Fiduciary Income Tax Refresher and Update 2026

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Review of Materials

- Slides
  - Will cover most – rest is for reference
  - Focus on concepts rather than examples
  - More details in other webinars
- Several thousand page PDF

Navigate between Slides and Big PDF

- Open both documents
- Highlight cross-reference in slides
- Ctrl-c to copy
- Go to FULL TABLE OF CONTENTS in big PDF
- Crtl-f to find
- Ctrl-v to paste
- Click ENTER to execute search (might need to specify “exact” or “whole word” search
- Warning: search works only for to the fifth level of the heading, not the sixth, which ends in parentheses. For the latter, use the fifth level of the heading and scroll down just a little.

Overview

- Strategic income tax planning
- Documentation to avoid the multiple trust rule
- State fiduciary income taxation
- Discretionary distributions in the first 65 days of a taxable year, including how to make such a distribution carry out capital gain

Overview

- Trapping income in trust notwithstanding distributions
- Minimizing liability for trustee and the return preparer

Tips for Fiduciary Income Tax Return Preparers (II.J.4.)

- Possible change in beneficiary’s residence
- Distributions after yearend to carry out income to beneficiaries
- Capital gain elections
- Charitable distributions
- Making trust a partial grantor trust as to a beneficiary

Tips for Fiduciary Income Tax Return Preparers (II.J.4.)

- Making the trust a complete grantor trust as to the beneficiary
- Trapping income in trust notwithstanding distributions
- Modifying trust to make more income tax efficient
- Material participation for business or rental activities

Fiduciary Income Taxation (II.J.1.)

- Estate and nongrantor trust
  - Distributable net income (DNI) = income minus most deductions
  - DNI distributed (or deemed to be) is taxable to recipient
  - Estate/trust taxed on rest
- Grantor trust is taxed to deemed owner
- https://www.jct.gov/publications/2021/jcx-49-21 is a very basic summary of fiduciary income taxation (not included in materials)

Polling Question 1

How are estates and nongrantor trusts taxed?

1. Just send it all in!
2. Burden split with beneficiary
3. Depends how much they pay preparer

Strategic Income Tax Planning (II.J.3)

- Who Is Best Taxed on Gross Income
- Effect of Kiddie Tax on Rates
- Who Benefits Most from Losses
- Who Benefits Most from Deductions
- State and Local Income Tax

Strategic Income Tax Planning (II.J.3)

- Consider Trust Purposes
- Effect on Future Years
- Drafting for Flexibility in Trust Income Taxation
- Planning for Excess Losses

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

Increasing a beneficiary's adjusted gross income (AGI) can cause the following issues:

- Reduction in particular itemized deductions, including charitable contribution, and overall itemized deductions (II.G.4.n.i.(b).)
- Phase out of AMT exemption
- Net Investment Income (NII) tax
- Phase out of personal exemption (2026+)
- Effect on Medicare premiums and college financial aid on FAFSA form

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

- Consider beneficiary loss carryovers to offset income – especially capital loss carryovers
- Thus, beneficiary in top bracket could effectively have lower rate because income offset by losses is not taxed

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

- Child taxed at parent rate on much of child's investment income
- No rule coordinating net investment income tax of child with parent

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

- Administrative expenses above-the-line for trusts and disallowed for beneficiaries
- State tax deduction
- Charitable deduction limitations (discussed further below)
- Code § 1244 stock N/A to trusts
- Special rule for depreciation deductions

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

- Trust's vs. beneficiary's rates
- Generally, states do not tax nonbusiness income earned by a nonresident trust (II.J.3.e.i.)
- Effect of grantor trust status on a trust's residence (including grantor later moving)

Look for Change in Beneficiary's Residence (II.J.4.d.)

- Beneficiary changing residence might change trust's residence, so always check beneficiary's residence and consider various factors that might affect the trust's residence
- State statutes, regulations, and instructions might not be updated for the case law that follows

Polling Question 2

What is the best practice for determining whether a beneficiary’s tax rate is lower than the trust’s?

1. Embezzle the beneficiary's money so that (s)he has no income
2. Find out one year and assume nothing ever changes
3. Learn beneficiary's tax posture; check each year for changes

State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust, 588 U.S. 262 (2019)

- Unanimous decision that NC cannot subject to income tax a trust whose only ties consisted of a beneficiary who may at some point receive distributions in the trustee's "absolute discretion"
- Holding limited to "the circumstances in which a beneficiary receives no trust income, has no right to demand that income, and is uncertain necessarily to receive a specific share of that income"

State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

- The Court did not address whether, if the trust had made distributions to Kaestner, NC could have taxed her
- The Court noted in passing and without pause that, in a year after taxable year that was subject to the litigation, trust was to terminate when beneficiary reached age 40, but trustee decanted into new trust (in a year after the taxable year being litigated), with no objection from primary beneficiary

State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

- "Today's decision does not address state laws that consider the in-state residency of a beneficiary as one of a combination of factors, that turn on the residency of a settlor, or that rely only on the residency of noncontingent beneficiaries, see, e.g., Cal. Rev. & Tax. Code Ann. § 17742(a)…. We express no opinion on the validity of such taxes."
- Thus, no impact on 2013 case, *McNeil Trust v. Commonwealth of Pennsylvania*, in which a Pa. court struck down taxation based solely on settlor's residence

State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

Footnotes 12-13:

"The State directs the Court's attention to 10 other state trust taxation statutes that also look to trust beneficiaries' in-state residency …, but 5 are unlike North Carolina's because they consider beneficiary residence only in combination with other factors [citing statutes in Alabama, Connecticut, Missouri, Ohio, and Rhode Island]. Of the remaining five statutes, it is not clear that the flexible tests employed in Montana and North Dakota permit reliance on beneficiary residence alone .... Similarly, Georgia's imposition of a tax on the sole basis of beneficiary residency is disputed …. Tennessee will be phasing out its income tax entirely by 2021 ….That leaves California, which (unlike North Carolina) applies its tax on the basis of beneficiary residency only where the beneficiary is not contingent …."

"The Trust also raises no challenge to the practice known as throwback taxation, by which a State taxes accumulated income at the time it is actually distributed." [citing California law]

State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

- Counsel for the state struggled to explain how state and federal income taxation are connected and later publicly admitted that he got raked over the coals by the Supreme Court justices
- The North Carolina bar has in the past proposed a statute that would pass muster, and the legislature declined to address the issue
- At least 400 protective claims for refunds had been filed by the end of June 2019
- On July 2, 2019 NC Department of Revenue established procedures for refund claims in cases governed by the case

State Fiduciary Income Taxation – *Kaestner* (II.J.3.e.ii.)

- Court since declined to review *Fielding v. Commissioner*, 916 N.W.2d 323 (Minn. 2018)
- That case involved a trust that owned shares in an S corporation
- Nobody disputed Minnesota's ability to tax the trust's distributive share of the S corporation's Minnesota source income
- Rather, the dispute was taxing the other income when the trust's sole potentially meaningful contact with Minnesota regarding that other income was the grantor's residence

State Fiduciary Income Taxation (II.J.3.e.ii.)

- The Minnesota Supreme Court held that taxing the trust on non-Minnesota source income solely based on grantor's Minnesota residency violated the Due Process Clauses of the U.S. and Minnesota Constitutions, which it viewed as identical to each other
- The very limited holding in *Kaestner* and denial of cert. to *Fielding* seems to indicate that the court looked into providing guidance then decided against it and no longer wishes to tackle the issue

State Fiduciary Income Taxation (II.J.3.e.ii.)

Linn v. Department of Revenue - Illinois Court of Appeals

- Due process analysis looks to contacts only for the taxable year being analyzed
- By exercising a limited power of appointment, the trustee was able to convert an Illinois trust to a trust governed by Texas law, with no Illinois contacts
- The fact that the deceased grantor of this inter vivos trust was an Illinois resident had no bearing
- Thus, consider decanting to move a trust out of state

State Income Taxation of Business Income
(II.G.3.)

- An owner of an interest in a pass-through entity such as an S corporation or partnership (including an LLC) will report income taxable to the states in which the entity does business, or the entity will pay tax on the income taxable to one or more of its owners instead of its owners reporting that income
- States that tax income have various methods to apportion a business' income, which tend to consider one or more of sales, property, or wages within the taxing state
- Potential for double taxation – use Multistate Tax Commission

State Income Taxation of Business Income
(II.G.3.)

- If the entity is a C corporation, it pays tax on its own income
- That avoids its owners needing to file income tax returns in multiple states
- C corporation deducts state income tax paid, but owner of a pass-through entity is subject to limitation on deducting state and local taxes (and AMT)

Sale of business (II.Q.1.a., II.Q.8.e.iii.(f), II.Q.9, II.H.8.a., including II.H.8.a.ii.):

- When pass-through business sells its assets (or is deemed to do so), its owners are taxed wherever assets are sited, but their basis in their partnership/member interest or S corporation stock increases on account of that gain/income
- An owner’s partnership/member interest or S corporation stock is sitused to the state of the owner’s residence
- If basis increase causes a loss on sale, it is deducted only in that state of residence

State Income Taxation of Business Income
(II.G.3.)

Sale of business (II.Q.1.a., II.Q.8.e.iii.(f), II.Q.9, II. H.8.a., including II.H.8.a.ii.):

- When a C corporation sells its assets (or is deemed to do so), it is taxed wherever assets are sited
- Its owners' stock's basis does not increase on account of that gain/income
- Stock is sitused to the state of its owner's residence

State Fiduciary Income Taxation (II.J.3.e.ii.(f).)

- Sale or deemed sale of business assets taxable at business situs - *2009 Metropoulos Family Trust v. California Franchise Tax Board*, 79 Cal. App.5th 245, 294 Cal. Rptr.3d 557 (Cal. Ct. App. 2022)
- Sale of partnership interest taxable only at owner's situs - *Noell Industries, Inc. v. Idaho State Tax Commission*, 470 P.3d 1176 (2020), and *Vas Holdings & Investments LLC v. Commissioner of Revenue*, 186 N.E. 3d 1240 (Mass. 2022)
- Multistate Tax Commission seriously considering recommending that any investment partnership (not one that operates a business) be disregarded and asset sale deemed to occur

State Income Taxation of Business Income
(II.G.3.)

Other nuances:

- Code § 199A deduction is available in only a few states
- *South Dakota v. Wayfair, Inc.*, 138 S.Ct. 2080 (2018), was a key decision regarding taxing nexus in the context of state sales tax
- The Council on State Taxation, cost.org, tracks not only the implications of that case but also which elements of federal law are integrated into state income taxation

Polling Question 3

Would you like to receive quarterly a link to the then-most recent version of the several-thousand-page PDF that is included with the course materials, through Steve's free newsletter, Gorin's Business Succession Solutions?

1. Yes
2. No
3. Already subscribe

Please be sure to download most recent version of PDF each quarter, read articles, or otherwise engage. Not engaging may deactivate subscription.

Consider Trust Purposes

- Protecting beneficiary from third parties
- Protecting beneficiary from self
- Avoiding estate tax at beneficiary's death (increased exemption might change this need)

Are distributions advisable?

- Are distributions available?
- Protective nature of trust

Are distributions available? (II.J.2.b.)

- Support vs. welfare
- Consider or not consider other resources

Additional Tax Issues

- Estate tax on beneficiary's estate
- Distribution in kind to include in beneficiary's estate for basis step-up (II.J.8.d.)

Protective Nature of Trust

- Very real creditor or spousal issues
- Burning a hole in the beneficiary’s pocket
- Beneficiary saves but might one day have creditors

Ideal Trust Distribution Provisions (II.J.2.b.)

- Distributions of income and principal for support
- Distributions of income and principal for welfare by independent trustee
- Consider 5% withdrawal right exercisable that trustee can turn off before the taxable year begins

Using Distributions for Welfare

- If appropriate, beneficiary can appoint person who is not a related or subordinate party (Code § 672(c))
- Distributions can carry out capital gain
- Can decant into more suitable trust or facilitate estate inclusion to get basis step-up at death

Flexibility in Trust Income Taxation

- Support – check for considering or ignoring other resources
- See whether distributions for welfare are permissible – check living client's estate plan for welfare and 5% withdrawal right (described further below)

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

- Rough draft of return in February
- Compare to beneficiaries' tax rates/posture
- Distributions by 65 days after yearend (March 6, 2026 for 2025 returns) (II.J.2.)
- Distributions can carry out capital gains (see below)
- When file return, can decide how much of post-yearend distributions to count for the year

Polling Question 4

What is the deadline for discretionary distributions to carry out income for the year?

1. 65 days after yearend (March 5 or 6)
2. Whenever the trustee pays your bill
3. Yearend

Charitable Distributions (II.J.4.c.)

- Reduce adjusted gross income
- Exclusive way for charitable deductions to reduce NII
- More liberal than 65-day rule - contribution made on or before December 31, 2026 can count as a 2025 contribution
- Pursuant to the instrument (II.J.4.c.i.)
- From gross income (II.Q.7.c.i.)

Code § 645 Election (II.J.7.)

- Treat trust as an estate
- Allows fiscal year, charitable set-aside, and extended time to hold S corporation stock
- Terminates two years after the date of the decedent's death or six months after the date of the final determination of estate tax liability (12 months after closing letter)

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

- Cannot pass through losses other than depreciation (II.J.11.a.ii.(a)); level at which the passive loss rules apply is uncertain when trust has net income (II.K.2.b.iv.)
- Lose excess losses except for final year, net operating loss, or capital loss
- Passive loss rules might simplify due to suspended losses

Multiple Trust Rule (II.J.9.c.)

- Reg. § 1.643(f)-1(a) – "… two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax."
- Although the government eliminated the proposed regulations' overreaching as ACTEC suggested, ACTEC's comments point out various questions that remain based on the statute and legislative history

Multiple Trust Rule (II.J.9.c.)

- Legislative history seems to conflate which beneficiaries are considered in testing whether trusts have "substantially the same primary beneficiary or beneficiaries"
- Consider documenting nontax reasons for multiple trusts

Polling Question 5

What is the best practice for avoiding the multiple trust rules when some beneficiaries in each trust are similar?

1. Document nontax reason/fiduciary duties for multiple trusts
2. Do extensive research of the law and write a treatise
3. Get some tips from your local Multiples of America affiliate

Capital Gain Elections (II.J.4.b)

- Tax preparation software traps unless take special steps
- Next slides discuss strategic issues, law, and practical issues (II.J.8.)

Top Bracket (II.J.3.)

	2026	2025
Single	$640,600	$626,300
Married filing jointly	$768,700	$751,600
Trust	$ 16,000	$ 15,900

Additional 5% Capital Gain Tax (II.J.3.)

	2026	2025
Single	$ 545,500	$533,400
Married filing jointly	$ 613,700	$600,050
Trust	$ 16,250	$ 15,900

Zero Capital Gain Rate (II.J.3.)

	2026	2025
Single	$ 49,450	$ 48,350
Married filing jointly	$ 98,900	$ 96,700
Trust	$ 3,300	$ 3,250

3.8% Tax on Net Investment Income
(II.I.3.)

Single	$200,000
Married	$250,000
Trust	$ 16,250
	($ 15,900 for 2025)

Indexed for trusts but not individuals

Capital Gain is DNI Unless Excluded (II.J.8.a.)

Code § 643(a)(3): capital gain excluded only if:

- From sale of capital asset
- Allocated to corpus
- Not paid, credited, or required to be distributed to a beneficiary
- Paid, permanently set aside, or to be used for charitable purposes

Capital Asset (II.J.8.a.i.)

Not a capital asset:

- Code § 1231 property
- Amortized goodwill (self-created goodwill not amortizable is a capital asset)

Mechanism for Distributing Capital Gain: Reg. § 1.643(a)-3(b) (II.J.8.c.)

1. Allocated to income
2. Allocated to corpus but distributed consistently
3. 65-day rule distribution

Allocated to Income (II.J.8.c.i.)

- “Power to adjust” principal
- Uniform Principal & Income Act reflects Prudent Investor Rule; UPIA becoming UFIPA (Uniform Fiduciary Income & Principal Act) (Uniform Law Commission adopted in 2018; adopted in CA, FL, OR, UT, CO, KS, VA)
- No duty of consistency from year to year except unitrust

Materials

- Uniform Law Commission: https://www.uniformlaws.org/home
- Web site for UFIPA: https://www.uniformlaws.org/committees/community-home?CommunityKey=1105f9bb-eb93-4d4d-a1ab-a535ef73de0c
- Web site for UFIPA has a Documents tab, with a link to the Enactment Kit that includes mapping Principal & Income Act to its UFIPA counterparts
- ACTEC/ALI-CLE 7/28/2021: Fun, Flexible, and Fair: Drafting and Administering Trusts Under UFIPA

Power to Adjust (II.J.5.b.ii.(a).)

Under the Uniform Principal and Income Act, a trustee may adjust between principal and income to the extent the trustee considers necessary if:

- The trustee invests and manages trust assets as a prudent investor,
- The 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 adjustment is necessary to fulfill the trustee's duty of impartiality between the beneficiaries.

Power to Adjust (II.J.5.b.ii.(a).)

- UFIPA § 203(a) requires only that the trustee determine that "the exercise of the power to adjust will assist the fiduciary to administer the trust or estate impartially."
- Thus, UFIPA requires only that the power to adjust will be helpful, not necessary.
- UFIPA - trustee not liable for failing to exercise the power
- UFIPA - trustee not liable for decision in good faith

Power to Adjust (II.J.5.b.ii.(a).)

Factors a fiduciary must consider (adjust or unitrust):

- the terms of the trust
- the nature, distribution standards, and expected duration of the trust
- the effect of the allocation rules, including specific adjustments between income and principal, under Articles 4 through 7
- the desirability of liquidity and regularity of income
- the extent to which an asset is used or may be used by a beneficiary
- the increase or decrease in the value of principal assets, reasonably determined by the fiduciary

Power to Adjust (II.J.5.b.ii.(a).)

Factors a fiduciary must consider (adjust or unitrust):

- whether and to what extent the terms of the trust give the fiduciary power to accumulate income or invade principal or prohibit the fiduciary from accumulating income or invading principal
- the extent to which the fiduciary has accumulated income or invaded principal in preceding accounting periods
- the effect of current and reasonably expected economic conditions
- the reasonably expected tax consequences of the exercise of the power

Power to Adjust (II.J.5.b.ii.(a).)

A fiduciary cannot adjust if would:

- Reduce the amount payable to a current income beneficiary from a trust that qualifies for a special tax benefit, except to the extent the adjustment is made to provide for a reasonable apportionment of the total return of the trust between the current income beneficiary and successor beneficiaries
- Change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets under the terms of the trust
- Affect charitable set-aside

Power to Adjust (II.J.5.b.ii.(a).)

A fiduciary cannot adjust if would:

- Cause a person to be treated as the owner of all or part of the trust for federal income tax purposes (but can appoint special trustee)
- Cause all or part of the value of the trust assets to be included in the gross estate of an individual for federal estate tax purposes (but can appoint special trustee)
- Cause an individual to be treated as making a gift for federal gift tax purposes (but can appoint special trustee)
- Be done by fiduciary who is not an independent person
- Affect eligibility for public benefits
- Change a unitrust

Unitrust (II.J.5.b.ii.(b).)

- A fiduciary cannot convert to, modify, or turn off unitrust if would violate certain tax rules
- If trust qualifies for a special tax benefit or a fiduciary is not an independent person, then the unitrust rate must be 3%-5%
- Terms of the trust may write rules, in whole or in part
- Trustee adopts unitrust policy, including:
  - the unitrust rate or the method for determining the unitrust rate
  - the method for determining the applicable value
  - the application of certain mandatory or permissive rules

Unitrust (II.J.5.b.ii.(b).)

Unitrust policy may include:

- Provide methods and standards for:
  - Determining the timing of distributions;
  - Making distributions in cash or in kind or partly in cash and partly in kind; or
  - Correcting an underpayment or overpayment to a beneficiary based on the unitrust amount if there is an error in calculating the unitrust amount;
- Specify sources and the order of sources, including categories of income for federal income tax purposes, from which distributions of a unitrust amount are paid; or
- Provide other standards and rules the fiduciary determines serve the interests of the beneficiaries.

Comparing Power to Adjust to Unitrust
(II.J.5.b.ii.(c).)

- Generally, a fiduciary exercises the power to adjust annually and the power to modify a unitrust only once or occasionally
- Exercising a power to adjust generally is included in annual reports, whereas adopting, modifying, or revoking unitrust provisions requires specific notice to the beneficiaries
- However, UFIPA allows a power to adjust to apply to all future periods and also authorizes frequent changes to a unitrust policy, so the above generalization about frequency is not necessarily accurate
- Unitrust probably generates capital gain on distribution in kind (definitely does for CRUT)
- Power to adjust more flexible for tax planning

Allocated to Income (II.J.8.c.i.)

- Trust agreement can allocate capital gain to income
- Cannot "depart fundamentally from traditional principles of income and principal" per Reg. § 1.643(b)-1
- 3%-5% should be OK

Allocated to Corpus But Distributed Consistently (II.J.8.c.ii.)

- Existing trusts – probably did NOT allocate capital gain to DNI
- Solution discussed later
- New trusts – generally allocate capital gain to DNI unless beneficiary in higher federal & state combined bracket (including phase-outs)

Actual or Deemed Distribution (II.J.8.c.iii.)

- Tracing actual distribution often not practical unless terminate trust
- Referring to capital gain suffices – 65-day rule distribution when trustee refers to capital gain
- Can be inconsistent from year to year

Fairness Issues (II.J.8.c.v.)

- Fair for cash distribution to carry out taxable income
- If not, “gross up” distribution for taxes paid by distributee
- “Gross up” payment costs remaindermen less than if the trust paid the tax

Polling Question 6

How easily are capital gains carried out?

1. Only on termination
2. Several strategies
3. Never

Netting Capital Losses (II.J.8.c.iv.)

Reg. § 1.643(a)-3(d), "Capital losses," provides:

- Capital losses shall first be netted at trust level against any capital gains
- Netting N/A to capital gain that is utilized under Reg. § 1.643(a)-3(b)(3) in determining amount that is distributed or required to be distributed to a particular beneficiary
- Reg. § 1.642(h)-1 applies to capital loss carryovers in year of final termination of estate or trust (II.J.3.i.)

Netting Capital Losses (II.J.8.c.iv.)

Thus:

- If and to the extent that Reg. § 1.643(a)-3(b)(3) includes capital gains in DNI (II.J.8.c.iii), capital losses are not netted against such gains
- Recipient beneficiaries report all such capital gains, and capital losses remain in the trust

Netting Capital Losses (II.J.8.c.iv.)

Reg. § 1.643(a)-3(b)(3) has two elements (II.J.8.c.iii):

- "Actually distributed to the beneficiary," which would tend to require tracing except in the case of trust termination, or
- "Utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary," in which case trustee would have needed to consciously decide to refer to capital gain when making the distribution

Netting Capital Losses (II.J.8.c.iv.)

- Unless trustee traces or decides to refer to gross capital gain (instead of net capital gain) when making the distribution, loss would be offset under Reg. § 1.643(a)-3(b)(3) (II.J.8.c.iii)
- Alternatively, trustee might not trace and not refer to capital gain but rather exercise the power to adjust, which would invoke Reg. § 1.643(a)-3(b)(1) (II.J.8.c.i) and include an automatic offset

Netting Capital Losses (II.J.8.c.iv.)

- If distribution and gross capital gain are so large that the IRS could prove tracing, then would Reg. § 1.643(a)-3(b)(3) automatically apply?
- Reg. § 1.643(a)-3(e), Example (10) allows trustee to allocate basis to distribution, to extent distribution might have been paid out of basis and trust did not fully terminate
- If Consistent Principal Rule: Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary (II.J.8.c.ii) applies, then presumably one could choose to refer to Reg. § 1.643(a)-3(b)(2) in one's records, making Reg. § 1.643(a)-3(d) not apply unless trust terminated that year or was required to distribute sale proceeds

Final Year Income Tax Traps (II.J.4.h.ii.)

- Estate may have substantial gain from satisfying pecuniary bequests, which does not carry out to the recipient of the pecuniary bequest
- Specific bequest does not carry out income, either (II.J.8.d.ii)

Final Year Income Tax Traps (II.J.4.h.ii.)

Nondeductible expenses below may exceed income (example in materials):

- Claims against estate
- Mortgages
- State death taxes
- Administrative expenses deducted on estate tax return

Final Year Income Tax Traps (II.J.4.h.ii.)

- Expenses that are deductible for regular tax might not be deductible for net investment income tax (II.I.7)
- Depreciation may pass directly to beneficiaries (II.J.11.a.ii)
- If client wants to terminate by yearend, be sure to have your fees prepaid so deducted on final return
- Excess losses covered further below

Final Year Income Tax Traps (II.J.4.h.ii.)

- Executor/trustee personally liable if distributes assets before paying estate's/trust's taxes (III.B.5.e.iv and III.B.5.e.v)
- Form 4810 cuts short the statute of limitations for the IRS to audit returns (III.B.5.e.iv.(g))

Final Year Income Tax Traps (II.J.4.h.ii.)

- Reserve enough cash to defend an audit and pay any tax, interest, and penalties that may be due
- Retaining cash reserve does not prevent the estate/trust from terminating for income tax purposes (but interest-bearing account may generate awkward tax return filing requirements) (II.J.3.i)
- Release and refunding agreement

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

- Exercise discretion to declare a distribution
- Credit instead of distribute
- Lapse makes beneficiary partial deemed owner
- Portion accumulates over time
- Cannot turn off

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

- Trustee contributes assets to S corporation
- Convert to QSST
- Might increase beneficiary's rights, depending on how conversion is done
- Can turn off

Qualified Subchapter S Trust (QSST)

Similar to marital deduction trust (III.A.3.e.i.(a).):

- All income must be distributed annually to sole beneficiary
- Not as protective as trust that accumulates income
- No distribution of principal during life of sole beneficiary to anyone other than sole beneficiary

Trapping Income in Trust Notwithstanding Distributions (II.J.4.h.)

- Trustee contributes assets to S corporation
- Trustee makes ESBT election
- Can turn off

Trapping Income in Trust Notwithstanding Distributions (II.J.4.h.)

- Beneficiary already in top federal tax bracket and would benefit from not having more income, due to reductions in tax or other benefits from that inclusion (II.J.3, II.J.11)
- Trust is not subject to state income tax, but beneficiary is (II.J.3.e)
- Missouri resident trusts are taxed as nonresident trusts (II.G.29.b)

Trapping Income in Trust Notwithstanding Distributions (II.J.4.h.)

- Trust would deduct S corporation contributions to charity using Code § 170 rules instead of Code § 642(c), so contributions of appreciated property could be fully deductible rather than limited to basis
- Contributions must be less than substantially all of the S corporation's assets

Trapping Income in Trust Notwithstanding Distributions (II.J.4.h.)

- Exit issues (III.A.3.e.vi.(b))
- If beneficiary wants to make significant annual charitable contributions through trust (instead of applying beneficiary's deduction limitations) and trustee agrees:
  - Trust could fund S corporation with marketable securities to be contributed to charity and other assets that would generate enough taxable items to absorb full charitable deduction, applying individual contribution limitations
  - S corporation could invest the remaining assets that would generate returns through income rather than capital appreciation
  - upon exit, S corporation's assets would have value relatively close to basis, so liquidation would not have serious income tax detriment

Polling Question 7

When trap income in trust?

1. Beneficiary in top bracket and doesn’t want gross income
2. Avoid state income tax
3. Both of above
4. When conducting ambush

Electing Small Business Trust (ESBT)
(III.A.3.e.ii.)

- Can be a sprinkle trust
- All S corporation income taxed at highest income tax bracket
  - Limited deductions
  - No income distribution deduction for S corporation items
- Flexible Trusts (III.A.3.e.iv.) Discussion Follows

Flexible Trust Design – Spouses

- In many cases, do ***not*** use sprinkle credit shelter trust, which locks one into ESBT
- Bequeath all assets into a QTIP-able trust to toggle between QSST and ESBT as appropriate
- Quick funding of QSST for spouse?
- Automatic QSST on spouse's death?

III.A.3.e.i.(b).

Flexible Trust Design – Children

- At drafting stage, make flexible as described above but only one beneficiary
- Can give beneficiary inter vivos power of appointment
- Might be able to modify ESBT and split into one or more QSSTs (III.A.3.e.v.)
- See materials for strategic advantages and disadvantages and implementation steps

Flexible Trust Design Using Multiple Trusts

- ESBT portion holds only S stock
- Hold any reinvested distributions in separate investment trust
- Distributions from S corporation trust do not carry out income
- Distributions from investment trust do carry out income
- Caution - multiple trust rules

S Corporation Income Tax (including ESBT NOLs)

- Review of electing small business trust (ESBT) income taxation
- CCA 202335014 clarified ESBT's deduction of net operating losses, clarifying scope of CCA 200734019
- While on topic of S corporation trust, we will discuss toggling grantor trust status when business sold

ESBT Income Taxation (III.A.3.e.ii.(b).)

- Grantor trust rules supersede, so these rules applies only to extent taxed as nongrantor trust
- S corporation income taxed as separate trust, at highest individual rate, with no distribution deduction, and with no exemption
- S corporation income includes ONLY all K-1 items, any gain or loss on sale of stock in the corp., state or local income taxes or administrative expenses to the extent allocable to the above, and any interest expense on debt to acquire that stock

ESBT Income Taxation (III.A.3.e.ii.(b).)

CCA 200734019:

- Estate held S stock
- S stock generated net operating loss (NOL) to the estate
- Residual trust received the NOL as excess loss on termination of estate
- Residual trust did not elect ESBT until 2-year period ended
- IRS asserted that NOL deductible against non-S portion, not S portion, of ESBT

ESBT Income Taxation (III.A.3.e.ii.(b).)

CCA 202335014:

- ESBT generated NOL
- ESBT had basis against which to deduct loss, but did not have sufficient income in its S portion to cover loss, thus creating an NOL at trust level
- IRS agreed that ESBT can use this NOL to offset S portion’s income in another year

ESBT Income Taxation (III.A.3.e.ii.(b).)

- Suppose residual trust in CCA 200734019 incurred S corp losses after it received the stock but before making ESBT election
- IRS worksheet and Form 7203 explain that distributions reduce basis available to absorb loss (II.G.4.d.i.)
- If can't elect ESBT retroactive to beginning of year, consider distributing enough to reduce basis to disallow loss
- If corporation needs to borrow, loan guarantee will not generate basis (II.G.4.d.ii.)
- Contribute to corporation cash to repay loan after make ESBT election
- CCA 202335014 seems to suggest that freed-up loss would be deductible against ESBT income

Helping Trustee Cut Off Liability (II.J.4.j.)

- Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure
  - ➢ Need to Provide Notices
  - ➢ Sample Notice

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

- Trustee liable 5 years after termination (Missouri or other UTC states)
- Providing notice cuts to 1 year
- Litigious beneficiaries
- Harmonious situation
- Sample notice – all records on flash drive; mail with table of contents and receipt

Polling Question 8

Provide annual notice in which situations?

1. Hostile beneficiary
2. Friendly beneficiary
3. Both of the above

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

- Passive (II.K.) = NII (II.I.8.)
- Document Trustee's Participation
- Even If Trust Taxed to Deemed Owner under Grantor Trust Rules, Consider Having Trustee Participate (discussed below)
- Beneficiary's Participation Can Trigger Depreciation (II.J.11.a.ii.(b).)

Qualified Subchapter S Trust (QSST)

Beneficiary taxed as deemed owner of S corporation stock ***except*** for gain on sale of stock or business assets

- Allows beneficiary to run through all the lower brackets before getting to higher brackets
- For sale of business, see II.J.15., II.J.16., and II.J.17.

Material Participation for Trusts

Trust Type	**Participant**
QSST (normal operations)	Beneficiary
QSST (stock or asset sale)	Trustee*
ESBT	Trustee

* Per proposed regulations and IRS' litigation position on trust material participation

See II.K.2.

Toggling Between QSST and ESBT

- First time toggling – no time restrictions
- Subsequent toggling – 36 month wait

Modify Trust to Make More Income Tax Efficient (II.J.4.i.)

- Settlor and beneficiaries (depends on state)
- Decanting (helpful if distributions for welfare) (II.J.18.c.)

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

Final regulations (10/19/2020):

- To the extent that deductions are allocable to taxable items, taxpayer may choose which deductions offset which income (II.J.8.f.i.(a))
- Use less favorable deduction to offset income, which is the equivalent of deducting itemized deductions above-the-line

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

My example:

- terminating trust has $5,000 income, $2,000 of tax prep fees, and $4,000 of legal fees
- excess deductions are $1,000 ($5,000 – ($2,000 + $4,000))
- both deductions are Code § 67(e) above-the-line deductions (in other words, deducted in arriving at gross income)

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

- Before the 2020 regulations, this $1,000 excess deduction would have been a miscellaneous itemized deduction
- Under the 2020 regulations, the $1,000 excess is an above-the-line deduction

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

Variation 1:

- Same example, but the $4,000 in legal fees is replaced by $4,000 in state income tax, which is an itemized deduction
- Excess deductions remain $1,000
- When preparing the tax return, you choose to apply $1,000 in tax prep fees and $4,000 in state income tax to eliminate the $5,000 income

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

Variation 1:

- That leaves $1,000 in tax prep fees
- Under the 2020 regulations, the $1,000 excess is an above-the-line deduction

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

Variation 2:

- Same as Variation 1, but you instead offset the income by $2,000 in tax fees and $3,000 in state income tax
- That leaves $1,000 in state income tax
- Under the regulations, the $1,000 excess is a regular itemized deduction (not a miscellaneous itemized deduction)
- Variation 1 is better: $1,000 is above-the-line

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

Final regulations (10/19/2020):

- Consistent with explicit requirements of Code § 642(h)(2), personal exemption and Code § 642(c) charitable deduction are not excess deductions
- Preamble seems to confirm that an ESBT's charitable contributions, which are now Code § 170 deductions, are now excess deductions on termination

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

Preamble to proposed regulations (5/11/2020):

> "These proposed regulations apply to taxable years beginning after the date these regulations are published as final regulations in the Federal Register. However, estates, non-grantor trusts, and their beneficiaries may rely on these proposed regulations under Section 67 for taxable years beginning after December 31, 2017, and on or before the date these regulations are published as final regulations in the Federal Register. Taxpayers may also rely on the proposed regulations under Section 642(h) for taxable years of beneficiaries beginning after December 31, 2017, and on or before the date these regulations are published as final regulations in the Federal Register in which an estate or trust terminates."

Code § 199A Deduction and Taxable Income Thresholds (II.E.1.c.v.(a).)

- Threshold ranges are $403,500-$553,500 for 2026 and $394,600-$494,600 for 2025 for married filing jointly, $201,775-$276,775 for 2026 and $197,300-$247,300 for 2025 for married filing separately, and $201,750-$276,750 for 2026 and $197,300-$247,500 for 2025 for all other returns
- Below threshold, most ineligible service businesses become eligible and the wage limitations do not apply
- Benefits phase out over that range
- Phase-outs apply cumulatively

Trusts and QBI (II.E.1.f.)

- Grantor trusts are disregarded and their items attributed to their deemed owners
- The trust and beneficiaries are allocated the various items in proportion to their respective portions of distributable net income (“DNI”), determined after applying the separate share rules, if relevant

Trusts and QBI (II.E.1.f.)

- The Code § 199A deduction is not included in calculating DNI. Considering that both deductions are artificial deductions rather than deductions of actual expenditures, there is some logic to this.
- Taxable income thresholds are applied separately at the trust and beneficiary levels

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

Rev. Proc. 2019-38 "provides a safe harbor under which a rental real estate enterprise will be treated as a trade or business" solely for purposes of Code § 199A and the regulations thereunder, then says, "If an enterprise fails to satisfy the requirements of this safe harbor, it may be treated as a trade or business for purposes of section 199A if the enterprise otherwise meets the definition of trade or business in § 1.199A-1(b)(14)."

Rental Real Estate & Code § 199A

(II.E.1.e.i.(a).)

- "To be responsible for maintenance activities" indicated that, for the lease to be a disfavored "triple net lease" under Notice 2019-7, the tenant had to not only pay for maintenance but also arrange the maintenance
- Rev Proc. 2019-38 eliminates the responsibility requirement by providing that mere payment of maintenance is enough connection to maintenance activity that, when combined with other factors in both tests, would make the lease a disfavored triple net lease
- This change knocks out most large shopping centers and large office buildings from safe harbor, but those activities do not appear to need a safe harbor anyway, given the level of service typically provided
- Code § 199A Safe Harbor for Rental Real Estate; Partnership Structural Issues; Sale of Intangible Assets

Consider Forming Partnership (II.J.8.e.)

- Trust is General Partner
- Beneficiary is Limited Partner

Partnership

- Converts capital gain to trust accounting income
- Beneficiary can’t spend the partnership interest if distributed to carry out capital gain
- Need to gross up beneficiary for capital gain if use distribution of partnership interest to carry out capital gain

Conclusion

- Gorin's Business Succession Solutions (quarterly updates to several thousand pages of materials plus chance to subscribe to other publications)
- CPA Academy webinar page, including:
  - –How to Shift Income to Beneficiaries
  - –Pass-through Entities Held By Trusts
  - –Grantor Trusts
- Other free Thompson Coburn LLP resources