This chapter was first published by IICLE® Press.

Book containing this chapter and any forms referenced herein is available for purchase at www.iicle.com or by calling toll free 1.800.252.8062

6 Income Tax Aspects of Estate Planning

JOHN B. BEERY
JULIE SIRLIN PLESHIVOY
Gould & Ratner LLP
Chicago

I. [6.1] Introduction

II. [6.2] Grantor Trusts

A. [6.3] Situations in Which a Grantor Trust Is Desirable
B. [6.4] Definitions and Concepts Affecting the Grantor Trust Rules
  1. [6.5] Adverse Party and Non-Adverse Party
  2. [6.6] Related or Subordinate Party
  3. [6.7] Powers Subject to Notice and Waiting Requirements
  4. [6.8] Interests Held by Grantor's Spouse
  5. [6.9] Grantor Trust Rules and Foreign Entities
C. [6.10] When Grantor Is Treated as Owner
  1. [6.11] Code §673: Reversionary Interests
  2. [6.12] Code §674: Power To Control Beneficial Enjoyment
    a. Powers That May Be Held by Anyone
      (1) [6.13] Power to apply income to support a dependent
      (2) [6.14] Powers exercisable only after the occurrence of an event
      (3) [6.15] Powers exercisable only by will
      (4) [6.16] Powers to distribute principal for charitable contribution or to ESOP in qualified gratuitous transfer
      (5) [6.17] Powers to distribute principal subject to a "reasonably definite standard" or to a current income beneficiary
      (6) [6.18] Power to temporarily withhold income that ultimately must be payable
      (7) [6.19] Power to withhold and accumulate income while beneficiary is disabled or under age 21
      (8) [6.20] Power to allocate receipts and disbursements
    b. [6.21] Powers Held by Independent Trustees
    c. [6.22] Powers Held by Non-Grantor Trustees
    d. [6.23] Powers To Remove Trustees and To Add Beneficiaries
  3. [6.24] Code §675: Administrative Powers
  4. [6.25] Code §676: Revocation
  5. [6.26] Code §677: Powers To Distribute Income for Benefit of Grantor
D. [6.27] When Person Other than Grantor Is Treated as Owner

III. Non-Grantor Trusts

A. Specific Characteristics
  1. [6.28] Tax Rates
  2. [6.29] Taxable Income

3. [6.30] Distributable Net Income
4. [6.31] Character of Distributions
5. [6.32] In-Kind Treatment of Distributions
6. [6.33] The 65-Day Rule

B. [6.34] Distributions from Simple Trusts
1. [6.35] Tax Treatment of the Simple Trust
2. [6.36] Tax Treatment of Beneficiaries

C. [6.37] Distributions from Complex Trusts
1. [6.38] Separate Share Rule
2. [6.39] Code §663 Exclusions
3. [6.40] Tax Treatment of the Complex Trust
4. [6.41] Tax Treatment of Beneficiaries
5. [6.42] Throwback Rule
a. Definitions and Concepts Affecting the Throwback Rule
(1) [6.43] Undistributed net income
(2) [6.44] Accumulation distribution
(3) [6.45] Taxes imposed on the trust
(4) [6.46] Deemed distribution of taxes
(5) [6.47] Tax treatment of various deemed distributions
b. [6.48] Operation
(1) [6.49] Allocation to earlier taxable years
(2) [6.50] Example
c. [6.51] Trapping Distributions
d. [6.52] Taxable Year

D. [6.53] Distributions from Charitable Remainder Trusts
1. [6.54] Types of CRTs and Applicable Rules
2. [6.55] Tax Treatment of the CRT
3. [6.56] Tax Treatment of Beneficiaries

IV. [6.57] Estates

A. [6.58] Separate Share Rule
B. [6.59] Income in Respect of a Decedent
C. [6.60] Election into the Carryover Basis Regime for 2010 Decedents

V. [6.61] Income-Shifting Strategies

A. [6.62] Custodianship (Illinois Uniform Transfers to Minors Act)
B. [6.63] Code §2503(c) Trust
C. [6.64] *Crummey* Trust

D. [6.65] *Clifford* Trust
E. [6.66] Spousal Remainder Trust
F. [6.67] Multiple Trusts
G. [6.68] Interest-Free Loan
H. [6.69] Income Tax Rates and the Kiddie Tax
I. [6.70] Use of Fiscal Years

VI. Miscellaneous Provisions Affecting Income Tax Planning

A. [6.71] Personal Interest Deduction Limitation
B. [6.72] Alternative Minimum Tax for Individuals
C. [6.73] Estimated Tax Payments for Trusts
D. [6.74] Reciprocal Trust Doctrine
E. [6.75] Anti-*Hubert* Regulations

VII. Investment and Tax Deferral Techniques

A. [6.76] Zero-Coupon Bonds
B. [6.77] U.S. Savings Bonds
C. [6.78] Illinois General Obligation College Savings Bonds

I. [6.1] INTRODUCTION

Trusts have long been used to transfer wealth. A trust can provide a structure for managing wealth, preserving privacy, and protecting and meeting the particular needs of family members over an extended period of time. Because they can also be used to save transfer taxes, trusts have become one of the estate planner's most versatile tools.

Generally speaking, income on assets owned by a trust will be taxed in one of four ways, depending on the terms of the trust instrument. A trust can be taxed

a. to the person who created the trust (the "settlor" or "grantor") or to some other person who is treated as owning the trust assets for income tax purposes under the "grantor trust rules" of the Internal Revenue Code;

b. to the trust itself;

c. to the beneficiaries of the trust to the extent trust income is distributed to them; or

d. to both the trust and the beneficiaries.

A trust can be either a separate taxpayer for income tax purposes or an entity through which income flows to the beneficiaries. Income distributed to trust beneficiaries will be taxed to the beneficiaries who receive it.

Typically, not all members of a family are in the same income tax bracket, which opens an opportunity for a family's overall income taxes to be reduced if wealthy members of the family transfer income-producing assets to other family members. However, the donor must actually transfer the income-producing assets for such "income-splitting" strategies to be successful. Such transfers can be in the form of outright gifts to individual family members or gifts to trusts for their benefit. For a wide range of reasons, however, an individual may not always be willing to make outright gifts to members of his or her family. Family members are not all equally skilled at managing money or using it prudently. Some may benefit from spendthrift and other creditor protection; others may be minors or under a disability. A trust provides a structure for addressing all of these issues and for implementing the donor's wish to place some controls on a beneficiary's access to and use of the transferred property.

Much estate planning is done for purposes of minimizing gift, estate, and generation-skipping transfer taxes. However, many of the decisions that must be made in creating an effective plan for the transmission of assets are also affected by income tax considerations. The administrative and dispositive provisions of wills and trusts, as well as the actions actually taken by various fiduciaries acting under these instruments, can have significant income tax implications for the various individuals involved. The purpose of this chapter is to give an overview of the rules involved in analyzing the issues surrounding income tax treatment of estate planning entities. However, thorough analyses of certain less frequently encountered issues (such as foreign trusts and inbound and outbound trusts) are more properly the subject of an income tax treatise and have been intentionally omitted or addressed only briefly.

II. [6.2] GRANTOR TRUSTS

For many years, trust income was taxed at rates lower than the marginal rates that applied to individual taxpayers. This differential in tax rates prompted many individuals to create trusts that would be separate taxpayers for income tax purposes. The settlor who created the trust could still retain a range of power over the trust property, the administration of the trust, or both. Such a "shifting" of income to one or more trusts resulted in less tax than would have been paid at individual rates.

Congress perceived the use of trusts to effect such income-shifting to be abusive and in 1924 added several provisions to the Internal Revenue Code that were intended to cause the grantor (*i.e.,* the settlor) of a trust to continue to be treated for income tax purposes as the deemed owner of all or a portion of the assets held by a trust the grantor had created. These provisions are known as the "grantor trust rules" and are contained in Code §§671 – 679.

A person who is deemed to be the owner of trust assets under the grantor trust rules must include in his or her income the income, deductions, and credits against tax attributable to those trust assets the person is deemed to own. While the grantor trust rules most often apply to the settlor, or creator, of the trust, certain provisions of the grantor trust rules can cause other individuals (*i.e.,* persons other than the settlor of the trust) to be treated for income tax purposes as the owner of trust assets.

NOTE: While the Code itself is correct in restricting the term "grantor" to mean the settlor of the trust and not using this term to refer to others who may be treated as substantial owners of trust assets, colloquial usage regarding trusts affected by these rules has become confused. Often, the term "grantor" in this context is used to refer to the deemed owner of trust assets, whether or not that person is actually the settlor of the trust in question. This chapter uses the term "grantor" exclusively in the sense in which it is used in the Code; *i.e.,* in this chapter "grantor" never refers to a substantial owner of trust assets unless that person is also the settlor of the trust.

Congress concluded that the grantor trust rules had failed to eradicate income-shifting through the use of trusts and in 1986 significantly narrowed the brackets at which trust income is taxed. While the compression of tax rates has been effective in reducing the use of trusts as an income tax reduction strategy, it simultaneously gave rise to new consideration of the grantor trust rules in the realm of estate and gift tax planning. The result is that a set of rules designed to reduce perceived income tax abuse has become a powerful estate planning tool.

A. [6.3] Situations in Which a Grantor Trust Is Desirable

From an estate planning perspective, a primary benefit of a grantor trust is that the person treated as the owner of the trust assets is taxed on the income from those assets. Since the grantor trust rules and the estate and gift tax rules are not congruent, it is frequently possible to make a completed gift, which removes assets from the transferor's estate, while still having income on the gifted assets be taxed to the grantor. For example, *A* creates a trust for the benefit of *B* and makes a gift to the trust of assets having a value of $1 million. The trust agreement provides that *A* may "revest in himself" (*i.e.,* take back) the property originally contributed to the trust by

substituting other assets of an equal value. Because of this retained right to substitute trust assets, the grantor trust rules will cause *A* to be taxed on the trust income even though the transfer is complete for gift tax purposes and the trust assets will not be included in *A*'s estate. There is currently no provision of the Internal Revenue Code that will cause *A*'s payment of the income tax liability to be treated as an additional gift to *B*. Therefore, the assets given to *B* in trust can effectively grow tax free while the grantor continues to reduce the value of the grantor's own estate by paying tax on the income of assets owned by another.

B. [6.4] Definitions and Concepts Affecting the Grantor Trust Rules

Before embarking on a full discussion of the grantor trust rules, several useful terms and concepts need to be reviewed. Internal Revenue Code §672 defines three terms used throughout the grantor trust rules and sets forth three additional rules that also apply to the grantor trust rules. See §§6.5 – 6.9 below.

1. [6.5] Adverse Party and Non-Adverse Party

An "adverse party," for purposes of the grantor trust rules, is

> **any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.** Internal Revenue Code §672(a).

The term "adverse party" is defined only by reference to other persons. For example, *A* and *B* are adverse parties if their interests differ with respect to a trust power: *A* prefers that the power be exercised, while *B* does not. When *A* holds a power with respect to a trust, *A* is adverse to those persons who might benefit from the exercise or non-exercise of that power when *A* does not. The interests of adverse parties do not complement each other. When a trust instrument provides that income not distributed to the income beneficiary is to be added to principal, a remainderman holding the power to distribute or withhold income will be adverse to the income beneficiary.

A "nonadverse party" is any person who is not an adverse party. Code §672(b).

2. [6.6] Related or Subordinate Party

A "related or subordinate party" includes all of the following people:

a. the grantor's spouse if living with the grantor;

b. the grantor's father, mother, issue, brother, or sister;

c. an employee of the grantor;

d. a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; and

e. a subordinate employee of a corporation in which the grantor is an executive. Internal Revenue Code §672(c).

For purposes of Code §§672(f), 674, and 675, a related or subordinate party is presumed to be "subservient" to the grantor unless otherwise shown by a preponderance of the evidence. Code §672(c).

3. [6.7] Powers Subject to Notice and Waiting Requirements

Internal Revenue Code §672(d) states in general that

> [a] **person shall be considered to have a power described in this subpart even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.**

In other words, notice requirements and waiting periods that must be fulfilled or taken into account to properly exercise various powers with respect to trusts will not affect the treatment of those trusts for purposes of the grantor trust rules.

4. [6.8] Interests Held by Grantor's Spouse

The grantor of a trust will be treated as holding any power or interest in the trust held by

> **(A) any individual who was the spouse of the grantor at the time of the creation of such power or interest, or**
>
> **(B) any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor.** Internal Revenue Code §672(e)(1).

Former spouses and spouses who are legally separated under a decree of divorce or separate maintenance will not be considered as married for these purposes. Code §672(e)(2). Therefore, any power held by the current spouse of the grantor or by a person who was the grantor's spouse at the time the power was created will be treated as being held by the grantor for purposes of the grantor trust rules.

5. [6.9] Grantor Trust Rules and Foreign Entities

Under Internal Revenue Code §672, the grantor trust rules are to be used to compute the income of only domestic corporations and citizens and residents of the United States. Code §672(f)(1). The drafters of the grantor trust rules wanted to avoid treating persons as owners of trust assets when those persons are not subject to the federal income tax regime of the United States. The general rule that grantor trust rules are to be used to compute the income of only domestic corporations and citizens and residents of the United States has several exceptions that are found in Code §672(f)(2), which the practitioner should review with care when dealing with foreign entities.

C. [6.10] When Grantor Is Treated as Owner

Internal Revenue Code §§673 – 677 contain the rules under which the grantor of a trust will be treated for income tax purposes as the owner of trust assets, subject to the definitions and general rules set forth in Code §672. Most of these rules provide that trust income will be taxed to the grantor if the grantor retains certain rights in the trust assets or powers over the use of such assets.

1. [6.11] Code §673: Reversionary Interests

Before 1986 when the income tax rates for trusts were lower than those for individuals, a useful income tax planning technique was to divide a taxpayer's income among a variety of trusts, keeping the effective tax rate lower than that which would have applied to the taxpayer as an individual. This technique is called "income-splitting." However, income-splitting can run afoul of the assignment-of-income doctrine under which a person who transfers income to another person may still be required to pay the tax on the transferred income. When income-splitting among separate taxpayers was a more beneficial estate planning tool, one way to avoid application of the assignment-of-income doctrine was to transfer the property that produced the income rather than only a right to the income itself. An outright transfer of assets, however, results in the transferor's loss of control over the income-producing property.

One of the first techniques for avoiding the assignment-of-income doctrine without completely transferring all rights to the property itself was for a grantor to transfer assets to a trust and retain a reversionary interest in the corpus of that trust. During the term of the trust, the income would be taxed at preferential trust rates, and title to the trust principal would eventually revert back to the grantor. The conclusion that this technique was abusive led to the enactment of the original Internal Revenue Code §673, which provided that only transfers to trusts having terms in excess of ten years would be respected as separate taxpayers for income tax purposes. See the discussion of *Clifford* trusts in §6.65 below. Eventually, the ten-year rule also came to be perceived as abusive, and in 1986 Congress enacted the current Code §673, which effectively repealed the original Code §673.

Under present law, a grantor of a trust who retains a reversionary interest in either the principal or the income from a portion of a trust will be treated as the owner of that portion of the trust assets if the value of the grantor's reversionary interest exceeds five percent of the value of that portion of the trust. Code §673(a). Current valuation tables require that the reversion be delayed at least 23 years to ensure that the reversionary interest has a value of less than five percent of the value of the underlying portion of the trust, even assuming the highest acceptable interest rate. Treas.Reg. §20.2031-7(d)(6), Table B. However, if the reversionary interest takes effect only upon the death of the sole beneficiary of the trust before that beneficiary attains age 21 and the beneficiary is a lineal descendant of the grantor, the grantor will not be treated as the owner of the portion of the trust assets in which a reversionary interest was retained. Code §673(b).

In calculating the value of the reversionary interest, the Code requires that any discretion given to the trustee is assumed to be exercised in favor of the grantor. Code §673(c). Further, when the trust instrument calls for a postponement of the grantor's reacquisition of the assets to

which the reversionary interest applies, that postponement is deemed to be a new transfer into the trust. Code §673(d). Such a transfer is deemed to commence on the date the postponement begins and to terminate on the date prescribed by the postponement. However, income during the postponement period shall not be attributed to the grantor by reason of the deemed transfer if that income would not have been includible without reference to the deemed transfer. *Id.* These rules effectively closed two holes in the general rule of Code §673(a). Neither adding discretion in the timing of the reversionary interest nor postponing the reversion itself to some fixed date in the future will avoid causing the grantor of the trust to be treated as the owner of the assets of the trust under Code §671.

2. [6.12] Code §674: Power To Control Beneficial Enjoyment

Internal Revenue Code §674 is a broad general rule under which trust income will be taxed to a grantor who has retained a power to control the "beneficial enjoyment" of trust assets. The general rule is that

> [t]**he grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.** Code §674(a).

Thus, if the grantor or a party non-adverse to the grantor can control the beneficial enjoyment of income or principal of a trust without the consent of an adverse party, trust assets subject to the power of control are treated as owned by the grantor for income tax purposes.

"Power" as the term is used for purposes of Code §674(a) means "an ascertainable and legally enforceable right." *Estate of Goodwyn v. Commissioner,* 35 T.C.M. (CCH) 1026, 1039 (1976). A mere informal delegation to the grantor of something less than a legally enforceable right will be insufficient to cause deemed ownership of the trust assets under Code §674(a). On the other hand, an actual retained power, even one not expressly retained, will be sufficient to cause the grantor to be treated as owner of the trust assets for income tax purposes. *See Bennett v. Commissioner,* 79 T.C. 470 (1982) (holding that when grantor was serving as trustee and trust document provided that income was to be distributed to grantor's sons, grantor implicitly retained right to affect relative size of distributions). Further, such powers do not necessarily have to be described as "powers" over the trust assets. A grantor's unrestricted right to amend the trust is a power to control the beneficial enjoyment of the trust income or corpus because a grantor can change the terms of the trust and alter the original disposition of assets.

While the general rule of Code §674 seems relatively straightforward, its application is complicated by a myriad of exceptions. The powers discussed in §§6.13 – 6.23 below are specifically exempted from the general rule set forth in §674(a).

a. Powers That May Be Held by Anyone

(1) [6.13] Power to apply income to support a dependent

The power to apply income to support a dependent will not be a power to control beneficial enjoyment if it falls within the description set forth in Internal Revenue Code §677(b). Code §674(b)(1). Code §677(b) describes the power of certain individuals to apply or distribute trust assets for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support. To the extent that such a power is exercised, it may cause trust income to be taxed to the grantor under Code §677 (discussed in §6.26 below), but the mere existence of the power itself will not cause the grantor to be deemed the owner of trust assets.

(2) [6.14] Powers exercisable only after the occurrence of an event

A power with respect to a trust is not within the scope of the beneficial enjoyment rule of Internal Revenue Code §674(a) if the power in question is exercisable only after the occurrence of an event, such that if the power were in fact a reversionary interest, the grantor would not be treated as the owner under Code §673. Code §674(b)(2). Once that event occurs, however, the grantor will be treated as the owner of the trust assets unless the power is relinquished. The Code §674(b)(2) test looks back to the time of the creation of the portion of the trust to which the power relates because Code §673 affects only reversionary interests whose value is sufficiently large at the time that portion of the trust was created.

(3) [6.15] Powers exercisable only by will

A power exercisable only by will is not within the scope of the beneficial enjoyment rule of Internal Revenue Code §674(a) unless it is a power to appoint income by will held by the grantor when the income is either required to be accumulated for a disposition by the grantor or permitted to be accumulated in the discretion of the grantor or a non-adverse party without the approval or consent of an adverse party. Code §674(b)(3). In essence, all powers exercisable by will are outside the treatment prescribed in Code §674(a) except for the power to appoint income under either of two circumstances. The first circumstance occurs when the income is actually being accumulated awaiting such disposition, and the second occurs when the grantor or a non-adverse party has the power to direct the trustee to accumulate the income for the grantor's testamentary disposition without the approval of an adverse party.

(4) [6.16] Powers to distribute principal for charitable contribution or to ESOP in qualified gratuitous transfer

A power to control the beneficial enjoyment of trust principal or income will not cause the grantor to be treated as the owner when any exercise of this power must be for a purpose set forth in Internal Revenue Code §170(c) (relating to charitable contributions) or to an employee stock ownership plan (ESOP) in a "qualified gratuitous transfer" (as defined in Code §664(g)(1)). Code §674(b)(4). This prevents the grantor from being treated as the owner of trust assets under the grantor trust rules when the grantor's power can be used only to donate to charity or to transfer qualified employer securities to an ESOP.

(5) [6.17] Powers to distribute principal subject to a "reasonably definite standard" or to a current income beneficiary

Internal Revenue Code §674(b)(5) provides two exceptions from the general rule of Code §674(a) that trust income will be taxed to a grantor who holds powers to distribute principal. The first exception applies when the power is limited by a "reasonably definite standard." Code §674(b)(5)(A). The Treasury Regulations provide that a "reasonably definite standard" is essentially the same as the familiar "ascertainable standard." Treas.Reg. §1.674(b)-1(b)(5)(i). Examples of reasonably definite standards include "education, support, maintenance, or health"; "reasonable support and comfort"; enabling a beneficiary to maintain an "accustomed standard of living"; or allowing a beneficiary to "meet an emergency." *Id.* See also Treas.Reg. §1.674(b)-1(b)(5)(iii), Example 1. However, a power to distribute principal for the beneficiary's "pleasure, desire, or happiness" is not limited by a reasonably definite standard. Treas.Reg. §1.674(b)-1(b)(5)(i).

The second exception under Code §674(b)(5) is for powers to distribute the principal of the trust to a current income beneficiary such that the principal distributed will then be charged against the proportionate share of principal held in trust for the payment of income to that beneficiary. Code §674(b)(5)(B). This exception is applicable when the current income beneficiary, after receiving a distribution of principal, will lose a corresponding amount of trust income for future years.

(6) [6.18] Power to temporarily withhold income that ultimately must be payable

Internal Revenue Code §674(b)(6) provides that the power to withhold income from a beneficiary will not be a power to control beneficial enjoyment under Code §674(a) if the income must ultimately be payable

(A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or

(B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

This grantor trust rule will not apply when the accumulated income goes to the beneficiary from whom the income was withheld, to that beneficiary's estate, or to that beneficiary's appointees. The grantor will not be treated as the owner of the trust assets when the beneficiary possesses a power of appointment that excludes from appointment no one other than the beneficiary, his or her estate, his or her creditors, and the creditors of his or her estate. *Id.* In essence, although the income is withheld from the beneficiary, the power is effective only temporarily, as the beneficiary or the beneficiary's appointee will eventually receive the accumulated income.

The other permissible mode of disposition under Code §674(b)(6) is the distribution of the accumulated income to current income beneficiaries in amounts irrevocably specified in the trust agreement, either upon termination of the trust or in conjunction with a distribution of corpus. Code §674(b)(6)(B).

In either type of disposition under §674(b)(6), if a beneficiary does not survive a distribution date that could reasonably be expected to occur within that beneficiary's lifetime, the disposition will still be considered within the bounds of Code §674(b)(6) if the deceased beneficiary's share will pass either to his or her appointees or to an irrevocably specified "designated alternate taker." In such cases, a beneficiary's death at an unexpectedly early time will not cause the grantor to be treated as the owner of the assets of the trust.

(7) [6.19] Power to withhold and accumulate income while beneficiary is disabled or under age 21

The power to withhold and accumulate income will not cause the grantor to be treated as the owner of trust assets under Internal Revenue Code §674(a) if the power extends only to time periods during which the beneficiary is disabled or while the beneficiary is under age 21. Code §674(b)(7). This exception is not subject to the various ultimate distribution rules required under Code §674(b)(6). The effect is that a broader power may be effectively retained during the time periods specified under Code §674(b)(7).

(8) [6.20] Power to allocate receipts and disbursements

The last power that may be held by anyone that is exempt from the application of Internal Revenue Code §674(a) is the power to allocate receipts and disbursements between corpus and income. Code §674(b)(8). Such a power is specifically excepted even though it may be expressed in broad language. *Id.*

b. [6.21] Powers Held by Independent Trustees

Two powers are outside the scope of Internal Revenue Code §674(a) when solely exercisable by a trustee who is not the grantor or by cotrustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. Code §674(c). Despite the apparently stringent requirements regarding who can hold such a power and still qualify for the Code §674(c) exceptions, courts have given the phrase "related or subordinate parties" a generous interpretation from a taxpayer perspective. In *Estate of Goodwyn v. Commissioner,* 35 T.C.M. (CCH) 1026 (1976), the Tax Court ruled that two lawyers serving as trustees who allowed the grantor to control virtually every aspect of the management of trust assets, even going as far as to sign blank checks on the trusts' accounts, were not parties who were "related and subordinate" to the grantor so that the grantor trust rules did not apply.

The first such power is the power of an independent trustee to distribute, accumulate, or apportion income to or for one or more beneficiaries. Code §674(c)(1). The second is the power of an independent trustee to distribute trust principal to or for one or more beneficiaries. Code §674(c)(2). Naturally, under some circumstances these powers will also fall within the exceptions

set forth in Code §674(b). Nonetheless, the Code §674(c) powers are not riddled with exceptions to nearly the same degree as the Code §674(b) powers. When seeking to avoid having trust income taxed to the grantor, §674(c) powers can in many cases provide greater protection to the trustees.

c. [6.22] Powers Held by Non-Grantor Trustees

The final exception to Internal Revenue Code §674(a) applies to certain powers that are exercisable by one or more trustees other than the grantor or the grantor's spouse. Such powers are protected if they are powers limited by a "reasonably definite external standard" to distribute, apportion, or accumulate income to or for one or more beneficiaries or within a class of beneficiaries. Code §674(d). In defining "reasonably definite external standard," the Treasury Regulations refer to the definition of "reasonably definite standard" set forth in Treas.Reg. §1.674(b)-1(b)(5) and discussed in §6.17 above. Treas.Reg. §1.674(d)-1. Like the exceptions for powers held by independent trustees, Code §674(d) covers powers that may frequently be exempted from Code §674(a) by other provisions of Code §674, but the exemptions under §674(d) will often be broader in scope than other applicable provisions.

d. [6.23] Powers To Remove Trustees and To Add Beneficiaries

The retention by the grantor or the grantor's spouse of a power to remove the trustee can affect application of the provisions of Internal Revenue Code §674. Both Code §§674(c) and 674(d) relate to powers held by trustees other than the grantor and the grantor's spouse. The grantor may wish to retain for himself or herself or a spouse the right to remove the current trustee and name himself or herself or a spouse as successor trustee. In such a situation, if the trustee holds a power described in Code §674(c) or §674(d), the grantor (either directly or through the spouse) has retained a right to become a trustee and therefore has retained for himself or herself the rights possessed by the current trustee. Under such circumstances, the trust agreement may appear to avoid the application of Code §674(a), but the trust will in fact be subject to the general provisions of that section.

If any person has the power to add beneficiaries to the trust (except after-born or after-adopted children), that power will render the exceptions of Code §§674(b)(5) – 674(b)(7), 674(c), and 674(d) unavailable with respect to that trust. Code §674(b)(6). A beneficiary's power of appointment is ignored for this purpose, apparently because the beneficiary's interest is adverse to the exercise of such a power. Treas.Reg. §1.674(d)-2(b). A testamentary power of appointment, as addressed in Code §674(b)(3), is also not a power to add beneficiaries to the trust. Treas.Reg. §1.674(d)-2(b).

3. [6.24] Code §675: Administrative Powers

Internal Revenue Code §675 was presumably enacted to address grantors who retain certain types of control over the trust yet fall outside the other grantor trust rules. This section causes the grantor of a trust to be treated as the owner of all or a portion of the trust assets if the grantor retains certain administrative powers over the trust. *Id.* Such powers need not be specified in the trust instrument but "may be indicated by the actual administration of the trust." Treas.Reg. §1.675-1(c).

A power in the grantor to deal with the trust for less than full and adequate consideration may cause the grantor to be treated as the owner of trust assets for income tax purposes. Code §675(1). Such a power includes any power to "purchase, exchange, or otherwise deal with or dispose of the corpus or the income" of the trust for less than adequate consideration. *Id.* If the planning objective is to ensure grantor trust treatment, this power must be exercisable by the grantor or a non-adverse party, or both, without the approval of an adverse party. *Id.* The rationale behind this provision is easy to infer: the retention of this power by the grantor (or a non-adverse party) would effectively permit the grantor to withdraw trust assets at will while technically avoiding application of the other grantor trust rules.

For what are likely similar reasons, the possession by the grantor or a non-adverse party of the power to borrow trust assets without adequate security or without adequate interest will also cause the grantor to be treated as the owner of the trust assets. Code §675(2). However, there is one exception to this rule: it does not apply to a trustee (other than the grantor) who is authorized to make loans to anyone without regard to interest or security. *Id.* While neither the grantor nor the grantor's spouse can be the trustee in such a circumstance, under Code §§675(1) and 672(e) any other person can be a trustee with a general power to lend without adequate interest or security. The trustee would then be able to lend without interest or security to the grantor without being subject to the application of Code §671.

The advantages available under Code §675(2) are reduced by application of Code §675(3), which provides that, if the grantor (or the grantor's spouse) has directly or indirectly borrowed principal or income from the trust and not repaid the loan with interest before the beginning of the taxable year, the grantor will be treated as owner of the appropriate portion of the trust assets. The only stated exception to this rule is for loans that provide for adequate interest and adequate security and are made by a trustee other than the grantor, his or her spouse, or a related or subordinate party subservient to the grantor. Code §675(3). Therefore, a general lending power allowing interest-free loans may not trigger application of Code §675(2) as discussed above, but an actual borrowing by the grantor, unless repaid, will still require that the grantor be treated as an owner of a portion of the trust estate for income tax purposes under Code §671.

Code §675(4) provides for three general administrative powers that will cause the grantor to be treated as owner of some portion of a trust if the power is exercisable by a non-fiduciary without the approval or consent of a fiduciary:

> **(A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.**

All three of these powers are fairly straightforward.

A powerful planning opportunity is available under Code §675(4)(C). When the grantor's treatment as owner of the trust assets is desirable, the power to reacquire the trust corpus by substituting other property of an equal value is frequently used to ensure such treatment. The grantor has little meaningful power over the assets of the trust and is not required to undertake any actions whatsoever to cause his or her income tax treatment to continue indefinitely into the future.

4. [6.25] Code §676: Revocation

Internal Revenue Code §676(a) provides the general rule that

> [t]**he grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.**

The power to revoke all or a portion of a trust, when held by the grantor or a non-adverse party, will cause that portion of the trust assets to be treated as owned by the grantor for income tax purposes. In addition, powers to terminate the trust or to amend the trust and add the right to revoke the trust will be treated as a power to revest the assets of the trust in the grantor. Prior to the enactment of this provision, a significant loophole existed for avoiding the assignment-of-income doctrine: a grantor could retain the right to revest title in himself or herself yet not be taxed as the owner of the trust for income tax purposes. Assets could be placed in trust, the income would be received by the trust and taxed to the beneficiaries or to the trust itself, and the grantor could then revoke the trust, regaining title in the assets. This planning technique is no longer effective.

There is only one exception to the general grantor trust treatment of Code §676(a). If the power described in §676(a) exists only after the occurrence of an event such that the grantor would not be treated as the owner under Code §673 if the power were a reversionary interest, the likelihood of the power ever actually existing is sufficiently small that a trust containing the power will not be treated as a grantor trust. Code §676(b). Nonetheless, once such a power is effective, the grantor will be treated as the owner of the trust assets. *Id.*

5. [6.26] Code §677: Powers To Distribute Income for Benefit of Grantor

Internal Revenue Code §677(a) provides that the grantor will be treated as the owner of any portion of a trust when the income is subject to certain powers exercisable by the grantor or a non-adverse party. Those powers include the power to distribute income to the grantor or the grantor's spouse, the power to accumulate income for future distribution to the grantor or the grantor's spouse, and the power to apply income to the payment of insurance premiums on policies of insurance on the life of the grantor or the grantor's spouse (unless those policies are irrevocably payable for a purpose specified in Code §170(c)). Code §677(a).

Two exceptions to this treatment are listed in Code §677. The first is that income is not taxable to a grantor holding a power described in §677(a) if that power will exist only after the

occurrence of an event such that the grantor would not be treated as the owner under Code §673 if the power was a reversionary interest. Code §677(a).

The second exception is that income is not taxable to a grantor under Code §677(a), or any other provision of Chapter 1 of the Code, merely because it is distributable to discharge the grantor's legal obligation of support, except to the extent funds are actually so distributed. Code §677(b). To the extent amounts distributed are used for such support yet are chargeable to principal rather than income, the treatment of the distribution is governed under Code §662 (discussed in §6.41 below) rather than being taxed as income to the grantor. Code §677(b).

D. [6.27] When Person Other than Grantor Is Treated as Owner

Internal Revenue Code §678 allows for a person other than the grantor to be treated as the owner of all or a portion of the trust assets for income tax purposes if

> **(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or**
>
> **(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.** Code §678(a).

In essence, a non-grantor is treated as the owner of any portion of a trust with respect to which he or she possesses a power to withdraw corpus or income. Further, a non-grantor who releases or modifies such a right with respect to a trust is treated (for purposes of the grantor trust rules of Subpart E (Code §§671 – 679) only) as if he or she were the grantor of the same portion of the trust with respect to which he or she holds the power to revest (*i.e.,* retake title in) assets.

Several exceptions to this general treatment are set forth in Code §678. Code §678(b) indicates that the general rule of Code §678(a) shall not apply with respect to a power over income if the grantor of the trust, or a transferor to whom Code §679 applies, is treated as the owner of the trust assets under Code §§671 – 677 or §679. Clearly, no portion of a trust can have two persons deemed to own it.

Another exception to Code §678(a) is that income shall not be taxable to the grantor under Code §678(a) merely because such income is distributable to discharge the person's legal obligation of support, except to the extent funds are actually so distributed. Code §678(c). To the extent amounts distributed are so used yet are chargeable to principal rather than income, their treatment is governed under Code §662 rather than being treated as income of the grantor. Code §678(c).

Finally, Code §678(a) does not apply to any power that the holder of the power has renounced or disclaimed within a "reasonable time" after becoming aware of its existence. Code §678(d). Since the renunciation or disclaimer of a power is sufficient to keep the (former) holder

of that power from being treated as owner of the trust under Code §678(a), the "reasonable time" limitation presumably affects the treatment of the trust only before the disclaimer or renouncement.

A beneficiary of a qualified Subchapter S trust may also elect to be treated as the owner of that portion of the trust that consists of stock in the S corporation. Code §1361(d). The various requirements for making such an election are set forth in Code §1361(d)(2).

III. NON-GRANTOR TRUSTS

A. Specific Characteristics

1. [6.28] Tax Rates

Congress concluded that the grantor trust rules alone were not effectively halting the abuses perceived to result from the use of trusts to effect income-shifting. Beginning in 1986, Congress subjected trusts and estates to very narrow tax brackets. For example, in the year 2011, the maximum tax rate of 35 percent applies to trust taxable income in excess of $11,350. A single individual having that amount of taxable income would still be well within the 15-percent bracket and would not reach the 35-percent bracket until he or she has taxable income that exceeds $379,150. While an individual taxpayer is allowed an inflation-adjusted personal exemption ($3,700 for the year 2011) for himself or herself and each of his or her dependents, the personal exemption for an estate is $600. Trusts required to distribute all income currently are allowed an exemption of $300. All other trusts are allowed an exemption of $100. Internal Revenue Code §642(b). Code §63(c) provides that individuals who do not itemize their deductions may claim a "standard deduction" when defining taxable income. The standard deduction is not available to estates and trusts. Code §63(c)(6)(D).

Trust income will rarely be taxed at rates lower than those at which such income would be taxed to the grantor or beneficiary of the trust. This is another reason the grantor trust rules are now used by taxpayers to cause trust income to be taxed at individual rates: the overall tax burden can be lower than if the income is taxed to the trust.

However, not all trusts can be subject to the grantor trust rules. Non-grantor trusts do not necessarily pay tax on trust income. Distributing the trust income of a non-grantor trust to beneficiaries can cause the tax burden to shift from the trust itself to the beneficiaries. The system for determining these various tax liabilities of a non-grantor trust is not a simple one. Different types of trusts and beneficiaries can be treated very differently.

2. [6.29] Taxable Income

Calculating the various tax liabilities of a non-grantor trust or an estate and its beneficiaries begins with a computation of the taxable income of the trust or estate. (NOTE: In the following discussion, "trusts" also includes estates unless otherwise noted.) The taxable income of a trust is calculated in the same manner as the taxable income of an individual (unless otherwise treated

under Part I of Subchapter J of the Internal Revenue Code). Code §641(b). The gross income of a trust is determined as it would be for an individual. There are significant variations in the deductions and credits against tax available to trusts and estates. Because of these variations, the "taxable income" of a trust or estate is often substantially different than its "fiduciary accounting income," which in Illinois is determined by reference to accounting principles set forth in §4 of the Principal and Income Act, 760 ILCS 15/1, *et seq.*

What follows is a general overview of the differences between the taxable income of an individual taxpayer and the taxable income of a trust. It is particularly important to note that while the terms used to refer to various available deductions for the computation of a trust's taxable income may resemble the terms used to compute an individual's taxable income, the terms often have a substantially different meaning in this context.

A general rule of Subparts A, B, C, and D of Part I of Subchapter J (Code §§641 – 668) is that the word "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means "the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law." Code §643(b). This definition of "income" is fiduciary accounting income as determined under the Principal and Income Act. Fiduciary accounting income is a state law concept, not a tax concept. When the word "income" is defined by reference to Code §§167(d) and 611(b), it generally refers to income as computed for fiduciary accounting purposes. While a discussion of the Principal and Income Act is beyond the scope of this chapter, the estate and trust practitioner must have a working familiarity with that statute. An excellent discussion is to be found in TRUST ADMINISTRATION (IICLE®, 2008).

As noted in §6.28 above, trusts required to distribute all current income are allowed a personal exemption of $300, all other trusts are permitted a personal exemption of $100, and estates are allowed an exemption of $600. Code §642(b). Standard deductions are not available to estates and trusts. Code §63(c)(6)(D). The estate and trust exemption amounts not only differ from one another but also differ vastly from personal exemptions for individuals.

The charitable deduction allowed to trusts and estates is also different from that allowed for individuals. Among other differences, no percentage limitations exist for trusts and estates. Compare Code §642(c) with Code §170.

The deduction for net operating losses is specifically allowed for trusts and estates. Code §642(d). While a full discussion of the computation of net operating losses for trusts and estates is beyond the scope of this chapter, it is important to note that neither charitable deductions under Code §642(c) nor distribution deductions under Code §651 or §661 can be utilized in computing net operating losses for estates or trusts. Treas.Reg. §1.642(d)-1(b). There is also a lack of clarity in the law regarding allocation of fiduciary expenses when a fiduciary carries on a decedent's trade or business.

Deductions for depreciation and depletion are also available to trusts that hold qualified property. Code §642(e). These deductions, however, must be allocated between the beneficiaries and the trust itself in accordance with the terms of the trust instrument. Code §§167(d), 611(b), 642(e). In the event that the trust instrument does not specify the manner for allocating

depreciation and depletion deductions, the default rules of Code §§167 and 611 apply. In each case, an estate must allocate depreciation and depletion deductions "between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each." Code §§167(d), 611(b)(4). Similarly, a trust must allocate such deductions between the income beneficiaries and the trust "on the basis of the trust income allocable to each." Code §§167(d), 611(b)(3). The "income" as used in these sections is probably fiduciary accounting income as determined under the Principal and Income Act.

Amortization deductions under Code §§169 and 197 are available to trusts and estates. Code §642(f). Such deductions will be apportioned to income beneficiaries and the fiduciary according to regulations. *Id.* The regulations under Code §642(f) indicate that amortization deductions are to be allocated in the same manner as the depreciation and depletion deductions. Treas.Reg. §1.642(f)-1.

It is important to note that some deductions allowable to estates, *e.g.,* executor commissions, attorneys' fees, and casualty losses, can also be claimed as deductions on federal estate tax returns. However, double deductions are specifically disallowed for items deductible by reason of Code §§2053 and 2054 (relating to expenses, debts, taxes, and losses). Code §642(g). The default rule is that those amounts are deductible only on the estate tax return under Code §§2053 and 2054, but the estate may elect to use those deductions for income tax purposes instead of estate tax purposes. Code §642(g). The specifics involved in making such an election are laid out in Code §642(g).

3. [6.30] Distributable Net Income

"Distributable net income" (DNI) is an essential concept in fiduciary income taxation. The term DNI applies to the entire income of the trust that can be distributed to the beneficiaries as "income." Conceptually, a trust's DNI is allocated to various beneficiaries of the trust who then include their allocable portion of the trust DNI on their individual income tax returns.

"Distributable net income" is defined in Internal Revenue Code §643(a) as the taxable income of the estate or trust for any taxable year with several modifications. DNI, like "taxable income," is substantially different from fiduciary accounting income. For federal income tax purposes, income, expenses, deductions, and losses are not necessarily allocated between principal and income in the same manner as for trust accounting purposes under the Principal and Income Act.

The first modification to be taken into account when calculating DNI under Code §645 is that "[n]o deduction shall be taken under sections 651 and 661 (relating to additional deductions)." Code §643(a)(1). Code §§651 and 661, under most circumstances, allow trusts and estates deductions for distributions made or required to be made. See §§6.35 and 6.40 below. Naturally, since DNI is *distributable* net income, whether amounts were actually distributed is not taken into account in computing DNI.

The personal exemptions for trusts and estates are much lower than for individuals. Code §642(b). Nonetheless, the personal exemption does not affect the amount of income that is distributable in a given year because the personal exemption is not taken into account when

computing DNI. Code §643(a)(2). Since standard deductions are not available to estates and trusts, standard deduction amounts are not specifically excluded from the DNI calculation. Code §63(c)(6)(D).

Capital gains are excluded from DNI except to the extent the gains are paid, credited, or required to be distributed to any beneficiary or for charitable purposes. Code §643(a)(3). The reason for this treatment is that gains paid to beneficiaries represent income that has actually been distributed, while amounts distributed to charity will generate a charitable deduction before tax is imposed. The converse treatment is true for capital losses, except that charitable use issues are not accounted for. *Id.* Capital losses, therefore, are accounted for only to the extent that they are used to calculate gains paid, credited, or required to be distributed. The exclusion under Code §1202 for certain transactions in qualified small business stock will be ignored. Code §643(a)(3).

Trusts that are required to distribute all income currently may not include extraordinary dividends and taxable stock dividends in DNI. Code §643(a)(4). To exclude such dividends from a trust's DNI, the trustee must not pay or credit any beneficiary with this income — extraordinary dividends must be allocated to principal. *Id.* This treatment is consistent with the general principal that income items allocated to principal are included in the determination of DNI.

Tax-exempt interest is included in computing DNI less any amounts that would be deductible in respect of disbursements allocable to that interest but for the provisions of Code §265. Code §643(a)(5). The inclusion of tax-exempt interest in DNI minus deductions attributable to that interest is logically consistent; tax-exempt income is actual income despite its being tax exempt, and the deductions otherwise disallowed by Code §265 are real expenses despite the normal inability to deduct them.

Special rules applicable to the calculation of DNI for foreign trusts are set forth in Code §643(a)(6). While a discussion of foreign trusts is beyond the scope of this chapter, the practitioner should review these rules with care when dealing with a foreign trust.

If the estate or trust is allowed a charitable deduction under Code §642(c), the amount of the modifications specified in Code §§643(a)(5) and 643(a)(6) (relating to tax-exempt interest and foreign trusts, respectively) shall be reduced to the extent that the amount of income that is paid, permanently set aside, or to be used for charitable purposes is deemed to consist of items specified in those paragraphs. Code §643(a).

4. [6.31] Character of Distributions

In the absence of specific provisions in the governing instrument, a distribution from an estate or trust is deemed to consist of "the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all classes." Internal Revenue Code §643(a). Income distributed from an estate or trust retains it character (ordinary income, capital gain, tax exempt, etc.). A beneficiary is treated as receiving a proportional amount of each type of income distributed from the estate or trust. The only exception to this treatment is for charitable remainder trusts. See §§6.53 – 6.56 below.

5. [6.32] In-Kind Treatment of Distributions

When property is distributed in kind to beneficiaries, several issues are encountered that do not arise in the context of cash distributions. Internal Revenue Code §643(e) addresses these issues and covers all distributions in kind except those described in Code §663(a) (relating to charitable transfers and special gifts or bequests payable in less than three installments; see §6.39 below).

For the purposes of Code §§661 – 662 (relating to the distribution deduction and the beneficiary's share of taxable income), the amount of a distribution in kind is equal to the lesser of the fair market value of the property or its basis in the hands of the beneficiary immediately after the distribution. Code §643(e)(2). The distributee's basis in property distributed from an estate or trust is equal to the estate's or trust's adjusted basis immediately before the distribution, adjusted for any gain or loss recognized by the estate or trust because of the distribution. Code §643(e)(1).

Code §643(e) allows an estate or trust to elect to recognize gain or loss on an in-kind distribution as if the property had been sold to the beneficiary at fair market value. Code §643(e)(3)(A)(ii). Further, for purposes of Code §§661 – 662, the trust or estate will then treat the "amount" of the "sale" as being equal to the fair market value of the property. Code §643(e)(3)(A)(ii). Such an election is irrevocable (except with permission of the Secretary of the Treasury) and must be made on the income tax return of the estate or trust for the taxable year in question. Code §643(e)(3)(B). Code §643(e)(1)(B) contains the only provision for the recognition of gain or loss on an in-kind distribution of property. This provision is inapplicable to property described in Code §663(a) (relating to charitable transfers and special gifts or bequests payable in less than three installments; see §6.39 below). Code §643(e)(4).

6. [6.33] The 65-Day Rule

A trust distribution from an estate or trust properly paid or credited within the first 65 days of a trust's taxable year can be treated as paid or credited on the last day of the preceding taxable year. Internal Revenue Code §663(b)(1). The executor or trustee must affirmatively elect to have such treatment apply. Code §663(b)(2). The amount of distributions that may be carried back under the 65-day rule is limited to the greater of the estate's or trust's income for the preceding taxable year or the distributable net income for that year minus any amounts deductible by reason of other payments, credits, or required distributions. Treas.Reg. §1.663(b)-1(a).

To treat the timing of such distribution deductions consistently, a trust or estate electing the 65-day rule treatment for distributions in a taxable year cannot then use that same distribution as the basis for an increased distribution deduction in the year of payment. Code §663(a)(3). A trust or estate can deduct its distributions only once despite the additional flexibility afforded by the Code §663(b) rules.

B. [6.34] Distributions from Simple Trusts

Although it never appears in the Internal Revenue Code, practitioners use the term "simple trust" to refer to a trust that satisfies the three requirements set forth in Code §651(a). A simple

trust is one that (1) is required to distribute all of its income currently, (2) does not provide for charitable payments under Code §642(c), and (3) does not distribute any amounts other than income during the taxable year in question.

The requirement that the trust must distribute income currently may contain a trap for the unwary. If the trust agreement requires the trustee to distribute the income and the trustee fails to do so, the trust is still a simple trust for income tax purposes even though the income is not actually distributed. It is the *requirement* that all income be distributed that is important for this determination.

Any other trust is a "complex trust." The tax treatment of distributions from simple trusts and complex trusts differs dramatically. It is possible for a trust to be a simple trust in one year and a complex trust in another. The exercise of a discretionary power to distribute principal will prevent a trust from being treated as a simple trust during the taxable year because the trustee has distributed an amount "other than income." During a year in which such a power is not exercised, however, the trust will be treated as a simple trust for income tax purposes. Nonetheless, if not exercised, such a power will not affect the trust's treatment as a simple trust.

1. [6.35] Tax Treatment of the Simple Trust

In a given taxable year, a simple trust receives a deduction for the amount of trust income that the trustee is required to distribute. Internal Revenue Code §651(a). However, this deduction cannot exceed distributable net income minus "items of income which are not included in the gross income of the trust and the deductions allocable thereto," *i.e.,* tax-exempt income and any deductions allocable to tax-exempt income. Code §651(b). Therefore, the distribution deduction cannot exceed the distributable taxable net income.

2. [6.36] Tax Treatment of Beneficiaries

The amount of income required to be distributed from a simple trust in a given taxable year must be included in the gross income of the beneficiaries to whom distribution is required to be made, "whether distributed or not." Internal Revenue Code §652(a). This rule occasionally produces harsh results. A beneficiary is taxed on trust income when he or she has the present right to receive it whether or not the trustee actually distributes the income to the beneficiary. *See Freuler v. Helvering,* 291 U.S. 35, 78 L.Ed. 634, 54 S.Ct. 308 (1934) (decided relative to identical language in what was §219(d) of Internal Revenue Code of 1921).

In *Estate of Bruchmann v. Commissioner,* 53 T.C. 403 (1969), the court held that a beneficiary was responsible for paying tax on income required to be distributed to her from a simple trust for the years 1949 through 1955 even though no income was actually distributed to her until 1955. The trust instrument provided that the trustee was to pay all income to the surviving "issue" of Ms. Bruchmann's adoptive parents. While Ms. Bruchmann's status as "issue" was being litigated, the trustee did not pay out the income. Ms. Bruchmann was held to be liable for tax on the income for those seven years despite neither receiving the income nor being certain during the litigation that she would receive the income.

The character of the income (*i.e.,* capital gain versus ordinary income) required to be distributed from a simple trust will be passed through to each beneficiary proportionally unless the trust instrument requires otherwise. Code §652(b). This allocation is typically based on how much income each beneficiary is entitled to receive. When distributable net income equals or exceeds fiduciary accounting income, each beneficiary pays tax on what he or she receives. However, if fiduciary accounting income exceeds DNI, each beneficiary is taxed on an amount of DNI that bears the same relationship to the entire DNI as his or her distribution of income bears to the total fiduciary accounting income. In short, if fiduciary accounting income exceeds DNI, each beneficiary will be taxed on a proportional amount of the taxable income.

C. [6.37] Distributions from Complex Trusts

As discussed in §6.34 above, any trust that is not a simple trust for a given taxable year is a complex trust. Income from a complex trust is treated under what practitioners (but not the Internal Revenue Code itself) refer to as the "tier system."

There are two separate "tiers" of beneficiaries who receive income from a complex trust. Beneficiaries with different rights to distributions are treated differently for income tax purposes and are thus described as being on different tiers. First-tier beneficiaries are those to whom income is required to be distributed currently (including amounts that may be paid from principal or income to the extent distributions are actually paid from income), whether distributed or not. See Code §662(a)(1). Second-tier beneficiaries are those to whom any other distributions are paid, credited, or required to be distributed. See Code §662(a)(2). It is possible for one beneficiary to be on both tiers, as when two distributions are required to be made to one beneficiary: one from income and the other from corpus.

Beneficiaries who receive distributions that may be allocated either to income or to principal are referred to as "variable tier" beneficiaries because their status on the first or second tier depends on the actions of the trustee in any given year. For instance, a trust that provides for "payments of $10,000 each year to *A*" without specifying whether the amount is to be paid from income or principal allows the trustee to choose how to allocate the payment. To the extent the payment is allocated to principal, *A* will be a second-tier beneficiary, but to the extent the payment is allocated to income, *A* will be a first-tier beneficiary. If the payment to *A* is allocated to both principal and income, *A* will be partially a second-tier beneficiary and partially a first-tier beneficiary.

1. [6.38] Separate Share Rule

Internal Revenue Code §663(c) contains the separate share rule. Generally, this rule states that, for estates and complex trusts, "substantially separate and independent shares of different beneficiaries" shall be treated as separate trusts or estates. The separate share rule applies solely for the calculation of distributable net income. This rule has no consequence for the number of returns to be filed by a trust or estate or the number of personal exemptions allowed to the trust or estate. Treas.Reg. §1.663(c)-1(b). The separate share rule, as set forth in the Treasury Regulations promulgated under Code §663, treats irrevocable trusts and "qualified revocable trusts"

differently. A "qualified revocable trust" for these purposes is any trust (or portion of a trust) that was treated as owned by a decedent by reason of a power to revoke such trust held by that decedent (determined without regard to the foreign ownership rules of Code §672(e)). Code §645(b)(1); Treas.Reg. §1.663(c)-4(a).

"Separate and independent shares" for an irrevocable trust will generally exist only when distributions from the trust are made in substantially the same way that such distributions would have been made if different trusts were created. Treas.Reg. §1.663(c)-3(a). However, if the instrument has sufficient effect under local law to actually create separate trusts, the separate share rule will not apply. Separate shares are explicitly possible for tax purposes even if an irrevocable trust instrument requires that upon the death of a beneficiary that beneficiary's share of the corpus and any accumulated income are to be added to the shares of the remaining beneficiaries. *Id.*

Qualified revocable trusts are subject to slightly different rules. If the fiduciary of such a trust together with the executor of the deemed owner's estate elect treatment of trust assets as part of the estate, the trust itself remains a separate share of the estate. Treas.Reg. §1.663(c)-4. Nonetheless, there may be separate shares within a qualified revocable trust. The rules governing such further shares are identical to those discussed for estates in §6.58 below.

2. [6.39] Code §663 Exclusions

Certain distributions are immediately excluded from consideration under the tier system. The first of these are specific gifts and bequests. Excluded from the general treatment of Internal Revenue Code §§661(a) and 662(a) is any amount that is properly credited as a gift or bequest of a specific sum of money or specific property and paid in not more than three installments. Code §663(a). Any payment that may be paid or credited only from the income of the trust or estate will not be considered a specific gift or bequest of a specific sum of money. *Id.*

To constitute a "specific gift or bequest," the amount of the gift or bequest must be ascertainable as of the testator's death or the inception of the trust. The expression of a bequest or gift as "*X* percent of the net value of the probate (or trust) estate" will still permit the gift to be treated as a specific sum of money for purposes of Code §663. Treas.Reg. §1.663(a)-1(b). Fractional amounts, percentages, ratios, etc., are all acceptable forms of expressing specific gifts as long as the amount is ascertainable at the defined time. A "specific" gift must therefore refer to a percentage of the initial trust estate; otherwise, the value of the gift cannot be known at the time of the trust's inception. *Id.*

Complying with the three-installment rule is somewhat more complicated than it may initially appear. Fortunately, the Treasury Regulations provide five interpretative rules to assist the fiduciary:

a. Gifts or bequests of articles for personal use (*e.g.,* personal effects, automobiles, etc.) are disregarded. Treas.Reg. §1.663(a)-1(c)(1)(i).

b. Real property whose title passes to a devisee under local law (*e.g.,* joint tenancy with right of survivorship) is not taken into account. Treas.Reg. §1.663(a)-1(c)(1)(ii).

c. Testamentary gifts and bequests required to be satisfied during the normal course of estate administration, but for which there is no time of payment specified, will be treated as required to be paid or credited in a single installment. Treas.Reg. §1.663(a)-1(c)(1)(iii).

d. All gifts and bequests payable at any one specified time are treated as a single installment. Treas.Reg. §1.663(a)-1(c)(1)(iv).

e. Beneficiaries will not be treated collectively for purposes of determining the number of installment payments made. Treas.Reg. §1.663(a)-1(c)(1).

These rules assist in determining the income tax consequences of certain actions undertaken during the ordinary course of estate (or trust) administration. The timing of actual payments and transfers generally need not be made with Code §663(a) in mind.

Distributions in kind in satisfaction of a Code §663(a) gift or bequest may have tax consequences to the trust or estate making the distribution. The loss nonrecognition provision of Code §643(e) is inapplicable in such a situation. As a result, the distribution of property in kind to satisfy a specific pecuniary obligation (*e.g.,* the funding of a pecuniary formula of the marital bequest) will result in gain or loss recognition in an amount equal to the difference between the obligation and the trust's or estate's basis in the property used to satisfy the obligation.

NOTE: A marital bequest is often phrased in terms of a formula in order to produce the maximum allowable marital deduction. Rev.Proc. 64-19, 1964-1 Cum.Bull. 682, holds that a marital deduction will not be allowed when a pecuniary bequest can be satisfied with assets distributed in cash or kind at their federal estate tax values. A "true pecuniary marital formula" is a bequest expressed in terms of a specific dollar amount; for example, "the smallest pecuniary amount that results in no, or the least possible, federal estate tax payable by reason of my death." This language conforms to the express requirements of Rev.Proc. 64-19. Assets distributed to fund a pecuniary formula marital bequest must be valued at the date or dates of distribution. With this formula, a pecuniary amount passes to the marital bequest, and the residue of the estate consists of the credit shelter amount.

The pecuniary formula has been a favorite with estate planners for many years. It is easy to administer: once the amount of the marital deduction is determined, the assets need to be valued and distributed to the marital bequest. However, capital gain will be realized on funding if assets distributed to the marital bequest have appreciated in value since the date of the decedent's death because a fixed dollar obligation is being satisfied and the funding is treated as a sale or exchange. Treas.Reg. §1.1014-4(a)(3); *Kenan v. Commissioner,* 114 F.2d 217 (2d Cir. 1940); *Suisman v. Hartford-Connecticut Trust Co.,* 83 F.2d 1019 (2d Cir. 1936). The estate or trust that funds the pecuniary marital bequest is the taxpayer that realizes the capital gain. The tax is thus effectively borne by the residuary credit shelter trust.

When administering an estate utilizing a true pecuniary formula marital deduction, consideration should be given to funding all or a substantial portion of the marital trust as early as possible.

Capital gain is not recognized upon funding a marital trust based on a "true fractional" formula or on a Rev.Proc. 64-19 formula that requires that assets used to fund a pecuniary gift must be fairly representative of the appreciation or depreciation in value of all assets available to fund the marital trust.

3. [6.40] Tax Treatment of the Complex Trust

For income tax purposes, the tier system primarily affects the beneficiaries of a complex trust and not the trust itself. A complex trust is not significantly affected by the tier system because the trust receives a distribution deduction equal to the sum of any income required to be distributed currently plus any other amounts properly paid or credited or required to be distributed currently. Amounts not required to be paid with income are included as income "required to be distributed currently" to the extent such amounts were actually paid from income. Internal Revenue Code §661(a). The distribution deduction cannot exceed distributable net income (*id.*) and must be further reduced by tax-exempt income otherwise included in DNI (Code §661(c)).

The deduction determined under this rule is treated as consisting of

> **the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument.** Code §661(b).

In other words, the character of the deduction is prorated among the various types of assets included in DNI. This is essentially the same rule set forth for simple trusts (as discussed in §6.35 above) with slight modifications made to account for the fact that beneficiaries of a complex trust may receive distributions of both income and principal.

4. [6.41] Tax Treatment of Beneficiaries

The principal result of the use of a tier system is that beneficiaries are treated under different rules for income tax purposes. There is a simple concept behind these rules: distributable net income is allocated first to the gross income of first-tier beneficiaries, next to the gross income of second-tier beneficiaries, and finally to the gross income of the trust or estate itself. The taxable portion of DNI allocated to each beneficiary is then taxed to that beneficiary. The trust is entitled to a distribution deduction for the amount of the first-tier and second-tier distributions, up to a limit equal to the DNI. Internal Revenue Code §661. The trust or estate will be taxed only on the DNI that it retains. This basic concept is implemented through the rules set forth in Code §662 that allocate DNI to beneficiaries according to their distributions. In dealing with Code §662(a), however, the exceptions are as important as the general rule.

First-tier beneficiaries must include in their gross income for the taxable year all trust income required to be distributed currently (including amounts that may be paid from corpus or income to the extent actually paid from income), whether distributed or not. Code §662(a)(1). However, if DNI is less than the total of all first-tier distributions, the first-tier beneficiaries will include in

their income the proportion of their distribution that is equal to the proportion that DNI bears to the total first-tier distributions. *Id.* In other words, DNI is allocated ratably to each first-tier beneficiary, and each such beneficiary then includes that portion of DNI in his or her gross income.

Second-tier beneficiaries must include in their gross income all amounts properly paid, credited, or required to be paid to them as beneficiaries for that taxable year. Code §662(a)(2). When the first-tier distributions are greater than DNI, the entire tax burden of the trust income is allocated to the first-tier beneficiaries since no amount remains to be allocated to the second-tier beneficiaries. Code §662(a)(1). When DNI exceeds the first-tier distributions, the remaining DNI is allocated ratably among the second-tier beneficiaries, each of whom must then include that portion of DNI in his or her gross income. Code §662(a)(2).

The tier system spreads the tax burden by allocating DNI first to the first-tier beneficiaries to the extent of their distributions and then to the second-tier beneficiaries to the extent of their distributions. If any DNI remains, the remaining tax burden falls on the trust (or estate). Clearly, the right to receive income distributions from a trust carries a tax cost. It is important to note the tax effect that decisions made by a fiduciary can have on "variable tier" beneficiaries. The tax effect to a beneficiary may be dramatically changed if the fiduciary simply allocates payments to principal instead of income to the extent that such an allocation comports with the governing instrument and the requirements of local law.

5. [6.42] Throwback Rule

The throwback rule is itself a "throwback" to an earlier era of trust tax law. Before the passage of the Tax Reform Act of 1986, Pub.L. No. 99-514, 100 Stat. 2085, when income-shifting through the use of trusts was more effective as a tax-saving strategy, the throwback rule was a powerful deterrent against reducing tax through the use of "accumulation distributions." For example, assuming a trust established in Year 1 made no distributions to beneficiaries in its first year, the trust paid tax on its Year 1 income and added the "accumulated but undistributed" income to principal. In Year 2, the trust distributed that "accumulated" income, less the taxes paid, to the beneficiaries. Such a strategy would have effectively shifted the income tax burden from the beneficiaries to the trust. The throwback rule operated to "throw back" the accumulated income into the beneficiaries' returns for the year in which the income had been received by the trust. Application of the throwback rule requires computation of what the tax would have been on a deemed distribution of the income to the beneficiaries in the year received and then imposes a tax on the difference between the tax estimated on the "deemed distribution" and the tax actually paid by the trust. Even before trust income brackets were narrowed and tax rates compressed, the throwback rule effectively discouraged the use of accumulation distributions as a tax planning strategy. Now that trusts are used less frequently as separate taxpayers, the throwback rule may seem largely an anachronism, but trustees and their advisors must nevertheless be familiar with its application and effect.

a. *Definitions and Concepts Affecting the Throwback Rule*

(1) [6.43] Undistributed net income

"Undistributed net income" (UNI) is income accumulated by a trust in a given taxable year. The Internal Revenue Code defines a trust's UNI for a given taxable year as the amount by which the trust's distributable net income exceeds the sum of the amounts deductible in the trust distribution deduction, plus the amount of taxes imposed on the trust attributable to that year's DNI. Code §665(a). In other words, UNI is DNI minus the distribution deduction and taxes on DNI. Since the goal of the throwback rule is to rectify the under-taxation of undistributed income, it seems reasonable to deduct both of these amounts when computing UNI. Note that distribution deductions permitted under Code §651 are not mentioned in the definition of UNI. Simple trusts can have UNI equal to the greater of the trust's "outside income" or the required distributions that were not distributed. Treas.Reg. §1.665(e)-1A(b).

"Outside income" is not defined in the Code. The term refers to any items includible in DNI that are not part of fiduciary accounting income. *Id.* Specifically, "outside income" includes income taxed to the trust under Code §691 (relating to income in respect of a decedent (IRD)), unrealized accounts receivable assigned to the trust, and distributions from another trust that include amounts of DNI or UNI from the other trust. *Id.*

(2) [6.44] Accumulation distribution

Internal Revenue Code §665(b) defines an "accumulation distribution" as the amount by which Code §661(a)(2) distributions exceed distributable net income minus Code §661(a)(1) distributions. Distributions of principal that do not allocate DNI to the distributee beneficiaries are accumulation distributions. Conceptually, this is reasonable because the DNI allocable to a beneficiary in a taxable year represents the portion of the trust income that is allocated to that beneficiary. All first-tier distributions are made up of current income so they cannot include any accumulated income. However, second-tier distributions in excess of DNI come from a source other than the trust's taxable income for that year.

(3) [6.45] Taxes imposed on the trust

Internal Revenue Code §665(d) defines "taxes imposed on the trust" as the actual income tax payable by the trust to the extent that such tax is allocable to undistributed distributable net income or undistributed capital gains. This amount, however, is to be reduced by any taxes deemed distributed under Code §§666(b) and 666(c) to any beneficiary. Code §665(d)(1). The regulations require that this tax be allocated proportionally between the sum of such undistributed DNI and undistributed capital gains and other income. Treas.Reg. §1.665(d)-1A(b)(1).

(4) [6.46] Deemed distribution of taxes

For any distribution that Internal Revenue Code §666(a) deems to occur within the description of Code §661(a)(2) for a previous year for which the undistributed net income is not greater than the distribution, the trust will also be deemed to distribute the amount of taxes paid by the trust in that year. Code §666(b). Specifically, the taxes deemed distributed that year are the

taxes imposed on the trust attributable to UNI. *Id.* If the deemed distribution under Code §666(a) is less than the UNI for that year, a distribution equal to the total taxes on the UNI for that year is also deemed to occur, reduced ratably by the amount of UNI not deemed distributed. Code §666(c).

In addition to the income deemed distributed in prior years, the taxes on the accumulated income are also deemed to have been distributed. In making a computation under the throwback rule, the distributee will generally be given credit for these taxes paid. The only exception is that, if the beneficiary receives accumulation distributions from more than two trusts, the taxes are not deemed to have been distributed in earlier years and the beneficiary will not be credited with the trust taxes paid. Code §667(c)(1).

(5) [6.47] Tax treatment of various deemed distributions

After determining the tax years in which distributions were deemed to occur, the deemed distributions for each such year must be reduced by any amount that would not have been included in the beneficiary's income if it had been distributed at the end of that taxable year. Internal Revenue Code §667(a). The remainder is the amount of income that, if actually distributed, would have been taxable to the beneficiary. To avoid deviation resulting from averaging, the number of taxable years in which deemed distributions are treated as occurring is then reduced by any years in which a deemed distribution is less than 25 percent of the average deemed distribution. Code §667(b)(3). This reduction in the number of years does not change the collective amount of the deemed distributions.

The total amount of deemed distributions that would have been taxable when distributed, divided by the reduced number of taxable years in which income has been "thrown back" (the adjusted average distribution), is used to compute the throwback tax. Code §667(b)(1). The adjusted average distribution is added to the beneficiary's income for three of the last five tax years. The three years used for this calculation are the three years that remain after dropping the years with the highest and the lowest taxable income for the beneficiary. The next step is to calculate the average increase in tax that would have occurred for each of these three years if the amount of the adjusted average distribution had been included in the beneficiary's income in each of those years. This result is then multiplied by the number of years used in computing the adjusted average distribution. This total increase in tax is then reduced by the taxes deemed distributed to the beneficiary in each of the preceding taxable years in which the accumulated distribution was thrown back. The resulting amount is the throwback tax owed by the beneficiary. *Id.*

b. [6.48] Operation

The throwback rule imposes a tax on various deemed distributions. Despite the apparent language of Internal Revenue Code §§665 – 667, this is not done through inclusion of amounts in gross income but rather through separate calculations under Code §667. In brief, Code §665 defines various terms necessary to apply the throwback rule, Code §666 deems several distributions to be made to the beneficiary in preceding years, and Code §667 imposes a tax on the accumulated distribution based on the amounts of the various deemed distributions.

(1) [6.49] Allocation to earlier taxable years

Once it has been determined that a distribution (or part of a distribution) is an "accumulation distribution," the amount of the accumulation distribution must be allocated to previous tax years, which is done by determining the earliest years in which the trust had undistributed net income. Internal Revenue Code §666(a). To the extent that UNI in earlier years has already been used to calculate taxes under the throwback rule, that amount of UNI is no longer available for this purpose. *Id.;* Treas.Reg. §1.666(a)-1A(b). The accumulation distribution is allocated to the earliest years that, when added together, have sufficient UNI to equal the amount of the accumulation distribution. Code §666(a). For each year to which the accumulation distribution is allocable, the amount of UNI used from that year will thereafter be treated as an amount distributed under Code §661(a)(2). Code §666(a).

The effect is that the accumulation distribution itself is deemed to have been distributed, to the extent of UNI, in the earliest possible years of the trust's existence. Any accumulations of trust income from those years will be subject to application of the throwback rule.

(2) [6.50] Example

A trust has the following distributable net income, distributions, and taxes (all of which are considered to be paid on undistributed DNI) for the following taxable years:

Year	DNI	Distributions	Taxes Paid	Accumulation
2006	$30,000	$ 0	$6,000	$24,000
2007	$25,000	$ 3,000	$4,500	$17,500
2008	$ 5,000	$ 3,000	$ 500	$ 1,500
2009	$20,000	$ 2,000	$4,000	$14,000
2010	$20,000	$ 2,000	$4,000	$14,000
2011	$20,000	$70,000	$ 0	($50,000)

In 2011, the trustee distributed $20,000 of income to beneficiary *A* and $50,000 of trust principal to beneficiary *B.* The $70,000 distributed in year 2011 is an accumulation distribution because it exceeds DNI for that year. The amount listed in the accumulation column for each year is DNI, minus distributions, minus taxes, and is equal to the trust's undistributed net income for each such year. The accumulation distribution in 2011 is allocated to years 2006, 2007, 2008, and 2009. The total UNI for these years, however, is $57,000, so the allocation to 2009 takes into account only a part of the taxes from that year. The deemed distributions under Internal Revenue Code §666 are as follows:

Year	UNI	Taxes Deemed Distributed	Deemed §661(a)(2) Distribution	Total Deemed Distribution
2006	$24,000	$6,000	$24,000	$30,000
2007	$17,500	$4,500	$17,500	$22,000
2008	$ 1,500	$ 500	$ 1,500	$ 2,000
2009	$14,000	$2,000	$ 7,000	$ 9,000
2010	$14,000	$ 0	$ 0	$ 0
2011	$ 0	$ 0	$ 0	$ 0

For purposes of this example, assume that all such amounts in the deemed distributed column would have been includible by beneficiary *B*. The actual average deemed distribution to *B* is $15,750. Since the $2,000 deemed distribution in 2008 is less than 25 percent of $15,750, the deemed distributions will be treated as occurring over three years instead of four. Therefore, the adjusted average distribution is $21,000.

In the five taxable years immediately preceding the accumulation distribution, Beneficiary *B* had the following amount of taxable income

Year	Taxable Income
2006	$100,000
2007	$120,000
2008	$ 80,000
2009	$ 90,000
2010	$110,000

According to Code §667(b), the highest (2007) and lowest (2008) income years must be ignored. The years 2006, 2009, and 2010 are used to compute the adjusted average distribution. The adjusted average distribution is then added to beneficiary *B*'s taxable income for each of those years. The corresponding increases in beneficiary *B*'s tax liability are then calculated. The increase in taxes for each year is as follows:

Year	Increase in Taxes
2006	$6,500
2009	$6,500
2010	$7,000

The average annual increase in taxes is $6,666.67, which, when multiplied by the number of years taken into account (three), results in a total of $20,000 in increased tax liability. Since $13,000 in taxes were deemed distributed to beneficiary *B,* the throwback tax owed by beneficiary *B* on this distribution is $20,000 minus $13,000, or $7,000.

Obviously, the throwback rule has significant impact when trust tax rates are lower than individual rates. As discussed in §6.49 above, if the beneficiary's tax would be less than the trust's, the throwback rule, though applicable, does not impose an additional tax. Consequently,

accumulation distributions will usually not impose a tax on the recipient beneficiary, but practitioners need to be aware of the possibility that a tax liability can be incurred on such a transfer.

c. [6.51] Trapping Distributions

Classification of an item as "principal" or "income" for trust accounting purposes can, in certain circumstances, yield a tax-saving opportunity when distributions are made from a probate estate to a trust. A "trapping distribution" is a distribution from a probate estate that represents principal for trust accounting purposes when received by the trust but that also carries out distributable net income from the probate estate. If the trust does not or cannot distribute that principal to a beneficiary, the amount of DNI from the estate is "trapped" inside the trust and the trust pays tax on the estate's income. Before trust tax rates and brackets were as compressed as they are under present law, the trapping distribution was a classic strategy for spreading income among two or more taxpayers during probate administration. Trapping distributions are of limited utility as a tax-saving strategy under the present rate structure, but they should be considered in cases in which a trust or a trust beneficiary could utilize the lowest brackets. Trapping distributions can also be made from one irrevocable trust to another.

d. [6.52] Taxable Year

A former popular strategy for using trusts in tax planning was to select a fiscal year for the trust that was different from that of the beneficiaries. A trust with a non-calendar year-end could, under certain circumstances, distribute income to beneficiaries and defer the payment of tax on that income by up to one full year. Now, however, trusts are generally required to be calendar-year taxpayers. Internal Revenue Code §644(a). The only two exceptions to this general rule are tax-exempt trusts described in Code §501(c) and charitable trusts described in Code §4947(a)(1).

D. [6.53] Distributions from Charitable Remainder Trusts

Charitable remainder trusts (CRTs) are not taxed under the rules that govern the tax treatment of non-grantor trusts. Taxing undistributed income to trusts having a tax-exempt charity as remainder beneficiary would be unfair to the charity. However, to the extent that income remains untaxed in the year it is earned, later distribution without taxation also seems unfair. Congress has thus provided a separate set of rules for taxing the income of CRTs, outlined in §§6.54 – 6.56 below.

1. [6.54] Types of CRTs and Applicable Rules

Charitable remainder annuity trusts (CRATs) are trusts that pay an annuity amount to one or more beneficiaries (at least one of which is not a charity) for either a term of years or for the life or lives of individual beneficiaries, with the remainder paying to charity. Internal Revenue Code §664(d)(1). The value of the remainder interest in a CRAT must be at least 10 percent of the value of the initial fair market value of the trust estate. Code §664(d)(1)(D). In addition, the annuity amount must be not less than 5 nor more than 50 percent of the initial fair market value of the trust estate, the term cannot exceed 20 years, and any individual beneficiary must be alive at the inception of the trust. Code §664(d)(1)(A). While the trust agreement may provide for an

earlier termination of the CRAT on the occurrence of a stated contingency, that contingency will not affect the valuation of the charitable deduction or the remainder interest. Code §664(f). No additional contributions may be made to a CRAT. Treas.Reg. §1.664-2(b). When drafting a CRAT, it is also important to review several additional technical requirements that are specified in Treas.Reg. §1.664-2.

Charitable remainder unitrusts (CRUTs) differ from CRATs in that the required annual payment is not in the form of an annuity. The payment is a “unitrust” amount, a percentage of the trust assets as valued at the time of the payment. Code §664(d)(2). Because the unitrust amount varies with the value of the assets held in the trust, additional contributions can be made to CRUTs. See *id.;* Treas.Reg. §1.664-3(d). However, under certain circumstances these additional contributions may be treated as part of a separate trust. Code §664(d)(4).

For transfers to CRATs and CRUTs made after July 28, 1997, the value of the remainder must be no less than 10 percent of the fair market value of the trust estate. Code §§664(d)(1)(D), 664(d)(2)(D), as amended by Pub.L. No. 105-34, §1089(b), 111 Stat. 960 (1997). Earlier CRATs and CRUTs are grandfathered for purposes of this requirement. If a CRUT was established in 1996 with a remainder interest having a value far less than 10 percent of the trust estate, an additional transfer to the CRUT may result in the “new” CRUT assets still having a remainder interest valued at less than 10 percent of the trust estate in violation of Code §664(d)(2)(D). To preserve the treatment of old CRUTs, an additional contribution to a CRUT that would disqualify that trust as a CRUT under the 10-percent rule of Code §664(d)(2)(D) will be treated as a contribution to a separate trust. Code §664(d)(4).

A trust created under Code §664(d)(3) is referred to as a “net income with makeup charitable remainder unitrust” (NIMCRUT). If the income of a NIMCRUT in a given tax year is less than the unitrust amount, only the income of the trust is to be distributed in that year to the income beneficiary. If the income of a NIMCRUT in a subsequent tax year is greater than the unitrust amount, the income will be distributed to the extent that the aggregate of payments in prior years has been less than the aggregate unitrust amounts. The effect is to “make up” for years in which the unitrust amount was not fully paid.

2. [6.55] Tax Treatment of the CRT

Charitable remainder annuity trusts and charitable remainder unitrusts (including net income with makeup charitable remainder unitrusts) generally do not pay income tax unless the trust has unrelated business taxable income (UBTI) within the meaning of Internal Revenue Code §512 determined as if Part III of Subchapter F of the Code (§511, *et seq.*) applied to the trust. Code §664(c). Generally, UBTI is income from any trade or business carried on by an organization exempt from tax under Code §501 when that trade or business is unrelated to the purpose of the organization that gives rise to the exemption. Code §512.

3. [6.56] Tax Treatment of Beneficiaries

The income beneficiaries of a charitable remainder trust are usually taxed on distributions received from the CRT. Distributions received by the beneficiaries of a CRT are treated as follows:

a. first, as amounts of income (other than gains, and amounts treated as gains, from the sale or other disposition of capital assets) includible in gross income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years;

b. second, as a capital gain to the extent of the capital gain for the trust for the year and the undistributed capital gain of the trust for prior years;

c. third, as other income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years; and

d. fourth, as a distribution of trust corpus. Internal Revenue Code §664(b).

Further, the undistributed capital gain is computed on a cumulative net basis. *Id.* The purpose of these rules is to ensure that ordinary income of the trust is taxed first, then capital gains, then other income. To the extent that the trust distributions are smaller than these amounts, some income and/or gain will remain untaxed, but eventually such untaxed income will be either distributed and taxed to the income beneficiary or distributed to a charity as remainder beneficiary.

IV. [6.57] ESTATES

Generally, the income tax treatment of a probate estate is very similar to that of a complex trust. See §§6.37 – 6.52 above. The exceptions to this general rule result from certain fact patterns that are found only in a post-death administration of a decedent's estate or from the presence of "income in respect of a decedent." Additionally, unlike trusts, estates are able to select a non-calendar fiscal year, allowing for tax deferral in some circumstances. See §6.70 below. Finally, the interactions between estates and certain trusts can produce anomalous results. See the discussion of trapping distributions in §6.51 above.

A. [6.58] Separate Share Rule

As discussed in §6.38 above, the separate share rule is contained in Internal Revenue Code §663(c). The separate share rule applies to the calculation of distributable net income and provides that the "substantially separate and independent shares of different beneficiaries" (*id.*) of an estate or a complex trust are to be treated as separate estates or separate trusts. In the context of an estate or a "qualified revocable trust," as defined in Code §645(b)(1) and as discussed in §6.38 above, "separate and independent shares" exist when different beneficiaries (or classes of beneficiaries) possess separate economic interests. Treas.Reg. §1.663(c)-4(a). In other words, a separate share exists if economic rights held by the beneficiaries of that share neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries. *Id.* The rule does not affect the number of returns to be filed by an estate or the number of personal exemptions allowed to the trust or estate. Treas.Reg. §1.663(c)-1(b).

The regulations explicitly permit three types of interests in a decedent's estate to be treated as separate shares. The first is a surviving spouse's elective share, if determined as of the date of death and not entitled to income, appreciation, or depreciation. Treas.Reg. §1.663(c)-4(b). A

qualified revocable trust is also permitted to be a separate share of an estate if the trust is treated as part of the estate by reason of an election filed under Code §645(a). Treas.Reg. §§1.633(c)-4(a), 1.663(c)-4(b). The final such specified interest is a pecuniary formula bequest that is not entitled to income, appreciation, or depreciation, whether so limited in the instrument itself or by the applicable local law. Treas.Reg. §1.663(c)-4(b).

Once the separate shares of an estate have been determined, the only difference between the treatment of such estate shares and the treatment of separate shares of an irrevocable trust is in the area of income in respect of a decedent, discussed more thoroughly in §6.59 below. An amount of IRD is allocated among the various shares that could potentially be funded with that amount, prorated by the relative value of the IRD that could potentially fund each share. Treas.Reg. §1.663(c)-2(b)(3). Therefore, if three equal separate shares are created in a will and an amount of IRD could potentially fund two such shares but not the third, the amount of IRD would be allocated equally between the two shares that could potentially be funded by that amount.

The regulations provide that application of the separate share rule to estates and qualified revocable trusts generally depends on whether the governing instrument and local law create separate economic interests in one beneficiary or in a class of beneficiaries of the estate or trust. Treas.Reg. §1.663(c)-4(a). A "separate economic interest" is treated as existing only if the interests of the beneficiaries are not interdependent. The regulations also provide that a qualified revocable trust electing to be treated as part of the estate for income tax purposes under Code §645 will always be a "separate share." A separate share "exists" at the instant the executor or trustee determines that a separate economic interest is present; separate share treatment cannot be deferred until there is a final determination of the value of that separate economic interest. This essentially means that the executor or trustee must allocate distributable net income before knowing the value of a separate economic interest.

B. [6.59] Income in Respect of a Decedent

There was a time when all assets owned by a decedent, including rights to receive income, passed into the decedent's estate with an altered basis. A right to future income for a cash basis taxpayer therefore received a basis adjustment before the income was actually received, rendering it relatively tax free from an income tax perspective. A decedent who was an accrual basis taxpayer would have already recognized the income from many such types of deferred income and was thereby subjected to higher taxes. An early solution to this problem was to require that all taxpayers' final income tax returns be filed on an accrual basis. See §42 of the Revenue Act of 1932, ch. 209, 47 Stat. 169. This solution proved unsatisfactory, and in 1942 Congress changed the Internal Revenue Code to provide that the income of an estate was to be taxed in a manner similar to the treatment such income would have received had the decedent been alive at the time of receipt. This concept is known as "income in respect of a decedent" and is described in §691 of the Internal Revenue Code.

Code §691(a)(1) provides:

> **The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period (including the amount of all items of gross income in respect**

of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of:

(A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

(B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

(C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

The effect is that IRD is taxed to the estate or person that eventually receives the income after a decedent's death. If the right to receive income is sold, the fair market value of that right is included as income at the time of sale. *Id.* The character of any IRD remains the same as it would have been had it been collected by the decedent. Code §691(a)(3). A special rule applies the IRD concept to situations in which a decedent holds an installment note subject to Code §453 at his or her death. The difference between the face amount of the note and the decedent's basis in the note is treated as IRD. Code §691(a)(4).

The right to receive IRD is includible as an asset of the decedent's estate for federal estate tax purposes. As a result, both income taxes and estate taxes are paid on items of IRD. To minimize the impact of this double taxation, a deduction is allowed to each person or entity that includes IRD in its income. Code §691(c). The deduction is related to the estate tax paid on all IRD in the same proportion that the recipient's includible IRD bears to all IRD. *Id.* In other words, the estate tax is prorated to each IRD recipient according to the amount of IRD received and is then deducted from the income of each recipient. Special rules apply for amounts received by a surviving annuitant under a joint and survivor annuity contract. Code §691(d).

Deductions arising from Code §162, §163, §164, §212, or §611 (relating to deductions for expenses, interest, taxes, and depletion) and credits specified in Code §27 (relating to foreign tax credits) also survive a decedent's death. Code §691(b). Such deductions (or credits) are allowed to the decedent's estate unless the obligation relating to the deduction must be undertaken by another person, in which case the deduction is allowed to that person. *Id.*

C. [6.60] Election into the Carryover Basis Regime for 2010 Decedents

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub.L. No. 107-16, 115 Stat. 38, effective January 1, 2010, the date-of-death step-up (or step-down) in basis regime of Internal Revenue Code §1014 was replaced with a carryover basis regime of a new Code §1022. However, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub.L. No. 111-312, 124 Stat. 3296, retroactively repealed §1022 but

established a regime allowing estates of decedents who died in 2010 to choose between (1) estate tax (based on a $5 million exemption and 35-percent top rate) and a step-up in basis regime or (2) no estate tax and a modified carryover basis regime. Pub.L. No. 111-312, §§301(c), 301(a). Thus, the now-repealed §1022 will apply only to property acquired from decedents who died in 2010 and whose executors make the election to apply §1022 (§1022 election). While a complete discussion of §1022 and related Code sections is beyond the scope of this chapter, an overview is provided in this section. See ILLINOIS ESTATE ADMINISTRATION (IICLE®, 2009, Supp. 2011).

In order to have the modified carryover basis system of §1022 apply, a §1022 election must be made by the executor of a decedent who died in 2010 by filing Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent, on or before January 17, 2012. IRS Notice 2011-66, §IA, 2011-35 Int.Rev.Bull. 184 as modified by IRS Notice 2011-76, 2011-40 Int.Rev.Bull. 479. For those estates that make the §1022 election, the general rule under §1022, subject to some exceptions described below, is that property acquired from a decedent dying during 2010 shall be treated as transferred by gift and the basis of such property in the hands of a person acquiring it from such a decedent will be the lower of (1) the decedent's adjusted basis in the property or (2) the fair market value of the property at the decedent's death. Code §1022(a) before repeal by Pub.L. No. 111-312, §301(a). For example, if a person dies on January 1, 2010, owning corporation *X* stock that, on the date of his or her death, has an adjusted basis of $30,000 and a fair market value of $40,000, then, assuming the §1022 election is made, the stock's basis in the hands of the recipient of the property is $30,000 (assuming no allocation of basis increases under §§1022(b) and 1022(c) discussed below). If we assume the same facts, except that the stock is worth $20,000 on the date of death of the decedent, the basis in the stock in the hands of the recipient of the property is $20,000.

There are two major exceptions to the general carryover basis rule (*i.e.,* the lesser of adjusted basis or fair market value). The first exception under §1022(b) allows for an aggregate basis increase of up to $1.3 million for qualifying property passing to any person. Code §1022(b) before repeal by Pub.L. No. 111-312, §301(a). Stated differently, each decedent who dies in 2010 and elects the carryover basis regime receives $1.3 million of basis to be added to the carryover basis of any one or more of the decedent's assets held at death. The second major exception allows for an additional $3 million of basis to be allocated among the assets passing to a surviving spouse. Code §1022(c) before repeal by Pub.L. No. 111-312, §301(a). Also, there is an additional basis increase equal to the sum of (1) the decedent's unused capital loss carryforwards, (2) the decedent's unused net operating loss carryforwards, and (3) the amount of losses that would have been allowable with respect to the property acquired from the decedent if the property had been sold at fair market value immediately before death. Code §1022(b) before repeal by Pub.L. No. 111-312, §301(a). In the case of nonresident alien decedents, the aggregate basis increase (up to $1.3 million) is limited to $60,000 and the additional basis increase (unused operating or capital loss carryovers that would have been available to the decedent but for his or her death and allowable built-in losses) is not allowed at all. Code §1022(b)(3) before repeal by Pub.L. No. 111-312, §301(a). All of the basis adjustments under §§1022(b) and 1022(c) shall not increase the basis of any interest in property acquired from the decedent above its fair market value in the hands of the decedent as of the date of the decedent's death. Code §1022(d)(2) before repeal by Pub.L. No. 111-312, §301(a).

While the general rules operate on property that is "acquired from a decedent," the basis adjustments discussed above are available only with respect to property that was "owned" by the decedent at the time of his or her death. Code §1022(e) before repeal by Pub.L. No. 111-312, §301(a). The term "property acquired from the decedent" is defined in the statute as (1) property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent; (2) property transferred by the decedent during his or her lifetime to (a) a "qualified revocable trust" (as defined in §645(b)(1) of the Code) or (b) to any other trust with respect to which the decedent reserved the right to make any change in the enjoyment of the trust through the exercise of a power to alter, amend, or terminate the trust; or (3) any other property passing from the decedent by reason of death to the extent that the property passed without consideration. Code §1022(e) before repeal by Pub.L. No. 111-312, §301(a). However, even if property is "acquired from the decedent" within the meaning of Code §1022(e), the elaborate provisions of Code §1022(d) define whether such property was "owned by the decedent" and, therefore, is eligible for basis adjustments. For example, under §1022(d), property over which the decedent holds any power of appointment is not considered owned by the decedent at death. Code §1022(d)(1)(B)(iii) before repeal by Pub.L. No. 111-312, §301(a). The application of the "ownership" and "acquired from the decedent" concepts as well as general rules for determining basis under §1022 and other substantive provisions of §1022 have been addressed in the optional safe harbor provided by the IRS in Rev.Proc. 2011-41, 2011-35 Int.Rev.Bull. 188. These safe-harbor procedures apply to executors of the estates of decedents who died in 2010 and to recipients of property acquired from those decedents, if the executors make the §1022 election. Rev.Proc 2011-41, §3. If the executor of the estate of the decedent who died in 2010 makes the §1022 election, follows the applicable provisions of the safe harbor, and takes no return position contrary to any provisions of the safe harbor, the IRS will not challenge the taxpayer's ability to rely on the safe harbor either on the Form 8939 or any other return of tax. *Id.*

The allocations of the basis adjustments under §§1022(b) and 1022(c) must be made by the executor, or other person in possession of a decedent's property, and must be reported to the IRS and the property recipients. Code §1022(d)(3) before repeal by Pub.L. No. 111-312, §301(a). Additional information regarding the manner in which the executor of the estate of a decedent who died in 2010 makes the §1022 election, the deadline for making that election and related procedures, and allocating the decedent's generation-skipping transfer exemption to transfers occurring at a death occurring in 2010 are addressed in IRS Notice 2011-66, *supra,* the final Form 8939 Instructions, and IRS Publication 4895, Tax Treatment of Property Acquired from a Decedent Dying in 2010.

V. [6.61] INCOME-SHIFTING STRATEGIES

As discussed throughout this chapter, income-shifting has long been an effective income tax planning strategy. By splitting income among several taxpayers or by ensuring that income is taxed to an entity with lower marginal tax rates, the collective tax burden can be reduced.

Current law generally requires an individual to give up control of assets transferred to a trust or to another individual in order to utilize the other entity as an additional taxpayer. While Congress has eliminated or reduced the effectiveness of many of the income-shifting strategies formerly used in estate planning, some income-shifting opportunities are still available.

The income tax treatment of a number of common estate planning techniques is discussed in §§6.62 – 6.70 below. Care should be exercised when considering these techniques because many of them are no longer available for use by new trusts. While some entities may continue to be treated in the same manner for income tax purposes, such "grandfather" treatment is not universally beneficial since tax savings may no longer necessarily be obtained by shifting income to a trust.

A. [6.62] Custodianship (Illinois Uniform Transfers to Minors Act)

Assets can be held for the benefit of a minor under the Illinois Uniform Transfers to Minors Act (UTMA), 760 ILCS 20/1, *et seq.* If the custodianship assets produce income, one of two possible tax treatments will be required. If the child is under age 18 at the close of the taxable year and has at least one parent living, income from the custodianship property will be taxed according to the rules set forth in Internal Revenue Code §1(g), as discussed in §6.69 below. If, however, the child is 18 or older at the close of the taxable year, the income will be taxed at the single individual rates, which may result in lower tax. Code §1.

Under Illinois law, an UTMA custodianship can now be terminated in whole or in part by transferring assets from the custodial account into a trust that satisfies the requirements of Code §2503(c). 760 ILCS 20/15(a-5). The minor for whom the custodianship was created must be the sole beneficiary of the §2503(c) trust. 760 ILCS 20/2(13.5). Generally, this change of entity status will not alter the tax treatment of income produced by these assets. See §6.63 below. A chief benefit of transferring UTMA assets into a §2503(c) trust is that the trust can continue even after the beneficiary attains age 21. This is typically achieved by giving the beneficiary a temporary withdrawal right upon attaining age 21. An UTMA custodianship, however, terminates when the beneficiary reaches age 21, and the assets become the property of the person for whose benefit the custodianship has been created.

B. [6.63] Code §2503(c) Trust

A trust created to comply with Internal Revenue Code §2503(c) must have the following characteristics:

1. all corpus and income may be expended by, or for the benefit of, the donee before the donee attains the age of 21; and

2. to the extent corpus and/or income is not so expended, it will pass to the donee upon reaching age 21 or, if the donee dies before reaching age 21, to the donee's estate or pursuant to a general power of appointment exercised by the donee. Code §2053(c).

There is thus considerable latitude in drafting such a trust. While a complete discussion of the treatment of a Code §2503(c) trust is beyond the scope of this chapter, several important issues must be raised.

If, as is frequently the case, the grantor of the §2503(c) trust is a lineal ancestor of the beneficiary, the trust will not be treated as a grantor trust solely because the ancestor may hold a reversionary interest in the property by being a potential heir of a beneficiary who dies without a

will. Code §673(b). Further, if the grantor is the parent of the beneficiary or otherwise has a legal obligation to support the beneficiary, the trust income may (but not necessarily will) be taxed to the grantor by operation of the grantor trust rules. To the extent that income is used to discharge the grantor's legal obligation of support, the income will be taxed to the grantor. Code §677(b). To the extent that distributions to the beneficiary are allocable to principal, the trust will have a Code §661(a)(2) distribution deduction and the grantor will be taxed on the distribution by operation of the rules of Code §662.

Even if not the grantor, a person with a legal obligation to support the beneficiary can be taxed on the income under Code §678(c). A person not acting in the capacity of trustee or cotrustee yet having a legal obligation to support a beneficiary will be treated as a substantial owner of the trust assets if he or she has the power, exercisable solely by him or her, to expend income or corpus to discharge that obligation. Code §678(a). However, if a person with such an obligation of support has the power, exercisable solely by him or her as trustee or cotrustee, to expend income or corpus for the support or maintenance of the beneficiary, that person will be taxed on the income if so expended. Code §678(c). Further, to the extent that such a distribution is chargeable to corpus, the trust will receive a Code §661(a)(2) distribution deduction and the holder of the power will be taxed under Code §662. Code §678(c).

C. [6.64] *Crummey* Trust

Generally, the annual exclusion from gift tax applies only to gifts of present interests. A donor cannot use the annual exclusion to avoid gift tax on a gift of assets to a trust if the donee has only a future interest in the trust estate. One way to maximize the effectiveness of the annual exclusion is to make a gift of assets to a trust that provides the donee with a present right to withdraw the assets within a certain time after the gift is made. Such a power is referred to as a *"Crummey"* power, after *Crummey v. Commissioner,* 397 F.2d 82 (9th Cir. 1968). The present right of the donee to withdraw the assets allows the gift to qualify for the gift tax annual exclusion. Once the withdrawal period has expired, however, the assets not withdrawn remain in the trust to be administered pursuant to the provisions of the trust agreement, which is typically established by the donor.

The beneficiary of a *Crummey* trust has a present right to withdraw principal or income depending on the terms of the trust agreement. This power will lapse at some future time and may lapse partially at various times. During any period in which this power exists with respect to any portion of the trust, Internal Revenue Code §678(a)(1) will cause the beneficiary to be treated as the owner of that portion of the trust. To the extent that such a power has lapsed or been waived, released, or otherwise modified, the former holder of the power will be treated as the grantor of the portion of the trust assets to which the power related. The income tax treatment of a *Crummey* beneficiary mirrors the general treatment of grantors under the grantor trust rules.

D. [6.65] *Clifford* Trust

In 1924, Congress enacted a provision that was a precursor of the current grantor trust rules. Section 219 of the Revenue Act of 1924, ch. 234, 43 Stat. 253, caused the grantor to be taxed on the income of a trust if he or she held an income interest in the trust or a power of revocation.

Clearly, many of the planning opportunities that have been foreclosed by the current grantor trust rules were available to taxpayers under this 1924 provision.

One such opportunity involved the retention of a reversionary interest. *Helvering v. Clifford,* 309 U.S. 331, 84 L.Ed. 788, 60 S.Ct. 554 (1940), involved a grantor who had retained a reversionary interest in a short-term trust. The IRS argued that income from the trust should be taxed to the grantor. The Supreme Court upheld the IRS's position and taxed Mr. Clifford on the income of the trust in which he held a reversionary interest. The Court held that the grantor trust provisions of the 1924 Code applied to cases in which the grantor retained dominion and control over the trust estate. Treasury Regulations were issued in response to *Clifford* to clarify those situations in which a trust would be treated under the rule of *Clifford.* These regulations were known as the "*Clifford* regulations."

A *Clifford* trust is a trust designed to avoid application of the *Clifford* regulations. The grantor of a *Clifford* trust retains a reversionary interest that vests in more than ten years. Prior to 1954, the retention of a reversionary interest that did not vest for ten years would not cause the grantor to be taxed on trust income. In 1954, this ten-year safe-harbor rule for reversionary interests was codified into the predecessor of Internal Revenue Code §673. For many years the *Clifford* trust was an effective technique for shifting income while retaining the right to reacquire the property transferred to the trust. Then came the Tax Reform Act of 1986.

Effective for transfers made after March 1, 1986, the ten-year safe-harbor rule for reversionary interests was repealed. The current Code §673 applies to transfers made after that date. Pub.L. No. 99-514, 100 Stat. 2711 (1988). For most purposes, *Clifford* trusts should have terminated by 1996. However, to the extent that planners may have built an extra cushion of time into the reversionary interests, they may still exist. The ten-year rule is still applicable with respect to trusts established on or before March 1, 1986, in which the grantor retained a reversionary interest.

E. [6.66] Spousal Remainder Trust

Under the grantor trust rules, the grantor of a trust is treated as the owner of any interest owned by the grantor's spouse. Internal Revenue Code §672(e). Prior to the enactment of this Code section, the grantor trust rules could be circumvented if the grantor gave his or her spouse a reversionary interest in a trust. Such a trust was known as a "spousal remainder trust." A spousal remainder trust is no longer effective in avoiding application of the grantor trust rules. However, a spousal remainder trust that was created by the grantor on or before March 1, 1986, may not be a grantor trust because the provisions of Code §672(e) are effective only for transfers in trust made after that date. Pub.L. No. 99-514, 100 Stat. 2711 (1986).

F. [6.67] Multiple Trusts

Income-splitting not only will divide income among one or more taxpayers but also can significantly reduce the total amount of tax paid when lower-bracket taxpayers are included in the split. An easy way to accomplish income-splitting was by dividing assets through transfers to a number of trusts. However, unless the provisions of each trust were substantially identical, the tax

savings resulting from the use of multiple trusts were eroded by expenses of trust administration. Internal Revenue Code §643(f) effectively prohibits the use of multiple trusts if the trusts were established by substantially the same grantor or grantors, have substantially the same primary beneficiary or beneficiaries, and were created principally for the purpose of income tax avoidance.

When these requirements are met, multiple trusts are treated as a single trust for income tax purposes. For purposes of applying this rule, the grantor and the grantor's spouse are treated as the same individual. *Id.* While regulations under Code §643 are authorized to further clarify the meaning of this provision, no such regulations have been promulgated. It is important to note that the rule of Code §643(f) applies to tax years beginning after March 1, 1984. Pub.L. No. 98-369, §81, 98 Stat. 597 (1984). Trusts formed in earlier years will not be aggregated under this rule.

G. [6.68] Interest-Free Loan

In the 1970s and early 1980s, the interest-free loan was a popular income-shifting tool used for estate planning purposes. An individual (often a parent) would lend money to a borrower (a child) on demand without interest. Gift tax was not incurred because there was no gift, the borrower was taxed on the income from the borrowed assets, and no interest income or deductions accrued to either party. However, the enactment of Internal Revenue Code §7872 in 1984 changed all this. While Code §7872 is enormously complex, its provisions concerning interest-free loans are readily summarized.

Code §7872 provides for treatment of loans with stated interest below the applicable federal rate (AFR) that are not otherwise addressed by Code §1274 or §483. These loans specifically include

1. gift loans;

2. loans between employers and employees;

3. loans between companies and shareholders;

4. loans entered into with the principal purpose of avoiding taxes;

5. loans to continuing care facilities; and

6. various other loans permitted to be specified in the regulations. Code §7872(c)(1).

If certain requirements are met, gift loans and demand loans will be treated for all purposes of the Code as if the forgone interest were transferred to the borrower by the lender and then transferred back to the lender as interest. Code §7872(a)(1). The demand interest payment is computed by reference to tables of "applicable federal rates" compiled and published by the IRS on a monthly basis. See, *e.g.,* Rev.Rul. 2000-32, 2000-2 Cum.Bull. 1. Loans subject to this treatment are "below-market loans" (as defined in Code §7872(e)(1)) that are "gift loans" (as defined in Code §7872(f)(3)) or "demand loans" (as defined in Code §7872(f)(5)). Code §7872(a)(1). If the loan is between relatives, the initial deemed transfer will presumably be

treated as a taxable gift. However, if the aggregate amount of outstanding gift loans between two individuals at the end of a taxable year is less than $10,000, the loans will be ignored for purposes of Code §7872 unless the proceeds were used to purchase income-producing assets. Code §7872(c)(2). The interest deemed paid to the lender will be includible in the lender's income under Code §61(a)(4), but the borrower's interest deduction will be subject to the potential restrictions of Code §163, which limit the deductibility of interest to certain specific situations. However, under certain circumstances, Code §7872(d)(1) will not allow the interest deemed paid to exceed the borrower's "net investment income" (within the meaning of Code §163).

Below-market loans that are not "gift loans" are treated in a substantially different manner. Such "non-gift" loans will be treated as if the lender loaned the borrower the present value of the payments due on the loan and then transferred the remainder of the amount borrowed in some other fashion. Code §7872(b)(1). The amount deemed to have been loaned to the borrower is then treated as having an original-issue discount (OID), computed under the rules of Code §1274, equal to the difference between the amount actually loaned to the borrower and the amount treated as being loaned to the borrower. Code §7872(b)(2).

If either Code §483 (relating to certain installment sales of property without adequate interest) or §1274 (relating to the OID rules) applies to a loan (except by reason of Code §7872), then Code §7872 is specifically inapplicable to the loan. Code §7872(f)(8). In either case, interest is deemed to be part of the transaction, and both parties to the loan are treated as if the loan was structured in a way that called for market rate interest to be paid on the loan.

H. [6.69] Income Tax Rates and the Kiddie Tax

As shown in the table below, there are significant differences in the tax brackets that apply to different types of taxpayers. The tax brackets that apply to married couples filing jointly, for example, are much wider than those that apply to single individuals but are still less than twice the single individual brackets. For a married couple in which both spouses earn substantial incomes, the effect of marriage is to increase the overall taxes paid, while a married couple in which only one person has income will derive a tax benefit from marriage. The following table shows the various tax brackets for married couples, individuals, and non-grantor trusts in 2011 as set forth in Rev.Proc. 2011-12, 2011-2 Int.Rev.Bull. 297:

Tax Rate	Married Filing Jointly	Single Individuals	Non-Grantor Trust
10%	$0 – $17,000	$0 – $8,500	N/A
15%	$17,000 – $69,000	$8,500 – $34,500	$0 – $2,300
25%	$69,000 – $139,350	$34,500 – $83,600	$2,300 – $5,450
28%	$139,350 – $212,300	$83,600 – $174,400	$5,450 – $8,300
33%	$212,300 – $379,150	$174,400 – $379,150	$8,300 – $11,350
35%	$379,150 –	$379,150 –	$11,350 –

Among these choices, the most preferential tax rates apply to married couples filing jointly. However, to the extent a married couple could shift top-bracket income to their children, the lower brackets available to a "single individual" could be used to shield up to $379,150 of income per child from the 35-percent bracket.

For a number of years, many wealthy taxpayers employed this income-shifting strategy. Congress responded by enacting Internal Revenue Code §1(g), which imposes the so-called "kiddie tax," under which a child's unearned income is taxed at the parents' marginal rate. The kiddie tax is applicable to individuals under age 18 who have at least one parent alive at the close of the taxable year. Code §1(g)(2). Code §1(g) requires a child who is subject to the kiddie tax to pay a tax equal to the greater of the tax ordinarily computed under Code §1 (without regard to the kiddie tax) or the sum of the child's tax computed without the net unearned income of that child plus his or her share of the "allocable parental tax." Code §1(g)(1).

The "allocable parental tax" is defined as the excess of the parent's tax if the parent's taxable income included all net unearned income of all children of the parent to whom the kiddie tax applies over the tax otherwise imposed on the parent. Code §1(g)(3)(A). However, a child's net unearned income is not taken into account in computing exclusions, deductions, or credits of the parent. *Id.* A child's share of the allocable parental tax is the portion of the allocable parental tax that bears the same relationship to the total allocable parental tax that the child's net unearned income bears to the aggregate net unearned income used to calculate the allocable parental tax under Code §1(g)(3)(A). Code §1(g)(3)(B). If the parent has a different taxable year, the child's tax is computed based on the parent's taxable year that ends during the child's taxable year. Code §1(g)(3)(C).

"Net unearned income" is defined in Code §1(g)(4)(A) to mean the excess of

(i) the portion of the adjusted gross income for the taxable year which is not attributable to earned income (as defined in section 911(d)(2)), over

(ii) the sum of —

(I) the amount in effect for the taxable year under section 63(c)(5)(A) (relating to limitation on standard deduction in the case of certain dependents), plus

(II) the greater of the amount described in subclause (I) or, if the child itemizes his deductions for the taxable year, the amount of the itemized deductions allowed by this chapter for the taxable year which are directly connected with the production of the portion of adjusted gross income referred to in clause (i).

In no circumstance will net unearned income be greater than the child's taxable income for the taxable year in question. Code §1(g)(4)(B).

I. [6.70] Use of Fiscal Years

All trusts except charitable trusts and trusts exempt from tax are required to be calendar year taxpayers. Internal Revenue Code §644. Estates, however, may still select a fiscal year. This allows an estate to have a fiscal year that is different from that of the estate's beneficiaries. Income distributed from an estate is required to be included in the beneficiary's taxable year in which the estate's taxable year ends. Code §662(c). Further, income distributed from an estate or trust is deemed to be distributed on the last day of the estate's fiscal year. For example, if an

estate's fiscal year ends on January 31, 2011, all current income distributed to a beneficiary in that fiscal year will be treated as having been remitted on January 31, 2011, even if all or part of it had actually been paid to the beneficiary on February 1, 2010. The beneficiary will include the income in his or her year 2011 tax return. In such a situation, the taxes on the income will be deferred by up to one year.

Care must be taken when closing an estate that is on a fiscal year, however. The closing of the estate will still cause the beneficiary to recognize income from the last (typically short) year of the estate in the beneficiary's taxable year in which the estate's taxable year ends. Code §662(c). However, if the estate's taxable year ends in the same calendar year as the end of the estate's prior taxable year, the beneficiary may have to recognize up to 23 months of estate income in a single year. For instance, if an estate's fiscal year ends on January 31, 2011, and the estate closes on December 31, 2011, the income from the fiscal year ending January 31, 2011, and the income from the estate's final year ending December 31, 2011, will be included on the beneficiary's return for the calendar year 2011. In such a case, the beneficiary will recognize income from February 1, 2010, through December 31, 2011, on the beneficiary's year 2011 income tax return. To avoid this problem, the estate should be closed in January 2011; the estate's last year of income will then be taxed to the beneficiary in the year 2011. A January closing will avoid this problem to the maximum extent possible, regardless of the fiscal year of the estate.

VI. MISCELLANEOUS PROVISIONS AFFECTING INCOME TAX PLANNING

A. [6.71] Personal Interest Deduction Limitation

Personal interest is not deductible from gross income for noncorporate taxpayers. Internal Revenue Code §163(h). "Personal interest" is defined in the Code as any interest other than interest accrued on indebtedness properly allocable to a trade or business, investment interest, interest used to compute income or loss from a passive activity, qualified residence interest, interest payable under Code §6601 (relating to unpaid taxes while extension of time is in effect), and interest allowed as a deduction under Code §221 (relating to student loan interest). Code §163(h)(2). "Qualified residence interest" applies only to the taxpayer's principal residence and one other residence so used by the taxpayer and is defined in Code §163(h)(3) to include interest on acquisition indebtedness up to $1 million or home equity indebtedness up to the lesser of $100,000 or the equity in the home (*i.e.,* fair market value minus acquisition indebtedness). If indebtedness on a residence existed prior to October 13, 1987, Code §163(h)(3)(D) should be consulted to review other rules that may also apply.

B. [6.72] Alternative Minimum Tax for Individuals

Individual taxpayers are potentially subject to the alternative minimum tax (AMT). The AMT is an "alternative" method of computing tax that is based on a lower tax rate but allows far fewer deductions and credits against tax. For example, miscellaneous itemized deductions are disallowed completely when computing AMT for individuals. Internal Revenue Code §56(b)(1)(A)(i). Other deductions are allowed to a lesser degree or under more narrow circumstances. Medical expenses, for example, are subject to a floor equal to ten percent of

adjusted gross income, while interest deductions are broadly limited. Code §§56(b)(1)(B), 56(b)(1)(C). For persons who reduce their "normal" income tax liability through deductions, the AMT can have a tremendous negative impact.

The AMT also applies to trusts and estates. The normal rules of Part I of Subchapter J (Code §§641 – 685, including the computation of taxable income for trusts and estates as well as the grantor trust rules) are to be applied to an estate or trust with the adjustments made in Code §§55 – 59. A discussion of the many adjustments required to calculate the AMT for an estate or trust exceeds the scope of this chapter, but it is important always to keep in mind that the basic purpose of the AMT is to tax a higher level of income at a lower rate by reducing deductions. To the extent that an entity's taxable income is greatly reduced through deductions, AMT issues must be considered.

C. [6.73] Estimated Tax Payments for Trusts

Generally, trusts and estates are subject to the same estimated tax rules that apply to individuals. Internal Revenue Code §6654(*l*). Private foundations and charitable trusts, however, are exempt from these rules. Estates are also not subject to the estimated tax rules for any taxable year ending within the year of the decedent's death. A grantor trust treated as owned by the decedent prior to the decedent's death is also not required to make estimated tax payments for any tax year ending within two years of the decedent's death if the residue of the decedent's estate will pass to the trust. *Id.* In addition, a grantor trust is not subject to estimated tax rules to the extent that the trust's assets are treated as owned by one or more individuals. In such cases, the trust income is subject to whatever rules may apply to the individual "owners" of trust assets.

Trusts and estates, like individuals, will be assessed penalties for failing to make estimated tax payments. Code §6654. However, special treatment may be elected for estimated payments made by a trust. A trust that makes estimated tax payments may elect to have any portion of those payments treated as having been made by a beneficiary of the trust. Code §643(g). That portion of the estimated tax payment is then treated as having been distributed to the beneficiary on the last day of the taxable year in which the payment was made. Such a payment is treated as having been made by the beneficiary on January 15 following the taxable year of the deemed distribution. This special treatment may be elected up to 65 days after the close of the taxable year in which the distribution was made. *Id.*

D. [6.74] Reciprocal Trust Doctrine

The reciprocal trust doctrine may be illustrated by the following example. Taxpayers *A* and *B* each establish a trust. The trust created by *A* pays income to *B* for life, with the remainder to *B*'s children. The trust established by *B* has identical provisions except that income is paid to *A* for life, with the remainder to *A*'s children. Neither *A* nor *B* has retained a life estate in the property he or she has transferred, yet if the amounts transferred into trust are equal, each has effectively received a life estate in the transferred assets while technically circumventing the grantor trust rules and the estate tax rules regarding retained life estates. To prevent the use of trusts to achieve this objective, courts have developed the reciprocal trust doctrine.

The modern formulation of the reciprocal trust doctrine was promulgated by the U.S. Supreme Court in *United States v. Estate of Grace,* 395 U.S. 316, 23 L.Ed.2d 332, 89 S.Ct. 1730 (1969). In *Grace,* the decedent created a trust with himself as cotrustee that provided his wife with an income interest for life, the right to distributions of principal in the discretion of the trustees, and a testamentary limited power to appoint trust property to the decedent and their children. Two weeks later, the decedent's wife created a trust with provisions mirroring those of the decedent's trust. The IRS took the position that the trusts should be re-characterized as two trusts in which each trust's grantor retained a life estate in trust income. The Court created a two-part test for determining whether trusts are "reciprocal": (1) the trusts must be interrelated, and (2) to the extent of mutual value, the arrangement must leave the settlors in approximately the same economic position that they would have been in had they created trusts naming themselves as life beneficiaries. Applying this test, the Court ignored the form of the transfers, and the two Grace trusts were treated as having created life estates for the settlors.

This doctrine has also been applied in the income tax area. In *Krause v. Commissioner,* 57 T.C. 890 (1972), *aff'd,* 497 F.2d 1109 (6th Cir. 1974), *cert. denied,* 95 S.Ct. 780 (1975), the tax court "uncrossed" two non-grantor trusts to create two trusts subject to the grantor trust rules. In *Schultz v. United States,* 493 F.2d 1225 (4th Cir. 1974), the reciprocal trust doctrine was also applied to uncross annual exclusion transfers, thereby imposing a gift tax liability. See also Rev.Rul. 85-24, 1985-1 Cum.Bull. 329. An explication of all situations in which the reciprocal trust doctrine has been applied is beyond the scope of this chapter, but the practitioner must be alert that the doctrine has potential for application in a variety of situations.

E. [6.75] Anti-*Hubert* Regulations

In *Commissioner v. Estate of Hubert,* 520 U.S. 93, 137 L.Ed.2d 235, 117 S.Ct. 1124 (1997), the Supreme Court effectively allowed two separate deductions for certain administrative expenses. In *Hubert,* a residuary estate of approximately $26 million was to be divided between marital and charitable interests. The executor incurred approximately $2 million of expenses, of which $500,000 was charged to principal and $1.5 million to income. The executors deducted these expenses on the estate's income tax return and took the position that such items ought not to reduce the value of the marital or charitable deductions to the extent the items were properly charged to income. The IRS took the opposing position. The U.S. Supreme Court ruled for the taxpayer based on the Treasury Regulations then in effect. Treas.Reg. §20.2056(b)-4 has now been promulgated in response to *Hubert,* effective for estates of decedents dying on or after December 3, 1999. The "anti-*Hubert* regulations" have created a new way of classifying various administrative expenses and determining their relationship to the amount of the marital deduction.

The anti-*Hubert* regulations divide administration expenses into two broad categories: "management expenses" and "transmission expenses." "Management expenses" are expenses that are "incurred in connection with the investment of estate assets or with their preservation or maintenance during a reasonable period of administration." Treas.Reg. §20.2056(b)-4(d)(1)(i). "Transmission expenses" are all administration expenses other than management expenses. Treas.Reg. §20.2056(b)-4(d)(1)(ii). This broad definition of "transmission expenses" is then specifically narrowed to include only those expenses that would not have been incurred but for the decedent's death and the consequent necessity of creating, administering, and closing the

decedent's estate. *Id.* Further, because the anti-*Hubert* regulations affect the amount of the marital deduction, one further definition is necessary: "marital share" is defined as the property or interest in property that passed from the decedent for which a master deduction is allowable under Internal Revenue Code §2056(a). Treas.Reg. §20.2056(b)-4(d)(1)(iii).

Under the anti-*Hubert* regulations, the amount of the marital deduction is determined by subtracting from the "marital share" all "transmission expenses" paid from the marital share. Treas.Reg. §20.2056(b)-4(d)(2). Further, while "management expenses" allocable to and paid from the marital share generally do not affect the amount of the marital deduction, the marital share is reduced by "management expenses" to the extent that those expenses are deducted under Code §2053 on the decedent's federal estate tax return. Treas.Reg. §20.2056(b)-4(d)(3). Finally, the marital share is reduced by the "management expenses" that are paid from the marital share although not allocable to the marital share. Treas.Reg. §20.2056(b)-4(d)(4).

VII. INVESTMENT AND TAX DEFERRAL TECHNIQUES

A. [6.76] Zero-Coupon Bonds

Zero-coupon bonds accrue interest over their life and pay all such interest, together with all original principal, at maturity. Zero-coupon bonds issued after July 1, 1982, are usually governed by the general rule of Internal Revenue Code §1272(a)(1), which provides that the original-issue discount (OID) of a debt instrument is to be recognized by the holder of such an instrument as gross income over the life of the debt instrument. Specifically excepted from this treatment are any tax-exempt obligation, any U.S. savings bond, any debt instrument with a fixed maturity date not more than one year from issuance, any obligation held by a natural person before March 2, 1984, and certain loans between natural persons when the outstanding amount of such loans does not exceed $10,000. Code §1272(a)(2).

When applied to investments other than zero-coupon bonds, the OID rules are extremely complex. However, their application to zero-coupon bonds is straightforward: a taxpayer who holds a zero-coupon bond must recognize the interest that accrues in a given year regardless of the fact that no such interest has been paid. Code §1272. If a taxpayer purchases a zero-coupon bond at a premium, the premium may be taken into account under Code §1272(a)(7) to reduce the amount of interest recognized by the holder of the bond.

B. [6.77] U.S. Savings Bonds

U.S. savings bonds, one of the exceptions to the original-issue discount rules of Internal Revenue Code §1272, discussed briefly in §6.76 above, are subject to a unique set of income tax rules. There are five types of savings bonds: Series H, Series HH, Series I, Series E, and Series EE, though neither Series H nor Series HH are currently issued. Effectively, however, there are only three types of savings bonds because Series H and HH are treated identically, as are Series E and EE. Series EE and Series I bonds can be purchased, up to certain limits, for cash. Series HH bonds, however, were available only in exchanges for Series EE bonds or certain U.S. Treasury notes.

Series HH bonds pay interest every six months, and the interest is recognized as gross income upon receipt. However, while Series EE and Series I bonds are zero-coupon bonds, they are explicitly excluded from the recognition of imputed interest under Code §1272. Code §1272(a)(2)(B). The interest on Series EE and Series I bonds is recognized either at maturity or upon their sale or exchange. No interest received on Series E, EE, H, HH, or I bonds is taxable at the state or local level.

U.S. savings bonds are an effective way to defer income taxation of bond interest. The applicable limits on purchase and exchange of the various bonds renders these benefits unavailable on a large scale but effectively encourages their widespread use. For certain individuals, such as those for whom social security payments make up a large portion of their income every year, Series EE or Series I bonds can be a most useful investment. Taxation on the interest income that might render a taxpayer's social security benefits taxable can be postponed, and income accrued over many years will render social security taxable in one year only, instead of in each year of accrual. This form of income-shifting can have significant impact and in appropriate cases may prompt a more detailed review of the rules and regulations surrounding U.S. savings bonds. Further, some additional tax benefits are available when qualified education expenses are paid in the year that such interest income would be included in that bondholder's income.

C. [6.78] Illinois General Obligation College Savings Bonds

Illinois general obligation college savings bonds yield certain favorable tax and financial planning consequences, as provided by the Illinois Baccalaureate Savings Act, 110 ILCS 920/1, *et seq.* The interest on these bonds is not taxable in Illinois. 110 ILCS 920/7. In the past, the first $25,000 of Illinois general obligation college savings bonds were not considered when evaluating the financial need of a student who applied for any state-sponsored or state-affiliated scholarship or grant. 110 ILCS 920/9, repealed by P.A. 93-812 (eff. Jan. 1, 2005). The State of Illinois is authorized and required to provide a grant program of additional financial incentives for holders of such bonds to encourage their enrollment at various state-affiliated institutions of higher education. 110 ILCS 920/8. From a tax perspective, this benefit is obviously minimal. However, the repeal of the preferential financial aid treatment dramatically reduces the benefits of such bonds for those saving for higher education in state-affiliated institutions.