Income Tax Considerations in Estate Planning and Estate and Trust Administration

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Presents

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By:

Charles A. Redd

CHARLES A. REDD, PARTNER
STINSON LEONARD STREET LLP
7700 FORSYTH BOULEVARD
SUITE 1100
ST. LOUIS, MISSOURI 63105-1821
(314) 259-4534 - TELEPHONE
(314) 259-3952 - FACSIMILE
charles.redd@stinson.com

www.stinson.com

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CHARLES A. REDD

CHARLES A. REDD is a partner in the St. Louis, Missouri, office of the law firm of STINSON LEONARD STREET LLP. Mr. Redd concentrates his practice in estate planning, estate and trust administration and estate and trust-related litigation. Prior to joining Stinson, Mr. Redd was a partner in and Vice Chairman of the Trusts & Estates Practice Group at the law firm of SNR Denton US LLP (now Dentons US LLP). Mr. Redd was also previously a partner in the law firm of Armstrong, Teasdale, Schlafly & Davis (now Armstrong Teasdale LLP) and was Chairman of that firm's Trusts & Estates Department. He was previously employed as a Trust Administrator by First Wisconsin Trust Company (now U.S. Bank, N.A.), Milwaukee, Wisconsin, and as an Assistant Counsel by Centerre Trust Company of St. Louis (now U.S. Trust, Bank of America Private Wealth Management).

Mr. Redd has extensive experience and expertise in: (a) the drafting of wills, trust instruments, durable powers of attorney, marital agreements and other estate planning documents; (b) pre- and post-death tax planning for individuals, trusts and estates; (c) preparation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (d) representation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (e) representation of individual and corporate fiduciaries and (f) litigation in the Probate Division and other equity divisions of the Circuit Court. Mr. Redd has worked on estates and estate planning projects, some involving assets valued at over a billion dollars, and has successfully handled numerous estate tax, gift tax and generation-skipping transfer tax matters, will and trust construction cases, will contests, contests of trust agreements, alleged breach of fiduciary duty cases and other types of cases involving estates and trusts.

Mr. Redd is a member of the State Bar of Wisconsin, The Missouri Bar (Probate and Trust Committee), the Illinois State Bar Association (Section on Trusts and Estates), The Bar Association of Metropolitan St. Louis (Probate and Trust Section, member and past chairman) and the Estate Planning Council of St. Louis.

Mr. Redd was Chairman of the Missouri Bar's Health Care Durable Power of Attorney Subcommittee, and he played a significant role in the drafting and enactment of the Missouri Durable Power of Attorney for Health Care Act. In 1991, Mr. Redd received The Missouri Bar President's Award. Mr. Redd was the principal draftsman of the recently enacted Missouri Family Trust Company Act.

Mr. Redd is an elected member of The American Law Institute and a Fellow of The American College of Trust and Estate Counsel (Past Missouri State Chair; Past Regent; Communications Committee (Past Chair); Estate and Gift Tax Committee; and Fiduciary Litigation Committee). He was an adjunct professor of law (Estate Planning) at Northwestern University School of Law for fifteen years. He serves as Co-Chair of the Editorial Advisory Board of, and writes a regular column in, TRUSTS & ESTATES magazine. Mr. Redd is listed in The Best Lawyers in America and is nationally ranked by Chambers USA in its "Wealth Management" category. He frequently writes and lectures nationally on topics in the trusts and estates field.

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Income Tax Considerations in Estate Planning and Estate and Trust Administration

By: Charles A. Redd
Stinson Leonard Street LLP
St. Louis, Missouri

A. Benefits and Detriments of Grantor Versus Non-Grantor Trusts

1. In General

A "grantor trust" is a trust that's recognized under state law for property disposition purposes but for federal and state income tax purposes[1] is completely invisible. Internal Revenue Code ("IRC") § 671. All items of income, deduction and credit generated by and with respect to assets held in the trust are reportable by person who created and funded the trust (the "grantor"), on his individual income tax returns, as if such person had never created the trust. Treas. Reg. § 1.671-2(e). *See* Rev. Rul. 85-13, 1985-1 C.B. 184. Put another way, the grantor is considered the owner of the trust for income tax purposes.[2]

There are myriad ways to cause an irrevocable trust to be a grantor trust. Treatment of a trust as a "grantor trust" *generally* occurs when the grantor or, in some cases, a nonadverse party, derives benefits from the income,[3] holds the power to revoke the trust or withdraw trust property,[4] holds a power to control beneficial enjoyment,[5] holds a power to exercise certain administrative powers over the trust's operation[6] or retains a reversionary interest in either principal or income.[7] Almost certainly the most widely-used method for generating grantor trust status is to include in the governing instrument a power, exercisable in a nonfiduciary capacity by the grantor or any person without the approval or consent of any person in a fiduciary capacity, to reacquire the trust corpus by substituting property of an equivalent value (a "substitution power"). *See* IRC § 675(4)(C). Using a substitution power to trigger grantor trust treatment has been popular for many years because it's clear that a substitution power yields the desired objective and doesn't result in inclusion of the value of trust property in the powerholder's gross estate. Rev. Rul. 2008-22, 2008-1 C.B. 796, and Rev. Rul. 2011-28, 2011-49 I.R.B. 830. *See*, *also*, Rev. Proc. 2008-45, 2008-30 I.R.B. 224, and Rev. Proc. 2008-46, 2008-30 I.R.B. 238.

Estate planning professionals are familiar with the main estate planning advantages of irrevocable trusts that are structured as "grantor trusts." Any transaction at the trust's creation, *i.e.*, a sale by the grantor to the trust, is ignored for income tax purposes. Any income generated

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[1] But not for Pennsylvania income tax purposes. *See* Nenno, 869 T.M *State Income Taxation of Trusts*, p. A-45.
[2] In some circumstances, however, a person other than the grantor, *e.g.*, a substantial powerholder with respect to the trust, may be treated as such owner. IRC § 678.
[3] IRC § 677.
[4] IRC § 676.
[5] IRC § 674.
[6] IRC § 675.
[7] IRC § 673.

within the trust (interest, dividends, rents, royalties, realized capital gains) is taxable to the grantor (sometimes at rates lower than the rate at which such income would be taxed if the trust were a nongrantor trust),[8] thereby enabling the trust to grow unimpeded, and the grantor's estate to be depleted, by any income tax burden associated with such income. Any transactions during the trust's term, *i.e.*, sales or exchanges between the grantor and the trust, or distributions from the trust, are ignored for income tax purposes.

A client may view his or her ongoing liability for income taxes on grantor trust-generated income as a disadvantage, especially if the grantor has no beneficial interest in the trust. The grantor may believe he or she has "done enough" for the beneficiaries by funding a trust for their benefit and that he or she should not be responsible for income taxes arising from the trust as well. In fact, as happened in *Millstein*, discussed below, the income taxes generated by a grantor trust may become unaffordable for the grantor.

A potential trap may arise with a grantor trust that converts to non-grantor status during the grantor's life. If the trust assets are subject to liabilities that exceed basis, the termination of grantor trust status will cause the grantor to recognize gain equal to the excess of the liabilities over the basis. Treas. Reg. § 1.1001-2(c), Ex. 5; Rev. Rul. 77-402, 1977-2 C.B. 222; *Madorin v. Comm'r*, 84 T.C. 667 (1985).

A non-grantor trust pays its own income taxes and files its own income tax return under a separate tax identification number. The income tax brackets for a non-grantor trust are much more compressed than the income tax brackets for individuals. Under An Act To Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, (December 22, 2017) ("2017 Tax Act"), a trust is taxed at the maximum rate of 37% if the trust has taxable income in excess of $12,500 for the taxable year. In contrast, the highest tax rate for an individual, also 37%, does not apply until taxable income exceeds $500,000 for a single person and does not apply until taxable income exceeds $600,000 for a married couple. A similar disparity exists with the application of the net investment income tax under IRC § 1411 to trusts and individuals. *See generally*, Keebler & Doyle, "Income Taxation of Trusts and Estates," HECKERLING INSTITUTE ON ESTATE PLANNING (2015).

In recent years, non-grantor trusts have regained some popularity because such trusts can sometimes be used to obtain more advantageous income tax consequences than if the trust's income tax liability flowed through to the grantor. For example, incomplete gift, non-grantor trusts ("ING Trusts") can sometimes be used to avoid the state income taxes that otherwise would be incurred by a grantor. In addition, a grantor may wish to utilize a non-grantor trust to increase charitable contribution deductions under IRC § 642(c) that otherwise would not be available under the new restrictions on itemized deductions under the 2017 Tax Act. Similarly, non-grantor trusts may be utilized to avoid other restrictions imposed by the 2017 Tax Act on state and local income tax deductions and to increase the deduction for qualified business income under new IRC § 199A. *See generally*, Shenkman & Blattmachr, "Summary of Selected

[8] *See* Internal Revenue Code Section 1.

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Considerations After the 2017 Tax Act," LISI Estate Planning Newsletter #2628 (February 20, 2018).

2. *Millstein v. Millstein*, 2018 Ohio App. LEXIS 2493 (June 14, 2018)

The grantor created two irrevocable grantor trusts in 1987 and 1988 for the benefit of his children. The grantor wasn't a beneficiary of the trusts. One of the children was the sole trustee of both trusts.

In 2010, the grantor asked the trustee to reimburse him from the trusts for "substantial income taxes" owed by him on the taxable income generated by the trusts. The trustee declined but reached an agreement whereby the assets of a third, unrelated trust would be used to defray the grantor's tax liabilities. In 2013, the trustee informed the grantor that the third trust no longer had liquid assets with which to pay the grantor's income tax liabilities. The trustee arranged for the grantor no longer to be taxed on the income of one of the trusts beginning in 2014.

In a petition filed by the grantor, he alleged he paid $5,225,837 in federal and state income taxes in 2013 with respect to taxable income generated by one of the trusts and $1,261,068 in respect of his tax liability for the tax years 2013, 2014 and 2015 caused by the other trust. The grantor asked the court to enter an order for "equitable reimbursement of income taxes" from the trusts. The trustee and the trust beneficiaries moved to dismiss the petition, arguing that the grantor lacked standing, that there was no cognizable claim under applicable state law (the law of Ohio) for equitable reimbursement in the circumstances of this case and that the grantor's claim was inequitable. The court granted the motions to dismiss.

On appeal, the Court of Appeals ruled the trial court correctly dismissed the grantor's petition for failure to state a claim upon which relief could be granted. The Court of Appeals reasoned that the relief the grantor sought was specifically addressed in the Ohio Trust Code – specifically, in R.C. 5804.16, entitled "Modification to achieve settlor's tax objectives" – and that, under R.C. 5804.10, only a trustee or beneficiary, not a settlor, could commence a proceeding to approve or disapprove a modification under R.C. 5804.16. The Court of Appeals noted the grantor didn't file his petition under the Ohio Trust Code and, as grantor, was precluded from unilaterally seeking modification to achieve his tax objectives. The Court of Appeals further observed that "[n]o court may employ equitable principles to circumvent valid legislative enactments" and that the situation in which the grantor found himself was of his own making.

Millstein shows quite starkly how grantor trust status, which may have seemed like a great idea when an irrevocable trust was conceived and established, can blow up in the grantor's face if the trust's investment performance is *too successful*. To mitigate the likelihood of a result like that in *Millstein*, the governing instrument of an irrevocable grantor trust should contain explicit provisions allowing grantor trust status to be discontinued and granting the trustee

unfettered discretion to reimburse the grantor for income taxes for which he's legally liable because of taxable income generated by the trust.[9]

B. Some Techniques to Achieve Basis Step-Up

1. Basis Step-Up in General

Today, with portability and a historically high applicable exclusion amount, inclusion of the value of trust assets in a beneficiary's gross estate to obtain a step-up in basis will often be desirable. For low-basis, highly appreciated assets, a step-up in basis will minimize what would have been a sizable gain realized by the beneficiary upon the sale or exchange of such assets.[10] At the same time, so long as the value of the beneficiary's gross estate is equal to or less than his or her unused applicable exclusion amount, no federal estate tax will result.

2. Formula General Powers of Appointment

Post-2017 Tax Act, not only do many clients anticipate having no estate tax issues, they reasonably believe their children and grandchildren will also have no such issues. Nevertheless, trusts for clients' children and more remote descendants (at least until they reach designated ages) remain as viable and important as ever.

It is possible to design trusts for clients' descendants in a manner that will cause the value of the assets in such trusts to be included in their respective gross estates just up to the point beyond which estate tax would be incurred.

IRC § 2041(b)(1) defines a general power of appointment as a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. IRC § 2041(a)(2) provides that "the power of appointment shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised."

Whether the holder of a testamentary power of appointment chooses to exercise it, the property that was subject to the power will be deemed to have been acquired from the deceased testator and will, therefore, qualify for the step-up in basis. *See* Treas. Reg. §§ 1.1014-2(a)(4), (b)(2). Thus, it is important to consider under what circumstances and to what extent it is wise to

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[9] It should be noted that provisions of these types might not have prevented the result in *Millstein*. Also, the trusts in *Millstein* were created long before the issuance of Rev. Rul. 2004-64, 2004-2 C.B. 7, which was the first clear indication that a grantor's reserving the potential of receiving reimbursement for income taxes doesn't alone cause inclusion of the value of trust property in the grantor's gross estate under Internal Revenue Code Sections 2036 and 2038.

[10] In this connection, *see* IRC § 1014(f), which requires, among other things, that the basis of property acquired from a decedent cannot exceed the value of such property as finally determined for estate tax purposes if inclusion of such property in the decedent's estate increased estate tax liability.

confer a general power of appointment with respect to property held in trust to generate basis step-up and income tax savings.

A testamentary general power of appointment can be conferred by means of a formula in such a way that the power would be exercisable only to the extent holding such power would not, by itself, cause imposition of any estate tax. Such a formula could effectively be further refined in such a way so as to have effect only with respect to certain assets in a trust, or to subject to such power, first, those trust assets having the lowest basis and then cascading to each next lowest basis asset until holding the power would no longer not cause any imposition of estate tax.

A trust instrument could also be drafted in such a way that an independent trustee or a trust protector may grant a general power of appointment (perhaps, a formula general power of appointment, as described above) to a beneficiary after having examined the income and transfer tax consequences of so doing. Conditioning the grant of a general power of appointment to the determination of an independent trustee or a trust protector may provide more flexibility than having the trust instrument itself confer the general power of appointment. Consider, however, whether a given independent trustee will have the willingness and sophistication to grant a general power of appointment to a beneficiary and whether such independent trustee will even be available when needed for such purpose.

3. Use Elderly Parents

Wealthy clients with elderly less wealthy parents (even incapacitated less wealthy parents) could consider giving low-basis property to an irrevocable trust for the lifetime benefit of a parent, or selling such property to an irrevocable grantor trust for the lifetime benefit of a parent, in either case naming the client or the client's descendants as remainder beneficiaries and conferring on such parent a narrowly circumscribed formula general power of appointment of the type described above. A client considering this strategy would need to have substantial confidence that the parent would not attempt to divert the property away from the client at the parent's death and that there would be no undue risk under applicable state law that the parent's creditors could gain access to the trust property. In fact, given that an individual is deemed to possess a general power of appointment conferred on him or her even if he or she is unaware of it, an adventurous client without less wealthy parents could use a variation of this strategy with an elderly person who is a perfect stranger as the lifetime beneficiary of such a trust!

4. Avoiding IRC Section 1014(e)

IRC § 1014(e) sets out an exception to the general rule of IRC § 1014(a) with respect to transfers of appreciated property acquired by the decedent within one year of his or her death. IRC § 1014(e)(1) states that, if appreciated property was acquired by the decedent by gift during the one-year period ending on the date of the decedent's death and such property is acquired from the decedent by (or passes from a 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. A close reading of this statutory language suggests that the provisions of IRC § 1014(e) could be avoided in cases of certain transfers of assets involving spouses and trusts created by them that take place within one year of death of either spouse.

Assume that a soon-to-be surviving spouse transferred her assets to the soon-to-be-deceased spouse and it is inevitable that the predeceasing spouse will die within one year of such transfer. If, instead of directing a transfer of all of the predeceased spouse's assets to the surviving spouse outright upon predeceased spouse's death, the predeceasing spouse creates a trust in his estate plan providing that his surviving spouse and descendants living from time to time may receive discretionary distributions of income and directs that all assets passing by reason of the predeceasing spouse's death be transferred to the discretionary trust, all assets in the discretionary trust should be eligible to receive a step-up in basis pursuant to IRC § 1014(a). In this scenario, the surviving spouse (the donor) does not acquire the transferred assets back from the predeceased spouse. The assets are acquired by the discretionary trust. Thus, IRC § 1014(e) cannot apply.

5. Designing Spousal Asset Ownership Structure to Ensure Some Basis Step-Up at Death of First Spouse to Die

Portability notwithstanding, where spouses have unequal net worth, they may benefit from dividing their estates and allocating their wealth more evenly between them. Unequal allocation of wealth between spouses can result in forfeiture of valuable basis step-up and payment of unnecessary capital gains taxes.

Assume one spouse owns substantially all the couple's assets (the "wealthy spouse") and that the aggregate value of such assets exceeds one applicable exclusion amount. Such assets are highly appreciated. The other spouse (the "poor spouse") is the first to die. If assets had been transferred to the poor spouse and the couple avoids the application of IRC § 1014(e), discussed above, such assets would have been included in the poor spouse's gross estate, would have received a full step-up in basis to fair market value as of the poor spouse's date of death and could have passed to the wealthy spouse free of estate tax. While it is true that the executor of the poor spouse could elect portability and transmit the DSUEA to the wealthy spouse, note that in this scenario the wealthy spouse will not own any assets during his or her remaining life that have a stepped-up basis. Accordingly, if any of the couple's assets need to be sold during the surviving spouse's remaining life to generate cash to pay for the surviving spouse's health, maintenance, support, care, comfort, etc., all that is available to be sold are highly appreciated, low basis assets. Had the spouses reallocated their assets between them while both were alive, then, at the death of the first spouse to die, there would have been a meaningful amount of assets with a stepped-up basis that could have been sold at minimum capital gains tax cost to generate cash to pay for the surviving spouse's health, maintenance, support, care, comfort, etc.

C. Minimizing Trust-Level Income Taxes

1. Distributions of Ordinary Income

Given the current framework of income taxation of individuals and trusts, if given the discretion and authority to do so, a Trustee may desire to make discretionary distributions so as to carry out as much of the trust's taxable income to trust beneficiaries as possible. IRC § 661. Since the applicable threshold amount for the top income tax rate of 37% is much higher and, therefore, more favorable, for individuals than for non-grantor trusts as outlined above, distributions to trust beneficiaries in lower tax brackets can offer substantial savings. The differential can be even greater when also considering state income tax.

Trustees should not, however, overlook the potential impact of the "kiddie tax," which, after the 2017 Tax Act, imposes a trust's income tax rate on certain unearned income shifted from a trust to the child. IRC § 1(j)(4). The kiddie tax generally applies to children under age 18 at the close of the taxable year but may extend to a child who has not attained the age of 24 at the close of the taxable year if the child is a student. *See* IRC §§ 1(g)(2)(A), 152(c)(3). The changes made by the 2017 Tax Act to the kiddie tax expire on January 1, 2026.

2. Distributions of Capital Gain

a. <u>Methods of Including in DNI</u>. As a general rule, capital gains are not included in distributable net income ("DNI"), except in the year the trust terminates. IRC § 643(a)(3). Capital gains and losses generally are allocated to principal and benefit (or disadvantage) the remainder beneficiaries of a trust or the residuary beneficiaries of an estate.

There are exceptions to the general rule which provide that capital gains will be included in DNI if they are: (1) allocated to fiduciary accounting income; (2) allocated to principal and "paid, credited, or required to be distributed to any beneficiary during the year" or (3) allocated to principal and "paid, permanently set aside, or to be used for [charitable] purposes specified in § 642(c)." IRC § 643.

With respect to charitable distributions, IRC § 643 provides that capital gains distributable for charitable purposes are included in DNI and may be offset by the corresponding charitable contribution deduction. Thus, DNI reflects the net taxable and nontaxable income available for distribution, after considering the items of gross income paid, permanently set aside or used for charitable purposes under IRC § 642(c).

With respect to items (1) and (2) above, Treas. Reg. § 1.643(a)-3(a) provides that "except as provided in 1.643(a)-6 [dealing with foreign trusts] and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary." Treas. Reg. § 1.643(a)-3(b) provides that capital gains will be included in DNI to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or

pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law):

(1) Allocated to income (but, if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph Treas. Reg. §1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

b. Capital Gains Allocated to Income. If capital gains are appropriately allocated to income, then such gains will be included in DNI. Treas. Reg. § 1.643(a)-3(b)(1). This occurs most frequently when a Trustee sells unproductive or underproductive property and the applicable principal and income act requires that a portion of the net sale proceeds be allocated to income to compensate for the lack of productivity while the property was held. In some cases, the governing instrument or applicable law authorizes the Trustee to allocate gains between income and principal as the Trustee considers best. While such provision offers some flexibility to the Trustee, allocations pursuant to this provision cannot fundamentally depart from the traditional principles of income and principal in order to be recognized for federal income tax purposes. *See* Treas. Reg. § 1.643(a)-3(b)(1), Acker, 852-4th T.M., *Income Taxation of Trusts and Estates.* Absent unique circumstances, the allocation of capital gains to income in accordance with the exercise of discretion granted by the governing instrument or applicable law will not be considered to depart fundamentally from the traditional principles of income and principal.

c. Capital Gains Treated Consistently As Part of a Distribution. Capital gains will be a part of DNI notwithstanding that they are allocated to principal if the Trustee treats such gains consistently on the trust's books, records and tax returns as part of a distribution to a beneficiary. Treas. Reg. § 1.643(a)-3(b)(2). This consistent treatment may be declared by the Trustee or evidenced by the Trustee's actions even in the first taxable year or the first time such situation arises. *See* Treas. Reg. § 1.643(a)-3(b)(2) Ex. (2). Once declared, the examples in the Treasury Regulations require the Trustee to treat all discretionary distributions in future years as being made first from any realized capital gains.

d. Gains Actually Distributed to Beneficiary. Capital gains appropriately allocated to principal but actually distributed to a beneficiary will be included in DNI. Treas. Reg. § 1.643(a)-3(b)(3).

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The preamble to the Treasury Regulations provides that capital gains allocated to principal will be treated as part of a distribution to a beneficiary if the Trustee allocates capital gains to the distribution (pursuant to a discretionary power under local law or under the governing instrument if not inconsistent with local law) and the allocation is exercised in a reasonable and consistent manner and evidenced on the trust's books, records and tax returns. *See* T.D. 9102, 69 Fed. Reg. 12 (2004); Acker, *supra*.

This rule is implemented as follows: A trust provides that all income is to be distributed currently to A, and that one-half of the principal is to be distributed when A reaches age 35 and the balance of the principal at age 45. When A reaches age 35, the Trustee sells one-half of the principal held in trust and distributes the net proceeds to him. All of the gains from such sale are included in DNI. If the Trustee sold all of the trust assets when A reached age 35, but only distributed one-half of the proceeds to A, then only one-half of the capital gains from such sales would be included in DNI. *See* Treas. Reg. § 1.643(a)-(3)(e), examples 9 & 10.

e. Capital Gains Used to Determine Amount of Distribution. Treas. Reg. § 1.643(a)-3(b)(3) also provides that capital gains that are allocated to corpus, but utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary, will be included in DNI. This exception is closely related to the exception where a Trustee treats capital gains consistently on its books, records and tax returns, as part of a distribution to a beneficiary. However, under this exception, a Trustee uses the capital gains to determine the amount to be distributed, while under the other exception a Trustee treats capital gains as always a part of DNI to the extent distributed and, thus, always a part of the distribution to the beneficiary. Acker, *supra*.

The examples in the Treasury Regulations demonstrate this rule as follows: A Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During the trust's first taxable year, the trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. ". . . Trustee decides that discretionary distributions will be made only to the extent the trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000 . . . Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year." *See* Treas. Reg. 1.643(a)-(3)(e), example 5.

f. General Requirements. In each of these four instances discussed above, the allocation of capital gains to income must be made: (1) pursuant to the terms of the governing instrument and applicable local law; or (2) pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by local law). *See* Treas. Reg. § 1.643(a)-3(b). A Trustee must meet one of these two requirements at all times.

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g. <u>Capital Gains From a Partnership</u>. In the absence of clear guidance under local laws or in the governing instrument, a Trustee could consider forming a partnership. Capital gains earned through a partnership will typically constitute trust accounting income. *See* Gorin, *Primer on Carrying Out Capital Gain*, AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, Fiduciary Income Tax Committee Meeting (Fall 2013). In *Crisp v. United States*, 34 Fed. Cl. 112 (1995), the Court of Claims held that capital gain distributed in the ordinary course of a partnership's operations is includible in DNI. Additionally, the Uniform Principal and Income Act provides helpful guidance indicating that cash distributions from an entity (including a partnership) would constitute fiduciary accounting income. *See* Gorin, *supra.*

D. Miscellaneous Itemized Deductions for Estates and Trusts

1. In General

IRC § 67(a) provides that, for an individual taxpayer, miscellaneous itemized deductions are allowed only to the extent that the aggregate of those deductions exceeds two-percent of adjusted gross income. IRC § 67(b) excludes certain itemized deductions from the definition of "miscellaneous itemized deductions." IRC § 67(e) provides that, for purposes of IRC § 67, miscellaneous itemized deductions for an estate or trust shall be computed in the same manner as in the case of an individual. However, IRC § 67(e)(1) provides that the deductions for costs paid or incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in such estate or trust shall be treated as allowable in arriving at adjusted gross income. Therefore, deductions described in IRC § 67(e)(1) are not subject to the two-percent floor for miscellaneous itemized deductions under IRC § 67(a).

2. Final Regulations

On May 9, 2014, the IRS released final regulations that provide guidance on which costs incurred by estates or non-grantor trusts are subject to the two-percent floor for miscellaneous itemized deductions. T.D. 9664 (May 9, 2014). Treas. Reg. § 1.67-4(a) provides that, for purposes of IRC § 67(e), a cost is subject to the two-percent floor "to the extent that it is included in the definition of miscellaneous itemized deductions under section 67(b), is incurred by an estate or non-grantor trust, and commonly or customarily would be incurred by a hypothetical individual holding the same property."

Treas. Reg. § 1.67-4(b)(1) provides that whether a cost is "commonly or customarily" incurred in this circumstance depends on the type of product or service rendered to the estate or non-grantor trust in exchange for the cost rather than the description of the cost of the product or service. These costs include expenses such as costs incurred in defense of a claim against the estate, the decedent or the non-grantor trust that are unrelated to the "existence, validity, or administration of the estate or trust."

Treas. Reg. § 1.67-4(b)(2)-(3) discusses specific costs incurred by an estate or non-grantor trust that may be considered "commonly or customarily" incurred and therefore subject to the two-percent floor. Treas. Reg. § 1.67-4(b)(2) provides that "ownership costs" are subject

to the two-percent floor. Ownership costs are costs that are "chargeable to or incurred by an owner of property simply by reason of being the owner of the property," and include condominium fees, insurance premiums, maintenance and lawn services and automobile registration and insurance costs. If such costs are incurred in connection with a trade or business or for the production of rents or royalties, they are not miscellaneous deductions and therefore are not subject to the two-percent floor. Instead, such costs are fully deductible under IRC § 162 or IRC § 62(a)(4). Similarly, partnership costs reported by a partner are not subject to the two-percent floor if they are fully deductible.

Treas. Reg. § 1.67-4(b)(3) provides that the cost of preparing estate and generation-skipping transfer tax returns, fiduciary income tax returns and a decedent's final individual income tax returns are not subject to the two-percent floor but that the cost of preparing all other tax returns, including gift tax returns, are subject to the two-percent floor.

Treas. Reg. § 1.67-4(b)(5) provides that certain appraisal fees incurred by an estate or non-grantor trust are not subject to the two-percent floor. Those appraisal fees are for appraisals needed to determine value as of the decedent's date of death (or the alternate valuation date), to determine value for purposes of making distributions or as otherwise required to properly prepare the estate's or trust's tax returns.

Treas. Reg. § 1.67-4(b)(6) provides the following nonexclusive list of fiduciary expenses that are not subject to the two-percent floor: probate court fees and costs; fiduciary bond premiums; legal publication costs of notices to creditors or heirs; the cost of certified copies of the decedent's death certificate; and costs related to fiduciary accounts.

a. Investment Advisory Fees. In the final regulations the IRS applied IRC § 67(e) to investment advisory fees as interpreted by the Supreme Court in *Knight v. Comm'r*, 552 U.S. 181 (2008). Treas. Reg. § 1.67-4(b)(4) provides that investment advisory fees are subject to the two-percent floor. However, "certain incremental costs of investment advice beyond the amount that normally would be charged to an individual investor, added solely because the investment advice is rendered to a trust or estate instead of to an individual, are not subject to the 2% floor." Such incremental costs may be attributable to an unusual investment objective or the need for a specialized balancing of the interests of the parties (beyond the usual balancing of the varying interests of current beneficiaries and remainder persons).

The IRS explained that "where the costs charged to the trust do not exceed the costs charged to an individual investor, the cost attributable to taking into account the varying interests of current and remainder beneficiaries is included in the usual investment advisory fees and is not the type of cost that is excluded from the 2-percent floor under this narrow exception."

b. Bundled Fees. Regarding bundled fees (*i.e.*, a fee for both costs that are subject to the two-percent floor and costs that are not), in accordance with the *Knight* decision, Treas. Reg. § 1.67-4(c) generally requires such fees to be "unbundled" and allocated between costs subject to the two-percent floor and costs that are not.

This regulation provides that the portion of such fee attributable to investment advice (including any related services that would be provided to any individual investor as part of the investment advisory fee) and which is not computed on an hourly basis will be subject to the two-percent floor. The remaining portion of such fee is not subject to the two-percent floor.

In addition, except for the portion so allocated to investment advice, a fiduciary fee is fully deductible except for: (1) payments made to third parties out of the bundled fee that would have been subject to the two-percent floor if they had been paid directly by the estate or non-grantor trust; and (2) any payments for expenses separately assessed (in addition to the usual or basic bundled fee) by the fiduciary or other service provider that are commonly or customarily incurred by an individual.

The final regulations allow the fiduciary and/or return preparer to use any reasonable method to make these allocations. However, the amount of any payment out of the fiduciary's fee or commission to a third party for expenses subject to the two-percent floor, and of each separately assessed expense that is commonly or customarily incurred by an individual owner of such property, are readily identifiable without any discretion on the part of the fiduciary. Therefore, the reasonable method standard does not apply to these amounts. Treas. Reg. § 1.67-4(c)(3).

The final regulations provide a nonexclusive list of facts to consider in determining a reasonable allocation method: the percentage of the value of the principal subject to investment advice, whether a third party advisor would have charged a comparable fee for similar advisory services and the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries, distribution decisions and other fiduciary functions.

The final regulations state that the IRS may provide safe harbors regarding bundled fees in future published guidance.

3. 2017 Tax Act

Miscellaneous itemized deductions subject to the 2% floor under IRC § 67(a)-(b) are suspended through December 31, 2025. IRC § 67(g).

Note that this suspension does not include expenses of an estate or trust not subject to the 2% floor under IRC § 67(e). Expenses of an estate or trust are not subject to the 2% floor if such expenses would not have been incurred if the property were not held in a trust or estate. Thus, executor and trustee fees and attorney's fees related to trust and estate administration should continue to be deductible. The IRS plans to issue regulations to this effect. Notice 2018-61, 2018-31 I.R.B. 278 (July 13, 2018).

IRC § 642(h)(2) states that on termination of an estate or trust any deductions (other than the estate or trust exemption and other than the charitable deduction) for the estate or trust in excess of gross income are allowable as deductions to the beneficiaries. This deduction is

eliminated due the suspension of miscellaneous itemized deductions for individuals under IRC § 67(g). However, the IRS has announced that it is considering whether this deduction should continue to be a miscellaneous itemized deduction. Notice 2018-61, 2018-31 I.R.B. 278 (July 13, 2018). Beneficiaries may still claim a trust or estate's net operating losses or capital loss carryovers upon trust or estate termination under IRC § 642(h)(1).

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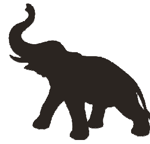

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Income Tax Considerations in Estate Planning and Estate and Trust Administration

October 23, 2018

Laurie Frye
Professional Education Coordinator

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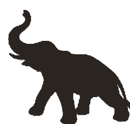

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