INCOME TAX PLANNING FOR TRUSTS:
A NEW LOOK AT AN OLD (AND OFTENTIMES IGNORED) TOPIC

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I. INTRODUCTION.

With the current Federal exemption at over $5 million and many states with no state level estate tax, many estate planning practitioners wonder what will keep them busy in the future. Practitioners are also facing the possibility of losing the irrevocable grantor trust as an estate planning vehicle, which will result in more irrevocable non-grantor trusts, since trusts will remain a staple in clients' estate plans. The administration of irrevocable non-grantor trusts can be a source of ongoing work for practitioners and the income tax planning for these trusts is both sophisticated and little understood, by many accountants and attorneys. This outline will provide an overview of certain issues of concern in the area of fiduciary income taxation for trusts, both in the area of drafting these trusts as well as administering. Hopefully, it will assist the estate planner in drafting a more tax-efficient trust agreement and provide guidance for the income tax planning that becomes necessary when a trustee is considering whether to make distributions or when a trust holds special or unusual assets or is planning to enter into a transaction.[1]

II. WHAT IS A TRUST FOR INCOME TAX PURPOSES?

A. The Income Tax Meaning of Trusts

1. Definition:

a. Treasury Regulations define the term "trust" as used in the Internal Revenue Code (the "Code") as "an arrangement created either by a will or 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."[2]

b. Regulations also provide that "[g]enerally speaking, an arrangement will be treated as a trust 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."[3]

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[1] This outline will address non-grantor trusts taxed under Section 641 of the Code et. seq. It will not discuss any other trust or a trust with foreign beneficiaries, trustees, settlors or assets.

[2] Treas. Reg. Sec. 301.7701-4(a).

[3] *Id.*

2. Trust or Agency or Business Entity

a. A fiduciary relationship (established between a Trustee and beneficiaries of a trust) differs from an agency relationship because (1) unlike an agent, the trustee actually owns the trust property and (2) unlike an agent, a trustee has an affirmative duty to act.

b. For purposes of federal income taxation, organizations are classified as associations taxable as corporations, as partnerships, or as trusts.[4]

3. Business Trusts: A Business Association in Trust's Clothing

a. Business trusts are *not* classified as trusts for purposes of the Code. (Note: not every organization that defines itself as a trust will be honored as such for purposes of subchapter J.)

b. Distinguishable from entities classified as "trusts" for purposes of the Code because they are not simply arrangements to protect or conserve property for the beneficiaries; rather, they generally are created by beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Code.[5]

c. The IRS may treat such entities as associations, subject to taxation as corporations, or as partnerships.[6]

(1) There are a number of characteristics ordinarily found in a pure corporation which, when taken together, distinguish it from other organizations, including:

(a) The existence of associates;

(b) An objective to carry on business and divide the gains therefrom;

(c) Continuity of existence,

(d) Centralization of management,

(e) Liability for corporate debts limited to corporate property, and

(f) Free transferability of interests.

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[4] The classifications of any particular organization is determined under the tests and standards set out in Treas. Reg. Sections 301.7701-2, 301.7701-3 and 301.7701-4.

[5] Treas. Reg. Sec. 301.7701-4(b).

[6] Treas. Reg. Sec. 301.7701-2(a).

(2) However, some of these characteristics are common to both trusts and corporations (specifically, centralization of management, continuity of existence, and limited liability). As a result, in determining whether a particular organization is to be classified as a trust or association, those characteristics common to both trusts and corporations are immaterial.

(3) Thus, the most important factors in determining whether a trust should be treated as a trust or a business association are (1) whether there are associates and (2) whether there exists an objective to carry on business and divide the gains therefrom. If an organization that is formed as a trust under local law lacks either associates or a business purpose, it will not be classified as an association for federal tax purposes.

(a) For beneficiaries of a trust to be considered associates, they must display some volitional joint activity directed towards the conduct of business for profit. Some factors[7] to be considered in determining whether the beneficiaries of a trust should be considered associates in a joint enterprise for profit include:

(b) Whether the trust relationship came into existence or continues in existence as a result of the volitional activities of the beneficiaries;

(i) Whether the beneficiaries, as such, influence the management activities of the trust; and

(ii) Whether the interests of the beneficiary are freely transferable.

4. Land or Real Estate Trusts

a. Land trusts are formed to hold or acquire real property, and may be taxed as a business entity or as a trust (usually a grantor trust, within the meaning of Sections 671 – 679 of the Code).

(1) People establish land trusts for any number of reasons, for example: to convert a real property interest under state law into a personal property interest, to hide the identity of a the true owner of the property, to centralize management of the property, and/or to enforce agreements regarding how decisions affecting the property will be made.

(2) The determination as to whether a land trust is taxed as a business entity or a trust hinges on whether the purpose of the trust is to carry on a business or divide gain (in which case the land trust will be taxed as a corporation or a partnership), or whether the land trust was formed to protect and conserve the land (in which case the land trust will be treated as a trust for income tax purposes).

b. In certain circumstances, land trusts may be treated as trusts for income tax purposes, such as inter vivos or testamentary trusts that invest in real estate and have

[7] P.L.R. 8842043.

beneficiaries who acquired their interests by gift or devise and are not involved in the administration of the trust.

5. Investment Trusts

a. An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power under the trust agreement to vary the ownership shares in the trust of the certificate holders.[8]

b. An investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity (and taxed as a corporation or a partnership, as the case may be); however, such an investment trust will be classified as a trust under the Code if: (1) there is no power under the trust agreement to vary the ownership shares in the trust of the certificate holders *and* (2) it is determined that the trust was formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership is incidental to that purpose.[9]

6. Liquidating Trusts

a. Liquidating Trusts are treated as a trust for purposes of the Code.[10]

b. An organization will be considered a liquidating trust if it is organized for the primary purpose of liquidating and distributing the assets transferred to it, and if its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose.[11]

c. The status of such an organization will no longer be that of a trust for purposes of the Code if it is determined that either: (1) the liquidation is unreasonably prolonged, or (2) the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation can be said to be lost or abandoned.[12]

7. Environmental Remediation Trusts

a. These trusts are treated as trusts for purposes of the Code.[13]

b. An environmental remediation trust is an organization that is organized under state law as a trust, the primary purpose of which is collecting and disbursing

[8] Treas. Reg. Sec. 301.7701-4(c).

[9] *Id*.

[10] Treas. Reg. Sec. 301.7701-4(d).

[11] Treas. Reg. Sec. 301.7701-4(d).

[12] *Id*.

[13] Treas. Reg. Sec. 301.7701-4(c).

amounts for environmental remediation of an existing waste site to resolve, satisfy, mitigate, address or prevent the liability (or potential liability) of persons imposed by federal, state or local environmental laws. All contributors to the trust must have actual or potential liability or a reasonable expectation of liability under federal, state or local environmental laws, and the trust must not be qualified settlement fund as defined in the Code.

c. The status of such an organization will no longer be that of a trust for purposes of the Code if it is determined that the remedial purpose is altered or becomes so obscured by business or investment activities that the declared remedial purpose is no longer controlling.

8. Settlement Funds

a. Code Sec. 468B provides a special set of income taxation rules that allow qualified, irrevocable payments to a designated settlement fund (a trust or other type of fund established under court order by a taxpayer for the purpose of settling and paying claims arising out of personal injury, death or property damage) to be deducted by an accrual basis taxpayer at the time the payment is made to the fund.[14] The gross income of a designated settlement fund, less certain expenses, is taxed at the maximum rate applicable to trusts and estates under Section 1(e) of the Code.[15]

b. Treasury Regulation Sec. 1.468B-1 expanded the same income tax treatment otherwise applicable to designated settlement funds to a broader range of funds, referred to as qualified settlement funds.[16]

9. Escrow Accounts

a. Escrow accounts or trusts may be used to hold the proceeds received from a sale of investment property in order that such proceeds can be reinvested in property of a like kind, to create a deferred like-kind exchange under Sec. 1031(a)(2). Generally, escrow account or trust funds used to facilitate 1031 deferred exchanges are treated as loaned by the party that transfers the relinquished property to the exchange facilitator, who must take into account all items of income, deduction and credit (including capital gains and losses.[17] However, the transferor/taxpayer may be required to take into account such items in computing his taxable income if the exchange funds agreement so provides.[18]

b. A pre-closing escrow is an escrow account, trust or fund established in connection with the sale or exchange of real or personal property, funded with a down payment (or similar payment) used to secure the obligation of the purchaser to pay the

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[14] I.R.C. Sec. 461(h).

[15] I.R.C. Sec. 468B(b).

[16] Treas. Reg. Sec. 1.468B-1

[17] Treas. Reg. Sec. 1.468B-6.

[18] Treas. Reg. Sec. 1.468B-6(c)(2).

purchase price of the property, the assets of which will be paid to the purchaser or distributed for the purchasers benefit when the property is sold or exchanged which is not an escrow account or trust established in connection with a deferred exchange. With a pre-closing escrow, the purchaser must take into account all items of income, deduction and credit (including capital gains and losses) of the pre-closing escrow in computing the purchaser's income tax liability.

10. Funeral Trusts

a. A "qualified funeral trust" is defined as any trust that arises as a result of a contract with a person engaged in the trade or business of providing funeral or burial services or property necessary to provide such services, the sole purpose of which is to hold, invest, and reinvest funds in the trust and to use such funds solely to make payments for such services or property for the benefit of the trust beneficiaries; provided, that (1) the only beneficiaries of such trust are individuals with respect to whom such services or property are to be provided at their deaths, (2) the only contributions to the trust are contributions by or for the benefit of such beneficiaries, (3) the trustee makes an appropriate election under Code Sec. 685, and (4) the trust is one that would be treated as owned by the purchaser of the contract under the grantor trust rules if no Sec. 685 election was made.[19]

b. The amount of tax paid with respect to each purchaser's qualified funeral trust is determined in accordance with the income tax rate schedule generally applicable to estates and trusts under Code Section 1(e), but no personal exemption is allowed.[20] The tax on the annual earnings of the trust is paid by the Trustee. Amounts received from the trust by the funeral or burial service provider are included in such provider's gross income. No gain or loss is recognized to the beneficiary of the trust for payments from the trust to such beneficiary upon the cancellation of the contract, and the beneficiary would take a carryover basis in any assets so received upon such cancellation.[21]

11. Grantor Trust or Non Grantor Trust?

a. Subchapter J (Code Section 641 et. seq.) deals with the taxation of income of estates and trusts and their beneficiaries. Generally speaking, subchapter J taxes trust income once – either to the trust that receives it, or to the beneficiary to whom such income is distributed within the trust's taxable year – and distributions of income from a trust to its beneficiaries qualify the trust for an income tax deduction (known as the "distribution deduction"). Subchapter J treats trusts as conduits to the extent income is distributed, and treats the trust as a separate taxpaying entity to the extent such income is not actually or deemed to be distributed.

b. However, special rules in subchapter J (known as the "grantor trust rules") provide that if a grantor (or another person) of a trust holds an interest or a power described in Code Sections 671 through 679, then such grantor (or other person) is deemed to

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[19] I.R.C. Sec. 685(b).

[20] I.R.C. Sec. 685(c).

[21] I.R.C. Sec. 685(d).

be the owner of the portion of the trust property over which such interest exists or over which such power can be exercised and, therefore, such grantor (or other person) is properly treated as the taxpayer with respect to such portion of the trust. To the extent the grantor (or other person) is treated as the owner of the trust under one or more of those Code sections, such person is treated as if he owns such trust assets personally, and he must take into account the income, deductions and credits arising from such property in calculating his taxable income. Therefore, a trust is not treated as a separate tax-paying entity to the extent that it is treated as a "grantor trust

c. There are three categories of trusts that are treated as grantor trusts under the grantor trust rules:

(1) Trusts in which the grantor retains certain trust powers or interests (or grants such powers or interests to people who are deemed to be under the grantor's control), including: a reversionary interest; direct or potential beneficial interest in trust income; a power to revoke the trust and recover trust principal; certain retained controls over the distribution of trust income or principal; certain retained administrative powers; the authority to borrow trust funds without adequate interest and security; or if the grantor (or such person) actually borrows trust funds without adequate interest and security approved by an independent trustee.

(2) Trusts with respect to which a beneficiary has a right to demand principal or income from the Trustee; and

(3) Certain foreign trusts with both a U.S. grantor (directly or indirectly) and a U.S. beneficiary.

d. To avoid application of the "grantor trust rules", the language of the trust agreement should limit any powers or interests of the grantor and/or beneficiaries appropriately. A provision negating grantor trust powers that could inadvertently trigger grantor trust status should also be considered.

III. DEFINITION OF TRUST INCOME AND TRUST SITUS DISCUSSION.

A. Taxable Income versus Fiduciary Accounting Income

1. Fiduciary Accounting Income – To What Is An Income Beneficiary Entitled?

a. Each year, the Trustee of a trust must determine fiduciary accounting income in order to determine the rights of trust beneficiaries with respect to trust income, and for income tax purposes, to determine the distribution deduction (discussed below) and the resulting gross income to the beneficiaries under Code Sections 652 (for simple trusts) or 662 (for complex trusts).

b. Fiduciary accounting income is an accounting concept that the Trustee of a trust employees to distinguish between property that is principal (which will be distributed to remainder beneficiaries or beneficiaries entitled to receive a principal distribution) and property that is income (which will be distributed to current income beneficiaries). Code Sec. 643(b) defines the concept of fiduciary accounting income as 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.[22]

c. Thus, the Trustee, in determining fiduciary accounting income, must look to (1) the provisions of the trust's governing instrument and (2) applicable local law.

(1) If the governing instrument specifies how receipts and expenditures are to be allocated as between income beneficiaries and remainder beneficiaries, such provisions are often binding for state law and income tax purposes; however, if applicable state law is determined to override or preclude a provision in the trust instrument, or if it is determined that the provisions of the trust "depart fundamentally from traditional principles of income and principal", applicable state law will control.[23]

(2) In cases where the trust governing instrument is silent as to how receipts and expenditures are to be allocated, applicable state law will govern.

(3) All states have enacted statutes that lay out rules for determining and allocating fiduciary accounting income. Most states have adopted some version of the Uniform Principal and Income Act, which provides default rules for principal and income allocations in an effort to establish uniformity of law across various jurisdictions.

d. Particular Issues with Fiduciary Accounting Income

(1) There are certain types of taxable income that do not fall easily into the definition of fiduciary accounting income (unless the applicable state law or governing instrument defines it as such[24]). These include distributions from retirement accounts, partnerships and certain distributions from corporations.

(2) When an amount is distributed from such an entity, for income tax purposes such amount will be includable in a trust's taxable income based on the entity's tax reporting. However, the trustee must investigate the source from which such distributions are made to determine if such amounts are added to the income or the principal of the trust. Does a partnership distribution represent the trust's share of current partnership income (income) or does it include proceeds from a refinancing or sale of a partnership asset (principal)? Does a retirement account distribution include just the income earned in the account in the current year (income) or a portion of the actual account assets (principal)? Finally, a corporation can pay out what is referred to as an "extraordinary dividend" which is a one-time distribution of corporate assets (principal).

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[22] Code Sec. 643(b).

[23] Treas. Reg. 1.643(b)-1.

[24] See, for example, the Delaware Uniform Principal and Income Act Title 12, Delaware Code, Chapter 61, Section 61-501.

(3) Are the parenthetical answers above what the settlor of the trust intended? If not, the trust agreement (the governing instrument) can direct that such distributions are to be added to the income of the trust (or to the principal of the trust) based on the Settlor's goals for the income and principal beneficiaries.

2. Taxable Income

a. In general, taxable income of a trust is calculated in the same manner as taxable income of an individual, with a few differences, including (but not limited to) the following significant differences:

(1) Unlike individuals, trusts are entitled to a distribution deduction under Code Sections 651 (for simple trusts[25]) or 661 (for complex trusts[26]) for amounts of income (and sometimes principal) distributed to beneficiaries.

(2) Trusts, like individuals, are entitled to a personal exemption, but the amount of available exemption depends on the type of trust (simple trusts are entitled to a $300 annual exemption, while complex trusts are entitled to a $100 annual exemption) and are less generous than the personal exemptions to which individuals are entitled.[27]

(3) There are different rules for computing the income tax charitable deduction for trusts than those applicable to individuals, which are discussed below.

B. Planning With (and for) Trust Income Tax Rates

1. The federal income tax rates applicable to trusts (and estates) are the highest in the Internal Revenue Code[28]. Still, circumstances may exist where there may be a modest tax advantage to certain individuals to be gained by avoiding trust distributions and/or accumulating income in a trust (however, any such benefit will likely be outweighed by the fiduciary fees and expenses incurred by a trust), for example:

a. Where a distribution might push a beneficiary into a higher income tax bracket, or may subject his estate to federal or state estate taxes; or

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[25] There are separate sets of rules for simple versus complex trusts, which are properly classified based on the trustee's duty under the trust's governing instrument. A "simple trust" is a trust, the terms of which (1) provide that all trust income is required to be distributed annually, (2) distribute no principal in the calendar year, and (3) do not provide that any amounts are to be paid, permanently set aside, or used for charitable purposes. Code Sec. 651(a). A trust can be a complex trust one year and a simple trust the next year or vice versa.

[26] A "complex trust" is any trust that does not meet the requirements of a simple trust. Code Sec. 661(a).

[27] Code Sec. 642(b)(2).

[28] In 2013, a trust is taxed at the highest rate on any income over $11,950.

b. Where a distribution might contribute to the phase-out loss of a beneficiary's personal exemption; or

c. Where a beneficiary desires to claim itemized deductions or medical expense deductions and a distribution from a trust might increase the person's AGI,[29] upon which the loss of such deductions is calculated.

2. There are, however, many non-tax reasons not to make distributions to trust beneficiaries. A beneficiary may have creditors, may not handle money well, may be impaired by an addiction or may just be too young to receive the distribution. The trustee should be prepared to respond to questions about why the trust paid such a high rate of tax when a distribution would have resulted in the income being taxed at a lower rate.

C. State-Level Fiduciary Income Taxation and the Situs of a Trust

a. In addition to the imposition of federal income taxes on trusts, many states also impose a state-level income tax on undistributed trust income. Many state legislatures have enacted statutes that adopt one or more common bases of state income taxation, which serve as "triggers" for a state's imposition of income tax on the trust. Such statutes generally purport to impose state-level income tax where:

(1) The trust is a testamentary trust and the testator of the trust was living in the state at his or her death; or

(2) The trust is an inter vivos trust and the settlor is living in the state as a resident as of the date of creation of the trust, date of funding of the trust, during the current taxable year in question and/or the date on which the trust became irrevocable; or

(3) The trust has at least one trustee or beneficiary who is a resident of the state; or

(4) The trust is considered to be administered in the state (which may be determined by facts and circumstances or by a statute that, if a certain set of circumstances exists, finds the trust to be a resident of such state for state income tax purposes).

b. Although many trusts contain a provision that purports to designate which state's laws govern administration of the trust, such a provision is not necessarily dispositive in the determination of such trust's state tax residency.

(1) Sometimes, courts are called upon to decide whether a state taxing authority has pushed the constitutional limits too far in asserting its ability to tax a trust based on the contacts existing between the subject trust and the state.

(a) For example, in the recent case of *Residuary Trust A v. Director, 27 N.J. Tax 68 (N.J. Tax Ct. 2013),* decided this year, the New Jersey Tax Court granted summary judgment in favor of the taxpayer and determined that a trust could not be deemed to own assets in New Jersey merely because the trust was a shareholder in an S Corporation that owned New Jersey assets, and held that a resident trust that does not have any assets in New Jersey or income from New Jersey sources, and does not have any trustees in New Jersey is not subject to New Jersey Tax.

(2) In determining whether a trust may be treated as a resident trust and, thus, subject to fiduciary income taxation under relevant state law, one should also look to rulings issued by the state's taxing authority for guidance.

(a) In a recent ruling, P.D. 13-18, issued this year, the Virginia Tax Commissioner provided guidance regarding circumstances in which a trust will be considered as being administered in Virginia, such that the trust should be considered a resident trust for Virginia income tax purposes under the definition provided under Virginia law. Specifically, the Commissioner provided that where a Co-Trustee of a trust is a resident of Virginia, but cannot make decisions regarding the Trust in his individual capacity and such Co-Trustee's power and discretion over trust assets may only be exercised by him if the out-of-state corporate Co-Trustee (with no offices in Virginia) agrees, the trust is not being administered in Virginia, is not a resident trust for Virginia income tax purposes and is not required to file a Virginia fiduciary income tax return.

c. DING Trusts – Potential for State Income Tax Planning

(1) The IRS recently issued a series of taxpayer-favorable private letter rulings[30] regarding a trust structure referred to by practitioners as "Delaware Incomplete Gift Non-Grantor Trusts", or "DING trusts." By structuring a trust as a DING trust, a trust settlor may be able to mitigate overall income tax exposure by shifting assets and, potentially, state income tax liability from a high-income tax state to a state with more favorable income tax laws (or perhaps to a state that does not impose state-level income tax on trusts).

(2) The key objectives in structuring a DING trust are:

(a) To avoid making a completed gift for federal gift tax purposes to the trust at the time it is funded; and

(b) To avoid grantor trust status for federal income tax purposes, so that the trust, rather than the grantor, is taxed on income earned by the trust (and for these purposes, a DING must be domiciled in a state that authorizes self-settled spendthrift trusts - otherwise the settlor's creditors could potentially attach the trust's assets, which would result in grantor trust treatment of the trust for federal income tax purposes).

(3) Thus, if structured properly, a DING trust should have no gift tax consequences (since the transfer of assets to the trust is considered an incomplete gifts for federal wealth transfer tax purposes) and, depending on the laws of the settlor's state of residence, the

[30] PLR 201310002; PLR 201310003; PLR 201310004; PLR 201310005; and PLR 201310006.

trust may only be subject to income tax in the state that governs the trust (rather than being subject to tax in the settlor's state of residence). If the laws of the state that govern the trust do not tax trust income, the trust may not have any state income tax liability associated with its undistributed income.

(4) DING trusts may be especially appealing to individuals who:

(a) Hold significant income generating portfolios or anticipate a liquidity event with regard to assets that have appreciated significantly; and

(b) Reside in a high-tax state that will not tax the DING trust that is a resident in a low income tax or no income tax state.

(5) Note that an individual's decision to create a DING trust will necessarily involve a careful analysis of the laws of the person's state of residence, his or her particular circumstances, and the appropriate DING trust jurisdiction.

(6) In light of the IRS's apparent willingness to issue private letter rulings on DING trusts and offer insights into acceptable structures for creating such trusts, individuals may want to seek their own PLR from the IRS on which they can rely before funding a DING trust, as a PLR is only binding with regard to the requesting taxpayer and may not be cited as president that is binding on the IRS or relied on by another taxpayer. Further, although a PLR represents the IRS's conclusions as to the particular transaction described in the ruling request, the IRS isn't prevented by its ruling on a question of law or fact for a particular ruling from reaching a different conclusion and applying a contrary ruling later.

IV. TRUST INCOME TAX ISSUES.

A. The Passive Activity Loss Rules for Purposes of Section 469 and the new Net Investment Income Tax

1. Congress enacted the passive activity loss rules, codified at Code Sec. 469, in 1986 to curtail the perceived abuses by taxpayers who purchased "tax shelter" investments to generate tax losses in order to shelter other sources of positive income, such as salary or investment income. In doing so, Congress enacted Code Sec. 469, which it intended to disallow losses from so-called passive activities in which the taxpayer does not materially participate on a regular, continuous and substantial basis except to the extent such passive activity losses are used to offset passive activity income, while still allowing active business owners to deduct their non-passive losses against all taxable income. Passive activity losses are not disallowed entirely, but may be deducted in future years if and when passive activity income exists, or if and when the taxpayer ultimately disposes of the passive activity that generated the passive activity losses.[31]

[31] Disallowed passive activity losses are available to offset compensation income, active business income and portfolio income when the taxpayer disposes of his entire interest in the passive activity in a fully taxable transaction. Code Sec. 469(a), 469(b).

2. Congress has excluded from the new 3.8% Net Investment Income Tax trust income derived from trades or businesses in which the trust is an active participant and refers to Section 469 for the definition of such active participation.[32]

3. Passive Activities Defined: Passive activities include (1) any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate[33], and (2) rental activities, even if the taxpayer does materially participate in such activities[34]. Further, working interests in oil and gas property which the taxpayer holds directly or through an entity that does not limited the liability of the taxpayer with respect to such interest are statutorily excluded from the definition of passive activities, regardless of whether the taxpayer materially participates in such activity.

4. Material Participation Defined: the general rule disallowing passive activity losses under Code Sec. 469 does not apply where a taxpayer-investor "materially participates" (or is deemed to material participate) in an activity on a regular, continuous and substantial basis.[35] The underlying rationale of the material participation test is that the more involved an investor is in the business activity, the more likely his investment in the business was legitimate, and was not merely a passive activity, intended to shelter portfolio income.

a. Temporary Treas. Reg. 1.469-5T(a) lays out the following seven alternative circumstances, any one of which, if demonstrated, is sufficient to establish "material participation" by taxpayers who are general partners of a general partnership, S corporation shareholders, or who are certain non-limited partner investors:

(1) The taxpayer-investor participated in the activity for greater than 500 hours during the year in question;[36]

(2) The taxpayer-investor's participation in the activity during the taxable year constituted substantially all of the participation of all individuals engaged in the activity for that year (including those individuals who are not owners of interests in the activity);[37]

(3) The taxpayer-investor participated in the activity for more than 100 hours during the year and his participation was not less than any other person's participation in that activity during that year;[38]

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[32] Code Section 1411, which was enacted as part of the Health Care and Education Reconciliation Act of 2010.

[33] Code Sec. 469(c)

[34] Code Sec. 469(c)(2), 469(c)(7).

[35] Code Sec. 469(h).

[36] Temp. Treas. Reg. Sec. 1.469-5T(a)(1).

[37] Temp. Treas. Reg. Sec. 1.469-5T(a)(2).

[38] Temp. Treas. Reg. Sec. 1.469-5T(a)(3).

(4) The activity is an activity that is a trade or business activity in which the taxpayer-investor participates for more than 100 hours, but does not materially participate during that year (a "significant participation activity"[39]) and the taxpayer-investor's aggregate participation in all "significant participation activities" during that year exceed 500 hours;[40]

(5) The taxpayer-investor materially participated for any five (5) taxable years during the ten (10) taxable years immediately preceding the taxable year in question;[41]

(6) The activity is a "personal service activity" (which is an activity that involves the performance of personal services in the fields of health, law, engineering, architecture, actuarial science, performing arts or consulting; or any other trade or business in which capital is not a material income-producing factor[42]) and the investor materially participated for any three (3) taxable (consecutive or non-consecutive) years preceding the taxable year in question;[43] or

(7) Based on all the facts and circumstances, after taking into account certain limitations, the taxpayer-investor participated in the activity on a regular, continuous and substantial basis during that year.[44]

b. Limited Partners: Presumption against Material Participation

(1) As a general rule, subject to a few exceptions, no interest in a limited partnership as a limited partner is treated as an interest with respect to which a taxpayer materially participates.[45]

(2) Notwithstanding the presumption against material participation by limited partners in a limited partnership, a limited partner will still be considered to materially participate in an activity for purposes of the passive activity loss rules if:

(a) The taxpayer-investor is also a general partner in a partnership; or

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[39] Temp. Treas. Reg. Sec. 1.469-5T(c).

[40] Temp. Treas. Reg. Sec. 1.469-5T(a)(4).

[41] Temp. Treas. Reg. Sec. 1.469-5T(a)(5).

[42] Temp. Treas. Reg. Sec. 1.469-5T(d).

[43] Temp. Treas. Reg. Sec. 1.469-5T(a)(6).

[44] Temp. Treas. Reg. Sec. 1.469-5T(a)(7).

[45] Code Sec. 469(h)(2).

(b) The taxpayer-investor satisfies one of the "material participation tests" laid out in Temp. Treas. Reg. Sec. 1.469-5T(a)(1) (by participating in the activity for greater than 500 hours during the year in question),[46] (by materially participating for any five taxable years during the ten taxable years preceding the taxable year in question) or (if, the activity is a personal service activity and the individual materially participated in the activity for any three taxable years preceding the taxable year in question).[47]

c. Grouping Activities: Treas. Reg. 1.469-4 sets forth the rules a taxpayer must follow when grouping his trade or business activities and rental income for purposes of applying the passive activity loss rules. In general, the regulation provides that one or more trade or business activities[48] may be treated as a single activity if the activity constitutes an appropriate economic unit for the measurement of gain or loss, and such determination is to be made after applying the following factors to such activities:

(1) Similarities and differences in the types of trade or businesses;

(2) The extent of common control;

(3) The extent of common ownership;

(4) Geographical location; and

(5) Interdependencies between or among the activities (such as the extent to which the activities purchase or sell goods among themselves, involve products that are normally provided together, have the same customers, same employees or are accounted for with a single set of books and records).

d. Application of PAL Rules to Trusts

(1) Code Sec. 469(a)(2)(A) clearly states that the passive activity loss rules apply to trusts.

(2) The regulations under Code Sec. 469 are comprehensive in many respects, yet they do not address the question of how trusts establish material participation in an activity for purposes of the PAL rules. One lingering unresolved issue is whether material participation is determined based only on the Trustee's participation, or

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[46] Temp. Treas. Reg. Sec. 1.469-5T(a)(5)

[47] Temp. Treas. Reg. Sec. 1.469-5T(a)(6)

[48] Treas. Reg. 1.469-4 defines "trade or business activities" to including activities (other than rental activities or activities treated as incidental to an activity of holding property for investment) that (i) involve the conduct of a trade or business, (ii) are conducted in anticipation of a trade or business, or (iii) involve research or experimental expenditure expenditures that are or would be deductible under Code Sec. 174.

based on the participation of other individuals (such as employees of the trust, trust beneficiaries or "special" trustees) participating in the activity on behalf of the trust.

(a) The Senate Report accompanying the Tax Reform Act of 1986 (which Act included Sec. 469), provides that a trust (or estate) is determined to be materially participating in an activity if the executor or fiduciary, in his capacity as such, is so participating.[49]

(b) Mattie K. Carter Trust v. United States.[50] The issue in this case was how a trust could establish material participation for purposes of Code Sec. 469. The case involved a trust, referred to as the *Carter Trust*, which operated a range business directly through employees and agents of the trust. The IRS argued that "material participation" should be determined based on the actions of the Trustee alone. The Court agreed with the taxpayer, that the materially participation standard applies at the trust level (the "taxpayer level" under Code Sec. 469(a)(2)(A)) and, thus, should be determined by reference to whoever participates in the activity on behalf of the trust (which, in this case, included two individuals to whom the trustee had delegated functions).

(c) Subsequent IRS Rulings Reject *Mattie K. Carter Trust* Decision.

(i) In Technical Advice Memorandum 200733023 ("2007 TAM"), the IRS took the position that it is the activities of the fiduciary and not the employees of the trust that is determinative of a trust's material participation and also rejected the activities of a special trustee in determining material participation. The trust in question acquired an interest in a limited liability company classified as a partnership. The Will establishing the trust provided for an appointment of a special trustee who had all the rights, titles, powers, duties discretions and immunities of the trustees. The trustees appointed a special trustee, but stated in the appointment that the special trustee "will not possess the capacity to legally bind or commit the trust to any transaction or activity and the trustee acknowledges that it retains all decision making responsibilities related to the trust's financial, tax or business matters." The special trustee spent time reviewing operating budgets, analyzing a tax dispute between partners, preparing and analyzing financial documents, with repeated contacts with the trustee. The special trustee also spent considerable time negotiating the sale of the trust's interest in the company to a newly-admitted partner. The trustee also spent time on these matters. The IRS held that "The focus on the trustee's activities for purposes of section 469 accords with the general policy rationale underlying the passive loss regime. As a general matter, the owner of a business may not look to the activities of the owner's employees to satisfy the material participation requirement. See S. Rep. No. 99-313 at 735 'the activities of [employees]…are not attributed to the taxpayer.'. Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity." The IRS stated in the 2007 TAM that to be a fiduciary, the trustee must be vested with some degree of discretionary power to act on

[49] S. Rep. No. 99-313 (1986), at 735 and n. 287.

[50] 256 F. Supp.2d 536 (N.D. Tex. 2003).

behalf of the trust. Accordingly, although the special trustee devoted a substantial amount of time on the business, it was not a fiduciary, in light of the restrictions in the appointment and the special trustee is no more than an advisor, consultant or general employee. The IRS also took the position that even if the special trustee were a fiduciary, the special trustee's work (as well as the trustee's hours spent in the same fashion) was more of the work of an investor (sale of the business to a newly admitted partner) than work actively managing the operations of the business on a day-to-day basis.

(ii) In PLR 201029014, the IRS expressed its opposition to the decision in the Mattie K. Carter Trust case, stating that, "[c]onsistent with the treatment of other business owners, … it is appropriate in the trust context to look only to the activities of the trustee. Thus, the sole means for a trust to establish material participation is if its fiduciary is involved in the operations of the activity on a regular, continuous and substantial basis."[51].

(iii) In Technical Advice Memorandum 201317010 ("2013 TAM"), there were two trusts with trustees created by "C". The Trusts owned interests in a S corporation which, in turn was the 100% owner of the entity that was the active business. "A" was the president of this entity and was also a special trustee in the two trusts who had the specified power to vote the stock of the S corporation and to determine the retention or sale of both the entity and the S corporation. The issue was whether "A"s actions as president of the active business, which by itself would have been considered material participation, would be considered as actions by the trustees (since "A" was a special trustee) which would result in the trusts having been materially participating with respect to the entity. In this TAM the special trustee had full discretion, but only over voting the stock of the corporation, the stock of which was owned by the two trusts, and over decisions regarding the retention and sale of the stock in such corporation and also of the corporation's wholly owned subsidiary. Here, although the IRS treated the special trustee as a fiduciary, it also took the position that the areas in which the special trustee was acting were not areas that involved the active management of the operation of the business on a day-to-day basis, and therefore the actions that the special trustee could take under its limited powers were not enough to cause the trusts to be considered to have materially participated in the business.

e. Planning Opportunities:

(1) If you are going to use a special trustee, it should be a "vertical slice" of trusteeship for material participation purposes. The special trustee should have full discretion and authority over the areas over which it has authority.

(2) Ask yourself if a special trustee is appropriate.

(3) Is a corporate trustee the only trustee whose employee's participation will count on behalf of the Trustee?

[51] PLR 201029014.

(4) Will this approach toward a special trustee appear in other areas?

5. Net Investment Income Tax

a. Beginning on January 1, 2013, a new and separate income tax regime went into effect and applies against many trusts, as well as against individuals and estates. The Net Investment Income Tax, as it is called (hereinafter "the NIIT"), is codified at Code Section 1411, which was enacted as part of the Health Care and Education Reconciliation Act of 2010. Treasury recently proposed regulations that provide guidance as to how this tax will be applied. The NIIT is required to be reported annually on the Form 8960, a draft of which has been developed by the IRS and was recently released to the public.

b. The NIIT applies at a rate of 3.8% to certain net investment income (described below) of individuals, estates and trusts that have income in excess of certain statutory threshold amounts. However, the statutory threshold amount applicable to trusts and estates is much lower than the statutory threshold amount applicable to individuals when determining NII subject to the new tax:

(1) An individual is subject to the tax on NII above an adjusted gross income threshold of $200,000 ($250,000 if married filing jointly).

(2) However, estates and trusts are subject to the tax on undistributed NII above the threshold level at which the top federal income tax rate begins, which is $11,950 in 2013. (Note that individual beneficiaries will be subject to the tax on distributed NII if their NII exceeds their own threshold for the NII tax.) Because the threshold level for trusts that must be reached before the NIIT will apply is so low, it is crucial that Trustees be made aware of the potential application of the tax and plan accordingly.

c. The NIIT is imposed on "net investment income", which is comprised of three categories of gross income (referred to as "gross investment income"), the aggregate amount of which is then reduced by specified "NII deductions" that are properly allocable to such gross income or net gain (described below).

(1) Specified income, which includes gross income from interests, dividends, annuities, royalties, rents and other passive income other than excluded business income (described below);

(2) Covered business income, which is gross trade or business income that falls within one of these three sub-categories (and all other income derived in the ordinary course of a trade or business that is not described below is "excluded business income", and is not subject to the NIIT):

(a) Derived in the trade or business of trading in financial instruments or commodities,

(b) Earned in a passive activity of the taxpayer within the meaning of Code Sec. 469,[52] and

(c) Produced from the investment of working capital; and

(3) Covered gain, which is net gain (to the extent taking into account in computing taxable income) from dispositions of property other than gain comprising excluded business income.

d. Exclusions**:** Specific types of income are specifically exempted from the NIIT under Code Sec. 1411, including:

(1) Employment income and compensation (which are subject to the hospital insurance Medicare tax and, therefore, are not subject to the NIIT);

(2) Qualified plan distributions; and

(3) Income excluded from taxable income (such as tax-exempt interest on state and municipal bonds, life insurance proceeds, and deferred or excluded gain such as that from a like-kind exchange or the sale of a personal residence).

e. NII Deductions: Deductions that can be used to reduce "NII include:

(1) investment interest expense,

(2) investment advisory and brokerage fees,

(3) expenses related to rental and royalty income, and

(4) state and local income taxes properly allocable to items included in net investment income.

f. Three Step Computation of the NIIT of a Non-Grantor Trust[53]

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[52] Note that Congress adopted Congress adopted the passive activity loss rules, including the material participation concept, for determining the NIIT under Code Sec. 1411. Thus, the discussion above regarding the ambiguity in the law regarding how material participation is determined for trusts under the passive activity loss rules takes on even greater importance this year as those same rules will apply to determine the amount of undistributed income of a trust that is subject to the NIIT. Note also that, prior to enactment of the NIIT, income classified as passive activity income was generally favored by taxpayers, as it could be used to offset passive activity losses to the extent they existed. However, now that passive activity income will be subject to the 3.8% NIIT, taxpayers may desire to convert passive income into non-passive income to the extent it is not needed to offset passive activity losses.

(1) Step One: determine adjusted gross income, as defined under Code Section 67(e), for the taxable year. AGI for a trust is the same as for an individual, except that Code Sec. 67(e) permits three additional deductions for (1) administration expenses unique to the fiduciary arrangement, (2) the distribution deduction, limited to DNI, and (3) the trust's personal exemption. If the trust's AGI exceeds the applicable threshold amount, the Trustee will need to move on to Step Two.

(2) Step Two: determine undistributed NII, which is equal to a trust's net investment income (as described above) less any distributions of NII made to beneficiaries under Code Sections 651 and 661 and by deductions for amounts set aside for a charitable purpose under Code Sec. 642.

(3) Step Three: apply the 3.8% tax rate to the lesser of the two numbers derived under steps one and two.

g. Planning Opportunities. Barring any Congressional action changing the manner in which the NIIT applies to trusts and estates, as a result of the disparate application of the NIIT to trusts and estates versus application thereof to individuals, Trustees will likely feel more pressure (and may be more inclined now than in prior years) to distribute net investment income to its beneficiaries to avoid imposition of the NIIT. This plan, however, may not be what the Settlor of the trust intended and exposes such assets to the creditors of the recipient beneficiary or the beneficiary may not be able to handle the funds responsibly. Alternatively, Trustees may aim to reduce the trusts' net investment income by reducing its passive activity income or by employing a new investment strategy for the trust that will allow the trust to avoid generating net investment income. A trustee may consider acquiring a life insurance policy that has investment features and taking advantage of the income-tax free build up in such a policy to handle some of its investing that would otherwise give rise to NII, however, the trust's insurable interest in the insured for such policy may be an issue.

B. Deductions from Trust Income, Section 67(e) and the *Knight* Decision

1. For purposes of the rule under Code Sec. 67 that miscellaneous itemized deductions are allowed only to the extent that the aggregate of those deductions exceed the 2%-of-AGI floor, the same rule applicable to individuals applies to trusts, and the AGI of a trust is computed in the same way as an individual's AGI, except that the following amounts are treated as allowable in full in arriving at a trust's AGI:

a. Deductions for costs that are paid or incurred in connection with the administration of the trust and that would not have been incurred if the property were not held in trust;

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[53] Grantor trusts are disregarded for purposes of the NIIT, and the NIIT on grantor trusts is computed as the same manner as the NIIT is computed for individuals. (Prop. Reg. Sec. 1.1411-3(b)(5)). Note also that special computational rules apply for charitable remainder trusts and electing small business trusts, which rules can be found in the proposed regulations.

b. The deduction for personal exemption allowable under Code Sec. 642(b);

c. The distribution deduction allowable under Code Sec. 651 (for simple trusts) or Code Sec. 661 (for complex trusts).

2. What are “costs… that would not have been incurred if the property were not held in trust”?

a. In its recent *Knight*[54] decision, the Supreme Court addressed this question, which previously created conflicts among circuit courts.

b. In that case, the Supreme Court interpreted Code Sec. 67(e)(1) as providing an exception to the 2%-of-AGI floor for costs that would not “commonly or customarily” be incurred by individuals. The court reasoned that the language of Code Sec. 67(3)(1) necessarily involved a “prediction” of what would happen if the property were held by an individual rather than a trust, and that predictions are based on customary or common occurrences.

c. In that case, the Court held that investment advisory fees paid by a trust were subject to the 2%-of-AGI floor because no evidence was presented to suggest or support the conclusion that the investment advisor charged the trustee anything extra than it would have charged an individual with similar investment objectives.

d. *Knight* Test: After this decision, the appropriate inquiry in determining whether a cost is subject to the 2%-of-AGI floor under Code Sec. 67(e)(1) is whether a hypothetical individual who held the same property outside of a trust “customarily” or “commonly” would incur such expense. Expenses that are “customarily” or “commonly” incurred by individuals are subject to the 2%-of-AGI floor.

e. In response to the *Knight* decision, the IRS withdrew previously-issued proposed regulations[55] regarding which costs incurred by a non-grantor trust are subject to the 2%-of-AGI floor for purposes of Code Sec. 67(a), and replaced those regulations with Prop. Reg. Sec. 1.67-4, which, if adopted, would reflect the Supreme Court’s reasoning and holding in *Knight*.

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[54] *Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust v. Commissioner*, 552 U.S. 181, 128 S. Ct. 782 (2008).

[55] The proposed regulations that were subsequently withdrawn would have adopted a more restrictive approach toward allowance of Code Sec. 67(e) costs than the approach advanced by the Supreme Court in *Knight*. Prop. Reg. Sec. 1.67-4(b), before withdrawn by Preamble to Prop. Reg. Sec. 1.67-4, 9/7/2011.

C. The Charitable Deduction Available to Trusts: Section 642(c)

1. Trusts are eligible for an income tax deductions for certain payments made to or for the benefit of charitable organizations.[56] Code Sec. 642(c)(1) provides that, generally, a trust is allowed a deduction in computing its taxable income any amount of gross income, without limitation, which, pursuant to the terms of the governing instrument is, during the taxable year in question, paid for a charitable purpose specified in Section 170(c).

2. While the charitable deduction available to trusts is similar to that deduction available to individuals under Code Sec. 170, the charitable deduction available to trusts is more favorable than the charitable deduction available to individuals in a few key ways, including:

a. "Without Limitation" – the charitable deduction available to a trust is generally unlimited, while the charitable deduction available to individuals is subject to a 50%-of-AGI ceiling in accordance with Code Sec. 170(b)(1).

b. Election to treat contributions as paid in previous taxable year - The final sentence of Sec. 642(c)(1) permits a trust to elect to treat a charitable contribution paid after the close of a taxable year (but before the last day of the following taxable year) as having been paid during such taxable year. This allows the trustee some flexibility as to whether a charitable deduction should be claimed in the year it is actually paid or in the year prior and may be particularly useful in the year in which the trust terminates. This election is not available to individual taxpayers.

c. Trusts are permitted to make charitable contributions for a charitable purpose specified in Code Sec. 170(c)(2) even if such contribution is to a foreign organization. Thus, unlike individual taxpayers, are not limited to making charitable contributions only to those charitable organizations created or organized within or under the laws of a state, the U.S., a U.S. possession or the District of Columbia.

3. Additional Requirement To Keep In Mind: Contributions Must Be "Pursuant To" Directive in Governing Instrument

a. For a contribution by a trust to qualify for the income tax charitable deduction under Code Sec. 642(c)(1), the payment must be made "pursuant to the terms of the governing instrument."

b. The Supreme Court has held that it is not necessary that a trust instrument *direct* the charitable contribution claimed as a deduction; rather, it is sufficient that the charitable use is *authorized* in the trust instrument, and that the amount is actually

[56] Under Code Sec. 642(c), certain trusts (specifically, trusts established before October 8, 1969 that meet certain requirements laid out in that Code section) may deduct gross income "permanently set aside" for the benefit of a charitable organization, as well as income currently paid to such organizations.

distributed.[57] For example, the distribution of trust income to a charitable organization was considered to be made "pursuant to the governing instrument" (and the trust was entitled to an income tax charitable deduction for the distribution) where the trust agreement gave the beneficiary a lifetime limited power of appointment that could be exercised only in favor of charitable organizations, and the beneficiary exercised the power to cause the Trustee of the trust to distribute income to the charities.[58]

D. Cost Recovery Deductions (Depreciation, Depletion and Amortization

1. Cost Recovery Deductions – one prevalent theme throughout the Code is that taxpayers who derive an economic benefit from an asset with a limited useful life should be able to offset their income generated by those assets with a cost recovery deduction. The most common types of cost recovery deductions are depreciation (for costs of tangible assets), amortization (for costs of intangible assets) and depletion (for costs of mines, oil and gas wells, other natural deposits and timber).

2. In the case of trusts, it may be difficult to determine whether the income beneficiaries or the remaindermen should be entitled to benefit from such cost recovery deductions, since both classes of beneficiaries may stand to benefit from the income generated by such assets, but at different times. The trust governing instrument can (and should) provide how the benefit of those cost recovery deductions should be apportioned between the income beneficiaries and the remainder beneficiaries.

3. Allocation of Depreciation Deductions By Trusts (Code Sec. 167(d))

a. In the case of property held in trust, the allowable depreciation deduction is properly apportioned between income beneficiaries and the trustee (which, in economic effect, is the same as the remainder beneficiaries) in accordance with the pertinent provisions of the governing instrument or, in the absence of such provisions, on the basis of the trust fiduciary accounting income allocable to each.[59] Code Sec. 61(b)(3) provides that depletion deductions attributable to trust are allocated among income beneficiaries and the trustee in the same manner.

b. Allocation among Beneficiaries of a Trust

(1) Each income beneficiary of a trust is allowed a share in the overall deduction in proportion to the amount of the trust's fiduciary accounting income that is "allocable" to such beneficiary through a distribution of income.

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[57] Old Colony Trust Co. v. Com., (1937 S. Ct) 301 US 379.

[58] IRS Letter Ruling 200906008.

[59] Code Sec. 167(d). In contrast, in the case of an estate, the allowable deduction is properly apportioned between the estate and the heirs, legatees and/or devisees on the basis of income of the estate allocable to each, regardless of any directive or provision to the contrary that is included in the testator's Last Will and Testament.

(2) Where the depreciation deduction must be apportioned among multiple beneficiaries, that portion of the deduction allocated to tax-exempt beneficiaries (such as charitable organizations) are necessarily wasted.

c. Depreciation or Depletion from Partnership Property. If a trust is a partner in a partnership and, as such, is entitled to a portion of the distribution or depletion deduction allowable to the partnership, the trust's distributive share of such deductions may be apportioned between the trusts and its income beneficiaries in the same manner as the rules applicable to a trust holding the asset subject to depletion or depreciable property.[60]

d. Planning Opportunity. If a client has a lot of these deductions, thought should be given to whether such deductions should be allocated to a particular beneficiary, if one particular beneficiary could benefit from these deductions, rather than allowing the deductions to be allocated to all beneficiaries.

E. Nondeductibility of Expenses Allocated to Tax-Exempt Income – Sec. 265

1. Code Sec. 265 generally disallows deductions for income tax purposes any amount otherwise allowable as a deduction that is allocable to income that is wholly exempt from income tax.

2. For purposes of determining which expenses are disallowed as deductions under Code Sec. 265, expenses directly allocable to exempt income must be allocated to exempt income (and, therefore, are not deductible) and expenses directly allocable to non-exempt income must be allocated to nonexempt income. However, if an expense otherwise allowable as a deduction is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof, determined in light of all the facts and circumstances in each case, shall be allocated to each.

a. For purposes of making this allocation, the Tax Court has approved the method of allocation in which the expenses are divided in the same proportion as exempt income to total income.

b. Example: A taxpayer received a total of $6,000 of interest, of which $4,800 was tax-exempt and $1,200 was taxable. He incurred $500 of expenses in earning the interest, but cannot specifically trace the amount of expenses that is properly allocable to each category. An acceptable allocation method would be to allocate 80% of the $500 expense (so, $400) to tax-exempt income and allocate 20% of the $500 expense (so, $100) to taxable income. As a result, the taxpayer would be permitted to deduct $100 of the expense, while the remaining $400 would be disallowed in accordance with Code Sec. 265.

3. Code Sec. 265 presents unique problems for trusts when some, but not all, of the trust's funds are invested in tax-exempt securities, in which case a portion of fiduciary commissions (and other miscellaneous expenses) are generally required to be disallowed. Fiduciary commissions are generally not deemed to be directly allocable to either exempt or

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[60] Rev. Rul. 74-71.

nonexempt income and are therefore required to be allocated on a reasonable basis. Unfortunately, there is little guidance (and plenty of disagreement) over what allocation formula is appropriate in determining the amount of fiduciary commissions that are disallowed under Code Sec. 265. IRS, courts and commentators have advanced different theories of the appropriate allocation formula to be employed, including disallowance based on:

a. The ratio of exempt income to the total "gross income" for the year;

b. The ratio of exempt income to total "ordinary income" of the trust for the year;

c. The ratio of FMV of exempt securities to the total FMV of the trust as of one or more determination dates during the year; and

d. The ratio of the basis of tax-exempt securities to total adjusted basis of trust assets as one of one or more determinates dates during the year.

F. Deductions for Estate Taxes Paid – Sec. 691(c): Not as Generous as You Might Think

1. Treas. Reg. 1.691(a)-1 defines "income in respect of a decedent" as "those amounts to which a decedent was entitled as gross income, but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent."

2. Sec. 691(c) provides that a taxpayer who includes in gross income any amount of income in respect of a decedent (also known as "IRD") may deduct for the same taxable year that portion of the federal estate tax imposed on the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive that amount.[61] The decedent's spouse also receives his or her allocable portion of this deduction, even though the portion of the estate passing to the spouse was eligible for the estate tax marital deduction and therefore did not give rise to any estate tax. Accordingly, the beneficiaries of the residuary estate whose shares were charged with the estate tax may not receive 100% of the deduction, if there is a spouse who received a portion of the residuary estate.

3. The deduction for estate tax attributable to income in respect of a decedent available to a trust is computed by excluding from gross income of the trust so much of the decedent's post-mortem income as is properly paid, credited, or to be distributed to the beneficiaries during the tax year, and such income shall be considered IRD to such beneficiary for purposes of allowing the deduction under Sec. 691(c).[62]

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[61] Code Sec. 691(c)(1)(A); Treas. Reg. 1.691(c)-1(a).

[62] Treas. Reg. 1.691(c)-2.

G. What is Distributable Net Income?

1. Distributable Net Income ("DNI") is a federal tax concept that is used to determine the appropriate amount of tax to be borne by the trust and its beneficiaries, and ensures that a trust acts as conduit entity for tax purposes (so that it is not subject to double taxation at the trust and beneficiary level). DNI serves three significant purposes:

a. First, DNI establishes the amount of the distribution deduction that may be claimed by a trust under Code Section 651 or 661, as the case may be;

b. Second, DNI establishes the maximum amount of income that will be reportable by trust beneficiaries as taxable income under Code Section 652 or 662, as the case may be (and as NII as well); and

c. DNI determines the tax character of income distributed for purposes of computing the distribution deduction and determining the items taxable to the beneficiaries.

2. Code Section 643(a) provides that distributable net income is determined with respect to any taxable year by computing taxable income for the trust with certain modifications, including the following:

a. No distribution deduction is taken;

b. No personal exemption is taken;

c. Capital gains allocated to trust principal and not paid, set aside or required to be distributed to beneficiaries (under state law or the governing instrument) during the year are excluded (see discussion below);

d. Capital losses allocated to principal are included;

e. Extraordinary dividends or taxable stock dividends allocated to principal by the Trustee in good faith are excluded (note, however, that a corporate distribution treated as a recovery of capital or a nontaxable stock dividend is not treated as gross income or DNI);

f. Tax-exempt interest that is allocated to income is included (net of disallowed deductions); and

g. Special rules apply for income of foreign trusts.

3. Illustration of DNI Computation from Treas. Reg. Sec. 1.643(d)-2:

Under the terms of the trust instrument, the income of the trust is required to be currently distributed to W during her lifetime. Capital gains are allocable to principal and all expenses are charges against principal. During the taxable year the trust has the following items of income and expenses:

Dividends from domestic corporations	$30,000
Extraordinary dividends allocable to principal by the Trustee in good faith	$20,000
Taxable interest	$10,000
Tax-exempt interest	$10,000
Long-term capital gains	$10,000
Trustee's commissions and miscellaneous expenses allocable to principal	$5,000

Other information: The fiduciary accounting income of the trust determined under section 643(b), which is currently distributable to W, is $50,000, consisting of dividends of $30,000, taxable interest of $10,000 and tax-exempt interest of $10,000. The Trustee's commissions and miscellaneous expenses allocable to tax-exempt interest amount to $1,000 ($10,000/$50,000 x $5,000).

Computation of DNI: In determining the DNI of $45,000, the taxable income of the trust is computed with the following modifications: No deductions are allowed for distributions to W and for personal exemption of the trust; capital gains allocable to principal are excluded, the extraordinary dividends allocated to principal by the Trustee in good faith are excluded, and tax-exempt interest (as adjusted for expenses) is included.

Include dividends from domestic corporations	+ $30,000
Include taxable interest	+ $10,000
Include tax-exempt interest, net of expenses allocated thereto ($10,000 - $1,000 = $9,000)	+ $9,000
Subtract expenses, excluding expenses allocated to tax-exempt interest ($5,000 - $1,000 = $4,000)	($4,000)
Distributable Net Income	**$45,000**

3. Distributions from a trust are deemed to be taxable income to the beneficiary to the extent of DNI. After DNI is exhausted, distributions are deemed to be tax-free distributions to the beneficiaries.

4. Including Capital Gains in DNI.

a. The regulations under Section 643 state that capital gains may only be includable in DNI (and hence carried out to the beneficiaries as distributions and for which a distribution deduction will be available to the trust) only under the following circumstances:

(1) the capital gain income was to be so allocated under local law or the governing instrument; or

(2) actually distributed to the beneficiaries and the Trustee makes a regular practice of distributing "the exact net proceeds."

b. This last requirement for a regular practice is pretty difficult to establish in the first year of a trust and if not done at that time, how can it be established in subsequent years? The IRS rarely finds that capital gains was actually distributed because they rarely find that a regular practice has been established.

c. The issue is whether the drafter wants to include capital gains in DNI, due to the loss of value the trust will suffer (and the amounts the trustee will have to distribute) in order to pass the gain out of the trust for income tax purposes.

5. Distribution Deduction: Allocating the Tax Burden

a. Simple Trusts:

(1) The distribution deduction for a simple trust (that does not actually distribute principal amounts in a given year) is the amount of fiduciary accounting income that is required to be distributed currently during such year (even if it is not actually distributed), but only to the extent such amount does not exceed the taxable amount of DNI of the trust. (Note definition of FAI in beginning of outline. If a distribution in a simple trust is not considered FAI under the terms of the governing instrument or state law, it is not part of DNI, not part of the distribution deduction and, as a result will be taxable to the trust.)

(2) Inclusion of amounts in gross income of beneficiaries of simple trusts: The amount of income that is required to be distributed by a simple trust is properly included in the gross income of the beneficiaries to whom the income is required to be distributed (whether actually distributed or not). If such amount exceeds DNI, there shall be included in the gross income of each beneficiary an amount which bears the same ratio to DNI as the amount of fiduciary accounting income required to be distributed to such beneficiary bears to the amount of income required to be distributed to all beneficiaries. The amount includible in a beneficiary's gross income shall have the same character in the hands of the beneficiary as in the hands of the trust and, unless the terms of the trust specify some different allocation of income to beneficiaries, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of DNI of the trust as the total of each class bears to the total DNI.

(3) Example of computation of distribution deduction for simple trust:

A simple trust provides that A is to receive 55% of the trust income and B is to receive 45%. The income of the trust consists of $20,000 of interest on corporate bonds. The expenses consist of $3,000 in commissions, legal fees and other deductible expenses allocable to principal, and $800 of expenses allocable to income. The trust income required to be distributed is $20,000 - $800, or $19,200. DNI ($16,200) is computed by taking the $20,000 in income and reducing it by the total of $3,800 in deductible expenses. The trust has a distribution deduction of $16,200. A receives $10,560 as a distribution ($19,200 x 55%), but he includes only $8,910 ($16,200 x 55%) in his gross income. B receives $8,640 as a distribution ($19,200 x 45%), but includes only $7,290 ($16,200 x 45%) in his gross income.

b. Complex Trusts:

(1) The “Tier Rules” – because of the ability to accumulate income in complex trusts for later distribution, special rules (often referred to by practitioners as “tier rules”) are necessary to distinguish mandatory distributions of income from other distributions of income made from complex trusts in calculating the distribution deduction and the amount of inclusion in beneficiaries’ gross income.

(a) “First Tier” distributions (described in Code Sec. 661(a)(1)) are required current distributions of income (including any amount required to be distributed which may be paid out of income or principal to the extent such amount is actually paid out of income), not to exceed DNI.

(b) “Second Tier” distributions (described in Code Sec. 661(a)(2)) are all other distributions, whether required or discretionary and whether made from current fiduciary accounting income, from prior years’ accumulated income, or from principal.

(2) The distribution deduction for a complex trust is the sum of first tier distribution amounts and second tier distribution amounts, but only to the extent such sum does not exceed the taxable amount of DNI of the trust.

(3) Inclusion of amounts in gross income of beneficiaries of complex trusts:

(a) For purposes of applying the DNI ceiling on complex trusts, the beneficiaries are divided into two groups:

(i) Those entitled to income distributions currently (first tier beneficiaries), who bear the primary burden of income taxation; and

(ii) Those receiving, or entitled to receive any other noncurrent distribution (second tier beneficiaries), who are taxable on their distributions only to the extent of any DNI not charged to the first tier.

(b) NOTE: The tiers are not mutually exclusive, thus, in any given year, a person may be both a first tier beneficiary and a second tier beneficiary.

(c) DNI is applied first to first tier required distributions of current income (and is prorated among those beneficiaries entitled to such distributions based on their respective interests in such distributions) (note the discussion of FAI above) and, if any DNI remains after satisfaction of all first tier distributions, the excess is prorated among second tier beneficiaries on the basis of their second tier distributions. The balance is a tax-free distribution of trust principal. The amount includible in a beneficiary’s gross income shall have the same character in the hands of the beneficiary as in the hands of the trust and, unless the terms of the trust specify some different allocation of income to beneficiaries, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of DNI of the trust as the total of each class bears to the total DNI.

(d) Example of computation of distribution deduction for complex trust:

The terms of a trust require distribution annually of $10,000 of income to A. If any income remains, it may be accumulated or distributed to B, C and D in amounts in the Trustee's discretion. The Trustee may also invade principal for the benefit of A, B, C or D. In the taxable year, the trust has $20,000 of income after the deduction of all expenses. DNI is $20,000. The Trustee distributes $10,000 of income to A. Of the remaining $10,000 of income, the Trustee distributes $3,000 to each of B, C and D, and also distributes an additional $5,000 to A. A, as a first tier beneficiary, includes $10,000 in his gross income under Code Sec. 662(a)(1). The sum of the other amounts distributed equal $14,000 ([$3,000 x 3] + $5,000) and are includible in the gross income of the second tier beneficiaries (A, B, C and D) to the extent of $10,000 (DNI less the income currently distributable to A). A will include an additional $3,571 ($5,000/$14,000 x $10,000) in income, and B, C and D will each include $2,143 ($3,000/$14,000 x $10,000) in their gross income. (Note that A was a both a first tier beneficiary and a second tier beneficiary under this example). With respect to the second tier distributions in excess of DNI, ($1,429 with respect to A and $857 with respect to each of B, C and D), unless there was accumulated UNI in the trust and the trust was subject to throwback, such amount would be distributed to those beneficiaries tax free.

H. The 65-day Rule is Your Friend

1. One income tax planning technique that Trustees of complex trusts may take advantage of is the so-called "65-day rule"[63], which allows the Trustee to make an election to treat a distribution amount (or a portion of a distribution amount) properly paid or credited within the first 65 days of any trust taxable year as paid or credited on the last day of the preceding trust taxable year.

2. Limitations:

a. To take advantage of the 65-day rule, the Trustee must make an election in accordance with Treas. Reg. 1.663(b)-2; and

b. The amount to which such election applies shall not exceed the greater of:

(1) The amount of income of the trust for the taxable year for which such election is made, or

(2) The amount of DNI for such taxable year reduced by any amounts paid, credited or required to be distributed in such taxable year.

c. Note: You cannot use the 65-day rule to make large second tier tax-free distributions. You can only use it to absorb remaining first tier income or DNI that was not distributed at the end of the preceding tax year.

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[63] Code Sec. 663(b).

3. Illustration of Application of 65-Day Rule:

A calendar year trust has $1,000 of income and $800 of DNI in 2012. The trust properly pays $550 to A, a beneficiary, on January 15, 2012, which the Trustee elects to treat under section 663(b) as paid on December 31, 2011. The trust also properly pays to A $600 on July 19, 2012, and $450 on January 17, 2013. The maximum amount that can be elected under this subdivision to be treated as properly paid or credited on the last day of 2012 is $400 ($1000 - $600). The $550 paid on January 15, 2012 does not reduce the maximum amount to which the election may apply because that amount is treated as properly paid on December 31, 2011.

I. Election to Recognize Gain Upon a Distribution of Principal

1. When a trust distributes an appreciated asset (unless it is in satisfaction of a specific bequest), there is no gain as a result of the distribution. The recipient take the asset with the same tax cost basis as the trust plus any gain or loss recognized by the trust as a result of the distribution.

2. Section 643(e)(3), however, allows the trustee to make an election to treat the distribution of the asset as a sale to the recipient at its then fair market value. The recipient receives the asset with a new FMV tax cost basis.

3. This election, however, is not an asset by asset election. Once made, it will apply to all distributions of assets made during that taxable year of the trust.

4. This election is not available for assets that are distributed pursuant to a specific bequest in the trust that is made in less than three installments.

a. Accordingly, if, for example, the trust holds 90 shares of stock and the trust agreement states that the stock shall be distributed in equals shares over a three year period (three distributions of 30 shares of stock, once a year). Then each year, the trustee can decide whether to elect to recognize the gain (or loss) when distributing the 30 shares.

b. If, on the other hand, the trustee is directed to make two distributions, once a year, of 45 shares of stock. The trustee does not have the right to make this election.

5. If the election is made and gain is recognized, then if capital gain is not included in DNI, it causes the trust to pay the tax on the gain, whereas if the asset is distributed with the trust's tax basis, then the recipient pays the tax on the gain when the asset it sold. Whether this is something that is appropriate for the recipient and the remaining trust beneficiary is something the drafter must consider when drafting any such specific bequests, as well as the trustee when making the distribution.

J. Termination of a Trust

1. A trust terminates by the terms of its governing instrument upon the occurrence of a terminating event, which is when the trust completely terminates. A trust does

not terminate on the exact day (when a beneficiary attains a certain age or upon a certain date), the trustee has a reasonable period of time to wind up the affairs of the trust and make final distributions. Accordingly, if the trust is to terminate on November 30 of a year, if the assets are not distributed until the following year, the trust continues (and must file a tax return) for the following year, although it will be a short year.

2. For income tax purposes, the year of a termination occurs in the year in which a trust has distributed to its beneficiaries all current income, previously undistributed income (if any) and all remaining principal.

a. To the extent such trust has any unused NOL carry forwards, unused capital loss carry forwards, and/or deductions (other than a personal exemption or a charitable contribution) in excess of gross income in the taxable year of termination, under Section 642(h) of the Code, such excess deductions shall be passed through to the beneficiaries (in proportion to their respective interests in the trust), and will retain their character in the hands of the beneficiaries; to be used in the year they received them.[64]

b. Note: certain deductions to which a trust would ordinarily be entitled are not allowable in the year in which the trust terminates including:

(1) A personal exemption, which may not be claimed in the year of termination, and

(2) A charitable contribution that is nondeductible because the contributions exceeded the entity's taxable income in the year of termination. However, note that the Sec. 642(c)(1) election (described above) may be available under these circumstances and, if made, would permit the charitable contribution paid in the year the trust terminates to be deducted in the year immediately preceding the year of termination, and

(3) Suspended passive activity losses are not allowable as a deduction, but the basis of such interest immediately before such distribution is increased by the amount of any passive activity loss allocable to such interest.[65]

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[64] Code Sec. 642(h).

[65] 469(j)(12).