
Fundamentally Fun Solutions To Perilous Income Tax Pitfalls In Estate Planning

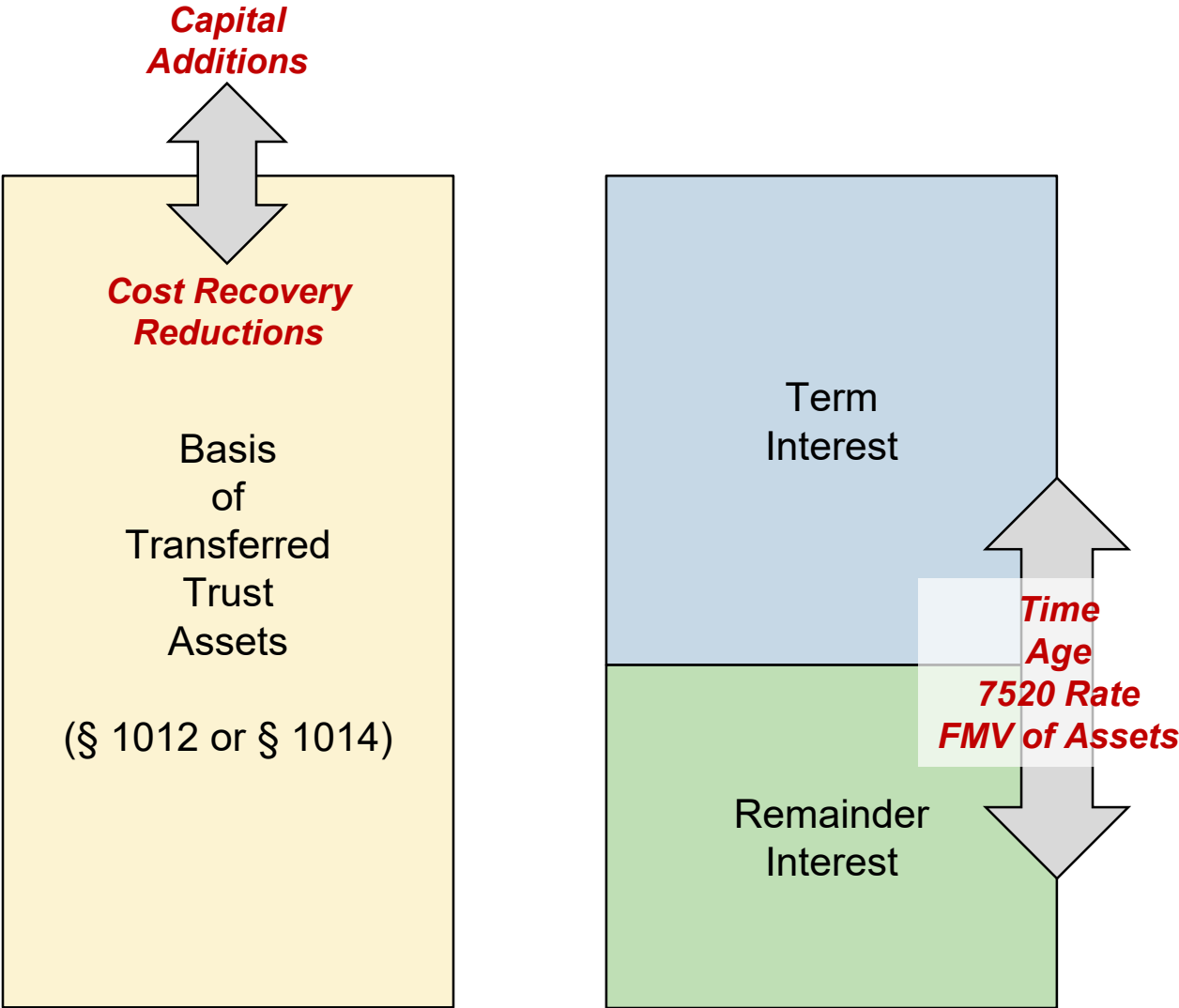
Turney P. Berry
Wyatt, Tarrant & Combs LLP
Louisville, Kentucky

Paul S. Lee
The Northern Trust Company
New York, New York

Melissa J. Willms
Davis & Willms, PLLC
Houston, Texas

Trust Modification, Sales, Decantings, and Terminations

Uniform Basis Rule and Sales of Trust Interests

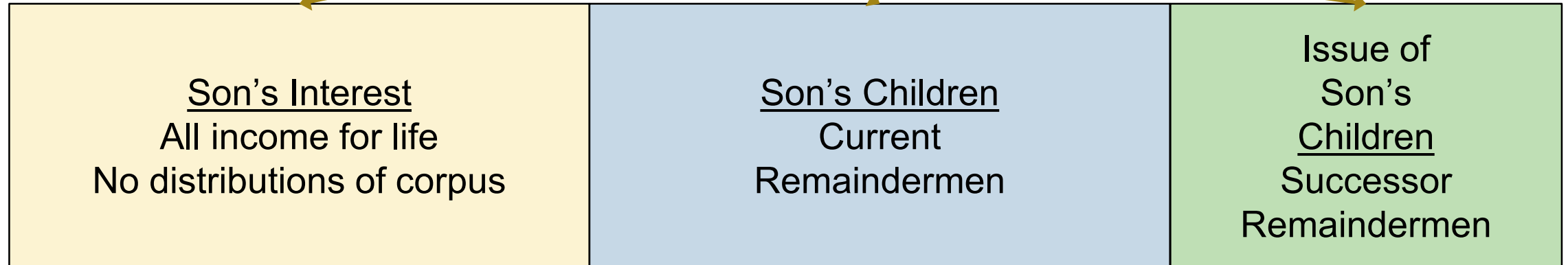


Interest	Taxable Sale	Other
Term	No Basis § 1001(e)(1)	§ 351 Rule No § 721 Rule
Remainder	Portion of Uniform Basis	Adjustment for death of life tenant and remainderman
All Interests	100% of Uniform Basis § 1001(e)(2)	Can result in gain and loss at the same time

Commutations and Early Terminations

PLRs 201932001 through 201932010

Distribution of Trust Assets Pro-Rata or In-Kind



Seller of Capital Asset
No Basis
§ 1001(e)(1)

Purchaser
Gain or Loss on Distribution
of Trust Assets to the Sellers

Seller of Capital Asset
Some Basis
No § 1001(e)(1) Rule

Cottage Savings
Exchange of
“materially different”
property

Alternative Planning Options?

- Non-judicial modification
- Decanting
- Power of appointment

Tax Considerations

- Distribute high basis assets
- Loss may be limited by the related party rule

Decantings and Trust Modifications

TAX CONSEQUENCES OF DECANTINGS AND TRUST MODIFICATIONS

- No income tax consequences (considered same trust)
vs.
Current or terminating distribution under subchapter J
- Conversion of trust status (grantor to non-grantor/non-grantor to grantor)
- Taxable event due to “materially different” exchange of property
- May depend if beneficiary consent or action is required for decanting or modification

Request for Comments
(Notice 2011-101)

No Ruling List
(Rev. Proc. 2021-3)

EXAMPLE 1

Splitting Pot Trust for 3 Beneficiaries

- One child wants income, second child wants principal distributions, and third child wants special investment assets
- Accomplished by:
 - Decanting
 - Trust Modification
- Are all the assets the same before and immediately after the division?
- *Cottage Savings* risk if assets are different.
- If assets are not the same, trust modification is the better option.
- Higher *Cottage Savings* risk if the consent or action of the beneficiaries is required to accomplish the modification.

EXAMPLE 2

Distributing 3 Different Trust Assets

- Three different types of assets: marketable securities, ranch, and family business.
- Each of the three beneficiaries wants the benefit of a different trust asset
- If you divide each of the assets into different trust, you may have a *Cottage Savings* issue.
- Partnership can be used to both avoid the *Cottage Savings* issue and to divide assets to separate trusts

EXAMPLE 3

Dealing with a Nuisance Beneficiary

- Desire to remove a beneficiary or restrict the beneficial interest of a beneficiary
- More difficult to do via a decanting unless independent trustee has unlimited discretion with proper justification
- If, for example, trust is supposed to terminate at age 30, if the modified or new trust is for the life of the beneficiary, is the beneficiary now the grantor of the new trust? May depend on beneficiary involvement and the breadth of trustee's discretion

Conversions of Grantor & Non-Grantor Trusts

Conversions Change the Taxpayer... But How?

Conversions: What We Know and What We Don't Know

- Trust assets are now “owned” (for tax purposes) by another taxpayer (non-grantor trust, grantor, or § 678 beneficiary).
- How does that change of “ownership” occur?
- If the change in ownership is a deemed transfer, is it treated like a gift under § 1015 (i.e., carry-over basis)?
- If the transferred asset is subject to debt and debt is in excess of basis, is gain recognized?

GRANTOR TO NON-GRANTOR DURING GRANTOR'S LIFETIME

Rev. Rul. 77-402

■ Grantor Trust

- A contributes funds to irrevocable Trust (T)
- Trustee purchases interest in real estate partnership (P)
- P purchases real estate with recourse and nonrecourse debt
- P elects accelerated depreciation (deducted on A's return)

■ Conversion to Non-Grantor Trust

- Outside basis of interest in P is zero and P starts generating net income
- A's share of partnership liabilities are in excess of the A's outside basis
- A renounces grantor trust powers

[A]t the time A renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust, with the result that A was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, A is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor.

A realized an amount equal to the share of partnership liabilities that existed immediately before T converted from grantor to nongrantor status for Federal income tax purposes. The gain or loss realized by A is the difference between the amount realized from the reduction of the share of P's liabilities and the adjusted basis in the partnership interest ... immediately prior to the change in T's tax status.

Crane, Tufts, and Treas. Reg. § 1.1001-2(c), Ex. 5 vs. *Madorin*

Treas. Reg. § 1.1001-2(a)(4)(i) & (iii)

The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability.
A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject.

Grantor to Non-Grantor Due to Grantor's Death

Conversion at Grantor's Death: What We Don't Know about IDGTs

- If the IDGT asset is subject to debt and if debt is in excess of basis, is gain recognized?
- Do the assets in the IDGT get a basis adjustment at death under § 1014?

Gain is Not Recognized at Death

- *Crane, Diedrich*, and § 1.1001-2
- CCA 200923024: "[D]eath ... is generally not treated as an income tax event."
- Rev. Rul. 73-183: No loss to estate when decedent dies with asset that got a "step-down" in basis under § 1014.

Basis of IDGT Assets Determined under § 1014

- PLR 201245006: Foreign Trust. Non-U.S. Persons. Irrevocable trust with retained income and limited testamentary power of appointment. IRS ruled that § 1014(b)(9) is inapplicable and held § 1014(b)(1) applied. Some question about whether IRS should have applied § 1014(b)(3).
- PLR 201544002: Foreign Trust. Non-U.S. Persons. Revocable trust and community property. Ruling request submitted before no-rule policy was announced (Rev. Proc. 2015-26).

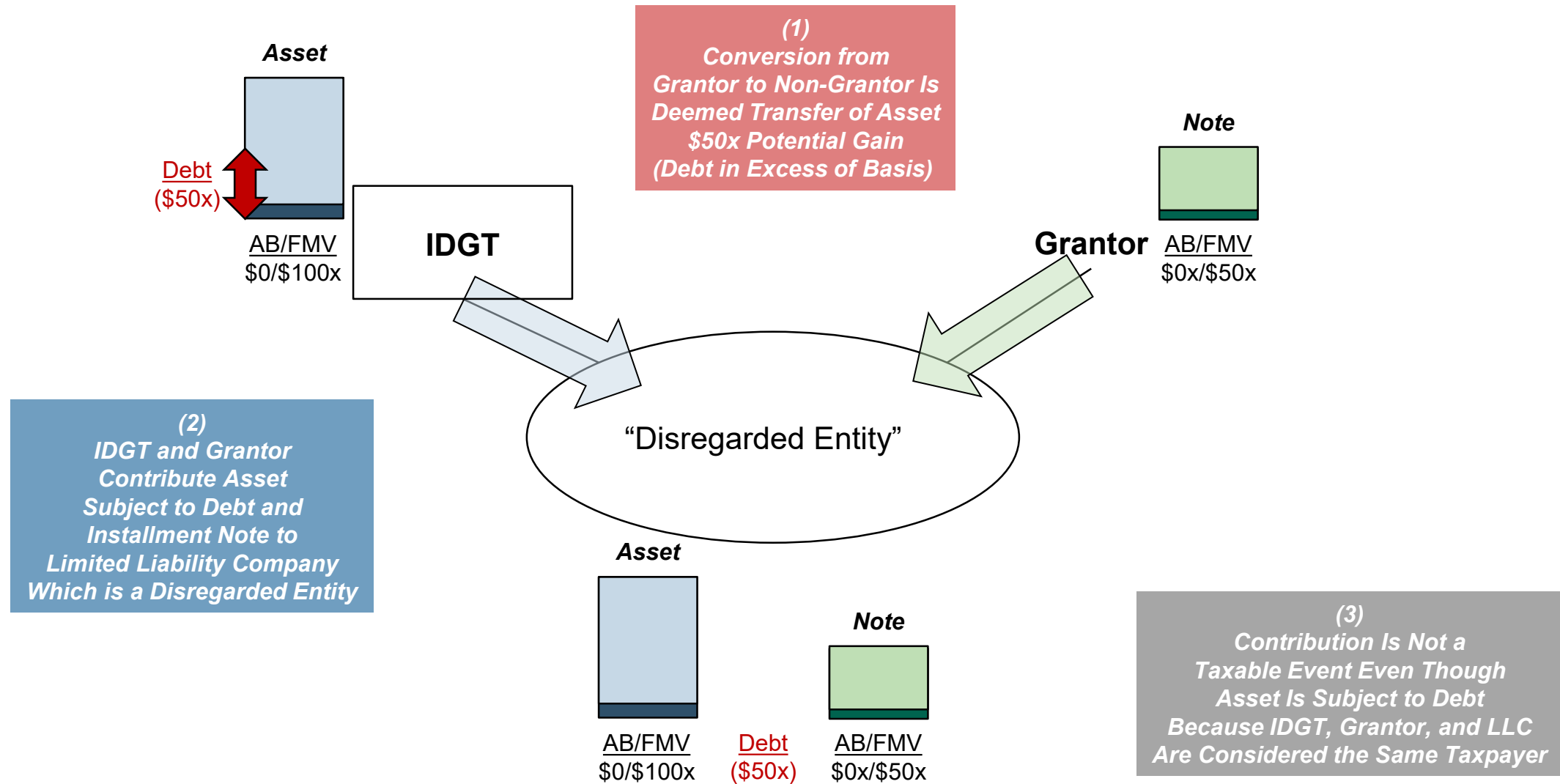
Gain Will Be Recognized if Debt Exceeds Basis

- *Crane, Tufts, Diedrich*, and § 1.1001-2
- Transfers at death are not taxable events because § 1014 eliminates debt in excess of basis
- 2010 carryover basis: "In determining whether gain is recognized on the acquisition of property from a decedent by a decedent's estate or any beneficiary ..., and from the decedent's estate by any beneficiary ..., and in determining the adjusted basis of such property, liabilities in excess of basis shall be disregarded." § 1022(g)(1).
- 1976 tax act carryover basis: "[T]ransfer effected at death should not be taxed any differently so far as the decedent transferor is concerned than are inter vivos transfers. Any gain or loss recognized on a transfer at death should be reported on the decedent's final return." Del Cotto & Joyce.

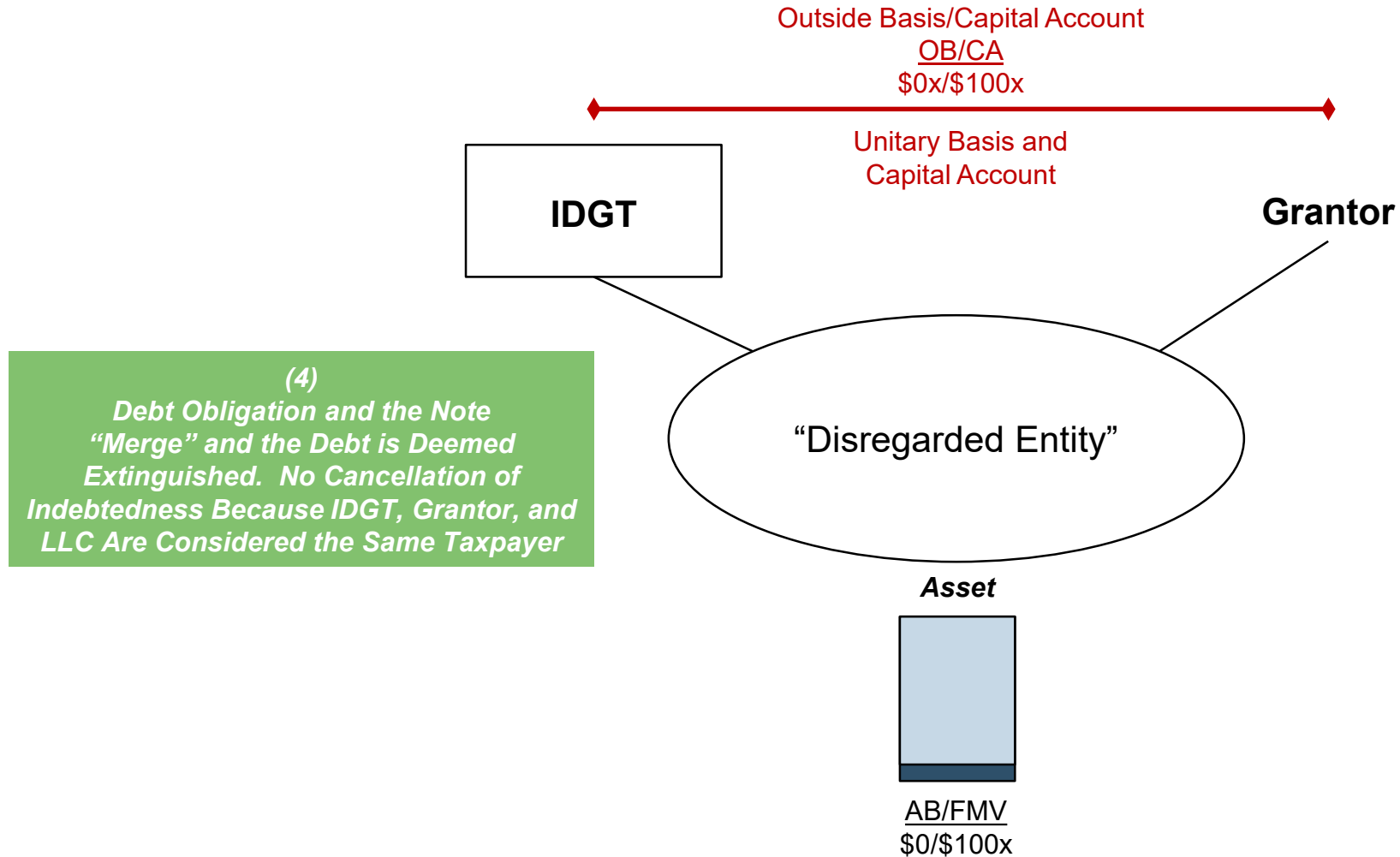
Basis of IDGT Assets Determined under § 1015

- CCA 200937028: "Based on my reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9)."
- § 1015(b): "Transfer in trust (other than by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer."

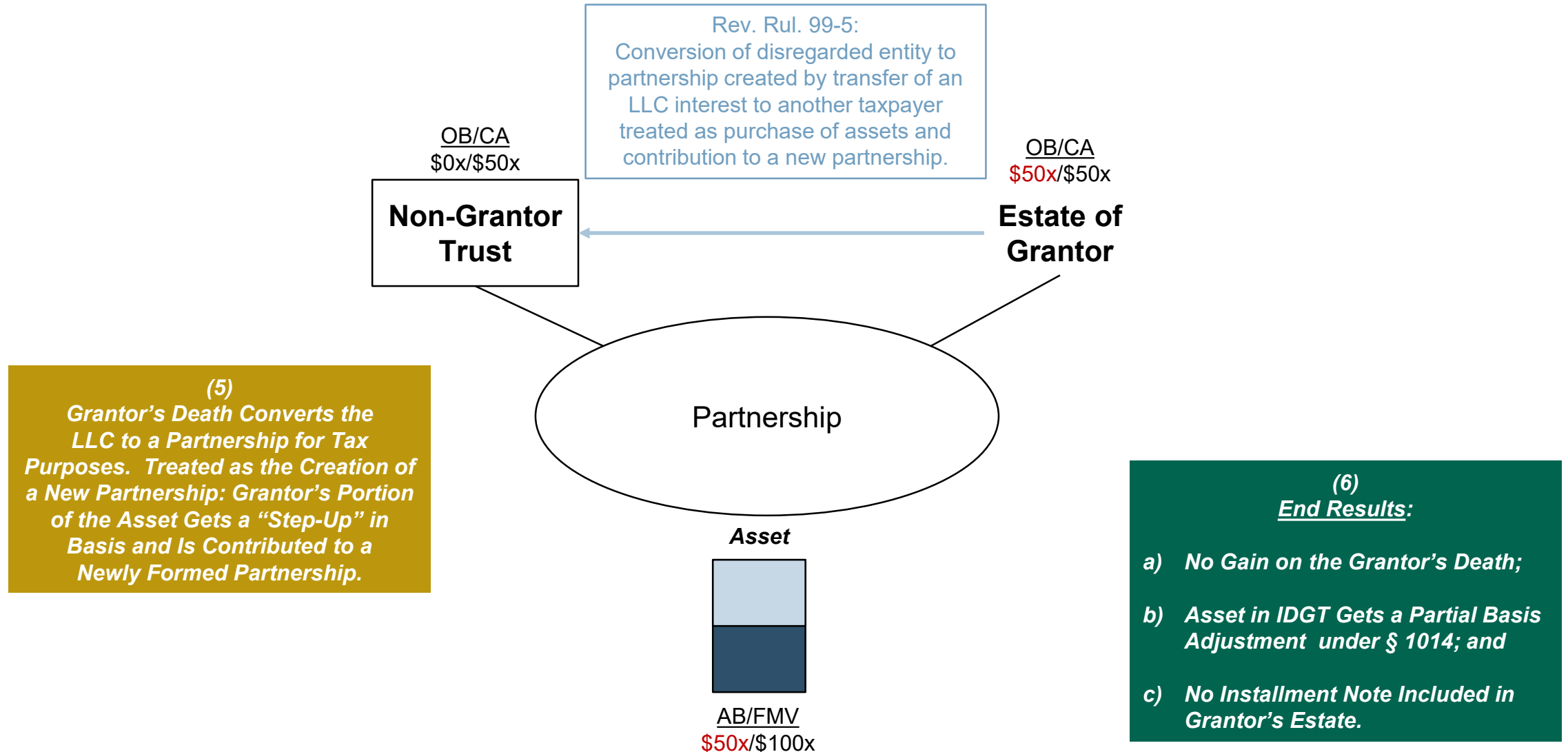
Making the Debt Disappear with a Disregarded Entity



Debt “Merges” and Disappears: Non-Taxable Event



Death of Grantor Converts Disregarded Entity to a Partnership



Non-Grantor to Grantor

CCA 200923024

- Partnership Interest Private Annuity Sale to Non-Grantor Trust
 - § 754 election and inside basis adjustment under § 734 to increase partnership's tax basis in stock of corporation about to IPO
 - IPO occurs and partnership reports no capital gain
- Conversion of Non-Grantor Trust to Grantor
 - Taxpayer claims to "own" all of partnership interest sold in private annuity sale
 - Taxpayer reports no gain or other taxable income attributable to any payments on the private annuity
- IRS Agent
 - Deemed transfer of partnership interest to grantor and taxable exchange
 - Gain to transferee (grantor trust) because debt in excess of basis
 - Cites Rev. Rul. 77-402, § 1.1001-2(c), Ex. 5, and *Madorin*
- IRS Chief Counsel
 - Rejects IRS agent's citations because they only apply to transferors, not transferees

As to the cited authorities, "We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event."

As to transfer upon conversion, "not a transfer for income tax purposes of the property held by the nongrantor trusts to the owner of the grantor trust that requires recognition of gain to the owner."

"Please note that we are not opining on the possible applicability of the step transaction, the economic substance doctrine or other judicial doctrines to the transaction in the present case... Because the case presents an apparent abuse, however, we would like to explore with you further case development that may lead to other arguments to challenge the transaction."

PLR 201730018 (Non-Grantor CLAT to Grantor CLAT)

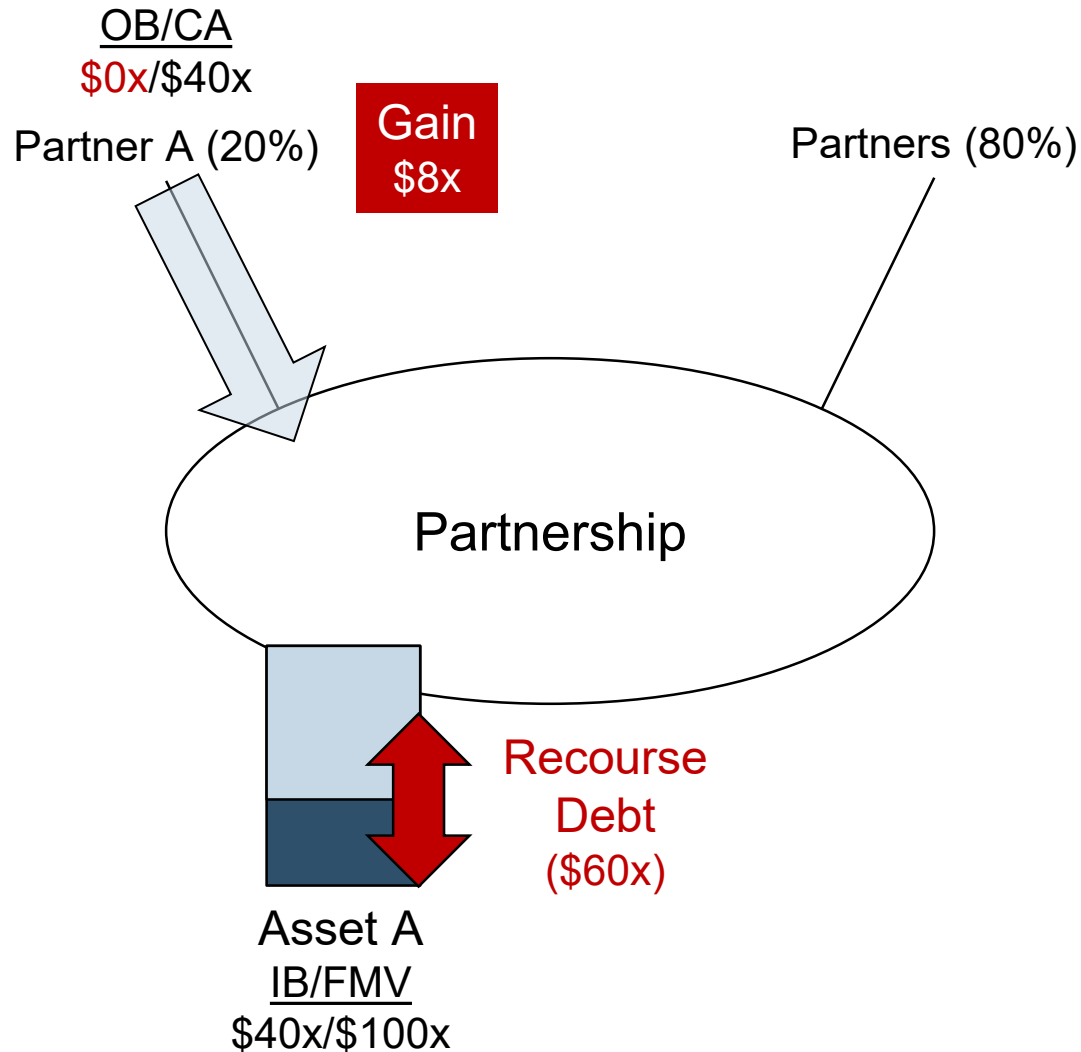
"Given the lack of authority imposing such consequences, we conclude that the conversion of Trust from a non-grantor trust to a grantor trust will not be a transfer of property to Grantor from Trust under any income tax provision."

What can be taken from this ruling?

- No transfer
- Not a transfer that is a taxable event

Partnerships: Opportunities, Misconceptions, and Quirks

Debt in Excess of Basis Is Often Not a Problem with Partnerships



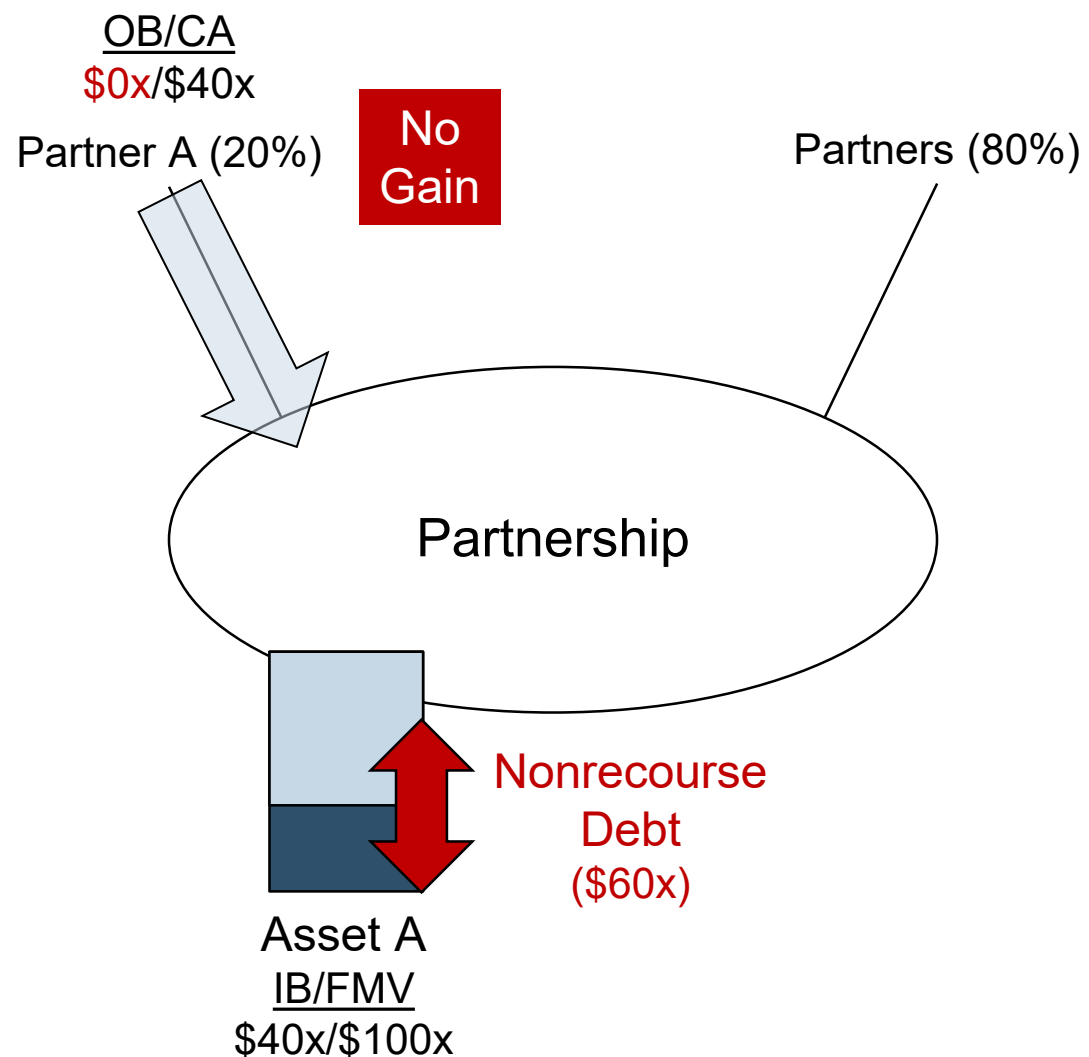
"Contributions of property between a partner and a partnership are not sales or other dispositions." Treas. Reg. § 1001-2(a)(4)(iv).

Initial Outside Basis of A	\$40x
Reduced by Debt Reduction (80% of -\$60x) (Deemed Distribution)	(\$48x)
Resulting Outside Basis	\$0x
Gain	\$8x

Relatively Rare, Occurs When:
Low basis property,
Highly mortgaged property, and
Small % interest in the partnership

Gain can also be avoided if Partner A agrees to remain responsible for some or all the debt (recourse as to Partner A)

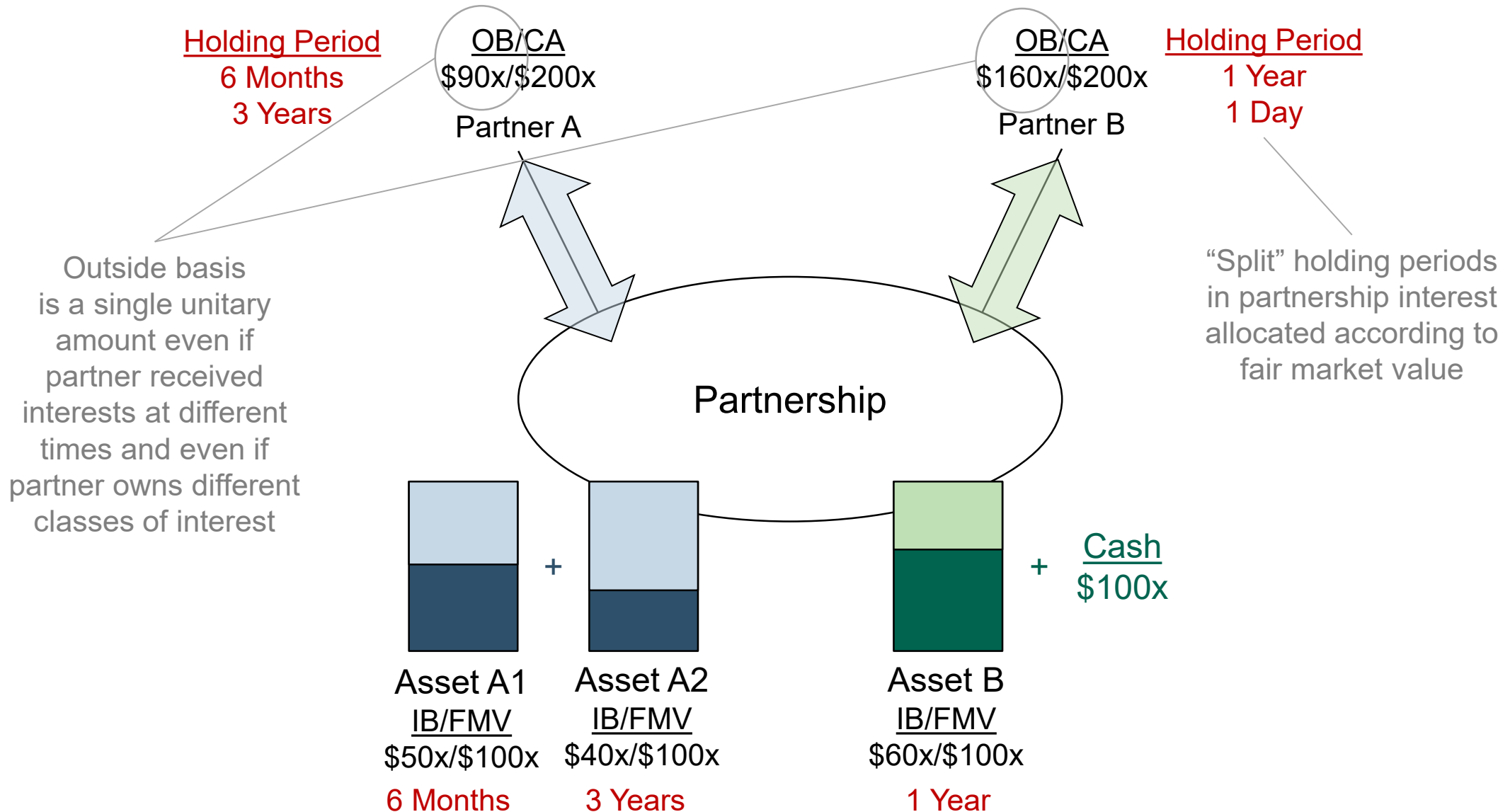
Nonrecourse Debt Is Never a Problem on Contribution



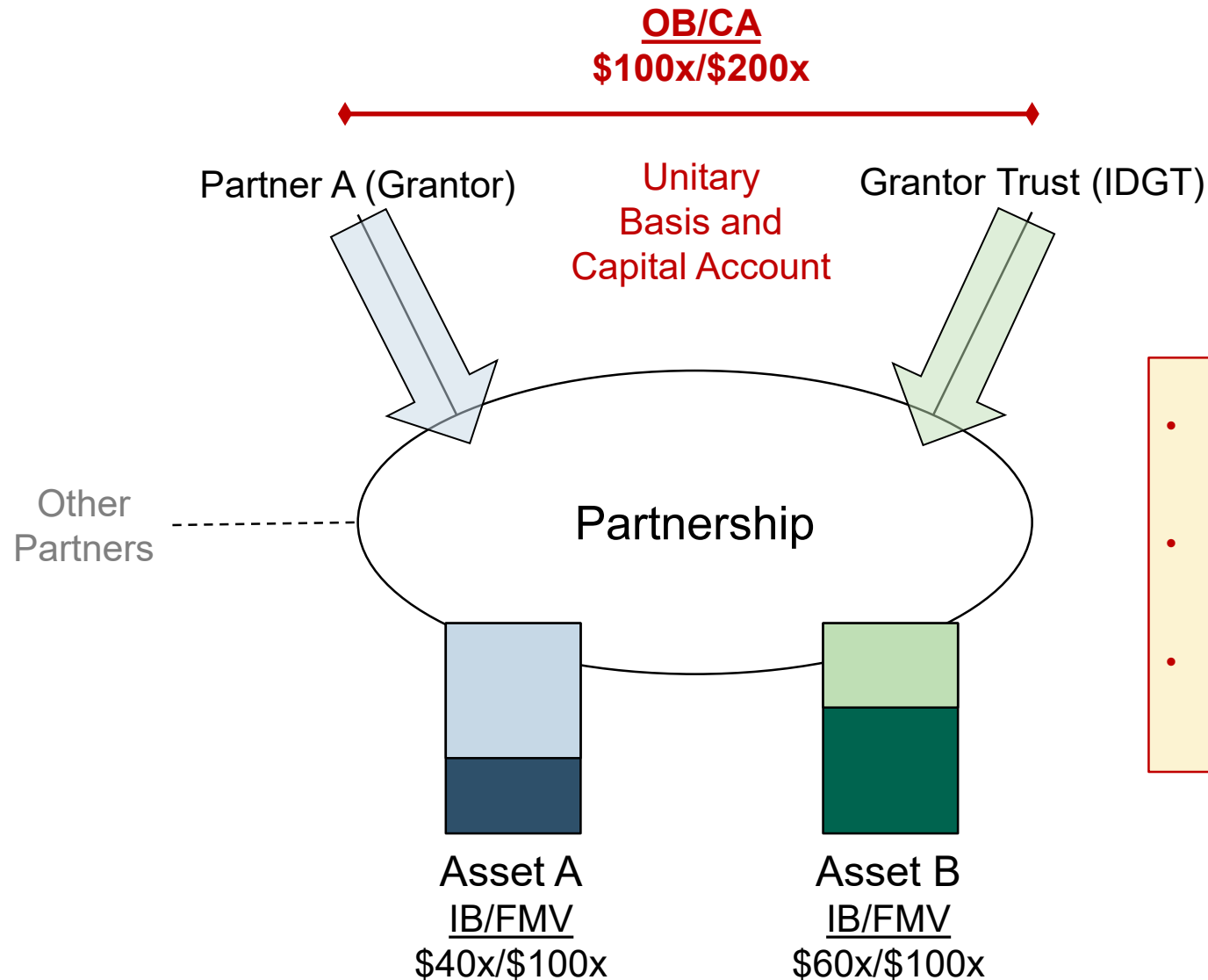
A is allocated share of nonrecourse debt to the extent of debt in excess of basis.

Initial Outside Basis of A		\$40x
A's share of nonrecourse debt due to § 704(c) minimum gain ("Second Tier Allocation") (\$60x debt - \$40x basis)		\$20x
Residual allocation of nonrecourse debt to A ("Third Tier Allocation") (20% of -\$40x of remaining debt)		\$8x
Net reduction of A's share of liabilities (\$60x - \$28x) (Deemed Distribution)		(\$32x)
Resulting Outside Basis		\$8x

Unitary Basis Rule and Split Holding Periods



Unitary Basis Rule Applies to Grantors and Grantor Trusts



Why is outside basis important?

- Determines amount of money that can be distributed without gain
- Partnership losses are allowable only to the extent of outside basis
- Determines amount of gain or loss recognized on a taxable sale of partnership interest

The Unitary Basis Rule: Quirks, Opportunities, and Questions

■ Distributions

- Liquidating distributions can result in (i) gain or **loss**, and (ii) an **increase** or decrease in the basis of distributed property
- Current distributions can only result in gain and a decrease in the basis of distributed property
- When grantor and IDGT are partners, a full redemption of one of the partners is not a liquidating distribution (possibly preventing recognition of loss or to increase the basis of distributed assets)
- If loss is suspended, turning off grantor trust status will allow recognition of the loss only if the conversion is treated as a sale or exchange (i.e., debt in excess of basis or reduction of partner's liabilities under § 752(b) but beware of related party rules)
- Disproportionate distributions of cash to IDGT will decrease outside basis of grantor's partnership for "step-up" in basis purposes

■ Contributions

- Contributions of cash or property by a grantor or grantor trust will result in increases to the unitary basis for the benefit of the non-contributing partner

■ Partnership Liabilities

- Grantor and grantor trust have one unitary liability allocation
- Redemption of a partner's interest could reduce that partner's partnership liabilities, but the combined basis of the other partner could completely offset the deemed § 752(b) distribution

■ Conversion to Grantor Trust

- Conversion from non-grantor to grantor trust would allow grantor and IDGT to share basis
- The combined basis might allow one of the partners (i) to receive tax free distributions, (ii) have a reduction of partnership liabilities without causing gain, and (iii) deduct partnership losses that otherwise would be suspended because of lack of basis

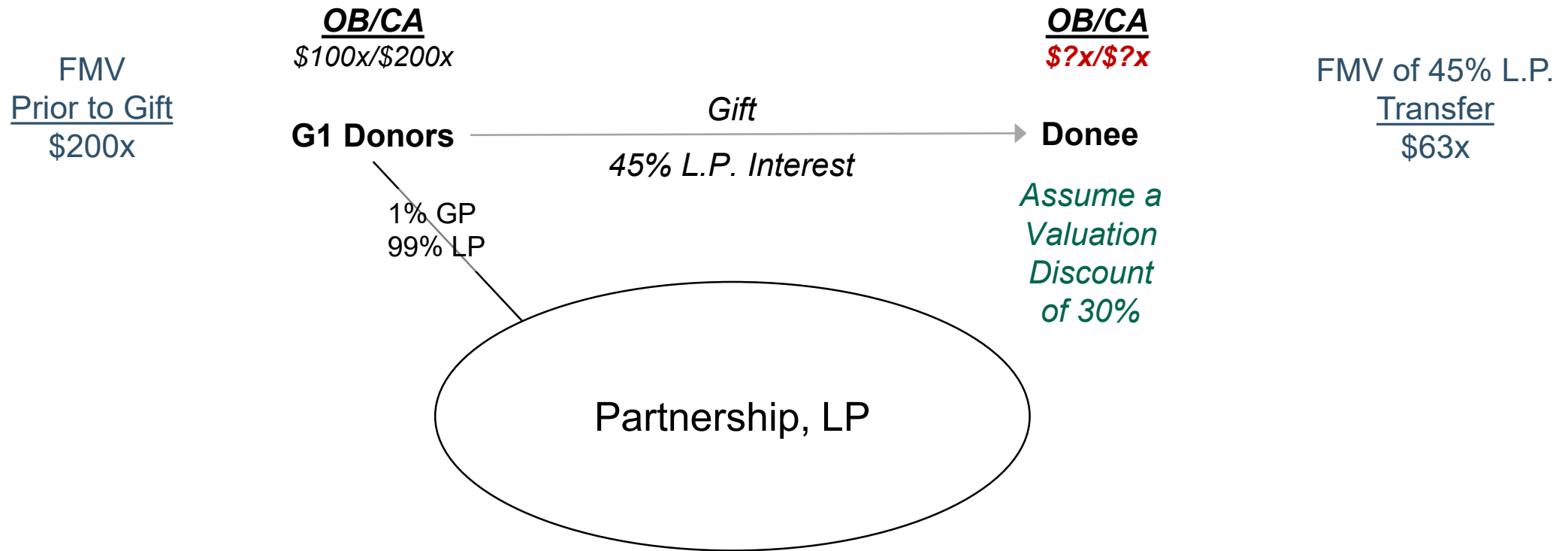
■ Conversion to Non-Grantor Trust

- Deemed transfer of partnership interest from grantor to non-grantor trust
- Requires allocation of outside basis between grantor and the trust

■ Grantor Trust Status

- Unclear whether grantor trust as to the entire trust (income and corpus) is required for unitary basis rule to apply
- Unclear whether under § 678, power to vest all income and corpus is required for unitary basis rule to apply

Transferring Basis and Capital Account



Calculating Capital Account & Basis of Transferred Interest

CAPITAL ACCOUNT OF TRANSFERRED INTEREST

Upon a transfer of all or a part of a partnership interest, the transferor's capital account "that is attributable to the transferred interest carries over to the transferee partner." Treas. Reg. § 1.704-1(b)(2)(iv)(I). See Treas. Reg. § 1.704-1(b)(5), Ex. 13.

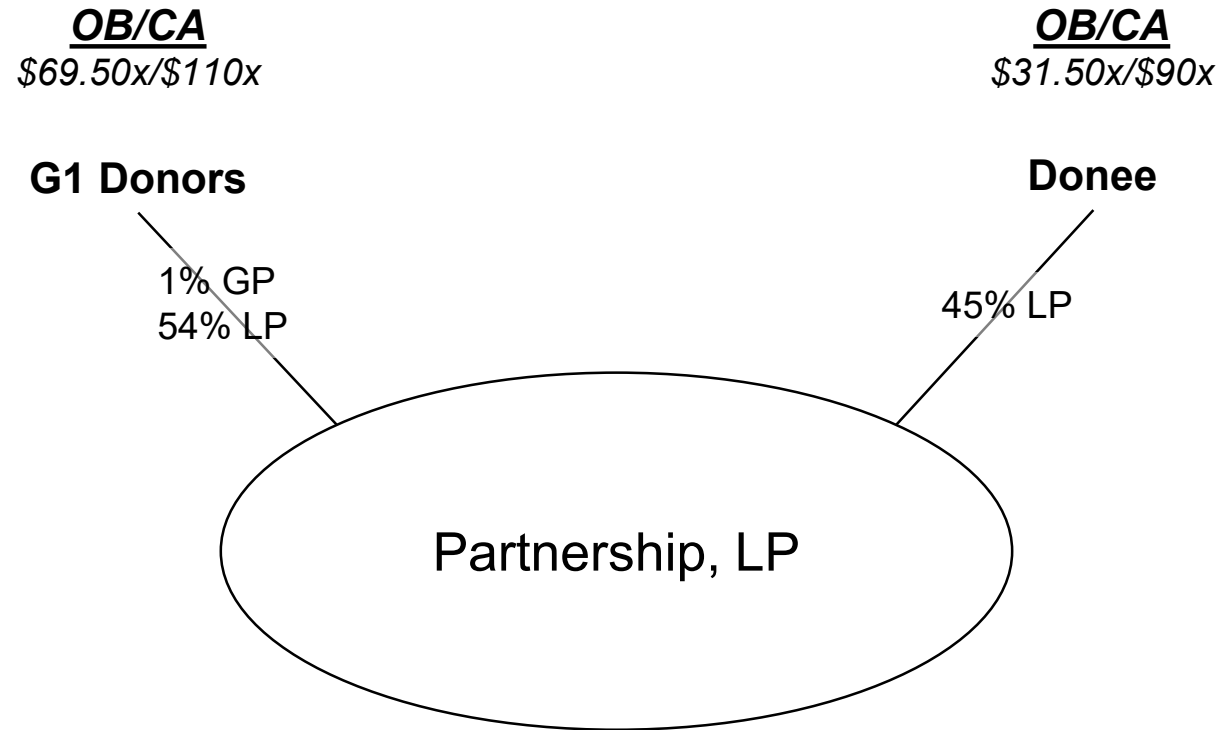
$$\begin{array}{ccccc} \text{Transferor's} & & \text{Percentage} & & \text{Transferee's} \\ \text{Capital Account} & & \text{Transferred} & & \text{Capital Account} \\ \$200x & \times & 45\% & = & \$90x \end{array}$$

ADJUSTED BASIS OF TRANSFERRED INTEREST

"[T]he basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest." Rev. Rul. 84-53, 1984-1 C.B. 159.

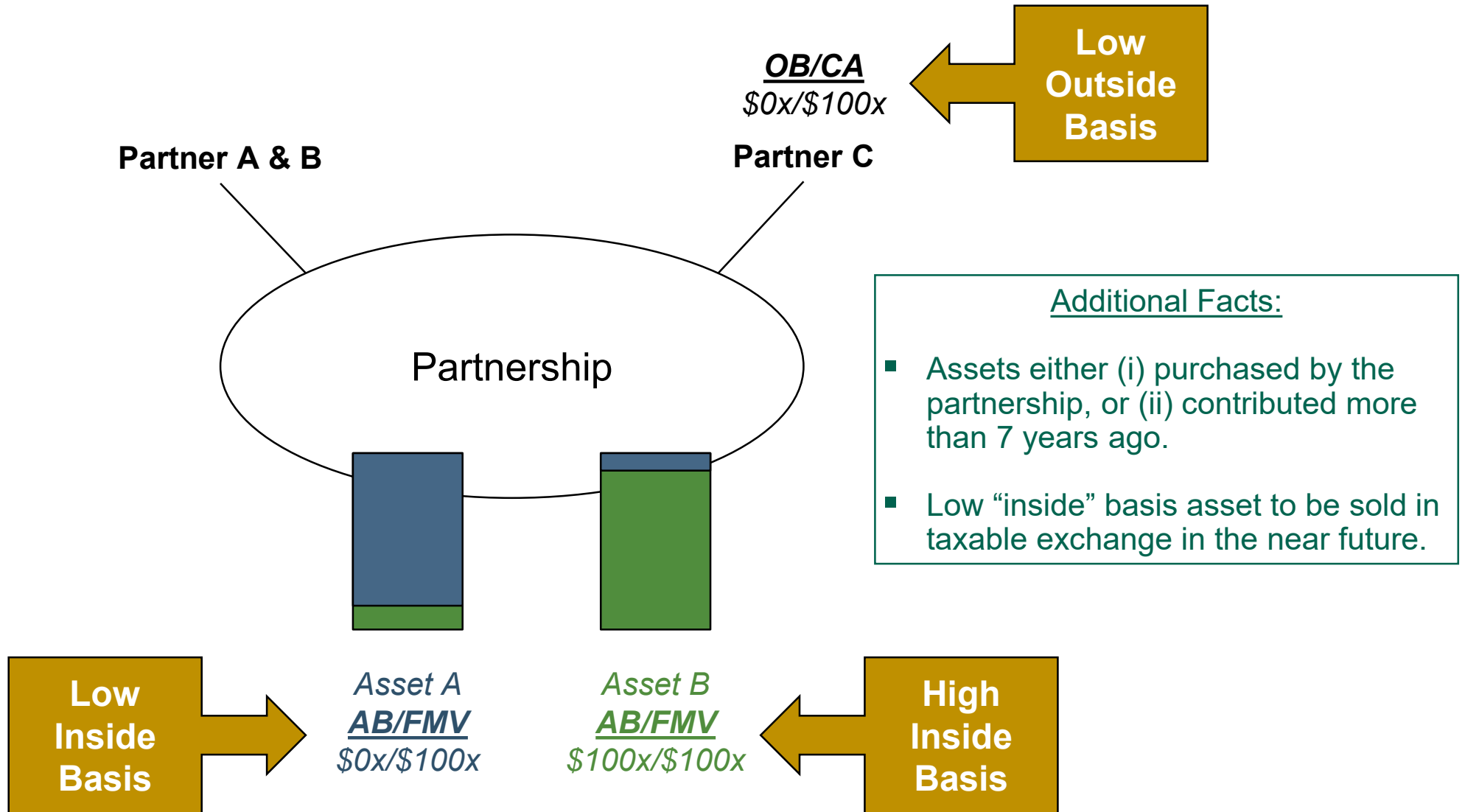
$$\begin{array}{ccccc} & & \text{Fair Market Value (Discounted)} & & \\ & & \text{Transferred Portion} & & \\ & & \$63x & & \\ \text{Transferor's} & & & & \text{Transferee's} \\ \text{Adjusted Basis} & \times & \frac{\text{Fair Market Value}}{\text{Transferor's Entire Portion}} & = & \text{Adjusted Basis} \\ \$100x & & \$200x & & \$31.50x \end{array}$$

Less Outside Basis Is Transferred

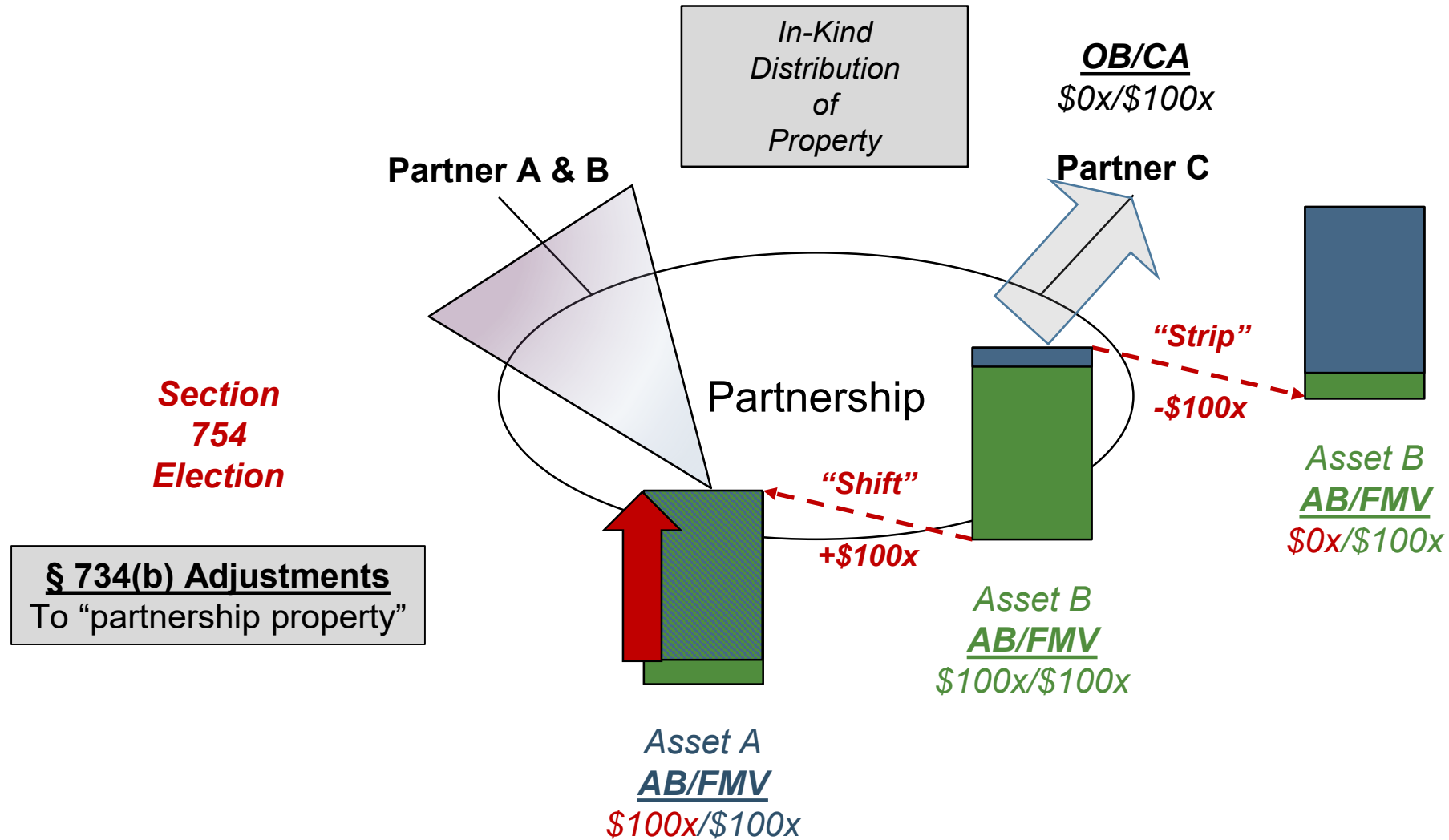


If the fair market value of donor's entire interest prior to the gift included the same valuation discount as the gifted interests, then 45% of the total outside basis would be transferred to the donee.

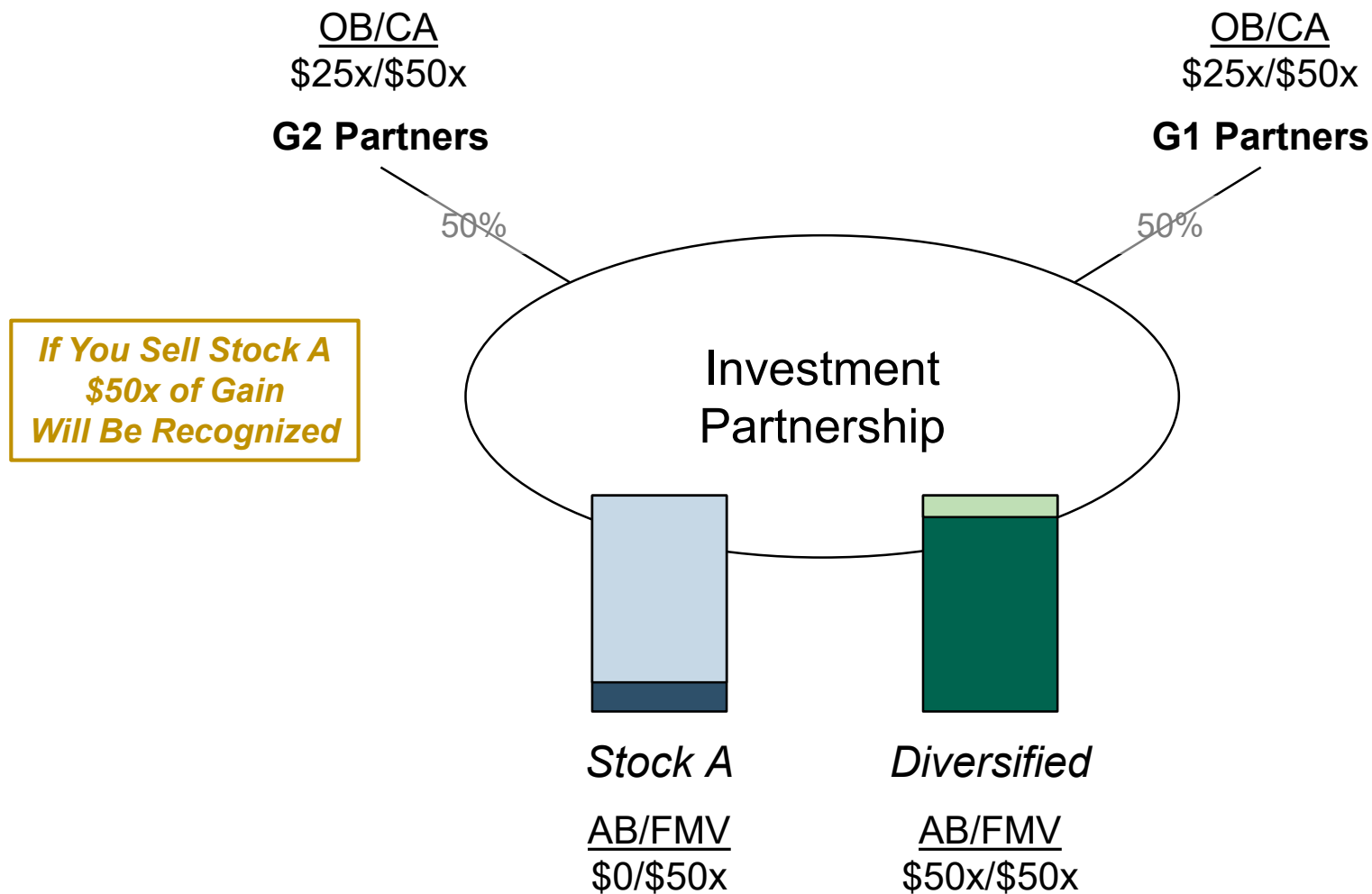
Basis Shifting: The Basic Elements



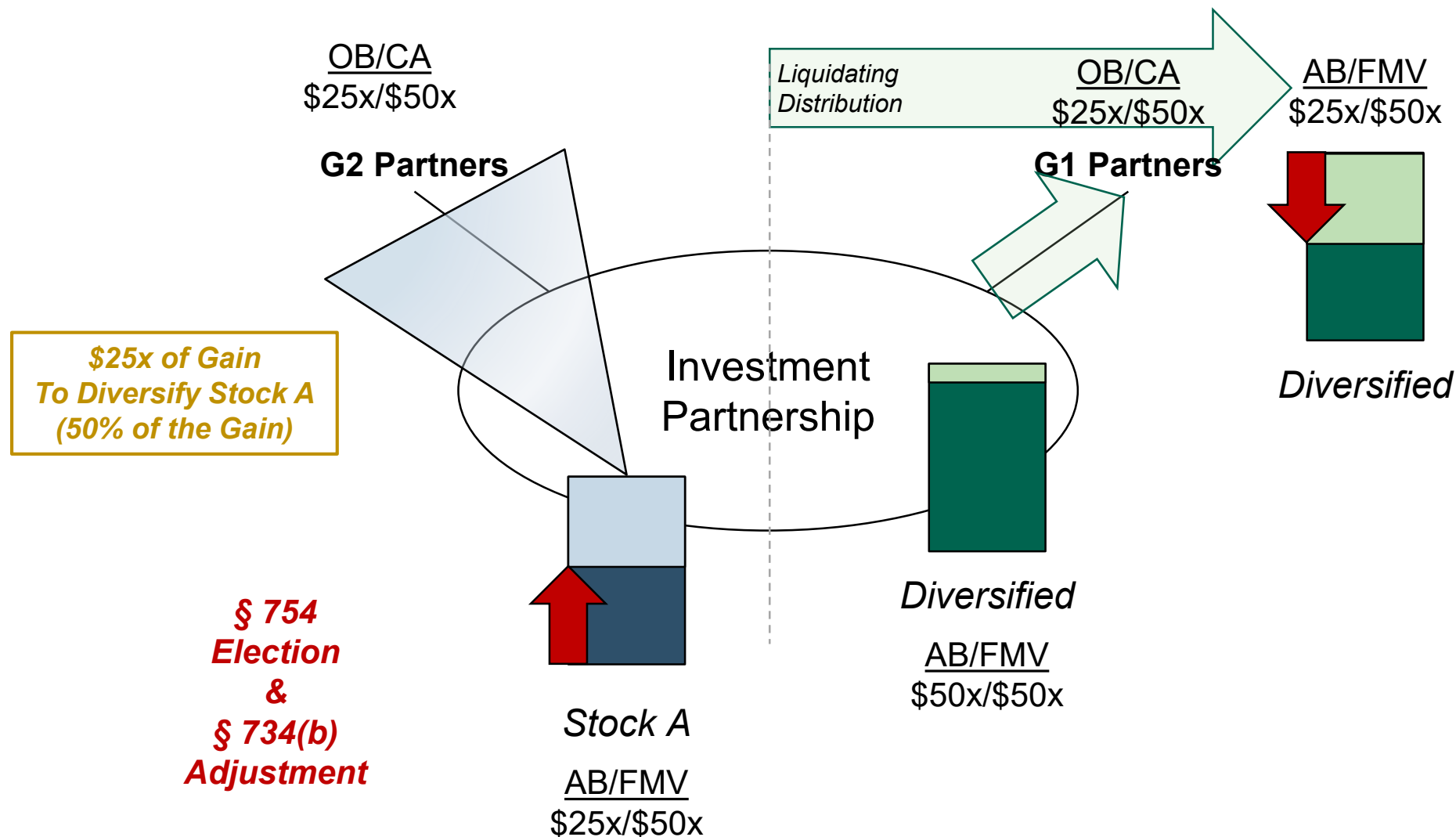
“Strip” Basis with Distribution of Property & “Shift” with Election



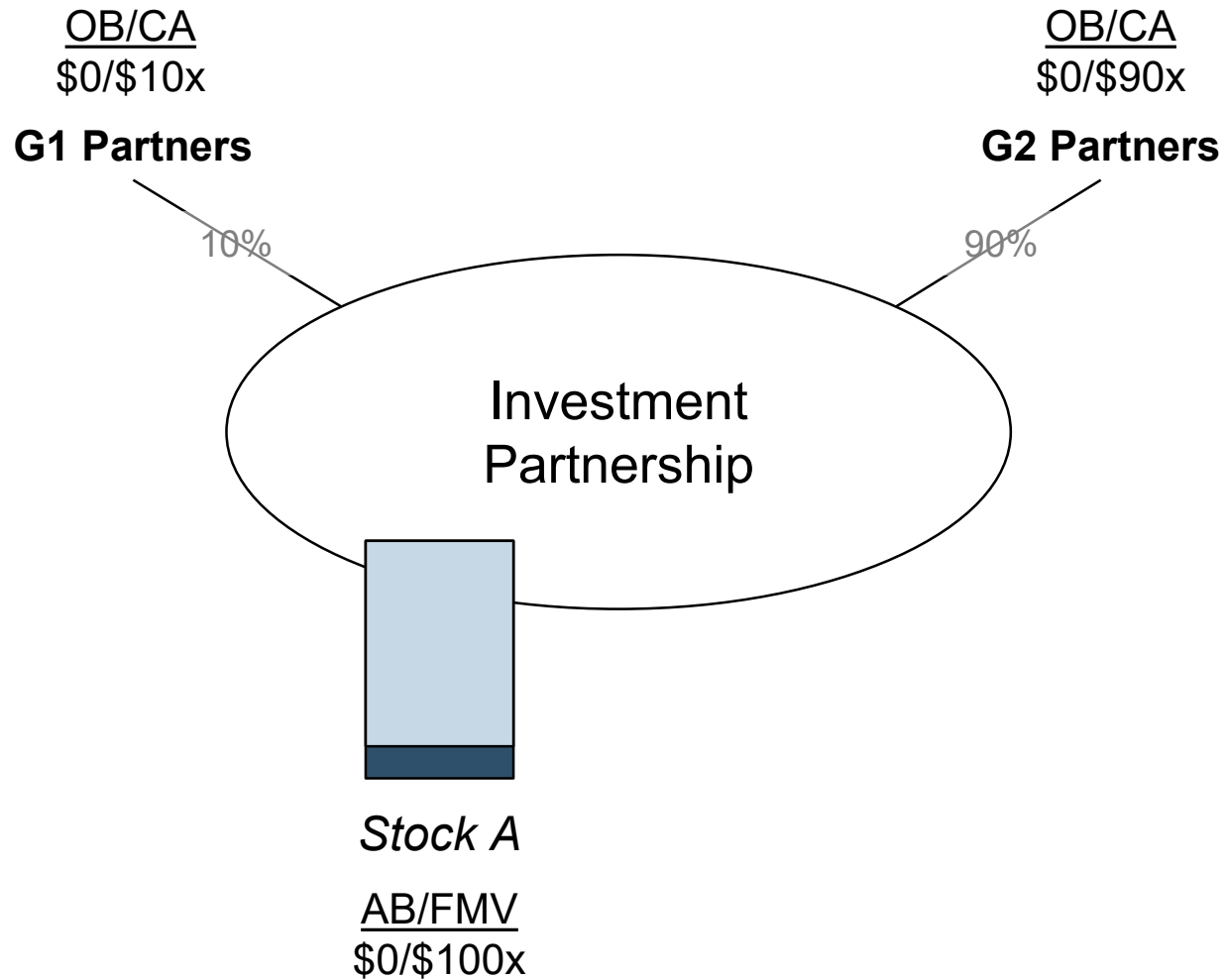
Simple Basis Shift with Appreciated Stock & Diversified Portfolio



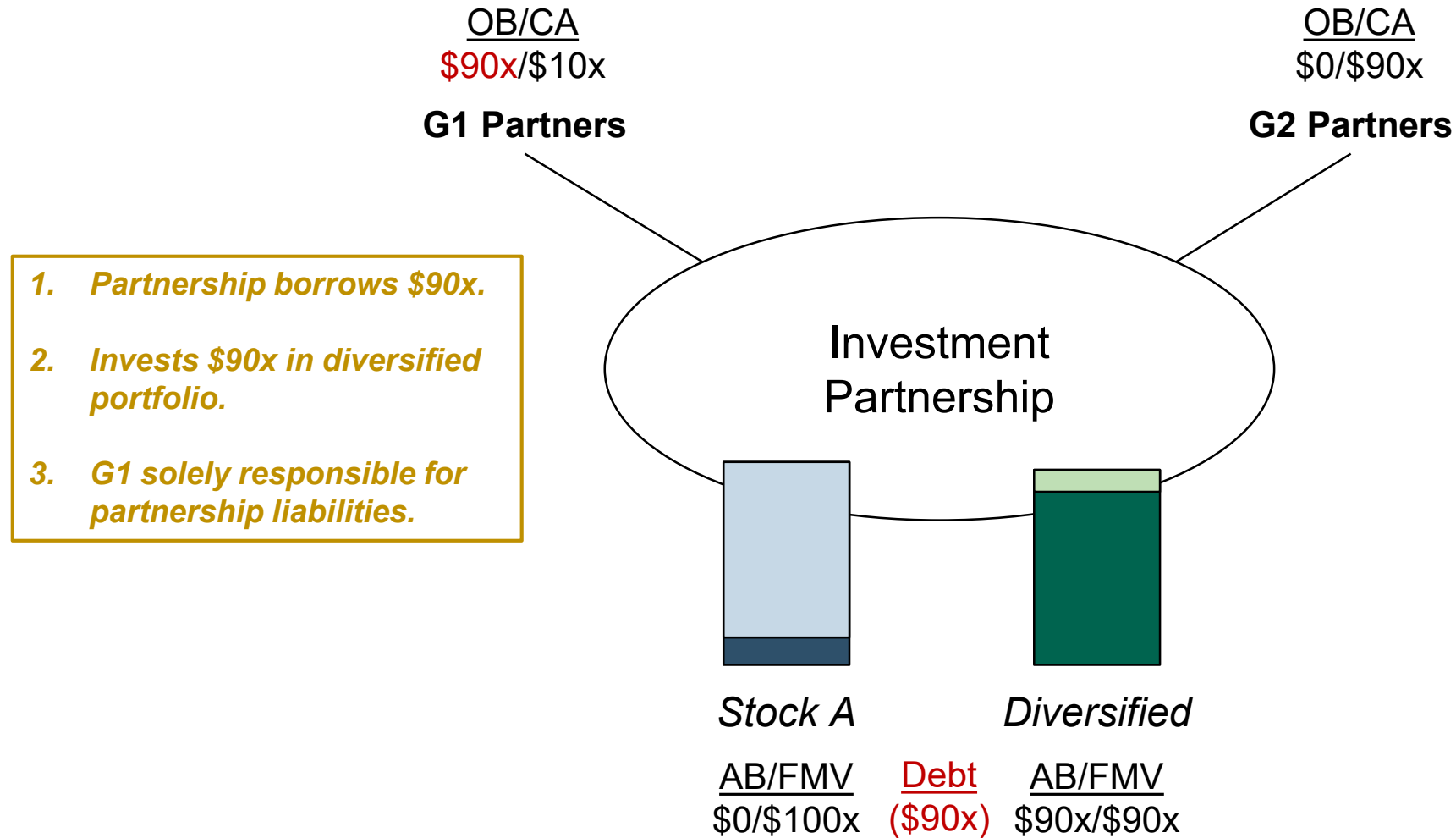
Simple Basis Shift with Appreciated Stock & Diversified Portfolio



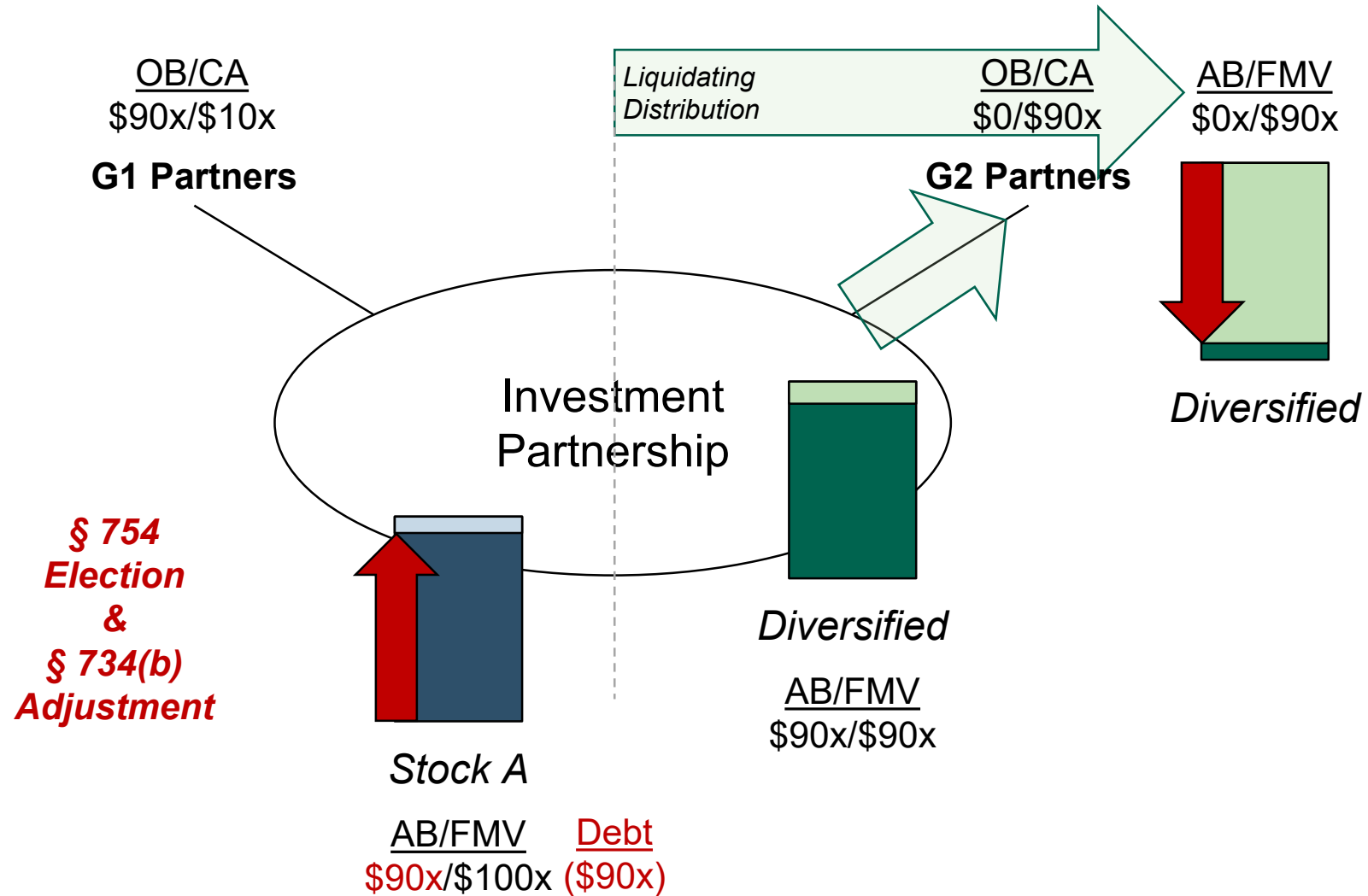
Debt to Exchange Concentrated for Diversified Position



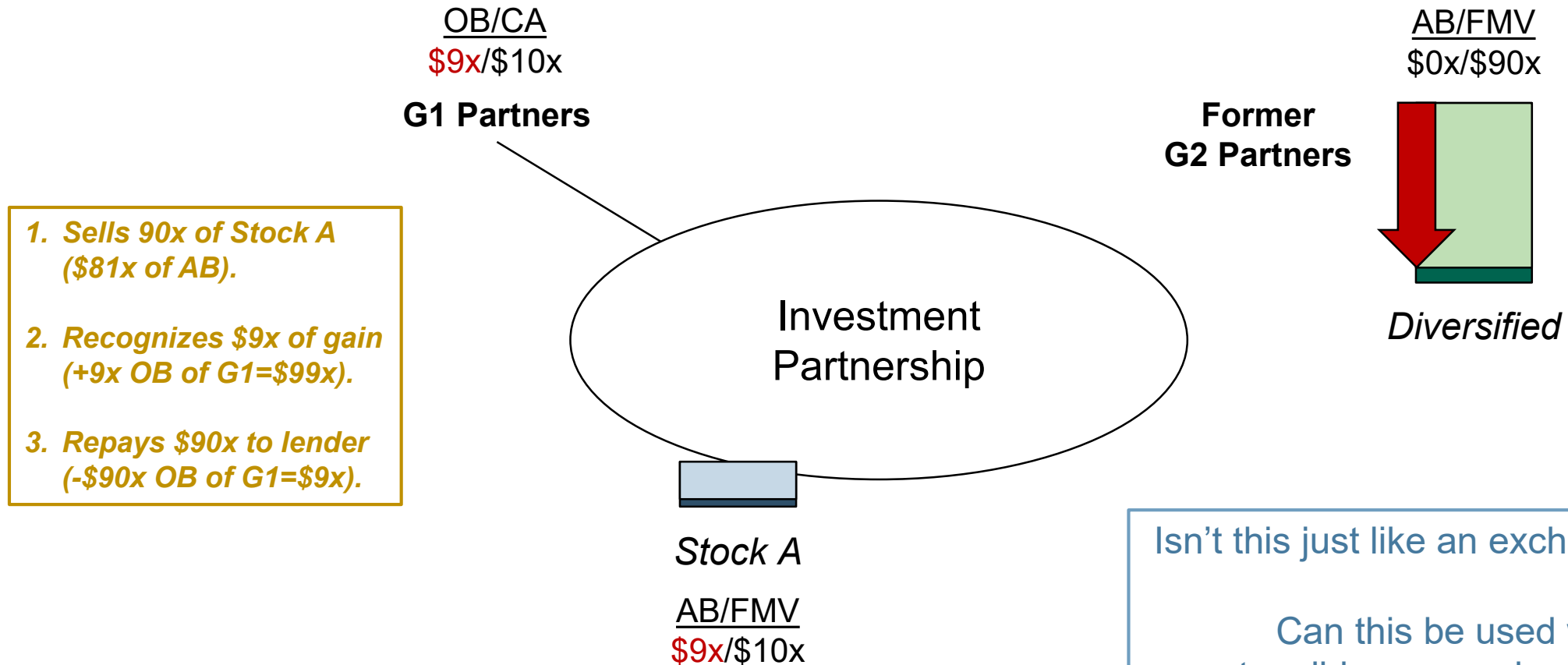
Debt to Exchange Concentrated for Diversified Position



Debt to Exchange Concentrated for Diversified Position



Debt to Exchange Concentrated for Diversified Position

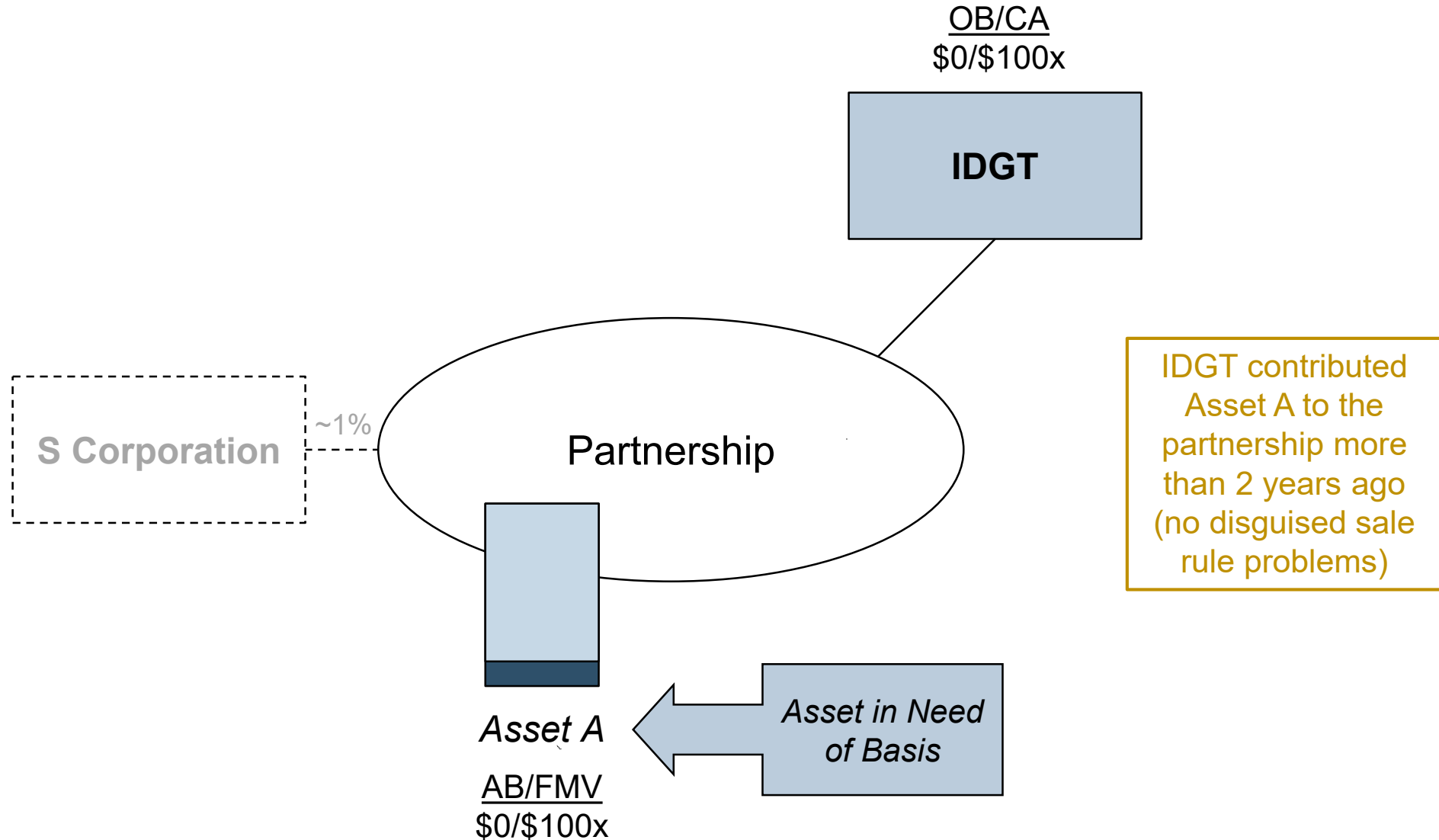


1. Sells 90x of Stock A (\$81x of AB).
2. Recognizes \$9x of gain (+9x OB of G1=\$99x).
3. Repays \$90x to lender (-\$90x OB of G1=\$9x).

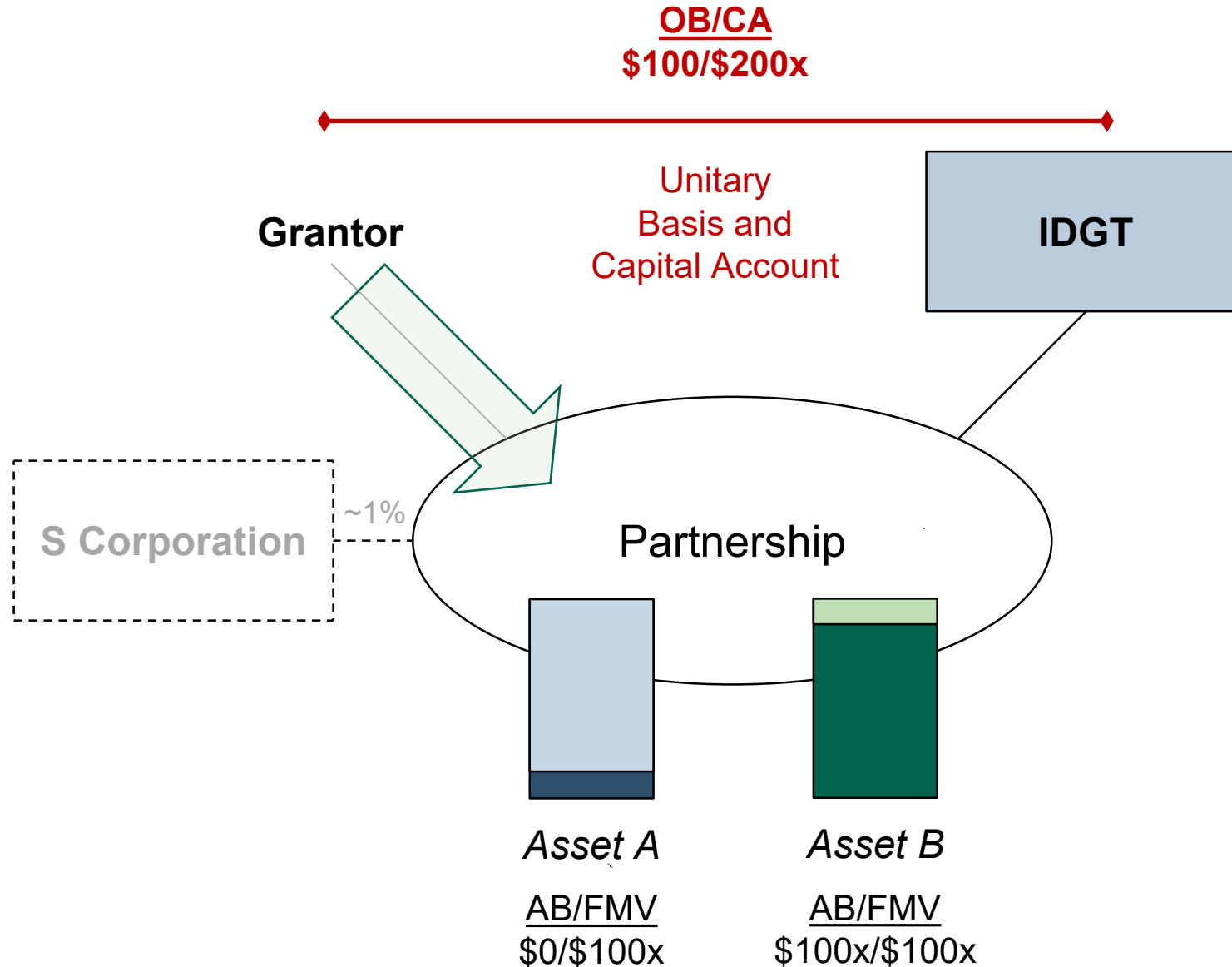
Isn't this just like an exchange fund?

Can this be used with tangible personal property in lieu of a "like-kind" exchange?

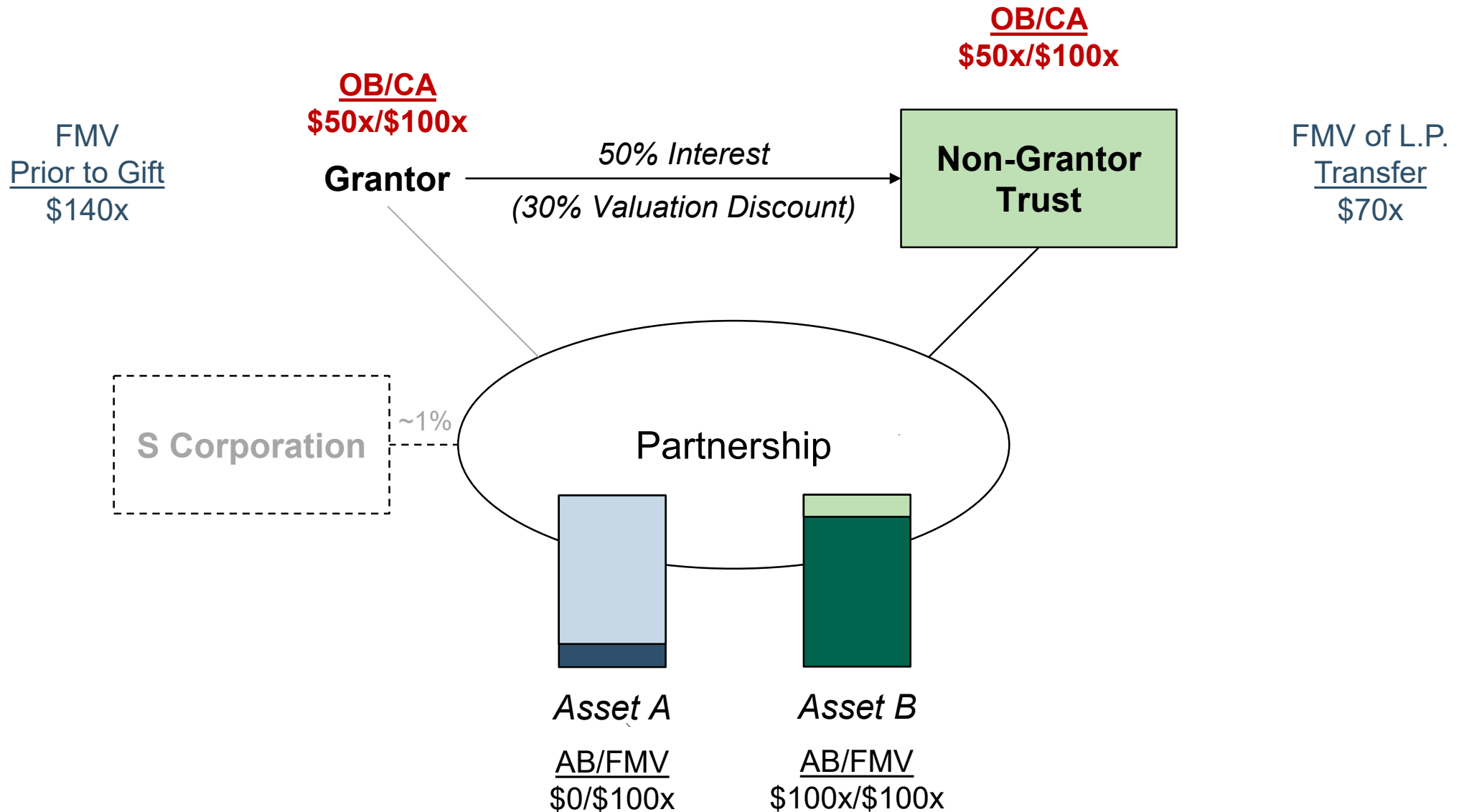
Shifting with Grantors, Grantor Trusts, and Partnerships



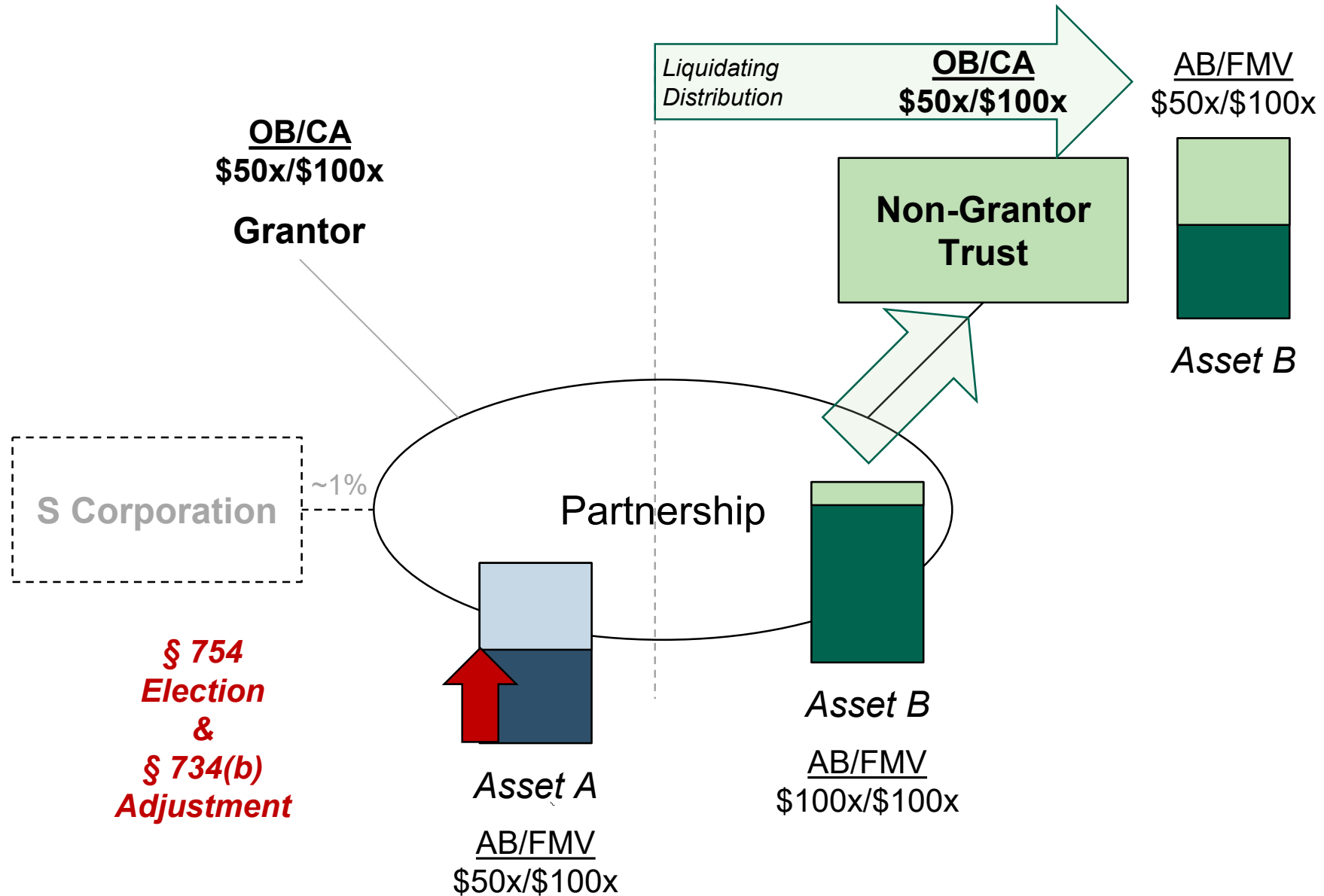
Contribution and Unitary Basis Rule: Sharing of Outside Basis



Conversion to Non-Grantor & Deemed Transfer: Basis Is Divided

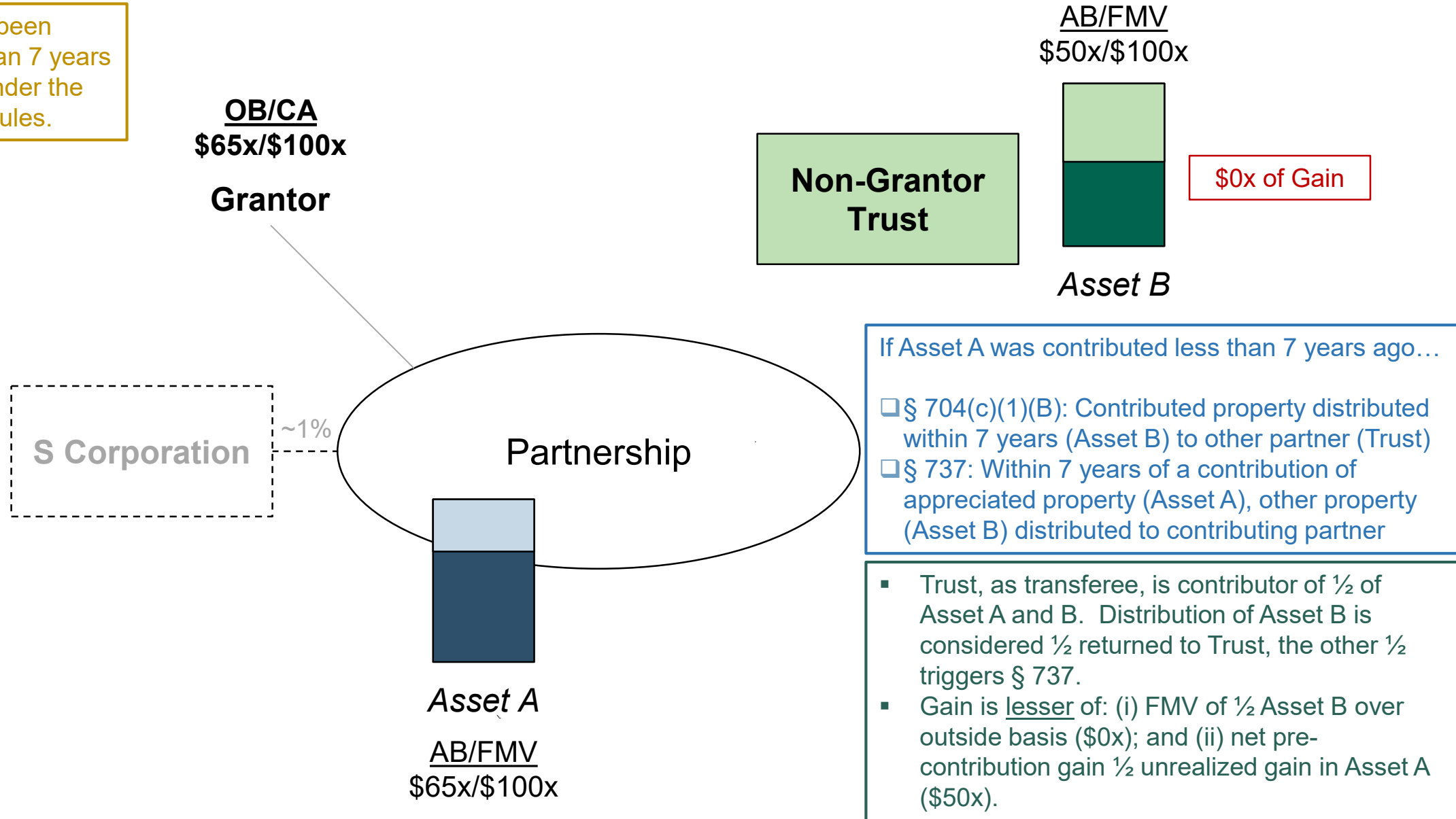


“Strip” and “Shift” of Basis



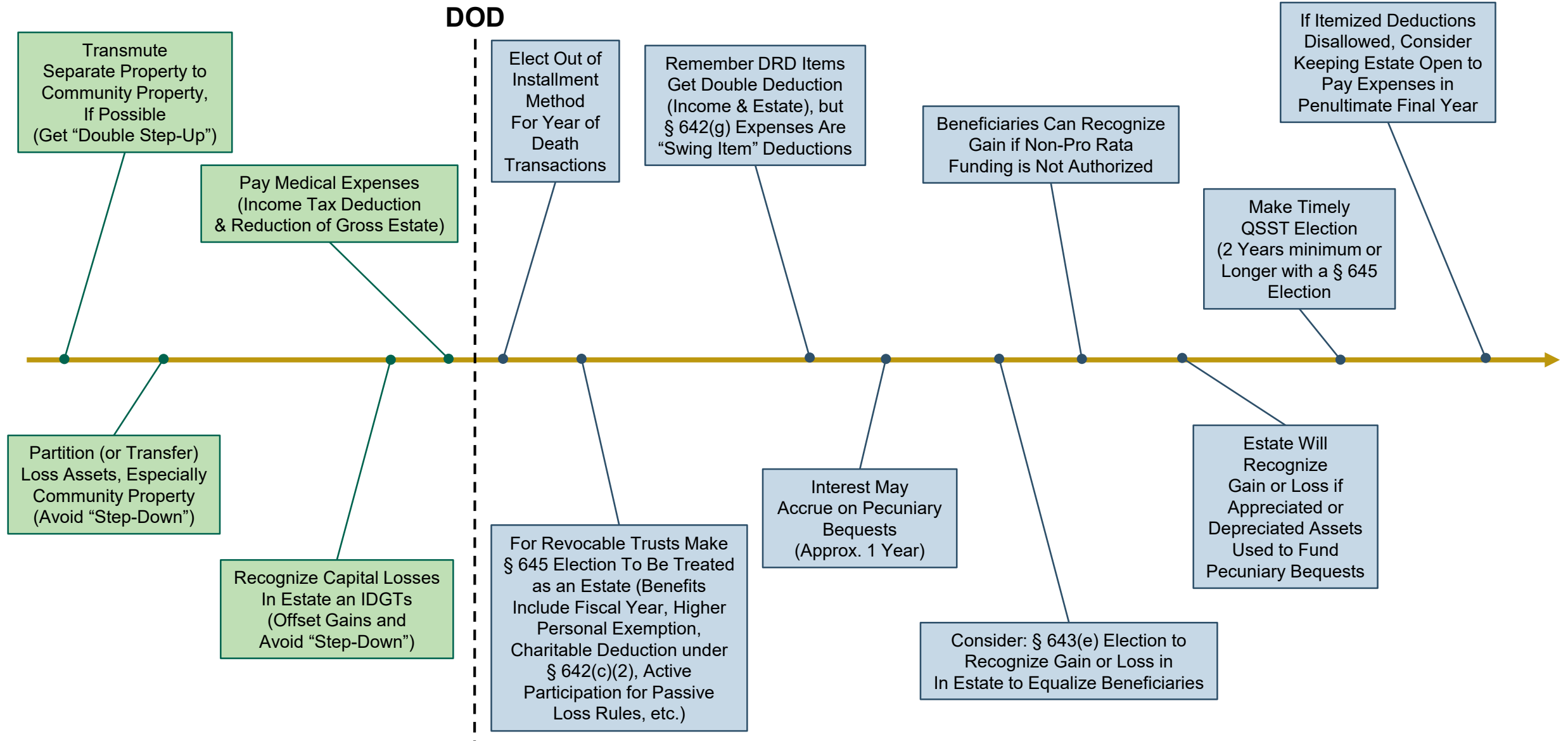
Possible “Mixing Bowl” Issues

If Asset A had been contributed more than 7 years earlier, no gain under the “mixing bowl” rules.



Pre- and Post-Mortem Income Tax Opportunities and Pitfalls

Pre- and Post-Mortem Pitfalls and Planning Opportunities.



“Pseudo Grantor Trusts”
Under Section 678
(BDOTs and BDITs)

Sort of Like a “Grantor Trust”... 2 Rulings, 2 Different Results?

GRANTOR TRUST CONSIDERATIONS

- *Rothstein* and Rev. Rul. 85-13
- Portion Rules
 - Income and corpus of all assets
 - Income or corpus
 - Income and corpus on less than all

CREATING “PSEUDO GRANTOR TRUST” STATUS

- § 678(a)(1): Power to vest income or corpus (BDOT)
- § 678(a)(2): Released power with retained powers under §§ 671-677 (BDIT)
- § 678(b): Provided original grantor is not considered owner under §§ 671-677

PLR 201633021

- Trust 1
 - Grantor deceased
 - F/B/O children, spouse, and issue
 - Trustee proposes to transfer assets to Trust 2
- Trust 2
 - F/B/O children, spouse, and issue
 - Trust 1 retains sole power to revest net income of Trust 2
 - Lapses on the last day of the calendar year
 - “Net income” includes income under § 643(b) & capital gain

Trust 1 will be treated as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a). Accordingly, Trust 1 will take into account in computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to which enter into the computation of distributable net income. Additionally, Trust 1 will also take into account the net capital gains of Trust 2.

PLR 202022002

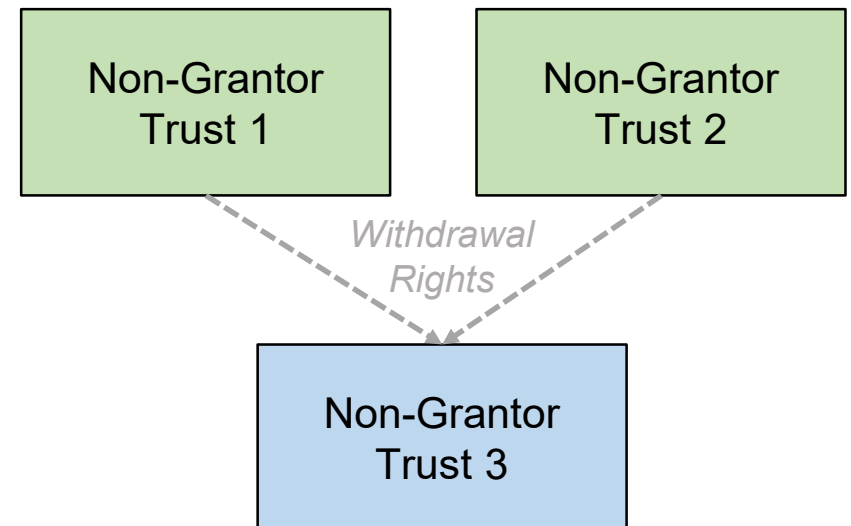
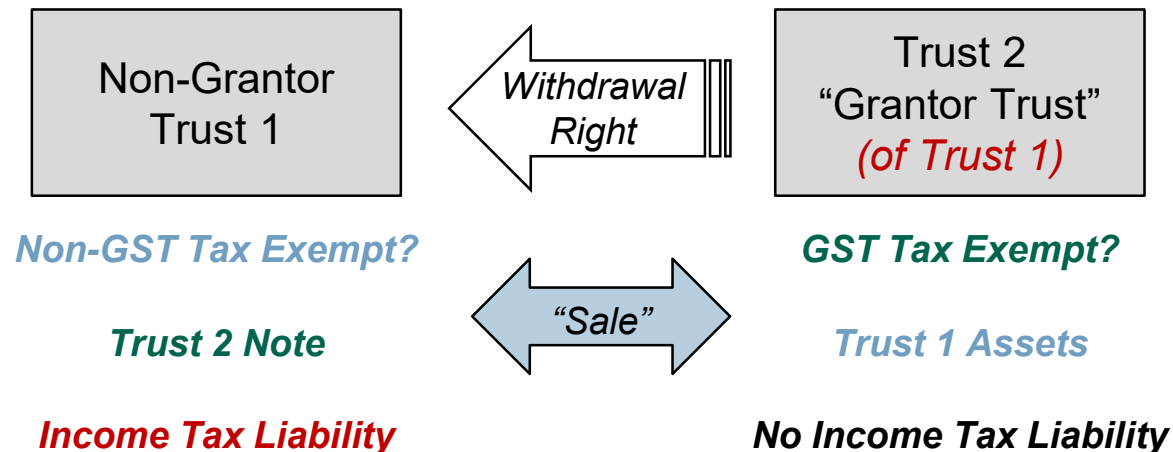
- Trust 1
 - Prohibited distribution of “Shares” (family company)
 - Contributed Shares to LLC
 - LLC interests transferred to Subtrust F/B/O beneficiary A
 - A exercised withdrawal right of all assets of Subtrust (other than LLC interests, which may not be distributed)
 - Subtrust agrees to sell LLC interests to Trust 2 for cash and promissory note
 - A has withdrawal right over cash and promissory note in Subtrust
- Trust 2
 - Grantor trust of A

[B]ecause A has a power exercisable by herself to vest the proceeds of Subtrust’s LLC interest in herself and that those proceeds are Subtrust’s only asset, A will be treated as the owner of Subtrust under § 678. Consequently, the transfer of the LLC interests to Trust 2 is not recognized as a sale for federal income tax purposes because Trust 2 and Subtrust are both wholly owned by A.

Planning Implications?

POSSIBLE PLANNING IMPLICATIONS

- Beneficiary (or another non-grantor trust) will be considered the taxpayer for purposes of reporting all of the trust's tax items (income shifting)
 - Income from intangible assets will be sourced for state income tax purposes with the residence of the beneficiary (or other trust)
- Beneficiary (or another non-grantor trust) may be able to sell or swap assets with the trust without any federal income tax consequences (income tax ownership)
 - Right to withdraw income (and capital gain) may not be considered a "grantor trust" as to the entire trust
 - Right to withdraw all of the corpus and income may be required to be considered a "grantor trust" as to the entire trust
- Consideration should be given to whether the right to withdraw lapses or remains open indefinitely
- Three trust structure (one trust may withdraw all corpus and income of two other trusts) may be preferable
- Partnership unitary basis rule may apply to trust and beneficiary (or another trust)

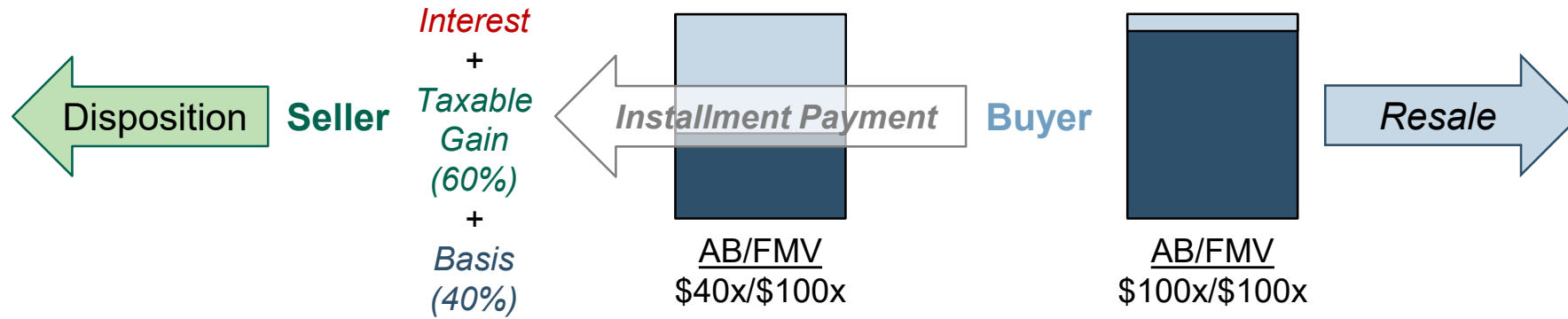


Installment Obligations and Promissory Notes

Comparing Installment Obligations and Promissory Notes

	Taxable Installment Obligation	IDGT Installment Note	Intra-Family Promissory Note
Treatment of Death of Holder	Income in Respect of a Decedent (No § 1014 Basis Adjustment)	Capital Asset (§ 1014 Basis Adjustment)	Capital Asset (§ 1014 Basis Adjustment)
Tax Basis of Note	Initially equal to the basis of asset and adjusted for remaining unrealized gain and unreturned basis	Likely Initially equal to basis of asset sold to IDGT, possibly adjusted for remaining unrealized gain due to payments, and the basis of swapped assets	Likely Zero (Less likely equal to obligation amount)
Treatment of Gift Transfer of the Note	Taxable disposition. Recognize gain equal to difference between the basis and the fair market value of the installment obligation.	Likely Not a taxable disposition with carryover basis.	Not a taxable disposition with carryover basis.

Taxable Installment Obligations & Notes



■ Death of Seller

- Installment note is IRD
- Estate distribution of note to the obligor is a taxable disposition

■ Taxable Dispositions

- Sale or exchange
- Gift, contribution to trust, and distribution to beneficiary

■ Not a Taxable Disposition

- Transfers between grantor and grantor trust
- Transfer to former spouse incident to divorce
- § 721 contributions and § 731 distributions (partnerships)
- § 351 contributions and § 361 distributions (corporations)

■ Taxation

- Gross profit percentage (profit divided by total contract price) determines gain
- Minimum interest at AFR
- Installment method by default (may elect out by due date of income tax return)
- Can have variable principal payments or interest only
- Only applies to gain, not loss

■ Installment Method Not Allowed

- Dealer Dispositions
- Inventory Sales
- Marketable Securities
- Depreciable Property Sales to Related Persons
- Portion of Gain Attributable to Recapture

■ Resales by Related Party

- Second disposition within 2 years of the first disposition
- Amount realized on second disposition treated as payment to original seller

■ Tolling of 2-Year Period

- Related party's risk of loss is substantially diminished
- Put, short, right to acquire, or other transaction

■ Second Disposition

- Sale, exchange, **gift**, or cancellation of installment obligation
- Does NOT include any transfer after earlier of death of original seller or related party

Related Party Rules

Related Party Rules and Transactions

§ 267:

Disallowance of Losses Between Related Parties

§ 707(b):

Disallowance of Loss on Sales with Controlled Partnerships

§ 108:

Cancellation of Debt and Related Party Acquisitions

§ 1031(f):

Related Party Resales with Installment Sales

§ 1239:

Conversion of Gain to Ordinary Income

(Property Subject to Depreciation in Hands of Related Transferee)

CONSTRUCTIVE OWNERSHIP

- Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its owners or beneficiaries;
- An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family; and
- An individual owning (but not including any stock owned directly or indirectly by or for his family) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner.

RELATED PARTY DEFINED

- Family: brothers and sisters (including half siblings), spouse, ancestors, and lineal descendants;
- An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
- Two corporations which are members of the same controlled group (more than 50 percent);
- A grantor and a fiduciary of any trust;
- A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
- A fiduciary of a trust and a beneficiary of such trust;
- A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
- A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
- A person and a tax-exempt organization which is controlled directly or indirectly by such person or by members of the family of such individual;
- A corporation and a partnership if the same person owns more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interest, or the profits interest, in the partnership;
- An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;
- An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; and
- An executor of an estate and a beneficiary of such estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.