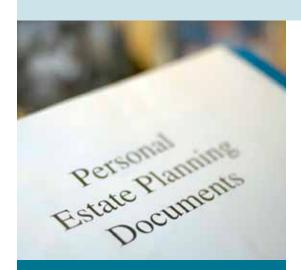


Advanced Estate Planning 2018



Cosponsored by the Estate Planning and Administration Section

Friday, June 22, 2018 8:30 a.m.–4:45 p.m.

5.75 General CLE credits and 1 Ethics (Oregon specific) credit

ADVANCED ESTATE PLANNING 2018

SECTION PLANNERS

Philip Jones, Duffy Kekel LLP, Portland Robin Smith, Butcher & Smith Law LLC, Portland Margaret Vining, Davis Wright Tremaine LLP, Portland Katharine West, Wyse Kadish LLP, Portland Eric Wieland, Samuels Yoelin Kantor LLP, Portland

OREGON STATE BAR ESTATE PLANNING AND ADMINISTRATION SECTION EXECUTIVE COMMITTEE

Ian T. Richardson, Chair Philip N. Jones, Chair-Elect Melanie E. Marmion, Past Chair Holly N. Mitchell, Treasurer Eric J. Wieland, Secretary Stuart B. Allen Sibylle Baer Michele Buck-Romero Eric R. Foster Janice E. Hatton Amelia E. Heath Erin K. MacDonald Hilary A. Newcomb Erik S. Schimmelbusch Barbara J. Smith Robin A. Smith Margaret Vining

The materials and forms in this manual are published by the Oregon State Bar exclusively for the use of attorneys. Neither the Oregon State Bar nor the contributors make either express or implied warranties in regard to the use of the materials and/or forms. Each attorney must depend on his or her own knowledge of the law and expertise in the use or modification of these materials.

Copyright © 2018

OREGON STATE BAR 16037 SW Upper Boones Ferry Road P.O. Box 231935 Tigard, OR 97281-1935

TABLE OF CONTENTS

Sche	dule
Facul	l ty
1A.	Tax Cuts and the Jobs Act: Selected Issues for Individuals
1B.	Tax Legislation: Estate Planning—Presentation Slides 1—1 — Eric Hormel, Perkins & Co., Portland, Oregon 1—1 — Kim Spaulding, Perkins & Co., Portland, Oregon
2.	Oregon Estate Transfer Tax Overview and Filing Issues—Presentation Slides 2—i — Dennis Maurer, Oregon Department of Revenue, Salem, Oregon — Zach Wenger, Oregon Department of Revenue, Salem, Oregon
3.	Understanding the Deduction for Qualified Business Income
4.	Contemporary Estate Planning Paradigms for Married Couples—Presentation Slides 4—i — Professor Samuel Donaldson, Georgia State University, Atlanta, Georgia
5.	Legal Ethics for Estate Planners 5-i — David Elkanich, Holland & Knight LLP, Portland, Oregon
6.	Transfer Tax Considerations Under the 2017 Tax Act—Presentation Slides 6—i — Brent Berselli, Holland & Knight LLP, Portland, Oregon
7.	A Fiduciary Income Tax Primer

SCHEDULE

7:30 Registration

8:30 Tax Cuts and the Jobs Act: Selected Issues for Individuals

- ♦ Changes with the greatest impact on individuals
- ◆ Effects on taxpayers' 2018 income tax liability
- ◆ Limitations on state and local deductions for Oregon taxpayers
- ♦ Planning opportunities

Christopher Cline, Riverview Trust Company, Vancouver, WA

Eric Hormel, Perkins & Co., Portland, OR

Samantha Pahlow, Riverview Trust Company, Lake Oswego, OR

Kim Spaulding, Perkins & Co., Portland, OR

9:30 Oregon Department of Revenue OR-706 Filings

- ◆ Effect on tax receipt letters and request for discharge processes
- ◆ Common 706 return errors
- ◆ LLC property, QTIP, and OSMP
- ◆ Federal legislation impacts
- ◆ POA forms

Dennis Maurer, Oregon Department of Revenue, Salem, OR Zach Wenger, Oregon Department of Revenue, Salem, OR

10:15 Break

10:30 Understanding the Deduction for Qualified Business Income

- ♦ New §199A deduction for qualified business income
- ♦ Issues expected to be addressed in forthcoming guidance
- ◆ Planning opportunities to maximize the deduction

Professor Samuel Donaldson, Georgia State University, Atlanta, GA

11:45 Lunch

12:45 Contemporary Estate Planning Paradigms for Married Couples

- ♦ Planning templates for couples with small, medium, and large estates
- ♦ Maximizing income tax basis step-up on the death of the surviving spouse
- ◆ Proper uses of portability elections, credit shelter trusts, and Clayton QTIP trusts

Professor Samuel Donaldson, Georgia State University, Atlanta, GA

1:30 Legal Ethics for Estate Planners

David Elkanich, Holland & Knight LLP, Portland, OR

2:30 Break

2:45 Transfer Tax Considerations Under the Tax Cuts and Jobs Act

- ◆ Increased estate, gift, and GST exemptions
- ♦ Formula funding concerns in pre-2018 estate plans
- ◆ Expanded use of GST planning
- ◆ Use of increased exemption in leveraged sales and/or gifts to grantor trusts
- ◆ Additional uses for increased exemption

Brent Berselli, Holland & Knight LLP, Portland, OR

SCHEDULE (Continued)

3:45 Fiduciary Income Tax

- ◆ Federal and Oregon fiduciary income tax rules
- ♦ Administering trusts and estates to minimize income taxes
- ♦ Using administration expenses to best advantage
- ◆ Timing distributions to reduce income tax consequences

Philip Jones, Duffy Kekel LLP, Portland, OR

4:45 Adjourn

FACULTY

Brent Berselli, *Holland & Knight LLP, Portland, OR.* Mr. Berselli is a member of the firm's Private Wealth Services Practice Group. He focuses his practice on tax planning for individuals and businesses, including corporate and estate planning for closely held and family-owned businesses. He also provides tax planning counsel for all types of business transactions related to corporate entities, including IRC § 501(c)(3) nonprofit corporations, general and limited partnerships, subchapter C and subchapter S corporations, and limited liability companies. Mr. Berselli also represents personal representatives of probate estates, trustees, conservators, and guardians in the discharge of their fiduciary duties.

Christopher Cline, Riverview Trust Company, Vancouver, WA. Mr. Cline joined Riverview Trust Company in April 2016 as President and CEO after heading up the trust department in Oregon and southwest Washington for a national bank for eight years. Prior to joining the wealth management industry, he was an estate planning attorney working with very wealthy families. In addition to overseeing all aspects of the company's operations, Mr. Cline helps Riverview's clients navigate the challenges of estate planning and trust administration, particularly with business succession, trust design, and charitable planning. Mr. Cline is a Fellow of the American College of Trust and Estate Counsel. He is a nationally recognized speaker and author on estate planning topics. He has written seven books on estate planning, including *The Law of Trustee Investments*, published by the American Bar Association. He has been active in drafting trust and probate legislation for the State of Oregon.

Professor Samuel Donaldson, *Georgia State University, Atlanta, GA.* Professor Donaldson teaches a number of tax and estate planning courses, as well as courses in the areas of property, commercial law and professional responsibility. Prior to joining the Georgia State faculty in 2012, he was on the faculty at the University of Washington School of Law in Seattle for 13 years. During his tenure at the University of Washington, he was a five-time recipient of the Philip A. Trautman Professor of the Year award from the School of Law's Student Bar Association. Professor Donaldson served for two years as Associate Dean for Academic Administration and for six years as the Director of the law school's Graduate Program in Taxation. Professor Donaldson is an Academic Fellow of the American College of Trust and Estate Counsel (ACTEC) and a member of the bar in Washington, Oregon, and Arizona. Among his scholarly works, he is a coauthor of the popular West casebook, *Federal Income Tax: A Contemporary Approach*, and a coauthor of *Price on Contemporary Estate Planning*, published by Wolters Kluwer. Professor Donaldson has served as the Harry R. Horrow Visiting Professor of International Law at Northwestern University and a Visiting Assistant Professor at the University of Florida Levin College of Law. He holds an LL.M. in Taxation from the University of Florida.

David Elkanich, *Holland & Knight LLP, Portland, OR.* Mr. Elkanich focuses his practice on litigation, with an emphasis on legal ethics and risk management. He advises both lawyers and law firms in a wide range of professional responsibility matters. In addition, Mr. Elkanich has a commercial litigation practice, where he regularly represents clients in the financial services industry. Mr. Elkanich is an adjunct professor at Lewis & Clark Law School, where he has taught the required ethics course (Regulation and Legal Ethics) since 2012. He is an active member of the Oregon State Bar, including service on the Discipline System Review Committee and Legal Ethics Committee. He is also a member of the Multnomah Bar Association, the Association of Professional Responsibility Lawyers, and the ABA Center for Professional Responsibility. Mr. Elkanich is admitted to practice in Idaho, Washington, and Oregon.

Eric Hormel, *Perkins & Co., Portland, OR.* Mr. Hormel is a CPA and a member of the firm's Legacy Planning Practice Group. He specializes in working with high–net worth individuals and their families. He provides income and tax consulting, including review of estate plans, business succession, and charitable gift planning. He also works with executives on the tax issues surrounding compensation, including the implications of exercising and selling stock options. Mr. Hormel also leads the firm's Creative Services Practice Group. He is a member of the American Institute of Certified Public Accountants, the Oregon Society of Certified Public Accountants, and the Estate Planning Council of Portland.

FACULTY (Continued)

Philip Jones, *Duffy Kekel LLP, Portland, OR.* Mr. Jones practices primarily in the areas of estate planning, estate and gift taxation, estate and trust administration, fiduciary income taxation, tax procedure, tax controversies, and estate and trust litigation. He is a Fellow of the American College of Trust and Estate Counsel and a member of the Estate Planning Council of Portland. He served for 20 years as an Adjunct Professor of Law at Lewis & Clark Law School, where he taught Estate & Gift Taxation and Federal Tax Procedure. He is the author of numerous articles in the *Journal of Taxation* and other publications. He has argued cases on behalf of taxpayers in the Oregon Supreme Court, the United States Tax Court, the Ninth Circuit Court of Appeals, and the United States Supreme Court. Mr. Jones is admitted to practice law in Oregon and Washington.

Dennis Maurer, *Oregon Department of Revenue, Salem, OR.* Mr. Maurer is a Senior Tax Auditor in the Estate Unit. He has worked for the Oregon Department of Revenue for 31 years in various capacities. He started his career as a tax auditor in the Personal Income Tax Division and was later promoted to Senior Tax Auditor in the Business Division, Corporation Estate Section. Other positions he has held include Personal Income Tax Filing Enforcement Program Manager, Employee Tax Compliance Officer, and Division Budget Officer. He has also spent time as a policy analyst for 11 other tax programs the department administers. Mr. Maurer was invited to be part of the vendor selection process for the Core System Replacement Project (GenTax). He was also a trainer and tester during the project.

Samantha Pahlow, *Riverview Trust Company, Lake Oswego, OR.* Ms. Pahlow serves as Senior Vice President and Private Wealth Director of Riverview Trust Company. She also serves on the firm's trust management and investment committees. She is a CPA and Certified Trust and Financial Advisor (CTFA) with an extensive background in taxation, accounting, and finance. She is a member of the Estate Planning Council of Portland, the Oregon Society of CPAs, the American Institute of Certified Public Accountants, the American Bankers' Association, and the Financial Planning Association.

Kim Spaulding, *Perkins & Co., Portland, OR.* Ms. Spaulding is a CPA and Senior Manager at Perkins & Co. and leader of the firm's Legacy Planning Practice Group. She focuses on serving high–net worth individuals and closely held businesses and their owners to minimize income and estate tax using a variety of techniques, including gifting, charitable and other types of trusts, and entity planning. She is a member of the American Institute of Certified Public Accountants, the Oregon Society of Certified Public Accountants, and the Estate Planning Council of Portland.

Zach Wenger, *Oregon Department of Revenue*, *Salem*, *OR*. Mr. Wenger is a Senior Tax Auditor in the Estate and Fiduciary Unit, where he has spent the last five years auditing and reviewing estate transfer and fiduciary income tax returns. He has been with the Oregon Department of Revenue since 2006 and has worked in many different areas throughout the agency. He began his career as a Support Specialist in the Administrative Services Division. In 2009, he transferred to the Personal Income Tax and Compliance Section processing and reviewing returns for the personal income tax program. He was promoted to an Entry Level Tax Auditor in 2011, working in the Corporation Section.

Chapter 1A

Tax Cuts and the Jobs Act: Selected Issues for Individuals

CHRISTOPHER CLINE
Riverview Trust Company
Vancouver, Washington

Samantha Pahlow Riverview Trust Company Lake Oswego, Oregon

Contents

I.	Rates
II.	Deductions
III.	Deferred Income
IV.	Pass-Through Income
V.	Taxes on Nonprofits
VI.	Trustee Fees
VII.	Charts
	Individual Income Tax Rates
	Standard Deduction, Itemized Deductions, and Personal Exemptions
	Child Tax Credit
	Alternative Minimum Tax (AMT)

Chapter 1A—Tax Cuts and the Jobs Act: Selected Issues for Individuals					

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act, the most sweeping change to the Internal Revenue Code since 1986. The marquee change made by the Act was the significant reduction in the tax rate paid by corporations. However, the Act had a significant impact on the way taxes will be paid by individuals as well.

These materials will provide an introduction and overview to what we feel are the most important changes affecting individuals. They in no way provide a comprehensive discussion, and the impacts of the Act are still being discussed and considered. Nevertheless, we hope they provide a good starting point.

But before getting into the details, we need to mention one point. A Senate rule, known as the "Byrd Rule," requires, in effect, that any law that has a negative fiscal impact beyond ten years requires at least 60 votes. Because the Republicans had only a bare majority, they had to pass a bill that, from a long-term perspective, was revenue-neutral. For that reason, a number of the changes, and most of the changes to personal taxes, made by the Act sunset at the end of 2025.

Unless otherwise stated, rates and exemptions presented in this article are for married couples filing jointly, and references to the "Code" are to the Internal Revenue Code.

I. Rates.

Rates for individuals went from 10, 15, 25, 28, 33, 35 and 39.6 percent last year to 10, 12, 22, 24, 32, 35 and 37 percent. This change sunsets after 2025. Capital gains rates stay at 15% and 20%, but the threshold pushing you into the higher rate is now indexed for inflation. Code section 1(j).

Personal exemptions, which previously were scheduled to be \$4,150 per person in 2018, have been suspended through 2025. Code section 151(d)(5)(A).

The rates for trusts and estates are still 10, 24, 35 and 37 percent. The top rate of 37% kicks in after \$12,500 of income. Code section 1(j).

The "Kiddie Tax" previously taxed a child under the age of 19 (or 24 if a full time student) at the parents' rates, if their rates were higher. Under the Act, a child's earned income is taxed under rates for single individuals, and unearned income is taxed the same as trusts and estates. Code section 1(j).

And while we're on the subject of children, under prior law the maximum child tax credit was \$1,000 and was phased out if modified adjusted gross income exceeded certain amounts. If the credit exceeded the tax liability, the child tax credit was refundable up to 15% of the amount of earned income in excess of \$3,000 (the earned income threshold). The Act increases the credit to \$2,000. A nonrefundable credit of \$500 is available for qualifying dependents other than qualifying children. The maximum refundable amount of the credit is \$1,400, indexed for inflation. The amount at which the credit begins to phase out is increased to \$400,000, and the earned income threshold is lowered to \$2,500. The changes to the credit sunset and revert to pre-existing law after 2025. Code section 24(h).

The benefit to these rate changes in rates is not clear without looking as well at the changes in deductions. As will be clear, many taxpayers whose rates will go down will nevertheless pay more tax in 2018 because their deductions will go down even more.

The IRS has released a new version of Form W-4 and a revised Withholding Calculator on irs.gov (IR-2018-36). These updated tools can help you check your 2018 tax withholding to determine if it's still appropriate following passage of the Tax Cuts and Jobs Act in December 2017. The IRS urges taxpayers to use these tools to make sure they have the right amount of tax withheld from their paychecks, taking into account significant changes to the tax law for 2018.

The IRS notes that the following groups, in particular, should make an extra effort to check their withholding:

- Two-income families
- People with more than one job at the same time
- People who work only for part of the year
- People with children who claim credits, such as the child tax credit
- People who itemized deductions in 2017
- People with high incomes and more complex returns

II. Deductions.

Perhaps the most important change for individuals is the increase in the standard deduction. Before the Act, the deduction was to be \$13,000 in 2018. Under the Act, this deduction increases to \$24,000 until 2026. This is important, because taxpayers are allowed to deduct either the standard deduction or the sum of all their itemized deductions. Code section 63(c)(7). By increasing the standard deduction (and reducing certain itemized deductions, below), the Act will make it more beneficial for many taxpayers NOT to itemize. This could have a significant impact, for instance, on the number of taxpayers who deduct charitable contributions.

The next important change, especially for Oregonians, is the limitation on deducting state and local taxes. Previously, state and local income, property and sales taxes were deductible against federal income tax. Under the Act, however, through 2025 the total amount of such state and local taxes that can be deducted is \$10,000. Code section 164(b)(6). This limitation does not apply to property taxes paid or accrued in carrying on of a trade or business under Code section 212.

Mortgage deductions also are affected. The deduction for mortgage interest is limited to \$750,000 of underlying indebtedness. This limitation does NOT apply to debts incurred before December 15, 2017and reverts back to the prior \$1,000,000 limitation starting in 2026. Further, deductions for home equity indebtedness (typically home equity lines of credit, or "HELOCs") where the proceeds are not used to buy, build, or substantially improve the residence secured by the loan (for example, when the proceeds are used to pay for a vacation or tuition) are suspended for the same period. Code section 163(h)(3)(F)(I).

Clarification: Under prior law, "Qualified Residence Interest" was deductible as long as it was interest paid on either Acquisition Debt or Home Equity Debt (with limits on the total amount of debt). Although the Act has temporarily eliminated the deduction for interest on Home Equity Debt, it is important to note that whether a debt is Acquisition Debt or Home Equity Debt is not based on how the loan is structured by the bank but instead on how the loan proceeds were used. Home Equity debt is any debt that is NOT Acquisition Debt. And Acquisition Debt is mortgage debt used to acquire, build, or substantially improve the taxpayer's primary home when the debt is secured by that residence. So although the Act has eliminated the deductibility of HELOC interest generally, if the HELOC was used in such a way as to qualify it as Acquisition Debt, and the taxpayer can prove that is the case by tracing the use of the proceeds to the building or improvement of the home, the interest may still be deductible. Talk to your CPA if you think you may fall into that category.

One deduction that becomes more useful under the Act is for medical expenses. Before the Act, such expenses were deductible only to the extent that they exceeded 10% of the taxpayer's adjusted gross income. Under the Act, that threshold is reduced to 7.5% of adjusted gross income. This change goes away even earlier than most, and is only available for the next two years. Code section 213(f)(2).

The charitable deduction under the Act remains largely unchanged except in one respect. Previously, contributions to a charity were limited to 50, 30 or 20 percent of modified adjusted gross income, depending upon the type of charity to whom the property was donated, and the type of property donated. Under the Act, the 50% limitation is increased to 60%. This increase also ends after 2025. Code section 170(b)(1)(G)(i).

The miscellaneous itemized deduction, which includes fees for investment advice and which are subject to the 2% of AGI floor, have been suspended through 2025. Code section 67(g). This has led to a question about the extent to which it applies to trustee fees (discussed below).

In good news to higher income taxpayers, the limitation on itemized deductions (known as the "Pease" limitation) under which such deductions are reduced by 3% of a taxpayer's AGI if it exceeded a stated threshold, has been eliminated through 2025. Code section 68(f).

The Alternative Minimum Tax, or "AMT," was intended to prevent high income taxpayers from avoiding tax liability through the use of various deductions, exclusions and credits. Unfortunately, the exemption amount used to eliminate certain deductions was not indexed for inflation, so that an increasing number of taxpayers were affected over the years. The AMT was not eliminated under the Act as had been initially proposed but instead has been retained with higher exemption amount: it increased from \$86,200 to \$109,400. Although a discussion of how the exemption works and the AMT is calculated is beyond the scope of these materials, this exemption change will take a great number of taxpayers out of the AMT regimen. Code section 55(d)(4).

The interplay of these provisions will produce interesting results. For example, a retired but still high-earning Oregonian who has paid off her mortgage may find herself with only \$10,000 of itemized deductions (that is, the cap on state and local tax). This means that her charitable contributions would have to exceed \$14,000 (if she was married filing jointly) in order for her itemized deductions to exceed the amount of her standard deduction. And, in this case, it would

only be the charitable contributions in excess of \$14,000 that would produce a benefit over the standard deduction (in other words, this taxpayer would have to donate \$15,000 in order to see a benefit of a \$1,000 deduction over the standard). This analysis would change significantly if that taxpayer had medical costs in excess of 7.5% of her AGI and still had a mortgage. In other words, it's no longer clear who will and will not benefit from charitable deductions from a tax perspective.

Hot Tip: Maybe the most useful planning recommendation deals with charitable contributions by older clients. Those clients who have significant retirement plan or IRA balances must start taking "required minimum distributions," or "RMDs," after they reach age 70 $\frac{1}{2}$. Wealthier clients may not need those distributions, but are required to take them into income anyway. By making a "charitable rollover" of some or all of those distributions, a client is not entitled to a charitable deduction, but simply does not have to take the portion given to charity into income if the client has attained age 70 $\frac{1}{2}$. Code section 408(d)(8)(F). This is an excellent way to make charitable gifts in a tax-efficient way, and still take advantage of the higher standard deduction (bearing in mind that the charitable rollover is limited to \$100,000 per year).

Less Hot Tip: Another way to think about getting as much income tax benefit from a client's charitable contributions is for the client to consider "bunching" his or her contributions into a single year. For example, assume a client gives \$10,000 per year to her favorite charity and has paid off her home. Her total itemized deductions might only equal \$20,000, which is \$4,000 less than her itemized deduction (assuming she's married). She would get no tax benefit from her contributions because she would never itemize. On the other hand, if she made no charitable contributions in years one and two, and instead made \$30,000 of gifts in year three, she would still get the standard deduction in the first two years, but would get \$40,000 of itemized deductions in year 3. Put another way, this client would get an additional \$16,000 of income tax deduction over three years by saving up all her charitable contributions. This approach may be of limited usefulness, however, as many clients probably will not choose to give in this way.

III. Deferred Income.

Several more minor changes were made to retirement plans and deferred compensation, but are worth discussing.

First, taxpayers can no longer recharacterize contributions to Roth IRAs as contributions to a regular IRA within the same taxable year. This limits the flexibility of making a Roth contribution but keeping your options open if your tax situation changes. Code section 408A(d)(6)(B)(iii).

Second, taxpayers who have certain stock options exercised starting on January 1, 2018 can elect to defer income recognized on the transfer of qualified stock. Code section 83(i). The rules regarding this deferral is beyond the scope of these materials.

Third, the amount that can be contributed to ABLE accounts has increased. An ABLE account is essentially a tax-deferred plan that benefits individuals with disabilities. Code section 529A. Further, in some cases amounts from 529 plan accounts can be rolled over into ABLE accounts. This might be a way to redirect over-funded 529 plans into accounts for disabled family members. Code section 529(c)(3)(C)(i)(III).

Finally, 529 plan funds can now be used to pay private elementary and secondary school tuition, up to a \$10,000 annual limit. Previously such funds could be used only for college expenses. Code section 529(c)(7).

Warning: Oregon does provide an additional deduction to Oregon taxpayers of \$4,660 (in 2017) for contributions to the Oregon 529 plan. However, Oregon House Bill 4080, awaiting the Governor's signature, will require Oregon taxpayers to add back to their state income any amount of a 529 plan distribution that covers K – 12 private school tuition, if the contribution from which the distribution was made received an Oregon state income tax deduction. Additionally, those taxpayers also will have to add earnings to such a 529 plan back into their taxable income.

IV. Pass-Through Income.

The Act provides a significant benefit to individuals with trade or business income from an S corporation, partnership, LLC taxed as a partnership or sole proprietorship. The individual is entitled to a deduction of 20% of "qualified business income" (QBI) from such an entity. Investment income is generally not included in QBI, nor are reasonable compensation or guaranteed payments. Taxpayers earning more than \$415,000 (with a phase-out starting at \$315,000) are unable to take the deduction for income generated from the following trades or businesses: health, law, consulting, athletics, financial or brokerage services, or where the reputation or skill of an owner or employee is its principal asset. So, for example, a lawyer in a partnership who is just starting out and whose income is lower might be able to take advantage of this provision, but if she becomes successful, she can't. See generally Code section 199A.

There are many limitations and computational complexities involved in determining the amount of this deduction, beyond the scope of these materials, so the owner of a pass-through entity that wants to take advantage of the deduction should consult with her accountant.

As with most of the rest of the Act, this deduction is only available through 2025.

V. Taxes on Nonprofits.

The Act made three changes to the taxation of nonprofits that won't have wide-ranging effects, but could have significant impacts on a few nonprofits.

First, nonprofits are subject to tax at the corporate rate on compensation paid to a "covered" employee (i.e., one of the five highest paid) in excess of \$1 million, as well as on excess parachute payments. Code section 4960.

Second, certain private colleges and universities have to pay a 1.4% excise tax on net investment income if they have assets of at least \$500,000 per student. Code section 4968.

Finally, unrelated business taxable income (or "UBTI") is now calculated differently: losses from one unrelated tax or business cannot be used to offset gains from another. Rather, gains and losses have to be calculated separately for each trade or business. Code section 512(a)(6).

VI. Trustee Fees.

As discussed earlier, miscellaneous itemized deductions (those that are only deductible to the extent they exceed 2% of the taxpayer's AGI) are suspended through 2025. Personal representative and trustee fees are miscellaneous itemized deductions, and therefore also subject to the 2% floor, except to the extent that those fees "would not have been incurred if the property [generating the tax] were not held in such trust or estate." Code section 67(e). Trustee fees attributable to investment advice, which is an expense individuals incur as well as fiduciaries, are subject to the 2% floor, but administrative expenses are not.

This leads to the question whether trustee fees as a whole are no longer deductible, or only those fees subject to the 2% floor. Several large financial institutions, as well prominent ACTEC Fellows on national presentations, have opined (without apparent support) that the administrative portion of trustee fees will remain deductible.

However, this position violates the plain language of Code section 67(b), which states that a "miscellaneous itemized deduction" is any deduction other than those described in a long list of specifically enumerated exceptions. Trustee fees (both administrative and investment) are not included in that list, and therefore are miscellaneous itemized deductions. Code section 67(g) says that all miscellaneous itemized deductions are suspended through 2025. It makes no mention of those deductions that are subject to the 2% floor.

There's no clear answer; respected professionals and institutions have come down on both sides of the question (or have refused to take a position).

VII. Charts.

The following charts illustrate some of the changes described above.

Individual income tax rates

Income Bracket Thresholds					
Tax Rate	Single	Married Filing Jointly/ Surviving Spouse	Married Filing Separately	Head of Household	Trust/Estate
10%	\$0	\$0	\$0	\$0	\$0
12%	\$9,525	\$19,050	\$9,525	\$13,600	N/A
22%	\$38,700	\$77,400	\$38,700	\$51,800	N/A
24%	\$82,500	\$165,000	\$82,500	\$82,500	\$2,550
32%	\$157,500	\$315,000	\$157,500	\$157,500	N/A
35%	\$200,000	\$400,000	\$200,000	\$200,000	\$9,150
37%	\$500,000	\$600,000	\$300,000	\$500,000	\$12,500

Standard deduction, itemized deductions, and personal exemptions

Personal and Dependency Exemptions (you, your spouse, and dependents)			
	Pre-existing law	New law	
Exemption	\$4,150	No personal exemption	

Standard Deduction			
	Pre-existing law	New law	
Married filing jointly	\$13,000	\$24,000	
Head of household	\$9,550	\$18,000	
Single/married filing separately	\$6,500	\$12,000	
Additional aged/blind			
Single/head of household	\$1,600	\$1,600	
All other filing statuses	\$1,300	\$1,300	

Itemized Deductions		
	Pre-existing law	New law
Medical expenses	Yes, to extent expenses exceed 10% of AGI floor	Yes, 10% AGI floor reduced to 7.5% for 2017 and 2018
State and local taxes	Yes, income (or sales) tax, real property tax, personal property tax	Yes, limited to \$10,000 (\$5,000 for married filing separately)
Home mortgage interest	Yes, limited to \$1,000,000 (\$100,000 for home equity loan), one-half those amounts for married filing separately	Yes, limited to \$750,000 (\$375,000 for married filing separately), no home equity loan; the \$1,000,000/\$500,000 limit still applies to debt incurred before December 16, 2017
Charitable gifts	Yes	Yes, 50% AGI limit raised to 60% for certain cash gifts
Casualty and theft losses	Yes	Federally declared disasters only
Job expenses and certain miscellaneous deductions	Yes	No

Child tax credit

Child Tax Credit				
	Pre-existing law	New law		
Maximum credit	\$1,000	\$2,000		
Non-child dependents	N/A	\$500		
Maximum refundable	\$1,000	\$1,400 indexed		
Refundable earned income threshold	\$3,000	\$2,500		
Credit phaseout threshold				
Single/head of household	\$75,000	\$200,000		
Married filing jointly	\$110,000	\$400,000		
Married filing separately	\$55,000	\$200,000		

Alternative minimum tax (AMT)

Alternative Minimum Tax (AMT)			
	Pre-existing law	New law	
Maximum AMT exemption amount	\$86,200 (MFJ), \$55,400 (Single/HOH), \$43,100 (MFS)	\$109,400 (MFJ), \$70,300 (Single/HOH), \$54,700 (MFS)	
Exemption phaseout threshold	\$164,100 (MFJ), \$123,100 (Single/HOH), \$82,050 (MFS)	\$1,000,000 (MFJ), \$500,000 (Single, HOH, MFS)	
26% rate applies to AMT income (AMTI) at or below this amount (28% rate applies to AMTI above this amount)	\$191,500 (MFJ, Single, HOH), \$95,750 (MFS)	\$191,500 (MFJ, Single, HOH), \$95,750 (MFS)	

Chapter 1A—Tax Cuts and the Jobs Act: Selected Issues for Individuals						

Chapter 1B

Tax Legislation: Estate Planning— Presentation Slides

Eric Hormel Perkins & Co. Portland, Oregon

KIM SPAULDING Perkins & Co. Portland, Oregon

Chapter 1—Tax Legislation: Estate Planning—Presentation Slides					
	_				
	_				
	_				
	_				
	_				
	_				
	_				
	_				
	_				
	_				

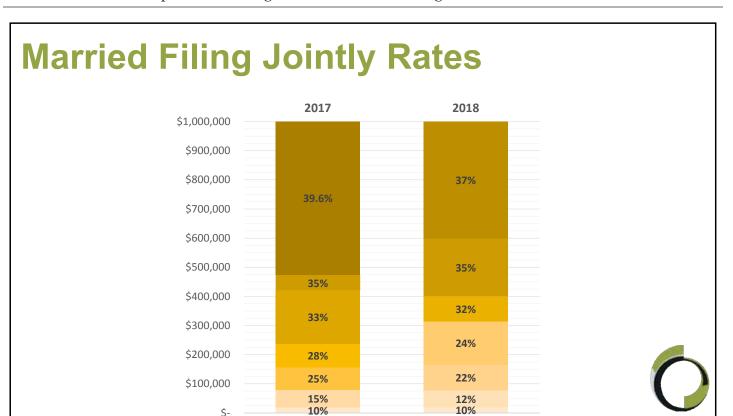


Speakers

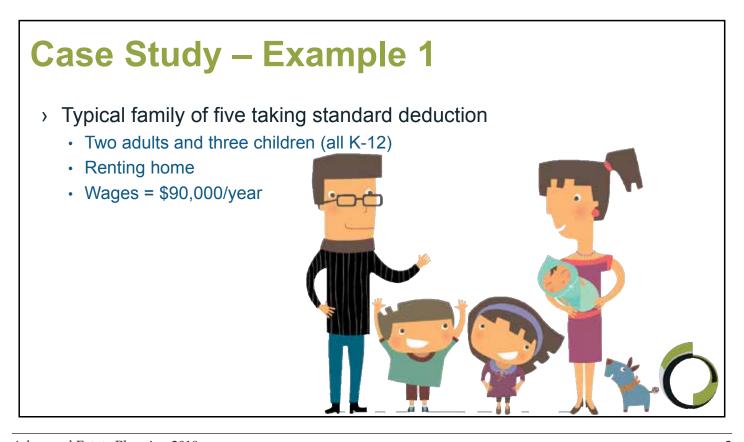








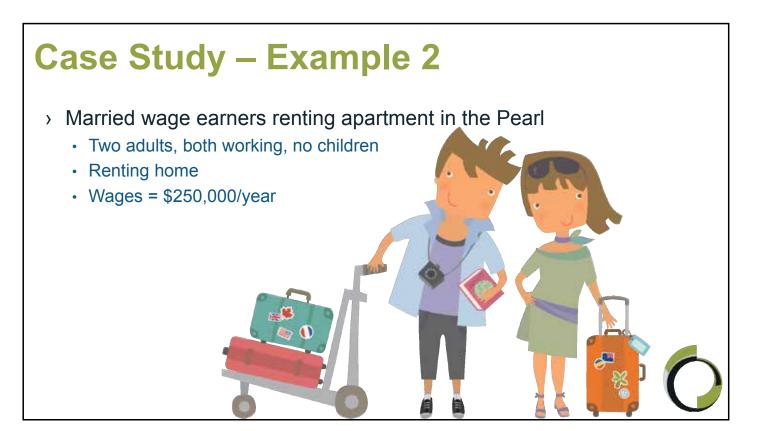
10%



Family of 5, standard deductions	2017	2018
Wages	90,000	90,000
Exemption	(20,250)	(20,250) 0
Standard deductions	(12,700)	(24,000)
Total deductions	(32,950)	(24,000)
Taxable income	57,050	66,000
Federal tax (before credits)	7,629	7,539
Child tax credits*	3,000	6,000
Net federal tax	4,629	1,539



*Note credits not available for children 17 and older





DINKs (renting)	2017	2018
Wages	250,000	250,000
Exemption	(8,100)	0
Charitable contributions	(13,000)	(13,000)
State tax deductions	(20,000)	(20,000) (10,000)
Total itemized deductions	(33,000)	*(23,000)
Standard deductions	(12,700)	(24,000)
Taxable income	208,900	226,000
Federal tax	45,377	42,819

Planning opportunity to bundle charitable deductions for several years into one. Planning provides **\$3,000** in **federal savings** over two years in this example.



*Note this is less than the standard deduction. Charitable contributions do not provide any extra tax benefit.

Case Study – Example 3

- > Retired couple who own home out-right
 - Two adults, both retired, no dependents
 - · Own home; no mortgage





Retired couple, no mortgage	2017	2018
Interest, dividends, IRA distributions	250,000	250,000
Exemption	(8,100)	0
Charitable contributions	(14,000)	(14,000)
State & property tax deductions	(25,000)	(25,000) (10,000)
Total itemized deductions	(47,100)	*(24,000)
Taxable income	202,900	226,000
Federal tax	44,272	42,819



*Note this is less than the standard deduction. Charitable contributions do not provide any extra tax benefit.

Case Study – Example 3 v2



> Planning opportunity to contribute IRA distributions directly to charity if aged $70\frac{1}{2}$

	2018	2018
Retired couple, no mortgage	No IRA to charity	IRA to charity (\$14K)
Income	250,000	250,000 236,000
Standard deduction	(24,000)	(24,000)
Taxable income	226,000	212,000
Federal tax	42,819	39,459

\$3,360 federal savings



> High wage earner vs. real estate developer



Case Study – Example 4

	2018	2018
	High wage	Real estate
	earner	developer
Income	3,000,000	3,000,000
20% pass-through deduction	-	(600,000)
Charitable contributions	(50,000)	(50,000)
Mortgage interest expense	(50,000)	(50,000)
Property & Oregon income tax	(400,000) (10,000)	(10,000)
Total itemized deductions	(110,000)	(110,000)
Taxable income	2,890,000	2,290,000
Federal tax	1,033,429	786,679



Chapter 1—Tax Legislation: Estate Planning—Presentation Slides				

Chapter 1—Tax Legislation: Estate Planning—Presentation Slides				

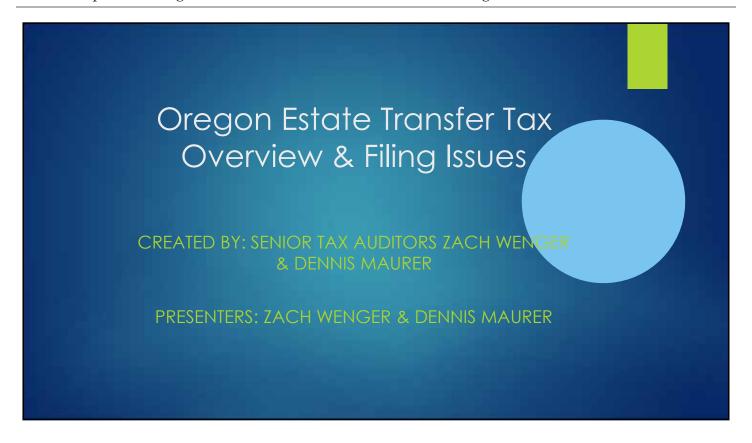
Chapter 2

Oregon Estate Transfer Tax Overview and Filing Issues—Presentation Slides

Dennis Maurer Oregon Department of Revenue Salem, Oregon

ZACH WENGER
Oregon Department of Revenue
Salem, Oregon

Chapter 2–	–Oregon Estate	Transfer Tax C	Overview and	Filing Issues—	-Presentation S	lides



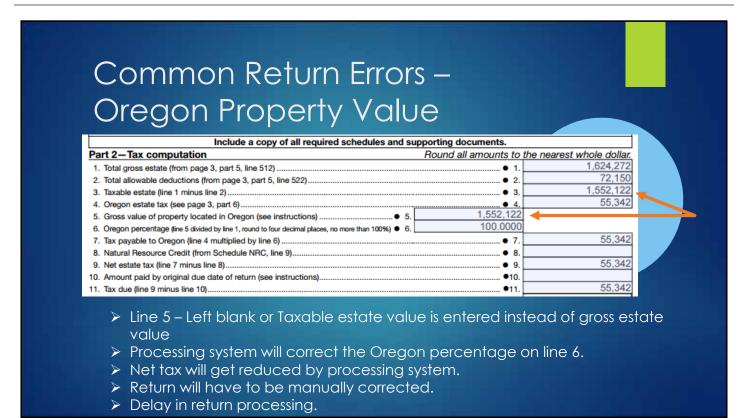


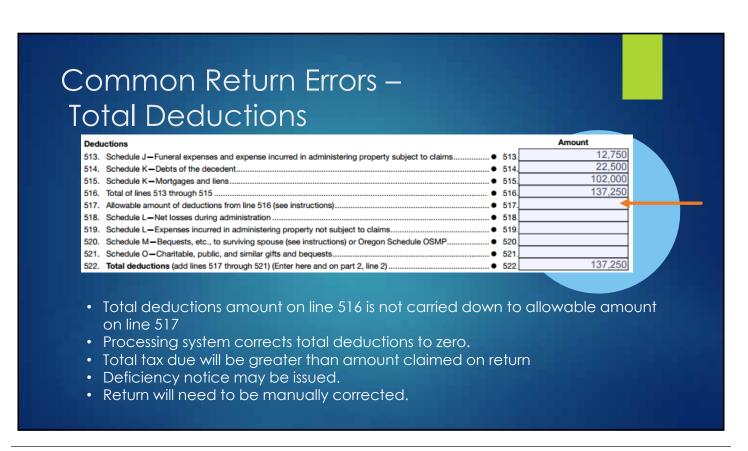
Processing System Update

- Oregon Estate Transfer Tax Receipt Letter
 - System generated letter
 - Issued when return has been processed and the tax, plus any applicable penalty and interest has been paid in full
 - If the OR-706 is amended, the system will generate a new receipt letter when the amended has been processed and the tax, plus any applicable interest has been paid in full.
 - If the amended OR-706 is requesting a refund, the system will still generate a new receipt letter showing the amended tax amount after return has been processed.
 - Copy of receipt letter will be issued if authorized representative box is checked on the return or we have a valid POA on file.

Processing System Update

- Request for Discharge from Personal Liability
 - DOR has 18 months from the date the discharge was received, or if the discharge was received before the return, 18 months from the date the return was filed.
 - We try to get the discharge requests signed off on as quickly as possible, however DOR may take up to the full 18 months before issuing.
 - > Discharge will be issued to the executor or trustee.
 - Copy of discharge request will be issued if DOR has a valid POA on file, or the authorized representative box is checked on the return.
 - Please fax your POA forms to our section's fax.





Common Return Errors – Alternate Valuation

Part	5—Recapitulation	Round all amounts to the nearest whole dollar.	
Gross	: Estate	(a) Alternate value	(b) Value at date of death
501.	Schedule A-Real estate • 501.	350,000	
502.	Schedule B-Stocks and bonds • 502.	221,150	
503.	Schedule C-Mortgages, notes, and cash • 503.	75,000	
504.	Schedule D-Insurance on the decedent's life [include Form(s) 712] ● 504.	150,000	
505.	Schedule E-Jointly owned property [include Form(s) 712]	42,500	
506.	Schedule F-Other miscellaneous property [include Form(s) 712] ● 506.	600,000	
507.	Schedule G-Transfers during decedent's life [include Form(s) 712] ● 507.	•_	
508.	Schedule H-Powers of appointment • 508.	•	
509.	Schedule I – Annuities 509.		
510.	Total gross estate (add lines 501 through 509) • 510.	1,438,650	
511.	Schedule U-Qualified conservation easement exclusion • 511.		
512.	Total gross estate less exclusion (line 510 minus line 511).		
	Enter here and on part 2, line 1 512.	1,438,650 ●	

- Alternate valuation elected, no date of death value listed.
- Date of death value needs listed to determine if the alternate valuation decreases gross estate. (IRC 2032).
- Return will suspend.
- Delay in return processing.

Common Return Errors – Penalty

- > 5% late filing penalty.
 - > Assessed on returns filed after due date of return (including extensions).
- 5% late payment penalty.
 - > Assessed on amount of unpaid tax after original due date.
 - Extension of time to file does not extend time to pay.
- 20% additional late filing penalty.
 - > Assessed on returns filed more than 3 months after due date of return (including extensions).
- ➤ OAR 150-118.260(1)(b) If return is filed late and tax is paid late, only one 5% delinquency penalty will be added.
- > OAR 150-314-0195 "90 percent rule" does not apply to the estate transfer tax program.

Extension to File Oregon Estate Transfer Tax Payment Voucher OR706-V Payment type (check only one): Original OR706. Exension payment, . Date of death: _ Prepayment. Amended OR706. pedent's first name and initial \$ Note: Don't use this voucher as an extension to file. Use IRS Form 4768, Application for Extension of Time to File a Return md/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes, and mail to us by the original due date of your Form OR706 Include a copy of the extension with your return. The estate must file a federal form 4768 to apply for an Oregon extension of time to file/time to pay by the original due date of the return. Oregon grants an automatic 6 month extension of time. > The tax payment voucher is not an application for extension.

Extension of time to file/pay

- ▶ The federal form 4768 (request for extension to file / pay) must be filed by the original due date of the return to make a timely request for extension of time to file or pay.
- If the federal form 4768 is not file before the due date to the return then your extension will be denied and penalties will be assessed.
- The department will allow up to one year from the due date of the return to pay the amount due (with an approved extension to pay) without penalty. The department will also allow this amount of time to pay without providing collateral.
- ▶ If the estate needs more than one year from the due date of the return to pay the amount due and meets the criteria under ORS 118.225 they can request a payment plan of up to 14 years with collateral of at least 2 times the amount of tax still owing.

Residency

- ORS 118.010(1)(b) "Resident Decedent" means an individual who is domiciled in Oregon on the date the individual dies.
- If the decedent is temporarily living in another state on the date of their death but they did not intend to abandon their Oregon domicile then they are considered to be domiciled in Oregon.
- ORS 118.010(1)(a) "Nonresident decedent" means an individual who is domiciled outside of Oregon on the date the individual dies.

LLC Interest – Nonresident

- Nonresident decedent Property taxable by Oregon include all real property located in Oregon and tangible personal property located in Oregon.
- ORS 63.239 provides "A membership interest is personal property. A member is not a co-owner of and has no interest in specific limited liability company property."
- Membership interest in an LLC is considered intangible personal property.
- Since LLC interest is considered intangible, a nonresident decedent will not include any LLC interest that holds Oregon real property in the Oregon numerator.

LLC Interest – OR Resident

- Oregon resident Property taxable by Oregon includes all real property located in Oregon, tangible personal property located in Oregon, and intangible personal property.
- Since interest in a LLC is considered intangible personal property, all LLC interest will be included in the Oregon numerator.
 - ***Exception*** If the LLC interest is taxed by another state or another country due to the decedent's death it will not be included in the Oregon numerator. (ORS 118.010(5))
 - If Oregon resident holds real property located in another state through an LLC interest, that property would be included in the Oregon numerator.

Oregon QTIP and OSMP

- New core system at DOR allows for easier tracking of QTIP and OSMP elections.
- Any return that claims a QTIP or OSMP election is flagged until the surviving spouse files a return.
- Important to identify each asset that is being claimed as an OSMP or QTIP election.
 - > Schedule listing "20% of trust A" is not sufficient.
- Important we receive signed copy of Consent to Establishment of Oregon Special Martial Property with Schedule OR-OSMP.
 - If surviving spouse is the only beneficiary entitled to a distribution of the property during their lifetime, the OSMP consent form (page2 of Schedule OR-OSMP) is not required to be filled out.

Oregon QTIP and OSMP continued

- Estimated values of assets / deductible assets subject to the special rule of Reg. section 20.2010-2(a) (7) (ii), claimed on Part 5, lines 10 and 23 of the federal 706.
- > The estate needs to provide a separate schedule for Oregon listing the schedule, item number, and estimated value of the asset(s) that are deductible under section 2056 or 2056A (marital deduction property) or under section 2055(a) (charitable deduction property).
- The estate will add up the estimated values for each schedule, and add that to the total value of the corresponding schedule as reported on the federal 706 recapitulation.
 - Example: Federal schedule B reports total assets of \$600,000 but also includes an asset that is deductible under section 2056 or 2056A (marital deduction property) or under section 2055(a) (charitable deduction property) which is reported on line 10 of the federal 706 recapitulation. The estimated value of the asset is \$250,000. For Oregon purposes, the estate would provide the federal schedule B with the Oregon 706, and provide a separate schedule listing the estimated value of the asset listed on schedule B. The estate would then add the estimated value of \$250,000 to the amount listed on the federal 706 recapitulation, line 2 (\$600,000), and report the total on the Oregon 706 recapitulation, line 502 (\$850,000).

Natural Resource Credit Legislative Changes

- > SB 864 passed in 2015 modified the natural resource credit.
- Old rule Oregon NRC property had to make up at least 50% of the gross estate.
- New rule Oregon NRC property has to make up at least 50% of Oregon adjusted gross estate.
- Oregon adjusted gross estate is the Oregon gross estate less allowable deductions as they relate to the Oregon assets.
- Allows eligibility for nonresident decedents to own Oregon NRC property.
- Past processing issues occurred due to Schedule NRC not being keyed. New system edits should prevent this in the future.

Federal Legislation impacts

- ▶ New federal filing threshold for 2018 is \$10 million.
- ▶ Oregon's filing threshold is still \$1 million.
- ▶ Less federal returns will be required to be filed.
- More people may think they do not need to file for Oregon due to the change in the federal threshold.

2012-2016 Filing Statistics

Total taxes	owed b	ov estate	size	2012-2016

	-,	
category	total # of estates	payable tax
category	Cototco	payable tax
Less than \$1 million	2,206	0
1m – 1.5m	3,054	46,426,000
1.5m - 2m	1,007	67,316,000
2m – 3.5m	924	128,186,000
3.5m – 5m	292	79,538,000
5m – 10m	204	103,958,000
More than \$10 million	76	201,103,000
total	7,763	626,527,000

average taxes owed by estate size 2012-2016

average taxes owed by estate size 2012-2010							
category	total # of estates	avg payable tax					
Less than \$1 million	2,206	0					
1m - 1.5m	3,054	15,202					
1.5m – 2m	1,007	66,848					
2m – 3.5m	924	138,729					
3.5m – 5m	292	272,390					
5m – 10m	204	509,598					
More than \$10 million	76	2,646,092					
total	7,763	80,707					

percent of taxes owed by estate size 2012-

	total # of	
category	estates	payable tax
Less than \$1 million	2,206	0%
1m – 1.5m	3,054	7%
1.5m – 2m	1,007	11%
2m – 3.5m	924	20%
3.5m – 5m	292	13%
5m – 10m	204	17%
More than \$10 million	76	32%
total	7,763	100%

percent of filers by estate size 2012-2016

	total # of	
category	estates	payable tax
Less than \$1 million	2,206	28%
1m - 1.5m	3,054	39%
1.5m - 2m	1,007	13%
2m – 3.5m	924	12%
3.5m – 5m	292	4%
5m – 10m	204	3%
More than \$10 million	76	1%
total	7,763	100%

2012 – 2016 Filing Statistics

Payable Tax (in 000's) by Oregon Taxable Estate Size - Ta	years 2012-2016
-----------------------------------------------------------	-----------------

							,										
Tax	<\$1 r	nillion	1m-1	.5m	1.5m-	2m	2m-3.	5m	3.5m	5m	5m-1)m	10m+				Total
		Payable	1	Payable		Payable		Payable		Payable		Payable		Payable			Payable
Year	#	Tax	#	Tax	#	Tax	#	Tax	#	Tax	#	Tax	#	Tax	#		Tax
2012	370) 0	556	\$7,855	152	\$9,683	147	\$19,207	50	\$13,151	39	\$19,831	10	\$24,544	1	,324	\$94,271
2013	400) 0	538	\$7,969	191	\$12,768	166	\$22,823	57	\$16,085	29	\$16,652	13	\$30,566	1	,394	\$106,863
2014	488	3 0	603	\$8,916	215	\$14,853	199	\$27,382	50	\$14,288	42	\$18,383	16	\$29,872	1	,613	\$113,694
2015	500) 0	711	\$11,298	229	\$15,217	198	\$28,465	76	\$19,228	43	\$21,136	20	\$62,247	1	,777	\$157,591
2016	442	2 0	642	\$10,362	218	\$14,663	213	\$30,171	57	\$16,298	51	\$27,956	17	\$53,874	1	,640	\$153,324

^{*}Oregon Taxable Estate is the entire estate determined taxable by Oregon, not necessarily estate property in Oregon

Statistics are from the 2018 Oregon Public Finance: Basic Facts report, from the Legislative Revenue office.

Contact Information

- ➤ Email <u>estate.help.dor@oregon.gov</u>
- Phone Salem area or outside Oregon (503) 378-4988
 Toll-free from Oregon prefix 1 (800) 356-4222
- > Fax (503) 945-8787. Attention: Estate Unit
- Mail Estate Audit, Business Division, Oregon Department of Revenue.

PO Box 14110 Salem, OR 97309-0910

*** Please allow 3-5 business days for response.

Chapter 2–	–Oregon Estate	Transfer Tax C	Overview and	Filing Issues—	-Presentation S	lides

Chapter 2–	–Oregon Estate	Transfer Tax C	Overview and	Filing Issues—	-Presentation S	lides

Chapter 3

Understanding the Deduction for Qualified Business Income

Professor Samuel Donaldson Georgia State University Atlanta, Georgia

Contents

Understanding the Tax Cuts and Jobs Act
Part One: Individual Tax Reform
Part Two: Business Tax Reform
Part Three: Wealth Transfer Tax Reform
Part Four: Alternative Minimum Tax Reform
Part Five: Reforms That Did Not Make the Final Bill
Appendix 1—Text of New §199A
Presentation Slides

Chapter 3—Understanding the Deduction for Qualified Business Income

Understanding the Tax Cuts and Jobs Act April 2018 Edition

Samuel A. Donaldson

Georgia State University College of Law Atlanta, Georgia

Signed by President Trump on December 22, 2017, Public Law 115-97, formally titled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" but commonly known as the "Tax Cuts and Jobs Act," represents the most dramatic change to the Internal Revenue Code since passage of the Tax Reform Act of 1986. This manuscript summarizes key provisions of the Act affecting United States individuals, small businesses, estates, and trusts. It does not cover changes made to pension and retirement accounts, provisions applicable only to certain industries, rules applicable to tax-exempt organizations, international tax reform, or repeal of the individual mandate under the Patient Protection and Affordable Care Act.

How We Got Here

Whereas the Tax Reform Act of 1986 was the product of years of bipartisan negotiation, the Tax Cuts and Jobs Act was the product of a deeply partisan and largely closed-door process. Early in 2017, Senate leadership indicated it would not seek to produce "permanent" legislation with bipartisan support. To prevent a Democratic filibuster, Senate procedural rules generally required that tax legislation be revenue-neutral over a ten-year timeframe. That led observers to believe any tax reform would "sunset" after ten years, as was the case with the Economic Growth and Tax Relief Reconciliation Act of 2001. But achieving long-standing tax reform goals proved to be a costly endeavor, even with the potential of a sunset. When it became clear that the hoped-for package of tax cuts would generate a considerable deficit over the next ten years, leadership in both houses scrambled to get the votes required to pass budget resolutions that permit a cumulative ten-year deficit did not exceed \$1.5 trillion. Passage of those resolutions late in October, 2017, soon led to the introduction of legislation.

The House Ways and Means Committee publicly unveiled its bill (H.R. 1, The Tax Cuts and Jobs Act) on November 2, 2017. Prior to that date, there were only three documents offering any suggestion of what the bill would contain. The first was the Republican blueprint for tax reform, published on June 24, 2016, with the title "A Better Way: Our Vision for a Confident America." Though not quite a "contract with America," the 35-page blueprint outlined how Republicans would seek to reform the Internal Revenue Code in the names of fairness and simplicity. It proposed three income tax brackets for individuals (12 percent, 25 percent, and 33 percent), complete repeal of the alternative minimum tax, "postcard filing," elimination of all itemized deductions except for mortgage interest and charitable contributions, and repeal of the estate and generation-skipping transfer taxes.

The second document was a one-page bullet-point memorandum from the White House issued on April 26, 2017. Given its "length" it is not surprising that the memo was short on detail. It generally agreed with the Republican blueprint but also spoke of a "15% business tax rate," a "one-time tax on trillions of dollars held overseas," and the need to "eliminate targeted tax breaks that mainly benefit the wealthiest taxpayers."

The third document was the Unified Framework for Fixing Our Broken Tax Code, a nine-page memorandum issued on September 27, 2017, by a conglomerate of White House and Congressional leaders. It contained details on three fundamental themes of tax reform (tax relief and simplification for families, competitiveness and growth for job creators, and global competitiveness), but little in the way of specifics as to how those details would be implemented. Like the blueprint and the White House memo, the Framework called for substantially larger standard deduction, a reduction in the number of tax brackets (with a top rate of either 35 percent or 39.6 percent), a larger child tax credit, and the elimination of all itemized deductions except for mortgage interest and charitable contributions. But other themes were explained much more cryptically. Consider this language from the Framework under the heading of "Other Provisions Affecting Individuals," reproduced in its entirety:

Numerous other exemptions, deductions and credits for individuals riddle the tax code. The framework envisions the repeal of many of these provisions to make the system simpler and fairer for all families and individuals, and allow for lower tax rates.

With only this much background to go on, tax professionals were anxious to see how the House bill exactly implemented these ideas. As it turned out, the House bill was consistent with the broad themes of the Republican blueprint, the White House memo, and the Unified Framework, but it also contained a number of surprises, especially regarding itemized deductions and the treatment of certain exclusions. A "chairman's mark" from the Senate Finance Committee indicated that while Senate leadership was largely on board with the House bill, it would take a much different approach on key issues. The House bill passed on November 16, 2017, by a vote of 227 - 205, shifting the spotlight to the Senate.

The Senate bill retained the general themes of the House bill with one important exception: it also included repeal of the individual mandate imposed by the Patient Protection and Affordable Care Act. House leadership questioned whether linking tax reform with continued efforts to strip away "Obamacare" would delay a vote or, even worse, jeopardize the entire endeavor. But the Senate passed by its bill on December 2, 2017, with a 51-49 vote, despite vehement objection from Democrats that the final version of the bill was made available only hours before the vote.

As expected, the House and Senate bills were different, so a Conference Committee bill was required. Generally speaking the House bill was more ambitious in its scope, but the very

narrow majority margin in the Senate essentially ensured that the resulting Conference Committee bill would hew more closely to the Senate version.

The 503-page Conference Committee bill was accompanied by a 560-page Joint Explanatory Statement of the Committee of Conference, herein cited as the "Conference Report." The final legislation, passed on December 20, 2017, contained just a few small differences from the Conference Committee bill. Preliminary estimates from the Joint Committee on Taxation indicate that the ten-year cumulative deficit incurred to implement the Act's changes will be approximately \$1.5 trillion, just within the margin approved by Congress in its budget packages.

PART ONE: INDIVIDUAL TAX REFORM

Individual Ordinary Income Tax Brackets

Originally, Republican leadership sought to reduce both the number of individual income tax brackets and the tax rates. Under prior law, seven tax brackets ranging from 10% to 39.6% applied to an individual taxpayer's ordinary income. The Blueprint for Tax Reform pushed for three brackets of 12%, 25%, and 33%. But by the time of the Unified Framework, that position changed to brackets of 12%, 25%, and 35%, with the possible retention of the 39.6% bracket.

Ultimately, the Act preserved the seven-bracket regime, though it reduced the rates in the top six brackets and widened the sizes of the top four brackets. The Joint Committee on Taxation estimates the ten-year cost of reducing the individual income tax brackets to be \$1.21 trillion. Estimated Budget Effects of the Conference Agreement for H.R. 1, The "Tax Cuts and Jobs Act" (December 17, 2017) (hereafter, "Estimated Budget") at 1. The Act also cut the number of tax brackets applicable to trusts and estates from five to four, but it retained the super-thin lower brackets. The following chart offers a visual comparison of pre- and post-Act tax brackets for 2018:

Federal Income Tax Brackets for Individuals, Estates, and Trusts – ORDINARY INCOME

	PRE-TAX CUTS	AND JOBS ACT*	Post-Tax Cuts and Jobs Act (through 2025)					
2018 Ta	axable Incor	ne Exceeding		2018 Taxable Income Exceeding				
Single	Married	Trusts and	Rate	Single	Married	Trusts and	Rate	
		Estates				Estates		
\$0	\$0		10%	\$0	\$0	\$0	10%	
\$9,525	\$19,050	\$0	15%	\$9,525	\$19,050		12%	
\$38,700	\$77,400	\$2,600	25%	\$38,700	\$77,400		22%	
\$93,700	\$156,150	\$6,100	28%	\$82,500	\$165,000	\$2,550	24%	
\$195,450	\$237,950	\$9,300	33%	\$157,500	\$315,000		32%	
\$424,950	\$424,950		35%	\$200,000	\$400,000	\$9,150	35%	
\$426,700	\$480,050	\$12,700	39.6%	\$500,000	\$600,000	\$12,500	37%	

^{*} From Revenue Procedure 2017-58, issued October 19, 2017.

Individual Adjusted Net Capital Gain and Dividend Income Tax Brackets

Neither the House bill nor the Senate bill intended any changes to the federal taxation of adjusted net capital gain or qualified dividend income. Thus, the three brackets for capital gain and dividend income (0%, 15%, and 20%) remain. Curiously, however, the Act makes very slight modifications to the bracket ceilings, as the following chart indicates:

Federal Income Tax Brackets for Individuals, Estates, & Trusts – CAPITAL GAINS & DIVIDENDS

Pre-Tax Cuts and Jobs Act*			Post-Tax Cuts and Jobs Act (through 2025)				
2018 Taxable Income Exceeding				2018 Taxable Income Exceeding			
		Trusts	Cap			Trusts	Cap
Single	Married	and	Gain	Single	Married	and	Gain
		Estates	Rate			Estates	Rate
\$0	\$0	\$0	0%	\$0	\$0	\$0	0%
\$38,700	\$77,400	\$2,600	15%	\$38,600	\$77,200	\$2,600	15%
AGI >	AGI >		18.8%	AGI >	AGI >		18.8%
\$200,000	\$250,000			\$200,000	\$250,000		
\$426,700	\$480,050	\$12,700	23.8%	\$425,800	\$479,000	\$12,700	23.8%

^{*} From Revenue Procedure 2017-58, issued October 19, 2017.

The chart also shows that the Act made no changes to §1411, the 3.8-percent surcharge on net investment income applicable to individuals with adjusted gross incomes above a stated (and still fixed) threshold and to estates and trusts in the highest tax bracket.

Zero-Bracket Provisions: Standard Deduction, Child Tax Credit, and Personal Exemptions

Prior law achieved a so-called "zero-bracket" through the trinity of the standard deduction, the deduction for personal and dependency exemptions, and the child tax credit. In an effort to simplify this regime, the Act repeals the deduction for personal and dependency exemptions and embiggens both the standard deduction and the child tax credit. All of the modifications set forth here expire at the end of 2025.

Standard Deduction. The Act substantially increases the amount of the standard deduction, as shown in the following table:

2018 Standard Deduction	Filing Status 2018 Standard Deduct		
Pre-Tax Cuts and Jobs Act		Post-Tax Cuts and Jobs Act	
\$13,000	Married Filing Jointly	\$24,000	
\$9,550	Head of Household	\$18,000	
\$6,500	Unmarried	\$12,000	
\$6,500	Married Filing Separately	\$12,000	

The Act makes no changes to the inflation-adjusted additional standard deduction amount available to blind taxpayers and those age 65 and over. Thus, for 2018, the additional standard deduction amount for "the aged or the blind" is \$1,300, or \$1,600 if the taxpayer is also unmarried and not a surviving spouse. The estimated foregone revenue over a ten-year period attributable to the increased standard deduction is \$720.4 billion. Estimated Budget at 1.

Child Tax Credit. The Act generally doubles the amount of the child tax credit and even adds a temporary (smaller) credit for dependents that are not qualifying children of the taxpayer. It also makes the credit more available to upper-middle-class taxpayers by increasing the thresholds before the phaseout begins. It also increases the refundable portion of the credit. The following table summarizes these changes:

Child Credit Feature	Pre-Tax Cuts and Jobs Act	Post-Tax Cuts and Jobs Act	
Credit Amount	\$1,000 per child	\$2,000 per child	
		\$500 per other dependent	
Phaseout Begins When AGI			
Exceeds			
Unmarried & Head of House	\$75,000	\$200,000	
Joint Filers	\$110,000	\$400,000	
Phaseout Complete When AGI			
Hits			
Unmarried & Head of House	\$95,000	\$240,000	
Joint Filers	\$130,000	\$440,000	
Refundable Portion	15% of earned income in	15% of earned income in	
	excess of \$3,000	excess of \$2,500, not to	
		exceed \$1,400 per child (as	
		adjusted for inflation)	

The estimated revenue loss from modifying the amount of the child tax credit is \$573.4 billion over ten years. Estimated Budget at 1. The Act also provides that in order to claim the credit for a qualifying child, the taxpayer must include the child's social security number on the return. That provision is estimated to generate \$29.8 billion in revenue over ten years. Estimated Budget at 1.

Personal and Dependency Exemptions. Under prior law, a taxpayer could claim a personal exemption deduction of \$2,000, though this amount was adjusted for inflation (the 2018 inflation-adjusted exemption was set to be \$4,150). Married coupled filing jointly could claim two exemptions. In addition, a taxpayer could claim an exemption deduction for each of the taxpayer's dependents, generally defined as either "qualifying children" or "qualifying relatives." Thus, for example, a married couple with two qualifying children could claim four personal exemptions on their joint return, a total deduction that would have been \$16,600 in 2018. But if the couple's adjusted gross income exceeded an inflation-adjusted threshold

amount (what was to be \$320,000 in 2018), the amount of the deduction would be gradually reduced (reaching zero if the couple's 2018 adjusted gross income was \$442,000 or more).

The Act effectively repeals the deduction for personal and dependency exemptions for the years 2018 through 2025 by reducing the exemption amount in those years to zero. The Act expressly retains the regular personal exemption for so-called "qualified disability trusts," and the nominal personal exemptions currently in play for estates (\$600) and trusts (\$100 or \$300, depending on whether the trust is required to distribute its income) also survive. The Joint Committee on Taxation projects that repealing the personal exemptions will generate over \$1.21 trillion in revenue between 2018 and 2026. Estimated Budget at 1.

Tax Treatment of Education Expenses

Section 529 Plan Withdrawals for Elementary and Secondary Schooling: Distributions from "qualified tuition programs" (more popularly, "§529 plans") are not included in gross income if used to pay for "qualified higher education expenses." The Act now defines "qualified higher education expenses" to include tuition expenses at "an elementary or secondary public, private, or religious school." Importantly, the maximum amount that may be distributed tax-free for elementary and secondary school tuition or for homeschooling expenses is \$10,000 per child (not \$10,000 per account); distributions in excess of that amount will be taxable under the normal rules of §529. The projected revenue cost of this measure is \$500 million over ten years. Estimated Budget at 3.

Exclusion for Discharge of Student Loan Debt at Death: New §108(f)(5) generally excludes from gross income the cancellation of a student loan on account of the student's death or total disability if such cancellation occurs after 2017 and before 2026. The new provision is expected to cost about \$100 million in foregone revenue over ten years. Estimated Budget at 3.

New Rollovers Between §529 Plans and ABLE Accounts: The Act permits amounts from qualified tuition plans to be rolled over to an ABLE account without penalty, so long as the ABLE account is owned either by the qualified tuition plan's designated beneficiary or his or her spouse, descendant, sibling, ancestor, stepparent, niece, nephew, aunt, uncle, first cousin, or in-law. Any amounts rolled over from a qualified tuition plan count toward the overall limit on amounts that can be contributed annually to an ABLE account. Any rolled-over amount in excess of the contribution limit will be treated as ordinary income to the distributee. Such penalty-free rollovers will be in effect through 2025. The estimated revenue loss from this new rule is expected to be less than \$50 million. Estimated Budget at 3. For more on the contribution limit and ABLE accounts generally, see the material below under "Other Individual Income Tax Items of Note."

New Excise Tax on Certain Private Colleges and Universities: Although this particular reform does not directly affect individuals, it affects college education and is thus included here. Starting in 2018, private colleges and universities may pay an excise tax equal to 1.4 percent of

the school's net investment income, but the excise tax only applies to tax-exempt private schools with: (1) at least 500 tuition-paying full-time equivalent students (more than half of whom are located in the United States); and (2) aggregate endowments of at least \$500,000 per student. The expected revenue gain from this new tax is \$1.8 billion over ten years. Estimated Budget at 5. The Act asks the Treasury to issue regulations describing which assets are used directly in carrying out the school's exempt purpose and thus are exempt from the tax. Regulations are also to explain the computation of net investment income, though the statute says generally that rules relating to the net investment income of a private foundation will apply for this purpose.

Reform of Other Exclusions and Deductions Applicable to Individuals

Overall Limit on Itemized Deductions Suspended: Section 68 generally reduces the amount of otherwise allowable itemized deductions once a taxpayer's adjusted gross income exceeds a certain inflation-adjusted threshold. (That threshold, for example, was set to be \$320,000 for married couples and \$266,700 for unmarried individuals in 2018.) For taxpayers with very high adjusted gross incomes, up to 80 percent of itemized deductions could be lost under this rule. Through new §68(f), the Act suspends the application of this phaseout for the years 2018 through 2025.

Home Mortgage Interest Deduction Modified: Under prior law, a taxpayer could deduct "qualified residence interest," generally defined as the interest paid on either "acquisition indebtedness" or "home equity indebtedness." Acquisition indebtedness is debt incurred to buy, build, or improve either the taxpayer's principal residence or one other residence selected by the taxpayer (a taxpayer thus cannot have acquisition debt on three or more homes), provided the subject home secures the debt. Home equity indebtedness is any other debt secured by the residence, regardless of how the loan proceeds are used by the taxpayer. Prior law limited the amount of acquisition indebtedness to \$1 million (half that amount for a married individual filing separately) and the amount of home equity debt to \$100,000. Thus, for example, if an unmarried taxpayer borrowed \$1.5 million to purchase the taxpayer's only home and gave the lender a mortgage on the home, the taxpayer could deduct 11/15 of the interest paid to the lender (\$1 million of the \$1.5 million loan is acquisition debt and another \$100,000 of the loan qualified as home equity debt).

For 2018 through 2025, the Act limits the amount of acquisition debt to \$750,000 (\$375,000 for a married individual filing separately) and suspends entirely any deduction for home equity debt. In the above example, then, the taxpayer can only deduct half of the interest paid to the lender (\$750,000 of the \$1.5 million loan is acquisition debt and none of it qualifies as home equity debt).

Importantly, the new limit on acquisition debt only applies to **debt incurred after December 15, 2017**; preexisting acquisition debt is subject to the original \$1 million cap. The Act also applies the \$1 million acquisition debt cap to taxpayers who made a binding contract before December

15, 2017, to close on the purchase of a principal residence before 2018 and who actually purchase such residence by the end of March, 2018. There is no similar exception for home equity debt—the deduction for interest on home equity debt is suspended regardless of when such debt was incurred.

Deduction for State and Local Taxes Unrelated to a Business Modified: Prior law allowed a taxpayer to deduct state and local property tax as well as either state and local income or sales taxes (as well as foreign real property taxes) without limitation. For example, if a taxpayer in 2017 paid local real property tax of \$5,000 in connection with the taxpayer's personal residence, state income tax of \$10,000, and state sales tax of \$13,000 on personal costs, the taxpayer can deduct a total of \$18,000 (the \$5,000 in real property tax and the sales tax of \$13,000, since that amount is larger than the \$10,000 of state income tax).

For 2018 through 2025, the Act limits the total deduction a taxpayer can claim for state and local taxes unrelated to the taxpayer's trade or business or other profit-seeking activity to \$10,000, and the deduction for foreign real property taxes on property unrelated to a business or investment activity is repealed entirely. In the example above, then, if the same taxes were paid in 2018 the total deduction would be limited to \$10,000. If, on the other hand, the real property taxes were paid in connection with investment property, the total deduction would be \$15,000 (\$10,000 in state income or sales tax plus the \$5,000 in real property taxes since the real property taxes are incurred in connection with a profit-seeking activity).

The \$10,000 limit on personal state and local taxes is reduced to \$5,000 in the case of a married individual filing a separate return. It seems odd that the limit is the same for joint filers and unmarried individuals (whether filing as head of household or not), but the separate figure for married individuals filing separately clearly signals this is the case.

Deduction for Charitable Contributions Modified: The Act increases the deduction limit for cash contributions to charitable organizations. Under prior law, a taxpayer could not deduct more than 50 percent of the taxpayer's "contribution base" (in most cases, an amount equal to the taxpayer's adjusted gross income) for cash contributions. Thus, for example, if a taxpayer donated \$100,000 cash to a qualified charitable organization in a year in which the taxpayer's contribution base was \$150,000, the taxpayer could deduct only \$75,000 of the contribution in the year of donation. The remaining \$25,000 would carry over to the next year as though the cash contribution was made in that year.

Under the Act, §170(b)(1)(G) now provides that for **cash donations** made from January 1, 2018, through December 31, 2025, the applicable limit is **60 percent of the donor's contribution base**. In the prior example, then, the taxpayer could deduct \$90,000 of the \$100,000 cash contribution under the new rule, with only \$10,000 carrying over to the next year. Further, cash contributions are deemed to happen before all other contributions, maximizing the chance of their deduction.

The Act also repeals the deduction for 80 percent of payments to an institution of higher education in exchange for the right to purchase seats at athletic events. Accordingly, such payments are deductible only to the extent the amount paid exceeds the value of the consideration received (the season tickets).

Finally, the Act **repeals §170(f)(8)(D)**, which permitted an exception to the requirement that a taxpayer receive a contemporaneous written acknowledgement from the charity in order to claim a charitable contribution deduction in some cases. The exception contemplated that the Service would promulgate a form by which a charity could provide a substitute for the written acknowledgement, but the Service never did so. (Well, it issued proposed regulations in October of 2015 that it promptly withdrew in January of 2016.) In a couple of Tax Court cases from 2017, taxpayers learned that until Treasury produced such a form, the exception was dormant. Apparently, Congress held little hope that a form would ever be forthcoming, so it simply killed the exception.

The Joint Committee on Taxation estimates the cumulative revenue gain from repealing the overall limit on itemized deductions, limiting the home mortgage interest deduction, limiting the deduction of state and local taxes, and reforming the charitable contribution deduction will be over \$668.4 billion between 2018 and 2026. Estimated Budget at 2.

Deduction for Medical Expenses Modified: Prior to 2013, individuals could deduct unreimbursed medical expenses to the extent they exceeded 7.5 percent of adjusted gross income. Part of the Patient Protection and Affordable Care Act increased the deduction threshold from 7.5 percent of adjusted gross income to 10 percent of adjusted gross income, but the 7.5-percent threshold still applied to taxpayers age 65 and over through 2016. For alternative minimum tax purposes, however, all taxpayers were subject to the 10 percent threshold as of 2013.

While the House bill originally called for the complete repeal of the deduction for medical expenses, the Senate version both saved the deduction and made it more attractive. Under the Act, the threshold for deducting medical expenses is 7.5 percent of adjusted gross income for all taxpayers, regardless of age. But this new rule (actually, a return to the old rule) applies for **2017 and 2018 only**. Still, the Joint Committee on Taxation expects that Congress will lose \$5.2 billion in revenue over this two-year period. Estimated Budget at 2. The Act also provides that the medical expense deduction threshold for alternative minimum tax purposes during these years is also 7.5 percent.

Deduction for (and Inclusion of) Alimony Payments Repealed: Prior law provided that the recipient of certain "alimony" payments had to include those payments in gross income. Likewise, individuals making those payments could deduct them in determining adjusted gross income. The Act permanently repeals the deduction for alimony payments and likewise repeals the rules related to inclusion of such payments in gross income, effective for any divorce or separation instrument **executed after 2018** or for any divorce or separation instrument **modified after 2018 where the modification expressly provides that the new law is to apply**.

In effect, then, we return to the pre-statute common law, which provided that payments between ex-spouses were neither income to the recipient nor deductible by the payor. In most cases, not surprisingly, the payor of alimony is in a higher tax bracket than the payee. Repealing both the deduction and the inclusion requirement is thus not revenue-neutral; the new regime is expected to generate \$6.9 billion in additional revenue over the next ten years. Estimated Budget at 3.

Deduction for Personal Casualty and Theft Losses Limited: Prior law permitted individuals to deduct losses unrelated to a business or investment activity when such losses arose from fire, storm, shipwreck, or other casualty, or from theft, but only to the extent any such loss exceeded \$100 and only to the extent the net personal casualty loss for the year exceeded 10 percent of an individual's adjusted gross income. Under the Act, such losses are deductible in 2018 through 2025 only if they are attributable to Presidentially-declared disasters under §401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Deduction for Moving Expenses Suspended: Subject to certain requirements related to the distance moved and the amount of work time spent at the new location, §217 generally permits a deduction for moving expenses (costs of moving household goods plus traveling expenses except meals) paid or incurred during the taxable year in connection with starting work as an employee or as a self-employed individual at a new principal place of work. New §217(k) suspends the deduction from 2018 through 2025, except in the case of members of the United States Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station. The measure is expected to add \$7.6 billion in revenue during the suspension period. Estimated Budget at 2.

Suspension of Miscellaneous Itemized Deductions: Prior law allowed an individual to deduct "miscellaneous itemized deductions" to the extent that they, in the aggregate, exceeded 2 percent of the individual's adjusted gross income. Section 67 defines a "miscellaneous itemized deduction" as any itemized deduction other than one listed in §67(b). Common examples of miscellaneous itemized deductions include safe deposit box rentals for storing investment assets, net hobby expenses, fees paid for appraisals in connection with casualty loss and charitable contribution deductions, fees paid to accountants and attorneys for tax advice and tax return preparation, and the unreimbursed business expenses of an employee. New §67(g) suspends any deduction for miscellaneous itemized deductions for 2018 through 2025. The Act makes no change to the above-the-line deduction of up to \$250 for unreimbursed expenses paid by an elementary or secondary school educator.

Exclusion for Qualified Bicycle Commuting Reimbursements Suspended: Section 132(f)(1)(D) allows an employee to exclude from gross income any "qualified bicycle commuting reimbursement," defined generally in §132(f)(5)(F)(i) as a reimbursement paid to an employee to cover reasonable expenses "for the purchase of a bicycle and bicycle improvements, repair, and storage, if such bicycle is regularly used for travel between the employee's residence and place of employment." The exclusion is limited to \$20 per "qualified bicycle commuting month," defined generally as a month in which the employee uses the bike for a substantial

portion of the commute to and from work and during which the employee receives no other qualified transportation fringe. The Act, through new §132(f)(8), suspends the exclusion for qualified bicycle commuting reimbursements from 2018 through 2025. To the surprise of none, the measure is not expected to generate more than \$50 million in revenue during the period of the suspension. Estimated Budget at 2.

Other Individual Income Tax Items of Note

Kiddie Tax Simplification: Section 1(g) imposes the so-called "kiddie tax" on the net unearned income of certain minors. Generally, the tax applies where a child is age 18 or under on the last day of the taxable year (or age 23 or under and a full-time student on such date), the child has at least one living parent at such time, the child has more than \$2,100 of unearned income for the year (that was the 2017 threshold), and the child does not file a joint return. If the child is 18 or older, however, the tax does not apply unless the child's earned income is less than one-half of the amount of the child's support. Unearned income is defined generally as all income other than compensation for services and distributions from qualified disability trusts. Where the tax applies, the child's net unearned income (unearned income in excess of the \$2,100 threshold for 2017), is taxed at the parents' marginal rate if such rate is higher than the rate that would be applicable to the child. Earned income is unaffected by the kiddie tax.

The Tax Cuts and Jos Act simplifies this regime through 2025. Instead of taxing net unearned income at the parent's marginal rate, net unearned income is taxed using the same brackets and rates as in effect for trusts and estates. As before, *earned* income of a minor child is still taxed using the ordinary rates and brackets for unmarried persons. The thinking behind this change is that the child's tax is now "unaffected by the tax situation of the child's parent or the unearned income of any siblings." (Conference Report, page 9).

Paid Preparers Must Investigate Claims of Head of Household Status: The Tax Cuts and Jobs Act modifies §6695(g) to direct promulgation of regulations imposing due diligence requirements on paid tax return preparers in determining a taxpayer's eligibility to file as a head of household. Failure to meet these requirements results in a \$500 penalty per failure.

Increased Contribution Limits to ABLE Accounts: Late in 2014, Congress created §529A, which authorized states to create so-called "qualified ABLE programs" under which one could make contributions to a tax-exempt account for the benefit of a disabled individual. A disabled person (defined as one who would qualify as blind or disabled under Social Security Administration rules) may have a single account to which total annual contributions may not exceed the federal gift tax annual exclusion amount (\$14,000 at the time, but now \$15,000). Income from the account is exempt from federal income tax, and distributions made to the beneficiary for "qualified disability expenses" are likewise tax-free. Qualified disability expenses are defined broadly to include education, housing, transportation, employment training, assistive technology, health, wellness, financial management, and legal expenses (some of which are not already covered by Medicaid and OASDI benefits). Any other distributions,

however, are subject to a 10-percent penalty and count as resources for purposes of the beneficiary's Medicaid exemption. There is no income tax deduction for contributions to the account, and any such contributions from third parties are treated as completed gifts of present interests to the beneficiary. Assets inside of an ABLE account do not count as "resources" of the beneficiary for purposes of qualifying for federal assistance. If, however, the account balance ever exceeds \$100,000, the beneficiary will be denied eligibility for SSI benefits. Furthermore, any assets inside of the account upon the beneficiary's death are subject to Medicaid payback rules.

The Act provides that through 2025, once \$15,000 has been contributed to an ABLE account, the account's designated beneficiary generally may contribute an additional amount up to such beneficiary's compensation for the year or, if less, the federal poverty line for a one-person household. Moreover, any such additional contribution is eligible for the so-called "saver's credit" under §25B.

PART TWO: BUSINESS TAX REFORM

Reduction in C Corporation Tax Rates

Under prior law, §11(b) set forth four federal income tax brackets applicable to a C corporation's taxable income:

Taxable Income	Marginal Tax Rate	
Up to \$50,000	15%	
\$50,001 - \$75,000	25%	
\$75,001 - \$10,000,000	34%	
\$10,000,001 and up	35%	

If a corporation's taxable income exceeds \$100,000, the lower two brackets are phased out such that the corporation ultimately pays a flat tax of 34 percent on its first \$75,000 of taxable income. In addition, so-called "personal service corporations" paid a flat 35-percent tax on taxable income.

The Act provides for a **flat rate of 21 percent** on all corporate taxable income, with no special rate for personal service corporations, effective for taxable years beginning in 2018 and later. This provision therefore does not "sunset;" it is as permanent as possible. The estimated revenue loss from the new 21-percent flat rate is nearly \$1.35 trillion over ten years. Estimated Budget at 3.

The Act also repeals §1201, which provided that if the maximum corporate tax rate exceeds 35 percent, the maximum rate applicable to a corporation's net capital gain will be 35 percent. A 21-percent flat rate rendered this rule obsolete.

Over the coming months, planners will figure out strategies for maximizing the benefit of the reduced corporate tax rate. Some initial ideas include the following (these ideas are adapted from Avi-Yonah, Batchelder, Fleming, Gamage, Glogower, Hemel, Kamin, Kane, Kysar, Miller, Shanske, Shaviro, Viswanathan, "The Games They Will Play: An Update on the Conference Committee Tax Bill" (December 18, 2017) at 7-8. Available at SSRN: https://ssrn.com/abstract=3089423):

- Consider establishing a C corporation to hold investment income. A taxpayer in the 37-percent bracket might prefer to place investments in a C corporation that will pay tax of only 21 percent. Subsequent dividends are subject to tax at a rate as high at 23.8 percent, so the combined bite from the double tax is just over 39.8 percent (\$100 of income less \$21 in corporate tax leaves \$79, and after paying dividend tax of \$18.80, there is \$60.20 left after all taxes). While that is slightly higher than the 37-percent top individual bracket, the corporation can defer the second layer of tax by delaying the payment of dividends. Of course, planners should consider the possible applications of the accumulated earnings tax and personal holding company tax to this strategy.
- Consider using a C corporation for labor income. In some cases a service provider might seek to work through a C corporation to take advantage of the lower tax rate. The corporation would need to pay reasonable compensation to the shareholder-laborer, but amounts in excess of reasonable compensation can be taxed at 21 percent.
- Consider paying smaller salaries to shareholder-employees. Until now, closely-held C corporations often paid generous wages to shareholder-employees to reduce the double-tax bite—the corporation could deduct compensation but not a dividend distribution. With a lower corporate tax rate, however, shareholder-employees will often have less after tax if payments from the corporation comes as compensation (don't forget employment taxes) instead of dividends. So while there used to be an incentive to pay generous compensation to shareholder-employees, that incentive may no longer exist.

Reduction in Dividends-Received Deduction for C Corporations

Prior law allowed corporations to claim a deduction for dividends received from other domestic corporations subject to federal income tax. The Act reduces the size of this deduction to reflect the lower 21-percent flat tax, as the following table shows:

If the receiving corporation	The Dividends-Received	The Dividends-Received	
	Deduction under PRIOR	Deduction under the NEW LAW	
	LAW was	is now	
Owns less than 20% of the	70% of the dividend	50% of the dividend received	
stock of the paying corporation	received	(so such dividends would be	
(by vote and value)		taxed at a top rate of 10.5%)	

Owns 20% or more of the stock of the paying corporation (by vote and value)	80% of the dividend received	65% of the dividend received (so such dividends would be taxed at a top rate of 7.35%)
Is a member of the same affiliated group as the paying corporation	100% of the dividend received	100% of the dividend received

<u>Deduction for Qualified Business Income from Partnerships, S Corporations, and Sole</u> <u>Proprietorships</u>

Executive Summary of the New §199A Deduction for Qualified Business Income:

- (1) Who Qualifies To qualify for the new deduction, you must be a partner in a business entity taxed as a partnership, a shareholder of an S corporation, or a sole proprietor engaged in a trade or business. C corporations and their shareholders do not qualify for this deduction, nor do employees.
- **(2) Taxable Income Zones** Your eligibility for the deduction as well as the amount of your deduction depends on your taxable income (without regard to this new deduction).
- ZONE 1 \rightarrow Your taxable income does not exceed \$157,500 (\$315,000 if you're married and filing a joint return with your spouse)
- ZONE 2 \rightarrow Your taxable income exceeds \$157,500 (\$315,000 for joint filers) but does not exceed \$207,500 (\$415,000 for joint filers)
- ZONE 3 \rightarrow Your taxable income exceeds \$207,500 (\$415,000 for joint filers)
- (3) Specified Service Businesses If your business: (1) involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services; (2) has as its principal asset the reputation or skill of one or more of its employees or owners; or (3) involves the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests, or commodities, then your deduction may be limited, as shown below:
- ZONE 1 \rightarrow No restriction
- ZONE 2 \rightarrow Your deduction is subject to a phase out
- ZONE 3 \rightarrow You get no deduction at all
- (4) Must be Engaged in Conduct of United States Trade or Business Your partnership, S corporation, or sole proprietorship must be engaged in the conduct of a trade or business

within the United States. The deduction is not available with respect to investment or personal activities, even if conducted as partnerships or S corporations.

- **(5) Deduction Amount** The amount of the deduction depends on your taxable income zone:
- ZONE 1 \rightarrow 20% of "qualified business income"
- ZONE 2 → 20% of "qualified business income," reduced if 50% of your "wage-basis limit" is less
- ZONE 3 → 20% of "qualified business income," or, if less, 50% of your "wage-basis limit"
- (6) Qualified Business Income Generally, "qualified business income" is the net amount of your items of income, gain, loss, and deduction from an eligible trade or business, except that items of capital gain and loss (whether short-term or long-term) are excluded. The term also does not include certain dividends from REITs, cooperatives, and publicly-traded partnerships, as those items are subject to special rules. If the net amount from all of your eligible businesses produce a net loss, that net loss carries over to the next taxable year as a loss from a separate qualified trade or business. Compensation paid to you from the business (and guaranteed payments paid to you by a your partnership) are not qualified business income.
- (7) The "Wage-Basis Limit" This amount is *greater* of: (a) 50% of the W-2 wages paid by the business to all employees (including you); and (b) 25% of the W-2 wages paid to all employees (including you) *plus* 2.5% of the unadjusted basis immediately after acquisition of all depreciable property used in the business that is still on hand at the end of the year.
- **(8) Application to Trusts and Estates** Estates and trusts with interests in partnerships and S corporations are eligible for the deduction. The Act instructs Treasury to issue regulations explaining how the deduction is to be apportioned between fiduciaries and beneficiaries.
- (9) Sunrise, Sunset The new deduction applies in taxable years that begin after 2017 and before 2026. In most cases, this means the deduction expires at the end of 2025. The estimated hit to the federal coffers over the lifespan of this deduction is over \$414 billion. Estimated Budget at 1.

Under the Hood Look at the New §199A Deduction: For reference, the complete text of new §199A appears at the end of this manuscript as Appendix 1. Generally under new §199A(a), a noncorporate taxpayer may claim a deduction from 2018 through 2025 equal to the taxpayer's "combined qualified business income," but the total deduction cannot exceed 20 percent of the taxpayer's ordinary and dividend income. To compute the deduction amount, therefore, one must determine: (1) the taxpayer's "qualified business income" from any particular activity; (2) how to compute the "combined qualified business income" from all such activities; and (3) the taxpayer's ordinary and dividend income.

Qualified Business Income. Section 199A(c)(1) generally defines "qualified business income" as the net amount of "qualified items of income, gain, deduction, and loss" (think ordinary items effectively connected with the conduct of a United States trade or business that are included or allowed in computing taxable income) with respect to any "qualified trade or business" of the taxpayer.

The statute generally defines a "qualified trade or business" as any trade or business *except for*: (1) one involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services; (2) one where the business's principal asset is the reputation or skill of one or more of its employees or owners; (3) one involving the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests, or commodities; and (4) the trade or business of performing services as an employee. But if the taxpayer's taxable income in 2018 is less than \$157,500 (\$315,000 for married couples filing jointly), the first three disqualifications do not apply. (Those taxable income thresholds are to be adjusted annually for inflation.) If the taxpayer's 2018 taxable income is more than \$157,500 but less than \$207,500 (or, in the case of married joint filers, more than \$315,000 but less than \$415,000), however, only a percentage of the qualified items of income, gain, deduction, or loss counts as qualified business income.

Combined Qualified Business Income and the Wage- and Capital-Based Limitation. One would expect "combined qualified business income" simply to be the net sum of the qualified business incomes from all of the taxpayer's trade or business activities, but it's not quite that simple. Instead, §199A(b)(1)(A) effectively defines the term to mean the sum of the deductible amounts from each trade or business activity. Section 199A(b)(2) generally provides that the deductible amount is 20 percent of the taxpayer's qualified business income from the trade or business. But for taxpayers with taxable incomes above a set threshold, the deductible amount cannot exceed 50 percent of the "W-2 wages" from the business or, if greater, 25 percent of the W-2 wages plus 2.5 percent of the unadjusted basis immediately after acquisition of all "qualified property." This limit phases in once a taxpayer's taxable income for 2018 exceeds \$157,500 (\$315,000 for joint filers), and applies fully once taxable income for 2018 exceeds \$207,500 (\$415,000 for joint filers).

Under §199A(b)(4), a taxpayer's "W-2 wages" from a trade or business generally means the amount of wages and deferred compensation paid by the taxpayer that are attributable to qualified business income. In the case of partnerships and S corporations, §199A(f)(1)(A) explains that each partner or shareholder is treated as having W-2 wages in an amount equal to such partner or shareholder's allocable share of the W-2 wages paid by the entity. For S corporations that will be an easy determination. Treasury will have to issue guidance on the application of this rule in the case of entities taxed as partnerships.

Under §199A(b)(6), "qualified property" basically means depreciable tangible property on hand at the close of the taxable year and used in the production of qualified business income,

provided the property is still within its "depreciable period" (generally defined as the first ten years in which the taxpayer has placed the property in service or the asset's regular recovery period, whichever is longer).

The Conference Report explains the wage- and capital-based limitation with this example: "[A] taxpayer (who is subject to the limit) does business as a sole proprietorship conducting a widget-making business. The business buys a widget-making machine for \$100,000 and places it in service in 2020. The business has no employees in 2020. The limitation in 2020 is the greater of (a) 50 percent of W-2 wages, or \$0, or (b) the sum of 25 percent of W-2 wages (\$0) plus 2.5 percent of the unadjusted basis of the machine immediately after its acquisition: \$100,000 x .025 = \$2,500. The amount of the limitation on the taxpayer's deduction is \$2,500." (Conference Report, page 38.)

Limitation Based on Taxable Income. Even after the application of the foregoing rules, the total deduction under §199A generally cannot exceed 20 percent of the excess (if any) of the taxpayer's taxable income over the sum of any net capital gain plus any "qualified cooperative dividends." By carving out net capital gain, the rule effectively means the total §199A deduction cannot exceed the taxpayer's ordinary and dividend income.

Not an Above-the-Line Deduction. The Act clarifies that the §199A deduction is not allowed in computing adjusted gross income. It is, instead, a "below-the-line" deduction that a taxpayer may claim in addition to the standard deduction or as part of the taxpayer's itemized deductions, as was the case with the former deduction for personal and dependency exemptions under §151.

Trusts and Estates. Section 199A(a) only excludes corporate taxpayers from the deduction. By negative implication, therefore, trusts and estates may claim the §199A deduction. In fact, §199A(f)(1)(B) provides that in determining the apportionment of W-2 wages and the apportionment of unadjusted basis in qualified property between fiduciaries and beneficiaries, rules similar to those in the old §199 deduction will apply.

Conference Report Examples. Here are two examples cribbed from the Conference Report's explanation of the Senate version of §199A. (Conference Report at 36-37.) The examples have been altered to reflect the provisions of the final Act.

Example 1

H and W file a joint return on which they report taxable income of \$335,000 (determined without regard to this provision). H is a partner in a qualified trade or business that is not a specified service business ("qualified business A"). W has a sole proprietorship qualified trade or business that is a specified service business ("qualified business B"). H and W also received \$10,000 in qualified REIT dividends during the tax year.

H's allocable share of qualified business income from qualified business A is \$300,000, such that 20 percent of the qualified business income with respect to the business is \$60,000. H's allocable share of wages paid by qualified business A is \$100,000, such that 50 percent of the W–2 wages with respect to the business is \$50,000. As H and W's taxable income is above the \$315,000 threshold amount for a joint return but not above \$415,000, the wage limit for qualified business A is phased in. Accordingly, instead of limiting the deduction amount to the \$50,000 share of W-2 wages, the \$60,000 deduction amount is reduced by 20 percent of the difference between \$60,000 and \$50,000, or \$2,000. H's deductible amount for qualified business A is therefore \$58,000.

W's qualified business income and W–2 wages from qualified business B, which is a specified service business, are \$325,000 and \$150,000, respectively. H and W's taxable income is above the \$315,000 threshold amount for a joint return. Thus, the exclusion of qualified business income and W–2 wages from the specified service business are phased in. W has an applicable percentage of 80 percent. (Their taxable income is \$20,000 more than the threshold amount, and \$20,000 is 20 percent of \$100,000, so they must take 20 percent off the otherwise allowable amounts.) In determining includible qualified business income, W takes into account 80 percent of \$325,000, or \$260,000. In determining includible W–2 wages, W takes into account 80 percent of \$150,000, or \$120,000. W calculates the deductible amount for qualified business B by taking the lesser of 20 percent of \$260,000 (\$52,000) or 50 percent of includible W–2 wages of \$120,000 (\$60,000). W's deductible amount for qualified business B is \$52,000.

H and W's combined qualified business income amount of \$120,000 is comprised of the deductible amount for qualified business A of \$58,000, the deductible amount for qualified business B of \$52,000, and 20 percent of the \$10,000 qualified REIT dividends (\$2,000). H and W's deduction is limited to 20 percent of their taxable income for the year (\$335,000), or \$67,000. Accordingly, H and W's deduction for the taxable year is \$67,000.

Example 2

H and W file a joint return on which they report taxable income of \$200,000 (determined without regard to this provision). H has a sole proprietorship qualified trade or business that is not a specified service business ("qualified business A"). W is a partner in a qualified trade or business that is not a specified service business ("qualified business B"). H and W have a carryover qualified business loss of \$50,000.

H's qualified business income from qualified business A is \$150,000, such that 20 percent of the qualified business income with respect to the business is \$30,000. As H and W's taxable income is below the threshold amount for a joint return, the wage limit does not apply to qualified business A. H's deductible amount for qualified business A is \$30,000.

W's allocable share of qualified business loss is \$40,000, such that 20 percent of the qualified business loss with respect to the business is \$8,000. As H and W's taxable income is below the threshold amount for a joint return, the wage limit does not apply to qualified

business B. W's deductible amount for qualified business B is a reduction to the deduction of \$8,000.

H and W's combined qualified business income amount of \$12,000 is comprised of the deductible amount for qualified business A of \$30,000, the reduction to the deduction for qualified business B of \$8,000, and the reduction to the deduction of \$10,000 attributable to the carryover qualified business loss (20 percent of the \$50,000 carryover loss—treated as its own qualified business activity under \$199A(c)(2)—is \$10,000). H and W's deduction is limited to 20 percent of their taxable income for the year (\$200,000), or \$40,000. Accordingly, H and W's deduction for the taxable year is \$12,000.

A baker's dozen of tax scholars have identified some of the policy problems with the qualified business income deduction:

Some professionals, such as architects and engineers, have been moved in the conference bill from the "disfavored service" category to the "favored service" category. As a result, they are now most likely excepted from some restrictions on service providers, and so can be very highly paid and still get a partial or full deduction. There is no clear policy explanation for why these services are "favored" services, while, say, doctors or those in the performing arts are still in the "disfavored" category.

Avi-Yonah, Batchelder, Fleming, Gamage, Glogower, Hemel, Kamin, Kane, Kysar, Miller, Shanske, Shaviro, Viswanathan, "The Games They Will Play: An Update on the Conference Committee Tax Bill" (December 18, 2017) at 8. Available at SSRN: https://ssrn.com/abstract=3089423. The article goes on to suggest some specific strategies that wealthy individuals might use to take advantage of the new deduction (and how the Service might attempt to thwart them):

• John Doe, independent contractor (or partner)—but definitely not an employee. The pass-through deduction is still denied to anyone who is an employee. This is good news to anyone who can quit their job and become an independent contractor (and so considered a "sole proprietor") or a partner in a firm. The game is clear: Don't be an employee, instead be an independent contractor or partner in a firm. Don't be John Doe, employee. Be John Doe, independent contractor (or partner in an LLC, receiving a profit share rather than wages).

Individuals who provide "specified services" (such as lawyers and doctors) must have taxable income of less than \$315,000 for a married couple (or half that for a single individual) to be fully eligible—with the benefit phasing down over the next \$100,000. But keep in mind, taxable income is calculated *after* taking into account other deductions, like the standard deduction or itemized deductions. As a result, individuals with even more actual economic income could still fully qualify for the deduction.

Originally, we had described this game as the Law Firm Associates, LLC loophole. Given the new income restrictions, it probably won't as broadly cover the highest paid law firm associates, but it still should apply to plenty—who will all be incentivized to form their own separate Associates, LLC firm. For instance, median base salary for a fourth year associate this year was \$155,000, an income level that would still qualify for the pass-through deduction.

The technique would also apply, without any income limit, to any "favored" business—like real estate—that is willing to turn an employee into a junior partner in the business. That is so long as the business pays sufficient W-2 wages or has enough original tax basis in depreciable property.

The bottom line is that these techniques will cover a wide swath of relatively high-income people who are now employees. The IRS already faces challenges enforcing the tax distinction between employees and independent contractors (since employers already have some incentive to characterize workers as independent contractors), and this pressure will increase hugely with the added tax gaming incentives. And, if an employee can't easily be recharacterized as an independent contractor, they can always become a partner to access the preferential treatment.

• Doctors and lawyers are now in the real estate business, and celebrities should sell face cream. The highest paid doctors and lawyers (and those in other professions that are specifically listed) would not be directly eligible for the 20% write off since they are in restricted "specified service" industries, which covers certain listed professionals above the income threshold. Other professionals who are not on the list are also denied the passthrough deduction if the "principal asset" of the business is their "reputation or skill." This category could affect celebrities and other public figures.

Restricted professionals can potentially still game these rules through two basic strategies. To borrow from the terminology of gerrymandering strategies, let's call them "cracking" and "packing."

o **Cracking.** The first strategy is to "crack" apart the revenue streams from the service partnership, so as much income as possible can qualify for the deduction. This is probably the preferred route for those in the "listed" professions.

To do this, doctors and lawyers (and others listed professionals) would set up separate companies. As Victor Fleischer has pointed out, the ideal arrangement from a tax avoidance perspective would involve a real estate investment trust (REIT), which is automatically eligible for the pass-through rate, without any requirement that the REIT pay W-2 wages. (This is the other big real estate loophole.) Then, the REIT should charge the law firm the maximum rent they can get away with in order to qualify some of the service income for the pass-through rate. The REIT strategy is limited by the fact that REITs must have at least 100 beneficial owners, but there are currently ways of adding

additional owners with relative ease and giving them only a very small share of any profits.

Similarly, doctors and lawyers might try to form separate firms owning ancillary services that aren't providing the forbidden kinds of services. That includes firm [sic] handling their accounting, document management, software, and so on. Again, the game would be to essentially overcharge the main firm for these ancillary services—though, unlike with the REIT, this game would immediately be restricted by the need to pay sufficient W-2 wages from the new businesses.

The IRS can and should try to crack down on these kinds of arrangements in at least two ways. First, the IRS could seek to apply rules similar to those used to define personal service corporations under existing law. Under those rules, the performance of administrative and support functions incident to a service trade or business are considered to be part of the performance of the service trade or business. (This approach would most easily reach the ancillary services described above, but probably not the separate real estate firm.) Second, the IRS could try to attack the mispricing that could strip income out of the service firms. However, these kinds of transfer pricing games among related parties have proven very difficult to stamp out in other contexts.

o **Packing.** The second strategy is to "pack" other qualifying businesses into the service partnership, to transform the combined entity into one that is not primarily providing services. The IRS may be able to attack this strategy in the case of listed professionals (and we encourage the IRS to do so quickly) but would have a harder time dealing with other professionals who blend their reputation or skill with other business activities. As a result, "packing" will be particularly advantageous to taxpayers in this category.

Here's the form that may be hardest for the IRS to attack: Non-listed professionals blending their reputation or skill with other businesses. For example, say you're Gwyneth Paltrow, a celebrity with a generally positive reputation. Now consider her "lifestyle brand" goop, which sells \$125 face creams, among other products. Does goop rely too much on Paltrow's reputation, or is it just another business? A business like this (if it were not incorporated, as is the case with goop) would almost certainly qualify for the special pass-through deduction, notwithstanding the centrality of the owner's reputation. We would expect to see more goop-like business to appear. It's not just Gwyneth Paltrow. Imagine a certain real estate mogul and reality TV star who might want to combine a business based on his reputation (and associated licensing deals) with real estate investments. Once the business operations are packed together, it would be harder for the IRS to argue that reputation is still the principal asset.

For listed professionals (lawyers, doctors, and others), the availability of the packing strategy is more complicated. First, there is a question whether provision of *any* forbidden service to customers means that the entire trade or business cannot qualify

for the deduction, even if it includes qualifying activities as well. If it does, then packing won't work—they're stuck with cracking. But, if the IRS were to allow provision of qualifying services to cleanse the operation, then you can expect similar games. Real estate lawyers might both provide legal advice and manage real estate and so on to get the pass-through deduction for the whole operation, trying to mix the businesses so that the IRS can't effectively distinguish.

When it comes to the listed professionals, the IRS has more flexibility, which it should use to disallow such packing by them. But, when it comes to others—the goops or reality TV stars of the world—it will be much more difficult for the IRS to attack such strategies.

- Go in-house (or be an architect or engineer). Another route for service partners is to simply work at a firm that is not in the business of providing the restricted services. They can go in-house (as a partner) at a partnership engaged in another line of business and get the full deduction. For example, a lawyer becomes a partner in a real estate firm. Or, if doing work at all related to construction/development, they may categorize themselves as "architecture" or "engineering" firms in order to avoid definitely being classified as a disfavored trade or business.
- Athlete's Brand, LLC—a game denied, or not? Our prior report (and an earlier Washington Post article), explained how highly paid services providers like doctors, lawyers and athletes might be able to access the business deduction by spinning off their "brand" into a separate firm. This new firm would not provide services but instead would manage the brand and therefore avoid the restrictions on professionals. (This may also be useful for, say, a reality TV star whose main source of income is royalties.)

It is unclear whether ... the conference bill allows this game. The conference bill specifies that, if the principal asset of the firm is the "reputation" of the owner (and not just "employees" as in the prior version of the legislation), then this source of value also falls into the denied "service" category.

This addition to the conference bill probably kicks out the law firm trying to spin off its reputation as a brand. However, if an athlete or someone in the performing arts (also listed) assigns the right to actively license his or her image and name to a pass-through, it would be the pass-through's intellectual property (the right to license the image), and not the reputation of the owner that would be its principal asset. So, this is yet another way that an athlete or entertainer could access the pass-through rate—in addition to the packing strategy discussed above. Argue that the source of value isn't reputation in the first place.

Would this argument ultimately succeed? We don't know the answer, and will read future cases on these issues with interest. In at least some circumstances in the past,

the IRS has not been particularly strict in its application of the rules defining when a firm's principal asset is the reputation or skill of its employees.

To be sure, even if the spin-off game still works, that separate firm would need to pay sufficient W-2 wages (or own enough depreciable property) to preserve eligibility, but this barrier could be overcome since managing these brands often involves services from others. Further, even if there aren't many employees, the firm could pay some W-2 wages to the original service providers (like the athlete) in order to get the deduction on the rest of the income running through the firm.

• Property counting toward the pass-through deduction—game or a glitch or both? In the new conference bill, pass-throughs can take the special 20% deduction now without paying any wages. They just need property. What kinds of property count? That's ambiguous. Apparently, for these purposes, property includes any kinds of tangible property that's in theory subject to depreciation. The initial cost of any such property gets counted for a minimum of ten years.

First, this allowance generates several bad incentives and loopholes. Businesses are incentivized to own tangible property within the firm in order to take advantage of the pass-through deduction. Do not rent from others if the limitation on deductibility is having any bite. In fact, you could own very old property (like an old building) that has been depreciated over decades, but you count it as it were a brand new property, at its original cost. And, again, it is possible to do this and access the pass-through deduction even in the absence of any employees or W-2 wages paid.

Basing eligibility for the pass-through deduction on depreciable property and wages can even incentivize businesses to engage in money-losing operations (making investments or paying employees) just to access the pass-through deduction. This particular formula may even encourage businesses to replace employees with equipment in some cases.

Second, the conference bill is ambiguous as to what property actually counts for these purposes—and taxpayers can play games here as well. Does computer paper count (so long as you keep the documents around the firm)? How about paper clips? They are both forms of tangible property—in theory, subject to depreciation (if they weren't immediately expensed as business supplies). And, what about improvements to property? The provision says that you use "unadjusted basis" in this calculation allowing the deduction; improvements are an adjustment to basis. Do you get no credit for that? Should you buy improved property then rather than improve the property yourself in order to become eligible for the deduction? The questions go on, and the IRS has its work cut out for it.

In all of these cases, the fundamental problem is the lack of any underlying logic in deciding who benefits from the pass-through deductions, and who does not. Independent contractors and partners benefit, but not employees. Why? An owner of

real estate through a REIT benefits, but not the doctor in the building. Why? An architect benefits in some ways that a lawyer does not. And so on. For each of these formalistic and seemingly arbitrary distinctions, there is a game to be played to fall within the favored category. The IRS should try to staunch the bleed in revenue—and action here is far better than nothing—but it will naturally be an uphill battle. The much better answer would be to simply eliminate the provision.

Avi-Yonah, Batchelder, Fleming, Gamage, Glogower, Hemel, Kamin, Kane, Kysar, Miller, Shanske, Shaviro, Viswanathan, "The Games They Will Play: An Update on the Conference Committee Tax Bill" (December 18, 2017) at 8-15 (footnotes omitted). Available at SSRN: https://ssrn.com/abstract=3089423.

Cost Recovery

Expansion of §179 Expensing: Under prior law, a taxpayer (other than an estate or trust) generally could elect to expense the first \$500,000 of so-called "§179 property" placed in service during the taxable year, but that amount was reduced by the amount by which all such property placed in service during the year exceeded \$2 million. Both of those numbers, however, were adjusted for post-2015 inflation, and we were therefore set to have a cap of \$520,000 for 2018 that would not be reduced until a taxpayer placed in service more than \$2,070,000 in §179 property for the year. Revenue Procedure 2017-58. "Section 179" property, generally, is depreciable tangible personal property (or certain computer software) acquired by purchase for use in the active conduct of a trade or business.

The Act increases the annual cap from \$500,000 to \$1 million and increases the phaseout threshold from \$2 million to \$2.5 million. Both numbers will adjust for post-2018 inflation. In addition, the Act expands the scope of \$179 property to include "qualified real property," generally defined as any of the following improvements made to nonresidential real property made after the property was first placed in service: roofs, HVAC systems, fire alarms, and security systems. The changes made to \$179 are not scheduled to expire, and the estimated revenue loss over the next ten years is nearly \$26 billion. Estimated Budget at 3.

Increased Expensing Bonus Under §168(k): Prior law allowed a bonus depreciation deduction equal to 50 percent of the adjusted basis of "qualified property" (generally, new property with a recovery period of not more than 20 years and certain improvements made to other property) in the year the property was placed in service. For this purpose, the property's adjusted basis is determined after the elective application of §179 but before the application of the regular depreciation rules described in §168(a).

The Act generally increases the bonus depreciation deduction for qualified property as shown in the following table:

Year(s)	Applicable Percentage of Adjusted Basis
2018 – 2022	100%
2023	80%
2024	60%
2025	40%
2026	20%
2027 and later	0%

The Act also generally allows a taxpayer to claim the §168(k) bonus with respect to used property, so long as the property is new to the taxpayer. This measure is expected to cost an aggregate \$86.3 billion over the next ten years. Estimated Budget at 3.

Depreciation Limits on Luxury Cars and Certain Personal-Use Property Modified: The Act increases the limits imposed by §280F(a) on the depreciation of certain passenger cars, as the following table shows:

Maximum Depreciation Deduction for Luxury Car	2017 Amounts	2018 Amounts
(assuming no §168(k) bonus)	Pre-Tax Cuts and	Post-Tax Cuts and
	Jobs Act	Jobs Act
First year the vehicle is placed in service	\$3,160	\$10,000
Second year the vehicle is placed in service	\$5,100	\$16,000
Third year the vehicle is placed in service	\$3,050	\$9,600
Fourth year the vehicle is placed in service and	\$1,875	\$5,760
later		

The new §280F amounts will be adjusted for inflation, and they are not subject to sunset.

In addition, the Act permanently removes "computer or peripheral equipment" from designation as "listed property." As a result, for example, a computer will no longer be subject to straight-line cost recovery if the business use of the asset is less than half of its total use, the rule denying a deduction where the business use is by an employee will not apply, and the ongoing substantiation requirements related to the computer's cost and business use likewise will not apply.

Applicable Recovery Period for Real Property Improvements Consolidated: Prior law had separate rules and depreciation limits for "qualified improvement property," "qualified leasehold improvements," "qualified restaurant property," and "qualified retail improvement property." The Act eliminates the last three categories so those assets generally become "qualified improvement property." The Act generally provides that qualified improvement property may be depreciated over a 10-year recovery period (15 years where the alternative depreciation system applies) using the straight-line method and half-year convention. As a

result, restaurant buildings (which generally do not meet the definition of qualified improvement property but are instead nonresidential real property) will be depreciable over 25 years using the straight-line method and the mid-month convention.

Alternative Depreciation System for Electing Farming Businesses: Farmers who elect out of the new limitation on the deduction for interest (see below) will automatically elect to depreciate any property with a recovery period of 10 years or more using the "alternative depreciation system," which generally requires use of the straight-line method over the asset's class life.

Other Business Income Tax Items of Note

New Limitation on Excess Business Losses of Individuals, Partnerships, and S Corporations: Under new §461(I), a noncorporate taxpayer's "excess business loss" for the taxable year is disallowed and treated as a net operating loss carryover to the next taxable year. "Excess business loss" is defined as the amount by which the taxpayer's aggregate deductions attributable to all trades or businesses exceeds the sum of the taxpayer's aggregate gross income attributable to all such trades or businesses plus \$250,000 (or \$500,000 in the case of joint filers). Both of these dollar amounts will be adjusted for inflation, but this new limit under §461(I) expires at the end of 2025. Section 461(I)(4) provides that in the case of a partnership or S corporation, the limitation applies at the partner or shareholder level.

Carried Interests: The benevolent overlord of students everywhere, Wikipedia, explains a carried interest as "a share of the profits of an investment paid to the investment manager in excess of the amount that the manager contributes to the partnership, specifically in alternative investments (private equity and hedge funds). It is a performance fee, rewarding the manager for enhancing performance." As such, of course, it is compensation for services. But because the carried interest is held in the form of a profits interest of an entity taxed as a partnership, the managers receive their fees in the form of a share of the partnership's long-term capital gains. So while mutual fund managers and other investment advisors receive fee payments taxable as ordinary income, their counterparts in private equity and venture capital firms enjoy a preferential rate on payments allocable to their partnership profits interests.

The Act purports to address this anomaly through new §1061, which generally treats a partner's share of long-term capital gain from partnership investments held three years or less as short-term capital gain where the partner acquired the partnership interest through the performance of substantial services. The rule only applies to partnerships engaged in raising or returning capital and investing in, disposing of, or developing securities, commodities, investment or rental real estate, and cash or cash equivalents.

"That's pretty much a joke," writes Washington Post columnist Allan Sloan, "given that venture capital and buyout funds — whose managers are the biggest beneficiaries of the 'carried interest' loophole — typically hold investments for well over three years before selling them.

This legislation has the appearance of reform, but not the substance." Sloan, *Carried Interest Reform is a Sham*, Washington Post, December 1, 2017.

The Conference Report states that the three-year holding period applies even in the case of a §83(b) election:

[T]he fact that an individual may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a section 83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest. Thus, the provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies. In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

Conference Report at 269. The estimated revenue gain from the new rule is \$1.1 billion over ten years. Estimated Budget at 6.

Limiting Like-Kind Exchanges to Real Property: Under prior law, the exchange of personal property held for business or investment use for property of like kind qualified for nonrecognition under §1031. The Act now limits the scope of §1031 to exchanges of real property, simply by changing every reference to "property" in §1031 to "real property," as well as deleting §1031(e) related to livestock and §1031(i) related to certain stock.

The new limit applies to exchanges completed in 2018 or later. Section 1031 still applies to a like-kind exchange of personal property if either (1) the property given up was disposed of by the taxpayer before 2018; or (2) the property received by the taxpayer was acquired before 2018. The estimated revenue gain from narrowing the scope of §1031 is \$31 billion over ten years. Estimated Budget at 3.

Modification of Deduction for Entertainment Expenses: Prior law disallowed a deduction for entertainment costs unless the taxpayer established that the entertainment was "directly related to" or "substantially associated with" the taxpayer's business or profit-seeking activity. Even then, the taxpayer could only deduct 50 percent of the cost of the entertainment. The Act amends §274 to disallow a deduction for all entertainment expenses period, no matter whether the entertainment relates to or is associated with the taxpayer's business. The change applies to amounts paid or incurred for entertainment in 2018 or later, and is expected to generate \$23.5 billion in revenue over the next ten years. Estimated Budget at 4.

Deduction for Certain Fines and Penalties Explained: Section 162(f) used to be sweet and to the point: "No deduction shall be allowed under subsection (a) for any fine or similar penalty

paid to a government for the violation of any law." The Act now expands the verbiage of §162(f) considerably, with five new paragraphs, all generally effective as of December 22, 2017. The thrust of the new rule is to deny a deduction for amounts paid or incurred to (or at the direction of) a government or certain listed nongovernmental regulatory entities in relation to the violation of a law or the investigation or inquiry into the potential violation of a law.

The Act contains exceptions for payments that are restitution, remediation of property, or amounts paid to come into compliance with any law that violated or involved in the investigation or inquiry. It also adds reporting requirements whereby government agencies have to report settlement agreements and orders entered into where the amount required to be paid is at least \$600.

Deduction for Local Lobbying Expenses Repealed: Section 162(e) generally disallows deductions for lobbying expenses and expenses connected with political campaigns, but prior law contained an exception for expenses connected with appearing before or communicating with "any local council or similar governing body." The exception treated tribal governments as local councils for purposes of this exception. The Act repeals this exception effective as of December 22, 2017. The estimated revenue gain from this measure is just \$800 million over the next ten years. Estimated Budget at 6.

No Deduction for Settlements Subject to Nondisclosure Agreements in Connection with Sexual Harassment or Sexual Abuse: Introduced in the Senate Bill, new §162(q) provides as follows:

- (q) PAYMENTS RELATED TO SEXUAL HARASSMENT AND SEXUAL ABUSE.—No deduction shall be allowed under this chapter for—
 - (1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or (2) attorney's fees related to such a settlement or payment.

While the statute is clear that settlement payments related to sexual harassment or sexual abuse might be deductible if there is no nondisclosure agreement, it is not clear whether attorney fees paid in cases where there is no nondisclosure agreement could be deductible. On the one hand, §162(q)(2) does not contain the "if such settlement or payment is subject to a nondisclosure agreement" clause, suggesting that the denial of a deduction for attorney fees is not conditioned on the presence of a nondisclosure agreement. But on the other hand, §162(q)(2) refers to "such" a settlement or payment, which is either a reference to "a settlement or payment related to sexual harassment or sexual abuse" or a reference to "a settlement or payment ... subject to a nondisclosure agreement." In any case, the new provision applies to amount paid or incurred after December 22, 2017. The estimated revenue gain from the new rule is less than \$50 million over the next ten years. Estimated Budget at 6.

Exclusion of and Deduction for Employee Achievement Awards Modified: Section 74(b) allows an employee to exclude from gross income (and §274(j)(1) sometimes allows an employer to

deduct) the value of an "employee achievement award." Section 274(j)(3) defines an employee achievement award as an item of tangible personal property awarded from an employer to an employee in a meaningful ceremony recognizing the employee's length of service or safety achievement, provided the circumstances and condition of the award do not create a significant likelihood that the award is just disguised compensation. The Act clarifies that "tangible personal property," for this purpose, does not include cash, cash equivalents, gift cards, gift coupons, most gift certificates, vacations, meals, lodging, event tickets, stock, bonds, securities, or similar items. The new definition applies to awards made in 2018 or later. The Joint Committee estimates a revenue pickup of less than \$50 million over the next ten years from this new rule. Estimated Budget at 4.

Accrual Method Modified: Traditionally, an accrual-method taxpayer has income when all events have occurred that fix the right to payment and the amount can be determined with reasonable accuracy. This is known as the "all-events test" for income. The Act adds a new §451(b), effective starting in 2018, which generally provides that the all events test is met with regard to an item of income no later than when the income is taken into revenue on the taxpayer's financial statement. This is expected to add over \$8 billion in federal revenues in the next ten years. Estimated Budget at 4.

The Act also adds a new §451(c), also starting in 2018, allowing an accrual method taxpayer to elect to defer the inclusion of certain advance payments to the end of the year following the year of receipt if such income is likewise deferred for financial accounting purposes. The new rule does not apply to advance receipts of rents, insurance premiums, and other specified items. In effect, this rule is the codification of guidance previously published by the Service (Revenue Procedure 2004-34).

More Self-Created Property Excluded from Definition of Capital Asset: Section 1221(a)(3) provides that copyrights, compositions, letters, memoranda and similar property held by the creator or by someone whose basis is determined with reference to the creator's basis are not capital assets. The Act adds patents, inventions, models, designs (whether or not patented), secret formulae and processes to this list, applicable to dispositions made in 2018 or later. The Joint Committee estimates this may add about \$500 million in revenues over the next ten years. Estimated Budget at 4.

The House bill likewise called for the repeal of §1235, which provides that a transfer of substantially all rights in a patent or undivided portion thereof by the creator (or an unrelated party who acquired the patent by paying consideration in money or money's worth to the creator before the invention was reduced to practice) automatically qualifies for long-term capital gain treatment. Since self-created patents would not be capital assets under the new law, the House bill figured a provision conferring automatic long-term capital gain treatment would be a contradiction. But the Act makes no change to §1235. So we have one provision (§1221(a)(3)) saying a patent is not a capital asset in the hands of the inventor, but another provision (§1235) says the inventor can still qualify for automatic long-term capital gain treatment on the sale of the entire patent or an undivided portion thereof. If that stands, it

would seem the only taxpayers affected by §1221(a)(3) are those who receive patents by gift from the inventor—donees cannot claim the benefit of §1235 because they do not give the inventor consideration in money or money's worth. They are thus stuck with ordinary income treatment.

Small Business Accounting Method Reform: Prior law generally limited the cash method of accounting to individuals and businesses that use the cash method for financial accounting purposes. Prior law provided that C corporations, partnerships with a C corporation partner, and certain tax-exempt entities could not use the cash method, with exceptions for certain farming businesses, qualified personal service corporations, and entities with average annual gross receipts of no more than \$5 million for all prior years. A taxpayer also could not use the cash method where the purchase, production or sale of merchandise is an income-producing factor.

The Act now expands the availability of the cash method to include all taxpayers (other than tax shelters) with average annual gross receipts of up to \$25 million for the three prior taxable years, even where a taxpayer produces income from the purchase, production, or sale of inventory. The \$25-million figure will be adjusted for post-2018 inflation.

In addition, taxpayers meeting the \$25 million gross receipts test above are no longer required to use the inventory method of accounting for inventories. Instead, taxpayers can account for inventory either by treating inventory for tax purposes either the same way as the taxpayer accounts for it for financial accounting purposes or by treating inventory as non-incidental materials and supplies (deductible when first used or consumed in the taxpayer's business).

But wait, there's more! Taxpayers meeting the \$25 million gross receipts test are also exempted from the uniform capitalization rules of \$263A. This expansion of favorable tax accounting rules applies to taxable years beginning in 2018 and later. The estimated revenue hit from all of these measures is \$30.5 billion over ten years. Estimated Budget at 3.

S Corporation Conversions to C Corporations: Given the new 21-percent flat tax applicable to C corporations, some S corporation shareholders might consider terminating the S election, thus converting the entity to a C corporation. Shareholders should know that one consequence of making the conversion might be a change in accounting method. The former S corporation may have used the cash method if it maintained no inventory, but the new C corporation may be forced to use the accrual method. (Note the discussion immediately above, however, in connection with the expanded availability of the cash method under the Act.)

If a change of accounting method is required, §481(a)(2) requires that in the year of change "there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted...." To mitigate the impact of the "§481 adjustment" in this scenario, the Act creates new §481(d) specifically targeted to conversions from S corporation to C corporation status. Under the new rule, the §481 adjustment" is prorated over the first six taxable years starting

with the year of conversion, but only in cases where: (1) the entity was an S corporation on December 21, 2017; (2) the entity revoked its S corporation status on or after December 22, 2017, and on or before December 21, 2019; and (3) all of the persons who were shareholders of the corporation on December 22, 2017 are the only persons who were shareholders of the corporation on the date of the revocation of the S election. The estimated revenue loss from this new rule is \$6.1 billion over ten years. Estimated Budget at 3.

New Limit on Deduction of Business Interest: Starting in 2018, the deduction for "business interest" in the case of a taxpayer with average annual gross receipts of \$25 million or more over the past three years is limited to an amount equal to the sum of: (1) the taxpayer's "business interest income;" plus (2) 30 percent of the taxpayer's "adjusted taxable income;" plus (3) where applicable, the taxpayer's "floor plan financing interest." Any business interest not allowed as a deduction under this rule carries over the next taxable year. In the case of partnerships, the limit is applied at the entity level, and each partner will have a share of the entity's adjusted taxable income. The Joint Committee estimates this restriction will add over \$253 billion to federal revenues over the next ten years.

Business Interest. New §163(j)(5) defines business interest as any interest paid or accrued on debt properly allocable to a trade or business. The term does not include "investment interest," which has its own cap under §163(d). Section 163(j)(7) excludes certain businesses from the definition of a "trade or business" solely for purposes of the business interest deduction limitation, meaning the limit on interest expense will not apply to these specified groups. They include the business of being an employee, certain utilities, as well as any "electing real property trade or business" (defined as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business) and any "electing farming business." In the case of farmers, though, note the consequence of making the election as regards depreciation of equipment used by an electing farmer as discussed above.

Business Interest Income. New §163(j)(6) defines business interest income as the amount of interest includible in the taxpayer's gross income for the year that is properly allocable to a trade or business of the taxpayer. Here too, investment interest income expressly does not count as business interest income.

Adjusted Taxable Income. New §163(j)(8) defines adjusted taxable income as the taxpayer's taxable income computed without regard to six items: (1) items not properly allocable to a trade or business; (2) business interest; (3) business interest income; (4) any net operating loss deduction; (5) any deduction for qualified business income under new §199A; and (6) for 2018 through 2021 only, deductions for depreciation, amortization, or depletion. The statute authorizes Treasury to announce other adjustments going forward.

Floor Plan Financing Interest. New §163(j)(9) generally defines floor plan financing interest as interest paid on debt used to finance the acquisition of motor vehicles (defined to

include both boats and farm equipment) held for sale or lease and which is secured by such vehicles.

Modification of Net Operating Loss Deduction: Prior law allowed a taxpayer to deduct the net operating loss carryovers to the taxable year plus any net operating loss carrybacks to such year. The Act **caps this deduction to 80 percent of taxable income** (computed without regard to the net operating loss deduction).

The Act also **repeals the two-year carryback** of net operating losses except in the case of certain losses incurred by farmers. Similarly, the net operating losses of a property and casualty insurance company may be carried back two years and carried forward 20 years.

Finally, the Act allows for **indefinite carryforwards** of net operating losses, as opposed to the 20-year limit that was in place under prior law (with the exception for property and casualty insurance companies described above). Combined, these modifications are expected to drive up federal revenues by more than \$201 billion over ten years. Estimated Budget at 3.

Repeal of Deduction for Income Attributable to Domestic Production Activities: The Act repeals §199, effective for taxable years beginning in 2018 or later. Section 199 had authorized a deduction equal to nine percent of either a taxpayer's "qualified production activities income" or, if less, taxable income. Generally, "qualified production activities income" was excess of the taxpayer's "domestic production gross receipts" over the sum of the cost of goods sold allocable to those receipts and other expenses, losses, and deductions allocable to those receipts. The statute generally defined "domestic production gross receipts" as gross receipts derived from the sale, exchange, disposition, lease, rental, or license of tangible personal property, computer software, motion pictures, films, videotapes, and sound recordings that was made, grown or extracted in whole or in significant part within the United States, as well as real property construction performed in the United States by one in the ordinary course of a construction business. The total deduction, however, could not exceed 50 percent of the W-2 wages paid by the taxpayer that were properly allocable to domestic production gross receipts. Repeal of the deduction is expected to add \$98 billion to federal revenues over the next ten years. Estimated Budget at 4.

Excessive Employee Remuneration Limitation Modified: Section 162(m) generally limits the deduction for compensation paid to a "covered employee" of a publicly held corporation to no more than \$1 million per year. A "covered employee" is either a CEO on the last day of the taxable year or an employee whose compensation must be reported to shareholders under federal securities laws because the employee is one of the four most highly compensated officers other than the CEO.

The Act makes a few modifications to this rule starting in 2018, three of which are worth mention here. First, the Act includes the company's CFO as a covered employee no matter whether the CFO is one of the four highest paid officers. Second, the CEO and CFO are covered employees if they held their roles at any point during the taxable year (not just the last day of

the taxable year, as under prior law). Finally, the Act eliminates preexisting exceptions for commissions and performance-based compensation from application of the \$1 million limit. Accordingly, commissions and performance-based compensation now count toward the \$1 million limit. Combined, these new limits are expected to raise some \$9.2 billion in revenues over the next ten years. Estimated Budget at 4.

PART THREE: WEALTH TRANSFER TAX REFORM

Increase in Basic Exclusion Amount

The American Taxpayer Relief Act of 2012 made permanent the \$5,000,000 basic exclusion amount for federal estate, gift, and generation-skipping transfer taxes that was introduced in the Tax Relief and Unemployment Insurance Reauthorization and Job Creation Act of 2010. The basic exclusion amount adjusted for inflation after 2011.

For decedents dying in	The basic exclusion amount is
2011	\$5,000,000
2012	\$5,120,000
2013	\$5,250,000
2014	\$5,340,000
2015	\$5,430,000
2016	\$5,450,000
2017	\$5,490,000

Pursuant to Revenue Procedure 2017-58, the basic exclusion amount for 2018 was set to be \$5,600,000. But the Act doubles the basic exclusion amount under \$2010(c)(3) from \$5 million to \$10 million, with adjustments for inflation after 2011. Thus, the basic exclusion amount for 2018 may be \$11,200,000 (twice the \$5.6 million figure originally estimated for 2018). The actual figure may be different due to rounding that happens from the inflation adjustments. The Act provides that the basic exclusion amount will revert to \$5 million (adjusted for post-2011 inflation) after 2025. The estimated revenue loss from doubling of the basic exclusion amount is \$83 billion over ten years.

The House Bill called for a temporary repeal of the estate and generation-skipping transfer taxes, along with a reduction in the tax rate applicable to taxable gifts. But the Senate Bill focused only on doubling the basic exclusion amount, an approach adopted in the Conference Bill. Thus, the federal wealth transfer taxes survive, but once again suffer a significant reduction in scope.

Retention of Stepped-Up Basis

Neither the House Bill nor the Senate Bill proposed any changes to the application of §1014, which provides a fair-market-value-at-date-of-death basis for property acquired from a decedent. Some commentators were of the belief that if the estate tax was repealed, Congress would be forced to repeal or at least substantially curtail the scope of §1014, perhaps treating property acquired from a decedent the same as property acquired through an inter-vivos gift (with, generally, a carryover basis under §1015). But since the Conference Bill took temporary estate tax repeal off the table, no one was surprised at the retention of "stepped-up" basis under §1014.

Post-Act Estate Planning Ideas

Estate planning for unmarried individuals likely changes very little. Some previously "wealthy" single persons (those with, say, estate of \$8 million) no longer need to sweat the federal wealth transfer taxes as part of their estate planning, though they will want to consider how to plan for the potential re-introduction of those taxes in 2026 when the basic exclusion amount is set to drop back to \$5 million (adjusted for post-2011 inflation). Because the doubling of the basic exclusion amount is only temporary under the Act, one should be hesitant to tear down an existing estate plan that took wealth transfer taxes into account.

Planning for married couples, however, could change significantly. The current structure of the federal income, estate, and gift tax system makes it so no one template can be used for all married couples. Instead, modern tax planning requires married couples to be sorted into one of three "buckets," each with its own template.

BUCKET ONE	BUCKET TWO	BUCKET THREE
Combined net worth less than one basic exclusion amount	Combined net worth more than one basic exclusion amount but not more than two basic	Combined net worth more than two basic exclusion amounts
	exclusion amounts	exclusion amounts
(no more than \$11.2 million in 2018)	(more than \$11.2 million but not more than \$22.4 million in 2018)	(more than \$22.4 million in 2018)

This section of the materials offers a possible template for each bucket. Before doing so, two points must be stressed from the outset. First, the application of state estate, gift, and inheritance tax laws may affect the relative size of each bucket and even, perhaps, the total number of buckets in play. Suppose, for example, that a married couple with a \$7 million combined net worth resides in a state that imposes its own wealth transfer tax with an exclusion amount of only \$2 million. The strategies discussed below for Bucket One assume no transfer tax at all will be imposed. If the amount of state estate tax is a concern, the planner in this example might limit the Bucket One template to couples with combined net wealth of \$2

million or less and use some of the strategies from Bucket Two in an attempt to plan for the state estate tax. But even that approach requires caution, as state estate tax systems may not permit all of the options described in Bucket Two, most notably QTIP and portability elections. So where state transfer taxes are an issue, the planner will need to give careful consideration as to how these templates may be applied successfully to couples that face liability for such taxes.

Second, just as no two snowflakes are alike, no two estate plans are ever identical. What follows are general templates that a planner can use as a starting point in designing the precise estate plan that will work best for any particular married couple. These templates do not consider the special issues that arise, for example, in planning for a beneficiary with special needs, planning for couples that hear the word "dynasty" and get all atwitter, or planning for couples that intend to leave the bulk of their wealth to one or more charitable organizations. Likely no one will use the exact templates set forth herein, but hopefully they provide a helpful framework for building plans that will actually be implemented.

Planning for Bucket One Couples. There is a three-part template for married couples with a combined net worth not in excess of the basic exclusion amount.

BUCKET ONE TEMPLATE

- * Trust or outright gift upon death of first spouse?
- * Ensure stepped-up basis for all assets on death of surviving spouse
- * Consider protective portability election

Transfer Upon First Spouse's Death: Trust or Outright Gift? The couple needs to decide how the assets of the first of them to die should pass. For most couples, there are two choices: by outright gift to the surviving spouse or to a trust of which the surviving spouse is a beneficiary. In answering this question, taxes are irrelevant. Clients choosing to use a trust will be doing so for non-tax reasons. Those reasons could include: (1) the desire of the first spouse to die to control the disposition of his or her assets after death; (2) a concern that the surviving spouse may not have the capacity or desire to manage the assets; and (3) a concern that assets in the name of the surviving spouse might be vulnerable to creditors.

Of course there are also good reasons for clients to prefer an outright gift, like the desire to avoid the costs of trust formation and administration or the desire to avoid the complexity of trusts (you can't get much simpler than an outright gift). Happily, Bucket One couples are free to choose the method that works best for them; taxes do not control any of the decisions here.

Ensure All Assets Get Stepped-Up Basis on Survivor's Death. Since transfer tax planning is not an issue for Bucket One couples, it is crucial that planners get the income tax planning piece right. And that means ensuring everything gets a fresh-start, fair market value basis for income tax purposes upon the surviving spouse's death.

Where couples choose to let assets pass to the surviving spouse by **outright gift**, the step-up in basis on the surviving spouse's death is assured since the spouse owns everything. At this point, however, it is worth mention that the fresh-start, fair market value basis on property passing from a decedent can cause a "step-down" in basis as well (as where the property's value at the time of the surviving spouse's death is less than the surviving spouse's adjusted basis in the property). While estate planners are well-trained in making sure such losses are recognized prior to death so they are not lost, clients will sometimes find a way to die before fully purging loss assets from their portfolios. "Step-downs" will thus happen from time to time. But most beneficiaries will benefit from the application of the fair-market-value-at-date-of-death rule.

Obtaining a stepped-up basis for everything on the surviving spouse's death is more complicated where the couple decides to have assets pass from the first spouse to die via a **trust**. If structured as a typical irrevocable trust, the assets of the trust will not receive a stepped-up basis on the death of the surviving spouse because those assets are not included in the surviving spouse's gross estate for estate tax purposes. For Bucket One couples using trusts, therefore, the key is to create a trust that causes inclusion of the trust assets in the survivor's gross estate. Gross estate inclusion is not an adverse result for Bucket One couples, recall, because federal wealth transfer taxes are not an issue: even if everything is included in the surviving spouse's gross estate, the total size of the estate is less than the surviving spouse's basic exclusion amount.

There are at least two ways to structure a trust so that it results in gross estate inclusion, thus assuring that the assets get a stepped-up basis on the surviving spouse's death. First, the trust instrument can give the surviving spouse a testamentary power to appoint all or any portion of the trust estate to the surviving spouse's estate. This is a **general power of appointment**, and property subject to a general power of appointment is generally includible in the gross estate of the power-holder. In order for this approach to get the maximum advantage, the surviving spouse should be entitled to all of the income from the trust (payable at least annually) for the surviving spouse's life. This makes the property passing to the trust eligible for the estate tax marital deduction, thus maximizing the amount that can pass to the surviving spouse through a portability election, as described below. But since estate taxes are not a factor for Bucket One clients, it is not critical that the surviving spouse receive the income. Nor is it crucial that the power be so broad; it is sufficient, for example, that the spouse has a testamentary power to appoint the trust property only to the creditors of the surviving spouse's estate.

Second, the trust can be structured to qualify for the qualified terminable interest property ("QTIP") exception to the terminable interest rule. If a trust meets the requirements for a QTIP election and the executor of the estate of the first spouse to die properly makes the QTIP election, the assets remaining in trust upon the death of the surviving spouse will be included in the surviving spouse's gross estate, thus assuring here too that the assets qualify for a stepped-up basis. Some practitioners had been concerned that the Service might disregard QTIP elections made by the estate of a Bucket One deceased spouse on the grounds that the QTIP election was not necessary to avoid imposition of federal estate tax. In Revenue Procedure

2016-49, however, the Service made clear that it would not disregard a valid QTIP election unless requested to do so by the executor.

Consider the Protective Portability Election. By definition, estate taxes are not an issue for Bucket One couples. Even if the clients completely bungle the handling of the first spouse's estate, the surviving spouse alone has a basic exclusion amount ample enough to shelter all of the property from federal wealth transfer taxes. Thus one may rightfully wonder why the Bucket One template would consider the need for a portability election.

Planners might consider a portability election upon the death of the first spouse simply because the surviving spouse may come into other, unexpected wealth (prizes, jackpots, punitive damage awards, treasure trove) or may see unexpected surges in the value of assets. In any of those cases, having the deceased spouse's unused exclusion amount in addition to surviving spouse's own basic exclusion amount could prove helpful. Since the only cost to making the portability election is filing a timely estate tax return that would be subject to the relaxed reporting requirements described above, this would likely be cheap insurance.

Planning for Bucket Two Couples. Planning for these couples is perhaps the most challenging. Clearly *some* transfer tax planning is in order; if the planner does nothing and wastes the first spouse's applicable exclusion amount, the surviving spouse will not have sufficient exclusion to cover the couple's combined net worth, even if those assets do not appreciate in value after the death of the first spouse.

The question, though, is what kind of planning makes the most sense. Before 2011, we always used our friend, the credit shelter trust. Even where the credit shelter trust made no sense outside the world of taxes, it was often the only recourse to make sure each spouse's exclusion was utilized fully. Now, however, we also have the portability election at hand. And for clients in Bucket Two, the portability election is usually all we need to make sure federal wealth transfer taxes remain a nullity. So the planner has to consider which is better: using the good, old-fashioned credit shelter trust or the new-fangled portability election.

When Credit Shelter Trust is Better. In many cases, the credit shelter trust will be the better option. The two principal advantages of credit shelter trusts are these:

1. Asset Appreciation Expected. Unlike the basic exclusion amount, the "deceased spousal unused exclusion amount" from a portability election does not adjust for inflation. Thus, for example, suppose the executor of the first deceased spouse elects to have a \$11 million DSUE Amount pass to the surviving spouse. When the surviving spouse dies 25 years later, the basic exclusion amount will be substantially higher, but the DSUE Amount will still be \$11 million.

On the other hand, assets placed in a credit shelter trust will not be subject to estate tax on the death of the surviving spouse no matter how much they may appreciate in value. If the assets

owned by the surviving spouse are expected to appreciate substantially before the surviving spouse's death, then, the credit shelter trust will usually be the preferred option.

2. Client Wants to Use the Generation-Skipping Transfer Tax Exemption. While the portability election applies for both federal estate tax and federal gift tax purposes, it does not apply for purposes of the generation-skipping transfer tax. On the other hand, executors can elect to apply the GSTT exemption to assets placed in a credit shelter trust, permanently shielding the trust assets from the generation-skipping transfer tax. If the couple wants to make significant provision for grandchildren and other beneficiaries further down the line of descent, the credit shelter trust will be more attractive.

When Portability is Better. But there are situations where portability may have the edge over credit shelter trusts. Here are three that come to mind:

- 1. Some Assets Don't Fit Well in Credit Shelter Trusts. Retirement accounts and residences make for poor assets in a credit shelter trust. For income tax purposes we can generally achieve better results by naming the surviving spouse as beneficiary instead of a trust. For purposes of excluding gain from the sale of a residence, moreover, title in the surviving spouse's name is better since trusts cannot occupy a residence, one of the conditions required for excluding gain.
- **2. Some Surviving Spouses Don't Survive Long Enough.** If the surviving spouse does not live for a meaningful period of time following the first spouse's death, there is little chance that assets inside of a credit shelter trust will have had an opportunity to appreciate in value to any significant extent. So after undergoing the expense, delay, and complexity involved in funding and administering the credit shelter trust, it would do no better than the simple, cost-effective portability election.
- **3. Stepped-Up Basis May be More Important.** Remember that assets owned either outright by the surviving spouse or by a QTIP trust will get a stepped-up basis for income tax purposes on the death of the surviving spouse. Assets inside of the typical credit shelter trust, however, do not get a step-up in basis. One must therefore check the balance sheets, for if the lurking capital gain in the estate is substantial yet the combined net worth puts the couple just over one basic exclusion amount, the step-up in basis matters much more than the estate tax savings—to the point that a credit shelter trust may be unwise.

BUCKET TWO TEMPLATE

- * Trust or outright gift upon death of first spouse?
- * If outright gift preferred, use disclaimer planning
- * If trust is preferred, use Clayton QTIP

So the decision between a credit shelter trust and a portability election, ultimately, comes down to the answers to these five questions: (1) when will the first spouse die?; (2) what assets will the couple have at the time of the first spouse's death?; (3) how much longer will the

surviving spouse live after the death of the first spouse?; (4) what will the basic exclusion amount be when the first spouse dies?; and (5) what will the transfer tax rates be upon the death of the first spouse? If we know this information, we can make the right choice. But few planners will be in a position to answer these questions with any confidence. Accordingly, the important theme for all planning in Bucket Two is **flexibility**. We want a plan that can let the couple choose the right path (credit shelter trust or portability election) when they have better answers to those five questions (i.e., after the death of the first spouse) instead of a plan that forces them to commit to one path now when there is so much uncertainty. This template does that.

Transfer Upon First Spouse's Death: Trust or Outright Gift? It all starts with the same question posed to Bucket One couples: if taxes were not an issue, what should happen to the assets when the first spouse dies? Since we can create an effective plan regardless of which option the couple chooses (outright gift or trust), tax consequences have no relevance at this stage. See the Bucket One template for discussion of when couples might prefer outright gifts over trusts and vice versa.

Outright Gifts – Disclaimer Planning. If the couple elects to have the assets of the first spouse pass to the survivor by outright gift, then the testamentary document (will or living trust) should contain a provision whereby any gift properly **disclaimed** by the surviving spouse shall pass to a credit shelter trust. This way, we keep both portability and the credit shelter trust on the table, and we need not choose between them until after the death of the first spouse to die.

If, for example, we know after the death of the first spouse that portability is the better option (because the survivor is not expected to live long, or because of the nature of the assets, or because of whatever other reason), the surviving spouse simply accepts the gift. The executor can then file an estate tax return that claims a full marital deduction. This reduces the taxable estate to zero (since all passes to the surviving spouse outright), and then the unused applicable exclusion amount passes to the surviving spouse. But if we decide that a credit shelter trust is the better option, the spouse can disclaim the gift (or disclaim an amount equal to the amount of the first spouse's remaining applicable exclusion amount) and by operation of the instrument the gift will pass to the credit shelter trust.

This structure postpones making the ultimate decision until after the death of the first spouse. Like any plan making use of qualified disclaimers, the planner should discuss with the couple the practical constraints involved. For instance, the surviving spouse must not accept the benefit of any of the deceased spouse's property in order for any disclaimer to be valid. That means funds will need to be available for the surviving spouse so that the survivor is not tempted to accept the benefit of the deceased spouse's property before the final decision whether to make a disclaimer has been made.

Trusts – Clayton *QTIP*. If the couple instead opts to have the assets of the first spouse pass to the survivor through a trust, a good vehicle is the so-called *Clayton* QTIP trust. A *Clayton*

QTIP is just like a regular QTIP trust in that all income is to be paid at least annually to the surviving spouse and trust distributions during the spouse's lifetime can be made only to the surviving spouse. And like a regular QTIP trust, the executor has to elect to treat assets intended to qualify for the marital deduction as "qualified terminable interest property." But the *Clayton* QTIP trust contains an additional provision: to the extent the executor does not elect to qualify an asset passing to the trust as qualified terminable interest property, such property shall automatically pass to a credit shelter trust.

An example illustrates the flexibility of this approach. Suppose the deceased spouse's will leaves everything to a *Clayton* QTIP. If the deceased spouse's executor decides that portability is the preferred planning option for whatever reason, the executor will make the QTIP election on a timely filed estate tax return for all of the assets in the trust. The gift will qualify for the unlimited marital deduction, meaning the deceased spouse's taxable estate will be reduced to zero and the full deceased spousal unused exclusion amount can port over to the surviving spouse. If the executor instead decides that the credit shelter trust is best, the executor can select assets with a value equal to the deceased spouse's remaining applicable exclusion amount and then make the QTIP election for *all other assets*. The unelected assets will pass automatically to the credit shelter trust.

As with the disclaimer approach, the *Clayton* QTIP allows the couple to defer making the decision between portability and the credit shelter trust until after the first spouse dies. It thus provides the needed flexibility.

Planning for Bucket Three Couples. Unlike good stories, we have saved the most boring for last. Not much has changed when it comes to advising, say, the \$50 million estate. The techniques used prior to both the Act and the American Taxpayer Relief Act remain attractive now. Choosing between portability and a credit shelter trust alone will not be enough.

The planner still needs to consider strategies that can reduce the amount of wealth subject to tax while still retaining the desired level of control over and cash flow from the assets in the estate. These strategies include: spousal lifetime access trusts (SLATs); irrevocable life insurance trusts (ILITs); grantor retained annuity trusts (GRATs); charitable lead trusts (CLATs and CLUTs); charitable remainder trusts (CRATs, CRUTs, NIMCRUTs); donor-advised funds, private foundations, and pooled income funds; family limited partnerships (FLPs) and limited liability companies; installment sales to "defective" grantor trusts; and dynasty trusts. Of course, even some Bucket Two couples may find one or more of the these strategies useful in their own planning as well. But it's now primarily Bucket Three couples that are concerned with gross estate minimization.

PART FOUR: ALTERNATIVE MINIMUM TAX REFORM

Corporate AMT Repealed

Prior law imposed an alternative minimum tax (AMT) on some corporations. The key to calculating a corporation's AMT liability was to determine its "alternative minimum taxable income" (AMTI). The starting point, no surprise, was the corporation's regular taxable income. Certain adjustments to that figure were made under §§56 and 58. For example, a corporation had to recompute certain depreciation deductions by using the straight-line method rather than the usual accelerated cost recovery system allowed for regular tax purposes. §56(a)(1)(A)(i). The taxable income figure was then further adjusted by the so-called "preference items" in §57. For example, a corporation had to increase taxable income by the amount of tax-exempt interest received on private activity bonds. §57(a)(5)(A). (For regular tax purposes, such interest is excluded from gross income under §103.)

The final major adjustment to taxable income was the "adjusted current earnings" (ACE) adjustment provided in §§56(c)(1) and (g). The purpose of this adjustment was to reflect the corporation's true earnings for the taxable year. Once all adjustments have been made, a "tentative minimum tax" was computed by computing 20 percent of the corporation's AMTI as exceeds the exemption amount (\$40,000). But the \$40,000 exemption amount was reduced by 25 percent of the amount by which AMTI exceeded \$150,000. §55(d)(3). AMT liability thus applied to the extent tentative minimum tax liability exceeded the corporation's regular tax liability.

The corporate AMT was only a concern to very large corporations. Certain "small" C corporations were wholly exempt from the AMT. A C corporation with average annual gross receipts of \$7.5 million or less for all three-year periods beginning after 1993 and ending before the taxable year was considered a "small" corporation and, as such, was deemed to have a tentative minimum tax liability of zero. IRC §55(e). For the corporation's first three-year period (or portion of a period), the limit was \$5 million instead of \$7.5 million.

The Act repeals the corporate AMT effective for taxable years beginning in 2018 or later. This repeal is permanent; it is not scheduled to sunset. The estimated revenue loss from repeal is \$40.3 billion over ten years. Estimated Budget at 3.

Individual AMT Retained with Higher Exemptions

Individuals, estates, and trusts are likewise subject to the AMT. The minimum tax imposed is the amount by which tentative minimum tax exceeds the regular income tax liability for the year. There is a "tentative minimum tax" when AMTI (computed in roughly the same manner for individuals as for corporations) exceeds the exemption amount. Taxpayers with high AMTIs face a phaseout of the exemption amount.

The House Bill called for complete repeal of the individual AMT to accompany repeal of the corporate AMT, but the Senate would not have it. Instead, the final Act temporarily increases both the exemption amount and the exemptions amount phaseout threshold, as illustrated in the following table (effective for 2018 through 2025):

	Pre-Tax Cuts and Jobs Act*			POST-TAX CUTS AND JOBS ACT		
Taxpayer	Joint	Unmarried	Estates	Joint	Unmarried	Estates
	Filers		and	Filers		and
			Trusts			Trusts
AMT Exemption	\$86,200	\$55,400	\$24,600	\$109,400	\$70,300	\$24,600
Amount						
Phaseout of	\$164,100	\$123,100	\$82,050	\$208,400	\$156,300	\$82,050
exemption amount						
begins when AMTI						
exceeds						

^{*} Figures from Revenue Procedure 2017-58.

The new dollar amounts are set to be adjusted for inflation, but will expire at the end of 2025. These adjustments are expected to cost about \$637 billion in foregone revenue over this period. Estimated Budget at 2.

PART FIVE: REFORMS THAT DID NOT MAKE THE FINAL BILL

Both the House and Senate bills contained provisions that were left on the cutting room floor by the Conference Committee. A number of these last-minute cuts had been discussed in the popular press, so some clients might be under the mistaken impression that the final Act contains some of these provisions. Accordingly, these materials conclude with a brief mention of various reform proposals from the House and Senate bills that were <u>not</u> included in the final Act, as confirmation that these proposals are not in fact part of the new law.

Individual Tax Reforms Not Enacted

Exclusion of Gain on Sale of Personal Residence: The House bill made three changes to the §121 exclusion applicable to gain from the sale of a personal residence. First, it replaced the requirement that the taxpayer own and occupy the home for two of the five years prior to the sale with the requirement that the taxpayer own and occupy the home for five of the right years prior to the sale. Second, it would have limited the application of §121 to every five years instead of every two years. Finally, it would have imposed a phaseout of the exclusion once the taxpayer's adjusted gross income exceeded \$250,000 (\$500,000 for joint filers).

The Senate bill was on board with the first two changes, but it did not include an income-based phaseout. It also provided for a sunset of the changes come 2026. But for reasons not apparent, the Conference bill enacted none of the proposed changes to §121.

American Opportunity Tax Credit and Lifetime Learning Credit. Current law provides for both the American Opportunity Tax Credit and the Lifetime Learning Credit. The American Opportunity Tax Credit gives individuals a credit of up to \$2,500 for qualified tuition and related expenses paid first the "first four years" of post-secondary education in a degree or certificate program, though the credit generally is phased out ratably for taxpayers with adjusted gross incomes between \$80,000 and \$90,000 (double those amount for joint filers). Up to 40 percent of the credit is refundable The Lifetime Learning Credit is nonrefundable credit of 20 percent of qualified tuition and related expenses, but subject to a cap of \$2,000. The credit extends beyond the first four years of undergraduate education, but is phased out ratably for taxpayers with adjusted gross incomes between \$56,000 and \$66,000 (double those amount for joint filers).

The House bill would have repealed the Lifetime Learning Credit and modified the American Opportunity Tax Credit by also allowing a half-credit in the *fifth* year of undergraduate education. The Senate bill did not address the education credits at all, and the Conference bill did not include the House bill provision.

Student Loan Interest: The House bill would have repealed the §221 deduction for interest paid on student loans. The Senate bill contained no similar provision, and it was dropped from the Conference bill.

Qualified Tuition and Related Expenses: The House bill would have repealed §222 deduction for qualified tuition and related expenses, but the Senate and Conference bills rejected this.

Exclusion for Qualified Tuition Reductions: The House bill called for repeal of §117(d), which generally excludes from gross income the value of tuition reductions furnished to employees, their spouses, and their dependents. Colleges and universities vocally opposed the measure, as it would have made most graduate assistant positions taxable. The Senate bill did not contain this provision, and the provision was dropped from the Conference bill.

Exclusion of Interest on United States Savings Bonds Used for Higher Education: The House bill repealed §135, the exclusion of interest earned on a Series EE savings bond issued after 1989 to the extent the interest does not exceed the taxpayer's qualified higher education expenses. The Senate bill ignored the proposed repeal, as did the Conference bill.

Exclusion for Educational Assistance Programs: The House bill also called for repeal of §127, which excluded up to \$5,250 of annual educational assistance provided to an employee by an employer relevant to undergraduate and graduate education. But neither the Senate bill nor the Conference bill included this provision.

Deduction and Contributions to Archer Medical Savings Accounts: The House bill made contributions to Archer MSAs nondeductible as of 2018, and likewise provided that such payments would be includible in gross income and count as wages if paid by an employer. But the Senate bill did not include this provision and it was likewise dropped from the Conference bill.

Exclusion for Employer-Provided Housing: Section 119 allows an employee to exclude from gross income the value of lodging furnished by an employer for the convenience of the employer, provided the employee is required to accept the lodging on the employer's business premises as a condition of employment. The House bill limited this exclusion to a maximum \$50,000 exclusion, subject to a phaseout based on the employee's compensation. It also disallowed the exclusion entirely to employees who own five percent or more of the employer. The Senate bill did not pick up this provision; neither did the Conference bill.

Business Tax Reforms Not Enacted

Expenses in Contingent Fee Cases: *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995), held that an attorney could deduct litigation costs in contingent fee cases even though the attorney may later recoup those expenses under the contingent fee arrangement. The House bill would have overruled *Boccardo* through a specific rule disallowing a deduction for litigation costs paid under a contingent fee arrangement until the contingency ends. The Senate bill contained no similar provision, and the Conference bill let it die.

25 Percent Rate on Qualified Business Income: Instead of the 20-percent deduction for qualified business income coined in the Senate bill, the House bill would have instead applied a maximum rate of 25 percent to qualified business income. In addition, the House version treated passive activities differently than active businesses: all of the ordinary income from a passive activity would qualify for the rate preference, but only the "capital percentage" of business income (presumptively 30 percent of the ordinary income) would qualify in the case of active businesses.

Wealth Transfer Tax Reforms Not Enacted

Delayed Repeal of the Estate and Generation-Skipping Transfer Taxes: As explained in Part Three above, the House bill called for eventual repeal of the federal estate and generation-skipping transfer taxes, accompanied with a reduced tax rate of 35 percent for purposes of the federal gift tax. But the Senate settled simply for doubling the basic exclusion amount and leaving the tax rate alone.

APPENDIX 1 – TEXT OF NEW §199A

SEC. 199A. QUALIFIED BUSINESS INCOME.

- (a) IN GENERAL.--In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to the sum of--
 - (1) the lesser of--
 - (A) the combined qualified business income amount of the taxpayer, or
 - (B) an amount equal to 20 percent of the excess (if any) of--
 - (i) the taxable income of the taxpayer for the taxable year, over
 - (ii) the sum of any net capital gain (as defined in section 1(h)), plus the aggregate amount of the qualified cooperative dividends, of the taxpayer for the taxable year, plus
 - (2) the lesser of--
 - (A) 20 percent of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year, or
 - (B) taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

The amount determined under the preceding sentence shall not exceed the taxable income (reduced by the net capital gain (as so defined)) of the taxable year.

- (b) COMBINED QUALIFIED BUSINESS INCOME AMOUNT.--For purposes of this section--
- (1) IN GENERAL.--The term "combined qualified business income amount" means, with respect to any taxable year, an amount equal to--
 - (A) the sum of the amounts determined under paragraph (2) for each qualified trade or business carried on by the taxpayer, plus
 - (B) 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.
- (2) DETERMINATION OF DEDUCTIBLE AMOUNT FOR EACH TRADE OR BUSINESS.--The amount determined under this paragraph with respect to any qualified trade or business is the lesser of--
 - (A) 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or
 - (B) the greater of--
 - (i) 50 percent of the W-2 wages with respect to the qualified trade or business, or
 - (ii) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.
 - (3) MODIFICATIONS TO LIMIT BASED ON TAXABLE INCOME.--
 - (A) EXCEPTION FROM LIMIT.--In the case of any taxpayer whose taxable income for the taxable year does not exceed the threshold amount, paragraph (2) shall be applied without regard to subparagraph (B).
 - (B) PHASE-IN OF LIMIT FOR CERTAIN TAXPAYERS.--
 - (i) IN GENERAL.--If--

- (I) the taxable income of a taxpayer for any taxable year exceeds the threshold amount, but does not exceed the sum of the threshold amount plus \$50,000 (\$100,000 in the case of a joint return), and
- (II) the amount determined under paragraph (2)(B) (determined without regard to this subparagraph) with respect to any qualified trade or business carried on by the taxpayer is less than the amount determined under paragraph (2)(A) with respect such trade or business,

then paragraph (2) shall be applied with respect to such trade or business without regard to subparagraph (B) thereof and by reducing the amount determined under subparagraph (A) thereof by the amount determined under clause (ii).

- (ii) AMOUNT OF REDUCTION.--The amount determined under this subparagraph is the amount which bears the same ratio to the excess amount as--
 - (I) the amount by which the taxpayer's taxable income for the taxable year exceeds the threshold amount, bears to
 - (II) \$50,000 (\$100,000 in the case of a joint return).
- (iii) EXCESS AMOUNT.--For purposes of clause (ii), the excess amount is the excess of--
 - (I) the amount determined under paragraph (2)(A) (determined without regard to this paragraph), over (II) the amount determined under paragraph (2)(B) (determined without regard to this paragraph).
- (4) WAGES, ETC.--
- (A) IN GENERAL.--The term `W-2 wages' means, with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.
- (B) LIMITATION TO WAGES ATTRIBUTABLE TO QUALIFIED BUSINESS INCOME.--Such term shall not include any amount which is not properly allocable to qualified business income for purposes of subsection (c)(1).
- (C) Return requirement.--Such term shall not include any amount which is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.
- (5) ACQUISITIONS, DISPOSITIONS, AND SHORT TAXABLE YEARS.--The Secretary shall provide for the application of this subsection in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year.
 - (6) QUALIFIED PROPERTY.--For purposes of this section:

- (A) IN GENERAL.--The term 'qualified property' means, with respect to any qualified trade or business for a taxable year, tangible property of a character subject to the allowance for depreciation under section 167--
 - (i) which is held by, and available for use in, the qualified trade or business at the close of the taxable year,
 - (ii) which is used at any point during the taxable year in the production of qualified business income, and
 - (iii) the depreciable period for which has not ended before the close of the taxable year.
- (B) Depreciable Period.--The term "depreciable period" means, with respect to qualified property of a taxpayer, the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of--
 - (i) the date that is 10 years after such date, or
 - (ii) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (determined without regard to subsection (g) thereof).
- (c) QUALIFIED BUSINESS INCOME.--For purposes of this section--
- (1) IN GENERAL.--The term "qualified business income" means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Such term shall not include any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income.
- (2) Carryover of Losses.--If the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount shall be treated as a loss from a qualified trade or business in the succeeding taxable year.
- (3) QUALIFIED ITEMS OF INCOME, GAIN, DEDUCTION, AND LOSS.-- For purposes of this subsection--
 - (A) IN GENERAL.--The term "qualified items of income, gain, deduction, and loss" means items of income, gain, deduction, and loss to the extent such items are--
 - (i) effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "qualified trade or business (within the meaning of section 199A)" for "nonresident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears), and
 - (ii) included or allowed in determining taxable income for the taxable year.
 - (B) EXCEPTIONS.--The following items shall not be taken into account as a qualified item of income, gain, deduction, or loss:
 - (i) Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.
 - (ii) Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G).

- (iii) Any interest income other than interest income which is properly allocable to a trade or business.
- (iv) Any item of gain or loss described in subparagraph (C) or (D) of section 954(c)(1) (applied by substituting "qualified trade or business" for "controlled foreign corporation").
- (v) Any item of income, gain, deduction, or loss taken into account under section 954(c)(1)(F) (determined without regard to clause (ii) thereof and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7)).
- (vi) Any amount received from an annuity which is not received in connection with the trade or business.
- (vii) Any item of deduction or loss properly allocable to an amount described in any of the preceding clauses.
- (4) Treatment of reasonable compensation and guaranteed payments.--Qualified business income shall not include--
 - (A) reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,
 - (B) any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and
 - (C) to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.
- (d) QUALIFIED TRADE OR BUSINESS.--For purposes of this section--
- (1) IN GENERAL.--The term "qualified trade or business" means any trade or business other than--
 - (A) a specified service trade or business, or
 - (B) the trade or business of performing services as an employee.
- (2) Specified service trade or business.--The term "specified service trade or business" means any trade or business--
 - (A) which is described in section 1202(e)(3)(A) (applied without regard to the words "engineering, architecture,") or which would be so described if the term "employees or owners" were substituted for "employees" therein, or
 - (B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).
 - (3) EXCEPTION FOR SPECIFIED SERVICE BUSINESSES BASED ON TAXPAYER'S INCOME.--
 - (A) In general.--If, for any taxable year, the taxable income of any taxpayer is less than the sum of the threshold amount plus \$50,000 (\$100,000 in the case of a joint return), then--
 - (i) any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A), but

- (ii) only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W-2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W-2 wages, and the unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section.
- (B) APPLICABLE PERCENTAGE.--For purposes of subparagraph (A), the term "applicable percentage" means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio of--
 - (i) the taxable income of the taxpayer for the taxable year in excess of the threshold amount, bears to
 - (ii) \$50,000 (\$100,000 in the case of a joint return).
- (e) OTHER DEFINITIONS.--For purposes of this section--
- (1) TAXABLE INCOME.--Taxable income shall be computed without regard to the deduction allowable under this section.
 - (2) THRESHOLD AMOUNT .--
 - (A) IN GENERAL.--The term "threshold amount" means \$157,500 (200 percent of such amount in the case of a joint return).
 - (B) INFLATION ADJUSTMENT.--In the case of any taxable year beginning after 2018, the dollar amount in subparagraph (A) shall be increased by an amount equal to--
 - (i) such dollar amount, multiplied by
 - (ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting `calendar year 2017' for `calendar year 2016' in subparagraph (A)(ii) thereof.

The amount of any increase under the preceding sentence shall be rounded as provided in section 1(f)(7).

- (3) QUALIFIED REIT DIVIDEND.--The term "qualified REIT dividend" means any dividend from a real estate investment trust received during the taxable year which--
 - (A) is not a capital gain dividend, as defined in section 857(b)(3), and
 - (B) is not qualified dividend income, as defined in section 1(h)(11).
- (4) QUALIFIED COOPERATIVE DIVIDEND.--The term "qualified cooperative dividend" means any patronage dividend (as defined in section 1388(a)), any per-unit retain allocation (as defined in section 1388(f)), and any qualified written notice of allocation (as defined in section 1388(c)), or any similar amount received from an organization described in subparagraph (B)(ii), which--
 - (A) is includible in gross income, and
 - (B) is received from--
 - (i) an organization or corporation described in section 501(c)(12) or 1381(a), or

- (ii) an organization which is governed under this title by the rules applicable to cooperatives under this title before the enactment of subchapter T.
- (5) QUALIFIED PUBLICLY TRADED PARTNERSHIP INCOME.--The term "qualified publicly traded partnership income" means, with respect to any qualified trade or business of a taxpayer, the sum of--
 - (A) the net amount of such taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (as defined in subsection (c)(3) and determined after the application of subsection (c)(4)) from a publicly traded partnership (as defined in section 7704(a)) which is not treated as a corporation under section 7704(c), plus
 - (B) any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset under section 751(a).
- (f) SPECIAL RULES.--
 - (1) APPLICATION TO PARTNERSHIPS AND S CORPORATIONS.--
 - (A) IN GENERAL.--In the case of a partnership or S corporation--
 - (i) this section shall be applied at the partner or shareholder level,
 - (ii) each partner or shareholder shall take into account such person's allocable share of each qualified item of income, gain, deduction, and loss, and
 - (iii) each partner or shareholder shall be treated for purposes of subsection (b) as having W-2 wages and unadjusted basis immediately after acquisition of qualified property for the taxable year in an amount equal to such person's allocable share of the W-2 wages and the unadjusted basis immediately after acquisition of qualified property of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary).

For purposes of clause (iii), a partner's or shareholder's allocable share of W-2 wages shall be determined in the same manner as the partner's or shareholder's allocable share of wage expenses. For purposes of such clause, partner's or shareholder's allocable share of the unadjusted basis immediately after acquisition of qualified property shall be determined in the same manner as the partner's or shareholder's allocable share of depreciation. For purposes of this subparagraph, in the case of an S corporation, an allocable share shall be the shareholder's pro rata share of an item.

- (B) APPLICATION TO TRUSTS AND ESTATES.--Rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W-2 wages shall apply to the apportionment of W-2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section.
 - (C) TREATMENT OF TRADES OR BUSINESS IN PUERTO RICO.--
 - (i) IN GENERAL.--In the case of any taxpayer with qualified business income from sources within the commonwealth of Puerto Rico, if all such

income is taxable under section 1 for such taxable year, then for purposes of determining the qualified business income of such taxpayer for such taxable year, the term `United States' shall include the Commonwealth of Puerto Rico.

- (ii) Special rule for applying limit.--In the case of any taxpayer described in clause (i), the determination of W-2 wages of such taxpayer with respect to any qualified trade or business conducted in Puerto Rico shall be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services in Puerto Rico.
- (2) COORDINATION WITH MINIMUM TAX.--For purposes of determining alternative minimum taxable income under section 55, qualified business income shall be determined without regard to any adjustments under sections 56 through 59.
- (3) DEDUCTION LIMITED TO INCOME TAXES.--The deduction under subsection (a) shall only be allowed for purposes of this chapter.
- (4) REGULATIONS.--The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this section, including regulations--
 - (A) for requiring or restricting the allocation of items and wages under this section and such reporting requirements as the Secretary determines appropriate, and
 - (B) for the application of this section in the case of tiered entities.
- (g) DEDUCTION ALLOWED TO SPECIFIED AGRICULTURAL OR HORTICULTURAL COOPERATIVES.--
- (1) IN GENERAL.--In the case of any taxable year of a specified agricultural or horticultural cooperative beginning after December 31, 2017, there shall be allowed a deduction in an amount equal to the lesser of--
 - (A) 20 percent of the excess (if any) of--
 - (i) the gross income of a specified agricultural or horticultural cooperative, over
 - (ii) the qualified cooperative dividends (as defined in subsection(e)(4)) paid during the taxable year for the taxable year, or(B) the greater of--
 - (i) 50 percent of the W-2 wages of the cooperative with respect to its trade or business, or
 - (ii) the sum of 25 percent of the W-2 wages of the cooperative with respect to its trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property of the cooperative.
- (2) LIMITATION.--The amount determined under paragraph (1) shall not exceed the taxable income of the specified agricultural or horticultural for the taxable year.
- (3) Specified AGRICULTURAL OR HORTICULTURAL COOPERATIVE.--For purposes of this subsection, the term "specified agricultural or horticultural cooperative" means an organization to which part I of subchapter T applies which is engaged in--
 - (A) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product,

- (B) the marketing of agricultural or horticultural products which its patrons have so manufactured, produced, grown, or extracted, or
- (C) the provision of supplies, equipment, or services to farmers or to organizations described in subparagraph (A) or (B).
- (h) ANTI-ABUSE RULES.--The Secretary shall--
- (1) apply rules similar to the rules under section 179(d)(2) in order to prevent the manipulation of the depreciable period of qualified property using transactions between related parties, and
- (2) prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.
- (i) Termination.--This section shall not apply to taxable years beginning after December 31, 2025.

Understanding the Deduction for Qualified Business Income

SAMUEL A. DONALDSON

GEORGIA STATE UNIVERSITY COLLEGE OF LAW

ATLANTA, GEORGIA

Agenda

- The Origin Story
- What We Know About §199A
- What We Think We Know About §199A
- What We Don't Know About §199A
- Planning Strategies

§199A's Back Story

- New 21% flat rate for C corporations, but what about small businesses?
 - 1.7 million C corporation returns filed in 2013
 - 4.2 million S corporation returns filed in 2013
 - 3.3 million partnership returns filed in 2013
 - 24 million sole proprietorship returns (1040 Schedule C) filed in 2013
- Use §199 as a framework
 - 9% of "qualified production activities income" (or 9% of taxable income, if less)
 - Deduction could not exceed 50% of W-2 wages allocable to domestic production
- Give a reduced benefit to taxpayers in the 32% and higher brackets

Federal Income Tax Brackets – Individuals, Estates, and Trusts – ORDINARY INCOME

Federal Income Tax Brackets for Individuals, Estates, and Trusts - ORDINARY INCOME

Pre-Tax Cuts and Jobs Act*			Post-Tax Cuts and Jobs Act (through 202			025)	
2018 Ta	axable Incon	ne Exceeding		2018 Ta	axable Incon	ne Exceeding	
Single	Married	Trusts and	Rate	Single	Married	Trusts and	Rate
		Estates				Estates	
\$0	\$0		10%	\$0	\$0	\$0	10%
\$9,525	\$19,050	\$0	15%	\$9,525	\$19,050		12%
\$38,700	\$77,400	\$2,600	25%	\$38,700	\$77,400		22%
\$93,700	\$156,150	\$6,100	28%	\$82,500	\$165,000	\$2,550	24%
\$195,450	\$237,950	\$9,300	33%	\$157,500	\$315,000		32%
\$424,950	\$424,950		35%	\$200,000	\$400,000	\$9,150	35%
\$426,700	\$480,050	\$12,700	39.6%	\$500,000	\$600,000	\$12,500	37%

* From Revenue Procedure 2017-58, issued October 19, 2017.



(1) Who Qualifies

- Partner in a "partnership"
- Shareholder in an S corporation
- Sole proprietor engaged in a trade or business
- C corporation shareholders DO NOT QUALIFY
- Employees DO NOT QUALIFY

§199A: What We Know – DEDUCTION MECHANICS

(2) **Taxable Income Zones** – Eligibility for (and the amount of) the deduction depend on taxable income (w/o regard to §199A)

ZONE 1:

Taxable income does not exceed \$157,500 (\$315,000 for MFJ)

ZONE 2:

Taxable income \$157,500 - 207,500 (\$315,000 - 415,000)

ZONE 3:

Taxable income more than \$207,500 (\$415,000 for MFJ)

(3) Specified Service Businesses

- Services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services
- Business's principal asset is the **reputation or skill** of 1+ employees or owners
- Services consisting of **investing and investment management**, trading, or dealing in **securities**, **partnership interests**, or **commodities**.

ZONE 2: Deduction phases out

ZONE 3: No deduction

§199A: What We Know - DEDUCTION MECHANICS

(3) Specified Service Businesses - EXAMPLE

- Married couple
- \$200,000 net income from a specified service business
- Taxable income of \$375,000



(4) Must be Engaged in Conduct of United States Trade or Business

(5) **Deduction Amount**

Do this for each trade or business!

Total deduction capped at 20% of TI – net cap gain

ZONE 1:

20% of QBI

ZONE 2: 20% of QBI, reduced if 50% of "wage-basis limit" is less ZONE 3: 20% of QBI or, if less, 50% of the "wagebasis limit"

§199A: What We Know – DEDUCTION MECHANICS

(6) Qualified Business Income

- Net amount of items of income, gain, loss, and deduction from an eligible trade or business, except for items of capital gain and loss, and certain dividends from REITs, cooperatives, and publicly-traded partnerships
- If the net amount from all eligible businesses is a net loss, that net loss carries over to the next taxable year as a loss from a separate qualified trade or business

(7) The "Wage-Basis Limit"

The *greater* of:

- 50% of W-2 wages paid by business to employees; or
- 25% of W-2 wages paid plus 2.5% of unadjusted basis immediately after acquisition of all depreciable property used in the business still on hand at year end

§199A: What We Know – DEDUCTION MECHANICS

(7) The "Wage-Basis Limit" – EXAMPLE

 Married couple, Taxable income of \$375,000, QBI of \$200,000, W-2 wages of \$40,000, Depreciable property of \$1,000,000 (2.5% = \$25,000)

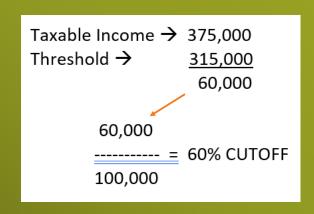
```
Taxable Income → 375,000
                                     50% W-2 wages → $20,000
Threshold →
                  315,000
                   60,000
                                     25% W-2 wages → $10,000
                                     + 2.5% deprec. → $25,000
                                                       $35,000
        60,000
                                     20% QBI → $40,000
                                                                   20% QBI → 40,000
       ---- = 60%
       100,000
                              Wage-basis limit \rightarrow ($35,000)
                                                                   Reduction \rightarrow (3,000)
                                                                                37,000 deduction
                                                  $5,000
                                                  X 60%
                                                 $3,000 OFF
```

(8) Trusts and Estates –

- Estates and trusts with interests in partnerships and S corporations are eligible for the deduction
- Act instructs Treasury to issue regulations explaining how the deduction is apportioned between fiduciaries and beneficiaries
- (9) **Sunrise, Sunset** The deduction applies in taxable years that begin after 2017 and before 2026
- (10) **Penalty** 20% accuracy penalty threshold reduced (from 10% to 5%)

§199A: What We Know - DEDUCTION MECHANICS

- Married couple filing jointly
- Taxable income = \$375,000
- Sole shareholder of mfg S-corp
 - QBI = \$100,000
 - W-2 wages = \$20,000
 - Depreciables = \$400,000
- Sole proprietor of SSB
 - Net income = \$200,000
 - W-2 wages = \$50,000
 - Depreciables = zero



- Married couple filing jointly
- Taxable income = \$375,000
- Sole shareholder of mfg S-corp
 - QBI = \$100,000
 - W-2 wages = \$20,000
 - Depreciables = \$400,000
- Sole proprietor of SSB
 - Net income = \$200,000
 - W-2 wages = \$50,000
 - Depreciables = zero

20% QUALIFIED BIZ INCOME	\$20,000	\$16,000
QUALIFIED BIZ INCOME	\$100,000	\$80,000
BUSINESS INCOME	\$100,000	\$200,000
	MFG S-CORP	SOLE SSB

§199A: What We Know – DEDUCTION MECHANICS

- Married couple filing jointly
- Taxable income = \$375,000
- Sole shareholder of mfg S-corp
 - QBI = \$100,000
 - W-2 wages = \$20,000
 - Depreciables = \$400,000
- Sole proprietor of SSB
 - Net income = \$200,000
 - W-2 wages = \$50,000
 - Depreciables = zero

	MFG S-CORP	SOLE SSB
W-2 WAGES	\$20,000	\$50,000
199A W-2 WAGES	\$20,000	\$20,000
50% W-2 WAGES	\$10,000	\$10,000

	MFG S-CORP	SOLE SSB
QUALIFIED PROPERTY	\$400,000	\$0
199A QUALIFIED PROPERTY	\$400,000	\$0
2.5% QUALIFIED PROPERTY	\$10,000	\$0
25% W-2 WAGES - 2.5% QUAL'D PROP.	\$15,000	\$10,000

- Married couple filing jointly
- Taxable income = \$375,000
- Sole shareholder of mfg S-corp
 - QBI = \$100,000
 - W-2 wages = \$20,000
 - Depreciables = \$400,000
- Sole proprietor of SSB
 - Net income = \$200,000
 - W-2 wages = \$50,000
 - Depreciables = zero

	MFG S-CORP	SOLE SSB
20% QUALIFIED BIZ INCOME	\$20,000	\$16,000
WAGE-BASIS LIMIT	\$15,000	\$10,000
EXCESS	\$5,000	\$6,000
CUTOFF	60%	60%
REDUCTION AMOUNT	\$3,000	\$3,600
DEDUCTION	\$17,000	\$12,400

§199A: What We Think We Know

• Wealthiest taxpayers still expected to be biggest winners, despite the

taxable income zones

Table 3Distribution of Tax Benefit for Pass-Through Deduction				
Under Section 199A				

Income Category [1]	2018		2024		
Thomas Garages (1)	Returns (Millions)	\$ Billions	Returns (Millions)	\$ Billions	
Less than \$10,000	[2]	[3]	[2]	[3]	
\$10,000 to \$20,000	0.5	-\$0.1	0.6	-\$0.1	
\$20,000 to \$30,000	0.7	-\$0.2	0.7	-\$0.2	
\$30,000 to \$40,000	0.8	-\$0.2	0.8	-\$0.3	
\$40,000 to \$50,000	0.9	-\$0.3	1.0	-\$0.4	
\$50,000 to \$75,000	2.5	-\$1.0	2.6	-\$1.3	
\$75,000 to \$100,000	2.5	-\$1.2	2.6	-\$1.5	
\$100,000 to \$200,000	6.2	-\$6.3	6.5	-\$8.0	
\$200,000 to \$500,000	3.0	-\$9.4	3.2	-\$11.6	
\$500,000 to \$1,000,000	0.2	-\$3.6	0.3	-\$5.3	
\$1,000,000 and over	0.2	-\$17.8	0.2	-\$31.6	
Total, All Taxpayers	17.4	-\$40.2	18.4	-\$60.3	
(1) The income concept used to place toy get use into income categories is adjusted once income (AGI) plus:					

[1] The income concept used to place taxretums into income categories is adjusted gross income (AGI) plus: (f) tax-exempt interest, (g) employer contributions for health plans and life insurance, (g) employer share of PICA tax, (4) worker's compensation, (5) nontasable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (6) individual share of business taxes, and (9) excluded income of U.S. oitzens living abroad. Categories are measured at 2018 levels.

[2] Less than 50,000.

[3] Less than \$50 million.

Source: Joint Committee on Taxation staff estimate:

§199A: What We Think We Know

- Wealthiest taxpayers still expected to be biggest winners, despite the taxable income zones
- A taxpayer may take into account W-2 wages paid by another entity provided that the wages were paid to the taxpayer's employees as compensation for work performed for the taxpayer
- The wage-basis limitation appears to benefit sole-shareholder S corporations over sole proprietorships

§199A: What We Think We Know

	S-CORP SH	PROPRIETOR
QUALIFIED BIZ INCOME	\$375,000	\$500,000
WAGES	\$125,000	
TAXABLE INCOME	\$500,000	\$500,000
20% QUAL'D BIZ INCOME	\$75,000	\$100,000
50% W-2 WAGES	\$62,500	
25% W-2 WAGES + 2.5% DEPRECIABLES	\$33,750	
DEDUCTION	\$62,500	

§199A: What We Think We Know

- Wealthiest taxpayers still expected to be biggest winners, despite the taxable income zones
- A taxpayer may take into account W-2 wages paid by another entity provided that the wages were paid to the taxpayer's employees as compensation for work performed for the taxpayer
- The wage-basis limitation appears to benefit sole-shareholder S corporations over sole proprietorships
- A specified service business acquiring a nonspecified service business in order to avoid the limitations on specified service businesses likely will not work

§199A: What We Think We Know

 Workers want to be independent contractors; employers want them to be W-2 employees

§199A: What We Don't Know

- Does ordinary income from the sale of partnership and LLC interests constitute qualified business income?
- Is a rental activity a "trade or business" eligible for the deduction?
- How strictly will the specified services be construed?
 - Is a movie makeup artist in the "performing arts?"
 - What other businesses have reputation/skill as the principal asset?
- Are 1231 gains included in determining qualified business income?
- Do improvements to depreciable property count?

§199A: Planning Ideas

- Amend partnership agreement provisions regarding guaranteed payments
- Use portfolio income to pay down mortgages in real estate activities so as to increase the §199A deductions from those businesses
- Reduce taxable income through larger pension contributions
- Have S corporations pay 28.5714% of pre-wages profits as W-2 wages

§199A: Planning Ideas

Pre-wage profits: \$1,000,000

Wages (28.5714%): (\$285,714)

Qualified Biz Income: \$714,286

X 20%

Initial Deduction: \$142,857

50% W-2 wages: \$142,857

Chapter 3—Understanding the Deduction for Qualified Business Income

Chapter 4

Contemporary Estate Planning Paradigms for Married Couples—Presentation Slides

Professor Samuel Donaldson Georgia State University Atlanta, Georgia

Chapter 4—Contemporary Estate Planning Paradigms for Married Couples—	-Presentation Slides

Contemporary Estate Planning Paradigms for Married Couples

SAMUEL A. DONALDSON

GEORGIA STATE UNIVERSITY COLLEGE OF LAW

ATLANTA, GEORGIA

Wealth Transfer Tax Changes – 2017 TCJA



"I think not having the estate tax recognizes the people that are investing, as opposed to those that are just spending every darn penny they have, whether it's on booze or women or movies." - Iowa Sen. Chuck Grassley, December 2, 2017

- Increase basic exclusion amount to \$10 million, adjusted for post-2011 inflation, starting in 2018
- Retain complete step-up in basis for property acquired from a decedent
- Revert to \$5 million exclusion, adjusted for post-2011 inflation, starting in 2026
- Estimated 10-year revenue cost from "doubling" the exclusion = \$83 billion

PLANNING PARADIGMS FOR MARRIED COUPLES



BUCKET ONE
Up to \$11.18 million



BUCKET TWO \$11.18 - \$22.36 million



BUCKET THREE \$22.36+ million

PLANNING PARADIGMS FOR MARRIED COUPLES



BUCKET ONEUp to \$11.18 million

- TRUST OR NO TRUST?
- STEPPED-UP BASIS FOR EVERYTHING
 - Outright gift
 - Trust with general power of appointment
 - QTIP trust
- PROTECTIVE PORTABILITY ELECTION

PLANNING PARADIGMS FOR MARRIED COUPLES



BUCKET TWO \$11.18 – 22.36 million

- TRUST OR NO TRUST?
- If NO TRUST (outright gift)
 - All to surviving spouse
 - Disclaimed amounts pass to credit shelter trust
- If TRUST
 - Clayton QTIP
 - Unelected amounts pour into credit shelter trust

PLANNING PARADIGMS FOR MARRIED COUPLES



BUCKET THREE \$22.36+ million

- KEEP CALM AND CARRY ON
 - Valuation discount planning
 - Charitable planning
- BUSINESS SUCCESSION PLANNING FOR PASS-THROUGH ENTITIES

Chapter 4—Contemporary Estate Planning Paradigms for Married Couples—	-Presentation Slides

Chapter 5

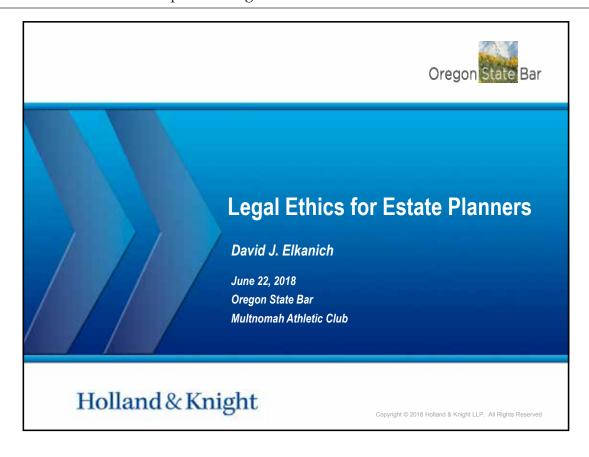
Legal Ethics for Estate Planners

David Elkanich Holland & Knight LLP Portland, Oregon

Contents

Presentation Slides	5–1
Formal Opinion No 2018-194—Conflicts of Interest, Current Clients: Representing Husband	
and Wife in Preparation of Estate Plan Involving Waiver of Elective Share 5-	-17

Chapter 5—Legal Ethics for Estate Planners



Overview – Nuts & Bolts

- » Risk management
- » Client intake and identification
- » Confidentiality
- » Conflicts of interest
- » Ethics Opinion and New Cases Updates
- » Questions

Holland & Knight

Risk Management and Client Intake

Holland & Knight

Now Do We Defend Ourselves? **Science **Occional Science** **Docket** **Docket**

Acting Competently – RPC 1.1

» A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.

Holland & Knight

5

Risk Management / Rocket Science

- » Clients:
 - Intake & red flags
 - Expectations
 - Subject matter
- » Lawyers:
 - Too busy bandwidth?
 - Not well organized
 - Outside practice area
 - Not evaluating (or re-evaluating) conflicts
- » Firm:
 - Work together firm needs to know what you are doing
 - Trust/respect within firm

Holland & Knight

О

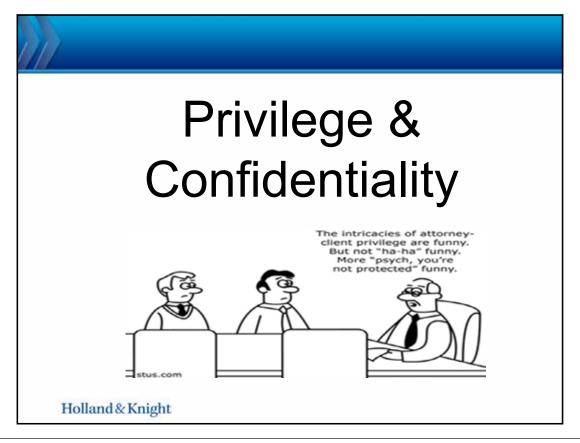
Identifying (Potentially) Bad Clients The Shopper Mr. Great Expectations The Missionary Lawsuit of the Month Club Member Dr. Strange Client The Penny Pincher Ms. Eleventh Hour The Dirtball Holland & Knight

Avoiding Risky and Red Flag Clients

- » Conflict systems that work
 - Identifying all the constituents forces the client to have thorough conversations at intake
- » New matter review by someone other than the lead lawyer
 - Management, committee, practice group leader, mentor, partner...anyone
- » Manage clear expectations with the client
 - Use engagement letters
 - Define scope of engagement in the fee agreement
 - Retainers are key risk management tools if the client doesn't write the first check you can be assured they will not write the last check.
 - Communication expectations for both the law firm and the client
- » Highest risk should receive highest level of scrutiny
 - Matters involving investors
 - Matters involving passion

Holland & Knight





Exploring the A/C Privilege

- » The A/C privilege Evidence NOT Ethics
- » Five elements:
 - Client
 - Lawyer
 - Communication
 - Confidential
 - Purposes of receiving legal advice
- » Test: Can any privilege question be answered with this five questions?

Holland & Knight

What Is and Is Not Privileged?

Yes

- » Oral and written communications with client
- » Memorialization of communications
- » Communications for purpose of retaining counsel
- » Communications with paralegals/staff

No

- » Underlying facts of the case
- » Communications where client is not seeking advice
- » Communications to (or in the presence of) third parties
- » Advice that aids in commission of crime
- » Non-privileged documents previously created and sent to lawyer

Holland & Knight

Loosing Privilege in 15 Seconds

- » Copying 3d party on an email (and bcc)
- » "Reply to all"
- » Forwarding attorney emails
- » Not confirming identity of caller/writer
- » Social media and "real" social settings
- » Remember: The A/C privilege belongs to the <u>client</u> not the lawyer.

Holland & Knight

Exploring Confidentiality

- » Duty of Confidentiality RPC 1.6(a) & (c)
 - Relates to "information relating to the representation of a client.
 - Make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client

Holland & Knight

The "Mays" in Confidentiality

- » The "Mays" in Oregon
 - 1. To disclose intent to commit a crime
 - 2. To prevent reasonably certain death or substantial bodily harm
 - 3. To secure legal advice
 - 4. To establish a claim or defense
 - 5. To comply with other law or court order
 - 6. To detect conflicts when moving firms.
- » Washington: has one shall to prevent reasonably certain death or substantial bodily harm

Holland & Knight

Work Product – It's a <u>Doctrine</u> not a Privilege...

- » Protects from discovery documents or material things prepared:
 - In anticipation of litigation or for trial; and
 - By or for a party or by or for a party's representative
- » Covers materials prepared <u>by anyone</u> at the direction of attorney where future litigation was distinct possibility – including:
 - Attorney's paralegals and support staff
 - Consultants/investigators/experts engaged by attorney
 - Client acting at attorney's direction
- » Disclosure? Only with substantial need, no other access and undue hardship

Holland & Knight

Tips to Preserve Confidentiality When Using Experts

- » An attorney should advise clients and discuss whether to hire a consultant with the attorney <u>before</u> actually hiring the consultant.
- » To preserve privilege, the lawyer should engage the consultant to assist the lawyer in formulating legal advice.
- » To preserve the ability to argue that a report was prepared "in anticipation of litigation" the report should be prepared under the direction and control of an attorney.

Holland & Knight

Conflicts "So, I'm the only one who sees a conflict of interest here?" Holland & Knight

- » Oregon RPC 1.7(a): Current client conflict of interest if:
 - (1) the representation of one client will be directly adverse to another client;
 - (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer; * * *
- » Oregon RPC 1.7(b): notwithstanding the conflict, you may go forth if:
 - (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
 - * * *
 - (3) the representation does not obligate the lawyer to contend for something on behalf of one client that the lawyer has a duty to oppose on behalf of another client; and
 - (4) each affected client gives informed consent, confirmed in writing.

Holland & Knight

19

- » American Collect of Trust and Estate Counsel Commentaries 1.7:
 - A lawyer who is asked to represent multiple clients regarding related matters
 must consider at the outset whether the representation involves or may involve
 impermissible conflicts, including ones that affect the interests of third parties
 or the lawyer's own interests.
- » To consider joint representation, at a minimum:
 - Confirm clients' interest appear consistent and not likely to diverge
 - Have an open discussion with all clients re pros/cons of the representation
 - Discuss confidentiality/privilege issues
 - Obtain effective conflicts waivers

Holland & Knight

Examples of Nonwaivable Conflicts

- » Fixed sum game more for one / less for the other
 - Buyer/seller or lender/borrower in same transaction
 - Rep bk debtor and debtor's secured creditor
 - Two criminal defendants offered inconsistent deals
 - Divorcing spouses
- » Extreme unreasonableness conflicts
- » Informed consent issues
 - Lacks capacity
 - Can't disclose enough info to gain informed consent

Holland & Knight

21

- 1. Make it informed:
- Communicate adequate information and explanation about material risks of and reasonably available alternatives to the proposed course of conduct.
- 2. When it must be confirmed in writing or in writing signed by client:
- Recommend the client seek independent legal advice to determine if consent should be given.
- They don't have to but it is up to them.
- 3. When and how?
- Spell things out, put it in writing, get signatures where you can.
- Clearly identify the consents being sought
- Clearly identify why the client should care
- Obtain or transmit within "reasonable time"

Holland & Knight

OSB Ethics Op 2018-194

- » Married Couple approaches Lawyer jointly and asks Lawyer to represent both of them in the matters described below. Married Couple have been married for 15 years and both have children from their previous marriages. They have no children from their current marriage. Married Couple own their house as tenants by the entirety, but have kept the majority of their assets separate.
- » Spouse A has substantially more assets than Spouse B. They inform Lawyer that it is their individual intent that they would prefer that their estate plans provide that their separate assets be distributed to their children by their previous marriages and their jointly owned assets pass to the surviving spouse by right of survivorship. Because of the value of Spouse A's separate property, it is clear to Lawyer that Spouse B would have an elective share claim if Spouse A were to die first. An elective share claim would defeat Married Couple's current intentions for their estate plan. Married Couple do not have a prenuptial agreement.

Holland & Knight

23

- 1. May Lawyer provide information to Married Couple as to their respective elective share rights under ORS 114.600 to 114.725? [yes]
- » Providing general information about the elective share does not create a significant risk that Lawyer's responsibility to one client will be materially impaired by his responsibilities to the other.
- » Each spouse has a fiduciary obligation to the other requiring full disclosure and fairness.
- » Providing information about the elective share and its waiver to both spouses is consistent with each spouse's duty to each other

Holland & Knight

- 2. May Lawyer advise both Spouse A and Spouse B as to whether they should waive their elective share rights as provided in ORS 114.620(1)? [no, qualified]
- » Spouses often seek joint representation in estate planning and have aligned interest for such purposes.
- » But not always. See OSB Ethics Op 2005-86: "spouses with children by prior marriages may have very different opinions concerning how their estates should be divided.":
- » See In re Plinski, 16 DB Rptr 114 (2002): reprimand for representing both spouses, whose interests were adverse; they had children from prior marriages, their respective estates were of different values, they had ongoing financial disagreements, and one spouse was, for reasons of health and disposition, likely susceptible to pressure from the other.

Holland & Knight

25

- » An agreement to waive the elective share presents conflicting interests.
- » Could have an RPC 1.7(a)(2) material limitation conflict because the lawyer may not be able to provide competent and diligent legal advice. E.g.,
 - Contemplates spouses may leave majority of estate to other but one spouse may really want to provide for other children
 - May be potential imbalance between estates right may be more important to one than the other.
 - One spouse may be more sophisticated, better health, more likely to benefit.
 - May require renegotiation of prenuptial agreement

Holland & Knight

- » Can you waive? "Perilous" to do so.
- » In re Jans: "[i]t is never proper for a lawyer to represent clients with conflicting interests no matter how carefully and thoroughly the lawyer discloses the possible effect and obtains consent."
- » Confidentiality limits ability to explore concerns of waiver.
- » Other spouse may be impacted as well if elective share waiver found later to be invalid.
- » <u>But what if</u>: the elective share appears unlikely to substantially affect the estate plan, the spouses do not have children from prior marriages, their separate assets are similar in value, they are both highly sophisticated and unlikely to be susceptible to pressure, and they are similarly positioned with respect to life expectancy?

Holland & Knight

27

- 3. May Lawyer prepare an agreement to mutually waive the elective share rights of Married Couple? [no, qualified]
- » If nonwaivable conflict exists with respect to the representation, also exists with respect to drafting the waiver of the elective share.
- » Consider Matter of Marriage of Eltzroth, 67 Or App 520 (1984) lawyer "acted only as a scrivener" and "did not provide independent advice to either party." Court said:
 - We do not condone the conduct of the attorney in continuing to represent both parties in this case. Canon 5 of the Oregon Code of Professional Responsibility allows an attorney to represent co-petitioners in a divorce action only in very limited circumstances. See Legal Ethics Opinion No. 218. When the proposed "agreement" between the parties presents obvious inequities on its face and raises questions and conflicts over the disposition of a substantial marital asset, it is the clear duty of the attorney to withdraw and advise the parties to seek independent counsel.

Holland & Knight

4. After Spouse A and Spouse B have executed an agreement to waive the elective share, may Lawyer advise Married Couple concerning their estate plan?

Yes – absent other circumstances that would create a conflict of interest under RPC 1.7

Holland & Knight

29

Other Update on Recent Cases

- » In re Webb Trust account / disbarment.
- » In re Klemp 2 issues:
 - 1. Whether lawyer failed to protect client's interests upon terminating her representation by refusing to surrender documents belonging to the client until her fees were paid. (See RPC 1.16(d))
 - Do have a right to assert a lien under ORS 87.430 based on a quantum meruit theory.
 - Whether in taking certain actions, lawyer assisted 3d party from diverting money from his incapacitated wife's trust account (RPC 1.2(c), RPC 4.1(b), RPC 8.4(a)(3), RPC 4.3).
 - No but did commit 4.3 violation.
 - Disbarment to public reprimand.

Holland & Knight

- » In re McGraw (April 2018) lawyer appointed as conservator. Alleged:
- » 1. A violation of RPC 1.5(a) (charging excessive fees) when he charged the conservatorship estate fees for fiduciary services at the higher attorney-fee rate and when he charged for unrelated actions.
- » 2. A violation of RPC 3.1 for knowingly advancing meritless positions, when he threatened protected person's spouse and tried to become that person's conservator.
- » 3. A violation of RPC 4.4(a) when the lawyer sent letters to the friends of the protected person's husband seeking support for his proposals to be appointed conservator over the husband and to have husband removed as his wife's guardian (among other actions).
- » 4. Catchall RPC 8.4(a)(4) violation.

Holland & Knight

31



» David Elkanich is a partner in Holland & Knight's Portland office, where he focuses his practice on litigation, with an emphasis on legal ethics and risk management. Mr. Elkanich advises both lawyers and law firms in a wide range of professional responsibility matters. He has extensive experience defending lawyers in attorney discipline matters, and in related litigation, such as sanction, withdrawal and disqualification motions, and fee disputes.

» Telephone: 503.517.2928

» Email: david.elkanich@hklaw.com

» Twitter: @DavidElkanich» Website: hklaw.com

Holland & Knight

FORMAL OPINION NO 2018-194

Conflicts of Interest, Current Clients: Representing Husband and Wife in Preparation of Estate Plan Involving Waiver of Elective Share

Facts:

Married Couple approaches Lawyer jointly and asks Lawyer to represent both of them in the matters described below.

Married Couple have been married for 15 years and both have children from their previous marriages. They have no children from their current marriage.

Married Couple own their house as tenants by the entirety, but have kept the majority of their assets separate. Spouse A has substantially more assets than Spouse B. They inform Lawyer that it is their individual intent that they would prefer that their estate plans provide that their separate assets be distributed to their children by their previous marriages and their jointly owned assets pass to the surviving spouse by right of survivorship.

Because of the value of Spouse A's separate property, it is clear to Lawyer that Spouse B would have an elective share claim if Spouse A were to die first. An elective share claim would defeat Married Couple's current intentions for their estate plan.

Married Couple do not have a prenuptial agreement.

Questions:

- 1. May Lawyer provide information to Married Couple as to their respective elective share rights under ORS 114.600 to 114.725?
- 2. May Lawyer advise both Spouse A and Spouse B as to whether they should waive their elective share rights as provided in ORS 114.620(1)?
- 3. May Lawyer prepare an agreement to mutually waive the elective share rights of Married Couple?

4. After Spouse *A* and Spouse *B* have executed an agreement to waive the elective share, may Lawyer advise Married Couple concerning their estate plan?

Conclusions:

- 1. Yes.
- 2. No, qualified.
- 3. No, qualified.
- 4. Yes.

Discussion:

Oregon RPC 1.7 provides:

- (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a current conflict of interest. A current conflict of interest exists if:
- (1) the representation of one client will be directly adverse to another client;
- (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer; or
- (3) the lawyer is related to another lawyer, as parent, child, sibling, spouse or domestic partner, in a matter adverse to a person whom the lawyer knows is represented by the other lawyer in the same matter.
- (b) Notwithstanding the existence of a current conflict of interest under paragraph (a), a lawyer may represent a client if:
- (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
- (2) the representation is not prohibited by law;
- (3) the representation does not obligate the lawyer to contend for something on behalf of one client that the lawyer has a duty to oppose on behalf of another client; and
- (4) each affected client gives informed consent, confirmed in writing.

1. Lawyer May Provide Information about the Elective Share and Its Potential Waiver to Both Spouses.

Under Oregon's elective share statute, a surviving spouse may elect to receive a percentage share of the decedent's estate according to a formula based on the length of the marriage. ORS 114.605. Absent a waiver of that right, the elective share will override a contrary provision in the decedent's will. ORS 114.605. However, that legal right can be waived. Under ORS 114.620, a spouse may enter into a written agreement, before or after the marriage, to waive his or her elective share. Such agreement to waive the elective share is a type of prenuptial or postnuptial agreement. *In re Estate of Richard B. Wilber*, 165 NH 246, 75 A3d 1096, 1099 (2013).

Providing general information about the elective share does not create a significant risk that Lawyer's responsibility to one client will be materially impaired by his responsibilities to the other. Each spouse has a fiduciary obligation to the other requiring full disclosure and fairness. Day v. Vitus, 102 Or App 97, 792 P2d 1240, rev den, 310 Or 281 (1990); Matter of Marriage of Eltzroth, 67 Or App 520, 526, 679 P2d 1369 (1984); Bauer v. Bauer, 1 Or App 504, 464 P2d 710 (1970). Providing information about the elective share and its waiver to both spouses is consistent with each spouse's duty to each other. Therefore, it does not create a significant risk of impairing Lawyer's obligation to either spouse for Lawyer to provide such information to both spouses.

2. Advice to Waive Elective Share Presents a Current-Client Conflict Of Interest.

Spouses often seek joint representation in estate planning. Typically, the interests of the spouses will be aligned for such purposes. However, there are exceptions in which simultaneous representation would be prohibited. OSB Formal Ethics Op No 2005-86. For example, "spouses with children by prior marriages may have very different opinions concerning how their estates should be divided." OSB Formal Ethics Op No 2005-86. Thus, an attorney was reprimanded for representing both spouses in revising their estate plans in *In re Plinski*, 16 DB Rptr 114 (2002). In that case, the spouses' interests were adverse because

they had children from prior marriages, their respective estates were of different values, they had ongoing financial disagreements, and one spouse was, for reasons of health and disposition, likely susceptible to pressure from the other. *In re Plinski*, 16 DB Rptr 114.

An agreement to waive the elective share presents such conflicting interests. As with any prenuptial or postnuptial agreement, it requires one or both spouses to give up potentially valuable legal rights. Such agreement may be particularly fraught with issues that could impair a lawyer's ability to provide competent and diligent representation to both spouses. By definition, it contemplates that the spouses might leave the majority of their estates to others. One or both spouses may wish to provide for children from another marriage. There may be a potential imbalance between the spouses' respective estates, such that the right to an elective share could be more important to one spouse than the other. One spouse may be more sophisticated than the other; one may be in better health and more likely to benefit from the elective share. Waiver elective shares might even require renegotiation of the terms of a prenuptial agreement. Any of those factors creates "a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client." Oregon RPC 1.7(a)(2).

Some conflicts may be waivable with informed consent confirmed in writing. Oregon RPC 1.7(b)(1) allows such waiver if "the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client." Comment 15 to ABA Model RPC 1.7 notes that "[c]onsentability is typically determined by considering whether the interests of the clients will be adequately protected if the clients are permitted to give their informed consent to representation burdened by a conflict of interest." The *Restatement (Third)* of the Law Governing Lawyers § 122, comment g(iv), explains:

The general standard . . . assesses the likelihood that the lawyer will, following consent, be able to provide adequate representation to the clients. The standard includes the requirements both that the consented-to conflict not adversely affect the lawyer's relationship with either client and that it not adversely affect the representation of either client. In general, if a reasonable and disinterested lawyer would conclude

that one or more of the affected clients could not consent to the conflicted representation because the representation would likely fall short in either respect, the conflict is nonconsentable.

Were Lawyer to represent both spouses with respect to an agreement to waive the elective share, Lawyer would be literally representing both sides of an agreement likely to benefit one client more than the other. Such conflict may be waivable in limited circumstances, but it is perilous. The Oregon Supreme Court observed, in a case where an attorney drafted an employment contract while representing both the employer and the employee, that "[i]t is never proper for a lawyer to represent clients with conflicting interests no matter how carefully and thoroughly the lawyer discloses the possible effect and obtains consent." *In re Jans*, 295 Or 289, 295, 666 P2d 830 (1983). The court explained:

"It is of the utmost importance that the attorney representing both parties to a transaction reflect upon the rationales behind conflict of interest proscriptions. It is not sufficient that the attorney believes himself able adequately to represent potentially differing interests, or even that all parties have consented. The possibility of subconsciously favoring the interests of either party, the appearance of impropriety that may arise from even the slightest dissatisfaction, the likelihood of receiving confidential information from one party that is damaging or helpful to the other, and the possibility that a court will subsequently disagree with the attorney's decision that he was able adequately to represent both interests—all dictate extreme caution in these situations.

The temptation to represent potentially conflicting interests is particularly difficult to resist in family disputes. Often the attorney is the 'family lawyer' and has represented husband, wife, and even the children on previous occasions. . . . If the parties have not clearly understood the lawyer's ethical responsibilities *ab initio*, the ensuing rancor may be directed toward him."

In re Jans, 295 Or at 295 n 7 (quoting Robert Aronson, Conflict of Interest, 52 Wash L Rev 807, 826–27 (1977)); see also In re Robertson, 290 Or 639, 648, 624 P2d 603 (1981) (lawyer is disciplined for representing both buyer and seller of real property).

Comment 30 to ABA Model RPC 1.7 notes that "[a] particularly important factor in determining the appropriateness of common representation is the effect on client-lawyer confidentiality." Attorney-client privilege is typically waived among clients who are jointly represented. OEC 503(4)(e). Such lack of confidentiality may make it difficult for Lawyer to explore whether one spouse has concerns about waiving the elective share, since that spouse may be reluctant to fully share those concerns with the other spouse. That, in turn, impairs Lawyer's ability to fully advise each spouse.

In addition to potentially impairing the lawyer's ability to represent the spouse who might object to waiving the elective share, the conflict also creates risk for the other spouse. A spouse may make certain estate planning decisions based on what he or she believes to be other spouse's waiver of the elective share. A later finding that the waiver was invalid, due to the attorney's conflictive representation, would likely frustrate the decedent's estate plan that counted on that waiver of elective share.

Under the facts as presented here, the conflict is very likely to be nonconsentable. The facts listed are likely to impair Lawyer's ability to give complete, competent, and diligent advice to both spouses as to waiver of the elective share. In particular, the existence of children from previous marriages and the imbalance between the spouses' separate estates heightens their need for thorough and independent advice. One may reasonably expect Lawyer's ability to render such advice to be impaired by Lawyer's duties to the other spouse.

There may be other circumstances in which a lawyer could reasonably believe that he or she could provide competent and diligent representations to both parties to an agreement to waive the elective share. That is more likely if the elective share appears unlikely to substantially affect the estate plan, the spouses do not have children from

It is not always clear, at the time an estate plan is created, whether a devise is likely to be more or less than the elective share. The value of the estate and the devise may be changed by fluctuating values of joint and separate assets, unforeseen expenses, and other inheritances or gifts. Additionally, the statutory percentage of the elective share changes with the length of the marriage.

prior marriages, their separate assets are similar in value, they are both highly sophisticated and unlikely to be susceptible to pressure, and they are similarly positioned with respect to life expectancy. *See In re Plinski*, 16 DB Rptr 114 (2002). Additionally, OSB Formal Ethics Opinion No 2005-86 sets forth a list of factors that, in rare circumstances, might allow for joint representation during a divorce. Although that opinion addressed different circumstances, some of the listed factors may be applicable here, including:

- (3) The marital estate must not contain substantial assets or liabilities;
- (4) The parties must have fully agreed on the disposition of all assets and liabilities [or, here, waiver of the elective share] before consulting the lawyer;
- (5) The lawyer must be in a position to conclude that each party has provided full disclosure of all assets . . .

To sum up, the more important the elective share appears to be to either spouse, the less likely the conflict is to be waivable, and vice versa.

A lawyer weighing the totality of these factors might reasonably believe that he or she could competently and diligently represent both spouses with respect to an agreement to waive the elective share. Even in a case in which the conflict is waivable, the lawyer would still be required to obtain both clients' informed consent pursuant to Oregon RPC 1.7(b).

3. Preparation of Agreement Waiving Elective Share.

The same analysis applies with respect to preparing the agreement to waive the elective share. Once Lawyer has undertaken to represent both spouses with respect to estate planning, there is a conflict if he represents either spouse with respect to drafting an agreement to waive the elective share. For example, an attorney drafted a property settlement on behalf of divorcing spouses in *Matter of Marriage of Eltzroth*, 67 Or App 520. The lawyer "acted only as a scrivener" and "did not provide independent advice to either party." *Matter of Marriage of Eltzroth*, 67 Or App at 526. Nonetheless, the court of appeals noted that it did "not con-

done the conduct of the attorney in continuing to represent both parties" to the agreement. *Matter of Marriage of Eltzaroth*, 67 Or App at 526 n 7.

This conflict may be avoided if Lawyer has not yet undertaken representation of one of the spouses with respect to estate planning. As attorney for only one of the spouses, Lawyer may prepare an agreement mutually waiving the elective share on behalf of the spouse that Lawyer represents. It is not mandatory that both parties to a prenuptial or post-nuptial agreement be represented by counsel, although that is a factor in determining whether such agreement is enforceable. *Matter of Marriage of Leathers*, 98 Or App 152, 779 P2d 619 (1989), *rev den*, 309 Or 625 (1990).

4. Advice Concerning Estate Plan after Execution of Agreement to Waive Elective Share.

Once the issue of waiver of the elective share has been eliminated by execution of an agreement, Lawyer may represent Spouse *A* and Spouse *B* in preparation of their estate planning, absent other circumstances that would create a conflict of interest under Oregon RPC 1.7.

Approved by the Board of Governors, March 2018.

COMMENT: For additional information on this general topic and other related subjects, see *The Ethical Oregon Lawyer* chapter 9 (economic and personal conflicts), chapter 10 (multiple-client conflicts) (OSB Legal Pubs 2015); and *Restatement (Third) of the Law Governing Lawyers* chapter 8 (conflicts of interest) (2000).

Chapter 5—Legal Ethics for Estate Planners					

Chapter 5—Legal Ethics for Estate Planners					

Chapter 6

Transfer Tax Considerations Under the 2017 Tax Act—Presentation Slides

Brent Berselli Holland & Knight LLP Portland, Oregon

C	Chapter 6—	-Transfer Tax	(Considerati	ions Under t	he 2017 Tax	Act—Presen	tation Slides	8



General Perspectives on the 2017 Act

- The new tax act represents the most significant changes to U.S. tax policy in more than 30 years.
- Originally titled the Tax Cuts and Jobs Act, the legislation's name was changed to comply with the Senate's reconciliation rules, and it is now commonly known as the 2017 Tax Act.
- The Act was passed in the Senate along party lines and did not receive the required 60 vote supermajority required by the "Byrd Rule."
- Many of the Act's provisions including those relating to transfer tax consequences – sunset after 2025.
- A new administration could change the law in advance of the scheduled sunset date.

Holland & Knight

Impact on Transfer Tax Regime

- Amended IRC § 2010, doubling the basic exclusion amount from \$5,000,000 to \$10,000,000.
 - IRC § 2010(c)(3)(C), states: "In the case of estates of decedents dying or gifts made after December 31, 2017, and before January 1, 2026," subparagraph

 (A) identifying the basic exclusion amount as \$5,000,000 shall be applied by "substituting '\$10,000,000' for '\$5,000,000."
- Altered the IRC's inflation calculation, used to determine the annual increases in the basic exclusion amount, from the Consumer Price Index for All Urban Consumers (the "CPI") to the *Chained* Consumer Price Index for All Urban Consumers (the "Chained-CPI"). See IRC § 1(f).
- Amended IRC § 2001(g) and directed the Secretary of the Treasury ("Treasury") to issue regulations addressing the potential for "clawback" of lifetime gifts made between January 1, 2018 and December 31, 2026 where the decedent subsequently dies on or after January 1, 2026.
- Estate, gift, and generation-skipping transfer ("GST") tax rate remains at 40%.

Holland & Knight

- 3

Increased Basic Exlusion Amount

- Estate, gift, and GST basic exclusion amount increased to \$10 million, subject to inflation increases. See IRC § 2010(c)(3).
- Pursuant to Rev. Proc. 2018-18, basic exclusion amount for decedents dying in 2018 is \$11,180,000, or \$22,360,000 for married taxpayers.
- IRC § 2505(a) allows a credit against gift tax in an amount equal to:
 - (1) the applicable credit amount in effect under section 2010(c) which would apply if the donor died as of the end of the calendar year, reduced by
 - (2) the sum of the amounts allowable as a credit to the individual...for all preceding calendar periods.
- IRC § 2010(c)(3)'s adjustment from \$5,000,000 to \$10,000,000 correspondingly increases the lifetime gift tax exclusion, which is now \$11,180,000 for 2018.
- IRC § 2631(c) identifies the "GST exemption amount for any calendar year" to equal the "basic exclusion amount under section 2010(c) for such calendar year." Therefore, the GST exemption in 2018 is \$11,180,000.

Holland & Knight

Inflation Adjustments and the Increased Exemption

- Act changed the cost-of-living adjustment in IRC §1 from the CPI to Chained CPI.
- Chained CPI produces lower inflation than the CPI, as can be seen from the 2018 inflation-adjusted basic exemption amount increasing to \$11,180,000 (as opposed to \$11,200,000 if we merely doubled the 2017 exemption).
- "Since 2000, the primary CPI has risen by 45.7 percent and the chained CPI by only 39.7%, a difference of 6 percentage points." See Brookings Institution, The Hutchins Center Explains: The Chained CPI, December 7, 2017.
- CBO previously estimated that switching to the chained CPI "on a government-wide basis starting in calendar year 2014 would reduce the deficit by a total of \$340 billion over the next 10 years." See Congressional Budget Office, What Would Be the Effect on the Deficit of Using the Chained CPI to Index Benefit Programs and the Tax Code?, April 18, 2013.
- Use of Chained CPI intended to offset other provisions in the 2017 Act that will decrease revenue.

Holland & Knight

5

Clawback

- Potential for clawback arises due to the manner in which estate tax is calculated under IRC § 2001(b):
 - (1) Computing a tentative tax on (i) the decedent's taxable estate, plus (ii) "adjusted taxable gifts."
 - Adjusted taxable gifts are those made after 1976 that are not pulled back into the decedent's gross estate. See IRC § 2001(b).
 - (2) The "aggregate amount of tax which would have been payable" on gifts made after 1976 is subtracted from the tentative tax. See IRC § 2001(b)(2).
- Under IRC § 2001(g)(1), the rate in effect at death (not at time the gift was made) is used in calculating the tax.
- IRC § 2001(g)(1) is potentially problematic because it does not specify whether
 to use the applicable credit amount as of the date of the gift or the death of the
 taxpayer. If the applicable credit amount at the time of the gift is used, and the
 amount decreases at death (i.e., once the increased exemption amounts sunset
 after 2025), taxpayers could be subject to estate tax on gifts made during
 lifetime.

Holland & Knight

О

Example – Clawback Applies

Taxpayer makes a \$10,000,000 gift in 2025. Taxpayer dies in 2026 with a taxable estate of \$0. Basic exclusion amount in 2026 has reverted to \$5,000,000. Assuming a 40% estate tax rate, the computation would be:

Taxable Estate: \$0

Adjusted Taxable Gifts: \$10,000,000

Tentative Tax (40% on \$10,000,000): \$4,000,000

Gift Tax Payable (using \$10,000,000 BEA*): \$0

Estate Tax Before Credits: \$4,000,000
Applicable Credit Amount: (\$2,000,000)
Estate Tax \$2,000,000

Taxpayer's estate owes \$2,000,000 of estate tax on the \$10,000,000 gift, even though no gift tax was payable at the time the gift was made.

*BEA = Basic Exclusion Amount

Holland & Knight

7

Example – No Clawback

If, however, the \$5,000,000 basic exclusion amount is used, for estate tax purposes, to compute the gift tax payable, there is no clawback or net estate tax in this hypothetical:

Taxable Estate: \$0

 Adjusted Taxable Gifts:
 \$10,000,000

 Tentative Tax (40% on \$10,000,000):
 \$4,000,000

 Gift Tax Payable (using \$5,000,000 BEA*):
 (\$2,000,000)

 Estate Tax Before Credits:
 \$2,000,000

 Applicable Credit Amount:
 (\$2,000,000)

Estate Tax \$0

No estate tax on the \$10,000,000 gift because, without clawback, the estate holds a \$2,000,000 credit.

* BEA = Basic Exclusion Amount

Holland & Knight

ŏ

Congressional Clawback Solution

- Congress was certainly aware of the clawback issue when the 2017 Act was drafted.
- IRC § 2001(g)(2) directs the Treasury to enact regulations to address clawback:

Treasury is to prescribe "such regulations as may be necessary or appropriate to carry out this section with respect to any difference between –

- (A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and
- (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent."
- Congress could have addressed the clawback concern directly in the Act.
 - Likely, Congress neglected to do so instead deferring to Treasury to avoid a potential "extraneous" provision under the Byrd Rule.
 - Or simply insufficient time.

Holland & Knight

9

Is Clawback Coming?

- IRC § 2001(g)(2) could provide statutory authority for Treasury to pursue clawback once the increased exemption sunsets after 2025.
- · Treasury officials have already stated:

"if you have made a gift that was exempt when you made it, that should never increase your later gift tax or estate tax just because that exclusion no longer exists. That's the concept of the clawback; we're not going to double tax it."

See Tax Notes Today, Deductibility of Executor, Trustee Fees Under Review at IRS, February 12, 2018.

Holland & Knight

Should Potential For Clawback Delay Current Planning?

- Even if Treasury embraces clawback, use of the increased exemption still would provide some benefit.
- While the date-of-gift value of the transferred assets would not escape taxation, any post-gift appreciation and income generated by the gifted property would not be included.
- Thus, even assuming the worst possible interpretation by the Service of IRC §
 2001(g)(2), the taxpayer may still be better off making the full gift and taking
 advantage of the increased exemption.
- Assuming the donor of the gift also allocates GST exemption to a trust, that trust would remain GST exempt.

Holland & Knight

11

Portability Concerns

- "Portability" generally permits the surviving spouse to claim his or her deceased spouse's unused basic exclusion amount.
 - Portability does not apply to the GST basic exclusion amount.
 - Oregon does not have portability, and traditional Credit Shelter Trust planning remains highly relevant for Oregon estate tax purposes.
- IRC § 2010(c)(2) adds the deceased spousal unused exclusion ("DSUE") amount to the surviving spouse's basic exclusion amount.
- Similar to clawback concerns, portability of the increased exemption amount may not last beyond 2025 due to the mechanics of the estate tax calculation:
- DSUE is defined under IRC §2010(c)(4) as the lesser of:
 - (A) the basic exclusion amount, or
 - (B) the excess of:
 - (i) the applicable exclusion amount of the last such deceased spouse of such surviving spouse, over
 - (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.

Holland & Knight

Basis Planning

- 2017 Act did not change the step-up in basis for assets included in the decedent's estate.
- Taxpayers must weigh the use of the increased exemption in lifetime gifting strategies against the loss of a step-up in basis.
 - Particularly true for Oregon estate tax mitigation. Minimization of Oregon estate tax may be outweighed by subsequent capital gain tax on sale of a low-basis asset.
- Consider whether is feasible to gift high basis assets, while retaining low basis assets in the estate. The 2017 Act's sunset – and potential for early repeal – add difficulty to this calculation.
 - Potential for increased use of grantor trusts with a substitution power to swap assets of varying bases.
- Taxpayers who have previously used exemption to gift assets out of their taxable estate (i.e., to an irrevocable trust) may wish to consider strategies to bring those assets back into their estate.
- Use of grantor trusts with a power of substitution under IRC § 675(c)(4) may be
 useful in addressing potential basis concerns in making gifts to irrevocable trusts.

Holland & Knight

13

Upstream Basis Planning

- · "Upstream Basis Planning" will have a renewed importance.
- Available where there is an older family member with substantial remaining exemption but relatively few assets.
- Transfer must be made more than one year prior to the death of the older family member to avoid application of IRC § 1014(e), which may disallow the step-up in basis if the asset is inherited by the donor.
- IRC § 1014(e): In the case of a decedent dying after December 31, 1981, if
 - (A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and
 - (B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor),

the basis of such property in the hands of such *donor* (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.

Holland & Knight

Upstream Basis Planning To Effectuate Gift to Children

- Upstream basis planning requires donor to use his or her gift tax exemption.
- Outright gifts to parent are likely to be less common than use of an irrevocable trust that grants the parent a general power of appointment.
 - The general power of appointment will cause inclusion in the parent's estate under IRC § 1041, thereby permitting the step-up in basis.
 - Are we required to notify parent of the existence of the general power of appointment?
 - Can we draft for an adverse party that must approve parent's exercise of a general power?
- If parent fails to exercise general power of attorney, assets will continue in trust for the benefit of donor's children. This avoids the need for donor to use his or her GST exemption.
- Consider parent's personal finances. Is the parent subject to substantial creditor claims or otherwise a risk?
- Does this plan present a risk of a "step transaction" or "prearranged plan" argument that could cause the Service to deem the initial gift to be made directly to donor's children?

Holland & Knight

15

Upstream Basis Planning: GRATs

- After the 2017 Act, the determination of when GRATs are advisable will change.
 No doubt that a GRAT can still be beneficial, but the increased basic exclusion amount gives clients a host of additional, simpler options to consider.
- The increased basic exclusion amount will permit more straightforward one-time transfers to irrevocable trusts, simplifying the plan and eliminating the annuity payments coming back into the taxpayer's gross estate.
- GRATs in the context of upstream basis planning will be an interesting concept.
 - If the client does not wish to use his or her increased basic exclusion amount, a GRAT that directs its remainder interest to an upstream trust for the benefit of the client's parents may be attractive.
 - This strategy preserves the basic exclusion amount for other lifetime gift transactions.

Holland & Knight

Formula Funding Clauses

- Review the "formula funding clause" in light of the increase of the basic exclusion amount under IRC § 2010(c)(3)(C).
- Formula funded clauses are typically structured to retain in the credit shelter trust the "greatest amount that can pass free of federal estate tax." The balance often then passes to a marital trust or outright to a surviving spouse.
- If we take no action, significantly less assets will pass to the marital trust. The surviving spouse could then receive less than his or her mandatory statutory minimum share. This concern will be particularly acute in blended families.
- May create a significant incentive for the surviving spouse to take an elective share against the estate. Consider elective share planning directing any elective share claimed by surviving spouse to be held in a lifetime QTIP trust.
- Consider existing marital agreements in reviewing the formula funding clauses.
 Does an existing marital agreement preclude a surviving spouse from claiming an elective share? Does this then incentive the surviving spouse to challenge the validity of the estate plan?

Holland & Knight

17

How to Improve Formula Funding Clauses

- · Consider use of a "collar."
- Collar could set a "basket" for funding of the marital trust based on the independent testamentary wishes of the client.
- Consider establishing a "cap" to prevent overfunding of the marital trust if the exemption is ever lowered beyond 2017 levels (as Democrats have advocated) by diverting the additional funds to a non-exempt share of the Credit Shelter Trust
- Consider elective share provisions. Perhaps create a sub-trust to be funded if a surviving spouse claims an elective share. This provides some additional protection to a client that preserves his or her testamentary desires.
- For many of us, Oregon estate tax is now the primary consideration. Tie formula funding clause to Oregon exemption to fund Credit Shelter Trust or consider expanded use of disclaimer planning where survivor can disclaim to CST.
 - Disclaimer may provide more flexibility and allow the survivor to plan for how best to minimize total anticipated taxes, i.e. Oregon estate and capital gain.
 - Depending on the asset composition, surviving spouse may be wise to avoid disclaimer – and lose the deceased spouse's Oregon estate tax exemption – but receive a second step-up in basis at the survivor's death.

Holland & Knight

Late Allocations of GST Exemption

- Don't ignore GST exemption for even low or moderate wealth clients. Absent GST allocation, client trusts will be subject to GST tax at the death of the beneficiary, unless the trust assets are included in the beneficiary's gross estate.
- Pursuant to IRC § 2631(a), a taxpayer's GST exemption can be allocated to "any property with respect to which such individual is the transferor."
- An individual may be the "transferor" with respect to pre-2018 irrevocable trusts that have not received a GST allocation. Under IRC § 2631(a), GST exemption, including the increased amount available in 2018, can be allocated to these prior transfers.
 - Automatic allocation rules may already address such issues, but this should be confirmed.
- Taxpayers can make a late GST allocation on a timely filed Form 709 with respect to another transfer. See Treas. Reg. § 26.2632-1(b)(4)(ii)(A)(2). The late allocation is effective on the date of filing. See Treas. Reg. § 26.2632-1(b)(4)(ii)(A)(1).
- Where late allocations are made to trusts that have already been funded, no additional gift tax exemption would be used.

Holland & Knight

19

Installment Sales to Irrevocable Trusts

- The increased basic exclusion amount and withdrawal of the IRC § 2704 proposed regulations will likely increase the occurrence of sale and/or gift transactions to irrevocable trusts.
- Installment sales to grantor trusts have and will continue to be a popular mechanism in UHNW client estate plans. Consider impact of increased exemption on irrevocable trust sales.
 - Using a 10:1 debt-to-equity ratio, an additional \$10 million of exemption seed gift to an
 irrevocable trust could support an installment sale of \$100 million of assets to the trust.
- Clients may also wish to use their increased exemption to shore up the economics of existing note sale transactions to irrevocable trusts. May permit the removal of any trust beneficiary personal guarantees.
- In smaller note sale transactions, clients may consider additional gifts to the trust to enable it to repay the note, which reduces the risk of an IRC § 2036 argument for inclusion in the gross estate.
- Recommend incorporating a defined valve mechanism, as in Wandry v. Commissioner, TC Memo 2012-88, non-acq. 2012-46 IRB 543.

Holland & Knight

Access to Trust Assets

- Clients may be hesitant to use their increased exemptions by making transfers in trust if the client has no ability to access funds.
- Recall 2012 and those clients who later became disappointed in their "rush" to move assets out of their estates.
- · Options to consider:
 - Self-settled DAPTs established in a jurisdiction permitting such arrangements could permit the grantor to retain some degree of access to trust assets. See PLR 200944002.
 - Alternative to DAPT is to include provision in standard irrevocable trust permitting another person, acting in a non-fiduciary capacity, to add the grantor as a permissible beneficiary of the trust. Once the grantor is a beneficiary, consider use of a non-fiduciary, adverse party to approve discretionary distributions to the grantor. Or even provide that such distributions are made at the direction of the non-fiduciary.
 - Spousal lifetime access trusts ("SLATs").
 - Loans to the grantor. Consider desired grantor versus non-grantor trust status in drafting the loan provision.

Holland & Knight

21

Spousal Lifetime Access Trusts

- Consider non-reciprocal, grantor, dynastic, GST exempt, spousal lifetime access trusts ("SLATs").
- Actively plan for possible application of the reciprocal trust doctrine. With increasing exemptions and a larger portion of the estate potentially subject to SLATs, avoidance of the reciprocal trust doctrine is more complicated.
- The 2017 Act has given rise to significant commentary on so-called "SALTy SLATs," which are effectively non-grantor SLATs.
- SALTy SLAT commentary focuses on the use of such trusts to own real property for purpose of maximizing SALT deductions.
- Are SALTy SLATs worth the effort and expense?
 - Perhaps if you gift income-producing property to such trusts in addition to the real property, as the trust would need income in any event to pay property taxes and receive the SALT deduction.
 - Even still, what is the annual benefit of receiving an additional \$10,000 SALT deduction spread across several trusts in light of the initial planning and ongoing maintenance expenses.
 - Also consider IRC §121 home sale exclusion, which would not be available for a primary residence sold out of a SALTy SLAT.

Holland & Knight

Life Insurance Planning

- "Do I really need this life insurance now? What about this insurance trust? We're tired of sending these letters every year."
- · Insurance professional should review policy performance.
- Consider alternate use for life insurance if there is now a less pressing need for estate liquidity.
- · ILIT considerations:
 - Do nothing.
 - Use increased basic exemption amount to gift sufficient assets (perhaps income producing property) to ILIT so that the trust pays future premiums without the need for Crummey notices and/or future annual exclusion gifts.
 - Terminate policy and distribute cash value to trust beneficiaries, or hold cash value for administration under the trust.
 - Sell policy into the secondary life market and reinvest the proceeds for administration under the trust.
- Consider using increased gift exclusion to roll out of existing split-dollar arrangement, such as in terminating a prohibitively expensive economic benefit split-dollar arrangement.

Holland & Knight

23

Existing Durable Powers of Attorney

- · Review existing powers of attorney.
- Are the gift provisions still appropriate? Expand or eliminate gifting authority?
- If creating new trusts that will receive lifetime gifts, consider specifically referencing those trusts in a new power of attorney.
- Proper power of attorney planning is particularly important if clients do not wish to
 use increased exclusion amounts now but want flexibility for their attorney-in-fact
 to do so if they become incapacitated.

Holland & Knight

Key Charitable Planning Provisions in 2017 Act

- · Provisions Impacting Charitable Planning
 - Lower income tax rates for most brackets (and fewer brackets overall), with a top marginal rate of 37%
 - Increased standard deduction for most taxpayers, but reduction of itemized deductions including mortgage interest and SALT.
 - Increased percentage limitation for gifts of cash to public charities and certain foundations from 50% to 60% of AGI
 - Repeal of the so-called "Pease" limitation (which generally only affected high-income earners)

Holland & Knight

25

Key Charitable Planning Provisions in 2017 Act (cont'd)

- ESBTs could previously claim an unlimited charitable deduction (but no carryforward).
- 2017 Act subjects ESBTs to the same rules governing individual taxpayers, such as percentage limitations and carry-forward. See IRC § 641(c)(2)(E).
- AGI computed in same manner as individuals for percentage limitation purposes.
 See IRC § 170(b)(1)(G).
- An important distinction is that the 2017 Act permits ESBTs to claim deductions for administration that would not be permitted to individual taxpayers. See IRC § 641(c)(2)(E)(ii).

Holland & Knight

Deductible Charitable Contribution Limitations

- Higher percentage limitations for gifts to public charities and certain foundations.
- Percentage limitations based on type of asset contributed and classification of charitable organization:
 - Cash to public charities and certain foundations: 60% of AGI
 - Long-term capital gain property to public charities and certain foundations: 30% of AGI
 - · Cash to private foundations: 30% of AGI
 - Long-term capital gain property to private foundations: 20% of AGI

Holland & Knight

27

Gifts with Split Interests: Charitable Remainder Trust

- Charitable Remainder Trust (CRT):
 - A CRT makes annual payments to one or more individual beneficiaries for term of up to 20 years, or for lives of beneficiaries.
 - · Form of CRT:
 - Charitable remainder annuity trust (CRAT)
 - Charitable remainder unitrust (CRUT)
 - Income only or with makeup unitrust (NICRUT or NIMCRUT)
 - Payout: minimum of 5% up to maximum of 50% of initial value (CRAT) or annual fair market value (CRUT) of trust assets.
 - At end of term, remaining assets distributed to one or more charities, which may include family foundation.
 - 10% minimum remainder requirement.

Holland & Knight

Charitable Gifts with Split Interests: Charitable Lead Trust

- · Charitable Lead Trust (CLT)
 - CLT is inverse of CRT, providing annual payment to one or more charitable beneficiaries for period of time, with remainder interest to family members.
 - Like CRTs, CLT may be structured with either annuity or unitrust payout, but unlike CRTs, no minimum or maximum payout requirement.
 - CLT structured as unitrust can be used to leverage generation-skipping transfer tax exemption.
 - CLT structured as grantor or non-grantor trust for income tax purposes:
 - Grantor CLT permits donor to take income tax deduction for actuarial value of lead interest, but donor will be taxed on income for term of CLT. Recapture rules also apply if CLT ceases to be grantor trust.
 - Non-grantor CLT is taxed as complex trust; charitable distribution is deductible annually.
 - CLT permits transfer of appreciation in excess of IRS benchmark rate to family, free of estate and generation-skipping transfer tax.

Holland & Knight

29

Income and Estate Tax Considerations

- · Gifts to charity during life or at death are not subject to estate or gift tax.
- Lifetime gifts also eliminate donor's future taxable income from gifted assets.
- Gifts during lifetime provide income tax deduction, and careful planning can take advantage of high AGI years.
- Value of charitable contribution deduction depends on applicable tax rate. Charitable contributions made when higher rates apply will generally produce more savings:
 - In 2018, highest rate on capital gains and dividends is 20%, and highest ordinary income rate is 37%.
 - In addition, surcharge of 3.8% applies to net investment income of high income taxpayers.
 - Overall limitation on itemized deductions is eliminated for tax years 2018 through 2025.
- Cash gifts and gifts to public charities get higher deduction limits, but cash gifts do not offer as many tax planning opportunities.

Holland & Knight

C	Chapter 6—	-Transfer Tax	(Considerati	ions Under t	he 2017 Tax	Act—Presen	tation Slides	8

Chapter 7

A Fiduciary Income Tax Primer¹

PHILIP JONES
Duffy Kekel LLP
Portland, Oregon

Contents

1.	Introduction
2.	Entities Not Taxed as Trusts
3.	Tax Rates
4.	Simple vs. Complex Trusts; Credit Shelter Trusts
5.	Filing Thresholds
6.	Estimated Taxes
7.	The Decedent's Final Tax Year and the First Tax Year of an Estate or Trust
8.	Formerly Revocable Trust Election to Use a Fiscal Year
9.	The Final Tax Year
10.	Fiduciary Accounting Income
11.	Partnerships and S Corporations
12.	Distributable Net Income (DNI)
13.	Capital Gains and Losses
14.	Exemptions
15.	Calculating Taxable Income; Deductions
16.	The Net Investment Income Tax
17.	The Election to Take Deductions on the Fiduciary Income Tax Return
18.	The Distribution Deduction
19.	Tax-Exempt Income
20.	Specific Bequests
21.	In-Kind Distributions
22.	Charitable Deduction
23.	The Sixty-Five Day Rule
24.	Tiers of Distributions and Beneficiaries
25.	Income in Respect of a Decedent (IRD)
26.	Retirement Accounts
27.	Separate Share Rule
28.	Basis Step-up and Basis Reporting

 $^{^{1}}$ © 2018 Philip N. Jones. This paper is not intended to provide legal advice applicable to a particular situation. If the reader seeks legal advice, the services of a professional advisor should be obtained.

Chapter 7—A Fiduciary Income Tax Primer

Contents (continued)

29.	State Fiduciary Income Taxes	7–99
30.	Revocable Trusts and Grantor Trusts	' –100
Select	ed Additional Research Materials	' –103
Appei	ndix A: Interest Deductions by Estates and Trusts	'-105
Appei	ndix B: Miscellaneous Itemized Deductions of Trusts and Estates	'-107
Appei	ndix C: Retirement Plan Distributions After Death	'–109
Appeı	ndix D: Basis Reporting and Consistency	<i>7</i> –111

1. Introduction

The purpose of this paper is to summarize the basic elements of the fiduciary income tax for the benefit of professionals (particularly attorneys and trust officers) who administer trusts and estates or who advise fiduciaries. Those professionals and their clients will regularly make administrative decisions that will impact the fiduciary income taxation of trusts and estates, and those decisions will also impact the individual income taxation of beneficiaries (including the taxation of trusts that are beneficiaries of estates, or are beneficiaries of other trusts). Because administrative decisions have a significant impact on income tax consequences, attorneys and trust officers who administer trusts and estates should familiarize themselves with the basics of fiduciary income taxation. Even if an accountant experienced with the fiduciary income tax is part of the professional team advising an estate or trust, attorneys and trust officers should be conversant on the subject of fiduciary income taxation, if only to spot issues that need to be discussed with the accountant.

If you are new to the fiduciary income tax, and you would like an abbreviated introduction to the most important aspects of the tax, consider reading the following sections of this paper first: 3, 7, 8, 9, 12, 13, 17, 18, 20, 23, and 26.

This paper is devoted primarily to the federal fiduciary income tax, but discussion of Oregon law and the Oregon fiduciary income tax is also included, along with some discussion of Washington law.

This paper does not discuss city or county income taxes that are imposed on estates and trusts. For example, the City of Portland and Multnomah County impose a business income tax on business activities, including the business activities of trusts and estates (such as the rental of real estate or the sale of rental real estate, or other business activities), and that tax liability cannot be passed on to the beneficiaries, even in the final year of an estate or trust. The tax has a \$50,000 annual exemption. See Business Tax Administrative Rule 200.95-1A.

The fiduciary income tax is imposed on the income of all trusts and estates, to be reported by each trust or estate on a Form 1041 federal fiduciary income tax return (and on a Form 41 Oregon fiduciary income tax return). In some cases, the income tax will actually be paid by the trust or estate, but in many cases the income will be taxed to the beneficiaries (or even to the grantor), and the trust or estate will escape tax on that same income. The income allocable to the beneficiaries appears on one or more Schedules K-1 (one for each beneficiary) attached to the Form 1041. In general, the income of a trust or estate will be taxed only once, either to the trust or estate, or to the beneficiaries, or to the grantor. But beneath that general rule lie a myriad of other rules and exceptions to those rules.

Nearly every estate and trust presents fiduciary income tax issues that must be dealt with by the attorneys, accountants, and trust officers administering those estates and trusts. Even an uncomplicated estate involving only a residence, an investment account, and a retirement account will present many fiduciary income tax issues.

The fiduciary income tax is governed by Subchapter J of Subtitle A of the Internal Revenue Code (Internal Revenue Code §§641-692) and the regulations promulgated thereunder. The number of Code sections that govern fiduciary income taxes are relatively few, but they provide an elegant framework that efficiently allocates trust and estate income among the trust, the estate, the beneficiaries, and/or the grantor. In addition, much of the rest of the Internal Revenue Code applies to trusts and estates, because trusts and estates are defined as persons under §7701(a)(1), because taxpayers are defined as persons subject to tax under §7701(a)(14), and because trusts and estates are taxed in the same manner as individuals, with certain exceptions. §641(b).

The general statutes of Subchapter J appear in Subpart A (§§641-646). The statutes applicable to simple trusts appear in Subpart B (§§651-652). The statutes applicable to estates and complex trusts appear in Subpart C (§§661-664). (The distinction between simple trusts and complex trusts is discussed below.) The statutes applicable to grantor trusts appear in Subpart E (§§671-679).

A caution to the reader: Although the general rules governing the fiduciary income tax are relatively simple, the many nuances and exceptions can be very complex; many of the general rules stated in this short paper are subject to exceptions that are not discussed in this paper. In addition, changes to the law may have occurred after this paper was published. References to Internal Revenue Code sections, along with regulations and cases, are included in this paper; please review those Code sections, the applicable regulations, and the case law when applying the general rules to your particular situation, in order to make certain that you are correctly applying the many exceptions and the current law. Other Code sections, regulations, and cases may be applicable that are not cited in this brief summary. Selected additional research materials are listed at the end of this paper.

The foregoing paragraph is particularly applicable to the changes enacted by the Tax Cuts and Jobs Act of 2017 (P.L. 115-97), which was enacted in late 2017. In general, those changes became effective on January 1, 2018. Some of the changes made by that Act were corrected and/or amended in March of 2018 by the Consolidated Appropriations Act of 2018 (H.R. 1625; P.L. 115-141). The 2017 Act made many changes to the income tax laws, and many of those changes are complex and not yet fully understood. In addition, new regulations interpreting those changes will likely not be published for some time to come. Many of the provisions of the 2017 Act will

sunset at the end of 2025, and old law will be restored on January 1, 2026, unless future legislation changes that schedule. As a result of those complexities, practitioners should proceed cautiously regarding matters affected by the new law.

The author would appreciate hearing from readers who have corrections, suggestions, or updates to offer regarding this paper.

A fiduciary must take care to ensure that all of the tax obligations of the estate or trust are satisfied. If a fiduciary were to distribute assets of a trust or estate without completely satisfying those obligations, and the estate was then insolvent and unable to pay those taxes, then two forms of liability are created. First, the fiduciary will become personally liable for those tax obligations, to the extent assets were distributed by the fiduciary. Second, the beneficiaries will be liable for those tax obligations to the extent the beneficiaries received assets. §6901(a); Reg. §20.2002-1; Rev. Rul. 80-112, 1980-1 C.B. 306. The former is known as fiduciary liability, while the latter is known as transferee liability. Transferee liability not only applies to initial transferees, but also to successive transferees. Hawk v. Commissioner, T.C. Memo 2017-217. In general, these two types of liability are created by state law, but enforced by federal procedural law; \$6901(a) is merely a federal procedural statute. Sawyer v. Commissioner, T.C. Memo 2011-298; Julia R. Swords Trust v. Commissioner, 142 T.C. 317 (2014); Feldman v. Commissioner, 779 F3d 448 (7th Cir. 2015). The determinations of liability under state law and of transferee status under federal law are separate and independent determinations. Hawk v. Commissioner, T.C. Memo 2017-217. In most cases, the state law is the Uniform Fraudulent Transfer Act, also known as the Uniform Voidable Transactions Act. In Oregon, see ORS chapter 95. In Washington, see RCW chapter 19.40. In some situations, state law might even govern the calculation of interest on the transferee tax liability. Schussel v. Commissioner, 758 F.3d 82, 114 AFTR2d ¶2014-5038 (1st Cir. 2014). For a discussion of what constitutes insolvency of an estate, see Singer v. Commissioner, T.C. Memo 2016-48. An additional year is tacked on to the normal statute of limitations if the IRS finds it necessary to enforce fiduciary liability or transferee liability. §6901(c); see also Reg. §1.641(b)-2; 31 U.S.C. §3713(b); United States v. Coppola, 85 F.3d 1015, 1020 (2d Cir. 1996); U.S. v. McNicol, 829 F.3d 77, 118 AFTR 2d ¶2016-5038 (1st Cir. 2016; cert. den. 1/9/17). In some cases, the IRS may be able to collect against a fiduciary or a transferee without having made an assessment against the fiduciary or transferee. U.S. v. Geniviva, 16 F.3d 522 (3rd Cir. 1994); U.S. v. Botefuhr, 309 F.3d 1263 (10th Cir. 2002); U.S. v. Russell, 532 F.2d 175 (10th Cir. 1976). The statute of limitations does not even begin to run if no return has been filed, and the tax can be assessed at any time. §6501(c)(3). The obligation for an estate or trust to pay taxes includes the obligation to pay the tax liabilities of the decedent. United States v. Shriner, 113 AFTR 2d ¶2014-616 (D.C. Md. 2014). In a transferee liability case or a fiduciary liability case, the IRS has the burden to prove the liability, but the transferee or fiduciary has the burden to disprove the amount of tax. §6902(a). These rules apply to income taxes, estate taxes, and gift taxes. For an example of an estate, two marital trusts, and a surviving spouse all being held responsible for transferee liability, see *Hawk v. Commissioner*, T.C. Memo 2017-217. See also §6324 and ORS 118.210 regarding estate and gift taxes, and see ORS 316.382 and OAR 150-316-0445 regarding the decedent's Oregon income taxes. See also ORS 314.310 and ORS 116.063(3)(c). In Washington, see RCW 83.100.120. The moral of this story: Don't risk the personal assets of the fiduciary in order to save the beneficiaries a few dollars of tax.

Many of the words and phrases used in this paper are terms of art, defined in the Internal Revenue Code, the regulations, or elsewhere. Whenever possible, those exact terms will be employed. For purposes of clarity, practitioners should become accustomed to using that same terminology.

As you read this paper, you will note seven recurring themes:

- (1) Trusts and estates are usually taxed at higher rates than individuals. See section 3, below.
- (2) Those higher-rate taxes are often avoidable by deducting administration expenses. See sections 15 and 17, below.
- (3) Those higher-rate taxes are often avoidable by making distributions to beneficiaries, which are generally deductible. The beneficiaries then become taxed. See sections 18 and 23, below. This ability to cause income to be taxed to the beneficiaries generally applies only to ordinary income; capital gains are usually taxed to the trust or estate. See section 13, below.
- (4) Income is taxed only once (to the trust/estate, or to the beneficiaries, but not to both). See section 18, below.
- (5) Estates and some trusts can select their own fiscal year-end. See sections 7 and 8, below.
- (6) After a death, estates and trusts can often elect whether to take their administration expense deductions either on the income tax return or on the estate tax return, but not on both. See section 17, below.
- (7) Estates and trusts pay no income tax in their final year. The beneficiaries pay the tax in the final year, both on ordinary income and capital gains. See section 9, below.

2. Entities not Taxed as Trusts

The fiduciary income tax does not apply to grantor trusts, which include revocable living trusts (while the grantor is alive) and certain other trusts that are specifically designed to be taxed to the grantor. (A brief summary of grantor trusts appears at the end of this paper.) Similarly, assets held in custodianships for minors are not taxed as trusts; income generated by a custodianship is taxed directly to the minor. *Anastasio v. Commissioner*, 67 T.C. 814 (1977), *aff'd without opinion*, 573 F.2d 1287 (2nd Cir. 1977). For the same reason, conservatorships and guardianships are not taxed as trusts. §7701(a)(6); §6012(b)(2). Split-interest trusts, such as charitable remainder trusts, are not subject to the regular fiduciary income tax rules; they have their own rules that trigger taxation of the noncharitable beneficiaries. See §664, Reg. §1.664, and Form 5227.

3. Tax Rates

Practitioners dealing with trusts, estates, and beneficiaries must keep in mind one fundamental principle: trusts and estates are usually taxed at much higher income tax rates than are most individuals. In 2017, individuals reached the highest tax bracket (39.6%) at \$418,400 of taxable income (\$470,700 for married couples filing jointly). \$1(a), (c). In 2018, the highest bracket was reduced to 37%, and the threshold amount of taxable income became \$600,000 for married filing jointly and \$500,000 for single individuals. But trusts and estates reach the highest tax bracket at only \$12,500 of income in 2017, and the same amount in 2018. \$1(e). Those figures will be adjusted for inflation in future years. See Rev. Proc. 2013-35, 2013 I.R.B. 537. (The purpose of those compressed brackets is to prevent taxpayers from using trusts as income tax reduction devices.) For that reason, fiduciaries have a strong incentive to make certain that their trust or estate has very little taxable income, or possibly no taxable income. The most common techniques for minimizing the income of a trust or estate can be summarized as follows, and are discussed in detail in other parts of this paper:

a. Maximizing the use and timing of deductions for administration expenses. This is usually done by paying such expenses before the end of the fiscal year, and by electing to take those deductions on the fiduciary income tax return, and not on the estate tax return. (In some cases, the reverse is better, as is discussed below.) If done properly, the taxable income of the trust or estate can be reduced to a small amount, or possibly to zero. (In an Oregon estate, some administration expenses, such as attorney fees and personal representative's fees, require prior court approval; plan ahead.) Ideally, enough administration expenses could be paid and deducted each year to exactly reduce the taxable income to zero. By doing so, that strategy would minimize the amount of excess deductions to be passed out

to the beneficiaries in the final tax year (note that excess deductions cannot be passed out to the beneficiaries in tax years after 2017 or before 2026). These various deductions are discussed below, as is the election whether to take the deductions for income tax purposes or estate tax purposes.

- b. Maximizing the use and timing of the distribution deduction by making distributions to beneficiaries. §651; §661. In general, those distributions need to be made before the end of the tax year, or within 65 days following the end of the tax year. If done properly, the taxable income of the trust or estate can be reduced to a small amount, or possibly to zero, and the income will then be taxed to the beneficiaries at their lower tax rates. §652; §662. (In an Oregon estate, distributions require prior court approval; plan ahead.) The distribution deduction is discussed in greater detail below.
- c. Closing an estate on or before the end of the fiscal year, or terminating a trust on or before the end of its fiscal year. If this is accomplished, then all of the income, gains, deductions, and other tax attributes of the trust or estate for that final tax year will flow out to the beneficiaries to be taxed at the beneficiaries' rates, not at the higher rates of the trust or estate. §662; §643(a)(3); Reg. §1.643(a)-3(d). In many cases, the estate or trust can be commenced and closed within the same tax year, so that year becomes both the first tax year and the final tax year. In many cases, that will often be the simplest solution. (In an Oregon estate, final distributions require prior court approval; plan ahead.) The final year is discussed in greater detail below.

Many years ago, trusts were taxed in lower brackets than individuals. Because some taxpayers were able to minimize taxation by accumulating income in trusts and distributing that income in subsequent years, Congress enacted what are known as the throwback rules to increase the taxation of such distributions. §\$665-667. Although those statutes are still on the books, they have little impact due to subsequent changes in the tax rates applicable to trusts and estates. In addition, 1997 amendments to the throwback rules now make them primarily applicable to foreign trusts.

Keep in mind that some beneficiaries under the age of 24 might be taxed on investment income at very high rates, due to the Kiddie Tax found in §1(g), which applies to investment income in excess of \$2,100. In 2017, the child will be taxed at the same rate as his parents. In 2018, the child will be taxed at the same rate as estates and trusts. As a result, under some circumstances distributions to young beneficiaries might not produce tax savings.

The Internal Revenue Code prevents taxpayers from using multiple trusts in an attempt to divide income among multiple trusts, thus avoiding the high tax brackets of trusts. If several trusts have the same grantor/grantors, and the same primary beneficiary/beneficiaries, then the trusts will be treated as one trust. §643(f). Regulations have yet to be published under §643(f).

4. Simple vs. Complex Trusts; Credit Shelter Trusts

Trusts are generally divided into two types for purposes of the fiduciary income tax:

- A simple trust is one that is required to distribute all of its income on a current basis, and it may not pay or permanently set aside funds for charitable purposes. §651(a); Reg. §1.651(a)-1. If during any particular tax year a simple trust distributes principal, it will be treated as a complex trust for that tax year. §651(a)(2); Reg. §1.651(a)-3(b). If it does not distribute any principal in the following year, it will regain its status as a simple trust. Reg. §1.651(a)-3(b). Similarly, an in-kind distribution does not cause a simple trust to be reclassified as a complex trust, unless the value of the in-kind distribution exceeds trust income. Rev. Rul. 67-74, 1967-1 C.B. 194. See the discussion of in-kind distributions, below. Because distributions of principal cause a trust to be taxed as a complex trust, all trusts are complex trusts in their final year. Simple trusts and their beneficiaries are treated as if the mandatory income distributions were distributed to the beneficiaries, regardless of whether the distributions were actually made. §651(a); §652(a).
- A complex trust is any trust that is not a simple trust. §661. Thus a complex trust may accumulate income, may distribute corpus, and may make charitable contributions. If a trust qualifies as a simple trust under §651 and §652, then it will be governed by those sections and not by §661. For example, if a trust is permitted to distribute principal, but in a particular year it distributes only income, it will be taxed as a simple trust. Reg. §1.661(a)-1. Thus the Code establishes a priority that trusts be classified as simple trusts if possible. If a complex trust calls for mandatory income distributions (as well as permitting principal distributions), the mandatory income distributions will be deemed to have been distributed to the beneficiaries regardless of whether the income was actually distributed. §661(a); §662(a). For a discussion of local law and the vesting of assets and income in the beneficiaries and the effect of that vesting on the taxation of the income, see *Hibernia Nat'l Bank v. Donnelly*, 121 F. Supp. 179, 188 (E.D. La.), *aff'd*, 214 F.2d 487 (5th Cir. 1954).

The Code does not use the terms simple and complex, but the regulations adopt that terminology. Reg. §1.651(a)-1.

An estate is neither a simple trust nor a complex trust, but it is taxed in the same manner as a complex trust. §661; §662; Reg. §1.651(a)-5; Reg. §1.661(a)-1. The regulations are particularly succinct on that point, providing that "Subpart B has no application to an estate." Reg. §1.651(a)-5. Subpart B pertains to simple trusts.

A revocable trust typically becomes a complex trust upon the death of the trustor, because it typically contains no requirement that income be distributed currently. A formerly-revocable trust typically directs the trustee to pay debts, expenses, and taxes, and then distribute the assets to the beneficiaries. The administration of such a trust might take a year or two, but the trust typically does not mandate interim income distributions. As a result it is a complex trust. §651(a); Reg. §1.651(a)-1.

Where does a credit shelter trust fit into this scheme? Is it a simple trust or a complex trust? Or is it a grantor trust? (See the discussion of grantor trusts, below.) A typical credit shelter trust usually has the following characteristics:

- a. It was created by the will or revocable trust of the first spouse to die.
- b. The surviving spouse is the trustee.
- c. The surviving spouse is entitled to receive all of the net income of the trust for the rest of her life.
- d. The surviving spouse may receive discretionary distributions of principal under an ascertainable standard that permits distributions of principal for her health, education, maintenance, and support in order to maintain her standard of living. This is known as a HEMS standard.
- e. After the death of the surviving spouse, the remainder of the trust passes to the children of the couple.

Such a trust is a simple trust, except for those years in which principal is distributed, in which event it would be a complex trust for that year. §651(a)(2); Reg. §1.651(a)-3(b). As a simple trust, it is required to file a separate fiduciary income tax return (Form 1041), which would report the ordinary income as passing out to the surviving spouse and taxable to the surviving spouse, regardless of whether that ordinary income is actually distributed or not. §652(a). The result would be the same if the trust were classified as a complex trust; if the trust is required to distribute ordinary

income, that required amount will be taxed to the surviving spouse regardless of whether it is actually distributed. §662(a)(1).

But could it be classified as a grantor trust, thus eliminating the need for the surviving spouse to file a separate income tax return for the credit shelter trust created by her late husband? Couldn't the surviving spouse simply report the income (and capital gains) on her individual income tax return (Form 1040)? The grantor trust statutes include within the definition of a grantor trust any trust subject to the power of a person to vest the income or the principal in that person. §678(a)(1). Thus a typical credit shelter trust might appear to be a grantor trust.

Is it a regular (simple or complex) trust, or is it a grantor trust? The question is much debated. Clearly, the surviving spouse is taxed on the ordinary income, and §678(a)(1) states that such a trust is a grantor trust. But who is taxed on the capital gains? Some practitioners believe that a trust can be a grantor trust as to income, while not being a grantor trust as to principal, and §678(a) itself does state that a person shall be treated as the grantor if that person holds a power over "any *portion* of a trust" with respect to which the person holds a power to withdraw income *or* principal. (Emphasis added.)

The Ninth Circuit, sitting *en banc*, has held that a credit shelter trust is not a grantor trust. In *United States v. DeBonchamps*, 278 F.2d 127 (9th Cir. 1960), the Ninth Circuit held that a surviving spouse who had the right to withdraw income, but whose right to withdraw principal was limited by a standard, would be taxable on the income, but not on the capital gains, even though the standard was a rather loose one. In *DeBonchamps*, the rights were created by a deed that granted to the surviving spouse an income interest, along with the right to withdraw principal under a standard, with the remainder passing to a remainderman. Although a trust was not expressly created, the court held that the situation would be taxed as if it were a trust, the grantor trust statutes would not apply, and the capital gains would be taxed to the trust, not to the surviving spouse. See also, Blattmachr, Gans, and Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, ACTEC Journal, Vol. 35, No. 2, Fall 2009, which reached the conclusion that the right to withdraw income, combined with the right to withdraw principal under an ascertainable standard, did not trigger grantor trust status under §678(a)(1).

Thus the safest answer seems to be that a typical credit shelter trust is not a grantor trust, and it should obtain its own EIN (employer identification number) and file a separate income tax return, in which case the surviving spouse will be taxed on the ordinary income through the issuance of a K-1, and the trust will be taxed on the capital gains. This also means that a personal residence held in a credit shelter trust is not eligible for the capital gains exclusion on personal residences provided by §121. PLR

200104005; PLR 199912026; Reg. §1.121-1(c)(3). See the discussion of capital gains and losses, below.

A QTIP trust is a trust for the benefit of a surviving spouse that was made eligible for an estate tax marital deduction because it was the subject of a QTIP election under §2056(b)(7). Such trusts typically provide that the surviving spouse is to receive all of the income of the trust on an annual basis. Such trusts are subject to the fiduciary income tax in the same manner as other irrevocable trusts. The QTIP status affects the estate tax status of the trust, but not the fiduciary income tax status.

The next question is whether a credit shelter trust that has an Oregon QTIP election over part of it, or an Oregon Special Marital Property election over part of it, or a Washington QTIP election over part of it, needs to be treated as two trusts with two EINs and the resulting need to file two annual income tax returns. The answer is no. The two parts can be held in two separate accounts at a brokerage, for example, or the two parts can be held in one account with one percentage deemed to be the QTIP portion and another percentage deemed to be the non-QTIP portion. The advantage of two separate accounts is that the surviving spouse might decide to spend down the QTIP portion and not spend down the non-QTIP portion, in order to minimize state estate taxes on the second death. Regardless of whether one account or two accounts are used, only one EIN need be used, and only one income tax return needs to be filed. However, the use of one trust and one EIN to report the income of the entire trust on one income tax return is not universally accepted. Some accountants, for example, might insist on two trusts, two accounts, two EINs, and two tax returns.

A spousal lifetime access trust (SLAT) is usually similar to a credit shelter trust, but in most cases it also includes provisions that trigger grantor trust status with respect to the donor spouse. (But since most spouses file joint returns, the income is effectively taxed to both of them.) If it is a grantor trust, it will usually become a nongrantor trust upon the death of the donor spouse. However, a SLAT can be drafted as a nongrantor trust from its inception. See the discussion of grantor trusts, below. The main purpose of a SLAT is to make use of the donor's unified credit during the donor's lifetime, thus protecting the assets from estate tax on the death of the donor spouse. The credit shelter trust aspects of a SLAT protect the assets from estate tax on the death of the beneficiary spouse. As a result, the assets held in a SLAT usually pass to the next generation free of estate tax.

5. Filing Thresholds

An estate must file a Form 1041 if it has gross income of \$600 or more, or has a nonresident alien beneficiary. Reg. §1.6012-3(a)(1)(i).

A trust must file a Form 1041 if it has any taxable income for the year, gross income of \$600 or more, or a beneficiary who is a nonresident alien. Reg. 1.6012-3(a)(1) (ii).

For purposes of determining whether a trust or estate has gross income in excess of \$600, gross income does not necessarily include gross proceeds from the sale of a capital asset. Instead, gross income includes an amount equal to gross proceeds minus basis. Reg. §1.61-6(a).

6. Estimated Taxes

Estates and trusts are required to pay quarterly estimated federal fiduciary income taxes in a manner similar to individuals. §6654(l)(1). (The state of Oregon does not require estimated fiduciary income taxes, and Washington does not impose a fiduciary income tax.) The quarterly installments for calendar year trusts and estates are due on April 15, June 15, September 15, and January 15.

Estates need not pay estimated taxes for tax years ending before the second anniversary of the date of death. §6654(l)(2). (Form 1041 specifically asks whether the estate has been open for more than two years, and if so, an explanation is requested.) Formerly-revocable trusts are obligated to pay estimated taxes, but not during the first two years following the grantor's death if the trust has made a §645 election to use a fiscal year as part of the decedent's estate. Reg. §1.645-1(e)(4). See the discussion of a trust's election to use a fiscal year, below. (Regarding estimated taxes for the decedent's final individual income tax return, see the next section.)

Nor are estimated taxes due if the preceding tax year was a twelve-month year and had no tax liability. §6654(e)(2).

Estimated taxes are not required unless the estate or trust is expected to owe at least \$1,000 in tax, \$6654(e)(1), or the withholdings and credits are expected to be the lesser of ninety percent of the current year's tax or 100% of the prior year's tax, assuming the prior year was a twelve-month year. \$6654(d)(1). If the adjusted gross income is more than \$150,000, then the 100% requirement becomes 110%. \$6654(d)(1)(C)(i).

A trust (or an estate in its final year) is permitted to elect to treat its estimated tax payments as if the payments had been made by the beneficiaries. §643(g)(1)(A). The election must be made within sixty-five days following the end of the taxable year, and a late election is not valid. §643(g)(2). The election is made by filing a Form 1041-T. As a result of this election, the estimated tax payments of the estate or trust are allocated to the beneficiaries to reduce the tax liability of the beneficiaries. The estimated tax payments are allocated to the beneficiaries as of the last day of the tax year of the trust,

and are treated as if the beneficiaries had paid those estimated taxes on January 15 of the following year. §643(g)(1)(C)(ii). Because the estimated payments are deemed to have been paid on January 15 of the following year, this §643(g) election is of little assistance to beneficiaries who should have made estimated payments in earlier quarters. (The trustee might consider advising the beneficiaries that such an election does not retroactively cure any problems of beneficiaries who are under-estimated for prior quarters.) The allocation is treated as a second tier distribution to the beneficiaries, and thus it is shown on Form 1041 Schedule B as an "other amount paid." (See the discussion of tiers below.) The Schedule K-1 provided to each beneficiary will reflect the allocation of the estate tax among the beneficiaries.

The allocations of estimated tax to multiple beneficiaries need not be equal; the Form 1041-T allows unequal allocations following a §643(g) election. The election applies to estimated taxes only; it does not apply to tax withholdings. §643(g)(1)(A).

7. The Decedent's Final Tax Year and the First Tax Year of an Estate or Trust

Fiduciaries are obligated to file a final individual income tax return (Form 1040) for the final tax year of the decedent, and for any prior years that remain unfiled. §6012(b)(1); Reg. §1.6012-3(b)(1). Fiduciaries are also obligated to file any unfiled gift tax returns of the decedent. Reg. §25.6019-1(g).

The taxable year of a decedent ends on the date of death, and his executor or trustee is obligated to file a final personal income tax return (Form 1040) for the short year beginning on January 1 and ending on the date of death. Reg. §1.443-1(a)(2). That return is not due until April 15 of the following year, regardless of when during the year the decedent died. Reg. §1.6072-1(b). Subject to some exceptions, the surviving spouse is permitted to file a joint return for that tax year. §6013(a)(3). That joint return will report the surviving spouse's income for the entire year, and the decedent's income for the short year during which he was alive. §6013(a)(3); Reg. §1.6013-1(d). No adjustment need be made to reflect the fact that the decedent's tax year was a short year. Reg. §1.443-1(a)(2). The allocation of the income tax liability between the decedent and the surviving spouse is determined under Reg. §20.2053-6(f). The same regulation also governs the allocation of any income tax refund that might be due. (The liability or refund needs to be reported on the estate tax return, if one is being filed.) If both spouses die within the same tax year, their executors may file a joint return. \$6013(a)(3); Reg. \$1.6013-1(d)(3). The return for the final year of a decedent is filed with the service center based on where the executor (or surviving spouse) is located, not where the decedent lived. \(6091(b)(1)(A)(i); Reg. \(1.6091-2(a). \)

If, for the final year of the decedent's life, the decedent and his spouse file as married filing separately, if one of them itemizes their deductions, the other will be disallowed the use of the standard deduction. 63(c)6.

A final return for the decedent is not required to be filed if the decedent's income was less than the filing threshold for the year of death. The filing threshold varies from year to year, and is based on the decedent's age, the standard deduction, the personal exemption, and the filing status of the decedent. §6012(a). See also Reg. §1.443-1.

The decedent's final individual income tax return is usually signed by either the personal representative (or trustee) or, in the case of a joint return, by the surviving spouse (who signs as surviving spouse if a fiduciary has not been appointed). Section 6012(b)(1) authorizes the decedent's final return to be signed by "his executor, administrator, or other person charged with the property of such decedent." This could include personal representatives, trustees, claiming successors, surviving joint owners, and designated beneficiaries. See also the instructions to Form 1040, §2203, §7701(a)(6), Reg. §1.6012-3(b)(1) and CCA 201334040. If a decedent left behind both a probate estate and a formerly-revocable trust, it is not entirely clear whether the personal representative or the trustee should sign the decedent's final individual return, but Rev. Rul. 79-409, 1979-2 C.B. 208, suggests that the personal representative has primary responsibility for filing the decedent's final individual income tax return. SCA 200139031 agrees.

The fiduciary income tax return is signed by the personal representative or trustee. §6061; Reg. §6061-1(a); §7701(a)(6). If two fiduciaries are serving as co-fiduciaries, then only one needs to sign the fiduciary income tax return. See the instructions to Form 1041. In contrast, if two or more fiduciaries are serving, all need to sign the Form 706 estate tax return, Reg. §20.6018-2, although the instructions to the Form 706 state that only one fiduciary needs to sign. See also §2203 and §6018(a)(1) regarding the signing of estate tax returns, which state that the court-appointed executor is required to sign the estate tax return. See also Reg. §20.6018-2. Although §2203 states that if no executor is appointed, any person in possession of the decedent's property is required to file an estate tax return, that code section does not apply to income tax returns, although many practitioners apply that rule to income tax returns.

If the decedent's final individual income tax return shows a refund due, the filing of a joint return by the surviving spouse is sufficient to claim the refund. If the surviving spouse is a court-appointed fiduciary, a copy of the court appointment should be attached to the Form 1040. Other filers need to attach a Form 1310 to the return. See the instructions to Form 1040.

A decedent's estate (or trust) is not required to make estimated payments on the decedent's individual (Form 1040) tax liability after the date of death. PLR 9102010 (10/10/90). However, a surviving spouse might need to continue to make estimated payments due to her own personal income.

The personal representative of an estate (or the trustee of a formerly-revocable trust) should file a Form 56 (Notice Concerning Fiduciary Relationship) with the IRS to ensure that the fiduciary will receive any notices concerning the decedent's income tax liability. §6903; Reg. §301.6903-1. A copy of the Form 56 should also be sent to the Oregon Department of Revenue, for the same reason. Ideally, the Form 56 should be completed to include multiple years of personal income taxes of the decedent, multiple years of fiduciary income taxes of the fiduciary, and estate taxes of the decedent. If an income tax refund is owing to the decedent, a federal Form 1310 should be filed with the return, and/or an Oregon Form 243 should be filed. Under some circumstances, a fiduciary can ask to be released from the decedent's personal income tax liabilities (both state and federal), or can request a prompt assessment of income tax liabilities (decedent's personal income tax liability and also fiduciary income tax liability, both state and federal). For a discussion of releases, requests for prompt assessment, Form 1310, and Form 243, see Mitchell, Tax Procedure Issues for Estates and Trusts, Oregon State Bar Estate Planning and Administration Section Newsletter, Vol. XXVII, No. 3, July 2010.

When filing a Form 56 following a death, the name, address, and social security number of the decedent should exactly match the name, address and social security number used by the decedent to file his personal income tax returns. If the name, address, and social security number are incorrect (i.e., do not match the IRS records), the Form 56 will be rejected.

If a Form 56 is filed with the IRS, the Form 56 should be terminated if the fiduciary leaves office and a new fiduciary is named. See §6903(a). To terminate a Form 56, use Part II of the form. The new fiduciary should file a new Form 56, and the Part II of the form permits the former fiduciary to inform the IRS of the name and address of the new fiduciary. If the trust or estate simply ends, and a new fiduciary is not taking office, the effectiveness of a Form 56 termination is questionable, as indicated in Reg. §301.6903-1(e). In that event, the fiduciary might not want to terminate the Form 56, since the (former) fiduciary would probably want to be aware of any subsequent notices sent by the IRS.

The Form 56 should be used to notify the IRS of a fiduciary relationship, and a Form 8822 should not be used. The Form 8822 is a change of address form, and should be used only if the fiduciary (who has previously filed a Form 56 or filed a tax

return) changes addresses. The decedent did not change addresses; the decedent merely died.

Fiduciaries are required to file fiduciary income tax returns for trusts and estates. §6012(a); Reg. §6012-3(a). See the discussion of the filing thresholds, above.

If the decedent's assets were held in a revocable trust, the successor trustee will usually obtain an EIN (employer identification number) for the now-irrevocable trust and then proceed to administer the trust and eventually distribute the assets to the beneficiaries and file a final fiduciary income tax return. Reg. § 301.6109-1(a)(3)(i)(A); Rev. Rul. 57-51, 1957-1 C.B. 171. However, in some cases distributing trust assets immediately following a terminating event (such as the death of the decedent) is a simple and advantageous alternative. Thus, when a revocable trust calls for termination of the trust upon the death of the trustor, the successor trustee has two choices. First, the successor trustee may continue the trust as a new trust with its own EIN, which will then carry out the various administrative tasks and file fiduciary income tax returns for the period of administration. Such a trust is often described as an administrative trust, even though it might continue in existence for a year or two or more. Second, in the alternative, the successor trustee might decide to forgo the administrative trust and simply distribute the assets of the trust to the beneficiaries in a prompt fashion, without obtaining an EIN or filing fiduciary income tax returns. If that second alternative is chosen, then the successor trustee will supply appropriate income tax information to the beneficiaries, and the beneficiaries will each report their respective shares of the income earned after the date of death, along with their share of the deductions. Reg. §1.641(b)-3(d). This second alternative might be appropriate if the post-mortem administration of the trust is very straight-forward, such as is the case with a small trust that has no need to file federal or state estate tax returns.

When commencing the administration of an estate, it is helpful to obtain an IRS power of attorney (Form 2848) from the personal representative, in order to ease any future dealings with the Internal Revenue Service. In fact, three Forms 2848 should be obtained and retained for future use, as needed. One should be obtained in the name of the estate, using the estate EIN, and it should indicate that it pertains to fiduciary income tax. (As a general rule, the IRS will accept a Form 2848 that applies to the current year and the future three-year period.) The second should be obtained in the name of the decedent, using the decedent's social security number, and it should indicate that it pertains to the decedent's individual income tax, estate tax, and gift tax (if applicable). The third should be obtained in the name of the executor, using the executor's social security number (in the case of an individual) or EIN (in the case of a corporate executor), and it should indicate that it pertains to the Form 8971 (basis reporting), if that form will be necessary; otherwise the third Form 2848 will not be

needed. Failure to follow this protocol will result in rejection of one or more of the Forms 2848 when (and if) they are eventually submitted to the IRS. Although it might seem odd to obtain a power of attorney in the name of a decedent, it is because the income tax returns, estate tax return, and gift tax returns are filed under the decedent's name and social security number, not under the estate's EIN. In contrast, the fiduciary income tax return is filed under the EIN of the estate, and the Form 8971 is filed under the identifying number of the executor. All three Forms 2848 will be signed by the personal representative in her capacity as personal representative. (If a post-mortem revocable trust is involved, rather than a probate, the same principles apply, but the Forms 2848 will be signed by the trustee.) Although Forms 2848 are not normally attached to tax returns when the returns are filed, it is a common practice to attach a Form 2848 to the estate tax return. For a further discussion of Form 8971, see the section on basis reporting, below. Another form to consider filing is Form 8821, which allows accountants, attorneys, etc., to receive information from the IRS regarding a taxpayer, but does not allow those persons to represent (speak on behalf of) the taxpayer. That form is useful, for example, if the trustee or personal representative would like to authorize her accounting firm to receive information concerning an estate, a trust, or a decedent.

Like all taxpayers, trusts and estates are required to adopt a taxable year. With some exceptions (see the following section), trusts are required to use a calendar year, §644(a), while estates are permitted to use either a fiscal year or a calendar year. §441(e).

The first tax year of a decedent's estate (or formerly-revocable trust) most likely begins on the day after the date of death of the decedent, regardless of the time of day that death took place, and regardless of when the personal representative is appointed. However, transactions carried out after the moment of death are likely to be viewed as transactions of the estate, not the decedent. These points are not entirely clear. For example, IRS Publication 559 states that the tax year of the decedent ends on the day *before* the date of death. Reg. §1.6012-3(b)(1) states that the decedent's tax year ends "with the date of his death," but then it goes on to provide that "the return shall cover the period during which he was alive." Section 1014(a) grants a basis adjustment to property not disposed of "before the decedent's death," which seems to suggest that the moment of death is the dividing line, not necessarily the date of death. Some practitioners believe that transactions that take place on the date of death, but after the moment of death, are still included in the decedent's final tax year, and are not included in the first tax year of the estate. They base that opinion on the following language of §691(a)(1):

- (a) Inclusion in Gross Income.
 - (1) General rule. -- The amount of all items of gross income in respect of a decedent which are not properly includable in respect of *the taxable period in which falls the date of his death* or a prior period ... shall be included in the gross income for the taxable year when received, of [the estate]. (Emphasis added.)

The problem is that there is no definitive authority on this issue. Or perhaps this issue is really two issues: (1) In which tax year did the sale take place and should be reported? and (2) Did the asset receive a new basis as a result of the death? It might be possible that the transaction should be reported on the decedent's final individual return, but the asset nevertheless received a new basis as a result of the death.

Because the decedent's final return reports the income received before death, and the first fiduciary income tax return reports the income received after death, the income must be allocated between the two periods (and the two returns) based on when the income was received relative to the date of death. Invariably, some of the income allocable to the fiduciary income tax return will be incorrectly reported on 1099s showing the decedent's name and social security number, due to delays in closing the decedent's accounts and opening accounts for the estate. The accountant preparing the two returns will need to make appropriate adjustments/allocations. Some accountants report the full amounts of the 1099s on the decedent's final return, and then show negative entries for amounts properly reportable on the fiduciary return, in hopes of avoiding inquiries from the IRS asking about mismatches between the 1099s and the decedent's final return.

The tax year of the estate ends on the last day of a month selected by the executor, as long as the first tax year does not exceed twelve months. §441(e). As a result, the first tax year of an estate is almost always a short year, unless the decedent died on the last day of a month. If the decedent died in the middle of a month, then the first tax year could be as short as two weeks, or as long as eleven and a half months. For example, if a decedent died on May 10, 2017, the first tax year of the estate could end as early as May 31, 2017, or as late as April 30, 2018 (for an 11.5-month year), but the first tax year could not possibly extend beyond April 30, 2018. §441(e).

The selection of an ending month for the fiscal year is made by filing an initial fiduciary income tax return for the period ending on the last day of that month. Reg. §1.441-1(c)(1). The election may be made on a late-filed return. Reg. §1.441-1(c)(1). The filing of an extension request, or the filing of a Form SS-4 (application for EIN), or the payment of estimated taxes, does not constitute the making of an election to use a fiscal year, nor does it constitute the selection of an ending month, even though the Form SS-4 asks for the ending month of the fiscal year.

The selection of a fiscal year has important tax implications for the beneficiaries of a trust or estate, in addition to the tax implications for the trust or estate itself. If a trust or estate makes a distribution of distributable net income (DNI) to a beneficiary (or income is deemed to be taxable to the beneficiary under §652(a) or §662(a)(1)), then the beneficiary will be taxed on that distribution in the tax year of the beneficiary in which the tax year of the estate or trust ends. §662(c); Reg. §1.662(c)-1. In some cases, it might be desirable to select a first fiscal year that is as long as possible, in order to defer taxation. Selecting a long fiscal year also increases the possibility of completing the administration of the estate or trust within one year, so that the first fiscal year is also the final year, thus allowing all of the income (or the excess deductions in years prior to 2018 or after 2025) to be carried out to the beneficiaries, with no chance that any of the income will be taxed at the higher income tax rates of the trust or estate. §662; §643(a)(3); Reg. §1.643(a)-3(d). See the discussion of the final tax year, below.

The selection of a fiscal year can be used to prevent a trust from earning sufficient income in the first tax year to put the trust or estate in the highest income tax bracket. If need be, the trustee or personal representative can monitor the income as it is received, and then terminate the tax year before the amount is reached that would place the estate or trust in the highest bracket.

The selection of a fiscal year can also help solve the following related problem. Assume that an estate has experienced a significant taxable event, such as the withdrawal of significant funds from an IRA. If the estate has also experienced significant expenses and needs to make certain that those expenses are incurred in the same tax year as the taxable event, the selection of a fiscal year can help achieve that goal. Or perhaps the estate has experienced a significant taxable event that occurred within the first twelve months of the estate administration, but that first twelve-month period has now ended, and the estate failed to distribute that income to the beneficiaries. These problems can often be addressed by selecting a year-end that causes the estate to have a very short first year (say, a first fiscal year of only three or four months), followed by a full twelve-month second year. That decision can be made at any time prior to the filing of the first fiduciary income tax return, and it can be made even though it causes the return for the short first year to be overdue, since the election of a fiscal year can be made on a late-filed return. Reg. §1.441-1(c)(1). This technique cannot be used if the tax issues occur in a formerly-revocable trust that has elected under \645 to use the fiscal year of the estate (discussed in the following section), since the §645 election cannot be made on a late-filed return. §645(c).

For example, assume that a decedent died in February, 2013. The longest possible first fiscal year of the estate would end on January 31, 2014, and the personal representative made a tentative decision to use that year end for the fiscal year. The

estate withdrew all of the funds in a large IRA account in October 2013, but no significant expenses were incurred in 2013, nor were any distributions made. In April 2014, the personal representative realized that using a fiscal year end of January 31, 2014, would result in a significant tax due at the highest rates, because of the lack of deductible expenses and the lack of deductible distributions. What can the personal representative do in April 2014 to remedy this situation? Rather than use a year end of January 31, the personal representative could decide to use a year end of September 30. Although the income tax return for a year ending September 30 was due on January 15, the personal representative could nevertheless file a late return and make the election to use September 30 as the year end (paying particularly close attention to any applicable interest and penalties). The personal representative would then have until September 30, 2014, to mitigate the large taxable event that occurred in October 2013. That mitigation could take the form of (a) paying deductible expenses, (b) making distributions that carry out income to the beneficiaries, or (c) closing the estate in order to carry the income out to the beneficiaries in the final tax year.

For a discussion of which version (which year) of the Form 1041 to file for an estate or trust, see the discussion in the section dealing with the final tax year, below.

If the beneficiary has the same year-end as the trust or estate, distributions to the beneficiary will cause the beneficiary to be taxed on the trust or estate income in the same tax year that the trust or estate received the income. §652(c). If the beneficiary is on a different tax year, the beneficiary will be taxed in his or her tax year in which the trust or estate tax year ends. §652(c). This is a deferral opportunity: If the trust or estate tax year ends on January 31, 2013, the income earned during most of 2012 will not be taxable to the beneficiary until 2013, and the tax will not be payable by the beneficiary until April 15, 2014 (subject, of course, to the need for the beneficiary to make estimated tax payments of his individual tax liability).

If a decedent's will creates a testamentary trust, the first tax year of the testamentary trust does not begin on the date of death, because the trust typically acquires no assets on that date. Instead, the first tax year of a testamentary trust begins when the trust first acquires assets, which is usually on the date that the probate estate distributes its assets to the testamentary trust. *United States v. Britten*, 161 F.2d 921 (3rd Cir. 1947); *Maresca Trust v. Commissioner*, T.C. Memo 1983-501. If a partial distribution is made to the trust from the estate prior to the termination of the estate, then the trust will have been created on that earlier date of the partial distribution.

An annual fiduciary income tax return is due within three and a half months following the end of each taxable year. §6072(a). The federal form is 1041; the Oregon form is 41. Thus an estate or trust with a tax year ending on December 31 will file its

annual fiduciary income tax return on or before April 15, while an estate with a tax year ending June 30 will file its annual fiduciary income tax return by October 15.

An automatic extension of the time within which to *file* a return for a trust or for an estate can be obtained by filing a Form 7004 on or before the due date of the return. See §6081; Reg. §1.6081-6(a). (Form 8736 is no longer used.) Unlike extensions for individual returns that are for six months, the automatic extension for a fiduciary return is for only five and a half months (five months for tax years beginning before January 1, 2016). Reg. §1.6081-6(a)(1); Temporary Reg. §1.6081-6T (T.D. 9821, 7/18/17). Extensions of time to *pay* the tax are not authorized. Reg. §1.6081-6(c). Further extensions to file beyond the original five-month extension are not authorized. Reg. §1.6081-6(a). The extension of the time to file a return for a trust or estate does not extend the time for the beneficiaries to file their returns or to pay their tax. Reg. §1.6081-6(d). As a result, a fiduciary who extends the time for filing a fiduciary income tax return should advise the beneficiaries to obtain their own extensions of time to file their individual returns, and the fiduciary should advise them to pay an estimated tax at the time that the beneficiaries extend their own returns.

If a fiduciary resigns or is removed, and a new fiduciary is appointed, there is little authority on the question of which of the two fiduciaries is required to file the fiduciary income tax return for periods during the administration of the former fiduciary. The consensus seems to be that the new fiduciary should file the return with information supplied by the former fiduciary, but both are probably responsible for seeing to it that the return is filed.

8. Formerly-Revocable Trust Election to Use a Fiscal Year

Although trusts are generally required to use a calendar tax year, §644(a), a formerly-revocable living trust may elect to use a fiscal year following the death of the grantor. §645. This election is made by filing a Form 8855, in which the revocable living trust (which is now neither revocable nor living) elects to be taxed as if it were part of the decedent's estate. The form is normally filed with the first fiduciary income tax return filed for the estate, and a box is checked on page 1 of the initial and subsequent returns. Form 8855 is due by the due date of the fiduciary income tax return, or the extended due date; the election cannot be made on a late return. §645(c). The §645 election is irrevocable. §645(c).

The election is available regardless of whether a probate estate is actually being administered for the decedent. If a probate is not being administered, there is some debate as to whether an EIN (employer identification number) must nevertheless be obtained for the nonexistent estate. The instructions to Form 8855 state that the trust's EIN should be entered in both Part I of the form (for the estate) and Part III of the

form (for the trust), which would support the view that no estate EIN is needed if no probate is being administered. If a probate is being administered, both the estate and the trust should obtain separate EINs, and the estate will file the Form 1041 under the estate EIN; the trust will not file a separate return. The trust will be treated as a separate share of the estate for purposes of the separate share rule. Reg. §1.663(c)-4(a). (The trust itself might consist of two or more separate shares; see below for a discussion of the separate share rule.) Thus if a probate estate is being administered, then both the estate and the trust will report their income on the same Form 1041, which will be the income tax return of the estate. Each beneficiary will receive only one K-1, which will combine the income of the trust and of the estate. But because of the application of the separate share rule, two beneficiaries might be taxed differently.

If, at the time of filing the Form 8855, no probate is being administered, but a probate is later commenced, an amended Form 8855 must be filed. See the instructions to Form 8855.

The election to be treated as part of the decedent's estate may not be continued indefinitely. If a federal estate tax return is not required to be filed, the election may remain in place for tax years ending up to two years following the date of death. §645(b)(2)(A). If a federal estate tax return is required to be filed, the election may remain in place for tax years ending up to six months after the estate tax liability is finally determined. §645(b)(2)(B). The filing of a state estate tax return is not relevant for purposes of this rule. For a fuller discussion of the applicable time periods, see the regulations under §645. Reg. §1.645-1(f)

The election may be used only by (and applies only to) a Qualified Revocable Trust (QRT) as defined by Reg. $\S1.645-1(b)(1)$. The election cannot continue to be used by subsequent trusts that are created by or funded by the QRT. Reg. $\S1.645-1(f)(1)$.

After the period has expired during which a fiscal year is permitted to be used, the trust will then be required to file a short-year return ending December 31, and subsequent returns will be full-year returns ending December 31. Reg. §1.645-1(h)(4)(ii). At the end of the §645 election period, the trust is deemed to have distributed its assets and all of its tax attributes to a new trust in a distribution to which §661 and §662 apply. Reg. §1.645-1(h)(2). The trustee might need to obtain a new EIN for the trust, depending on whether an estate exists. See Reg. §1.645-1(h)(3); Reg. §301.6109-1(a)(4).

The election to be treated as part of the decedent's estate, and to use the fiscal year of the estate, also triggers several other fiduciary income tax benefits that estates are allowed, compared to trusts. Those benefits include fewer obligations to pay

estimated taxes, use of the charitable set-aside deduction, use of the exemption applicable to estates, fewer restrictions on holding S corporation stock, and the ability to take a loss on the distribution of an in-kind asset in satisfaction of a pecuniary bequest, among others. Those benefits are discussed separately under those topics.

9. The Final Tax Year

Special rules apply to the final tax year of all trusts and estates. The primary purpose of most of these special rules is to shift all of the tax liability for the final year to the beneficiaries. As a result, all trusts and all estates pay no income taxes for income received (or gains realized) in their final year, but they nevertheless must file a final return. The reason why no tax is due: the Code is designed to permit trusts and estates to distribute all of their assets to their beneficiaries at the end of their final year, without any need to hold back a reserve to pay income taxes. All of the income, capital gains, and deductions are reported on the final return, but then a distribution deduction is allowed for all of the income and capital gains (unlike a non-final year), and then all of

the income, deductions, and gains are carried out to the beneficiaries. §662; §643(a)(3); Reg. §1.643(a)-3(d).

This is a very important rule, and so it bears repeating: trusts and estates pay no taxes in their final year; all of their income, gains, deductions and other tax attributes flow out to the beneficiaries in the final year; and the beneficiaries pay the resulting tax (or obtain the benefit of any excess deductions in years prior to 2018 or after 2025). §662(b). Although the Code does not expressly state that the final year involves no tax liability for an estate or trust, that is the net effect of §662 and §643.

For that reason, simple trusts are no longer classified as simple trusts in their final year; they are classified as complex trusts. The mechanism that forces that classification is 661(a)(2) and the last sentence of 651(a). Reg. 1.651(a)-3(a).

Any excess deductions in the final year flow out to the beneficiaries to be used by the beneficiaries on their individual tax returns, subject to two restrictions. §642(h). Excess deductions are defined as the amount by which deductions exceed gross income in the final year. §642(h); Reg. §1.642(h)-2(a). (Excess deductions cannot be passed out to the beneficiaries in tax years after 2017 and before 2026. §67(g).)

For purposes of calculating the excess deductions, all of the following adjustments are made in the calculation. Net operating loss carryovers under §172 and capital loss carryovers under §1212 are included. §642(h) and Reg. §1.642(h)-1. The personal exemption and the charitable deduction are disregarded. §642(h)(2). In effect, the charitable deduction in the final year is wasted. *O'Bryan v. Commissioner*, 75 T.C. 304 (1980). The distribution deduction is also disregarded. §643(a)(1).

Although \(642(h) \) provides that excess deductions in the final year flow out to the beneficiaries to be used by the beneficiaries on their individual tax returns, two restrictions apply. Because of those two restrictions, some beneficiaries will not be able to make use of the excess deductions. Those restrictions stem from the fact that excess deductions are considered to be miscellaneous itemized deductions on the individual income tax returns of the beneficiaries. §67(b). Miscellaneous itemized deductions can be used by a beneficiary (1) only if the beneficiary itemizes his deductions, and (2) even then the deductions can be utilized by the beneficiary only to the extent that his miscellaneous itemized deductions exceed two percent of the beneficiary's adjusted gross income (this latter rule is known as the two percent floor). §67(a); §642(h); Reg. §1.642(h)-2(a); Rev. Rul. 59-392, 1959-2 C.B. 163. Those excess deductions cannot be carried forward or backward by a beneficiary to a subsequent year or a prior year; they may be used, if at all, in the beneficiary's year in which the trust's final year or the estate's final year ended. Reg. §1.642(h)-2(a). If the trust or estate passes out a net operating loss carryover or a net capital loss, the beneficiaries may continue to carry over the losses. Reg. §1.642(h)-1.

Section 642(h) provides that the excess deductions flow out to the beneficiaries "succeeding to the property of the estate or trust." For a discussion of which beneficiaries so qualify, see Reg. §1.642(h)-3. But after 2017 and before 2026, excess deductions may no longer be deducted by the beneficiaries, because the excess deductions are classified as miscellaneous itemized deductions, which individuals may no longer deduct, due to the provisions of the Tax Cuts and Jobs Act of 2017 (P.L. 115-97). But trusts are still allowed to deduct miscellaneous itemized deductions under §67(e), which permits such deductions that "would not have been incurred if the property were not held" in a trust or estate. But what if the beneficiary of a trust with excess deductions in the final year were itself a trust? Can that beneficiary trust deduct the excess deductions it receives? The answer is probably no, since those deductions do not relate to the administration of the beneficiary trust.

If a trust or estate lacks sufficient income to fully absorb administration expenses, and if the beneficiaries can make use of the excess deductions, then consideration should be given to paying most of the administration expenses in the final year of the trust or estate, so that the deductions will flow out to the beneficiaries. On the other hand, because of the restrictions on the deductibility of the excess deductions by the beneficiaries, the ideal strategy might be to pay enough administration expenses each year to reduce the taxable income to zero, thus minimizing the excess deductions to be passed out to the beneficiaries in the final year, while still keeping the trust or estate taxable income to a minimum each year. (Again, excess deductions cannot be passed out to the beneficiaries in tax years after 2017 and before 2026. §67(g).)

When does a trust terminate? A trust does not end its existence simply because the governing document states that the trust terminates upon the happening of a particular event. Instead, the trust continues in existence until it has distributed all (or almost all) of its assets. Reg. §1.641(b)-3(b); Reg. §1.641(b)-3(c)(1); Dominion Trust Co. of Tenn. v. United States, 786 F.Supp. 1321 (M.D. Tenn. 1991) aff'd 7 F.3d 233 (6th Cir. 1993; unpublished opinion); Herbert v. Commissioner, 25 T.C. 807 (1956), acq. 1956-2 C.B. 6; Rev. Rul. 55-287, 1955-1 C.B. 130. For example, if a trust document states that the trust terminates upon the death of the life income beneficiary, and the document then requires that the trust distribute all of its assets to a remainderman, the trust does not actually terminate on that date of death. Similarly, a revocable living trust might provide that it terminates on the death of the trustor, but the trust usually continues in existence for the purposes of paying debts, resolving claims, filing the decedent's final income tax return, filing an estate tax return, filing income tax returns for the trust, resolving an estate tax audit, liquidating assets, formulating a plan of distribution, obtaining releases, etc. Not all of those tasks are required of every trust, but nearly all trusts have tasks to complete before the assets can be distributed to the ultimate beneficiaries. In Dominion Trust, the completion of those tasks took more than three years; that period of time is somewhat typical for an estate in which the estate tax return is audited by the IRS. In Lowery v. Evonuk, 95 Or. App. 98 (1989), the court held that a trustee had not administered a trust within a reasonable period of time when the postmortem administration of the trust took more than twenty-one months. Of course, what constitutes a reasonable time depends of the facts and circumstances of each case; twenty-one months might be too short for a large, complex trust. Even if a court orders a trust to be terminated, the trust does not terminate until it has accomplished the tasks necessary to effectuate a full distribution of its assets. Richards v. Campbell, 21 AFTR2d 1122, 68-1 USTC ¶9288 (N.D. Tex. 1968). However, ORS 130.730 requires that a trustee proceed expeditiously to distribute trust property following a terminating event, and thus a trustee has an obligation to complete those tasks with reasonable promptness. See also Reg. §1.641(b)-3(a).

Although a trust terminates for tax purposes when it has disposed of all of its assets, the trust may retain a reserve for contingencies and still be treated as having been terminated. Reg. §1.641(b)-3(a), (b). The regulation does not specify the permitted size of the reserve or how long it can be held.

If the goal is to distribute all of the assets of a trust or estate before the last day of the final fiscal year, and then file the final fiduciary income tax returns a few months later, this question is often posed: How will the fiduciary pay for the preparation of the final returns when the fiduciary holds no assets? Some attorneys hold back a reserve for that purpose, but a simpler solution is to ask the accountant to agree to a predetermined fixed fee for the preparation of the final returns. That fee can then be paid

to the accountant immediately before the final distribution of all of the remaining assets to the beneficiaries. After all, no tax will be due with the final returns.

An estate or trust files the version of the Form 1041 published for the year in which the tax year begins, according to the Form 1041 instructions. If the final tax year concludes prior to the end of a calendar year, some accountants are reluctant to file a final return until the following tax season, when new tax forms become available, new tax return preparation software becomes available, and end-of-year forms 1099 are issued. For example, if a decedent dies in January 2014 and the estate fully distributes its assets and closes in August of 2014, the final Form 1041 is due December 15, 2014, and the return is supposed to be filed using 2014 tax forms, but 2014 forms (and 2014 tax return preparation software and 2014 1099s) won't become available until January of 2015. Filing that return during the subsequent tax season in early 2015 usually causes no harm (even though it is technically late), but some fiduciaries prefer to file the final return sooner, in order to fully and finally satisfy their all of their duties. One solution: the IRS usually will accept that final 2014 return filed on 2013 forms if the "2013" in the upper-right corner of the forms is crossed out and "2014" is written in bold digits above the struck-out "2013." For tax return preparers who are required to file all of their returns electronically, a special "opt-out" Form 8948 can be attached to the return and will permit the preparer to file such a return in paper form. Using the prior year's form for a short-year return is specifically authorized by the instructions to the Form 1041, if the estate or trust is filing a short-year year return, the new forms have not yet been published, and the preparer takes into account any tax law changes.

Note that the beginning date of a fiscal year (not the ending date) governs the year of the Form 1041 to be used (this rule does not apply to Forms 1040). Thus a fiscal year beginning July 1, 2014, and ending June 30, 2015, should be filed using 2014 forms, not 2015 forms. See Form 1041 and its instructions. That sometimes solves the problem of needing tax forms and tax preparation software, but it does not solve the problem of needing 2014 1099s.

Although in Oregon ORS 116.083(3)(a) requires that each probate final accounting must make a representation to the court that all required tax returns have been filed, most practitioners interpret that statute as not requiring the filing of the final fiduciary income tax returns prior to filing the final accounting with the court, since the final 1041 is not required to be filed until after the final accounting has been approved and the estate has been fully distributed. See also ORS 116.113.

As discussed above, fiduciary income tax returns are signed by the personal representative or trustee. §6061; Reg. §6061-1(a). But because the final tax year ends when all of the assets have been distributed, the personal representative or trustee usually finds himself signing the final fiduciary income tax returns after the estate or

trust has been closed or terminated. In an estate, the personal representative has usually been discharged by the time the final fiduciary returns are prepared and are ready to be signed and filed. And a trustee, who no longer holds any assets, is technically no longer serving as trustee. Can these former fiduciaries nevertheless sign the final income tax returns? There is no legal authority directly on point, but most attorneys believe that such fiduciaries do have the authority, and the obligation, to sign and file the final returns. (In Washington, RCW 11.68.114 provides that a personal representative of a closed probate retains the authority to deal with taxing authorities, and may retain a reserve of up to \$3,000.) Reg. §1.641(b)-2(a) is clear that the obligation continues after the discharge:

The fiduciary is required to make and file the return and pay the tax on the taxable income of an estate or of a trust. Liability for the payment of the tax on the taxable income of an estate attaches to the person of the executor or administrator up to and <u>after his discharge</u> if, prior to distribution and discharge, he had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed. (Emphasis added.)

10. Fiduciary Accounting Income

Fiduciary accounting income is essentially the income of a trust or estate defined by the will or trust, and by local law. §643(b). In general, the IRS will not honor definitions of income or principal contained in a trust document that fundamentally vary from state law; a "reasonable apportionment" is required. Reg. §1.643(b)-1. In most states, the principal source of that law is the Uniform Principal and Income Act (UPIA), which has been enacted in Oregon as chapter 129 of the Oregon Revised Statutes, and in Washington as RCW 11.104A. Because fiduciary accounting income is based on state law, it is usually expressed as a dollar amount of income net of expenses. The Uniform Principal and Income Act refers to it as net income. ORS 129.205(8); RCW 11.104A.005(8). (The National Conference of Commissioners on Uniform State Laws is now in the process of revising the UPIA and renaming it the Uniform Fiduciary Income and Principal Act (UFPIA). When it will be finished, and when the various states might adopt it, is not yet known.)

The fiduciary income tax provisions of the Internal Revenue Code refer to fiduciary accounting income whenever the word income is not preceded by the words gross, taxable, distributable net, or undistributed net. §643(b).

A trust or estate is permitted to compute its taxable income under the cash method, the accrual method, or other permissible methods. \$446(c); see also \$641(b); \$7701(a)(1), (14). Once a method has been adopted, however, the method cannot be changed without the permission of the IRS. \$446(e).

The primary purpose for the term fiduciary accounting income is to distinguish between principal (including capital gains) and income, particularly since many trusts call for the distribution of income to one beneficiary, followed by a distribution of principal (including capital gains) to a different beneficiary, such as a remainderman. But fiduciary accounting income also has important uses in determining DNI and the distribution deduction, as noted below.

However, fiduciary accounting income will usually not trump the definition of taxable income contained in the Internal Revenue Code. For example, assume that a trust received the proceeds of an annuity that had been owned by a decedent. Under the Uniform Principal and Income act, much of the proceeds of an annuity is considered to be principal. (In Oregon, see ORS 129.355. In Washington, see RCW 11.104A.180.) Despite that state law definition, the federal tax laws will likely reach a different result: a significant portion of the annuity proceeds is often considered to be taxable income under §72 of the Code. (Note that some of that amount is probably also income in respect of a decedent under §691. See the discussion of IRD, below.) Because a portion is taxable income, that portion is included in the distributable net income (DNI) of the trust, for the simple reason that taxable income is the starting point in the definition of DNI. §643(a). If that amount is distributed to the beneficiary of the trust, that amount would be treated as a deductible \(661(a)(2)\) distribution of DNI, because that subsection includes "any other amounts," not just income. And then it would be included in the taxable income of the beneficiary under \662(a)(2), because that subsection includes "all other amounts properly paid," not just income. That treatment of a portion of the proceeds as taxable income would take place even though the amount distributed might be considered to be principal under the state law definition of fiduciary accounting income. As a result, the tax laws would determine that the distribution was income, even though the fiduciary accounting laws would treat it as principal. (However, in that situation the trustee of the trust will need to carefully review the distributive provisions of the trust to make certain that principal, as defined by state law, may be distributed under the terms of the trust.) See also Reg. §1.662(a)-2(c).

In that situation, DNI exceeded fiduciary accounting income. In other situations, DNI might be less than fiduciary accounting income. For example, a trust might deduct for income tax purposes a distribution that the Uniform Principal and Income act requires be allocated to principal. If so, the distribution deduction will nevertheless be limited to the amount of DNI. §651(b); §661(a). The amount taxable to the beneficiaries will similarly be limited to the amount of DNI. §652(a); §662(a). See the discussions of distributable net income and the distribution deduction, both below.

The definition of fiduciary accounting income also causes special problems when a trust or estate holds an interest in an S corporation or a partnership. The income of such entities is generally taxed to the shareholders/partners, regardless of whether the income is actually distributed to them. If the entity earns income, but does not distribute it, then the K-1s issued to the shareholders/partners will show income taxable to the shareholders/partners, but the shareholder/partners will have received no cash with which to pay the tax on that taxable income. Such income unaccompanied by cash is known as phantom income. But the problem is even more complicated if the shareholder/partner is a trust or estate. Under the Uniform Principal and Income Act enacted in most states, income is generally limited to amounts received in cash. See, e.g., ORS 129.300(2). Items that do not qualify as income are deemed to be principal. ORS 129.300(3)(a). Amounts actually distributed by the entity will be treated as income, and will be included in DNI. But amounts not actually distributed by the entity are not included in fiduciary accounting income of the trust or estate, due to the provisions of the UPIA cited above. Yet they are taxable to the trust or estate under the sections of the Internal Revenue Code that govern S corporations and partnerships. Van Buren v. Commissioner, 89 T.C. 1101 (1987). And the trust or estate is not able to distribute such income to the beneficiaries and cause it to be taxed to the beneficiaries, because §651(a) and §661(a) allow distribution deductions only for income actually distributed or required to be distributed, and it is not possible for the fiduciary to distribute income which the fiduciary has not actually received, nor will income be deemed to have been distributed if the UPIA does not define it as income. Yet for income tax purposes, the fiduciary is taxed on that income, and the beneficiary will not be taxed on that income. Thus when an entity such as a partnership or an S corporation fails to distribute cash to a trust or estate when the entity has taxable income, that taxable income is effectively trapped in the trust or estate and taxed to the trust or estate at the usually higher rates applicable to trusts and estates. Van Buren v. Commissioner, 89 T.C. 1101 (1987). To prevent that trapping from taking place, cash should be distributed from the entity to the trust or estate (so that the trust or estate will have received fiduciary accounting income), and then (in the case of an estate or a complex trust) cash should be distributed to the beneficiaries. In the case of a simple trust, the cash need not be distributed to the beneficiaries, because the income of the trust is eligible for a distribution deduction regardless of whether it is actually distributed. §651(a). See the next section for a further discussion of partnership and S corporation interests held in an estate or trust.

11. Partnerships and S Corporations

S corporations pose special problems in estate and trust administration after an S corporation shareholder has died. Only certain kinds of trusts are eligible to be shareholders in S corporations, and some of those trusts are eligible only for brief

periods following the death of a shareholder. The types of trusts eligible to hold S corporation stock include grantor trusts, revocable trusts within two years following the death of the shareholder, testamentary trusts within two years of the receipt of S corporation stock, estates during a reasonable period of administration, Qualified Subchapter S Trusts (QSSTs), and Electing Small Business Trusts (ESBTs). See §1361 and Reg. §1.1361-1. For more detail on this subject, see Heath and Schnell, *Estate Planning with S Corporation Stock*, Oregon State Bar Estate Planning and Administration Section Newsletter, Vol. XXVII, No. 3, July 2010. A trust may be treated as an estate for purposes of these rules if the trust has made a §645 election to use a fiscal year as part of the decedent's estate. Reg. §1.645-1(e)(3)(i). See the discussion of a trust's election to use a fiscal year, above.

See the previous section for a discussion of fiduciary accounting income when a trust or estate holds an interest in an S corporation or a partnership.

If a decedent owned an interest in a partnership or an LLC, the partnership or LLC may make an election under §754 to adjust the basis of partnership assets with respect to the transferee partner only (the person taking the interest as a result of the death of the partner). (The partnership or LLC might already have a \$754 election in place, either because a partner previously died or because a partner purchased an interest and desired to get increased depreciation deductions.) This adjustment is made pursuant to \$743(b). The amount of the \$743(b) adjustment is equal to the difference between the transferee's initial basis in his partnership interest (fair market value as of the date of death) and his proportionate share of the adjusted basis of partnership property. The adjustment can be a positive or a negative adjustment. Once the election is made, the §743(b) adjustment applies to all transfers of partnership interests by sale or exchange or upon the death of a partner until the election is formally revoked, and revocation is difficult or impossible. The election must be filed with a timely partnership return for the taxable year during which the transfer occurs. Reg. §1.754-1(b). In the case of a transfer caused by a death, this would be the return for the year of the death. Section 743(b) basis adjustments are mandatory if the partnership has a substantial built-in loss immediately after the transfer of a partnership interest. A substantial built-in loss exists where the adjusted basis of all partnership property exceeds its fair market value by at least \$250,000. Reg. \$1.754-1(d)(1).

Assuming the adjustment is positive, the benefit of the election is that the transferee is allowed an increase in his or her basis in the partnership assets. This in turn reduces the transferee's share of capital gain realized on the sale of any of the assets. A §743(b) basis adjustment has no effect on the partnership's computation of any item under §703, nor does it impact the transferee's capital account. If the assets

are depreciable, then the increased basis in the assets results in increased depreciation, which appears on the K-1 issued to the transferee.

The disadvantages of the election to adjust the basis of partnership assets include:

- a. The election is essentially irrevocable (except with IRS consent).
- b. If the transferee's basis in partnership assets exceeds his or her basis in his or her partnership interest, the §743(b) adjustment would decrease his or her basis in partnership assets.
- c. The election applies to both transfers of partnership interests and distributions of partnership assets. This could result in future decreases in basis depending upon subsequent events.
- d. The election adds accounting and record-keeping complexity for the partnership.
- e. If a §743(b) election is not made, the gain that could have been avoided by the basis increase will be recognized. However, since this gain increases the partner's basis in his partnership interest, upon a sale of his partnership
 - interest the partner would have an offsetting recovery of the amount earlier recognized.

12. Distributable Net Income (DNI)

The concept of distributable net income is central to understanding the fiduciary income tax. DNI is essentially the taxable income of the estate or trust, including both taxable income and tax-exempt income. §643(a); Reg. §1.643(a)-5(a). Since it is based on taxable income, DNI is calculated after reducing the income by deductible administration expenses, such as attorney fees, executor fees, and other expenses, but DNI is not reduced by distributions to beneficiaries, or by the personal exemption of the trust or estate. When including tax-exempt income in DNI, the income is reduced by expenses that are non-deductible by reason of having been allocated to the tax-exempt income. §643(a)(5); Reg. §643(a)-5. See tax-exempt income, below.

The primary function of the DNI calculation is to serve as a limit on how much of a distribution to beneficiaries may be deducted under the distribution deduction. §651(b); §661(a). That fact explains why DNI is calculated without taking into account the distribution deduction. See the discussion of the distribution deduction, below.

DNI does not include most capital gains, except in the final year. §643(a)(3); Reg. §1.643(a)-3(d). See the discussion of the final year, above. The exclusion of capital gains from DNI explains why capital gains are subtracted from adjusted total income on Schedule B of Form 1041 in order to calculate DNI. The fact that DNI does not include capital gains (except in the final year) explains why most capital gains are taxed to the trust or estate, and not to the beneficiaries, except in the final year. §643(a)(3).

Because DNI is based on taxable income, charitable deductions have already been removed from DNI, and no further adjustment to DNI is needed with respect to charitable deductions. §643(a). This rule prevents non-charitable beneficiaries from being taxed on income distributed to charity or set aside for charitable purposes, with one exception: tier 1 beneficiaries receive no benefit from a charitable distribution of income. §662(a)(1). In effect, tier 1 beneficiaries have priority to be taxed on the income of a trust or estate, and charitable distributions of income are treated as a lower priority, but a higher priority than tier 2 distributions. See the discussions of the charitable deduction and the tier system, both below.

The calculation of DNI is made without subtracting the §691(c) deduction for estate taxes paid on income in respect of a decedent. Reg. §1.691(c)-2(a)(2). See income in respect of a decedent, below.

Deductible items that enter into the calculation of DNI must be allocated among the income items received by the estate or trust. Deductions directly attributable to a particular class of income are first deducted against that class of income, and the excess may then be deducted against other classes of income, unless the excess is attributable to tax-exempt income. Reg. §1.652(b)-3.

If an estate or trust has both tax-exempt income and a charitable deduction, the tax-exempt income (reduced by deductions attributable to the tax-exempt income) is included in DNI, but the tax-exempt income included in DNI is reduced by the portion deemed to have been distributed to (or set aside for) the charity. Reg. §1.643(a)-5(b).

As noted below, the fiduciary may elect to deduct some expenses on an estate tax return under §642(g), in which case those particular expenses may not be deducted on the fiduciary income tax return, and in that event such expenses will not reduce DNI. Nor may expenses deducted on the estate tax return also be used to reduce capital gains on a fiduciary income tax return. §642(g).

13. Capital Gains and Losses

In general, capital gains and losses are taxed to trusts and estates in much the same fashion as they are taxed to individuals. The general rule, subject to many exceptions, is that in each year long-term gains are netted against long-term losses, and

short-term gains are netted against short-term losses. Then the long-term net gain/loss is netted against the short-term net gain/loss. If the result is a gain, it is taxed to the trust or estate at 20%, or 15% if taxable income is less than \$12,500 for 2017. §1(h). That number increased to \$12,700 for 2018. If the result is a loss, it can be deducted up to the amount of \$3,000 in that year, and the excess can be carried over into future years indefinitely until it has been consumed in those future years. §1212(b). See also \$1.643(a)-3(d).

Trusts and estates reach the highest capital gain rates at a much lower threshold than do individuals. An individual single person does not reach the maximum 20% rate unless taxable income is above \$400,000 in 2013, and joint-filing married taxpayers do not reach the maximum 20% rate unless taxable income is above \$450,000 in 2013. §1(h). In 2014, those numbers increased to \$406,750 and \$457,600, and in future years those numbers will continue to be adjusted for inflation. See Rev. Proc. 2013-35. In 2015, those numbers increased to \$413,200 and \$464,850, and in 2016 they increased to \$415,050 and \$466,950. In 2017, those numbers increased to \$418,400 and \$470,700. In 2018, those numbers increased to \$425,800 for single persona and \$479,000 for married couples.

Assets acquired from a decedent and disposed of within one year after the death are automatically deemed to have been held by the recipient for more than one year, even if the recipient disposed of the asset shortly after the death of the decedent. §1223(9). As a result, any gain realized is deemed to be long-term. This rule applies not only to estates, but also to revocable trusts that became irrevocable upon the death of the decedent. §1014(b). In fact, this rule applies to any asset where the basis is determined by §1014 (basis of property acquired from a decedent). §1223(9). See the discussion of basis step-up, below.

In general, capital gains and losses do not pass out to the beneficiaries; the trust or estate pays the income tax on the net gains, and the net losses are deductible by the trust or estate subject to the limitations described above. That result is brought about by the fact that such gains and losses are not included in DNI. §643(a)(3). That result is based in part on state law, which typically allocates capital gains to principal. ORS 129.310; RCW 11.104A.130. However, in the final year of a trust or estate, all of the tax attributes of that tax year pass out to the beneficiaries as part of DNI, so that any capital gains realized in that final year will be reported by the trust or estate on the fiduciary income tax return, but then the gains will be carried out to the beneficiaries on their K-1s, as will the losses. §662; §643(a)(3); Reg. §1.643(a)-3(d). See the discussion of the final year, above.

Under some circumstances, capital gains are included in DNI in a non-final year of a trust or estate, and thus those exceptions allow capital gains to be passed out to the

beneficiaries. Those exceptions are described in §643(a)(3) and Reg. §1.643(a)-3. In general, those exceptions require that the allocation of capital gains to income must be done pursuant to the terms of the governing instrument, or pursuant to the provisions of local law, or pursuant to a reasonable and impartial exercise of discretion granted by the governing instrument or by local law. Once those hurdles are crossed, the available exceptions are:

- a. Gains that are allocated to fiduciary accounting income by the fiduciary.
- b. Gains that are allocated to principal, but are consistently treated by the fiduciary on the books, records, and tax returns of the trust as distributed to a beneficiary.
- c. Gains that are actually distributed to a beneficiary, or are used by the fiduciary to determine the amount distributed or required to be distributed to a beneficiary.

In addition, gains can be treated as part of income if paid or permanently set aside for charitable purposes under §642(c) by an estate (not a trust, with some exceptions, such as trusts making a §645 election). See the discussion of the charitable deduction, below.

The regulations under §643 provide fourteen examples to illustrate how §643(a)(3) operates to allow capital gains to be passed out to beneficiaries. Those examples demonstrate that the exceptions described above can be used only if the governing instrument or state law permits such distributions. Reg. §1.643(a)-3(e).

In general, the inclusion of capital gains in DNI pursuant to any of these exceptions requires a consistent treatment by the trustee in each year after the decision is made to allocate capital gains to income, as indicated in the examples in the regulations. In 2015, the Oregon legislature amended ORS 130.715 to make it easier for a trustee to include capital gains in DNI. (Oregon Laws 2015 ch. 126 §3; 2015 HB 2331). Prior to the latest version of the regulations, the IRS had a history of not concluding that a consistent practice was present that would allow the allocation of capital gains to income. PLRs 8105028, 8324002, 8429005, 8506005 and 8324002.

In many modest estates, capital gains are relatively few and small, particularly since the assets will have received a stepped-up basis for income tax purposes. §1014(a). In a relatively small estate, oftentimes the only significant capital transaction is the sale of the decedent's personal residence. Let's assume that the house is sold on the open market a few months after the date of death, through the services of a professional real estate broker. That sale usually determines the fair market value of the residence, and it is not unreasonable to use that sale price as the fair market value on

the estate tax return and as the post-mortem income tax basis of the residence. But how are the broker's commission, the title insurance premium, and related closing costs handled for tax purposes? As noted below in the discussion of deductions, the expenses of sale are usually not deductible on an estate tax return under \$2053(a)(2) or against ordinary income for fiduciary income tax purposes. Instead, those expenses are offsets against the selling price to reduce gain or to increase loss. *Scull v. Commissioner*, T.C. Memo 1994-211, n. 14. But because the sale price is also the basis, offsetting those closing costs will produce a capital loss. That loss can be offset against capital gains, and if the losses exceed the gains (as noted above), the excess can be deducted up to \$3,000 per year against ordinary income. If the sale takes place in the final year of the estate (and modest estates often have only one tax year, which is both the first tax year and also the final tax year), then the loss flows out to the beneficiaries, who can use the loss to offset their own capital gains, and any net loss of each beneficiary can be deducted against ordinary income by each beneficiary up to \$3,000 per year under \$1211(b). \$1.642(h)-1(c).

The IRS once took the position that a loss on the postmortem sale of a personal residence could not be deducted unless the estate had rented out the residence, SCA 1998-012, but apparently the IRS no longer takes that position. See IRS Publication 559. For examples of cases that have held that the sale of a personal residence by an executor is always entered into for a profit motive, and thus losses are deductible, see Waterman Estate v. Commissioner, 195 F.2d 244 (2d Cir. 1952), reversing 16 T.C. 467 (1951); Wilmington Trust Co. v. U.S., 76-1 USTC ¶9372 (Ct. Cl. 1976), adopting 76-1 USTC ¶9163 (Ct. Cl. 1976). In other cases, the sale of a residence was not deemed to have been entered into for a profit motive when the fiduciary allowed a beneficiary to use the property as a personal residence. Barnes v. U.S., 222 F. Supp. 960 (D. Mass. 1963), aff'd 326 F.2d 825 (1st Cir.); Meurir v. Commissioner, 221 F.2d 223 (2d Cir. 1955). In Watkins v. Commissioner, T.C. Memo 1973-167, a husband sold his deceased wife's personal residence shortly after she died, although he lived in it briefly after she died. The Tax Court reasoned that if the wife had sold the residence during her lifetime, a loss could not have been deducted, but property acquired by inheritance has a neutral status, and the state of mind and/or conduct of the executor or heir after the owner's death must be examined in order to decide whether a profit motive was present. The court decided that the husband's dominant purpose was a profit motive, regardless of his temporary use of the residence. A similar result was reached in Miller v. Commissioner, T.C. Memo 1967-44, when there was no personal use of the residence after the death.

Unless it is a grantor trust, a trust is not eligible for the capital gain exclusion on the sale of a personal residence provided by §121. PLR 200104005; PLR 199912026; Reg. §1.121-1(c)(3). (For individuals, the amount of that exclusion is \$250,000, or

\$500,000 for married couples.) If the trust is deemed to be partially a grantor trust, then the grantor may exclude that portion of the gain. PLR 200104005.

Occasionally an undivided half interest in a personal residence is placed in a credit shelter trust, while the other half interest continues to be owned by the surviving spouse. Under the prior version of §121, the owner of a partial interest could exclude that owner's portion of the gain. Rev. Rul. 67-234, 1967-2 C.B. 78; Rev. Rul. 67-235, 1967-2 C.B. 79. Presumably that result is still available under the current version of §121.

On the other hand, if the residence is not placed in a trust following the death of one spouse, the surviving spouse may still take advantage of the full \$500,000 exclusion if the residence is sold within two years after the death and the other eligibility requirements of \$121 were met immediately before the date of death. \$121(b)(4).

For purposes of determining whether a trust or estate has gross income in excess of the \$600 filing threshold, gross income does not necessarily include gross proceeds from the sale of a capital asset. Instead, gross income includes an amount equal to gross proceeds minus basis. Reg. §1.61-6(a).

14. Exemptions

Under §642(b), an estate is allowed a personal exemption of \$600, a simple trust is allowed a personal exemption of \$300, and a complex trust is allowed a personal exemption of \$100. These exemptions are not available in the final year of a trust or estate because the trust or estate pays no taxes in the final year and the exemption may not be passed out to the beneficiaries as an excess deduction. §642(h)(2).

A trust is allowed to use the larger \$600 exemption of an estate if the trust has made a §645 election to use a fiscal year as part of the decedent's estate. Reg. §1.645-1(e)(2)(ii)(A). See the discussion of a trust's election to use a fiscal year, above.

The above exemptions were not altered by the Tax Cuts and Jobs Act of 2017 (P.L. 115-97).

15. Calculating Taxable Income; Deductions

Estates and trusts are generally taxed in the same manner as individuals, with several exceptions. §641(b). Calculating the taxable income of an estate or trust involves several steps. The most important steps are:

a. <u>Determine gross income</u>. Gross income generally does not include the proceeds of life insurance received due to the death of the decedent.

- §101(a)(1). Also, gross income does not include tax-exempt income, such as municipal bond income. §103. In the following discussion of deductions, deductions relating to tax-exempt income must be allocated in full or in part to the exempt income, and the portion so allocated may not be deducted. §265. For example, a trustee's fee for investment management must be allocated between taxable investments and tax-exempt investments.
- b. Deduct the above-the-line deductions. These are deductions defined by §62 as deductions from gross income to determine adjusted gross income (AGI). They are known as above-the-line deductions because they are deducted from gross income, not from adjusted gross income. These are primarily deductions incurred in carrying on a trade or business, including ordinary and necessary business expenses under §162, business interest under §163, business taxes under §164, business losses under §165, and depreciation of business assets under §167, 168, and 642(e). The allocation of depreciation deductions between trusts, estates, and their beneficiaries is governed by §642(e), §167(d) and §611(b). If the business generates a net operating loss, the NOL may be carried back two years and then may be carried forward up to twenty years. §642(d); §172(b).
- c. The result would normally be adjusted gross income (AGI) as it is defined by \$62 if it were calculated for an individual taxpayer, but \$67(e) makes several significant changes to the calculation of adjusted gross income if it is being calculated for a trust or an estate. Section 67(e), which establishes a test known as the 2% floor, requires that four deductions that would normally be below-the-line deductions from adjusted gross income must, in the case of trusts and estates, be subtracted in order to calculate adjusted gross income. Those four deductions are (1) administration expenses that "would not have been incurred if the property were not held in such trust or estate," (2) the personal exemption under §642(b), (3) the distribution deduction for simple trusts under §651, and (4) the distribution deduction for complex trusts under §661. Note that §67(e) does not actually permit those four deductions to be taken above-the-line; it merely provides that they should be subtracted when calculating adjusted gross income "[f]or purposes of this section." In other words, those four deductions will be subtracted for purposes of determining AGI, but only for purposes of determining the 2% floor, which is applied later in the tax calculation (see below). Those deductions that are subtracted from gross income for purposes of this calculation of adjusted gross income will be deducted below for purposes of calculating adjusted total income and eventually

- taxable income, but in this step the calculation simply takes a minor detour to calculate the special definition of adjusted gross income for purposes of estates and trusts. Because adjusted gross income is later used to determine the 2% floor on some of those deductions, and because those deductions are used to calculate adjusted gross income and taxable income, a simultaneous (circular) calculation is often required.
- d. The result is adjusted gross income, as it is specially defined by \(67(e) \) for trusts and estates for purposes of calculating the 2% floor (discussed below). However, because of the circular nature of the calculation, the term adjusted gross income is not actually used in the calculation of the tax; it is used only to calculate the 2% floor. For example, the Form 1041 does not actually use the term adjusted gross income on the form itself, although the term is used in the instructions to calculate the 2% floor. The instructions give an example of how to manually perform the circular calculation. Most practitioners, however, use commercial tax return software, which eliminates the need for the manual calculation. The circular calculation is not required in every case; for example, some trusts have no miscellaneous itemized deductions that are subject to the 2% floor. In another example, some trusts distribute less than DNI, and their distribution deduction is therefore less than DNI, and thus the distribution is not limited by DNI. In that situation, the impact that AGI has on DNI does not affect the distribution deduction.
- e. <u>Deduct the below-the-line deductions</u>. These are defined by §63(d)(1) as deductions other than the above-the-line deductions. They are referred to as below-the-line deductions because they are deductions that are normally (in the case of individuals) deducted from adjusted gross income, not deductions taken to determine adjusted gross income. In the case of an estate or trust, however, adjusted gross income is given a special definition (see above) that in some cases results in a circular calculation. For that reason, these below-the-line deductions are not actually deducted from adjusted gross income. Instead, they are merely deducted as the next step after deducting the above-the-line deductions. These below-the-line deductions include itemized deductions and a subset of itemized deductions known as miscellaneous itemized deductions. §63(d)(1). (Trusts and estates are not permitted to take a standard deduction. $\S63(c)(6)$.) The itemized deductions include expenses relating to property or investments held for the production of income, including ordinary and necessary expenses under §212 for the production of income, including administration expenses. Reg. §1.212-1(i). It should be noted that estates

and trusts are not subject to the §68 reduction in itemized deductions that applies to high-income individuals. Administration expenses generally include personal representative's fees, trustee's fees, attorney's fees, and accountant's fees under §212; interest under §163; state and local taxes (including property taxes) under §164; losses under §165; bad debts under §166; depreciation under §§167, 168 and 642(e); and tax advice and tax preparation costs under §212(3). For tax years after 2017 and before 2026, tax preparation costs are no longer deductible, except for the preparation of returns unique to a trust or an estate. \(\)67(e) and (g). Miscellaneous itemized deductions are defined by §67(b) as not including interest under §163, state and local taxes (including property taxes) under §164, the charitable deduction under \(642(c), \) and estate taxes under \(691(c). \) Thus miscellaneous itemized deductions are defined by §67(b) to include most itemized deductions, and those miscellaneous itemized deductions are subject to a restriction known as the 2% floor. Thus the only below-theline itemized deductions that are not subject to the 2% floor are interest under §163, state and local taxes (including property taxes) under §164, the charitable deduction under \(642(c), \) and estate taxes under \(691(c). \) In tax years after 2017 and before 2026, state and local taxes are no longer deductible to the extent they exceed \$10,000, but taxes paid in connection with a trade or business, or under §212 in connection with the production of income, may still be deducted, despite the limitation. See footnote 171 of the Joint Explanatory Statement to the Tax Cuts and Jobs Act of 2017 (P.L. 115-97). The deduction of miscellaneous itemized deductions, and the restrictions on those deductions, are described in the following step. In this particular step, however, we are merely deducting the itemized deductions that are not considered to be miscellaneous itemized deductions, which are deducted below. Expenses incurred in selling property are generally not deductible as administrative expenses, but are offsets against the selling price to reduce gain or to increase loss, because such expenses reduce the amount realized under §1001(b). Scull v. Commissioner, T.C. Memo 1994-211, n. 14. However, if an asset must be sold in order to pay taxes, to pay claims, or to satisfy pecuniary bequests, then the expenses of sale become deductible as administration expenses. Estate of Jenner v. Commissioner, 577 F.2d 1100 (7th Cir. 1978); Estate of Joslyn v. Commissioner, 566 F.2d 677 (9th Cir. 1977). A sale for the convenience of the beneficiaries so that they will not end up owning the asset as tenants in common does not fall into that exception. Hibernia Bank v. U.S., 581 F.2d 741 (9th Cir. 1978). The fact that the local court may have approved the expenses does not necessarily make the expenses deductible as administration expenses. Pitner v. U.S., 388 F.2d 651 (5th Cir. 1967); Smith v.

Commissioner, 510 F.2d 479 (2nd Cir. 1975). Note regarding property taxes: Property taxes paid before death are deducted as an itemized deduction on the decedent's final form 1040 individual income tax return. §161; §164(a)(1). Property taxes accrued before death but paid after death are deductible on the estate tax return as a debt. §2053(c)(1)(B). Property taxes accrued after death are deductible as an administration expense on either the estate tax return or the fiduciary income tax return. \$164(a)(1); §2053. (Note that in tax years after 2017 and before 2026, property taxes are no longer deductible, except for property taxes paid in connection with carrying on a trade or business or under §212 for the purpose of producing income.) Note regarding interest: The interest deductible under §163 does not include personal (non-business) interest, and most interest paid by an estate or trust is personal interest, unless the estate or trust is engaged in a trade or business. §163(h). However, post-mortem interest is usually deductible on an estate tax return as an administration expense under §2053. See, for example, Rev. Rul. 1979-252, 1979-2 C.B. 333, which held that interest on an estate tax deficiency is deductible for estate tax purposes. See also Reg. \$20.2053-4(e)(2). Although interest on estate tax deferred under \6166 is no longer deductible for estate tax purposes due to §2053(c)(1)(D), interest on estate tax deferred under §6161 is deductible for estate tax purposes if a §6166 election is not in place. Interest on state inheritance taxes is deductible for estate tax purposes, since §2053(c)(1)(D) does not limit deductions for interest on state estate taxes, but interest is generally not deductible for fiduciary income tax purposes, unless it is business interest. §163(h). For a summary of interest deductions available (or not available) on a fiduciary income tax return and/or on an estate tax return, see Appendix A.

f. Deduct miscellaneous itemized deductions. Pursuant to §67(e), estates and trusts are permitted to deduct miscellaneous itemized deductions, but only to the extent that the miscellaneous itemized deductions "would not have been incurred if the property were not held" in a trust or estate. §67(e)(1). If a deduction fails that test, then that deduction may be deducted only to the extent that the total miscellaneous itemized deductions exceed 2% of the adjusted gross income of the trust or estate (as AGI is specially defined for purposes of estates and trusts). §67(a). The Supreme Court has interpreted that statute as exempting from the 2% floor such miscellaneous itemized deductions that an individual would have been unlikely to incur. Knight v. Commissioner, 552 U.S. 181, 128 S.Ct. 782, 101 AFTR2d 2008-544 (2008); Jones, Supreme Court Rules - Negatively - on Deductibility of Trust Investment Advisor Fees, Journal of Taxation, February 2008, Vol. 108 No. 2;

Jones, Final Regulations on Trust Administration Expenses – No Surprises, Journal of Taxation, July 2014, Vol. 121 No. 1. Attached to this paper as Appendix B is a table describing how miscellaneous itemized deductions are affected by the *Knight* opinion and the final regulations that were published following the *Knight* opinion. The regulations became final on 5/9/14. In general, those regulations allow full deductibility (not subject to the 2% floor) of administration expenses that "would not have been incurred if the property were not held in [an] estate or trust." Reg. §1.67-4(a). Those regulations are effective for tax years beginning after December 31, 2014. After the miscellaneous itemized deductions are divided into those that are 100% deductible and those that are deductible only to the extent they exceed 2% of adjusted gross income, those deductions (after the application of the 2% floor) are referred to in the Form 1041 instructions as adjusted miscellaneous itemized deductions (AMID). However, the 2017 Act has disallowed (for tax years after 2017 and before 2026) the deduction of any miscellaneous itemized deductions, except those miscellaneous itemized deductions that are not subject to the 2% floor. See \(67(g)\). For example, it would appear that tax preparation costs for fiduciary income tax returns will still be deductible, since they fall into the category that is exempt from the 2% floor under the *Knight* opinion.

- g. After the above deductions are taken, the result is referred to by Form 1041 as adjusted total income, although the Code itself does not use that term. Occasionally this amount is called the tentative taxable income, but the precise definition of that term is elusive.
- h. Deduct the distribution deduction under §651 or §661, the estate tax deduction under §691(c), and the personal exemption under §642(b). Note that two of these deductions were taken into account above in calculating adjusted gross income for purposes of the 2% floor of §67(a), but they were not actually deducted at that stage, which is another reason why the calculation of the tax of an estate or trust is often circular.
- i. <u>Deduct 20% of qualified business income</u>. This new deduction was created by the Tax Cuts and Jobs Act of 2017 (P.L. 115-97), in order to reduce the discrepancy between the new low corporate income tax rates and the higher rates applicable to individuals, estates, and trusts, which are now allowed to deduct 20% of business income generated by sole proprietorships, partnerships, LLCs, and S corporations. §199A(b)(2)(A). As a result of this deduction, the maximum income tax rate on such income is reduced from the normal maximum rate of 37% to 29.6%. The

qualified business income (QBI) eligible for this 20% deduction must have been generated by an active trade or business, but the rules applicable to the determination of qualified business income, and the resulting deduction, are very complex and complicated. See new §199A for details on how this new deduction works, but here is a brief synopsis: The deduction is limited to 50% of the trust's (or estate's) prorata share of the total W-2 wages paid by the business (with an adjustment for tangible depreciable property). §199A(b)(2)(B) and (b)(6)(A). In the case of trusts and estates, the W-2 wages are allocated between the fiduciary and the beneficiaries pursuant to §199(d)(1)(B)(i) and Reg. §1.199-9(d) and (e). §199A(f)(1)(B). The business income does not include investment income (capital gains and dividends); interest is not included unless the interest is related to a trade or business. §199A(c)(3)(B). The QBI deduction is not available for certain service industries, including health, law, accounting, actuaries, performing arts, consulting, athletics, financial services, brokers, or business where the principal asset is the reputation or skill of one or more of its employees, but oddly income from engineering firms and architectural firms is eligible for the deduction. §199A(d)(2). The wage limitation and the service industry limitation do not apply to trusts or estates with taxable income of less than \$157,500 (indexed for inflation), but the QBI deduction is phased out over the next \$50,000 of income in excess of \$157,500 (indexed for inflation). §199A(d)(3)(B) and (e)(2). This summary barely scratches the surface of the complexities and exceptions described in §199A; practitioners should be very careful when trying to determine the effect of §199A, which sunsets after 2025. Even worse, the penalty for a substantial understatement of tax attributable to this new deduction is subject to a lower threshold than other substantial understatements. \(\) \(\) \(6662(d)(1)(C).

- j. The result is taxable income. §63. If the taxable income is a negative, the excess deductions will flow out to the beneficiaries, but only the deductions incurred in the final year of the trust or estate. §642(h). Excess deductions cannot flow out to the beneficiaries in tax years after 2017 and before 2026. In non-final years, the only negatives that may be carried over to the next tax year are capital loss carryovers and business net operating losses. §642(h).
- k. Apply the tax rate table to the taxable income. §641(a); §1(e). The result is the tax due, but some trusts might be subject to two additional taxes. First, some trusts might be subject to the alternative minimum tax (AMT) under §455. See Schedule I of Form 1041. The 2014 AMT exemption amount

for estates and trusts was only \$23,500, much lower than the exemption amount for married couples (\$82,100) or single individuals (\$52,800). \$55(d)(1). Those amounts increased to \$23,800, \$83,400, and \$53,600 in 2015. In 2016, they increased to \$23,900, \$83,800, and \$53,900. In 2017, they increased to \$24,100, \$84,500, and \$54,300. In 2018 (under the 2017 Act), those amounts were changed to \$24,600, 109,400, and \$70,300. And the AMT exemption for estates and trusts phases out at much lower levels as well. \$55(d)(3). See Rev. Proc. 2013-35. In addition, miscellaneous itemized deductions are not deductible for purposes of calculating the alternative minimum tax, even if they exceed the 2% floor; taxes are also not deductible. \$56(b)(1)(A). Second, some trusts and estates will also be required to pay an additional tax on net investment income; see the following section.

16. The Net Investment Income Tax

The net investment income tax became effective on January 1, 2013. §1411. It imposes a 3.8% tax on the net investment income of individuals, trusts, and estates. The tax is reported on Form 8960 attached to the Form 1041. As in the case of the maximum income tax rate, the threshold for applying this tax is much lower for trusts and estates than for individuals. While individuals are subject to this tax if their adjusted gross income exceeds \$200,000 (\$250,000 for married couples filing jointly), the 2015 threshold level for trusts and estates was \$12,300 of undistributed net investment income. §1411(a), (b). The threshold for estates and trusts is inflationadjusted annually, but the threshold for couples and individuals is not adjusted. §1411(a), (b); see Rev. Proc. 2013-35. In 2017, the threshold for estates and trusts increased to \$12,500, and in 2018 it increased to \$12,700. The tax is applied to the lesser of (a) the undistributed net investment income, or (b) the excess of adjusted gross income over the threshold amount. §1411(a)(2).

The tax is imposed on three types of income described in §1411(c):

- a. Interest, dividends, annuities, rents, royalties, and certain other passive income.
- b. Trade or business income ("covered business income") derived from trading in financial instruments or commodities, passive activity income under §469, and income generated by investing working capital.
- c. Net gain from the disposition of property, with some exclusions. This includes most capital gains, with some exceptions.

The net investment income tax does not apply to distributions from retirement plans, including qualified plans and IRAs. §1411(c)(5).

The U.S. Tax Court has held that a trust will be deemed to have materially participated in real estate business activities under §469(c)(7), and thus the real estate business will not be deemed to be a passive activity under §469, if the trustees personally performed sufficient services to meet the exception described in §469(c)(7). Aragona v. Commissioner, 142 T.C. 165 (2014). That exception permits a real estate business to not be a passive activity if more than half of the personal services performed by the taxpayer in trades or businesses were performed in real estate activities in which the taxpayer materially participated, and the taxpayer performed more than 750 hours in its material participation in real estate businesses. In Aragona, the trustees were individuals who actively worked in the real estate business of the trust as trustees, and some of the trustees were also employees of a real estate LLC that was wholly-owned by the trust. The court held that their activities as trustees and as employees could be aggregated to determine whether the trust materially participated in the real estate business, because under local trust law trustees who operate a trust business through a corporation controlled by the trust continue to have the same fiduciary responsibilities that trustees have. (Oregon law is similar. ORS 130.655(7).) That decision has important implications for the application of the net investment income tax to trusts, because §1411(c) exempts taxpayers who materially participate in a trade or business under the standards of §469. However, the Tax Court in Aragona limited its holding to the facts and arguments of that case (the arguments advanced by the IRS in that case were somewhat narrow), and the court specifically declined to express an opinion whether a trust could materially participate through employees who were not also trustees.

Although the imposition of the maximum income tax rates on the taxable income of trusts and estates in excess of \$12,500 in 2017 and in 2018 has in recent years given fiduciaries a strong incentive to distribute income to beneficiaries (who will often be in lower income tax brackets), the imposition of this new investment income tax will give fiduciaries an even stronger incentive to distribute income, because trusts and estates do not pay this new tax on income that is distributed to the beneficiaries, and the beneficiaries might not be subject to the tax if their adjusted gross income is below the threshold level for individuals, which is much higher than the threshold level for trusts, as discussed above. (The net investment income is also reduced if some or all of the income is eligible for a charitable income tax deduction under §642(c). See the instructions to Form 8960.) In the alternative, the fiduciary could minimize investments that produce tax-exempt income or produce little dividend income but offer greater future growth potential. Of course, the fiduciary would need to consider the future application of the

tax to capital gains, while also considering the investment objectives of the trust and of the individual beneficiaries.

Section 652(b) provides that income passed out to the beneficiary of a trust "shall have the same character in the hands of the beneficiary as in the hands of the trust." Reg. §1.652(b)-1 states the same rule, and clarifies that the tax status of amounts passed out to beneficiaries "depends upon the beneficiary's status with respect to them not upon the status of the trust." An example offered by Reg. §1.652(b)-1 involves income received by a beneficiary of a foreign trust that is passing through foreign income. In that example, the includibility of that income in the gross income of the beneficiary depends on "his taxable status with respect to that income." Another possible example might be a tax-exempt charity that receives taxable income from a trust. In that situation, the income would have been taxable to the trust if retained by the trust, but it will not be taxable if distributed to a charity.

17. The Election to Take Deductions on the Fiduciary Income Tax Return

Decedents' estates and decedent's trusts are permitted to make an election to deduct their administration expenses either on the fiduciary income tax return (Form 1041) for the year in which the expense is incurred, or on the estate tax return (Form 706) for the decedent. §642(g); §2053(a)(2). The choice is often made by comparing the marginal estate tax rate (combined federal and state) with the marginal income tax rate (combined federal and state). If the estate tax rate is higher than the income tax rate, then claiming the deductions on the estate tax returns is usually most beneficial. If the income tax marginal rate is higher than the estate tax marginal rate, then claiming the deductions on the fiduciary income tax returns is usually most beneficial. If no estate tax returns (federal or state) are being filed because the estate is below the estate tax filing thresholds (or no tax is due because of the marital deduction), then taking the deductions on the estate tax returns might appear to be pointless, but deducting those expenses on the estate tax return might nevertheless have the beneficial effect of increasing the size of the credit shelter trust, and that benefit should be weighed against the possible benefit of deducting those expenses on the fiduciary income tax return, as is discussed below. The estate tax filing thresholds (federal and state) are based on the size of the gross estate, not the size of the taxable estate, so the deductions do not affect whether estate tax returns are required to be filed, but the taking of deductions on the estate tax returns might either reduce the estate tax due or eliminate the estate tax due.

When calculating bequests under formula clauses that calculate the amounts to be used to fund a credit shelter (bypass) trust, or to fund a marital trust, or to fund an outright marital bequest, the §642(g) election can alter the amounts to be placed in those parts of the estate. In general, electing to take the administration expense

deductions on the income tax returns causes a portion of the estate (equal to the administration expenses) to be exposed to the estate tax, because those deductions are not being deducted on the estate tax returns. Formula clauses in tax-planning wills and trusts are usually designed to reduce the estate tax to zero through the use of two tools: the unified credit and the marital deduction. Since the administration expense deduction will not be available on the estate tax returns if the election is made to take those deductions on the income tax returns, then one of those two tools must be used to shelter that amount from tax, or a tax will result. Obviously, those expenses do not qualify for the marital deduction. As a result, a portion of the unified credit must then be used to shelter from estate tax the portion of the estate that was used to pay those expenses. The credit shelter trust will then be reduced by that amount; the formula clauses used in most wills and trusts will require that result. For a fuller discussion of this subject, see Jones, *Calculating Bequests Under Formula Clauses*, Oregon State Bar Estate Planning and Administration Section Newsletter, Vol. XXVI, No. 4, October 2009.

IRS regulations divide administration expenses into two types. These are the infamous *Hubert* regulations that were developed after the Supreme Court decided *Commissioner v. Estate of Hubert*, 520 U.S. 93 (1997). The holding in *Hubert* is now of merely academic interest, because the regulations take an entirely different approach than the Supreme Court opinion. The regulations divide administration expenses into management expenses and transmission expenses. Management expenses are incurred to maintain estate assets; they include investment advisory fees, brokerage commissions, custodial fees, and interest. Transmission expenses include the costs of marshaling estate assets, paying debts and taxes, and distributing the assets; they include fiduciary fees and attorney fees. Reg. §20.2056(b)-4(d)(1). Management expenses paid from the marital share will reduce the marital deduction only if those expenses are deducted on the estate tax return. Transmission expenses paid from the marital share will always reduce the marital deduction. Reg. §20.2056(b)-4(d)(2), (3).

Another factor to consider is whether taking the administration expense deductions on the income tax return will actually cause a reduction in tax. If the estate does not have sufficient income to absorb the deductions, then excess deductions will result, and those excess deductions will often be wasted (and will always be wasted in a non-final year). If those excess deductions are incurred in the final year of the estate or trust, the excess deductions can be passed out to the beneficiaries, §642(h), (except in tax years after 2017 and before 2026), but in some cases the beneficiaries will not be able to use those excess deductions, because excess deductions are classified as miscellaneous itemized deductions on the income tax return of the estate or trust. Reg. §1.642(h)-2(a). Those excess deductions can be used by the beneficiaries only if the beneficiaries itemize their deductions, and even

then the deductions can be utilized by the beneficiaries only to the extent that the deductions exceed two percent of the beneficiary's adjusted gross income. §67(a); Reg. §1.642(h)-2(a).

The §642(g) election is made by filing a statement, in duplicate, with the fiduciary income tax return to the effect that the deductions have not been allowed as deductions on the estate tax return, and the right to claim them on the estate tax return is being waived. Reg. §1.642(g)-1. If the election is not made, and the deductions are claimed on the estate tax return, no statement is needed. *Estate of Keitel v. Commissioner*, T.C. Memo 1990-416 (1990). Even if the deductions are claimed on the fiduciary income tax return, many practitioners don't bother to file the statement with the income tax return, since the regulations provide that the statement can be filed at any time before the running of the applicable statute of limitations. Reg. §1.642(g)-1. That approach permits flexibility, since the filing of the statement with the income tax return precludes later claiming the deductions for estate tax purposes. Reg. §1.642(g)-1.

This election need not be made on a blanket basis. It can be made for some deductions and not others, or it can be made for parts of some deductions and not other parts. Reg. §1.642(g)-2.

Funeral expenses are not subject to this election. They may be deducted only on the estate tax return, and not on the fiduciary income tax return. §2053(a)(1); Reg. §2053-2. The fiduciary income tax statutes contain no provision for deducting funeral expenses. *Estate of Yetter v. Commissioner*, 35 T.C. 737 (1961).

Similarly, claims against the estate can be deducted only on the estate tax return, not on the fiduciary income tax return. §2053(a)(3). The same rule applies to income taxes and gift taxes owing as of the date of death, even if those taxes have not yet been calculated as of the date of death; they may be deducted only on the estate tax return. Reg. §20.2053-6.

Similarly, the medical expenses of the decedent paid by the estate are not deductible on a fiduciary income tax return. Reg. §1.642(g)-2. They may be deducted either on the final individual income tax return of the decedent (even if paid after his death, but they must be paid within one year of his death) or on the decedent's estate tax return. §213(c); Reg. §1.642(g)-2; §2053. A 7.5% of adjusted gross income floor applies to medical expenses deducted on the decedent's final income tax return, but that limitation does not apply to the estate tax return. §213.

The §642(g) election does not apply to deductions in respect of a decedent, which should be deducted on both the fiduciary income tax return and on the estate tax return. Reg. §1.642(g)-2. See income in respect of a decedent, below.

The same §642(g) election is available for purposes of the Oregon fiduciary income tax. OAR 150-316-0390; 150-118-0040. The Oregon statutes permit independent (inconsistent) elections for federal estate tax and state estate tax purposes. ORS 118.010(8). Washington does not allow inconsistent elections for federal estate tax and state estate tax purposes, except for elections pertaining to the marital deduction. RCW 83.100.047(1)(a). As a result, even though Washington does not impose a fiduciary income tax, amounts deducted for federal income tax purposes are not allowed as deductions for purposes of the Washington estate tax. RCW 83.100.047(2). For further discussion of inconsistent elections and their effect on basis, see Basis Step-up and Basis Reporting, below.

18. The Distribution Deduction

As a general rule, a trust or estate that has DNI in a particular tax year will pay income tax on that DNI if the trust or estate retains that income, but distributions (of income *or* principal) to beneficiaries in the same tax year will usually cause that DNI to be carried out to the beneficiaries receiving those distributions. §662(a). Distributions made in the first sixty-five days of the following tax year can also qualify; the sixty-five day rule is discussed in a separate section below.

The DNI of a simple trust will be taxed to the beneficiaries regardless of whether it is distributed. §652(a). Similarly, if a complex trust is required to distribute income, that required amount will be taxed to the beneficiaries regardless of whether it is distributed. §662(a)(1).

Thus trusts and estates operate differently than partnerships and S corporations. The income of partnerships and S corporations is taxed to the partners/shareholders regardless of whether the income is distributed, but the income of estates and complex is taxed to the beneficiaries only if distributed to the beneficiaries. However, the DNI of a simple trust will be taxed to the beneficiaries regardless of whether it is distributed.

A distribution of income or principal usually qualifies as a distribution of income (to the extent income is present) because of the tier system (see the discussion of the tier system, below), which causes income to be deemed to have been distributed with the highest priority, even if the distribution was actually made in the form of an asset classified as principal. *Van Buren v. Commissioner*, 89 T.C. 1101 (1987). However, the tax laws do not alter the trust laws, which provide that the trustee cannot make distributions that are not permitted by the terms of the trust. For example, if a trust permits distributions of income but does not permit distributions of principal, problems can develop. That trust might have received a distribution from an annuity or from a retirement plan that is classified as principal for fiduciary accounting purposes, but that distribution is classified as taxable income for purposes of the fiduciary income tax.

Because the trust does not permit principal distributions, the trust will be prevented from passing that income out to the beneficiaries. A more permissively-drafted trust would have solved this problem.

If the DNI is carried out to the beneficiaries, then the beneficiaries will be taxed on that DNI, and the trust or estate will not be taxed. Thus the income will be taxed only once. The exact mechanism used by the Code to carry out that single taxation is the distribution deduction: amounts distributed to beneficiaries are deductible by the trust or estate, up to the amount of DNI. §651(b); §661(b). (One exception: A distribution of a specific bequest does not carry out DNI to the recipient beneficiary. §663(a)(1). As a result, the trust or estate will not be entitled to a distribution deduction under §661, nor will the beneficiary be taxed under §662. See the discussion of specific bequests below.)

For example, if a complex trust has \$40,000 of DNI for the tax year 2014, but the trust distributes \$25,000 to its beneficiaries, then the trust will be taxed on the \$15,000 of DNI retained by the trust, and the beneficiaries will be taxed on the \$25,000 of DNI distributed to them. If that same trust were to distribute \$60,000 to the beneficiaries in that tax year, then the trust would be able to deduct only \$40,000 of the amount distributed, and the beneficiaries would be taxed on only \$40,000 of the amount distributed. The other \$20,000 of distributions to the beneficiaries would not be deductible by the trust (since it exceeds DNI), nor would the beneficiaries be taxed on that other \$20,000. Instead, that \$20,000 would be treated as a distribution of principal, which is not taxable to the beneficiaries nor deductible by the trust. \$661(a); \$662(a)(2).

If the amount distributed to the beneficiaries exceeds DNI for the year, then each beneficiary will be taxed on his or her prorata share of the DNI, based on the relative amounts received by each of the beneficiaries. §662(a); Reg. §1.662(a)-2(b); Reg. §1.662(a)-3; Reg. §1.662(b)-1. For example, assume a trust has \$10,000 of DNI and it distributes \$14,000 to four beneficiaries: A receives \$5,000, and B, C, and D each receive \$3,000. A will be deemed to have received income of \$3,571 (5/14ths of \$10,000) and B, C, and D will each be deemed to have received principal of \$1,429 (5/14ths of \$4,000). And A will be deemed to have received principal of \$1,429 (5/14ths of \$4,000). Reg. §1.662(a)-3(d).

The amounts included in the distribution deduction are deemed to include a portion of each class or character of amounts included in DNI, in the same proportions, unless the governing instrument or local law provides for a different allocation. §661(b); Reg. §1.661(b)-1. Thus a trust that received rents, interest, and dividends will be deemed to have distributed those same amounts, in the same proportions as those amounts were included in DNI. But if the governing instrument

or local law provides for a special allocation of certain classes of income, those allocations will not be given effect unless they have economic effect independent of the tax consequences. Reg. §1.652(b)-2. Thus the allocation will not be followed unless it actually increases or decreases the amounts passing to particular beneficiaries. Van Buren v. Commissioner, 89 T.C. 1101 (1987). (The regulations that deal with the allocation of various classes of income to particular beneficiaries, including charities, are sometimes referred to as the ordering rules, and a provision in a governing document that calls for a special allocation is sometimes referred to as an ordering provision.) If one of the beneficiaries is a charity, the regulations are particularly clear on this point: the regulations under §661 make reference to Reg. §1.643(a)-5(b), which provides that an allocation in the trust agreement to charities will not be given effect unless the allocation has independent economic effect. Reg. §1.661(b)-2. Although Reg. §1.643(a)-5(b) governs tax-exempt income, the cross-reference to it in Reg. §1.661(b)-2 appears to make it applicable to any class of income if a charitable income tax deduction is involved. For a discussion of the independent economic effect rule, see the sections below regarding tax-exempt income, charitable deductions, retirement accounts, and the separate share rule. Regarding the interplay between the distribution deduction and the charitable deduction, see below in this section.

DNI includes tax-exempt income, but the distribution deduction is limited to the taxable portion of DNI. §651(b); §661(c). See the discussion of tax-exempt income, below. Thus a simple trust is entitled to a distribution deduction equal to the lesser of (a) the income required to be distributed currently, or (b) DNI, but in either case the amount is reduced by the portion attributable to tax-exempt income. §652(b). A complex trust is entitled to a distribution deduction equal to the lesser of (a) the amount paid or required to be distributed, or (b) DNI, but in either case the amount is reduced by the portion attributable to tax-exempt income. §661(c); §662(b).

Simple trusts deduct the income they are required by the terms of the trust to distribute, regardless of whether that income is actually distributed. §652(a). Estates and complex trusts deduct both the income that is required to be distributed and other amounts that are "properly paid or credited or required to be distributed." §661(a)(2). Both deductions, however, are limited to the amount of DNI. §651(b); §661(a). And both deductions cause income to be taxed to the beneficiary. §652(a); §662(a).

Because complex trusts deduct the income that they are required to distribute, a complex trust will receive a distribution deduction (and the beneficiary will be taxed) even if the required distribution is less than all of the income. For example, a complex trust with \$5,000 of income that is required to distribute \$2,000 of income to the beneficiary annually, will receive a \$2,000 distribution deduction (and the beneficiary

will be taxed on that \$2,000), even if the distribution is not actually made, or is not made until a later year. \$661(a); \$662(a); Reg. \$1.662(a)-2.

Distributions that are "properly paid or credited" include distributions of income, or principal, or both, since §661(a)(2) describes "any other amounts" without limiting those amounts to either income or principal. In order to carry income out to the beneficiaries, the distribution need not come from income, and thus there is no need to trace the source of a distribution to income or to principal. §661(a)(2). Any distribution (except distributions of specific bequests) will carry out income if the trust or estate has DNI for that tax year.

Charitable distributions are not included in the distribution deduction. §651(a)(2); §661(b); §663(a)(2); Reg. §1.663(a)-2; Rev. Rul. 68-667, 1968-2 C.B. 289. Instead, they are deductible under §642(c), and they may not be deducted through the distribution deduction. Reg. §1.663(a)-2; Reg. §1.661(a)-1(last sentence); Reg. §1.662(a)-1(last sentence). Even if some of the charitable distribution does not qualify for a charitable income tax deduction, that portion is still not eligible for a distribution deduction. Rev. Rul. 68-667, 1968-2 C.B. 289. Thus a distribution of income to charity that does not qualify for the charitable income tax deduction does not qualify for any income tax deduction whatsoever. As a result, distributions of income to a charity do not appear on a Schedule K-1 issued to the charity, and in fact a charity normally does not receive a K-1, because a distribution of income to a charity does not result in a distribution deduction. Instead, it results in a charitable deduction. §642(c). And if principal is distributed to a charity, neither a distribution deduction nor a charitable deduction is allowed for income tax purposes, although a charitable deduction will usually be available for estate tax purposes. §2055.

However, charitable distributions out of income, which are deductible under §642(c), reduce DNI, so that the non-charitable beneficiaries will not be taxed on the income distributed to charity. §661(b); §663(a)(2). However, that rule does not apply to tier 1 beneficiaries, who will still be taxed on the income required to be distributed each year, regardless of any charitable distribution. §662(a)(1). The taxation of that mandatory income distribution will reduce the income available to be taxed to Tier 2 beneficiaries, as will income distributions to charities. In effect, income is treated as having been distributed in the following order of priority: tier 1, charities, and tier 2. See the discussion of the charitable deduction, below, and the discussion of the tier system, also below.

In the past, certain distributions were commonly made from an estate to a simple trust using a technique that would cause income to be carried out from the estate to the simple trust, but without causing the simple trust to treat the income as having been distributed to the trust beneficiary. These were known as trapping distributions. The

technique worked like this example: the estate would distribute \$50,000 of principal to the simple trust. The estate had \$15,000 of DNI, which was carried out to the trust for income tax purposes, but the entire \$50,000 was treated by the trust as principal for fiduciary accounting purposes. Thus the simple trust had received no income from the estate for purposes of fiduciary accounting, and thus the terms of the trust did not require that any of the \$50,000 be distributed to the beneficiary. However, the trust did have \$10,000 of ordinary income of its own, which (because it is a simple trust) is required to be distributed to the beneficiary, who will be taxed on that \$10,000 regardless of whether the \$10,000 was actually distributed. But the beneficiary will not be taxed on the \$15,000 of estate income; that income was "trapped" in the trust and thus was taxed to the trust. This was a popular technique prior to the time that the fiduciary income tax rate brackets were compressed; back then, trusts were often in lower income tax brackets than individual beneficiaries. Now, with fiduciary income tax brackets usually higher than individual beneficiary income tax brackets, the use of trapping distributions has lost most of it popularity.

If a trust is required by the terms of the trust to maintain a residence for the use of a beneficiary, the amounts spent by the trust to maintain the residence are not considered to have been distributed to the beneficiary, are not deductible as a distribution, and are not taxed to the beneficiary. Instead, the income used to pay those expenses is taxed to the trust. Commissioner v. Plant, 76 F.2d 8 (2nd Cir. 1935); PLR 8341005. The Tax Court and the Fifth Circuit have both held that expenses paid by a trust to maintain a residence owned by the trust, but used by a beneficiary, are not deductible, either as expenses of the trust or as distributions to the beneficiary. A.I. DuPont Testamentary Trust v. Commissioner, 574 F.2d 1332 (5th Cir. 1978) affirming 66 T.C. 761 (1976) and 514 F.2d 917 (5th Cir. 1975), affirming 62 T.C. 36 (1974); Fuller v. Commissioner, 9 T.C. 1069 (1947), aff'd. 171 F.2d 704 (3rd Cir. 1948); Prince v. Commissioner, 35 T.C. 974, 978 (1961). For a contrary result, with no significant legal analysis, see Moreell v. U.S., 221 F.Supp. 864 (W.D. Pa. 1963). When drafting such a trust, the better practice (in order to avoid the high income tax rates of trusts) might be to require distributions to the beneficiary, and then the trust should require the beneficiary to pay the maintenance expenses as a condition of living in the residence.

19. Tax-Exempt Income

The income carried out to the beneficiaries takes with it the income tax attributes that the income had in the trust or estate. §652(b); §662(b). For example, tax-exempt municipal bond interest earned by an estate or trust and carried out to the beneficiaries is reported by the beneficiaries as tax-exempt income. Similarly, interest distributed to the beneficiaries retains its character as interest, dividends retain their character as dividends, etc. The beneficiaries are deemed to have received each of those items in the

same percentage as each of those items bears to the total DNI, unless the trust instrument allocates the different types of income in a different manner. §652(b); §662(b).

DNI includes tax-exempt income, but gross income does not. §103; §643(a)(5). However, the distribution deduction does not include tax-exempt income distributed to the beneficiaries. §651(b); §661(c). And as noted above, §652(b) and §662(b) require that the income allocable to the beneficiaries will be deemed to include the same proportion of the tax attributes as was received by the estate or trust. The net effect of these rules can be illustrated by the following examples. Assume a trust has \$50,000 of ordinary taxable income and \$20,000 of tax-exempt income, for a fiduciary accounting income of \$70,000, a gross income of \$50,000 and a DNI of \$70,000. If that trust distributes \$100,000 to its beneficiaries, the trust will have \$50,000 of gross income, which is then reduced by a \$50,000 distribution deduction. The beneficiaries will then be taxed on \$50,000 of ordinary income, but they will not be taxed on the \$20,000 of tax-exempt income they received. The same result would have taken place if the trust had distributed only \$70,000. But if the trust distributes only \$60,000, DNI will still be \$70,000, but the distribution deduction will be reduced to \$42,857, or 85.7% of its level in the previous example (60,000/70,000 = .857). In that event, the beneficiaries will be deemed to have received \$42,857 of taxable income and \$17,143 of tax-exempt income, for a total taxable and exempt income of \$60,000. The trust will then be taxed on the other \$7,143 of ordinary income, and will be deemed to have retained \$2,857 of taxexempt income. The net effect of these rules is that if the trustee of this particular trust wishes to distribute all of the taxable income to the beneficiaries and obtain the benefit of a distribution deduction for all of that distributed taxable income, then the trustee must distribute an amount equal to (or greater than) all of the taxable income and all of the tax-exempt income. \(652(b); \(661(c); \) \(662(b); \) Reg. \(\) 1.661(c)-1.

Keep in mind that deductions relating to tax-exempt income must be allocated in whole or in part to the exempt income, and the portion so allocated may not be deducted. §265. For example, a trustee's fee for investment management must be allocated between the taxable investments and the tax-exempt investments. Reg. §1.652(c)-4(d). As a result, trusts and estates with tax-exempt income will need to calculate a disallowance ratio, which will vary from year to year. The ratio will be the ratio between tax-exempt income and the total income included in DNI. *Manufacturers Hanover Trust Co. v. U.S.*, 312 F.2d 785 (Ct.Cl. 1963). The portion disallowed, however, may be deducted on the estate tax return under §2053. Rev. Rul. 59-32, 1959-1 CB 245.

If the will or trust (or local law) attempts to allocate a greater share of tax-exempt income to one beneficiary, and not to another beneficiary, that allocation will be given effect only if the allocation has economic effect independent of the income tax

consequences. §1.652(b)-2(b); *Van Buren v. Commissioner*, 89 T.C. 1101 (1987). That rule is particularly applicable if a charitable income tax deduction is present. Reg. §1.643(a)-5(b).

If the economic effect rule is applicable, is the rule satisfied if the allocation contained in the governing instrument could result in an independent economic result, or must the allocation actually have an independent economic result in order to satisfy the rule? For example, assume that a trust agreement bequeaths to charity the greater of \$50,000 or the proceeds of the decedent's IRA, and the trust also directs that the bequest shall be funded first with IRD. The decedent then dies with an IRA balance of \$45,000, payable to the trust as beneficiary. The charity later receives a check from the trust in the amount of \$50,000. Is the IRD entirely allocated to the charity? Or does the independent economic effect rule prevent the IRD from being allocated to the charity, and instead the IRD must be allocated prorata among all of the beneficiaries? If the IRA had held \$55,000, then the bequest would have had actual independent economic effect, and the IRD will be allocated entirely to the charity. But the IRA held only \$45,000, and thus the allocation lacked actual independent economic effect. Reg. §1.642(c)-3 states that a special allocation will be honored to the extent it "has" economic effect, not "might have." Reg. §1.643(a)-5(b) uses the same language, as does Reg. §1. 652(b)-2(b). As a result, in this example the IRD will be allocated prorata among all of the beneficiaries, and the special allocation will be disregarded. Reg. §1.642(c)-3(b)(2); Reg. §1.643(a)-5(b); Reg. §1.652(b)-2; §662(a); Reg. §1.662(a)-2(b); Reg. §1.662(b)-1; Van Buren v. Commissioner, 89 T.C. 1101 (1987). Yet see Reg. §1.663(c)-5, Example 9, where such a special allocation was effective, although a charity was not involved in that example.

One could make the argument that an allocation (stated in a will or trust) of tax-exempt income to one beneficiary, and not to the other beneficiaries, will be effective for fiduciary income tax purposes, even if the allocation does not have an independent economic effect. If an independent economic effect is lacking, the regulations under §643 dealing with tax exempt income prohibit such allocations if a charitable income tax deduction is being taken. Reg. §1.643(a)-5(b). But no such prohibition appears in that regulation if a charity is not involved. Similarly, the regulations describing the classes of income deemed to have been distributed by a complex trust allow such allocations if provided for in the governing instrument or by local law, with no mention of economic result. Reg. §1.661(b)-1. But the section of those regulations that applies when a charitable income tax deduction is present includes a cross-reference to Reg. §1.643(a)(5), which requires independent economic effect. Reg. §1.661(b)-2. And an example in the separate share regulations suggests that no economic effect is required when allocating classes of income among separate shares in a setting where no

charitable income tax deduction is present. Reg. §1.663(c)-5, Example 9. See the discussion of the separate share rule, below.

But the position adopted by the Service seems to be that allocations of tax-exempt income will not be effective without independent economic effect, even when a charitable income tax deduction is not present. The regulations under §652 (which deal with the classes of income includable in the income of a beneficiary of a simple trust) have provided since 1956 that special allocations of classes of income will not be given effect unless the allocations have independent economic effect, regardless of whether a charitable deduction is involved. Reg. §1.652(b)-2(b). In 2012, when the Service amended the regulations under §642 and §643 to incorporate the independent economic effect rule, the Service explained that the economic effect rule is "a principal that applies throughout Subchapter J" and is "the general rule imposed throughout Subchapter J in the case of all kinds of complex trusts." T.D. 9582, 4/30/12.

Yet the regulations are not exactly a work of art when it comes to clarity, even after the 2012 amendments. When Reg. §1.662(b)-1 describes allocations made when no charitable income tax deduction is present, it appears to allow such allocations, regardless of whether independent economic effect is present. But then a cross-reference is made to Reg. §1.652(b)-1, even though the economic effect rule is actually contained in a different regulation, Reg. §1.652(b)-2. And when Reg. §1.662(b)-2 describes allocations made when a charitable income tax deduction is present, it similarly cross-references Reg. §1.652(b)-1, and not Reg. §1.652(b)-2. Reg. §1.662(b)-2 also cross-references Reg. §1.643(a)-5, which requires independent economic effect if an allocation is made when a charitable income tax deduction is present. A clear answer is elusive.

20. Specific Bequests

Specific bequests include two types of bequests: a pecuniary bequest of a specific amount of money, and a specific bequest of a particular item of property. A bequest of \$1,000 is a specific bequest because it is a pecuniary bequest. A bequest of 100 shares of General Motors stock is also a specific bequest, but it is not a pecuniary bequest.

Distributions of specific bequests do not carry out DNI to the recipient beneficiary. §663(a)(1). As a result, the trust or estate will not be entitled to a distribution deduction under §661, nor will the beneficiary be taxed under §662. The logic behind this rule is that such distributions are in the nature of principal, not income. §102.

A specific bequest is defined as "a gift or bequest of a specific sum of money or of specific property." §663(a)(1). Thus a bequest of \$1,000 or of 100 shares of General

Motors stock is clearly a specific bequest. The amount of money or the identity of the specific property must be ascertainable under the will as of the date of death, or ascertainable under the terms of an intervivos trust as of the date of inception of the trust. Reg. §1.663(a)-1(b). A bequest of an amount of money to be calculated by the fiduciary (or of property to be selected by the fiduciary) equal to a stated fraction or percentage of the estate is not considered to be a specific bequest. Reg. §1.663(a)-1(b); Rev. Rul. 60-87, 1960-1 C.B. 286; see PLR 200210002. There is some debate over whether a pecuniary formula (as opposed to a fractional share formula or a percentage share formula) is a specific bequest, but the consensus seems to be that a pecuniary formula bequest is not a specific bequest, and thus it does carry out DNI. See Reg. §1.663(a)-1(b)(1).

Query: If a testator leaves a bequest equal to "the greater of \$100,000 or 10% of my net estate," is that a specific bequest? Under the regulations, a specific bequest must be ascertainable as of the date of death. Reg. §1.663(a)-1(b). Thus it would appear that such a bequest is not ascertainable as of the date of death, because the size of the net estate cannot be determined as of the date of death. For example, if the size of the bequest is dependent on the payment of administration expenses, then the bequest is not specific. Reg. §1.663(a)-1(b). Note that the issue of whether a bequest is specific enough is a different issue than whether a bequest is pecuniary and thus triggers gain when it is funded with appreciated property. Reg. §1.663(a)-1(b).

Several exceptions apply to this general rule that specific bequests do not carry out income. The following distributions will carry out DNI:

- a. If the governing document requires the amount to be paid from income. §663(a)(1).
- b. If the bequest is a residuary bequest. Reg. §1.663(a)-1(b)(2)(iii).
- c. If the bequest is required by the governing document to be paid in three or more installments. §663(a)(1).

After a distribution is made pursuant to a specific bequest, the basis of the distributed property in the hands of the beneficiary will be determined under either §1014 (property acquired from a decedent, if the bequest was in a will, in a formerly-revocable trust, or in a testamentary trust) or §1015 (property acquired by gift, if the asset was acquired by the trust through an intervivos gift), and the beneficiary will receive the same basis as the trust or estate had in the property immediately before the distribution. The basis determined under §1014 is usually referred to as a stepped-up basis (although it can also be stepped-down), and the basis determined under §1015 is usually referred to as carryover basis.

If property is specifically bequeathed to a beneficiary, and instead of distributing the asset to the beneficiary, the trust or estate sells the asset at the request of the beneficiary and then distributes the proceeds to the beneficiary, the gain or loss will be taxable to the beneficiary. The transaction will be treated as if the asset had been distributed to the beneficiary and the beneficiary had returned the asset to the trust or estate with instructions to sell the asset on behalf of the beneficiary. Rev. Rul. 68-666, 1968-2 C.B. 283. As a result, the trust or estate will not recognize gain or loss in that situation, but the beneficiary will recognize gain or loss.

21. In-Kind Distributions

An in-kind distribution (a distribution of assets other than cash) raises several questions:

- a. Does the in-kind distribution carry out DNI to the recipient? If the distribution is made pursuant to a specific bequest (a bequest of a particular item of property, such as 100 shares of stock in General Motors), then the distribution does not carry out DNI. §663(a)(1). Similarly, if a trust distributes securities in satisfaction of a pecuniary bequest (such as a bequest of \$1,000), then the distribution does not carry out DNI to the recipient beneficiary. §663(a)(1). See the previous section. In both situations, the trust or estate will not be entitled to a distribution deduction. §663(a)(1). But in other situations, such as a distribution of property in-kind to satisfy a residuary bequest, the distribution will carry out DNI to the beneficiary. §662.
- b. Will the estate or trust recognize gain or loss as a result of the in-kind distribution? The general rule is that the estate or trust does not recognize gain or loss on an in-kind distribution, unless the distribution is being made in satisfaction of an obligation to pay money or an obligation to distribute property other than the property distributed in kind. Reg. §1.661(a)-2(f); Kenan v. Commissioner, 114 F.2d 217 (2nd Cir. 1940). Thus gain or loss will be recognized if assets are distributed in-kind to satisfy a pecuniary bequest. Reg. §1.663(c)-5, Example 4; Rev. Rul. 66-207, 1966-2 C.B. 243; Rev. Rul. 83-75, 1983-1 C.B. 114. (That rule applies even if the estate is insufficient to fully fund the pecuniary bequest and the bequest in effect becomes a residuary bequest. Rev. Rul. 66-207.) Gain or loss is also recognized when an asset is distributed in-kind to a creditor in satisfaction of a debt in the form of a specific dollar amount. First Trust & Deposit Co. v. United States, 58 F.Supp. 162 (N.D.N.Y. 1944); Reg. §1.661(a)-2(f). Gain or loss is also recognized if the trust or estate was obligated to make an income distribution to the beneficiary (or the trust or estate was obligated to

distribute a pecuniary amount, or was obligated to distribute specific property other than that distributed), but the trust or estate chose instead to distribute in-kind assets equal in value to the required distribution. Reg. §1.661(a)-2(f); Reg. §1.1014-4(a)(3); Rev. Rul. 67-74, 1967-1 C.B. 194; Suisman v. Eaton, 15 F.Supp. 113, 36-2 USTC ¶9443 (D.Conn. 1935), aff'd 83 F.2d 1019 (2nd Cir. 1936), cert. denied 299 U.S. 573 (1936). For example, if a will requires a \$100,000 cash bequest to a beneficiary, and rather than distributing cash to the beneficiary the estate distributes marketable securities with a current value of \$100,000 and a basis of \$60,000, the estate will recognize a gain of \$40,000. Thus the result is the same as if the estate had sold the securities and then distributed the cash to the beneficiary. The same gain would be recognized if the trust distributed appreciated securities to a beneficiary in lieu of making a required income distribution. The same gain would be recognized if the trust distributed appreciated securities to a creditor in satisfaction of a claim. Rev. Rul. 74-178, 1974-1 C.B. 196. Similarly, distributing appreciated assets in satisfaction of a pecuniary formula bequest will trigger gain. Rev. Rul. 83-75, 1983-1 C.B. 114. (In contrast, in-kind distributions in satisfaction of a fractional formula bequest will not result in recognition of gain or loss, because a fractional formula is not pecuniary.) If the trust distributed securities that had decreased in value in satisfaction of a pecuniary bequest, then a loss will be recognized. In most cases, however, any resulting loss will be disallowed under the related-party rules of §267, which applies to both trusts and estates. But note §267(b)(13), which permits an estate (but not a trust) to recognize a loss on an in-kind distribution in satisfaction of a pecuniary bequest. That statute might be an additional incentive to make a \$645 election for a trust to be treated as part of an estate. See the discussion, above, on the subject of a trust election to use a fiscal year. For a discussion of the tax consequences of using IRD to satisfy a pecuniary bequest, see the discussion of retirement accounts, below. Finally, if a trust or estate is not permitted by its governing instrument or local law to make nonprorata distributions, but it does so in satisfaction of a pecuniary bequest as a result of an agreement among the beneficiaries, the beneficiaries will recognize gain or loss as if the assets had been distributed prorata and then exchanged among the beneficiaries. Rev. Rul. 69-486, 1969-2 C.B. 159. But if the governing document or local law permits the fiduciary to make nonprorata distributions, then no gain or loss will be recognized when inkind assets are distributed in satisfaction of a pecuniary bequest. Rev. Rul. 69-486, 1969-2 C.B. 159.

- c. If no gain or loss is required to be recognized on an in-kind distribution, may the fiduciary nevertheless elect to recognize gain or loss? Yes, the fiduciary may elect under \(643(e)(3)\) to recognize gain or loss on an in-kind distribution. The election is made by checking a box on Form 1041. If the election is made, then the trust or estate will be deemed to have sold the asset at its then fair market value, and the beneficiary will receive the asset with a basis equal to that fair market value. If the election is not made, the beneficiary's basis will be the basis of the asset in the hands of the fiduciary, and that basis will be used to calculate both the distribution deduction and the amount includable in the income of the beneficiary. §643(e). This election does not apply to in-kind distributions made in satisfaction of pecuniary bequests or in-kind distributions made in satisfaction of specific bequests that are made in less than three installments. \(\) \(643(e)(4); \(\) \(663(a)(1). \) Thus it appears that the election applies only to residuary bequests. The election applies to all eligible inkind distributions made during the year, not just selected in-kind distributions; the fiduciary cannot pick and choose. \$643(e)(3)(B). If the election is made, the distribution will be deemed to have carried out DNI in an amount up to the value of the property. §643(e)(3). But if the election is not made, the distribution carries out DNI in an amount equal to the lesser of the basis in the property or the property's fair market value. \$643(e)(2). This is a complex subject that warrants careful consideration by the fiduciary. The fiduciary will need to weigh the possible recognition of gain by the estate or trust, the availability of a distribution deduction, the income tax consequences to the beneficiary, and the resulting basis in the hands of the beneficiary. For example, the trust or estate might have losses or deductions that can be used to offset the gain resulting from the election. If the estate or trust does not have such losses or deductions, then oftentimes it is best to not make the election, and the beneficiary will receive the asset with a lower carry-over basis. The beneficiary might have losses of his own that might be available to offset the gain the beneficiary might realize when he sells the low-basis asset he has received from the trust. If the beneficiary subsequently dies with the asset in his possession, the gain will be forgiven due to the stepped-up basis rule of §1014(a). And a \(643(e) \) election might cause the distribution of an IRD asset to trigger tax. For a more detailed explanation of the election and its consequences, see Janiga, Harrison, and Morris, Is a Section 643(e)(3) Election Advisable?, Practical Tax Strategies, October 2014.
- d. If the in-kind distribution carries out DNI, what is the value of the in-kind distribution for purposes of calculating the distribution deduction? If gain

- or loss is recognized on the distribution (due to a §643 election or for the other reasons described above), then the distribution deduction will include the fair market value of the asset. If no gain or loss is recognized, then the distribution deduction will include only the adjusted basis of the asset, the amount taxable to the beneficiary will be that same amount, and the basis of the asset in the hands of the beneficiary will be the same. §643(e).
- e. What is the income tax basis of the asset in the hands of a beneficiary? The general rule is that the beneficiary will receive the same basis that the asset had in the hands of the estate or trust, except that the basis will be increased by any gain recognized by the estate or trust and decreased by any loss recognized by the estate or trust. §643(e). In other words, if gain or loss was recognized by the estate or trust on the distribution of the asset, then the basis of the asset in the hands of the beneficiary will be the fair market value of the asset on the date of distribution. Rev. Rul. 67-74, 1967-1 C.B. 194; §1012. If no gain or loss was recognized by the estate or trust on the distribution of the asset, then the basis of the asset in the hands of the beneficiary will be the income tax basis of the asset in the hands of the fiduciary immediately before the distribution. §1014 and §1015. If the basis in the hands of the fiduciary is greater than fair market value as of the date of distribution, then the basis in the hands of the beneficiary will be the fair market value. §1015.
- f. Can a simple trust make an in-kind distribution? Yes, but an in-kind distribution with a value in excess of trust income will cause a simple trust to be reclassified as a complex trust for that tax year. Rev. Rul. 67-74, 1967-1 C.B. 194.
- g. What holding period will the beneficiary be deemed to have with respect to the asset received in an in-kind distribution? The general rule under §1223(2) is that the holding period of the fiduciary will tack onto the holding period of the recipient if the basis of the asset in the hands of the recipient is determined by the basis of the asset in the hands of the fiduciary. In other words, if gain or loss was recognized, the beneficiary will be required to start a new holding period. But if gain or loss was not recognized, then the holding period of the beneficiary will tack onto the holding period of the fiduciary.

For a discussion of the income tax consequences of funding the various shares of a tax-planning will or trust, including the funding of pecuniary marital bequests and fractional-share marital bequests, see chapter 17 of *Administering Trusts in Oregon* (Oregon State Bar, 2018), particularly §17.11.

22. Charitable Deduction

Estates and some complex trusts (but not simple trusts) may deduct charitable contributions of gross *income* that are paid to a charity or permanently set aside for later payment to a charity. §642(c). This deduction does not apply to simple trusts, because a simple trust will be reclassified as a complex trust in any year in which it makes a charitable contribution, regardless of whether the contribution is from income or principal. §651(a); Reg. §1.651(a)-3(a). For a complex trust to qualify for the set-aside deduction, it must make an election under §645, as discussed below. Most trusts that claim a charitable income tax deduction under §642(c) will need to file a Form 1041-A. §6034(b); Reg. §1.6034-1. See the instructions to Form 1041-A.

The charitable contribution deduction for estates and trusts is more generous than the charitable deduction available for individuals, in six respects:

- a. Trusts and estates may deduct charitable contributions in any amount of income up to the total amount of gross income (including capital gains), and are not limited to a ceiling of 50% of adjusted gross income. §642(c)(1); Rev. Rul. 78-24, 1978-1 C.B. 196. (Starting in 2018, the 50% ceiling was raised to 60%.)
- b. An estate or trust may elect to deduct a charitable contribution made in one year as if it had been paid in the prior year. §642(c)(1); Reg. §1.642(c)-1(2). See the discussion of this subject below.
- c. A trust or estate may deduct a contribution to a foreign charity. §642(c)(1); Reg. §1.642(c)-1(3)(b).
- d. An estate or trust need not distinguish between contributions to public charities and private foundations, while individuals must comply with separate limitations on deductions to private foundations. Section 642(c) does not include such limitations.
- e. An estate or trust apparently does not need to comply with the detailed §170 substantiation requirements, while individuals are subject to those rules. See the discussion below.
- f. Estates and trusts may deduct portions of income that are actually paid to charity. §642(c)(1). But estates (but not most trusts) may also deduct those portions of net income that are permanently set aside for charitable purposes, even though that income has not yet been distributed to charity. §642(c)(2). However, a trust may take advantage of this set-aside deduction if the trust has made a §645 election to use a fiscal year as part of the decedent's estate. Reg.

 $\S1.645-1(e)(2)(iv)$, (e)(3)(i). See the discussion of a trust's election to use a fiscal year, above. The set-aside deduction is discussed further below.

Unlike individuals, trusts and estates are not permitted to carry forward a charitable income tax deduction. As noted above, a charitable deduction is not eligible to be passed out to the beneficiaries as an excess deduction in the final year of the trust or estate. §642(h)(2); O'Bryan v. Commissioner, 75 T.C. 304 (1980).

The ability to elect to treat charitable contributions as if made in the prior year can have significant advantages in the final year of a trust or estate, when the trust or estate is prohibited from passing out charitable deductions as excess deductions. §642(h)(2). In that situation, the fiduciary may elect to treat the charitable contributions made in the final year as if made in the prior year, thus allowing a deduction in the prior year. The election needs to be made no later than the due date (including extensions) for filing the income tax return for the succeeding year (the year in which the distribution was actually made). Reg. §1.642(c)-1(b)(2). However, the election itself is made by attaching a statement to the return (or the amended return) for the prior tax year (the year in which the distribution will be deemed to have been made). Reg. §1.642(c)-1(b)(3). That same regulation describes the required content of the statement.

To be deductible as a charitable contribution, the contribution must be made pursuant to the terms of the governing instrument (the will or trust). The wording of the statute and the regulations suggests that the governing instrument need not require the contribution; it need only permit it. \$642(c); Reg. \$1.642(c)-1(a)(1). The Supreme Court has ruled under the precursor of \$642(c) that the governing instrument need not require that the distribution be made from income; the governing instrument need only authorize the fiduciary to make a discretionary decision to pay the charitable contribution from income. Old Colony Trust Co. v. Commissioner, 301 U.S. 379, 383, 19 AFTR 489 (1937). The prior version of §642(c) authorized a charitable income tax deduction if the distribution of income was made "pursuant to the terms of the will or deed creating the trust." §162 (1928). The current version of §642(c) uses identical language: "pursuant to the terms of the governing instrument." Thus the holding in Old Colony Trust is still good law. The Second Circuit has agreed. Weir Foundation v. U.S., 508 F. 2d 894, 35 AFTR2d 75-538 (2nd Cir. 1974), affirming 362 F. Supp. 928, 32 AFTR2d 73-5649 (D.C.N.Y. 1973); Brownstone v. U.S., 465 F.3d 525, 98 AFTR2d 2006-6889 (CA2 2006). In Weir and Brownstone, a beneficiary exercised a general power of appointment to make a distribution to charity, when the governing instrument made no mention of charity; the charitable income tax deduction was denied. Similarly, in Chief Counsel Advice 201651013 and 201747005, a trust was modified to permit charitable distributions, but the Service ruled that such distributions were not deductible because

the trust before the modification was not ambiguous, nor was the grantor's intent in question. Instead, the modification was made solely to acquire tax benefits.

An even safer approach would be to draft the governing instrument to require that the charitable distributions be made from income. See CCA 200644020. If a trust makes distributions to charity when the instrument does not provide for charitable distributions, those amounts may not be deducted as charitable contributions or as distributions to the beneficiaries. Crown Income Charitable Fund v. Commissioner, 98 T.C. 327 (1992), aff'd 8 F.3d 571 (7th Cir. 1993). The governing instrument must not only authorize the distribution, it must authorize the distribution to be made out of income. If the governing instrument is silent on the question of whether a charitable distribution should be made from income, look to local law, but the safest approach would be to include the authorization in the instrument itself. Rev. Rul. 71-285, 1971-2 C.B. 248; Rev. Rul. 68-667, 1968-2 C.B. 289. For an example of a trust that collected the proceeds of an IRA and then distributed the proceeds to a charity, but was denied a charitable income tax deduction because the trust instrument did not authorize distributions of income to the charity, see ILM 200848020. If the governing document directs that a pecuniary charitable bequest be made first out of income, and principal is used to fund the bequest, then the charitable income tax deduction will be limited to the gain recognized by the use of appreciated assets to fund the pecuniary bequest. Rev. Rul. 83-75, 1983-1 C.B. 114.

As noted above, estates and trusts may deduct amounts of income that are paid to charity (if the requirements of §642(c) are complied with), but estates may also deduct amounts of income that are set aside for charitable purposes. The deduction will not be allowed unless those amounts are permanently set aside under the terms of the governing document and the circumstances of the particular case are such that the possibility that the funds might not eventually be distributed to charity is so remote as to be negligible. Reg. §1.642(c)-2(d); Rev. Rul. 70-452, 1970-2 C.B. 199; PLR 200336020. For example, if the estate faces possible future litigation that might deplete assets, then the set-aside deduction will not be available. See *Belmont v. Commissioner*, 144 T.C. 84 (2015); *DiMarco v. Commissioner*, T.C. Memo 2015-184; and the cases cited therein. The regulations do not indicate how an estate should go about setting aside funds for charity. Presumably setting funds aside in a separate account will be helpful, but the existence of a separate account does not necessarily protect the funds from creditors.

Special substantiation requirements apply to charitable deductions in excess of \$250 made by individuals, but there is some debate whether those substantiation requirements apply to trusts and estates. In general, individuals must obtain (prior to the filing date of the return) a written acknowledgment from the charitable donee,

confirming the donation received, the amount of the donation, a description of any property received, whether any goods or services were provided by the donee, and a description of any such goods or services. Property (other than cash or publicly-traded securities) with a value of \$5,000 or more requires an appraisal. $\S170(f)(8)$ and (f)(17); Reg. $\S1.170A-13(f)$. Whether those same substantiation requirements apply to trusts and estates has not been clearly established. Section 642(c), which governs the income tax charitable deductions of trusts and estates, provides that that subsection allows a charitable income tax deduction "in lieu of the deduction" allowed to individuals under $\S170(a)$, which hints that the substantiation requirements of $\S170(f)(8)$ do not apply. See also Reg. $\S1.642(c)-1(a)$. In addition, $\S170(f)(8)$ states that deductions under $\S170(a)$ will not be allowed without the $\S170(f)(8)$ substantiation, which again suggests that the substantiation requirements of $\S170(f)(8)$ do not apply to deductions taken by trusts and estates under $\S642(c)$. The instructions to Form 1041 make no mention of the substantiation requirements. And the substantiation rules could not possibly be satisfied in the case of a set-aside charitable deduction by an estate or trust.

The amount deducted must be a portion of gross income (including capital gains and income in respect of a decedent, but not including tax-exempt income or unrelated business income), not principal. §642(c); §681(a); Reg. §1.642(c)-3(a); Reg. §1.642(c)-3(b); Reg. §1.642(c)-3(d); Crestar Bank v. Commissioner, 47 F.Supp.2d. 670 (E.D.Va. 1999); Rev. Rul. 2003-123, 2003-50 I.R.B. 1200; Rev. Rul. 78-24, 1978-1 C.B. 196. Distributions of principal, such as a simple charitable bequest, will usually qualify for an estate tax charitable deduction, but not a fiduciary income tax deduction. §2055; §642(c). For those reasons, charitable contributions need to be traced to their source as either distributions of income or distributions of principal, and distributions of principal will not qualify as a charitable income tax deduction. Mott v. United States, 462 F.2d 512 (Ct. Cl. 1972); Riggs National Bank v. United States, 352 F.2d 812 (Ct. Cl. 1965); O'Connor v. Commissioner, 69 T.C. 165 (1977); Van Buren v. Commissioner, 89 T.C. 1101 (1987); Crestar Bank v. IRS, 47 F.Supp.2d 670, 83 AFTR2d 99-2555 (D.C. Va. 1999); Rev. Rul. 2003-123, 2003-50 I.R.B. 1200. The income need not necessarily be traced to income earned in the year of the charitable contribution; tracing to income earned in a prior year is sufficient. Old Colony Trust Co. v. Commissioner, 301 U.S. 379, 383, 19 AFTR 489 (1937). If the distribution is made from assets that make up principal, the fact that the trust had sufficient amounts of income on hand will not justify a charitable income tax deduction. W.K. Frank Trust v. Commissioner, 145 F.2d 411 (3rd Cir. 1944). This is one of the few examples of a distribution from a trust or an estate that needs to be traced to the source of the distribution; it is a rare exception to the general rule of fiduciary income taxation that tracing is not required. Crestar Bank v. IRS, 47 F.Supp.2d 670, 83 AFTR2d 99-2555 (D.C. Va. 1999). For that reason, it might be helpful to keep income in a separate account if it is destined to be used to fund a charitable bequest.

If the income of the trust or estate was derived from a pass-through entity, such as an S corporation or a partnership, the tracing requirement will be difficult to satisfy if the entity did not actually distribute cash income to the estate or trust, but instead was deemed to have distributed phantom income unaccompanied by cash. See the discussion of S corporations and partnerships, above. Effective beginning in 2018, Electing Small Business Trusts (ESBTs) are no longer governed by the charitable income tax deduction rules of §642(c), but instead are subject to the same §170 rules that are applicable to individuals, as a result of the 2017 Act. That change is permanent, and does not sunset in 2026.

One exception to the charitable tracing rule: if a trust has both taxable income and tax-exempt income, charitable distributions of income will produce charitable income tax deductions that are reduced by the ratio between the tax-exempt income and DNI, regardless of whether the charitable distribution was made from taxable income or tax-exempt income. Reg. §1.642(c)-3. Attempts in the governing document to allocate taxable income to charity will be unsuccessful unless the allocation has economic effect independent of the income tax consequences. Reg. §1.642(c)-3(b)(2); §1.643(a)-5(b); §1.661(b)-2. The allocation of taxable income and tax-exempt income to the §642(c) charitable distribution takes place before any other deductions are allocated among the items of DNI. Reg. §1.661(b)-2; Reg. §1.662(b)-2. See the examples in that regulation. The economic effect rule is discussed in greater detail below in this section, and in the section on retirement accounts.

In a case of first impression, the Tenth Circuit has held that a trust, whose governing document authorized its trustee to make charitable distributions out of income, may not deduct the current full fair market value of real estate donated to charity if the real estate was purchased in earlier years using the gross income of the trust to fund the purchase price. Instead, the deduction will be limited to the trust's adjusted basis in the property, since that was the amount that was originally included in gross income. *Green v. U.S.*, 880 F.3d 519, 121 AFTR2d 2018-427, 2018 WL 386656 (10th Cir. 2018), reversing 144 F.Supp.3d 1254, 116 AFTR2d 2015-6668, 2015 WL 6739089 (D.C. OK 2015).

If a trust holds an interest in a partnership which makes a charitable contribution from gross income, the trust must take into account its share of the partnership's income, credits, and deductions (including the charitable deduction). §702(a)(4). For a discussion of the effect of a charitable contribution by a partnership in which a trust or estate holds an interest, in a situation where the governing document was silent on the subject of charitable contributions, see Rev. Rul. 2004-5, 2004-1 C.B. 295. See also Bluestein v. Commissioner, 15 T.C. 770 (1950) acq. 1951-1 C.B. 1; Lowenstein v. Commissioner, 12 T.C. 694 (1949). Regarding S corporations, see Reg. §1.641(c)-1(d)(2).

See the discussion of the distribution deduction, above, regarding the interplay between the distribution deduction and the charitable deduction. That section discusses the fact that a distribution of income to a charity does not result in a distribution deduction. §663(a)(2); Reg. §1.663(a)-2. Instead, it results in a charitable deduction. And if principal is distributed to a charity, neither a distribution deduction nor a charitable deduction is allowed for income tax purposes, but a charitable deduction is most likely available for estate tax purposes. §2055. In other words, distributions of income under §642(c) are the exclusive means for a charitable income tax deduction by a trust or estate; distributions to charities do not produce a distribution deduction under §661. Reg. §1.663(a)-2; Rev. Rul. 2003-123, 2003-50 I.R.B. 1200; Rev. Rul. 68-667, 1968-2 C.B. 289; Chief Counsel Advice 201651013 and 201747005; Reg. §1.661(a)-1(last sentence). Some commentators have questioned whether the statute justifies this conclusion reached by the regulations, but the courts have agreed with the regulations. *Mott v. U.S.*, 462 F.2d 512 (Ct. Cl. 1972), cert. denied 409 U.S. 1108 (1973); *O'Connor v. Commissioner*, 69 T.C. 165 (1977).

A distribution of IRD (income in respect of a decedent) to a charity is even more complicated. As noted in the discussion of IRD below, IRD is included both in the gross estate for estate tax purposes and in gross income for fiduciary income tax purposes. If an item of IRD (such as a retirement account) is distributed to a charity before the income is collected (the retirement account is distributed intact before funds are withdrawn from the account) and before the income is realized, then the charity will realize and recognize the income from the retirement account in the year in which the charity withdraws the funds from the account. But the estate will not realize or recognize income when it distributes the account intact, and the estate need not claim a charitable income tax deduction. §691(a)(2); Reg. §691(a)(4)(b); Rollert v. Commissioner, 752 F.2d 1128 (6th Cir. 1985); PLR 2005-20004; PLR 200002011. And, of course, charities don't pay income taxes. Thus distributing the account to the charity intact, prior to any withdrawals, might be the best option to avoid income taxation. In some situations, such a distribution might require language in the governing instrument (or local law) authorizing nonprorata distributions. In Oregon, see ORS 130.725(22). In Washington, see RCW 11.98.070 and 11.68.090. But if the estate collects the income (withdraws funds from the retirement account) and then distributes the funds to charity, the estate will realize and recognize the income, and a charitable income tax deduction under \(642(c)(1) \) will be desirable, preferably all in the same tax year in order to offset the IRD income. PLR 201611002. If the income is not paid out in the same year, then a charitable set-aside deduction under §642(c)(2) might be available. When seeking a charitable income tax deduction for retirement account proceeds, keep in mind that Reg. §1.642(c)-3 provides that income in respect of a decedent is included in the gross income of the estate or trust, and thus is eligible for a charitable income tax deduction. Also keep in mind that the governing instrument must authorize the

distribution of income. §642(c)(1); Reg. §1.642(c)-1(a)(1). For that reason, some practitioners suggest that every will or trust that includes a charitable bequest should direct that the charitable bequest should be paid first out of income in respect of a decedent, if the estate or trust has any IRD.

When an item of IRD is payable to charity, oftentimes both an estate tax charitable deduction and an income tax charitable deduction will be available. That might seem odd that the same dollars might generate two separate deductions (one for estate tax purposes and one for income tax purposes, but both for the very same dollars), but that is the result of the fact that IRD is included both in the gross estate for estate tax purposes and in gross income for fiduciary income tax purposes. See *Crestar Bank v. IRS*, 47 F.Supp.2d 670, 83 AFTR2d 99-2555 (D.C. Va. 1999). (If a private foundation receives IRD from a retirement account, that IRD will not be subject to the two percent excise tax on investment income under §4940. PLR 9838028 and 2000-03055.)

If an estate or trust is making a charitable bequest of a particular class of income (for example, the will or trust specifically directs that a charitable bequest must be funded with IRD from a retirement account), that designation of a particular class of income will not be honored for purposes of the charitable income tax deduction unless the designation has an economic effect independent of the income tax consequences. This rule applies to any particular class of income, not just IRD. Reg. §1.642(c)-3(b)(2). For example, a beguest of \$10,000 to a charity, with a direction that to the extent possible the bequest should be paid from IRD, will cause the direction to be ineffective for tax purposes, because the actual amounts to be received by the various beneficiaries will not be increased or decreased by the amount of IRD available; each beneficiary will receive the exact same amount, regardless of the amount of IRD available. In that situation, all of the beneficiaries will be deemed to each have received a prorata share of each type of income, both IRD and non-IRD. Reg. §1.642(c)-3(b)(2); Reg. §1.643(a)-5(b); Reg. §1.652(b)-2; §662(a); Reg. §1.662(a)-2(b); Reg. §1.662(b)-1; Van Buren v. Commissioner, 89 T.C. 1101 (1987). But a bequest of all of the ordinary income of a trust or estate to a charity will have independent economic effect (the charitable bequest will increase or decrease depending on the amount of ordinary income generated by the estate or trust), and thus such a bequest will cause the tax-exempt charity to receive that income, and the charity will be deemed to have received that income for fiduciary income tax purposes, and the estate or trust will be able to make use of a charitable income tax deduction for the full amount of ordinary income passing to charity. See the examples in Reg. 1.642(c)-3(b)(2). Or a bequest that requires the trust or estate to distribute to charity all of the proceeds of the decedent's IRA to charity will permit a charitable income tax deduction, because the amount passing to charity will vary depending on the amount held in the IRA at death. PLR 201611002. This economic

effect rule is important to remember when drafting estate plans that contemplate using retirement accounts to fund charitable bequests. The economic effect rule does not necessarily disallow a charitable income tax deduction. Instead, it affects the allocation of certain classes of income to the charity, and thus it might reduce the charitable income tax deduction, particularly if tax-exempt income is present. In some cases, the application of the economic effect rule might decrease the charitable income tax deduction while simultaneously increasing the distribution deduction for distributions to noncharitable beneficiaries. Thus the economic effect rule might cause income to be shifted away from a charity and thus cause noncharitable beneficiaries to be taxed on a larger share of the income than would have been the case had the rule not applied. The economic effect rule can be avoided by naming the charity (not the trust or the estate) as the beneficiary of the retirement account. Or the rule can be avoided by having the trust or estate transfer the retirement account intact to the charity prior to making any withdrawals from the account. By doing so, the trust or estate will not have realized income, and thus a charitable income tax deduction will not be needed in order to offset the IRD income. PLR 9123036; PLR 9537011. However, the estate or trust will nevertheless recognize income if the IRA is transferred to a charity in satisfaction of a pecuniary charitable bequest. But if the will or trust authorizes the distribution of income to the charity, then an offsetting charitable income tax deduction will be available. Rev. Rul. 83-75, 1983-1 C.B. 114. See the discussion of in-kind distributions, above, and the discussion of retirement accounts, below.

To illustrate one possible impact of the economic effect rule, consider the following situation. Father's will leaves a bequest of \$50,000 to Charity, with the entire residue passing to Daughter. Assume that the estate collected the proceeds from an IRA in the amount of \$20,000, all of which was IRD. In addition to the \$20,000 of IRD, the estate had other taxable income of \$30,000 from dividends and interest, for total taxable income of \$50,000. Father's will directs that the charitable bequest is to be satisfied first from income, both IRD and ordinary income, and then from principal. However, that language has no economic effect, because the charity will receive \$50,000, no more and no less, regardless of how much IRD and/or other income might be received by the estate. Because that language has no economic effect, it will be disregarded. Reg. §1.642(c)-3(b)(2). The estate distributed \$50,000 to Charity (in full satisfaction of the charitable bequest) and \$50,000 to Daughter (in partial satisfaction of her residuary interest). Charity received its funds from a separate bank account that consisted solely of the IRD and the ordinary income, and thus the funds received by Charity will be traceable to income, as required by \$642(c) in order to be eligible for a charitable income tax deduction. However, because the special allocation lacked economic effect, the allocation was disregarded and Daughter and Charity will each be deemed to have received their prorata share of the income, so that each will be deemed to have received \$25,000 of income (half of the total of \$50,000 of income). Reg.

1.642(c)-3(b)(2); Reg. 1.643(a)-5(b); Reg. 1.652(b)-2; 662(a); Reg. 1.662(a)-2(b); Reg. §1.662(a)-3(d); Reg. §1.662(b)-1; Van Buren v. Commissioner, 89 T.C. 1101 (1987). Of the \$25,000 of income that Charity and Daughter will each be deemed to have received, each will be deemed to have received 40% IRD and 60% ordinary income, since the IRD was \$20,000 and the ordinary income was \$30,000. Thus Charity is deemed to have received \$25,000 of income, which was made up of \$10,000 of IRD and \$15,000 of ordinary income, while and Daughter is deemed to have received \$25,000 of income, which (just like Charity) was made up of \$10,000 of IRD and \$15,000 of ordinary income. The balance received by Charity and Daughter will be deemed to be principal, in the amount of \$25,000 each. Although Father attempted to allocate all of the \$50,000 of income to Charity, thus sparing Daughter from paying any income tax on her residuary bequest, that attempt failed and Daughter was taxed on part of the income, all because the economic effect rule disregarded Father's attempted allocation. It is important to note that the estate was nevertheless able to deduct all of its income, both IRD and ordinary income: Half of the IRD and half of the ordinary income were deducted under \642(c) as a charitable income tax deduction, and the other half was deductible as a distribution to Daughter under the \662(a) distribution deduction. In effect, the estate's charitable income tax deduction was reduced due to the disregard of the special allocation, but the estate's distribution deduction was increased by the amount of the reduction in the charitable deduction. So the estate did not suffer any adverse income tax consequences as a result of the economic effect rule. But Daughter did suffer an adverse income tax consequence, since she was taxed on income that her Father attempted to allocate to Charity. (The result in this illustration would have been the same even if all of the income had been IRD, or if all of the income had been ordinary dividends and interest.)

In the above illustration, if the special allocation had been honored (even though it had no economic significance independent of the tax consequences), then Charity would have received \$50,000 of taxable income, and Daughter would have received \$50,000 of nontaxable principal; neither would pay any income taxes on their respective distribution.

The result described in that illustration appears to be the result intended by the economic effect regulations. Yet that conclusion is not entirely certain or clear. Three arguments could be made to the contrary:

First, the regulations that create the tier system (discussed in a separate section below), provide that income will be taxed to beneficiaries in a priority known as the tier system. The highest priority to be taxed are Tier 1 beneficiaries, who receive mandatory income distributions, if the trust provides for mandatory income distributions. Other beneficiaries (Tier 2 beneficiaries, who received discretionary distributions) will be taxed

only if they received distributions and the total distributions to all beneficiaries exceeded the Tier 1 income. But charitable distributions are classified as a separate tier, intermediate between Tier 1 and Tier 2. Thus charitable distributions have a higher priority to be allocated income than Tier 2 distributions. See the discussion of §662(a)(1) and §662(a)(2) in the section on the tier system, below. In the illustration above, Tier 1 is absent, and the distribution to the charity is considered to be an intermediate tier with higher priority than the Tier 2 distribution to the daughter. As a result, the charity has a higher priority to be deemed to have received income than the daughter, all of the income will be deemed to have been distributed to the charity, and no income will be deemed to have been distributed to the daughter. Thus the special allocation contained in the will was unnecessary, and the disregarding of that allocation (due to a lack of economic effect) has no effect. See Example 1 in Reg. §1.662(b)-2. This argument boils down to a simple question: Do the tier regulations override the economic effect regulations?

Second, if the separate share rule (discussed below) is applicable, then Reg. §1.663(c)-2 indicates that income will be allocated among the separate shares in accordance with the governing instrument or local law, apparently without regard to the economic effect rule, and Example 9 in Reg. §1.663(c)-2(b)(3) permits such an allocation that has no economic effect. Thus it appears that if the separate share rule applies, allocations lacking economic effect will nevertheless be honored. However, a strong argument could be made that a charitable bequest is not a separate share. For example, the application of the separate share rule exists for the sole purpose of determining DNI in the application of §661 and §662. §663(c); Reg. §1.663(c)-1(b). Yet DNI cannot be allocated to a charity under §661 and §662, particularly because the charitable distribution has already been removed from DNI. §643(a); *Mott v. U.S.*, 462 F.2d 512 (Ct. Cl. 1972). This conclusion is consistent with the rule that a charitable distribution is deductible under §642(c), and cannot be deducted as part of the distribution deduction. Reg. §1.663(a)-2.

Third, it could be argued that the economic effect rule of Reg. §1.642(c)-3(b)(2) deals only with the character of the income deductible under §642(c), and does not specifically state that the economic effect rule will actually cause a trust or an estate to be denied a §642(c) deduction. Yet that same regulation states that an allocation will be disregarded if it lacks economic effect, and if an allocation is disregarded it seems possible that the charitable income tax deduction will be reduced, as in the illustration above.

Also, an argument could be made that when the economic effect regulations discuss a special allocation of income, those regulations refer to income, not principal, and IRD is considered to be principal under local law, particularly the Uniform

Principal and Income Act. Thus the economic effect regulations do not apply to IRD. That argument is difficult to accept, since IRD is income for income tax purposes. After all, they don't call it *Income* in Respect of a Decedent for nothing.

The addition of the economic effect rule to the charitable deduction regulations took place in 2012. T.D. 9582, 4/30/12. Prior to 2012, the economic effect rule appeared only in §1.652(b)-2(b), which governs the inclusion of income by beneficiaries of simple trusts. The regulations governing inclusion of income by beneficiaries of complex trusts did not include an economic effect rule, but did include a cross reference to the §652 regulations, together with an indication that the principles of §652 "generally apply" to both simple trusts and complex trusts. Reg. §1.662(b)-2. The regulations under \652 also generally require a prorata allocation of the various elements of income. Reg. §1.652(b)-2(a). In 2012, when the economic effect rule was added to Reg. §1.642(c)-3(b)(2) (dealing with charitable deductions) and Reg. §1.643(a)-5(b) (dealing with tax-exempt income), some practitioners complained that the Code did not justify that rule, but the Service argued that the economic effect rule had always been generally applicable throughout the fiduciary income tax, and that the 2012 changes merely clarified that fact. See also Reg. §1.661(b)-2, which appears to make Reg. §1.643(a)-5(b) applicable to any class of income, not just tax-exempt income. The Service also argued that although \(652(b) \) allows governing instruments to allocate different classes of income to different beneficiaries, the very next sentence authorizes the Treasury to adopt regulations on that subject. T.D. 9582, 4/30/12.

One possible solution to the problem of charity and IRD might be to distribute to the other beneficiaries their full distributive shares of the trust using non-IRD assets, so that the remaining assets (which are IRD) will be payable entirely to the charity. And then, in the following year, the IRD can be withdrawn from the retirement account and can be distributed to the charity, and a charitable income tax deduction will then be allowed in the final year for the full amount of the IRD, since the charity will be the sole beneficiary in that year. (Even though the charitable deduction cannot be carried out as an excess deduction in the final year, the charitable deduction will nonetheless reduce the IRD income of the trust to zero.)

Another possible solution has been suggested. In lieu of a specific pecuniary bequest to charity, a governing instrument might direct that all of the trust income (subject to a pecuniary cap) will be paid to charity. The pecuniary cap would be in lieu of a pecuniary bequest. For example, instead of a \$50,000 bequest to charity, the governing instrument might provide that all of the income of the trust will be paid to charity, but not to exceed \$50,000. If the trust has income in excess of \$50,000, then the net economic effect of this provision will be identical to a \$50,000 bequest. But such a provision would appear to be effectively identical to a \$50,000 specific bequest

accompanied by an allocation directing that the bequest be satisfied out of income, and Reg. §1.642(c)-3(b)(2) specifically states that such an allocation will be disregarded due to a lack of an independent economic effect. Since the substance of the two provisions appears to be the same, perhaps the form of the bequest will be disregarded, and it will be treated as a specific bequest with a disregarded special allocation. If this provision is employed, and if it is successful in generating an income tax charitable deduction, the estate tax charitable deduction will most likely not be available, since the charitable bequest will not be satisfied by assets held on the date of death. (This proposal has been suggested by Prof. Christopher Hoyt.)

By the way, statistics show that fiduciary income tax returns are rarely audited. But anecdotal evidence suggests that charitable income tax deductions might be a triggering factor.

23. The Sixty-Five Day Rule

As a general rule, income retained by an estate or a complex trust is taxed to the estate or trust, and income distributed to the beneficiaries during the taxable year is taxed to the beneficiaries. §662(a). Thus a distribution of current income carries that income out to the beneficiaries, to be taxed to the beneficiaries, and not taxed to the trust or estate. If income is retained by an estate or a complex trust, but distributed in a later year, that later distribution has no income tax significance; it is treated as a distribution of income that was already taxed to the trust or estate in the prior year. (See below for a different rule for simple trusts.) In effect, it is treated as if it were a distribution of principal. §663(a)(3). (However, if in that later year the trust or estate has undistributed DNI, then a distribution of principal will carry out that undistributed DNI, since the distribution rules do not require any tracing of a distribution to determine whether it came from income or principal. See the tier rules, discussed below.)

However, §663(b) permits a significant exception to that rule: If an amount is distributed within sixty-five days following the end of the tax year, and if a §663(b) election is made by checking a box on the Form 1041, then the distribution will be treated as if made on the last day of that preceding tax year. Reg. §1.663(b)-1(a)(1). For example, if a calendar year trust earns income in 2013, and a distribution of that amount is made within the first sixty-five days of 2014, and the §663(b) election is made, then the distribution can be deducted on the trust's 2013 return, and that amount will then be taxed to the beneficiaries on their 2013 returns.

The purpose of this election is to permit a trust or estate to calculate its taxable income in the first sixty-five days of the following tax year, after the trust or estate has received its Forms 1099 and other tax information for the year. The trust or estate can

then distribute the exact amount necessary to carry that income out to the beneficiaries. Without this election, many fiduciaries would need to make an estimate of the trust or estate income, and then distribute that estimated amount to the beneficiaries prior to December 31, in order to carry the income out to the beneficiaries for that tax year.

Although §663(b) distributions must be made within the sixty-five day period, the election is not made until the Form 1041 is filed, either on time or under an extension. The election cannot be made on a late return. Reg. §1.663(b)-2(a). Once made, it is irrevocable after the last day prescribed for making it, but it may be revoked up until that date. Reg. §1.663(b)-2(a). The election is made by checking a box on the Form 1041. The election applies only to that particular tax year; it does not affect subsequent or previous tax years. Reg. §1.663(b)-1(a)(2). Thus, if desired, the election needs to be made each and every year.

For calendar-year trusts, the deadline for making the §663(b) distributions is March 6. In leap years, it is March 5.

The sixty-five day rule applies only to estates and complex trusts. Simple trusts, which are required to distribute all of their income in the year in which it is earned, are always treated as if that income were distributed currently, regardless of whether the income is actually distributed. §652(a). As a result, making a §663(b) election for a simple trust would have no effect.

The sixty-five day rule applies only to distribution deductions. It does not apply to other deductions, such as administration expenses. §663(b). If a deduction for administration expenses is needed for a particular year, those expenses must actually be paid before the end of the year, and not within the first sixty-five days of the following year. Also, the sixty-five day rule does not apply to distributions to charity, because the application of §663(b) is limited to §661 and §662. That inapplicability extends not only to distributions that are eligible for the charitable income tax deduction under §642(c), but also to other distributions to charity (such as principal distributions) that are not eligible for a charitable income tax deduction. That result is brought about by the fact that a distribution to charity is not eligible for a distribution deduction under any circumstances. §663(a)(2); Reg. §1.663(a)-2. See the sections above regarding the charitable deduction and the distribution deduction.

If income was received in one year, and deemed to have been distributed in that year under the rules governing simple trusts, or deemed to have been distributed in that year under the sixty-five day rule applicable to distributions made early the next year, that income distribution cannot be used to support a distribution deduction in the next year. Reg. §1.663(a)-3.

The §663(b) election need not apply to all distributions made within the first sixty-five days of the following year; some distributions may be designated for the election, while other distributions not so designated will not be affected by the election. Reg. §1.663(b)-1(a), (2)(a).

Query: Can a §663(b) election be used to terminate a trust or estate? In other words, may a fiduciary distribute all of the assets of a trust or an estate within the first 65 days of a tax year and then treat the trust or estate as having terminated in the previous year, such that the previous year is deemed to be the final year of the trust or estate? The answer is no. Section 663(b)(1) states that the distribution must be made within the first 65 days "of any taxable year," and if the effect is to terminate the trust or estate in the prior tax year, then the distribution will not have been made within a taxable year. In addition, Reg. §1.663(b)-1(a)(2) limits the election to distributions of income, not principal; the deduction cannot exceed the greater of DNI or fiduciary accounting income. Naturally, when a trust or estate terminates, it distributes all of its assets, both income and principal, and the terminating principal distribution will not be deemed by \$663(b) to have been distributed in the prior tax year. Also, a distribution made under the sixty-five day rule will carry out the income received in the prior year, but it will not carry out the income received in the subsequent year, and so a return might need to be filed for that subsequent year, which prevents the prior year from being the final year.

24. Tiers of Distributions and Beneficiaries

When the income of a trust or estate is taxed to the beneficiaries, it is taxed on a tier system. Neither the Code nor the regulations utilize the word tier, but that is the common parlance.

The first tier consists of the income that is required to be distributed on a current basis, regardless of whether it is actually distributed. §662(a)(1); Reg. §1.662(a)-2(a).

The second tier consists of other amounts that may be distributed, but are not required to be distributed as part of the first tier. §662(a)(2). For example, the second tier includes discretionary distributions of income, distributions of principal, and distributions of income accumulated from prior years. *Broadhead Trust v. Commissioner*, T.C. Memo 1972-196.

In the case of both the first and second tiers, the amount that is taxable to the beneficiaries is limited to the amount of DNI for the year, and in particular is limited to the taxable portion of DNI. §651(b); §661(c). If the amount of first tier income is less than DNI, and no second tier distribution is made, then the distribution deduction will be limited to the amount of the first tier income. If the amount of first tier income

exceeds DNI, the deduction will be limited to the amount of DNI. In that latter case, each beneficiary will be deemed to have received (and will be taxed on) a portion of the DNI based on that beneficiary's right to receive tier 1 income. For example, if income is required to be distributed 75% to Beneficiary A and 25% to Beneficiary B, then 75% of the DNI will be allocated to Beneficiary A and 25% will be allocated to Beneficiary B. \$662(a)(1).

Beneficiaries will be deemed to have received second tier income only if DNI exceeds the first tier distributions and distributions exceed first tier income. §662(a)(2). The purpose of this rule is to give priority to the taxation of first tier income, and to give priority to the taxation of first tier beneficiaries. Thus the first dollars distributed by a trust or estate will be deemed to carry out first tier income, up to a limit equal to the lesser of first tier income or DNI. One of the benefits of this rule is to eliminate the need to trace a particular distribution to its source in order to determine whether the distribution consisted of income or principal. *Crestar Bank v. IRS*, 47 F.Supp.2d 670, 83 AFTR2d 99-2555 (D.C. Va. 1999). (Prior to 1954, tracing was often required. See *Van Buren v. Commissioner*, 89 T.C. 1101 (1987).)

For example, assume Beneficiary A is entitled to receive \$10,000 of current income annually, and Beneficiary B may receive discretionary distributions of income or principal. If DNI is \$12,000, and each beneficiary receives \$10,000, then Beneficiary A will be taxed on \$10,000 of tier 1 income and Beneficiary B will be taxed on \$2,000 of tier 2 income. The other \$8,000 received by Beneficiary B is deemed to be a distribution of principal, which is not taxable to Beneficiary B.

The tier system applies not only to types of income, but also to types of beneficiaries. Tier 1 beneficiaries are the recipients of mandatory current income distributions, while tier 2 beneficiaries may receive other distributions. The beneficiaries are taxed on a priority system: DNI is allocated to tier 1 beneficiaries first, and DNI is allocated to tier 2 beneficiaries only to the extent that the DNI exceeds the amount allocated to tier 1 beneficiaries. Reg. §1.662(a)-3(c). After all of the DNI has been allocated, any distributions in excess of DNI are treated as distributions of principal. In some cases, a beneficiary might be both a tier 1 beneficiary and a tier 2 beneficiary.

If the total amount distributed is less than DNI, then the tier system becomes irrelevant; every amount received by a beneficiary carries out DNI and is taxable to the beneficiary, and the portion of DNI not distributed is taxed to the estate or trust, because the distribution deduction will be limited to the amount distributed. §661(a). Tier 1 income is an exception to this rule; tier 1 income is taxed to tier 1 beneficiaries regardless of whether it is distributed. §652(a).

Simple trusts have only one tier of distributions; all distributions are deemed to be tier 1 distributions, and all beneficiaries are deemed to be tier 1 beneficiaries. If a simple trust distributes more than tier 1 income in any one year, the trust will be treated as a complex trust for that year. §651(a)(2); Reg. §1.651(a)-3(b).

If unequal distributions are made to two or more beneficiaries, all of whom are in the same tier, then the income will be allocated among them on a prorata basis. Reg. §1.662(a)-3(c) and (d).

If a charitable income tax deduction is being claimed, then an intermediate tier exists between tier 1 and tier 2. The income distributed (or set aside) for charity under \$642(c) is subtracted from DNI after the tier 1 income is subtracted, but before the tier 2 income is subtracted. That result is caused by a parenthetical that appears in \$662(a)(1), but does not appear in \$662(a)(2).

25. Income in Respect of a Decedent (IRD)

Income in respect of a decedent (known as IRD) is an item of gross income that was earned by the decedent, or accrued for the benefit of the decedent, during his lifetime, but it was not actually received by the decedent during his lifetime. §691. As a result, the income was not taxed during his lifetime.

IRD is not well-defined in the Code or in the regulations, because the definition is intended to be broad enough to encompass a wide variety of situations. In *Peterson v. Commissioner*, 667 F.2d 675 (8th Cir 1981), *affirming* 74 T.C. 630 (1980), IRD was defined using a four part test: (1) the decedent had entered into a legally significant agreement, (2) the decedent had performed the substantive tasks required by the contract, (3) there were no economically significant contingencies that would have prevented the decedent from receiving the funds, and (4) the decedent would have received the funds had the decedent not died. And remember the elements required by §691: the item must be an element of gross income (it must be taxable as income), earned or accrued during life, but received after death.

Examples of IRD usually include:

- a. Wages earned during life, but not paid until after death.
- b. Other forms of deferred compensation not paid until after death.
- c. Interest accrued during life, but not received until after death.
- d. Assets held in an Individual Retirement Account (but not a Roth IRA) as of the date of death.

- e. Assets held in other qualified retirement accounts as of the date of death.
- f. Gains or losses from assets sold during life, but not received until after death.

If the decedent held an annuity, the general rule is that the portion of the proceeds in excess of basis is taxable as ordinary income, regardless of whether the amount is received before or after death. §72(a) and (b); Rev. Rul. 2005-30, 2005-1 C.B. 1015. Basis is generally what the decedent paid for the annuity. If proceeds of an annuity are received after the decedent's death, the taxation of those postmortem proceeds is governed partly by the annuity taxation rules of §72 and partly by the IRD rules of §691(a)(5). In general, each payment received is divided into taxable income and return of basis, using an exclusion ratio, so that a portion of each payment is excludable as a return of basis and a portion is includable in income as ordinary income or (in the case of a decedent) income in respect of a decedent. §72(b)(1). One of the primary disadvantages of an annuity is that it does not receive a stepped-up basis at death. §1014(b)(9)(A). See also §691(d) and the discussion of annuities in the section pertaining to fiduciary accounting income, above.

The gross income of a trust or an estate includes any IRD received by the trust or estate, to be reported as taxable income in the tax year in which it is received. §691(a)(1). Because IRD is part of taxable income, it is also part of DNI. §643(a); Reg. §1.663(c)-5, Exs. 6 and 9. IRD is ordinary income for fiduciary income tax purposes, and it is not capital gain, despite any definition of fiduciary accounting income or the provisions of the Uniform Principal and Income Act. CCA 2006-44016. IRD does not receive a stepped-up basis on the date of death. §1014(c).

As a result, one of the duties of a fiduciary is to carefully manage (or postpone) the receipt of IRD. If an estate receives a paycheck resulting from pre-death work performed by the decedent, the estate has no choice but to include that IRD in gross income. But if the estate is the beneficiary of a retirement account (which is usually 100% IRD), the estate has some flexibility regarding when to withdraw funds from that account, and thus the estate has some flexibility to decide when that IRD will be taxed.

Section 691 also permits an estate or trust to take certain deductions that accrued during the decedent's lifetime, but could not be claimed on the decedent's individual income tax returns. §691(b). These deductions are known as deductions in respect of a decedent (DRD). For example, business expenses, interest, or taxes that were incurred or accrued during the life of the decedent, but were not paid during his lifetime, would be considered to be deductions in respect of a decedent, if paid by the estate. These are known as double deductions, because they are allowed to be taken on both the estate tax return and the fiduciary income tax return. Reg. §1.642(g)-2.

Not only is IRD included in gross income for income tax purposes, it is also included in the gross estate for estate tax purposes. Thus it might be taxed twice, once for income tax purposes and once for estate tax purposes. If an estate is required to include IRD in its gross income for a particular year, then it is entitled in that year to deduct the federal estate tax attributable to that IRD. §691(c). This deduction applies only to that part of the IRD that was not distributed or was not required to be distributed to the beneficiaries during that year. §691(c)(1)(B). If that limitation applies, then the beneficiaries are taxed on the IRD that they received, and they may take the §691(c) deduction in the year in which the IRD was taxed. Reg. §1.691(c)-1(a). But the §691(c) deduction is available to the beneficiary only if the beneficiary itemizes his or her deductions, since the deduction is not listed in §62. Rev. Rul. 78-203, 1978-1 C.B. 199. However, the deduction is not considered to be a miscellaneous itemized deduction. §67(b)(7). As a result, the §691(c) deduction was not suspended by the 2017 Act. §67(g). But, as in the case of other itemized deductions, high-income individuals are subject to the \68 reduction in itemized deductions (the Pease limitation), and so the \691(c) deduction might not be fully available to all beneficiaries. (The Pease limitation was suspended by the 2017 Act for years after 2017 and before 2026.)

The calculation of the \(691(c) \) deduction is complicated. The statute requires that the first step is to determine the estate tax attributable to all of the IRD items. Then a ratio is determined equal to the ratio that the IRD items reported for income tax purposes by the recipient taxpayer bear to all of the IRD items reported for estate tax purposes. That ratio is then applied to the amount of estate tax attributable to the IRD items. (691(c)(1)(A); Reg. (1.691(c)-1(a)(2)). But the calculation of the estate tax itself is also complicated. The amount of estate tax attributable to the IRD items is determined by calculating the estate tax twice, once with the IRD items included and once with the IRD items excluded. In making the second calculation, it might be necessary to recompute any estate tax deductions that are based on the gross estate. The recomputed deductions could include the marital deduction and the charitable deduction. Reg. §1.691(c)-1(a)(2). Thus even though property passing to the surviving spouse or to charity normally does not generate any estate tax (due to the marital and charitable deductions), the surviving spouse and charitable beneficiaries can be eligible for a \(\)691(c) deduction, or a portion of the deduction. For discussions of the relationship between the marital deduction and the §691(c) deduction, see Kincaid v. Commissioner, 85 T.C. 25 (1985); Cherry v. U.S., 133 F.Supp.2d 949, 87 AFTR2d 2001-814 (W.D. KY 2001); Findlay v. Commissioner, 39 T.C. 580 (1962), aff'd 332 F.2d 620 (2nd Cir. 1964); PLR 200316008 (Dec. 31, 2002). The same rule applies to IRD passing to a charity. Chastain v. Commissioner, 59 T.C. 461 (1972). In the case of a charity, however, the deduction will be of no use to the charity, but the portion of the deduction available to the charity will not be available to the taxable beneficiaries who received other portions of the IRD.

The deduction is limited to the federal estate tax paid on items of IRD; no deduction is allowed for state estate taxes or state inheritance taxes. §691(c)(2)(a). If the item of IRD is not taxable in Oregon for purposes of the Oregon income tax, then ORS 316.680(2)(c) denies an Oregon income tax deduction under §691(c) for the federal estate tax paid with respect to that item.

The most common form of IRD encountered by estates and trusts is a retirement account. See the following section for a discussion of the IRD aspects of retirement accounts.

Installment sale proceeds are another common example of IRD. When a taxpayer receives a payment on an installment sale of an asset, the payment is normally reported by the recipient as the receipt of three elements: (1) interest, which is taxable as ordinary income, (2) the portion of principal that represents gain, which is often taxable as capital gain, and (3) the portion of principal that represents a return of basis, which is not taxable. §453; §453A; §453B. Within each payment, the relative portions of principal that represent gain and return of basis are usually calculated by applying the same ratio that the purchase price bears to the gain and the basis.

When an installment obligation is acquired from a decedent seller (as opposed to an installment obligation created by an estate when the estate sells an asset), the portion of each payment that represents gain is treated as IRD. §691(a)(4); Reg. §1.691(a)-5. As with other items of IRD, no step-up in basis takes place on the death of the decedent. §1014(c).

Thus payments received by the estate or beneficiary on an installment obligation will continue to be reported by the estate or beneficiary in the same manner that the payments were being reported by the decedent. Reg. §1.691(a)-5. Thus the gain is not accelerated on the death of the decedent or on the transfer of the obligation to a beneficiary who is entitled to receive it under the will or trust. Instead, the estate or beneficiary will continue to report the gain over time, as the payments are received. Reg. §1.691(a)-5. See below for a different rule if the beneficiary is also the obligor.

If the estate or the beneficiary sells the installment obligation or transfers the obligation to a non-beneficiary, the seller must recognize gain as IRD, using the fair market value of the obligation and the decedent's basis in the sold asset, adjusted to reflect the portions of basis that were previously received by the decedent or by his estate. $\S691(a)(2)$. The receipt of basis is not considered to be an item of IRD. $\S691(a)(4)$.

If a decedent bequeaths an installment obligation to the person who is obligated to make the installment payments, then the estate realizes a gain equal to the amount of gain that had not yet been reported by the decedent. §691(a)(5). The gain is measured by the difference between the fair market value of the obligation and the decedent's remaining basis in the obligation. §691(a)(5). That same result takes place if the decedent discharges the debt at the death of the decedent. §691(a)(5). If the decedent discharges the debt at death, and the decedent and the obligor are related, then the value of the obligation will not be less than its face value. §691(a)(5)(B). In the case of such a discharge or bequest of the debt to the obligor, the estate must recognize the gain no later than the conclusion of the estate administration, unless some act of cancellation occurs prior to that time. PLR 8806048; S. Rep. No. 96-1000, 27 (1980-2 C.B. 494, 508; 1980 WL 356610). However, a residuary bequest that includes the installment obligation does not automatically transfer the obligation to the obligor on the death of the obligee; instead, the transfer takes place in the tax year during which the obligation is actually transferred to the obligor. PLR 8806048. That result is correct even if state law provides that the assets of the estate vest immediately in the beneficiaries, subject only to the administration of the estate. PLR 8806048. (Oregon law so provides. ORS 114.215(1)(a).) If the cancellation takes place at death, the cancellation is to be treated as if the transfer had been made by the estate of the decedent. S. Rep. No. 96-1000, 27 (1980-2 C.B. 494, 508; 1980 WL 356610). Presumably, that transfer will be deemed to have taken place in the first tax year of the estate. The Senate Report goes on to state, "However, if the obligation were held by a person other than the decedent, such as a trust, the cancellation will be treated as a transfer immediately after the decedent's death by that person."

Another possible type of IRD is the refund received after the death of a resident of a continuing care retirement community (CCRC). When the decedent entered the CCRC, usually a large deposit (entrance fee) was made, and occasionally the decedent was advised that part of that deposit was deductible in the year of payment as a medical expense. When a resident of a CCRC moves out or dies, oftentimes a large refund is received, and the prior deduction might cause part of the refund to be taxable as income to the resident, or IRD to his estate, under the tax benefit rule. Rev. Rul. 76-481, 1976-2 C.B. 82, Rev. Rul. 78-292, 1978-2 C.B. 233; and Rev. Rul. 75-302, 1975-2 C.B. 86; §213; Reg. §1.213-1(g)(1)); §111. However, a 1998 article in the Virginia Law Review suggests (without citing any authority) that none of the post-death refund is IRD. 18 Va. Tax Rev. 1 (1998). In order to assist in resolving this question after a death has occurred, keep good records of the amount of the original deposit and how much of it was deducted in the year of payment.

For the same reason, a state income tax refund, received after death for taxes that were deducted during life, is most likely IRD.

26. Retirement Accounts

The largest and most commonly-encountered forms of income in respect of a decedent (IRD) are retirement accounts.

Retirement accounts (except Roth IRAs) are almost always made up of IRD, which is taxable income to the estate, trust, or beneficiary who withdraws assets from a retirement account. In other words, neither a retirement account nor the assets in a retirement account receive a stepped-up basis on the death of the owner of the retirement account. §1014(c). Funds withdrawn from the retirement account are considered to be ordinary income, and must be reported on the income tax return of the recipient in the year of the withdrawal.

That fact makes retirement accounts very dangerous to deal with, since an inadvertent withdrawal (or an inadvertent closing of the account, which is the same as a withdrawal) can trigger a very large income tax liability. Proceed with caution.

The income tax treatment of a retirement account under the Internal Revenue Code takes place despite the fact that local law often characterizes required retirement account withdrawals as constituting 10% income and 90% principal. For example, see Uniform Principal and Income Act §409. In Oregon, see ORS 129.355. In Washington, required retirement account withdrawals constitute 4% income and 96% principal. RCW 11.104A.180. Although those local law provision are not followed for income tax purposes (due to the characterization of retirement accounts as IRD, and thus as ordinary income), the local law plays a large role in determining what distributions may be made under the terms of the governing instrument. For example, a trust agreement that prohibits distributions of principal will be constrained by local law definitions of principal and income.

One exception to the income tax rule that retirement accounts are usually made up entirely of IRD: in some cases portions of a retirement account are attributable to after-tax (non-deductible) contributions. Those portions have income tax basis and are not considered to be IRD. The challenge is finding out whether the decedent made any non-deductible contributions. Such contributions were supposed to have been reported to the IRS annually with the decedent's individual income tax return (Form 1040), using Form 8606. One hopes that the decedent did so, and kept copies of his tax returns.

The taxation of a retirement account depends primarily on who the beneficiary is:

• <u>Family Members</u>. In most cases, the designated beneficiaries of the retirement account will be family members (such as children of the decedent or the surviving spouse). In those situations, the attorney representing the personal representative

or representing the trustee will often be called on by family members to give advice on how to handle the retirement account. If the fiduciary is not also the beneficiary, maintain an awareness of who your client is, and watch for conflicts of interest.

- The Estate or a Trust. In some cases, the beneficiary of the retirement account will be the estate or trust, and not an individual family member. If so, the attorney will need to carefully advise the fiduciary about how the actions of the fiduciary will affect the timing of the taxation of the account.
- No Beneficiary Named. In some instances, the decedent might have neglected to name a beneficiary for a retirement account. In those instances, the retirement plan document must be reviewed in order to determine the identity of the default beneficiary. Often, the default beneficiary will be the estate of the decedent or the surviving spouse, but retirement plans vary. A 2014 survey indicated that 30% of retirement plans default to the estate of the decedent, 43% default to the surviving spouse and then to the estate, and 22% default to the spouse, and then to the estate, and then to the children.
- <u>Charity Named as Beneficiary</u>. If a charity is named as the beneficiary of a retirement account, the income taxation of the account is usually avoided. Because of the IRD nature of retirement accounts, such assets make good candidates for charitable dispositions. If a person holds both regular (after-tax) investments and a pre-tax retirement account, and that person desires to leave some of his assets to his family and other assets to a charity, the charity should be designated as the beneficiary of the retirement account, because the charity is taxexempt and will not be required to pay income tax when the retirement assets are withdrawn from the retirement account. In contrast, if the retirement account were left to family members, the family members would be required to pay income tax on their withdrawals from the retirement account. If the retirement account is left to charity through an estate or trust (the estate or trust is designated as the beneficiary of the retirement account, as opposed to the designation of a charity as the beneficiary), see the discussion of the charitable deduction, above, particularly the portion discussing a bequest of IRD to a charity.

Typically, the surviving spouse is the designated beneficiary of most retirement accounts, including IRAs. If the spouse is the beneficiary, the spouse can usually roll the account over into a new retirement account in her own name without triggering income tax. §408(d)(3)(C). The income tax will then be postponed until the spouse makes withdrawals from the new account. This is usually the optimum result, since surviving spouses are permitted to defer withdrawals longer than other beneficiaries.

If the estate is the beneficiary of an IRA, the fiduciary must exercise extreme care. In such instances, the fiduciary should carefully consider methods that might be used to postpone the taxation of that account, keeping in mind that a withdrawal from the account is a taxable event, but the assignment of the account intact is typically not a taxable event if the assignment is to a person who is entitled to receive the IRD under the governing document (will or trust). §691(a)(2); Reg. §691(a)(4)(b). If the account is a small one, then perhaps the simplest answer would be to withdraw all of the assets and pay the tax. But if the account is a large one, the fiduciary should consider assigning the account to the beneficiaries in the form of one or more inherited IRA accounts, without making any actual withdrawals from the IRA. If the decedent had three children as beneficiaries of his estate, for example, the account can typically be divided into three separate inherited IRAs, one for each of the three children. The three children could then each decide when each of them would like to withdraw funds from their respective separate accounts, and thus each of them can control when each will be taxed on the withdrawals, because the funds will not be taxed until withdrawn from one of the inherited IRAs. Reg. §1.691(a)-4(b). This is particularly helpful if the beneficiaries are in different circumstances: One beneficiary might not need the income, and might wish to postpone withdrawals and taxation for as long as possible, while another beneficiary might be in need of income and might be willing to make a withdrawal and pay tax immediately.

Before taking action with respect to a retirement account, consider every possible alternative in order to minimize (i.e., postpone) the exposure to income taxation. Typically, the alternatives include the following (in this discussion, a reference to a beneficiary means the beneficiary of the retirement account, not the beneficiary of an estate or trust):

- a. Have the beneficiary withdraw all of the assets from the retirement account, which is a taxable event for the beneficiary. This is usually not the best choice, unless the account is small and the tax consequences minor.
- b. If the beneficiary is the surviving spouse, she can roll the account into an IRA in her own name. Note that this does not involve a withdrawal; the assets stay within an IRA. Taxation will not take place until the spouse, as the beneficiary of the rollover IRA, makes a withdrawal from the rollover account. §408(d)(3)(C). This rollover option is usually the best choice for a spouse beneficiary, since the spouse can defer withdrawals for a longer period than other beneficiaries.
- c. If the spouse is not the beneficiary (the beneficiaries are the children of the decedent, or are non-relatives), the beneficiaries cannot do a rollover, but they can do something similar: they can convert the account into one or more inherited IRAs. Note that this does not involve a withdrawal; the assets stay

- within the inherited IRAs and are not taxed until later withdrawn from one of the inherited IRAs. §691(a)(2); Rev. Rul. 78-406, 1978-2 C.B. 157.
- d. If the beneficiary is the estate or a trust, the estate or trust might wish to continue to maintain the account as an inherited IRA for the benefit of the estate or trust, but that would require keeping the estate or trust open. In most cases, the estate or trust will prefer to convert the account into one or more inherited IRAs for the benefit of the beneficiaries of the estate or trust. In effect, the estate or trust will have transferred the retirement account intact to one or more beneficiaries without having actually made any withdrawals from the account. The transfer of an IRA account from an estate or a trust as a result of the death of the owner is not a taxable event. §691(a)(2); Reg. §1.691(a)-4(b). (But see the discussion of pecuniary bequests, below.) Thus a taxable event does not take place until a withdrawal is made from the account by the beneficiary who received it from the trust or estate. PLR 200520004. It might be necessary to check your governing instrument or your local law to determine whether nonprorata distributions are permitted. In Oregon, see ORS 130.725(22). In Washington, see RCW 11.98.070 and 11.68.090. If the estate or trust feels the need to make an actual withdrawal from the account, perhaps the withdrawals could be made over two or more years, and hopefully that income can be offset by administration expense deductions or distribution deductions, but distributing the account intact to the beneficiaries is usually the best approach. But see below regarding trusts that qualify as a Designated Beneficiary.
- e. If the beneficiary is a charity, the charity can withdraw funds from the account with impunity, since the charity will not be taxable on the IRD. If the beneficiary is the estate or a trust, but the estate or trust benefits (in whole or in part) a charity, then the situation becomes much more complicated. See the discussion of the charitable deduction, above.

The complexity of the issues described above requires careful drafting of beneficiary designations and the dispositive provisions of wills and trusts that pertain to distributions to beneficiaries. And the beneficiary designations and dispositive provisions must be carefully coordinated.

Keep in mind that some retirement plans, or some plan custodians, will not permit a retirement account to be divided into separate inherited accounts for each beneficiary; contact the plan custodian/administrator and review the plan document to determine what is permitted.

The primary purpose of the techniques described above is to permit the beneficiary to postpone withdrawals for the longest period of time permitted by the tax laws, although the beneficiary is also free to make withdrawals on a more accelerated basis, if that is what the beneficiary desires. The length of that possible deferral period depends on several factors. Attached to this paper as Appendix C is a summary of the general rules governing those time periods, entitled "Retirement Plan Distributions After Death." Exceptions may apply to those general rules. See also, Duffy, *Beneficiary Designation: More Prominent Considerations in Today's Estate Tax World*, Oregon State Bar Estate Planning and Administration Section Newsletter, Vol. XXX, No. 3, July 2013.

When a trust is named as the beneficiary of a retirement account, the trust might distribute the account intact (without making withdrawals from the account) to the trust beneficiaries in the form of one or more inherited IRAs, as discussed above. Or the trust could retain ownership of the account as an inherited IRA, but that choice does not allow a maximum stretch-out of the required minimum distributions (RMDs). However, a trust can be specially designed and drafted as a "see-through trust" (also known as a look-through trust), which allows the life expectancy of the oldest beneficiary to be used to maximize the stretch-out. See Reg. §1.401(a)(9) for a discussion of the requirements to be classified as a see-through trust. Or the trust could be drafted as a "conduit trust," in which the trust agreement requires the trustee to distribute to the beneficiaries any distributions that the trust might receive from the retirement account. A conduit trust is considered to be a safe-harbor, in that it automatically qualifies as a see-through trust. Any trust not considered to be a conduit trust is considered to be an accumulation trust, since it allows the trustee to accumulate funds withdrawn from the retirement account, rather than distributing the withdrawals as they are made. Another alternative might be to use an individual retirement trust, also known as a trusteed IRA. The details of these alternatives are beyond the scope of this paper. See the Choate book listed in the Selected Additional Research Materials at the end of this paper.

If the fiduciary transfers the retirement account to a non-beneficiary (in satisfaction of a debt, for example, or in return for consideration), then the estate or trust will immediately realize income in an amount equal to the IRD in the account. §691(a)(2). But if the transfer is to a beneficiary in satisfaction of the beneficiary's right to inherit a non-pecuniary bequest from the estate or trust (such as a residuary bequest), that rule does not apply, the estate or trust will not be taxed on the IRD, and the beneficiary will not be taxed until the time that the beneficiary makes a withdrawal from the account. §691(a)(1)(C) and (a)(2). But if the transfer is in satisfaction of a pecuniary bequest, there is some debate as to whether the transfer will trigger realization of income. Although the IRS has indicated in CCA 200644020 and in PLR 201438014 that a transfer of an IRA account to a beneficiary in satisfaction of a pecuniary bequest will trigger IRD to the estate or trust, §691(a)(2) suggests that the estate or trust will not realize IRD, and the beneficiary will realize IRD only when the beneficiary makes

withdrawals from the account. Reg. §1.691(a)-2; Reg. §1.691(a)-4(b). In CCA 200644020, the IRS specifically stated its disagreement with that interpretation. Until this question is resolved, using the transfer of a retirement account to satisfy a pecuniary bequest is not without risk. See also PLR 9315016.

If the fiduciary makes a withdrawal from a retirement account (causing realization of ordinary income), and then makes a distribution to one of several beneficiaries, the tax situation becomes considerably more complicated if the separate share rule applies. See the discussion of the separate share rule in the following section. The problem is determining whether the IRD will be deemed to have been received prorata by all of the separate shares, or received (and distributed) by only one of the separate shares. The separate share rule might, under some circumstances, allocate only some of the IRD to the beneficiary who actually received the entire amount of the IRD. In order to avoid the impact of the separate share rule, one option might be to provide in the governing instrument that the IRD will be allocated to just one of the shares. That allocation will normally be respected for purposes of the separate share rule. Reg. 1.663(c)-2(b)(3); Reg. 1.663(c)-5, Example 9. However, that allocation will not be respected if the IRD is being distributed to a charity, unless the allocation has independent economic effect. Reg. §1.642(c)-3(b)(2); Reg. §1.663(a)-2. See the discussion of the independent economic effect rule in the sections on the distribution deduction, tax-exempt income, and the charitable deduction, above, and the separate share rule, below.

A second option would be to distribute the account itself to one or more beneficiaries without the estate or trust making any withdrawals from the account, thus preventing the DNI from being realized by the estate or trust. In that situation, the separate share rule would not apply to the IRD for the simple reason that the trust or estate did not receive (realize) any IRD, and thus need not report (recognize) any IRD.

A third option might be to distribute non-IRD assets in a prior year in full satisfaction of the other beneficiaries' interests in the estate or trust, thus creating a situation in a subsequent year where the estate or trust has only one beneficiary, the separate share rule will not apply, and the beneficiary receiving the IRD will be taxed on all of it, not just part of it. This technique might be useful to direct all of the IRD to a charity, which will not pay tax on the IRD it is deemed to have received. See the discussion of the charitable deduction, above.

The separate share rule (discussed in the following section) applies to shares of a trust that are independent of one another, such that a distribution from one share to that share's beneficiary does not diminish the share of another beneficiary. Once it is determined that the separate share rule applies, the manner in which it applies to an item of IRD depends in part on whether the item constitutes principal or income under

fiduciary accounting rules. As noted above in the discussion of fiduciary accounting income, the distinction between fiduciary accounting income and principal is defined by local law and the governing instrument. §643(b). The separate share regulations contain a special provision that governs the portion of IRD that is considered to be principal for fiduciary accounting purposes. Reg. §1.663(c)-2(b)(3). (Note that all IRD is taxable as income for income tax purposes, but not all IRD is defined as income for fiduciary accounting purposes.) Most states have adopted a version of the Uniform Principal and Income Act (UPIA). The Oregon version defines required distributions from a retirement account as constituting 90% principal and 10% income. ORS 129.355. (In Washington, required retirement account withdrawals constitute 4% income and 96% principal. RCW 11.104A.180.) If no part of the withdrawal was required to be made, then the withdrawal is considered to be 100% principal. ORS 129.355; RCW 11.104A.180. Under Reg. §1.663(c)-2(b)(3) of the separate share regulations, the principal portion of the IRD is allocated among the separate shares that "could potentially" be funded with the IRD, and the allocation is then made on a prorata basis, depending on the relative values of the shares. Reg. §1.663(c)-5, Examples 6 and 10. The income portion of the IRD (as defined for fiduciary accounting purposes) is allocated among the separate shares according to the terms of the governing instrument and local law, apparently without regard to whether the allocation has any independent economic effect. Reg. §1.663(c)-2(b)(2). However, if the allocation made by the governing document or by local law involves a charitable income tax deduction, then the allocation will not be honored for income tax purposes unless it has independent economic effect. Reg. §1.642(c)-3(b)(2); Reg. §1.663(a)-2. See PLR 201611002 for an example of an allocation that had economic effect and was honored.

If a trust receives an IRD distribution, and the trust agreement *requires* that the IRD be paid or held for the benefit of the share of Beneficiary A, then that allocation will be respected by the separate share regulations, because no other share could potentially be funded with the IRD. Reg. §1.663(c)-2(b)(3) (See the discussion above regarding charitable IRD distributions, which are subject to the independent economic effect rule. Reg. §1.642(c)-3(b)(2); Reg. §1.663(a)-2.) But if the trust agreement permits the IRD to be shared among the separate shares, then the regulation requires that the IRD be allocated prorata among those shares. Reg. §1.663(c)-2(b)(3). This result can be altered using several different techniques. First, the governing document could make the allocation mandatory. Second, the governing document could be drafted to alter the definition of principal or income, which would alter the application of that regulation, since that regulation applies only to principal. However, the ability of the governing document to make that change might be limited by Reg. §1.643(b)-1, which provides that the IRS will not honor definitions of income contained in a trust document that fundamentally vary from state law. Third, the retirement account could

be distributed intact (without making any withdrawals from the account) to one beneficiary, thus preventing the trust from realizing IRD, and thus causing that one beneficiary to realize IRD whenever that one beneficiary makes a withdrawal from the account. §691(a)(2); Reg. §1.691(a)(4)(b); PLR 200234019. Fourth, the other shares could be fully funded with non-IRD assets, and then in a subsequent year the IRD could be withdrawn by the trust and then paid to the share of Beneficiary A, and the other shares would not be allocated any IRD because in the subsequent year those other shares would no longer exist, and thus the separate share rule would not apply. In the third and fourth situations, such distributions might require language in the governing instrument (or local law) authorizing nonprorata distributions. In Oregon, see ORS 130.725(22). In Washington, see RCW 11.98.070 and 11.68.090.

As noted in the above discussion, a *requirement* in the governing document that a particular class of income (such as IRD) must be allocated to a particular share will usually be effective to cause that allocation to be honored for purposes of the separate share rule. Reg. §1.663(c)-2(b)(3); Reg. §1.663(c)-5, Example 9. But such a provision will not be effective for purposes of the separate share rule if the governing instrument merely *permits* the trustee to allocate the IRD to other shares. Although such a mandatory provision can be effective for purposes of the separate share rule, it will not be effective for purposes of the charitable income tax deduction unless the provision has independent economic effect. Reg. §1.642(c)-3(b)(2); Reg. §1.663(a)-2. See the discussion of the independent economic effect rule in the sections on tax-exempt income and on the charitable deduction, above.

The question of whether an income interest in a trust or a retirement account qualifies as an income interest for purposes of a QTIP election and the estate tax marital deduction is not discussed here.

27. Separate Share Rule

If multiple trusts are established for the respective benefit of multiple beneficiaries, then each of those trusts will be treated for tax purposes as a separate and different trust, each calculating its own income and deductions and each filing its own income tax return. But if a single trust (or an estate) is designed to benefit multiple beneficiaries and the terms of the trust or will prevent distributions to one beneficiary from affecting the interests of the other beneficiaries, then $\S663(c)$ requires the application of the separate share rule. Reg. $\S1.663(c)$ -3. The separate share rule is stated very simply in $\S663(c)$, with nearly all of the detail provided in regulations. Reg. $\S1.663(c)$ -1. The determination of whether the rule applies is made on a year-to-year basis; a trust or estate might be subject to the rule in one year and not in another. TAM 200733024.

A separate share is defined as that portion of a trust that is administered as if it were a separate trust. Reg. §1.663(c)-3. For example, if a trust created for the benefit of three beneficiaries requires that distributions to each beneficiary may be made only from the respective share of that particular beneficiary, without affecting the shares of the other beneficiaries, then the separate share rule will apply. It does not apply if the trust document actually requires the creation and administration of a separate trust for each beneficiary. And it does not apply to trusts where the trustee has the power to sprinkle unequal distributions of income or principal from the entire trust among the various beneficiaries, because such distributions to one beneficiary will affect the interests of the other beneficiaries. Reg. §1.663(c)-3(b). A specific bequest that is paid in three or fewer installments is not considered to be a separate share, because it does not carry out DNI. §663(a)(1); Reg. §1.663(c)-4.

The separate share rule is mandatory if the requisite facts are present; it is not elective. Reg. $\S1.663(c)$ -1(d). As a result, the decision whether the separate share rule will apply is made in the drafting stage. The rule can apply to both estates and trusts. $\S663(c)$. However, the separate share rule for estates varies slightly from the separate share rule for trusts, while qualified revocable trusts are subject to the separate share rule applicable to estates, even if no election is made under $\S645$ to treat the trust as a part of the estate. For a discussion of the different treatment of trusts and estates, see Reg. $\S1.663(c)$ -3 and $\S63(c)$ -4.

If the separate share rule applies, then the result is that each separate share of the trust or estate will calculate its own DNI, separate and apart from the other shares of the trust or estate. §663(c). That result is significant for two reasons. First, and most obvious, the calculation of DNI within each share is independent of the calculation of DNI in any of the other shares. Second, and less obvious, the application of the separate share rule, and the division of the trust or estate into separate shares for income tax purposes (if the rule is applicable) takes place before the calculation of DNI within each share. Reg. §1.663(c)-5, Example 11.

The mechanism used to achieve the goal of the separate share rule is the calculation of separate DNI and a separate distribution deduction for each separate share. Reg. §1.663(c)-2(b). Once those separate distribution deductions are calculated per share, they are then added together to create one distribution deduction for the entire trust. That one combined distribution deduction is then subtracted from the adjusted total income of the trust to determine taxable income, and then the trust files a single income tax return for all of the shares. The separate share rule does not result in separate trusts that file separate returns.

The statute states that the separate share rule exists for the "sole purpose" of determining DNI in the application of §661 and §662. §663(c); Reg. §1.663(c)-1(b).

The former section deals with distribution deductions by estates and complex trusts; the latter deals with the inclusion the distributions in the gross income of the recipient beneficiaries. The separate share rule does not apply for any other purpose. It does not require or permit the creation of separate trusts, nor does it require or permit the filing of separate tax returns. Reg. §1.663(c)-1(b). Instead, the separate share rule operates within a single trust to ensure that the tax attributes of one separate share held for the benefit of one beneficiary do not affect the taxation of any other share held for the benefit of any other beneficiary. As a result of the separate share rule, if it is applicable, a beneficiary will not be taxed on income distributed to, or accumulated for the benefit of, another beneficiary. Reg. §1.663(c)-1.

For example, let's assume that a trust is established for the benefit of three beneficiaries. The terms of the trust provide that the trust is to be held as one trust, but in three shares, one share for each of the three beneficiaries. The trustee is authorized by the trust to distribute discretionary amounts of income and discretionary amounts of principal up until each beneficiary reaches the age of thirty-five years. At that time, each respective share will be distributed to the beneficiary of that share at age thirtyfive. Any distributions prior to that age will be considered to be an advancement from each respective share, so that any beneficiary who receives discretionary distributions will receive less at age thirty-five. As a result, any discretionary distributions to one beneficiary will not affect the respective shares of the other two beneficiaries. Under those facts, the separate share rule will apply, and the DNI and the distribution deduction will be calculated separately for each share. If in one year the entire trust receives \$15,000 of net income, each share will have DNI of \$5,000. If in that same year one beneficiary receives a distribution of \$12,000, that beneficiary will be deemed to have received \$5,000 of income and \$7,000 of principal. The trust will take a distribution deduction of \$5,000, and the other \$10,000 of DNI will be taxed to the trust. Reg. §1.663(c)-5, Example 1.

In the previous example, if the trust agreement had directed that the discretionary distributions would be made from the trust as a whole, so that a distribution to one beneficiary would reduce the shares of all three beneficiaries, then the separate share rule would not apply. Under those circumstances, the beneficiary receiving the distribution of \$12,000 would be taxed on DNI of \$12,000, and the trust would be taxed on the \$3,000 of undistributed DNI. The other two beneficiaries (who received no distributions) would not be taxed. This illustrates how the applicability (or inapplicability) of the separate share rule can alter the relative manner in which the various beneficiaries are taxed, along with altering the manner in which the trust is taxed.

Because the separate share rule expressly applies only to \$661 and \$662, it apparently does not affect the charitable deduction under \$642(c). \$663(a)(2); Reg. \$1.663(a)-2. As a result, a charitable bequest or a charitable share is most likely not a separate share under the separate share rules. (This conclusion is not entirely clear. See Reg. \$1.663(c)-5, Example 11, the facts of which are unusual, and thus the conclusion reached by that example is ambiguous.) Thus it appears that an attempt to use the separate share rule to allocate special classes of income (such as IRD or tax-exempt income) to charity or away from charity will not be successful. Reg. \$1.642(c)-3(b)(2); Reg. \$1.663(a)-2.

The separate share rule never applies to a simple trust, because its application is unnecessary; the DNI of any separate shares contained within a simple trust will be allocated to each separate share in any event. The fact that the separate share rule is inapplicable to simple trusts is evidenced by the fact that the first sentence of §663(c) limits its application to the determination of DNI under §661 and §662 (which apply to estates and complex trusts) and no mention is made of §651 and §652 (which apply to simple trusts).

In order for the separate share rule to apply, the governing document need not describe the shares as separate shares. For example, a trust that creates a residue that is payable in equal thirds to three beneficiaries might appear to be a single residue. Yet that single residue actually constitutes three separate shares. Reg. §1.663(c)-5, Example 11. If all three shares receive the same income and are distributed at the same time, then the tax result brought about by the separate share rule will be the same as if the rule had not applied, but if the three shares are distributed at different times, particularly in different years, then the separate share rule will produce a different result. For example, if one of the three beneficiaries receives a distribution that exceeds the total DNI received by the trust, and the other beneficiaries receive no distributions in that same year, then only a third of the DNI will be carried out to the beneficiary who received the distribution and he will be taxed on that one-third of the DNI, and the other two-thirds of the DNI will be taxed to the trust.

In 2013, the Oregon legislature enacted a new trust statute, providing that if a trust calls for the creation of separate shares for the benefit of separate beneficiaries, then each of those separate shares will be deemed to be a separate trust for the sole benefit of its beneficiaries, and the trust (or portion of the trust) from which those new trusts were created will be deemed to have terminated to the extent of the new trusts. ORS 130.232 (2013 SB 592, Oregon Laws 2013 ch. 529, §24). However, that 2013 legislation was further amended in 2015 to permit the governing document to determine whether separate trusts or separate shares are created. ORS 130.232 (2015 HB 2331, Oregon Laws 2015 ch. 126, §3).

28. Basis Step-up and Basis Reporting

The income tax basis of property acquired by an estate (or a formerly-revocable trust) from a decedent is its fair market value on the date of death, §1014(a)(1), or its alternate value on the alternate valuation date if elected under §2032, or its special use value if elected under §2032A. §1014(a)(2) and (3). This is known as the basis step-up, although in times of declining values it becomes a basis step-down. §1014(a).

The basis step-up generally applies to all assets included in the gross estate by reason of any Code section, not just assets held in the individual name of the decedent. §1014(b)(9); Reg. §1.1014-1(a). One exception: Income in respect of a decedent (IRD) does not receive a basis step-up. §1014(c). See the discussion of IRD, above.

The basis step-up takes place even if the estate was too small to file an estate tax return, or the estate was not required to pay estate tax. Rev. Rul. 56-215, 1956-1 C.B. 324. Because only half of property held in joint name by a husband and wife is included in the gross estate of the first spouse to die, only half of the property receives a new basis. §1014(a) and (b)(9). If the couple holds community property, then both halves of the property acquire a new basis upon the death of the first spouse to die. §1014(a) and (b)(6).

In contrast, the basis of property acquired by a lifetime gift or by an intervivos transfer into an irrevocable trust remains the same basis that the property had in the hands of the donor or transferor. §1015. This is known as carry-over basis.

As a result, the basis of assets held by an estate, a testamentary trust, or a post-mortem formerly-revocable trust is the date of death value under §1014(a)(1), or the alternate valuation date value if elected under §2032, or the special use value if elected under §2032A. The same rule applies to other forms of transfers at death. But intervivos transfers do not receive a new basis, unless for some reason the transfer became included in the gross estate of the decedent for estate tax purposes. §1014(b). For example, a lifetime gift with a retained income interest will be brought back into the gross estate of the donor under §2036.

This is a very important point because in most situations a trust, estate, or beneficiary receiving a decedent's property that appreciated significantly during the decedent's lifetime can sell that asset after death with little or no capital gain realization or recognition. (See the discussion of capital gains and losses, above.) And depreciable assets transferred at death receive a new income tax basis, so that the estate, trust, or beneficiary may begin depreciating the assets all over again. However, the new income tax basis of depreciable assets transferred to a recipient at death must be reduced by any

depreciation taken by the recipient (not the decedent) during the life of the decedent. §1014(b)(9); Reg. §1.1014-6(a)(1); Rev. Rul. 58-130, 1958-1 C.B. 121.

Section 1014(e) denies a stepped-up basis for appreciated property acquired from a decedent who had acquired the property from the beneficiary within the one-year period prior to the decedent's death. §1014(e). As a result, gifting low-basis assets to a terminally ill relative, only to receive it back again when the relative dies, does not increase the basis. It is an open question whether the denial of the basis step-up applies not only to the beneficiary, but also to a trust for the benefit of the beneficiary. Thus if Wife conveys appreciated property to Husband, and Husband dies within one year and then bequeaths the property to a credit shelter trust for the benefit of Wife (or to a QTIP trust for the benefit of Wife), whether the trust receives a stepped-up basis on Husband's death is uncertain. Siegel, *I.R.C. Section 1014(e) and Gifted Property Reconveyed in Trust*, 27 Akron Tax J. 33 (2012). Regulations under §1014(e) have not yet been promulgated, but the IRS has taken the position that §1014(e) does deny a basis step-up for appreciated property left in trust for the benefit of the spouse who conveyed the property to the decedent within one year prior to death. PLRs 200101021 and 200210051.

If an estate (or a trust) makes inconsistent federal and Oregon elections on the federal and Oregon estate tax returns as authorized by ORS 118.010(8), then ORS 316.716 requires that different tax bases be used on the federal and Oregon income tax returns of the taxpayers who receive assets from the estate. That statute very broadly requires that any differences between federal and Oregon law that affect basis will result in different bases on the federal and Oregon income tax returns. More specifically, that statute requires that an amount be added to (or subtracted from) federal taxable income in order to adjust for the difference in Oregon basis. Those differences could come about as a result of inconsistent elections concerning the marital deduction, the alternate valuation date, special use valuation, and other elections. ORS 118.010(8) describes several inconsistent elections that might be made, but it also permits other inconsistent elections that are not specified there. This adjustment is considered to be part of the fiduciary adjustment described in ORS 316.287 and 316.697. Taxpayers reporting a difference in basis will need to attach a Schedule OR-ASC to their returns. For an intriguing discussion of inconsistent QTIP elections in Washington, see Fujimoto, Washington Estate Tax Surprises Along the Way to a Federal Second Step-up in Basis, Real Property, Probate and Trust Section Newsletter, Washington State Bar Association, Vol. 42, No. 1, Winter 2014-2015.

Historically, there was some debate whether the beneficiary of an estate was required to use, for income tax basis purposes, the values shown on the estate tax return, or whether the beneficiary could produce evidence to overcome those values.

See, for example, Rev. Ruling 54-97, 1954-1 C.B. 113. Effective for estate tax returns filed after July 31, 2015, beneficiaries of estates and trusts are now required to use a basis that does not exceed the value as finally determined for federal estate tax purposes. §1014(f) (§2004(a) P.L. 114-41). Penalties apply to violations of this consistency provision by a beneficiary, including the 20% accuracy-related penalty. §6662. This new consistency requirement applies only to those assets whose inclusion in the estate actually increased the estate tax liability. §1014(f)(2).

In order to encourage beneficiaries to comply with new §1014(f), fiduciaries who file estate tax returns after July 31, 2015, are now required to report valuation (basis) information to the beneficiaries and to the IRS within thirty days after filing an estate tax return. §6035 (§2004(b) P.L. 114-41). The IRS has issued a new Form 8971 to be used for reporting basis information, along with instructions for the form. The form requires a separate Schedule A for each beneficiary to be attached to the Form 8971 and to be supplied to each beneficiary, showing exactly what assets were acquired from the estate by each beneficiary. Each beneficiary will receive his or her own Schedule A, but the beneficiaries will not receive a copy of Form 8971, nor will they receive the Schedules A that pertain to any of the other beneficiaries. The Form 8971 is to be filed with the IRS, along with copies of all of the Schedules A.

This basis information reporting requirement does not apply to estate tax returns filed solely for the purpose of electing portability under §2010(c)(4). Reg. §1.6035-1(a)(2). With the doubling of the estate tax exemption effective January 1, 2018, through December 31, 2025, it seems likely that the number of federal estate tax returns filed (both regular returns and portability returns) will dramatically decrease beginning in 2018. As a result, the number of Forms 8971 filed will likely also decrease.

If the values shown on the estate tax return are later adjusted, or assets are discovered that were omitted from the estate tax return, supplemental reports must be provided to the beneficiaries and to the IRS. Reg. §1.6035-1(e).

This basis reporting requirement applies to both estates and trusts. Values reported should not be reduced by mortgages. Reg. §1.6035-1(a)(2). Penalties apply for failure to provide these reports; the penalties are particularly steep if the failure to file is willful. §6721(e); §6722(e); §6724; Reg. §1.6035-1(h). If willful, the penalty could be as high as 10% of the value of the assets required to be reported. §6721(e)(2). The penalties apply even if no estate tax was payable, and even if the beneficiary was not subject to the consistency requirement. An inconsequential error or omission on the Form 8971 will not generate a penalty, but an incorrect value, or an incorrect name of a beneficiary, or an incorrect EIN of a beneficiary, is considered to be consequential, according to the Form 8971 instructions. The instructions discuss the penalties in some detail. Because the code and regulations provide no penalty for over-reporting, but do

provide penalties for under-reporting, when in doubt the safest course of action is to fully report or possibly over-report, either on an original Form 8971, or if subsequent changes occur, on a supplemental Form 8971, discussed below.

The basis reporting rules under §6035 and the basis consistency rules under §1014(f) vary somewhat. They are two different statutes, they are supported by two different sets of regulations, and their requirements are not entirely consistent. For example: Although a beneficiary is not required to use the estate tax value of an asset as his income tax basis unless the inclusion of the asset actually increased the estate tax liability, the fiduciary is nevertheless required to report the estate tax value to the beneficiary and to the IRS regardless of whether the inclusion of the asset increased the estate tax liability. §1014(f)(2); §6035. For a summary of the differences between the §6035 basis reporting rules and the §1014(f) basis consistency rules, see the attached Appendix D.

Although the estate tax value of an asset (usually its fair market value on the date of death under §2031) usually establishes the beneficiary's basis (usually its fair market value on the date of death under §1014), there are some exceptions to that general rule. For example, an appreciated asset gifted to the decedent within one year prior to death will be denied a stepped-up basis if the asset is bequeathed back to the donor of the gift. §1014(e). In that case, the estate tax value reported on both the Form 706 and the Form 8971 will be higher than the beneficiary's basis. For that reason, it would not be technically correct to state that the Form 8971 notifies the beneficiary of his basis (although it almost always does). Instead, it would be technically correct to state that the Form 8971 merely provides to the beneficiary the estate tax value, which is not always the basis. This is consistent with §1014(f)(1), which states that the basis reported by the beneficiary "may not exceed" the estate tax value.

In early March 2016, temporary and proposed regulations were issued to provide guidance regarding many unanswered questions concerning this new basis information reporting and the basis consistency requirement. T.D. 9757; REG-127923-15; FR Doc. 2016-04718, 3/4/16. The temporary regulations and the proposed regulations are identical. This discussion of basis reporting and basis consistency is based on those temporary and proposed regulations, which were in effect as of this writing. In the future, check to see if final regulations have been published. The new regulations will appear in Reg. §1.1014-10, §1.6035-1, and §1.6035-2. The IRS once indicated that the final regulations would likely be published by January 2017, but when that date arrived the IRS stated that the final regulations would be delayed. A new due date of June 30, 2018, has since been announced, but that date might be extended.

The Form 8971, the instructions, and the temporary regulations now provide the following answers, although these answers are subject to change when the temporary

regulations are revised and made final. (This is a brief summary of the answers; review the regulations for details. See FR Doc. 2016-04718, 3/4/16.) The basis reporting must be performed by any person who is an executor or is deemed to be an executor, and the reporting must be supplied to the IRS and to the beneficiaries, including those beneficiaries who are also serving as executors. Reg. §1.6035-1(c)(1). The definition of an executor is very broad. §2203, §7701(a)(6), Reg. §1.6012-3(b)(1) and CCA 201334040. If a trust is a beneficiary of an estate, the basis information from the estate needs to be supplied to the trustee, and not to the trust beneficiaries. Reg. §1.6035-1(c)(2).

The Form 8971 is to be accompanied with separate schedules (Schedule A), one for each beneficiary, and the Form 8971 and all of the Schedules A must be filed with the IRS. Each Schedule A is required to describe the assets (and the basis of each asset) to be received by each beneficiary. Each beneficiary is to receive his or her own Schedule A, and is not to receive copies of the Schedules A for the other beneficiaries, nor are any of the beneficiaries to receive a copy of the Form 8971. If the fiduciary does not yet know which assets will be distributed to which beneficiaries, then each beneficiary will receive a Schedule A listing all of the assets that *could* be used to distribute to each beneficiary his or her share of the estate or trust. Reg. §1.6035-1(e)(3)(B). The instructions to Form 8971 and Reg. §1.6035-1(e)(3)(B) state that in such circumstances, a supplemental Form 8971 may later be filed, but isn't required. Thus finalization of the funding does not require the filing of a supplemental Form 8971. However, if the original basis reporting was incorrect or incomplete, or values are later adjusted for other reasons (such as an estate tax audit), or assets are discovered that were not previously reported, then supplemental reporting is required within thirty days after the event causing the change. Reg. §1.6035-1(e)(4).

The ability to report all of the assets that could be used to distribute to each beneficiary makes the basis reporting relatively easy if the assets to be distributed to each beneficiary have not yet been selected within thirty days following the filing of the estate tax return. In that situation, all of the assets (or all of the reportable assets) can be reported on each of the Schedules A, and then the selection of assets to be distributed to each beneficiary can be made at a later date, with no need to engage in supplemental reporting. That approach might be particularly useful if all of the beneficiaries will be receiving equal shares. But if the beneficiaries will be receiving unequal shares, and the fiduciary would prefer to not disclose the full extent of the estate assets to all of the beneficiaries, then such an approach might lead to friction among the beneficiaries.

According to a controversial provision of the temporary and proposed regulations, if an asset is omitted from the estate tax return, and the inclusion of that

asset would have increased the estate tax, and the statute of limitations on assessment of the tax has expired, then the recipient beneficiary will have a zero basis in that asset. Reg. $\S1.1014-10(c)(3)(i)(B)$. This situation can be remedied if a supplemental return is filed before the expiration of the statute of limitations expires on the assessment of the tax. Reg. $\S1.1014-10(c)(3)(i)(B)$. If no estate tax return was filed under circumstances such that the return should have been filed and tax paid, the basis of *all* of the inherited property will be zero until the property is reported and its basis established. Reg. $\S1.1014-10(c)(3)(ii)$.

Some commentators have questioned the validity of this zero basis rule, since the statute itself makes no mention of a zero basis. In response, the IRS argues that the zero basis rule is based on the statute, which provides that the basis employed by the beneficiary cannot exceed the basis established for federal estate tax purposes, and since the asset was not reported for estate tax purposes, no basis was established. §1014(f) (§2004(a) P.L. 114-41). It is important to note that the zero basis rule applies only to assets which, if included on the estate tax return, would have increased the federal estate tax. Reg. §1.1014-10(b)(1); §1.1014-10(c)(3)(ii).

The zero basis rule, the possible penalties, and the required filing of a supplemental Form 8971 for newly discovered assets represents a substantial change in the law. Previously, there was little or no authority that required the filing of a supplemental estate tax return if assets were discovered after the return was filed. In the income tax arena, amended returns are generally not required, although they might be advisable. *Broadhead v. Commissioner*, T.C. Memo 1955-328; *Goldring v. Commissioner*, 20 T.C. 79, 83 (1953). In the past, many practitioners have followed that same rule with respect to estate tax returns, although other practitioners have felt that the filing of a supplemental estate tax return is often advisable, depending on the circumstances. But now, under some circumstances (described above) the §6035 regulations require the filing of a supplemental Form 8971 and impose penalties and a zero basis on taxpayers who fail to do so, and presumably anyone who files a supplemental Form 8971 will also want to file a supplemental Form 706.

These new reporting rules do not apply to cash distributions (other than coins or bills with numismatic value), or to bequests of tangible personal property for which no appraisal is required under Reg. §20.2031-6(b). Life insurance proceeds which were paid to a beneficiary in the form of a check will most likely be treated as cash for purposes of the reporting rules. These new rules also do not apply to IRD assets (although they probably apply to assets that are part IRD). Marital deduction distributions and charitable deduction distributions are not subject to the mandatory consistency rules, but they nevertheless must be reported to the beneficiaries who receive them. The Schedule A is required to inform the beneficiaries regarding which

assets did (or did not) increase the estate tax, and thus the beneficiaries who receive assets that did not increase the tax will not be obligated to use the estate tax values as their basis. Reg. §1.1014-10(b)(1).

The question of which assets increased the estate tax liability, and which assets did not, is answered by the temporary/proposed regulations. If an estate tax is due, even after the application of the unified credit, then all of the assets are deemed to have increased the estate tax, except for marital and charitable bequests. Reg. §1.1014-10(b)(3). All of the assets will be reported on the Form 8971, but the marital and charitable bequests will be marked with an "N" to indicate that those bequests did not increase the estate tax. On the other hand, if no estate tax is due (because of the application of the unified credit, other credits, and various deductions), then all of the bequests will be marked with an "N," and basis consistency will not be required. In both cases, however, a Form 8971 will still need to be filed to report the basis to the IRS and to the beneficiaries. Reg. §1.6035-1(b)(1).

The first draft of the instructions to the Form 8971 was published in late 2015. Draft revised instructions were published in late January, 2016, and then were revised again in early June, 2016, effective September 2016. The draft revised instructions surprisingly indicated that the required information must be supplied on one or more Schedules A without the use of attachments to the Schedules A, but the final instructions issued in June 2016 permit the use of attachments. Appraisals should not be attached to the Schedules A, according to the instructions.

The instructions indicate that if co-fiduciaries are serving, only one need sign the Form 8971, but all co-fiduciaries will be responsible for the content of the submitted form.

In some circumstances, an executor will be required to supplement the Form 8971 if certain facts change after the initial filing of the Form 8971. Those circumstances include the discovery of property that should have been reported on the original Form 8971, a change in value (basis) as a result of an estate tax audit or estate tax litigation, a change in the identity of a beneficiary, or the disposition of property in a transaction in which the basis was carried over to a new asset (such as a like-kind exchange). Reg. §1.6035-1(e). If such a supplemental filing is required, it is due within thirty days after the event that caused the change. Reg. §1.6035-1(e)(4).

If a beneficiary subsequently transfers any of the estate assets to a related party transferee in a transaction in which the transferee's basis is determined in whole or in part with reference to the beneficiary's basis, then the beneficiary must file a Form 8971 and supply a Schedule A basis report to the transferee and to the IRS, and apparently that obligation continues for decades, regardless of when the second transfer takes

place. Reg. §1.6035-1(f). And if the estate has not yet reached a final value of the assets, then that reporting of a subsequent transfer must also be submitted to the executor, and the executor must give the transferee (and not the original beneficiary) notice of any subsequent changes in basis. Reg. §1.6035-1(f). For purposes of this reporting of subsequent transfers to related parties, the regulations provide a definition of related parties. Reg. §1.6035-1(f). Those related parties include family members, controlled entities, and grantor trusts. But they apparently do not include nongrantor trusts. Reg. §1.6035-1(f), which refers to §2704(c)(2). Thus if an estate transfers assets to a trust (and reports the basis to the IRS), and then later the trustee transfers the assets to a beneficiary who is an individual, the trustee need not file a basis report, because the trust and the individual are apparently not related under the definition of related parties. This conclusion is not entirely clear, but does seem to flow from the language of the regulation. The fact that the regulation requires reporting of a transfer to a grantor trust seems odd, since the grantor trust will be reporting its income on the grantor's income tax return. Perhaps this uncertainty will be cleared up in the final regulations.

When filing a Form 8971, the instructions suggest that a Form 2848 power of attorney should be attached if the executor would like the return preparer to be able to discuss the Form 8971 with the IRS. In that instance, the September 2016 version of the Form 8971 instructions states that the taxpayer listed on the Form 2848 should be the executor, not the estate, and the executor's EIN should be listed, not the estate's EIN nor the decedent's social security number. The instructions also state that the Form 8971 should be listed on the Form 2848 as one of the matters that the preparer is authorized to discuss. It seems odd that the Form 8971 instructions call for the use of the executor's EIN on the Form 2848 associated with the Form 8971, since the Form 8971 is closely related to the Form 706 estate tax return, which is filed under the decedent's SSN, not the executor's EIN.

Forms 8971 are filed by mailing them to a designated mail stop at the IRS Cincinnati Service Center. See the instructions for the Form 8971. This is a different address than that used for a Form 706. When the Form 8971 is received by the IRS, it is normally forwarded to whichever IRS office has the estate tax return. As a result, if the estate tax return is being audited, the Form 8971 will be sent to the office auditing the estate tax return.

The IRS delayed the earliest due date of the Form 8971 basis reports to June 30, 2016. As a result, reports relating to Forms 706 filed between July 31, 2015, and May 31, 2016, were due on June 30, 2016, and reports relating to Forms 706 filed after May 31, 2016, will be due thirty days after the Form 706 is filed. Notice 2015-57, I.R.B. 2015-36; Notice 2016-19, I.R.B. 2016-09; Notice 2016-27; TD 9797.

29. State Fiduciary Income Taxes

Most states impose their own fiduciary income taxes, in addition to the federal fiduciary income tax, but the rules vary widely from state to state regarding when a state considers a particular trust to be subject to its state fiduciary income tax. State fiduciary income taxes typically tax both ordinary income and capital gains, without distinguishing between the two. The rules applicable to California, Oregon, and Washington are:

California - The California fiduciary income tax applies to trusts that have a California resident trustee or a California resident non-contingent beneficiary. (If only one of several trustees is a California resident, then only a proportionate fraction of the income is taxed. The same rule applies if only one of several beneficiaries is a California resident.) The tax also applies to estates if the decedent was a resident of California. Income distributed to the beneficiaries is generally not taxed to the estate or trust; it is taxed to the beneficiaries, as in the federal system. If the beneficiary is a nonresident of California, the beneficiary will not be taxed by the state of California unless the income is California-source income. The initial (lowest) income tax rate is 1% on the first \$7,582 of taxable income; the maximum rate is 13.3% on income in excess of \$1 million. Cal. Rev. and Tax. Code §§17041, 17043, 17742. For a fuller discussion of the California fiduciary income tax, see Kinyon, Marois, and Johnson, California Income Taxation of Trusts and Estates, ACTEC Law Journal, Vol. 39, No. 1 & 2, 69 (Spring/Fall 2013). See also California Form 541 and its instructions.

Oregon - The Oregon fiduciary income tax (reportable on Oregon Form 41) applies to both resident Oregon trusts and nonresident trusts, but in different ways. A trust is deemed to be a resident trust if the trust has one Oregon trustee or co-trustee, or the administration of the trust is carried on in Oregon. ORS 316.282(1)(d); OAR 150-316-0400(4), (5) ex. 3. Administration is defined as fiduciary decision-making, not incidental execution of decisions made by others. ORS 316.282(3); OAR 150-316-0400(5). A resident trust is a trust with a resident fiduciary or if the administration is being carried on in Oregon, even if the trustee is a corporate trustee with headquarters elsewhere. ORS 316.282(1)(d); OAR 150-316-0400(5). Nonresident trusts are defined as trusts other than resident trusts. ORS 316.302. The Oregon fiduciary income tax also applies to an estate if the fiduciary was appointed by an Oregon court or the administration of the estate is carried on in Oregon. ORS 316.282(1)(b); OAR 150-316-0400(2). A principal probate and an ancillary probate in two different states are considered to be one estate, but if the principal administration takes place in Oregon, all of the income of both estates will be taxed in Oregon. If the principal administration takes place in another state, then the estate will be taxed as a non-resident estate. OAR 150-316-0400(2). The calculation of the Oregon fiduciary income tax on resident trusts and

estates is made in much the same manner as the Oregon individual income tax, with some exceptions. ORS 316.272; OAR 150-316-0400(6). Similarly, Oregon taxes the Oregon-source income of nonresident trusts and nonresident estates as if the trust or estate were a nonresident individual. ORS 316.307(3); ORS 316.312; OAR 150-316-0420. The Oregon tax applies to both ordinary income and capital gains, at the same rates; capital gains are not taxed at a lower rate, with some exceptions. The taxable income of an estate or trust is based on federal taxable income, but an Oregon fiduciary adjustment is made. ORS 316.282; ORS 316.287; OAR 150-316-0410. The initial (lowest) rate of the Oregon fiduciary income tax is 5% on the first \$3,250 of taxable income; the maximum rate is 9.9% on income in excess of \$125,000. ORS 316.037; ORS 316.282. Under some circumstances, Oregon grants a credit for fiduciary income taxes paid to other states. ORS 316.082 (residents); ORS 316.131 and 316.292 (nonresidents). A nonresident beneficiary of a trust or estate (resident or nonresident) is taxed in the same manner as if the beneficiary had received the income directly, and not through a trust or an estate. OAR 150-316-0400(7). As a result, a nonresident beneficiary of a resident Oregon trust will be taxed in Oregon if the income resulted from the ownership or disposition of tangible property (real or personal) in Oregon, or from the operation of a trade or business in Oregon. ORS 316.127; OAR 150-316-0171. If an asset has a different basis for Oregon purposes than it has for federal purposes, see the discussion of basis step-up, above.

Washington – Washington has not enacted a fiduciary income tax. Washington is one of eight states that do not tax the income of trusts and estates.

In other western states, fiduciary income taxes have been adopted in Idaho (maximum rate 7.4%) Arizona (maximum rate 4.54%) and Hawaii (maximum rate 8.25%). Fiduciary income taxes have not been adopted in Alaska or Nevada. Overall, forty-three states have adopted state fiduciary income taxes.

Keep in mind that state fiduciary income taxes are deductible for purposes of the federal fiduciary income tax. $\S67(b)(2)$. See the section above on calculating taxable income. See also Appendix B.

30. Revocable Trusts and Grantor Trusts

A detailed discussion of grantor trusts (including revocable trusts) is beyond the scope of this paper, but the following is a brief summary of the basic elements of revocable trusts and grantor trusts.

A grantor trust is essentially a trust that a person (usually the grantor or trustor, but not always) has sufficient control over, such that some aspects of the trust are taxed to that person. The most common example is a trust that is treated as a grantor trust

for income tax purposes because the grantor has retained certain powers that make the income of the trust taxable to that person for income tax purposes. Other trusts grant the trustor such powers that the trust becomes part of the trustor's gross estate for estate tax purposes, but the term grantor trust is usually used primarily in the income tax context. (See the above discussion of credit shelter trusts for a discussion of whether a typical credit shelter trust is a grantor trust.)

Grantor trusts typically fall into two primary categories:

First, a revocable living trust is a grantor trust for purposes of both the income tax (during the grantor's life) and the estate tax (at the grantor's death). It is primarily a probate-avoidance tool, and the trustor of a revocable living trust is not intending to achieve any particular income tax advantages or estate tax advantages, although revocable living trusts (like wills) often create post-mortem trusts that have estate tax advantages for the surviving spouse of the trustor. Several alternative methods are available for reporting the income of a revocable living trust. One method (described in Reg. §1.671-4(a)) is for the trustee to file a Form 1041, and to check the box on the first page of the form to indicate that the trust is a "grantor type trust." If that method is chosen, the income, deductions, and credits of the trust are not reported on Form 1041 and its various schedules, but instead they are all shown on a separate statement attached to the return. The statement is then supplied to the grantor, but the grantor does not receive a Schedule K-1. But the most commonly-used method (described in Reg. (1.671-4(b)) is for the grantor to file an individual income tax return, using the grantor's social security number; that return will report all of the income and capital gains received by the trust or by the grantor. Reg. §1.671-4(b)(2)(i)(A). The same is true for a husband and wife who have a joint revocable trust and file a joint return. Reg. §1.671-4(b)(8). In both cases, no further reporting is needed, but if the grantor is not the trustee then certain specified information must be supplied to the grantor by the trustee. Reg. §1.671-4(b)(2)(ii). See Reg. §1.671-4 for alternative reporting methods, but most practitioners prefer the technique that does not require the grantor trust to obtain an EIN, partly because the lack of an EIN greatly simplifies the tax reporting after the grantor dies (the pre-death income is reported on the final individual income tax return using the decedent's SSN and the post-death income is reported on a fiduciary income tax return using a newly-obtained EIN). Also see the instructions to Form 1041, particularly the section of the instructions entitled "Special Reporting Instructions," for details on these various reporting methods.

Second, other grantor trusts are often created that are designed to be grantor trusts for income tax purposes, but not for estate tax purposes. These trusts are sometimes referred to as intentionally defective grantor trusts, or IDGTs. These trusts are designed to offer certain income tax advantages during the life of the trustor, but

the assets also avoid estate tax on the death of the trustor. For example, a trustor might create a grantor trust during his lifetime, and then sell an appreciated asset to that trust. The income generated by the trust might be payable to the trustor's children, and on the grantor's death the principal of the trust would be distributed to his children or be held in further trust for the benefit of his children. But because the trust is a grantor trust for income tax purposes, the sale of the appreciated asset is not a taxable event, because the trustor has in effect sold the asset to himself. In some cases, the asset is not sold to the trust, but instead is gifted to the trust, and a completed taxable gift will have taken place, because the children received a vested interest in the trust. Following the sale or gift, any income earned by the asset in the hands of the trust is taxed to the trustor (and reported using his SSN), because the trust contains certain provisions that trigger the grantor trust provisions of the Code, such as §§673 through 677. However, the income earned by the trust is not payable to the trustor, even though the trustor is taxed on that income for income tax purposes. Such a trust typically contains no provisions that would trigger estate tax on the death of the trustor. In particular, the trust contains no provisions that would trigger the string sections of the estate tax statutes. (Sections 2036 through 2038 are colloquially known as the string sections, because they will result in inclusion in the gross estate of the donor or grantor if the lifetime transfers were made with certain strings attached, such as retention of an income interest, retention of a right to revoke, etc.) Thus a trustor can reduce his taxable estate by transferring assets to a grantor trust, and then further reduce his estate by paying the income tax on the income generated by the grantor trust, all the while excluding the transferred assets (and the income generated by those transferred assets) from his gross estate for estate tax purposes. The payment of the income taxes by the grantor is not considered to be a gift to the trust or to its beneficiaries.

To invoke grantor trust status without triggering estate tax on the death of the trustor, the grantor trust must be carefully designed to trigger the income tax grantor trust statutes without triggering the estate tax statutes. To avoid the latter, the trust must not give the trustor the right to receive the income of the trust, or the right to amend, alter, or revoke the trust. §\$2036 through 2038. To trigger the grantor income tax provisions, the trustor is typically given the power to borrow trust assets without adequate security or adequate interest, or the trustor is given the power to reacquire trust assets and replace them with property of equivalent value. §675(2); §675(4)(C). Or the grantor could give a nonadverse party the power to add a charitable beneficiary. *Madorin v. Commissioner*, 84 T.C. 667 (1985). Upon the death of the grantor, a grantor trust usually becomes a nongrantor trust.

See also the discussion of credit shelter trusts and SLATs in section 4, above.

The income, including capital gains, earned by an irrevocable life insurance trust is taxable to the grantor because $\S677(a)(3)$ provides that if trust assets may be applied to the payment of premiums on the life of the trustor, or his spouse, then the trust will be treated as a grantor trust for income tax purposes. For that reason, most ILITs do not file income tax returns, but most obtain an EIN in order to open a trust bank account.

Selected Additional Research Materials

Acker, *Income Taxation of Trusts and Estates*, Portfolio 852-4th, Bloomberg Bureau of National Affairs: Tax Management Estates, Gifts and Trusts Portfolios (2017).

Acker, *Income in Respect of a Decedent*, Portfolio 862-3d, Bloomberg Bureau of National Affairs: Tax Management Estates, Gifts and Trusts Portfolios (2010).

Ferguson, Freeland, and Ascher, Federal Income Taxation of Estates, Trusts, and Beneficiaries, CCH/Wolters Kluwer (2015).

Berek, Federal Income Taxes of Decedents, Estates and Trusts, CCH Tax Spotlight Series, CCH/Wolters Kluwer (2017).

Choate, Life and Death Planning for Retirement Benefits, Ataxplan Publications (7th ed. 2011).

Kantor, Miller, Newcomb, and Richardson, eds., Administering Trusts in Oregon, Oregon State Bar, 2018.

Zaritsky and Lane, Federal Income Taxation of Estates and Trusts, Warren, Gorham, and Lamont (3d ed. 2003).

Chapter /—A Fiduciary Income Tax Primer

Appendix A: Interest Deductions by Trusts and Estates

Note: Interest is not a miscellaneous itemized deduction. §67(b).

Type of Interest	Estate Tax Deduction	Fiduciary Income Tax
		Deduction
Business interest	Deductible. §2053(a)(3); Reg.	Deductible, above the line.
accrued pre-death	§20.2053-1; §20.2053-4(e)(1).	§62; §163(h)(2)(a).
Postmortem	Deductible. §2053(a)(2); Reg.	Deductible, above the line.
business interest	§20.2053-3; §20.2053-4(e)(2).	§62; §163(h)(2)(a).
Investment interest	Deductible. §2053(a)(3); Reg.	Deductible, below the line.
accrued pre-death	§20.2053-1; §20.2053-4(e)(1).	§163(h)(2)(B).
Postmortem	Deductible. §2053(a)(2); Reg.	Deductible, below the line.
investment interest	§20.2053-3; §20.2053-4(e)(2).	§163(h)(2)(B).
Personal interest	Deductible. §2053(a)(3);	Not deductible.
accrued pre-death	Reg. §20.2053-4(e)(1).	§163(h)(1).
Postmortem	Deductible. §2053(a)(2); Reg.	Not deductible.
personal interest	§20.2053-3; §20.2053-4(e)(2).	$\S163(h)(1)$; Reg. $\S1.663(c)-5$,
		Example 7.
§6166 interest	Not deductible.	Not deductible.
	§2053(c)(1)(D).	§163(h) and (k).
§6161 interest	Not deductible while a §6166	Not deductible.
	election is in place.	§163(h) and (k).
	§2053(c)(1)(D). Otherwise	
	deductible. §2053(a)(2); Reg.	
	§20.2053-3; §20.2053-4(e)(2);	
	Rev. Rul. 79-252.	
Interest on federal	Deductible. §2053(a)(2);	Not deductible.
estate tax, other	Reg. §20.2053-1; §20.2053-3;	§163(h) and (k).
than §6161 or	§20.2053-4(e)(2);	
§6166.	Rev. Rul. 79-252.	
Interest on state	Deductible. §2053(a)(2);	Not deductible.
estate tax	Reg. §20.2053-1; §20.2053-3;	§163(h).
	§20.2053-4(e)(2);	
	Rev. Rul. 79-252.	

Compiled by Philip N. Jones, of Duffy Kekel LLP, Portland, OR. This is a summary only; read the statutes, regulations, and rulings before applying these conclusions to your situation. 5/18/18.

Chapter 7—A Fiduciary Income Tax Primer

Appendix B: Miscellaneous Itemized Deductions of Trusts and Estates

under §67(e), Knight v. Commissioner, and Reg. §1.67-4 (TD 9664; 5/8/14)

	(e), Knight v. Commissioner, and Reg. §1.0	Deductible Subject to 2% Floor
		(and not deductible at all after
Type of Deduction	Fully Deductible	12/31/17)
Trustee Fees and Investment Management Fees	Fees attributable to estate or trust administration, including specialized balancing of trust beneficiary interests, allocation of income and principal among beneficiaries, distribution of assets to beneficiaries, pursuit of unusual fiduciary investment objectives, and specialized fees applicable only to trusts and estates.	Fees attributable to investment management or balancing investments between current beneficiaries and remaindermen. Unitary trustee fees that compensate for both trust administration and investment management must be unbundled or allocated between trust administration and investment management, beginning with tax years starting after 12/31/14.
Attorney Fees	Most attorney fees are fully deductible, because most are not commonly incurred by individuals.	Fees not unique to trusts and estates, such as attorney fees expended in defense of claims.
Will/Trust Contests	All.	None.
Court fees	Most court fees, including most probate court fees and legal publication costs.	Fees incurred defending against claims.
Fiduciary Accountings and Bond Premiums	All, including certified copies of the death certificate.	None.
Appraisal Fees	Fully deductible if obtained to determine estate taxes, GST taxes, gift taxes, or to determine distributions.	Appraisals obtained for insurance purposes, or for purposes of refinancing.
State and Local Taxes (incl. property taxes)	All (not a Miscellaneous Itemized Deduction). §67(b)(2); §164(a)(1). After 2017 and before 2026, deductions for state and local taxes are limited to \$10,000, §164(b)(6), except for business pursuits and for the production of income under §212.	None.
Real Estate Management	None, unless the trust or estate is engaged in real estate business. §62. Business expenses are not itemized deductions. §62(a)(1).	Real estate management fees, insurance, property repairs and maintenance, condo association fees, utilities.

Chapter 7—A Fiduciary Income Tax Primer

Type of Deduction	Fully Deductible	Deductible Subject to 2% Floor (and not deductible at all after 12/31/17)
Estate and GST Tax Return Preparation	All.	None.
Income Tax Return Preparation	Fiduciary income tax returns. Decedent's final income tax return.	All other income tax returns and gift tax returns. Returns for sole proprietorships and retirement plans are deductible. §162.

Review the statutes, court opinion, and regulations for application to particular situations.

Appendix C: Retirement Plan Distributions After Death

Status of Account	Death Before Age 70.5	Death After Age 70.5
Individual Designated Beneficiary named	Beneficiary may withdraw over the beneficiary's single life expectancy table.	Beneficiary may withdraw over the beneficiary's single life expectancy table.
No Designated Beneficiary named	Beneficiary must complete withdrawals within five years (by the end of the year containing the fifth anniversary of the death).	Beneficiary must begin withdrawals by the end of the year following death, and may thereafter follow the decedent's remaining life expectancy.
Surviving Spouse named as beneficiary	Surviving spouse may roll the account over into an IRA in the surviving spouse's name. Spouse may then defer withdrawals until age 70.5, and may then use her own life expectancy table.	Surviving spouse may roll the account over into an IRA in the surviving spouse's name. Spouse may then defer withdrawals until age 70.5, and may then use her own life expectancy table.
Estate is named as beneficiary	Estate cannot qualify as a Designated Beneficiary. See No Designated Beneficiary named, above.	Estate cannot qualify as a Designated Beneficiary. See No Designated Beneficiary named, above.
Trust is named as beneficiary and qualifies as a Designated Beneficiary	Withdrawals may be made over the life expectancy of the oldest beneficiary.	Withdrawals may be made over the life expectancy of the oldest beneficiary.
Marital Trust named as beneficiary, and does not qualify as a Designated Beneficiary	Surviving spouse must complete withdrawals within five years (by the end of the year containing the fifth anniversary of the death).	Surviving spouse must begin withdrawals by the end of the year following death, and may thereafter follow the decedent's remaining life expectancy.
Account (but not withdrawals from the account) is used to fund a pecuniary bequest from an estate or trust	IRS contends that IRD income is realized immediately by the estate or trust under §691(a)(2). See CCA 200644020. This conclusion might be incorrect.	IRS contends that IRD income is realized immediately by the estate or trust under §691(a)(2). See CCA 200644020. This conclusion might be incorrect.
Decedent had not yet taken an RMD for the year of death	Not applicable. No RMDs required.	Beneficiary must timely withdraw the RMD.

Compiled by Philip N. Jones and Peter J. Duffy, of Duffy Kekel LLP. Some exceptions apply. 5/18/18. See also OSB Estate Planning and Administration Section Newsletter, July 2013.

Chapter 7—A Fiduciary Income Tax Primer

Appendix D: Basis Reporting and Consistency

Type of Asset	§6035 Basis Reporting Required	§1014(f) Basis Consistency Required
Asset Does Not Increase Estate Taxes	Yes. §6035(a)(1); Reg. §1.6035-1(a)(1); Reg. §1.6035-1(b).	No. §1014(f)(2); Reg. §1.1014-10(b)(1).
Marital Deduction Assets	Yes. §6035(a)(1); Reg. §1.6035-1(a)(1); Reg. §1.6035-1(b).	No. §1014(f)(2); Reg. §1.1014-10(b)(2).
Charitable Deduction Assets	Yes. §6035(a)(1); Reg. §1.6035-1(a)(1); Reg. §1.6035-1(b).	No. §1014(f)(2); Reg. §1.1014-10(b)(2).
Cash (including coins & bills with no numismatic value)	No. Reg. §1.6035- 1(b)(1)(i).	Not applicable (cash basis equals face value)
Tangible Personal Property - Small Amounts	No. Reg. §1.6035- 1(b)(1)(iii).	No. Reg. §1.1014-1(b)(2).
Estate Tax Returns Filed for Portability Purposes Only	No. Reg. §1.6035-1(a)(2).	No. §1014(f)(2); Reg. §1.1014-10(b)(3).
Estate Tax Returns Filed for GST Allocation Only	No. Reg. §1.6035-1(a)(2).	No. §1014(f)(2); Reg. §1.1014-10(b)(3).
Income in Respect of a Decedent	No. Reg. §1.6035- 1(b)(1)(ii).	No. IRD receives no basis step-up at death.
Assets Sold by the Estate and Gain or Loss is Recognized	No. Reg. §1.6035- 1(b)(1)(iv).	No. Asset not distributed to a beneficiary.
Gross Estate Less Than Filing Threshold	No. Reg. §1.6035-1(a)(2).	No. §1014(f)(2); Reg. §1.1014-10(b)(3).
Other Assets, in General	Yes. §6035(a)(1); Reg. §1.6035-1(a)(1); Reg. §1.6035-1(b).	Yes. §1014(f)(1); Reg. §1.1014-10(b).

Compiled by Philip N. Jones of Duffy Kekel LLP. Based on the temporary and proposed regulations published 3/4/16. FR Doc. 2016-04718 (TD 9757). Some exceptions apply; review the relevant statutes and regulations for applications to particular situations.

Chapter 7—A Fiduciary Income Tax Primer