, divided by (b) the Applicable Distribution Period; or such greater amount (if any) as the Trustee shall be required to withdraw under the laws then applicable to such Retirement Plan to avoid penalty. If the Grantor's death occurred before the Grantor's "required beginning date" with respect to such benefit, the Applicable Distribution Period means the life expectancy of the Descendant's Separate Trust Measuring Life. If the Grantor's death occurred on or after the Grantor's "required beginning date" with respect to such benefit, the Applicable Distribution Period means the life expectancy of

the Descendant's Separate Trust Measuring Life, or if longer, the Grantor's remaining life expectancy.

3. Notwithstanding the foregoing, if the Grantor's death occurred on or after the Grantor's "required beginning date" with respect to such benefit, the Minimum Required Distribution for the year of the Grantor's death shall mean (a) the amount that was required to be distributed to the Grantor with respect to such benefit during such year, minus (b) amounts actually distributed to the Grantor with respect to such benefit during such year.

4. Life expectancy, and the meaning of "required beginning date" and other terms in this paragraph, shall be determined in accordance with Code Sec. 401(a)(9).

5. As used in this paragraph to define the person who is to be treated as the designated beneficiary whose life expectancy will be used under Code Sec. 401(a)(9)(B)(iii), the term "Descendant's Separate Trust Measuring Life" refers to the Grantor's oldest descendant who is living at the date of the Grantor's death.

D. **Exclusion of Retirement Benefits from Creditors.** Anything to the contrary in this Trust Agreement notwithstanding, any Retirement Benefits payable to the Trustee under this Trust Agreement shall never be or become part of the Grantor's probate or testamentary estate hereunder, and nothing in this Trust Agreement shall be deemed to subject those proceeds to payment of the Grantor's debts or expenses.

Sample Age Restriction Accumulation See-Through Trust Clause:[64]

"NO BAD PEOPLE" PLAN BENEFITS TRUST

1.1. Plan Benefits Trusts. To the extent that the **Trustee** is designated as the beneficiary of any qualified benefit plan or individual retirement account or other Nonprobate Asset subject to the Minimum Required Distribution Rules (the "MRD Rules") (collectively "Plan Benefits"), the following provisions apply: (i) a Plan Benefits Trust corresponding to each trust provided for in this **instrument** is created; (ii) all Plan Benefits shall be allocated (A) in accordance with the directions, if any, contained in the beneficiary designation or other instrument of transfer; otherwise, (B) **if there is a surviving spouse, [subject to Section ____ (allocating all income in respect of a decedent to the Marital Deduction Amount),] to or among the trusts or individuals receiving the Deceased Spouse's Remaining Property; otherwise, (C)** Plan Benefits received with respect to the death of the Deceased Spouse shall be allocated to or among the trusts or individuals receiving the Deceased Spouse's Remaining Trust Property and Plan Benefits, substituting in each case Plan Benefits Trusts for their corresponding trusts; (iii) each Plan Benefits Trust shall be irrevocable; (iv) each Plan Benefits Trust shall be identical to its corresponding trust except that all of the following persons, if any, who would otherwise be beneficially interested in the trust (other than those whose interests are contingent solely upon the death of a prior beneficiary), are completely excluded as beneficiaries and permissible appointees of the trust: (A) individuals having a shorter life expectancy than the measuring beneficiary and (B) entities not having a life expectancy; and (v) the Trustee shall deliver a copy of this instrument or alternate descriptive information to the plan administrator in the form and content and within the time limits required by applicable statute and treasury regulations. For purposes of this Section, the "measuring beneficiary" of a Plan Benefits Trust means **(1)** the oldest individual who is both living and ascertainably specified in this instrument (by name or by class) as a current permissible beneficiary of the trust as of the date for determination of the "Designated Beneficiary" under applicable statute and treasury regulations**; or, if older, (2) our oldest then living descendant, if any**. We intend that, except for persons whose interests are contingent solely upon the death of a prior beneficiary, only individuals eligible as designated beneficiaries (as defined in Code Section 401(a)(9) and applicable treasury regulations) for purposes of the MRD Rules shall ever be permissible distributees or appointees of Plan Benefits Trusts. This instrument shall be administered and interpreted in a manner consistent with this intent. Any provision of this instrument which conflicts with this intent shall be deemed ambiguous and shall be construed, amplified, reconciled, or ignored as needed to achieve this intent.

[64] Contributed by Mickey Davis.

Sample Age Restriction Accumulation See-Through Trust Clause: [65]

In the allocation of property to Descendant's Trusts, we add the following if separate trusts will be maintained for retirement and non-retirement assets:

Each share so created for a child or more remote descendant of the Settlor shall constitute a separate Descendant's Trust to be held and distributed for his or her benefit as provided in Section [Cross references our regular Descendant's Trust provision], except that to the extent such property consists of an interest in a Retirement Account benefit, such interest shall instead constitute a separate Descendant's Retirement Trust to be held and distributed for his or her benefit as provided in Section __. Except as otherwise expressly provided to the contrary, references in this instrument to Descendant's Trusts shall include Descendant's Retirement Trusts. The Current Beneficiary of a Descendant's Trust is also referred to as the Primary Beneficiary of his or her Descendant's Trust.

Then we have a separate Descendant's Trust provision just for retirement assets:

1.1 Descendant's Retirement Trusts. The Descendant's Retirement Trust for each Primary Beneficiary shall commence upon the first receipt of property by the Trustee of such Descendant's Retirement Trust. Such property and any subsequent additions of property shall constitute the trust estate of such Descendant's Retirement Trust, which shall be held, administered and distributed pursuant to this Section __. Each such Descendant's Retirement Trust created for the benefit of a Primary Beneficiary may be referred to as the "[*Name of Primary Beneficiary*] Descendant's Retirement Trust." If a Descendant's Retirement Trust is divided into separate trusts pursuant to Section [Cross references our Division Into Separate Trusts provision] or otherwise, all references in this instrument to such "Descendant's Retirement Trust" shall be deemed to refer to all such separate trusts unless otherwise indicated *(please also refer to Section [Cross references our Distributions from Divided Trusts provision] if a Descendant's Retirement Trust is divided into separate trusts)*.

(a) **Distribution of Income and Principal**. The income and principal of each Descendant's Retirement Trust shall be held, administered and distributed as follows:[66]

(i) The Trustee, in the Trustee's discretion, may distribute to or for the benefit of the Primary Beneficiary as much of the net income and, if insufficient, the principal of the Descendant's Retirement Trust as the Trustee, in the Trustee's discretion, may determine to be necessary for the Primary Beneficiary's health, education and support.

(ii) Additionally, the Trustee, other than an Interested Person, may distribute to or for the benefit of the Primary Beneficiary as much of the net income and, if insufficient, the principal of the Descendant's Retirement Trust as such Trustee deems advisable, in such Trustee's sole discretion.

(iii) Any Officer authorized to make distributions under this Section __, may consider the Primary Beneficiary's other income or resources that are known to such Officer, including resources held in other trusts for the benefit of the Primary Beneficiary, the Primary Beneficiary's ability to obtain gainful employment, the obligations of others to support the Primary Beneficiary, and any benefits of income tax deferral that can be accomplished by accumulating the Primary Beneficiary's Tax-Advantaged Account assets.

(iv) Any income not so distributed shall be added to principal.

(v) The Settlor intends that any Officer determining whether to make distributions from a Descendant's Retirement Trust to its Primary Beneficiary consider the Primary Beneficiary's interests to be the primary concern, and the interests of any other beneficiary as subordinate to this purpose.

(b) **Descendant's Retirement Trust as Beneficiary of Retirement Account; Age Restrictions**. The Settlors intend that each Descendant's Retirement Trust that owns an interest in one or more Stretch-Out Retirement Accounts benefit from an extended deferral period under the Minimum Distribution Rules with respect to each

[65] Contributed by Steve Trytten.

[66] If the Primary Beneficiary's spouse or descendants are included among the current beneficiaries, be sure to draft carefully to ensure that this will not bring older life expectancies into play.

Stretch-Out Retirement Account of the trust. Accordingly, each Descendant's Retirement Trust shall be administered as follows:

(i) The Trustee shall either account separately or maintain separate shares in order to keep track of the source and amount of any Stretch-Out Retirement Account Accumulations held by the trust. *Please refer to Section X.[Cross references our Division Into Separate Trusts provision], which grants the Trustee the power to divide a trust into two or more separate trusts having the same terms and conditions as the original trust in order to accomplish this purpose.*

(ii) A person[67] is a "Disqualified Recipient" with respect to a Stretch-Out Retirement Account[68] if said person is not a "Qualified Recipient." A person is a "Qualified Recipient" if that person would, had that person been designated as the sole death beneficiary of the Stretch-Out Retirement Account, be allowed under the Minimum Distribution Rules to calculate the minimum required distributions from said Stretch-Out Retirement Account following the year of the Participant's death using the life expectancy of an individual born no sooner than January 1 of the calendar year of birth of the Settlor's oldest descendant living at the time of said Participant's death.[69]

(iii) Any exercise of the special power of appointment granted to the Primary Beneficiary under Section 1.1(d)(i) with respect to a Stretch-Out Retirement Account or Stretch-Out Retirement Account Accumulations therefrom shall be interpreted and carried out as if each and every person who is a Disqualified Recipient with respect to said Stretch-Out Retirement Account is deceased upon the Primary Beneficiary's death or not then in existence, even if the result is that said exercise fails with respect to said assets. Notwithstanding the foregoing, any exercise of said special power of appointment in favor of one or more Disqualified Recipients with respect to said assets shall not otherwise cause the exercise of such power of appointment to be deemed an invalid exercise.

(iv) The general power of appointment granted to the Primary Beneficiary under Section 1.1(d)(ii) may not be used to appoint any Stretch-Out Retirement Account or Stretch-Out Retirement Account Accumulations therefrom. The "Limited Portion" referred to in said Section shall be determined only with respect to the assets of the trust other than Stretch-Out Retirement Accounts or Stretch-Out Retirement Account Accumulations therefrom.

(v) Any allocation or distribution of a Stretch-Out Retirement Account or Stretch-Out Retirement Account Accumulations therefrom arising by reason of the Primary Beneficiary's death under Section 1.1(e) shall be interpreted and carried out as if each and every person who is a Disqualified Recipient with respect to said Stretch-Out Retirement Account is then deceased or not then in existence, even if the result is that said allocation or distribution cannot be made for lack of any recipient who is not a Disqualified Recipient. Further, in the event any such allocation or distribution is made to a Descendant's Retirement Trust pursuant to Section 1.1(e), the Trustee of that Descendant's Retirement Trust shall administer the portion of the trust consisting of such allocation or distribution as if each and every person who is a Disqualified Recipient with respect to said Stretch-Out Retirement Account is then deceased or not then in existence.[70]

(vi) Any distribution of a Stretch-Out Retirement Account or Stretch-Out Retirement Account Accumulations therefrom under Section [Cross references our Alternate Distribution provision, which directs distribution of assets if all of the intended beneficiaries are deceased] shall be interpreted and

[67] The term "person" is intentionally used to include the broadest possible class of individuals, trusts, estates, charities, or other entities.
[68] The term Stretch-Out Retirement Account is drafted in a way that excludes retirement plans that do not stretch-out over the intended life expectancy. Thus, the age restriction provisions will not be imposed if the Obama proposal to impose a five year limit on post-death distributions is enacted.
[69] Using the age of the oldest descendant avoids drafting complications. Although the age of each primary beneficiary could be used, this makes the drafting of successor dynasty trusts and cross-over provisions very difficult since multiple ages must be tracked.
[70] This additional language is necessary to avoid bringing Disqualified Persons back into subsequent dynasty trusts for descendants.

carried out as if each and every person who is a Disqualified Recipient with respect to said Stretch-Out Retirement Account Accumulations therefrom is then deceased or not then in existence.[71]

(c) **Lifetime Power to Withdraw GST Non-Exempt Retirement Assets With Consent of Trust Protector**. Each Primary Beneficiary may direct the Trustee of his or her Non-GST Exempt Descendant's Retirement Trust to distribute to the Primary Beneficiary all or any portion of said trust's Stretch-Out Retirement Accounts or Stretch-Out Retirement Account Accumulations therefrom with the advance, written consent of the Trust Protector, which the Trust Protector may grant or not grant in its sole discretion. Notwithstanding the foregoing, subject to the restrictions set forth in Section [Cross references the provision of our trust that puts restrictions on the amendment powers held by the Trust Protector] the Trust Protector shall have the power to modify or eliminate the Primary Beneficiary's lifetime power of withdrawal granted under this Section __.[72]

(d) **Primary Beneficiary's Powers of Appointment**. The Primary Beneficiary shall have the following powers of appointment over his or her Descendant's Retirement Trust, each of which shall be exercisable in the manner provided in Section [Cross references our Provisions Regarding Powers of Appointment clause]:

(i) **Special Power Over Descendant's Retirement Trust.** Subject to the limitations set forth in Section __, each Primary Beneficiary who has attained 25 years of age shall have the power to appoint the principal and any undistributed income of his or her Descendant's Retirement Trust to pass upon his or her death in favor of any one or more appointees[73] other than the Primary Beneficiary's creditors, estate, or the creditors of the Primary Beneficiary's estate (said power is referred to as a "Special Power"). The Primary Beneficiary's Special Power under this Section __ is intended not to cause any part of the trust to be included in the Primary Beneficiary's gross estate for federal estate tax purposes and shall not be construed as a general power of appointment within the meaning of Code Section 2041(b)(1).

(ii) **General Power over Limited Portion of GST Non-Exempt Descendant's Retirement Trust.** Subject to the limitations set forth in Section __, each Primary Beneficiary (regardless of age) of a GST Non-Exempt Descendant's Retirement Trust shall also have the power to appoint the principal and any undistributed income of the Limited Portion (as hereinafter defined) of such trust to pass upon his or her death in favor of the creditors of his or her estate (other than any taxing authority) (said power is referred to as a "General Power"). The "Limited Portion" of such trust is that portion, if any, for which GST Tax would be payable by reason of the Primary Beneficiary's death if the Primary Beneficiary did not have the General Power under this Section __ (after taking into account all exemptions, exclusions, deductions and credits other than any GST exemption allocated to such trust by reason of the Primary Beneficiary's death), without regard to any exercise of a Special Power by the Primary Beneficiary under Section __. The Primary Beneficiary's General Power under this Section __ is intended to cause the Limited Portion of such trust to be included in the Primary Beneficiary's gross estate for federal estate tax purposes rather than being subject to GST Tax, and shall constitute a "general power of appointment" within the meaning of Code Section 2041(b)(1).

(iii) **Trust Protector's Power to Alter Powers of Appointment**. Please refer to Section [Cross references our provision granting the Trust Protector amendment powers over powers of appointment], which grants the Trust Protector certain powers to alter, eliminate or reinstate the powers of appointment granted to a Primary Beneficiary under this Section __. *(The Settlor included these powers to allow tax planning flexibility.)*

(e) **Death of Primary Beneficiary**. Subject to the limitations set forth in Section __, upon the death of a Primary Beneficiary, the Trustee shall distribute said Primary Beneficiary's Descendant's Retirement Trust (including such items of property as may pass generally to said trust by reason of said Primary Beneficiary's death) in such manner as the Primary Beneficiary shall have effectively appointed, if applicable, and shall allocate the

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[71] The Alternate Distribution provision contains a cross-reference to this provision.

[72] This clause is intended to force inclusion of non-exempt retirement interests in the Primary Beneficiary's gross estate, without including a general power of appointment that might interfere with optimal stretch-out of MRDs. This clause may not be desirable in all cases. In some cases it may be worthwhile providing a mechanism that would allow this power to be "turned off" for certain beneficiaries.

[73] This clause illustrates a broad special power, but there is no reason why it could not be limited to a more select group of appointees.

unappointed balance of the trust into shares on the principle of representation for the then living members of the class of descendants identified earliest in the following list with at least one class member then living:

1ST The deceased Primary Beneficiary's descendants.

2ND The descendants of the deceased Primary Beneficiary's closest lineal ancestor who was a descendant of the Settlor.

3RD The descendants of the Settlor.

Subject to Section 1.1(b)(v), any share so established for an individual under this Section __ shall be applied to create or augment a Descendant's Retirement Trust to be held and distributed for such individual as provided in this Section __ (each of whom is referred to as the "Primary Beneficiary" of his or her Descendant's Retirement Trust).

If none of the individuals described above are then living, the Trustee shall distribute such property as provided in Section [Cross references our Alternate Distribution provision].

See Steve Trytten's sample forms in Chapter X for selected provisions from the administrative sections of the trust instrument. The following clause is an important addition to ensure that any division between Exempt and Non-Exempt trusts complies with the GST regulations.

10.11 **Division Into Separate Trusts.** The Trustee of a trust hereunder may divide the trust into two or more separate trusts having the same terms and conditions as the original trust in order to accomplish any purpose the Trustee determines is consistent with the purpose of the trust. For example, but not by way of limitation, a trust may be divided:

(a) To enable Tax-Advantaged Accounts to be segregated from other trust assets;

(b) To avoid holding one or more Stretch-Out Retirement Accounts with other trust assets; provided, however, that Stretch-Out Retirement Account Accumulations therefrom stay with the Stretch-Out Retirement Account;

(c) To avoid holding GST Exempt and GST Non-Exempt assets together in the same trust; and

(d) To avoid jeopardizing the S corporation status of any corporation seeking to maintain S corporation status as to which the trust is a shareholder.

When dividing a trust under this Section 10.11, the Trustee shall generally have the discretion to select the assets to be allocated to the trusts arising from such a division in any manner that is fair and equitable, except that with respect to any division into GST Exempt and GST Non-Exempt trusts, the Trustee shall allocate assets to the trusts arising from such a division in a manner consistent with the requirements of Treasury Regulation Section 26.2654-1(b)(1) (or any related or successor rule or regulation).

Any separate trusts resulting from the division of an original trust pursuant to this Section 10.11 may be given descriptive names to distinguish them from one another. For example, a Descendant's Trust that is divided to avoid holding GST Exempt and GST Non-Exempt assets together in the same trust may be referred to respectively as a "GST Exempt Descendant's Trust" and a "GST Non-Exempt Descendant's Trust."

Sample Last One Standing Accumulation See-Through Trust Clause: [74]

1.1 Descendant's Retirement Trusts. The Descendant's Retirement Trust for each Primary Beneficiary shall commence upon the first receipt of property by the Trustee of such Descendant's Retirement Trust. Such property and any

[74] Contributed by Steve Trytten. The "last one standing" approach limits a trust to a class of descendants, and then terminates if at any point there is only one descendant. Note that in many cases, using an "age restriction" trust that uses the age of the oldest descendant will be a more flexible approach in that non-descendants could be included, and the trust does not necessarily terminate at such time as there is only one descendant.

subsequent additions of property shall constitute the trust estate of such Descendant's Retirement Trust, which shall be held, administered and distributed pursuant to this Section __. Each such Descendant's Retirement Trust created for the benefit of a Primary Beneficiary may be referred to as the "[*Name of Primary Beneficiary*] Descendant's Retirement Trust." If a Descendant's Retirement Trust is divided into separate trusts pursuant to Section [Cross references our Division Into Separate Trusts provision] or otherwise, all references in this instrument to such "Descendant's Retirement Trust" shall be deemed to refer to all such separate trusts unless otherwise indicated *(please also refer to Section [Cross references our Distributions from Divided Trusts provision] if a Descendant's Retirement Trust is divided into separate trusts)*.

(a) **Distribution of Income and Principal**. The income and principal of each Descendant's Retirement Trust shall be held, administered and distributed as follows:

(i) The Trustee, in the Trustee's discretion, may distribute to or for the benefit of the Primary Beneficiary as much of the net income and, if insufficient, the principal of the Descendant's Retirement Trust as the Trustee, in the Trustee's discretion, may determine to be necessary for the Primary Beneficiary's health, education and support.[75]

(ii) Additionally, the Trustee, other than an Interested Person, may distribute to or for the benefit of the Primary Beneficiary as much of the net income and, if insufficient, the principal of the Descendant's Retirement Trust as such Trustee deems advisable, in such Trustee's sole discretion.

(iii) Any Officer authorized to make distributions under this Section __, may consider the Primary Beneficiary's other income or resources that are known to such Officer, including resources held in other trusts for the benefit of the Primary Beneficiary, the Primary Beneficiary's ability to obtain gainful employment, the obligations of others to support the Primary Beneficiary, and any benefits of income tax deferral that can be accomplished by accumulating the Primary Beneficiary's Tax-Advantaged Account assets.

(iv) Any income not so distributed shall be added to principal.

(v) The Settlor intends that any Officer determining whether to make distributions from a Descendant's Retirement Trust to its Primary Beneficiary consider the Primary Beneficiary's interests to be the primary concern, and the interests of any other beneficiary as subordinate to this purpose.

(vi) **Descendant's Retirement Trust as Beneficiary of Retirement Account**. The Settlor intends that each Descendant's Retirement Trust that owns an interest in a Stretch-Out Retirement Account benefit from an extended deferral period under the Minimum Distribution Rules with respect to each Stretch-Out Retirement Account of the trust. Accordingly, each Descendant's Retirement Trust shall either account separately or maintain separate shares in order to keep track of the source and amount of any Stretch-Out Retirement Account Accumulations held by such trust. *Please refer to Section [Cross references our Division Into Separate Trusts provision], which grants the Trustee the power to divide a trust into two or more separate trusts having the same terms and conditions as the original trust in order to accomplish this purpose.*[76]

(b) **Termination of Trust's Interest in Retirement Assets – Primary Beneficiary is Last Remaining Class Member**. At such time that the Primary Beneficiary is the only living member of the class of the Settlor's descendants (excluding any individual born prior to January 1 of the Primary Beneficiary's year of birth, as if such individual had predeceased the Primary Beneficiary)[77], each of his or her Descendant's Trusts shall terminate with respect to the trust's interests in Stretch-Out Retirement Accounts or Stretch-Out Retirement Account Accumulations, and said interests shall be distributed to the Primary Beneficiary outright and free of trust.

[75] If any other beneficiaries are included, it is essential that they are within the eligible class of descendants.

[76] Compare this provision to Section 1.2 of the Age Restriction sample form – it is much shorter. The takeaway is that the last one standing approach requires less complex drafting than the age restriction approach.

[77] Only include this parenthetical if each trust is to be "age restricted" to that Primary Beneficiary, which would exclude older class members. This will complicate drafting of cross-over provisions and successor trusts to track the various ages that may be in play.

(c) **Lifetime Power to Withdraw GST Non-Exempt Retirement Assets With Consent of Trust Protector**. [78] Each Primary Beneficiary may direct the Trustee of his or her Non-GST Exempt Descendant's Retirement Trust to distribute to the Primary Beneficiary all or any portion of said trust's Stretch-Out Retirement Accounts or Stretch-Out Retirement Account Accumulations therefrom with the advance, written consent of the Trust Protector, which the Trust Protector may grant or not grant in its sole discretion. Notwithstanding the foregoing, subject to the restrictions set forth in Section [Cross references the provision of our trust that puts restrictions on the amendment powers held by the Trust Protector] the Trust Protector shall have the power to modify or eliminate the Primary Beneficiary's lifetime power of withdrawal granted under this Section__.

(d) **Primary Beneficiary's Powers of Appointment**. The Primary Beneficiary shall have the following powers of appointment over his or her Descendant's Retirement Trust, each of which shall be exercisable in the manner provided in Section [Cross references our Provisions Regarding Powers of Appointment clause]:

(i) **Special Power Over Descendant's Retirement Trust.** Each Primary Beneficiary who has attained 25 years of age shall have the power to appoint the principal and any undistributed income of his or her Descendant's Retirement Trust to pass upon his or her death in favor of any one or more of the Settlor's descendants[79] (said power is referred to as a "Special Power"). The Primary Beneficiary's Special Power under this Section __ is intended not to cause any part of the trust to be included in the Primary Beneficiary's gross estate for federal estate tax purposes and shall not be construed as a general power of appointment within the meaning of Code Section 2041(b)(1).

(ii) **General Power over Limited Portion of GST Non-Exempt Descendant's Retirement Trust.** In no event may the Primary Beneficiary exercise his or her general power of appointment to appoint any Stretch-Out Retirement Account or Stretch-Out Retirement Account Accumulations.[80] Otherwise, each Primary Beneficiary (regardless of age) of a GST Non-Exempt Descendant's Retirement Trust shall also have the power to appoint the principal and any undistributed income of the Limited Portion (as hereinafter defined) of such trust to pass upon his or her death in favor of the creditors of his or her estate (other than any taxing authority) (said power is referred to as a "General Power"). The "Limited Portion" of such trust is that portion, if any, for which GST Tax would be payable by reason of the Primary Beneficiary's death if the Primary Beneficiary did not have the General Power under this Section __ (after taking into account all exemptions, exclusions, deductions and credits other than any GST exemption allocated to such trust by reason of the Primary Beneficiary's death), without regard to any exercise of a Special Power by the Primary Beneficiary under Section __. The Primary Beneficiary's General Power under this Section __ is intended to cause the Limited Portion of such trust to be included in the Primary Beneficiary's gross estate for federal estate tax purposes rather than being subject to GST Tax, and shall constitute a "general power of appointment" within the meaning of Code Section 2041(b)(1).

(iii) **Trust Protector's Power to Alter Powers of Appointment**. Please refer to Section [Cross references our provision granting the Trust Protector amendment powers over powers of appointment], which grants the Trust Protector certain powers to alter, eliminate or reinstate the powers of appointment granted to a Primary Beneficiary under this Section __. *(The Settlor included these powers to allow tax planning flexibility.)*

(e) **Death of Primary Beneficiary; Retirement Assets to Last Remaining Class Member**. Upon the death of a Primary Beneficiary (the "deceased Primary Beneficiary"), the following shall apply:

(i) In the event that the deceased Primary Beneficiary is survived by only one member of the class of the Settlor's descendants (excluding any individual born prior to January 1 of the deceased Primary Beneficiary's year of birth, as if such individual had predeceased the deceased Primary Beneficiary)[81], the

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[78] This clause is intended to force inclusion of non-exempt retirement interests in the Primary Beneficiary's gross estate, without including a general power of appointment that might interfere with optimal stretch-out of MRDs. This clause may not be desirable in all cases. In some cases it may be worthwhile providing a mechanism that would allow this power to be "turned off" for certain beneficiaries.

[79] This power of appointment must be limited to descendants.

[80] Stretch-out retirement plans must not be able to be appointed to anyone other than descendants, and thus should be excluded from this general power of appointment.

[81] Only include this parenthetical if each trust is age restricted for each Primary Beneficiary.

Descendant's Trust's interests in Stretch-Out Retirement Accounts or Stretch-Out Retirement Account Accumulations, if any, shall pass to said surviving class member outright and free of trust, and any exercise of a power of appointment over such assets under Section __ shall be ineffective with respect to those assets, but shall not otherwise cause the exercise of such power of appointment to be deemed to be an invalid exercise.

(ii) Except as provided in subsection__, the Trustee shall distribute said Primary Beneficiary's Descendant's Retirement Trust (including such items of property as may pass generally to said trust by reason of said Primary Beneficiary's death) in such manner as the Primary Beneficiary shall have effectively appointed, if applicable, and shall divide the unappointed balance of the trust into shares on the principle of representation for the then living members of the class of descendants identified earliest below with at least one class member then living:

1ST The deceased Primary Beneficiary's descendants.

2ND The descendants of the deceased Primary Beneficiary's closest lineal ancestor who was a descendant of the Settlor.

3RD The descendants of the Settlor.

Any share so established for an individual under this Section __ shall be applied to create or augment a Descendant's Retirement Trust to be held and distributed for such individual as provided in this Section __ (each of whom is referred to as the "Primary Beneficiary" of his or her Descendant's Retirement Trust).

If none of the individuals described in the foregoing provisions of this Section __ are then living, the Trustee shall distribute such property as provided in Section [Cross references our Alternate Distribution provision].

Notwithstanding the foregoing, with respect to the Descendant's Retirement Trust's interests in Stretch-Out Retirement Accounts or Stretch-Out Retirement Account Accumulations therefrom, the determination of whether a class of descendants listed in the foregoing provisions of this Section __ has one or more members then living, and the division among the class that is do determined to have one or more members then living, shall be made as if each individual born prior to January 1 of the deceased Primary Beneficiary's year of birth had predeceased the deceased Primary Beneficiary.[82]

See Steve Trytten's sample forms in Chapter X for selected provisions from the administrative sections of the trust instrument.

We give the Trust Protector a broad amendment power to carry out the purposes of the trust for its intended beneficiaries, which includes as an example: "to enhance the overall after-tax valuation of any Tax-Advantaged Account in which the trust has an interest." However, we restrict the Trust Protector's broad amendment powers to protect see-through trust status:

(i) Notwithstanding any of the foregoing provisions of this Section, with respect to a Descendant's Trust created hereunder that holds an interest in a Stretch-Out Retirement Account, including Stretch-Out Retirement Account Accumulations, as to which a Primary Beneficiary is the Stretch-Out Retirement Beneficiary, permits a Disqualified Recipient (as defined in Section __) to (a) receive any interest in any Stretch-Out Retirement Account of the trust or Stretch-Out Retirement Account Accumulations therefrom, (b) be included as a potential recipient of any interest in any Stretch-Out Retirement Account of the trust or Stretch-Out Retirement Account Accumulations therefrom by reason of the Primary Beneficiary's exercise of a power of appointment over such Descendant's Trust, or (c) otherwise possess any beneficial interest in such Descendant's Trust.

[82] Only include this paragraph if each trust is to be age restricted for each Primary Beneficiary.

We give the Trust Protector broad amendment powers over powers of appointment, as well. But we limit these powers specifically in an Age Restriction scenario as follows:

(iii) Notwithstanding the foregoing, the Trust Protector shall not exercise any of its powers under this Section [Cross references the provision granting the Trust Protector amendment powers over powers of appointment] in a manner that would permit a Disqualified Recipient (as defined in Section__) to receive any interest in any Stretch-Out Retirement Account of the trust or Stretch-Out Retirement Account Accumulations therefrom.

XII. Apportionment of Expenses and Death Taxes on Retirement Plans

Background. Tax apportionment provisions are important in every estate plan. They are generally outside the scope of these materials, but a few comments and sample clauses are in order where retirement plans are concerned.

Absent special drafting, death taxes or expenses may be chargeable to retirement plans, resulting in retirement plan distributions that could otherwise be deferred. If these distributions are taxable, additional income taxes will also occur. In some cases this may trigger even more retirement plan distributions to fund income tax payments, and these cascading distributions are sometimes referred to as "retirement plan melt-down."

The solution may not always be as simple as directing that retirement plan assets pass free of taxes and expenses, since they might be passing to different persons than the other assets that would absorb said taxes and expenses. The following sample clauses allow for the possibility of different heirs, and provide the fiduciary with as much flexibility as possible to locate funds to pay taxes and expenses, without changing the dispositive outcome.

Sample Clause Addressing Apportionment of Expenses and Death Taxes to Retirement Plans: [83]

1.1 Exceptions and Clarifications to Payment of Debts, Expenses and Death Taxes. The following exceptions and clarifications shall modify the rules provided in Sections [Cross references our Payment of Debts and Expenses provision] and [Cross references our General Rule for Payment and Apportionment of Death Taxes provision]:

(a) **Tax-Advantaged Accounts or Other Assets Passing Outside Trust**. If the Trustee determines that all or any portion of a debt of the Settlor, expense of administration, or Death Tax is properly chargeable, by reason of the Settlor's death, to a beneficiary's interest in property not passing under any trust hereunder (including a Tax-Advantaged Account[84]), the Trustee may in its sole discretion pay all or part of said amount by applying any combination the Trustee determines in its sole discretion of the following assets (and any such payment shall be credited against the amount chargeable to said interest in property not passing under any trust hereunder): (i) assets the beneficiary offers to provide for this purpose; or (ii) assets the Trustee selects for this purpose (other than assets qualifying for the charitable or marital deductions from federal estate tax in the Settlor's estate) from assets passing under any one or more trusts hereunder to or for the benefit of the beneficiary as determined by the Trustee in its sole discretion. The Settlor requests, but does not require, that the Trustee apply assets other than Tax-Advantaged Account assets to pay said amount when doing so reduces the need to take a distribution from a Tax-Advantaged Account earlier than would otherwise be necessary, thus enhancing the beneficiary's ability to benefit from income tax deferred compounding. The Trustee's powers provided under this Section 0 are in addition to, and not in place of, other powers provided the Trustee under this or other instruments, or under applicable law.

(b) **"Stretch-Out Retirement Accounts" Passing Under Trust Instrument**. The Trustee shall not apply Stretch-Out Retirement Account assets passing under any trust hereunder to pay any portion of a debt of the Settlor, expense of administration, or Death Tax arising by reason of the Settlor's death, except as follows:[85]

(i) **Payment Prior to September 30 Determination Date**. If the Trustee determines, prior to the Determination Date (as defined in Section__), that all or any portion of a debt of the Settlor, expense of administration, or Death Tax is properly chargeable by reason of the Settlor's death to a beneficiary's interest in a Stretch-Out Retirement Account passing under any trust hereunder, the Trustee shall pay said amount prior to the Determination Date by applying the following assets in any combination the Trustee determines in its sole discretion (and such payment shall be credited against the amount chargeable to said Stretch-Out Retirement Account interest): (a) assets from said Stretch-Out Retirement Account interest; (b) assets the beneficiary offers to provide for this purpose; or (c) assets the Trustee selects for this purpose (other than assets qualifying for the charitable or marital deductions from federal estate tax in the Settlor's

[83] Contributed by Steve Trytten.

[84] For the definitions of the retirement account capitalized terms used in these provisions, see any of Modules 8, 9, and 10.

[85] Commentators have expressed concern whether the IRS might treat a trust as having the decedent's estate as a beneficiary if the trust can be burdened with the decedent's debts, expenses of administration, or death taxes. However, there is no known authority or case in which the IRS has raised this issue. If it is desired to protect against potential challenge by the IRS on these grounds, this section provides an argument that any debts, expenses, or death taxes had to have been paid prior to the end of the post-mortem planning window. It follows that even if the estate was a beneficiary, it has dropped out within the post-mortem planning window and should not be counted for purposes of determining the trust's minimum distributions.

estate) from assets passing under any one or more trusts hereunder to or for the benefit of the beneficiary as determined by the Trustee in its sole discretion. The Settlor requests, but does not require, that the Trustee apply assets other than Stretch-Out Retirement Account assets to pay said amount when doing so reduces the need to take a distribution from the Stretch-Out Retirement Account earlier than would otherwise be necessary, thus enhancing the beneficiary's ability to benefit from income tax deferred compounding.

(ii) **Amounts Determined On or After September 30 Determination Date**. If the Trustee determines, on or after the Determination Date, that all or any portion of a debt of the Settlor, expense of administration, or any Death Tax would be properly chargeable by reason of the Settlor's death, but for the operation of this Section __, to a beneficiary's interest in one or more Stretch-Out Retirement Account interests passing under any trust hereunder, the Trustee shall pay said amount by first applying the following assets in any combination the Trustee determines in its sole discretion: (a) assets the beneficiary offers to provide for this purpose; or (b) assets the Trustee selects for this purpose (other than Stretch-Out Retirement Account assets or assets qualifying for the charitable or marital deductions from federal estate tax in the Settlor's estate) from assets passing under any one or more trusts hereunder to or for the benefit of the beneficiary as determined by the Trustee in its sole discretion; and the Trustee shall apply assets from said Stretch-Out Retirement Account interests to pay said amount only to the extent that said other assets are insufficient to do so.

(iii) **Determination Date**. For purposes of this instrument, the term "Determination Date" means, with respect to a Stretch-Out Retirement Account as to which the Participant has died, the thirtieth day of September of the calendar year following the calendar year of the death of the Participant, or such other date as may be provided for determining post-death designated beneficiaries under the Minimum Distribution Rules (e.g., Treasury Regulations Section 1.401(a)(9)-4).

1.2 Payment and Apportionment of GST Tax. As a general rule, any GST Tax arising by reason of the Settlor's death or by reason of a distribution or termination under this instrument (which for purposes of this Section shall be interpreted as including tax payments, if any, treated as part of the distribution or termination for purposes of determining the GST Tax), shall be paid, charged to, prorated among, or recovered in the manner provided by California and federal law in effect at the time of such death or event (not to the exclusion of laws of other jurisdictions when applicable, and allowing appropriate deference to federal rules to the extent they supersede the rules of California or other jurisdictions). The following exceptions and clarifications shall modify this general rule for the payment and apportionment of GST Taxes and, since GST Tax is defined making reference to Chapter 13 of the Code, are intended to satisfy the requirements of Code Section 2603(b):

(a) **Tax-Advantaged Accounts or Other Assets Passing Outside Trust**. If the Trustee determines that all or any portion of a GST Tax is properly chargeable, by reason of the Settlor's death, to a beneficiary's interest in property not passing under any trust hereunder (including a Tax-Advantaged Account), the Trustee may in its sole discretion pay all or part of said GST Tax by applying any combination the Trustee determines in its sole discretion of the following assets (and any such payment shall be credited against the amount chargeable to said interest in property not passing under any trust hereunder): (i) assets the beneficiary offers to provide for this purpose; or (ii) assets the Trustee selects for this purpose (other than assets qualifying for the charitable or marital deductions from federal estate tax in a Settlor's estate) from assets passing under any one or more trusts hereunder to or for the benefit of the beneficiary as determined by the Trustee in its sole discretion. The Settlor requests, but does not require, that the Trustee apply assets other than Tax-Advantaged Account assets to pay said amount when doing so reduces the need to take a distribution from a Tax-Advantaged Account earlier than would otherwise be necessary, thus enhancing the beneficiary's ability to benefit from income tax deferred compounding. The Trustee's powers provided under this Section __ are in addition to, and not in place of, other powers provided the Trustee under this or other instruments, or under applicable law.

XIII. Flexibility to Manage State Fiduciary Income Tax

Background. State income taxes can have a significant economic impact. Flexibility in the trust instrument to move a trust's situs can be very helpful in managing state income tax issues. A Trustee's State of residence could cause higher state income taxes at the trust level (for example if the Trustee lives in California, which apportions fiduciary income tax based on the residence of Trustees and the residence of non-contingent beneficiaries). The Trustee may be concerned whether he or she has any duty to resign, and whether he or she has any exposure for continuing to serve. Explicit exoneration may helpful, if it is consistent with the Settlor's intent.

Sample Clause Addressing Change of Situs: [86]

Q. **Change of Situs.** The situs of the property of any trust created hereunder may be maintained in any jurisdiction that is appropriate to the trust purposes and its administration, in the discretion of the Trustee (other than an Interested Trustee), and thereafter transferred at any time or times to any such jurisdiction selected by the Trustee (other than an Interested Trustee) in accordance with applicable state law, which may include court approval of the transfer or adequate notice to trust beneficiaries. Upon any such transfer of situs, the trust estate of that trust may thereafter, at the election of the Trustee (other than an Interested Trustee) of said trust, be administered exclusively under the laws of (and subject, as required, to the exclusive supervision of the courts of) the jurisdiction to which it has been transferred. Accordingly, if the Trustee (other than an Interested Trustee) of any trust created hereunder elects to change the situs of any such trust, said Trustee is hereby relieved of any requirement to qualify in any other jurisdiction and of any requirement to account in any court of such other jurisdiction.

Sample Clause Addressing Change of Situs and Governing Law: [87]

CHANGE OF SITUS AND CHANGE OF GOVERNING LAW:

Governing Law.

(a) **Generally.** To the extent consistent with the other provisions of this instrument, (i) the Trustee shall have the powers, duties, and liabilities of trustees set forth in the [State Trust Code], as amended and in effect from time to time, and (ii) the construction, validity and administration of every trust created under this instrument shall be governed by Texas law.

(b) **Change Of Governing Law.** The Trustee of any trust may designate any other jurisdiction's law as the governing law with respect to the administration of that trust, on the following conditions: (i) The change of governing law must be in the best interests of the trust's beneficiaries and must not jeopardize (A) the grantor's[s'] purpose in establishing the trust or (B) any otherwise allowable estate tax deduction or generation-skipping transfer tax exemption. (ii) The Trustee (or at least one Co-Trustee) of the trust must be domiciled (in the case of an individual Trustee) or have its principal place of business (in the case of a bank or other corporate trustee) in the designated jurisdiction. (iii) The designated jurisdiction may be any nation, state, district, territory, political subdivision, or similar jurisdiction. (iv) The designation must be by signed, acknowledged declaration which states the effective date of the designation and is filed among the trust records. (v) Unless waived, thirty days' advance written notice of the proposed designation must be given (A) to [each grantor] who is then living, and to the beneficiary for whom the trust is named, if any, otherwise to each adult beneficiary of the trust who is then permitted to receive distributions from the trust, if any, and (B) to the [Trustee Appointer or Trust Protector]. (vi) There is no limit on the number of successive designations of governing law for any trust. (vii) Notwithstanding any designation, [State] law shall continue to apply to the extent that the powers of the Trustee are broader under [State] law than under the designated jurisdiction's law.

Sample Clause Addressing Change of Situs and Governing Law: [88]

1.3 Governing Law and Change of Situs. The validity, construction and all rights under this instrument (including those respecting the exercise of a power of appointment) are governed by the internal law (and not the law of conflicts) of the State of California; provided, however, that all matters pertaining to the Trustee's administration of real property shall be governed by the laws of the situs of such real property, including such state's conflict of law principles.

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[86] See Article XXX, Section O. of sample trust contributed by Jonathan Blattmachr.
[87] Contributed by Mickey Davis.
[88] Contributed by Steve Trytten.

This Section ___ shall apply regardless of any change of residence of any Trustee or any beneficiary, or the appointment or substitution of a Trustee residing in another state. The Trustee of a trust hereunder may, with the consent of a majority of the Current Beneficiaries of such trust, change the situs of such trust and elect to have such trust be governed by the laws of another jurisdiction.

Sample Clause Addressing Exoneration of Fiduciary (including State Income Tax Arising from Fiduciary's Residence): [89]

1.1 Advancement of Expenses; Exoneration of Trustees.

(a) **Indemnification of Individual Trustees**. Each Trustee who is an individual, other than an individual who is a Professional Trustee (as defined in Section __), shall not be held liable and shall be held harmless and indemnified against any and all claims (including any error of judgment, exercise or non-exercise of any power or discretion, mistake of law, or action or inaction of any kind), except for (i) a breach of trust committed intentionally, with gross negligence, in bad faith, or with reckless indifference to the interest of the beneficiary bringing the claim, or (ii) any profit that the Trustee derives from such a breach of trust. Said indemnification shall extend to any expenses incurred by the Trustee in connection with said claims to the fullest extent not prohibited by applicable law.

(b) **Increased Tax Arising by Reason of Trustee's Residence**. The claims that qualify for indemnification for certain Trustees under Subsection 1.1(a) include any increased taxes that apply to the trust by reason of such Trustee's residence in the State of California. Further, such Trustee shall owe no duty to resign notwithstanding increased taxes apply to the trust by reason of such Trustee's residence in the State of California.

(c) **Advancement of Expenses**. Expenses incurred by any Trustee in defending any claim or demand against the Trustee or the trust shall be paid by the trust estate in advance of the final disposition of such claim or demand (and the Trustee shall, for this purpose, be entitled to a presumption that the Trustee is not liable under such claim or demand); provided, however, that the Trustee shall repay any such advanced amount if it is ultimately determined that such Trustee is liable for such claim or demand.

(d) **Definitions**. For purposes of this Section __, the following terms shall have the following meanings:

(i) The term "expenses" shall be broadly construed and shall include, without limitation, court costs, attorneys' fees, witness fees, fines, reduction in compensation for service as a Trustee, amounts paid in settlement or judgment and any other costs and expenses of any nature or kind incurred in connection with any proceeding.

(ii) The term "proceeding" shall be broadly construed and shall include, without limitation, the investigation, preparation, prosecution, defense, settlement, arbitration and appeal of, and giving of testimony in, any threatened, pending or completed action or lawsuit.

(iii) The term "Professional Trustee" shall mean any individual who regularly engages in the business of serving as a trustee or regularly holds himself or herself out to the public as offering such service for a fee; provided, however, that in no event shall the term "Professional Trustee" be deemed to include an attorney or C.P.A. serving as a Trustee as a result of the nomination, designation or appointment to such office by a client (or an employee or affiliate of a client) or if such nomination, designation or appointment is otherwise related, directly or indirectly, to the relationship between a client or former client and his or her attorney or C.P.A.

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[89] Contributed by Steve Trytten.

XIV. Managing Whether Dynasty Trust is Taxed Under Ch. 11 or Ch. 13 at Beneficiary's Death

Background. The assets in a non-exempt dynasty trust may be subject to transfer tax at the primary beneficiary's death. The terms of the trust and the actions of the primary beneficiary may allow a choice as to whether the assets are included in the primary beneficiary's estate for estate tax. If not, generation skipping transfer tax ("GST Tax") may apply if the primary beneficiary's death is a GST taxable event.

It is difficult to predict in advance whether it is better for non-exempt assets to be subjected to estate tax or to GST tax. A number of variables are involved, and that analysis will be a moving target over time as circumstances and tax laws evolve. An in-depth treatment of this issue also is outside the scope of these materials, but a few key variables to consider include:

- The other assets that may be subject to transfer tax, and the amounts of transfer tax credits, exemptions, graduated rate brackets, *etc.* available to the primary beneficiary, spouse, or other family members;
- Whether it may be possible to pay transfer tax on a "tax exclusive" basis, such as the gift tax calculated on lifetime gifts (or the generation skipping transfer tax calculated on direct skips);
- The potential credit for taxes paid on prior transfers that is available under IRC Section 2013 with respect to estate tax payments, but not generation skipping transfer tax;
- The likelihood that the non-exempt assets will pass to persons or trusts who are skip persons, as generation skipping transfer tax would not apply if the assets pass to non-skip persons (*e.g.*, are assets likely to pass to or for the benefit of the primary beneficiary's other siblings, descendants, or perhaps even a "double skip" to or for the benefit of his or her grandchildren or more remote descendants);
- The potential for a new cost basis under IRC Section 1014 if the assets are included in the primary beneficiary's estate (assets that are not included in an estate but are subject to generation skipping transfer tax do not receive a new cost basis, except in the case of a taxable termination occurring at the same time as and by reason of the death of a decedent);[90]
- The potential deduction in respect of a decedent allowed under IRC Section 691(c) with respect to estate tax (but not gift or generation skipping transfer tax); and
- State transfer tax implications.

Sample Disposition of Non-Exempt Trust Clause:[91]

A. **Special Provisions for GST Non-Exempt Trust.**

1. **Death of Beneficiary Whose Death Would Cause Generation-Skipping Transfer Tax.** Upon the death of the Beneficiary (referred to in this paragraph as the "Deceased Beneficiary"), if the death of such Deceased Beneficiary would cause the imposition of a generation-skipping transfer tax if the GST Non-Exempt Trust were distributable in the same manner as that provided herein for distribution of the GST Exempt Trust, then the GST Non-Exempt Trust shall be distributed as follows:

    a) **If any Grandchild or more Remote Descendant of the Deceased Beneficiary is Living.** If upon the death of the Deceased Beneficiary any descendant of the Deceased Beneficiary other than a child of the Deceased Beneficiary is then living, the GST Non-Exempt Trust, to the extent, if any, not effectively appointed by the Deceased Beneficiary, shall, upon his or her death, continue in trust until the fifth (5th) anniversary of the death of the Deceased Beneficiary and, until such fifth (5th) anniversary, shall be held in a separate trust for the benefit of those descendants of the Deceased Beneficiary

[90] IRC § 2654(a)(2).

[91] See Article V, Section C. of sample trust contributed by Jonathan Blattmachr.

living upon the death of the Deceased Beneficiary who are then assigned to the youngest generation from the Grantor for generation-skipping transfer tax purposes of the Code (hereinafter collectively the "Deceased Beneficiary's Youngest Descendants"). During the term of such trust, The Distributions Trustee shall distribute to one or more of the Deceased Beneficiary's Youngest Descendants as much of the net income and principal of the trust as the Trustee (excluding, however, any Interested Trustee) may at any time and from time to time determine, in such amounts or proportions as the Trustee (excluding, however, any Interested Trustee) may from time to time select, for any purpose. Any net income not so distributed shall be accumulated and annually added to principal.

Upon the fifth (5th) anniversary of the death of the Deceased Beneficiary, the trust principal then held for the benefit of the Deceased Beneficiary's Youngest Descendants hereunder, as it is then constituted, together with any accrued, accumulated and undistributed income, shall be set aside and divided into per stirpital shares for the Deceased Beneficiary's descendants then living or, if there is no descendant of the Deceased Beneficiary then living and if the Deceased Beneficiary was a grandchild or more remote descendant of the Grantor, for the descendants then living of the Deceased Beneficiary's nearest ancestor who was a descendant of the Grantor with descendants then living or, if there is no such descendant then living or if the Deceased Beneficiary was a child of the Grantor, for the Grantor's descendants then living, the share so set aside for a descendant to be distributed to the Trustee of the Descendants' Separate Trusts, to be held as a separate trust to be disposed of under the terms of this Article, the descendant for whom the share is set aside to be the Beneficiary of his or her own Descendant's Separate Trust.

b) **If no Grandchild nor any more Remote Descendant of the Deceased Beneficiary is Living.** If upon the death of the Deceased Beneficiary either (i) no descendant of the Deceased Beneficiary other than a child of the Deceased Beneficiary is then living or (ii) no descendant of the Deceased Beneficiary is then living, but a descendant of the Grantor who is assigned to a generation for generation-skipping transfer tax purposes at least two generations younger than that of the Deceased Beneficiary is then living, the GST Non-Exempt Trust, to the extent, if any, not effectively appointed by the Deceased Beneficiary, shall, upon his or her death, continue in trust until the fifth (5th) anniversary of the death of the Deceased Beneficiary and until such fifth (5th) anniversary, shall be held in a separate trust for the benefit of those then living descendants who are then assigned to the youngest generation from the Grantor for generation-skipping transfer tax purposes of the Code of the ancestor of the Deceased Beneficiary of the closest degree of consanguinity to the Deceased Beneficiary which ancestor has descendants who are then living and which ancestor is (or was) a descendant of the Grantor or which ancestor is (or was) the Grantor (hereinafter collectively the "Youngest Collateral Relatives"). During the term of such trust, The Distributions Trustee shall distribute to one or more of the Youngest Collateral Relatives as much of the net income and principal of the trust as the Trustee (excluding, however, any Interested Trustee) may at any time and from time to time determine, in such amounts or proportions as the Trustee (excluding, however, any Interested Trustee) may from time to time select, for any purpose. Any net income not so distributed shall be accumulated and annually added to principal.

Upon the fifth (5th) anniversary of the death of the Deceased Beneficiary, the trust principal then held for the benefit of the Youngest Collateral Relatives hereunder, as it is then constituted, together with any accrued, accumulated and undistributed income, shall be set aside and divided into per stirpital shares for the Deceased Beneficiary's descendants then living or, if there is no descendant of the Deceased Beneficiary then living and if the Deceased Beneficiary was a grandchild or more remote descendant of the Grantor, for the descendants then living of the Deceased Beneficiary's nearest ancestor who was a descendant of the Grantor with descendants then living or, if there is no such descendant then living or if the Deceased Beneficiary was a child of the Grantor, for the Grantor's descendants then living, the share so set aside for a descendant to be

distributed to the Trustee of the Descendants' Separate Trusts, to be held as a separate trust to be disposed of under the terms of this Article, the descendant for whom the share is set aside to be the Beneficiary of his or her own Descendant's Separate Trust.

2. **Death of Beneficiary Whose Death Would Not Cause Generation-Skipping Transfer Tax.** Upon the death of the Deceased Beneficiary, and if the death of such Deceased Beneficiary would not cause the imposition of a generation-skipping transfer tax if the GST Non-Exempt Trust were distributable in the same manner as that provided herein for distribution of the GST Exempt Trust, then the GST Non-Exempt Trust shall be distributed in the same manner as that provided herein for distribution of the GST Exempt Trust.

B. **Disinterested Trustee May Confer Power.** The Trustee (excluding, however, any Interested Trustee)[92] may at any time, prior to the death of the Beneficiary, by an instrument in writing (1) confer upon the Beneficiary a power exercisable only by Will to appoint all or part of the Trust to the creditors of the Beneficiary's estate (other than any taxing authority), and the instrument conferring such power upon the Beneficiary may require the consent of the Trustee (other than any Interested Trustee) to exercise the power, (2) revoke any such instrument previously executed, with or without executing a replacement instrument and/or (3) irrevocably relinquish the powers conferred under (1) and/or (2). Without limiting the Trustee's discretion, the Trustee may use the authority conferred by this paragraph to subject the trust property to estate tax instead of the generation-skipping transfer tax when it appears that it may reduce overall taxes to do so. If a power is conferred upon a Beneficiary by the Trustee in accordance with this paragraph, such power shall not be exercisable in any manner so as to postpone the vesting of any estate or interest in the appointed property or to suspend the absolute ownership or power of alienation of the appointed property for a period ascertainable without regard to the date of this Agreement, and the validity of any exercise shall be measured with respect to that date.

Sample Exercise to "Spring" Delaware Trap:[93]

Sample Exercise of Formula Power of Appointment Triggering the Delaware Tax Trap[94]

_____. Exercise of Powers of Appointment.

A. **Identification of Power.** Under the Last Will and Testament of my deceased [spouse] dated **_________**, ("my [spouse]'s Will") the **_________** Trust (the "Trust") was created for my primary benefit. Pursuant to Section **___** of my [spouse]'s Will, I have a Testamentary Power of Appointment to appoint all of the remaining property of the Trust (outright, in trust, or otherwise) to any one or more of my [spouse]'s descendants.

B. **Exercise of Power.** I hereby appoint the property described in Subsection ___. below to my children who survive me, in equal shares. However, if any child fails to survive me but leaves one or more descendants who survive me, I give the share that child would have received (if he or she had survived) per stirpes to his or her descendants who survive me. All of the preceding distributions are subject to the provisions of Article ___ (providing for lifetime Descendant's Trusts [*that grants the primary beneficiary thereof (or others) a presently exercisable general power of appointment*] for my children and other descendants).

C. **Extent of Exercise.** The foregoing exercise does not apply to the following assets held by the Trust: (i) cash or cash equivalent accounts (such as savings accounts, certificates of deposit, money market accounts or cash on hand in any brokerage or equivalent accounts); (ii) property that constitutes income in respect of a decedent as described in Code Section 1014(c); (iii) any interest in any Roth IRA accounts or Roth variants of other retirement plans, such as Roth 401(k)s, 403(b)s, 457(b)s, and the like; and (iv) any interest in any property that has a cost basis for federal income tax purposes that is greater than or equal to the fair market value of the property at the time of my death (the "Excluded Assets"). If, after eliminating the Excluded Assets, the inclusion of the value of the other assets in the Trust in my taxable estate for federal estate tax purposes would not increase the federal estate tax and state death taxes payable from all sources

[92] It is important that this power can only be exercised by a dis-interested Trustee to ensure against any risk of causing inclusion of trust assets in the grantor's estate.
[93] Contributed by Mickey Davis.
[94] This language is loosely adapted from Morrow, "The Optimal Basis Increase and Income Tax Efficiency Trust" available at http://tinyurl.com/qen5gwl at pp. 86-87.

by reason of my death, this power of appointment shall apply to all remaining assets of the Trust other than the Excluded Assets (the "Included Assets"). However, in the event that the inclusion of the value of all of the Included Assets in the Trust in my taxable estate for federal or state estate or inheritance tax purposes would increase the taxes so payable, the assets of the Trust appointed by this Section shall be further limited as follows: The Trustee shall for each of the Included Assets evaluate the ratio of the fair market value at the time of my death to the cost basis immediately prior to my death first (the "Gain Ratio"). The Trustee shall thereafter rank the Included Assets in order of their respective Gain Ratio. The appointment shall apply first to the Included Asset with the largest Gain Ratio, and thereafter in declining order of Gain Ratio to each of the subsequent Included Assets; however, as such point that inclusion of the next in order of the Included Assets would otherwise cause an increase in my estate's federal or state estate tax liability as described above, my appointment pursuant to this Section ___ shall be limited to that fraction or percentage of that Included Asset that will not cause any federal or state estate tax liability, and all lower ranked Included Assets shall be excluded from the exercise of this power of appointment.

D. **Statement of Intent.** It is my intention by the foregoing exercise of my power of appointment to trigger Code Section 2041(a)(3) by postponing the vesting of an estate or interest in the property which was subject to the power for a period ascertainable without regard to the date of the creation of my power, and to thereby obtain for the assets of the Trust the maximum possible increase in the cost basis of those assets as may be permitted under Code Section 1014 as a result of my death without causing any increase in the federal estate tax and state death taxes payable from all sources by reason of my death. This Will shall be administered and interpreted in a manner consistent with this intent. Any provision of this Will which conflicts with this intent shall be deemed ambiguous and shall be construed, amplified, reconciled, or ignored as needed to achieve this intent.

Sample Trust Provisions to Incorporate Delaware Trap in States that Allow Perpetual Trusts: [95]

SECTION 11.3 DURATION OF TRUSTS.

The rule against perpetuities does not apply to any trust created under this Agreement; however: (a) if a trust holds real property in a state which subjects such ownership to the rule against perpetuities or another rule limiting the maximum duration of trusts, then such trust shall terminate with respect to such property no later than the fixed period of years provided under such rule or, if such rule does not provide a fixed number of years, then twenty-one (21) years after the death of the last to die among my spouse and my descendants who are living at the time of my death or at such earlier time as this trust becomes irrevocable with respect to such property; and (b) subject to subsection (a), no trust shall terminate later than one thousand (1,000) years after my death or at such earlier time as this trust becomes irrevocable, unless extended under Section 12.1. This Section shall not preclude the trustee from exercising the trustee's powers, provided in this Agreement or under any provision of law, to merge and administer as one trust any trust(s) created in this Agreement with any trust(s) created under an instrument to which the rule against perpetuities applies (any trust resulting from any such merger being referred to in this Section as a "Merged Trust"), and such Merged Trust shall terminate on the earliest date when any of such trusts would, without regard to such merger, have been required to expire under the governing document, the rule against perpetuities or other applicable law governing the maximum duration of trusts. If all or any portion of a trust is terminated pursuant to this Section, the trustee shall distribute all of the assets of the terminated portion, outright and free of trust, to the primary beneficiary of the trust.

SECTION 12.1 APPOINT.

The exercise by any person (the "Donee" in this Section) of any power to "Appoint" in this Agreement shall be subject to this Section. Subject to the restrictions stated in this Section and any other provisions of this Agreement specifically to the contrary, in the exercise of such power of appointment the Donee may appoint outright or in trust (including continuing the existing trust but with modified terms), may appoint to or for the benefit of one or more persons (whether born or unborn on the date of this Agreement) in the restricted group who are objects of such power to the complete exclusion of any one or more other persons in such group, may create additional powers of appointment that may be exercised in favor of persons within or without the restricted group, and generally may appoint in any lawful manner. Notwithstanding the foregoing, if a power to Appoint that is not a general power of appointment (within the meaning of Code section 2041) is exercised by creating another power of appointment which under the applicable local law could be validly exercised so as to postpone the vesting of any

[95] Contributed by Steve Gorin.

estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, then any trust created by such exercise shall terminate no later than one thousand (1,000) years after (a) the earlier of my death or the date when this trust becomes irrevocable with respect to such property, or (b) any other event from which a pertinent perpetuities or suspension testing period, if it were applicable, would run; however, the limitations of this sentence shall not apply if the exercise specifically states an intent to create a general power of appointment or specifically refers to Code section 2041(a)(3) in a manner which demonstrates such an intent (this clause is referred to below as the "Delaware Tax Trap"). Except where specifically provided in this Agreement to the contrary, any exercise shall affect only the assets remaining in the trust at its termination, if any. Except with respect to triggering the Delaware Tax Trap, the power is personal to the Donee, and no person is authorized to exercise the power on behalf of the Donee. Any exercise must specifically refer to the power and shall be effected only by a will duly admitted to probate or other written instrument. Any exercise by an instrument other than a will shall be revocable by a subsequent instrument or by will, unless the Donee specifically provides otherwise in the instrument. Each exercise or revocation by an instrument other than a will shall be accomplished upon the delivery to the trustee during the Donee's life of a written instrument of exercise or revocation that is dated and signed by the Donee. So far as possible, the laws of the State of Missouri shall govern the validity of any interest created by the exercise of such power of appointment. (334)

Sample Trust Provisions to Incorporate Delaware Trap in States With Traditional Rule Against Perpetuities: [96]

(a) **General Power over Limited Portion of GST Non-Exempt Descendant's Trust.** The Primary Beneficiary (regardless of age) of a GST Non-Exempt Descendant's Trust shall also have the power to appoint the principal and any undistributed income of the Limited Portion (as hereinafter defined) of such trust to pass upon his or her death in favor of the creditors of his or her estate (other than any taxing authority) (said power is referred to as a "General Power"). The "Limited Portion" of such trust is that portion, if any, for which GST Tax would be payable by reason of the Primary Beneficiary's death if the Primary Beneficiary did not have the General Power under this Section __ (after taking into account all exemptions, exclusions, deductions and credits other than any GST exemption allocated to such trust by reason of the Primary Beneficiary's death), without regard to any exercise of a Special Power by the Primary Beneficiary under Section [Cross references the limited power of appointment we grant to a Primary Beneficiary over his or her Descendant's Trust]. The Primary Beneficiary's General Power under this Section __ is intended to cause the Limited Portion of such trust to be included in the Primary Beneficiary's gross estate for federal estate tax purposes rather than being subject to GST Tax, and shall constitute a "general power of appointment" within the meaning of Code Section 2041(b)(1).

[96] Contributed by Steve Trytten.

XV. State Specific Drafting Challenges; California Prop. 13

Background. State-specific issues may require additional attention in drafting a dynastic trust. For example, California has a unique system for property tax assessment, that began with Proposition 13 in 1978. Under this system, annual increases to property tax assessments may not exceed 2% even if fair market value has increased by more. However, the property will be fully reassessed upon a change in ownership. Certain transfers from parents to children (or vice versa) may qualify for an exclusion from reassessment. A transfer in trust may also qualify, but only if there are no current beneficiaries other than children (or parents, as the case may be). Thus, a trust must be drafted carefully to ensure that no other current beneficiaries will interfere with the parent-child exclusion.

Sample Trust Provisions to Qualify for Parent-Child Exclusion: [97]

If a trust may seek qualification for the parent-child exclusion, it is best not to include the common dynastic trust provision allowing direct payments of health and tuition for the benefit of the child's descendants. Instead, we address these issues as part of the Trust Protector's amendment powers. The Trust Protector is authorized to amend the trust to add this provision, but only as to assets other than California real property that carries a reduced property tax assessment resulting from parent-child exclusion. The clause also prohibits the Trust Protector from making any other amendment or modification that would interfere with qualification for parent-child exclusion.

> (a) The Trust Protector shall have the power to amend the terms of any Descendant's Trust created hereunder for a Primary Beneficiary to provide that the Trustee, other than an Interested Person, may make distributions for the benefit of any descendant of the Primary Beneficiary for tuition or medical care paid directly to the applicable educational institution, medical provider, or medical insurance carrier, taking into account the tax benefits to be achieved by making such payments from GST Non-Exempt assets. However, under no circumstances may a distribution be made to a descendant of a Primary Beneficiary from California real property (or income from such real property) that carries a reduced property tax assessment due to the allowance of an exclusion under California Revenue and Taxation Code Section 63.1 (relating to certain "parent-child" and "grandparent-grandchild" transfers).
>
> (b) Notwithstanding the foregoing, the Trust Protector may not amend, modify, or terminate any trust hereunder in any manner that adds an "impermissible beneficiary" to receive distributions from any California real property (or net income thereon) that carries a reduced property tax assessment due to the allowance of an exclusion under Revenue and Taxation Code Section 63.1 (relating to certain "parent-child" and "grandparent-grandchild" transfers), and in that regard an "impermissible beneficiary" refers to any person who, if that person had been a beneficiary of the trust (or predecessor trust, if applicable) that received the property in connection with the transfer that qualified for Section 63.1 exclusion at the time of the transfer, would have caused that trust to fail to qualify for that exclusion.

If the trust will be containing a decanting power (or if a decanting power applies under applicable State law), we restrict the decanting power as follows:

> (a) The Appointing Fiduciary may not exercise the Appointing Power in any manner that would add an "impermissible beneficiary" to receive distributions from any California real property (or net income thereon) that carries a reduced property tax assessment due to the allowance of an exclusion under Revenue and Taxation Code Section 63.1 (relating to certain "parent-child" and "grandparent-grandchild" transfers), and in that regard an "impermissible beneficiary" refers to any person who, if that person had been a beneficiary of the trust (or predecessor trust, if applicable) that received the property in connection with the transfer that qualified for Section 63.1 exclusion at the time of the transfer, would have caused that trust to fail to qualify for that exclusion.

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[97] Contributed by Steve Trytten.

XVI. Decanting and Trust Protector Powers to Modify

Background. The three most important qualities of a good dynasty trust are: flexibility, flexibility, and flexibility. Modern concepts such as Trust Protectors and decanting authority have greatly expanded the potential flexibility of an irrevocable trust to respond to changes in law or circumstance.

Savings language may be valuable in clarifying limits to these powers as necessary to preserve favorable tax benefits such as the marital deduction for gift and estate tax, see-through trust status for purposes of minimum required distributions from retirement plans, and so forth.[98]

Some clients may not want others to make changes to what they have set up, and explicit language may be necessary to set the limit as to what modifications or decantings, if any, are permitted.[99]

The potential income and transfer taxes of a decanting are not clear.[100] The potential for negative tax consequences may be reduced if the adjustments to the trust can be accomplished as a modification of the same trust, rather than a transfer of assets out of the existing trust and into a new trust. The Uniform Trust Decanting Act specifically authorizes the exercise of a decanting power to modify the existing trust.[101]

Sample Disposition of Non-Exempt Trust Clause:[102]

See Section A.8. for savings language that is intended to avoid negative tax consequences arising from the very existence of the decanting clause.

A. **Trustees Can Create Trusts.** The authorized Trustee (as defined in this paragraph) may, subject to the provisions set forth in this paragraph, exercise any power to invade the principal of the invaded trust by appointing (whether or not there is a current need to invade principal under any standard for invasion of principal set forth in the invaded trust) part or all of the principal of the invaded trust in favor of a trustee of another trust (referred to as the "appointed trust," and defined further below) for the benefit of one, or more or all of those beneficiaries for whom the principal of the invaded trust may be currently paid to the exclusion of any one or more of such beneficiaries. The exercise of the power to invade the principal of a trust under this paragraph shall be subject to the following additional provisions:

1. If all of the assets of the invaded trust are to be paid to the appointed trust under the applicable appointment, then the exercise of the power by the authorized Trustee under this paragraph shall apply both to (1) all of the assets currently comprising the principal of the invaded trust, including undistributed accumulated income, and (2) to all assets subsequently paid to or acquired by the invaded trust after the payment to the appointed trust, unless the authorized Trustee who so appoints the principal of the invaded trust provides otherwise in writing at the time of appointment. If only a portion of the trust assets of the invaded trust are to be paid over to the appointed trust under the applicable appointment, then subsequently discovered assets of the invaded trust or assets subsequently paid to or acquired by the invaded trust shall remain assets of the invaded trust, unless the authorized Trustee who so appoints the principal of the invaded trust provides otherwise in writing at the time of appointment.

2. The exercise of the power to invade the principal of a trust under this paragraph shall be by an instrument in writing, signed, and acknowledged by the authorized Trustee. The instrument exercising the power shall be maintained with the records of the invaded trust and may be filed in any court having jurisdiction over the invaded trust.

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[98] The Uniform Trust Decanting Act promulgated in July, 2015 has excellent savings language. See Sections 19 and 22. The Uniform Law Commission comments that accompanied the Act are particularly helpful.

[99] Explicit language limiting or forbidding decanting will be respected under the Uniform Trust Decanting Act, Section 15.

[100] ACTEC has submitted comments in response to Notice 2011-101, which can be found online at: http://www.actec.org/resources/comments-on-transfers-by-a-trustee/

[101] Section 2(10) of the Uniform Trust Decanting Act.

[102] See Article XVI, Section D. of sample trust contributed by Jonathan Blattmachr.

3. The exercise of the power to invade the principal of a trust under this paragraph shall not be treated as being prohibited by any provision in the invaded trust instrument that prohibits amendment or revocation of the trust or that constitutes a spendthrift clause.

4. The provisions of this paragraph shall not be construed to abridge the right of any Trustee to appoint property in further trust that arises under any statutory law or under common law, or as directed by any court having jurisdiction over the invaded trust.

5. Nothing in this paragraph shall be construed as creating or implying a duty on any Trustee acting hereunder to exercise a power to invade principal, and no inference of impropriety shall be made as a result of a Trustee not exercising the power conferred under this paragraph.

6. The authorized Trustee, acting pursuant to the authority granted by this paragraph, may not exercise a power to decrease or indemnify against a Trustee's liability or exonerate a Trustee from liability for failure to exercise the duty of care, diligence and prudence otherwise applicable to the Trustee or to make a binding and conclusive fixation of the value of any asset for purposes of distribution, allocation or otherwise.

7. The authorized Trustee, acting pursuant to the authority granted by this paragraph, may not exercise a power to increase the total compensation of any Trustee of the appointed trust, other than by reason of extending the period, as may be permitted hereunder, during which such Trustee will serve. No Trustee shall receive any paying commission with respect to property transferred pursuant to this paragraph.

8. If any contribution to the invaded trust qualified for the annual exclusion under Code Sec. 2503(b), the marital deduction under Code Sec. 2056(a) or 2523(a), or the charitable deduction under Code Sec. 170(a), 642(c), 2055(a) or 2522(a), is a direct skip whether or not a nontaxable gift under Code Sec. 2642(c), or qualified for any other specific tax benefit that would be lost by the existence of the authorized Trustee's authority under this paragraph for income, gift, estate, or generation-skipping transfer tax purposes under the Code, then the authorized Trustee shall not (1) have the power to invade the principal of a trust pursuant to this paragraph in a manner that would prevent the invaded trust from qualifying for or would reduce the exclusion, deduction, nontaxable gift or other tax benefit which was originally claimed with respect to that contribution, (2) have the power to make a change, including the grant of a power of appointment, that will result in (a) a change or modification of any standard of payment to or for one or more of the beneficiaries of the invaded trust or (b) a reduction, limitation or other change in any beneficiary's right to a mandatory distribution of income, a mandatory annuity or unitrust interest, a right annually to withdraw a percentage of the value of the trust or a right annually to withdraw a specified dollar amount provided that such mandatory or annual right has already come into effect with respect to the beneficiary. Notwithstanding the foregoing (2) but subject to (1), the authorized Trustee may pay to an appointed trust that is a supplemental needs trust.

9. The authorized Trustee exercising the authority granted by this paragraph may not make a change that will violate any rule against perpetuities or similar rule limiting the duration of trusts applicable to the invaded trust and may not make a change that will disqualify a trust which owns S corporation stock and is a permitted shareholder under Code Sec. 1361(c)(2) from being a permitted shareholder.

10. The current beneficiaries of the appointed trust shall be one, more than one or all of the current beneficiaries of the invaded trust and the successor and remainder beneficiaries of the appointed trust shall be one, more than one or all of the successor or remainder beneficiaries of the invaded trust. If a beneficiary includes a class of persons, such class shall include any person who falls within the class of persons after the payment to the appointed trust. The appointed trust may grant to one or more of the beneficiaries of the appointed trust a power of appointment.

11. The term "appointed trust" shall mean an irrevocable trust other than the invaded trust to which principal is appointed under this paragraph including, but not limited to, a new trust created by the authorized Trustee.

12. The standard for invasion in the appointed trust may be no greater than the standard for invasion of the invaded trust.

13. As used in this paragraph, the term "authorized Trustee" shall refer to the Trustee of any trust hereunder, provided, however, that with respect to any trust which provides that principal may be invaded for any reason other than support, maintenance, health and education within the meaning of Code Sec. 2041(b), the authorized Trustee of that trust shall exclude any Interested Trustee.

Sample Trust Protector Clause, Including Power to Modify:[103]

SECTION . TRUST PROTECTOR.

For all purposes of this Agreement:

(a) Definition and Requirements. "Trust Protector" means a person who has been appointed in writing by the then acting trustee, and such appointment has been accepted in writing by the person appointed to act as Trust Protector. The trustee then acting shall designate the initial Trust Protector at such time as the trustee deems appropriate, in the trustee's sole and absolute discretion. However, in no event may any beneficiary of a trust or any related or subordinate party (as defined by Code section 672(c)) with respect to any such beneficiary be appointed as Trust Protector of that trust.

(b) Designation of Successor Trust Protector. Subject to the preceding provisions of this Section, the trustee then acting may appoint a successor Trust Protector.

(c) Majority Rule. During such time when two or more persons are serving as Trust Protectors, any decision of the Trust Protectors shall require the affirmative consent of a majority of them.

(d) Powers of Trust Protector. The Trust Protector may, from time to time, notwithstanding any other provision of this Agreement, modify this Agreement, including the dispositive, management, administrative and other provisions of all kinds with respect to any or all trusts created under this Agreement. Without limiting the generality of the foregoing, the Trust Protector shall have the following powers which may be exercised in the sole and absolute discretion of the Trust Protector:

(1) To modify the distributive provisions with respect to any one or more beneficiaries or to terminate a trust in order to address changes in tax or other laws or circumstantial changes that may affect the trust and/or trust beneficiaries, including any changes a court may approve under RSMo sections 456.4-415 (reformation to correct mistakes), 456.4-416 (modification to achieve settlor's tax objectives, or both);

(2) To exercise the powers described in Section __;

(3) To modify the management or administrative provisions of a trust;

(4) To modify any power of appointment by increasing or decreasing the class of appointees and by converting any limited power of appointment to a general power of appointment, the exercise of which takes effect at the death of the person holding the power, or to similarly change such a general power of appointment to a limited power of appointment; and

(5) To distribute the principal of any trust created under this Agreement in further trust under RSMo section 456.4-419 or any successor statute.

[103] Contributed by Steve Gorin.

(e) Exercise of Powers. All powers granted herein: (1) shall be exercised only by an instrument that is signed by the Trust Protector and delivered to the trustee; (2) may be exercised any number of times without exhausting the power; (3) are personal to the Trust Protector, and no individual is authorized to execute the power on behalf of the Trust Protector; and (4) may not be exercised in a manner that directly or indirectly authorizes distributions to the Trust Protector, the Trust Protector's estate or the creditors of either or to the natural objects of the Trust Protector's bounty who are not descendants of mine.

(f) Release of Powers. The Trust Protector, acting on the Trust Protector's own behalf and on behalf of all successor Trust Protectors, may at any time irrevocably release, renounce, suspend, reduce or modify to a lesser extent any or all powers and discretions conferred under this Section.

(g) No Requirement to Act. The Trust Protector need not consider the advisability of exercising a power under this Section until the trustee requests by written instrument delivered to the Trust Protector that the Trust Protector consider exercising the powers under this Section. The Trust Protector shall not be liable to any person for any action taken or omitted under this Section unless and except to the extent that the person asserting liability proves, by clear and convincing evidence, that the Trust Protector acted in bad faith.

(h) Liability. A Trust Protector exercising the powers under this Section is not a trustee or any other fiduciary with respect to those powers and shall not have the same legal responsibilities as a trustee or any other fiduciary in the exercise of the powers under this Section.

(i) Miscellaneous. Sections [references to various trustee provisions that make sense to apply to a trustee, such as providing for reasonable compensation and expense reimbursement] shall apply to the Trust Protector by substituting the words "Trust Protector" for the word "trustee."

Sample Virtual Representation Clause:[104]

A virtual representation clause can be very helpful when carrying out a modification of decanting.

SECTION 0.1 VIRTUAL REPRESENTATION OF TRUST BENEFICIARIES. Where an adult competent party to a proceeding relating to a trust has the same interest as a person who is a minor or is incapacitated (such person referred to in this Section as "disabled"), it is unnecessary to serve process upon the disabled person, and the disabled person is bound by the judgment rendered in such proceeding. Similarly, where an adult competent party to a non-judicial settlement of the account of any fiduciary has the same interest as a disabled person, it is unnecessary to have the interest of the disabled person further represented, and the disabled person is bound by the settlement. Subject to the foregoing limitations, the parents, custodian, conservator or guardian of any disabled beneficiary may, in carrying out the provisions of this Section, act and receive notice or accounting for the disabled beneficiary and execute any instrument for such beneficiary and on such beneficiary's behalf.

Sample Trust Protector Clause, Including Power to Modify:[105]

We grant both specific and broad amendment powers to the Trust Protector to provide flexibility throughout the life of the trust. Section 1.1(c) contains several limitations and savings provisions.

1.1 Powers and Duties of Trust Protector. In addition to other powers specifically granted to the Trust Protector elsewhere in this instrument, the Trust Protector shall have the following powers, each of which may be exercised in the Trust Protector's sole discretion:

(a) **Powers Regarding Officers and Officer Powers**. The Trust Protector shall have the power:

(i) With respect to the Removal and Replacement Powers under Section [Cross references the provision in our trust that provides Trustee removal, replacement, and designation powers to various individuals]:

[104] Contributed by Steve Gorin.
[105] Contributed by Steve Trytten.

(A) While the Settlor is holding Removal and Replacement Powers, to exercise Removal and Replacement Powers without the consent of the Settlor.

(B) At any time after the Settlor becomes unable or unwilling to hold Removal and Replacement Powers, to revest the Settlor with the Removal and Replacement Powers that the Settlor may have previously relinquished.

(ii) With respect to a Primary Beneficiary's powers over his or her Descendant's Trust, to postpone or accelerate the age at which a Primary Beneficiary may:

(A) serve as Co-Trustee of his or her Descendant's Trust; or

(B) exercise the Removal and Replacement Powers over his or her Descendant's Trust.

In exercising its discretion under this Section __, the Trust Protector shall take into consideration the facts and circumstances at that time, including issues relating to (a) the Primary Beneficiary's ability to handle money and make decisions wisely; (b) the Primary Beneficiary's health, marriage and need for asset protection; and (c) tax planning implications.

(iii) To modify or eliminate any existing restrictions set forth in Section [Cross references our provision providing restrictions on Removal and Replacement Powers] or create additional restrictions on the exercise of Removal and Replacement Powers, as may be applicable to any provision of this instrument.

(iv) To modify any trust arising hereunder to direct whether Co-Trustees are to act by unanimous agreement or by majority vote or whether any one Co-Trustee shall have the power to act alone in carrying out any or all powers of the Trustee.

(v) To direct or modify a procedure for resolving deadlock among current or future Co-Trustees (including the designation of a tiebreaker and a mechanism for designating successor tiebreakers).

(vi) To revest in the office of Trustee any right or power to the extent it has been previously relinquished or restricted in scope by the Trustee.

(b) **Amendment Powers**. The Trust Protector shall have the power:

(i) To amend the terms of any Descendant's Trust created hereunder for a Primary Beneficiary to provide that the Trustee, other than an Interested Person, may make distributions for the benefit of any descendant of the Primary Beneficiary for tuition or medical care paid directly to the applicable educational institution, medical provider, or medical insurance carrier, taking into account the tax benefits to be achieved by making such payments from GST Non-Exempt assets. However, under no circumstances may a distribution be made to a descendant of a Primary Beneficiary from California real property (or income from such real property) that carries a reduced property tax assessment due to the allowance of an exclusion under California Revenue and Taxation Code Section 63.1 (relating to certain "parent-child" and "grandparent-grandchild" transfers).[106]

(ii) To amend the terms of any trust arising hereunder to create, modify, or eliminate various offices thereunder (such as offices to hold incidents of ownership of life insurance policies, certain investments or voting rights in entity interests, or distribution powers) for any purpose, including to bifurcate or consolidate the Trustee's powers, or to add or eliminate a directed trust arrangement. Unless the Trust Protector specifically directs otherwise, each new office so created shall provide that expenses incurred by any person acting in the capacity of such new office shall be advanced, and any individual acting in the capacity of such new office who is an individual, other than an individual who is a Professional Trustee (as defined in Section [Cross references the provision defining this term in our Exoneration provision]), shall be held harmless and indemnified, in the same manner as if said officer were

[106] This last part of the provision is for California parent-child property tax exclusion purposes.

a "Trustee" within the meaning of Section [Cross references our Exoneration provision], subject to the limitations contained therein.

(iii) Subject to Section [Cross references our provision relating to Controlled Corporation Stock] regarding Controlled Corporation Stock, to amend, modify or terminate all or any part of a trust arising hereunder in any manner that the Trust Protector determines is appropriate to carry out the purposes of the trust for its intended beneficiaries, including (a) to protect a beneficiary, (b) to limit taxation, (c) to avoid jeopardizing S corporation status for any corporation seeking to maintain S corporation status as to which the trust is a shareholder, (d) to respond to a change in laws, economic condition or other circumstances, (e) to enhance the overall after-tax valuation of any Tax-Advantaged Account in which the trust has an interest, (f) to enable the trust to be an owner or permitted transferee of ownership interests in closely held business or other business entities pursuant to the terms of any applicable contractual agreement governing such business entities, or (g) from and after such time as the Substitution Power, the Power to Vest Borrowing Power, and the Power to Add Charitable Beneficiaries are no longer in effect with respect to such trust, to eliminate or restrict any power that would cause such trust to be a grantor trust.

(c) **Restrictions on Trust Protector Powers**. Notwithstanding the foregoing, the Trust Protector may not amend, modify, or terminate any trust hereunder in any manner that:

(i) Reduces the amount of trust assets in which a beneficiary (other than a beneficiary whose beneficial interest in the trust, taking actuarial considerations into account, is worth less than 5% of the trust) has a beneficial interest. By way of example and not limitation, an amendment that purports to change the respective shares of two beneficiaries from 50/50 to 40/60 would not be allowable hereunder. However, any amendment that purports to do any of the following would be allowable hereunder if such amendment otherwise serves one or more of the purposes enumerated above: (a) change the age at which a beneficiary receives a distribution or right under a trust from one age to an older age, (b) change a trust that terminates at a certain age to a trust that does not terminate at a certain age, (c) change a trust that requires distribution of all income to the sole Current Beneficiary to a trust that provides that the Trustee may accumulate or distribute income on a discretionary basis to the sole Current Beneficiary but to no one else, or vice versa (for example, to allow a trust that is a Qualifying Subchapter S Trust to an Electing Small Business Trust, or vice versa), or (d) change a trust as to which the beneficiary is the sole Current Beneficiary into a Special Needs Trust as to which the beneficiary continues to be the sole Current Beneficiary.

(ii) Adds an "impermissible beneficiary" to receive distributions from any California real property (or net income thereon) that carries a reduced property tax assessment due to the allowance of an exclusion under Revenue and Taxation Code Section 63.1 (relating to certain "parent-child" and "grandparent-grandchild" transfers), and in that regard an "impermissible beneficiary" refers to any person who, if that person had been a beneficiary of the trust (or predecessor trust, if applicable) that received the property in connection with the transfer that qualified for Section 63.1 exclusion at the time of the transfer, would have caused that trust to fail to qualify for that exclusion.[107]

(iii) Permits the Settlor to serve as Trustee, Co-Trustee, or in any other fiduciary capacity with respect to the trust in any manner.

(iv) Vests the Settlor with any interest in the trust estate of any trust hereunder, any right to income or principal of any such trust estate, or any power to vary the interest of any trust beneficiary or otherwise designate the persons who shall possess or enjoy any such trust estate or the income therefrom.

(v) Causes the Settlor's Substitution Power under Section [Cross references the provision granting the Settlor's Substitution Power] to be deemed to be a power to shift benefits among trust beneficiaries within the meaning of Revenue Rulings 2008-22 or 2011-28 (for example, an amendment that purports to change the terms of a trust in a way that would cause the nature of the trust's investments, the level of income produced by any or all of the trust's investments, or the provisions of Section [Cross

[107] This provision is for California parent-child property tax exclusion purposes.

references our Diversification provision] to have an impact on the respective interests of the beneficiaries of such trust).

(vi) Vests the Settlor with any incidents of ownership in any life insurance policy on the life of the Settlor owned by any trust hereunder.

(vii) Causes inclusion of all or any portion of the trust estate in the gross estate of the Settlor for federal estate tax purposes.

(viii) Jeopardizes the status of any trust created under this instrument as an eligible S corporation shareholder if such trust owns or is expected to own stock in a corporation seeking to maintain S corporation status. See Section [Cross references our S Corporation provision].

(ix) Notwithstanding any of the foregoing provisions of this Section, alters the terms of this instrument in a way that adversely affects a federal estate tax marital or charitable deduction that would, absent such alteration, be available to the estate of the Settlor, if applicable, or any beneficiary or adversely affects the status of any trust as GST Exempt.

Sample Decanting Clause:[108]

Our decanting clause defers to the decanting statute of the trust's situs, if applicable. If there is no decanting statute, then the clause provides decanting authority as part of the trust instrument. In the latter case, limitations and savings provisions can be found in Subsections 1.1(e) and (f).

1.1 Appointing to Another Trust. This Section explains when and how a Fiduciary holding a power to invade principal of a trust created hereunder after the death of the Settlor ("Invasion Power"), other than a Fiduciary who is a Current Beneficiary or Successor Beneficiary of such trust, may exercise said power by appointing all or part of said principal in favor of the Trustee of one or more other trusts. Said Fiduciary is referred to as the "Appointing Fiduciary."

If the situs of any such trust created hereunder after the death of the Settlor is a jurisdiction that expressly permits the Appointing Fiduciary to exercise its Invasion Power by appointing the property subject to the Invasion Power in favor of the Trustee of one or more other trusts, then the Appointing Fiduciary may so exercise such Invasion Power in accordance with and subject to the applicable law of said jurisdiction, and with the exception of Section __, the remaining provisions of this Section __ shall not apply.

If the situs of any such trust created hereunder after the death of the Settlor is any jurisdiction other than a jurisdiction that expressly permits the Appointing Fiduciary to exercise its Invasion Power by appointing the property subject to such Invasion Power in favor of the Trustee of one or more other trusts, then the Appointing Fiduciary may so exercise such Invasion Power in accordance with and subject to the remaining provisions of this Section __.

(a) **Appointing Power**. An Appointing Fiduciary may exercise its Invasion Power with respect to such trust (the "Original Trust") by appointing all or any part of the property subject to such Invasion Power in favor of the trustee of any one or more trusts that each qualify as an "Appointed Trust" with respect to the Original Trust (as provided in Section __). Such power is hereinafter referred to as the "Appointing Power."

The Appointing Power may be exercised regardless of whether there is a current need to distribute any of such property that is governed by such Invasion Power pursuant to any standard set forth in the Original Trust. The Appointing Power may be exercised without the consent of any beneficiary of the Original Trust. The exercise of the Appointing Power shall not be treated as being prohibited by any provision in the Original Trust that prohibits amendment or revocation of the trust or that constitutes a spendthrift clause. Nothing in this Section __ or the remaining provisions of Section __ shall be construed as creating or implying a duty on any Appointing Fiduciary to exercise the Appointing Power, and no inference of impropriety shall be made as a result of an Appointing Fiduciary not exercising the Appointing Power.

[108] Contributed by Steve Trytten.

(b) **Appointed Trust**. A trust qualifies as an Appointed Trust with respect to an Original Trust if:

(i) The current beneficiaries of the trust consist of one, more than one, or all of the Current Beneficiaries of the Original Trust and no one else.

(ii) The successor and remainder beneficiaries of the trust consist of one, more than one, or all of the current, successor, or remainder beneficiaries of the Original Trust and no one else.

(iii) The trust is an irrevocable trust.

(iv) A trust qualifies as an Appointed Trust regardless of whether the trust grants (or does not grant) a power of appointment to one or more of the beneficiaries of the trust.

The Appointed Trust may have dispositive and/or administrative provisions that differ from the Original Trust. If the beneficiaries of the Original Trust are identified as an open class (e.g., comprised of descendants of a person who is living or who has living descendants), the Appointed Trust will not fail the requirements of Sections __ and __ solely because it creates interests for others who may fall within said open class after the exercise of the Appointing Power.

(c) **Treatment of Trust Assets Acquired After Appointment**. Unless provided otherwise in a written instrument by the Appointing Fiduciary:

(i) If the Appointing Power is exercised with respect to all of the principal of the Original Trust as constituted at the time of exercise, it shall apply to all of the assets comprising the net income and principal of the Original Trust (other than income for periods prior to said exercise of the Appointing Power that is currently required to be distributed under the Original Trust), including any and all income or principal discovered, paid to, or acquired by the Original Trust subsequent to said exercise.

(ii) If the Appointing Power is exercised with respect to less than all of the principal of the Original Trust as constituted at the time of exercise, it shall not apply to any income for periods prior to said exercise of the Appointing Power that is currently required to be distributed under the Original Trust, and it shall not apply to income or principal discovered, paid to, or acquired by the Original Trust subsequent to such exercise.

(d) **Manner of Exercise**. The exercise of the Appointing Power shall be by written instrument, signed and acknowledged by the Appointing Fiduciary. Such written instrument shall be maintained with the records of the Original Trust and may be filed in any court having jurisdiction over the Original Trust.

(e) **Restrictions on Power**. The Appointing Fiduciary may not exercise the Appointing Power in any manner that would:

(i) decrease or indemnify against any Trustee's liability or exonerate any Trustee from liability for failure to exercise the duty of care, diligence and prudence otherwise applicable to the Trustee or to make a binding and conclusive fixation of the value of any asset for purposes of distribution, allocation or otherwise; provided, however, that this Section shall not be constructed to prevent the Appointing Fiduciary from exercising its Appointing Power to appoint to a trust that has a directed Trustee and that exonerates the Trustee from liability for following the directions of the directed Trustee;

(ii) result in any Trustee receiving compensation that is greater than any compensation they would have received as Trustee under the Original Trust;

(iii) violate any rule against perpetuities or similar rule limiting the duration of trusts applicable to the Original Trust;

(iv) jeopardize the S corporation status of the Original Trust or any Appointed Trust as an eligible S corporation shareholder if any such trust owns or is expected to own stock in an S corporation;

(v) add an "impermissible beneficiary" to receive distributions from any California real property (or net income thereon) that carries a reduced property tax assessment due to the allowance of an

exclusion under Revenue and Taxation Code Section 63.1 (relating to certain "parent-child" and "grandparent-grandchild" transfers), and in that regard an "impermissible beneficiary" refers to any person who, if that person had been a beneficiary of the trust (or predecessor trust, if applicable) that received the property in connection with the transfer that qualified for Section 63.1 exclusion at the time of the transfer, would have caused that trust to fail to qualify for that exclusion; or

(vi) jeopardize such trust's ability to hold an interest in a retirement account in a manner that would qualify for the longest possible deferral period with respect to such account under the minimum distribution rules.

(f) **Special Considerations Regarding Tax Treatment (Savings Clause)**. The Settlor intends that the existence of the Appointing Power shall not interfere with the trust's ability to qualify for and benefit from any benefits for income, gift, estate, or generation-skipping transfer tax purposes under the Code relating to the trust or contributions to the trust, including the annual exclusion under Code Section 2503(b), the marital deduction under Code Section 2056(a) or 2523(a), or the charitable deduction under Code Sections 170(a), 642(c), 2055(a) or 2522(a), and this Section shall be interpreted accordingly. In particular, to the extent that any tax benefit would be lost by the existence of the Appointing Power, the Appointing Fiduciary shall not have the power to:

(i) distribute the net income or principal of an Original Trust pursuant to this Section in a manner that would reduce or prevent the Original Trust from qualifying for the exclusion, deduction, nontaxable gift or other tax benefit that was originally claimed with respect to that contribution; or

(ii) make a change, including the grant of a power of appointment, that will result in (a) a change or modification of any standard of distribution to or for one or more of the beneficiaries of the Original Trust or (b) a reduction, limitation or other change in any beneficiary's right to a mandatory distribution of income, a mandatory annuity or unitrust interest, a right annually to withdraw a percentage of the value of the trust or a right annually to withdraw a specified dollar amount provided that such mandatory or annual right has come into effect with respect to the beneficiary.

Notwithstanding the foregoing Section 1.1(f)(ii), but subject to Section __, the Appointing Fiduciary may distribute to an Appointed Trust that is a supplemental needs trust.

XVII. Unitrust Distributions to Individual Beneficiaries

Background. Unitrust distributions are a modern alternative to an income interest. The unitrust approach strikes a fair balance between the interests of current and remainder beneficiaries without interfering with optimal investment strategy for the trust.

Although the unitrust concept is straight-forward, the drafting and implementation requires addressing a number of details, as illustrated in the sample clauses below.

Sample Unitrust Clause:[109]

1.3. Unitrust Amount.

A. Generally. For each calendar year of a trust, the Unitrust Amount of that trust is the product of:

1. the specified percentage amount, and

2. the average of the net fair market value of the assets of the trust (i) valued as of the close of the last business day of the preceding three calendar years, or, (ii) in the first three calendar years of the trust, valued as of the date of my death and as of the close of the last business day of each calendar year thereafter.

B. Source Of Payment. The Unitrust Amount shall be paid first from available income, then from capital gains, then from principal.

C. Prorations And Adjustments. The Trustee shall prorate the Unitrust Amount for any short year (including the initial year and the final year of the trust) on a daily basis. If an incorrect valuation of trust assets for any year results in an incorrect distribution, the Trustee shall pay to the recipient--in the case of an undervaluation--or receive from or charge against a subsequent Unitrust payment to the recipient--in the case of an overvaluation--an amount equal to the difference between the amount distributed and the proper Unitrust Amount, in either case without interest. This adjustment shall be made within a reasonable time after the proper Unitrust Amount is finally determined.

D. Valuation. For purposes of computing the Unitrust Amount, assets shall be valued at their net fair market value, with no accrual of interest or other periodic payments, and considering the debts and any accrued estate tax (but not income tax or property tax) liability of the trust. In determining the fair market value of a non-marketable asset, the Trustee may (but need not) have the non-marketable asset appraised by a valuation professional. The cost of the appraisal shall be paid from the principal of the trust estate. The Trustee need not revalue a non-marketable asset each year, but may use the prior year's value or a reasonable estimate of the current value. I suggest, but do not require, that if a non-marketable asset was last valued at more than $100,000, it be revalued (by the Trustee or via appraisal) within three years. The Trustee's assignment of a value to a non-marketable asset, done in good faith, shall be binding on all current and future beneficiaries of the trust or share and shall not be subject to question. "Marketable assets" are (i) cash, and moneys held at financial institutions, (ii) securities (including mutual fund shares) for which market quotations are readily available, and (iii) interests in common trust funds. "Non-marketable assets" are all assets which are not marketable assets. Examples of non-marketable assets include (but are not limited to) real estate, partnership interests, closely held stock and loans.

E. Residential Property. If the trust holds a residence, including a seasonal or vacation home, the trustee in its discretion may allow the recipient of the Unitrust Amount to occupy the residence. In such case: (i) the value of the residence shall be excluded in determining the

[109] Contributed by Mickey Davis.

Unitrust Amount payable; (ii) neither the expenses of the residence nor the value of its use shall be charged against the Unitrust Amount payable to the recipient; and (iii) Section ___ shall govern the recipient's occupancy rights.

Sample Unitrust Clauses for Trust with Retirement and Non-Retirement Assets:[110]

Trusts that are "see-through trusts" with respect to retirement plans and that also hold non-retirement assets require particular attention in coordinating the distribution provisions that support see-through trust status with the unitrust provision.

"Wrap-around Unitrust Clause." The first clause below illustrates one of two possible approaches for a see-through trust that is a conduit trust. Under this first approach, the conduit distribution is a given, and the unitrust distribution is "wrapped around" the conduit distribution. The clause does this by directing an additional distribution amount if necessary to produce combined distributions equal to the unitrust percentage of all trust assets including retirement plan assets. Note that the value of any residential property is excluded from the asset base if the beneficiary has the right to occupy the property. Subsection (b) of the clause also permits additional distributions for support, health, or education at the Trustee's discretion.

(a) In each year of the Descendant's Trust (a "trust year"), the Trustee shall distribute to or for the benefit of the Primary Beneficiary, in no less frequent than quarterly installments, the Unitrust Amount corresponding to that trust year (defined next).

(i) The Unitrust Amount for any given calendar year shall be an amount equal to 3% (the "Unitrust Percentage") multiplied by the Asset Base (defined next) and then reduced by the value of all distributions from Stretch-Out Retirement Accounts made during said year to the Primary Beneficiary pursuant to Section __. The Unitrust Amount shall not be reduced by trust expenses that might otherwise be charged to income if the trust were not a unitrust. The Asset Base for a given calendar year is the average of the fair market value of the trust estate of the Descendant's Trust (including Stretch-Out Retirement Accounts) at the beginning of the current and two prior calendar years (or such lesser number of calendar years as have occurred since inception of the Descendant's Trust). However, the Asset Base shall be determined by excluding the value of any residential property (and any Tangible Personal Property contained therein) that, as of the first day of the current valuation year, the Primary Beneficiary had the right to occupy. Notwithstanding the foregoing:

(A) For a short trust year, including the year of the Primary Beneficiary's death, the Unitrust Amount shall be prorated to reflect the number of days in the short trust year.

(B) For a trust year in which assets are added to the Descendant's Trust (other than the first funding of the trust) or distributed from the Descendant's Trust (other than the distribution of the Unitrust Amount) (hereinafter "adjustment year"), the Unitrust Amount shall be increased (in the case of a contribution) or decreased (in the case of a distribution) by an amount equal to the Unitrust Percentage times the fair market value of the assets contributed or distributed (valued as of the date or dates of contribution or distribution), multiplied by a fraction, the numerator of which is the number of days from the contribution or distribution to the end of the calendar year, and the denominator of which is the days in the calendar year. Further, the beginning year values for the adjustment year and the trust year immediately preceding the adjustment year (unless the adjustment year is the first year of the trust) shall be increased by the amount of such addition, or decreased by the amount of such distribution, for purposes of determining the Unitrust Amount for the year following the adjustment year.

(ii) The Trustee shall value assets consisting of cash and marketable securities, or any other liquid assets for which there is a clear, public market indication of value ("Liquid Assets"). The Trustee, other than an Interested Person, shall value all assets other than Liquid Assets using such method of valuation as the Trustee, other than an Interested Person, deems reasonable in the its sole discretion under the circumstances. The Trustee shall value assets held in Stretch-Out Retirement Accounts without any downward adjustment for income tax that may be payable and without any upward adjustment for the potential benefit of tax deferred compounding that may occur. The Trustee, other than an Interested Person, may engage appraisers at the trust's expense to determine such fair market values but is not required to do

[110] Contributed by Steve Trytten.

so. Any determination of fair market value shall be binding on all parties, including the Primary Beneficiary and any remainder beneficiaries of the Descendant's Trust and not subject to appeal absent manifest error or bad faith on the part of the Trustee. For administrative convenience when determining the "Asset Base" the Trustee may assume that the value of any asset at the close of a calendar year equals the value of that asset at the beginning of the next calendar year. No computation of the fair market value of the trust estate of the Trust shall require accruals, other than accruals for distributions that are payable but not paid as of the date for the determination of such fair market value.

(iii) The Unitrust Amount shall be paid (a) first from net accounting income and then from any other ordinary income (as such term would be determined if the Descendant's Trust were not a unitrust), and to the extent said net accounting income and other ordinary income is insufficient, (b) next from net realized short term capital gains, and if such short term capital gains are insufficient, (c) next, from net realized long-term capital gains, and if such long-term capital gains are insufficient, then (d) last, from corpus. The preceding sentence shall be interpreted as excluding those items of income or gain arising from distributions (either Minimum Required Distributions or Excess Distributions) from a Stretch-Out Retirement Account as to which the Primary Beneficiary is the Stretch-Out Retirement Beneficiary, since said amounts are the subject of specific distributions under Section ___.

(iv) The goal of the unitrust structure is to provide a relatively smooth flow of guaranteed distributions to the Primary Beneficiary.

(b) If the Primary Beneficiary needs additional funds for his or her support, health or education, upon receipt of satisfactory evidence of such need and after considering all other resources available to the Primary Beneficiary that are known to the Trustee (including the Unitrust Amount payable to the Primary Beneficiary, but excluding the Primary Beneficiary's primary residence and Tax-Advantaged Account assets that if accumulated may have benefits of income tax deferral), the Trustee, in the Trustee's discretion, may distribute to or for the benefit of the Primary Beneficiary so much of the Descendant's Trust, up to the whole thereof, as the Trustee may deem necessary to meet said need.

(c) Any income not so distributed shall be added to principal.

(d) The Settlor intends that any Officer determining whether to make distributions from a Descendant's Trust to its Primary Beneficiary consider the Primary Beneficiary's interests to be the primary concern, and the interests of any other beneficiary as subordinate to this purpose.

Non-Retirement Only Unitrust Clause. The next clause below illustrates the alternate approach for a see-through trust that is a conduit trust. The conduit distribution is a given, and the unitrust clause directs a unitrust distribution based only on the value of non-retirement plan assets. Note that the value of any residential property is excluded from the asset base if the beneficiary has the right to occupy the property. Subsection (b) of the clause also permits additional distributions for support, health, or education at the Trustee's discretion.

(a) In each year of the Descendant's Trust (a "trust year"), the Trustee shall distribute to or for the benefit of the Primary Beneficiary, in no less frequent than quarterly installments, the Unitrust Amount corresponding to that trust year (defined next).

(i) The Unitrust Amount for any given calendar year shall be an amount equal to 3% (the "Unitrust Percentage") multiplied by the Asset Base (defined next). The Unitrust Amount shall not be reduced by trust expenses that might otherwise be charged to income if the trust were not a unitrust. The Asset Base for a given calendar year is the average of the fair market value of the trust estate of the Descendant's Trust at the beginning of the current and two prior calendar years (or such lesser number of calendar years as have occurred since inception of the Descendant's Trust). However, the Asset Base shall be determined by excluding (a) the value of the Descendant's Trust's interest in any Stretch-Out Retirement Account, and (b) the value of any residential property (and any Tangible Personal Property contained therein) that, as of the first day of the current valuation year, the Primary Beneficiary had the right to occupy. Notwithstanding the foregoing:

(A) For a short trust year, including the year of the Primary Beneficiary's death, the Unitrust Amount shall be prorated to reflect the number of days in the short trust year.

(B) For a trust year in which assets are added to the Descendant's Trust (other than the first funding of the trust) or distributed from the Descendant's Trust (other than the distribution of the Unitrust Amount) (hereinafter "adjustment year"), the Unitrust Amount shall be increased (in the case of a contribution) or decreased (in the case of a distribution) by an amount equal to the Unitrust Percentage times the fair market value of the assets contributed or distributed (valued as of the date or dates of contribution or distribution), multiplied by a fraction, the numerator of which is the number of days from the contribution or distribution to the end of the calendar year, and the denominator of which is the days in the calendar year. Further, the beginning year values for the adjustment year and the trust year immediately preceding the adjustment year (unless the adjustment year is the first year of the trust) shall be increased by the amount of such addition, or decreased by the amount of such distribution, for purposes of determining the Unitrust Amount for the year following the adjustment year.

(ii) The Trustee shall value assets consisting of cash and marketable securities, or any other liquid assets for which there is a clear, public market indication of value ("Liquid Assets"). The Trustee, other than an Interested Person, shall value all assets other than Liquid Assets using such method of valuation as the Trustee, other than an Interested Person, deems reasonable in the its sole discretion under the circumstances. The Trustee, other than an Interested Person, may engage appraisers at the trust's expense to determine such fair market values but is not required to do so. Any determination of fair market value shall be binding on all parties, including the Primary Beneficiary and any remainder beneficiaries of the Descendant's Trust and not subject to appeal absent manifest error or bad faith on the part of the Trustee. For administrative convenience when determining the "Asset Base" the Trustee may assume that the value of any asset at the close of a calendar year equals the value of that asset at the beginning of the next calendar year. No computation of the fair market value of the trust estate of the Trust shall require accruals, other than accruals for distributions that are payable but not paid as of the date for the determination of such fair market value.

(iii) The Unitrust Amount shall be paid (a) first from net accounting income and then from any other ordinary income (as such term would be determined if the Descendant's Trust were not a unitrust), and to the extent said net accounting income and other ordinary income is insufficient, (b) next from net realized short term capital gains, and if such short term capital gains are insufficient, (c) next, from net realized long-term capital gains, and if such long-term capital gains are insufficient, then (d) last, from corpus.

(iv) The goal of the unitrust structure is to provide a relatively smooth flow of guaranteed distributions to the Primary Beneficiary.

(b) If the Primary Beneficiary needs additional funds for his or her support, health or education, upon receipt of satisfactory evidence of such need and after considering all other resources available to the Primary Beneficiary that are known to the Trustee (including the Unitrust Amount payable to the Primary Beneficiary, but excluding the Primary Beneficiary's primary residence and Tax-Advantaged Account assets that if accumulated may have benefits of income tax deferral), the Trustee, in the Trustee's discretion, may distribute to or for the benefit of the Primary Beneficiary so much of the Descendant's Trust, up to the whole thereof, as the Trustee may deem necessary to meet said need.

(c) Any income not so distributed shall be added to principal.

(d) The Settlor intends that any Officer determining whether to make distributions from a Descendant's Trust to its Primary Beneficiary consider the Primary Beneficiary's interests to be the primary concern, and the interests of any other beneficiary as subordinate to this purpose.

Appendix A:

Planning for Charitable Contributions
by Estate and Trusts

By Jonathan G. Blattmachr, F. Ladson Boyle and Richard L. Fox

APPENDIX A

Introduction

The income tax charitable deduction for an estate or trust[1] is similar to but somewhat different from the income tax charitable deduction for individuals. These differences include: no percentage limitation on the amount of income that may be reduced by donations to charity by an estate or a trust, but the deduction is limited to gifts of gross income; the ability of an estate or trust to deduct a charitable contribution in the immediately preceding tax year in some circumstances; a requirement that the governing instrument of the estate or trust must evidence a charitable intent; and no necessity that the charitable recipient of the gift from an estate or trust be a US (domestic) organization.

Because the parameters for a charitable deduction are not the same, it is important to recognize the differences when trusts are created that might or should or, perhaps, should not seek an income tax charitable deduction. In some instances, the income tax charitable deduction for an estate or trust may be more advantageous for some individuals than contributions they might make themselves and, thus, there may be important planning opportunities to consider.

This article explores the requirements for an income tax charitable deduction under section 642(c) for estates and trusts and the planning that is required to qualify for the deduction and some special planning that may be available.

Charitable Contributions by Individuals

As a general rule under section 170(a), individuals are entitled to a deduction for the value of contributions (donations) of property (including cash) to or for the use of charitable organizations defined in section 170(c), which is limited to domestic (US) charitable entities. This deduction is subject to several limitations and special rules. In general, the deduction may never exceed 20%, 30% or 50% of the taxpayer's contribution base.[2] The amount allowable as a deduction also may be dependent upon the type of property contributed (e.g., tangible, intangible or real estate)[3], the nature of any gain inherent in the asset (e.g., ordinary income or long-term capital gain), [4] the use to which the charitable recipient will devote the property (e.g., sell it or use it in conjunction with its exempt function),[5] the type of charitable organization (e.g., private foundation defined in section 509(a)), [6] and other possible factors. [7] Also, the Treasury Department Regulations appear to distinguish between a contribution made by an individual "to" a charitable organization and one that is "for the use" of the organization, basically limiting the deduction for a contribution for the use of charity in no event to more than 30% of the taxpayer's contribution base.[8]

In addition, if the amount otherwise allowable to an individual for charitable contribution made in the tax year of the taxpayer exceeds the applicable percentage of his or her contribution base, the excess may be carried forward for deduction in any of the succeeding five tax years of the taxpayer (again subject to a percentage of contribution base for any such later year).[9]

Individual taxpayers are subject to the substantiation requirements under section 170, including those under section 170(f)(8). Under these rules, no charitable deduction is allowed under section 170 for gifts of $250 or more unless the taxpayer receives a contemporaneous written receipt from the donee charity.[10]

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[1] For purposes of this article, all trusts are assume not to be a grantor trust, that is, a trust the income, deductions and credits against tax of which his attributed under section 671 of the Internal Revenue Code of 1986 as amended ("Code") to its grantor (or in one instance, under section 678, someone else) as though the trust did not exist. Such trusts have, at least in general, no separate existence, for income tax purposes. See Rev. Rul. 85-13, 1985-1 C.B. 184.
[2] Contribution base is the taxpayer's "adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under section 172)." Section 170(b)(1)(G).
[3] See section 170(e)(1)(B)(i).
[4] See section 170(e)(1)(A).
[5] See section 170(e)(1)(B)(i)(I).
[6] See section 170(e)(1)(B)(ii).
[7] See, e.g., section 170(b)(1)(E).
[8] Treas. Reg. § 1.170A-8(a)(2).
[9] Section 170(b)(1)(B).
[10] For a more expansive discuss of the substantiality rules of section 170(f)(8) see the instructions for IRS Form 1040, 1065, or 1120 and IRS Publication 526.

Introduction to the Estate or Trust Charitable Deduction

There are several differences between a section 170 charitable deduction for an individual and a section 642(c) charitable deduction for an estate or trust. A decedent's estate or a trust is entitled to a charitable deduction under section 642(c) for its gross income paid (or, for a decedent's estate, paid or set aside[11]) pursuant to the terms of its governing instrument for a charitable purpose described in section 170(c). Unlike an estate or trust, the contribution by an individual need not be paid from gross income.

While an estate or trust is entitled to the deduction under section 642(c) only for a contribution made from its gross income, the deduction may be allowed whether the gross income is from the current year or a prior year that has not previously been distributed or deducted. Moreover, an estate or trust may elect in the current year to treat a distribution of gross income earned in the immediately preceding year as though it had been distributed in the prior year, as long as the distribution is made by the time the income tax return for the estate or trust is due to be filed for the later year. The due date of the return may be extended to not later than five and one-half months after the normal three and one-half month filing due date after the close of the tax year.[12] For calendar year estates and for trusts, the extended due date would be September 30 of the year following the year in which the gross income was included in the gross income of the estate or trust but, beginning for years after 2015, this would be extended to five and one half months (e.g., September 30 for trusts and calendar year estates).[13] Thus, the election allows the estate or trust to take the deduction retroactively in the immediate prior year in which the gross income was earned, but not paid, or, if the fiduciary does not elect, to take the deduction in the year the gross income is paid. Individuals cannot take a deduction in a prior year for a contribution made in any later year. On the other hand, unlike an individual, an estate or trust cannot carryover any excess charitable deduction to a subsequent year and take a deduction for a contribution made in an earlier year.

Furthermore, an estate or a trust may reduce its taxable income to zero through contributions for a charitable purpose except, as discussed below, to the extent the payment to charity consists of unrelated business income ("UBI"). In other words, the deduction under section 642(c) is not limited to a maximum 50% of the contribution base[14] of the estate or trust, as is the case with an individual, except to the extent of its UBI.

In addition, the charitable deduction for estates and trusts is not dependent upon the type of charitable organization that receives the contribution, as it is for individuals. Section 642(c) does not distinguish between contributions to public charities (including so-called "publicly support charities") and private foundations. In addition, an estate or trust is entitled to the deduction for a charitable purpose even if not made to or for a domestic (US) charitable organization, as is required for individuals.

Finally, it seems relatively certain that estates and trusts are generally not subject to the charitable deduction substantiation rules, including the contemporaneous written acknowledgment requirement of section 170(f)(8).[15] The requirement of substantiation applies to charitable deductions under section 170. The charitable deduction for estates and trusts is authorized by section 642(c) and is in lieu of a deduction under section 170. There is one exception. To the extent that a trust (but not an estate), has UBI, no deduction is allowed under section 642(c). Instead, section 681 references over to section 512 that permits a potentially more limited charitable deduction as provided under section 170. As a result, the substantiation rules likely apply that situation given that the deduction is then permitted only pursuant to section 170. The UBI limitation is discussed in greater detail later in this article.

Pursuant to the Terms of the Governing Instrument

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[11] A set aside deduction is also allowed for certain pre-1970 trusts. See section 642(c)(2)(A).

[12] For tax years before 2016, an estate or a trust may receive a *five month* automatic extension of time to file its income tax return by timely filing the appropriate form (IRS Form 7004). Section 6081. Note that both the Code and Treas. Reg. § 1.642(c)-1(b)(1) provide that the payment must be made by the end of the year following the year in which the gross income was earned. Treas. Reg. § 1.642(c)-1(b)(2) states that the "election…shall be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for the succeeding taxable year." The regulation goes on to provide that the election may be revoked within the time prescribed for making it.

[13] A trust must use a calendar tax year. See section 644. An estate may choose a non-calendar year.

[14] The term contribution base has no meaning for an estate or trust but the equivalent for an individual is adjusted gross income, as specially computed.

[15] Treas. Reg. 1.170A-13(f)(13).

To be deducted under section 642(c), the payment of gross income for a charitable purpose must made pursuant to the terms of the governing instrument -- likely the will or trust agreement under which the trust was created.[16]

The payment need not be mandated by the governing instrument but courts have held that "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."[17] Therefore, a discretionary payment to charity will support the deduction if authorized in the governing instrument.[18] However, payments to charity will not be treated as made pursuant to the terms of the governing instrument where found not to be made to in accordance with the terms of the will or trust agreement. For example, in *Crown v. Commissioner,*[19] commutation payments (or prepayments) to the charitable beneficiary of a charitable lead trust[20] that mandated annual payments to charity were not deductible under section 642(c) where the court found the prepayment of the annuity payments was not authorized under the terms of the instrument that created the trust. In *Love Charitable Foundation v. U.S.*,[21] a trustee made distributions to a charitable foundation on the basis that such distributions "were agreeable or conformable to the expressed intent of the Trust instrument." The court held that a charitable income tax deduction was not available under section 642(c) because it was "clear that the trustee was without authority to make these distributions." Thus, where a will or trust makes no provision for a payment to a charitable organization, a charitable income deduction will not be allowed to an estate or trust, even though all of the beneficiaries may agree to the contribution. Where the terms of a trust authorize charitable payments only on termination of a trust, payments made prior to termination do not qualify for a charitable income tax deduction.[22] In *Riggs National Bank v. U.S.*,[23] a testamentary trust was established under the decedent's will, under which the corpus would be shared by four charities upon the termination of the trust. A charitable income tax deduction was disallowed for income accumulated by a trust because the "will did not direct that the surplus trust income be set aside for, or paid to, the charities" and, under local law, such income was to pass to the decedent's heirs under the laws of intestacy. The court rejected the argument that the trust income was deductible because it was used to repay a loan that was secured by trust property that was to be distributed to charities upon the termination of the trust.

A payment of gross income to charity pursuant to the exercise of a power of appointment granted to a beneficiary may qualify for the deduction under section 642(c). [24] However, in *Brownstone v. United States,*[25] the court held that no deduction would be allowed to a testamentary trust for its gross income paid to the estate of the grantor's surviving spouse although the grantor's surviving spouse exercised her general power of appointment over the trust in favor of her estate and her will devised the entire residue to charity. The court determined that the surviving spouse's will contained the requisite "positive charitable intent or purpose," but the terms of the testamentary trust created by the husband did not express that intent or purpose: his will was the governing instrument and payments had to be made without regard to his wife's exercise of the power of appointment. In other words, the exercise of general power in favor of the spouse's estate which passed to charity was insufficient—the governing instrument was the one that created the power and not the document that exercises it.[26]

The result in *Brownstone* may be questioned on several grounds. First, it seems that the result might have been different if the widow had appointed the property directly to charity rather than to her estate which passed to charity.[27] Arguably, that is a distinction without any meaningful difference as her will essentially mandated that the income be paid to charity. Second, it seems that the distribution from the trust to the widow's estate would have been deemed to consist of the trust's distributable net income (DNI),[28] which would have been deductible by the trust (except to the extent consisting of tax exempt income) under section 651(a) or 661(a). The amount deducted by the trust would have been included in the gross income of the estate under sections 652(a) or 662(a) and then would have been set aside for charity pursuant to the terms of

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[16] See discussion in *Brownstone v. United States,* 465 F.3d 525 (2006).

[17] *Weir v. United States*, 362 F. Supp. 928 (S.D. N.Y. 1973), aff'd, 508 F2d 894 (1974); see, also, *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937).

[18] See, e.g., *Green v. United States*, 144 F.Supp 3d 1254 (W.D. OK 2015).

[19] 8 F.3d 571 (1973)

[20] The term "charitable lead trust" refers to one described in section 170(f)(2)(B).

[21] 710 F2d 1316, 52 AFTR2d 83-5487 (8th Cir. 1983) .

[22] Rev. Rul. 55-92, 1955-1 CB 390; *Frank Trust v. Commissioner*, 145 F2d 411 (3d Cir. 1944) .

[23] 352 F2d 812 (Ct. Cl. 1965) .

[24] See, e.g., *Green v. United States*, *supra*.

[25] *Supra,* note 17.

[26] In a similar decision, the United States District Court for the Northern District of California, in *Williams v. United States*, 158 F Supp 227 (N.D. CA. 1957), *aff'd*, 251 F.2d 847 (9th Cir., 1958), reached an analogous result.

[27] Gen. Couns. Mem. 34,277 (1970).

[28] DNI is defined in section 643(a), which is taxable income as specially computed.

the widow's will. This would seem to support a deduction for her estate under section 642(c).[29] Third, the court stated that it reached its decision, at least in part, because it viewed deductions, quite apparently including charitable deductions, as a matter of legislative grace. Thus, in cases of doubt, the controlling statute should be construed in favor of the government (to collect tax). This conclusion should be contrasted with the many statements of courts that there should be a liberal construction of the law in favor of charitable deductions. For example, in *Green v. United States*,[30] in discussing the deduction allowed under section 642(c), the court emphasized that charitable deductions are not a matter of legislative grace, but rather expressions of public policy that should be liberally construed.[31]

A similar question of deductibility under section 642(c) may arise when a trust that does not have the requisite "positive charitable intent or purpose of the settlor" is decanted or otherwise reformed by transferred trust assets to a new trust that has the requisite intent or purpose.[32] For example, a father creates a trust exclusively for the benefit of his descendants and does not grant any of them a power of appointment. Independently, the mother creates a separate trust for them and grants the oldest child a power to appoint all or a portion of the trust's gross income to charity. It appears relatively certain that a deduction will be allowed under section 642(c), to the extent the child exercises the power. Thereafter, the trustee of the trust created by the father decants (contributes) the trust assets to the trust created by the mother. The section 642(c) question is whether a deduction is allowed to the extent the eldest child directs that the gross income earned by the assets formerly contained in the trust created by the father be paid to charity. The identity of the grantor of a trust for income tax purposes does not change when assets of one trust are contributed to another,[33] it is as though the income earned on the assets in the trust the father created has effectively been distributed to the trust the mother created which contains the requisite positive charitable intent or purpose of its settlor. Thus, the ultimate question is whether decanting can add the requisite charitable intent or does the father's lack of a stated chartable purpose carryover to the trust created by the mother so that the income produced by the assets from the trust the father created are not being distributed pursuant to the terms of the governing instrument.

The uncertainty of decanting suggests that trustees seek a more viable alternative. One potential way to work-around the prerequisite of positive charitable intent or purpose of the settlor is to have the trust invest in a partnership that may make contributions to charity from gross income of the partnership. Under section 702(a)(4), charitable contributions made by a partnership pass through to the partners. A trust that is a partner must take into account its distributive share of the partnership's income, gain, loss, deductions (including charitable contributions). In Revenue Ruling 2004-5,[34] the Service ruled that a trust was allowed a deduction under section 642(c) for the trust's distributive share of a charitable contribution made by the partnership from the partnership's gross income, even though the governing instrument of the trust neither authorized nor directed the trustee to make distributions to charity. However, when a partnership makes a charitable contribution from gross income, that income is never available to the trust. In the ruling, it seemed important that the partnership made the charitable contribution from its own gross income.

Paid from Gross Income: Tracing the Income

Unlike the deduction for distributions to beneficiaries which are deemed to consist of DNI, even if the distributions consist of corpus (with certain exceptions[35]), some type of tracing of the charitable contribution to gross income received by

[29] This conclusion seems supported by Gen. Couns. Mem. 34,277 (1970) (not precedent).
[30] *Green v. United States*, *supra*.
[31] The court, referring to other case law, stated:: "However, and of particular importance here, Weingarden went further to distinguish statutes regarding charitable deductions, stating they are not matters of legislative grace, but rather "expression[s] of public policy." *Weingarden*, 825 F.2d at 1029 (citing *Helvering v. Bliss*, 293 U.S. 144, 150–51, 55 S.Ct. 17, 79 L.Ed. 246 (1934) (further citations omitted, internal quotations omitted)). As such, "[p]rovisions regarding charitable deductions should ... be liberally construed in favor of the taxpayer." Id. (citing *Hartwick Coll. v. United States*, 801 F.2d 608, 615 (2d Cir. 1986)). Thus, even if the language of the statute were unclear, a liberal construction in favor of the taxpayer would be appropriate."
[32] Decanting is the act of "pouring" assets of one trust to another, where permitted under the terms of the governing instrument or state law. See, generally, Zeydel & Blattmachr, "Tax Effects of Decanting - Obtaining and Preserving the Benefits," 111 Journal of Taxation 288 (November 2009), cited in *Morse v. Kraft,* 466 Mass. 92 (2013).
[33] Treas. Reg. § 1.671-2(e)(5).
[34] Rev. Rul. 2004-5, 2004-1 C.B. 295. *See also* Chief Couns. Adv. 200928029. Under I.R.C. § 6110(k)(3), neither National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
[35] See, e.g., IRC section 663(a)(1).

the trust or estate is required to support a deduction under section 642(c).[36] Tracing is required because the statute specifically requires that the source of the contribution be gross income.[37]

For example, in *Sid W. Richardson Foundation v. U.S.*,[38] the decedent left his estate to charity. The estate included stock in an S corporation and as a result the income from the S corporation was attributed to the estate under section 1366, although there were no distributions from the S corporation. The decedent's estate took a set aside deduction under section 642(c) for the S income as all of the S stock apparently was distributed eventually (even if kept in the corporation) to the charitable residuary beneficiary. However, the court held that no set aside deduction would be allowed because the income, although imputed to the estate, was never actually received by it and, therefore, could not have been set aside for charity.

A distribution of appreciated stock was held not deductible because the shares constitute corpus and were not items of gross income, even if under the instrument the distribution was chargeable to trust-accounting income.[39] However, in Chief Counsel Advice 201042023, the Internal Revenue Service ruled that 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, although the charitable deduction was limited to the trust's adjusted basis in the property. Moreover, the federal district court in *Green v. United States*, *supra,* in a case of apparent first impression, disagreed on the limitation of the deduction to basis. The district court held that a trust that was authorized to distribute any amount of its gross income to charity was entitled to an income tax deduction under section 642(c) for the full fair market value of property that was purchased with gross income the trust had received in prior years and was not limited to the trust's adjusted basis in the property. In this case, the gross income received by the trust was specifically traceable to the property purchased and subsequently contributed to charity.

Estates and trusts that seek to make contributions of property may follow the Green pattern, that is, acquire property with gross income and when it has appreciated, contribute it to charity. An alternative plan for an estate or trust that already owns property it would like to contribute to property might be structured with a two trust arrangement that involves transferring the property from the old trust to a second trust that has the requisite charitable intent in a manner that the distribution from the first trust to the second one (that is the one with the requisite charitable intent) will be deemed to be gross income under the DNI rules of sections 662.[40] Therefore, when received by the second trust it will be deemed to consist of gross income to the extent of DNI. Moreover, it could or might be fiduciary accounting income under UPIA section 402 (1997), if the Trustee of Trust 1 so designates the distribution. As a result, the property represents both gross income in a tax sense and accounting income when contributed to charity by the second trust. The only real issue is the amount of the charitable deduction as section 643(e) will limit amount of gross income by the second trust to the basis of the property distributed, unless the transferor trust elects to recognize gain. At that point, Green held that a fair market deduction is appropriate.

> **Example:** A created and funded Trust 1 for the benefit of her issue. The Trustee has discretion to distribute trust income and principal to or for the benefit of A's issue and charity. Trust 1 has assets valued at $10 million and, for the current year, has $200,000 of gross income. Assume that Trust 1's DNI is $200,000 and its fiduciary accounting income is $200,000. Among its assets is Stock X with a fair market value of $100,000 with an income tax basis of $40,000. The Trustee would like distribute Stock X to charity. Because Stock X is fiduciary accounting principal, a transfer of the stock to charity would not entitle Trust 1 to an income tax charitable deduction.
>
> However, if A creates a second discretionary trust (Trust 2) for her issue and charity, it is possible that the Trustee of Trust 1 could distribute Stock X to Trust 2. Under the rules of section 643(e), the distribution will result in only

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[36] Compare the following cases with each other: *Old Colony Trust Co. v. Commissioner, supra; U.S. v. Benedict,* 592 U.S. 692 (1950); *Crestar Bank v. Internal Revenue Service,* 47 F. Supp. 2d 670 (1999); *Van Buren v. Commissioner*, 89 T.C. 1101 (1987); *Riggs National Bank v. U.S.*, 352 F.2d 812 (1965); *Frank Trust of 1931 v. Commissioner of Internal Revenue*, 145 F.2d 411 (1944); *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); *Estate of Esposito v. Commissioner*, 40 TC 459 (1963), acq. 1964-1 CB (pt. 1) 4.

[37] *Riggs Nat'l Bank v. U.S.*, 352 F2d 812, 16 AFTR2d 5881 (Ct. Cl. 1965). The tracing in the context of section 642(c) forms the basis for the limited exception to the general removal of the tracing requirement accomplished by Subchapter J. *Caroline P. Van Buren v. Comm'r*, 89 TC 1101 (1987) . This concept was specifically recognized in *Mott v. U.S.*, 462 F2d 512, 30 AFTR2d 72-5193 (Ct. Cl. 1972) (en banc), wherein the court stated that "tracing of charitable distributions is still required under Section 642(c) and to the extent that a charitable deduction is not paid out of gross income in accordance with the requirements of Section 642(c), then we think that Congress intended that no deduction is allowable."

[38] 430 F.2d 710 (5th Cir. 1970), *reh. denied*, 403 U.S. 912 (1971).

[39] *W.K. Frank Trust of 1931 v. Comm'r*, 145 F2d 411 (3rd Cir. 1944).

[40] A distribution from a simple trust will like generate income if the property is appreciated as under Kenan, the amount required to be distributed is being satisfied with appreciated property.

$40,000 of DNI being attributable to the distribution and Trust 2 will have gross income of $40,000 under section 662. Trust 1 will receive a distribution deduction of $40,000 under section 661.

Assuming that the Trustee of Trust 1 charges the entire $200,000 distribution of Stock X to its fiduciary accounting income, the receipt of Stock X by trust 2 will be both gross income, at least to the extent of $40,000, and fiduciary accounting income. Therefore, in the hands of the Trustee of Trust 2, Stock X is both gross income and fiduciary accounting income and therefore should support a section 642(c) deduction for Trust 2. The only question is the amount of the deduction. Is it limited to the Trust's basis of $40,000 or is $200,000? *Green* would support the higher amount.

The apparent tracing requirement may present a problem for trusts and estates that own entities, such as partnerships and S corporations, where the entities' income is imputed to the partners without an equivalent amount of cash necessarily being distributed to and received by them. A significant number of investments available in the market are or use pass-through vehicles (typically, partnerships or limited liability companies treated as partnerships), including hedge funds, private equity investments and others. And, virtually none of these currently distributes the amount of income imputed to its partners or shareholders during the year in which the income is earned and imputed. Although it would seem that the trust or estate could make the election, discussed above, to treat income paid to charity in the year following the year the gross income is attributed by the investment to the estate or trust, many of these investments do not pay such income even in the year following the year in which the income was earned and imputed to the investors. Indeed, when the income earned in a pass-through entity is distributed, it is not treated as a distribution of the entity's gross income, for income tax purposes, but essentially as a redemption of the investment, because the income has already been imputed to the partners or S corporation shareholders.

Notwithstanding the lack of cash distributed by the investment vehicle to the estate or trust, there seems to be a workaround, although it is somewhat complicated. The estate or trust creates and owns virtually all, but not all, of the equity in a partnership that is not a disregarded entity.[41] That partnership would make investments in pass-through entities (such as other partnerships) that the estate or trust might otherwise make. The income from the pass-through investments will be imputed to the partnership that the estate or trust "owns" and it is that partnership's income, and not the income of the pass through-investments, that will be imputed to the estate or trust that is the partner. The partnership that is "owned" directly by the trust may distribute an amount of cash equal the amount of its gross income (which, of course, would include the gross income attributed to it from the pass through investments). As a consequence, the amount distributed should qualify for the section 642(c) deduction, or that might be set aside for an estate. As a practical matter, the determination of the amount of gross income imputed from the partnership to the estate or trust and, therefore, the amount to be distributed as gross income will not be determined until the year after the income is imputed to the estate or trust, meaning the estate or trust would need to make the distribution by the time its income tax return for the year the income is imputed is due to be filed and to make the election, discussed above, to treat the distribution as having been made in the year in which the income was so imputed.[42]

Example:

Trust A owns a 25% interest in an investment partnership (Partnership 1) valued at $500,000 together with cash equal to the anticipated earnings that will be imputed to the 25% interest over the next several years. Trust A contributes its interest in Partnership 1 and the cash to a new Partnership 2, in exchange for a 99% limited partnership interest in Partnership 2. As a result, Partnership 2 is a 25% partner of Partnership 1 and Trust A is the 99% partner of Partnership 2. In 2015, Partnership 1 earns $50,000, of which the Partnership 2's share, as a partner in Partnership 1, is $49,500, but Partnership 1 makes no distribution of the earnings to its partners, including Partnership 2. Trust A would like to distribute all of the income from Partnership 2 (totaling $49,500) to charity and receive a deduction under Section 642(c). For Trust A to receive that deduction, Partnership 1 distributes $49,500 in cash to Trust A and then Trust A contributes $49,500 to Charity C. Partnership 2 advises Trust A that the $49,500 distribution is of Partnership 2's income for 2015. Even if Trust X does not receive the cash until 2016, it can distribute it to charity by the time it must file its income tax return for 2015 (not later than September 15, 2016), if it receives the cash from Partnership 2 by then, and can elect to treat the distribution as though made in 2015.

Limit Where UBI Is Distributed by a Trust

[41] Under Treas. Reg. 301.7701-3, certain entities are disregarded for Federal tax purposes. If the trust or estate "owns" such an entity, income imputed from pass thru entities (such as a hedge fund) to that entity might be treated as received by the trust or estate.

[42] Cf, PLR 201246003 (not precedent).

Although an estate or a non-grantor trust is entitled to a charitable deduction, without limitation, under section 642(c) for its gross income paid (or, for a decedent's estate, paid or set aside), no section 642(c) deduction is allowed for payments from a non-grantor trust for a charitable purpose to the extent the income so paid is allocable to the trust's UBI within the meaning of section 681. To the extent the trust has UBI that is paid to charity, the deduction limitations are the same as those for an individual.[43]

UBI, for this purpose, consists of the trust's income from certain business activities and from certain property acquired with borrowed funds reduced by the modifications listed in section 512(b). These modifications include a deduction for charitable contributions allowed by section 170, subject to the percentage limitations applicable to individuals. UBI, within the meaning of section 681, is essentially the same as unrelated business taxable income or "UBIT" defined in section 512, which includes income attributable to acquisition indebtedness.[44] Capital gain recognized on the sale of an asset is not normally UBIT if there is no indebtedness against the property.[45]

As mentioned above, an estate or trust that is a partner in a partnership is entitled to a deduction under section 642(c) for charitable contributions made by the partnership even if the governing instrument of the estate or trust does not provide the requisite charitable intent that would be required to support the deduction if made directly by the estate or trust.

Rev. Rul. 2004-5 states explicitly that the charitable contribution by a partnership was from its gross income although the conclusion (that the trust that as a partner is entitled to take a deduction under section 642(c) for its share of the partnership's charitable donation) is not expressly limited to a case where the donation is made from the partnership's gross income. Nonetheless, it appears to be the position of the IRS that, for a charitable contribution by a partnership to be deductible by a trust that is a partner, the charitable contribution must have been made by the partnership from its gross income.[46] Also, 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).[47] In other words, if gross income is used to acquire an asset, that asset itself should continue to be treated as gross income at least as long as the asset can be traced to such gross income.[48]

Rev. Rul. 2004-5 indicates that section 681 would apply if the partnership makes the charitable contribution from it gross income that would have been UBI if received directly by the trust.[49] Although the concept of UBI (or UBIT) does not apply to a partnership, the nature of a partnership's income presumably passes through to a trust for UBI purposes.[50]

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[43] See Treas. Reg. § 1.681(a)-2(a)(second to last sentence); section 512(b)(11)).

[44] If there is no debt on the asset, there can be no acquisition indebtedness. Acquisition indebtedness is defined in section 514(c)(7).

[45] Section 512(b)(5) provides that from UBIT "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."

[46] See Field Service Advice 200140080 (not precedent).

[47] See, e.g., *Green v. U.S., supra.* Also, see, *Old Colony Trust Co. v. Commissioner*, *supra*, 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*, *supra*; *Freund's Estate v. Commissioner*, *supra*; *Sid W. Richardson Foundation v. U.S., supra; Frank Trust of 1931 v. Commissioner*, *supra; Estate of Joseph Esposito v. Commissioner supra.*

[48] *Id.*

[49] The ruling states, in part, "Because none of [the partnership]'s income for the taxable year would be considered 'unrelated business income' for purposes of § 681(a), the amount of the charitable deduction is not limited under § 681." Also, note that Box 20 of Schedule K-1 of a partnership income tax return specifically requires that the share of the partner's UBI of the partnership be disclosed. In Field Service Advice 200140080 (not precedent), which dealt with a trust's distributive share of

Nonetheless, when an estate or trust distributes its gross income to charity pursuant to section 642(c) or otherwise, the gross income should not be treated as UBIT in the hands of the charity even if it would have been UBIT if received directly by the charity.[51] Note also, that section 681 does not apply to an estate.

In any event, the safer course, in order to allow a non-grantor trust partner to be entitled to the charitable deduction without the limitation on contributions made by the partnership, is to have the contribution made from the partnership's gross income other than what would be UBI. [52]

Although not addressed in Rev. Rul. 2004-5, it may suggest that tracing of the source of the contribution by the partnership may be permitted—that is, because the partnership can make the charitable contribution from its gross income as opposed to any other asset it holds, its seems to follow that it can make it from gross income that would not be UBI (at least to the extent it has gross income that would not be UBI). However, a 2012 amendment to the regulations under section 642(c) provides that, for purposes of determining the type of income deemed distributed from an estate or trust to charity for purposes of "shifting" income to charity, any such distribution will be treated as consisting proportionately of all classes of gross income unless the governing instrument of the estate or trust provides otherwise and such provision has independent economic effect.[53] This recent amendment does not, by its terms, apply to income distributed to charity by a partnership where a trust is a partner. Because a trust and an estate under the prior regulation could specify the character of the income being distributed to charity and because the amended regulation does not, as just stated, by its terms apply to distributions of income by a partnership of which the trust is a partner, it may be that the partnership may specify the type of income being paid which would be respected for purposes of section 681.

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a partnership's charitable contributions, the IRS stated that although the courts in *Lowenstein v. Commissioner*, 12 TC 694 (1949), aff'd, 183 F.2d 172 (*sub nom First National Bank of Mobile v. Commissioner*) (5th Cir. 1950), and *Estate of Bluestein v. Commissioner*, 15 TC 770 (1950), did not analyze the governing instrument requirement, "the basis for the court's allowance of the deductions appears to be the fact that the contributions were made at the partnership level and that the estate would never receive the benefit of these amounts." The IRS further stated, "Based on the Bluestein and Lowenstein cases, we believe that a trust should be allowed a deduction for its distributive share of charitable contributions made by a partnership even though the trust's governing instrument does not authorize the trustee to make charitable contributions. However, all of the other requirements of IRC § 642(c) must be met, and the limitations of IRC § 681(a) must be taken into account."

[50] Section 513(b).

[51] This conclusion is based upon the absence of a provision that would cause the distribution to be treated as UBTI in the hands of the charitable recipient, the several provisions that otherwise cause a recipient of a distribution from an estate or trust to treat it as having the same income tax character as it had in the hands of the estate or trust, and the fact that there is an explicit provision requiring a charity that is a partner to treat any partnership income (without applying the rule to distributions from an estate or trust) attributed to it as UBTI if it would have been UBTI if earned directly by the charity. For example, in the case of a partnership, UBTI carries out to any partner that is a charity, as provided in section 512(c) and as UBI to a trust partner which, to that extent, would be subject the trust's charitable distributions of the UBI to the section 170 limitations to individuals. However, payments to charity from an estate or trust even if consisting of UBI should not be treated as UBTI in the hands of the charitable recipient. Such transfers from an estate or trust to charity do not qualify for a distribution deduction under section 651(a) or 661(a) and do not consist of the distributable net income (DNI) of the estate or trust under section 652(a) or 662(a) whose tax character is also passed out to the non-charitable recipient of the DNI. See section 663(a)(2), which denies this treatment for amounts paid to charity that are deducted under section 642(c) (and determined without regard to section 681) by an estate or trust. This seems consistent with the private foundation rules where the net investment income of a trust or estate does not retain its character in the hands of a private foundation for purposes of section 4940. See Notice 2004-35, 2004-19 IRB 889. So UBI should not be treated as "carried out" from an estate or trust to a charity and treated as UBIT in its hands. But, as previously mentioned in this article, section 681(a) provides that in computing the deduction allowable under section 642(c) to a trust (but not an estate), no amount otherwise allowable as a deduction under section 642(c) shall be allowed as a deduction with respect to income of the taxable year which is allocable to "unrelated business income." See also section 642(c)(4), which provides that in the case of a trust (but not an estate), the deduction allowed by section 642(c) is subject to section 681 (related to UBI). Cf., also, discussion in J. Blattmachr, "Something Pretty Scary: Application of Certain Private Foundation and UBTI Rules in Estate Planning and Administration," 26th Annual Heckerling Institute on Estate Planning, Chapter 10 at 1004.3 (1992).

[52] Note that section 68(a), which provides an overall limitation on itemized deductions, does not apply to a non-grantor trust or a decedent's estate. Section 68(e). The two percent "floor" rule of section 67(a) does not apply to section 642(c) deductions. Section 67(b)(4).

[53] See Treas. Reg. §1.642(c)-3(b)(2).

In any event, under Rev. Rul. 2004-5, if a trust is a partner in a partnership, the trust will be entitled to a deduction for charitable contributions made by the partnership (at least if made from the partnership's gross income and potentially subject to section 681 if paid or deemed paid from what would be UBI if received directly by the trust) and, usually, without the normal limitations (related to "contribution base") applicable to an individual taxpayer.

There is developed law on whether a non-grantor trust that is a shareholder of an S corporation may take a deduction for charitable contributions made by the S corporation.[54] The Treasury regulations dealing with Electing Small Business Trusts ("ESBTs"), defined in section 1361(e)(1), which are certain trusts that may qualify by electing to be eligible shareholders of S corporations, provide that an ESBT is entitled to a charitable deduction attributable to contributions made by the S corporation from its gross income, although "[t]he 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."[55]

If the shareholder is a grantor trust for income tax purposes[56], the charitable deduction would pass through to the individual who is the income tax owner of the trust.

Certain trusts that are not grantor trusts may be eligible shareholders of an S corporation. These consist of voting trusts, the beneficial owners of which are treated as the S shareholders (to whom any charitable contribution made by the S corporation would be attributed); certain testamentary trusts, including certain formerly revocable trusts[57], for a limited period, of which the decedent's estate will be treated as the shareholder (and to which any charitable contribution made by the S corporation would be attributed); and certain tax exempt trusts. In addition, a decedent's estate is an eligible S shareholder.[58]

Hence, in circumstances where the decedent's estate is the shareholder or treated as the shareholder of the S corporation, the principles of Rev. Rul. 2004-5 should apply so the estate will obtain a section 642(c) deduction for contributions by the S corporation (and not limited by section 681 as that section does not apply to a decedent's estate).

The limit on a charitable deduction for UBI of a trust does offer one possible advantage.[59] Section 681 disallows the charitable deduction under section 642(c). However, the regulations under section 681 permit a partial deduction by applying 512(b)(11) which imposes the percentage limitations applicable to individuals.[60] The regulations provide in part: "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)."[61] Then section 511(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 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).

Therefore, a trust with UBI is potentially entitled to charitable deduction under section 170. As a result, the special rules of section 642(c) are not applicable, in particular the requirement that the contribution is from gross income and

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[54] Although section 1366(a)(1) provides that an S corporation shareholder may deduct on the shareholder's own income tax return a pro rata portion of the corporation's charitable contributions, Section 1366(d)(1) limits the deduction to the sum of the shareholder's basis in his or her stock and any basis in any indebtedness the corporation owes to the shareholder. For years 2006 through 2013, a somewhat different rule on the limitation for such deductions applied. This limitation does not apply to a partner on charitable contributions made by the partnership.

[55] Treas. Reg. § 1.641(c)-1(d)(2). The "S portion" of the ESBT's income is the income from the S corporation that is attributed to the trust. See, generally, Blattmachr & Boyle, Income Taxation of Estates & Trusts (PLI 2015), Chapter 7.

[56] Note that the beneficiary of a Qualified Subchapter S Trust makes an election pursuant to section 1361(d)(2) for the trust to qualify by the beneficiary being treated as the income tax owner of the S stock pursuant to section 678. See Blattmachr & Boyle, *supra*.

[57] See section 645.

[58] For a more complete discussion of these matters, see Blattmachr & Boyle, *supra*.

[59] Section 681(a).

[60] Treas. Reg. § 1.681(a)(2).

[61] *Supra*.

possibly traceable to gross income. In addition, the requirement that the contribution be authorized by the terms of the governing instrument may not be applicable, although trustees, for their own fiduciary protection, should otherwise ensure the permissibility of distributions to charity. Without the section 642(c) limits applying, it may be possible for a trust to make charitable gifts in kind and deduct the fair market value of the donated property, subject to the limits applicable to individuals and the amount of UBI for the tax year. Moreover, the charitable deduction carryover may in fact be applicable.

Contributions of Partial Interests

As a general rule, an individual is not entitled to a charitable deduction for a gift of a partial interest in property unless it is the only interest the taxpayer owns[62] or is the remainder in a charitable remainder trust described in section 664.[63] It seems that these partial interest rules do not apply to contributions by an estate or trust that qualify for deduction under section 642(c). The reason is that the partial interest rules are contained in section 170(f)(1) et seq. which states that "No deduction shall be allowed *under this section*…." (Emphasis added.) The word "section," obviously, means section 170.[64] But there is no comparable condition in section 642(c).[65] Thus, it seems that an estate or trust could create a charitable remainder trust with its gross income, if permitted under the terms of the governing instrument, without complying with the statutory rules under section 664. Alternatively, a trust might consider contributing gross income to a charitable lead trust but again not necessarily in the form described in section 170(f)(2)(B). This might be advantageous where it is desired to pay the non-charitable recipient the fiduciary accounting income or some other payment not consisting of an annuity or unitrust amount, as required by section 664 and section 170(f)(2)(B).

Charitable Purpose

For an individual, the contribution must be to or for an organization described in section 170(c). For an estate or trust, the deduction is allowed under section 642(c) if made for a charitable purpose. It is not certain what the scope of "charitable purpose" is. Neither the Code nor any regulation seems to provide a definition. Perhaps, it would permit the estate or trust directly to apply its gross income for a charitable purpose such as "to foster national…sports competition" or provide education, but not paid to an educational organization, within the meaning of section 170(c)(2).[66] Alternatively, the trust might provide a direct benefit such as providing food directly to the hungry or make gifts to families of police officers or soldiers killed in the line of duty. Nevertheless, it would be more prudent to find an organization described in section 170(b) or (c) to carry out the program or make the benevolent transfers.

As mentioned above, section 642(c) provides that the deduction it provides is lieu of the deduction under section 170, indicating that whatever is a charitable purpose under section 170 also is one for purposes of section 642(c). This seems

[62] Note that both the gift tax and income tax charitable contribution provisions contain similar partial interest rules. Both, in general, disallow any deduction for a contribution of a partial in property although both permit a deduction if the only interest the taxpayer holds is the partial interest. Section 170(f)(3) and section 2522(c). However, for income tax purposes, the rule disallowing a deduction for the partial interest applies even if that is the only interest the taxpayer held in the property if it was divided to avoid the partial interest disallowance rule even if the division occurs by a sale for full and adequate consideration. Treas. Reg. 1.170A-7(a)(2)(i)(third sentence). Nonetheless, for gift tax purposes, the disallowance applies regardless of the reason for the division if the interest not contributed to charity is retained by the donor or has been transferred to anyone for less than an adequate and full consideration in money or money's worth.
[63] Section 170(f)(2)(A).
[64] Similarly, other parts of section 170(f) will not apply to contributions by an estate or trust that qualify under section 642(c), such as the substantiation requirement under section 170(f)(8), which begins "No deduction shall be allowed under subsection (a)…." There is no substantiation requirement in section 642(c).
[65] Note that somewhat different partial interest rules are contained in sections 2055 and 2522 for estate and gift tax purposes. But there is none under Section 642(c) and the deduction under that section is "in lieu of the deduction allowed by section 170(a)." Note that to begin, under section 641(b), the taxable income of a decedent's estate and a non-grantor trust is determined in the same manner as that of an individual with certain differences provided in the Code. Perhaps, the most important difference in computing the taxable income of an estate or trust compared to that of an individual is the allowance of a deduction under section 651(a) or 661(a) for its DNI distributed or required to be distributed to one or more of its beneficiaries. The DNI deducted by the estate or trust is included under section 652(a) or 662(a) in the gross income of the beneficiary or beneficiaries who are treated as receiving it.
[66] Under section 170(b)(1), charitable contributions include those to certain charitable organizations including "an education organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on."

to be reinforced by section 681 which, as discussed above, provides, in effect, that to the extent the contribution by charitable consists of UBI, the estate or trust is denied the deduction under section 642(c) but is allowed as provided in section 170.

State Income Tax Limitations on Charitable Deductions

Some states (or their political subdivisions) limit an individual's charitable deduction for state (or local) income tax deductions even to a greater extent than does the federal government. For example, certain deductions, allowed for federal income tax purposes are not allowed for New York income tax purposes[67] and all itemized deductions for New York income tax purposes, including charitable contributions made by an individual, are reduced in many situations especially for "high" income taxpayers.[68]

One potential way to avoid these state limitations is for the individual taxpayer to create a trust that is not treated as a grantor trust (which essentially would be disregarded for income tax purposes) and, perhaps, transfers to the trust are not complete for Federal gift tax purposes.[69] Because the trust would not be a grantor trust, it would be entitled to a charitable deduction for its gross income paid pursuant to its terms for a charitable purpose without limitation under section 642(c) except to the extent that gross income consists of UBI.[70]

Structuring Non-Grantor Trusts in Light of Section 642(c)

It is at least arguable that all trusts should permit distributions of gross income to charity, other than ones where a tax benefit would be lost, such as for a trust qualifying for the marital deduction.[71] This discretionary power could be held by the trustee or by a beneficiary. Perhaps, it would be appropriate to require the trustee to obtain the consent of one or more of the beneficiaries of the trust to avoid the appearance that the trustee is trying to garner favor with one or more charities as the "expense" of the beneficiaries. Alternatively, one or more beneficiaries could be given the power conditioned on obtaining the consent of another beneficiary and/or the trustees, to avoid any concern that the charity has unfairly influenced the beneficiary or that the beneficiary is trying to "punish" another beneficiary by giving away trust assets to charity.

In some cases, it might be preferable for the beneficiary to make the donation and the trust could allow discretionary distributions to the beneficiary, so he or she could make the charitable contributions with the distributions from the trust. It might be contended that a beneficiary who exercises the power to distribute gross income to charity has made a gift[72] by diverting gross income from himself or herself to charity, the amount so distributed should qualify for the gift tax charitable deduction.[73]

If gifts of income to charity are anticipated by the trust's grantor, it may be preferable to merely authorize general distributions to the non-charitable beneficiaries rather than mandate them. This is may be advantageous because DNI is defined as the trust's taxable income (with the adjustments provided under section 643(a)), but the charitable deduction under section 642(c) is not allowed in determining DNI for mandatory distributions of accounting income.[74] However, DNI

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[67] New York Tax Law § 615(c).
[68] New York Tax Law § 615(g).
[69] See, generally, Blattmachr & Lipkind, "Fundamentals of DING Type Trusts: No Gift Not a Grantor Trust," Probate Practice Reporter, Vol. 26, No. 4, April 2014
[70] Note that New York has enacted legislation that causes such a trust that created by an individual that is not a grantor trust for Federal income tax purposes and transfers to which are not complete for gift tax purposes to be treated as a grantor trust for New York income tax purposes. N.Y. Tax Law § 612(b)(41)
[71] Only the surviving spouse may be the beneficiary during his or her lifetime of a trust that is intended to qualify for the gift or estate tax marital deduction. See sections 2523 and 2056. Although certain marital deduction trusts (see, e.g., section 2056(b)(5) may permit the spouse who is the beneficiary to exercise a general power of appointment, any exercise in favor of charity likely would be treated as being made by the spouse and not the trust.
[72] See *Estate of Regester v. Commissioner,* 83 TC 1 (1984).
[73] It should be noted that the meaning of charitable varies slightly for income and gift tax purposes. To avoid any issue, transfers, at least above the gift tax annual exclusion under section 2503, should be made only charitable organizations transfer to which qualify for the gift tax deduction under section 2522(a).
[74] The last sentence of section 662(b), which determines the character of amounts distributed from a trust (or estate) to a beneficiary, provides that with respect to amounts of fiduciary accounting income required to be distributed currently, "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." It may be noted that no section 642(c) deduction is allowable with respect to trust distributions of which are governed by sections 651 and 652. See, e.g., TAM 8738007, *supra.*

computed for discretionary deductions is calculated after the charitable deduction is allowed. This difference is how DNI is computed and how a beneficiary's reportable income is determined is part of the unique tier system that is a cornerstone of the Subchapter J of Chapter 1 of Subtitle A of the Code.

Under what are known as the "tier" rules, all amounts treated as distributed or distributable fall into one of two categories: (1) the amount of income, for trust-accounting purposes, required to be distributed currently, including the amount of an annuity (or other item payable out of income or corpus) that is actually paid out of such income for the year (and known as "tier 1 or first-tier distributions"), or (2) all other amounts of income or corpus either required to be distributed or properly paid or credited (and known as "tier 2 or second-tier distributions").[75] The total amount taxable to the beneficiaries is limited to distributable net income, however, and then only to the taxable portion of DNI.[76]

Amounts in the first category, or first-tier, are included in gross income in full, to the extent distributable net income is not exceeded, before amounts in the second tier are included in gross income at all. If the first-tier amounts exceed distributable net income, each recipient of first-tier distributions includes in gross income a proportionate part of the distributable net income.[77]

If first-tier distributions alone do not exceed distributable net income, the second-tier distributions are included in the gross income of the recipient-beneficiaries, to the extent of the balance of DNI. When the total of first-tier and second-tier distributions exceed DNI, each recipient of second-tier distributions includes in income a proportionate part of the amount that remains after distributable net income is reduced by the first-tier distributions.[78] For purposes of the DNI limit on taxing first-tier distributions, the trust's income tax charitable deduction is not allowed when computing distributable net income.[79]

> **Example:** A trust has $65,000 of taxable dividend income. Annually, the Trust is required to distribute the first $10,000 of income to a qualified charity, *C*, and the balance of its accounting income to an individual, *A*. In addition, the Trustee is authorized to invade principal for the benefit of a second individual, *B*, and distributes $10,000 to *B*. The trust pays $10,000 in trustee fees that are chargeable one-half to income and one-half to principal. The accounting income for the trust is $60,000 ($65,000 less $5,000, one-half of the trustee's fee). Thus, the amount distributable to *A* is $50,000 ($60,000 less $10,000 due the charity). The trust's taxable income, before any deduction for the distribution of DNI, is $45,000 ($65,000 less $10,000 trustee fee and less $10,000 charitable deduction). The DNI for the trust is $45,000. Because distributions to *A* and *B* exceed DNI, the trust's distribution deduction is limited to $45,000.
>
> When the amount of income *A* must report is computed, DNI is recomputed without a charitable deduction. Thus, DNI is $55,000 for this purpose and *A* has $50,000 of taxable income under section 662. Note that the amount of income *A* must report is less than the recomputed DNI by $5,000, because *A* has received only $50,000.
>
> Nevertheless, *B* has no income on the distribution of principal as the DNI for purposes of the tier 2 distribution is the original $45,000 and that amount is not in excess of the tier 1 distribution to *A*.

Therefore, a mandatory distribution as well as a discretionary one shift the trust's DNI from the trust to the beneficiary but potentially less income for the same amount of a distribution. For trusts that will make distributions to charities and individuals, only discretionary beneficiaries will indirectly receive the benefit of the charitable deduction and that potential can be planned for.

Thus, it seems that any distribution to charity of gross income of the trust, for which a section 642(c) deduction is allowed and that is attributable to fiduciary accounting income, does reduce DNI. The regulations under section 662(b) flesh that out. Treasury Regulations section 1.662(b)-2 provides, in part:

> [T]he charitable contributions deduction allowed under section 642(c) is . . . allocated among the classes of income entering into the computation of estate or trust income in accordance with the rules set forth in paragraph (b) of

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[75] I.R.C. § 662(a).

[76] Distributable net income is described in detail in section 3:3.2 of Blattmachr & Boyle, *supra*. However, in the very limited circumstances when the "throwback rules" apply, distributions of accumulated (prior years') income may also become taxable to the beneficiary.

[77] An exception exists if certain classes of income are distributable to only certain beneficiaries. Treas. Reg. § 1.662(b)-1.

[78] I.R.C. § 662(a)(2).

[79] I.R.C. § 662(a)(1).

> [Treas. Reg. section] 1.643(a)-5. In the application of the preceding sentence, for the purpose of allocating items of income and deduction to beneficiaries to whom income is required to be distributed currently, the amount of the charitable contributions deduction is disregarded to the extent that it exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently.

This regulation seems to limit the extent to which the charitable deduction can reduce DNI for purposes of determining the character or flavor of a distribution of fiduciary accounting income required to be distributed so it has no practical effect.

Income Tax Advantages of a Trust's charitable Deduction

Another potential advantage of using a trust to make charitable gifts rather than gifts by an individual is that neither a trust nor an estate is subject to the 3% "cutback" rule of section 68. See section 68(e).

Also, the net investment income (NII) rules of section 1411 apply differently to estates and trusts and how it applies to individuals and it may be less NII tax if charitable gifts are made by an estate or trust. Under the regulations, income distributed for charitable purposes that entitles the estate or trust to a deduction under section 642(c) is not subject to NIIT in the hands of the trust or estate or presumably in the hands of any tax-exempt recipient.[80]

The fact that an estate or trust can shift its NII to a charity may provide it with an advantage compared to an individual taxpayer. Because an individual pays the NIIT on the lesser of NII or adjusted gross income (over the threshold), charitable contributions do not reduce NII because the charitable deduction is an itemized deduction for an individual. However, they do for an estate or trust.[81]

Summary and Conclusions

One of the most important differences in computing the taxable income of an individual, on the one hand, and an estate or trust, on the other, relates to the deduction for charitable contributions, except where the contribution by an estate or trust consists of UBI which will cause the trust or estate to fall under at least some of the same rules as those applicable to an individual taxpayer. This difference may result in preferable outcomes for taxpayers by arranging for contributions to be made by an estate or trust rather than by its beneficiaries. Building in the opportunity for the trust or estate to make discretionary distributions to charity (where doing that will not cause adverse effects, as it would for a trust intended to qualify for the marital deduction) may be beneficial.

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[80]. The deduction under section 642(c) is permitted when the distribution is for a charitable purpose, which might not include an income tax exempt charity. See section 3:2.1[J] of Blattmachr & Boyle, *supra,* for a detailed discussion. In any case, it seems that no part of a distribution of NII could be considered unrelated business taxable income within the meaning of section 512(a). See generally Jonathan G. Blattmachr, "Something Pretty Scary: Application of Certain Private Foundation and UBTI Rules in Estate Planning and Administration," The Twenty Sixth Annual Philip E. Heckerling Institute on Estate Planning (1992).

[81] However, it may not reduce the NII allocated to a non-charitable beneficiary of an estate or trust to the extent the beneficiary is entitled to a current distribution of fiduciary accounting income. See *supra* note 66 and accompanying text.

Appendix B:

Income Tax Trap – Reduction in Trust's S Corporation Charitable Deduction

By Steven B. Gorin

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This Appendix is excerpted from Gorin, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," over 1,100 pages available as a PDF from the author.

The author sends a link to the most recent version to the PDF in his free electronic newsletter (roughly quarterly), called "Gorin's Business Succession Solutions." If you would like to receive the PDF or this newsletter, please email the author at sgorin@thompsoncoburn.com with "Gorin's Business Succession Solutions" in the subject line and indicate whether you want the PDF, newsletter, or both; the newsletter email list is opt-in only.

APPENDIX B

II.Q.7.c.i. Income Tax Trap - Reduction in Trust's Charitable Deduction

Although trusts can deduct amounts of gross income[2546] paid to charity, the trust must actually receive the income and must be authorized to make the payment to charity. [2547] 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.[2548] 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.[2549] 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.[2550]

[2546] 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.

[2547] 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 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.

[2548] *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).

[2549] Letter Ruling 201246003.

[2550] See part II.A.2.f Shareholders, especially fns. 102-105, 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.

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.[2551]

Although normally trusts may deduct all of their gross income that they pay to charity,[2552] this deduction is eliminated to the extent that the trust has unrelated business taxable income (UBTI).[2553] However, in computing the UBTI causing this disallowance, a charitable contribution deduction is allowed, using the percentages that apply to contributions by an individual.[2554] Thus, a partial charitable contribution is allowed to be made out of unrelated business income.[2555] 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.[2556] Furthermore, consider whether the trust also becomes subject to an individual's restrictions[2557] regarding substantiation[2558] and identity of donee.[2559]

[2551] 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 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. 2546 (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).

[2552] Code § 642(c).
[2553] Code §§ 642(c)(4) and 681.
[2554] Code § 512(b)(11); Reg. § 1.512(b)-1(g).
[2555] Reg. § 1.681(a)-2(b).
[2556] Reg. § 1.681(a)-2(a).
[2557] 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 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:

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;[2560] 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 categories. 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,[2561] 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 unrelated business income (UBI) to charity, because the trust will need to pay income tax on the UBI that cannot be fully offset by the charitable deduction.[2562] If the trust mandates that all of the income be paid to charity, the trustee may still allocate the taxes as an expenditure charged against income so that the trustee can pay the taxes.[2563]

Fortunately, these rules do not apply to estates.[2564] If a qualified revocable trust elects to be taxed as an estate, then it should escape this limitation.[2565] 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;[2566] 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.[2567]

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.[2568]

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(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).

[2558] See part II.J.3.d Who Benefits Most from Deductions, fn. 1172.

[2559] See part II.J.3.d Who Benefits Most from Deductions, fn. 1173.

[2560] Code § 512(e), which was added by P.L. 104-188, effective for taxable years beginning after December 31, 1997.

[2561] 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.

[2562] 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.

[2563] Section 506(a)(2) of the Uniform Principal and Income Act.

[2564] 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.

[2565] See part II.J.7 Election to Treat a Revocable Trust as an Estate.

[2566] See fn. 3371.

[2567] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 3406.

[2568] 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).

Appendix C:

Trusts and the 3.8 Tax on Net Investment Income

By Steven B. Gorin

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This Appendix is excerpted from Gorin, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," over 1,100 pages available as a PDF from the author.

The author sends a link to the most recent version to the PDF in his free electronic newsletter (roughly quarterly), called "Gorin's Business Succession Solutions." If you would like to receive the PDF or this newsletter, please email the author at sgorin@thompsoncoburn.com with "Gorin's Business Succession Solutions" in the subject line and indicate whether you want the PDF, newsletter, or both; the newsletter email list is opt-in only.

APPENDIX C

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.

II.I.1. Taxpayers and Years Affected

For taxable years beginning after December 31, 2012,[939] net investment income in excess of certain thresholds is subject to a 3.8% tax.[940] The preamble to the final regulations explains:[941]

> 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:[942]

> 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[943] 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:[944]

> 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 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

[939] P.L. 111-152, section 1402(b)(3).
[940] Code § 1411(a).
[941] T.D. 9644.
[942] T.D. 9644.
[943] A more direct link is http://www.regulations.gov/#!docketBrowser;rpp=25;po=0;dct=PS;D=IRS-2012-0049.
[944] T.D. 9644.

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:[945]

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 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:[946]

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.

[945] REG-130843-13.
[946] REG-130843-13.

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

The preamble describes how to calculate the tax:[947]

> 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 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.[948]

Short taxable years use the full threshold,[949] without proration,[950] unless the short year results from a change in the annual accounting period.[951]

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

The preamble describes how to calculate net investment income:[952]

> 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 (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).

[947] T.D. 9644.

[948] 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).

[949] Reg. § 1.1411-1(d)(1) sets forth the thresholds.

[950] Reg. § 1.1411-1(d)(2).

[951] Reg. § 1.1411-1(d)(3).

[952] T.D. 9644.

> 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:[953]

> 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 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:[954]

> 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

[953] T.D. 9644.
[954] T.D. 9644.

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 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[955] also apply in determining net investment income ("NII").[956]

NII[957] is the excess (if any) of:[958]

1. The sum of:

   a. Gross income from interest,[959] dividends,[960] annuities,[961] royalties,[962] and rents,[963] except to the extent excluded by the ordinary course of a trade or business exception;[964]

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[955] As defined in Code § 63(a)

[956] 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*.

[957] Reg. § 1.1411-1(d)(8) provides:

> The term net investment income (NII) 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).

[958] Reg. § 1.1411-4(a).

[959] Reg. § 1.1411-1(d)(6) provides:

> The term gross income from interest 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.

[960] Reg. § 1.1411-1(d)(3) provides:

> The term gross income from dividends 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 gross income from dividends 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.

[961] 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

b. Other gross income derived from a passive trade or business;[965] and

c. Net gain from the disposition of property,[966] except to the extent attributable to property held in an active trade or business[967] or otherwise provided,[968]

over

2. Deductions allowable for income tax purposes that are properly allocable to such gross income or net gain.[969]

The corollary to self-employment income being excluded from NII is that items excluded from SE income might constitute NII.[970] Note also that wages are not among the type of income constituting NII.

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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).

[962] 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.

[963] 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.

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

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

[966] 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.

[967] 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.

[968] 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).

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

[970] 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

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.[971]
- 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.[972]
- Penalty on early withdrawal of savings.[973]
- Net operating loss arising from NII items.[974]

The following itemized deductions also apply to NII:

- Investment interest expense.[975]
- Investment expenses.[976]
- State, local, and foreign income, war profits, and excess profit taxes that are allocable to net investment income.[977]
- Deduction for unrecovered investment in an annuity in the decedent's final income tax return if the annuity was NII.[978]
- Deductions for estate GST tax allocable to income in respect of a decedent that is NII.[979]
- Deductions in connection with the determination, collection, or refund of any tax arising from NII.[980]

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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.

[971] Reg. § 1.1411-4(f)(2)(i).
[972] Reg. § 1.1411-4(f)(2)(ii).
[973] Reg. § 1.1411-4(f)(2)(iii).
[974] Reg. § 1.1411-4(f)(2)(iv), cross-referencing Reg. § 1.1411-4(h).
[975] 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).

[976] Reg. § 1.1411-4(f)(3)(ii), cross-referencing Code § 163(d)(4)(C).
[977] 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).
[978] Reg. § 1.1411-4(f)(3)(iv).
[979] Reg. § 1.1411-4(f)(3)(v).
[980] Reg. § 1.1411-4(f)(3)(vi) provides:

- Amortizable bond premium on a taxable bond.[981]

- Fiduciary expenses.[982]

Other deductions include:

- Loss deductions.[983]

- Ordinary loss deductions for certain debt instruments.[984]

- Other deductions not yet announced.[985]

Generally, deductions limited for regular income tax purposes are also limited for NII purposes.[986]

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.[987] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items. When using expenses to offset taxable

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

[981] Reg. § 1.1411-4(f)(3)(vii).

[982] 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.

[983] 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.

[984] 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).

[985] 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.

[986] 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, 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.

[987] Reg. § 1.1411-4(g)(1) provides:

items of income, consider which items of income constitute NII,[988] 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).[989]

Deductions in respect of a decedent also count against NII if they are described in any of the preceding paragraphs.[990]

Deductions on termination of a trust or estate generally receive NII treatment consistent with their character.[991]

Special rules apply to losses allowed in computing taxable income by reason of the rules governing former passive activities[992] or losses allowed when a passive activity is disposed of.[993]

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

Generally,[994] 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[995] over the taxable income threshold[996] for its highest marginal income tax bracket.[997]

> *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.

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

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

[990] 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).

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

[992] Reg. § 1.1411-4(g)(8), referring to losses under Code § 469(f)(1).

[993] Reg. § 1.1411-4(g)(9), referring to losses under Code § 469(g)(1).

[994] 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.

Regarding grantor trusts, the tax is imposed on the deemed owner rather than the trust:[998]

- Thus, the beneficiary of a qualified subchapter S trust (QSST)[999] 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 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.[1000] 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.[1001]

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

UNII[1002] is the estate's or trust's NII reduced by distributions of net investment income to beneficiaries[1003] and by charitable deductions.[1004]

(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.

[995] As defined in Code § 67(e) and as adjusted under Reg. § 1.1411-10(e)(2), if applicable.

[996] Code § 1(e).

[997] Reg. § 1.1411-3(a)(1)(ii).

[998] Reg. § 1.1411-3(b)(1)(v).

[999] See part III.A.3.e.i QSSTs.

[1000] 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.

[1001] Rev. Rul. 81-6.

[1002] 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.

[1003] 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.

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.[1005] See parts II.I.6 Deductions Against NII (especially the text accompanying fns. 987-988) 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.[1006] Distributions include amounts required to be distributed[1007] and any other amounts properly paid, credited, or required to be distributed to such beneficiary.[1008] Generally, an amount is considered credited if the trustee must pay it on the beneficiary's demand (without the trustee exercising any discretion when the beneficiary makes the demand) and there is no practical or legal impediment to making the payment.[1009] Query whether,

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[1004] Reg. § 1.1411-3(e)(4) provides:

> Deduction for amounts paid or permanently set aside for a charitable purpose. 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 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. 2547, 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. 3406 regarding limitations on charitable deductions.

[1005] 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. 1317, controls the allocation of deductions to items comprising DNI for regular income tax purposes.

[1006] 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. 1327 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).

[1007] Code §§ 652(a), 662(a)(1).

[1008] 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.

[1009] 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.

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)[1010] and that the lapse would make the trust a partial grantor trust taxable to the beneficiary.[1011] 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.[1012] 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.[1013]

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.

[1010] 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. 3811, and III.B.2.h.ii Can a Trust Without a Withdrawal Right Be a Code § 678 Trust?, especially fn. 3819.

[1011] 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.

[1012] 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."

[1013] For the potentially lower valuation of QTIP assets, see fn. 1976.

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.[1014] Paying reasonable trustee fees[1015] to a trustee who is a beneficiary would reduce NII while maintaining the same aggregate taxable income between the trust and beneficiary, subject to the following caveats:

[1014] 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. 1659, 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.

[1015] 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 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

- If the trust has tax-exempt income, some of the trustee fees will be disallowed as a deduction.[1016]

- 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. 945 in part II.I.2 Regulatory Framework.

The AICPA has resources on the Estate and Trust Impact of 3.8% Net Investment Income Tax.[1017]

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,[1018] dividends, annuities, royalties,[1019] 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;[1020] 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.[1021] Gain from the

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> 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.

[1016] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 1316.

[1017] See http://www.aicpa.org/InterestAreas/Tax/Resources/TrustEstateandGift/ToolsandAids/Pages/EstateandTrustImpactof38MedicareSurtax.aspx.

[1018] 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. 1021, 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.

[1019] 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).

[1020] 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….

[1021] 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;

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;[1022] 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.[1023] Other gross income from a trade or business is NII if it a passive activity.[1024]

Passive income is subject to the NII tax, and Code § 469 and the regulations thereunder determine whether a trade or business is passive.[1025]

Income from a trade or business of trading in financial instruments[1026] or commodities[1027] is also subject to NII tax.[1028] This rule applies to traders – not to dealers or investors.[1029]

(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);
(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.

[1022] Reg. § 1.1411-4(a)(1)(iii).

[1023] 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.

[1024] Reg. § 1.1411-4(c).

[1025] Reg. § 1.1411-5(b)(1)(ii).

[1026] 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).

[1027] 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).

[1028] Code § 1411(c)(2)(B); Reg. § 1.1411-5(a)(2).

[1029] 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**
>
> 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,

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.[1030] 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,[1031] one should consider that exit strategies[1032] and basis step-up issues[1033] 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.[1034]

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).[1035]
- Certain rental activities.[1036]
- 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[1037] and

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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.

[1030] 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. 1035.

[1031] See part II.L.4 FICA: Corporation.

[1032] 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.

[1033] See part II.H.2 Basis Step-Up Issues.

[1034] See part II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.

[1035] Reg. § 1.1411-5(b)(2)(i), referring to Reg. § 1.469-2T(f)(2), which is described in fn. 1588 of part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

[1036] 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. 1574 and 1557, respectively, within part II.K.1.e Rental Activities.

[1037] 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).

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,[1038] such trade or business is a nonpassive activity solely with respect to such recharacterized gain.[1039]

- 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.[1040] The relevant portfolio income provision is either:

  - the rental of nondepreciable property, equity-financed lending activities, and royalty income from passthrough entities,[1041] 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.[1042]

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:[1043]

> 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.[1044]

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[1045] or rent[1046] received from a business are automatically deemed nonpassive trade or business income if the borrower/tenant is a nonpassive trade or business; however, self-charged interest is excluded only to the extent it is self-charged.[1047]

[1038] Reg. § 1.469-2(c)(2)(iii)(F).
[1039] Reg. § 1.1411-5(b)(2)(i).
[1040] Reg. § 1.1411-5(b)(2)(iii).
[1041] 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).
[1042] Reg. § 1.469-2(c)(2)(iii)(F).
[1043] Part 6.B.1.(b)(4) of the preamble.
[1044] Reg. § 1.1411-5(b)(3), Example (2).
[1045] 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

Note that the taxpayer must materially participate, satisfying the more-than-500-hours or similar rules,[1048] to satisfy the self-rental exception of footnote 1046:

- Although significant participation (more than 100 hours) suffices for other business income,[1049] 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)[1050] 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,[1051] perhaps migrating as depicted in part II.E.7 Real Estate Drop Down into Preferred Limited Partnership.

- Material participation requires ownership.[1052]

If self-charged rental is excluded from NII, gain on the sale of the rental property is also excluded.[1053]

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,[1054] the determination of whether such gross income is derived in a trade or business is made at the owner's level.[1055]

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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).

[1046] 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.

See fn. 1083 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. 1557 for the text of Reg. § 1.469-2(f)(6).

[1047] 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.

[1048] See part II.K.1.a.ii Material Participation.

[1049] 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.

[1050] See fn. 1053

[1051] 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.

[1052] See fn. 1556 and part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

[1053] 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.

See fns. 1083 and 1558 regarding Reg. § 1.469-2(f)(6).

[1054] 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.

[1055] Reg. § 1.1411-4(b)(1).

If an individual, estate, or trust owns an interest in a trade or business through a partnership or S corporation:[1056]

- 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[1057] 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.[1058] The preamble to the proposed regulations explains:[1059]

> 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 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:[1060]

> 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.[1061]

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:[1062]

> 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

[1056] Reg. § 1.1411-4(b)(2).
[1057] Reg. § 1.1411-5(c) discusses financial instruments and commodities.
[1058] 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.
[1059] Part 7 of the preamble.
[1060] T.D. 9644.
[1061] Reg. § 1.1411-5(b)(3), Example (5).
[1062] T.D. 9644.

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 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:[1063]

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

[1063] 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.

> 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 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[1064] trade or business.[1065]

However, this exception does not apply to the gain or loss attributable to the disposition of investments of working capital.[1066]

Although a partnership interest or S corporation stock generally is not property held in a trade or business qualifying for the exclusion,[1067] the portion of the sale proceeds attributable to business assets does qualify.[1068]

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.[1069] 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.[1070]

[1064] 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. 1025.
[1065] Reg. §§ 1.1411-4(a)(1)(iii), 1.1411-4(d)(4)(i)(A).
[1066] Reg. § 1.1411-4(d)(4)(i)(A). See Reg. § 1.1411-6 regarding working capital.
[1067] Reg. § 1.1411-4(d)(4)(i)(B)(1).
[1068] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[1069] Reg. § 1.1411-4(d)(4)(i)(B)(2).
[1070] 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[1071] or not only is from a trade or business but also nonpassive.[1072]

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.[1073] The NII rules elaborate on exceptions to this general rule. For example, short-term equipment leasing income is not NII,[1074] if the taxpayer materially participates.[1075]

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.[1076] 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.

[1071] See fn. 1046.

[1072] See fn. 1020. 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*.

[1073] See part II.K.1.e Rental Activities.

[1074] 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.

[1075] Reg. § 1.1411-5(b)(3), Example (4) provides:

> 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.

Although the final regulations declined to provide broad relief for real estate professionals, the preamble informs us:[1077]

> 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.[1078]

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.

[1076] See fns. 1550-1562.
[1077] T.D. 9655.
[1078] 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 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.

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.[1079]

The preamble to the final regulations explains how the IRS views rental as a trade or business (emphasis added):[1080]

> 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.[1081]
>
> 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.
>
> 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

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[1079] 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).

[1080] T.D. 9655.

[1081] 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.

> 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):[1082]

> 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:[1083]

> 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.
>
> 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

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[1082] Reg. § 1.1411-5(b)(3), Example 1.

[1083] 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.

maintain the properties.[1084] 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.[1085] The article that made these comments offers excellent planning tips.[1086] Additional clues regarding when rental is a trade or business might be found in the rules governing tax-free split-ups/spin-offs.[1087] Equipment rental appears to have much easier standards in qualifying as a trade or business.[1088]

[1084] 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.

[1085] 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 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 issue*, 776 F.2d 1428, 1433 (9th Cir. 1985).

[1086] 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).

[1087] See part II.Q.7.f.iii Active Business Requirement for Code § 355.

[1088] 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.[1089]

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

[1089] See part II.E.7 Real Estate Drop Down into Preferred Limited Partnership.

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 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:[1118]

> 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.

[1118] T.D. 9655

The preamble to the 2013 proposed regulations summarized these rules:[1119]

> 9. Calculation of Gain or Loss Attributable to the Disposition of Certain Interests in Partnerships and S Corporations
>
> 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 only to the extent of 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 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)[1120] held in a nonpassive trade or business.[1121]

To determine whether net gain is from property held in a trade or business:[1122]

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.

[1119] REG-130843-13.
[1120] As described in Reg. § 1.1411-6.
[1121] Reg. § 1.1411-4(d)(4)(i)(A).
[1122] Reg. § 1.1411-4(d)(4)(i)(B).

2. In the case of an individual, estate, or trust that owns or engages in a trade or business,[1123] 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.

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[1124] 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:[1125]

> 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).
>
> 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

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[1123] 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.

[1124] Reg. § 1.1411-5(c) discusses financial instruments and commodities.

[1125] 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. 1417-1418.

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.[1126]

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.

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),[1127]
- 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,[1128] 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).[1129]

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.[1130]

1126 Reg. § 1.1411-4(f)(9).

1127 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.

1128 See part II.K.1.a.ii Material Participation, including fn. 1440, 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.

1129 See parts II.I.8.a General Application of 3.8% Tax to Business Income and II.K.1.a Counting Work as Participation.

1130 See fns. 1437-1438 and accompanying text, found in part II.K.1.a.ii Material Participation.

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

- Various credits arising from significant participation activities might be suspended.[1131]

- From an income tax perspective, consider that losses from a significant participation activity offset regular income only in certain situations.[1132]

- 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. 1129 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.[1133]

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.[1134]

- 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.[1135]

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,[1136] 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 part II.J.3.a Who Is Best Taxed on Gross Income, especially the text accompanying fns. 1161-1165.

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:

[1131] See part II.K.1.h.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.
[1132] See part II.K.1.a Counting Work as Participation.
[1133] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent.
[1134] 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.
[1135] For details and nuances, see fn. 1574 in part II.K.1.e Rental Activities.
[1136] Code § 164(f)(1).

- 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.[1137] Material participation in the tenant's business includes owning an interest in the tenant's business.[1138] 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[1139] 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:[1140]

- Regrouping passive activities.[1141]

- 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.[1142]

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.[1143] 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.[1144]

[1137] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent Is Not NII, especially fn. 1052, and part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity, especially fn. 1556-1557.
[1138] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.
[1139] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.
[1140] 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.
[1141] 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.
[1142] Code § 1411(e)(1).
[1143] Code §§ 401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3).
[1144] Code § 453, which is subject to Code §§ 453A and 453B.

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.

II.J.14. Application of 3.8% Tax to ESBTs

Electing small business trusts (ESBTs)[1381] are separated into S and non-S portions[1382] and subjected to the NII tax as follows:[1383]

1. The S portion and non-S portion computes each portion's undistributed net investment income as separate trusts[1384] 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,[1385] 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[1386] 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.[1387]

[1381] See part III.A.3.e.ii ESBTs.

[1382] 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.

[1383] Reg. § 1.1411-3(c)(2). Reg. § 1.1411-3(c)(3) provides an example.

[1384] In the manner described in Reg. § 1.1361-3(e).

[1385] As defined in Reg. § 1.1361-3-(a)(1)(ii)(B)(1).

[1386] As calculated under Reg. § 1.1361-3(c)(2)(ii).

[1387] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 3402.

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.[1407]

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.[1408]
- 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.[1409]
- The taxpayer needs to sufficiently participate in a business to make it nonpassive.[1410]

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.[1411]
- 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;[1412] 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.[1413]

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.

[1407] 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. 3402.

[1408] See part II.I.8 Application of 3.8% Tax to Business Income.

[1409] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

[1410] See part II.K.1.a Counting Work as Participation.

[1411] 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).

[1412] See part II.K.2.b Participation by an Estate or Nongrantor Trust.

[1413] See part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.

Appendix D:

Selected Fiduciary Income Tax Issues

By Steven B. Gorin

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This Appendix is excerpted from Gorin, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," over 1,100 pages available as a PDF from the author.

The author sends a link to the most recent version to the PDF in his free electronic newsletter (roughly quarterly), called "Gorin's Business Succession Solutions." If you would like to receive the PDF or this newsletter, please email the author at sgorin@thompsoncoburn.com with "Gorin's Business Succession Solutions" in the subject line and indicate whether you want the PDF, newsletter, or both; the newsletter email list is opt-in only.

APPENDIX D

II.J. Fiduciary Income Taxation

Generally, a "trust" is:[1144]

> 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.[1145]

However, a mere agency agreement does not constitute a trust.[1146]

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.

[1144] 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). 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.

[1145] Taxpayers sought that conclusion in fn. 3360 (found in part III.A.3.e.i QSSTs) to confirm treatment as a QSST.

[1146] 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.

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.[1147]

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).[1148] It also deducts any other amounts of DNI that are "properly paid or credited or required to be distributed" for the taxable year.[1149] 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.[1150] The beneficiary includes in income the amount of the trust's deduction for DNI.[1151]

The above is a simplistic explanation. Among omissions are the treatment of tax-exempt income, the separate share rule,[1152] and charitable deductions.[1153]

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).[1154] 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.

This tactic can carry out capital gains, without regard to any prior year election regarding distributing capital gains.[1155]

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?[1156]

[1147] 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.

[1148] 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.

[1149] 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.

[1150] Part II.J.2 Tactical Planning Shortly After Yearend describes the 65-day rule.

[1151] Code §§ 651, 652.

[1152] See part II.J.9 Separate Share Rule.

[1153] 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..

[1154] See part II.J.3 Strategic Fiduciary Income Tax Planning for tax and nontax issues to consider in deciding whether to make distributions.

[1155] 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.

- Who benefits most from deductions?[1157]

- Consider not only the effect of federal tax but also state and local income tax.[1158]

- 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,[1159] 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:

- 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.[1160] 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.[1161] 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.[1162] If the trust is a grantor trust, the deemed owner's work is what

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[1156] See parts II.J.3.a Who Is Best Taxed on Gross Income and II.J.3.b Effect of Kiddie Tax on Rates.
[1157] See part II.J.3.d Who Benefits Most from Deductions.
[1158] See part II.J.3.e State and Local Income Tax.
[1159] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 1316.
[1160] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[1161] See part II.I.8 Application of 3.8% Tax to Business Income.
[1162] See part II.K.2.b Participation by an Estate or Nongrantor Trust.

counts while that person is the deemed owner,[1163] although the trustee's work might be important to set the stage for future nonpassive treatment.[1164] For a nongrantor trust, beneficiary's participation should count for depreciation but does not count for other items of business income.[1165]

- o If the beneficiary is charitably inclined, the trust and beneficiary can avoid NII tax by the trust instead of the beneficiary making charitable contributions.[1166]

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.[1167]

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[1168] the fiduciary income tax system allows nongrantor trusts[1169] 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.[1170]

Also, nongrantor trusts and estates may deduct charitable contributions made during the taxable year or in the next taxable year,[1171] 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[1172] and

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[1163] See part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, especially fn. 998.

[1164] 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.

[1165] See part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary; Interaction with Special Depreciation Rules.

[1166] 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. 1004.

[1167] For thresholds, see part II.I.3 Tax Based on NII in Excess of Thresholds.

[1168] Depreciation and similar deductions are an exception to this rule. See part II.J.11.a Depreciation Advantages and Disadvantages.

[1169] Reg. § 1.67-2T(g)(1) prevents grantor trusts from netting deductions.

[1170] Code § 67(e)(1), which regulations narrow the definition more than one might have otherwise thought.

[1171] Code § 642(c)(1); Reg. § 1.642(c)-1(b).

[1172] 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:

appear to be more liberal as to who the donee is.[1173] However, rules requiring nongrantor trusts and estates to use gross income to make contributions can be tricky,[1174] especially when a nongrantor trust has unrelated business income.[1175]

Certain losses from the sale of small business stock[1176] are not available to nongrantor trusts,[1177] so grantor trust planning might be considered for that asset. Similarly, 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.[1178]

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.[1179]

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.[1180] On the other hand, some states do not recognize grantor trust status of irrevocable trusts.[1181]

> 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.

[1173] 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))."

[1174] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 2546-2547.

[1175] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 2553-2559, which impose individual percentage limitations in lieu of Code § 642(c) and seem to undo the benefits described above in the text accompanying fns. 1172-1173. This rule does not apply to estates. See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 2564-2565.

[1176] See part II.Q.7.k Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244.

[1177] See part II.J.11.b Code § 1244 Treatment Not Available for Trusts.

[1178] 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.

[1179] "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.

[1180] 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.

[1181] 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

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

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.[1182]

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.[1183]

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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 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.

[1182] See part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

However, turning off the powers that make a trust deemed owned by one or more beneficiaries is more challenging.[1184] 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).[1185]

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

When drafting using an ascertainable standard for distributions ("support" in my documents),[1186] 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"[1187] to emphasize that distributions are more than just the minimum that is required to discharge a support obligation.[1188]

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))[1189] with respect to the beneficiary.[1190]

When drafting, consider including an annually lapsing withdrawal right to make the trust deemed owned in part by the beneficiary;[1191] 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.[1192] In either case, such treatment generally has a permanent effect.[1193]

[1183] See part III.B.2.g How to Make a Trust a Grantor Trust.

[1184] See generally part III.B.2.h Code § 678 (Beneficiary Grantor) Trusts.

[1185] 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.

[1186] 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. 1289).
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."

[1187] As defined in Reg. §§ 25.2511-1(g)(2) and 1.674(b)-1(b)(5)(i).

[1188] 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 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.

[1189] See Rev. Rul. 66-160 (director of a corporation is not an "employee" under Code § 672(c)); Letter Rulings 9842007 and 9841014.

[1190] For the latter, see fn. 3800.

[1191] See part III.B.2.h.vi.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.

[1192] See text accompanying fns. 1009-1011.

[1193] For flexibility regarding beneficiary grantor trust status, see fn. 1185.

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,[1194] 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.[1195] However, planning using S corporations involves additional long-term planning.[1196]

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.[1197]

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

Generally, an estate or nongrantor trust cannot pass losses (other than depreciation)[1198] to beneficiaries except in the year of termination. Also consider the points made in 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.[1199]

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).[1200]

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

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.[1201]

[1194] 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.

[1195] 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.

[1196] See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made).

[1197] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 1287.

[1198] See part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss.

[1199] Code § 642(h).

[1200] Reg. § 1.641(b)-3(b), incorporated by reference by Reg. § 1.642(h)-1(a).

[1201] See part II.J.3 Strategic Fiduciary Income Tax Planning.

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).

II.J.4.c. Charitable Distributions

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.[1202]

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.[1203] For example, a contribution made December 31, 2016 can count as a 2015 contribution for a calendar year fiduciary taxpayer. 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.[1204] But for these limitations, generally a nongrantor trust's charitable deduction is not subject to the limitations that would apply to a beneficiary.

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.[1205] Other trusts claiming Code § 642(c) deductions have certain filing requirements (Form 1041-A)[1206] 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,"[1207] or the trust is described in Code § 4947(a)(1).[1208]

Charitable contributions are merely deductions and do not trigger issuing a K-1 to the charity.[1209]

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[1210] applies to passive activities a trust holds.[1211] 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.

[1202] See fn. 1004.
[1203] 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. 1245.
[1204] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 3406.
[1205] 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 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 ….

[1206] Code § 6034(b)(1).
[1207] 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.
[1208] 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)….

[1209] See fn. 2568, found in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.
[1210] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[1211] 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.

Special rules apply to trusts when determining whether an activity is passive.[1212]

Consider how to document[1213] the trustee's participation as trustee in business activities,[1214] whether the trust should be converted to a beneficiary grantor trust to use the beneficiary's work rather than the trustee's work,[1215] and the effect of the beneficiary's participation on any depreciation deductions.[1216]

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,[1217] the trustee might try to convert a trust to a partial beneficiary grantor trust[1218] 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.[1219] 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).[1220]

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.[1221] Note that the trust can continue to be a discretionary trust as to income if all of the income is actually distributed.[1222] 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).

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.[1223]

Before engaging in this approach, be careful to plan an exit strategy upon termination.[1224]

[1212] See part II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business.
[1213] See part II.K.1.a.vi Proving Participation.
[1214] 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.
[1215] 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.
[1216] 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.
[1217] See part II.J.3 Strategic Fiduciary Income Tax Planning.
[1218] 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.
[1219] See text accompanying fns. 1009-1011.
[1220] See part III.A.3.e.i.(a) QSSTs Generally III.A.3.e.vi and QSST as a Grantor Trust; Sales to QSSTs.
[1221] 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.
[1222] See parts III.A.3.e.i.(a) QSSTs Generally (especially fn. 3362) and III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.
[1223] See part III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

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[1225] 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.[1226]

If circumstances change, the trust could toggle to being taxed to the beneficiaries.[1227]

Before engaging in this approach, be careful to plan an exit strategy upon termination.[1228]

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.[1229]

Also, depending on the distribution standard and state law, the trustee might be able to amend a trust using decanting.[1230]

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. [1231]

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. [1232]

[1224] 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.
[1225] See part III.A.3.e.ii ESBTs.
[1226] See part III.A.3.e.ii.(c) When ESBT Income Taxation Might Help.
[1227] See part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs.
[1228] 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.
[1229] 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.
[1230] Uniform Trust Decanting Act, found at http://www.uniformlaws.org/Act.aspx?title=Trust Decanting, with the drafting committee's work found at 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. 3357, found in part III.A.3.e.i.(a) QSSTs Generally.
[1231] 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.
[1232] 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

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.[1233] 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 constitute a gift,[1234] 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 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.

> 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.

[1233] 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.

[1234] 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. 3629, 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.

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]

<u>ACKNOWLEDGEMENT</u>

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.[1235] 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.[1236]

- 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.[1237]

- 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.[1238] 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[1239] and might be a recognition event for partnerships,[1240] so consider distributing high basis assets (which the entity might need to purchase).

Also consider whether the trustee needs to sell part of the unmarketable asset or planning to avoid this issue.[1241]

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.[1242] 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.[1243]

[1235] Section 501 of the Uniform Principal & Income Act.

[1236] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 1287.

[1237] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 1272.

[1238] Section 401(c)(1) of the Uniform Principal & Income Act.

[1239] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

[1240] See part II.Q.8.b.i Distribution of Property by a Partnership.

[1241] 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.

[1242] 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.

[1243] 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

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

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[1244] 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)[1245] and UBTI not reducing the charitable deduction,[1246] 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.[1247] 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;[1248] 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;[1249] otherwise, it is six months after the date of the final determination of estate tax liability.[1250] Final determination of estate tax liability is the earliest of the following:[1251]

(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;

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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.

[1244] "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).

[1245] 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."

[1246] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, especially fn. 2564.

[1247] See part II.K.1.e.iv Active Rental Subject to AGI Limits, especially fn. 1573.

[1248] 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.

[1249] Code § 645(b)(2)(A).

[1250] Code § 645(b)(2)(B).

[1251] Reg. § 1.645-1(f)(2)(ii).

(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.[1252]

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.[1253]

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.[1254]

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

Taxable income is DNI unless expressly excluded.[1255]

Code § 643(a)(3) provides:[1256]

> *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.

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.[1257]

[1252] See fn. 4129.

[1253] 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."

[1254] Reg. § 1.643(a)-3(e), Example (14).

[1255] 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….

[1256] 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.

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.[1258] Therefore, the sale of such property would constitute DNI, although it would not constitute trust accounting income.[1259]

However, "any recognized gain on the sale or exchange of property used in the trade or business" often receives capital gain treatment[1260] to the extent it does not constitute certain depreciation recapture.[1261] Goodwill that has not been amortized is a capital asset, but goodwill that is being amortized is not a capital asset.[1262] 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.

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.[1263] In fact, one of the prongs discusses the treatment when capital gains are allocated to income.[1264]
- 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.

[1257] Code § 643(a)(3); Reg. § 1.643(a)-3(a).
[1258] Code § 1221(2).
[1259] Section 401(c)(1) of the Uniform Principal & Income Act.
[1260] 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.
[1261] Depreciation recapture on the sale of tangible personal property is taxed as ordinary income; see fn. 596. Depreciation recapture on the sale of real property tends to be taxed as a capital gain but at a higher rate; see fn. 597. 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).
[1262] Letter Ruling 200243002. For more discussion of goodwill, see fns. 785, 2166, and 2188 (especially the latter).
[1263] See part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal, which quotes the regulation.
[1264] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law and the various subparts thereunder.

- 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).

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,[1265] are excluded from distributable net income (DNI).[1266]

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 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) -

[1265] 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.

[1266] 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)).

(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.[1267]

II.J.8.c.i. Capital Gain Allocated to Income Under State Law

Most states have adopted the Uniform Principal and Income Act.[1268]

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.[1269]

Generally, the Act allocates capital gains to principal.[1270] 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.[1271] 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:[1272]

- The trustee invests and manages trust assets as a prudent investor,

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[1267] 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).

[1268] 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.

[1269] See part II.J.8.e Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries.

[1270] Act § 401.

[1271] 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).

[1272] Act § 104(a).

- 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.[1273] 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[1274] and circumstances that limit or prevent the exercise of this power.[1275] Illinois has a more concise power to adjust that is in some ways more flexible and in some ways less flexible than the Act.[1276]

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.[1277] 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.[1278]

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.

[1273] 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.
[1274] Act § 104(b).
[1275] Act § 104(c).
[1276] 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.

[1277] See part III.A.4 Trust Accounting Income Regarding Business Interests.
[1278] See part II.J.8.c.i.(a) Power to Adjust.

- 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.

- 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[1279] to spread distributions over an appropriate period of time. Such a spread over time might be more palatable if, instead of labeling the adjustment to sale proceeds as a tax reimbursement, the trustee labeled 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.[1280] 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 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

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[1279] Part II.J.8.c.i.(a) Power to Adjust.

[1280] "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.

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.[1281]

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:[1282]

> 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];

[1281] 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.

[1282] Act § 103(a).

(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.

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.[1283] The Uniform Principal and Income Act authorizes the trust agreement to override the Act.[1284]

However, Reg. § 1.643(b)-1[1285] 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.

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

[1283] 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.

[1284] 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.

[1285] This version of the regulation applies to taxable years of trusts and estates ending after January 2, 2004.

> 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.[1286]

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 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.[1287] That language comes from the marital deduction regulations.[1288] Generally, the

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[1286] 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.

[1287] 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. 1403.

[1288] 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:

trustee's authority to allocate between income and principal does not constitute a power of appointment,[1289] nor does it have generation-skipping transfer tax implications.[1290] 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.[1291]

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 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.[1292]

> 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.

[1289] 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. 1186 for additional authority on ascertainable standards.

[1290] 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.

[1291] See part II.J.4.j Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure.

[1292] See fn. 1307.

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 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. The beneficiary needs regular annual distributions that cannot be made using a power to adjust. 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. The beneficiary's need for distributions in excess of income is sporadic. 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,[1293] 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.[1294] For example, any distribution made on or before March 5, 2016 can be treated as a 2015 or 2016 distribution.[1295] This election applies to the greater of accounting income under Reg. § 1.643(b)-1 or DNI under Reg. §§ 1.643(a)-1 through 1.643(a)-7.[1296] 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

[1293] 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.

[1294] Code § 663(b).
[1295] In a leap year, the deadline is March 5; in other years, the deadline in March 6.
[1296] Reg. § 1.663(b)-1(a)(2)(i).

decides how much of a current year distribution is allocated to the prior year; the balance would then be credited to the current year.[1297]

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.[1298] 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.[1299]

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.
- Electing <u>not</u> to establish a practice of carrying out capital gain to beneficiaries under Reg. § 1.643(a)-3(b)(2) <u>unless</u> 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

[1297] 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).

[1298] 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. 3800. 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.

[1299] Code § 643(e)(2).

> 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

When a trust distributes property to satisfy a pecuniary obligation, the trust recognizes gain on the deemed sale.[1300] Otherwise, the trust does not recognize any gain or loss unless the trust elects[1301] to treat the distribution as a sale.

The amount deemed distributed is the lesser of the property's basis or fair market value,[1302] unless gain was recognized, in which case it is the property's value. [1303]

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.[1304] (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.)[1305]

[1300] 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).

[1301] Code § 643(e)(3).

[1302] Code § 643(e)(2).

[1303] Code § 643(e)(3).

[1304] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.

[1305] Rev. Proc. 2015-3, Section 4.01(36) identifies as an area in which rulings or determination letters will not ordinarily be issued:

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,[1306] consider forming an entity taxed as a partnership. Capital gains earned through a partnership generally constitute trust accounting income.[1307]

The Uniform Principal and Income Act provides that, generally, all cash distributions from an entity (including a partnership) are considered trust accounting income.[1308] Only the following distributions from an entity are not considered trust accounting income:[1309]

- 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;
- 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

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> 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 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.

[1306] 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.

[1307] 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.

[1308] Act § 401(b).

[1309] Act § 401(c).

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. [1310] 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.[1311] Also consider whether a state with jurisdiction over the trust might subject the partnership itself to state income tax.[1312]

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.[1313] Furthermore, interrelated calculations might be required for a mandatory income trust.[1314] 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.

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.[1315] 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.[1316]

- 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.[1317] Such indirect expenses include trustee fees, the rental of safe deposit boxes, and state income

[1310] See part II.M.3.b Exception: Diversification of Investment Risk.
[1311] See part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.
[1312] Although Illinois subjects partnerships to an income tax called the "replacement tax," it does not tax investment partnerships. See fn. 2871.
[1313] 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.
[1314] 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.
[1315] Reg. § 1.652(b)-3(a).
[1316] Reg. § 1.652(b)-3(d).
[1317] 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

and personal property taxes.[1318] 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.[1319] 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. 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. 987-988).

- 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.[1320]

- Special rules apply to depreciation deductions.[1321]

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:[1322]

> 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.

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would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

[1318] Reg. § 1.652(b)-3(c).

[1319] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

[1320] 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.

[1321] See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

[1322] Code § 661(b).

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,[1323] subject to tax-exempt income being allocated in a manner that does not allow it to be deducted.[1324]

Thus, except for tax-exempt income and allocations between the charitable and noncharitable shares (and any special rules regarding depreciation deductions),[1325] 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.[1326]

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[1327] (which, among other things, is important for net investment income tax purposes).[1328]

[1323] Reg. § 1.661(b)-1.

[1324] 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.

[1325] See fn. 1320.

[1326] In adopting Reg. § 1.642(c)-3(b)(2), which is quoted in fn. 1320, 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.

[1327] 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.

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."[1329]

When allocating among beneficiaries:[1330]

> 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 to Other Income apply without being modified by any special

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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.

[1328] See fn. 1006, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles.

[1329] Reg. § 1.662(b)-1, which is quoted in fully in fn. 1327. 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.

[1330] 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.

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

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[1331] and for certain nonqualified deferred compensation plans.[1332]

"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,"[1333] which really means that "distributions of the trust are to be made in

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[1331] See part III.A.3.e.i.(a) QSSTs Generally, especially fns. 3368-3370.

[1332] Reg. § 1.404(a)-12(b)(3).

[1333] 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 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

substantially the same manner as if separate trusts had been created."[1334] 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 trust instrument and the requirements of proper administration require different treatment."[1335] 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."[1336] Special rules apply to specific bequests, trusts with Code § 645 elections, and elective shares;[1337] 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.[1338] Any separate share's DNI is computed as if each share constituted a separate trust or estate:[1339]

> 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. 3368.

[1334] 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.

[1335] Reg. § 1.663(c)-1(d).

[1336] Reg. § 1.663(c)-1(c).

[1337] 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.

[1338] 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).

[1339] 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.

- 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 share is entitled to under the terms of the governing instrument or applicable local law."[1340]

- 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."[1341]

- 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."[1342]

- "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."[1343] 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.[1344] I believe that the former is the better view,[1345] although when taking

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[1340] Reg. § 1.663(c)-2(b)(2).
[1341] Reg. § 1.663(c)-2(b)(3).
[1342] Reg. § 1.663(c)-2(b)(4).
[1343] Reg. § 1.663(c)-2(b)(5).
[1344] 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? 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.
[1345] 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. 1344 and the accompanying text and states that the view I adopted is the better approach. Footnote 93 in Yu's

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).[1346] 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…."[1347] For 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.[1348]

However, the amount the trust deducts[1349] and the amount each separate share includes in income[1350] is the lesser of the DNI allocated to[1351] or the amount actually distributed to that separate share.

If a beneficiary dies, to the extent that this part II.J.9 does not apply, see part II.J.6 Income Allocation on Death of a Beneficiary.

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.

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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).

[1346] Such an explanation is saved as my document no. 6149985.

[1347] Reg. § 1.663(c)-2(c).

[1348] 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.

[1349] Code § 661(a).

[1350] Code § 662(a).

[1351] 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.

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.[1352] However, a trust cannot deduct this special Code § 179 expense that flows through on its K-1 from a partnership or S corporation.[1353] The business entity does not reduce its basis in, and may depreciate, this depreciable property to the extent that this deduction is disallowed.[1354] Presumably, this complexity would be avoided by using a grantor trust.[1355]

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.[1356]

The allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each;[1357] 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,[1358] and the trust agreement may not override this rule.[1359] 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.[1360] I am unaware of any guidance how to allocate in a sprinkle

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[1352] See Stevens, "Section 179's Special Pass-Through Entity Rules," *Business Entities* (WG&L) (July/August 2010).

[1353] Code § 179(d)(4).

[1354] 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 to the trust or estate.

[1355] See fn 2277, 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.

[1356] 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.

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).

[1357] 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) .

[1358] 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.

[1359] *Dusek v. Commissioner*, 376 F.2d 410 (10th Cir. 1967).

[1360] Reg. § 1.167(h)-1(b).

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).[1361]

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.[1362]

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.[1363]

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.[1364] 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),[1365] because the rules for determining an individual's participation are more well-defined and easier to apply than determining a trust's participation.[1366]

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,[1367] 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.[1368] (This is a bad result if the trust is included in a person's estate.)[1369]

[1361] Rev. Rul. 90-82.
[1362] Rev. Rul. 74-530.
[1363] Rev. Rul. 74-530.
[1364] Query whether the aggregate theory of partnership taxation affects this analysis any.
[1365] See part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary.
[1366] See part II.K.2.b Participation by an Estate or Nongrantor Trust.
[1367] 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.
[1368] 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]

- 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)[1370] 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.[1371]

Trusts and estates are not entitled to this treatment.[1372]

Note that, for S corporations, trusts can deduct losses as the S corporation incurs them if they have sufficient basis,[1373] 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)[1374] and Blattmachr (1984)[1375] 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.[1376] The court viewed the tax

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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 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.

[1369] 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.

[1370] Reg. § 1.641(c)-1(c).

[1371] Part II.Q.7.k Special Provisions for Loss on the Sale of Stock in a Corporation.

[1372] Code § 1244(d)(4).

[1373] See part II.G.3.c.i Basis Limitations for S Corporation Owners.

[1374] "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.

[1375] "The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey," *18th University of Miami (Heckerling) Estate Planning Institute ¶ 1400* (1984).

[1376] The court reasoned and held:

> 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

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.[1377]

The Uniform Principal & Income Act, which has not been enacted in Illinois,[1378] takes the following approach:[1379]

> **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

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> 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.

[1377] See fn. 1375, ¶ 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.)

[1378] 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).

[1379] http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008).

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).[1380]

[1380] 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.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:[1388]

> H. Qualified subchapter S trusts (QSSTs)
>
> 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 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

[1388] REG-130843-13.

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[1389] and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

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).[1390] 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.[1391]

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:

[1389] Particularly the text accompanying fns. 3373-3375, 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). 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. 3445.

[1390] See part II.J.3.e.ii Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence.

[1391] 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.

- 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[1392] and any ordinary income[1393] is automatically included in DNI.[1394]

- 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.[1395] 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,[1396] 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.[1397] 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.[1398] However, if and to the extent that they are not paid or credited during the year or within 65 days thereafter[1399] and are not required to distributed, consider whether they can be allocated to income if the trust is a mandatory income trust.[1400]

- State and local income taxes are not deductible in determining alternative minimum tax (AMT).[1401] 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.[1402] 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 income trust.[1403] 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.

[1392] See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).
[1393] 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.
[1394] Code § 643(a).
[1395] 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.
[1396] See part II.J.8.a Capital Gain Constitutes DNI Unless Excluded.
[1397] See fns. 2184-2188.
[1398] Code § 661(a)(1), (c).
[1399] See part II.J.2 Tactical Planning Shortly After Yearend.
[1400] 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.
[1401] Code § 56(b)(1)(A)(ii).
[1402] 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. 3373-3375, 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.
[1403] 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. 3364-3367 in part III.A.3.e.i.(a) QSSTs Generally. For form language that might facilitate this allocation, see fn. 1287, found in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

For an ESBT, consider allocating administrative expenses and state income taxes to the S portion as much as is reasonable to do.[1404] Allocating administrative expenses to the non-S portion might create a loss that is not deductible unless the trust is terminating,[1405] 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,[1406] 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.

[1404] 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. 3404-3405.
[1405] Code § 642(h). See part II.J.3.i Planning for Excess Losses.
[1406] Code § 56(b)(1)(A)(ii).

II.J.18. Other Special Purpose Trusts

See part II.D Special Purpose Trusts.

II.K. Passive Loss Rules

II.K.1. Passive Loss Rules Generally

Although owners of partnerships and S corporations[1414] generally can deduct losses, subject to various basis and at-risk limitations, a passive loss from a trade or business[1415] is deductible only against other passive income[1416] or when the activity that generated the loss is sold;[1417] 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 the disposed of activity are treated as nonpassive under Code § 469(g)(1)(A).[1418] Losses disallowed by the passive loss rules are suspended and carried into future years.[1419] If the business interest is transferred by gift, any suspended passive losses are permanently lost but added to basis;[1420] 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.[1421]

[1414] *Williams v. Commissioner*, T.C. Memo. 2015-76, *aff'd* 117 A.F.T.R.2d 2016-600 (5th Cir. 2/2/2016), 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.

[1415] A mortgage or banking activity is a trade or business subject to the passive loss rules. INFO 2009-0229.

[1416] Code § 469(d)(1)(B).

[1417] Code § 469(g)(1), (3). Worthless stock is considered disposed of for purposes of this rule. See fn. 506. 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).

[1418] 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. 1124.

[1419] 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.

[1420] Code § 469(j)(6).

[1421] Code § 469(e)(1)(A)(i)(I).

The material participation rules are based on the number of hours the taxpayer participates in the activity[1422] 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).[1423] 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,[1424] 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.[1425] 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.[1426]

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.[1427]

[1422] See part II.K.1.a Counting Work as Participation.
[1423] See part II.K.1.b Grouping Activities.
[1424] See part II.I 3.8% Tax on Excess Net Investment Income.
[1425] See part II.L.1 Income Subject to Self-Employment Tax, including the exclusion of certain types of income from SE tax.
[1426] See part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.
[1427] See generally part II.I 3.8% Tax on Excess Net Investment Income (NII).

Appendix E:

Passive Loss Rules for Trusts

By Steven B. Gorin

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This Appendix is excerpted from Gorin, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," over 1,100 pages available as a PDF from the author.

The author sends a link to the most recent version to the PDF in his free electronic newsletter (roughly quarterly), called "Gorin's Business Succession Solutions." If you would like to receive the PDF or this newsletter, please email the author at sgorin@thompsoncoburn.com with "Gorin's Business Succession Solutions" in the subject line and indicate whether you want the PDF, newsletter, or both; the newsletter email list is opt-in only.

APPENDIX E

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.[1428] 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.[1429]

A taxpayer's activities include those conducted through C corporations that are subject to Code § 469, S corporations, and partnerships.[1430]

The owner in an interest in an organization may materially participate in the activities of a wholly owned subsidiary of the organization.[1431]

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:[1432]

[1428] 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.

[1429] *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).

[1430] 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 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.

[1431] Letter Ruling 201029014.

(1) The individual participates in the activity for more than 500 hours during such year;[1433]

(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, if the owner is not a limited partner;[1434]

(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,[1435] if the owner is not a limited partner;[1436]

(4) The activity is a significant participation activity[1437] for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours, if the owner is not a limited partner;[1438]

(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;[1439]

(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;[1440] or

(7) Based on all of the facts and circumstances,[1441] the individual participates in the activity on a regular, continuous, and substantial basis during such year, if the owner is not a limited partner.[1442]

[1432] 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.
[1433] Reg. § 1.469-5T(a)(1).
[1434] Reg. § 1.469-5T(a)(2).
[1435] 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).
[1436] Reg. § 1.469-5T(a)(3).
[1437] 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.
[1438] 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 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. 1588-1593) 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.
[1439] Reg. § 1.469-5T(a)(5).
[1440] 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.

[1441] 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

Note that some of the tests above apply only if the owner is not a limited partner.[1443] These differences arise from the statutory prohibition against limited partners being treated as materially participating except as provided in regulations.[1444] A member in an LLC is not inherently a limited partner.[1445] Proposed regulations would treat an interest in an entity as an interest in a limited partnership as a limited partner if:[1446]

- 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;[1447] thus, being a general partner and a limited partner causes the partner's entire partnership interest to be 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.[1448]

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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 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.

[1442] Reg. § 1.469-5T(a)(7).

[1443] 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).

[1444] Code § 469(h)(2).

[1445] 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.

[1446] Prop. Reg. § 1.469-5(e)(3)(i).

[1447] Prop. Reg. § 1.469-5(e)(3)(ii).

[1448] See part II.L.3 Self-Employment Tax: Limited Partner, especially fn. 1738.

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.[1449]

However, working to help a spouse's business does not establish the taxpayer as engaging in his own trade or business.[1450] 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,[1451] 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.[1452]

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).[1453]

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 such work is to avoid the disallowance, under Code § 469 and its regulations, of any loss or credit from such activity.[1454]

- 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.[1455] "Investor" work includes:[1456]

[1449] Reg. § 1.469-5T(f)(3), authorized under Code § 469(h)(5).

[1450] *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.

[1451] Reg. § 1.469-5T(f)(3), authorized under Code § 469(h)(5).

[1452] *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).

[1453] 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. 1447.

[1454] 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.

[1455] 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.

- 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.

- 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.[1457]

II.K.1.a.vi. Proving Participation

One needs to use reasonable means to establish participation:[1458]

- "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,[1459] they are not required if the extent of participation may be established by other reasonable means;[1460] however, failure to keep good records can lead

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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.

[1456] 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.

[1457] Committee Reports for Senate Bill 99-313, P.L. 99-514.

[1458] 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.

[1459] *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:

to penalties.[1461] Note, however, that reconstructing participation[1462] might lead one to make serious flaws in compiling the documentation.[1463] The court will not respect a "postevent 'ballpark guesstimate.'"[1464] However, reconstructing

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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.

[1460] *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 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).

[1461] *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.

[1462] 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.

[1463] 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:

> 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.]

[1464] *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).

> participation is acceptable when corroborated by phone records, third-party witness testimony, the parties' comprehensive stipulations of fact, and other contemporaneous materials.[1465]

Hiring a management company tends to undermine one's own participation.[1466]

[1465] *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 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.

[1466] *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. Grouping Activities

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.[1467]

To meet these participation rules, one or more trade or business activities[1468] or rental activities[1469] 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 rules.[1470] A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities.[1471] 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:[1472]

- Similarities and differences in types of trades or businesses;

[1467] Reg. § 1.469-4(a). *Schwalbach v. Commissioner*, 111 T.C. 215 (1998), held that this regulation is valid.

[1468] 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. 1083.

[1469] 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.

[1470] 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.

[1471] Reg. § 1.469-4(c)(2).

[1472] 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.

- 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.[1473]

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.[1474] 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 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.[1475]
- 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.[1476]
- 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).[1477]
- 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;[1478] 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.[1479]

[1473] *Williams v. Commissioner*, T.C. Memo. 2014-158.
[1474] Reg. § 1.469-4T(j)(1).
[1475] Reg. § 1.469-4T(j)(2)(ii).
[1476] Reg. § 1.469-4T(j)(2)(iii).
[1477] 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.

[1478] Reg. § 1.469-4T(j)(3)(iii)(A), (C).
[1479] Reg. § 1.469-4T(j)(3)(iii)(B).

Grouping is subject to the following limitations:[1480]

- 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:[1481]
  - 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;[1482] 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.[1483]
- 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.[1484]
- Generally, a taxpayer that owns an interest as a limited partner or a limited entrepreneur,[1485] in certain activities described in the at-risk rules,[1486] 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.[1487]
- The IRS may issue additional guidance prohibiting grouping.[1488]

[1480] Reg. § 1.469-4(d).
[1481] Reg. § 1.469-4(d)(1).
[1482] *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.
[1483] 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.
[1484] Reg. § 1.469-4(d)(2)
[1485] As used here, a limited entrepreneur is a person does not actively participate in the management of a farm. Code § 464(e)(2).
[1486] 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.
[1487] 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):

> 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**.

[1488] 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.

The undertaking is generally the smallest unit that can constitute an activity, and it may include diverse business and rental operations.[1489] 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.[1490]

- 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.[1491]

- 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.[1492]

- Also, oil and gas wells that are subject to a certain working-interest exception as separate undertakings.[1493]

- 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 that fact that one or more of the mortgages go into foreclosure likely will not allow the company to deduct its passive losses.[1494]

When separate entities are involved:[1495]

- 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.[1496]

- A shareholder or partner may not treat activities grouped together by a section 469 entity as separate activities.

[1489] 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.

[1490] Reg. § 1.469-4T(a)(3)(ii).
[1491] Reg. § 1.469-4T(a)(3)(iii).
[1492] Reg. § 1.469-4T(a)(3)(iv).
[1493] Reg. § 1.469-4T(a)(3)(v).
[1494] INFO 2009-0229.
[1495] Reg. § 1.469-4(d)(5)(i).
[1496] Reg. § 1.469-4(c)(3), Example (2).

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:[1497]

- Trade or business undertakings include all nonrental undertakings other than certain oil and gas undertakings and certain professional service.[1498]

- 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.[1499]

- 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.[1500]

- 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.[1501]

- 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.[1502]

- 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.[1503]

- 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.[1504]

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.[1505]

Subject to certain exceptions,[1506] 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.[1507] For this purpose, business and

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[1497] Reg. § 1.469-4T(a)(4)(i).
[1498] Reg. § 1.469-4T(a)(4)(ii)(A).
[1499] 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).
[1500] Reg. § 1.469-4T(a)(4)(ii)(B).
[1501] Reg. § 1.469-4T(a)(4)(ii)(B).
[1502] Reg. § 1.469-4T(a)(4)(iii).
[1503] Reg. § 1.469-4T(a)(4)(iv).
[1504] Reg. § 1.469-4T(a)(4)(v).
[1505] Reg. § 1.469-4T(a)(5).
[1506] 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).

rental operations shall be treated as a separate source of income production if and only if such operations are conducted at the same location[1508] and are owned by the same person[1509] and income-producing operations[1510] owned by such person are conducted at such location.[1511] If the rule described in this paragraph would require treatment as a single undertaking that is separate from other undertakings, generally its rental operations[1512] and its operations other than rental operations are treated as two separate undertakings,[1513] the income and expenses that are reasonably allocable to an undertaking is taken into

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[1507] Reg. § 1.469-4T(c)(1).

[1508] 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 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.

[1509] 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).

[1510] 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.

[1511] Reg. § 1.469-4T(c)(2)(i).

[1512] 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, 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).

[1513] 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

account in determining the income or loss from the activity or activities that include such undertaking,[1514] 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.[1515]

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.[1516]

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.[1517]

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.[1518] 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.[1519] Until the taxpayer makes a change to the 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.[1520]

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.[1521] 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.[1522]

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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).

[1514] Reg. § 1.469-4T(d)(1)(ii), which is applied after considering the text accompanying fn. 1513.

[1515] Reg. § 1.469-4T(d)(1)(iii), which is applied after considering the text accompanying fn. 1513.

[1516] See fns. 1561-1562.

[1517] 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.

[1518] Rev. Proc. 2010-13, Section 4.03, which provides reporting requirements similar to those of Section 4.02.

[1519] 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.

[1520] Rev. Proc. 2010-13, Sections 4.06 and 5.

[1521] Rev. Proc. 2010-13, Section 4.07.

[1522] 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).

Partnerships and S corporations are not subject to the above requirements:[1523]

> 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.

The instructions to Form 1120S seem to me to be quite vague.[1524] All I can discern is:[1525]

> 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.[1526] 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?[1527] 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.[1528]

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:[1529]

> 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 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

[1523] Rev. Proc. 2010-13, Section 4.05.

[1524] Page 10 of the 2014 instructions discusses grouping but don't say how to do it.

[1525] Page 11 of the 2014 instructions, heading, "Passive Activity Reporting Requirements."

[1526] 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.

[1527] 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?

[1528] See fn. 1522.

[1529] Part 6.B.1.(b)(4) of the preamble.

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[1530] 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[1531] and such taxpayer's income exceeds the applicable thresholds.[1532]

The preamble to the final regulations explains:[1533]

> 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 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

[1530] Reg. § 1.469-11(b)(3)(iv).
[1531] As defined in Reg. § 1.1411-4.
[1532] 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).
[1533] T.D. 9644. The first sentence quoted here appears to be erroneous, in that, as fn. 1530 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.

> 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,[1534] such as a Delaware statutory trust,[1535] so that each owner can separately engage in regrouping.

- 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.[1536] 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.[1537]

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.[1538]

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.[1539]

[1534] 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 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).

[1535] See fn. 379.

[1536] Reg. § 1.469-11(b)(3)(iv)(C)(2).

[1537] For more information on dispositions, see fn. 1417.

[1538] See text accompanying fn. 1440.

[1539] See fn. 1561. Real estate professionals have a separate aggregation election available.

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.[1617] 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.

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.[1618] 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.[1619]

[1617] Part II.K.2.b Participation by an Estate or Nongrantor Trust.

[1618] Thompson Coburn LLP document number 6252341 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicUrc/OGHGu+qSyFQIHlSrV/Yyi63VldeR&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

- 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.[1620]

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 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.[1621] The legislative history provides:[1622]

> 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."[1623] 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."[1624] 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.[1625]

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*,[1626] 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

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[1619] Thompson Coburn LLP document number 6252340 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicikIVHHCCawA0JoSeWnL+iQcx1y1EIbsot+x1JadeV10=&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.
[1620] Thompson Coburn LLP document number 6252339 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicxjC0od0egqdZH1P8mlbZQ43UvnjYGixP&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.
[1621] 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. 998.
[1622] 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.
[1623] Code § 7701(a)(6), which applies to Code § 469 where not otherwise distinctly expressed or manifestly incompatible with that section's intent.
[1624] Reg. § 301.7701-6(b)(1).
[1625] Reg. § 301.7701-6(b)(2).
[1626] 256 F.Supp.2d 536 (N.D. Tex. 2003).

actions were subject to the trustee's approval, and (2) a beneficiary who supervised the manager and general ranch operations.

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:[1627]

> **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.[1628]
>
> 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 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**[1629] **(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;[1630] and,

[1627] 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.

[1628] Note that Reg. § 1.469-5T(g) is "Reserved".

[1629] See IRC § 1361(d) where the beneficiary elects to be treated as the owner of the trust for purposes of IRC § 678.

2. Working interests in oil and gas activities.[1631] 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.
- 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**[1632] 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."

[1630] Reg. § 1.469-1T(e)(6).
[1631] IRC § 469(c)(3), Reg. § 1.469-1T(e)(4)(v).
[1632] S. Rep. No. 313, 99th Cong., 2d Sess., Reprinted in 1986-3 C.B. (Vol. 3) 1, at 735.

In its April 5, 2013 comments to the proposed regulations under Code § 1411, the American Bar Association's Section on Taxation said:[1633]

> 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:
>
> > (a) The fiduciary materially participates under the standards that apply to individuals under previously promulgated Regulations.[1634]
> >
> > (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.[1635]
> >
> > (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.[1636]

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*[1637] 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 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.[1638] The IRS Audit Technique Guide for Passive

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[1633] 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.

[1634] See Temp. Reg. § 1.469-5T(a)(1)-(5).

[1635] See Temp. Reg. § 1.469-5T(a)(7).

[1636] 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).

[1637] *Mattie K. Carter Trust v. U.S.*, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

[1638] 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,

> 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.[1639]
>
> 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 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,[1640] 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.[1641]

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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.

[1639] TAM 200733023 (Aug. 17, 2007).

[1640] 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.

[1641] 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.

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.[1642] 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.[1643] 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.

> 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 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.

[1642] *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.

[1643] 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.

Since then, the AICPA,[1644] ABA Section on Taxation,[1645] and ACTEC[1646] have made formal comments to the government.

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.[1647]

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.[1648] 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.[1649] 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?[1650]
- 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.

[1644] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicUrc/OGHGu+qSyFQIHlSrV/Yyi63VldeR&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[1645] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicikIVHHCCawA0JoSeWnL+iQcx1y1EIbsot+x1JadeV10=&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[1646] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicxjC0od0egqdZH1P8mlbZQ43UvnjYGixP&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[1647] Particularly fn. 1665.

[1648] 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.

[1649] See part II.K.1.a.v What Does Not Count as Participation.

[1650] 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.

- 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;[1651] 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.[1652]

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 members.[1653] 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,[1654] 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)[1655] 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.[1656]

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.[1657] The trust would report the management income and expense on Schedule C or C-EZ.[1658] 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-

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[1651] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014).
[1652] See part II.K.1.a.v What Does Not Count as Participation.
[1653] See fn 482 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.
[1654] 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.
[1655] See parts II.C.9 Limited Partnership and II.C.10 Limited Liability Partnership Registration.
[1656] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.
[1657] For Thompson Coburn LLP personnel – see document number 5879530.
[1658] 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).

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;[1659] however, the IRS did not object when a 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.[1660]

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.[1661] Consider, however, any impact on employee benefits.

Finally, to avoid the 3.8% tax on net investment income, consider converting an ESBT into one or more QSSTs[1662] if the beneficiary works for the business (or could do so in any capacity for more than 100 hours per year)[1663] and a QSST's mandatory income requirement does not do violence to the estate planning goals. However, the trustee's participation will

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[1659] Generally, nonprofessional trustees do not pay self-employment tax. Rev. Rul. 58-5, reproduced in large part in fn. 1014, 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:

> *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 marshaling 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.

[1660] *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.

[1661] See fn. 1428 in part II.K.1.a.ii Material Participation.

[1662] See part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSST.

[1663] 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. 998-999. 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.

become important again if the stock or business assets are sold.[1664] 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.[1665]

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.[1666] 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.[1667]

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.[1668]

[1664] 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).

[1665] 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.

[1666] See fn. 1006, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, and fns. 1327-1328, found in part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It.

[1667] 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.

[1668] See fn. 1477.

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:[1669]

> 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 at the trust level.[1670] 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:[1671]

> 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?[1672] 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.[1673]

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.[1674]

I am unaware of any guidance directly addressing how the passive loss rules interact with these separate portions.

[1669] 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).

[1670] 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).

[1671] 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).

[1672] Code § 469(g). For more about Code § 469(g), see fn. 1417.

[1673] 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.

[1674] See part III.A.3.e.ii.(b) ESBT Income Taxation.

I believe that all portions should be combined in determining whether income or loss is active or passive. The grouping rules[1675] allow an individual and a C corporation that the individual owns to combine their participation even though they are separate taxpayers.[1676]

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,[1677] 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),[1678] 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,[1679] the deemed owner's work is what counts. Complications arise with Qualified Subchapter S Trusts.[1680]

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.[1681] 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),[1682] 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 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.[1683] 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[1684] (including QSSTs),[1685] particularly attractive; in fact, substantial triggered losses can generate a net operating loss carryback, generating income tax refunds.[1686] That also might apply to irrevocable grantor trusts taxed to the settlor[1687] - "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).

[1675] See part II.K.1.b Grouping Activities.
[1676] Reg. § 1.469-4(a), (d)(5)(ii).
[1677] See part III.A.3.e.ii.(b) ESBT Income Taxation, especially fn. 3396.
[1678] See fn. 3402.
[1679] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[1680] See part II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items.
[1681] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.
[1682] 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.
[1683] Code § 469(g)(2).
[1684] See part III.B.2.h Code § 678 (Beneficiary Grantor) Trusts.
[1685] See part III.A.3.e QSSTs and ESBTs.
[1686] FSA 200106018.
[1687] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

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.[1688] 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).

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.[1689]

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.[1690] 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)[1691] subject to the 3.8% tax on net investment income.[1692] However, for taxpayers who have income below the NII thresholds,[1693] 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)[1694] rather than material participation (more than 500 hours).[1695] 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.

Material participation might be difficult to impossible to turn off:

[1688] See part II.Q.8.e.ii.(b) Distribution of Partnership Interests.
[1689] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 3402.
[1690] See the introduction to part II.K.1 Passive Loss Rules Generally.
[1691] See part II.I.8 Application of 3.8% Tax to Business Income.
[1692] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[1693] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[1694] See part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, especially fns. 1590-1593.
[1695] See part II.K.1.a.ii Material Participation. Although more than 500 hours (see fn. 1433) is usually what people consider, it is not the only way to materially participate.

- 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.[1696]

  - 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.[1697]

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,[1698] and the active income avoids the 3.8% NII tax.[1699]

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.

[1696] See part II.K.1.a.ii Material Participation, especially fn. 1439.
[1697] See part II.K.1.a.ii Material Participation, especially fn. 1440.
[1698] See part II.K.1.i Former Passive Activities.
[1699] See part II.I.8 Application of 3.8% Tax to Business Income.

Appendix F:

Drafting See-Through Trusts

By Steve Trytten

APPENDIX F

I. See-Through Trusts Under the MRD Rules.

The MRD Rules effectively impose two steps of analysis when a trust has been designated as death beneficiary of a retirement plan account:

Step One – Determine If Trust Qualifies as a See-Through Trust.

Step Two – Determine The See-Through Trust Beneficiary(ies).

A. Step One – Qualifying As a See-Through Trust.

The term "DB" refers to a "designated beneficiary" within the meaning of the MRD rules (*i.e.*, a beneficiary who is recognized as having a life expectancy greater than zero). Individuals who take by reason of a death beneficiary designation or under the terms of the governing plan document are recognized as DBs under the MRD Rules.[1] As a general rule, charities, business entities, estates and trusts are not recognized as DBs.

However, there is an important exception to this general rule. If a trust that has been designated as death beneficiary meets certain requirements the trust's beneficiaries will be viewed as if they had been designated outright.[2] Such a trust is sometimes referred to as a "See-Through Trust."

A trust's status as a See-Through Trust will come into play when determining the MRD requirements after the Participant's death. Another scenario when a trust's status as a See-Through Trust matters is when a living Participant wants to designate a trust for the benefit of Spouse who is more than ten years younger than Participant, and to calculate lifetime MRDs based on actual joint life expectancies.

A trust is a See-Through Trust if it meets the following threshold requirements:[3]

1. Valid Under State Law.

The trust is a valid trust under state law, or would be but for the fact that there is no corpus. The final Regulations specifically approve the use of testamentary trusts.[4]

2. Irrevocable.

The trust is irrevocable or will, by its terms, become irrevocable upon the death of the Participant.

3. Beneficiaries Are Identifiable.

The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the Participant's plan are "identifiable" from the trust instrument. "Identifiable" refers to general requirements that apply to any beneficiary designation.[5] Under these requirements, an individual does not necessarily have to be specified by name so long as he or she is identifiable as of the date the Designated Beneficiary is determined. In particular, members of a class that is capable of expansion or contraction will be treated as being identifiable if it is possible, as of the date the Designated Beneficiary is determined, to identify the class member with the shortest life expectancy.

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[1] Reg. § 1.401(a)(9)-4, A 3.
[2] Reg. § 1.401(a)(9)-4, A 5.
[3] Reg. § 1.401(a)(9)-4, A 5.
[4] Reg. § 1.401(a)(9)-5, A 7, Example 2.
[5] Reg. § 1.401(a)(9)-4, A 1.

4. Documentation Provided to Plan Administrator.

During Participant's Lifetime. It will not be necessary in most situations to determine whether a trust is a See-Through Trust during the Participant's lifetime (including the year of Participant's death). As a result, it will not be necessary in most situations for a trust to satisfy the threshold documentation requirement prior to the Participant's death.

However, there is one situation in which these issues arise and documentation is required. This situation arises when: (i) the Participant's Spouse is more than ten years younger than the Participant; (ii) the Participant has designated a See-Through Trust for Spouse rather than designating the Spouse individually; and (iii) the Participant seeks to calculate lifetime MRDs based on the actual joint life expectancy of the Participant and Spouse, rather than the Uniform Table. When this situation arises, a documentation requirement applies. To satisfy this requirement, the Participant must provide the plan administrator with either:[6]

A copy of the trust instrument, accompanied by the Participant's promise that whenever the trust is amended the Participant will provide the plan administrator with a copy of the amendment within a reasonable time; or

A list of all of the beneficiaries of the trust (including contingent and remainder beneficiaries with a description of the conditions on their entitlement *sufficient to establish that the spouse is the sole beneficiary*) for purposes of IRC Section 401(a)(9). The italicized language was added by the final Regulations. The list must be accompanied by the Participant's certification that, to the best of the Participant's knowledge, the list is correct and complete and that the other requirements above are satisfied, and further accompanied by the Participant's promise that, whenever the trust is amended the Participant will provide the plan administrator with an updated list and, if applicable, an updated certification. The Participant also must promise to provide a copy of the trust to the plan administrator upon demand.

The Regulations do not provide a time deadline for providing this documentation in the context of lifetime MRDs. Nonetheless, your author recommends that the documentation be submitted prior to the Participant's RBD, or as soon as possible thereafter. It is doubtful that the young Spouse's life expectancy in this situation may be considered in any MRD year if the documentation requirement has not been satisfied by the beginning of that year.

Death of Participant. To satisfy the documentation requirement in connection with MRDs for years following the year of Participant's death, the trustee must provide the plan administrator with either:[7]

A copy of the trust instrument as of the Participant's date of death; or

A final list of all of the beneficiaries of the trust (including contingent and remainder beneficiaries, with a description of the conditions on their entitlement) as of the Determination Date (September 30 of the calendar year following year of death), accompanied by the trustee's certification that, to the best of the trustee's knowledge, the list is correct and complete and that the other requirements above are satisfied. The trustee must also promise to provide a copy of the trust to the plan administrator upon demand.

In the context of post-death MRDs, the deadline for providing this documentation is October 31 of the calendar year following the year of death (one month after the

[6] Reg. § 1.401(a)(9)-4, A 6(a).
[7] Reg. § 1.401(a)(9)-4, A 6(b).

Determination Date of September 30).[8] ***The consequence of failing to meet this deadline is that the trust will not meet the threshold requirements to be a See-Through Trust in any year of post-death distributions.***

Relief for Missed Documentation Deadline. This threshold documentation requirement has been required under each version of the proposed and final Regulations. The final Regulations that were promulgated on April, 2002[9] provided a one-time grace period until October 31, 2003 for any trust that would have failed to qualify as a See-Through Trust solely because the trust failed to submit the required documentation for post-death MRDs on a timely basis.[10] This grace period was available regardless of how long ago the failure to submit documentation occurred. However, because the final Regulations are not generally considered to apply to years prior to 2002, it is unclear what benefit, if any, this grace period provided in determining MRDs for pre-2002 years.

Plan Will Not Be Disqualified Based On Inaccurate Documentation. In the context of maintaining a plan's qualified status, the Regulations provide that a plan has not failed to comply with IRC Section 401(a)(9) if MRDs were too small only because the plan administrator relied on trust documentation.[11] This leniency is limited, however, to preserving the plan's qualified status. Excise tax for failure to take MRDs is calculated based on the actual shortfall, regardless of what the trust documentation may have provided.[12]

Plan Administrator of IRA. The Regulations clarify that the "plan administrator" of an IRA is the IRA trustee, custodian, or issuer, and not the IRA owner.[13]

5. Drafting Suggestion - Documentation Requirement.

Because the consequence of failing to comply with the documentation requirement is that the trust is precluded from qualifying as a See-Through Trust, and because there is no known remedial procedure that can be followed if documentation is not submitted by the prescribed due date, your author suggests including language in each trust instrument that reminds the trustee of the documentation requirement. For a sample clause, see I.B.5.

B. Step Two – Identifying the See-Through Trust Beneficiaries.

If a trust meets the threshold requirements under Step One, it qualifies to have its MRDs calculated as if the "beneficiaries of the trust" (as this term is defined in the Regulations) had been designated outright.[14] These materials use the term "See-Through Trust Beneficiary(ies)" to refer to these beneficiaries and the term "See-Through Trust" to refer to the trust.

Step Two is the determination of the See-Through Trust Beneficiaries. Once the See-Through Trust Beneficiaries have been determined, the MRD Rules can be applied to determine MRDs as if the See-Through Trust Beneficiaries had been designated outright. The MRDs so determined will, of course, be distributed to the See-Through Trust to be administered pursuant to its terms.

A quick review of the MRD Rules is in order. When a Participant dies prior to the Participant's Required Beginning Date ("RBD"), and assuming no spousal rollover: (i) if the entire Plan is designated to a DB, the measuring life for post-death

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[8] Id.

[9] The final Regulations are published in the Fed. Reg. Vol. 67, No. 74, p. 18834 (4/17/2002); they were released for publication in T.D. 8987 (4/16/2002), which begins with a "Statement of Information" that provides background and explanation of provisions; the IRS also released Notice 2002-27 on the same day (4/16/2002) to finalize the rules for reporting of MRD amounts by IRA custodians.

[10] Reg. § 1.401(a)(9)-1, A 2(c).

[11] Reg. § 1.401(a)(9)-4, A 6(c)(1).

[12] Reg. § 1.401(a)(9)-4, A 6(c)(2).

[13] Reg. § 1.408-8, A 1(b).

[14] Reg. § 1.401(a)(9)-4, A 5(a).

MRDs is the DB's single life expectancy;[15] or (ii) if the Plan has no DB (e.g. the Plan was designated to an estate or a charity) no measuring life is allowed and the plan balance must be fully distributed by the end of the fifth calendar year following the year of death.

When a Participant dies on or after RBD, and assuming no spousal rollover, the measuring life for post-death MRDs will be: (i) if the entire Plan is designated to a DB, the greater of the DB's single life expectancy or the Participant's remaining life expectancy;[16] or (ii) if the Plan has no DB, the Participant's remaining life expectancy.

When multiple beneficiaries have been designated in such a way as to create separate accounts for each that are recognized under the Regulations[17], post-death MRDs may be determined on a share by share basis, with the likely result that some of the shares will benefit from longer life expectancies. If one beneficiary is not a DB, the other beneficiaries who are DBs will be entitled to take post-death MRDs from their respective shares based on their respective life expectancies.

If, however, the designation of multiple beneficiaries does not create separate accounts that are recognized under the Regulations, then: (i) if one or more of the beneficiaries is not a DB, the post-death MRDs for the entire plan must be determined as if the Plan has no DB; or (ii) if all of the beneficiaries are DBs, the post-death MRDs for the entire plan must be determined based on the life expectancy of the beneficiary with the shortest life expectancy.

In summary – under the MRD Rules, the best outcome is generally obtained by accomplishing separate account treatment for each DB. When separate account treatment is not possible, it is important to keep non-DBs out of the "pool" of beneficiaries, and to generally keep the "pool" as small as possible to minimize the risk of a DB who is much older than the others. These maxims are particularly important with See-Through Trusts, as the following discussion reveals.

1. Identifying See-Through Trust Beneficiaries - the Abridged Version.

The following is an excerpt from your author's article, "The Zen of Drafting See-Through Trusts."[18]

> Because the MRD rules can be metaphysical at times, I suggest the following exercise to attain enlightenment as to how these rules work. Sit cross-legged, and train your inner eye on an imaginary circle, which represents the see-through trust. Imagine that a dot appears inside the circle for each individual who could possibly receive an interest in the retirement plan assets now or in the future. This includes each current beneficiary, remainder beneficiary and contingent or alternate beneficiary. You're probably seeing lots and lots of dots, but you're not done. If the trust grants a power of appointment (POA) to anyone, you need to visualize additional dots for each permissible recipient who could possibly receive retirement plan assets under the POA.
>
> As you become one with all of the dots in the circle, you'll experience the bliss of understanding that MRDs for a see-through trust are determined as if all of the dots had been designated on the DBD, rather than the trust itself. This group of dots represents the pool of see-through trust beneficiaries.
>
> If all of the dots are individuals, the general rule is that the see-through trust's MRDs will be determined based on the individual beneficiary with the shortest life expectancy.[19] If even one dot is a charity or estate, no stretch-out will be allowed. If a dot is another trust, these rules are applied again to the dot trust to determine the beneficiaries of that trust who are counted as being in the circle corresponding to the original see-through trust.
>
> So what good is a see-through trust if it has to use the life expectancy of the oldest person in the world? Understanding can only come from mastering the exceptions to the general rule – the secrets to "managing the dots." I know of only three ways:

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[15] Except in the special case when Participant dies prior to RBD and designates Spouse, and Spouse does not elect a spousal rollover. See Reg. § 1.401(a)(9)-3, A 3(b).
[16] Reg. § 1.401(a)(9)-5, A 5(a)(1).
[17] Reg. § 1.401(a)(9)-8, A-2(a)(2).
[18] Trust and Estates Magazine, June, 2014.
[19] Treas. Regs. Section 1.401(a)(9)-4, A 5(c); Reg. § 1.401(a)(9)-5, A 7(a)(1).

Conduit trusts. The Regulations provide a specific exception to the general rule for conduit trusts. When a trust requires that all distributions passing from a retirement plan to the trust during the primary beneficiary's lifetime must be passed through to the primary beneficiary, rather than accumulated in the trust, the primary beneficiary of the trust is recognized as the sole see-through trust beneficiary with respect to that retirement plan.[20] In other words, the primary beneficiary is the only dot in the circle and all other dots are disregarded. Although the term "conduit trust" doesn't appear in the Regulations, it has been universally adopted as a name for this type of trust. The final Regulations reason that the alternate takers can be excluded from the pool of see-through trust beneficiaries because the primary beneficiary is entitled to all plan distributions while living.

Mere potential successor (MPS). Another exception under the Regulations provides that a successor beneficiary doesn't need to be counted "merely because the person could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death."[21] The Regulations offer the following example:

Thus, for example, if the first beneficiary has a right to all income with respect to an employee's individual account during that beneficiary's life and a second beneficiary has a right to the principal but only after the death of the first income beneficiary (any portion of the principal distributed during the life of the first income beneficiary to be held in trust until that first beneficiary's death), both beneficiaries must be taken into account in determining the beneficiary with the shortest life expectancy and whether only individuals are beneficiaries.[22]

In other words, a successor beneficiary is an MPS who can be disregarded only if the preceding beneficiary is entitled to all of the income and principal (essentially full distribution). If the preceding beneficiary's interest is any less than all of the income and principal, then the successor beneficiary's interest will be more, and the successor beneficiary won't qualify as an MPS and won't be disregarded. This is a very narrow rule. The successor beneficiaries under many common trust designs won't qualify as MPSs under this rule. In fact, the successor beneficiaries under a conduit trust probably wouldn't qualify either, but for the specific exception granted to conduit trusts.

Age restriction. In addition to the two exceptions allowed under the Regulations, there's one other way to manage the dots in the circle, which is to draft out everyone who's too old.

You have now attained enlightenment as to the three ways to manage the dots in the circle, and you're ready to enter the realm of drafting. As you will see, there are four ways to approach the drafting of a see-through trust. What if it is not clear at the time of drafting which type of see-through trust will be best? See "Establishing a Toggle Switch," p. x., which explains how to preserve flexibility to choose during the post-mortem period preceding the determination date.

The balance of this Section I and following Sections explain these concepts in much more detail.

2. "Separate Account" Treatment for See-Through Trusts.

The 2002 final Regulations provide that "separate account" treatment is not allowed with respect to multiple beneficiaries of a See-Through Trust.[23] When the final Regulations were issued, most commentators generally believed that a death beneficiary designation that directed division of the Plan into separate accounts, with each designated to a separate See-Through Trust, would still qualify for separate account treatment, even if the separate trusts were subtrusts arising under a common trust instrument.

[20] Treas. Regs. Section 1.401(a)(9)-5, A-7(c)(3), Example 2.
[21] Treas. Regs. Section 1.401(a)(9)-5, A-7(c)(1).
[22] *Ibid.*
[23] Reg. § 1.401(a)(9)-4, A 5(c).

In 2003, the IRS issued a group of private rulings that denied separate account treatment with respect to an IRA being distributed to three different subtrusts arising under a common trust instrument.[24] The rulings provide limited factual background, but it appears that the IRA was designated something like this:

> ***"The IRA shall pass to the T Family Trust established [date], to be divided into three equal shares and allocated to the A subtrust, B subtrust, and C subtrust arising at the IRA Owner's death thereunder."***

This language probably does not create separate accounts. A different outcome might have occurred had the IRA designation read as follows::

> ***"The IRA shall be divided into three equal separate accounts that are hereby designated respectively to the A subtrust, B subtrust, and C subtrust arising at the IRA Owner's death under the T Family Trust established [date]."***

The difference between these two examples is subtle, but critical. Under the first designation, the entire plan goes to Trust T, and the division occurs afterwards. Under the second designation, the division into separate accounts clearly occurs pursuant to the Plan's governing instrument (including the death beneficiary designation), and the plan interests pass directly to the respective subtrusts without passing through Trust T.

The validity of this analysis was reinforced by Priv. Ltr. Rul. 2005-37-044, which analyzed an IRA death beneficiary designation similar to the second example above, providing that the IRA was to be divided into nine shares for nine subtrusts arising under a common trust instrument. The IRS ruled that each subtrust was allowed to use the life expectancy of its respective primary beneficiary to calculate MRDs.

Other private letter rulings issued in recent years have denied separate account treatment when the death beneficiary language names the so-called "parent" trust without specifically calling for the plan interest to be divided into shares that are each designated to subtrusts.[25]

Of course, private letter rulings cannot be cited as authority by any taxpayer other than the taxpayer who obtained the ruling. What planning options are available for those clients who are determined to accomplish separate account treatment for multiple subtrusts and are not comfortable relying on Priv. Ltr. Rul. 2005-37-044?

- *Fund Early; Fund Often.* For additional safety, at least one commentator has suggested taking steps to ensure that the subtrusts to be designated are actually in existence at the plan owner's death, presumably by contributing a modest, initial funding to each subtrust. Perhaps this suggestion arises from language in the 2003 rulings discussing the requirement under Reg. Section 1.401(a)(9)-4, Q&A-4 that an individual beneficiary must be designated as of the date of the plan owner's death (the subtrusts in these rulings were created post-death by the Trustee pursuant to the trust instrument). Your author is not sure that this is what the IRS was getting at in these sections of the ruling, but setting up the subtrusts early certainly will not do any harm (other than the extra cost and effort to do so).

- *Create Multiple Trust Instruments Now.* Another possible interpretation of these rulings is that the IRS truly intends never to allow separate account treatment when an entire plan interest is passing to subtrusts arising under a common trust or Will. Under this interpretation, if the trusts arise under a common instrument the advance funding may not work, and there is nothing that can be written into the death beneficiary designation to salvage separate account treatment. To overcome this point of view, one might need to implement a more extreme approach of drafting multiple trust instruments, one for each of the respective beneficiaries. This approach raises the bar considerably in terms of cost and effort, but may appeal to clients with large plan balances or who are particularly risk averse. Given the effort involved, it makes sense to fund each trust or subtrust during the plan owner's lifetime as part of the effort.

- *Create Separate Accounts Now.* A Participant may be able to circumvent this whole problem by dividing the plan into separate accounts during life. This approach may ring strangely familiar, as this type of approach was necessary to obtain separate account treatment under the 1987 Proposed

[24] PLR 2003-17-041, 043, and 044.
[25] PLR 2004-32-027 through 029; PLR 2006-08-032.

Regulations, and was used commonly prior to the issuance of new Proposed Regulations in 2001. The disadvantages of this approach may include multiple annual fees, multiple statements, and logistical problems managing the investments of each account and the relative values of the accounts.

How much is at stake if "separate account" treatment is lost? If the difference in the ages of the various See-Through Trust Beneficiaries is only a few years (*e.g.* the traditional family with all of the children still living) the economic hit is not as much as one might think. If, however, there is a wide difference in age, the economic cost of losing "separate account" treatment is quite substantial.

3. Who Are The "See-Through Trust Beneficiaries?"

Up to this point, the MRD rules for trusts do not seem that difficult. Qualifying a trust as a See-Through Trust (Step One) is straightforward enough, and complying with the separate account rules is reasonably manageable. But the foregoing discussion has not addressed the question: "Who are the See-Through Trust Beneficiaries?" This short, simple question is the key to Pandora's box – it leads to a Deferral in Wonderland where nothing is as it seems.

The term "beneficiaries of the trust" is not defined in the Regulations, although the term is provided in response to a question that uses the phrase "beneficiaries of the trust with respect to the trust's interest in the employee's benefit." Thus, it is reasonable to conclude that a trust beneficiary whose interest is limited to non-plan assets is disregarded as a See-Through Trust Beneficiary.

Example 1*: Paul designates a See-Through Trust that provides a specific gift of a non-plan asset to George, and directs the balance of the trust to John. George may be disregarded - he is not a See-Through Trust Beneficiary.*

Any beneficiary entitled to current distribution of plan assets is a See-Through Trust Beneficiary (*i.e.*, the trustee "shall" or "must" distribute).

Example 2: *Paul designates a See-Through Trust directing that income shall be paid to George as long as he lives, and at George's death the balance shall pass to John. George is a See-Through Trust Beneficiary.*

Example 3: *Paul designates a See-Through Trust directing that trust distributions shall be paid to George if his other resources are not enough to satisfy a certain standard, such as health, education, or support, for as long as he lives. At George's death the balance shall pass to John. George is a See-Through Trust Beneficiary.*

Similarly, any beneficiary who is a permissible recipient of current distributions of plan assets is a See-Through Trust Beneficiary (*i.e.*, the trustee "may" distribute).

Example 4: *Paul designates a See-Through Trust that provides the trustee with broad discretion to make or not make distributions to George during George's lifetime, and at George's death the balance shall pass to John. George is a See-Through Trust Beneficiary.*

What about John in the above examples? As discussed below, John is a See-Through Trust Beneficiary, too. The Regulations provide a rule for determining when successor trust beneficiaries are counted in the pool of See-Through Trust Beneficiaries, and when they are not. This rule was changed with the release of final Regulations.

Rule Under Proposed Regulations. The rule under the 1987 and 2001 Proposed Regulations included all successor beneficiaries in the pool of See-Through Trust Beneficiaries subject to one exception: a successor beneficiary was excluded if his or her entitlement would only arise if another beneficiary dies before receiving the entire benefit to which that other beneficiary is entitled.[26]

Rule Under Final Regulations. The final Regulations narrow this exception by providing that a successor beneficiary may not be excluded if he or she has any right (including a contingent right) to a plan interest "beyond being a mere potential successor" to the interest of another beneficiary upon that other beneficiary's death.[27] The examples in the

[26] 2001 Prop. Reg. § 1.405(a)(9)-5, A-7(c).
[27] Reg. § 1.401(a)(9)-5, A-7(c).

Regulations are not very helpful in explaining this provision. Subsequent private letter rulings have shed a little light on the Service's thinking,[28] but the meaning of the "mere potential successor" concept remains far from clear.

The following example illustrates your author's interpretation of how the "mere potential successor" rule would work in connection with a type of trust commonly requested by clients:

> ***Example 5:*** *Paul designates his IRA in two equal shares to two See-Through Trusts for his two children, Len and Linda. Each trust provides for distributions to the child of income and principal as needed for health, education, or support until the child attains thirty-five years of age, at which time the child's trust terminates. (Upon termination, any remaining IRA interest would be "assigned" to the child without accelerating recognition of income.29) If a child dies prior to reaching age thirty-five, his or her trust passes to similar trusts for the child's living descendants or, if none, to a similar trust for the other child (or his or her descendants) or, if none, free of trust to Paul's heirs at law.*

The "pool" of See-Through Trust Beneficiaries is determined on the date of Paul's death, subject to certain post-mortem planning completed prior to the September 30 Determination Date following Paul's death.

Each child who is living and has attained age thirty-five as of Paul's death, and who has not accomplished a qualified disclaimer of his or her share prior to the Determination Date, will be the only See-Through Trust Beneficiary of his or her trust. Any contingent beneficiaries are excluded as "mere potential successors," because the child is entitled to full distribution of his or her share of the IRA from the trust with no contingencies.

Who would be a See-Through Trust Beneficiary of Len's See-Through Trust if Len has not attained thirty-five years of age at Paul's death? Your author analyzes this question as follows:

Is Len a See-Through Trust Beneficiary of Len's See-Through Trust? Yes.

If Len has living descendants as of the Determination Date, are they counted as See-Through Trust Beneficiaries of Len's See-Through Trust? Yes, although it is not likely to shorten the "stretch-out," because the descendants are likely to be younger than Len (the only way this would not be true would be if Len legally adopted an older person). This discussion assumes that all of Len's descendants are younger than Len. We already know that Len is not yet thirty-five, so we also know that none of his descendants have attained age thirty-five.

Under the Proposed Regulations, it appeared that Len's descendants were not See-Through Trust Beneficiaries, because they were entitled to a portion of the plan only if Len died before the entire benefit was distributed to Len. The Proposed Regulations were interpreted by many as allowing an implicit assumption that Len would live to a normal life expectancy and therefore would receive the entire benefit.

Under the final Regulations, Len's descendants *are* See-Through Trust Beneficiaries, because the interest each might receive if Len died would continue in trust until the descendant attains thirty-five years of age. In other words, there are two contingencies – a survivorship requirement and an age restriction.

Any basis for making the implicit assumption that Len will live to life expectancy and receive the entire benefit is clearly absent in the final Regulations. Perhaps this type of assumption was not a correct interpretation of the Proposed Regulations, either, as suggested by a 2002 private letter ruling that includes contingent beneficiaries in the pool of See-Through Trust Beneficiaries even though the primary beneficiaries were to receive full distribution upon reaching age thirty.[30]

Is Linda a See-Through Trust Beneficiary of Len's See-Through Trust? Yes. The analysis under the final Regulations is complicated, as follows:

> (i) If Len and Linda are both under age thirty-five at Paul's death, and if Len does not have any living descendants as of the Determination Date, Linda is counted as a See-Through Trust Beneficiary under the final Regulations for the same reasons that Len's

[28] PLRs 2004-38-044, 2005-22-012, and 2006-10-026.
[29] IRC § 691(a)(2).
[30] PLR 2002-28-025.

descendants, above, would have been counted (*i.e.* Len has to die *and* Linda has to live to age thirty-five). As a result, Linda's older life will govern MRDs on her younger brother's See-Through Trust even though the designation creates separate accounts.

(ii) If Len is under age thirty-five, Linda has attained age thirty-five as of Paul's death, and Len has no descendants, now can Linda can be excluded as a mere potential successor? No, she must be counted as a See-Through Trust Beneficiary, but any contingent beneficiaries who would follow Linda can be excluded, as Linda would receive her interest outright with no other contingencies.

(iii) If Len is under age thirty-five, Linda has attained age thirty-five, and Len has living descendants, is Linda a See-Through Trust Beneficiary of Len's See-Through Trust? Yes, she must be counted, but any contingent beneficiaries who would follow Linda can be excluded.

Are the descendants of the other child See-Through Trust Beneficiaries? It depends. Under the Proposed Regulations, some thought that the "other child's" descendants would not be See-Through Trust Beneficiaries for the reasons described above. Under the final Regulations, it depends on the "other child's" age at the Determination Date. If he or she has attained thirty-five years of age, his or her descendants can be disregarded under the final Regulations, for they truly have a "mere survivorship interest." But if the "other child" has not attained thirty-five years of age as of the Determination Date, then his or her descendants are See-Through Trust Beneficiaries under the final Regulations. Fortunately, they are likely to be younger than either of the children in most cases.

Must Paul's heirs at law be counted as See-Through Trust Beneficiaries? It depends. Under the Proposed Regulations, some thought that Paul's heirs at law would not have been counted for the reasons described above. Under the final Regulations, it depends on whether Linda has attained thirty-five years of age. If so, the fact that she would receive her interest outright with no other contingencies allows any contingent beneficiaries after her to be excluded as See-Through Trust Beneficiaries. If Linda has not attained thirty-five years of age, all of the contingents after her, including Paul's heirs at law, must be included in the pool of See-Through Trust Beneficiaries, and there is a significant chance that the oldest member of the pool will be quite a bit older than the children, resulting in a shorter deferral period.

4. Treasury's Rationale On Trust Requirements.

Why are the rules for trusts so difficult? Based on several informal conversations with Marjorie Hoffman, principal draftsperson of the proposed and final Regulations Treasury seemed very concerned that plan participants would use trusts as vehicles to take undue advantage under the MRD Rules. Specifically, Treasury worried that a younger person's life expectancy would be used to accomplish stretched-out deferral of plan assets that would eventually benefit an older beneficiary. Although your author does not share this view, it at least explains why the Regulations focus on whether a contingent beneficiary has any interest beyond that of a "mere potential successor."

It is interesting, however, that by extending special treatment to "conduit trusts" (discussed in detail in Section II.) the Treasury is willing to ignore accumulation for the possible benefit of older successor beneficiaries if the accumulation is occurring *inside* a plan. If the same accumulation occurs outside the plan and in the trust, the older successor beneficiaries will probably be included in the pool of See-Through Trust Beneficiaries.

5. General Drafting Suggestions for Trusts.

The IRS has hinted that the Participant's estate might be viewed as a See-Through Trust Beneficiary if the See-Through Trust requires or allows plan assets to be applied to satisfy general debts, expenses, and tax obligations arising at the

Participant's death.[31] Your author is not aware of any case in which the IRS has actually asserted this position, and there may be good arguments to refute this position, if raised.

Additional language could be included in a trust to minimize risk of this position being raised, but your author is not suggesting that this should be done in all cases.

The simplest drafting approach would be to simply forbid the trustee from applying plan assets to pay general debts, expenses, and tax obligations. This approach, however, seems too broad and could lead to administrative difficulties and economic distortions among beneficiaries.

Another simple drafting approach that is less likely to result in administrative difficulties or economic distortions is to limit the trustee's power to apply plan assets to pay general debts, expenses, and tax obligations to those that are properly chargeable to the plan assets. It seems reasonable that this is not the same as including the estate as a See-Through Trust Beneficiary, but there is no assurance the IRS would agree.

There is an alternative drafting approach to be considered. The post-mortem rules allow certain post-mortem planning to eliminate certain beneficiaries by a Determination Date of September 30 of the calendar year following the year of death[32]. Perhaps the IRS will be more comfortable with trust provisions that follow this model by requiring amounts that are properly chargeable to plan assets to be paid prior to the September 30 "Determination Date" provided in the Regulations. Of course, it may not be possible to determine all such amounts with certainty by the Determination Date, and the clause will need to provide guidance on how these amounts are to be handled. The following clause illustrates this type of approach. The sample form uses a defined term, "Stretch-Out Retirement Account," to narrow its application to those retirement plan interests that have the potential to provide stretched out distributions – a benefit that might be lost if the estate were included as a See-Through Trust Beneficiary. The sample form also addresses how "outside" assets are to be addressed (*e.g.*, annuity arrangements, which can present difficult tax apportionment issues when not properly addressed in the governing documents). The bold headings referring to "September 30" may be helpful in alerting the casual reader of the instrument of an unexpected deadline for determining and paying debts, expenses, and taxes.

> **9.3 "Stretch-Out Retirement Accounts" Passing Under Trust Instrument.** The Trustee shall not apply Stretch-Out Retirement Account assets passing under any trust hereunder to pay any portion of a debt of the Settlor, expense of administration, or Death Tax arising by reason of the Settlor's death, except as follows:
>
> **(a) Payment Prior to September 30 Determination Date.** If the Trustee determines, prior to the Determination Date, that all or any portion of a debt of the Settlor, expense of administration, or Death Tax is properly chargeable by reason of the Settlor's death to a beneficiary's interest in a Stretch-Out Retirement Account passing under any trust hereunder, the Trustee shall pay said amount prior to the Determination Date by applying the following assets in any combination the Trustee determines in its sole discretion (and such payment shall be credited against the amount chargeable to said Stretch-Out Retirement Account interest): (i) assets from said Stretch-Out Retirement Account interest; (ii) assets the beneficiary offers to provide for this purpose; or (iii) assets the Trustee selects for this purpose (other than assets qualifying for the charitable or marital deductions from federal estate tax in the Settlor's estate) from assets passing under any one or more trusts hereunder to or for the benefit of the beneficiary as determined by the Trustee in its sole discretion. The Settlor requests, but does not require, that the Trustee apply assets other than Stretch-Out Retirement Account assets to pay said amount when doing so reduces the need to take a distribution from the Stretch-Out Retirement Account earlier than would otherwise be necessary, thus enhancing the beneficiary's ability to benefit from income tax deferred compounding.
>
> **(b) Amounts Determined On or After September 30 Determination Date.** If the Trustee determines, on or after the Determination Date, that all or any portion of a debt of the Settlor, expense of administration, or any Death Tax would be properly chargeable by reason of the Settlor's death, but for the operation of this Section 9.3(b), to a beneficiary's interest in one or more Stretch-Out Retirement Account interests passing under any trust hereunder, the Trustee shall pay said amount by first applying the following assets in any combination the Trustee determines in its sole discretion: (i) assets the beneficiary offers to provide for this purpose; or (ii) assets the Trustee selects for this purpose (other than Stretch-Out

[31] PLR 98-20-021.
[32] Reg. § 1.401(a)(9)-4, A-4(a).

Retirement Account assets or assets qualifying for the charitable or marital deductions from federal estate tax in the Settlor's estate) from assets passing under any one or more trusts hereunder to or for the benefit of the beneficiary as determined by the Trustee in its sole discretion; and the Trustee shall apply assets from said Stretch-Out Retirement Account interests to pay said amount only to the extent that said other assets are insufficient to do so.

9.4 Tax-Advantaged Accounts or Other Assets Passing Outside Trust. If the Trustee determines that all or any portion of a debt of the Settlor, expense of administration, or Death Tax is properly chargeable, by reason of the Settlor's death, to a beneficiary's interest in property passing under a non-probate transfer arrangement other than this instrument, including by way of example and not limitation a Tax-Advantaged Account, the Trustee may in its sole discretion pay (or not pay) all or part of said amount by applying any combination the Trustee determines in its sole discretion of the following assets (and any such payment shall be credited against the amount chargeable to said interest in property not passing under any trust hereunder): (i) assets the beneficiary offers to provide for this purpose; or (ii) assets the Trustee selects for this purpose (other than assets qualifying for the charitable or marital deductions from federal estate tax in the Settlor's estate) from assets passing under any one or more trusts hereunder to or for the benefit of the beneficiary as determined by the Trustee in its sole discretion. The Settlor requests, but does not require, that the Trustee apply assets other than Tax-Advantaged Account assets to pay said amount when doing so reduces the need to take a distribution from a Tax-Advantaged Account earlier than would otherwise be necessary, thus enhancing the beneficiary's ability to benefit from income tax deferred compounding. The Trustee's powers provided under this Section 9.4 are in addition to, and not in place of, other powers provided the Trustee under this or other instruments, or under applicable law.

The following clause can be used as part of the administrative provisions in a trust document, or could be adapted to be included in a specific subtrust arising under the document. The clause recites the Settlor's intent that trusts receiving retirement plan assets are to be recognized as "see through trusts."

In particular, subsection (a) reminds the Trustee to deliver the documentation that is required under the Regulations in order for a trust to qualify as "see through."

Subsections (b) and (c) are intended to help with an issue that comes up from time to time with financial institutions when a trustee wants to make a distribution to a beneficiary consisting of an interest in a retirement plan that is part of the trust (e.g. upon division or termination of a trust). The trustee often wants to accomplish an assignment that results in the beneficiary taking over ownership of the retirement plan interest without causing a taxable distribution. The financial institution may be unsure whether it can comply with the trustee's instruction. Subsection (b) specifically authorizes and directs the Trustee to make distribution in a manner that minimizes income tax, and subsection (c) protects the financial institution that relies on the Trustee's instructions.

11. Powers and Administrative Provisions. (The following clause is suggested for inclusion in the "boilerplate" of most trusts. However, some of the sample trusts illustrated in these materials address specific retirement plan related issues in the body of the dispositive language, which may require some adjustment to provisions that would otherwise appear in the "boilerplate" section.)

11.15 Trust as Beneficiary of Retirement Account. The Settlor intends that each trust hereunder that owns an interest in a Retirement Account enjoy the longest possible deferral period under the Minimum Distribution Rules. Accordingly, the following shall apply:

(a) The Trustee of a trust so designated shall, within the time limit prescribed under the Minimum Distribution Rules, deliver documentation required under said rules to the respective administrators and custodians of each Retirement Account.

(b) For purposes of this instrument, when the Trustee is directed to "distribute" an interest in a Retirement Account to an individual or another trust, the Trustee is to assign all of the Trustee's interests in and powers over said Retirement Account interest (*e.g.*, to direct investments and withdrawals) to said individual or to the trustee of said other trust, and such direction shall not be interpreted as requiring the Trustee to arrange for the assets held in the Retirement Account to be withdrawn from said Retirement Account. The Settlor specifically intends that any such "distribution" of a Retirement Account shall be

handled in a manner that results in zero, or the minimum possible amount of income tax payable by either the trust, said individual, or said other trust.

(c) The administrators, custodians, or other fiduciaries of the respective Retirement Accounts shall incur no liability to the trust or to any of its beneficiaries for acting upon the written instruction of the Trustee pursuant to this Section 11.15.

12. Definitions. (The following are selected definitions relating to retirement plan issues. The term "Stretch-Out Retirement Beneficiary" will be important in drafting the conduit trust provisions discussed further below.)

12.5 Determination Date. The term "Determination Date" refers, with respect to the death of the Settlor (or the death of another, if the context specifically indicates) the thirtieth day of September of the calendar year following the calendar year of the death of said Settlor or other individual, or such other date as may be provided under Treasury Regulation Section 1.401(a)(9)-4 for determining post-death designated beneficiaries under the Minimum Distribution Rules.

12.8 Minimum Distribution Rules. The term "Minimum Distribution Rules" refers to the rules of IRC Section 401(a)(9).

12.10 Retirement Account. The term "Retirement Account" refers to a Tax-Advantaged Account that is subject to the Minimum Distribution Rules.

12.16 Stretch-Out Retirement Account. The term "Stretch-Out Retirement Account" refers, with respect to a trust hereunder, to an interest in a Retirement Account that satisfies the following conditions: (i) the interest in the Retirement Account (or a successor Retirement Account, *e.g.* an inherited IRA that receives a rollover from a qualified retirement plan) became part of the trust by reason of the Settlor's death (or the death of another, depending on the context); and (ii) the provisions governing the Retirement Account permit the Trustee of the trust to take distributions following the year of death of the balance of the interest over the life expectancy of a trust beneficiary (or the oldest member of a group of individuals determined under the Minimum Distribution Rules to which a trust beneficiary belongs), assuming said trust otherwise qualifies to do so under the Minimum Distribution Rules.

12.17 Stretch-Out Retirement Beneficiary. The term "Stretch-Out Retirement Beneficiary" refers, with respect to a trust hereunder that owns an interest in a "Stretch-Out Retirement Account," to the trust beneficiary whose life expectancy is or will be used in determining the timing and amount of post-death distributions (or whose life expectancy would have been so used if he or she was the oldest member of the group of individuals determined under the Minimum Distribution Rules to which he or she belongs).

12.19 Tax-Advantaged Account. The term "Tax-Advantaged Account" refers to any plan, contract, or other arrangement (other than a life insurance contract) that is allowed under the Internal Revenue Code to accumulate any part of its income in a tax-advantaged manner (e.g., income tax-deferred or income tax free) for the benefit of an owner, beneficiary, or successor, and includes, by way of example and not limitation, a qualified or non-qualified annuity, a deferred compensation plan, or a retirement or individual retirement account arrangement established under IRC Sections 401, 403, 408, 408A, or 457. A plan account or arrangement that is otherwise a "Tax-Advantaged Account" and that owns one or more life insurance contracts among its assets is a "Tax-Advantaged Account." A plan, contract, or other arrangement that is reasonably believed to qualify for tax-advantaged treatment under the Internal Revenue Code is a "Tax-Advantaged Account" even if it is subsequently determined it did not so qualify.

6. Terminology – "Spouse" or "Issue."

Special issues may arise if recipients are described using terms such as "spouse" or "issue," as follows:

a. If an interest is provided for a person's "spouse" with no name or further qualification, there is no way of knowing with certainty who that spouse will be and what his or her age will be. Thus, if the "spouse" will be included among the See-Through Trust Beneficiaries of a trust (other than a conduit trust, as discussed below), the trust is likely to be treated as not having an identifiable life expectancy.

b. If interests are provided for a person's issue or descendants with no further qualification, a similar question arises. Because it may be possible in many jurisdictions to adopt a person of any age, will this cause the trust to be treated as not having an identifiable life expectancy? Two private letter rulings that addressed trusts providing for a person and then the person's descendants ruled that the trusts qualified to use the person's life expectancy, without raising this question about adoption.[33] Nevertheless, the safest approach may be to draft the trust instrument in a way that limits the scope of adoptees who are considered to be descendants when doing so reflects limitations the client would have desired regardless of the MRD Rule implications.

7. Permissible Appointees Under A Power of Appointment.

If a trust provides a beneficiary with a testamentary power of appointment that could be used to appoint plan assets, are the permissible appointees also See-Through Trust Beneficiaries? The MRD Rules are silent, and a number of private letter rulings have been promulgated with respect to trusts that included powers of appointment without analyzing this issue.

A group of private letter rulings were issued in August, 2002 analyzing trusts as IRA beneficiaries under the final Regulations.[34] These rulings appear favorable, but leave too many questions unanswered to be of much use. The rulings pertain to the same fact pattern, in which subtrusts were established for a decedent's three children. Each child's subtrust was recognized as having the oldest child's life expectancy under the final Regulations, even though it was not a conduit trust. Each child's subtrust provided distributions to the child of income, and of principal subject to an ascertainable standard. Each child's subtrust also provided the child with a testamentary power of appointment that limited the class of permissible appointees to those who are not older than the oldest child. Based on these facts, the IRS ruled that the oldest See-Through Trust beneficiary of each subtrust was decedent's oldest child. The rulings do not identify the takers in default if the power of appointment is not exercised with respect to any of the subtrusts, and does not analyze whether those takers in default should be included in the pool of See-Through Trust Beneficiaries for each subtrust. Further, although the rulings mention the limited class of permissible appointees under the power of appointment in each subtrust, the rulings *do not* analyze whether the permissible appointees are treated as See-Through Trust Beneficiaries of any of the subtrusts. The reasoning in these rulings is incomplete, however, so it is unwise to rely on them.

Majority View – Permissible Appointees Are Included in Pool of DB Beneficiaries. Most commentators who have addressed this issue conclude that the permissible appointees under a power of appointment (testamentary or otherwise) are included among the pool of See-Through Trust Beneficiaries.[35] This view is consistent with the Treasury's concern that a trust should not be allowed to take MRDs based on one trust beneficiary's life expectancy if it is possible to accumulate them and ultimately distribute them to another, older trust beneficiary.

Conduit Trusts. As discussed in Section II., a "conduit trust" is allowed to disregard any See-Through Trust Beneficiaries other than the primary beneficiary who will be receiving conduit distributions. Thus, a testamentary power of appointment may be included in the conduit trust without risk of jeopardizing the conduit trust's ability to use the primary beneficiary's life expectancy for MRD purposes.

Non-Conduit Trusts. If a power of appointment (testamentary or otherwise) is included in a non-conduit trust, the safest course is to assume that all of the permissible appointees under the power of appointment will be included among the pool of See-Through Trust Beneficiaries. The inclusion of permissible appointees among the pool of See-Through Trust Beneficiaries can cause problems, however.

If the scope of permissible appointees is not limited in some way, the class of permissible appointees may either include a specific recipient with little or no life expectancy, or may be so broad that it is difficult or impossible to determine which recipient has the shortest life expectancy.

Limiting the permissible appointees to those who are not older than the "target" See-Through Trust Beneficiary is one possible solution, but could open up other problems in interpreting and administering the trust, and could

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[33] PLR 1999-03-050; PLR 1999-18-065.

[34] PLRs 2002-35-038 through 041.

[35] See, for example, Natalie Choate, *Life and Death Planning for Retirement Benefits*, 6th ed. (2006), Ataxplan Publications, Section 6.3.09; or Marcia Chadwick Holt, *Estate Planning for Retirement*, 1st ed. (2007), Bradford Publishing Company, Section 9.8.

potentially distort the economic outcome among the various beneficiaries and recipients. These problems may be partially mitigated if the age limitation is imposed only with respect to "stretch-out retirement assets."

If an age limitation is to be applied to only "stretch-out retirement assets," the age limitation must be drafted to apply to both the assets in the stretch-out retirement plan, and any assets that have been distributed from the stretch-out retirement plan and accumulated in the trust. It may be helpful to direct the trustee to account separately for accumulations of stretch-out retirement plan assets.

Some standard clauses granting powers of appointment include charities as permissible appointees. Charities are not recognized under the MRD Rules as having a life expectancy, and the trust will be treated as having no life expectancy if a charity is included among the See-Through Trust Beneficiaries.

Similarly, if the power of appointment is intended to function as a "general" power of appointment within the meaning of IRC Section 2041 (a common drafting technique with respect to certain marital trusts and trusts that are not anticipated to receive an allocation of generation-skipping transfer tax exemption), a standard clause normally will include one or more of the power holder's creditors, estate, or creditors of the power holder's estate. If any of these are included among the pool of See-Through Trust Beneficiaries, the trust will be treated as having no life expectancy. (Is it even possible to draft a general power of appointment in a non-conduit trust that will not cause the trust to be treated as having no life expectancy? Yes it is, and the techniques for doing so are discussed in Section VIII.C.)

This type of problem also can arise if a power of appointment allows an appointment in further trust. The Regulations provide that if another trust is a beneficiary of the trust, the other trust's beneficiaries also must be considered in determining the qualification of the trust.[36] Thus, the power of appointment either should prohibit appointments in further trust altogether, or should limit permissible trust recipients to trusts that will not jeopardize the primary trust's qualification under the MRD Rules (*e.g.*, conduit trusts or other trusts that have no life expectancy older than the "target" life expectancy).

As discussed in Section I.A., the Regulations generally require that a trust must meet certain threshold requirements in order for the trust to be a See-Through Trust.[37] These requirements normally must be satisfied on the Determination Date (the September 30 of the calendar year following the year of the plan owner's death). Specifically, the trust must then be a valid trust, must be irrevocable, and must provide certain documentation to the plan administrator no later than the October 31 of the calendar year following the death of the plan owner.[38] Must these requirements be met for purposes of determining the beneficiaries of a trust that is a permissible appointee under a power of appointment? No authority appears to address this question, but it is doubtful that these requirements would apply. If they did, it would rarely be possible for any trust to be recognized as having a life expectancy if it might someday pass to another trust.

As discussed in Section I.B.6., if the permissible appointees under a power of appointment include a person's "spouse" with no further qualification, there is no way of knowing who that spouse will be and what his or her age will be, and the trust is likely to be treated as not having an identifiable life expectancy.

Similarly, as discussed in Section I.B.6., if the permissible appointees under a power of appointment include a person's issue or descendants with no further qualification, there is a theoretical possibility that the class could include an adopted person of any age, and the trust is likely to be treated as not having an identifiable life expectancy.

Some trust instruments authorize a trust protector or independent trustee to modify powers of appointment. Any such power should be limited so that it cannot be used to add permissible appointees to a power of appointment over retirement assets (including accumulations).

As discussed in Sections IV.D. and E., the existence of a power of appointment may interfere with certain planning techniques that attempt to extend the conduit trust concept beyond the fact pattern of Example 2 of the conduit trust regulation.[39]

Minority View – Permissible Appointees Not Included in Pool of DB Beneficiaries. Although careful practitioners will follow the majority view outlined above, it could be argued that a power of appointment is better viewed as

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[36] Reg. § 1.401(a)(9)-4, A-5(d).
[37] Reg. § 1.401(a)(9)-4, A 5.
[38] Reg. § 1.401(a)(9)-4, A 6(b).
[39] Regs. § 1.401(a)(9)-5, A-7(c)(3), Example 2.

an enhancement of the interest provided to the See-Through Trust Beneficiary who holds the power of appointment, and should not be viewed as creating beneficial interests in the permissible appointees prior to an effective exercise of the power, and that consequently a person should not be considered a See-Through Trust Beneficiary solely because the person is a permissible appointee under a power of appointment. Notice 97-49 supports this conclusion, but in the context of electing small business trusts under IRC Section 1361, stating:[40]

> *The term "beneficiary" does not include a person in whose favor a power of appointment could be exercised. Such a person becomes a beneficiary only when the holder of the power of appointment actually exercises the power of appointment in such person's favor.*

8. Creditors.

If the provisions of a trust are such that the creditors of a beneficiary could attach all or a portion of the trust, must these potential creditors be included in the pool of See-Through Trust Beneficiaries? Again, no authority appears to address this issue. The conduit trust distribution approach, which is specifically blessed in the Regulations, could lead to attachment by creditors of the amounts that must be distributed under the conduit clause under the laws of many states. One could argue that this potential creditor problem must not be an issue under the MRD rules for trusts, as the Regulations have specifically approved the conduit trust without any discussion of creditor issues. But the MRD rules were generally written by employee benefits specialists, and there are numerous estate planning concepts that have not been adequately developed in these rules. Thus, it would be wise to draft any trust that is not a conduit trust in a way that will not result in exposure of the trust to creditors.

9. Summary of Various Approaches to Drafting Trusts.

When retirement plan interests are to be designated to one or more trusts, and the trusts are to qualify for "stretched-out" MRDs, there are several types of trusts that may or may not be appropriate in any given situation, as well as a number of other related issues. The next several Sections that follow provide coverage of each of the following:

a. Conduit Trusts. The "conduit trust" is the type of trust many consider to be the "default" approach that can be used except when there is a specific reason to use another approach. Sample forms and discussion of drafting "conduit trusts" appear in Section II.

b. Variations on Conduit Trusts. Your author will explore some possible variations on the conduit trust, including the "grantor"[41] conduit trust, which is designed to provide greater control and flexibility to the beneficiary and is discussed in Section III., and other possible (and untested) variations discussed in Section IV.

c. Outright Gifts to "Second Tier" Beneficiaries. The "outright gift to 'second tier' beneficiaries" is a relatively straightforward alternative to the conduit trust. An explanation of this approach, including sample forms, appears in Section V.

d. Recipients Limited By Age Restriction. The "age restriction" approach is another alternative to the conduit trust that should be used with great caution. This approach is discussed in Section VI.

e. Outright Gift to "Last One Standing." The "last one standing" is another somewhat specialized alternative to the conduit trust that also should be used with great caution. This approach is discussed in Section VII.

f. Dynasty Trusts. The term "dynasty trust" is often used to describe a trust that continues for multiple generations, and is often used in estate planning as a tool to reduce the aggregate transfer tax cost of passing assets across multiple generations. Dynasty trusts generally provide the greatest benefit to the extent that they can be made "exempt" by allocation of a transferor's generation-skipping transfer tax exemption, but designating a dynasty trust as beneficiary of retirement assets is the most complicated alternative of all, as explained in Section VIII.

g. IRD and Other Income Tax Issues. The rules for income and deductions in respect of a decedent and other income tax rules play a significant role in planning with trusts.

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[40] 1997-2 C.B. 304.

[41] A trust that is treated for income tax purposes as if "owned" by its beneficiary under IRC § 678 and related provisions.

h. Dispositive Planning for High Net Worth Clients. A discussion that addresses how to apply these various planning principles for high net worth clients appears in a Section not contained in this outline.

i. Uniform Principal and Income Act. Planning for trusts, particularly marital trusts, requires an understanding of applicable state law governing allocation between income and principal. Many states have adopted the Uniform Principal and Income Act.

j. Marital and Bypass Trusts. Special planning issues arise in connection with marital or bypass trusts that may receive retirement plan assets at the first spouse's death. These issues are discussed in Section I.B.9.j.

II. The Conduit Trust.

Conduit Trust as "Default Alternative." As will be discussed in this and the next several sections, there are several alternatives for structuring trusts that are intended to be designated as the beneficiary of retirement plan assets. The "conduit trust" discussed in this section is your author's default choice, as it is less complicated than most of the other alternatives, it does not limit the drafting of powers of appointment or provisions for remainder beneficiaries, and it offers a "safe harbor" under the Regulations. Of course, there will be certain cases in which the conduit trust alternative must be ruled out (*e.g.*, a special needs trust that cannot mandate conduit distributions), and there will be certain clients with more ambitious planning objectives who will appreciate a review of the pros and cons of other alternatives (*e.g.* a dynasty trust).

Safe Harbor. The Regulations specifically provide that when a trust requires all distributions taken from the plan during the primary beneficiary's lifetime to be distributed to the primary beneficiary, rather than accumulated in the trust, the primary beneficiary of the trust is recognized as the sole See-Through Trust Beneficiary.[42] Although the term "conduit trust" does not appear in the Regulations, it has been universally adopted as a name for this type of trust. The final Regulations reason that the alternate takers can be excluded from the pool of See-Through Trust Beneficiaries as "mere potential successors," because the primary beneficiary is entitled to all plan distributions while living. This interpretation seems inconsistent with the narrow provisions of the "mere potential successor" rule, but one should not look a gift horse in the mouth.

A. Pros and Cons of the Conduit Trust.

When a client is designating a retirement plan interest for an individual heir, and is considering a conduit trust structure, the following advantages and disadvantages should be considered:

- Of the various types of trusts that could be drafted to hold a retirement plan interest for the benefit of an individual heir and to accomplish "stretch-out" minimum distributions over the individual heir's life expectancy, the "conduit trust" is probably the least complex to draft and most certain to comply with MRD Rules.

- Multiple conduit trusts may qualify for the separate account rule so long as the death beneficiary designation directs the division of the plan into separate accounts.

- The primary disadvantage of the conduit trust is that the amounts of all distributions from the retirement plan (MRDs plus any other distributions) to the trust must then be distributed from the trust to the individual, regardless of whether he or she wants to receive them, subject to possible planning alternatives discussed in this section.

- The actual MRDs for a young individual, however, will be very small. For example, an individual who turns five years old in the year following the plan owner's death would receive a distribution of 1/78th (approximately 1.25%) of his or her account that year (or even less, depending on planning alternatives discussed in this section).

- The trust instrument may authorize the trustee to make conduit distributions to the minor individual's custodian acting under applicable state law *(e.g.* the Uniform Transfers to Minors Act).

- Distributions also can be directed to the legal guardian for the young individual, or the trustee may be given the discretion to do so, effectively allowing the trustee to apply distributions for the individual's needs.

- Will a trust comply with the MRD conduit requirements if it allows the trustee to apply distributions directly in payment of an individual's needs, without the participation of the individual's legal guardian? There does not appear to be any guidance on this issue in the MRD Rules, but there is favorable authority in the context of the marital deduction for estate tax. A marital deduction is allowed under IRC Section 2056(b)(5) and (7) with respect to certain interests in property passing to a spouse if certain requirements are satisfied, including the requirement that the surviving spouse shall receive the right to all income from the interest for the balance of his or her life.[43] Treasury Regulations provide that a trustee's power to apply income for the benefit of the spouse is a permissible administrative power that will not disqualify the marital deduction,

[42] Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2.
[43] IRC § 2056(b)(5).

provided that the overall terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers.[44]

- If a person with an obligation to support the individual beneficiary may be serving as trustee, the trust should be drafted to avoid providing that person with discretionary powers that would cause tax problems. In particular, the Trustee's power to take distributions from the retirement plan may need to be limited (as illustrated in the sample conduit trust form below).

- The funds that actually reach the young beneficiary may be less than the amounts of distributions from the retirement plan to the trust, due to the payment of legitimate trust expenses, such as trustee's fees, tax return preparation or other expenses, and possibly investment management fees of the retirement plan to the extent the trustee chooses not to arrange payment of these fees from inside the retirement plan.

- Paying the plan's investment management fees from non-retirement assets may or may not provide a better overall financial outcome.

- Financial institutions often do not understand trusts or other concepts that deviate from their standard death beneficiary designation form. As a general rule, any time that retirement plans are designated to trusts, allowance should be made for additional paperwork and coordination with the financial institution to get the trust's inherited account set up properly.

- A conduit trust may provide for a termination while the primary beneficiary is still living, *e.g.* at a specified age. Upon termination, however, the primary beneficiary must receive complete control over the balance in the retirement plan without any other contingencies. As discussed next, it is not always easy for a trustee to "assign" the balance in a retirement plan to the individual primary beneficiary. A conduit trust that provides for a terminating event should allow the trustee the flexibility to keep the trust going after the terminating event in case there are difficulties assigning the retirement plan interest. Along those lines, it may be advisable to include a power of appointment to ensure the primary beneficiary has dispositive control over a retirement plan interest that must continue in trust.

- A trust's interest in a qualified retirement plan may not necessarily be assignable to the trust's beneficiary due to anti-alienation requirements of ERISA and the plan document. IRAs are not subject to these anti-alienation requirements, but some financial institutions resist the notion that a trust can transfer its interest in an IRA to an individual beneficiary without causing a taxable distribution at the time the trust terminates, or at such time as the trustee may choose to distribute the IRA interest. Of course, if one financial institution does not understand, the trustee has the power to move the inherited IRA to another financial institution.

B. Case Study: Jane Reynolds.

Jane Reynolds is age 42, divorced, with two daughters, ages 14 and 10, a $600,000 IRA, a $250,000 home, and a few other assets. She would prefer to leave her estate to two trusts that "protect" each child until the child reaches age thirty-five. She would like for her children to benefit from "stretched-out" distributions, but would otherwise like to keep her estate plan as simple as possible. Based on these requirements, she decides to provide conduit trusts for each child.

C. Conduit Trust Drafting Considerations.

This section discusses issues that deserve consideration in drafting a conduit trust instrument for Ms. Reynolds (and most other clients for that matter). As discussed above, the primary disadvantage of the "conduit trust" structure is that plan distributions must be passed out to the beneficiary, whether it is in the beneficiary's best interest or not. Fortunately, for younger beneficiaries these distributions are likely to be a very small percentage of the plan balance. It also may be possible to apply the distributions to costs that otherwise would be paid from other sources. This disadvantage seems a small price to pay in return for certainty under the MRD Rules.

Drafting a good conduit clause requires more time and thought than one might initially expect. Here is a sampling of some of the drafting issues your author considered while drafting the forms that follow:

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[44] Reg. § 20.2056(b)-5(f)(4).

- *Subtrust Versus Standalone Trust*. The trusts for children could be structured as subtrusts under a common revocable trust or Will, or as a dedicated "stand-alone" trust instrument. The "subtrust" approach is adequate for many clients, and your author recommends this approach for Jane Reynolds. The "stand-alone" approach may be worthwhile for certain clients who want the planning that has been done for retirement assets to stand out in the form of a separate document. This may be helpful to fiduciaries, beneficiaries, and advisors who may be juggling many different issues during a death administration.

- *"Double-Duty" Trust.* It is possible to draft two different sets of subtrusts, one for retirement plan assets and the other for non-retirement assets, but it is probably not necessary to do so with a conduit trust. One set of "double-duty" subtrusts will work just fine for Jane Reynolds. Note that the subtrusts must be drafted to include language coordinating the "conduit" distribution provisions and the distribution provisions that apply to other assets.

- *May Be Confusing to the Uninitiated*. The conduit clause may be confusing to clients, trust officers, or advisors who are not familiar with the concept. It can be particularly confusing when the clause is referring in some contexts to distributions from the plan, and in other contexts to distributions from the trust. The sample form attempts to make a clear distinction between the beneficiary of the plan versus the beneficiary of the trust.

- *Need to Define "Stretch-Out" Plan*. It is not enough to provide that all plan distributions be distributed to the trust beneficiary. Otherwise, if a plan requires a lump sum distribution at the client's death the entire plan could be passed out to the beneficiary regardless of how young he or she might be. Thus, the term "Stretch-Out Retirement Account" is defined to effectively exclude from the scope of the conduit clause any plan that cannot pay out over the beneficiary's life expectancy (or the oldest life of a group of individuals that includes the beneficiary).

- *Separate Accounts.* The language allowing for a group of individuals is intended to apply the conduit provision in a situation when the trust is one of several conduit trusts that, for some reason, do not qualify for "separate account" treatment under the MRD Rules and must use the life expectancy of the oldest conduit trust beneficiary.

- *Chicken and Egg.* The sample form includes a phrase to address the "chicken and egg" relationship between the sentence that defines "Stretch-Out Retirement Account" and the conduit distribution clause (*i.e.*, the conduit distribution clause does not apply unless the plan satisfies the definition of "Stretch-Out Retirement Account," and the trust might not satisfy the definition unless the beneficiary is the only See-Through Trust Beneficiary).

- *Only Applies to Primary Beneficiaries*. Conduit distributions are only required as long as the primary beneficiary is alive. If the conduit provision does not specifically address this issue, unnecessary conduit distributions might be required from a trust that continues beyond the primary beneficiary's death. Thus, the definitions of "Stretch-Out Retirement Account" and "Stretch-Out Beneficiary" are incorporated into the conduit clause in a way to limit the scope of the conduit clause to only the primary beneficiary.

- *Designation of Trust that Subdivides*. The sample form defines Stretch-Out Retirement Accounts using the phrase "became part of the trust by reason of the Settlor's death (or the death of another, depending on the context)" rather than language such as "a trust that was designated" to clarify that the conduit clause applies even if a revocable trust is designated and immediately subdivides into conduit trusts.

- *Early Termination.* The sample form includes the phrase "or earlier termination of his or her trust" to clarify that the conduit clause does not somehow create an obligation that extends beyond the trust termination.

- *Distributions For Benefit Of*. The sample form authorizes the trustee to distribute conduit amounts outright or to "apply for the benefit of" the primary beneficiary, for reasons discussed above. In many trust instruments, additional language may be found in the "boilerplate" section of the trust providing options to the Trustee when a distribution is to be made to a minor or disabled beneficiary. One might consider relying only on the boilerplate language, but including the "apply for the benefit of" language in the conduit provision provides the clearest guidance to trust officers and other advisors. The "boilerplate" should be reviewed in any event to eliminate any contradictory language that might interfere with distribution either outright or for the benefit of the beneficiary.

- *Tax Apportionment Provisions; Payment of Taxes and Expenses*. Tax apportionment provisions in the client's estate plan should be reviewed carefully. If possible, it is best to avoid subjecting retirement plan assets to apportionment as the plan may "melt down" if distributions are needed to pay tax. In certain circumstances, however, a trustee may need to

apply plan assets to pay estate or generation skipping transfer tax. Any plan assets so applied are likely to generate an income tax at the trust level, as well. Trustee fees and other administration expenses may also need to be paid from plan assets. The sample form's conduit distribution clause clarifies that the trustee may pay the portion of these items chargeable to the plan assets, and may distribute the "net" remaining to the trust beneficiary. The example in the final Regulations does not address these issues, and your author is not aware of any authority that specifically sanctions this approach, but believes it would be irresponsible to draft a conduit clause that did not address payment of these items. Your author considered moving the language that addresses these items into the "boilerplate" section of the trust, but opted to leave all of the language together to provide the clearest guidance to trust officers and other advisors. For further discussion of payment of death taxes, including a "pay by September 30" requirement, see Section I.B.5.

- *Clarify Trustee's Authority to Take Plan Distributions*. Because a conduit clause results in "automatic" distribution to the trust beneficiary, some mechanism needs to be included to clarify the scope of the trustee's authority to take plan distributions, to avoid placing what is effectively a general power of appointment into the hands of a tax-sensitive trustee. Three possible tax-sensitive trustees are addressed: (i) an individual who has made a disclaimer; (ii) an individual subject to a legal obligation to support the beneficiary; and (iii) the beneficiary. The authority should be broad enough, however, to allow the trustee to pay expenses or taxes chargeable to the plan assets, and to take more than the minimum required distributions if the beneficiary is in need. Also, this clause restricts the trustee's authority only as long as the conduit provision is in effect. The sample form should work well for most clients, but certain clients may prefer more restrictive language (*e.g.*, the trustee may take only minimum distributions).

- *MRDs in Year of Participant/Owner's Death*. The language discussed above that defines a "Stretch-Out Retirement Account" as a plan that allows distributions based on the life expectancy of the primary beneficiary needs to drafted in a way that there is no confusion if, in the year of the plan owner's death, a minimum distribution remains to be made that is calculated using the so-called life expectancy of the deceased plan owner, and not the primary beneficiary.

- *Spendthrift Clause.* The language in boilerplate provisions (e.g. a spendthrift clause) should be reviewed carefully to ensure that there is no language that would interfere with the conduit distributions required to qualify the trust as a "conduit trust" under the MRD Rules.

D. SAMPLE FORM: "Conduit" Subtrust.

Here are sample clauses that might be used in Ms. Reynolds' revocable trust:

2.5 Division Into Shares. Upon the death of the Settlor, the Trustee shall divide the remaining assets in such manner as will create, in the aggregate, equal shares consisting of one such share for each child of the Settlor who is then living and one such share for each child of the Settlor who is then deceased but has descendants then living. Each share set aside for a child of the Settlor who is then deceased but has descendants then living shall be further divided into shares for such descendants on the principle of representation. Each share set aside for a child or more remote descendant of the Settlor (each child or more remote descendant is sometimes referred to as the "Beneficiary" of his or her trust) shall constitute a separate trust to be held and distributed in the manner set forth in Section 2.6 unless such Beneficiary shall have then attained Thirty-Five (35) years of age, in which case such Beneficiary's share shall be distributed to him or her outright and free of trust. If no descendant of the Settlor is then living, the Trustee shall distribute the trust estate in the manner set forth in Section 2.7 below.

2.6 Trusts for Children and More Remote Descendants. Each trust for a Beneficiary shall commence upon the first receipt of property by the Trustee. Such property and any subsequent additions of property shall constitute the trust estate, which shall be held, administered and distributed pursuant to this Section 2.6.

> **2.6.1 Distribution of Income and Principal - In General**. The Trustee shall distribute, from time to time, to or for the benefit of each Beneficiary so much of the net income and principal of assets (other than Stretch-Out Retirement Account assets) held in such Beneficiary's trust as in the reasonable discretion of the Trustee may be required for the health, support or education of such Beneficiary, taking into account the Beneficiary's other resources, including "conduit distributions" made or anticipated under Section 2.6.2.
>
> **2.6.2 Conduit Distributions**. To the extent the Trustee receives distributions from a Stretch-Out Retirement Account (as defined in Section 12.16) as to which the Beneficiary is the Stretch-Out

Retirement Beneficiary (as defined in Section 12.18), the Trustee shall distribute to or apply for the benefit of the Beneficiary all of said distributions (net of expenses, and net of income, estate, inheritance, generation-skipping transfer tax, or any other tax, to the extent said expenses and taxes are properly allocable to distributions received or to the balance remaining in said Stretch-Out Retirement Account), for as long as the Beneficiary shall live or until the earlier termination of his or her trust.

2.6.3 Limitations on Trustee's Power to Take Distributions. For so long as the Beneficiary is the Stretch-Out Retirement Beneficiary of a Stretch-Out Retirement Account, the following individuals, while serving a*s* Trustee, are prohibited from withdrawing Excess Distributions (as defined in Section 12.7) from said Stretch-Out Retirement Account: (i) the Beneficiary; (ii) any individual who made a qualified disclaimer of any interest in said Stretch-Out Retirement Account; and (iii) any individual who owes a legal obligation of support to the Beneficiary. The power to withdraw such Excess Distributions shall be reserved to others serving jointly as Trustee who are not so prohibited from withdrawing Excess Distributions. If no such Trustee is then serving, the Independent Trustee shall have the power to direct the Trustee to make (or not make) such Excess Distributions.

2.6.4 Termination. A Beneficiary's trust shall terminate when he or she attains Thirty-Five (35) years of age, and at such time, the Trustee shall distribute the then principal of a Beneficiary's trust to him or her outright and free of trust. For purposes of this Section 2.6.4, when the Trustee is directed to "distribute" an interest in any IRA or Roth IRA account, the Trustee is to arrange for the transfer of said interest from the trust to the Beneficiary so that the Beneficiary holds the various powers over such IRA or Roth IRA (e.g., to direct investments and withdrawals) that would otherwise be held by the Trustee, without necessarily causing a distribution of funds out of the IRA or Roth IRA account. The Trustee may postpone the termination of the trust with respect to any IRA, Roth IRA, or other Retirement Account if doing so will postpone the requirement of a distribution of funds out of said account or otherwise produce a better tax outcome for the Beneficiary, and shall continue to administer said account hereunder as if the Beneficiary had not yet attained Thirty-Five (35) years of age.

2.6.5 Limited Power of Appointment. Each Beneficiary who has attained Twenty-Five (25) years of age shall have the limited power to determine the manner in which the principal and any undistributed income of his or her trust shall be distributed at his or her death. This power may be exercised by the Beneficiary in the manner provided in Section 10.11 to provide distributions outright or in further trust in favor of any one or more of *[describe permissible appointees]* (other than his or her creditors, estate, or the creditors of his or her estate) as the Beneficiary shall determine.

2.6.6 Death Before Complete Distribution. Upon the death of a Beneficiary, the Trustee shall distribute said Beneficiary's trust (including such items of property as may pass generally to said trust by reason of said Beneficiary's death) in such manner as the Beneficiary shall have effectively appointed, and shall divide the unappointed balance of the trust into shares on the principle of representation for the then living members of the class of descendants identified earliest below with at least one class member then living:

1st The deceased Beneficiary's descendants.

2nd If applicable, the descendants of the deceased Beneficiary's closest ancestor who was a descendant of the Settlor.

3rd The descendants of the Settlor.

Each share so established for a descendant shall be distributed to him or her outright and free of trust if he or she has then attained Thirty-Five (35) years of age. Each share so established for a descendant who has not attained Thirty-Five (35) years of age shall either be added to the trust then held hereunder for him or her or, if no trust exists for him or her, shall constitute a trust to be held and distributed for him or her as provided in this Section 2.6 (each descendant shall be referred to as the "Beneficiary" of his or her trust). If none of the descendants described above are then living, the Trustee shall instead distribute said unappointed balance as provided in Section 2.6.7.

2.6.7 Alternate Heirs. If disposition be made under this Section 2.6.7, the Trustee shall distribute the affected trust estate to ________________________________.

Author's Note: *The following clause is suggested for inclusion in the "boilerplate" of most trusts.*

11.15 Trust as Beneficiary of Retirement Account. The Settlor intends that each trust hereunder that owns an interest in a Retirement Account benefit from the maximum extended deferral period under the Minimum Distribution Rules that is available based upon the terms of such trust. Accordingly, the following shall apply:

(a) The Trustee of a trust so designated shall, within the time limit prescribed under the Minimum Distribution Rules, deliver documentation required under said rules to the respective administrators and custodians of each Retirement Account.

(b) In addition to the powers granted to the Trustee by law or under other provisions of this instrument, the Trustee is authorized to exercise any power or right over a Retirement Account that is available to the Trustee as beneficiary or successor owner, including by way of example and not limitation powers to (i) select payment options, (ii) direct investments, and (iii) direct tax-free rollovers from one Retirement Account to another (and to establish any new Retirement Account that is to receive the rollover, if applicable).

(c) When the Trustee makes a distribution or an allocation of an interest in a Retirement Account to or for the benefit of a beneficiary of a trust hereunder, the Trustee is to assign all of the Trustee's interests in and powers over said Retirement Account interest (*e.g.*, to direct investments and withdrawals) to said individual or trustee, as the case may be, and nothing under this instrument shall be interpreted as requiring the Trustee to arrange for the assets held in the Retirement Account to be withdrawn from said Retirement Account. The Settlor specifically intends that any such distribution or allocation of a Retirement Account shall be handled in a manner that (i) results in zero, or the minimum possible amount of income tax payable by either the trust, said individual, or said other trust, and (ii) results in no change, or the minimum possible amount of change, to the deferral period that applies to the Retirement Account.

(d) The administrators, custodians, or other fiduciaries of the respective Retirement Accounts shall incur no liability to the trust or to any of its beneficiaries for acting upon the written instruction of the Trustee pursuant to this Section 11.15.

12. Definitions. (The following are selected definitions relating to retirement plan issues.)

12.7 Excess Distributions. The term "Excess Distributions" means, with respect to an interest in a Stretch-Out Retirement Account, any distribution in excess of those amounts reasonably necessary to: (a) comply with the Minimum Distribution Rules; (b) provide for the beneficiary's health, education, and support; (c) comply with the legal obligation to pay income, estate, inheritance, GST Tax, or other taxes properly chargeable to distributions received from or the balance remaining in said Stretch-Out Retirement Account; and (d) provide for payment of trust expenses properly allocable to distributions received from or the balance remaining in said Stretch-Out Retirement Account.

12.8 Minimum Distribution Rules. The term "Minimum Distribution Rules" means the incidental death benefit requirements of Code Section 401(a) and the minimum distribution rules of Code Section 401(a)(9) (or similar rules applicable to certain types of Retirement Accounts, including by way of example and not limitation the rules of Code Sections 408(a)(6) and 408(b)(3) that apply to IRAs, and the special rules of Code Section 408A(c)(5) that apply to Roth IRAs).

12.9 Participant. The term "Participant" means the employee, plan participant, or account owner of a Retirement Account as those terms are commonly used under the Minimum Distribution Rules.

12.10 Retirement Account. The term "Retirement Account" means a Tax-Advantaged Account that is subject to the Minimum Distribution Rules.

12.16 Stretch-Out Retirement Account. The term "Stretch-Out Retirement Account" means, with respect to a particular trust arising hereunder, an interest in a Retirement Account that satisfies the following conditions: (a) the interest in the Retirement Account (or a successor Retirement Account, *e.g.*, an inherited IRA that receives a rollover from a qualified retirement plan) became part of the trust by reason of the death of the Participant of said Retirement Account; and (b) the provisions governing said Retirement Account (including any death beneficiary designation in effect at Participant's death and any other relevant circumstances) permit the Trustee of the trust to take post-death distributions over a time period based on the life expectancy of an individual, assuming said trust otherwise qualifies to do so under the Minimum Distribution Rules. By way of explanation, if a trust with an interest in a Retirement Account that is a Stretch-Out Retirement Account ultimately terminates (*e.g.*, upon the death of a beneficiary), and if as a result the remaining Retirement Account interest is then allocated to a successor trust (*e.g.*, for a descendant of the deceased beneficiary), said remaining Retirement Account interest will not be considered a Stretch-Out Retirement Account with respect to said successor trust under this Section because said interest did not become part of said successor trust by reason of the death of the Participant.

12.17 Stretch-Out Retirement Account Accumulations. The term "Stretch-Out Retirement Account Accumulations" means, with respect to a particular trust arising hereunder, any amounts distributed from any one or more of said Stretch-Out Retirement Accounts to the trust that accumulate in the trust (including earnings thereon and net of any expenses or taxes allocable thereto). By way of explanation, if a trust with Stretch-Out Retirement Account Accumulations ultimately terminates (*e.g.*, upon the death of a beneficiary), and if as a result said Stretch-Out Retirement Account Accumulations are allocated to a successor trust (*e.g.*, for the descendants of the deceased beneficiary), said accumulations will not be considered Stretch-Out Retirement Account Accumulations in the hands of said successor trust, because it was the prior trust and not the successor trust that received distributions from a Stretch-Out Retirement Account and accumulated them.

12.18 Stretch-Out Retirement Beneficiary. The term "Stretch-Out Retirement Beneficiary" means, with respect to a trust hereunder that owns an interest in a "Stretch-Out Retirement Account," the trust beneficiary whose life expectancy is or will be used in determining the timing and amount of post-death distributions (or whose life expectancy would have been so used if he or she was the oldest member of the group of individuals determined under the Minimum Distribution Rules to which he or she belongs).

12.19 Tax-Advantaged Account. The term "Tax-Advantaged Account" means any plan, contract, or other arrangement (other than a life insurance contract) that is allowed under the Internal Revenue Code to accumulate any part of its income in a tax-advantaged manner (*e.g.*, income tax-deferred or income tax free) for the benefit of an owner, beneficiary, or successor, and includes, by way of example and not limitation, a qualified or non-qualified annuity, a deferred compensation plan, or a retirement or individual retirement account arrangement established under Code Sections 401, 403, 408, 408A, or 457. A plan account or arrangement that is otherwise a "Tax-Advantaged Account" and that owns one or more life insurance contracts among its assets is a "Tax-Advantaged Account." A plan, contract, or other arrangement that is reasonably believed to qualify for tax-advantaged treatment under the Internal Revenue Code is a "Tax-Advantaged Account" even if it is subsequently determined it did not so qualify.

E. SAMPLE FORM: IRA or Retirement Plan Death Beneficiary Form Designating Subtrusts.

RETIREMENT PLAN DEATH BENEFICIARY DESIGNATION

Person Making Designation (hereafter, "Owner")	JANE REYNOLDS
Owner's Social Security Number:	555-55-5555
Owner's Birth Date:	November 1, 1966
Plan Description (*e.g.*, 401(k), IRA, Roth IRA) (hereafter, "Retirement Plan")	IRA
Name of Plan Administrator, Trustee or Custodian (hereafter, "Administrator")	All American Financial
Retirement Plan Account Number (hereafter, "Retirement Plan Account")	7-7777777-77

1. Primary Death Beneficiary. The Owner hereby designates, as her primary designation, that the Retirement Plan be divided into separate accounts in the following manner:

One equal account shall be established for each of the Owner's two (2) children, namely, CHRISTINE REYNOLDS and CYNTHIA REYNOLDS. The following table provides pertinent information about the Owner's children:

Name	Relationship	Social Security Number	Birth Date
CHRISTINE REYNOLDS	Daughter	222-22-2222	October 3, 1994
CYNTHIA REYNOLDS	Daughter	333-33-3333	February 8, 1998

If any child does not survive the Owner, said deceased child's account shall be further divided into separate accounts for each of the deceased child's descendants who survive the Owner, on the principle of representation, or, if the deceased child has no then living descendants, the deceased child's share shall proportionately augment the other separate accounts so established.

Each separate account created for a child or more remote descendant of the Owner who has attained Thirty-Five (35) years of age shall be designated outright and free of trust to said individual.

Each separate account created for a child or more remote descendant of the Owner who has not attained Thirty-Five (35) years of age shall be designated to the Trustee of the [name of subtrust] established for the benefit of said child or descendant under the Jane Reynolds Revocable Trust established January 2, 2008, as amended from time to time during the Owner's lifetime (hereafter, the "Revocable Trust").

If there is no [name of subtrust] provided under the Revocable Trust for any one or more of said children or descendants: (i) if at the time of the Owner's death he or she has attained twenty-one (21) years of age and is not "disabled," his or her separate account shall be designated to him or her outright and free of trust; (ii) if at the time of the Owner's death he or she has not attained twenty-one (21) years of age and is not otherwise "disabled," his or her separate account shall be designated to him or her free of trust and held for him or her by his or her legal guardian as custodian under the Uniform Transfers to Minors Act until the child or descendant attains twenty-one (21) years of age or, if there is no such legal guardian, the custodian shall be the then serving Trustee of the Revocable Trust; or (iii) if at the time of the Owner's death he or she is "disabled," his or her separate account shall be designated to the Trustee of the Revocable Trust to hold for his or her benefit.

A person is "disabled" if he or she suffers from a mental or physical condition (other than minority) that renders said person mentally incapable of managing his or her business or personal affairs, whether or not there is an adjudication of incapacity or disability, which condition is likely to extend for a period of greater than ninety days. Any such condition shall be evidenced by written declaration of two licensed physicians under penalty of perjury filed with the IRA Custodian. Neither the IRA Custodian nor any licensed physician who executes such a declaration (other than under circumstances of fraud or gross negligence) shall be subject to liability because of such execution.

Alternate Death Beneficiary Designation: The IRA OWNER hereby designates, as her alternate death beneficiary, that to the extent that all or any portion of the IRA does not pass under her primary death beneficiary designation, it shall instead be designated to the Trustee of the REVOCABLE TRUST.

Assignments From Estates and Trusts. In the event a trust or estate holds an interest in the Retirement Plan Account after the Owner's death, and all or some portion of said interest is to be distributed to one or more beneficiaries of said trust or estate (e.g., upon partial or complete termination of said trust or estate), the Owner requests that the documents and terms governing the Retirement Plan Account (including the terms of this death beneficiary designation) be construed to the greatest extent possible to permit the fiduciaries of said trust or estate to accomplish said distribution by assignment of the interest in the Retirement Plan Account, rather than requiring said fiduciaries to withdraw assets from the Retirement Plan Account prior to said distribution.

No Liability for Plan Administrator. The Administrator shall incur no liability to any trust designated herein or to any of the beneficiaries of said trust for acting upon the written instruction of the Trustee of said trust.

Executed and accepted on this date of January 2, 2008.

____

JANE REYNOLDS - OWNER

[Notary attestation optional, but suggested]

III. Conduit Trust That Is "Grantor Trust" Under IRC Section 678.

A. Background.

Provide "Revocable Trust" Flexibility to Recipients. It is possible to structure a trust as beneficiary of retirement plan assets in a way that the trust could function as a sort of revocable trust for each recipient. The planning objective is not tax driven, and relates more to a desire to wrap an interim estate plan around each recipient's share until such time as the recipient affirmatively acts to establish his or her own estate planning provisions. The recipient is to have broad control over the trust, without the rigid structure normally associated with an irrevocable trust. An additional advantage, compared to designating the recipients as individuals, is that the trust can be drafted to include customized provisions that would be difficult to include in a death beneficiary designation, such as simultaneous death presumptions, no contest clauses, complex instructions regarding alternate heirs, *etc.*

B. Case Study: John Taylor.

John Taylor comes to you for advice. He has the same facts as Jane Reynolds (see prior section), except he is older (age 68) and his daughters are well-adjusted adults, ages 31 and 34. He does not want their inheritance tied up in an irrevocable trust, but he likes the idea of providing them with an interim estate plan until they affirmatively make an update.

C. Drafting Considerations.

Although each trust is intended to provide the beneficiary with the flexibility associated with a revocable trust, making the trusts revocable may flunk the requirement that a See-Through Trust must be irrevocable at the plan owner's date of death.[45] Thus, the safest approach is to make each trust irrevocable.

For reasons discussed below, this type of trust likely will be a wholly-owned grantor trust.[46] Nevertheless, a wholly-owned grantor trust should be characterized as a trust, and not an individual, for purposes of applying the Minimum Distribution Rules (as discussed below). Because the primary beneficiary will have a broad withdrawal right over the entire trust in order to make it a wholly-owned grantor trust, there should be little or no disadvantage to also including a conduit provision to ensure that the trust will be viewed as having only one See-Through Trust Beneficiary.

Flexibility still is possible for these irrevocable trusts if, for example, each trust provides the beneficiary the unqualified power to withdraw income and principal, designates the beneficiary as trustee, and/or provides the beneficiary a power of appointment. Be aware, however, that some IRA custodians may not necessarily agree with the notion that the power to withdraw income and principal allows the beneficiary to "assign" the inherited IRA out of the trust and into their own name without causing a taxable distribution. Thus, the client must allow for the possibility that each beneficiary must keep the trust in operation, at least as to continuing IRA accounts.

These withdrawal powers over income and principal cause each trust to be treated as if "owned" by the beneficiary under IRC Section 678, which leads to an interesting question: When a "grantor trust" is designated, are the MRD Rules applied as if the individual grantor was designated? If so, the MRD Rules for trusts might not apply, but one should not assume this is so. The legal analysis is fascinating, but complicated. Here is a capsule summary:

a. The grantor trust rules require someone who is deemed to "own" a grantor trust to report the income, deductions and credits of the trust ". . . as if the trust were not in existence."[47] This requirement does not necessarily mean that the trust is ignored in the context of other provisions of the income tax code not having to do with reporting of income, deduction and credits.

b. Taxpayers and the Service have on occasion argued for or against the notion that a grantor trust should be ignored with respect to certain transactions between owner and trust, rendering the transaction a "non-event" for income tax

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[45] Reg. § 1.401(a)(9)-4, A 5.
[46] A trust that is treated for income tax purposes as if "owned" by its beneficiary under IRC § 678 and related provisions.
[47] IRC § 671; Reg. § 1.671-3(a)(1).

purposes.[48] The Second Circuit held in Rothstein that a sales transaction was not a non-event.[49] Shortly thereafter, the Service ruled that sales transactions are non-events and that the Service will not follow Rothstein.[50]

c. Even if transactions are non-events, there does not appear to be any authority that supports the notion that a grantor trust can be entirely disregarded under the MRD Rules as if the individual owner had been designated. In fact, in another context, a trust that is not recognized for income tax purposes because it elected to be treated as an estate under IRC Section 645 is nevertheless treated as a trust under the MRD Rules " . . . as long as the trust continues to be a trust under state law."[51] Thus, the safest course is to draft and administer the continuing trusts so as to comply with the MRD Rules for trusts.

This will require an analysis of the identity of the trust's pool of See-Through Trust Beneficiaries, which leads to the next question, which is whether a grantor trust that allows the primary beneficiary the unlimited power to withdraw income and principal at any time can qualify as a conduit trust. If so, then the primary beneficiary is the only See-Through Trust Beneficiary and the trust will qualify for "stretched-out" MRDs over that beneficiary's life expectancy regardless of the other beneficiaries or permissible appointees who might possibly receive the trust's retirement assets. Unfortunately, it is not entirely clear whether this is so.

Even though the trust might be viewed as "disregarded" under the grantor trust rules in the context of reporting income, deductions and credits, the trust may be recognized as a trust under the MRD Rules. Conduit trust treatment is allowed under the final Regulations if the trust requires that any distributions taken from the plan while the trust's primary beneficiary is alive must be distributed from the trust to the primary beneficiary.[52] If the trust provides the primary beneficiary with an unqualified right to withdraw those amounts, but does not actually require that they be distributed, is this enough to satisfy the requirements of the final Regulations? As discussed in Section IV.B., this may not be enough.

If the trust is not a conduit trust, then all of the beneficiaries and permissible appointees (other than "mere potential successors") must be included in the pool of See-Through Trust Beneficiaries.

Further, it is important that the documentation requirement for trusts[53] and any other applicable formalities be observed.

D. SAMPLE FORM: Trust That Is "Grantor Trust" Under IRC § 678.

Here are sample clauses that might be used in John's revocable trust to establish continuing subtrusts that can serve double duty, holding both IRA and non-IRA assets. Note that John has chosen to provide "conduit trusts" for grandchildren in the unlikely event a child predeceases him.

[John Taylor's trust will employ the same provisions used in Jane Reynolds' Conduit Trust discussed above, except that the following provision is added to each conduit trust.]

2.6.3 Beneficiary's Power to Withdraw. The Beneficiary of a Conduit Trust who has attained Thirty (30) years of age shall have the unrestricted power to withdraw any portion or all of the trust estate of his or her Conduit Trust, upon delivery of written notice to the Trustee. As soon as reasonably possible after receipt of a notice of withdrawal, the Trustee shall distribute the affected property to the Beneficiary or other recipient designated by Beneficiary in his or her notice of withdrawal. In the event the Beneficiary is unable to exercise his or her power to withdraw, please refer to Section 9.1, which provides the manner in which certain others may exercise said power on the Beneficiary's behalf.

2.6.4 Beneficiary's General Power to Appoint Trust. The Beneficiary of a Conduit Trust shall have the general power to appoint the principal and any undistributed income of his or her Conduit Trust upon his or her death to or for the benefit of any one or more recipients. When exercising this power

[48] Rev. Rul. 77-402, added in 1980 as Reg. § 1.1001-2(c), Example 5. This regulation was upheld by the Tax Court in Madorin v. Comm., 84 T.C. 667 (1985).
[49] Rothstein v. U.S., 735 F.2d 704 (2d Cir. 1984).
[50] Rev. Rul. 85-13, 1985-1 C.B. 184.
[51] Preamble to final Regulations.
[52] Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2.
[53] Reg. § 1.401(a)(9)-4, A 6(b).

of appointment, the Beneficiary may appoint outright or in trust, in present or future interests, or in any combination of these, and may create new restrictions, conditions and powers of appointment in or for the objects of the power. This power of appointment may be exercised by the Beneficiary in the last (i) acknowledged written instrument delivered to the Trustee prior to the Beneficiary's death or (ii) valid Will or Codicil of the Beneficiary, which in either case specifically refers to such power and expressly exercises it. The Trustee shall have the absolute power to determine which document constitutes the Beneficiary's last acknowledged written instrument or his or her last valid Will or Codicil, and probate of such Will or Codicil shall not be required. In the event the Beneficiary is unable to exercise his or her power of appointment, please refer to Section 9.1, which provides the manner in which certain others may exercise said power on the Beneficiary's behalf.

9.1 Powers Personal. Each power and right granted to the Settlor or to a beneficiary under this instrument (including the power to exercise a power of appointment) is personal and may not be exercised by another, except that during such time that the power holder is unable to act, said powers and rights may be exercised by either: (i) the power holder's guardian or conservator acting by authority of a court of competent jurisdiction; or (ii) *[drafted to reflect facts and circumstances of each case to either provide that an agent under a durable power of attorney may **never** exercise said powers, or may only exercise said powers in limited circumstances]* the power holder's agent under an acknowledged durable power of attorney that specifically authorizes said agent to exercise such power or right, provided that said agent obtains the consent of *[list names, may include Settlor if durable power is "immediately effective"]* who is then living and has capacity to act, or if *[none of, or less than a certain number of, etc.]* said persons is then living or has capacity to act, the consent of each of *[alternate list, if applicable]* who is then living and has capacity to act.

IV. Variations on Conduit Trusts.

As discussed in Section II., the final Regulations provide that if a beneficiary is entitled to conduit distributions he or she is considered the sole See-Through Trust Beneficiary, and any alternate takers may be disregarded as "mere potential successors." This section explores planning techniques that take this concept beyond the specific fact pattern of Example 2 of the conduit regulation.[54]

A. Why A Conduit "Pot" Trust May Not Qualify.

It stands to reason that a "conduit 'pot' trust" that requires conduit distributions but allows the Trustee to sprinkle the distributions among a group of beneficiaries ought to fall within the spirit of the conduit "safe harbor" under the Regulations. This technique is not entirely without risk, however, because it involves different facts than those contained in Example 2 of the Regulations,[55] and there is no other specific authority condoning this approach.

In fact, there is a troubling technical position that the IRS could take with this sort of trust. With a "single beneficiary conduit trust" the primary beneficiary is the sole See-Through Trust Beneficiary, and all other beneficiaries are disregarded as "mere potential successors" because each could only take by reason of the death of the primary beneficiary. This is because the Regulations state that a beneficiary does not need to be counted as a See-Through Trust Beneficiary, "merely because the person could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death."[56] This language from the Regulations refers to "one of employee's beneficiaries," which is a reference to only one beneficiary, not a group of beneficiaries. Technically speaking, the interest of any remainder beneficiary of a so-called "conduit pot trust" is subject to a more complex array of contingencies than the death of one beneficiary. This means that other contingencies besides the death of one beneficiary are in play, and as such, it may not be possible to disregard the interest because it is more than that of a "mere potential successor."

B. Why "Conduit" Withdrawal Rights Do Not Qualify.

Will a trust be viewed as a conduit trust (*i.e.*, the primary beneficiary is the "sole" See-Through Trust Beneficiary and others are disregarded as "mere potential successors") if the trust provides the primary beneficiary with the unqualified right to withdraw conduit amounts, rather than mandating distribution? The IRS position is clearly, "no." The specific facts in Example 2 of the Regulations[57] are that all retirement plan distributions from the plan ("Plan X") that may be made to the trust ("Trust P") during the primary beneficiary's lifetime must be distributed to the primary beneficiary ("B"), and the Regulations reason that:

> *No amounts distributed from . . . Plan X to Trust P are accumulated in Trust P during B's lifetime for the benefit of any other beneficiary. Therefore, the residuary beneficiaries of Trust P are mere potential successors to B's interest in Plan X.*

If a withdrawal power over plan distributions is not exercised currently, the plan distribution proceeds may accumulate in the trust for other beneficiaries, which means that the primary beneficiary is no longer the "sole" beneficiary, and therefore other beneficiaries cannot necessarily be ignored as "mere potential successors." This view is confirmed in Rev. Rul. 2006-26, which primarily addresses issues relating to the marital deduction for estate tax when an IRA is designated to a Qualified Terminable Interest Property (QTIP) marital trust, but also includes the following statement:

> *Taxpayers should be aware, however, that in situations such as those described in this revenue ruling in which a portion of any distribution from the IRA to Trust may be held in Trust for future distribution rather than being distributed to B currently, B is not the sole designated beneficiary of A's IRA. As a result, both B and the remainder beneficiaries must be taken into account as designated beneficiaries in order to determine the shortest life expectancy and whether only individuals are designated beneficiaries. See A-7(c) of § 1.401(a)(9)-5.*

[54] Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2.
[55] Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2.
[56] Reg. § 1.401(a)(9)-5, A-7(c)(1).
[57] Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2.

C. "Toggle Power" to Change From Conduit to Accumulation Trust.

An innovative toggle power concept has been approved in a private letter ruling obtained by Robert Keebler, CPA, in Green Bay, WI, that allows an independent trustee to switch a conduit trust into an "age-restricted" accumulation trust. This is inventive planning, and the logic of the technique is compelling, because no matter what happens, the trust will fall within either the "conduit" or the "age restriction" methods of complying with the MRD Rules to allow distributions over the "target life" (normally that of the primary beneficiary).[58] Clearly the IRS was persuaded, because it ruled favorably, and some excellent work was surely involved in obtaining the favorable ruling result.

Nonetheless, one must be mindful that the very existence of the switching power could be argued to disqualify the trust as a "conduit trust," because the existence of the power means that it is theoretically possible there could be accumulations and, as a result, the trust would have more than one See-Through Trust Beneficiary and remainder beneficiaries who may not necessarily be disregarded as "mere potential successors." If the switching power disqualifies the trust as a conduit trust, the trust must be analyzed at inception taking into account all of the possible beneficiaries other than those who can be disregarded as "mere potential successors," regardless of whether the switching power is ever exercised. If any beneficiaries exist who are not recognized as having sufficient life expectancy (which is common – the trust in the ruling allowed a charity as a potential recipient of a power of appointment), the trust could fail to qualify for the intended deferral period.

Although not mentioned directly in the ruling, your author understands that this toggle power was drafted to require action prior to the September 30 Determination Date. In fact, the ruling states that the taxpayer has represented that the exercise of the toggle power by the Trust Protector of the trust is "treated as a disclaimer for all purposes associated with this ruling request." One assumes that the I.R.S. relied on this representation to recognize the trust protector's exercise of the power was comparable to a disclaimer and could be taken into account as a post-mortem event that causes certain alternate beneficiaries to "drop out" between the death and the Determination Date. It would then follow that such an exercise of the toggle power obviates the concerns mentioned above that the very existence of the power creates additional contingencies that interfere with disregarding alternate takers as "mere potential successors." However, your author questions whether the exercise of the toggle power bears any resemblance to a disclaimer, and if it is not a disclaimer, it is not clear whether or not it can be considered at the Determination Date. Until there is more authority confirming that such an exercise may be considered at the Determination Date even if it is not a disclaimer, caution is advised in using the toggle power.

D. Why Conduits for Alternate Beneficiaries May Not Qualify.

If the primary beneficiary of an accumulation trust is not entitled to conduit distributions, would providing a conduit trust for each "second tier beneficiary" allow exclusion of those who take after the "second tier beneficiaries" from the pool of See-Through Trust Beneficiaries? If this approach works, it produces the same outcome as the "outright gift to 'second tier' beneficiaries" approach discussed in Section V., but allows the advantage of a continuing trust structure for the second tier beneficiaries. Although at first blush this approach may seem a reasonable extension of the final Regulations, it probably does not work for the reasons discussed next.

Assume that an accumulation trust is established at IRA Owner A's death for child C, and at C's death, the balance of the trust is divided equally to form conduit trusts for D and E. C, D, and E must be considered as See-Through Trust Beneficiaries.

The Regulations provide that if another trust is a beneficiary of the trust, the other trust's beneficiaries also must be considered in determining the qualification of the trust.[59] The Regulations provide a set of two examples in which the primary beneficiary of a conduit trust is the sole See-Through Trust Beneficiary,[60] but a careful reading of these examples is essential to analyze the implications of a "second tier conduit trust."

In Example 1 of the regulation, A designates his retirement plan to a trust for his Spouse B that otherwise qualifies as a See-Through Trust. The trust pays income only to B, the remainder passes to the children of A and B, and there are no other individuals with a beneficial interest in the trust (not a "real world" assumption, but perhaps a short-hand way of saying that all other contingent beneficiaries were disregarded as "mere potential successors" because the children take outright and

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[58] PLR 2005-37-044.
[59] Reg. § 1.401(a)(9)-4, A-5(d).
[60] Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2.

free of trust). The Regulations state that in this fact pattern, the trust's See-Through Trust Beneficiaries consist of B and each child.

Example 2 of the regulation uses the same fact pattern, except that the trust requires that all distributions from the retirement plan made to the trust *"while B is alive"* (this phrase is important, as discussed next) shall be distributed directly to B. The Regulations conclude that in Example 2, B is the only See-Through Trust Beneficiary, and that the children may be disregarded as "mere potential successors" because no amounts distributed from the retirement plan will be accumulated for the benefit of anyone other than B. (By the way, even though Example 2 of the regulation refers to plan distributions made "while B is alive," it seems clear that the regulation should be interpreted as if it referred to distributions made "after A's death and while B is alive.")

Returning to the above example, there is no assurance that the "second tier conduit trust" beneficiaries, D and E, will receive all of the distributions made "after A's death and while the conduit beneficiary is alive," because plan distributions might be distributed from the initial accumulation trust to C. Consequently, the alternate takers after D and E may not be disregarded as "mere potential successors" because their interests now depend on a more complex array of contingencies than would be the case with the conduit trust described in Example 2 of the Regulations.[61]

Even if a clause were added to the initial accumulation trust for C requiring that all retirement plan distributions be accumulated for the eventual benefit of D and E, retirement plan distributions made while C is alive are not being distributed timely to D and E, and the arrangement still deviates significantly from the conduit trust described in Example 2 of the Regulations,[62] which again means that the alternate takers after D and E may not be disregarded as "mere potential successors" because their interests depend on a more complex array of contingencies than in Example 2.

E. Trust That Converts to Conduit Trust for "Last One Standing" May Not Qualify.

Is it possible to exclude more remote beneficiaries by creating a trust that begins as a "last one standing" accumulation trust and mandates a switch to a conduit trust if and when there is only one class member living? If so, this technique produces the same outcome as the "last one standing" approach discussed in Section VII., but allows the advantage of a continuing trust structure for the last one standing. Unfortunately, this approach probably does not work for the reasons described in the preceding section.

[61] Id.
[62] Id.

V. Non-Conduit Trust Providing Outright Gift to "Second Tier" Beneficiaries.

A. Background.

In those situations where a trust cannot be a conduit trust for some reason, there will be no conduit clause to limit the pool of See-Through Trust Beneficiaries to one beneficiary. The "outright gift to 'second tier' beneficiaries" is the first of three alternative techniques to consider when the conduit trust approach is not a good fit (*e.g.*, for a special needs trust that cannot mandate conduit distributions). The other two techniques, the "age restriction" approach and the "last one standing" approach, are discussed in the following two sections. Each of these three alternative techniques presents trade-offs that must be evaluated in light of each client's circumstances. The "outright gift to 'second tier' beneficiaries" may be the best choice when the client's overall financial and tax objectives do not require a continuing trust arrangement for the "second tier beneficiaries" (*i.e.*, the beneficiaries who would take after the primary beneficiary's death).

The "outright gift to 'second tier' beneficiaries" approach limits the pool of See-Through Trust Beneficiaries by relying on the rule under the final Regulations that a successor beneficiary may be excluded if he or she has no right (including a contingent right) to a plan interest beyond being a "mere potential successor" to the interest of another beneficiary upon that other beneficiary's death.[63] This approach provides that at the primary beneficiary's death, the trust interest will pass outright to the next tier of beneficiaries. These outright gifts must not be subject to any condition (other than surviving the primary beneficiary), not even an age restriction. The "second tier" beneficiaries still must be included, along with the primary beneficiary, in the pool of See-Through Trust Beneficiaries, but the more remote contingent beneficiaries may be excluded as "mere potential successors." This approach will rarely, if ever, limit the pool of See-Through Trust Beneficiaries to just one beneficiary, but if implemented effectively, has the potential to effectively limit the overall pool of See-Through Trust Beneficiaries to a known and manageable group of individuals.

The outright gifts to the "second tier" beneficiaries approach has its disadvantages that must be considered before proceeding. If a second tier beneficiary is very young, the termination of the trusts may result in loss of the benefits the trusts are intended to provide, and assets falling into the lap of a young person could do serious damage. If the second tier beneficiary is disabled or has special needs, the consequences could be even worse.

B. Case Study: Madeleine Freeman.

Madeleine Freeman comes to you for advice. She has the same facts as Jane Reynolds (see Section II.), except that Madeleine's younger daughter, Gwyneth, has special needs, and Madeleine has decided that Gwyneth's share needs to be structured as a purely discretionary trust. (Madeleine will provide a conduit trust for her older daughter, Iris, in the manner discussed in Section II.)

C. Drafting Considerations.

The need for a purely discretionary trust rules out the use of the conduit approach in this situation. After reviewing the alternatives and trade-offs associated with each, Madeline decides that the "outright gift to 'second tier' beneficiaries" approach is best. Although Madeleine chose to provide a fully discretionary trust and not a special needs trust for Gwyneth, the "outright gift to 'second tier' beneficiaries" approach will provide the same outcome under the MRD Rules with either a discretionary or a special needs trust.

The discretionary trust will provide for Gwyneth for as long as she lives, and then will direct how the remainder passes at Gwyneth's death. It will not be possible to exclude the remainder beneficiaries from the pool of See-Through Trust Beneficiaries because they are more than "mere potential successors." (Because Gwyneth's interest in the trust is less than complete ownership of the assets, it follows that the remainder beneficiaries have more of an interest than just a "mere potential successor.")

In other words, we must consider the "first tier" beneficiary (*i.e.*, Gwyneth), and the "second tier" beneficiaries (those who are named to take the remainder) as part of the pool of See-Through Trust Beneficiaries. But if we can exclude the "third tier" or more remote alternative beneficiaries, we can at least limit the pool of See-Through Trust Beneficiaries to a group that is manageable for purposes of analysis and drafting. The way to accomplish this is to provide that the remainder is to pass outright to the "second tier" beneficiaries, who will consist of one or more individuals, *with no age requirements or*

[63] Reg. § 1.401(a)(9)-5, A-7(c).

other contingencies. This allows exclusion of any "third tier" or more remote beneficiaries as "mere potential successors" within the meaning of the final Regulations.

What if a discretionary trust provides that at the "first tier" beneficiary's death, the assets pass outright to the "second tier" beneficiaries, with no other contingencies, but also provides that if any "second tier" beneficiary does not survive the "first tier" beneficiary, certain "third tier" beneficiaries take subject to an age requirement? This works (i.e., this excludes the "third tier" beneficiaries from the pool of See-Through Trust Beneficiaries) if, and only if, the "second tier" beneficiaries are living at the retirement plan owner's death. Alternatively, if the discretionary trust provides that everyone takes outright with no age contingencies at the death of the "first tier" beneficiaries, then this should work in all scenarios.

Does it work if the accumulation trust directs that all interests pass outright at the "first tier" beneficiary's death, except that interests passing to individuals under age twenty-one pass to a custodian under the Uniform Transfers to Minors Act (a "UTMA" account)? Probably, as many consider a gift to a UTMA account to someone under age twenty-one as equivalent to passing outright for purposes of the MRD Rules, even though there does not seem to be any authority that provides specific guidance on this point. However, in the absence of specific guidance, it is best to avoid any age older than twenty-one in those jurisdictions (such as California) that allow an older age to be designated.

The form below assumes that Madeleine has directed the remainder of Gwyneth's trust to pass to Gwyneth's descendants, if any, and otherwise to Madeleine's older daughter, Iris or, if Iris is not then living, to Iris's descendants. These interests are to pass outright, with no contingencies or age requirements, except that the share for any taker who has not attained age twenty-one is to pass to a custodian under the Uniform Transfer to Minors Act (UTMA).

Upon Madeleine's death, if Gwyneth and at least one of Gwyneth's descendants are living at the time, the more remote tiers of beneficiaries (*i.e.*, Iris, Iris's descendants, and any more remote tiers) can be disregarded, and the pool of See-Through Trust Beneficiaries will consist of Gwyneth and her descendant(s) then living. If no descendant of Gwyneth is living on the Determination Date, then Iris becomes the "second tier" beneficiary (or if Iris is not then living or disclaims, Iris's then living descendants become the "second tier" beneficiaries), and the pool of See-Through Trust Beneficiaries for Gwyneth's discretionary trust will include Gwyneth and Iris (or Iris's descendants, as the case may be). If Iris is included, her life expectancy will be the measuring life for determining MRDs for Gwyneth's trust, as Iris is the oldest daughter.

The preceding paragraph highlights one of the advantages of the "outright to 'second tier' beneficiaries" approach, compared to other approaches discussed next that apply an age restriction. With the "outright to 'second tier' beneficiaries" approach, it is possible to qualify to use Gwyneth's life expectancy without deleting Iris as a remainder beneficiary, if Gwyneth has descendants at her mother's death. This outcome is determined on a "wait and see" basis. The age restriction methods, on the other hand, require either exclusion of Iris as a trust beneficiary, or raising the age restriction used which, in these facts, reduces deferral by four years.

Disabled Beneficiaries. As mentioned above, outright gifts to disabled beneficiaries could have negative consequences. The IRS has shown some receptiveness to continuing trusts for disabled beneficiaries in another context, allowing a charitable unitrust to qualify under IRC Section 664 even though distributions for a disabled beneficiary are made to a second trust, rather than outright.[64] The IRS also has been lenient in the retirement plan context, allowing a disabled IRA beneficiary's share to be transferred into a special needs trust without recognizing income under IRC Section 691 on the transfer, and also allowing the special needs trust to calculate distributions using the disabled beneficiary's life expectancy, even though the trust's beneficiaries included intestate heirs without any specific age restriction.[65] Nonetheless, one should avoid relying on a continuing trust for a disabled beneficiary as the equivalent of an outright gift for See-Through Trust purposes without more reliable authority, except in situations where it is feasible to condition the trust on obtaining a favorable private letter ruling. Of course, continuing trusts may be possible by incorporating some of the other alternatives discussed below.

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[64] Rev. Rul. 2002-20, 2002-1 CB 794.

[65] PLR 2006-20-025. The special needs trust described in this ruling did not include a conduit provision, and provided that at the primary beneficiary's death the balance of the trust would first be applied to satisfy any obligations owed by the beneficiary's estate to the state department of health, and that the balance would be distributed to the original IRA owner's intestate heirs. These intestate heirs could include individuals older than the primary beneficiary, but the IRS ruled that the trust could calculate its MRDs using the primary beneficiary's life expectancy, without any discussion of the possibility of older intestate heirs.

Conduit Trusts as "Second Tier" Beneficiaries. Could the same MRD outcome be accomplished by providing conduit trusts instead of individuals as "second tier" beneficiaries? Unfortunately, it seems that this approach is vulnerable to I.R.S. attack, as explained in Section IV.E.

Here are some drafting issues that were considered in drafting the forms that follow:

- *Powers of Appointment*. In Madeleine's situation, there is no need to provide a power of appointment over the younger daughter's trust. However, if such a trust were to include a power of appointment, the scope of permissible appointees are likely to be considered among the pool of See-Through Trust Beneficiaries, and would need to be carefully limited to ensure the intended outcome of qualifying the trust for "stretch-out" MRDs over the oldest daughter's life expectancy.

- *Powers to Modify or Decant.* Madeleine's situation does not necessarily call for a sophisticated trust that includes trust protectors with powers to modify, decanting clauses, and the like. However, if any sophisticated devices are included in the trust instrument or allowed under state law, they should be reviewed carefully to ensure that any powers that could be used to alter the remainder beneficiaries or the permissible appointees under a power of appointment are carefully limited to ensure the intended outcome of qualifying the trust for "stretch-out" MRDs over the oldest daughter's life expectancy.

- *Remainder and Contingent Beneficiaries.* Unlike the conduit trust described earlier, the drafter must be aware of the ages of the potential individuals who will be named as remainder and contingent beneficiaries, and who could potentially be the "second tier" beneficiaries at the time the trust's pool of See-Through Trust Beneficiaries is determined. The ultimate success of the strategy will depend on the ages of the primary and "second tier" beneficiaries at Madeleine's death (subject to disclaimers or other events, if any, that would be considered at the Determination Date).

    - It may not be necessary to apply an age limit to the "second tier" beneficiaries if the drafter is confident that the class of "second tier" beneficiaries will not produce any surprises in the form of an unexpectedly old beneficiary for MRD purposes.
    - Of course, there is always the possibility that none of the intended "second tier" beneficiaries will be living at the time of the Plan owner's death, in which case the alternate heirs provision could introduce an unexpectedly old beneficiary for MRD purposes. To avoid this, one could include language in the "alternate heirs" provision that requires outright distribution of retirement plan interests and excludes any person or entity that does not satisfy an age limit. However, this solution is broader than necessary, because it only needs to apply if none of the intended "second tier" beneficiaries are living at the Plan owner's death. See Section 2.5.3(b) for a narrower solution that only applies if needed.

D. SAMPLE FORM: "Outright to 'Second Tier' Beneficiary" Subtrust.

Here are sample clauses that might be used in Ms. Freeman's revocable trust:

2.4 Division Into Shares. Upon the death of the Settlor, the Trustee shall divide the remaining assets in such manner as will create, in the aggregate, equal shares consisting of one such share for each child of the Settlor who is then living and one such share for each child of the Settlor who is then deceased but has descendants then living. Each share set aside for a child of the Settlor who is then deceased but has descendants then living shall be further divided into shares for such descendants on the principle of representation. The share set aside for GWYNETH FREEMAN shall constitute a Discretionary Trust to be held and distributed in the manner set forth in Section 2.5 (and GWYNETH FREEMAN is sometimes referred to as the "Discretionary Beneficiary" of her Discretionary Trust). Each share set aside for a child (other than GWYNETH FREEMAN) or more remote descendant of the Settlor (each such child or more remote descendant is sometimes referred to as the "Beneficiary" of his or her trust) shall constitute a separate trust to be held and distributed in the manner set forth in Section 2.6 unless such Beneficiary shall have then attained Thirty-Five (35) years of age, in which case such Beneficiary's share shall be distributed to him or her outright and free of trust. If no descendant of the Settlor is then living, the Trustee shall distribute the trust estate in the manner set forth in Section 2.7 below.

2.5 Discretionary Trust. The Discretionary Trust for GWYNETH FREEMAN (or any other Discretionary Beneficiary, if applicable) shall commence upon the first receipt of property by the Trustee. Such property and any subsequent additions of property shall constitute the trust estate, which shall be held, administered and distributed pursuant to this Section 2.5.

2.5.1 Distribution of Principal and Income; Retirement Account Distributions. The Trustee may distribute, from time to time, to or for the benefit of the Discretionary Beneficiary as much (or as little or none) of the net income and, if insufficient, as much of the principal of the Discretionary Beneficiary's Discretionary Trust as the Trustee shall determine in its sole and absolute discretion. When making such distributions, the Settlor requests, but does not mandate, that the Trustee consider the Discretionary Beneficiary's other income or resources that are known to the Trustee, including his or her ability to obtain gainful employment and the obligations of others to support him or her. Distributions under this Section 2.5.1 shall be made first from current distributions the trust receives from Stretch-Out Retirement Accounts, next from Stretch-Out Retirement Account Accumulations (as defined in Section 2.5.2), and then from other trust assets. Any income not so distributed shall be added to principal.

2.5.2 Trust as Beneficiary of Retirement Account. The Settlor intends that each Discretionary Trust that owns an interest in one or more Stretch-Out Retirement Accounts enjoy the longest possible deferral period under the Minimum Distribution Rules with respect to each. Accordingly, the following shall apply to each Discretionary Trust hereunder:

(a) The Trustee of a Discretionary Trust that owns an interest in one or more Stretch-Out Retirement Accounts shall provide documentation to the respective administrators and custodians of said accounts in the manner prescribed under the Minimum Distribution Rules.

(b) In order to facilitate distribution requirements that may arise under Section 2.5.3 or elsewhere, the Trustee shall either create a separate share or otherwise account for distributions from said Stretch-Out Retirement Accounts made to the trust and accumulated therein, and said accumulations (net of expenses properly chargeable thereto and including current distributions from said Stretch-Out Retirement Accounts not yet accumulated, if any) shall be referred to as "Stretch-Out Retirement Account Accumulations."

2.5.3 Distributions On Death of Discretionary Beneficiary. The Trustee shall distribute said Discretionary Beneficiary's Discretionary Trust (including such items of property as may pass generally to said trust by reason of said Discretionary Beneficiary's death) in the following manner:

(a) The Discretionary Trust's interest in Stretch-Out Retirement Accounts, including all Stretch-Out Retirement Account Accumulations, shall be distributed outright and free of trust to the Discretionary Beneficiary's descendants on the principle of representation. If the Discretionary Beneficiary is not survived by any one or more of his or her descendants, said amounts shall instead be distributed outright and free of trust to the descendants of the Settlor on the principle of representation. With respect to any individual receiving a share under this Section 2.5.3(a) who has not yet attained Twenty-One (21) years of age, his or her share shall be distributed to the individual's parent or legal guardian (as selected by the Trustee if there is more than one available) as custodian under the California Uniform Transfers to Minors Act until said individual attains twenty-one (21) years of age.

If the Discretionary Beneficiary is not survived by any his or her descendants and is not survived by any of the Settlor's descendants, said amounts shall be distributed in the manner provided in Section 2.7, except as provided in Section 2.5.3(b).

(b) With respect to the Discretionary Trust's interest in any Stretch-Out Retirement Account, if the Discretionary Beneficiary survives the Settlor but was not survived by any of his or her descendants or by any of the Settlor's descendants as of the Settlor's death, and if the Discretionary Beneficiary was not survived by any of his or her descendants or by any of the Settlor's descendants at the Discretionary Beneficiary's death, then the Discretionary Trust's interest in said Stretch-Out Retirement Account, including all Stretch-Out Retirement Account Accumulations, shall be distributed outright and free of trust to the heirs of last resort enumerated in Section 2.7, determined by excluding any charity, estate, trust, or entity that is not an individual, and by excluding each individual born prior to *[insert appropriate date; for Freemans it would be January 1, 1994 reflecting Iris's year of birth]* as if he or she had predeceased the deceased Discretionary Beneficiary. With respect to any individual receiving a share under this Section 2.5.3(b) who has not yet attained Twenty-One (21) years of age, his or her share shall be distributed to the individual's parent or legal guardian (as selected by the Trustee if there is more than one available) as custodian under the California Uniform Transfers to Minors Act until said individual attains twenty-one (21) years of age.

(c) The balance of the trust not distributed under Sections 2.5.3(a) and 2.5.3(b) shall be distributed: [Provide terms of distribution that do not need to be constrained by MRD considerations; i.e., shares could continue in trusts or be subject to other contingencies.] If none of the [described recipients are able to take], the Trustee shall instead distribute said balance of the trust in the manner provided in Section 2.7 [outlining the "heirs of last resort"].

(d) For purposes of this Section 2.5.3, when the Trustee is directed to "distribute" an interest in a Retirement Account to an individual, the Trustee is to assign all of the Trustee's interests in and powers over said Retirement Account interest (*e.g.*, to direct investments and withdrawals) outright and free of trust to said individual, and such direction shall not be interpreted as requiring the Trustee to arrange for the assets held in the Retirement Account to be withdrawn from said Retirement Account. The Settlor specifically intends that any such "distribution" of a Retirement Account shall be handled in a manner that results in zero, or the minimum possible amount of income tax payable by either the trust or said individual.

(e) The administrators, custodians, or other fiduciaries of the respective Retirement Accounts shall incur no liability to the trust or to any of its beneficiaries for acting upon the written instruction of the Trustee in connection with distributions under this Section 2.5.3 or any other matter arising hereunder.

[The balance of the trust form is identical to the sample conduit trust form shown above, except for additional language added to Section 2.6.5 regarding GWYNETH.]

2.6.5 Death Before Complete Distribution. Upon the death of a Beneficiary, the Trustee shall distribute said Beneficiary's trust (including such items of property as may pass generally to said trust by reason of said Beneficiary's death) in such manner as the Beneficiary shall have effectively appointed, and shall divide the unappointed balance of the trust into shares on the principle of representation for the then living members of the class of descendants identified earliest below with at least one class member then living:

1st The deceased Beneficiary's descendants.

2nd If applicable, the descendants of the deceased Beneficiary's closest ancestor who was a descendant of the Settlor.

3rd The descendants of the Settlor.

If a share is so established for GWYNETH FREEMAN, said share shall be applied to create or augment a Discretionary Trust for her to be held, administered, and distributed as provided under Section 2.5. Otherwise, each share so established for a descendant shall be distributed to him or her outright and free of trust if he or she has then attained Thirty-Five (35) years of age, and each share so established for a descendant who has not attained Thirty-Five (35) years of age shall be applied to create or augment a trust for him or her to be held, administered, and distributed as provided under this Section 2.6 (each descendant shall be referred to as the "Beneficiary" of his or her trust). If none of the descendants described above are then living, the Trustee shall instead distribute said unappointed balance as provided in Section 2.7.

2.7 Alternate Heirs. If disposition be made under this Section 2.7, the Trustee shall distribute the affected trust estate to *[provide "heirs of last resort"]*.

VI. Non-Conduit Trust Providing Age Restriction.

A. Background.

There is another alternative that may merit consideration in those cases when planning objectives preclude the use of both conduit distributions and outright gifts to "second tier" beneficiaries. Under this "age restriction" alternative, the trust provides all of the normal powers of appointment and trusts for contingent and remainder beneficiaries, but excludes any potential recipient who would not be recognized as being "young enough" under the Minimum Distribution Rules (*i.e.* either an individual born in a year prior to the "target" year, a trust that does not qualify to use the life expectancy of an individual born no earlier than the "target year," or a charity, estate, or other entity that does not qualify to use a life expectancy). This should, by definition, produce a pool of See-Through Trust Beneficiaries that cannot have any member with a shorter life expectancy than the primary beneficiary. ***The reader should be aware that the use of an age restriction can produce unnatural and unexpected results and should be used only with the greatest caution, and only after careful review and discussion with the client.***

B. Case Study: George Young.

George Young comes to you for advice. He has the same facts as Jane Reynolds (see prior section), except that he does not want gifts to "second tier" or more remote beneficiaries passing outright. He expects that his youngest daughter, Olivia, will not manage money well, so he wants to provide a discretionary trust for her, rather than a conduit trust. He also wants Olivia's trust to include a power of appointment. George will provide a conduit trust for his older daughter, Ashley, in the manner discussed above.

C. Drafting Considerations.

Here are some drafting issues that were considered in drafting the forms that follow:

- *Using Age of Oldest Child Avoids Excluding Child as Alternate Heir.* If an age restriction is rigidly applied to Olivia's trust based on Olivia's age, her older sister Ashley will be excluded as an heir of Olivia's trust. This problem can be avoided by using Ashley's age to set the age restriction, but the trade-off is four less years of deferral. Many clients would likely approve this trade-off, and the sample form is drafted accordingly.

- *Limit Scope of Permissible Recipients Under Powers of Appointment.* Any power of appointment needs to be limited in scope to minimize the risk of jeopardizing the outcome under the MRD Rules, as discussed above in Section I.B.7.

- *Limit Age Restrictions to Stretch-Out Retirement Plan Assets.* The age restriction can, and should, be applied only to "stretch-out retirement plan" assets. Consider whether to require the trustee to account separately for stretch-out retirement plan assets (including accumulations in the trust from stretch-out retirement plan assets).

- *Powers to Modify or Decant.* Madeleine's situation does not necessarily call for a sophisticated trust that includes trust protectors with powers to modify, decanting clauses, and the like. However, if any sophisticated devices are included in the trust instrument or allowed under state law, they should be reviewed carefully to ensure that any powers that could be used to alter the remainder beneficiaries or the permissible appointees under a power of appointment are carefully limited to ensure the intended outcome of qualifying the trust for "stretch-out" MRDs over the oldest daughter's life expectancy.

D. SAMPLE FORM: Trusts for Remaindermen; Age Restriction.

Here are sample clauses that might be used in Mr. Young's revocable trust:

2.4 Division Into Shares. Upon the death of the Settlor, the Trustee shall divide the remaining assets in such manner as will create, in the aggregate, equal shares consisting of one such share for each child of the Settlor who is then living and one such share for each child of the Settlor who is then deceased but has descendants then living. Each share set aside for a child of the Settlor who is then deceased but has descendants then living shall be further divided into shares for such descendants on the principle of representation. The share set aside for OLIVIA YOUNG shall constitute a Discretionary Trust to be held and distributed in the manner set forth in Section 2.5 (and OLIVIA YOUNG is sometimes referred to as the "Discretionary Beneficiary" of her Discretionary Trust). Each

share set aside for a child (other than OLIVIA YOUNG) or more remote descendant of the Settlor shall constitute a separate Conduit Trust to be held and distributed in the manner set forth in Section 2.6 and each such child or more remote descendant is sometimes referred to as the "Beneficiary" of his or her Conduit Trust, except that any share for a child or more remote descendant who has then attained Thirty-Five (35) years of age shall be distributed to him or her outright and free of trust. If no descendant of the Settlor is then living, the Trustee shall distribute the trust estate in the manner set forth in Section 2.7 below.

2.5 Discretionary Trust. The Discretionary Trust for OLIVIA YOUNG (or any other Discretionary Beneficiary, if applicable) shall commence upon the first receipt of property by the Trustee. Such property and any subsequent additions of property shall constitute the trust estate, which shall be held, administered and distributed pursuant to this Section 2.5.

2.5.1 Distribution of Principal and Income; Retirement Account Distributions. The Trustee may distribute, from time to time, to or for the benefit of the Discretionary Beneficiary as much (or as little or none) of the net income and, if insufficient, as much of the principal of the Discretionary Beneficiary's Discretionary Trust as the Trustee shall determine in its sole and absolute discretion. When making such distributions, the Settlor requests, but does not mandate, that the Trustee consider the Discretionary Beneficiary's other income or resources that are known to the Trustee, including his or her ability to obtain gainful employment and the obligations of others to support him or her. Any income not so distributed shall be added to principal.

2.5.2 Discretionary Trust as Beneficiary of Retirement Account; Age Restrictions. The Settlor intends that each Discretionary Trust that owns an interest in one or more Stretch-Out Retirement Accounts benefit from an extended deferral period under the Minimum Distribution Rules with respect to each Stretch-Out Retirement Account of the trust. Accordingly, each Discretionary Trust shall be administered as follows:

(a) The Trustee shall either account separately or maintain separate shares in order to keep track of the source and amount of any Stretch-Out Retirement Account Accumulations held by the trust. *Please refer to Section 11.11, which grants the Trustee the power to divide a trust into two or more separate trusts having the same terms and conditions as the original trust in order to accomplish this purpose.*

(b) A person is a "Disqualified Recipient" with respect to a Stretch-Out Retirement Account if said person is not a Qualified Recipient (defined next). A person is a "Qualified Recipient" if that person would, had that person been designated as the sole death beneficiary of the Stretch-Out Retirement Account, be allowed under the Minimum Distribution Rules to calculate the minimum required distributions from said Stretch-Out Retirement Account following the year of Participant's death using the life expectancy of an individual born no sooner than January 1 of the calendar year of birth of the Settlor's oldest descendant living at the time of said Participant's death *[January 1, 1994, the year of ASHLEY'S birth, not OLIVIA'S as discussed above].*

(c) Any exercise of the limited power of appointment granted to the Beneficiary under Section 2.5.3 with respect to a Stretch-Out Retirement Account or Stretch-Out Retirement Account Accumulations therefrom shall be interpreted and carried out as if each and every person who is a Disqualified Recipient with respect to said Stretch-Out Retirement Account is deceased upon the Beneficiary's death or not then in existence, even if the result is that said exercise fails with respect to said assets. Notwithstanding the foregoing, any exercise of said limited power of appointment in favor of one or more Disqualified Recipients with respect to said assets shall not otherwise cause the exercise of such power of appointment to be deemed an invalid exercise.

(d) Any allocation or distribution of a Stretch-Out Retirement Account or Stretch-Out Retirement Account Accumulations therefrom arising by reason of the Discretionary Beneficiary's death under Section 2.5.4 shall be interpreted and carried out as if each and every person who is a Disqualified Recipient with respect to said Stretch-Out Retirement Account is then deceased or not then in existence, even if the result is that said allocation or distribution cannot be made for lack of any recipient who is not a Disqualified Recipient. Further, in the event any such allocation or distribution is made to a Discretionary Trust pursuant to Section 2.5.4, the Trustee shall administer the portion of the Discretionary Trust consisting of such allocation or distribution as if each and every person who is a Disqualified Recipient with respect to said Stretch-Out Retirement Account is then deceased or not then in existence.

(e) Any distribution of a Stretch-Out Retirement Account or Stretch-Out Retirement Account Accumulations therefrom under Section 2.7 shall be interpreted and carried out as if each and every person who is a

Disqualified Recipient with respect to said Stretch-Out Retirement Account Accumulations therefrom is then deceased or not then in existence.

2.5.3 Limited Power to Appoint Discretionary Trust at Death. Subject to the provisions of Section 2.5.2, the Discretionary Beneficiary shall have the limited power to determine the manner in which the principal and any undistributed income of his Discretionary Trust shall be distributed at his death. Said power may be exercised by the Discretionary Beneficiary in the manner provided in Section 10.14 and shall be limited only to provide distributions outright or in further trust in favor of any one or more descendants of the Settlor as the Discretionary Beneficiary shall determine, or if there are no other then living descendants of the Settlor, to any recipient designated by the Discretionary Beneficiary, but in no event to the Discretionary Beneficiary's creditors, his estate, or the creditors of his estate.

2.5.4 Death of Discretionary Beneficiary. Subject to the provisions of Section 2.5.2, upon the death of the Discretionary Beneficiary the Trustee shall distribute said Discretionary Beneficiary's Discretionary Trust (including such items of property as may pass generally to said trust by reason of said Discretionary Beneficiary's death) in such manner as the Discretionary Beneficiary shall have effectively appointed, if applicable, and shall distribute the unappointed balance of the trust among the then living members of the class of descendants identified earliest below with at least one class member then living, on the principle of representation:

1st The deceased Discretionary Beneficiary's descendants.

2nd The descendants of the Settlor.

Each share so established for a descendant shall be applied to establish or augment a Discretionary Trust for his or her benefit to be held and distributed as provided in Section 2.5 (each descendant is sometimes referred to as the "Discretionary Beneficiary" of his or her Discretionary Trust).

If none of the descendants described above are then living, the Trustee shall instead distribute said unappointed balance of the trust in the manner provided in Section 2.7.

[The balance of the trust form is identical to the sample conduit trust form shown in Section II., except that additional language must be added regarding OLIVIA, as follows. Note that the stretch-out retirement plan interests that pass to OLIVIA'S trust by reason of the death of another beneficiary will not be treated as "Stretch Out Retirement Accounts" in OLIVIA'S trust and, thus, will not be subject to the age-restriction provisions.]

2.6.5 Death Before Complete Distribution. Upon the death of a Beneficiary, the Trustee shall distribute said Beneficiary's trust (including such items of property as may pass generally to said trust by reason of said Beneficiary's death) in such manner as the Beneficiary shall have effectively appointed, and shall divide the unappointed balance of the trust into shares on the principle of representation for the then living members of the class of descendants identified earliest below with at least one class member then living:

1st The deceased Beneficiary's descendants.

2nd If applicable, the descendants of the deceased Beneficiary's closest ancestor who was a descendant of the Settlor.

3rd The descendants of the Settlor.

If a share is so established for OLIVIA YOUNG, said share shall be applied to create or augment a Discretionary Trust for her to be held, administered, and distributed as provided under Section 2.5. Otherwise, each share so established for a descendant shall be distributed to him or her outright and free of trust if he or she has then attained Thirty-Five (35) years of age, and each share so established for a descendant who has not attained Thirty-Five (35) years of age shall be applied to create or augment a Conduit Trust for him or her to be held, administered, and distributed as provided under this Section 2.6 and each of said descendants is sometimes referred to as the "Beneficiary" of his or her Conduit Trust. If none of the descendants described above are then living, the Trustee shall instead distribute said unappointed balance as provided in Section 2.7.

2.7 Alternate Heirs. Subject to the provisions of Section 2.5.2, if disposition be made under this Section 2.7, the Trustee shall distribute the affected trust estate to *[provide "heirs of last resort"]*.

VII. Non-Conduit Trust Providing Trusts for Descendants, All to "Last One Standing."

An alternative to the age restriction approach is to include a "last one standing" provision that provides, in concept, that if at some point in time there is only one qualifying member of a class, the trust terminates and is distributed outright to the sole remaining member of the class with no contingencies or age requirements. As a result, any more remote beneficiaries can be disregarded as "mere potential successors."

The "last one standing" scenario has disadvantages that must be considered before proceeding. If the last remaining member of the class is very young, the termination of the trusts may result in loss of the benefits the trusts are intended to provide, and assets falling into the lap of a young person may do serious damage. If the last remaining member of the class is disabled or has special needs, the consequences could be even worse. Thus, this is not likely to be the best alternative for Ms. Freeman, discussed earlier, who has two daughters, one of whom is disabled.

A client with a large number of descendants may be more willing to tolerate these risks, because the probability of the class shrinking to one member may be perceived as being very low, but the risks should be considered in every case.

For more discussion and sample forms, please refer to Section VIII.

VIII. Dynasty Trusts.

A. Background.

Your author has mixed feelings about the term "dynasty trust." It has different meanings to different people, and a sensational tone that suggests a grandiose purpose that may not necessarily reflect the intentions of some clients. Nevertheless, the term has become part of day-to-day planning for many planners, and serves as a general reference to a cluster of issues that are essential to developing a plan that addresses multi-generational tax planning issues.

For purposes of these materials, the term "dynasty trust" refers to a trust that:

- probably has a child as its initial primary beneficiary (*i.e.* the trust does not "skip" any generations);

- has as its distinguishing feature the absence of any set termination date for the primary beneficiary's trust, and in many cases a default scheme of distribution that replicates the trust for members of successive generations, delaying termination for as long as possible, and possibly continuing in perpetuity if established in a state that allows perpetual trusts;

- provides flexible distribution provisions to allow broad latitude in accumulating or distributing trust income or principal as circumstances and income tax rules evolve;

- includes a spendthrift clause, that may in some cases be established in a situs providing favorable creditor protection laws, and that may in some cases limit the degree of control over the trust by the primary beneficiary, all for the express purpose of providing the strongest protection against creditors;

- may in other cases grant a substantial degree of control over the trust to the primary beneficiary, which will vary based on each client's circumstances and planning objectives, but may include allowing the primary beneficiary to serve as sole trustee or cotrustee at a certain age, and will likely provide the primary beneficiary with a power of appointment. The power of appointment may allow a broad range or permissible appointees, or may limit the class of permissible appointees to some combination of family descendants and possibly spouses;

- may provide an Independent Trustee (or Trust Protector) mechanism to allow the exercise of tax-sensitive powers, and to provide a mechanism to change situs or adjust to other changes in the tax and legal environments; and

- has been drafted carefully to navigate through the technical issues that arise under the estate and generation skipping transfer taxes. For example, a dynasty trust will likely provide differing provisions for "exempt" assets (*i.e.*, assets that receive allocation of a decedent's generation skipping tax exemption), than for non-exempt assets. In particular, the trust will be drafted to ensure that "exempt" assets are not includible in the gross estate of the primary or other trust beneficiaries. The trust will likely include provisions that cause non-exempt assets to be included in the Primary Beneficiary's gross estate if it is believed that the property can pass at lower tax cost under the estate tax rather than the generation skipping transfer tax. The trust also may provide a mechanism for toggling the assets into or out of the primary beneficiary's gross estate in those situations when it is not clear whether the estate tax is the best alternative (*e.g.*, if one sibling has no descendants, his or her share of non-exempt assets could pass for the benefit of other siblings without triggering generation-skipping transfer tax, and probably should not be pulled into his or her gross estate).

B. Case Study: Blake and Alexis Carrington.

Blake and Alexis Carrington are married, with a large estate that includes both retirement and non-retirement assets, and they want all assets to pass in dynasty trusts along the lines described in the preceding section for their children and more remote descendants. The trusts should preserve maximum flexibility to allocate or not allocate generation skipping transfer tax exemption to the various retirement and non-retirement assets, depending on the circumstances at the time of allocation.

C. Drafting Considerations.

Dynasty Trust Drafting Dilemma. The dilemma in drafting a dynasty trust is to both (i) create a trust that, for purposes of the MRD Rules, will be recognized as having a "target" individual's life expectancy (normally the primary beneficiary, and in certain cases the oldest child or class member); and (ii) provide appropriate provisions that keep "exempt"

assets out of the estate of the primary beneficiary and that address whether and how "non-exempt" assets are to be included in the estate of the primary beneficiary.

How to Include Non-Exempt Retirement Assets in Primary Beneficiary's Gross Estate. If non-exempt assets are to be included in the primary beneficiary's estate, the most common technique for doing so is to provide the primary beneficiary with a testamentary power of appointment that is classified as a general power of appointment under IRC Section 2041. The most common way of drafting such a power is to include among the permissible appointees either the primary beneficiary's estate, creditors, or creditors of the estate, even if the scope of other permissible appointees has been limited (*e.g.* family descendants only).

This type of general power of appointment can be used in a dynasty trust that is a conduit trust without jeopardizing the trust's status under the MRD Rules, because the primary beneficiary is the sole See-Through Trust Beneficiary of a conduit trust. Note, however, that a conduit provision is not likely to make sense with the exempt portion of a dynasty trust (because "exempt" assets would be forced out of the trust and into the hands of the primary beneficiary). A conduit provision may be acceptable in some cases for the non-exempt portion of a dynasty trust. In other cases it may be better to use some other approach that allows accumulations of retirement plan distributions to fully realize the full spectrum of benefits that are possible from a dynasty trust.

Assuming a dynasty trust is not a conduit trust, typical drafting techniques that rely on powers of appointment that may or may not include the beneficiary's creditors, estate, or creditors of the estate cannot be used with retirement assets (both the balance inside the retirement plan as well as retirement assets previously distributed to and accumulated in the trust). This is because the estate, creditors, and creditors of the estate would be included in the pool of See-Through Trust Beneficiaries and preclude the ability to take MRDs over an individual's life expectancy. (See I.B.7. for in-depth discussion of MRD implications of powers of appointment.) What other alternatives might be available to force inclusion of retirement plan assets in the primary beneficiary's estate?

- What if the trust provides the primary beneficiary with a right to withdraw or compel distributions during life constituting a general power of appointment under IRC Section 2041? This power must not allow distributions to the beneficiary's creditors, but is nevertheless a general power of appointment if it extends beyond the ascertainable standard permitted under IRC Section 2041(b)(1)(A) (*e.g.* an unlimited power to withdraw, or a power to compel distributions for the primary beneficiary's "comfort"). Unfortunately, in most states, these broad lifetime powers will expose part or all of the retirement plan assets to the primary beneficiary's creditors. The potential exposure to creditors may be in conflict with the fundamental objectives of the trust, and from an MRD standpoint, the creditors may then be considered to be among the pool of See-Through Trust Beneficiaries (as discussed in Section I.B.8.). Thus, this first approach is not viable in most states.

- A similar approach that may reduce the potential creditor exposure in some states is to provide the primary beneficiary with the right, during his or her life, to withdraw the entire principal of the trust (or the retirement portion, including accumulations), but only with the consent of a person who is not an adverse party within the meaning of IRC Section 2041(b)(1)(C)(ii). One or more non-adverse persons could be designated as independent trustee for purposes of providing (or not providing) this consent. The requirement of consent by a non-adverse party may reduce exposure to creditors in some states.

- An alternative approach (sometimes referred to as the "Delaware Trap Method") is to both (i) provide the primary beneficiary with a testamentary limited power of appointment (*i.e.*, excluding creditors, the estate, and creditors of the estate), that specifically allows the primary beneficiary to exercise the power in a way that violates the requirements of IRC Section 2041(a)(3), and (ii) *make sure that once the trust is established, the primary beneficiary actually exercises the power in such a way.* IRC Section 2041(a)(3) provides that property shall be included in a decedent's gross estate if the decedent:

> *" . . . exercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power."*

An in depth treatment of IRC Section 2041(a)(3) is beyond the scope of these materials, but suffice it to say that a commonly used technique for violating IRC Section 2041(a)(3) involves the exercise by the holder of a limited power of appointment in a way that allows the property subject to the exercise to pass to a newly created trust with a new power of

appointment that extends the perpetuities period beyond the period of time allowed under the perpetuities period that applied to the property prior to the exercise of the power. The history of this provision and its use predates modern developments by some states to extend or abolish their respective rules against perpetuities, and care should be exercised in interpreting the statute and drafting powers and exercises intended to violate the statute.

Whether to Include Non-Exempt Retirement Assets in Primary Beneficiary's Gross Estate. It is difficult to predict in advance whether it is better for non-exempt assets to be included in the primary beneficiary's estate, or to allow the assets to pass subject to the generation-skipping transfer tax rules, which are likely to impose a tax on assets that pass to or for the benefit of skip persons. A number of variables are involved, and that analysis will be a moving target over time as circumstances and tax laws evolve. An in-depth treatment of this issue also is outside the scope of these materials, but a few key variables to consider include:

- The other assets that may be subject to transfer tax, and the amounts of transfer tax credits, exemptions, graduated rate brackets, *etc.* available to the primary beneficiary, spouse, or other family members;

- Whether it may be possible to pay transfer tax on a "tax exclusive" basis, such as the gift tax calculated on lifetime gifts (or the generation skipping transfer tax calculated on direct skips);

- The potential credit for taxes paid on prior transfers that is available under IRC Section 2013 with respect to estate tax payments, but not generation skipping transfer tax;

- The likelihood that the non-exempt assets will pass to persons or trusts who are skip persons, as generation skipping transfer tax would not apply if the assets pass to non-skip persons (*e.g.*, are assets likely to pass to or for the benefit of the primary beneficiary's other siblings, descendants, or perhaps even a "double skip" to or for the benefit of his or her grandchildren or more remote descendants);

- The potential for a new cost basis under IRC Section 1014 if the assets are included in the primary beneficiary's estate (assets that are not included in an estate but are subject to generation skipping transfer tax do not receive a new cost basis, except in the case of a taxable termination occurring at the same time as and by reason of the death of a decedent);[66]

- The potential deduction in respect of a decedent allowed under IRC Section 691(c) with respect to estate tax (but not gift or generation skipping transfer tax); and

- State transfer tax implications.

In concept, many practitioners prefer to draft the trust to provide that non-exempt assets are included in the primary beneficiary's gross estate. This puts a default mechanism in place that requires no follow up or additional action, and should produce the right result in many cases. As mentioned earlier, however, the standard general power of appointment provisions are likely to interfere with obtaining stretch-out for the trust if the trust is not a conduit trust. The preceding section identifies two alternative ways to avoid this dilemma when retirement assets are involved.

Because there is no way of knowing what facts or law changes lie ahead, an even better approach is to preserve flexibility by including a mechanism that can be used to "toggle" the non-exempt assets in or out of the primary beneficiary's estate. Here are some alternatives:

- Draft the dynasty trust to provide the primary beneficiary with a testamentary general power of appointment over non-exempt assets (subject to the discussion above regarding structuring general powers of appointment for retirement plan assets), and provide an independent trustee with a power to convert the testamentary general power to a testamentary limited power of appointment. The language providing this conversion power to the independent trustee should not allow the independent trustee to expand the scope of permissible appointees in a way that interferes with the intended MRD outcome for retirement plan assets. The language should also authorize the independent trustee to convert the testamentary limited power back to a testamentary general power. The language also should clarify how any document purporting to exercise the power should be interpreted if a conversion is subsequently made that conflicts with or restricts the appointment originally intended. It may be helpful to require that any document purporting to exercise the power of appointment be lodged with the

[66] IRC § 2654(a)(2).

trustee within a reasonable amount of time after execution, so that it is known what exercises are in effect at the time the independent trustee considers making a conversion.

- Same, except the primary beneficiary is initially provided a testamentary limited power of appointment. Under this approach, it is better to start with a testamentary general power of appointment, partly because it is probably more likely to produce the best result, and also because any estate tax in the primary beneficiary's estate arising within ten years of the death of the grantor may qualify for the credit for tax paid on prior transfers under IRC Section 2013 if the testamentary general power of appointment was provided by the grantor and not converted by the time of the primary beneficiary's death.

- Another approach is to employ the "Delaware Trap" method described above, and make sure the primary beneficiary has an exercise in place that violates IRC Section 2041(a)(3) if the assets are to be subject to estate tax. To remove the assets from the primary beneficiary's estate, the primary beneficiary must revise or cancel the existing exercise in a way that cures any violation of IRC Section 2041(a)(3). This approach requires cooperation and action by the primary beneficiary, which may or may not be as easy to obtain as the action of the independent trustee. It may be helpful to make provision in the trust document allowing others (conservator, or possibly an agent under a durable power of attorney) to act for the primary beneficiary if he or she is unable to act. A disadvantage of this approach is that the power initially provided to the primary beneficiary does not qualify for the credit for estate tax paid on prior transfers under IRC Section 2013,[67] as it is a testamentary limited power of appointment.

- Perhaps the best approach for non-exempt dynasty trusts that do not hold retirement plan assets is a combination of the first approach (begin with testamentary general power of appointment and provide independent trustee with power to convert to limited power of appointment), and the "Delaware Trap" approach, in that the power of appointment can be exercised in a way that could extend the vesting of property. If this approach is used, an additional provision, discussed below, should be included to cause estate inclusion of retirement plan assets without using the standard general power of appointment. As to the non-retirement plan assets, if the independent trustee converts the general power to a limited power, the primary beneficiary becomes able to unilaterally opt "in" and "out" of estate tax inclusion. Doing so seems preferable to starting out with the Delaware Trap approach. Starting with a testamentary general power of appointment puts the default plan in place that is most likely to produce the best outcome without requiring any affirmative action by the primary beneficiary or anyone else. If the primary beneficiary prefers to opt "out" of estate inclusion, he or she can communicate his or her wishes to the independent trustee who can, in turn, convert the general power to a limited "Delaware Trap" style power.

Excluding Exempt Retirement Assets From the Primary Beneficiary's Gross Estate. The tax objectives of an exempt dynasty trust will be accomplished regardless of whether the primary beneficiary holds a testamentary limited power of appointment over the exempt assets (including retirement plan assets), but in most cases there are other planning objectives served by granting such a power. For the power to be a limited power, it cannot include the power holder's creditors, estate, or creditors of the estate among the permissible appointees, which avoids the difficult dilemma discussed above.

In drafting this approach, it is desirable to start with a relatively standard limited power of appointment with the ability to make a "Delaware Trap" exercise disabled at first, to minimize the risk of an inadvertent inclusion of "exempt" assets in the primary beneficiary's gross estate. The independent trustee can be granted a power to expand the power to include "Delaware Trap" type exercises, or to convert the power to a general power of appointment. It is hard to imagine, based on today's tax laws, why anyone would want to make these changes, but flexibility is a valuable commodity and the requirement of action by the independent trustee seems to be a reasonable safeguard.

Qualifying the Dynasty Trust Plan Assets for Stretched-Out MRDs. One of the techniques described in the preceding sections will be needed to qualify the retirement plan assets of a dynasty trust for stretched-out MRDs.

In some cases, there may be substantial non-retirement plan assets to make full use of available GST exemptions, and it may be most practical to simply include a conduit clause in the non-exempt dynasty trust and designate retirement plan assets to that trust.

In other cases, a conduit clause may not be the solution. For example: (i) the asset mix may be such that it is not as clear whether retirement assets will be passing to the exempt dynasty trust, the non-exempt trust, or partly to each; (ii) the projected amount of distributions that would arise under a conduit clause may be too large in light of the projected needs of

[67] IRC § 2013(e).

the beneficiaries; or (iii) the best tax strategy may be for retirement assets (particularly if a Roth IRA) to pass to and accumulate in the exempt dynasty trust. In cases like these, a non-conduit approach may be needed, as discussed next.

Exempt Retirement Assets. The choice of method may be more difficult for “exempt” retirement assets. The conduit trust approach generally is not the best choice for “exempt” retirement assets, as there may be valuable transfer tax benefits if plan distributions can be accumulated in the trust. An accumulating trust is likely to provide stronger creditor protection, as well.

Also, accumulating taxable distributions at the trust level does not always produce higher income tax than if distributed to the beneficiary, and in some cases the trust level income tax may be lower. Variables such as the alternative minimum tax can cause variations from year to year, and careful planning on a year to year basis to set the optimal level of distributions may produce the lowest combined income tax over time.

The “outright gift to ‘second tier’ beneficiary” approach usually is not the best choice for “exempt” retirement assets, either, as the dynasty trust is generally intended to continue for as long as possible, rather than terminate at the death of the initial beneficiary.

Thus, for most dynasty trusts, the two remaining alternatives are either the “age restriction” or the “last one standing” approaches discussed in Sections VI. and VII.

The “age restriction” approach should be viewed as the default choice. Although this approach is more complex to draft, and could arbitrarily exclude certain contingent beneficiaries if they are too old, it provides greater overall flexibility.

The “last one standing” approach is less complex to draft, but it carries a significant disadvantage – the trust will terminate and distribute outright at such time that only one class member remains, regardless of the class member’s age, health, or other circumstances. This outcome conflicts generally with the objective of continuing a dynasty trust for as long as possible, and could result in serious problems in specific situations involving young, disabled, or spendthrift beneficiaries. The problems of a young beneficiary can be mitigated somewhat with a provision for a UTMA account until age twenty-one, but this is obviously not a complete solution.

A client with a large number of descendants may be so confident that there will always be more than one descendant that the “last one standing” approach will be best. But in most cases, the “age restriction” approach (using the oldest child’s age as the “target age”) will probably be best.

Non-Exempt Retirement Assets. Once the technique has been determined for “exempt” retirement plan assets, the next step is to assess whether to use the same or a different technique for “non-exempt” assets. This determination also may vary with each case, and will reflect an overall comparison of the advantages and disadvantages of each option.

For example, some clients may prefer to use a standard conduit arrangement on “non-exempt” retirement assets even though it does not make sense for “exempt” retirement assets.

Generally, it is best to extend the same technique selected for “exempt” retirement assets to the “non-exempt” retirement assets, except when the disadvantage of the technique selected for “exempt” assets is significant enough to suggest that a conduit approach should be used, instead. In that event, it is important to pay close attention to the coordination of retirement plan designations that is discussed next.

Coordinating Retirement Plans and Division Between Exempt and Non-Exempt Trusts. It is common for the instrument that provides for a dynasty trust to allow the trustee to subdivide the trust into an “exempt” and “non-exempt” dynasty trust, based on how the decedent’s GST exemption is allocated.

If retirement assets will simply be designated to the dynasty trust, the exempt and non-exempt dynasty trusts should be drafted using the same see-through trust approach. There are two reasons for this.

The first reason has to do with the generation-skipping transfer tax. The division of the dynasty trust into exempt and non-exempt subtrusts is allowed for generation-skipping transfer tax purposes provided that the requirements of Regulation Section 26.2654-1(b)(1) are satisfied. These requirements are:

- Assets of the dynasty trust may be divided on a pecuniary basis only if required in governing instrument, with assets divided in a "fairly representative" manner and appropriate interest paid;

- Otherwise assets of the dynasty trust must be divided on a fractional basis and may be divided non pro rata based either on date of funding values or "fairly representative" manner; and

- The two new subtrusts may have differing provisions, so long as the terms in the aggregate provide for the same succession of interests and beneficiaries as provided in the original subtrust.

The second reason has to do with the see-through trust rules. If the dynasty trust is designated, it is the dynasty trust that will be analyzed on a pre-split basis under the see-through trust rules. If the exempt and non-exempt subtrusts use different see-through trust mechanisms, the dynasty trust as a whole will not qualify under any one mechanism and it is unlikely to qualify as a see-through trust with the intended beneficiary as the measuring life.

As discussed in the preceding section, there may be advantages to using different see-through trust techniques. For example, the exempt subtrusts may use an age restriction approach and the non-exempt subtrusts may use a conduit approach. When different techniques will be used, it is essential that the division of the retirement assets as between the exempt and non-exempt subtrusts is "hard-wired" in the death beneficiary designation or governing document of the retirement plan. This is a situation where a Trusteed IRA can be particularly helpful, as a custom-drafted Trusteed IRA document could contain a sophisticated formula clause governing the division of the IRA as between the exempt and non-exempt subtrusts.

D. SAMPLE FORM: Conduit Dynasty Trust.

Here is a sample dynasty trust form that uses a conduit clause to accomplish stretched-out distributions. As discussed above, there are trade-offs associated with using a conduit clause in a dynasty trust, and other alternatives should also be considered.

Other provisions that are scattered throughout the trust instrument that coordinate with the dynasty trust are also included, for ease of reference.

Author's Notes:

1. *The following form refers to the dynasty trusts as "Descendants Trusts."*

2. *The following form reflects a joint revocable trust approach, common in the author's State of California.*

3. *The testamentary powers of appointment and remainder provisions have not been modified to accommodate MRD planning considerations because this form relies on a conduit distribution provision.*

4. *See Section 6.6 regarding the office of Independent Trustee, and particularly Section 6.6(e) which is an important safeguard to ensure that the Independent Trustee's broad powers will not interfere with "conduit trust" status under the MRD Rules.*

5.2 Division of Trust Residue Into Shares. The Trustee shall divide the balance of the property passing pursuant to this Section 5 ("Residual Property") as follows:

(a) Descendants Trusts for Descendants. If one or more of the Settlors' descendants are then living, the Trustee shall divide the Residual Property in such manner as will create, in the aggregate, separate equal shares consisting of one share for each then living child of the Settlors and one share for each then deceased child of the Settlors who has descendants then living. Each share set aside for a deceased child of the Settlors who has descendants then living shall be further divided into shares for said descendants on the principle of representation. Each share so created for a child or more remote descendant of the Settlors shall constitute a separate Descendants Trust to be held and distributed for his or her benefit as provided in Section 5.3 (each is referred to as the "Beneficiary" of his or her Descendants Trust).

(b) Alternate Distribution if No Descendants. If no descendants of the Settlors are then living, the Trustee shall instead distribute the Residual Property in the manner set forth in Section 5.4 ("Alternate Distribution").

5.3 Descendants Trusts. The Descendants Trust for each Beneficiary shall commence upon the first receipt of property by the Trustee. Such property and any subsequent additions of property shall constitute the trust estate, which shall be held, administered and distributed pursuant to this Section 5.3, and if applicable, shall be further divided into an "Exempt Trust" and a "Non-Exempt Trust" as provided in Section 10.11.

(a) Distribution of Income and Principal.

(i) The Trustee may (but shall not be required to) distribute, from time to time, to or for the benefit of the Beneficiary as much of the net income and, if insufficient, the principal of the trust as the Trustee deems necessary for the Beneficiary's health, education, and support in his or her accustomed manner of living (including the tuition or medical expense of the Beneficiary's descendants).

(ii) In addition, the Independent Trustee (as defined in Section 6.6) may (but shall not be required to) distribute to or for the benefit of the Beneficiary as much of the net income and, if insufficient, as much of the principal of the trust as the Independent Trustee determines in the Independent Trustee's sole discretion.

(iii) When making such distributions, the Trustee (or Independent Trustee as the case may be) may consider (or not consider) the Beneficiary's other income or resources that are known to the Trustee including, by way of example and not limitation, resources held in other trusts for the benefit of the Beneficiary, current or anticipated distributions under Section 5.3(b), the Beneficiary's ability to obtain gainful employment, the obligations of others to support the Beneficiary, and the Beneficiary's Tax-Advantaged Accounts, if any. The Settlors request, but do not require, that any benefits of income tax deferral that the Beneficiary can accomplish by accumulating his or her Tax-Advantaged Account assets for as long as possible be included among all relevant considerations in determining the Beneficiary's available resources, and in determining the nature and extent of distributions, if any, to be made to the Beneficiary under this Section 5.3(a).

(iv) Distributions for the tuition or medical expense of the Beneficiary or a descendant of the Beneficiary shall be made (a) directly to the respective educational institution or medical provider and not to the Beneficiary or descendant directly, and (b) to the greatest extent possible from Non-Exempt assets.

(v) Distributions of income or principal to or for the benefit of a Beneficiary who is not a Skip Person (as that term is defined for generation skipping transfer tax purposes under the Code) shall be made to the greatest extent possible from Non-Exempt assets.

(vi) With respect to all other distributions of income and principal under this Section 5.3(a), the Trustee may make such distributions either on a pro rata or a non pro rata basis and may distribute any portion, all or none from either Exempt assets or Non-Exempt assets as the Trustee determines in the Trustee's sole discretion.

(vii) Any income not so distributed shall be added to principal.

(b) Conduit Distributions. To the extent the Trustee receives distributions from a Stretch-Out Retirement Account (as defined in Section 13.23) as to which the Beneficiary is the Stretch-Out Retirement Beneficiary (as defined in Section 13.25), the Trustee shall distribute to or apply for the benefit of the Beneficiary all of said distributions (net of expenses, and net of income, estate, inheritance, generation-skipping transfer tax, or any other tax, to the extent said expenses and taxes are properly allocable to distributions received or to the balance remaining in said Stretch-Out Retirement Account), for as long as the Beneficiary shall live or until the earlier termination of his or her trust.

(c) Limitations on Trustee's Power to Take Distributions. For so long as the Beneficiary is the Stretch-Out Retirement Beneficiary of a Stretch-Out Retirement Account, the following individuals, while serving as Trustee, are prohibited from withdrawing Excess Distributions (as defined in Section 13.8) from said Stretch-Out Retirement Account: (i) the Beneficiary; (ii) any individual who made a qualified disclaimer of any interest in said Stretch-Out Retirement Account; and (iii) any individual who owes a legal obligation of support to the Beneficiary. The power to withdraw such Excess Distributions shall be reserved to others serving jointly as Trustee who are not so prohibited from withdrawing Excess Distributions. If no such Trustee is then serving, the Independent Trustee shall have the power to direct the Trustee to make (or not make) such Excess Distributions.

(d) Limited Power to Appoint Exempt Trust at Death. Each Beneficiary who has attained twenty-five (25) years of age shall have the limited power to appoint the manner in which the principal and any undistributed income of his or her Exempt Descendants Trust shall be distributed at his or her death, outright or in trust, in favor of any one or more appointees as the Beneficiary designates, other than the Beneficiary's creditors, estate, or the creditors of the Beneficiary's estate. Said power shall be exercisable by the Beneficiary in the manner provided in Section 10.14, except that said power may not be exercised in a way that would cause all or any portion of the Exempt Trust to be included in the Beneficiary's gross estate under IRC Section 2041(a)(3).

(e) General Power to Appoint Non-Exempt Trust at Death. Each Beneficiary shall have the general power to appoint the manner in which the principal and any undistributed income of his or her Non-Exempt Descendants Trust shall be distributed at his or her death, outright or in trust, in favor of any one or more appointees as the Beneficiary designates, including the creditors of the Beneficiary's estate. Said power shall be exercisable by the Beneficiary in the manner provided in Section 10.14.

(f) Death of Beneficiary. Upon the death of a Beneficiary, the Trustee shall distribute said Beneficiary's Descendants Trust (including such items of property as may pass generally to said trust by reason of said Beneficiary's death) in such manner as the Beneficiary shall have effectively appointed, if applicable, and shall divide the unappointed balance of the trust into shares on the principle of representation for the then living members of the class of descendants identified earliest below with at least one class member then living:

1st The deceased Beneficiary's descendants.

2nd If applicable, the descendants of the deceased Beneficiary's closest ancestor who was a descendant of the Settlors.

3rd The descendants of the Settlors.

Each share so established for a descendant shall be applied to create or augment a Descendants Trust to be held and distributed for him or her as provided in this Section 5.3 (each descendant shall be referred to as the "Beneficiary" of his or her Descendants Trust). If none of the descendants described above are then living, the Trustee shall instead distribute said unappointed balance as provided in Section 5.4.

5.4 Alternate Distribution. The Trustee shall distribute any portion of the trust estate passing pursuant to this Section 5.4 to [specify alternate beneficiaries]

6. Trustee.

6.1 Initial and Successor Trustees. BLAKE CARRINGTON and ALEXIS CARRINGTON shall serve as the initial Co-Trustees. If either BLAKE CARRINGTON or ALEXIS CARRINGTON shall become unwilling or unable to serve as Trustee, the other of them shall serve as sole Trustee.

(a) General Rule for Successor Trustees. Except as provided in Section 6.1(b), upon the establishment of any trust hereunder, or upon a vacancy in the office of trustee of any trust hereunder, if neither Settlor is willing and able to serve, TRUST COMPANY shall serve as Trustee.

(b) **Successor Trustees of Descendants Trusts**. After the death of the Surviving Settlor, upon the establishment or upon a vacancy in the office of Trustee of a Descendants Trust, those designated earliest below who are willing and able shall serve as Trustee of said Descendants Trust:

1ST The Beneficiary of the Descendants Trust, if he or she has attained Thirty-Five (35) years of age.

2ND If the Beneficiary is a grandchild or more remote descendant of the Settlors, the Beneficiary's parent who is a descendant of the Settlors.

3RD The Beneficiary's parent who is the Spouse (or Surviving Spouse) of a descendant of the Settlors.

4TH TRUST COMPANY.

6.3 **Power to Remove, Replace or Designate Trustee.** Upon the death or disability of either Settlor, the other Settlor may, from time to time with respect to any trust (i) remove the Trustee and appoint one or more replacement Trustees (including himself or herself), or (ii) designate successor Trustees. Any such removal, replacement or designation of successors shall take precedence over the designations of successors contained in this instrument or previously made by the other Settlor or others. Upon the death or disability of the Surviving Settlor, the Settlors' then living children, acting in concert, may exercise said powers.

Upon the death of the Surviving Settlor, the Beneficiary of a Descendants Trust who has attained Thirty-Five (35) years of age may, from time to time with respect to said Descendants Trust (i) remove the Trustee of the trust and appoint one or more replacement Trustees (including himself or herself), or (ii) designate successor Trustees. Any such removal, replacement or designation of successors shall take precedence over the designations of successors contained in this instrument or previously made by the Surviving Settlor or others.

Any such removal, replacement or designation of successor Trustee shall be in the form of a writing delivered to the Trustee and filed with the records of the trust. Upon approval of the removed Trustee's final accounting by those entitled to it and acceptance of the trust by the successor Trustee, the removed Trustee shall be discharged.

6.6 **Independent Trustee.** The Settlors intend that the Trustee of each trust hereunder that is irrevocable have the ability to appoint an Independent Trustee on an "as needed" basis whose sole purpose would be to exercise tax sensitive or other discretionary powers. An Independent Trustee who so serves shall serve solely for such purpose and shall have no responsibility for the administration and management of the trust estate. No Independent Trustee shall be liable to any beneficiary of a trust established by this instrument or to any permissible appointee under any power of appointment for any good faith exercise, or non-exercise, of his or her powers under this instrument.

(a) The office of Independent Trustee shall be vacant at the time an irrevocable trust is first established. If at any time the office of Independent Trustee is vacant and the Trustee determines in its sole discretion that an Independent Trustee is needed, the Trustee shall select one or more "Qualified Persons" (defined below) to so serve. The Trustee may appoint himself, herself, or itself if the Trustee is a "Qualified Person."

(b) With respect to a trust, a person or entity is a "Qualified Person" if the person or entity is a corporation, partnership, limited liability company or an individual qualified to act as a trustee in the United States or any other common law jurisdiction other than a Settlor, a beneficiary of the trust, or a person who is a "related or subordinate party" (as such term is defined in Code Section 672) with respect to a Settlor or beneficiary of the trust.

(c) The Trustee's appointment of an Independent Trustee shall be in the form of a writing delivered to the appointee and filed with the records of the trust. Said appointee assumes the office of Independent Trustee upon the delivery of written acceptance to the Trustee and remains in office until he, she, or it resigns or is otherwise unable to serve, and may not be removed under Section 6.3.

(d) The Independent Trustee shall have the following powers in addition to any other powers specifically vested in the Independent Trustee under this instrument:

(i) to make distributions or exercise any other power to the extent that doing so would discharge the Trustee's legal obligation to support a dependent;

(ii) to hold and exercise all incidents of ownership with respect to any insurance policy on the life of the Surviving Settlor that is held in any irrevocable trust hereunder of which the Surviving Settlor is a Trustee in the manner provided in Section 8.3, and to hold and exercise all incidents of ownership with respect to any policy of insurance on the life of any other person serving as Trustee;

(iii) to grant, eliminate, or alter in any fashion a beneficiary's power of appointment (by way of example and not limitation, the Independent Trustee may exercise this power to cause trust property to become subject to estate tax rather than generation-skipping transfer tax at a beneficiary's death);

(iv) to grant, eliminate, or alter in any fashion a beneficiary's power to remove and replace a Trustee, or to designate successor Trustees;

(v) to exercise a right or power to the extent it has been disclaimed, released, or restricted in scope by the Trustee (unless such right or power is also disclaimed by the Independent Trustee); and

(vi) to exercise any other power specifically granted to the Independent Trustee under this instrument.

(e) Notwithstanding the foregoing, with respect to a Descendants Trust under Section 5.3 that holds an interest in a Stretch-Out Retirement Account as to which the Beneficiary is the Stretch-Out Beneficiary, the Independent Trustee shall not exercise any power hereunder in any way that might diminish the Beneficiary's interest in "conduit" distributions under Section 5.3(b).

(f) The Independent Trustee may disclaim, release, or restrict the scope of any power enumerated above at any time in connection with any trust.

9. Tax Apportionment Provisions.

9.3 "Stretch-Out Retirement Accounts" Passing Under Trust Instrument. The Trustee shall not apply Stretch-Out Retirement Account assets passing under any trust hereunder to pay any portion of a debt of the Settlor, expense of administration, or Death Tax arising by reason of a Settlor's death, except as follows:

(a) Payment Prior to September 30 Determination Date. If the Trustee determines, prior to the Determination Date (as defined in Section 9.3(c)), that all or any portion of a debt of a Settlor, expense of administration, or Death Tax is properly chargeable by reason of a Settlor's death to a beneficiary's interest in a Stretch-Out Retirement Account passing under any trust hereunder, the Trustee shall pay said amount prior to the Determination Date by applying the following assets in any combination the Trustee determines in its sole discretion (and such payment shall be credited against the amount chargeable to said Stretch-Out Retirement Account interest): (i) assets from said Stretch-Out Retirement Account interest; (ii) assets the beneficiary offers to provide for this purpose; or (iii) assets the Trustee selects for this purpose (other than assets qualifying for the charitable or marital deductions from federal estate tax in a Settlor's estate) from assets passing under any one or more trusts hereunder to or for the benefit of the beneficiary as determined by the Trustee in its sole discretion. Each Settlor requests, but does not require, that the Trustee apply assets other than Stretch-Out Retirement Account assets to pay said amount when doing so reduces the need to take a distribution from the Stretch-Out Retirement Account earlier than would otherwise be necessary, thus enhancing the beneficiary's ability to benefit from income tax deferred compounding.

(b) Amounts Determined On or After September 30 Determination Date. If the Trustee determines, on or after the Determination Date, that all or any portion of a debt of a Settlor, expense of administration, or any Death Tax would be properly chargeable by reason of a Settlor's death, but for the operation of this Section 9.3(b), to a beneficiary's interest in one or more Stretch-Out Retirement Account interests passing under any trust hereunder, the Trustee shall pay said amount by first applying the following assets in any combination the Trustee determines in its sole discretion: (i) assets the beneficiary offers to provide for this purpose; or (ii) assets the Trustee selects for this purpose (other than Stretch-Out Retirement Account assets or assets qualifying for the charitable or marital deductions from federal estate tax in a Settlor's estate) from assets passing under any one or more trusts hereunder to or for the benefit of the beneficiary as determined by the Trustee in its sole discretion; and the Trustee shall apply assets from said Stretch-Out Retirement Account interests to pay said amount only to the extent that said other assets are insufficient to do so.

(c) Determination Date. For purposes of this instrument, the term "Determination Date" means, with respect to a Stretch-Out Retirement Account as to which the Participant has died, the thirtieth day of September of the calendar year following the calendar year of the death of the Participant, or such other date as may be provided for determining post-death designated beneficiaries under the Minimum Distribution Rules (e.g., Treasury Regulations Section 1.401(a)(9)-4).

9.4 Tax-Advantaged Accounts or Other Assets Passing Outside Trust. If the Trustee determines that all or any portion of a debt of a Settlor, expense of administration, or Death Tax is properly chargeable, by reason of a Settlor's death, to a beneficiary's interest in property not passing under any trust hereunder (including by way of example and not limitation a Tax-Advantaged Account), the Trustee may in its sole discretion pay (or not pay) all or part of said amount by applying any combination the Trustee determines in its sole discretion of the following assets (and any such payment shall be credited against the amount chargeable to said interest in property not passing under any trust hereunder): (i) assets the beneficiary offers to provide for this purpose; or (ii) assets the Trustee selects for this purpose (other than assets qualifying for the charitable or marital deductions from federal estate tax in a Settlor's estate) from assets passing under any one or more trusts hereunder to or for the benefit of the beneficiary as determined by the Trustee in its sole discretion. Each Settlor requests, but does not require, that the Trustee apply assets other than Tax-Advantaged Account assets to pay said amount when doing so reduces the need to take a distribution from a Tax-Advantaged Account earlier than would otherwise be necessary, thus enhancing the beneficiary's ability to benefit from income tax deferred compounding. The Trustee's powers provided under this Section 9.4 are in addition to, and not in place of, other powers provided the Trustee under this or other instruments, or under applicable law.

10. Powers and Administrative Provisions.

10.11 Division Into Separate Trusts. The Trustee of a trust hereunder may divide the trust into two or more separate trusts having the same terms and conditions as the original trust in order to accomplish any purpose the Trustee determines is consistent with the purpose of the trust. For example, but not by way of limitation, a trust may be divided:

(a) To enable Tax-Advantaged Accounts to be segregated from other trust assets;

(b) To avoid holding one or more Stretch-Out Retirement Accounts with other trust assets; provided, however, that Stretch-Out Retirement Account Accumulations therefrom stay with the Stretch-Out Retirement Account;

(c) To avoid holding GST Exempt and GST Non-Exempt assets together in the same trust; and

(d) To avoid jeopardizing the S corporation status of any corporation seeking to maintain S corporation status as to which the trust is a shareholder.

When dividing a trust under this Section 10.11, the Trustee shall generally have the discretion to select the assets to be allocated to the trusts arising from such a division in any manner that is fair and equitable, except that with respect to any division into GST Exempt and GST Non-Exempt trusts, the Trustee shall allocate assets to the

trusts arising from such a division in a manner consistent with the requirements of Treasury Regulation Section 26.2654-1(b)(1) (or any related or successor rule or regulation).

Any separate trusts resulting from the division of an original trust pursuant to this Section 10.11 may be given descriptive names to distinguish them from one another. For example, a Descendant's Trust that is divided to avoid holding GST Exempt and GST Non-Exempt assets together in the same trust may be referred to respectively as a "GST Exempt Descendant's Trust" and a "GST Non-Exempt Descendant's Trust."

10.14 Exercise of Power of Appointment. The provisions of this Section 10.14 shall govern the exercise of any power of appointment granted under the provisions of this instrument:

(a) When exercising a power of appointment, the power holder may appoint outright or in trust, in present or future interests, or in any combination of these, and may create new restrictions, conditions and powers of appointment in or for the objects of the power, specifically including a general power of appointment exercisable by the object of the power during his or her lifetime (recognizing that the power holder may cause inclusion of assets in his or her estate by creating such a power). A power of appointment may be exercised in favor of such one or more of the class of permissible appointees in any proportions as the power holder shall direct and shall be exercised by the power holder only in the last (i) acknowledged written instrument delivered to the Trustee prior to the power holder's death or (ii) valid Will or Codicil of the power holder, which, in either case specifically refers to such power and expressly exercises it. The Trustee shall have the absolute power to determine which document constitutes the power holder's last acknowledged written instrument or his or her last valid Will or Codicil, and probate of such Will or Codicil shall not be required. The validity of a power holder's exercise of a testamentary power of appointment need not be determined prior to the power holder's death. Thus, such an exercise is not invalid if made by the power holder prior to attaining the minimum required age, so long as the power holder has attained that age prior to death; and an exercise is not invalid if the appointees indicated are not permissible appointee at the time of exercise but are permissible appointees at the time of power holder's death.

(b) Notwithstanding the foregoing, no power of appointment granted the Surviving Settlor may be exercised by the Surviving Settlor with respect to property held as a result of a disclaimer by the Surviving Settlor.

(c) The purported exercise of a power of appointment granted under this instrument shall be of no force or effect if such exercise was the result of compulsion. If such purported exercise is the result of compulsion, the Trustee shall administer the property subject to such power of appointment as if such exercise had not occurred. The exercise of a power of appointment shall be deemed to be the result of compulsion if such exercise is in response to or by reason of any order or other direction of any court, other than by the power holder's guardian or conservator acting by authority of a court of competent jurisdiction.

Author's Note: *The following clause is suggested for inclusion in the "boilerplate" of most trusts. However, some of the sample trusts illustrated in these materials address specific retirement plan related issues in the body of the dispositive language, which may require some adjustment to provisions that would otherwise appear in the "boilerplate" section.*

11.15 Trust as Beneficiary of Retirement Account. The Settlors intend that each trust hereunder that owns an interest in a Retirement Account enjoy the longest possible deferral period under the Minimum Distribution Rules. Accordingly, the following shall apply:

(a) The Trustee of a trust so designated shall, within the time limit prescribed under the Minimum Distribution Rules, deliver documentation required under said rules to the respective administrators and custodians of each Retirement Account.

(b) In addition to the powers granted to the Trustee by law or under other provisions of this instrument, the Trustee is authorized to exercise any power or right over a Retirement Account that is available to the Trustee as beneficiary or successor owner, including by way of example and not limitation powers to (i) select payment options, (ii) direct investments, and (iii) direct tax-free rollovers

from one Retirement Account to another (and to establish any new Retirement Account that is to receive the rollover, if applicable).

(c) When the Trustee makes a distribution or an allocation of an interest in a Retirement Account to or for the benefit of a beneficiary of a trust hereunder, the Trustee is to assign all of the Trustee's interests in and powers over said Retirement Account interest (*e.g.*, to direct investments and withdrawals) to said individual or trustee, as the case may be, and nothing under this instrument shall be interpreted as requiring the Trustee to arrange for the assets held in the Retirement Account to be withdrawn from said Retirement Account. The Settlors specifically intend that any such distribution or allocation of a Retirement Account shall be handled in a manner that (i) results in zero, or the minimum possible amount of income tax payable by either the trust, said individual, or said other trust, and (ii) results in no change, or the minimum possible amount of change, to the deferral period that applies to the Retirement Account.

(d) The administrators, custodians, or other fiduciaries of the respective Retirement Accounts shall incur no liability to the trust or to any of its beneficiaries for acting upon the written instruction of the Trustee pursuant to this Section 11.15.

12. Definitions. (The following are selected definitions relating to retirement plan issues. The term "Stretch-Out Retirement Beneficiary" will be important in drafting the conduit trust provisions discussed further below.)

12.5 Excess Distributions. The term "Excess Distributions" means, with respect to an interest in a Stretch-Out Retirement Account, any distribution in excess of those amounts reasonably necessary to: (a) comply with the Minimum Distribution Rules; (b) provide for the beneficiary's health, education, and support; (c) comply with the legal obligation to pay income, estate, inheritance, GST Tax, or other taxes properly chargeable to distributions received from or the balance remaining in said Stretch-Out Retirement Account; and (d) provide for payment of trust expenses properly allocable to distributions received from or the balance remaining in said Stretch-Out Retirement Account.

12.8 Minimum Distribution Rules. The term "Minimum Distribution Rules" means the incidental death benefit requirements of Code Section 401(a) and the minimum distribution rules of Code Section 401(a)(9) (or similar rules applicable to certain types of Retirement Accounts, including by way of example and not limitation the rules of Code Sections 408(a)(6) and 408(b)(3) that apply to IRAs, and the special rules of Code Section 408A(c)(5) that apply to Roth IRAs).

12.9 Participant. The term "Participant" means the employee, plan participant, or account owner of a Retirement Account as those terms are commonly used under the Minimum Distribution Rules.

12.10 Retirement Account. The term "Retirement Account" means a Tax-Advantaged Account that is subject to the Minimum Distribution Rules.

12.16 Stretch-Out Retirement Account. The term "Stretch-Out Retirement Account" means, with respect to a particular trust arising hereunder, an interest in a Retirement Account that satisfies the following conditions: (a) the interest in the Retirement Account (or a successor Retirement Account, e.g., an inherited IRA that receives a rollover from a qualified retirement plan) became part of the trust by reason of the death of the Participant of said Retirement Account; and (b) the provisions governing said Retirement Account (including any death beneficiary designation in effect at Participant's death and any other relevant circumstances) permit the Trustee of the trust to take post-death distributions over a time period based on the life expectancy of an individual, assuming said trust otherwise qualifies to do so under the Minimum Distribution Rules. By way of explanation, if a trust with an interest in a Retirement Account that is a Stretch-Out Retirement Account ultimately terminates (e.g., upon the death of a beneficiary), and if as a result the remaining Retirement Account interest is then allocated to a successor trust (e.g., for a descendant of the deceased beneficiary), said remaining Retirement Account interest will not be considered a Stretch-Out Retirement Account with respect to said successor trust under this Section because said interest did not become part of said successor trust by reason of the death of the Participant.

12.17 Stretch-Out Retirement Account Accumulations. The term "Stretch-Out Retirement Account Accumulations" means, with respect to a particular trust arising hereunder, any amounts distributed from any one or

more of said Stretch-Out Retirement Accounts to the trust that accumulate in the trust (including earnings thereon and net of any expenses or taxes allocable thereto). By way of explanation, if a trust with Stretch-Out Retirement Account Accumulations ultimately terminates (e.g., upon the death of a beneficiary), and if as a result said Stretch-Out Retirement Account Accumulations are allocated to a successor trust (e.g., for the descendants of the deceased beneficiary), said accumulations will not be considered Stretch-Out Retirement Account Accumulations in the hands of said successor trust, because it was the prior trust and not the successor trust that received distributions from a Stretch-Out Retirement Account and accumulated them.

12.18 Stretch-Out Retirement Beneficiary. The term "Stretch-Out Retirement Beneficiary" means, with respect to a trust hereunder that owns an interest in a "Stretch-Out Retirement Account," the trust beneficiary whose life expectancy is or will be used in determining the timing and amount of post-death distributions (or whose life expectancy would have been so used if he or she was the oldest member of the group of individuals determined under the Minimum Distribution Rules to which he or she belongs).

12.19 Tax-Advantaged Account. The term "Tax-Advantaged Account" means any plan, contract, or other arrangement (other than a life insurance contract) that is allowed under the Internal Revenue Code to accumulate any part of its income in a tax-advantaged manner (e.g., income tax-deferred or income tax free) for the benefit of an owner, beneficiary, or successor, and includes, by way of example and not limitation, a qualified or non-qualified annuity, a deferred compensation plan, or a retirement or individual retirement account arrangement established under Code Section 401, 403, 408, 408A, or 457. A plan account or arrangement that is otherwise a "Tax-Advantaged Account" and that owns one or more life insurance contracts among its assets is a "Tax-Advantaged Account." A plan, contract, or other arrangement that is reasonably believed to qualify for tax-advantaged treatment under the Internal Revenue Code is a "Tax-Advantaged Account" even if it is subsequently determined it did not so qualify.

E. SAMPLE FORM: Non-Conduit Dynasty Trust - "Age Restriction."

Here is a sample form for a dynasty trust that employs an "age restriction" approach as described in Section VI, based on the age of the oldest individual receiving a dynasty trust, which means that any descendant born prior to January 1 of said oldest individual's year of birth is to be excluded as a recipient of stretch-out retirement assets. The oldest individual's age is selected to ensure that none of the other individuals will be excluded as alternate beneficiaries under the age restriction. It is possible to draft in a way that allows each individual's trust to have an age restriction specific to that individual, but caution is advised as this approach may result in arbitrarily excluding some individuals and not others. Also, the drafting of cross-over provisions will be more complex to ensure that the correct age restriction follows the assets of each trust. The age restriction approach may not be the best approach in every case, and other alternatives should be considered.

Author's Notes:

1. *The following form refers to the dynasty trusts as "Descendants Trusts."*

2. *The following form reflects a joint revocable trust approach, common in the author's State of California, showing only selected provisions that distinguish this from the "Conduit Dynasty Trust" form presented in Section VIII.D.*

3. *The default form illustrates Descendants Trusts that will all use the life expectancy of the oldest individual who will be receiving Descendants Trusts. In other words, trusts for younger members of the class will not benefit from the separate account rule and will not be allowed to use the longer measuring lives of the respective younger class members. It is possible to add age restrictions to each class member's trust to obtain separate account rule treatment, but this adds significant complexity. In particular, the cross-over provisions that govern how trusts are allocated to other class members at death will need to preserve the correct age restriction. For example, at Participant's death, Descendants Trusts arise for A, B, and C. A's Descendants Trust includes an age restriction based on her life. B's Descendants Trust includes an age restriction based on his life, etc. If B dies and his trust is allocated into two trusts for A and C, B's age restriction must continue to govern – not A's, and not C's. The default form includes italicized inserts showing how the default form might be adjusted to incorporate these age restrictions.*

4. *The testamentary powers of appointment and remainder provisions have been modified to accommodate MRD planning considerations.*

5. *Section 6.6(e) has been modified to reflect the "age restriction" approach.*

5.3 Descendants Trusts. The Descendants Trust for each Beneficiary shall commence upon the first receipt of property by the Trustee. Such property and any subsequent additions of property shall constitute the trust estate, which shall be held, administered and distributed pursuant to this Section 5.3, and if applicable, shall be further divided into an "Exempt Trust" and a "Non-Exempt Trust" as provided in Section 10.11.

(a) Distribution of Income and Principal.

(i) The Trustee may (but shall not be required to) distribute, from time to time, to or for the benefit of the Beneficiary as much of the net income and, if insufficient, the principal of the trust as the Trustee deems necessary for the Beneficiary's health, education, and support in his or her accustomed manner of living (including the tuition or medical expense of the Beneficiary's descendants).

(ii) In addition, the Independent Trustee (as defined in Section 6.6) may (but shall not be required to) distribute to or for the benefit of the Beneficiary as much of the net income and, if insufficient, as much of the principal of the trust as the Independent Trustee determines in the Independent Trustee's sole discretion.

(iii) When making such distributions, the Trustee (or Independent Trustee as the case may be) may consider (or not consider) the Beneficiary's other income or resources that are known to the Trustee including, by way of example and not limitation, resources held in other trusts for the benefit of the Beneficiary, the Beneficiary's ability to obtain gainful employment, the obligations of others to support the Beneficiary, and the Beneficiary's Tax-Advantaged Accounts, if any. The Settlors request, but do not require, that any benefits of income tax deferral that the Beneficiary can accomplish by accumulating his or her Tax-Advantaged Account assets for as long as possible be included among all relevant considerations in determining the Beneficiary's available resources, and in determining the nature and extent of distributions, if any, to be made to the Beneficiary under this Section 5.3(a).

(iv) Distributions under this Section 5.3(a) for the tuition or medical expense of the Beneficiary or a descendant of the Beneficiary shall be made (a) directly to the respective educational institution or medical provider and not to the Beneficiary or descendant directly, and (b) to the greatest extent possible from Non-Exempt assets.

(v) Distributions of income or principal to or for the benefit of a Beneficiary who is not a Skip Person (as that term is defined for generation skipping transfer tax purposes under the Code) shall be made to the greatest extent possible from Non-Exempt assets.

(vi) Except as otherwise provided under this Section 5.3(a), the Trustee may make distributions under this Section 5.3(a) by selecting any one or more trust assets, either on a pro rata or a non pro rata basis, and may distribute any portion, all or none from either Exempt assets or Non-Exempt assets as the Trustee determines in the Trustee's sole discretion.

(vii) Any income not so distributed shall be added to principal.

(b) Descendants Trust as Beneficiary of Retirement Account; Age Restrictions. The Settlors intend that each Descendants Trust that owns an interest in one or more Stretch-Out Retirement Accounts shall benefit from an extended deferral period under the Minimum Distribution Rules with respect to each Stretch-Out Retirement Account of the trust. Accordingly, each Descendant's Trust shall be administered as follows:

(i) The Trustee shall either account separately or maintain separate shares in order to keep track of the source and amount of any Stretch-Out Retirement Account Accumulations held by the trust. *Please refer to Section 10.11, which grants the Trustee the power to divide a trust into two or more separate trusts having the same terms and conditions as the original trust in order to accomplish this purpose.*

(ii) A person is a "Disqualified Recipient" with respect to a Stretch-Out Retirement Account if said person is not a Qualified Recipient (defined next). A person is a "Qualified Recipient" if that person would, had that person been designated by the Participant as the sole death beneficiary of the Stretch-Out Retirement Account, be allowed under the Minimum Distribution Rules to calculate the minimum required distributions from said Stretch-Out Retirement Account following the year of Participant's death using the life expectancy of an individual born no sooner than January 1 of the calendar year of birth of the Settlors' oldest descendant living at the time of said Participant's death *[if age restriction is based on year of birth of the Beneficiary of each Descendants Trust, indicate with language such as "January 1 of the year in which the Beneficiary of the Descendants Trust was born . . ."; or if age restriction is based on year of another (e.g., the oldest sibling), indicate January 1, XXXX for the year to be used for age restriction purposes]*.

(iii) Any exercise of the limited power of appointment granted to the Beneficiary under Section 5.3(d) with respect to a Stretch-Out Retirement Account or Stretch-Out Retirement Account Accumulations therefrom shall be interpreted and carried out as if each and every person who is a Disqualified Recipient with respect to said Stretch-Out Retirement Account is deceased upon the Beneficiary's death or not then in existence, even if the result is that said exercise fails with respect to said assets. Notwithstanding the foregoing, any exercise of said limited power of appointment in favor of one or more Disqualified Recipients with respect to said assets shall not otherwise cause the exercise of such power of appointment to be deemed an invalid exercise.

(iv) The general power of appointment granted to the Beneficiary under Section 5.3(d) may not be used to appoint any Stretch-Out Retirement Account or Stretch-Out Retirement Account Accumulations therefrom. The "Limited Portion" referred to in said Section shall be determined only with respect to the assets of the trust other than Stretch-Out Retirement Accounts or Stretch-Out Retirement Account Accumulations therefrom.

(v) Any allocation or distribution of a Stretch-Out Retirement Account or Stretch-Out Retirement Account Accumulations therefrom arising by reason of the Beneficiary's death under Section 5.3(e) shall be interpreted and carried out as if each and every person who is a Disqualified Recipient with respect to said Stretch-Out Retirement Account is then deceased or not then in existence, even if the result is that said allocation or distribution cannot be made under Section 5.3(e) for lack of any recipient who is not a Disqualified Recipient. Further, in the event any such allocation or distribution is made to a Descendants Trust pursuant to Section 5.3(e), the Trustee shall administer the portion of the Descendants Trust consisting of such allocation or distribution as if each and every person who is a Disqualified Recipient with respect to said Stretch-Out Retirement Account is then deceased or not then in existence.

(vi) Any distribution of a Stretch-Out Retirement Account or Stretch-Out Retirement Account Accumulations therefrom under Section 5.4 shall be interpreted and carried out as if each and every person who is a Disqualified Recipient with respect to said Stretch-Out Retirement Account Accumulations therefrom is then deceased or not then in existence.

(c) **Lifetime Power to Withdraw Non-Exempt Retirement Assets With Consent of Independent Trustee.** Each Beneficiary may direct the Trustee of his or her Non-Exempt Descendants Trust to distribute to the Beneficiary all or any portion of said trust's Stretch-Out Retirement Accounts or Stretch-Out Retirement Account Accumulations therefrom with the advance, written consent of the

Independent Trustee, which the Independent Trustee may grant or not grant in its sole discretion. *[This clause is intended to force inclusion of non-exempt retirement interests in the Beneficiary's gross estate, without including a general power of appointment that might interfere with optimal stretch-out of MRDs. This clause may not be desirable in all cases, as discussed above. In some cases it may be worthwhile providing a mechanism that would allow this power to be "turned off" for certain beneficiaries. For an example of a such a mechanism, refer to Section 6.6(d)(iii).]*

(d) **Beneficiary's Powers of Appointment.** The Beneficiary shall have the following powers of appointment over his or her Descendant's Trust, each of which shall be exercisable in the manner provided in Section 10.14:

(i) **Limited Power Over Descendant's Trust.** Subject to the limitations set forth in Section 5.3(b), each Beneficiary who has attained twenty-five (25) years of age shall have the power to appoint the principal and any undistributed income of his or her Descendant's Trust to pass upon his or her death in favor of any one or more appointees (other than the Beneficiary's creditors, estate, or the creditors of the Beneficiary's estate). The Beneficiary's power of appointment under this Section 5.3(d)(i) is intended not to cause any part of the trust to be included in the Beneficiary's gross estate for federal estate tax purposes and shall not be construed as a general power of appointment within the meaning of Code Section 2041(b)(1).

(ii) **General Power over Limited Portion of GST Non-Exempt Descendant's Trust**. In addition to the power granted to a Beneficiary under Section 5.3(d)(i), and subject to the limitations set forth in Section 5.3(b), the Beneficiary shall have the power to appoint the principal and any undistributed income of the Limited Portion (as hereinafter defined) of such Beneficiary's GST Non-Exempt Descendant's Trust to pass upon the Beneficiary's death in favor of the creditors of the Beneficiary's estate (other than any taxing authority). The "Limited Portion" of a Beneficiary's GST Non-Exempt Descendant's Trust is the smallest portion of such trust that would, if the Beneficiary died holding a general power of appointment under this Section, be subject to lower total federal and state estate, inheritance and GST Taxes, in the aggregate, than would be imposed were the Beneficiary to die not holding such a general power of appointment. The Beneficiary's power of appointment under this Section 5.3(d)(ii) is intended to cause the Limited Portion of the Beneficiary's GST Non-Exempt Descendant's Trust to be included in the Beneficiary's gross estate for federal estate tax purposes rather than being subject to GST Tax, and shall constitute a general power of appointment within the meaning of Code Section 2041(b)(1).

(e) Death of Beneficiary. Subject to Section 5.3(b), upon the death of a Beneficiary, the Trustee shall distribute said Beneficiary's Descendants Trust (including such items of property as may pass generally to said trust by reason of said Beneficiary's death) in such manner as the Beneficiary shall have effectively appointed, if applicable, and shall divide the unappointed balance of the trust into shares on the principle of representation for the then living members of the class of descendants identified earliest below with at least one class member then living, but:

1st The deceased Beneficiary's descendants.

2nd If applicable, those descendants of the deceased Beneficiary's closest ancestor who was a descendant of the Settlors.

3rd The descendants of the Settlors.

Each share so established for a descendant shall be applied to create or augment a Descendants Trust to be held and distributed for him or her as provided in this Section 5.3 (each descendant shall be referred to as the "Beneficiary" of his or her Descendants Trust). If none of the descendants described above are then living, the Trustee shall instead distribute said unappointed balance as provided in Section 5.4.

[Insert if each trust is to be age restricted for each beneficiary: Notwithstanding the foregoing, with respect to the Descendants Trust's interests in Stretch-Out Retirement Accounts, including Stretch-Out Retirement Account Accumulations, the determination of whether a class of descendants listed above has one or more members then living, and the division

among the class that is so determined to have one or more members then living, shall be made as if each individual born prior to January 1 of the deceased Beneficiary's year of birth had predeceased the deceased Beneficiary.]

5.4 Alternate Distribution. Subject to Section 5.3(b), the Trustee shall distribute any portion of the trust estate passing pursuant to this Section 5.4 to *[specify alternate beneficiaries]*.

6.6 Independent Trustee. The Settlors intend that the Trustee of each trust hereunder that is irrevocable have the ability to appoint an Independent Trustee on an "as needed" basis whose sole purpose would be to exercise tax sensitive or other discretionary powers. An Independent Trustee who so serves shall serve solely for such purpose and shall have no responsibility for the administration and management of the trust estate. No Independent Trustee shall be liable to any beneficiary of a trust established by this instrument or to any permissible appointee under any power of appointment for any good faith exercise, or non-exercise, of his or her powers under this instrument.

(a) The office of Independent Trustee shall be vacant at the time an irrevocable trust is first established. If at any time the office of Independent Trustee is vacant and the Trustee determines in its sole discretion that an Independent Trustee is needed, the Trustee shall select one or more "Qualified Persons" (defined below) to so serve. The Trustee may appoint himself, herself, or itself if the Trustee is a "Qualified Person."

(b) With respect to a trust, a person or entity is a "Qualified Person" if the person or entity is a corporation, partnership, limited liability company or an individual qualified to act as a trustee in the United States or any other common law jurisdiction other than a Settlor, a beneficiary of the trust, or a person who is a "related or subordinate party" (as such term is defined in Code Section 672) with respect to a Settlor or beneficiary of the trust.

(c) The Trustee's appointment of an Independent Trustee shall be in the form of a writing delivered to the appointee and filed with the records of the trust. Said appointee assumes the office of Independent Trustee upon the delivery of written acceptance to the Trustee and remains in office until he, she, or it resigns or is otherwise unable to serve, and may not be removed under Section 6.3.

(d) The Independent Trustee shall have the following powers in addition to any other powers specifically vested in the Independent Trustee under this instrument:

(i) to make distributions or exercise any other power to the extent that doing so would discharge the Trustee's legal obligation to support a dependent;

(ii) to hold and exercise all incidents of ownership with respect to any insurance policy on the life of the Surviving Settlor that is held in any irrevocable trust hereunder of which the Surviving Settlor is a Trustee in the manner provided in Section 8.3, and to hold and exercise all incidents of ownership with respect to any policy of insurance on the life of any other person serving as Trustee;

(iii) to grant, eliminate, or alter in any fashion a beneficiary's power of withdrawal or of appointment (including by way of example and not limitation the powers described in Section 5.3(d)). The Independent Trustee may exercise this power in its sole discretion for any purpose, including by way of example and not limitation to cause trust property to become subject to estate tax rather than generation-skipping transfer tax at a beneficiary's death;

(iv) to grant, eliminate, or alter in any fashion a beneficiary's power to remove and replace a Trustee, or to designate successor Trustees;

(v) to exercise a right or power to the extent it has been disclaimed, released, or restricted in scope by the Trustee (unless such right or power is also disclaimed by the Independent Trustee); and

(vi) to exercise any other power specifically granted to the Independent Trustee under this instrument.

(e) Notwithstanding the foregoing, with respect to a Descendants Trust under Section 5.3 that holds an interest in a Stretch-Out Retirement Account, including Stretch-Out Retirement Account Accumulations, as to which the Beneficiary is the Stretch-Out Beneficiary, the Independent Trustee shall not exercise any power hereunder in any way that might make it possible for a charity, estate, trust, other entity, or an individual born prior to *[indicate appropriate age limitation]*: (i) to be included as a potential recipient of said Stretch-Out Retirement Account, including Stretch-Out Retirement Account Accumulations, by reason of the Beneficiary's exercise of a power of appointment over said Descendants Trust; or (ii) to otherwise possess any beneficial interest in said Descendants Trust. For purposes of this Section 6.6(e), a trust that would be allowed under the Minimum Distribution Rules to use a trust beneficiary's life expectancy as the measuring life to calculate minimum required distributions shall be considered an individual.

(f) The Independent Trustee may disclaim, release, or restrict the scope of any power enumerated above at any time in connection with any trust.

F. SAMPLE FORM: Non-Conduit Dynasty Trust - "Last One Standing."

Here is a sample form for a dynasty trust that employs a "last one standing" approach as described in Section VII., based on the class of the Settlors' descendants. The "last one standing" approach supports using the oldest class member's life expectancy by excluding any other trust beneficiary who is not a member of the class as a "mere potential successor." For this to work, the trust must terminate at such time as there is only one class member remaining. The last one standing approach may not be the best approach in every case, and other alternatives should be considered.

Author's Notes:

1. *The following form refers to the dynasty trusts as "Descendants Trusts."*

2. *The following form reflects a joint revocable trust approach, common in the author's State of California, showing only selected provisions that distinguish this from the "Conduit Dynasty Trust" form presented in Section VIII.D.*

3. *There are two "last one standing" provisions. The first, 5.3(c), terminates the trust if the Beneficiary is the only surviving class member. Unfortunately, this will cause termination even if the Beneficiary should subsequently produce offspring, but this clause must be included. Otherwise, if the Beneficiary were to die without descendants, there would not be any surviving class member to take, and the "last one standing" premise would not hold up. The second, 5.3(h) calls for outright distribution if only one class member survives.*

4. *The default form illustrates Descendants Trusts that will all use the life expectancy of the oldest living member of the class of Settlors' descendants as the measuring life. In other words, trusts for younger members of the class will not benefit from the separate account rule and will not be allowed to use the longer measuring lives of the respective younger class members. It is possible to add age restrictions to each class member's trust to obtain separate account rule treatment, but this adds significant complexity. In particular, the cross-over provisions that govern how trusts are allocated to other class members at death will need to preserve the correct age restriction. For example, at Participant's death, Descendants Trusts arise for A, B, and C. A's Descendants Trust includes an age restriction based on her life. B's Descendants Trust includes an age restriction based on his life, etc. If B dies and his trust is allocated into two trusts for A and C, B's age restriction must continue to govern – not A's, and not C's. The default form includes italicized inserts showing how the default form might be adjusted to incorporate these age restrictions.*

5. *The powers of appointment and remainder provisions have been drafted to ensure that the trust will remain with members of the class.*

6. *Section 6.6(e) illustrates savings language that should be included when an Independent Trustee or Trust Protector is given authority to modify trusts or make changes to powers of appointment.*

5.3 Descendants Trusts. The Descendants Trust for each Beneficiary shall commence upon the first receipt of property by the Trustee. Such property and any subsequent additions of property shall constitute the trust estate, which shall be held, administered and distributed pursuant to this Section 5.3, and if applicable, shall be further divided into an "Exempt Trust" and a "Non-Exempt Trust" as provided in Section 10.11.

(a) Distribution of Income and Principal.

(i) The Trustee may (but shall not be required to) distribute, from time to time, to or for the benefit of the Beneficiary as much of the net income and, if insufficient, the principal of the trust as the Trustee deems necessary for the Beneficiary's health, education, and support in his or her accustomed manner of living (including the tuition or medical expense of the Beneficiary's descendants).

(ii) In addition, the Independent Trustee (as defined in Section 6.6) may (but shall not be required to) distribute to or for the benefit of the Beneficiary as much of the net income and, if insufficient, as much of the principal of the trust as the Independent Trustee determines in the Independent Trustee's sole discretion.

(iii) When making such distributions, the Trustee (or Independent Trustee as the case may be) may consider (or not consider) the Beneficiary's other income or resources that are known to the Trustee including, by way of example and not limitation, resources held in other trusts for the benefit of the Beneficiary, the Beneficiary's ability to obtain gainful employment, the obligations of others to support the Beneficiary, and the Beneficiary's Tax-Advantaged Accounts, if any. The Settlors request, but do not require, that any benefits of income tax deferral that the Beneficiary can accomplish by accumulating his or her Tax-Advantaged Account assets for as long as possible be included among all relevant considerations in determining the Beneficiary's available resources, and in determining the nature and extent of distributions, if any, to be made to the Beneficiary under this Section 5.3(a).

(iv) Distributions under this Section 5.3(a) for the tuition or medical expense of the Beneficiary or a descendant of the Beneficiary shall be made (a) directly to the respective educational institution or medical provider and not to the Beneficiary or descendant directly, and (b) to the greatest extent possible from Non-Exempt assets.

(v) Distributions of income or principal to or for the benefit of a Beneficiary who is not a Skip Person (as that term is defined for generation skipping transfer tax purposes under the Code) shall be made to the greatest extent possible from Non-Exempt assets.

(vi) Except as otherwise provided under this Section 5.3(a), the Trustee may make distributions under this Section 5.3(a) by selecting any one or more trust assets, either on a pro rata or a non pro rata basis, and may distribute any portion, all or none from either Exempt assets or Non-Exempt assets as the Trustee determines in the Trustee's sole discretion.

(vii) Any income not so distributed shall be added to principal.

(b) Descendants Trust as Beneficiary of Retirement Account. The Settlors intend that each Descendants Trust that owns an interest in a Stretch-Out Retirement Account shall benefit from an extended deferral period under the Minimum Distribution Rules with respect to each Stretch-Out Retirement Account of the trust. Accordingly, the Trustee of each Descendants Trust hereunder shall either account separately or maintain separate shares in order to keep track of the source and amount of any Stretch-Out Retirement Account Accumulations held by such trust. *Please refer to Section 10.11, which grants the Trustee the power to divide a trust into two or more separate trusts having the same terms and conditions as the original trust in order to accomplish this purpose.*

(c) Termination of Trust's Interest in Retirement Assets – Beneficiary is Last Remaining Class Member. At such time that the Beneficiary is the only living member of the class of the Settlors' descendants *[include the following if each trust is to be "age restricted" to that Beneficiary, which would exclude older class members:* (excluding each individual born prior to January 1 of the Beneficiary's year of birth, as if such individual had predeceased the Beneficiary) *[end of insert]*, each of his or her Descendants Trusts shall terminate with respect to the trust's interests in Stretch-Out Retirement Accounts

or Stretch-Out Retirement Account Accumulations therefrom, and said interests shall be distributed to the Beneficiary, outright and free of trust.

(d) Lifetime Power to Withdraw Non-Exempt Retirement Assets With Consent of Independent Trustee. Each Beneficiary may direct the Trustee of his or her Non-Exempt Descendants Trust to distribute to the Beneficiary all or any portion of the Non-Exempt Descendants Trust's interests in Stretch-Out Retirement Accounts or Stretch-Out Retirement Account Accumulations therefrom with the advance, written consent of the Independent Trustee, which the Independent Trustee may grant or not grant in its sole discretion.

[The foregoing clause is intended to force inclusion of non-exempt retirement interests in the Beneficiary's gross estate, without including a general power of appointment that might interfere with optimal stretch-out of MRDs. This clause may not be desirable in all cases, as discussed above. In some cases it may be worthwhile providing a mechanism that would allow this power to be "turned off" for certain beneficiaries. For an example of a such a mechanism, refer to Section 6.6(d)(iii).]

(e) Beneficiary's Powers of Appointment. The Beneficiary shall have the following powers of appointment over his or her Descendant's Trust, each of which shall be exercisable in the manner provided in Section 10.14:

(i) **Limited Power Over Descendant's Trust**. Each Beneficiary who has attained twenty-five (25) years of age shall have the power to appoint the principal and any undistributed income of his or her Descendant's Trust to pass upon his or her death in favor of any one or more appointees (other than the Beneficiary's creditors, estate, or the creditors of the Beneficiary's estate). The Beneficiary's power of appointment under this Section 5.3(e)(i) is intended not to cause any part of the trust to be included in the Beneficiary's gross estate for federal estate tax purposes and shall not be construed as a general power of appointment within the meaning of Code Section 2041(b)(1).

(ii) **General Power over Limited Portion of GST Non-Exempt Descendant's Trust**. In no event may the Beneficiary exercise the general power of appointment granted to the Beneficiary under this Section 5.3(e)(ii) to appoint any Stretch-Out Retirement Account or Stretch-Out Retirement Account Accumulations. Otherwise, in addition to the power granted to a Beneficiary under Section 5.3(e)(i), the Beneficiary shall have the power to appoint the principal and any undistributed income of the Limited Portion (as hereinafter defined) of such Beneficiary's GST Non-Exempt Descendant's Trust to pass upon the Beneficiary's death in favor of the creditors of the Beneficiary's estate (other than any taxing authority). The "Limited Portion" of a Beneficiary's GST Non-Exempt Descendant's Trust is the smallest portion of such trust that would, if the Beneficiary died holding a general power of appointment under this Section, be subject to lower total federal and state estate, inheritance and GST Taxes, in the aggregate, than would be imposed were the Beneficiary to die not holding such a general power of appointment. The Beneficiary's power of appointment under this Section 5.3(e)(ii) is intended to cause the Limited Portion of the Beneficiary's GST Non-Exempt Descendant's Trust to be included in the Beneficiary's gross estate for federal estate tax purposes rather than being subject to GST Tax, and shall constitute a general power of appointment within the meaning of Code Section 2041(b)(1).

(iii) **Stretch-Out Retirement Plans and Accumulations.** Notwithstanding the foregoing, the Beneficiary may not exercise the powers described in subsections (i) and (ii) in any way that would cause any amount of Stretch-Out Retirement Accounts or Stretch-Out Retirement Account Accumulations therefrom to pass to (A) anyone other than a descendant of the Settlors' *[if age restrictions were used, indicate appropriate age limitation]*, or (B) any of the Beneficiary's creditors, estate, or the creditors of the Beneficiary's estate.

(f) Death of Beneficiary; Retirement Assets to Last Remaining Class Member. Upon the death of a Beneficiary (the "deceased Beneficiary"), the Trustee shall administer each of the deceased Beneficiary's Descendants Trusts as follows:

(i) In the event that the deceased Beneficiary is survived by only one member of the class of the Settlors' descendants *[insert if each trust is age restricted for each Beneficiary:* (excluding each individual born prior to January 1 of the deceased Beneficiary's year of birth, as if such

individual had predeceased the deceased Beneficiary) *[end of insert]*, the Descendants Trust's interests in Stretch-Out Retirement Accounts or Stretch-Out Retirement Account Accumulations, if any, shall pass to said surviving class member outright and free of trust, and any exercise of a power of appointment over said assets under Section 5.3(e)(i) shall be ineffective.

(ii) Except as provided in subsection 5.3(f)(i), the Trustee shall distribute said Beneficiary's Descendants Trust (including such items of property as may pass generally to said trust by reason of said Beneficiary's death) in such manner as the Beneficiary shall have effectively appointed, if applicable, and shall divide the unappointed balance of the trust into shares on the principle of representation for the then living members of the class of descendants identified earliest below with at least one class member then living:

1st The deceased Beneficiary's descendants.

2nd If applicable, those descendants of the deceased Beneficiary's closest ancestor who was a descendant of the Settlors.

3rd The descendants of the Settlors.

Each share so established for a descendant shall be applied to create or augment a Descendants Trust to be held and distributed for him or her as provided in this Section 5.3 (each descendant shall be referred to as the "Beneficiary" of his or her Descendants Trust). If none of the descendants described above are then living, the Trustee shall instead distribute said unappointed balance as provided in Section 5.4.

[Insert if each trust is to be age restricted for each beneficiary: Notwithstanding the foregoing, with respect to the Descendants Trust's interests in Stretch-Out Retirement Accounts, including Stretch-Out Retirement Account Accumulations, the determination of whether a class of descendants listed above has one or more members then living, and the division among the class that is so determined to have one or more members then living, shall be made as if each individual born prior to January 1 of the deceased Beneficiary's year of birth had predeceased the deceased Beneficiary.]

5.4 Alternate Distribution. The Trustee shall distribute any portion of the trust estate passing pursuant to this Section 5.4 to *[specify alternate beneficiaries]*

[Insert if each trust is to be age restricted for each beneficiary: Notwithstanding the foregoing, to the extent any such distribution arises from the death of the Beneficiary of a Descendants Trust and consists of interests in Stretch-Out Retirement Accounts, including Stretch-Out Retirement Account Accumulations, the provisions of this Section 5.4 shall be applied by excluding any charity, estate, trust, or entity that is not an individual, and by excluding each individual born prior to January 1 of the deceased Beneficiary's year of birth as if he or she had predeceased the deceased Beneficiary.]

6.6 Independent Trustee. The Settlors intend that the Trustee of each trust hereunder that is irrevocable have the ability to appoint an Independent Trustee on an "as needed" basis whose sole purpose would be to exercise tax sensitive or other discretionary powers. An Independent Trustee who so serves shall serve solely for such purpose and shall have no responsibility for the administration and management of the trust estate. No Independent Trustee shall be liable to any beneficiary of a trust established by this instrument or to any permissible appointee under any power of appointment for any good faith exercise, or non-exercise, of his or her powers under this instrument.

(a) The office of Independent Trustee shall be vacant at the time an irrevocable trust is first established. If at any time the office of Independent Trustee is vacant and the Trustee determines in its sole discretion that an Independent Trustee is needed, the Trustee shall select one or more "Qualified Persons" (defined below) to so serve. The Trustee may appoint himself, herself, or itself if the Trustee is a "Qualified Person."

(b) With respect to a trust, a person or entity is a "Qualified Person" if the person or entity is a corporation, partnership, limited liability company or an individual qualified to act as a trustee in

the United States or any other common law jurisdiction other than a Settlor, a beneficiary of the trust, or a person who is a "related or subordinate party" (as such term is defined in Code Section 672) with respect to a Settlor or beneficiary of the trust.

(c) The Trustee's appointment of an Independent Trustee shall be in the form of a writing delivered to the appointee and filed with the records of the trust. Said appointee assumes the office of Independent Trustee upon the delivery of written acceptance to the Trustee and remains in office until he, she, or it resigns or is otherwise unable to serve, and may not be removed under Section 6.3.

(d) The Independent Trustee shall have the following powers in addition to any other powers specifically vested in the Independent Trustee under this instrument:

(i) to make distributions or exercise any other power to the extent that doing so would discharge the Trustee's legal obligation to support a dependent;

(ii) to hold and exercise all incidents of ownership with respect to any insurance policy on the life of the Surviving Settlor that is held in any irrevocable trust hereunder of which the Surviving Settlor is a Trustee in the manner provided in Section 8.3, and to hold and exercise all incidents of ownership with respect to any policy of insurance on the life of any other person serving as Trustee;

(iii) to grant, eliminate, or alter in any fashion a beneficiary's power of withdrawal or of appointment (including by way of example and not limitation the powers described in Section 5.3(e)). The Independent Trustee may exercise this power in its sole discretion for any purpose, including by way of example and not limitation to cause trust property to become subject to estate tax rather than generation-skipping transfer tax at a beneficiary's death;

(iv) to grant, eliminate, or alter in any fashion a beneficiary's power to remove and replace a Trustee, or to designate successor Trustees;

(v) to exercise a right or power to the extent it has been disclaimed, released, or restricted in scope by the Trustee (unless such right or power is also disclaimed by the Independent Trustee); and

(vi) to exercise any other power specifically granted to the Independent Trustee under this instrument.

(e) Notwithstanding the foregoing, with respect to a Descendants Trust under Section 5.3 that holds an interest in a Stretch-Out Retirement Account, including Stretch-Out Retirement Account Accumulations, as to which the Beneficiary is the Stretch-Out Beneficiary, the Independent Trustee shall not exercise any power hereunder in any way that might make it possible for Stretch-Out Retirement Accounts or Stretch-Out Retirement Account Accumulations therefrom to pass to (A) anyone other than a descendant of the Settlors' *[if age restrictions were used, indicate appropriate age limitation]*, or (B) any of the Beneficiary's creditors, estate, or the creditors of the Beneficiary's estate.

(f) The Independent Trustee may disclaim, release, or restrict the scope of any power enumerated above at any time in connection with any trust.