Selected Subchapter J Subjects: From the Plumbing to the Planning, Preventing Pitfalls with Potential Payoffs
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I. INTRODUCTION TO SUBCHAPTER J
Overview of Subchapter J

- Objective
  - Allocate tax burden among persons benefiting from estate or trust
- Challenges
- Separating gifts from income earned on gifts
Types of Trusts under Subchapter J

- Grantor Trusts
- Non-Grantor Trusts
  - Simple Trusts
  - Complex Trusts (and Estates)
  - Charitable Remainder Trusts
Hybrid Entity/Conduit System

- **Purpose**

- **Characteristics similar to entity approach**
  - Separate tax on income of trusts and estates (Code §641(a))
  - Taxable income of a trust or estate is computed in the same manner as for an individual, subject to modifications (Code §641(b))

- **Characteristics similar to conduit approach**
  - Distribution deduction (Code §§651 and 661)
  - Beneficiary inclusion (Code §§652 and 662)
Calculating Taxable Income of an Estate or Non-Grantor Trust

- Gross income
- Deductions
- Tax rate
- Credits
Distributable Net Income ("DNI")

- Purpose
  - Determine the extent to which a distribution from an estate or non-grantor trust carries out gross income to a beneficiary

- Quantitative element
  - Helps determine how much of the income is taxed at the estate or non-grantor trust level and to the beneficiaries

- Qualitative element
  - Determines the character of income items taxes to the estate or non-grantor trust and beneficiaries
Computation of DNI

- Determine Taxable Income
- Apply Modifications
  - No Distribution Deduction
  - No Personal Exemption
  - Generally exclude capital gains and capital losses
    - Exceptions:
      - Capital gains allocated to fiduciary accounting income ("FAI")
      - Certain capital gains allocated to principal
      - Capital gains allocated to principal and for charitable purposes under Code § 642(c)
  - For simple trusts, exclude certain extraordinary dividends and taxable stock dividends
  - Add net tax-exempt income
Fiduciary Accounting Income ("FAI")

- State law concept of income
- Code §643(b):
  - Except with respect to Subpart E (the grantor trust rules), the term “income,” unless preceded by the words “taxable,” “distributable net,” “undistributed net” or “gross,” means FAI
  - FAI is the amount of income of a trust or estate determined under the terms of the governing instrument and applicable local law
- Importance of FAI definition (undistributed net income or “UNI”)
Reasonable Allocations to FAI under Treasury Regulations

- Prudent Investor Rule and Modern Portfolio Theory
- Unitrusts
- Power to adjust
- Allocation of gains to income from the sale of trust assets under certain circumstances
Simple Trusts

- Must be required to distribute all FAI to beneficiaries currently in the trust agreement
- No charitable contributions
- No distributions in excess of current income
Complex Trusts

- All non-grantor trusts that are not simple trusts or charitable remainder trusts are complex trusts

- Examples:
  - A trust in which less than all FAI must be distributed currently (accumulation of income is permitted)
  - A trust in which a distribution is made to charity
  - A trust in which an amount other than FAI is in fact distributed

- The status of a trust as a simple trust or complex trust can change from year-to-year
Charitable Remainder Trusts ("CRTs")

- Governed by Code §664

- Types of CRTs
  - Charitable Remainder Annuity Trusts ("CRATs")
  - Charitable Remainder Unitrusts ("CRUTs")
  - Variations (Flip CRUT, NICRUT, NIMCRUT)

- Character of distributions

- Taxation of CRT
  - CRT is tax exempt
  - Exception: 100% excise tax on unrelated business taxable income ("UBTI")
II. BASIC FIDUCIARY INCOME TAX RULES
Determination of Taxable Income for a Trust or Estate

- First - determine the taxable income of an individual (Code §641(b))
  - Generally gross income minus deductions
  - New law – changes to permissible deductions
    - State and local tax deduction limited to $10,000
    - Pease limitation eliminated

- Second – apply modifications
  - No standard deduction (Code §63(c)(6))
  - In lieu of personal exemption under Code §151 for individuals (Code §642(b))
  - Other modifications (e.g., Code §642(c) charitable deduction, Code §67(e))
Simple Trust – Tax Calculation

- Distribution deduction for trust (Code §651)
  - Generally equal to the lesser of FAI and DNI
- Income inclusion for beneficiaries (Code §652(a))
  - General limited to the lesser of FAI and DNI
  - If FAI exceeds DNI, beneficiary includes proportionate share of DNI in income
- Timing of deduction and inclusion
- Character of income inclusion
- Trust level taxation
Complex Trust – Tax Calculation

- Tier system for distribution deduction and income inclusion
  - Tier 1: Income required to be distributed currently
  - Tier 2: Any amounts properly paid, credited or required to be distributed (e.g., discretionary distributions of income or principal and mandatory distributions of principal)

- A beneficiary can be a Tier 1 and Tier 2 beneficiary

- If total distributions ≤ DNI, then the tiers are irrelevant

- If total distributions > DNI, then
  - If Tier 1 distributions > DNI
    - Each Tier 1 beneficiary includes his or her pro rata share of DNI and Tier 2 beneficiaries have no inclusion
  - If Tier 1 distributions ≤ DNI
    - Each Tier 1 beneficiary includes his or her Tier 1 distribution and each Tier 2 beneficiary includes his or her pro rata share of remaining DNI

- Character of income inclusion
Simple Trust v. Complex Trust

- Purpose of categories – to streamline income tax calculation for simple trusts
- Rarely have economic consequences
- Personal exemption
- Timing of inclusion
- 65 day rule election
- Extraordinary dividends and taxable stock distributions
Charitable Contribution Deduction

- Governed by Code §642(c)
- In lieu of a Code §170 deduction
- Requirements:
  - From gross income
  - For a Code 170(c) purpose
  - “Pursuant to” the governing instrument
- No percentage limitation for deduction (but no carryover)
- Recent Developments:
  - CCA 201747005
Miscellaneous Itemized Deductions and Code §67(e)

➤ Code § 67(a):
  - Can deduct miscellaneous itemized deductions only to the extent that such deductions exceed 2% of adjusted gross income

➤ Code §67(e) and Treas. Reg. §1.67-4:
  - Exceptions to 2% floor for certain trust and estate administrative expenses

➤ Impact of New Code §67(g)
  - Code §67(b) – Definition of miscellaneous itemized deductions
  - Code §63(d) – Definition of itemized deduction

➤ *Lender Mgmt, LLC v. Comm’r*
  - Family office and engaging in trade or business under Code §162
Termination of a Trust or Estate - Excess Deductions or Losses

- Interaction of Code §642(h)(2) and new Code §67(g)

- Code §642(h)(2):
  - In the last year of a trust or estate, deductions (other than the personal exemption or charitable deduction) in excess of gross income are allowed as deductions to the beneficiaries

- Code §67(b):
  - Such deductions are miscellaneous itemized deductions
  - Discussion under Code §67(e) inapplicable because these deductions are for individual beneficiaries and not trusts or estates

- Code §67(g):
  - No miscellaneous itemized deductions are allowed for 2018-2025
Payable in Less Than Three Installments Rule

- Governed by Code §663(a)(1)
- Requirements – the gift or bequest must be:
  - Properly paid under the terms of the governing instrument
  - A payment of a specific sum or specific property
  - Ascertainable at death or inception of the trust
  - Paid in no more than 3 installments
  - Not required to be paid from FAI
- Tax consequences
65 Day Rule

- Governed by Code §663(b)
- Requirements
  - Amount properly paid within 65 days of end of prior year
  - Limitation on amount
  - Election
  - Time and manner of election
- Purpose of making 65 day rule election
Separate Share Rule

- Governed by Code §663(c)
- Definition of separate shares of a trust
- Definition of separate shares of an estate
- Not elective
- Only affects DNI
Distributions in Kind

- Governed by Code §643(e)
- Rule
  - An estate or trust realizes gain or loss when it satisfies a pecuniary bequest in kind
  - Basis adjustment for the beneficiary
- Transfers when liabilities exceed basis
- Disallowance of loss
- Election to recognize gain
Election to Treat Revocable Trust as Part of the Estate

- Governed by Code §645
- Requirements
  - Qualified Revocable Trust
  - Timely election
- Benefits
  - Fiscal year v. calendar year
  - Estimated taxes
III. GRANTOR TRUSTS
What is a grantor trust?

Generally, a trust in which the grantor or another person has certain powers or interests that cause the grantor to be treated as owner of the trust’s assets for income tax purposes.
Overview of §§ 671 – 679 (“Subpart E”)  

► § 671 describes the consequences of being treated as the “owner” of a trust  

► § 672 provides definitions and rules of application relevant to the other sections of Subpart E  

► § 673 to § 679 generally identify a grantor as “owner” of a trust if the grantor or certain other persons have particular interest in or powers over the trust
Spousal attribution

- The grantor is treated as holding any power or interest held by the grantor’s spouse. § 672(e)
  - Spousal attribution rules do not apply for estate tax purposes
Power to revoke - § 676

- Grantor trust status will result if grantor has the power to revest title to trust property
Power to control beneficial enjoyment - § 674

- Discretionary sprinkle trust generally will be a grantor trust in any case where grantor’s spouse is a trustee.

- If spouse is not acting as a trustee but more than half of the trustees are “related or subordinate” parties who are “subservient to the wishes of the grantor,” trust generally also will be a grantor trust.
Power to add beneficiaries - § 674

- Trust generally will be a grantor trust if any person has the power to add beneficiaries (other than after-born or after-adopted children)
“Adverse party” exception to § 674

- An “adverse party” is a person who has a substantial beneficial interest in a trust that would be adversely affected by the person’s exercise or non-exercise of a power over the trust
  - § 672(a)
Power to reacquire trust property - § 675(4)

- Trust will be a grantor trust if grantor, in a non-fiduciary capacity, has the power to re-acquire trust property by substituting property of equivalent value, without the approval or consent of any person in a fiduciary capacity
  - Re-acquisition power generally will not result in estate inclusion
Power to borrow - § 675(2)

➤ Grantor trust status will result if grantor has the power to borrow trust property without adequate interest or security
  ▪ If grantor has the power to borrow trust property without adequate interest, estate inclusion may result
  ▪ Requiring adequate interest, but not security, should avoid estate inclusion
Actual borrowing - § 675(3)

- A trust generally will be a grantor trust in any year that the grantor has borrowed the trust fund and has not repaid the loan in full (including interest) before the beginning of the year
  - Rev. Rul. 86-82
Spouse as beneficiary - § 677

- Trust will be a grantor trust if the income of a trust may be distributed to or accumulated for the grantor or the grantor’s spouse without the consent of an adverse party.
Grantor trust status may result if trust income may be applied to pay premiums on life insurance policies on the life of the grantor or the grantor’s spouse.
Beneficiary as owner - § 678

- A beneficiary who has the right to withdraw trust assets will be treated as the owner of the portion of the trust attributable to the withdrawal right
  - Ex: 5 and 5 power, Crummey power
  - Rev. Rul. 67-241, PLR 9034004

- Grantor trust powers or interest of grantor likely trump powers of beneficiary
Rev. Rul. 85-13

- Transactions between grantor and grantor trust are disregarded
Rev. Rul. 2004-64

- Grantor’s payment of income taxes attributable to trust does not result in taxable gift

- Trustee’s discretion to reimburse grantor for income taxes will not in itself result in estate inclusion
Cessation of grantor trust status

- If a trust that is a grantor trust becomes a nongrantor trust during the grantor’s lifetime, there is a deemed transfer of assets held by the grantor trust to a nongrantor trust
  - In general: no income tax consequences
    - CCA 201730012
    - CCA 200923024
Cessation of grantor trust status – continued

- Gain may be recognized if liabilities of trust exceed trust’s basis in its assets
  - Treas. Reg. §1.1001-1(e) (ex. 5)
  - TAM 200010010
IV. DECANTING
What is decanting?

- Generally, a trustee’s distribution of property from one trust to another
Income tax consequences of decanting

- Notice 2011-101
- IRS Priority Guidance Plan
Decanting from grantor trust to non-grantor trust

- In general, no income tax consequences
- Gain may be recognized if decanted assets have liabilities in excess of tax basis
One non-grantor trust to another

- Distribution likely to carry out DNI from the distributing trust to the receiving trust
- Possible exception if all assets of distributing trusts decanted to a receiving trust with similar terms
V. CHARITABLE REMAINDER TRUSTS
Overview of Charitable Remainder Trusts ("CRTs")

- In general
  - Form of split interest trust where at least one beneficiary of the lead interest is noncharitable and the remainder interest benefits charity

- Types of CRTs
  - CRAT
  - CRUT
  - Variations
CRAT Requirements

- Annuity amount
- Timing of annuity payments
- Term of annuity
- Permissible beneficiaries of the annuity
- Remainder interest
- Value of the remainder interest
- Additional contributions prohibited
CRUT Requirements (Differ from CRATs)

- Unitrust amount
- Additional contributions are permitted
- Value of the remainder interest
- Additional types of CRUTs
  - NICRUT
  - NIMCRUT
  - Flip CRUT
Tax Consequences to CRT

- CRT is income tax exempt
- The net investment income tax does not apply to CRTs
- 100% excise tax on UBTI (including debt financed income)
  - History
  - Considerations
    - Potential violation of fiduciary duty
    - Double taxation
    - UBTI may exceed cash distributed to CRT (phantom income)
Character of Distributions from CRTs

- Ordinary income
- Capital gain
- Other income, such as tax-exempt income
- Trust corpus (tax free)
Distributions of Net Investment Income by CRTs

- Net investment income ("NII") governed by Code §1411

- General rule
  - If an annuity or unitrust distribution from a CRT carries out NII to a noncharitable beneficiary, then such items retain character as NII in the hand of the beneficiary

- Apportionment among multiple beneficiaries
Practical Considerations for CRTs

- Transfer of appreciated property to CRT
- Sale of income right of CRT
- GST considerations
- Self-dealing rules
VI. CHARITABLE LEAD TRUSTS
Overview of Charitable Lead Trusts (“CLTs”)

➤ In general
  ▪ A trust with a charitable lead interest of a guaranteed annuity or a unitrust amount and a noncharitable remainder interest

➤ Types of CLTs

➤ Requirements
  ▪ Similar to CRTs except:
    • No minimum 5% payout requirement
    • Permissible term may refer to one or more measuring lives plus a term of years
    • Prepayment clause in a CLT is not permitted

Non-Grantor CLTs

- Income tax consequences
  - CLT
    - Taxable entity
    - 642(c) charitable deduction for income passing to charity (except for UBTI)
  - Donor
    - No upfront charitable income tax deduction
- Advantages of non-grantor CLTs
- Disadvantages of non-grantor CLTs
Grantor CLTs

- Income tax consequences
  - CLT income is attributed to the donor
    - No charitable contribution deduction as annuity or unitrust is paid
    - Income earned by the CLT is reported by the donor (phantom income)
  - Upfront charitable income tax deduction for the donor (subject to Code §170(c) limitation)
  - Recapture

- Drafting considerations
  - Estate tax inclusion
  - Grantor trust status
  - Shark fin CLAT
VII. SUBCHAPTER S TRUSTS
What is a subchapter S trust?

A trust that is a permitted shareholder of an S corporation

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Types of subchapter S trusts

- Grantor trusts
- Trusts that cease to be grantor trusts by reason of the death of the grantor, for 2 years following grantor’s death
- Testamentary trusts
- Qualified Subchapter S Trusts (“QSSTs”)
- Electing Small Business Trusts (“ESBTs”)
- Voting trusts
Qualified Subchapter S Trust ("QSST")

- Requirements for a QSST similar to those for a QTIP
  - Single current beneficiary to whom all income payable
  - QSST election in effect
- QSST treated as a grantor trust, deemed owned by its income beneficiary
Electing Small Business Trust (“ESBT”)

- Requirements
  - Can have only certain types of beneficiaries – individuals, estates, trusts and certain charitable organizations
  - ESBT election in effect

- Tax treatment
  - Subject to tax on allocable share of income from S corporation
  - No distribution deduction
ESBTs - Changes Made by 2017 Tax Act

- Trust can qualify as an ESBT even if a nonresident alien is a potential current beneficiary

- If an S corporation makes a charitable contribution, requirements of 642(c) do not need to be satisfied for ESBT to get charitable contribution deduction
  - Rather, charitable contribution deduction subject to §170 rules applicable to individuals
VIII. Net Investment Income Tax
Overview of NII

- Governed by Code §1411 (took effect in 2013)
- Applies 3.8% tax on certain net investment income of trusts and estates above the statutory threshold (currently $12,500)
- NII and certain exempt trusts
- Reporting
- Definition of NII
  - Generally interest, dividends, capital gains, rental and royalty income, annuities, income from businesses involved in trading of financial instruments or commodities and businesses that are **passive activities** to the taxpayer
  - “Passive activities” defined in Code §469
    - Where taxpayer does not materially participate
    - Material participation of trusts and estates (IRS position and cases)
Thank you!

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