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Income Taxation of Fiduciaries and Beneficiaries

BYRLE M. ABBIN

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Income Taxation of Fiduciaries and Beneficiaries

2013 Edition

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McLean, Virginia

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Income Taxation of Fiduciaries and Beneficiaries 2013 Edition

by Byrle M. Abbin

Income Taxation of Fiduciaries and Beneficiaries provides step-by-step guidance on the taxation of fiduciary income. This comprehensive guide for practitioners advising fiduciaries and beneficiaries in federal and state income tax matters covers the broad range of complex issues from charitable remainder trusts to nexus rules and their effect. Providing expert practical advice, *Income Taxation of Fiduciaries and Beneficiaries* helps you obtain the most advantageous outcomes for your fiduciary and beneficiary clients.

2013 Edition

The 2013 Edition of *Income Taxation of Fiduciaries and Beneficiaries* brings you up to date on the latest developments in this complex and constantly changing area. Highlights include:

- Grantor trusts
  - Early termination of grantor CLAT;
  - Multiple grantors—tax items allocated;
  - Grantor treated as direct owners of all tax items;
  - Must special needs trust grantor receive an inherited IRA to qualify?
- DNI/Distribution rules
  - Separate shares can elect QSST/ESBT;
  - Allocate expenses to high tax rate trust income items;
  - Re-proposed IRC § 67(e) regulations;
  - Election not available for trust to expense depreciable assets;
  - Do tax related items—NOL and capital loss carryforwards, suspended PAL and tax credits, transfer to new trust receiving all of original trust's assets in a decanting?;
  - Proposed regulations issued on what qualifies as material participation in activities so IRC § 469 is not applicable;
  - Early termination of beneficial interest in a trust is not a taxable event.
- Special Foreign Bank Account Reporting (FBAR) requirements for power over non-U.S. financial assets.

About the Authors

Byrle M. Abbin is a Managing Director, WTAS LLC, in McLean, Virginia. He received his B.B.A. with distinction from the University of Michigan and his J.D. from Harvard Law School. In 1959, Mr. Abbin was awarded the Elijah Watt Sells Gold Medal as well as the Illinois Gold Medal for the best paper submitted on the national CPA exam.

He has had extensive experience in tax policy matters through congressional testimony, written analyses in tax journals, and is a member of various committees of the American Institute of Certified Public Accountants (AICPA) that have proposed legislative and regulatory recommendations. In this role, Mr. Abbin has appeared before the World Economic Forum, Davos, Switzerland, and various meetings including the Brookings Institution Conference on Tax Policy. His technical interests range from estate planning to the corporate alternative minimum tax, about which he edited and co-authored a treatise published by CCH. He is co-author of *Tax Economics of Charitable Giving* (Warren, Gorham & Lamont).

He has been a prolific speaker and writer in estate planning matters, appearing before most major tax institutes and conferences. He has been especially involved in the ALI-ABA program on Planning for Large Estates and in the University of Miami's Philip E. Heckerling Institute on Estate Planning, on whose advisory committee he serves. He is a former Director of the American Council for Capital Formation, The Tax Council, and a former Director and Chairman of the Institute for Research on the Economics of Taxation. He served as Chairman of the AICPA Consumption Taxation Task Force. He is also a member of the AICPA Fiduciary Income Tax Task Force and serves on the AICPA Transfer Tax Task Force and GST Tax Task Force. He was a member of the program and policy committee of the Tax Foundation, and the Advisory Board of numerous tax journals. He is a past member of the AICPA National Conference of Lawyers and CPAs and a former Director of the National Association of Estate Planning Councils, and he continues membership in numerous professional associations.

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Preface

The present statutory scheme for taxing estates, trusts, and their beneficiaries has remained relatively intact during the past 50 years. Even so, uncertainty continues because subchapter J, in providing special rules for the taxation of fiduciaries and beneficiaries, essentially represents a special "code" within the Internal Revenue Code that is designed to address the unique nature of estates and trusts. For federal income tax purposes, fiduciaries operate both as flow-through entities to the extent that current distributions are made to beneficiaries and as separate taxpayers with regard to undistributed amounts retained at the entity level. The situation is further complicated by the lack of integration existing between the two principal accounting conventions governing the operations of these fiduciaries—trust accounting and fiduciary tax accounting. As a result, advisers must be prepared to deal with such unique concepts as the "tier system" for prioritizing the flow of tax incidence to various categories of beneficiary distributions, while still being attentive to how they interact with the often contradictory nontax state-law rules underpinning trust accounting.

These challenges have resulted in confusion and a significant amount of noncompliance with the strict dictates of the statute and as set forth in explanatory regulations, rulings, and cases. A somewhat cavalier attitude among taxpayers and advisers causes them to proceed on the basis of what seems "fair" in light of the complexity of these statutory provisions. This attitude has been reinforced by the apparent reluctance of the Internal Revenue Service to examine fiduciary income tax returns. Unfortunately, the willingness to chance the audit lottery resulting from infrequent examinations has led to the wide spread of individually determined interpretations.

Certain statutory changes in the past four decades, such as simplification of the accumulation distribution rules and the combination of multiple trusts having similar grantors and beneficiaries in order to preclude what the government has considered tax avoidance, have been overshadowed by statutory changes in other areas of the Internal Revenue Code, outside subchapter J. Nonetheless, many of these changes have had a significant impact on fiduciaries, specifically in carrying out their responsibilities. Several of these new rules are highlighted in some detail, such as the impact of the passive activity loss limitation rules (IRC § 469) on fiduciaries and beneficiaries, a very complex treatment in its own right that has become most meddlesome to fiduciaries and their advisers because of a lack of explanatory regulations; the special treatment under subchapter S for qualified subchapter S trusts (QSSTs); the various income tax aspects that flow from the application of the generation-skipping transfer tax rules on taxable distributions or terminations; and the myriad special rules emanating from statutes, regulations, and public and private rulings, as well as decisions affecting the use of charitable lead trusts (CLTs) and charitable remainder trusts (CRTs).

The structure of this book has been accomplished in a fashion somewhat different from that attempted by others. At the outset, the state law trust accounting rules are explored in some depth, followed by a description of how subchapter J operates. This includes an in-depth review of (1) the distribution system and how the operation of the "tier" approach contrasts with the trust accounting rules; (2) limitations, especially with regard to payments to charities; and (3) the major challenge dealing with the passive activity loss limitations. With regard to the latter, the author provides his own analysis of what he considers appropriate filing positions.

To provide a better understanding of the application of some of the very special rules that apply solely to trusts, such as the accumulation distribution throwback rules and others that pertain solely or primarily to fiduciaries operating as estates (especially income in respect of a decedent), these specially treated items are discussed within the context of the life cycle of a trust. This life cycle approach addresses the tax aspects of formation, operation, and termination of the entity, including tax basis and other tax attributes that might flow to the distributees on trust termination. With regard to estates, the same cycle from formation to termination considers the special income, deduction, and distribution rules that specifically affect the taxation of the estates and their distributee-beneficiaries.

Historically, grantor trusts provisions had been considered traps for the unwary, but recent change in transactional structuring, as well as narrowing of the effective range of tax brackets, has resulted in significant use of grantor trust status as an affirmative tax planning device, both by individuals and businesses. Related is the use of these grantor trust rules for qualifying S corporation ownership, as well as current planning use allowed under IRC chapter 14 for the "acronym" devices such as GRATs (grantor retained annuity trusts) and QPRTs (qualified personal residence trusts), which are specifically highlighted. Also unique is the extensive discussion of the use of trusts in business activity such as liquidating trusts, investment trusts, and other forms of title holding trusts in which the flowthrough status may or may not be recognized, in contrast to treatment as an association taxable as a corporation or a partnership that depends on the structure. State income and intangibles tax challenges confronting fiduciaries and beneficiaries are addressed.

A chapter considers the fiduciary income tax consequences of funding activities by a trustee of a formerly revocable trust, or the executor under a will, involving legatees, devisees, and other designated distributees of a very favorite form of entity ownership in estate planning—the family limited partnership, commonly called by the acronym FLP.

The author's approach attempts to emphasize "user friendliness." To accomplish this, the technical text analysis has been restrained. Statement of the rules is expanded by many prose and number examples that are intended to assist the reader in understanding the technical concepts that have been provided by the Internal Revenue Code, regulations, rulings, and applicable decisions. As an ultimate application of the flow of activities involving fiduciaries and beneficiaries, and to better understand the application of all the myriad rules discussed in the text and examples, 35 separate case studies are provided (following Chapter 22) using discrete fact patterns that are reflected on completed tax and related information returns. These include the special information returns required of split-interest charitable lead and remainder trusts.

Even though the Uniform Principal and Income Act was revised in late 1997, significant uncertainty, if not confusion, appears to be extant in the minds of many lawyers, accountants, and trust officers as to how the revised UPIA [The 1997 Act] is to be interpreted and applied in those states that have adopted it *en toto* or with slight modifications.

The past year's activities relating to fiduciary income tax matters, as was the case in the previous year, were muted, primarily reflecting grantor trust and charitable deduction issues/situations. The most significant technical change involves the 3.8 percent Medicare tax. Much detail has been provided on the application of this new tax in proposed regulations and FAQs (frequently asked questions), yet as of the publication cut-off date, Form 1041 is not available, and related calculations aspects are set out in proposed regulations and FAQs, to be effective when finalized. The grantor trust situations that are analyzed include possible multiple grantors when the transferor has substitution power over a second transferor's funding, transfer/sale by one grantor trust to another is not a taxable event, a bankruptcy trust is not a grantor trust re its taxation or that of the involved taxpayers.

Charitable deduction treatment involves (1) distribution by trustees to a tax-exempt organization done under a limited power of appointment, (2) deduction for an in-kind distribution of assets from a wholly-owned S Corp. to the estate and then to the estate's sole beneficiary, a private foundation, (3) variable ascending/cascading amounts of CLT payouts—120 percent of the prior year's(s') amount, (4) CLUT to CLUT transfers that do not involve private foundation sanctions.

Other issues discussed are tax accounting and distribution rules application related to HEET (health, education, exclusion trust) trust; holding an annuity policy is not taxable to the trust—it is deemed owned by annuitant; staging FAI realization to equal/exceed DNI so there is no accumulation distribution; income ordering rules effected by a fiduciary are respected by IRS only if there is economic effect outside of tax consequences; TIN reflected when trust division takes place; personal non-real estate maintenance expenditures such as internet, boats, etc. if paid by trustee likely to be treated as distribution to trust beneficiaries.

March 2013

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