

**WHEN WORLDS COLLIDE**  
**HOLDING PASSTHROUGH ENTITIES IN TRUST**

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## I. Ability of Trust to Hold Pass-through Entities

### A. Business Interests – Generally

1. For a summary of the issues facing a fiduciary holding a business interest and some practical solutions, see Bekerman and Kirkpatrick, *Administration of a Business Interest Held by an Estate or Trust*, Estate Planning Journal, November 2001.
2. Traditionally, unless authorized by the trust instrument or statute, the trustee has no authority to continue the business or partnership interest of the Settlor. The same has been held with respect to the Settlor's interest in closely held stock. *See generally*, Bogert, *The Law of Trusts and Trustees*, § 679 (Rev. 2d. Ed. 1982).
3. Nevertheless in most states it appears that a trustee may retain a partnership or closely held corporation if:
  - a. It is not prohibited by statute or the governing instrument
  - b. Either the instrument grants broad investment powers or the Uniform Prudent Investor Act (has been enacted by the state of situs and) applies
  - c. The investment in the asset is determined on the same standard of care applicable to other assets

*Id.* § 679 (2003 Supplement)

4. The Uniform Prudent Investor Act (“UPIA”)<sup>1</sup>
  - a. States that have adopted some form – Appendix A
  - b. Standard for Investing
    - i. Section 2 of the UPIA is “the heart of the Act” UPIA Comment to Section 2

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<sup>1</sup> For purposes of this outline, unless otherwise noted, all references are to the 1994 Uniform Prudent Investor Act. Note that many states adopt uniform acts with local variations. Accordingly, the Prudent Investor Act in a particular jurisdiction may vary from the UPIA. Further, due to the possible differences between state laws, the UPIA is referenced throughout this outline.

- ii. Section 2 of the UPIA provides the standards with respect to Trustees' investments.
- iii. "A trustee shall invest and manage trust assets as a prudent investor would by considering the purposes, terms, distribution requirement, and other circumstances of the trust. In satisfying this standard, the Trustee shall exercise reasonable care, skill, and caution." UPIA § 2(a)
- iv. "A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy having risk and return objectives reasonably suited to the trust." UPIA § 2(b)
- v. UPIA § 2(c) provides: "Among the circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:
  - (1) General economic conditions
  - (2) The possible effect of inflation or deflation
  - (3) The expected tax consequences of investment decisions or strategies
  - (4) The role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property
  - (5) The expected total return from income and the appreciation of capital
  - (6) Other resources of the beneficiaries
  - (7) Needs for liquidity, regularity of income, and preservation of capital
  - (8) An asset's special relationship or value, if any, to the purposes of the trust or to one or more of the beneficiaries"

vi. “A trustee may invest in any kind of property or type of investment consistent with the standards of [the UPIA].” UPIA § 2(e)

vii. “A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee’s representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.” UPIA § 2(f)

(1) The Comment to Section 2(f) provides: “Because the standard of prudence is rational, it follows that the standard for professional trustees is the standard for prudent professionals; for amateurs, it is the standard of prudent amateurs.”

(2) “Case law strongly supports the concept of a higher standard of care for the trustee representing itself to be expert or professional.” *Id.*, citing, Annot., Standard of Care Required of Trustee Representing Itself to Have Expert Knowledge or Skill, 91 A.L.R. 3d (1979), 1992 Supp. at 48-49.

c. “The trustee shall diversify the investments of the trust unless the trustee reasonably determines that because of special circumstances, the purposes of the trust are better served without diversifying. UPIA § 3

i. One commentator states: “An exculpatory clause or provision in the trust instrument absolving a trustee from liability for its actions, absent willful misconduct or gross negligence, does not relieve a trustee from its duties under the Prudent Investor Rule.” Zaluda, *Tax Management Memorandum*, Vol. 44, No. 9, May 2003.

d. UPIA § 6 imposes its own duty of impartiality:

“If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.”

i. The Comment to section 6 provides in part: “Prudence in investing and administration requires the trustee to take account of the interests of all the beneficiaries for whom the trustee is acting, especially the conflicts between the interests

of the beneficiaries interested in income and those interested in principal.”

- ii. “The trustee’s duty of impartiality commonly affects the conduct of investment and management functions in the sphere of principal and income allocations.”
  - iii. Not only investments must be allocated to produce a fair result for both income beneficiaries but tax allocations must also treat income and remaindermen fairly. *See, e.g., In re Davies*, 559 N.Y.S.2d 933 (N.Y. Sur. 1990).
- e. “In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust and the skills of the trustee.” UPIA § 7
- f. Section 9 of the UPIA allows a trustee to “delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances”. Reasonable care skill and caution must be used in:
- i. Selecting an agent
  - ii. Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust
  - iii. Periodically reviewing the agent’s actions in order to monitor the agent’s performance and compliance with the delegation of authority

## 5. Uniform Trust Code (“UTC”)<sup>2</sup>

- a. The UTC provides a default rule and may be modified by the terms of the trust. UTC § 105
- b. The UTC also imposes upon a trustee duties of loyalty (UTC § 802) and impartiality among beneficiaries (UTC § 803)
  - i. The comment to UTC § 803 indicates that the duty of impartiality is identical to that found in Section 6 of the UPIA.

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<sup>2</sup> For purposes of this outline, unless otherwise noted, all references are to the 2000 Uniform Trust Code as Last Amended or Revised in 2003. Note that many states adopt uniform acts with local variations. Accordingly, the Uniform Trust Code in a particular jurisdiction may vary from the UTC. Further, due to the possible differences between state laws, the UTC is referenced throughout this outline.

- ii. UTC § 802(g) provides: “In voting shares of stock or in exercising powers of control over similar interests in other forms of enterprise, the trustee shall act in the best interests of the beneficiaries. If the trust is the sole owner of a corporation or other form of enterprise, the trustee shall elect or appoint directors or other managers who will manage the corporation or enterprise in the best interests of the beneficiaries.”
- iii. The Comment to UTC § 802(g) illustrates the duty of the trustee holding business interests:
  - (1) The trustee’s duty is to vote the shares and to use proper care to promote the interests of the beneficiary.
  - (2) If the trust holds all of the shares, “the corporation’s assets are in effect trust assets that the trustee determines to hold in corporate form”.
  - (3) The trustee cannot escape fiduciary duty to the beneficiaries by hiding behind corporate law. As the Comment to UTC § 802 states: “A trustee whose duty of impartiality would require the trustee to make current distributions for the support of current beneficiaries may not evade that duty by holding assets in corporate form and pleading the discretion of the corporate directors to determine dividend policy. Rather, the trustee must vote for corporate directors who will follow a dividend policy consistent with the trustee’s trust-law duty of impartiality”
- c. “A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee’s representation that the trustee has special skills or expertise, shall use those special skills or expertise.” UTC § 806
- d. UTC § 816 contemplates that a trustee may hold business interests and grants the trustee appropriate powers.

[A] trustee may:

- i. “[W]ith respect to an interest in a proprietorship, partnership, limited liability company, business trust, corporation, or other form of business enterprise, continue the business or other enterprise and take any action that may be taken by shareholders, members, or property owners, including merging,

dissolving, or otherwise changing the form of business organization or contributing to capital. UTC § 816(6)

ii. “[W]ith respect to stocks or other securities, exercise the rights of an absolute owner, including: vote, give proxies, hold the stock in nominee form, pay calls and assessments and any other charges against the security, and exercise subscription or conversion rights.” UTC § 816(7)

iii. Grant options regarding the sale or other disposition of the property. UTC § 817(10)

e. Note that the Comment to § 816(6) indicates that the power to continue a business must be exercised in accordance with the UPIA.

#### B. Partnership Interests – In Particular

1. Under the common law, absent clear authority in the trust instrument, a trustee could not invest in a partnership interest.

2. Under the prudent person standard, a trust could invest in a partnership interest if the liability of the trust and trustee are limited and the investment otherwise met the standard. *But see* OCC rules for National Banks.

3. Limited Partnership Interests:

a. Could be construed as an improper delegation of the trustees’ investment authority as the trustee cannot control the actions of the partnership.

b. Some states have statutes that expressly state that such an investment is not an improper delegation. *E.g.*, N.Y. Estates Powers & Trusts L. § 11-2.2(a)

4. National Banks acting as trustee may have difficulty holding partnership interests

a. National Banks are regulated by the Office of the Comptroller of the Currency (“OCC”)

b. The 1998 Comptroller’s Handbook for Fiduciary Activities provides:

“As a general partner, the bank’s liability is not limited to the principal of the particular account. However, the OCC would object to a bank investing in general partnerships, unless local law limits its liability. In the capacity of limited partner, the bank usually would have no say

in the management of the assets. In the case of investment in limited partnerships, the OCC would object if such investment is authorized by the governing instrument, local law or by written consent of account beneficiaries. Of course, the limited partnership also must be a prudent investment and meet the investment objectives of the account.”

### C. S Corporations – In Particular

1. See general rules regarding the ability of the trustee to hold an interest in a business, above.
2. Internal Revenue Code and Treasury Regulation Requirements for a Trust to hold Subchapter S Stock
  - a. Qualified Subpart E Trust – Treas. Reg. § 1.1361-1(h)(1)(i) – A trust all of which is treated as owned by an individual (whether or not the grantor) who is a citizen or resident of the United States. This requirement only applies during the period that the Trust holds S corporation stock.
  - b. Electing Qualified Subchapter S Trust (“QSST”) – Treas. Reg. §§ 1.1361-1(h)(1)(iii); (j) –
    - i. “All of the income (within the meaning of §1.643(b)-1) of the trust is distributed (or is required to be distributed) currently to one individual who is a citizen or resident of the United States. For purposes of the preceding sentence, unless otherwise provided under local law (including pertinent provisions of the governing instrument that are effective under local law), income of the trust includes distributions to the trust from the S corporation for the taxable year in question, but does not include the trust's pro rata share of the S corporation's items of income, loss, deduction, or credit determined under section 1366.” Treas. Reg. § 1.1361-1(j)(1)(i)
    - ii. Terms of the trust must require:
      - (1) During the lifetime of the current income beneficiary, there will be only one income beneficiary of the Trust.
      - (2) Any corpus distributed during the life of the current income beneficiary may be distributed only to that income beneficiary

- (3) The current income beneficiary's income interest in the trust will terminate on the earlier of that income beneficiary's death or the termination of the trust
- (4) Upon termination of the trust during the life of the current income beneficiary, the trust will distribute all of its assets to that income beneficiary.

iii. Other drafting issues:

- (1) The terms of the trust must satisfy the requirements outlined above from the earlier of the date the QSST Election is made or becomes effective through the period that the current income beneficiary and any successor income beneficiary is the income beneficiary of the trust. Treas. Reg. § 1.1361-1(j)(1)(iii); See Rev. Rul. 89-55, 1989-1 C.B. 268
- (2) If under local law a distribution to the income beneficiary is in satisfaction of the grantor's legal obligation to support the beneficiary the trust will not be a QSST as of the date of distribution. Treas. Reg. § 1.1361-1(j)(2)(ii)(B)
- (3) If under the terms of the trust a person (including the income beneficiary) has a special power to appoint, during the life of the income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust will not qualify as a QSST (unless the trust is a qualified subpart E trust) Treas. Reg. § 1.1361-1(j)(2)(iii)

iv. A substantially independent share of a trust within the meaning of Internal Revenue Code Section 663(c) and its regulations is treated as a separate trust and will qualify as a QSST if the general requirements are met.

- (1) QSST savings language – allows the trustees to create a separate trust with terms that allow the portion of the trust that holds S stock to qualify as a QSST

- (2) See Form

v. Elections to be treated as a QSST must be filed with Internal Revenue Service. Rev. Proc. 2003-43, I.R.B. 2003-23 provides

a simplified method for taxpayers to request relief for late filing of QSST (and other subchapter S) elections.

c. Electing Small Business Trust (“ESBT”) – Treas. Reg. § 1.1361-1(m)

i. Any trust if it meets the following requirements:

(1) The trust does not have as a beneficiary any person other than an individual, an estate, an organization described in section 170(c)(2) through (5) of the IRC, or an organization described in section 170(c)(1) of the IRC that holds a contingent interest in such trust and is not a potential income beneficiary

(2) No interest in the trust has been acquired by purchase

(3) And the trustee of the trust makes a timely ESBT election for the trust

ii. A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. If any portion of the basis in the acquired interest in the trust is determined under IRC § 1012, such interest has been acquired by purchase. This includes a “net gift” where the beneficiary pays the gift tax. The trust itself may acquire the S stock by purchase. Treas. Reg. § 1.1361-1(m)(1)(iii)

iii. Ineligible Trusts – Treas. Reg. § 1.1361-1(m)(1)(iv)

(1) A QSST

(2) Any trust exempt from tax under subtitle A

(3) A charitable remainder trust

iv. Calculation of Number of Shareholders

(1) An S corporation may have no more than 75 shareholders. IRC § 1361(b)(1)(A)

(2) Each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. A potential current beneficiary is a person who is entitled to or in the discretion of any person may receive a distribution from the income or principal of

the trust. Persons holding future interests are not current beneficiaries. Treas. Reg. § 1.1361-1(m)(4)(i)

(3) *Caution:* for presently exercisable powers of appointment: A person to whom a distribution is or may be made pursuant to a power of appointment is a current beneficiary. The ability to currently exercise a power of appointment in favor of more than 75 shareholders or an ineligible shareholder will terminate the corporation's S election. Treas. Reg. § 1.1361-1(m)(4)(vi)(A)

(4) A wholly owned grantor trust may make an ESBT election. Treas. Reg. § 1361-1(m)(2)(v). The owner of the trust under subpart E of the Internal Revenue Code will also be considered a shareholder. Treas. Reg. § 1.1361-1(m)(4)(ii)

v. *Caution:* if another trust becomes eligible to receive distributions from an ESBT – Treas. Reg. § 1.1361-1(m)(4)(iv)

(1) A distributee trust does not include a trust that is not currently in existence. A trust is deemed to not be in existence if it has no assets and no items of income, loss, deduction or credit.

(2) If the distributee trust is not described in IRC § 1361(c)(2)(A) – (a QSET; a QSST, pursuant to IRC § 1361(d)(1)(A); a trust that was a QSET following the death of its owner for 2 years; a trust receiving the stock pursuant to a Will but only for 2 years; a voting trust; and an ESBT) the corporation's S election will terminate.

(3) If the distributee trust is described in IRC § 1361(c)(2)(A) its potential current beneficiaries (as if the distributee trust were an ESBT) are treated as the beneficiaries of the distributing ESBT; provided that if the trust is one that holds stock following the death of the shareholder, the estate is treated as the potential current income beneficiary of the distributing ESBT. For purposes of determining the beneficiaries, the distributee trust will be deemed to be described in IRC § 1361(c)(2)(A) if it would qualify for a QSST election or and ESBT election.

- d. Regarding post-mortem administration, a trust that was a grantor trust immediately before the death of the deemed owner and which continues in existence after such death, is an eligible shareholder only for the 2-year period beginning on the day of the deemed owner's death. IRC § 1361(c)(2)(A)(ii). However, if the trust is subject to an election under IRC § 645, then the trust is taxed as an estate and can hold the stock during the entire period during which the trust is taxable as an estate. In either such a case, the grantor's estate is treated as the owner for purposes of the 75-shareholder limitation. IRC § 1361(c)(2)(B)(ii).

Note that, if the grantor's gross estate (for federal estate tax purposes) might be subject to estate tax, it is common for the trustee to hold the S stock for more than two years after the grantor's death. This is done to avoid the trustee incurring personal liability under the tax laws, because a final determination of estate tax might not be made until after the two-year period has expired. Therefore, the trustee should consider making a IRC § 645 election, by filing IRS Form 8855. The form is due by the time of the first income tax return filed for the grantor's estate (or grantor's revocable trust, if there is no probate estate).

Furthermore, a trust with respect to stock transferred to it pursuant to the terms of a will is an eligible shareholder for the 2-year period beginning on the day on which such stock is transferred to it. IRC § 1361(c)(2)(A)(iii). In such a case, the testator's estate is treated as an owner for purposes of the 75-shareholder limitation. IRC § 1361(c)(2)(B)(iii). Because a revocable trust that has made a IRC § 645 election is treated as an estate, any transfer from that trust by reason of termination of the election or by bequest under that revocable trust is treated as transferred pursuant to the terms of a will. Treas. Reg. § 1.1361-1(h)(1)(iv)(B).

#### D. Planning and Drafting

1. If state law permits, incorporate any state law powers to invest and manage business interests into the trust. *See, e.g.*, Connecticut General Statutes § 45a-235
2. Draft broad trustee powers enabling the trustee to hold and manage partnerships, closely held corporations, and business interests.
3. If a particular business interest will be held in the trust, specifically mention that trustees may continue to hold and manage the particular (by name) interest.

4. If it is the settlor's/testator's intention that the closely held business be continued by the trustees, the intention should be stated in the trust instrument.
5. If the settlor's/testator's intention is to benefit one beneficiary over another, the intention should be stated in the trust instrument.
6. Draft the trust to allow the trustee to elect either ESBT treatment or QSST treatment for trusts that hold S stock.
7. Draft "pocket trust" provisions that will allow the trustee to divide a trust that holds S stock and that would normally not qualify as a QSST to create a trust to hold the S stock that qualifies as a QSST.
8. If the trustee individually holds an interest in the business enterprise, exonerate the trustee to the extent possible from the conflict of interest.

## II. Fiduciary Accounting Issues

### A. Multiple Uniform Acts

1. There are significant differences between the 1962 and 1997 Uniform Principal and Income Acts with respect to accounting for receipts from partnerships.
2. For a summary of the differences and issues arising therefrom see Keene and Butler, *Accounting For Partnership Interests Held by Estates or Trusts: Planning to Avoid Pitfalls*, Taxes, The Tax Magazine, April 2002.

### B. Determination of Principal and Income

1. The determination of what constitutes income and principal is crucial to the administration of a Trust
2. Allocations between income and principal determine the interests of the trust's beneficiaries
3. Determination of accounting income can affect taxation of the trust and its beneficiaries
4. A fiduciary has a duty to treat the all of the beneficiaries of a trust fairly.
  - a. The allocation of items between income and principal is fundamental to a determination of fairness.

- b. As stated by Section 103(b) of the *1997 Uniform Principal and Income Act (Last Amended and Revised in 2000)* (for purposes of this outline “UP&IA”)<sup>3</sup>:

“In exercising the power to adjust under Section 104(a) or a discretionary power of administration regarding a matter within the scope of [the UP&IA], whether granted by the terms of a trust, a will or [the UP&IA], a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with [the UP&IA] is presumed to be fair and reasonable to all of the beneficiaries.”

5. The instrument establishing the trust may depart from the UP&IA and its provisions will supplant the UP&IA. Section 103(a)(1) of the UP&IA provides:

“In allocating receipts and disbursements between principal and income . . . a fiduciary: . . . shall administer a trust . . . in accordance with the terms of the trust or the will, even if there is a different provision in [the UP&IA].

“[The UP&IA] contains only default rules and that provisions in the terms of the trust are paramount.” Comment to § 103 of the UP&IA

### C. What is income? Different Definitions for Different Purposes --

#### 1. Fiduciary Accounting Income:

Determined under the governing instrument or state law, receipts allocated to the interest of the income beneficiaries (as opposed to the remaindermen of the trust).

- a. “Money or property that a fiduciary receives as a current return from a principal asset. The term includes a portion of receipts from a sale, exchange, or liquidation of a principal asset to the extent provided. . . UP&IA § 102(4)

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<sup>3</sup> For purposes of this outline, unless otherwise noted, all references are to the 1997 Uniform Principal and Income Act as Last Amended or Revised in 2000. Note that many states adopt uniform acts with local variations. Accordingly, the Uniform Principal and Income Act in a particular jurisdiction may vary from the UP&IA. Further, due to the possible differences between state laws, the UP&IA is referenced throughout this outline.

- b. “For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. . . . [A]n allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. . . . In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.” Treas. Reg. § 1.643(b)-1

## 2. Taxable Income:

- a. A trust generally calculates its taxable income in the same manner as an individual except as required by Subchapter J of the Internal Revenue Code. IRC § 641(b)
- b. Differences (selected):
- i. Personal exemption (\$300 for simple trusts; \$100 for complex trusts), IRC § 642(b)
  - ii. Unlimited charitable deduction, provided that the instrument requires such payment, IRC § 642(c)
  - iii. Deduction for depreciation and depletion allowed to the trust to the extent not allowed to the beneficiaries, IRC § 642(e)

- iv. Amortization deduction apportioned between the beneficiaries and trustee, IRC § 642(f)
  - v. Deduction for distributions to the beneficiary (up to distributable net income), IRC §§ 651, 661
3. Distributable Net Income -- “distributable net income” means, with respect to any taxable year, taxable income computed with the following modifications —
- a. No deduction shall be taken for distributions under sections 651 and 661.
  - b. No deduction shall be taken under for a personal exemption under section 642(b).
  - c. Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The exclusion under section 1202 shall not be taken into account.
  - d. For purposes only of subpart B (relating to trusts which distribute current income only), there shall be excluded those items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of the governing instrument and applicable local law.
  - e. There shall be included any tax-exempt interest to which section 103 applies, reduced by any amounts which would be deductible in respect of disbursements allocable to such interest but for the provisions of section 265 (relating to disallowance of certain deductions).
  - f. If a charitable deduction is allowed the amount of the modifications specified in paragraphs (5) and (6) shall be reduced to the extent that the amount of income which is paid, permanently set aside, or to be used for charitable purposes specified is deemed to consist of items specified in those paragraphs. For this purpose, such amount shall (in

the absence of specific provisions in the governing instrument) be deemed to consist of the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all classes.

4. Unitrust – Some states have adopted statutes that would categorize a unitrust payment within a certain range of percentages as “income”
  - a. The for accounting purposes such a payment would be income even if a portion of the payment were paid from principal.
  - b. The Treasury Regulations defining income respect this approach for tax purposes as follows: “an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust.” Treas. Reg. § 1.643(b)-1
5. Equitable Adjustment Between Income and Principal -- other states allow the fiduciary to equitably adjust between income and principal.
  - a. Some states characterize a payment from principal based upon equitable adjustment as “income”.
  - b. The Treasury Regulations defining income respect this approach for tax purposes as follows: “an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. . . . a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation

of receipts and disbursements to income and principal, is unable to administer the trust impartially.” Treas. Reg. § 1.643(b)-1

c. Section 104 of The UP&IA allows equitable adjustment if the trustee manages the trust under the Prudent Investor Rule, the terms of the trust describe what may be distributed in terms of income and the trustee determines that the trustee cannot treat all beneficiaries fairly otherwise. However the trustee shall consider “all factors relevant to the trust and its beneficiaries, including the following factors to the extent they are relevant:”

- i. The nature purpose and expected duration of the trust
- ii. The intent of the settlor
- iii. The identity and circumstances of the beneficiaries
- iv. The need for liquidity, regular income distributions and the preservation and appreciation of capital
- v. *The assets held in the trust; the extent to which the consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor [emphasis added]*
- vi. The net amount allocated to income under the UP&IA and the increase or in the value of the principal assets
- vii. Whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accounting income, and the extent to which the trustee has exercised the invasion power
- viii. The actual and anticipated effect of economic conditions and effects of inflation or deflation
- ix. The anticipated tax consequences of adjustment

6. Allocation of Gains to Income – For income tax purposes: “an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the

fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.”

D. Accounting for Interests in Pass-through Entities held in Trust.

1. UP&IA – Section 401

- a. Note that earlier versions of the Uniform Act may have required a different result. State law should be consulted for variations.
- b. Entity means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than and estate or trust or a business activity (sole proprietorship). UP&IA § 401(a).
- c. Receipts from entities are allocated to income unless the UP&IA requires a contrary allocation.
- d. Receipts allocated to principal
  - i. Property other than money
  - ii. Money received in one distribution or a series of related distributions in exchange for all of a trust’s interest in an entity
  - iii. Money received in total or partial liquidation of the entity
  - iv. Money received from an entity that is a regulated investment company or REIT if the money distributed is a capital gain dividend for federal income tax purposes
  - v. Money received in partial liquidation:
    - (1) To the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation
    - (2) If the total amount of money and property received in distribution or series of distributions is greater than 20% of the entity’s gross assets, as shown by the entity’s year-end financial statements immediately preceding the initial receipt.
    - (3) Money is not received in partial liquidation to the extent that it does not exceed the amount of income tax

that a trustee or beneficiary must pay on taxable income of the entity making the distribution.

- e. If the trustee elects (or continues and election) to reinvest dividends in the shares of the distributing corporation the shares are principal. If the trustee intends to make an equitable adjustment between income and principal for fairness, no additional allocation is needed. If the reinvestment is not for such purpose cash equal to the amount of the reinvested dividend must be transferred from principal to income. UP&IA Comment to Section 401

## 2. Entities that Retain Earnings and Do Not Distribute

- a. Is there a duty to make equitable adjustment to increase income?
- b. At least one commentator believes a trustee would not be required to “automatically” adjust between trust income and principal because investment partnerships owned by the trust retain their earnings and adjust capital accounts accordingly. The Practical Practitioner, *Application of the Principal and Income Act*, Estate Planning Journal, December 2003.
- c. Nevertheless, fairness may require adjustment in specific circumstances.

## 3. Entities that primarily hold wasting assets

- a. Some courts have held that entities holding interest in natural assets or improved real estate should be treated as a wasting asset unless the fiduciary sets aside a reserve from income for the principal being consumed. *See generally*, Bogert, *The Law of Trusts and Trustees*, § 827 (Rev. 2d. Ed. 1981).
- b. The terms of the governing instrument may preempt the UP&IA. See UP&IA § 103(a)(1) and Comment to § 103 (“the [UP&IA] contains only default rules and that the provisions in the terms of the trust are paramount”). A grant of discretion to allocate between principal and income will normally be effective to allow allocation of some receipts from a partnership holding a wasting asset to principal. *Id.*

## 4. Discretion granted in the trust to allocate receipts between income and principal.

- a. General Rule: An exercise of a discretionary power conferred upon a trustee is generally not subject to control by a court except to prevent an abuse of discretion. See generally, *Restatement of Trusts 2d* § 187.
- b. If the terms of the trust direct that the UP&IA does not apply, the UP&IA assumes that the trustee has been given discretion to decide the question. Nevertheless, the duty of impartiality between beneficiaries is required unless the trust instrument requires favoring one beneficiary over another. UP&IA Comment to § 103.

#### E. Planning and Drafting

1. Grant trustees the power to establish reserves
2. If the settlor/testator intends to benefit one beneficiary (or class of beneficiaries) over others, state this in the trust instrument
3. Grant the trustee the discretion to allocate receipts, income, administration and other expenses and disbursements, between principal and income (or partly to each). Make the power broad enough to include, stock dividends, extraordinary dividends and liquidating dividends, premiums and discounts on investments, compensation for professional and other personal services, and gain or loss on disposition of assets.
4. Give the trustee the discretion to allocate depreciation and amortization expenses, including such expenses taken by a partnership owning depreciable assets, between income or principal (or partly to each).
5. If depreciation and amortization is allocated to principal, trustee should establish and fund a reserve equal to such principal allocation, which shall be added to and made a part of principal.

### III. Issues of Taxation

#### A. Trust Owned Partnership Interests

1. Partnership Taxation -- Generally:
  - a. A partnership is not a separate taxable entity, rather its items of income, gain, loss, deduction and credit flow through to its partners who report these items on their individual income tax returns. IRC § 701
  - b. A number of items must be separately stated to the partners to be separately stated on their returns. They are:

- i. Gains and losses from sales or exchanges of capital assets held for not more than 1 year, IRC § 702(a)(1)
  - ii. Gains and losses from sales or exchanges of capital assets held for more than 1 year, IRC § 702(a)(2)
  - iii. Gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions), IRC § 702(a)(3)
  - iv. Charitable contributions, IRC § 702(a)(4)
  - v. Dividends with respect to which there is a deduction under part VIII of subchapter B, IRC § 702(a)(5)
  - vi. Dividends with respect to which section 1(h)(11) or part VIII of subchapter B applies, IRC § 702(a)(5)
  - vii. Taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States, IRC § 702(a)(6)
  - viii. Other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary, IRC § 702(a)(7)
  - ix. Taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection, IRC § 702(a)(8)
  - x. Non business expenses under IRC § 212, relating to the production of income, Treas. Reg. § 1.702-1(a)(8)(i)
- c. The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under the foregoing paragraphs shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. IRC § 702(b)
  - d. Special allocations under the partnership agreement if different for the allocation for tax purposes would also be reported separately. IRC § 702(a)(7); Treas. Reg. § 1.702-1(a)(8)(i)
  - e. A partner's distributive share of partnership items is determined by the partnership agreement. If the agreement is silent the partner's

distributive share is based on the partner's interest in the partnership.  
IRC § 704(a); 704(b)(1)

## 2. Taxation of Income to Beneficiaries or Trust -- Generally

- a. Beneficiaries pay tax to the extent income is required to be distributed (simple trust) or paid, credited or required to be distributed (complex trust). The trust receives a corresponding deduction. Simple Trust, IRC §§ 651, 652; Complex Trust, 661, 662
- b. However, the deduction available to the trust and the income taxable to the beneficiary are limited to Distributable Net Income ("DNI"). IRC §§ 643(a), 651(b), 652(b), 661(b), 662(b)
- c. See definition of DNI, above.
- d. See below for items pertaining to depreciation and depletion.
- e. Classes of income must be allocated between the beneficiaries and the trust. Generally, this is generally the in the same proportion as each class of income entering DNI bears to the amount of each class bears to the total DNI. An allocation other than pro-rata will be recognized if required by the governing instrument and has substantial economic effect independent of tax consequences. Treas. Reg. §§ 1.652(b)-2(b); 1.662(b)-1; 1.662(b)-2; 1.652(b)-3

## 3. Taxation of the Partnership's Distributive Share

- a. The partner's distributive share will affect the basis of the partner's interest in the partnership and the partner's capital account, however (absent a provision in the partnership agreement) the partner will not necessarily be entitled to a distribution from the partnership
- b. The partner would have a tax liability based upon the distributive share even if there is no distribution. Treas. Reg. § 1.702-1
- c. Accordingly, a partner may have a tax liability to pay and no cash with which to pay it.
- d. A trust's distributive share of a partnership's gross income is included in its gross income and in the determination of its taxable income. IRC §§ 61(a)(13); 641(b)
- e. However, the trustee should not treat the trust's distributive share of partnership items as fiduciary accounting income. Only partnership distributions actually received from the partnership are properly

considered fiduciary accounting income. See *Brown v. U.S.*, 21 F. Supp. 214 (E.D. Mo. 1937), *appeal dismissed per stipulation*, 106 F.2d 993 (8<sup>th</sup> Cir. 1939); *Caldwell v. U.S.*, 102 F. 2d 607 (7<sup>th</sup> Cir. 1939); *U.S. v. Blosser*, 104 F.2d 119 (8<sup>th</sup> Cir. 1939); *Comm'r v. Goldberger's Estate*, 213 F.2d 78 (3<sup>rd</sup> Cir. 1954); *Fickert v. Comm'r*, 15 T.C. 344 (1950), *non acq.*, 1951-1 C.B. 4

f. Discrepancy between Accounting Income and DNI

- i. A trust that owns a partnership interest may have DNI derived from its distributive share of partnership items
- ii. If, however the partnership does not receive an actual distribution from the partnership, it may not have accounting income to distribute to the beneficiaries
- iii. A trust that owns only a partnership interest may have taxable income from its distributable share of partnership items but no cash with which to pay the tax and no accounting income to distribute to its beneficiaries to carry out DNI and the corresponding tax liability to them.
- iv. If the trustee has other assets and uses other trust assets to pay the tax attributable to the trust's partnership distributive share, if the trust later receives a distribution from the partnership an adjustment may have to be made to reimburse trust principal for property used to pay a tax on an item allocable to income under the UP&IA. See generally, *Warms Estate*, 140 N.Y.S.2d 169 (Surr. Ct. N.Y. Co. 1955)
- v. If the trustee has other assets, the trustee could (if allowed by the terms of the trust) distribute such assets to the beneficiaries. This would "carry out" the DNI attributable to the partnership distributive share to the beneficiaries who would then pay the tax. Adjustments between income and principal may be required in later years to reimburse principal for amounts distributed to income beneficiaries.
- vi. If a portion of the distributive share consists of capital gain, the trust should be liable for the tax on that portion, since capital gain is not ordinarily allocated to income. The tax should be charged to principal. The capital gain, when later received as a distribution, should be allocated to principal. *But See* UP&IA Section 401(b)(4), limiting the allocation of cash distributions

capital gains to principal if the distributions are from a regulated investment company or a REIT.

#### 4. Depreciation and Depletion

- a. Generally, a trust is allowed a deduction with respect to depreciation and depletion only to the extent that the deduction is not allowable to the trust's beneficiaries. IRC § 642(e)
- b. The allowable depreciation deduction is apportioned between income beneficiaries and the trustee based upon fiduciary accounting income, rather than DNI. Treas. Reg. § 1.167(h)-1(b)
- c. If local law or the governing instrument permits the trustee to maintain a reserve, and if a reserve is maintained, the deductions are first allocated to the trustee to the extent of the reserve. Any excess deduction is then apportioned between the beneficiary and trustee. Treas. Reg. § 1.167(h)-1(b)

#### 5. Charitable Deductions

- a. Generally, a trust is only allowed a charitable deduction to the extent the governing instrument directs the distribution to charity. IRC § 642(c)
- b. Nevertheless the trust should be able to deduct its share of a partnership's charitable contribution included in its distributable share even if the governing instrument does not direct a distribution to charity. *See, Estate of Lowenstein v. Comm'r*, 12 T.C. 694 (1949), *aff'd sub nom, First Nat. Bank of Mobile v. Comm'r*, 183 F.2d 172 (5<sup>th</sup> Cir. 1950), *cert. denied*, 340 U.S. 911, *acq.* 1949-2 C.B. 2; *Estate of Bluestein*, 15 T.C. 770 (1950), *acq.*, 1951-1 C.B.1; Rev. Rul 2004-5, IRB 2004-3, 295.

6. The fiduciary must also consider how to allocate discrepancies that arise within the entity as to "book" income and "tax" income.

#### 7. Is there even a Partnership?

- a. For state law purposes a partnership may be formed by two legal entities such as an individual and the individual's "grantor trust" or wholly owned limited liability company.
- b. Be aware that a partnership between two entities that are distinct for state law purposes but treated as being the same for tax purposes may not form a valid partnership for federal tax purposes.

- i. A partnership between “grantor trusts” having the same “grantor” was not a partnership for tax purposes. Because the same person held all of the partnership interests there could be no partnership. Rev. Rul. 77-402, 1977-2 C.B. 222
- ii. IRS has also held that a partnership between the grantor and the grantor’s grantor trust is not a partnership for tax purposes. FSA 200035006; See also, PLR 200102037 (limited liability company with grantor and the grantor’s grantor trust as members has only one member for tax purposes).
- iii. See also Rev. Rul. 2004-77, I.R.B. 2004-31, 119 (August 2, 2004)

## B. Trust Owned S Corporation Shares

1. Qualified Subpart E Trust – this is a grantor trust. The beneficiary is treated as owning all of the assets of the trust and pays income tax on the items passed through from the corporation.
2. Qualified Subchapter S Trust – QSST
  - a. The income beneficiary must make an election for the trust to be treated as a QSST
  - b. As a condition of the election the income beneficiary is treated as owning the S corporation stock for income tax purposes (although the stock is owned by the trust). “The income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.” Treas. Reg. § 1.1361-1(j)(7)(i)
  - c. Accordingly, the income beneficiary will report the income from the shares of S corporation stock owned by the trust as if such beneficiary owned the shares.
  - d. Return filing requirement: “*Coordination with grantor trust rules.* — If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, solely for purposes of applying the preceding sentence to a QSST, an income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and

attributing the federal income tax consequences of a disposition of the stock by the QSST. For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. Similarly, if a QSST distributes its S corporation stock to the income beneficiary, the QSST election terminates as to the distributed stock and the consequences of the distribution are determined by reference to the status of the trust apart from the income beneficiary's terminating ownership status under sections 678 and 1361(d)(1). The portions of the trust other than the portion consisting of S corporation stock are subject to subparts A through D of subchapter J of chapter 1, except as otherwise required by subpart E of the Internal Revenue Code.” Treas. Reg. 1.1361-1(j)(8)

### 3. Electing Small Business Trust – ESBT

- a. The rules of trust taxation are changed for an ESBT. The ESBT is treated as two separate trusts: one holding S stock and the other holding other property.
- b. The tax on the S portion of the ESBT is calculated with the following modifications (IRC § 641(c)(1)(B)):
  - i. Except as provided in section 1(h) the amount of the tax imposed by section 1(e) shall be determined by using the highest rate of tax set forth in section 1(e). IRC § 641(c)(2)(A)
  - ii. The exemption amount under section 55 shall be zero. IRC § 641(c)(2)(B)
  - iii. The only items of income, loss, deduction, or credit to be taken into account are the following:
    - (1) The items required to be taken into account under section 1366. IRC § 641(c)(2)(C)(i)
    - (2) Any gain or loss from the disposition of stock in an S corporation. IRC § 641(c)(2)(C)(ii)
    - (3) To the extent provided in regulations, State or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii). IRC § 641(c)(2)(C)(iii)

- iv. No deduction or credit shall be allowed for any amount not described in this paragraph, and no item described in this paragraph shall be apportioned to any beneficiary.
- v. No amount shall be allowed under paragraph (1) or (2) of section 1211(b). IRC § 641(c)(2)(D)
- c. Return filing requirement: The tax on the S stock is calculated separately from the tax on the balance of the trust's property and stated separately on Schedule G of Form 1041. A rider showing the tax calculations is attached to Form 1041. See Instructions to Form 1041.

### C. Passive Activities

1. Generally, a passive activity is one that involves the conduct of a trade or business in which the taxpayer does not materially participate or (subject to certain exceptions) rental activity. Internal Revenue Code § 469(c). The following are passive activities:
  - a. Equipment leasing
  - b. Rental real estate except as provided in IRC § 469(c)(7)
  - c. Sole proprietorships for farming in which the taxpayer does not materially participate
  - d. Limited partnerships, with some exceptions
  - e. Partnerships, S corporations, and limited liability companies in which the taxpayer does not materially participate
2. Generally, "passive activity loss" and "passive activity credit" for a calendar year are not allowed. IRC § 469(a)
  - a. "Passive activity loss" is defined as: "the amount (if any) by which -- the aggregate losses from all passive activities for the taxable year, exceed the aggregate income from all passive activities for such year." IRC § 469(d)(1)
  - b. "Passive activity credit" is defined as: "the amount (if any) by which -- the sum of the credits from all passive activities allowable for the taxable year under -- subpart D of part IV of subchapter A, or subpart B (other than section 27(a)) of such part IV, exceeds the regular tax liability of the taxpayer for the taxable year allocable to all passive activities. IRC § 469(d)(2)

3. Trusts are subject to the passive activity rules. Internal Revenue Code § 469(a)(2)(A)
4. Treasury has not issued regulations regarding the application of the passive activity loss rules to trusts, estates and their beneficiaries. Treas. Reg. § 1.469-8 (“Reserved”)
5. When does a Trust Materially Participate?
  - a. The legislative history indicates that a trust is deemed to materially participate in an activity if a trustee, in the trustee’s capacity as such, materially participates in the activity. S. Rep. No. 313, 99<sup>th</sup> Cong. 2d Sess. 735 (1986); In the case of a grantor trust, material participation is determined from the grantor’s participation. S. Rep. No. 313, 99<sup>th</sup> Cong. 2d Sess. 735 (1986); Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100<sup>th</sup> Cong., 2d Sess. 242 (1987).
  - b. **But See**, *Mattie K. Carter Trust v. U.S.*, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

Deciding against the IRS’s position that only the activities of the trustee should be used in deciding a trust’s material participation in a ranching activity, the court ruled that material participation had to be determined by addressing the activities of the trust through its fiduciaries, employees and agents. According to the Court:

- i. Plain language of IRC § 469 indicates that the trust itself is the taxpayer (not the trustee).
- ii. A trust is treated as materially participating in a business if its activities in pursuit of the business are regular, continuous, and substantial.
- iii. Since the trust is the taxpayer activities should be scrutinized by reference to the trust itself “which entails an assessment of the activities of those who labor on the ranch or . . . in furtherance of ranch business on behalf of the . . . trust.
- iv. IRS position’ that the trust’s participation be measured solely by reference to the trustee, is not supported by the statute.
- v. Court recognizes IRS has not issued regulations and there are no cases on point, but this does not create ambiguity. The

legislative history is resorted to only if the statute is unclear, which to the court it was not.

Alternative holding: The trustee's activities with respect to the ranch were substantial enough to constitute material participation.

6. Generally, a limited partner does not materially participate in an activity, IRC § 469(h)(2), unless the limited partner is also a general partner or participates for more than 500 hours in a year, materially participates in the activity in any of the 5 of the 10 preceding years or materially participates in a personal service activity (health, law, engineering, architecture, accounting, actuarial science, performing arts, or any other trade or business in which capital is not a material income-producing factor). Temp. Treas. Reg. § 1.469-5T(e)(2)
7. Distribution of an interest in a passive activity from a trust to a beneficiary does not render the passive activity losses allocable to the activity deductible. Rather the basis of the interest is increased by the allocable passive activity losses. Gain or loss is then determined under the normal rules.

#### D. Planning and Drafting

1. If possible, consider funding a trust that holds a partnership interest with additional, non-partnership assets.
2. Draft a requirement into the partnership or shareholders' agreement that requires distributions to pay taxes.
3. Allow trustees to borrow – including the power to borrow from a trustee (or affiliate of a corporate trustee).

#### IV. Other Drafting and Planning Ideas

- A. If there are active and Non-active family members – consider who should receive the business.
  1. If the business is given to the active family members equalize the non-active family members with insurance or other assets.
  2. Give the family members who are active in the business the right to purchase (“call”) the interests of the non-active family members for fair market value.
    - a. Grant the call right in partnership agreement establishing the entity or in a shareholder's agreement to which any recipient of stock must agree.

- b. Make the call right the condition of any bequest of the interest. Grant this right in the Will.
  - c. Set a mechanism for determining the value of the stock that will be considered fair by all parties
  - d. Set a time for the payment of the call price (consider if the business alone will be the source of the payments and if its cash flow can service the debt).
3. Give the non-active family members the right to require the active family members to purchase (“put”) their interests for fair market value. *Similar drafting considerations should be considered as with the call right, above.*

B. Should the Business be Sold?

1. Should the Will include a direction to sell the business?
2. Will a direction to sell the business in the Will depress its value?