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Section Six

THE SECURE ("SETTING EVERY COMMUNITY UP FOR RETIREMENT ENHANCEMENT" OR "SENDING EVERYONE COWERING UNDER REDUCED EXPECTATIONS") ACT AND OTHER RECENT DEVELOPMENTS IN ESTATE PLANNING FOR RETIREMENT ASSETS

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Robert K. Kirkland
Kirkland Woods & Martinsen LLP
132 Westwoods Drive
Liberty, MO 64068
Telephone: 816-792-8300
Facsimile: 816-792-3337
E-mail: bkirkland@kwm-law.com
Website: www.kwm-law.com

Section Six

The Secure ("Setting Every Community Up for Retirement Enhancement" or "Sending Everyone Cowering Under Reduced Expectations") Act and Other Recent Developments in Estate Planning for Retirement Assets…………………………………………....Robert K. Kirkland

I. INTRODUCTION

A. If you take a step back and honestly assess the portion of total estate planning time spent for a client on planning for the client's retirement benefits, do you feel it is proportionately appropriate?

B. Prior to 2010, one could argue that, due to the relative estate/gift tax rates and exemptions then applicable and the number of clients to which the estate/gift tax applied, the majority of our planning time was necessarily focused on estate and gift tax planning techniques, to the potential detriment of appropriately considering the planning options with respect to retirement benefits.

C. I wish to make the case that, in the current tax law environment, especially with the enactment of the new tax law, planners should spend a disproportionate amount of planning time with respect to clients' retirement benefits.

1. According to the Urban-Brookings Tax Policy Center, the current estate and gift tax rates and exemptions impact only .15% of the U.S. population in general (<u>and</u> this was <u>prior to</u> the TCJA of 2017).

2. To the contrary, almost every client we encounter in the planning context has a retirement plan interest of sufficient size to warrant a greater amount of our attention.

D. Let us remind ourselves why retirement benefits are so unique so as to warrant a disproportionate amount of our planning time.

1. During a participant's life, retirement plan assets, while enjoying terrific income tax deferral options, remain "pregnant" with future income tax liability.

2. Maximum funding of retirement plan assets is a very effective asset protection technique.

3. The mere completion of a beneficiary designation form, which happens on many occasions with the assistance of someone who provides no tax or planning advice whatsoever, may greatly impact the amount and the timing of income taxation on the distribution of these benefits.

4. Unlike any other asset, directing retirement benefit assets <u>to a trust</u> involves a myriad of complicated rules and planning implications, as well as potential non-sensical income tax results (albeit a different set of implications under the SECURE Act).

5. Unlike most items of inheritance, every dollar distributed from a qualified retirement plan to a non-charitable beneficiary is subject to income tax.

6. In <u>some</u> states, a <u>beneficiary's</u> interest in a deceased participant's retirement plan can continue to enjoy creditor protection.

7. Retirement plan benefits open the door for a variety of proactive charitable planning techniques (especially after the SECURE Act!)

E. In February of this year, Treasury issued proposed regulations addressing some of the issues presented by the SECURE Act.

F. All references in this outline to an IRA shall be deemed to refer to a non-Roth IRA, unless specifically provided otherwise.

II. DESIGNATION OF INDIVIDUALS AS BENEFICIARIES OF QUALIFIED PLANS/IRAS

A. You Must Follow the Literal Guidelines of the Retirement Plan Document in Completing a Qualified Plan Beneficiary Designation (however, reformation is not out of the question).

1. In Ruiz v. Publix Super Markets, Inc., Case No. 8:17-cv-735-T-24 TGW, the U.S. District Court of the Middle District of Florida held that substantial compliance with plan requirements for designation of a beneficiary of a qualified retirement plan was not good enough to constitute an effective beneficiary designation.

2. The District Court relied heavily on the principles of the Supreme Court decision in Kennedy v. Plan Administrator for DuPont Savings and Investment Plan, 555 U.S. 285 (2009). A recent Fifth Circuit Court of Appeals

decision affirms these basic principles in Kinder Morgan Incorporated v. Crout, (No. 19-20037, 05/18/2020).

3. In a slip opinion which does not include the background facts, the Appellate Division of the New York Supreme Court reversed the decree of the Surrogate's Court of New York County and allowed a reformation of an IRA beneficiary designation. This changed the beneficiary from a "philanthropic fund" to the decedent's spouse of thirty-nine (39) years. *Matter of Sukenik*, 2018 NY Op. 04658 (June 21, 2018).

B. Distribution Rules During Life and After Death.

1. Distributions During the Taxpayer's Lifetime

a. In order to advise your client in structuring his or her IRA beneficiary designation, you have to be familiar with the minimum distribution rules. The required minimum distribution ("RMD") rules specify how long a taxpayer (and after the taxpayer's death, the beneficiary(s)) may defer withdrawals from retirement accounts. IRC § 401(a)(9).

b. During life, the taxpayer must generally begin taking withdrawals by April 1 of the year after the taxpayer reaches age 72. This date is referred to as the required beginning date ("RBD"). (For certain employees, the RMDs do not have to begin until the calendar year of retirement if the employee retires after age 72).

c. An IRS table that takes into account the taxpayer's life expectancy sets the RMD amount the taxpayer must withdraw in each year after the RBD. Treas. Reg. § 1.401(a)(9)-5.

(1) Unless the account owner's spouse is more than ten (10) years younger than the account owner, then the account owner will use the "Uniform Lifetime Table." Treas. Reg. § 1.401(a)(9)-9(A-2).

(2) If there is a spouse more than ten (10) years younger, then the account owner uses the "Joint and Last Survivor Table." Treas. Reg. § 1.401(a)(9)-9(A-3).

d. Distributions from qualified retirement plans that are taken before the taxpayer reaches the age of 59 ½ are subject to an additional 10% "early withdrawal" tax, unless the distribution falls within a statutory exception. IRC § 72(t).

(1) Code §72(t) was amended recently to expand the "Public Safety Employee" exception to the general rule of requiring a 10% additional tax on early distributions. Specifically, the Defending Public Safety Employees Retirement Act (H.R. 2146) was enacted after being signed by President Obama on June 29, 2015. One aspect of this legislation allows retired federal public safety officers to access their Thrift Savings Plan funds at age 50 without incurring the 10% early withdrawal penalty.

e. Recently, the courts have clarified under what circumstances this 10% tax will be imposed.

(1) In Kott v. C.I.R., T.C. Summ.Op. 2015-42 (2015), a taxpayer who was younger than age 59 ½ and delinquent in his mortgage payments withdrew funds from his 401(k) plan account in order to use such funds to avoid foreclosure. The Tax Court held that the taxpayer was liable for the 10% early distribution penalty as the Code does not include an exception for a general "financial hardship." While the Tax Court noted Reg. § 1.401(k)-1(d)(3)(iii)(B)(4), which allows for distributions to be made to employees for payments necessary to prevent eviction from the employee's principal residence or foreclosure, the Tax Court held that this exception only permitted the hardship distributions be made, and does not exempt the distributions from the 10% additional early distribution tax.

(2) In Adams v. Commissioner, the taxpayer lost his job with the Department of Defense and immediately filed suit for wrongful termination based on discrimination. Because he could not find another comparable job, the taxpayer took out over $220,000 from his IRA; he was under 59½ years old at the time. He reported all but $70,000 as income, and did not self-assess the premature withdrawal penalty. Upon examination by the IRS, Adams claimed that the penalty should not apply, as the withdrawals resulted from discrimination at work and were needed for medical care and "to fight for justice." The Service said fine, please

provide receipts and other documentation. Adams never provided any documentation, and the Tax Court held that the 10% premature withdrawal penalty applied (as well as the other penalties for underreporting income).

(3) In *In re* Bradford, 2015 WL 4549603 (Bankr. M.D. Ga., July 20, 2015), a Georgia bankruptcy court indicated that the early distribution tax imposed by §72(t) is an excise tax, and not a punitive tax measure, for purposes of bankruptcy.

(a) In examining the legislative history behind §72(t) of the Code and several relevant Supreme Court cases, the court held that this tax was enacted to deter debtor conduct rather that to support the government. Specifically, the court believed that the tax sought "to prevent retirement plans from being treated as savings accounts, to recapture a measure of tax benefits that have been provided prior to the withdrawal, and to deter the use of retirement funds for nonretirement purposes." *In re* Cassidy, 983 F.2d at 164.

(b) Next, the Court determined whether the penalty was entitled to priority as compensation of the government's actual pecuniary loss. After finding that the government sustains little loss if any when the tax recoups a loss to the government incurred through the taxpayer's deferment of income and that the losses claimed by the IRS do not constitute actual pecuniary loss, the Court held that Code § 72(t) is not entitled to priority.

(c) Ultimately, the court found the exaction was neither a tax, as it was not enacted to support the government, nor a penalty in compensation for actual pecuniary loss under Code § 507(a)(8). Therefore, the 10% exaction was not entitled to priority in the debtor's bankruptcy case.

f. How to reduce your clients RMDs.

(1) Your client can buy a qualified longevity annuity contract inside his or her IRA. This contract does not start paying the client an annuity until the client attains age 85. The funds used to purchase the annuity will have many years to accumulate and grow, so the income eventually received will be larger. Normally, such a delayed annuity is not permitted for IRAs, as the minimum distribution rules require RMDs no later than the RBD. The IRS has made an exception for qualified longevity annuities with up to $125,000 of the IRA balance, or 25% of the IRA owner's total IRA balance if it is less than $125,000.

(2) If a client is still working after attaining age 72, he or she may be entitled to reduce compensation income by tax deductible contributions to some type of retirement plan. These tax deductible contributions provide a current tax deduction reducing the income tax effect of his or her RMDs from other IRAs. If the client is self-employed, the client can adopt a SEP-IRA, to which such contributions may be made.

(3) If your client works for a non-profit entity, or a for-profit company if the client has less than 5% ownership in that company, and such entity has a qualified retirement plan that accepts rollovers from IRAs, the client can rollover his or her IRA into the company plan and then not have to take RMDs from that plan until actual retirement from that employer.

(4) If the client participates in an employer's qualified retirement plan, and has "after-tax money" in that plan, then upon retirement from that company the client should request that the plan send a direct rollover of all pre-tax money to a traditional IRA and the after-tax money to a Roth IRA. In essence, this is a tax-free Roth IRA conversion.

(5) Of course, there is always the plain old Roth conversion of the client's traditional IRA, as Roth IRAs do not require RMDs during the owner's life. However, the client must be willing to pay tax on the amount converted as though it were distributed from the plan at that time.

(6) We also have the ability to make a Qualified Charitable Distribution, discussed in more detail later in this outline.

2. Distributions After Death if the Spouse is Beneficiary.

a. The concept of a spousal rollover was NOT changed by the SECURE Act. We are all familiar with the rules enabling a spouse to roll over retirement benefits upon the death of his or her spouse, and they will not be repeated here. However, there are a few recent developments in this area that are worth discussing.

b. In 2009, the ACTEC Estate Planning for Employee Benefits Committee initially requested that the IRS issue a revenue ruling with respect to spousal rollovers of qualified plan and IRA benefits when an estate or trust is named beneficiary of a decedent's interest.

(1) This request was repeated in 2010 and again earlier this year, and guidance on this issue has been requested in connection with the ACTEC recommendations for the IRS Guidance Priority Plan in each of the last ten (10) years. So far, this has fallen upon deaf ears.

(2) Several hundred favorable private letter rulings have been issued over the last ten years, and it makes no sense for taxpayers to expend the filing fee required for a private ruling.

(3) As an example, in PLR 201511036, the IRS allowed spousal rollover treatment when the decedent's estate was named as beneficiary of several IRAs, and the spouse was the executor of the estate, the Trustee of decedent's trust, and was the income beneficiary and had a general power of appointment over the trust which was ultimately to receive the IRA proceeds.

(4) The most recent rulings in this regard include PLR 201821008, wherein the "default" beneficiary was the IRA owner's estate, and

the surviving spouse was the personal representative of the decedent's estate and the sole beneficiary of the estate. This favorable ruling was issued even though the IRA provider withheld taxes on the IRA distribution prior to paying the net amount over to the estate. The spouse received good advice, as she deposited the amount of the net proceeds plus the amount of the taxes withheld into a spousal rollover IRA in her name. In PLR 201831004, the IRS approved a spousal rollover when the beneficiary was the decedent's "Survivor's Trust" under a joint spousal trust, under which the surviving spouse was the sole income and principal beneficiary and had an unlimited power of appointment over the Trust. A similar result was more recently obtained in PLR 201923002.

(5) PLR 201839005, wherein the decedent did NO estate planning, the IRS examined a ruling request involving decedent's retirement plan under which the decedent failed to designate any post-death beneficiary. The plan provided that, in such event, the plan benefit was payable to decedent's estate. Under applicable state law, decedent's estate would be split between surviving spouse and children. The children all executed valid disclaimers of their interests in the decedent's estate, leaving spouse as the sole beneficiary of the estate. The IRS blessed spousal rollover treatment, after all of these timely post-death maneuvers.

(6) PLR 201901005 involved similar facts as PLR 201839005, except a Trust was named as IRA beneficiary. Trust timely disclaimed

its interest, and then son and two grandchildren all timely disclaimed their respective interests in decedent's estate, leaving only the spouse as a beneficiary of the estate. IRS again blessed spousal rollover treatment.

(7) PLR 201944003 reached a similar result with respect to a Survivor's trust share of a joint community property trust.

c. The Impact of the Windsor Ruling.

(1) As we all know, on June 26, 2013, the U.S. Supreme Court held in U.S. v. Windsor, 133 S.Ct. 2675 (2015) that Section 3 of the Defense of Marriage Act "DOMA" is unconstitutional.

(2) The IRS issued follow-up guidance for same-sex marriages in Revenue Ruling 2013-17 and Notice 2014-19.

(3) Generally, participants and their spouses who are in same-sex marriages must be treated as married for all purposes under a qualified retirement plan as of June 26, 2013.

(a) A sponsor of a qualified retirement plan may elect to recognize same-sex marriages as of a date that is prior to June 26, 2013, for some or all purposes under the plan. A plan amendment would be required to implement this optional retroactive effective date.

(b) If a qualified plan defines "spouse", "legally married spouse", "spouse under federal law", etc. in a manner consistent with

Windsor, or does not define those terms, then the plan does not need to be amended so long as the plan has been properly administered.

(c) However, if the plan's definitions of these terms are not consistent with the holding in Windsor, then the plan must be amended.

(4) For ERISA, Internal Revenue Code, and DOL Regulation purposes, the following is true:

(a) The term "spouse" includes an individual married to a person of the same gender IF he or she is lawfully married under state law (including foreign jurisdictions).

(b) The term "marriage" includes a marriage between individuals of the same gender.

(c) The term "spouse" does not include an individual in a registered domestic partnership or a civil union, and the term "marriage" does not include a registered domestic partnership or a civil union.

(d) A same-sex marriage validly entered into in a state or foreign jurisdiction that permits same-sex marriages will be recognized regardless of whether the couple moves to or lives in a state that does not permit or recognize same-sex marriages.

(5) In Schuett v. FedEx Corporation, et al., No. 15-CV-0189, N.D. Calif., 2016 U.S. Dist. LEXIS 224, the Federal District Court in the

Northern District of California applied Windsor retroactively, allowing a lesbian widow to pursue her claim to spousal benefits under her deceased spouse's pension plan. This same sex couple was married on June 19, 2013, and one of the spouse's passed away one (1) day later. Six (6) days later, the United States Supreme Court issued its decision in Windsor.

d. The impact of the Obergefell holding.

(1) Following in the wake of Windsor in 2013, on June 26, 2015, the United States Supreme Court in Obergefell v. Hodges, 135 S.Ct. 2584 (2015) held that same-sex married couples are entitled to equal protection under the laws of every state, and that their marriages must be recognized nationwide. As such, any state prohibitions against the recognition of a same-sex marriage were held to violate the 14th Amendment and were invalidated.

(2) Because state laws banning same sex marriage are effectively invalidated, after Obergefell, same-sex couples are afforded the same spousal rights that other couples enjoy. Spousal rights that occur independent of proactive planning and that are now equally granted to same-sex couples include, among others, (i) spousal survivorship rights under state pension or other retirement benefits, even in states that previously did not recognize same-sex marriage and the ability to file tax returns as a married couple and (ii) take advantage of the married couple's state estate tax exemption where applicable.

(3) After Windsor, same-sex married couples are to receive equal treatment under federal law and are to be treated the same as any other married couple for federal tax purposes and for other benefits under federal law (including spousal rights under ERISA, etc.). Now, in the aftermath of Obergefell, same-sex couples have been elevated to equal stature with other marriages and are entitled to equal protection under the laws of every state.

3. Distributions After Death if a Non-Spouse is Beneficiary (Non-Spouse Rollovers)

a. If someone other than the spouse is the beneficiary, under the SECURE Act, the beneficiary's RMD now depends on whether there is a (1) "Designated Beneficiary", (2) "Eligible Designated Beneficiary", or (3) "non-Designated Beneficiary" of the account.

b. The term "Designated Beneficiary" is specifically defined in Treasury Regulation § 1.401(a)(9)-5, and was not changed by the SECURE Act. Although individuals qualify as Designated Beneficiaries, estates, states, charities, and business entities do not qualify as Designated Beneficiaries for these purposes. Treas. Reg. § 1.401(a)(9)-4. As discussed in more detail later in this outline, only certain trusts qualify as a Designated Beneficiary.

c. The term "Eligible Designated Beneficiary" has been introduced by the SECURE Act. An Eligible Designated Beneficiary is:

(1) The surviving spouse of the participant.

(2) A minor child of the participant (not just any minor child). The life expectancy payout applies to the child until the child attains the age of majority…..then the ten year rule starts. There was lots of uncertainty created by the SECURE Act itself as to when the age of majority is reached. The proposed regulations provide a bright line rule that age 21 is the age of majority.

(3) A disabled individual (as defined in Internal Revenue Code Section 72(m)(7)). The life expectancy payout applies to the disabled individual, and upon his death, the ten year rule starts.

(4) A chronically ill individual (as defined in Internal Revenue Code Section 7702B(c)(2)). The life expectancy payout applies to the chronically ill individual, and upon his death, the ten year rule starts.

(5) An individual who is less than ten years younger than the participant. The life expectancy payout applies to this beneficiary, and upon his death, the ten year rule starts. The proposed regulations modify this provision by basing the less than ten years younger determination on actual dates of birth.

d. A trio of 2016 private letter rulings illustrate the rigidity of the Designated Beneficiary rules. In each of these letter ruling fact patterns, the taxpayer had designated a beneficiary on his IRA showing three separate trusts, each of which qualified as a Designated Beneficiary. Later that year, the taxpayer's financial advisors joined another firm and became affiliated with a different custodian, which required new IRA documents. At that time, the custodian had the taxpayer sign new beneficiary forms, which named the taxpayer's estate as the primary beneficiary. Upon the owner's death, this error was discovered and the trustees of the trusts petitioned the local probate court to reform the beneficiary designation retroactive to the time before the mistaken form was executed by the decedent which relief was granted by the local court. However, in each of these rulings, the IRS refused to recognize the reformed designations, and held that the estate was the beneficiary at the time of the taxpayer's death, and therefore, none of the IRAs had a Designated Beneficiary.

e. If there is a Designated Beneficiary -

(1) If the taxpayer died <u>before</u> the taxpayer's RBD, then the beneficiary's interest must be withdrawn within ten (10) years after the participant's death. The proposed regulations confirm that the "ten-year rule" shall be applied in the same manner as the older "five-year rule." There is NO requirement of annual distributions, as long as the entire interest is paid out by the end of the calendar year which includes the tenth anniversary of the participant's death.

(2) If the taxpayer died after the taxpayer's RBD, the proposed regulations provide that BOTH (i) the ten (10) years after the participant's death rule applies; and (ii) the taxpayer's life expectancy from the Single Life Table, based on the taxpayer's age in the calendar year of the taxpayer's death ("the ghost life expectancy") rule applies. In other words, the designated Beneficiary must take annual distributions based on the "ghost life expectancy" beginning in the year following the year of the participant's death, AND in any event, the entire account must be distributed by the end of the tenth year. In a very confusing twist, the proposed regulations further provides that in applying the "ghost life expectancy," the denominator is the greater of the participant's remaining life expectancy, or the beneficiary's life expectancy.

f. If there is an Eligible Designated Beneficiary –

(1) For most of the Eligible Designated Beneficiaries, a life expectancy payout may still be taken, using existing IRS life tables. Upon the death of the Eligible Designated Beneficiary, the ten-year payout rule then ensues. However, the proposed regulations provide that annual distributions are required during the ten year period!

(2) The proposed regulations provide that an Eligible Designated Beneficiary of a participant who dies before his or her RBD can elect to use the 10 year rule in lieu of the life expectancy payout.

(3) For a minor child of the participant, a life expectancy payout is used until the earlier of the death of the child or the child attaining the age of majority. Thereafter, a ten-year payout rule is used.

(4) For a “disabled” or “chronically ill” beneficiary, the documentation of such status is a critical issue. If the named beneficiary has already been determined disabled for purposes of Social Security disability benefits purposes, the beneficiary does not need to convince the IRS of his or her disability. An individual who has attained age 18 as of the participant’s death is “disabled” if, as of that date, such individual is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result on death or be of long-continued and indefinite duration. If such individual is under age 18, he or she is disabled if that person has a medically determinable physical or mental impairment that results on marked and severe functional limitations and can be expected to result on death or be of long-continued and indefinite duration. TO QUALIFY AS AN EDB, the beneficiary who is either disabled or chronically ill must provide the plan administrator documentation of the

disability or chronic illness no later than October 31 of the year following the year of the participant's death, and for chronically ill beneficiaries, such documentation must also include a certification from a licensed health care practitioner.

g. If there is <u>no</u> Designated Beneficiary –

(1) If the taxpayer died <u>before</u> the taxpayer's RBD, then the beneficiary must withdraw all of the retirement account within 5 years of the taxpayer's death.

(2) If the taxpayer died <u>after</u> the taxpayer's RBD, then the beneficiary's RMD is based on the Single Life Table that takes into account the deceased taxpayer's life expectancy immediately before death ("the ghost life expectancy").

h. The beneficiary may withdraw more than the RMD in a given year, but the beneficiary must withdraw at least the RMD each year to avoid IRS imposition of a penalty.

(1) Although payouts other than lump sum distributions in IRAs are common, not all IRAs offer this option.

(2) <u>Many</u> qualified plans typically require a lump sum distribution upon death.

(3) However, the Pension Protection Act of 2006 added Code § 402(c)(11), which now allows a non-spouse Designated Beneficiary to rollover a qualified plan account into an IRA by a trustee to trustee transfer.

4. Sixty (60) day rollover for inherited retirement benefits.

a. A participant, IRA owner or spousal beneficiary may take distributions of qualified plan or IRA assets and roll them over into another qualified plan or IRA within sixty (60) days of such distribution. However, any other non-spousal beneficiary cannot do such a rollover, but may do a direct trustee-to-trustee transfer.

b. Recent Private Letter Rulings have addressed specific scenarios that allow for a waiver of the 60-day rollover requirement:

(1) In PLR 201529016, the IRS, pursuant to Code §402(c)(3)(B), waived the 60-day rollover requirement where the taxpayer's failure to timely rollover funds was due to her medical and emotional condition following her spouse's death that impaired her ability to manage her financial affairs.

(2) In PLR 201529017, pursuant to Code §408(d)(3)(I), the IRS waived the 60-day requirement where the taxpayer's failure to timely rollover funds was due to the financial institution's failure to follow the taxpayer's instructions to keep those funds in his IRA.

(3) In PLR 20152901, again, pursuant to Code § 408(d)(3)(I), the IRS waived the 60-day rollover requirement where the taxpayer's failure to timely rollover funds was due to the bank making unauthorized distributions from his retirement accounts.

c. Rev. Proc. 2016-47, issued on August 24, 2016 establishes a "self-certification" procedure enabling the taxpayer to complete a rollover without the expense and hassle of a private letter ruling request.

(1) Prior to this Revenue Procedure, you could obtain a waiver of the 60-day rollover deadline only by making application to the IRS, paying a $10,000 filing fee, and waiting at least a year to get an answer.

(2) To qualify for this new self-certification approach, you must satisfy three requirements.

(a) You must not have been previously denied a waiver by the IRS for this particular distribution.

(b) You must have been unable to complete the rollover due to one or more of the eleven reasons listed below; and

(c) You must complete the rollover as soon as practical after you are no longer prevented from doing so due to the reasons you have certified.

(3) The following eleven (11) reasons are "blessed" by the IRS as justifying a waiver:

(a) An error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates.

(b) The distribution was made in the form of a check which was misplaced and never cashed.

(c) The distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan.

(d) The taxpayer's principal residence was severely damaged.

(e) A member of the taxpayer's family died.

(f) The taxpayer or a member of the taxpayer's family was seriously ill.

(g) The taxpayer was incarcerated.

(h) Restrictions were imposed by a foreign country.

(i) Postal error.

(j) The distribution was made on account of a levy under Internal Revenue Code Section 6331 and the proceeds of the levy have been returned to the taxpayer.

(k) The party making the distribution delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information.

(4) Be careful! If the taxpayer's return is audited, and a material misstatement was made in the self-certification of the rollover of an IRA distribution or one of the other requirements for self-certification was in fact not met, the IRS can still disallow the waiver, which will lead to income taxes, plus interest, plus penalties.

C. Separate Accounts and Multiple Beneficiaries.

1. If there are multiple beneficiaries of a retirement account, it is still important in some situations to establish separate accounts on a post-mortem basis. Treas. Reg. § 1.401(a)(9)-5, A-7(a)(1).

2. If separate accounts are "established" for multiple beneficiaries prior to December 31 of the year after the calendar year of the taxpayer's death, then the RMD rules will apply separately to each such separate account. Treas. Reg. § 1.401(a)(9)-4, A-5(c); Treas. Reg. § 1.401(a)(9)-8, A-2(a)(2).

a. To establish separate accounts, the beneficiaries' interests must be fractional (i.e. not pecuniary). In addition, some affirmative act is required to establish the separate accounts (i.e., a physical division of a single account into completely separate accounts, or using separate account language on the beneficiary designation form).

b. Whenever possible, it is best to create the separate accounts with appropriate language directly on the beneficiary designation form, especially after the SECURE Act, vis a vis <u>potential</u> Eligible Designated Beneficiaries.

3. Is separate account treatment available when a trust is the beneficiary of an IRA?

a. Treas. Reg. § 1.401(a)(9)-4, A-5(c) clearly provides that the separate account rules are not available to individual beneficiaries of a trust with respect to the trust's interest in the participant's retirement plan.

b. PLR 201503024 provided a lesson to the effect that, you should not believe every word you read in IRS regulations! This PLR involved an IRA wherein the decedent's trust was named as beneficiary, and such trust provided for ultimate distribution of its residuary to five (5) individual beneficiaries.

c. A similar result was recently obtained in PLR 201924013, and recent PLRs 201909003 and 201927009 extended this rationale and result to the context of an estate with multiple individual beneficiaries.

d. However, the proposed regulations provide that separate account treatment is not allowed for multiple trust shares under a single trust UNLESS the separate trust shares are named directly as the IRA or plan beneficiaries.

D. Eliminating Unwanted Beneficiaries Prior To September 30th.

1. The deadline for determining who the initial beneficiaries of a retirement account is the date of the taxpayer's death.

2. However, between the taxpayer's death and September 30th of the year following the year of the taxpayer's death, sometimes called the Beneficiary Determination Date ("BDD"), non-individual beneficiaries may be removed by a disclaimer of the interest, creating separate accounts, or eliminating them as beneficiaries by distributing their benefits outright to them in full. Treas. Reg. § 1.401(a)(9)-4, A-4(a). <u>This is still true under the SECURE Act</u>!

E. Roth IRAs

1. Although we do not have near as much heartburn about the structure of beneficiary designations on Roth IRAs, the above-described RMD rules

apply to the beneficiaries of a Roth IRA, and the RMD is computed as though the decedent had died before his RBD. Treas. Reg. § 1.408A-6, Q&A (14)(b).

2. As you know, contributions to a Roth IRA have already been taxed, and therefore, qualified distributions from such Roth IRAs are not subject to income tax. Nonetheless, it is still important to defer distributions from the Roth IRA as long as possible, so that the assets inside the Roth IRA continue to appreciate income tax free. Accordingly, it is still critical for the beneficiary of a Roth IRA to be considered a "Designated Beneficiary" or an "Eligible Designated Beneficiary".

3. If the Roth IRA owner is interested in generation-skipping planning with adult grandchildren, naming the adult grandchildren as the beneficiaries of the Roth IRA will be a more efficient utilization of the GST exemption than naming them as beneficiary of a traditional IRA (since parts of the traditional IRA proceeds will be consumed by income tax liability).

F. What if the IRA owner is incapacitated, and there is no or an inadequate beneficiary designation in place?

1. An agent under a durable power of attorney will need to be specifically empowered to make a new beneficiary designation.

2. Here is suggested sample language –

> "To make contributions to and withdrawals from, rollovers, voluntary contributions, or any elections with respect

to any retirement plans, including an individual retirement account, and to designate beneficiaries for any rollovers consistent with my overall estate plan;"

3. If there is no general durable power of attorney in place, then a court-appointed conservator (guardian in some states) will need specific court authority, and the acceptance of the IRA custodian, in order to make an effective beneficiary designation.

III. LEAVING RETIREMENT ASSETS TO TRUSTS

A. Situations In Which Trusts Are Crucial

1. In some situations a trust must be named as beneficiary, such as when (i) the beneficiary is a special needs child that relies on government benefits, (ii) the beneficiary is a second spouse whom you want to have limited access to the trust principal, (iii) the beneficiary is a minor, (iv) the beneficiary is a spendthrift, has substance abuse problems, etc., and (v) when retirement account assets must be used to fund a credit shelter trust. (discussed below).

2. In these situations, the client may decide the reasons for naming a trust as beneficiary of the IRA outweigh the lost income tax deferral, or may decide a look-through trust is appropriate.

B. What Are Look-Through Trusts, or See-Through Trusts?

1. A trust that qualifies as a Designated Beneficiary is often referred to as a "look-through trust" or "see-through trust". This has not changed under the SECURE Act. The proposed regulations officially adopt certain terminology that we have used in some fashion for some time. A "see-through trust" is a trust that is treated as a DB for required minimum distribution purposes. A "conduit trust" (discussed below) is one kind of a see-through trust. An "Accumulation trust" is any qualified see-through trust that is not a conduit trust.

a. If a taxpayer names a look-through trust as the beneficiary, then the trust will qualify as Designated Beneficiary (same as the old law), and **<u>may</u>** qualify as an Eligible Designated Beneficiary.

b. In essence, for these purposes, the trust is ignored and the beneficiaries of the trust are treated as the beneficiaries of the retirement account. This analysis remains important under the SECURE Act.

2. An Accumulation trust must satisfy five tests to qualify as a Designated Beneficiary. <u>These rules were not changed by the SECURE Act</u>.

a. The first four tests are as follows: (i) the trust must be valid under state law, (ii) the trust must be irrevocable or become irrevocable at the taxpayer's death, (iii) the trust beneficiaries must be identifiable, and (iv) certain documentation must be provided to the plan administrator or IRA custodian by October 31 of the year after the taxpayer's death.

b. If these four tests are met, then the trust is a Designated Beneficiary.

c. There is, in essence, a fifth test for the trust to be a Designated Beneficiary, as all of the beneficiaries of the trust must be individuals the oldest of whom can be identified.

d. What Trust Beneficiaries Can Be Ignored?

(1) It is many times a challenge to draft a trust that only has individual beneficiaries and where it is possible to ascertain the oldest beneficiary (especially when the IRS has not told us which contingent beneficiaries can be ignored!).

(2) The current official regulations provide that if the first four tests above are met, then the beneficiaries of the trust are considered beneficiaries of the retirement account. The question is, which beneficiaries must be considered?

(3) The current official regulations provide two rules in this regard.

(i) The general rule is that with respect to determining if there is a beneficiary of the trust that is not an individual (which would disqualify the trust as a Designated Beneficiary), and determining who is the oldest beneficiary, a "contingent beneficiary" must be taken into account.

(ii) The second rule provides that, a person will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy, or whether a person who is not an individual is a beneficiary, merely because the person could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death. However, the preceding sentence does not apply to a person who has any right (including a contingent right) to an employee's benefit beyond being a mere potential successor to the interest of one of the employee's beneficiaries upon that beneficiary's death.

(iii) This rather unhelpful regulation tells us that a "contingent beneficiary" must be taken into account, but a "mere potential successor" beneficiary can be ignored. However, it does not bother to define these terms!

e. Recent private IRS letter rulings have not been terribly helpful in providing additional guidance as to which contingent remainder beneficiaries can be ignored.

(1) Under the IRS's analysis in these rulings, if a trust is to distribute the assets <u>outright</u> to a beneficiary upon a life income beneficiary's death, then the only remainder beneficiaries that must be counted are the individuals that would receive those assets, <u>provided</u> those individuals are alive on the

taxpayer's death and they have already attained the required age to receive the assets outright.

(2) This ruling is not helpful to dynasty trusts or lifetime trusts with periodic principal distributions or withdrawal rights, as the beneficiary may never be required to take outright ownership of the trust assets.

f. PLR 201633025, published in mid-August of 2016, shed very important light on the IRS' then current thinking on this issue.

(1) In this ruling, a trust was named as beneficiary of an IRA. Under the terms of the trust, the Trustee is to distribute all of the net income of the trust to the decedent's child, and the trustee also has discretion to make principal distributions to the child or the child's issue for health, education, support or maintenance. When the child attains age fifty (50), the trust will terminate and all remaining income and principal will be distributed to the child.

(2) If the child dies prior to attaining age fifty (50), the trust provided that the trust will terminate and will be distributed to the children of the child. If the child and all of the child's issue are deceased prior to the final distribution of the trust assets, the trustee shall distribute the remaining trust assets to the decedent's siblings. If the child, all the child's issue, and the decedent's siblings are all then deceased, then the rest of the trust shall be distributed to various charitable organizations.

(3) The IRS ruled that the only beneficiaries which must be taken into account are the child and the child's children for purposes of determining whether the trust qualifies as a "Designated Beneficiary" for RMD purposes. Therefore, the trust qualified as a "see-through" trust and the trust may receive minimum distributions after the owner's death based on the child's life expectancy. All other potential recipients of the trust were deemed to be mere potential successors! Of course, under the new SECURE Act, this ruling only allows the usage of a ten year period instead of a five year distribution period in a similar fact pattern.

g. PLR 201840007 is a great recent example of post-mortem maneuvering in order to achieve "see-through" trust treatment and resulting stretching of an IRA payable to decedent's revocable trust.

(1) Decedent's trust was named as the primary beneficiary of decedent's 401(k).

(2) Upon decedent's death, the trust splits into three (3) separate describing trusts for each of decedent's three (3) oldest children.

(3) After decedent's death, the Trustee of the trust engineered a severance agreement which split each of the three children's trusts into a Trust A and Trust B. Each Trust A and Trust B has different sets of descendants as default remainder beneficiaries.

(4) Each discretionary trust has that child as primary beneficiary. Upon the death of such child, if he or she has attained age thirty (30), such child has a broad special power of appointment, with the potential appointees including any person or charity, other than the child's estate, the creditors of the child, or the creditors of the child's estate.

(5) On September 30 of the year following the decedent's death, as to the Trust share receiving the IRA, each of the three children executed a Partial Release of Power of Appointment, whereby each released his or her right to appoint to any charity or any individual other than an individual younger than the oldest child.

(6) The IRS ruled that each of the subtrusts qualified as see-through trusts, and RMD's may be stretched over the life expectancy of the oldest child. Under the SECURE Act, this successful see-through ruling under these facts would only buy a ten-year stretch.

h. The proposed regulations under Section 401(a)(9) provide some additional guidelines in determining "countable" beneficiaries.

(1) First, certain "specified beneficiaries", or any beneficiaries who could receive amounts in the trust representing the participant's interest in the plan or IRA that are neither contingent upon, nor delayed until, the death of another trust beneficiary, are always "countable".

(2) Second, certain "secondary beneficiaries", or a beneficiary who could receive amounts in the trust representing the participant's interest in the plan or IRA that were not distributed to the "specified beneficiaries," are NOT countable in the case of conduit trusts, but almost always countable in the case of see-through trusts.

(3) Third, a third category of beneficiaries are those who could receive amounts from the trust that represent the participant's interest in the plan or IRA solely because of the death of a secondary beneficiary. This third category of beneficiaries are NOT countable. However, if a beneficiary qualifies as both a secondary beneficiary and in the third category of beneficiary, he is characterized as a secondary beneficiary.

C. "Conduit Trusts"

1. Fortunately, the 401(a)(9) regulations do provide a type of safe harbor trust, a "conduit trust", where a beneficiary will be treated as a Designated Beneficiary. And now, the proposed regulations officially bless the label, "conduit trust"!

a. A conduit trust requires the trustee to distribute all of the retirement account withdrawals to the beneficiary.

b. The trustee may use conduit trust assets to pay expenses attributable to such assets.

c. As the trust may not accumulate any assets withdrawn from the retirement account, the IRS allows the trust beneficiary to be treated as the Designated Beneficiary of the retirement account.

2. Although conduit trusts have the advantage of certainty as they are specifically described in the treasury regulations, they also have a major disadvantage.

a. A conduit trust cannot withdraw retirement account proceeds and accumulate them inside of the trust.

b. This is often contrary to the intent of the client, who may be using a trust to prevent the retirement account assets from being distributed to the beneficiary for one reason or another.

3. In PLR 201902023, the IRS ruled that, when a revocable trust named as IRA beneficiary establishes a subtrust with conduit trust provisions to hold any retirement plan benefits payable to the revocable trust, such structure achieves the status of a conduit trust and a Designated Beneficiary.

4. Under the SECURE Act, depending directly on how an existing conduit trust is drafted, it may very well tie the hands of the individual beneficiary by either forcing the entire IRA to be paid out in the tenth year, or forcing the IRA to be paid out in ten annual installments. To the contrary, an accumulation trust

which qualifies as a Designated Beneficiary allows the Trust to take out the distributions at any time within the ten-year period. Accordingly, the usage and drafting of a conduit trust must be carefully evaluated going forward.

5. Nonetheless, a conduit trust will be very important for preserving Eligible Designated Beneficiary status for a trust for certain beneficiaries.

a. A conduit trust for a spouse, unlike an accumulation trust, results in the spouse being considered the sole beneficiary of the IRA, the trust not having to begin minimum distributions until the end of the year in which the decedent would have attained age 72, the spouse's life expectancy, recalculated annually, being the applicable distribution period, and ten year rule will not apply while the spouse is alive.

b. A conduit trust for a minor child will allow a modified stretch, until the child reaches the age of majority, followed by a ten year distribution period.

6. Proposed Regulation Section 1.401(a)(9)-4(f)(1)(ii)(A) removes any uncertainty that a conduit trust is permitted to have multiple current beneficiaries.

D. Other Issues Applicable to Accumulation Trusts

1. The compressed income tax brackets of a trust lead to a significant tax cost to the usage of an Accumulation trust.

a. A trust pays the highest rate of tax after the first $13,450 in income.

b. If significant amounts will likely be accumulated, the income tax cost is a significant detriment to consider before utilizing this type of trust.

2. Naming an Accumulation trust for an Eligible Designated Beneficiary as IRA beneficiary can be problematic.

a. Despite the fact that the primary beneficiary of an Accumulation trust is an Eligible Designated Beneficiary, other countable beneficiaries of the trust are not Eligible Designated Beneficiaries, and thus the general rule is that the trust will not qualify as an Eligible Designated Beneficiary. An Accumulation trust for either a spouse or a minor child may NOT qualify as an Eligible Designated Beneficiary.

b. The one exception under the SECURE Act allows an accumulation trust for a chronically ill or disabled beneficiary to qualify as an Eligible Designated Beneficiary, despite the existence of future other trust beneficiaries. The trust will be considered an "applicable multi-beneficiary trust" ("AMBT") if such trust has more than one beneficiary, each of which qualify as Designated Beneficiaries, and at least one of such beneficiaries is either a disabled or chronically ill beneficiary. If the applicable multi-beneficiary trust is required by the terms of the instrument to be divided immediately upon the death of the participant into separate trusts for each beneficiary, the RMD rules will be applied separately to the Eligible Designated Beneficiary. As long as there is no beneficiary other than a chronically ill or disabled beneficiary who has any right to the IRA until the death of all chronically ill or disabled beneficiaries, then this specific trust share will qualify for the stretch over the life of the chronically ill or disabled.

c. The proposed regulations bring additional relief in drafting for minor beneficiaries. If the trust requires complete distribution of the plan or IRA to an individual on or before the end of the tenth calendar year following the calendar year in which the minor attains the age of majority, or the end of the calendar year after the year of the minor's death if earlier, any beneficiary who receives nothing UNLESS a the minor dies before that point is not a countable beneficiary. This creates a safe harbor trust possibility for a participant's minor children, which will qualify as an EDB.

d. This safe harbor structure in fact is not limited to minor children. Any accumulation trust for any individual who is younger than 31 which provides for complete distribution of the plan or IRA to the individual beneficiary no later than his or her 31st birthday, can have its remainder beneficiaries not counted as beneficiaries for RMD purposes. For example, if the accumulation trust meets the above test, then the remainder beneficiaries who would take if the individual dies before attaining age 31 can include charities, and the trust will STILL be characterized as a DB (or an EDB).

4. Post-Death Changes to Trusts Which Are Beneficiaries of QRPs or IRAs.

a. Powers of appointment. What if the rusts which is named as a beneficiary of a QRP or IRA provides that, upon the life income beneficiary's death, the life income beneficiary has a power of appointment over the remaining trust property. The proposed regulations provide that the existence of such a power of appointment will not cause the trust to fail the requirement that the individual beneficiaries be "identifiable". If the power of appointment is exercised by the power holder on or before the Beneficiary Determination Date ("BDD") of September 30 of the year following the year of the participant's death, then those individuals named in such exercise are treated as the beneficiaries designated under the plan. Additionally, if in lieu of an exercise of the power of appointment, before the BDD, the power-holder has "restricted" it so that the power can be exercised at a later time in favor of only two or more identifiable beneficiaries, the those individuals are treated as beneficiaries designated under the plan. If by the BDD, the power of appointment is not exercised or restricted, then the takers in default under the trust instrument are treated as the beneficiaries designated under the plan. If the power holder exercises such power of appointment AFTER the BDD, then a prospective change to the minimum distribution schedule may need to be made. This section of the proposed regulations, while helpful in some respects, need more work!

b. Post-death modification of the trust. First of all, the proposed regulations make clear that the mere possibility of post-death modification does not prevent the trust from being a DB. If a post-death reformation or decanting of a trust occurs, the turns will need to be RE-evaluated for RMD purposes, and if the distribution period is accelerated, or the rust no longer qualifies as a DB, then the RMD is prospectively recomputed, no in any event, a complete required distribution is not required until the next calendar year.

E. Marital Trusts

1. We are all aware that one of the major requirements for a marital trust (either a general power of appointment trust or a QTIP trust) is that the surviving spouse be entitled all income of the Trust, at least annually.

2. Rev. Rul. 2006-26, 2006-1 C.B. 939, considered whether the "all income" requirement of I.R.C. §2056 and Treas. Reg. §§20.2056(b)-5(f)(1) and 20.2056(b)-7(d)(2) was satisfied in three fact situations. In each, a marital deduction trust held an IRA or a defined contribution plan.

a. Assuming that a QTIP marital trust was governed by the law of a state that had adopted the 1997 version of the Uniform Principal & Income Act ("UPIA"), the ruling concluded that the trust may not meet the "all income" requirement if: (1) the trust language did not require the trustee to distribute to the spouse the greater of all the income of the IRA (considered as if the IRA were a separate trust) or the annual required minimum distribution under I.R.C. §408(a)(6), and (2) the governing law included §§409(c) and (d) of the 1997 version of the UPIA.

(1) This was because UPIA §409(c) provided that a required minimum distribution from the IRA was allocated 10 percent to income and 90 percent to principal of the recipient trust, whereas the view of the IRS was that such an apportionment between principal and income was not based on the total return of the IRA and did not reflect a reasonable apportionment of the total return between income and remainder beneficiaries.

(2) If the trust language did not require the distribution of at least the income of the IRA when the spouse exercised the spouse's right to direct a withdrawal and UPIA §409(c) applied, the "all income" requirement may not be satisfied, according to the ruling.

(3) Although §409(d) of UPIA 1997 states that a trustee must allocate a larger portion of any distribution to income to the extent that doing so is necessary to qualify for the marital deduction, the Service in Rev. Rul. 2006-26 stated that this provision was ineffective to reform an instrument for tax purposes,

analogizing the statute to a savings clause in a document that would be ineffective to reform the document for federal tax purposes.

b. This ruling set forth a "safe harbor" that would apply if a QTIP election were made over both the trust and the IRA or retirement plan and the spouse had the power exercisable annually to compel the trustee to withdraw the income earned on the IRA or retirement plan and to distribute that income and all income earned on the other trust assets to the spouse.

c. The ruling concluded that marital trusts governed by §§409(c) and (d) of UPIA 1997 could not qualify for the safe harbor.

3. The Uniform Law Commission considered Rev. Rul. 2006-26 and made the changes discussed below to permit trusts governed by the 2008 version of the UPIA to qualify for the above-described safe harbor.

a. The 2008 UPIA §409 retains a 90/10 allocation for trusts other than QTIP and general power of appointment marital trusts.

b. However, for trusts intended to qualify for the estate tax marital deduction, the trustee is required to separately determine the income of each "separate fund" in such a trust for each accounting period. Separate funds include annuities, IRAs, pensions, profit sharing and bonus sock funds and stock ownership plans.

(1) All distributions received by a trust from such a separate fund are considered income until the income determined in this manner is reached. Distributions in excess of that amount are considered principal.

(2) If the distributions are less than this amount, the 2008 UPIA §409 states that the spouse may require that the trustee allocate principal from a source other than the separate fund to income, to make up the difference.

(3) Subsection (f) of the 2008 UPIA §409 requires that a trustee demand that the person administering the fund distribute the internal income to the trust upon the request of the surviving spouse.

(4) Under UPIA 2008, if a trustee cannot determine the income of a separate fund, the trustee is to apply a percentage between 3 and 5 percent, depending on the adopting state's choice, to the fund's value to determine the income.

(5) Further, if the value of the separate fund cannot be determined, the trustee is to compute an income equivalent by multiplying the I.R.C. §7520 rate by the present value of the payments, based on the §7520 rate.

4. The Service has published no new guidance on this issue since the 2008 revisions to the UPIA.

a. A new revenue ruling replacing Rev. Rul. 2006-26 and concluding that the "all income" requirement is satisfied by marital trusts governed by the laws of a state adopting §409 of UPIA 2008 is needed.

b. ACTEC has formally requested that the Service to issue a revenue ruling concluding that marital trusts governed by UPIA 2008 that hold IRAs or defined contribution plan benefits satisfy the "all income" requirement. (The UPIA was further amended in the summer of 2018 by the Uniform Law Commission, specifically in Sections 102(19(C), 203(e)(1) and 309(b), placing limits on a Trustee's power to adjust between income and principal, so as to avoid marital deduction qualification issues.)

F. Separate Accounts for Trusts

1. Treasury Regulations provide that the separate account rules are not available to beneficiaries of a trust with respect to the trust's interest in the employee's benefit.

a. The IRS now takes the position that separate account treatment is not available when a single trust is named as beneficiary.

b. Under the IRS's interpretation, if all of the separate truss created under a revocable trust are look through trusts, then the RMDs of all such separate trusts will be based on the oldest beneficiary of all of the separate trusts together, not the oldest beneficiary of each trust share at issue.

c. Therefore, on the beneficiary designation form, it is best to directly name the separate trusts to be created, as opposed to naming the funding trust. For example, instead of naming the "John T. Smith Revocable Trust" as the beneficiary, designate each separate share of the John T. Smith Revocable Trust as fractional beneficiaries.

2. However. . . see PLR201503024 (release January 16, 2015), which <u>in effect</u> allowed separate account treatment <u>in part</u> for a trust which paid out equally to five children.

G. Outright to Spouse Versus a Marital Trust

1. Leaving qualified retirement assets outright to the surviving spouse is always the best tax strategy, <u>as long as</u> it fits within the client's objectives.

2. On many occasions, a client is extremely reticent to leaving retirement assets outright to a spouse, for a variety of reasons, including the existence of a second marriage, asset protection concerns, spendthrift concerns, or disability concerns.

a. A "QTIP" Trust for a surviving spouse has the following consequences:

(1) The surviving spouse cannot rollover the IRA, and therefore distributions from the IRA must begin in the calendar year after the first spouse's death, instead of being deferred until the surviving spouse attains the age 72. Therefore, if the surviving spouse is younger than 72 years old, a tremendous

tax deferral opportunity will be lost.

(2) Minimum distributions during the spouse's life will be based on a single life expectancy table. If the benefits were left outright to the surviving spouse, then once the spouse begins distributions of her rolled over IRA, she uses the Uniform Lifetime Table, which is based on the joint life expectancy of the surviving spouse and a hypothetical new spouse who is ten years younger. Thus, the QTIP trust beneficiary designation forces larger annual distributions and less income tax deferral.

(3) If the intention is for the QTIP Trust to qualify for the estate tax marital deduction, then the trust must receive the greater of the minimum distribution amount, or the amount of income earned by the IRA. If the income earned by the IRA exceeds the minimum distribution amount, then greater amounts must be distributed from the IRA and less deferral is achieved.

b. As an alternative to the QTIP Trust technique in second marriage situations, I have been successful in persuading clients to instead leave a fractional amount to the surviving spouse and fractional amounts to the children of the first marriage.

c. Another alternative is to leave the total retirement asset amounts to the surviving spouse, and "compensate" the children of the first marriage with non-retirement assets.

d. If asset protection, spendthrift protection, or some other disability protection is the objective motivating the client to consider a trust for the spouse, we must make sure that the client understands the real cost in naming a trust versus naming the spouse outright.

IV. ESTATE PLANNING IN LIGHT OF THE SECURE ACT

A. Initial steps for the Estate Planner

1. Sending a client alert to everyone…..a quick concise notice aimed at getting their attention and inspiring them to contact us for possible new planning.

2. A more targeted outreach to those high net worth clients with large IRAs or QRPs.

3. Have your assistant globally search your client data base for certain key words, like “conduit trust”…. “special needs trust”

B. Immediate Issues to Address

1. Existing conduit trust planning in place

2. Taking steps to preserve “Eligible Designated Beneficiary” status.

a. Review plans where a spousal trust is the named beneficiary of an IRA.

b. Trusts for Minor children as IRA beneficiaries must be re-evaluated.

c. The designation of a special needs trust as IRA beneficiary should be reviewed and tweaked in light of the SECURE Act.

3. The immediate concerns to convey to our clients…..

a. The <u>rea</u>l post-death value of our clients' IRA and QRP interests have been potentially diminished significantly.

b. How will this income tax increase be paid?

c. A new reason for the ILIT wealth replacement concept?

d. More customized beneficiary designations!

C. Charitable Planning

1. Such a change will provide even more incentive for benefitting charity with IRAs upon death.

2. Funding a CRT with an IRA will achieve some of the deferral lost with the limited availability of the IRA stretch technique.

a. This should only be considered by the charitably inclined.

b. Computations specific to your fact pattern must be made in order to ascertain the real stretching benefit of this approach.

D. This law change will add more fuel to the fire in Roth IRA conversion planning.

E. If generation skipping planning is a major objective of a client, utilizing IRAs to push taxable inheritance down to lower bracket beneficiaries should be strongly considered.

F. The planner should anticipate to the extent feasible the possible use of disclaimers by designated beneficiaries of the IRA, in the structuring of the IRA owner's beneficiary designation, as such beneficiaries attempt to do their own post-death income tax planning.

G. Consider adding new boilerplate to your revocable trust forms.

1. Consider a springing separate share for a trust beneficiary who turns out to be disabled or chronically ill at the decedent's death

2. Consider a savings clause which precludes any non-disabled beneficiaries and any non-chronically ill beneficiaries from being eligible to receive any trust benefits during the life of the disabled or chronically ill beneficiary of an accumulation trust, to preserve Eligible Designated Beneficiary treatment.

3. Limit the class of potential appointees under a power of appointment to the extent necessary to preserve Eligible Designated Beneficiary treatment of an accumulation trust for disabled or chronically ill beneficiaries.

4. Consider inserting an elective process, by a trustee or trust protector, whereby either a conduit trust or accumulation trust becomes effective on or before the Beneficiary Determination Date for a separate Trust share.

H. Trusteed IRAs should see increased utilization.

I. You can find the SECURE Act as a new subparagraph (H) to Internal Revenue Code Section 401(a)(9), along with new definitions in Code Section 401(a)(9)(E).

V. MISCELLANEOUS PROVISIONS FROM THE SECURE ACT PROPOSED REGULATIONS

A. SECURE ACT Effective Date Issues.

1. Generally, the SECURE Act is effective as of January 1, 2020. Ironically, it beat the pandemic by about seventy-five (75) days….

2. What about pre-SECURE deaths, followed by deaths of those beneficiaries whose decedent died before 2020?

a. If a sole DB dies after 2019 (while enjoying a life expectancy payout), the ten-year rule applies, and remaining plan benefits must be distributed by December 31 of the year that includes the tenth anniversary of the Deb's death.

b. If there are more than one DBs enjoying a life expectancy payout, the proposed regulations provide that the ten-year rule is activated by the death of the oldest of the participant's designated beneficiaries IF such oldest DB survived the effective date of SECURE. (If such oldest DB died before January 1, 2020, the ten-year rule will never be activated.) If the pre-2020 DB was a Trust with multiple beneficiaries, the same rules apply.

c. If a sole DB who was enjoying a life expectancy payout dies before January 1, 2020, the successor beneficiaries continue taking distributions over the DB's ghost life expectancy.

VI. CREDITOR ACCESS TO INHERITED IRAs

A. It is always big news when an "estate planning" topic is addressed by the U.S. Supreme Court, and it happened most recently in the summer of 2014 in Clark v. Rameker, 573 U.S. ____, 134 S.Ct. 2242 (June 12, 2014).

1. In Clark, the United States Supreme Court granted c*ertiorari* to resolve a conflict between the Circuits on the issue of whether a beneficiary of an inherited IRA can claim a federal bankruptcy exemption from creditors for such inherited IRA.

2. The federal bankruptcy law provides an exemption for "[r]etirement funds to the extent that those funds are in a fund or account that is exempt from taxation under §§ 401, 403, 408, 408A, 414, 457 or 501(a) of the Internal Revenue Code of 1986." 11 U.S.C. §§ 522(b)(3)(c), 522(d)(12) (It is noteworthy that an "inherited IRA" is an IRA classification specifically recognized by Code Section 408(d).)

3. In a unanimous decision, the Court first defined "retirement funds" as funds set aside for the day when an individual is no longer working, and then cited three (3) characteristics which, in the view of the Court, prevents inherited IRAs from being considered "retirement funds."

a. First, the holder of an inherited IRA may never make contributions thereto, as opposed to traditional IRAs and Roth IRAs which receive tax incentives for the accumulation of additional funds for retirement.

b. Second, a holder of an inherited IRA is required to withdraw money from such account, without regard to how far away that person is from retirement.

c. Third, the holder of an inherited IRA may withdraw all of the funds at any time without penalty, and use them for any purpose, while the owner of a traditional IRA or a Roth IRA must wait until attaining age 59½ in order to withdraw funds from such accounts without penalty.

4. In a crowning blow, the Court stated that nothing about an inherited IRA's legal characteristics prevents or discourages an individual from using the entire balance immediately after bankruptcy for purposes of current consumption.

B. The history behind Clark.

1. Remember that IRAs belonging to the original account owner are generally exempt from the account owner's creditors in federal bankruptcy and otherwise.

2. One major source of confusion in this area is, although bankruptcy law is federal law decided in federal bankruptcy courts, many states opt out of the federal bankruptcy scheme, thus activating the application of state exemption statutes in federal bankruptcy cases (some states, like Texas, allow a debtor to select state or federal exemptions). The majority of states opt out, and thus the bankruptcy exemptions are decided under state exemption laws.

3. Prior to Clark, there were twelve (12) reported cases dealing with beneficiaries of inherited IRAs within the federal bankruptcy context.

a. Eight of these courts (all of which are in "opt-out" states, except for Texas) found that the inherited IRAs were not exempt from the bankrupt estate in federal bankruptcy, including: *In re* Sims, 241 B.R. 467 (Bankr. N.D. Okla. 1999); *In re* Greenfield, 289 B.R. 146 (Bankr. S.D. Cal. 2003); *In re* Navarre, 332 B.R. 24 (Bankr. M.D. Ala. 2004); *In re* Taylor, Bank. No. 05-93559, 2006 WL 1275400 (Bankr. C.D. Ill. May 9, 2006); *In re* Kirchen, 344 B.R. 908 (Bankr. E.D. Wis 2006); *In re* Jarboe, 365 B.R. 717 (Bankr. S.D. Tex. 2007); *Robertson v. Deeb*, 16 So. 3d 936 (Fla. 2d DCA 2009); and *In re* Chilton, 2010 WL 817331 (Bankr. E.D. Tex. March 5, 2010).

b. Four of the courts found that the inherited IRA was exempt in federal bankruptcy, those being: *In re* McClelland, Bank No. 07-40300, 2008 WL 89901 (Bankr. D. Idaho Jan. 7, 2008); *In re* Nessa, 2010 Bankr. Lexis 931 (B.A.P. 8th Cir. Apr. 9, 2010); *In re* Tabor, 2010 105 AFTR 2d (Bankr. M.D. Pennsylvania June 18, 2010); and *In re* Hamlin, 465 B.R. 863 (BAP 9th Cir. 2012).

c. The Nessa decision (in a non-opt-out state) led many district courts, in unreported decisions, to allow the inherited IRA to be an exempt asset, until Clark came along.

C. Clark is NOT the Last Word!

1. In some opt-out states, the interpretation of existing statutes with broad exemption language may allow the exemption of inherited IRAs for state exemption purposes, and state exemptions are recognized under U.S. Bankruptcy Code § 522(b)(3)(A).

a. The state of Kansas has such a broad statute which could arguably be construed to exempt inherited IRAs.

b. However, in Mosby v. Clark (In Re Mosby), 15-5193-JWL (D Kan. Oct. 30, 2015), the Kansas District Court held that an inherited IRA is not exempt under the Kansas exemption statute. The very recent case of In Re: Todd, Case No. 15-11083 (U.S. Bankr., NDNY 2018), held that the applicable New

York exemption statute was not intended to include inherited IRAs within the exemption from bankruptcy.

2. In my home state of Missouri, along with Alaska, Arizona, Delaware, Florida, Nevada, North Carolina, Ohio, South Carolina, Texas and Wyoming, the Clark holding is completely irrelevant, as these states have statutes which specifically exempt inherited IRAs for state exemption purposes and have opted to use the state exemptions for federal bankruptcy law purposes. Idaho has case law to this effect.

3. In a post-Clark decision, the federal Bankruptcy Court in New Jersey held that a debtor's inherited IRA was not property of the bankruptcy estate under New Jersey law. *In re* Andolino, 525 B.R. 588 (Bankr. D.N.J. 2015). The Bankruptcy Court stated that the question of inclusion in the estate must be reached first, before the Clark analysis of the application of an exemption can be made. (The Todd decision in New York also rejected an Andolino argument regarding inclusion of the inherited IRA.)

4. In another post-Clark decision, the federal Bankruptcy Court in Tennessee held that an IRA account was protected from creditors, even though the IRA owner had used part of the funds during the 60 day rollover period to purchase a home, as the owner ultimately deposited the exact amount eligible for rollover into the IRA. The In Re: Chaundry court rejected the bankruptcy trustee's contention

that the rollover was not qualified unless the IRA owner deposited the exact same funds received from the predecessor plan.

5. In October of 2019, the appellate court affirmed the Bankruptcy Court in Minnesota's ruling that a divorced former spouse who had received one-half of his ex-spouse's 401(k) and IRA upon the divorce could not claim an exemption in bankruptcy for such retirement assets. In Re: Lebakken, (No. 18-6018, 8th Circuit Court of Appeals). The courts relied on Clark in reaching this decision.

D. Use of spendthrift trusts as an alternative asset protection device.

1. If you are in a state where the applicable exemption is either indefinite or not existent, you should consider naming a spendthrift trust for the benefit of any beneficiary with creditor issues as the beneficiary of the IRA.

2. However, if the RMD amount received by the trust must be distributed from the trust (i.e. in a conduit trust), the Uniform Trust Code reverses the common law spendthrift protection for this type of a distribution interest and allows any creditor to attach the RMD amount from a spendthrift trust.

3. As an alternative, consider a "Trusteed IRA." If the provider offers a Trusteed IRA, and the Trusteed IRA agreement contains a spendthrift clause, then creditor protection should be accomplished.

VII. IRA OWNERS/RETIREMENT PLAN ADMINISTRATORS BEHAVING BADLY

A. Prohibited transactions disqualifying an IRA from recognition as such.

1. As discussed previously, IRAs are tax exempt as well as exempt from bankruptcy proceedings. However, when an IRA engages in a prohibited transaction, those exemptions are lost. One prohibited transaction occurs when an IRA is transferred to, or used by or for the benefit of, a disqualified person.

2. In Ellis v. Commissioner, Decision No. 14-1310, (8^{th} Cir. June 5, 2015), the 8^{th} Circuit affirmed a Tax Court holding that an IRA owner engaged in prohibited transactions under Code §4975(c) by directing his IRA to acquire a membership interest in an LLC with the expectation that the LLC would employ him (and in fact he received wages from the LLC). The facts of this case arose out of a business established in Harrisonville, Missouri, wherein Mr. Ellis invested almost his entire rollover IRA ($321,253) in a 98% membership interest in an LLC, under which Ellis served as General Manager. As a result of these transactions, the IRA lost its status as an individual retirement account and its entire fair market value was treated as taxable income as of the date of its establishment.

3. A different result was reached in *In re* Nolte, 2015 Westlaw 2128670 (Bankr. E.D. Va. 2015). At Nolte's instructions, the IRA investment advisor invested $100,000 out of the IRA in a 5% interest in an LLC. Nolte later

served on the Board of the LLC but received no compensation. In a bankruptcy proceeding, a creditor objected to the debtor's discharge on the basis that the IRA had lost its exemption because Nolte had engaged in a prohibited transaction under Code §4975. In this case, the Bankruptcy Court found that merely investing in a 5% interest in an entity in which the IRA owner served on the Board was not a prohibited transaction, and the IRA was not disqualified.

4. In contrast to Nolte, Mr. Kellerman's IRA was found not to be exempt due to actions taken by Mr. Kellerman. *In re* Kellerman, 2015 Westlaw 3377907 (Bankr. E.D. Ark. 2015). Kellerman formed a partnership between his self-directed IRA and another LLC which was wholly owned by Kellerman. Kellerman ordered the IRA custodian to sell a substantial portion of the assets of the IRA and purchase a tract of land, in which the LLC and his IRA owned undivided interests. After finding that the IRA had engaged in prohibited transactions, the Court held the IRA had been disqualified and was not entitled to a bankruptcy exemption.

5. In McGaugh v. Commissioner, T.C. Memo. 2016-28, the taxpayer's IRA custodian initially refused to purchase shares in a closely-held entity since it was not on the custodian's approved buy list. The taxpayer then instructed the custodian to wire IRA funds directly to the corporation whereupon shares were issued by the Corporation in the name of the IRA which were then

delivered by the taxpayer to the IRA custodian. Despite the fact that the taxpayer "pulled all strings" and controlled the wired funds in the transaction, the Tax Court held that the taxpayer was merely acting as a conduit for the custodian and that this transaction did not constitute constructive receipt of IRA proceeds. However, in Vandenbosch v. Commissioner, T.C. Memo. 2016-29, the taxpayer moved funds from his IRA to a joint account, followed by a move from the joint account into the taxpayer's personal account, followed by the taxpayer wiring the funds directly to a borrower, in exchange for a note from the borrower payable to the taxpayer and not the taxpayer's IRA. Here, the court held that the taxpayer was not a mere conduit in the same manner as in McGaugh, and the court held constructive receipt of IRA funds had occurred.

6. In Marks v. Commissioner, the taxpayer used the prohibited transaction rule to his advantage, in a very interesting outcome. In 2005, the taxpayer loaned funds from her IRA to a relative, and received two separate promissory notes. In 2013, while trying to execute a rollover of the IRA, the taxpayer failed to get the notes re-titled in to the new IRA. The IRS issued a deficiency for approximately $100,000 in taxable income, alleging that the full value of the promissory notes must be included in taxpayer's 2013 income as distributions from the IRA. The taxpayer successfully argued that a prohibited transaction occurred in 2005, rendering the IRA unqualified in that year, and thus

no taxable distribution occurred in 2013. AND, the statute of limitations had run on the 2005 income tax year, when the prohibited transaction occurred. Marks v. Commissioner, T.C. Memo 2018-49 (April 2018).

B. Claim of Breach of Fiduciary Duty against Plan Trustees

1. In Tibble v. Commissioner, 135 S.Ct. 1823 (2015), retirement plan participants brought suit against the plan for investing in mutual funds with high fees as opposed to low-cost mutual funds. The 9th Circuit had found that the statute of limitations of six years after "the date of the last action which constituted a part of the breach or violation" was a bar to this suit, because the mutual funds in question were purchased more than six years before the suit was instituted. However, the Supreme Court reversed this decision, holding that the plan trustees engaged in a continuing breach of their duty of prudence in failing to monitor the investments, and remanded the case to the trial court for determination of whether that issue was timely raised.

C. Loss of Bankruptcy Exemption

1. In Running v. Miller, 77 F.3d 711 (8th Cir. 2015), the taxpayer purchased an annuity from Minnesota Life Insurance Company for a lump sum purchase payment of $267,319. Miller used funds from his IRA to make this payment. Miller later filed for bankruptcy and claimed that the annuity was exempt from the bankruptcy estate as an individual retirement account. The

bankruptcy trustee objected, and the bankruptcy court overruled her objection. The bankruptcy trustee had claimed that, because Miller had used the IRA funds to purchase an annuity with a lump-sum premium, the funds thus became property of the bankruptcy estate.

VIII. NAMING CHARITY(S) AS BENEFICIARY OF THE IRA

A. If a client indicates a desire to leave funds to charity(s) upon his or her death, the first words out of our mouths should be to consider making such at-death gifts from qualified retirement plans or traditional IRAs.

1. If the client's estate plan contemplates benefits both to charity and to children or other individual beneficiaries, the most efficient income tax planning is accomplished by satisfying the charitable gifts with retirement plan assets, and using other assets to leave to the individual beneficiaries. While the charity will not pay income tax on <u>any</u> inheritance it receives, including retirement plan benefits, individual beneficiaries will pay income tax on the distribution of a retirement plan interest, and will not pay income tax on almost all other forms of inheritance.

2. In addition to satisfying the client's charitable desires, a variety of charitable giving techniques involving retirement benefits will help realize additional estate planning objectives as well.

3. With this planning, charitable intent should be more important than tax savings!

4. In contrast, since Roth IRAs pass to the designated beneficiary without any income tax liability, naming charity as beneficiary of the Roth IRA is not tax efficient.

B. There are various techniques for leaving retirement benefits to charity(s) upon a taxpayer's death.

1. The easiest way to leave retirement plan benefits to charity(s) is to name the charity(s) as a direct beneficiary of one hundred percent (100%) of the benefits payable upon the taxpayer's death.

a. A properly completed beneficiary designation form in this regard is easy to accomplish.

b. Although all of the income associated with retirement benefits will be included in the income of the charitable organization named as beneficiary, such charity's income tax exemption will make the retirement plan benefit distribution not taxable.

c. In addition, the deceased taxpayer's estate will receive a dollar for dollar estate tax charitable deduction for the estate tax value of the retirement plan interest.

2. In many instances, the client will want to leave a specific dollar amount to one or more charities, with the balance of the retirement plan interest passing to other individual beneficiaries (i.e., his or her lineal descendants, per stirpes).

a. This usually requires an attachment to the beneficiary designation form setting forth the specific amount gift, and a description of the residual beneficiaries.

b. In my experience, you should be sure at the planning stage that the retirement plan administrator will accept and honor this attachment!

c. In order for the individual beneficiaries to be able to use separate accounts and a deferred payout, it will be necessary to be sure that the charity(s) are "cashed out" (i.e., fully paid from the retirement plan) before September 30 of the year following the year of the taxpayer's death.

d. Be careful doing this through a trust vehicle!

(1) In PLR 201438014, decedent's Trust was named as beneficiary of his IRA, and the Trust provided for payment of pecuniary bequests to two charities and the residue to be distributed to individuals.

(2) A state court ordered a reformation of the Trust, providing that either the Trust's transfers to the charities were to be treated as direct bequests of the IRA amounts to the charities, or such transfers were to be considered

to be made out of the trust's gross income pursuant to the terms of the governing instrument.

(3) The IRS ruled that the Trust must treat the payments to the charities as sales or exchanges (since the IRA is being used to satisfy a pecuniary legacy), and the Trust must include in its gross income the amount of the IRA used to satisfy the charitable legacies. Further, the Trust is not entitled to a charitable income tax deduction for these distributions. The bottom line was, because the purpose of the reformation was not to resolve a conflict but merely to obtain tax benefits, then the IRS will not respect the reformation and treat it as part of the governing instrument. PLR 201438014.

e. Careful drafting will be necessary when an IRA is designated to be distributed to a Trust, which contains residuary charitable bequests.

(1) Chief Counsel Memorandum 200848020 (July 28, 2008), provides that a Trust is denied a charitable income tax deduction after it receives taxable IRA distributions and then distributes some of those amounts to charities.

(a) CCM 200848020 involved a decedent who left his IRA payable to his Trust upon his death, which benefited his six children and several charities. The Trust received distributions from the IRA, and the Trustee immediately paid those amounts to the charities, leaving the six children as the only remaining beneficiaries of the Trust. The Chief Counsel's Office concluded that the Trust had taxable income from the IRA distribution, but was not entitled to claim an offsetting charitable deduction (remember only an estate may claim an income tax charitable "set aside" deduction").

(b) In order for the distribution of IRA proceeds to charity to be deductible by the Trust, the Trust must meet the legal requirement for a trust to claim a charitable income deduction. In order to claim a charitable income tax deduction, the charitable payment must be traced to income and must generally be made pursuant to the terms of the governing instrument specifically requiring income to be paid to a charity. IRC § 642(c).

(c) In the Trust involved in CCM 200848020, there was no specific instruction to distribute income to a charity, just a general provision for a percentage of the residuary to be paid to several charities. Therefore, the Trust could not claim the charitable income tax reduction.

(2) Ostensibly, one solution would be to include a clause in the Trust document that instructs all residuary charitable gifts to be made, to the extent possible, from property that constitutes "income in respect of the decedent" as that term is defined under the U.S. income tax laws.

(a) However, Treas. Reg. § 1.642(c)-3(b)(2) provides that instructions in a trust instrument to distribute specific types of income to a charity will not be respected for federal income tax purposes unless the instruction has an "economic effect independent of income tax consequences".

(b) The examples in this Regulation provide that, unless the amount to be paid to charity is dependent upon the type of income from which it is to be paid, the above-described ordering provision is considered to not have economic effect independent of income tax consequences.

(3) Interestingly, in PLR 201444024, where the Trust was named as the beneficiary of decedent's IRA and the Trust provided that, after two pecuniary bequests to individuals, the residue shall be immediately distributed to charity, the IRS held that the Trust may re-title the name of the IRA to reflect the name of the charity in a non-taxable transfer, and the charity, not the trust, will include the taxable amount of the IRA distributions in charity's income for tax purposes, as if the charity were the direct beneficiary.

(4) The alternative answer at the planning stage is to draft the beneficiary designation of the IRA so as to mirror the dispositive provisions of the Trust (i.e., list the children and the charities and their respective percentages on the IRA designation itself, rather than sending the IRA to the decedent's Trust).

(5) In addition, the will and/or revocable trust of the decedent must provide that no estate taxes are to be charged against or paid out of the charity's share of trust assets.

f. Charitable Remainder Trusts. This technique involves a charitable remainder trust ("CRT") as that term is defined in IRC § 664.

(1) Income tax consequences

(a) Since a charitable remainder trust is exempt from income tax, the distribution of all the retirement benefits to a charitable remainder trust results in no current income tax liability.

(b) The individual beneficiaries of the charitable remainder trust will receive their lifetime interest earned from the entire amount, as opposed to an after-tax amount, of the distributed retirement benefit interest.

(c) However, the tax-deferred income received by the CRT must be "booked" from day one by the CRT, and will gradually "leak out" to the individual beneficiaries with the distribution of each lifetime payment. Under the "tiered" approach to income taxation of CRT distributions, the distribution to the individual lifetime beneficiary is deemed first to be derived from ordinary income earned in all prior years and the current year, to the extent such amount has not already been allocated to a prior distribution.

(d) Although an individual IRA beneficiary is entitled to a Section 691(c) income tax deduction for the portion of federal estate taxes attributable to retirement plan benefits, this deduction is rarely if ever available to an individual beneficiary of a CRT, as all of the tiers of ordinary income, capital gain income and tax-exempt income would need to be exhausted before any CRT distribution would carry out the use of the IRD deduction.

(2) Estate tax consequences

(a) The decedent's estate is entitled to a federal estate tax charitable deduction for the actuarial value of the charitable remainder interest at the time of the decedent's death.

(b) The actuarial value of the charitable remainder interest must be at least ten percent (10%) of the date of death value of the trust in order for the CRT to be qualified.

(c) Because the non-charitable actuarial interest in the CRT is taxable in the decedent's estate, the decedent's tax clause in his or her will or revocable trust will need to provide for payment of any estate tax attributable to the non-charitable CRT interest from other sources of the decedent's estate.

(3) Leaving a retirement plan interest to a CRT is not a good idea in all situations.

(a) If the individual beneficiary or beneficiaries are young enough, the actuarial value of the charitable interest may not exceed ten percent (10%) of the total value of the trust, and the trust will not qualify as a CRT. However, a term of years could be used to make the CRT work in this situation.

(b) If the CRT will receive a large amount of retirement benefits, it is possible that there will not be enough non-retirement assets to pay any estate tax due because of the actuarial value of the non-charitable interest in the CRT.

(4) With the severe limitation of the "stretch IRA" technique as a result of SECURE, a designation of a charitable remainder trust will allow some "stretching" to still occur.

4. Charitable Lead Trusts

a. Since a charitable lead trust ("CLT") is the theoretical opposite of a charitable remainder trust (i.e., the initial stream of payments is paid to a charity for a term of years, with the remainder passing to one or more individuals at the end of the term), this seems on its face to be a viable technique.

b. However, the charitable lead trust has one important characteristic which is different from a CRT; the CLT is <u>not</u> exempt from income tax. Therefore, when all of the retirement benefits are distributed to the CLT, the trust must pay income tax on the entire amount of benefits distributed.

c. Because of the drastic income tax consequences, one should not advise leaving retirement benefits to a CLT.

IX. LIFETIME GIFTS OF QUALIFIED RETIREMENT BENEFITS TO CHARITY

A. Lifetime Gifts From Retirement Plan Distributions

1. For some of our clients, the most readily available funds with which to make lifetime charitable gifts are their retirement plan funds.

2. Except for the charitable IRA rollover discussed below, the only way for this client to make such a gift is to withdraw funds from the qualified plan or IRA and then gift such funds to the charity.

a. This of course results in the immediate taxation of the distributed assets from the plan on the donor’s income tax return.

b. One would hope that the income tax charitable deduction will result in a “wash” of this income for income tax purposes. However, there are some circumstances which will prevent a complete wash of the income.

(1) If the charitable donations exceed the applicable percentage of AGI limits, then a complete wash will not result.

(2) For high income taxpayers, there is an automatic reduction of itemized deductions under Code § 68 which could also prevent a complete wash of the income.

(3) Of course, if the taxpayer is under age 59½ at the time of the withdrawal, he or she will suffer a ten percent (10%) penalty on the distribution. The charitable deduction will not in any way reduce this penalty.

(4) If the taxpayer resides in a state that does not allow a charitable deduction in computing its state income tax, then a complete wash will not be possible.

(5) Of course, any individual who does not itemize deductions would not achieve a wash of the income since he or she would not be itemizing the charitable deduction. There will be many more non-itemizers under the new tax law, with the increase of the amount of the standard deduction!

B. Gifts of RMD Amounts to Charity(s)

1. A taxpayer who is already receiving RMDs from his or her IRA or qualified plan may use the distributed amounts for charitable giving.

2. Although the above-described obstacles may prevent a complete wash of the income, since the taxpayer is <u>required</u> to receive the RMD in any event, he or she may as well attempt to receive some income tax relief through charitable giving.

C. There are Potential Charitable Gifts of Unique Retirement Plan Benefits That Can Be Beneficial During Life

1. An individual under age 59½ may avoid the ten percent (10%) premature withdrawal penalty through implementing a "series of substantially equal periodic payments" from a retirement plan, and such taxpayer could use those payments to make offsetting charitable gifts.

2. In certain limited circumstances, wherein a distribution is made from a qualified plan of employer stock which includes "net unrealized appreciation", the taxpayer is not immediately taxed on such net unrealized appreciation at the time of the plan distribution. Instead, taxation of this unrealized appreciation is deferred, and may be completely avoided through certain future charitable gifts.

3. A lump sum distribution from a qualified plan to a participant who is born before January 2, 1936 (or to the beneficiaries of such a participant) may exclude the distribution from the recipient's gross income and is taxed under a different rate schedule. In some circumstances, the distributee may give the distributed amount to charity, and effectively deduct the gift from his or her other income, since the lump sum distribution is taxed at a much lower rate.

4. "Qualified replacement property" received by a business owner who has sold his or her stock to an ESOP, wherein the owner did not have to pay income tax on the sale, may be gifted to charity to avoid permanently some or all of the tax on such sale.

D. IRA Charitable Rollover

1. Congress has had an on-again/off-again love affair with the IRA Charitable Rollover.

a. The 2006 Pension Protection Act first established the "IRA Charitable Rollover" concept. After being allowed to expire in 2008, this provision was renewed temporarily two more times, and expired again on January 1, 2014.

b. The "Public Good IRA Rollover Act" was introduced in the Senate on November 21, 2013, which sought to renew and make permanent the IRA Charitable Rollover. Comparable legislation was introduced in the House in early 2014, and passed on July 17, 2014. Finally, on December 16, 2014, the Senate signed off on several "extenders," including this provision, which was signed into law by the President on December 19, 2014. Unfortunately, the IRA Charitable Rollover provision expired again as of January 1, 2015!

c. After months of watching two separate bills which proposed to enact the IRA Charitable Rollover on a permanent basis sit idle in the House of Representatives, action finally came in December, 2015. President Obama signed the "Protecting Americans from Tax Hikes Act" into law on December 18, 2015. Among other things, this Act finally makes the IRA Charitable Rollover permanent.

2. What constitutes an "IRA Charitable Rollover"?

a. A "Qualified Charitable Distribution" is an otherwise taxable distribution from an IRA (not including an ongoing SEP or SIMPLE IRA) owned by an individual who is at least age 70½ (yes, this age limitation was NOT changed by the SECURE ACT), and that is paid directly from the IRA to "eligible charitable organizations."

b. A taxpayer can exclude from gross income up to One Hundred Thousand Dollars ($100,000) of a Qualified Charitable Distribution made for a given year.

(1) The Qualified Charitable Distribution can be used to satisfy any required minimum distributions from the IRA for that year.

(2) Likewise, the amount of the Qualified Charitable Distribution excluded from gross income is not shown as an itemized deduction for a charitable contribution.

c. An eligible charitable organization for these purposes includes a public charity, other than a donor advised fund or supporting organizations. Individuals can make a Qualified Charitable Distribution to a private operating foundation or to a private foundation that elects to meet certain conduit rules in the year of the distribution.

d. The donor must instruct their IRA administrator to make the contribution directly to the eligible charity.

3. TRAP CREATED BY THE SECURE ACT

a. A working individual who is 70 ½ or older can make tax-deductible contributions to a traditional IRA (in 2021, the maximum deductible contribution for anyone 50 years of age or older is $7,000)

b. Under the SECURE Act, if such an individua ever makes a tax-deductible contribution to a traditional IRA after attaining age 70 1/2 , then the amount of a qualified charitable distribution from an IRA that can be excluded from taxable income is reduced by that amount.

c. If your client wants to make charitable gifts from his or her IRA, they should never make a tax-deductible contribution to their IRA after attaining age 70 ½.

4. Who really benefits from this continued IRA Charitable Rollover technique?

a. A high income donor who itemizes deductions and whose charitable contribution deductions are reduced by the percentage of income limitation (otherwise, such individuals who receive a distribution from their IRA and make a corresponding charitable contribution, must count the entire distribution as income and receive a charitable deduction for a lesser amount).

b. Individuals who do not itemize their deductions.

c. Individuals in certain states where the operation of the state income tax law would offer greater benefits as a result of a charitable rollover.

d. Those rare individuals who already exceed their percentage of income limitation in terms of charitable contribution limits (i.e., more than 50% of their adjusted gross income for gifts of cash to public charities).

Section Seven

Current Issues in Federal & State Tax
K-2 and K-3

Richard L. Bartholomew
Girardot, Strauch & Co.
Lafayette, Indiana

Section Seven

MIDWEST ESTATE, TAX & BUSINESS PLANNING INSTITUTE 2022

CURRENT ISSUES IN FEDERAL & STATE TAX

K-2 AND K-3

BY RICHARD BARTHOLOMEW, JD CPA

GIRARDOT, STRAUCH & CO

RICHARD@GSC-CPA.COM

765-423-5313

NOT K2 THE MOUNTAIN

NOT K2 THE SKIS

K-2 AND K-3 TAX FORMS

- What entities are subject
  - Partnerships (1065).
  - S corporations (1120S)
  - US persons required to file form 8865
    - Return of U.S. persons with respect to certain foreign partnerships
  - Not C corporations (1120 or 1120-F) and
  - Not fiduciary (1041).

K-2 AND K-3

- What is it?
  - Supplemental forms for the IRS
  - Replaces two lines on schedule K and K-1
    - Lines 16 and 20 on form 1065
    - Lines 14 and 17(d) on form 1120S

HOW MANY PAGES

- Form 1065
  - 19 pages for form K-2
  - 20 pages for form K-3
- Form 1120S
  - 14 pages for form K-2
  - 15 pages for form K-3

WHY IS THE 1120S VERSION SHORTER

- The 1120S version is shorter because an S corporation cannot have foreign shareholders

WHAT DOES EACH FORM DO

- Form K-2 provides supplemental information for schedule K (entity numbers)
- Form K-3 provides supplemental information for the schedule K-1 (partner/shareholder numbers)

WHY DO WE NEED THEM

- These forms provide more information for foreign tax and credit calculations
- They also standardize the information reporting to the partners/shareholders so they do not receive a hodgepodge of information which may be incomplete, inconsistent, or just plain confusing

HOW MANY CLIENTS

- I estimate between 1% and 5% of partnerships and S corporations will need to fill out these forms depending on the activity of the entity, or the request of a single partner/shareholder

HOW MANY OF YOUR CLIENTS WILL YOU NEED TO TAKE ACTION ON

100%

SO, WHAT IF YOU DON'T

- It is only a tax form
- Lots of people miss forms all the time

HERE'S WHY

- Potential failure to file a complete return
  - May not start the statute of limitations
  - Penalty for failure to file a complete return
    - Not one, but three penalties
      - Section 6698
      - Section 6721
      - Section 6722

SECTION 6698

- Failure to file a partnership return
  - Includes failure to show the information required
  - $210 per partner per month for up to 12 months in 2022
  - $220 per partner per month for up to 12 months in 2023

SECTION 6721

- Failure to file correct information returns

Corrected on or before 30 days after required filing date	**$50 per return. Each K-2 and K-3 is considered a return**
Corrected after 30 days but before August 1	$150 per return Ditto
Corrected after August 1	$280 per return Ditto
Intentional disregard	Greater of $750 or 10% of the aggregate amount to be reported

SECTION 6722

- Failure to furnish correct payee statements

Corrected on or before 30 days after required filing date	**$50 per return. Each K-2 and K-3 is considered a return**
Corrected after 30 days but before August 1	$150 per return Ditto
Corrected after August 1	$280 per return Ditto
Intentional disregard	Greater of $750 or 10% of the aggregate amount to be reported

EXAMPLE

- Two partner partnership fails to file form K-2 and K-3 for 12 months
  - 6698 penalty = $210 * 2 partners * 12 months = $5,040
  - 6721 penalty = $280 * 1 * K-2 and K-3 (2 * 280) = $840
  - 6722 penalty = $280 * 1 * K-2 and K-3 (2 * 280) = $840
  - Total penalty = $6,720

S CORPORATIONS

- First penalty section is 6699
- Second and third penalties are the same as partnership penalties
  - 6721
  - 6722

  - Same amount of penalties

WAIVER

- We don’t know if the standard waiver request will work
  - 10 or fewer partners
  - All individuals
  - All who reported the information correctly on their personal return

LATER WE WILL TALK ABOUT THE TICKING TIME BOMB THAT THE CAT DRAGGED IN BECAUSE OF THE ASSUMPTIONS UNDER SECTION 1446

HAVE WE GOTTEN YOUR ATTENTION YET

WHAT IF YOU DON'T PREPARE RETURNS

- Can you zone out for the next 45 minutes?
- Or do you need to stay alert so you know what to discuss with your clients when you talk about choice of entity?
  - Single member LLC's might look more attractive (none of those penalties)

WHEN DO THE RULES APPLY

- A history lesson first
  - July 2021 IRS introduced schedules K-2 and K-3
  - Initial instructions said need not complete if there are no items of international tax relevance (typically international activities or foreign partners)

HISTORY PAGE 2

- January 18, 2022 additional instructions were added
  - A partnership with no foreign sourced income and no assets generating foreign source income and no foreign taxes paid or accrued may still need to complete K-2 and K-3

HISTORY PAGE 3

- For example, if a partner claims a credit for foreign taxes paid by the partner, the partner may need certain information from the partnership to complete their personal form 1116-foreign tax credit
- Instructions indicated that the ***preparer had to receive verification in writing from every partner or shareholder that they would not need the information or not be filing form 1116, or the K-2 and K-3 forms would need to be prepared***

HISTORY PAGE 4 (AFTER THE OUTCRY)

- IRS provided transitional relief for some (but not all) partnerships and S corporations.
- If you don't qualify, must still file K-2 and K-3 on your 2021 return

BUT FIRST, DO YOU NEED TRANSITIONAL RELIEF

- What are the exceptions that were already provided?
- There are two exceptions provided in Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S and 8865)

FAQ #15

- Must meet all four requirements (and it only applies to 2021)
  1. In 2021, the partners in a domestic (US) partnership must not be foreign partners, foreign corporations, foreign individuals, foreign estates, or foreign trusts

NUMBER 2

- In 2021 the partnership or S corporation has no foreign activity, including foreign taxes paid or accrued, or ownership of assets that generate, have generated, or may reasonably be expected to generate foreign source income

NUMBER 3

- In 2020 the partnership or S corporation did not provide to its partners or shareholders, nor did the partners or shareholders request the information regarding (see below)
  - On form 1065 schedule K, line 16 or 20(c)
  - On form 1120S schedule K, line 14 or 17(d)
    - (foreign tax credits or other foreign activity information)

NUMBER 4

- ➢The partnership or S corporation has no knowledge that the partners or shareholders are requesting such information for the tax year 2021

IF

- If you pass all 4 tests, then you get a free pass on filling out K-2 and K-3 **but just for 2021**

AFTER THAT

- The only other way to avoid having to provide K-2 and K-3 is to meet the requirements of FAQ #14 of Schedules K-2 and K-3 Frequently asked questions (Forms 1065, 1120S and 8865)
- Only need to meet one of the four exceptions

FAQ # 14 - # 1

- Verification by the partners/shareholders that no direct or indirect partner/shareholder is eligible to claim a foreign tax credit (on their personal or business return)

FAQ # 14 - #2

- Verification (by the same parties as in #1) that they will not be filing Form 1116 (or if a corporation form 1118) (Foreign Tax Credit Form)
  - The distinction is that in certain circumstances a taxpayer may use an exception and not file form 1116 if their tax credit is small enough

FAQ # 14- # 3 AND #4

- These exceptions deal with partnerships that only have US sourced income, no income or deductions that must be sourced or allocated and apportioned by the partner and there are less than 10% limited partners
- The exceptions appear to apply only to the LP’s

TRANSITIONAL PENALTY RELIEF PROVISIONS

- Notice 2021-39 in response to outcry
  - Requires good faith effort
    - Taxpayer must have made changes to its systems, processes, and procedures for collecting and processing information relevant to the filing of the K-2 and K-3

NOTICE 2021-39 CON'T

- IRS will also take into account the steps taken by the schedule K-2/K-3 filer to modify the partnership or S corporation agreement or governing instrument to facilitate the sharing of information with partners and shareholders that is relevant to the determination of whether and how to file schedules K-2 and K-3

MORE ON NOTICE 2021-39

- To obtain relief the filer must establish to the satisfaction of the commissioner that it made a good faith effort to comply with the schedule K-2 and K-3 filing requirements and the schedule K-3 furnishing requirements per the instructions
- The relationship between the filer and the partners will be taken into account
  - Two partners = higher standards – (you should know)
  - One hundred partners = lower standards

SOUNDS TO ME

- It sounds to me like the best practice would be for each of you to contact your partnership or S corporation clients about modifying their agreements or governing instruments to require the shareholders or partners to tell the partnership or S corporation each year whether they will be or are required to file form 1116 concerning the foreign tax credit

TOO EARLY TO TELL

- At this point, it is too early to tell whether you can use the absence of an affirmation such as each partner or shareholder is required to notify the partnership or corporation only if they will be filing form 1116, otherwise the partnership or corporation will assume that they are not

WHO IS RESPONSIBLE

- According to the IRS information, the partnership or S corporation is responsible for gathering and collecting this information, and it is they who are subject to the penalty
- Future litigation will surely occur where the partnership/ S corporation thought that the requirements were the duty of the income tax preparer instead

IF YOU PREPARE RETURNS

- Can you say modified engagement letter specifically excluding these penalties?

NOW FOR THE POTENTIAL BOMB

- Section 1446 Withholding tax on foreign partners' share of effectively connected income
- Regulation 1.1446-1(c)(3) states that in the absence of a valid W-9 or similar statement, an individual partner is presumed to be a foreign person

THEN WHAT

- Section 1446 then requires withholding on a (presumed) foreign partners' share of effectively connected income – generally at the highest rate of tax for an individual partner
- That is a partnership obligation and may cause liability of the GP or managing members of an LLC

WHAT WE DON'T KNOW

- Will the IRS take the position (now) that unless you have a W-9 for every partner, that you are required to presume they are a foreign partner and have withholding?
  - They haven't in the past, but ?????

DO YOU NEED TO BECOME A FOREIGN TAX EXPERT

- BEAT (Base Erosion Anti-Abuse Tax)
- GILTI (Global Intangible Low-Taxed Income)
- FDII (Foreign-Derived Intangible Income)
- Allocations (Foreign Partners ECI)
- Section 871(m) withholding

GOOD NEWS

- Generally, you will not need to become an expert in these foreign income tax issues

WHAT IS MOST LIKELY TO TRIGGER FORM K-2 OR K-3

- All it takes is $1 of foreign withholdings on investment income by the partnership/S corporation to trigger form K-2 and K-3
- Or a partner that will be filing form 1116

$1 OF FOREIGN WITHHOLDING

- So, what does it look like if you have $1 of foreign withholding or a partner/shareholder who will be filing form 1116

1099-DIV

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. Joe Partnership	1a Total ordinary dividends $ 100.00	OMB No. 1545-0110 Form **1099-DIV** (Rev. January 2022) For calendar year 20____	**Dividends and Distributions**
	1b Qualified dividends $ 80.00		
	2a Total capital gain distr. $	2b Unrecap. Sec. 1250 gain $	**Copy B** **For Recipient**
PAYER'S TIN / RECIPIENT'S TIN	2c Section 1202 gain $	2d Collectibles (28%) gain $	
	2e Section 897 ordinary dividends $	2f Section 897 capital gain $	
RECIPIENT'S name	3 Nondividend distributions $	4 **Federal income tax withheld** $	This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.)	5 Section 199A dividends $	6 Investment expenses $	
	7 Foreign tax paid $ $1.00 5.00	8 Foreign country or U.S. possession UK	
City or town, state or province, country, and ZIP or foreign postal code	9 Cash liquidation distributions $	10 Noncash liquidation distributions $	
11 FATCA filing requirement ☐	12 Exempt-interest dividends $	13 Specified private activity bond interest dividends $	
Account number (see instructions)	14 State / 15 State identification no.	16 State tax withheld $ $	

Form **1099-DIV** (Rev. 1-2022) (keep for your records) www.irs.gov/Form1099DIV Department of the Treasury - Internal Revenue Service

WHAT TO FILL OUT

- For Foreign Tax Credit (FTC)
- Fill out
  - K-2
    - Top of form
    - Part I
    - Part II
    - Part III

K-2 PAGE 1

SCHEDULE K-2 (Form 1065)

Department of the Treasury
Internal Revenue Service

Partners' Distributive Share Items—International

▶ Attach to Form 1065.
▶ Go to *www.irs.gov/Form1065* for instructions and the latest information.

OMB No. 1545-0123

2021

Name of partnership: Joes partnership

Employer identification number (EIN)

A Is the partnership a withholding foreign partnership?
☐ Yes ☑ No If "Yes," enter your WP-EIN ▶

B Is the partnership (including the home office or any branch) a qualified derivatives dealer?
☐ Yes ☐ No If "Yes," enter your QI-EIN ▶

C Check to indicate the parts of Schedule K-2 that apply.

			Yes	No
1	Does Part I apply? If "Yes," complete and attach Part I	1	✓	
2	Does Part II apply? If "Yes," complete and attach Part II	2	✓	
3	Does Part III apply? If "Yes," complete and attach Part III	3	✓	
4	Does Part IV apply? If "Yes," complete and attach Part IV	4		✓
5	Does Part V apply? If "Yes," complete and attach Part V	5		✓
6	Does Part VI apply? If "Yes," complete and attach Part VI	6		✓
7	Does Part VII apply? If "Yes," complete and attach Part VII	7		✓
8	Does Part VIII apply? If "Yes," complete and attach Part VIII	8		✓
9	Does Part IX apply? If "Yes," complete and attach Part IX	9		✓
10	Does Part X apply? If "Yes," complete and attach Part X	10		✓
11	Does Part XI apply? If "Yes," complete and attach Part XI	11		✓
12	Reserved for future use	12		

Part I Partnership's Other Current Year International Information

Check box(es) for additional specified attachments. See instructions.

- ☐ 1. Gain on personal property sale
- ☐ 2. Foreign oil and gas taxes
- ☐ 3. Splitter arrangements
- ☑ 4. Foreign tax translation
- ☑ 5. High-taxed income
- ☐ 6. Section 267A disallowed deduction
- ☐ 7. Form 8858 information
- ☐ 8. Form 5471 information
- ☐ 9. Other forms
- ☐ 10. Partner loan transactions
- ☐ 11. Dual consolidated loss
- ☐ 12. Other international items (attach description and statement)

Part II Foreign Tax Credit Limitation

MORE K-2 PAGE 1

(attach description and statement)

Part II **Foreign Tax Credit Limitation**

Section 1—Gross Income

	Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
			(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code ______)		
1	Sales							
A	widgets	100000						100000
B								
C								
2	Gross income from performance of services							
A	service of widgets	1000						1000
B								
C								
3	Gross rental real estate income							
A								
B								
C								
4	Other gross rental income							
A								
B								
C								

K-2 PAGE 2

Schedule K-2 (Form 1065) 2021 Page **2**

Name of partnership | EIN

Part II **Foreign Tax Credit Limitation** *(continued)*

Section 1—Gross Income *(continued)*

	Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
			(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
5	Guaranteed payments							
6	Interest income							
A								
B								
C								
7	Ordinary dividends (exclude amount on line 8)							
A	dividends from stock portfolio	100		5				105
B								
C								
8	Qualified dividends							
A	dividends from stock portfilio	80		0				80
B								
C								
9	Reserved for future use							
10	Royalties and license fees							
A								
B								
C								
11	Net short-term capital gain							
A								
B								
C								

K-2 PAGE 3

Name of partnership | EIN

Part II **Foreign Tax Credit Limitation** *(continued)*

Section 1—Gross Income *(continued)*

	Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
			(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code ____)		
15	Net section 1231 gain							
A	Sale of wieget machine	45000						45000
B								
C								
16	Section 986(c) gain							
17	Section 987 gain							
18	Section 988 gain							
19	Section 951(a) inclusions							
A								
B								
C								
20	Other income (see instructions)							
A								
B								
C								
21	Reserved for future use							
A								
B								
C								
22	Reserved for future use							
A								

K-2 PAGE 4

Name of partnership | EIN

Part II **Foreign Tax Credit Limitation** *(continued)*

Section 2—Deductions

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code ______)		
25 Expenses allocable to sales income	50000						50000
26 Expenses allocable to gross income from performances of services	300						300
27 Net short-term capital loss							
28 Net long-term capital loss							
29 Collectibles loss							
30 Net section 1231 loss							
31 Other losses							
32 Research & experimental (R&E) expenses							
A SIC code							
B SIC code							
C SIC code							
33 Allocable rental expenses—depreciation, depletion, and amortization							
34 Allocable rental expenses—other than depreciation, depletion, and amortization							
35 Allocable royalty and licensing expenses—depreciation, depletion, and amortization							
36 Allocable royalty and licensing expenses—other than depreciation, depletion, and amortization							

K-2 PAGE 5

Name of partnership | EIN

Part II **Foreign Tax Credit Limitation** *(continued)*

Section 2—Deductions *(continued)*

	Description	(a) U.S. source	Foreign Source: (b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code ______)	(f) Sourced by partner	(g) Total
46	Section 986(c) loss							
47	Section 987 loss							
48	Section 988 loss							
49	Other allocable deductions (see instructions)							
50	Other apportioned share of deductions (see instructions)							
51	Reserved for future use							
52	Reserved for future use							
53	Reserved for future use							
54	**Total deductions** (combine lines 25 through 53) ▶	50300						50300
55	**Net income (loss)** (subtract line 54 from line 24) ▶							

Part III **Other Information for Preparation of Form 1116 or 1118**

Section 1—R&E Expenses Apportionment Factors

	Description	(a) U.S. source	Foreign Source: (b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code ______) (country code ______)	(f) Sourced by partner	(g) Total
1	Gross receipts by SIC code							
A	SIC code							
B	SIC code							
C	SIC code							
D	SIC code							
E	SIC code							
F	SIC code							

2 Exclusive apportionment with respect to total R&E expenses entered on Part II, line 32. Enter the following

K-2 PAGE 6

Name of partnership | EIN

Part III **Other Information for Preparation of Form 1116 or 1118** *(continued)*

Section 2—Interest Expense Apportionment Factors

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code ____) (country code ____)		
1 Total average value of assets	300000						300000
2 Sections 734(b) and 743(b) adjustment to assets—average value							
3 Assets attracting directly allocable interest expense under Regulations section 1.861-10(e)							
4 Other assets attracting directly allocable interest expense under Regulations section 1.861-10T							
5 Assets excluded from apportionment formula							
6a Total assets used for apportionment (subtract the sum of lines 3, 4, and 5 from the sum of lines 1 and 2)	300000						300000
b Assets attracting business interest expense	300000						300000
c Assets attracting investment interest expense							
d Assets attracting passive activity interest expense							
7 Basis in stock of 10%-owned noncontrolled foreign corporations (see attachment)							
8 Basis in stock of CFCs (see attachment)							

Section 3—Foreign-Derived Intangible Income (FDII) Deduction Apportionment Factors

Foreign Source

K-2 PAGE 7

Schedule K-2 (Form 1065) 2021 Page **7**

Name of partnership | EIN

Part III **Other Information for Preparation of Form 1116 or 1118** *(continued)*

Section 4—Foreign Taxes

Description	(a) Type of tax	(b) Section 951A category income		(c) Foreign branch category income		
		U.S.	Foreign	U.S.	Foreign	Partner
1 Direct (section 901 or 903) foreign taxes: ☑ Paid ☐ Accrued						
A UK tax	withholding					
B						
C						
D						
E						
F						
2 Reduction of taxes (total)						
A Taxes on foreign mineral income						
B Reserved for future use						
C International boycott provisions						
D Failure-to-file penalties						
E Taxes with respect to splitter arrangements						
F Taxes on foreign corporate distributions						
G Other						
3 Foreign tax redeterminations						
A Related tax year ▶ Date tax paid ▶						
B Related tax year ▶ Date tax paid ▶						

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Name of partnership | EIN

Part III **Other Information for Preparation of Form 1116 or 1118** *(continued)*

Section 4—Foreign Taxes *(continued)*

	(d) Passive category income			(e) General category income			(f) Other (category code ______)	(g) Total
	U.S.	Foreign	Partner	U.S.	Foreign	Partner		
1								
A		2						2
B								
C								
D								
E								
F								
2								
A								
B								
C								
D								
E								
F								
G								
3								
A								
B								
C								
4								
5								
6								

Section 5—Other Tax Information

Description	(a) U.S. source	Foreign Source					(g) Sourced by partner	(h) Total
		(b) Section 951A category income	(c) Foreign branch category income	(d) Passive category income	(e) General category income	(f) Other (category code ______) (country code ______)		
1 Section 743(b) positive income adjustment								
2 Section 743(b)								

THEN THERE IS K-3 ON A PARTNER-BY-PARTNER BASIS

FINAL BIT OF ADVICE

- If the investment advisor gets the partnership or S corporation into an investment that generates ANY foreign tax withholding

FIRE THEM

MIDWEST ESTATE, TAX & BUSINESS PLANNING INSTITUTE 2022

CURRENT ISSUES IN FEDERAL & STATE TAX

K-2 AND K-3

BY RICHARD BARTHOLOMEW, JD CPA

GIRARDOT, STRAUCH & CO

RICHARD@GSC-CPA.COM

765-423-5313

Section Eight

49TH ANNUAL
MIDWEST ESTATE TAX & BUSINESS PLANNING INSTITUTE

LEGISLATION AND CURRENT CASES

IN ESTATES, TRUSTS AND

GUARDIANSHIPS

MaryEllen K. Bishop
Cohen Garelick & Glazier
8888 Keystone Crossing Boulevard, Suite 800
Indianapolis, IN 46240
marybishop@cgglawfirm.com
(317) 573-8888

Section Eight

Legislation and Current Cases in Estates, Trusts and Guardianships……………………..MaryEllen K. Bishop

LEGISLATIVE UPDATE FOR 2022

Senate Enrolled Act 66 **Solvent supervised estates.** Sets forth procedures for the distribution of assets in a solvent supervised estate after a final distribution has been entered in certain circumstances. Allows a distributee to distribute assets described in the decree of final distribution by filing an affidavit with the court. Provides that undistributed real property may be distributed after the estate is closed by recording certain information with the county recorder of the county in which the real property is situated. Allows a personal representative to complete distribution and delivery of all undistributed estate assets to continue for a period of 90 days after a court enters an order of discharge under certain circumstances.

Senate Enrolled Act 67 **Small estates.** Increases the value of estates that may be distributed via affidavit from $50,000 to $100,000. Increases the threshold for summary procedures for unsupervised estates from $50,000 to $100,000. (The introduced version of this bill was prepared by the probate code study commission.)

Senate Enrolled Act 193 **Probate Code Study Commission**. Provides that the chief justice of the supreme court, or the chief justice's designee, is a nonvoting member of the probate study commission and provides that only eight affirmative votes are required for the commission to take final action.

Senate Enrolled Act 149 **Marion Superior Court**. Makes clarifying changes to the powers and duties of the Marion superior court executive committee. Provides that an appointed judicial officer shall be vested by the judges of the family division of the Marion superior court with suitable powers for the handling of all probate matters of the court. Removes and reallocates the powers and duties of a probate hearing judge, probate commissioner, juvenile referee, bail commissioner, and master commissioner from the Marion superior court.

Senate Enrolled Act 131 Implements the **Uniform Electronic Legal Material Act**, which establishes a process for certain legal materials stored electronically to be: (1) designated as official; (2) authenticated; (3) preserved; and (4) made available to the public.

House Enrolled Act 1208 **Various probate and trust matters.** In one instance in the law on health care advance directives, changes the word "testator" to "declarant". Amends several provisions relating to the filing of notices to make those provisions consistent with Rules of Trial Procedure 86 and 87 concerning electronic filing. Resolves inconsistencies in two sections of the chapter on dispensing with administration so that those sections authorize a fiduciary to distribute and disburse the estate assets before filing a closing statement. Authorizes the appointment of a special administrator under certain circumstances and establishes a procedure for the appointment of a special administrator for the purpose of pursuing a claim for a decedent's wrongful death. In a section concerning the filing of an electronic will, replaces an incorrect reference with a reference to the Rules on Access to Court Records. Provides that a video or audio recording of a principal who executes a power of attorney may be admissible as evidence of matters relevant to the validity or enforceability of the power of attorney. Provides that any objection to a final account and petition for distribution of a decedent's estate must be filed at least 14 days before the hearing date.

Eliminates references to a trustee "docketing" a trust and identifies permissible methods for the filing of a copy of a trust instrument with a court. Amends two definitions of "electronic power of attorney" to provide that an electronic power of attorney may be signed in the presence of witnesses instead of being notarized. Provides that a person who has been found guilty, or guilty

but mentally ill, on a charge of causing an unlawful death of a decedent is a constructive trustee of certain property acquired or entitled to be received by the culpable person. Includes a married individual who does not have any dependents and whose death was caused by a spouse within the definition of "adult person" for the purpose of a wrongful death action. Makes conforming changes. Makes technical corrections. (The introduced version of this bill was prepared by the probate code study commission.)

House Enrolled Act 1205 **Uniform trust decanting act and trustee duties.** Allows a trustee of an irrevocable trust to appoint a successor trustee or multiple trustees. Provides that a trustee's power to appoint a successor trustee includes the power to allocate trustee powers to one or more trustees. Enacts the uniform trust decanting act. Creates a definition of the decanting power to include a power by a trustee to make limited modifications to an irrevocable trust, including an asset transfer to a new trust.

Requires that a modification be consistent with a settlor's or charitable organization's intent. Permits the trustee of an existing trust to make modifications to or distributions from an existing trust for the benefit of a disabled beneficiary. Prohibits a trustee from being required to decant. Requires advanced notice to all qualified beneficiaries. Provides that the decanting power of an authorized fiduciary is not precluded by certain terms. (The introduced version of this bill was prepared by the Probate Code Commission.)

CASE LAW UPDATE FOR 2021-2022

PROBATE

DEADMAN'S STATUTE – LLC OWNERSHIP – SUMMARY JUDGMENT. *Arnett v. Estate of Beavins,* 184 N.E.3d 679 (Ind. Ct. App. 2022). Joel Beavins filed articles of organization for Stewart Properties in 2001. His wife, Jill, owned 10%. In 2012 Joel and Arnett, old high school friends, began conducting business together. Arnett was responsible for managing four of the properties that were owned by Stewart Properties, including three rental properties. The fourth property, Arnett resided in and used for his Auto-Annex business. Arnett collected rents, executed leases with tenants, made capital improvements, preformed maintenance and paid utility bills. In 2019, Joel and Arnett sought a commercial loan which would allow Arnett to purchase the rental properties. In 2019, Joel and Arnett allegedly executed an Operating Agreement where Arnett would own 82% of Stewart Properties and Joel would own the remaining 18%. However, the Operating Agreement for Stewart Properties said that no one could become a member without the unanimous consent and Joel's wife, Jill, did not consent. Later in 2019, Joel and Arnett executed a $280,000.00 note whereby Stewart Properties would transfer the properties to Arnett. The first payment was to be made November 1, but Joel died in a plane crash on October 5 before any payments were made. Joel's estate filed a Complaint requesting possession of the residence and the other rental properties and amounts of rent collected by Arnett. The estate filed a Motion for Summary Judgment. The first issue was whether Arnett was a member of Stewart Properties. Arnett filed opposing affidavits which the estate moved to strike under the Dead Man's Statute and for authentication. The trial court granted in part, the Motions to Strike and gave the estate partial summary judgment on the membership issue.

The Court of Appeals affirmed. Most of the affidavits filed by Arnett were properly stricken under the Dead Man's Statute. Arnett attempted to avoid the Dead Man's Statute by arguing the affidavits covered issues which could not be disputed by the decedent. The Court of Appeals did not accept this way around the Dead Man's Statute. The remaining evidence in opposition to the Motion for Summary Judgment was stricken for lack of authentication. This included the email and attached Operating Agreement that would have given Arnett 82% of Stewart Properties. Finally, the Court of Appeals agreed with the trial court and the estate that the Operating Agreement for Stewart Properties clearly required Jill's consent before Arnett could become a member. It was clear that Jill never gave that consent and Arnett was never a member of Stewart Properties.

GIFT OR LOAN – STATUTE OF FRAUDS – PART PERFORMANCE – UNJUST ENRICHMENT. *Akin v. Simons,* 180 N.E.3d 366 (Ind. Ct. App. 2021). Akin and Simons were married and then divorced. Akin and Simons became co-guardians of their granddaughter. In 2012, Akin and Simons got back together but their romantic relationship didn't last. They filed separate custody and visitation action for their granddaughter. While the couple was back together, Akin transferred $229,227.05 to Simons to purchase a home where Simons could live with their granddaughter. Simons used the money to buy a home which she titled in her name alone. Akin alleged that they agreed that within thirty days of closing, Simons would repay Akin $130,000 of the money he provided by obtaining a mortgage on the home; and that the remainder of the interest in the home would be held in trust for their granddaughter. Akin filed an action against for breach of contract against his ex-wife and for the imposition of a constructive trust claiming he loaned the money to Simons. Akin also filed a Notice of Lis Pendens on the property. Simons claimed the funds were a gift. Simons filed a motion for partial summary judgment, arguing that the "alleged" agreement was unenforceable under the Statute of Frauds because there is no evidence of any writing signed to support such a claim. The trial court granted the motion. Akin appealed.

The Court of Appeals affirmed. Even though the parties differed as to whether the money was intended to be a loan or a gift, the Court of Appeals noted it was undisputed that the money was provided to Simons to purchase a home and their agreement was not in writing. The Court of Appeals held that the Statute of Frauds applied to the agreement, and the oral agreement cannot be enforced. Further, the Court held there is no requirement that Akin needed to obtain an interest in the land for the Statute of Frauds to apply. "The Statute of Frauds applies to an agreement "involving any contract for the sale of land" – and "any" means any." The Court held that Akin made a gift and not a loan. The Court further noted as a matter of law, by filing the lis pendens notice, Akin was seeking to enforce a interest against the real estate. The Court held that the lis pendens notice established a direct nexus between the action to enforce an alleged oral agreement and "an action involving any contract for the sale of the land," which implicates the Statute of Frauds.

As to the alleged independent oral agreement for the repayment of money, the Court held that the alleged oral contract for the repayment of money was not severable from the alleged oral agreement to take out a mortgage. The alleged promise to pay and the alleged promise to obtain a mortgage were indivisible and constituted a single, unitary transaction subject to the Statute of Frauds.

The Court next considered whether the alleged agreement to establish a trust for the granddaughter was enforceable. The Court held that the trust claim failed because there was no written evidence of an agreement to create a trust, and that pursuant to IC 30-4-2-1 a trust is enforceable only if there is written evidence of the terms of the trust bearing the signature of the settlor, the settlor's agent, or an authorized person on behalf of the settlor. There is no such written agreement.

Akin raised issues as to the exceptions to the Statute of Frauds: Part Performance Unjust Enrichment and Promissory Estoppel. Akin argued only promissory estoppel at the trial court, and the Court of Appeals said he did not adequately plead part performance nor unjust enrichment. A party seeking to preclude application of the Statute of Frauds based on promissory estoppel must establish the following five elements: (1) a promise by the promisor; (2) made with the expectation that the promisee will rely thereon; (3) which induces reasonable reliance by the promisee; (4) of a definite and substantial nature; and (5) injustice can be avoided only by enforcement of the promise. The Court held that Akin did not prove that his reliance on the oral promise to repay him and create a trust for his granddaughter resulted in reliance injuries that are independent from the benefit of the bargain and so substantial as to constitute the "infliction of an unjust and unconscionable injury and loss" that would remove the oral agreement from the operation of the Statute of Frauds. The Court felt the injuries Akin suffered were of the kind of adverse consequences which normally result from providing money without written documentation that the money provided is a loan and not a gift.

SPOUSE – COMPETENCY TO MARRY. Estate of Michael David Estridge v. Taylor, 2022 Ind. App. LEXIS 115. Estridge and Taylor, were firefighters and EMT/ paramedics, and they met in 2011 while employed at the same fire station. Estridge was diagnosed with cancer in 2015. In the fall of 2016, Estridge and Taylor started dating and near the end of that year, Estridge broached the subject of marriage. In 2017 the relationship became intimate and at the end of 2017, Estridge proposed to Taylor but she was hesitant to commit. After another marriage proposal in early 2018, Taylor agreed and accepted Estridge's ring. No wedding date was set as Estridge had upcoming cancer surgery. The couple's friends and co-workers were informed of the marriage plans, but Estridge and Taylor did not to tell their family because they were concerned about the big age difference between them. Taylor assisted Estridge with his medical care and appointments, and following his 2018 surgery, she assumed further caregiver duties. Estridge was informed that the cancer had spread and that his best option was palliative care. Estridge was discharged with a Fentanyl patch and Dilaudid as needed for pain. Estridge's palliative care physician noted that Estridge was able to make complicated decisions, was alert neurologically, and was sitting up in bed awake and alert, though he quickly fell asleep. Taylor asked Estridge if he still wanted to get married. Estridge replied yes and so Taylor and the others began calling people to assemble at the City-County building in Indianapolis where the wedding would take place. Back in Indianapolis, they stopped at the Firefighters Credit Union, where a notary witnessed Estridge sign the application for a marriage license. Estridge wanted Taylor to have his firefighter's pension, because, if he died unmarried, the benefit would disappear. Estridge signed a pension beneficiary designation, listing Taylor as his spousal beneficiary. At the wedding, a number of firefighter friends were present and the ceremony was presided over by the firefighter Chief. Estridge, Taylor, and the presiding officer signed the marriage license. Following the ceremony, Estridge was driven home, where he signed the Medicaid hospice election form. Estridge passed away four days later. His Estate filed a petition to annul the marriage, alleging fraud and Estridge's mental incapacity. During a two-day bench trial, both parties presented expert testimony. The Estate's expert, Dr. McCoy, when questioned as to Estridge's mental competency at the time of the marriage ceremony, testified that there's insufficient information for him to even attempt to do so, and that he believed others on Estridge's treatment team would have better opportunity to assess his competency. Taylor presented Dr. George Rodgers, PhD. In preparing his assessment of Estridge's competency, Dr. Rogers reviewed Estridge's medical records, deposition testimony of Taylor and others who observed and interacted with Estridge prior to and during the wedding ceremony, and the videorecording of the wedding ceremony. Focusing on the medical records, Dr. Rodgers opined that there was no indication other people were making medical decisions for Estridge. He noted the palliative care physician's observation that Estridge was alert and able to make complicated decisions, and the hospice admission record after the wedding noted that Estridge was alert and signed the hospice consent form himself. The trial court denied the Estate's petition to annul the marriage. The trial court also denied Taylor's request for attorney's fees. The Estate appealed and Taylor cross-appealed.

The Court of Appeals noted that marriage is a civil contract the validity of which may be challenged in court. I.C. 31-11-8-4 provides: A marriage is void if either party to the marriage was mentally incompetent when the marriage was solemnized. If a party is of unsound mind when the ceremony is performed, the marriage can be declared void, but the burden rests upon the challenger to prove that a party was incapable of understanding the nature of the marriage contract. The presumption in favor of the validity of a marriage consummated according to the forms of law is one of the strongest known. The Court of Appeals felt the trial court was presented with ample evidence and expert testimony from which it could reasonably infer that Estridge was capable of understanding the nature of the marriage contract he entered into and therefore was mentally competent at the time the marriage was solemnized. Accordingly, they affirmed the trial court's order.

Taylor contends that the trial court abused its discretion when it denied her an award of attorney's fees based on the parties' economic circumstances pursuant to Indiana Code sections 31-11-10-4 and 31-15-10-1. The Estate initially petitioned for annulment of the marriage based on I.C.§ 31-11-10-1, but it abandoned that claim before trial and pursued its claim instead pursuant to I.C.§ 31-11-8-4, which allows a marriage to be declared void due to mental incompetency. There is no statutory provision that allows a party to request reasonable attorney's fees when bringing a claim under I.C. § 31-11-8-4. Accordingly, as no statutory provision allows Taylor to request attorney's fees, and the Court affirmed the trial court's denial of Taylor's petition for attorney's fees.

GUARDIANSHIP CASES

GUARDIANSHIP – VENUE – SUFFICIENCY OF EVIDENCE – APPELLATE FEES. *Wright v. Ruiz,* 184 N.E.3d 629 (Ind. Ct. App. 2022). In 2006, Shawn Wright gave birth to a child whose father was Omar Ruiz. Since the child was 5 years old, the mother and child lived in Lake County, across the alley from the residence where the child's father lived with grandparents. The child attended Whiting schools her entire life. The father passed away July 22, 2020. Subsequent to his death, disputes arose between the father's grandparents and the mother over the care of the child. Mother was charged with disorderly conduct which was pending based on mother's successful completion of a Diversion Program. Mother had drug problems and was diagnosed with a Bipolar episode. The mother sent the child to stay with her adult half-brother in Porter County. The grandparents filed a guardianship proceeding in Lake County. The half-brother filed similar actions in Porter County. Porter County dismissed its actions without prejudice, sending everything to Lake County. The probate court entered extensive findings. Among those findings was that the mother appeared to remain off of drugs for a period of time which the court commended. However, the mother's psychological problems continued and were of a serious nature. As a result, the probate court granted the grandparents guardianship.

The Court of Appeals affirmed. The first issue was venue. The Court of Appeals found that the two weeks in Porter County was not enough to give it venue and that venue was proper in Lake County. The next issue was the sufficiency of the evidence regarding the appointment of the grandparents as guardians. The Court of Appeals agreed with the trial court that the mother's psychological condition did merit the appointment of guardians. The grandparents also asked for appellate attorney fees which was denied.

GUARDIANSHIP – DEFACTO CUSTODIANS. Geels v. Morrow, 182 N.E.3d 237 (Ind. App., 2022) and 2022 Ind. App. LEXIS 133 (opinion corrected on rehearing). Scott Geels and Erica Leitch (collectively, "Scott and Erica") appealed the trial court's denial of their petition for custody of A.R. ("Child"). Child was born on September 9, 2016, to Desiree Morrow ("Mother") and Sean Riley ("Father"). Erica provided daycare to Child from November 2017 to January 2018. In January 2018, Mother asked Scott and Erica to care for Child on a full-time basis after she lost heat in her apartment. In October, 2018, Mother asked Scott and Erica to return Child to Mother's care. They refused and Mother called police. Police contacted the Department of Child Services ("DCS"), which investigated. DCS found Mother's residence appropriate and released Child into Mother's care. Child lived with Mother for ten days until Mother returned Child to Scott and Erica where she stayed from late November 2018 until March, 2019. On March 5, 2019, Mother retrieved Child from Scott and Erica's care. On April 9, 2019, Mother allowed Scott and Erica to see Child, for the last time. On June 7, 2019, Scott and Erica filed a petition to establish guardianship of Child. From approximately June 2019 until May 2020, Child resided with Father and his girlfriend. On May 16, 2020, Mother retrieved Child from Father's care and Child has remained with Mother since. On April 29, 2021, the trial court issued its order denying Scott and Erica's petition for guardianship of Child. Scott and Erica appealed.

The Court of Appeals stated, "(w)hen we examine child custody decisions involving third parties, it is well-established that there is a presumption that fit parents act in the best interests of their children.... [S]o long as a parent adequately cares for his or her children (i.e., is fit), there will normally be no reason for the State to inject itself into the private realm of the family to further question the ability of that parent to make the best decisions concerning the rearing of that parent's children. 182 N.E.3d at 241 (citing Troxel v. Granville, 530 U.S. 57, 68, 120 S. Ct. 2054, 147 L.Ed.2d 49 (2000)). The Court went on to say, "[b]efore placing a child in the custody of a person other than the natural parent, a trial court must be satisfied by clear and convincing evidence that the best interests of the child require such a placement. The presumption in favor of the natural parent will not be overcome merely because a third party could provide better things for the child...” 182 N.E.3d at 24, 242 (citing to Truelove v. Truelove, 855 N.E.2d 311, 314 (Ind. Ct. App.2006)). The trial court determined Scott and Erica were de facto custodians of Child pursuant to Indiana Code section 31-9-2-35.5. The Court outlined numerous factors to be considered in the determination of the best interest of the child. In affirming the denial of guardianship, they court noted that Mother had provided an appropriate home for Child and the circumstances in her life had improved. While Scott and Erica may have the financial means to give Child a “better” life by some standards, their ability to so does not overshadow Mother's natural and constitutional right to raise Child. 182 N.E.3d at 246. Judgment affirmed.

Scott and Erica requested a rehearing because the Court of Appeal mischaracterized their action as a guardianship proceeding instead of a Petition to Establish De Facto Custodian Status and for Physical and Legal Custody of Minor Child. The court acknowledged that separate sections of the Indiana Code address guardianships and legal custody by a de facto custodian. I.C. § 29-3-5-3 indicates findings that must be made to appoint a guardian and I. C. § 31-17-2-8.5 defines how a de facto custodian can have legal custody of the child. The Court noted that both types of proceedings, when commenced with regards to a minor, requires inquiry into the existence of de facto custodians, which are defined in Indiana Code section 31-9-2-35.5. In addition, both types of proceedings require determination of what is in the best interests of the minor. Because the appellate review standards for guardianship cases and de facto custodian cases are used interchangeably by the Court of Appeals and the Indiana Supreme Court, the Court felt any erroneous reference in their ruling to a guardianship proceeding did not warrant a reexamination of the merits of the appeal. The Court noted that its decision was based on affirmation of the trial court's determination that Child's best interests were served by remaining in the custody of her Mother. That determination prohibited a ruling in Appellants’ favor regardless of whether the proceeding was for guardianship or custody as de facto custodians and the Court declined Appellants’ request to modify their prior decision.

WRONGFUL DEATH CASES

WRONGFUL DEATH – DEATH OF DEFENDANT – DISMISSAL – SUBSTITUTION. *Estate of Bichler v. Bichler*, 183 N.E.3d 316 (Ind. Ct. App. 2022). Jeffrey Bichler died November 17, 2017. His two children opened an estate for Jeffrey Bichler and sued their stepmother, Wanda Bichler, alleging she shot and killed their father. A life insurance company paid $300,000.00 into the court on a policy where the stepmother, Wanda, was the sole beneficiary. Wanda denied killing Jeffrey and filed a counterclaim for defamation. About a month after filing the counterclaim, Wanda died. Her two children were appointed personal representatives of her estate and moved to intervene in the cause of action filed on behalf of Jeffrey’s estate and the interpleader of the life insurance proceeds. Wanda’s estate then filed a Motion to Dismiss under TR 12(b)(2), (6) and (7) based on the Plaintiff’s failure to name the personal representative of Wanda’s estate as defendants. The trial court granted the Motion to Dismiss without specifying under what part of the TR 12 the case was dismissed.

The Court of Appeals reversed and remanded. It noted that when a party such as Wanda dies, evaluation needs to be done under TR 25 which deals with substitution of parties. While the Federal Rule has a time limit to substitute parties, Indiana's rule does not. The case was remanded for the trial court to apply the appropriate trial rule and allow substitution.

WRONGFUL DEATH – GRANDSON – PERSONAL REPRESENTATIVE OF FATHER'S ESTATE- RIGHT TO PURSUE. *Johnson v. Harris*, 176 N.E.3d 252 (Ind. Ct. App. 2021), trans. denied. In 2013, the two-year-old son of Bobby Nicely (Father) and Michelle Nicely (Mother), drowned in a swimming pool at the Harris'. (Maternal Grandparents). Mother soon filed for divorce from Father. Father retained a lawyer to discuss a possible wrongful death lawsuit against Maternal Grandparents. A dissolution decree was entered ending Mother and Father's marriage. Father died four days later. Paternal Grandmother, as PR of Father's (her son's) estate, brought a wrongful death action for the death of her grandson under the Child Wrongful Death Statute (CWDS) contained in I.C.§ 34-23-2-1. The trial court granted Maternal Grandparent's motion for summary judgment and Paternal Grandmother appealed.

Maternal Grandparents and Mother alleged that the CWDS does not authorize the Paternal Grandmother to file a wrongful death action and that the Mother was entitled to parental immunity. The Court of Appeals noted that wrongful death actions are purely statutory and therefore the statutes must be strictly construed. The CWDS provides in relevant part under Ind. Code § 34-23-2-1:

> (c) An action may be maintained under this section against the person whose wrongful act or omission caused the injury or death of a child. The action may be maintained by:
> > (1) the father and mother jointly, or either of them by naming the other parent as a codefendant to answer as to his or her interest;
> > (2) in case of divorce or dissolution of marriage, the person to whom custody of the child was awarded; and
> > (3) a guardian, for the injury or death of a protected person.
>
> (d) In case of death of the person to whom custody of a child was awarded, a personal representative shall be appointed to maintain the action for the injury or death of the child.
> (e) In an action brought by a guardian for an injury to a protected person, the damages inure to the benefit of the protected person.

Paternal Grandmother claimed her authority to sue under the CWDS arose under subsection (d) of Ind. Code § 34-23-2-1, in conjunction with Indiana Code § 29-1-13-3. Indiana Code § 29-1-13-3 provides that a personal representative has power to maintain any suit, in his name as such personal representative, for any demand of whatever nature due the decedent or his estate.... Maternal Grandparents argued that Father was never granted custody so subsection (d) could not apply, and that subsection (d) would only allow a PR to continue an action already filed. The Court of Appeals, in affirming the decision of the trial court reasoned that "strictly construed, the plain language of the CWDS authorizes three categories of people to "maintain"a child wrongful death lawsuit: 1) parents; 2) the child's guardian; and 3) the personal representative of the estate of a person who had been awarded custody of the child. I.C. § 34-23-2-1(c), (d). To avoid any violation of a non-custodial parent's right to equal protection under the Fourteenth Amendment, we have interpreted the CWDS "to permit non-custodial parents [as well as custodial parents] standing to bring an action for the wrongful death of a child," despite contrary language in the CWDS. *Chamness v. Carter,* 575 N.E.2d 317, 319-21 (Ind. Ct. App. 1991) (interpreting an earlier version of the child wrongful death statute, then codified as Indiana Code § 34-1-1-8)."

"Father had a right under the CWDS to file a wrongful death lawsuit during his lifetime. I.C. §34-23-2-1(c). However, Father's right to file the lawsuit for the wrongful death of his child expired at Father's death under the CWDS. I.C. § 34-23-2-1(c). As neither Father nor Mother ever filed a wrongful death lawsuit against Maternal Grandparents, Maternal Grandparents owed nothing to either Father or his estate as a result of son's death. Therefore, Paternal Grandmother, as personal representative of Father's estate, had nothing to collect from Maternal Grandparents under Indiana Code § 29-1-13-3." Judgment affirmed.

POWER OF ATTORNEY CASES

POWER OF ATTORNEY – ACCOUNTING – BURDEN OF PROOF. *DeHart v. DeHart,* 181 N.E.3d 989 (Ind. Ct. App. 2021). DeHart had two children, Jeff and Christine. DeHart and Christine signed an Indiana Durable Power of Attorney naming Christine as Darlene's attorney-in-fact. Darlene moved in with Christine. Son filed verified petition for accounting under power of attorney, alleging that his sister had signed the document naming herself as their mother's attorney-in-fact, that he had not seen document, and that he believed sister was misappropriating mother's funds. Mother moved to intervene and objected to petition. The court, granted mother's objection, concluding that it was not in Darlene's best interest to require an accounting in the absence of incapacity,undue influence, abuse, or misappropriation. Son appealed.

Prior to 2019, Indiana Code §30-5-6-4 provided in relevant part: "attorney in fact shall render a written accounting if an accounting is ordered by a court ... [or] requested by ... a child of the principal." In 2019, the statute was amended to state that the attorney in fact shall provide a written accounting to a child of the principal "unless a court finds that such a rendering is not in the best interests of the principal." DeHart provided the court with a letter from a nurse practitioner who examined her for over an hour less than a month before the evidentiary hearing stating she was of clear mind. DeHart told the trial court she approved of Christine's efforts as her agent; her daughter discussed her bills with her; she believed Jeff was only interested in her money, and she opposed his request for an accounting because she felt her finances were none of his business. In affirming the lower court's decision, the Court of Appeals noted there was ample evidence to support the decision that an accounting was not in DeHart's best interest because she was competent to appoint and maintain Christine as her agent and she was entitled to privacy in the management of her finances.

TRUST CASES

BENEFICIARY – IDENTIFICATION – REASONABLE CERTAINTY – "OTHERS". *Estate of Wilson v. Wilson*, 181 N.E.3d 417 (Ind. Ct. App. 2021). Personal representative of testator's estate filed petition to probate testator's will. Testator's son filed petition to require representative to produce trust documents identified in Decedent's residuary clause of his Will. The Decedent's attorney had not prepared a separate trust as he intended to create a testamentary trust. The residuary provision of testator's will provided for the residue of testator's estate to be given to the personal representative, in trust, to be distributed "to my family and others." The court concluded that the Trust had failed to identify the trust beneficiaries with reasonable certainty and concluded that because no trust can exist, the disposition of the residuary of the Estate was ineffective. The court determined the estate would pass pursuant to intestate succession. New counsel entered an appearance for the PR and attempted to enforce the decedent's intent, in spite of the language in the will. The PR filed a motion to correct errors, which was denied. PR next appealed. PR argued that the trial court erred when it denied his motion to correct error because the language in the Will created a valid trust under Indiana law as the beneficiaries had been sufficiently identified from the language to my family and others *as per my instructions to him* and PR was never given an opportunity to testify as to the directions given to him by Decedent. Further, PR argued that Indiana Code § 30-4-2-1 provides that a power of a trustee to select a beneficiary from an indefinite class is valid.

In affirming the decision of the trial court, the Court of Appeals reasoned that although the settlor need not identify a beneficiary with exact precision, the settlor must give the trustee the ability to determine an intended beneficiary. The Court noted that Indiana Code § 30-4-2-1(c) directs the settlor to identify a beneficiary with "reasonable certainty" and Indiana Code § 30-4-2-1(f) states that a beneficiary must be capable of being "ascertained," The Court interpreted Indiana Code § 30-4-2-1(g) to provide that a trustee can select a beneficiary "from an indefinite class," but that requires the settlor first limit the trustee's discretion by identifying an indefinite class. The Court that nothing close to such an identification existed in the document. While the Probate Code includes a definition for "family" neither the Trust Code nor the Probate Code defines "others."

RESTRAINT ON MARRIAGE – NOT APPLICABLE TO TRUSTS. *Roger D. Rotert v. Connie S. Stiles*, 174 N.E.3d 1067 (Ind. Ct. App. 2021). Borcherding executed a revocable living trust that divided her property between her son, Rotert; her daughter, Stiles; and her four stepchildren. The trust created a separate trust for Rotert's share and appointed Stiles as trustee. The trust contained the following provision:

> In the event that (Rotert's) is unmarried at the time of my death, I give, devise and bequeath his share of my estate to him outright and the provisions of this trust shall have no effect. However, in the event that he is married at the time of my death, this trust shall become effective, as set out below.

Rotert had been married to his third wife when Borcherding executed the trust. But before the trust's execution, Rotert's wife filed for divorce. The couple later reconciled and were married when Borcherding died. After Borcherding's death, Stiles, as trustee, distributed the cash in Rotert's trust to him but agreed that his real property would stay in his trust. Rotert filed suit, alleging the provision in the trust was a void restraint against marriage.

After a hearing, the trial court found that the trust's terms were not void for public policy; and denied Rotert's motion for summary judgment and granted Stiles motion. Rotert appealed and argued, that the trial court violated his due-process rights by not permitting him to respond to Stiles cross-motion for summary judgment (a procedural issue I am not addressing in this summary); and, second, that the challenged trust provision is void as a restraint against marriage. The Court of Appeals held that the challenged provision is an impermissible restraint against marriage and found in Rotert's favor, *Rotert v. Stiles*, 159 N.E.3d 46, 53 (Ind. Ct. App. 2020). Stiles sought transfer, which was granted.

The Indiana Supreme Court held that the statutory prohibition of restraints against marriage applies only to <u>dispositions to a spouse by will and not to dispositions by trust</u>. (Emphasis added). The Court affirmed the trial court. The Court referenced that the Indiana Probate Code says that "[a] devise to a spouse with a condition in restraint of marriage shall stand, but the condition shall be void." Ind. Code § 29-1-6-3. Further, the Court noted that 29-1-1-3(a) sets out the definitions that apply throughout the probate code. When used as a noun in the probate code, "devise" means "a testamentary disposition of either real or personal property or both." Id. § 29-1-1-3(a)(6). And a "testamentary disposition", though not defined by subsection 29-1-1-3(a), is something our Court has long considered the distinguishing feature of a will. The Court held that this matter involved neither a testamentary devise nor a devise to a spouse, but a disposition by a revocable trust to a child and therefore the statutory prohibition under Indiana's probate code did not apply.

The Court examined Indiana's Trust Code and noted that it does not prohibit conditions in restraint of marriage at all. According to the statute: "The rules of law contained in this article"— referring to the trust code—"shall be interpreted and applied to the terms of the trust so as to implement the intent of the settlor and the purposes of the trust." I.C. § 30-4-1-3. As a result, the section continues, "[i]f the rules of law and the terms of the trust conflict, the terms of the trust shall control unless the rules of law clearly prohibit or restrict the article which the terms of the trust purport to authorize." Because the probate code's bar against restraints on marriage does not apply to trusts or gifts to children, Borcherding's disposition by a revocable trust to her son is valid. The Court affirmed the trial court's entry of summary judgment.

Section Nine

Indiana Continuing Legal Education Forum

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GETTING ACQUAINTED WITH (AND USING) INDIANA'S UNIFORM TRUST DECANTING ACT

by Jeffrey S. Dible
Frost Brown Todd LLC
jdible@fbtlaw.com

Indianapolis, Indiana

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DISCLAIMER

Jeff Dible has used his best efforts to include accurate and up-to-date information in this paper. Citations to and the URL link for the Indiana Uniform Trust Decanting Act (HEA 1205) are the latest available from the Indiana General Assembly's web site.

Section Nine

Getting Acquainted With (and Using) Indiana's Uniform Trust Decanting Act..............................Jeffrey S. Dible

GETTING ACQUAINTED WITH (AND USING) INDIANA'S UNIFORM TRUST DECANTING ACT

(1) Overview of House Enrolled Act 1205 (P.L. 161-2022): One new provision in I.C. 30-4-3 *and* enactment of the Uniform Trust Decanting Act

Text: http://iga.in.gov/legislative/2022/bills/house/1205#document-286078ce

This legislation was signed by the Governor on March 18, 2022. HEA 1205 comprises two parts, and both are additions to the Indiana Trust Code, effective on and after July 1, 2022.

The **first part** is a single new section, § 30-4-3-29.3, which is added to the Trust Code to make it easier to change the trustee structure of an existing irrevocable trust, by replacing a single trustee with 2 or more trustees, with a division of labor established between those trustees, so that the multiple trustees have non-overlapping duties, powers, and potential liabilities.

New I.C. § 30-4-3-29.3 is fairly short, is based on a Delaware Trust Code provision, and will apply whenever some person has the power to fill a vacancy in a trustee position, whether the power to appoint a successor trustee exists under a provision in the trust instrument or under I.C. § 30-4-3-33:

> Sec. 29.3. (a) The power to appoint a successor trustee under a governing instrument or under section 33 of this chapter includes:
>
> (1) the power to appoint multiple successor trustees; and
>
> (2) the power to allocate trustee powers to one (1) or more trustees.
>
> (b) A trustee to whom powers:
>
> (1) have been exclusively allocated under subsection (a) must be a fiduciary only with respect to the powers allocated; and
>
> (2) have not been allocated under subsection (a) is not liable for the actions of a trustee to whom the powers, duties, and responsibilities are allocated.
>
> (c) The rules governing the rights, powers, duties, and liabilities of a governing instrument under this chapter apply to a trustee appointed under this section unless expressly limited by the terms of a governing instrument.

Note that new section 29.3 says nothing about *how many people* may hold the power to appoint a successor trustee. If the trust instrument is silent and if I.C. § 30-4-3-33 applies, the power to appoint a successor trustee may be held collectively by the qualified beneficiaries of the trust, who would have to act by majority vote to exercise the power. It may not be easy for multiple individuals to accomplish a successful majority vote that appoints 2 or 3 successor trustees and which establishes a division of powers and duties among the trustees.

Note also that new section 29.3 says nothing about establishing positions, powers and duties of non-trustee fiduciaries ("trust directors" under I.C. 30-4-9) *in addition to* multiple trustees. The ISBA may be able to get section 29.3 amended in a future year to allow trust director positions to be added at the same time as the appointment of one or more successor trustees.

The **second part** of HEA 1205 consists of the rest of the 24-page Enrolled Act which enacted Indiana's version of the Uniform Trust Decanting Act, which is added to the Indiana Trust Code as new chapter 10 (I.C. 30-4-10). Indiana is the 13th State to enact the UTDA.

The Indiana UTDA is effective on July 1, 2022, and our prior (2010) trust decanting statute (I.C. § 30-4-3-36) is repealed, also for decisions made or actions taken on or after July 1, 2022.

(2) CRUCIAL practice pointer: Time to use the "old" decanting statute § 30-4-3-36 before its June 30th repeal is quickly running out.

As explained in more detail below, the existing "old" trust decanting statute, despite its deficiencies, has permitted a trustee to make a wide variety of changes to the dispositive or substantive terms of an irrevocable trust *if the trustee has any discretion at all* to distribute trust principal to or for the benefit of any beneficiary of the original or "first" trust.

However, and depending on the structure of a particular "first trust" and whether it limits the trustee's discretionary distribution powers, some changes that can be made using the existing "old" decanting statute may be impossible on or after July 1, 2022 under the new Uniform Trust Decanting Act.

Under both the old statute and the new Act, the trustee or other fiduciary who has the power to decant (to distribute trust principal) must send a "pre-decanting notice" to the qualified beneficiaries of the first trust, at least 60 days before the actual exercise of the decanting power. The pre-decanting notice informs the qualified beneficiaries of the changes that the trustee or other fiduciary intends to make through decanting.

This 60-day lead time gives the trustee of the first trust an opportunity to start the decanting process on or before June 30, 2022, to say that the trustee is using and relying on the old existing statute, and to rely on the old statute. The argument is not perfect, and it works only if the trustee sends out the pre-decanting notice before June 30, 2022.

A trustee of an existing "first trust" who has been thinking about making changes through decanting should carefully review the extent of the trustee's discretionary distribution power *and* the kinds of substantive or dispositive changes that the trustee had planned to make through decanting. If a change is possible under old section 30-4-3-36 and not possible under the new Act, the trustee should send out the pre-decanting notice and other required information as early as possible before June 30, 2022. Conversely, if the desired change can be accomplished through decanting only under the new Act, the trustee should wait until July 1, 2022 or later to send out the pre-decanting notice.

(3) Trusts that are subject to the new Indiana trust decanting Act

Unless the trust has *only* charitable beneficiaries and is held or administered *solely* for charitable purposes (*see* I.C. § 30-4-10-1(c)(1)), or unless the trust's terms specifically prohibit the exercise of a statutory decanting power, the new Indiana Act will apply to every newly-created or existing *irrevocable* trust that has *either* a principal place of administration in Indiana *or* an Indiana governing law provision that applies to the administration or construction of the trust.

(4) Gaps in and shortcomings of old section 30-4-3-36

Indiana's previous trust decanting statute was based on Florida's statute, was first enacted in 2010, and consists of just 574 words. For highly experienced trust lawyers and for trustees that are not risk-averse, our old statute has offered a lot of freedom in designing the structure of the "second trust" that would receive assets decanted or poured from a first trust.

However, old I.C. § 30-4-3-36 was always short on detail, contained no internal definitions, and was silent on numerous issues:

- Old § 36 did not use the term "decanting" and based the trustee's power to decant on the old conceptual model of a trustee's discretionary power to distribute principal in further trust for at least one beneficiary or the first or current trust.
- Old § 36 did not address fact patterns in which *someone else* (e.g., a trust director such as a distribution committee or trust protector) has the *discretion* to direct the trustee to distribute principal.
- Old § 36 did not say who should be treated as the "settlor" of the second trust that receives a decanting distribution.
- Old § 36 did not address the potential loss of tax benefits for the second trust or for the settlor, *other than* the loss of a marital or charitable transfer tax deduction or the loss of a § 2503 annual exclusion.
- Old § 36 contained no provisions for protecting charitable beneficiaries' interests in a first trust, other than prohibiting changes that would destroy an estate or gift tax charitable deduction.

- Other than a single sentence in subsection (c) [which prohibited postponing the time for vesting for Rule Against Perpetuities purposes], old § 36 did not address GST tax issues.
- Old § 36 did not prohibit changes through decanting that could eliminate important rights or powers (such as a power to remove or replace a trustee) in the terms of the second trust.
- Old § 36 was silent on the issue of whether the terms of a second trust could grant or confer a power of appointment that could be exercised in favor of persons who are not beneficiaries of the first trust.
- Old § 36 was silent about whether a trustee could decant assets to a second trust that would increase the trustee's compensation or reduce the trustee's standard of liability or conduct.
- Old § 36 did not mention beneficiaries with disabilities and did not allow decanting to replace an "outright" distributive share or a mandatory income interest with a discretionary interest, to enable a disabled beneficiary to successfully apply for means-tested public benefits.

In practical terms, the above shortcomings and gaps in our old decanting statute created two types of problems: *First*, some worthwhile objectives could not be accomplished through decanting at all in Indiana. And *second*, a trustee who received substandard or incomplete legal advice could commit some costly mistakes by decanting trust assets to a second-trust with ill-conceived provisions.

All of the above-listed deficiencies are addressed in I.C. 30-4-10, Indiana's version of the Uniform Trust Decanting Act.

(5) New specifically defined terms in the new Decanting Act

New I.C. 30-4-10 includes 47 specifically defined terms. Seven (7) of those definitions are borrowed from elsewhere in the Indiana Trust Code or from other Indiana statutes, but the rest of the defined terms in the Act are new. Here are some of the more important new definitions:

- "Decanting power" (§ 30-4-10-12): The power of an "authorized fiduciary" (*see below*) to distribute property of a first trust to one or more second trusts OR "to modify the terms of the first trust." ***Comment***: *This definition is significant because it allows a trustee or other authorized fiduciary to modify the first trust's terms without actually transferring assets to a second trust.*
- "Authorized fiduciary" (§ 30-4-10-4): A trustee, trust director, or other fiduciary (but not a settlor) that has discretion to distribute or to direct the distribution of principal of the first trust to 1 or more current beneficiaries. ***Comment:*** *This definition recognizes that a trust director may be the person who has the discretion to direct*

principal distributions, and therefore will be the "authorized fiduciary" who can use the decanting procedures under the new Act.

- "Settlor" (§§ 30-4-10-28 and 30-4-10-55): The definition incorporates the regular Indiana Trust Code definition of "settlor" (a person who creates a trust) but with these additions:
  - With respect to assets that are decanted from the first trust to a second trust, the settlor of the first trust is "deemed" to be a settlor of the second trust (§ 55(a)).
  - If more than 1 person creates or contributes property to a trust, each person is a "settlor" with respect to the portion of the trust that is attributable to his or her contribution except to the extent that another person has a power to revoke or withdraw that portion (§ 24(b)).
  - In determining a "settlor's" intent with respect to a second trust, evidence of the intent of the authorized fiduciary (who exercises the decanting power) or of the intent of the settlor of the first trust may also be considered (§ 55(b)).
- "Current beneficiary" (§ 30-4-10-11): "A beneficiary who, on the date that the beneficiary's qualification is determined, is a distributee or permissible distributee of trust income or principal" (also includes the holder of a presently exercisable *general* power of appointment).
- "Successor beneficiary" (§ 30-4-10-41(c)): A beneficiary that is not a qualified beneficiary (under I.C. § 30-4-1-2(19)) on the date the beneficiary's qualification is determined. ***Comment***: *This concept is used to regulate what powers of appointment can be created within the second trust and what beneficiaries can be given stronger or more definite interests under the second trust.*
- "Presumptive remainder beneficiary" (§ 30-4-10-41(b)): A qualified beneficiary who is not a current beneficiary.
- "Beneficiary with a disability" (§ 30-4-10-6): This is a broad and detailed definition that does not appear in the national, original Uniform Act. It is similar to the definition of "incapacitated person" in the guardianship statute (I.C. § 29-3-1-7.5), but here, "disability" also includes susceptibility to financial exploitation *and* progressive diseases or conditions that may impair a beneficiary's ability to provide self-care or to manage assets *currently or in the future*.
- "Noncontingent right" (§ 30-4-10-41(a)): A right that is *not* subject to the exercise of discretion or subject to the occurrence of a specified event that is not certain to occur.
- "Vested interest" (§ 30-4-10-41(d)): This is an important multi-part definition:

- A "right to a mandatory distribution that is a noncontingent right as of the date of the exercise of the decanting power";
- A "current and noncontingent right, annually or more frequently, to a mandatory distribution of income, a specified dollar amount, or a percentage of value of some or all of the trust property";
- A "current and noncontingent right, annually or more frequently, to withdraw income, a specified dollar amount, or a percentage of value of some or all of the trust property";
- A "presently exercisable general power of appointment";[1] or
- A "right to receive an ascertainable part of the trust property on the trust's termination that is not subject to the exercise of discretion or to the occurrence of a specified event that is not certain to occur."

Unless a beneficiary of the first trust is disabled and unless new section 43 can be used to create a special needs trust as the second trust, the exercise of the decanting power cannot "reduce or eliminate a vested interest" under the first trust (§ 30-4-10-41(f)(3).

- "Ascertainable standard" (§ 30-4-10-3) and "reasonably definite standard" (§ 30-4-10-24): The Act borrows the federal tax law definitions of these terms from Code sections 674(b)(5)(A), 2041(b)(1)(A), and 2514(c)(1) and also refer to the "applicable regulations."
- "Expanded distributive discretion" (§ 30-4-10-14): "A discretionary power of distribution that is not limited to an ascertainable standard or a reasonably definite standard."
- "Limited distributive discretion" (§ 30-4-10-42(a)): "A discretionary power of distribution that is limited to an ascertainable standard or a reasonably definite standard."

As explained further in **Part (8)** below, one of the most important top-level changes in Indiana law under the Act is that the *kinds* of changes that can be made (through decanting) in the second trust will be *broad* if the trustee or other authorized fiduciary has "expanded distributive discretion" (no ascertainable standard or reasonably definite standard as a limitation), but the *kinds* of changes that can be made will be *narrow* if the trustee or other authorized fiduciary has only "limited distributive discretion."

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[1] New I.C. § 30-4-10-17, -20, -21, and -22 contain common-sense and helpful definitions of "powerholder," "power of appointment," general power of appointment," and "presently exercisable power of appointment."

(6) Decanting requirements, rules and procedures under old § 30-4-3-36 that are continued (but usually in more detail) under the new Act

Practical Issue, Rule or Requirement	Provision in Old § 30-4-3-36	Provision in New Act (IC 30-4-10)	Comment
The written terms of the "first trust" can prohibit or restrict decanting	Opening lines of § 36(a)	§ 1(d) and § 45(a)	If the first trust's terms do not prohibit or restrict decanting, § 33(d) says the first trust's terms are deemed to include the decanting power
Any "first trust" can include a specific decanting power that is broader than the statutory power	§ 36(g)	§ 1(c)(4)	A specific decanting provision included in the written terms of a trust controls over a contrary rule in the Act
Not a breach of fiduciary duty or actionable misconduct if a trustee declines to decant	§ 36(f)	33(c)	The trustee of a first trust also has no duty to inform the beneficiaries about the availability of decanting
A spendthrift clause or a general prohibition of amendment or revocation does not restrict or prohibit the trustee's power to decant	§ 36(e)	§ 45(c)	The Act adds that decanting is not prevented by a general provision that prohibits assignment of a beneficiary's interest in the first trust
Decanting does not require the probate court's approval or the consent of any beneficiaries	Inferred from the silence of section 36 about court approval or consent	§ 33(a)	To prevent the IRS arguing that any beneficiary has made a taxable gift to any other beneficiary as a result of a change accomplished through decanting to a second trust, the beneficiaries should not consent to any change in dispositive terms

Practical Issue, Rule or Requirement	Provision in Old § 30-4-3-36	Provision in New Act (IC 30-4-10)	Comment
A trustee with the power to decant can petition the probate court for instructions about whether to decant and with what changes	Inferred from I.C. § 30-4-3-18(a)	§ 39(a)	Section 39 in the Act is more detailed about the kinds of guidance that a trustee or other authorized fiduciary can request from the probate court
Requirement for a pre-decanting notice to qualified beneficiaries at least 60 days in advance of proposed decanting	§ 36(d), first sentence	§§ 35 through 38	The Act's requirements are broader and more detailed; *see* **Part (7)** below
Requirement for a written "record of exercise" of the decanting power	§ 36	§ 40	The Act's § 40 is more detailed about the required content of the record of exercise; *see* **Part (7)** below
A beneficiary can petition the probate court for an order preventing decanting *OR* to allege that the decanting is a breach of duty or has violated beneficiary rights	§ 36(d), last sentence	§ 37(a) § 39(a)(4) and (a)(7)	Even after expiration of the 60-day notice period or after a waiver of notice, a beneficiary or other person can file a petition for a determination that a proposed or completed decanting violated the act or is a breach of fiduciary duty
For Rule Against Perpetuities (RAP) purposes, preventing the postponement of vesting or termination under the second trust	§ 36(c), last sentence	§ 50(b)	The terms of the second trust *can* extend the duration or postpone the vesting in enjoyment of various beneficial interests, but not beyond the end of the RAP period

What is the legal effect of a change that is made through decanting in the second trust but which violates a rule or restriction in the new Act? A handy provision (new I.C. § 30-4-10-52) provides the answers:

- **The "read out" rule**: If the second-trust instrument contains a changed or new provision that is prohibited under the Act, that provision is *void* "to the extent necessary to comply with this chapter [IC 30-4-10]."
- **The "read in" rule** If the second-trust instrument should have kept some provision from the first trust that the Act required to be preserved, that provision is "deemed to be included in the instrument to the extent necessary to comply with this chapter."
- If a trustee or other fiduciary determines that either of the above rules applies as a result of a prior exercise of the decanting power, the trustee or other fiduciary "shall take corrective action consistent with the fiduciary's duties." I.C. § 30-4-10-52(c).

(7) Requirements for the "pre-decanting notice" and the "record of exercise" of the decanting power under the Indiana Act

As stated in the above table, these two requirements were also in the repealed section 30-4-3-36 and were carried over into the Act (in part because they are extremely common elements of the trust decanting statutes in most States).

Old I.C. § 30-4-3-36(d) required the trustee to provide the 60-day pre-decanting notice to all qualified beneficiaries (as defined in I.C. § 30-4-1-2(19)) of the first trust but did not specify the content of the pre-decanting notice, except for this sentence: "A copy of the proposed instrument exercising the power satisfies the trustee's notice obligation under this subsection."[2]

In the new Act, the person who must give the pre-decanting notice is the "authorized fiduciary" (which may be either a trustee or a trust director) who possesses and intends to exercise the decanting power. New I.C. § 30-4-10-36 lists the minimum required content for the 60-day pre-decanting notice, which must:

> "(1) specify the manner in which the authorized fiduciary intends to exercise the decanting power;
>
> (2) specify the proposed effective date for the exercise of the decanting power;

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[2] Because the required content for the written record of exercise was not specified in detail in subsection 36(c) of the repealed statute, this writer had to design his own "notice" and "record of exercise" forms to include, at a minimum, the details of the terms of the first trust that were being changed in the second trust.

(3) include a copy of the first-trust instrument; and

(4) include a copy of the second-trust instrument."

Section 35(a) in the new Act expands the class of persons who must be served with the 60-day pre-decanting notice, to include not just the qualified beneficiaries of the first trust but also —

- each settlor of the first trust who is still alive or in existence,
- each fiduciary of the first trust,
- each fiduciary of the second trust,
- each person that currently has the right to remove or replace the authorized fiduciary who is giving the notice,
- each person who holds a presently exercisable power of appointment under the first trust, and
- the attorney general of the state, if the first trust contains a charitable interest.

If an individual is listed above and is supposed to receive a pre-decanting notice, but if that individual is a minor or unborn or incapacitated or cannot be located, the authorized fiduciary can serve the notice on a virtual representative for that individual, including a "designated representative," under I.C.§ § 30-4-6-10.5. *See* new I.C.§ 30-4-10-35(a)(2), -35(c), and 38.

New § 30-4-10-35(b) says that the 60-day pre-decanting notice period begins on the day when the notice is given and expires 59 days later. Subsection 35(d) provides that the 60-day lead time may be waived only if *all* the persons who are entitled to receive the notice sign written waivers.

Under repealed I.C. § 30-4-3-36(c), the written record of exercise of the decanting power must be "signed and acknowledged by the trustee; and . . . filed with the records of the first trust." The old statute says nothing about the required *content* of the "record of exercise. In this writer's opinion, the best practice under this old Indiana statute is to include in the record of exercise, at a minimum, all of the written terms of the second trust and confirmation of what changes were made, compared to the first trust's terms.

New I.C. § 30-4-10-40 helpfully specifies the required content of the "record of exercise" that the authorized fiduciary must sign and keep. The signed record of exercise must:

"(1) directly or indirectly reference the notice required by section 35 of this chapter;

(2) identify the first trust and the second trust;

(3) identify and state the property of the first trust being distributed to each second trust; and

(4) identify the property that remains in the first trust."

The written terms (*i.e.*, the trust instrument) of the second trust are not required to be included in the record of exercise *because they are part of the required content of the 60-day pre-decanting notice*.

(8) Differences between "second trust" modifications that are possible with "expanded distributive discretion" vs. "limited distributive discretion"

Indiana's version of the Act, like the national version, contains *two separate* statements of the power and authority of an "authorized fiduciary to decant:

- Section 30-4-10-41(e) states, "an authorized fiduciary that has **expanded distributive discretion** over the principal of a first trust for the benefit of one (1) or more current beneficiaries may exercise the decanting power over the principal of the first trust." *The stated exceptions to this general rule are in subsection 41(f) [explained below] and in subsection 44 for trusts with charitable interests.*
- Section 30-4-10-42(b) states, "an authorized fiduciary that has limited distributive discretion over the principal of the first trust for the benefit of one (1) or more current beneficiaries may exercise the decanting power over the principal of the first trust," subject to important restrictions in subsections (c) and (d) [explained below].

If a trustee or other authorized fiduciary has a discretionary distribution power (decanting power) that applies to fewer than all the principal assets of the first trust (*e.g.*, only with respect to "Family Fund A"), then the authorized fiduciary can exercise the decanting power only with respect to that subset of the first trust's principal. *See* I.C. §§ 30-4-10-41(i) and 30-4-10-42(e).

The following table summarizes the kinds of changes that can or cannot be made in the terms of the second trust, according to whether the trustee or other authorized fiduciary has "expanded distributive discretion" or only "limited distributive discretion." These rules are found in sections 41 and 42 of the new Indiana Act.

If the authorized fiduciary has "expanded distributive discretion" —	**If the authorized fiduciary has only "limited distributive discretion" —**
The terms of the second trust *CAN* make these changes (compared to first trust): • *CAN* postpone or accelerate the vesting in enjoyment of a beneficiary's interest that is not a (currently) "vested interest"	The terms of the second trust *CAN* make these changes (compared to first trust): • *CAN* make any changes in administrative provisions not explicitly prohibited in the rest of the Act

If the authorized fiduciary has "expanded distributive discretion" —	If the authorized fiduciary has only "limited distributive discretion" —
• *CAN* make a successor beneficiary a presumptive remainder beneficiary	• *CAN* change the governing law under the second trust to a different jurisdiction
• *CAN* change the distribution standards for any beneficiary's *discretionary* interest in the first trust • *CAN* delete an appointment power that is NOT a presently exercisable general power of appointment	• If the first trust requires a distribution to be made *directly to* a beneficiary, *CAN* provide that the distribution can be paid or applied "for the benefit" of that beneficiary (so long as the "substantially similar beneficial interest" requirement is satisfied
• *CAN* create or modify a power of appointment for a current beneficiary who is eligible to benefit from principal distributed under expanded distributive discretion	The terms of the second trust *CANNOT* make these changes (except with respect to a beneficiary with a disability (Sec. 43)):
• *CAN* create or modify an appointment power for a successor beneficiary or presumptive remainder beneficiary of the first trust, but ONLY if the power will be exercisable after the power holder becomes a current beneficiary	• *CANNOT* reduce or eliminate a vested right such as a mandatory right to receive distributions or a currently exercisable withdrawal power
• *CAN* include a new or modified appointment power exercisable in favor of appointees who are not beneficiaries of the first trust • *CAN* change the governing law under the second trust to a different jurisdiction • *CAN* make any changes in administrative provisions not explicitly prohibited in the rest of the Act	• *CANNOT* add a current beneficiary who is not a current beneficiary of the first trust • *CANNOT* add as a presumptive remainder beneficiary or successor beneficiary a person who isn't a current beneficiary, presumptive remainder beneficiary, or successor beneficiary of the first trust

If the authorized fiduciary has "expanded distributive discretion" —	If the authorized fiduciary has only "limited distributive discretion" —
The terms of the second trust *CANNOT* make these changes (except with respect to a beneficiary with a disability (Sec. 43)): • *CANNOT* reduce or eliminate a vested right such as a mandatory right to receive distributions or a currently exercisable withdrawal power • *CANNOT* add a current beneficiary who is not a current beneficiary of the first trust • *CANNOT* add as a presumptive remainder beneficiary or successor beneficiary a person who isn't a current beneficiary, presumptive remainder beneficiary, or successor beneficiary of the first trust	

(9) Changes (compared to the first trust) that are possible under the Act with respect to the interest of a "beneficiary with a disability"

One of the innovations in the Uniform Act is a detailed section (in Indiana's version, I.C. § 30-4-10-43) which permits decanting to change the interest of a trust beneficiary who has a disability, even if that disabled beneficiary's interest is a mandatory income, annuity or unitrust interest and or even if that disabled beneficiary has a currently-exercisable right to withdraw assets from the first trust. In contrast, Indiana's old decanting statute (*see* I.C. § 30-4-3-36(a)(2) prohibited decanting to reduce or eliminate a mandatory income, annuity or unitrust interest of a beneficiary, whether disabled or not.

Because the new Act defines the "decanting power" as consisting of the power to distribute assets to a second trust *and* the power to modify the terms of the first trust, and because sections 6 and 43 of the new Act broadly define "beneficiary with a disability" and provide more flexible decanting rules for the interests of disabled beneficiaries,[3] the new Act will permit changes that will benefit the interests of a

[3] Ind. Code § 30-4-10-43(f)(3) confirms that if a first trust has a beneficiary with a disability *and also* one or more beneficiaries who are *not* disabled, the second trust(s) must grant to the non-disabled beneficiaries substantially the same beneficial interests as they have under the first trust.

beneficiary with a disability by (for example) making it possible for the disabled beneficiary to continue to receive or to qualify for means-tested government benefits.

New section 43 contains specific definitions of "government benefits" and "special needs trust" [a trust that the trustee reasonably believes would not be considered as a resource for the purpose of determining whether a beneficiary with a disability is eligible for government benefits]. Section 43 also contains an explicit and broad definition of "special needs fiduciary" [a trustee or other fiduciary who is not a settlor and who can exercise the decanting power to benefit a beneficiary with a disability]. This specific definition of "special needs fiduciary" is required because in some situations, the trustee who administers a first trust which has a disabled beneficiary may not have *any* discretionary power to distribute income or principal to the disabled beneficiary or to any other current beneficiary. That trustee will nevertheless fit the definition of "special needs fiduciary" if the trustee is required to distribute part or all of the first trust's income or principal to at least one current beneficiary, one of whom has a disability. *See* I.C. § 30-4-10-43(c)(3).

When a first trust has a beneficiary with a disability, the Act imposes two primary constraints on the exercise of the decanting power:

- The second trust (which could be a modification of the first trust or an actual separate trust) must be a "special needs trust" that benefits the beneficiary with a disability [I.C. § 30-4-10-43(e)(1)].
- The trustee or other "special needs fiduciary" who decants to the second trust must determine that the exercise of the decanting power "will further the purposes of the first trust" [I.C. § 30-4-10-43(e)(2)].

There is a third potential constraint under section 49 of the new Act if the decanting power were exercised to modify the disabled beneficiary's interest in a way that would destroy a past tax benefit that was claimed for assets of the first trust. If section 43 permits extensive change to the interest of the disabled beneficiary but if that change would violate section 49 of the Act and cause a loss of a tax benefit, does section 49 trump or control over section 43, ***or*** does section 43 (and the special circumstances and needs of the disabled beneficiary) cause section 43 to control?

Neither the national Uniform Act, nor the official comments, nor Indiana's version of the Act answers this question, and national estate planning commentators and appellate courts have (so far) not answered it either.

The opening sentence of I.C. § 30-4-10-49(e)(3) is worded almost identically to the corresponding text of the national Uniform Act and reads as follows [italics added]:

> (3) If the first trust contains property that qualified, *or would have qualified but for provisions of this chapter other than this section*, for the exclusion from the gift tax described in 26 U.S.C. 2503(b), as amended and in effect on July 1, 2022, the second-trust instrument must not include or omit a term

> that, if included in or omitted from the trust instrument for the trust to which the property was transferred, would have prevented the transfer from qualifying under 26 U.S.C. 2503(b), as amended and in effect on July 1, 2022.

Here is the simplest, most straightforward interpretation of the section 49 restrictions: If the beneficiary with a disability has an interest in the first trust that was funded with or traceable to an asset transfer that qualified for the estate or gift tax marital deduction or which qualified as an annual exclusion gift or "non-taxable gift" for federal gift tax or GST tax purposes, then section 49 prohibits a decanting which would change the disabled beneficiary's interest under the second trust in a way that would have caused the original funding transfer to the first trust to fail to qualify for the tax benefit.

In the sentence from I.C. § 30-4-10-52(e)(3) quoted above, the reason for including the italicized phrase "but for provisions of this chapter other than this section" is not clear. Section 43 is a "provision of this chapter [IC 30-4-10] other than this section." *Does this mean that section 43 controls if section 43 permits an exercise of the decanting power to make a change that section 49 (tax restrictions) would have prohibited?* The answer is not obvious.

If the straightforward interpretation of section 49 is the correct one, and if preserving or losing a marital deduction, an annual gift exclusion, or a zero inclusion ratio for a past GST gift is at stake, then it may be impossible for a trustee or other special needs fiduciary *to use the decanting power* to make the necessary changes to the disabled beneficiary's interest, in order to permit the disabled beneficiary to become or remain qualified to receive government benefits. Another trust modification method may have to be used.

When a beneficiary of the first trust has a disability and when new section 43 gives a "special needs fiduciary" (such as a qualifying trustee) broader and more flexible powers to decant or modify with respect to the disabled beneficiary's interest, subsection 43(f)(2) states that subsection 41(f)(3) does not apply. If the tax limitations in section 49 of the new Act do not apply, and if the disabled beneficiary has a "vested interest" in the first trust (*e.g.,* a mandatory income, annuity or unitrust interest, or a currently exercisable withdrawal power, or the right to receive direct distribution of an "outright" share of the assets of a terminating trust), the special needs fiduciary can eliminate that vested interest and replace it with an entirely discretionary spendthrift interest under the second trust.

If a special needs fiduciary uses new section 43 to create and fund a second trust which gives the disabled beneficiary an entirely discretionary spendthrift interest, that second trust cannot add remainder beneficiaries who are not either current beneficiaries or successor beneficiaries of the first trust. *See* I.C. § 30-4-10-43(f)(1), cross-referencing § 30-4-10-41(f)(2). However, unless the loss of a federal tax benefit is an issue, the possibilities for structuring the second trust as a "special needs" trust are otherwise wide open.

I.C. § 30-4-10-43(f)(1)(A) and (B) specifically permit the disabled beneficiary's interest in the second trust to be structured as a "(d)(4)(A) trust" under 42 U.S.C. § 1396p(d)(4)(A), or as a "(d)(4)(C) pooled trust" under 42 U.S.C. § 1396p(d)(4)(C). Both of those types of trusts are "self-settled trusts," treated as created by the beneficiary with the disability.

- If the beneficiary with a disability is *currently* entitled to receive one or more mandatory distributions of income or principal from the first trust or if that disabled beneficiary has a currently exercisable and unconditional power to withdraw assets from the first trust, this writer believes that the second trust (special needs trust) which receives the decanting distribution arguably should be treated as a self-settled trust for government benefit eligibility purposes. This means that unless it is a (d)(4)(C) pooled trust, it should contain a payback provision.
- In contrast, if the beneficiary with a disability has some *future* right to receive mandatory distributions starting at a later date or if that disabled beneficiary will have a withdrawal power that won't become exercisable until some date that is at least a year in the future, *and* if that disabled beneficiary either has no current right to receive distributions or has only a current discretionary interest, this writer believes that the second trust (special needs trust) can eliminate the future interest and can be structured as a third-party discretionary trust, without any payback provision.

(10) Protecting "charitable interests" under the first trust when the decanting power is exercised

Section 44 of the new Indiana Act (I.C. § 30-4-10-44) goes into more detail than our old, repealed decanting statute and contains safeguards to prevent most charitable interests in the first trust from being diminished or significantly altered. The restrictions in new section 44 operate as additional constraints on the decanting power even when the trustee of first trust has "expanded distributive discretion."

The rules in new section 44 should be read in light of the definitions of "charitable organization," "charitable purpose," and "charitable interest" in sections 7, 8 and 9 of the new Indiana Act. The main restrictions in new section 44 are in subsection (d) and state that if the first trust contains a charitable interest,

> . . . the second trust must not:
>
> (1) diminish the charitable interest [*for example, reduce a dollar amount or percentage or fractional interest*]:

(2) diminish the interest of an identified charitable organization that holds the charitable interest [*for example, replace one charitable beneficiary with a different one*];

(3) alter any charitable purpose stated in the first-trust instrument; or

(4) alter any condition or restriction related to the charitable interest.

Subsection 44(a) includes an additional defined term, "determinable charitable interest," which could include a charitable organization's lead interest under a CLAT or CLUT, a charitable organization's remainder interest under a CRAT or CRUT, or any other unconditional right that a charitable organization has or will later have to receive a distribution for charitable purposes, either currently or on the occurrence of a specified event.

If a charitable organization has a "determinable charitable interest" in the first trust, then two additional rules apply:

- The Attorney General of Indiana has the rights of a qualified beneficiary of the first trust and may represent and bind the charitable interest (new I.C. § 30-4-10-44(c)).[4]
- The terms of the second trust cannot change the governing law for the administration of the charitable interest to the law of some non-Indiana jurisdiction, unless the probate court approves the change, <u>or</u> *unless* the attorney general consents in writing to the change in governing law, <u>or</u> *unless* the attorney general fails to timely object within the 60-day notice period that is triggered by the pre-decanting notice (new I.C. § 30-4-10-44(f).

(11) Tax-driven restrictions on decanting under section 49 of the new Act

The longest section in the new Act is section 49 (§ 30-4-10-49), which is designed and intended to prevent the loss of significant tax benefits for the first trust as a result of ill-conceived or mistaken exercises of the decanting power.

The Uniform Trust Decanting Act was deliberately designed to include these long and detailed tax provisions to induce the Treasury Department and IRS to issue guidance on the federal tax consequences of trust decanting when decanting makes a change to the beneficial interests in a trust. On December 27, 2011, the Treasury Department posed questions, invited comments, and announced that it was "considering approaches" to be put into published guidance. *See* Notice 2011-101 (2011-52 IRB 932). However, After 2013, Treasury dropped "tax decanting" guidance from its topic list in its Priority Guidance Plan and has not restored it in any later Priority

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[4] Based on this writer's experience, it is unlikely that the Indiana Attorney General would take any position for or against any change that an authorized fiduciary might try to accomplish through decanting.

Guidance Plan. Beginning with Rev. Proc. 2011-3, 2011-1 IRB 111 (issued in January 2011), the IRS announced that the federal tax consequences of trust decanting was an "area under study" and that the IRS would not issue private letter rulings in this area until after the Treasury Department publishes regulations or other guidance.

Among estate planning professionals, the consensus was and is that the Treasury Department and IRS would become willing to issue official guidance on the federal tax consequences of trust decanting after state law acquired some uniformity. The Uniform Trust Decanting Act, and the section on tax benefits in particular, is an attempt to create that uniformity.

Subsection (e) of new section 49 consists of ten (10) specific tax-driven rules or restrictions, which are "limitations" on "the exercise of the decanting power." These restrictions work because under I.C. § 30-4-10-52(a)(1) and (a)(2), if an exercise of the decanting power results in a provision in the second trust that violates the Act, an offending provision is *void* to the extent necessary to comply with the new Act, and a provision that is missing is deemed to be included in the second-trust instrument. The rules and restrictions in subsection 49(e) are in subdivisions (1) through (10) and are summarized as follows:

(1) Don't terminate or jeopardize an estate or gift tax **marital deduction** that was claimed for assets of or a transfer to the first trust.

(2) Don't terminate or jeopardize an estate or gift tax **charitable deduction** that was claimed for assets of or a transfer to the first trust.

(3) Don't disqualify an interest in or assets of the first trust from an annual exclusion from taxable gifts under Code section 2503(b) or (c). [5]

(4) If the first trust holds S corporation stock, maintain provisions in the second trust which permit it to continue as a qualified subchapter S trust (QSST).

(5) If the first trust contained assets that qualified for a zero inclusion ratio for GST tax purposes because the assets were transferred to the first trust in the form of a non-taxable gift under Code § 2642(c). [6]

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[5] Three types of gifts to a "first trust" would have qualified as annual exclusion gifts under Code § 2503 and subsection 49(e)(3) of the Act: "Outright" gifts of a present interest in property, up to the per-donee annual maximum ($16,000 in 2022); gifts with Crummey-type withdrawal powers; and gifts to section 2503(c) minor's trusts.

[6] Under § 2642(c), a gift to a trust for a skip person is a "non-taxable gift" if it satisfies Code § 2503(b) or (c) *and* if the trust has that skip person as its sole beneficiary during his or her lifetime *and* if the trust assets will be included in the skip person beneficiary's federal gross estate if he or she dies before the trust terminates.

(6) If the first trust holds or is entitled to receive assets of any retirement plan or account that is subject to Code § 401(a)(9) and the corresponding regulations, the provisions of the second trust cannot make a change that would increase the required minimum distributions (RMDs) or [arguably] replace a 10-year payout requirement under the SECURE Act with a 5-year payout requirement.

(7) If the first trust has a grantor who is not a U. S. citizen or resident and if the first trust relies on Code § 672(f)(2)(A) to qualify as a grantor trust for income tax purposes, the authorized fiduciary cannot decant to a second trust that fails to also satisfy the requirements of Code § 672(f)(2)(A) to maintain grantor trust status.

(8) Subdivision (e)(8) is a catch-all provision that applies to any federal or state tax deduction, exemption, exclusion, or other tax benefit if the first-trust instrument either is clearly designed to qualify for that tax benefit *or* expressly indicates an intent to qualify for the tax benefit. When either condition is satisfied, decanting cannot be used to structure the second trust in a way that would have lost the tax benefit if the change(s) had been made originally in the first-trust instrument.

(9) [*and also* (10)] If the first trust is a grantor trust with a U. S. person as the grantor, the second trust may "switch off" grantor trust status and function as a non-grantor trust. If the first trust is a non-grantor trust, the second trust may be a grantor trust, but during the 60-day notice period, the living settlor can block the switch from non-grantor to grantor trust status by delivering a signed written objection to the trustee or other authorized fiduciary who proposed to decant. Finally, if the first trust is a grantor trust but authorizes the settlor or other person to take some action that will terminate grantor trust status, the second trust must grant an equivalent power to the settlor or another person to terminate grantor trust status.

(12) A potpourri of miscellaneous rules in the Indiana UTDA

The new Indiana Act, like the national Uniform Act, contains some additional rules, procedures and safeguards.

- New I.C. § 30-4-10-39 is analogous to the "petition for instructions" provision in I.C. § 30-4-3-18(a) but is broader. Section 39 permits an authorized fiduciary, a beneficiary, a person entitled to notice under section 35, or (with respect to a charitable interest) the Indiana attorney general to file a petition with the probate court to seek any of seven (7) listed types of relief, including:
    - Providing instructions to an authorized fiduciary about whether a proposed exercise of the decanting power is permitted under the Act and is consistent with fiduciary duties.
    - Approving a proposed or completed exercise of the decanting power.

  - If an authorized fiduciary is unwilling to directly exercise the decanting power, appointing another person as "special fiduciary," who can be authorized to decide whether to decant and to proceed with decanting.
  - Determining in advance that a proposed or attempted exercise of the decanting power is invalid or ineffective under the Act, in light of I.C. § 30-4-10-52.
  - Providing instructions to the authorized fiduciary and/or evaluating a past exercise of the decanting power about whether the "read out" or "read in" rules in section 52 apply.

- New I.C. § 30-4-10-46 prohibits an exercise of the decanting power to increase the compensation that an authorized fiduciary can collect from the second trust, unless the probate court approves the increase or all qualified beneficiaries of the second trust sign written consents to the increased compensation.

- Under new I.C. § 30-4-10-47(a), the terms of the second trust cannot absolve or relieve an authorized fiduciary from liability for breach of trust to a greater extent than the first trust (for example, by substituting a "lower" standard of conduct or liability for that authorized fiduciary.

- If the terms of the first trust provide for or permit indemnification of an authorized fiduciary, then subsection 47(b) permits the second-trust instrument to contain a provision for payment of indemnification to an authorized fiduciary.

- Subsection (c) of new I.C. § 30-4-10-47 prohibits the second-trust instrument from "reducing fiduciary liability in the aggregate."

- So long as the change in the administrative structure of a second trust would not "reduce fiduciary liability [of all fiduciaries] in the aggregate, subsection 47(d) allows an exercise of the decanting power to "divide and reallocate fiduciary powers among fiduciaries, including one (1) or more trustees and [trust directors]," and to relieve a fiduciary from liability for an act or omission of another fiduciary, as permitted by other state law (including the Indiana Directed Trust Act, IC 30-4-9).

- Under new I.C. § 30-4-10-48, if the terms of the first trust give some person a power to remove or replace an authorized fiduciary, that authorized fiduciary cannot exercise the decanting power to modify that removal power in the second-trust instrument, *unless* —
  - The removal power is held by just one person and that person consents in writing to the modification, or

- The modification grants a substantially similar removal power to another person and the original power holder and all qualified beneficiaries consent in writing to the modification, or
- The modification grants a substantially similar removal power to another person and the probate court approves the modification.

- New I.C. § 30-4-10-50(a) permits a second trust to have a duration that is the same as or different from the duration of the first trust (Subsection (b), explained on the bottom of page 8 above, provides that assets transferred from the first trust remain subject to the same RAP rules.)
- Under new I.C. § 30-4-10-51, even if the discretionary distribution standard under the first trust would not have allowed a court to *compel* the authorized fiduciary to make a discretionary distribution of principal, that authorized fiduciary can still exercise the decanting power (unless otherwise explicitly prohibited or restricted under the first-trust instrument).
- If an exercise of the decanting power did transfer or was intended to transfer *all* principal assets from the first trust to one or more second trusts, *and* if the authorized fiduciary does not adopt a specific provision to deal differently with later-discovered trust assets, new I.C. § 30-4-10-56(a) requires all later-discovered assets of the first trust to be treated as assets of the second trust. Conversely, if the decanting power is exercised to transfer *less than all* principal assets from the first trust to a second trust(s), later-discovered trust assets are treated as assets of the first trust.
- New I.C. § 30-4-10-57 states that If a debt or other obligation is owed to a creditor and if that obligation is enforceable against assets of the first trust, that obligation is enforceable to the same extent against those assets after they are transferred by decanting to the second trust.

Appendix 1 -- Text of the REPEALED old trust decanting statute

The "Old" Decanting Statute — REPEALED effective July 1, 2022

I.C. § 30-4-3-36
Trust decanting; notice; rules of construction

Sec. 36. (a) Unless a trust expressly provides otherwise, a trustee who has discretion under the terms of a trust (referred to in this section as the "first trust") to invade the principal of the trust to make distributions to or for the benefit of one (1) or more persons may instead exercise the power by appointing all or part of the principal of the first trust in favor of a trustee of another trust (referred to in this section as the "second trust") for the benefit of one (1) or more persons under the same trust instrument or under a different trust instrument as long as:

(1) the beneficiaries of the second trust are the same as the beneficiaries of the first trust;

(2) the second trust does not reduce any income, annuity, or unitrust interest in the assets of the first trust; and

(3) if any contributions to the first trust qualified for a marital or charitable deduction for purposes of the federal income, gift, or estate taxes, the second trust does not contain any provision that, if included in the first trust, would have prevented the first trust from qualifying for a deduction or reduced the amount of a deduction.

(b) The exercise of a power to invade principal under subsection (a) must be by an instrument that is:

(1) in writing;

(2) signed and acknowledged by the trustee; and

(3) filed with the records of the first trust.

(c) The exercise of a power to invade principal under subsection (a) is considered the exercise of a power of appointment, other than a power to appoint to the trustee, the trustee's creditors, the trustee's estate, or the creditors of the trustee's estate. The exercise of the power does not extend the time at which the permissible period of the rule against perpetuities begins and the law that determines the permissible period of the rule against perpetuities of the first trust.

(d) The trustee shall notify in writing all qualified beneficiaries of the first trust at least sixty (60) days before the effective date of the trustee's exercise of the power to invade principal under subsection (a) of the manner in which the trustee intends to exercise the power. A copy of the proposed instrument exercising the power satisfies the trustee's notice obligation under this subsection. If all qualified beneficiaries waive the notice period by signed written instrument delivered to the trustee, the trustee's power to invade principal may be exercised immediately. The trustee's notice under this subsection does not limit the right of any beneficiary to object to the exercise of the trustee's power to invade principal, except as otherwise provided by this article.

(e) The exercise of the power to invade principal under subsection (a) is not prohibited by a spendthrift clause or by a provision in the trust instrument that prohibits amending or revoking the trust.

(f) This section is not intended to create or imply a duty to exercise a power to invade principal. No inference of impropriety may be made as a result of a trustee not exercising the power to invade principal conferred under subsection (a).

(g) This section may not be construed to abridge the right of any trustee who has a power of invasion to appoint property in further trust that arises under the terms of the first trust, under any other provision of this article or any other statute, or under common law.

As added by P.L.6-2010, SEC.19; amended by P.L. 51-2014, SEC. 22.

SECTION 3. IC 30-4-10 IS ADDED TO THE INDIANA CODE AS A NEW CHAPTER TO READ AS FOLLOWS [EFFECTIVE JULY 1, 2022]:
http://iga.in.gov/legislative/2022/bills/house/1205#document-286078ce

Chapter 10. Uniform Trust Decanting Act

Sec. 1. (a) This chapter applies to a trust created before, on, or after July 1, 2022, that:

(1) as its principal place of administration in this state, including a trust whose principal place of administration has been changed to this state; or

(2) provides by its trust instrument that it is governed by the law of this state or is governed by the law of this state for the purpose of:

(A) administration, including administration of a trust whose governing law for purposes of administration has been changed to the law of this state;

(B) construction of terms of the trust; or

(C) determining the meaning or effect of terms of the trust.

(b) Except as provided in subsections (c) and (d), this chapter applies to an express trust that is irrevocable or revocable by the settlor only with the consent of the trustee or a person holding an adverse interest.

(c) This chapter does not:

(1) apply to a trust held solely for charitable purposes;

(2) limit the power of a trustee, powerholder, or other person to distribute or appoint property in further trust;

(3) limit the power to modify a trust under the trust instrument, law of this state other than this chapter, common law, a court order, or a nonjudicial settlement agreement; or

(4) affect the ability of a settlor to provide in a trust instrument for the distribution of the trust property or appointment in further trust of the trust property or for modification of the trust instrument. Such provisions in the trust instrument shall control over any applicable provision of this chapter.

(d) Subject to section 45 of this chapter, a trust instrument may restrict or prohibit exercise of the decanting power.

Sec. 2. As used in this chapter, "appointive property" means the property or property interest subject to a power of appointment.

Sec. 3. As used in this chapter, "ascertainable standard" means a standard relating to an individual's health, education, support, or maintenance as defined by 26 U.S.C. 2041(b)(1)(A) or 26 U.S.C. 2514(c)(1) and applicable regulations.

Sec. 4. As used in this chapter, "authorized fiduciary" means:

(1) a trustee, trust director, or other fiduciary, other than a settlor, that has discretion to distribute or direct a trustee to distribute part or all of the principal of the first trust to one (1) or more current beneficiaries;

(2) a special fiduciary appointed under section 39 of this chapter; or

(3) a special-needs fiduciary under section 43 of this chapter.

Sec. 5. As used in this chapter, "beneficiary" means a person that:

(1) has a present or future, vested or contingent, beneficial interest in a trust;

(2) holds a power of appointment over trust property; or

(3) is an identified charitable organization that may receive distributions under the terms of the trust.

Sec. 6. As used in this chapter, "beneficiary with disability" means a beneficiary who is determined, in the exercise of an authorized fiduciary's discretion, to have one (1) of the following conditions:

(1) Dementia, memory loss, Parkinson's disease, or other progressive condition that, currently or in the future, may impair the ability of the beneficiary to provide self care or manage the beneficiary's assets.

(2) A physical or mental condition or infirmity due to age, cognitive impairment, addiction, or disease that impairs the beneficiary's ability to provide self care or manage the beneficiary's assets.

(3) The susceptibility of the beneficiary, at any age, to financial exploitation, as defined in IC 23-19-4.1, IC 30-5-5-6.5, or FINRA Rule 2165 approved by the United States Securities and Exchange Commission.

(4) A condition requiring essential medical treatment or prescription medication that the beneficiary cannot reasonably provide for from the beneficiary's resources outside the trust assets.

(5) A condition related directly or indirectly to the disability of a beneficiary described in subdivisions (1) through (4) with respect to which the settlor of the trust has expressed the settlor's intent.

Sec. 7. As used in this chapter, "charitable interest" means an interest in a trust that:

(1) is held by an identified charitable organization and makes the organization a qualified beneficiary;

(2) benefits only a charitable organization and, if the interest were held by an identified charitable organization, would make the organization a qualified beneficiary; or

(3) is held solely for a charitable purpose and, if the interest were held by an identified charitable organization, would make the organization a qualified beneficiary.

Sec. 8. As used in this chapter, "charitable organization" means:

(1) a person, other than an individual, organized and operated exclusively for a charitable purpose; or

(2) a government or governmental subdivision, agency, or instrumentality to the extent it holds funds exclusively for a charitable purpose.

Sec. 9. As used in this chapter, "charitable purpose" means the relief of poverty, the advancement of education or religion, the promotion of health, a municipal or other governmental purpose, or a purpose that is beneficial to the community.

Sec. 10. As used in this chapter, "court" has the meaning set forth in IC 30-4-1-2(6).

Sec. 11. As used in this chapter, "current beneficiary" means a beneficiary who, on the date that the beneficiary's qualification is determined, is a distributee or permissible distributee of trust income or principal. The term includes the holder of a presently exercisable general power of appointment but does not include a person that is a beneficiary only because the person holds any other power of appointment.

Sec. 12. As used in this chapter, "decanting power" means the power of an authorized fiduciary under this chapter to:

(1) distribute property of a first trust to one (1) or more second trusts; or

(2) to modify the terms of the first trust.

Sec. 13. As used in this chapter, "designated representative" has the meaning set forth in IC 30-4-1-2(8).

Sec. 14. As used in this chapter, "expanded distributive discretion" means a discretionary power of distribution that is not limited to an ascertainable standard or a reasonably definite standard.

Sec. 15. As used in this chapter, "first trust" means a trust over which an authorized fiduciary may exercise the decanting power.

Sec. 16. As used in this chapter, "first-trust instrument" means the trust instrument for a first trust.

Sec. 17. As used in this chapter, "general power of appointment" means a power of appointment exercisable in favor of:

(1) a powerholder;

(2) a powerholder's estate;

(3) a creditor of the powerholder; or

(4) a creditor of the powerholder's estate.

Sec. 18. As used in this chapter, "jurisdiction" means a geographic area, including a state or country.

Sec. 19. As used in this chapter, "person" means:

(1) an individual;

(2) a corporation;

(3) a business trust;

(4) an estate;

(5) a trust;

(6) a partnership;

(7) a limited liability company;

(8) an association;

(9) a joint venture;

(10) a government;

(11) a governmental subdivision;

(12) an agency or instrumentality;

(13) a public corporation; or

(14) any other legal or commercial entity.

Sec. 20. As used in this chapter, "power of appointment" means a power that enables a powerholder acting in a nonfiduciary capacity to designate a recipient of an ownership interest in or another power of appointment over the appointive property. The term does not include a power of attorney.

Sec. 21. As used in this chapter, "powerholder" means a person in which a donor creates a power of appointment.

Sec. 22. (a) As used in this chapter, "presently exercisable power of appointment" means a power of appointment exercisable by the powerholder at the relevant time.

(b) The term includes a power of appointment exercisable only after the occurrence of a specified event, the satisfaction of an ascertainable standard, or the passage of a specified time.

(c) The term does not include a power exercisable only at the powerholder's death.

Sec. 23. As used in this chapter, "qualified beneficiary" has the meaning set forth in IC 30-4-1-2(19).

Sec. 24. As used in this chapter, "reasonably definite standard" means a clearly measurable standard under which a holder of a power of distribution is legally accountable within the meaning of 26 U.S.C. 674(b)(5)(A) and applicable regulations.

Sec. 25. As used in this chapter, "record" means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

Sec. 26. As used in this chapter, "second trust" means:

(1) a first trust after modification under this chapter; or

(2) a trust to which a distribution of property from a first trust is or may be made under this chapter.

Sec. 27. As used in this chapter, "second-trust instrument" means the trust instrument for a second trust.

Sec. 28. (a) As used in this chapter, except as provided in section 55 of this chapter, "settlor" has the meaning set forth in IC 30-4-1-2(21).

(b) If more than one (1) person creates or contributes property to a trust, each person is a settlor of the portion of the trust property attributable to the person's contribution except to the extent another person has power to revoke or withdraw that portion.

Sec. 29. As used in this chapter, "sign" means with present intent to authenticate or adopt a record to:

(1) execute or adopt a tangible symbol; or

(2) attach to or logically associate with the record of an electronic symbol, sound, or process.

Sec. 30. As used in this chapter, "state" means:

(1) a state of the United States;

(2) the District of Columbia;

(3) Puerto Rico;

(4) the United States Virgin Islands; or

(5) a territory or insular possession subject to the jurisdiction of the United States.

Sec. 31. As used in this chapter, "terms of the trust" has the meaning set forth in IC 30-4-1-2(22).

Sec. 32. As used in this chapter, "trust instrument" has the meaning set forth in IC 30-4-1-2(25). The term includes a written document executed by the settlor to create a trust or by a person to create a second trust that contains some or all of the terms of the trust, including any amendments.

Sec. 33. (a) Except as provided in this chapter, an authorized fiduciary may exercise the decanting power without the consent of any person and without court approval.

(b) An authorized fiduciary shall act in accordance with its fiduciary duties, including the duty to act in accordance with the purposes of the first trust in exercising the decanting power.

(c) This chapter does not create or imply a duty to exercise the decanting power or to inform beneficiaries about the applicability of this chapter.

(d) Except as provided in a first-trust instrument, the terms of the first trust are deemed to include the decanting power.

Sec. 34. A trustee or person that reasonably relies on:

(1) the validity of a distribution of the property of a trust to another trust; or

(2) a modification of a trust under this chapter, law of this state other than this article, or the law of another jurisdiction;

is not liable to any person for any action or failure to act as a result of the reliance.

Sec. 35. (a) Except as provided in subsection (c), an authorized fiduciary shall give notice in a record of the intended exercise of the decanting power not later than sixty (60) days before the exercise of the decanting power to:

(1) each settlor of the first trust, if living or then in existence;

(2) each qualified beneficiary of the first trust, including the designated representative, if any, or other representative under IC 30-4-6-10.5 of a qualified beneficiary who:

(A) is a minor or an incapacitated person;

(B) is unborn;

(C) is unknown; or

(D) cannot be located after a reasonably diligent search;

(3) each holder of a presently exercisable power of appointment in the first trust;

(4) each person that currently has the right to remove or replace the authorized fiduciary;

(5) each fiduciary of the first trust;

(6) each fiduciary of the second trust; and

(7) the attorney general, if section 44(c) of this chapter applies.

(b) A notice period under subsection (a) begins on the day that the notice is given and ends fifty-nine (59) days later.

(c) An authorized fiduciary is not required to give notice under subsection (a) to a person that:

(1) is not known to the fiduciary;

(2) is known to the fiduciary but cannot be located by the fiduciary after a reasonably diligent search; or

(3) has no representative under IC 30-4-6-10.5.

(d) The decanting power may be exercised before expiration of the notice period under subsection (a) if all persons entitled to receive notice waive the notice period in a signed record.

Sec. 36. A notice under section 35 of this chapter must:

(1) specify the manner in which the authorized fiduciary intends to exercise the decanting power;

(2) specify the proposed effective date for the exercise of the decanting power;

(3) include a copy of the first-trust instrument; and

(4) include a copy of the second-trust instrument.

Sec. 37. (a) The receipt of notice, waiver of the notice period, or expiration of the notice period does not affect the right of a person to file a petition under section 39 of this chapter asserting that:

(1) an exercise of the decanting power:

(A) is ineffective because it did not comply with this chapter;

(B) was an abuse of discretion; or

(C) was a breach of a fiduciary duty; or

(2) section 52 of this chapter applies to the exercise of the decanting power.

(b) An exercise of the decanting power is not ineffective because of the failure to give notice to one (1) or more persons under section 35 of this chapter if the authorized fiduciary acted with reasonable care to comply with section 35 of this chapter.

Sec. 38. (a) Notice to a person with authority to represent and bind another person under a first-trust instrument or this article has the same effect as notice given directly to the person represented.

(b) Consent of or waiver by a person with authority to represent and bind another person under a first-trust instrument or this article is binding on the person represented unless the person represented objects to the representation before the consent or waiver otherwise would become effective.

(c) A person with authority to represent and bind another person under a first-trust instrument or this article may file a petition under section 39 of this chapter on behalf of the person represented.

(d) A settlor may not represent or bind a beneficiary under this chapter.

Sec. 39. (a) Upon a petition by an authorized fiduciary, a beneficiary, or a person entitled to notice under section 35 of this chapter or with respect to a charitable interest by the attorney general or other person that has standing to enforce the charitable interest, the court may:

(1) provide instructions to the authorized fiduciary about whether a proposed exercise of the decanting power is permitted under this chapter and consistent with the fiduciary duties of the authorized fiduciary;

(2) appoint a special fiduciary and authorize the special fiduciary to determine whether the exercise of the decanting power is proper under this chapter and to exercise the decanting power;

(3) approve an exercise of the decanting power;

(4) determine that a proposed or attempted exercise of the decanting power is ineffective because:

(A) after applying section 52 of this chapter, the proposed or attempted exercise does not comply with this chapter; or

(B) the proposed or attempted exercise is an abuse of the fiduciary's discretion or a breach of a fiduciary duty;

(5) determine the extent section 52 of this chapter applies to a prior exercise of the decanting power;

(6) provide instructions to the trustee regarding the application of section 52 of this chapter to a prior exercise of the decanting power; or

(7) order relief to carry out the purposes of this chapter.

(b) Upon a petition by an authorized fiduciary, the court may approve:

(1) an increase in the fiduciary's compensation under section 46 of this chapter; or

(2) a modification under section 48 of this chapter of a provision granting a person the right to remove or replace the fiduciary.

Sec. 40. An exercise of the decanting power must be made in a record signed by an authorized fiduciary. The signed record must:

(1) directly or indirectly reference the notice required by section 35 of this chapter;

(2) identify the first trust and the second trust;

(3) identify and state the property of the first trust being distributed to each second trust; and

(4) identify the property that remains in the first trust.

Sec. 41. (a) As used in this section, "noncontingent right" means a right that is not subject to the:

(1) exercise of discretion; or

(2) occurrence of a specified event that is not certain to occur.

The term does not include a right held by a beneficiary if any person has discretion to distribute property subject to the right of any person other than the beneficiary or the beneficiary's estate.

(b) As used in this section, "presumptive remainder beneficiary" means a qualified beneficiary other than a current beneficiary.

(c) As used in this section, "successor beneficiary" means a beneficiary that is not a qualified beneficiary on the date the beneficiary's qualification is determined. The term does not include a person that is a beneficiary only because the person holds a nongeneral power of appointment.

(d) As used in this section, "vested interest" means a:

(1) right to a mandatory distribution that is a noncontingent right as of the date of the exercise of the decanting power;

(2) current and noncontingent right, annually or more frequently, to a mandatory distribution of income, a specified dollar amount, or a percentage of value of some or all of the trust property;

(3) current and noncontingent right, annually or more frequently, to withdraw income, a specified dollar amount, or a percentage of value of some or all of the trust property;

(4) presently exercisable general power of appointment; or

(5) right to receive an ascertainable part of the trust property on the trust's termination that is not subject to the exercise of discretion or to the occurrence of a specified event that is not certain to occur.

(e) Subject to subsection (f) and section 44 of this chapter, an authorized fiduciary that has expanded distributive discretion over the principal of a first trust for the benefit of one (1) or more current beneficiaries may exercise the decanting power over the principal of the first trust.

(f) Subject to section 43 of this chapter, an exercise of the decanting power under this section must not:

(1) except as provided in subsection (g), include as a current beneficiary a person that is not a current beneficiary of the first trust;

(2) except as provided in subsection (g), include as a presumptive remainder beneficiary or successor beneficiary a person that is not a current beneficiary, presumptive remainder beneficiary, or successor beneficiary of the first trust; or

(3) reduce or eliminate a vested interest.

(g) Subject to subsection (f)(3) and section 44 of this chapter, in an exercise of the decanting power under this subsection, a second trust may be a trust created or administered under the law of any jurisdiction and may:

(1) retain a power of appointment granted in the first trust;

(2) omit a power of appointment granted in the first trust, other than a presently exercisable general power of appointment;

(3) create or modify a power of appointment if the powerholder is a current beneficiary of the first trust and the authorized fiduciary has expanded distributive discretion to distribute principal to the beneficiary; and

(4) create or modify a power of appointment if the powerholder is a presumptive remainder beneficiary or successor beneficiary of the first trust, but the exercise of the power may take effect only after the powerholder becomes, or would have become a current beneficiary.

(h) A power of appointment described in subsections (g)(1) through (g)(4) may be general or nongeneral. The class of permissible appointees in favor of which the power may be exercised may be broader than or different from the beneficiaries of the first trust.

(i) If an authorized fiduciary has expanded distributive discretion over part of the principal of a first trust, the fiduciary may exercise the decanting power under this section over the principal that the authorized fiduciary has expanded distributive discretion.

Sec. 42. (a) As used in this section, "limited distributive discretion" means a discretionary power of distribution that is limited to an ascertainable standard or a reasonably definite standard.

(b) An authorized fiduciary that has limited distributive discretion over the principal of the first trust for the benefit of one (1) or more current beneficiaries may exercise the decanting power over the principal of the first trust.

(c) Under this section and subject to section 44 of this chapter, a second trust may be created or administered under the law of any jurisdiction. A second trust must grant each beneficiary of the first trust beneficial interests that are substantially similar to the beneficial interests of the beneficiary in the first trust.

(d) A power to make a distribution under a second trust for the benefit of a beneficiary who is an individual is substantially similar to a power under the first trust to make a distribution directly to the beneficiary. A distribution is for the benefit of a beneficiary if:

(1) the distribution is applied for the benefit of the beneficiary;

(2) the beneficiary is under a legal disability or the trustee reasonably believes the beneficiary is incapacitated and the distribution is made as permitted under this article; or

(3) the distribution is made as permitted under the terms of the first-trust instrument and the second-trust instrument for the benefit of the beneficiary.

(e) If an authorized fiduciary has limited distributive discretion of the principal of a first trust, the fiduciary may only exercise the decanting power under this section over the principal that the authorized fiduciary has limited distributive discretion.

Sec. 43. (a) This section applies to any trust that has a beneficiary with a disability, without limitation, whenever a special-needs fiduciary for the trust determines that the beneficiary with a disability may qualify for governmental benefits based on a disability, whether the beneficiary currently receives those benefits or has been adjudicated to be an incapacitated person under IC 29-3.

(b) As used in this section, "governmental benefits" means financial aid or services from a state, federal, or other public agency.

(c) As used in this section, "special-needs fiduciary" means:

(1) a trustee or other fiduciary, other than a settlor, that has discretion to distribute part or all of the principal of a first trust to one or more current beneficiaries;

(2) if no trustee or fiduciary has discretion under subdivision (1), a trustee or other fiduciary, other than a settlor, that has discretion to distribute part or all of the income of the first trust to one (1) or more current beneficiaries; or

(3) if no trustee or fiduciary has discretion under subdivisions (1) and (2), a trustee or other fiduciary, other than a settlor, that is required to distribute part or all of the income or principal of the first trust to one (1) or more current beneficiaries;

with respect to a trust that has a beneficiary with a disability.

(d) As used in this section, "special-needs trust" means a trust that the trustee reasonably believes would not be considered a resource for purposes of determining whether a beneficiary with a disability is eligible for governmental benefits.

(e) A special-needs fiduciary may exercise the decanting power under section 41 of this chapter over the principal of a first trust as if the fiduciary had authority to distribute principal to a beneficiary with a disability subject to expanded distributive discretion if:

(1) a second trust is a special-needs trust or other trust that benefits the beneficiary with a disability; and

(2) the special-needs fiduciary determines that an exercise of the decanting power will further the purposes of the first trust.

(f) In an exercise of the decanting power under this section, the following rules apply:

(1) Except as provided in section 41(f)(2) of this chapter, the interest in the second trust of a beneficiary with a disability may:

(A) be a pooled trust as defined by Medicaid law for the benefit of the beneficiary with a disability under 42 U.S.C. 1396p(d)(4)(C), as amended and in effect on July 1, 2022; or

(B) contain payback provisions complying with reimbursement requirements of Medicaid law under 42 U.S.C. 1396p(d)(4)(A), as amended and in effect on July 1, 2022.

(2) Section 41(f)(3) of this chapter does not apply to the interests of the beneficiary with a disability.

(3) Except as affected by a change to the interests of the beneficiary with a disability, the second trust, or if there are two (2) or more second trusts, the second trusts in the aggregate, must grant each other beneficiary of the first trust beneficial interests in the second trusts which are substantially similar to the beneficiary's beneficial interests in the first trust.

Sec. 44. (a) As used in this section, "determinable charitable interest" means a charitable interest that is a right to a mandatory distribution currently, periodically, on the occurrence of a specified event, or after the passage of a specified time and that is unconditional or will be held solely for charitable purposes.

(b) As used in this section, "unconditional" means not subject to the occurrence of a specified event that is not certain to occur, other than a requirement in a trust instrument that a charitable organization be in existence or qualify under a particular provision of the United States Internal Revenue Code of 1986, as amended and in effect on July 1, 2022, on the date of the distribution, if the charitable organization meets the requirement on the date of determination.

(c) If a first trust contains a determinable charitable interest, the attorney general has the rights of a qualified beneficiary and may represent and bind the charitable interest.

(d) If a first trust contains a charitable interest, the second trust must not:

(1) diminish the charitable interest;

(2) diminish the interest of an identified charitable organization that holds the charitable interest;

(3) alter any charitable purpose stated in the first-trust instrument; or

(4) alter any condition or restriction related to the charitable interest.

(e) If there are two (2) or more second trusts, the second trusts shall be treated as one (1) trust for purposes of determining whether the exercise of the decanting power diminishes the charitable interest or diminishes the interest of an identified charitable organization for purposes of subsection (d).

(f) If a first trust contains a determinable charitable interest, the second trust that includes a charitable interest pursuant to subsection (c) must be administered under the law of this state unless:

(1) the attorney general, after receiving notice under section 35 of this chapter, fails to object in a signed record delivered to the authorized fiduciary within the notice period;

(2) the attorney general consents in a signed record to the second trust being administered under the law of another jurisdiction; or

(3) the court approves the exercise of the decanting power.

(g) This chapter does not limit the powers and duties of the attorney general under the laws of this state other than this chapter.

Sec. 45. (a) An authorized fiduciary may not exercise the decanting power to the extent the first-trust instrument expressly prohibits exercise of:

(1) the decanting power; or

(2) a power granted by state law to the fiduciary to distribute part or all of the principal of the trust to another trust or to modify the trust.

(b) Exercise of the decanting power is subject to a restriction in the first-trust instrument that expressly applies to exercise of:

(1) the decanting power; or

(2) a power granted by state law to a fiduciary to distribute the principal of the trust to another trust or to modify the trust.

(c) The decanting power of an authorized fiduciary is not precluded by:

(1) a general prohibition of the amendment or revocation of a first trust;

(2) a spendthrift clause; or

(3) a clause restraining the voluntary or involuntary transfer of a beneficiary's interest.

(d) Subject to subsections (a) and (b), an authorized fiduciary may exercise the decanting power under this chapter even if the first-trust instrument permits the authorized fiduciary or another person to modify the first-trust instrument or to distribute the principal of the first trust to another trust.

(e) If a first-trust instrument contains an express prohibition described in subsection (a) or an express restriction described in subsection (b), the provision must be included in the second-trust instrument.

Sec. 46. (a) If a first-trust instrument specifies an authorized fiduciary's compensation, the fiduciary may not exercise the decanting power to increase the fiduciary's compensation above the specified compensation unless:

(1) all qualified beneficiaries of the second trust consent to the increase in a signed record; or

(2) the increase is approved by the court.

(b) If a first-trust instrument does not specify an authorized fiduciary's compensation, the fiduciary may not exercise the decanting power to increase the fiduciary's compensation above the compensation permitted by this article unless:

(1) all qualified beneficiaries of the second trust consent to the increase in a signed record; or

(2) the increase is approved by the court.

(c) A change in an authorized fiduciary's compensation that is incidental to other changes made by the exercise of the decanting power is not an increase in the fiduciary's compensation for purposes of subsections (a) and (b).

Sec. 47. (a) Except as otherwise provided in this section, a second-trust instrument must not relieve an authorized fiduciary from liability for breach of trust to a greater extent than the first-trust instrument.

(b) A second trust instrument may provide for indemnification of an authorized fiduciary of the first trust or another person acting in a fiduciary capacity under the first trust for any liability or claim that would have been payable from the first trust if the decanting power had not been exercised.

(c) A second-trust instrument must not reduce fiduciary liability in the aggregate.

(d) Subject to subsection (c), a second-trust instrument may divide and reallocate fiduciary powers among fiduciaries, including one (1) or more trustees, distribution advisors, investment advisors, trust protectors, or other persons, and relieve a fiduciary from liability for an act or failure to act of another fiduciary as permitted by the laws of this state other than this chapter.

Sec. 48. An authorized fiduciary must not exercise the decanting power to modify a provision in a first-trust instrument granting another person power to remove or replace the fiduciary unless:

(1) the person holding the power consents to the modification in a signed record and the modification applies only to the person;

(2) the person holding the power and the qualified beneficiaries of the second trust consent to the modification in a signed record and the modification grants a substantially similar power to another person; or

(3) the court approves the modification and the modification grants a substantially similar power to another person.

Sec. 49. (a) As used in this section, "grantor trust" means a trust as to which a settlor of a first trust is considered the owner under 26 U.S.C. 671 through 677, as amended and in effect on July 1, 2022, or 26 U.S.C. 679, as amended and in effect on July 1, 2022.

(b) As used in this section, "Internal Revenue Code" means the United States Internal Revenue Code of 1986, as amended and in effect on July 1, 2022.

(c) As used in this section "nongrantor trust" means a trust that is not a grantor trust.

(d) As used in this section, "qualified benefits property" means property subject to the minimum distribution requirements of 26 U.S.C. 401(a)(9), as amended and in effect on July 1, 2022, and any applicable regulations, or to any similar requirements that refer to 26 U.S.C. 401(a)(9) or the regulations.

(e) An exercise of the decanting power is subject to the following limitations:

(1) If a first trust contains property that qualified, or would have qualified but for provisions of this chapter other than this section, for a marital deduction for purposes of the gift or estate tax under the Internal Revenue Code or a state gift, estate, or inheritance tax, the second-trust instrument must not include or omit any term that, if included in or omitted from the trust instrument for the trust to which the property was transferred, would have prevented the transfer from qualifying for the deduction, or would have reduced the amount of the deduction, under the same provisions of the Internal Revenue Code or state law under which the transfer qualified.

(2) If the first trust contains property that qualified, or would have qualified but for provisions of this chapter other than this section, for a charitable deduction for purposes of the income, gift, or estate tax under the Internal Revenue Code or a state income, gift, estate, or inheritance tax, the second-trust instrument must not include or omit any term that, if included in or omitted from the trust instrument for the trust to which the property was transferred, would have prevented the transfer from qualifying for the deduction, or would have reduced the amount of the deduction, under the same provisions of the Internal Revenue Code or state law under which the transfer qualified.

(3) If the first trust contains property that qualified, or would have qualified but for provisions of this chapter other than this section, for the exclusion from the gift tax described in 26 U.S.C. 2503(b), as amended and in effect on July 1, 2022, the second-trust instrument must not include or omit a term that, if included in or omitted from the trust instrument for the trust to which the property was transferred, would have prevented the transfer from qualifying under 26 U.S.C. 2503(b), as amended and in effect on July 1, 2022. If the first trust contains property that qualified, or would have qualified but for provisions of this chapter other than this section, for the exclusion from the gift tax described in 26 U.S.C. 2503(b), as

amended and in effect on July 1, 2022, by application of 26 U.S.C. 2503(c), as amended and in effect on July 1, 2022, the second-trust instrument must not include or omit a term that, if included in or omitted from the trust instrument for the trust to which the property was transferred, would have prevented the transfer from qualifying under 26 U.S.C. 2503(c), as amended and in effect on July 1, 2022.

(4) If the property of the first trust includes shares of stock in an S corporation, as defined in 26 U.S.C. 1361, as amended and in effect on July 1, 2022, and the first trust is, or but for provisions of this chapter other than this section would be, a permitted shareholder under any provision of 26 U.S.C. 1361, as amended and in effect on July 1, 2022, an authorized fiduciary may exercise the power with respect to part or all of the S corporation stock only if any second trust receiving the stock is a permitted shareholder under 26 U.S.C. 1361(c)(2), as amended and in effect on July 1, 2022. If the property of the first trust includes shares of stock in an S corporation and the first trust is or, but for provisions of this chapter other than this section, would be a qualified subchapter S trust within the meaning of 26 U.S.C. 1361(d), as amended and in effect on July 1, 2022, the second-trust instrument must not include or omit a term that prevents the second trust from qualifying as a qualified subchapter S trust.

(5) If the first trust contains property that qualified, or would have qualified but for provisions of this chapter other than this section, for a zero (0) inclusion ratio for purposes of the generation skipping transfer tax under 26 U.S.C. 2642(c), as amended and in effect on July 1, 2022, the second-trust instrument must not include or omit a term that, if included in or omitted from the first-trust instrument, would have prevented the transfer to the first trust from qualifying for a zero (0) inclusion ratio under 26 U.S.C. 2642(c), as amended and in effect on July 1, 2022.

(6) If the first trust is directly or indirectly the beneficiary of qualified benefits property, the second-trust instrument may not include or omit any term that, if included in or omitted from the first-trust instrument, would have increased the minimum distributions required with respect to the qualified benefits property under 26 U.S.C. 401(a)(9), as amended and in effect on July 1, 2022, and any applicable regulations, or any similar requirements that refer to 26 U.S.C. 401(a)(9), as amended and in effect on July 1, 2022, or the regulations. If an attempted exercise of the decanting power violates this subdivision, the trustee is deemed to have held the qualified benefits property and any reinvested distributions of the property as a separate share from the date of the exercise of the power and section 52 of this chapter applies to the separate share.

(7) If the first trust qualifies as a grantor trust because of the application of 26 U.S.C. 672(f)(2)(A), as amended and in effect on July 1, 2022, the second trust may not include or omit a term that, if included in or omitted from the first-trust

instrument, would have prevented the first trust from qualifying under 26 U.S.C. 672(f)(2)(A), as amended and in effect on July 1, 2022.

(8) As used in this subdivision, "tax benefit" means a federal or state tax deduction, exemption, exclusion, or other benefit not otherwise listed in this section, except for a benefit arising from being a grantor trust. Subject to subdivision (9), a second-trust instrument may not include or omit a term that, if included in or omitted from the first-trust instrument, would have prevented qualification for a tax benefit if:

(A) the first-trust instrument expressly indicates an intent to qualify for the benefit or the first-trust instrument is clearly designed to enable the first trust to qualify for the benefit; and

(B) the transfer of property held by the first trust or the first trust qualified or, but for provisions of this chapter other than this section, would have qualified for the tax benefit.

(9) Subject to subdivision (4):

(A) except as provided in subdivision (7), the second trust may be a nongrantor trust, even if the first trust is a grantor trust; and

(B) except as otherwise provided in subdivision (10), the second trust may be a grantor trust, even if the first trust is a nongrantor trust.

(10) An authorized fiduciary may not exercise the decanting power if a settlor objects in a signed record delivered to the fiduciary within the notice period and:

(A) the first trust and a second trust are both grantor trusts, in whole or in part, the first trust grants the settlor or another person the power to cause the first trust to cease to be a grantor trust, and the second trust does not grant an equivalent power to the settlor or other person; or

(B) the first trust is a nongrantor trust and a second trust is a grantor trust, in whole or in part, with respect to the settlor, unless:

(i) the settlor has the power at all times to cause the second trust to cease to be a grantor trust; or

(ii) the first-trust instrument contains a provision granting the settlor or another person a power that would cause the first trust to cease to be a grantor trust and the second-trust instrument contains the same provision.

Sec. 50. (a) Subject to subsection (b), a second trust may have a duration that is the same as or different from the duration of the first trust.

(b) To the extent that property of a second trust is attributable to property of the first trust, the property of the second trust is subject to any rules governing maximum perpetuity, accumulation, or suspension of the power of alienation that apply to property of the first trust.

Sec. 51. An authorized fiduciary may exercise the decanting power whether under the first trust's discretionary distribution standard the fiduciary would have made or could have been compelled to make a discretionary distribution of principal at the time of the exercise.

Sec. 52. (a) If exercise of the decanting power would be effective under this chapter except that the second-trust instrument in part does not comply with this chapter, the exercise of the power is effective and the following rules apply with respect to the principal of the second trust attributable to the exercise of the power:

(1) A provision in the second-trust instrument that is not permitted under this chapter is void to the extent necessary to comply with this chapter.

(2) A provision required by this chapter to be in the second-trust instrument that is not contained in the instrument is deemed to be included in the instrument to the extent necessary to comply with this chapter.

(b) If a trustee or other fiduciary of a second trust determines that subsection (a) applies to a prior exercise of the decanting power, the fiduciary shall take corrective action consistent with the fiduciary's duties.

Sec. 53. (a) As used in this section, "animal trust" means a trust or an interest in a trust created to provide for the care of one (1) or more animals.

(b) As used in this section, "protector" means a person appointed in an animal trust to enforce the trust on behalf of the animal or, if no such person is appointed in the trust, a person appointed by the court for that purpose.

(c) The decanting power may be exercised over an animal trust that has a protector to the extent the trust could be decanted under this chapter if each animal that benefits from the trust were an individual, if the protector consents in a signed record to the exercise of the power.

(d) A protector for an animal has the rights under this chapter of a qualified beneficiary.

(e) If a first trust is an animal trust, in an exercise of the decanting power, the second trust must provide that trust property may be applied only to its intended purpose for the period the first trust benefitted the animal.

Sec. 54. A reference in this article to a trust instrument or terms of the trust includes a second-trust instrument and the terms of the second trust.

Sec. 55. (a) For purposes of law of this state other than this chapter and subject to subsection (b), a settlor of a first trust is deemed to be the settlor of the second trust with respect to the portion of the principal of the first trust subject to the exercise of the decanting power.

(b) In determining settlor intent with respect to a second trust, a settlor of the first trust, a settlor of the second trust, and the authorized fiduciary may be considered.

Sec. 56. (a) Except as provided in subsection (c), if exercise of the decanting power was intended to distribute all of the principal of the first trust to one (1) or more second trusts, later discovered property belonging to the first trust and property paid to or acquired by the first trust after the exercise of the power is part of the trust estate of the second trust.

(b) Except as provided in subsection (c), if exercise of the decanting power was intended to distribute less than all of the principal of the first trust to one (1) or more second trusts, later discovered property belonging to the first trust or property paid to or acquired by the first trust after exercise of the power remains part of the trust estate of the first trust.

(c) An authorized fiduciary may provide in an exercise of the decanting power or by the terms of a second trust for disposition of later discovered property belonging to the first trust or property paid to or acquired by the first trust after exercise of the power.

Sec. 57. A debt, liability, or other obligation enforceable against property of a first trust is enforceable to the same extent against the property when held by the second trust after exercise of the decanting power.

Sec. 58. In applying and construing this uniform act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among states that enact it.

Sec. 59. This chapter modifies, limits, or supersedes the Electronic Signatures in Global and National Commerce Act, 15 U.S.C. 7001 as amended and in effect on July 1, 2022, but does not modify, limit, or supersede Section 101(c) of that act, 15 U.S.C. 7001(c) as amended and in effect on July 1, 2022, or authorize electronic delivery of any of the notices described in Section 103(b) of that act, 15 U.S.C. 7003(b) as amended and in effect on July 1, 2022.

Sec. 60. If any provision of this chapter or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this chapter that can be given effect without the invalid provision or application, and to this end the provisions of this chapter are severable.

SECTION 4. IC 34-30-2-132.7 IS ADDED TO THE INDIANA CODE AS A NEW SECTION TO READ AS FOLLOWS [EFFECTIVE JULY 1, 2022]:

Sec. 132.7. IC 30-4-10-34 (Concerning a trustee who reasonably relies on a distribution or modification of a trust that transfers property to a second trust and does not act).

Getting Acquainted With (and *Using*) Indiana's Uniform Trust Decanting Act

Jeffrey S. Dible

June 10, 2022

ICLEF 49th Annual Midwest Estate, Tax and Business Planning Institute

Disclaimer

The primary materials for this program are contained in Jeff Dible's companion paper.

The statute described in this presentation is a new statute, and Indiana's courts may later make interpretations that differ from Jeff Dible's.

Opinions expressed in this presentation are those of Jeff Dible and should not be attributed to Frost Brown Todd LLC or to the Indiana State Bar Association.

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What's In the Companion Paper

- 21 pages of explanation and discussion of the Uniform Trust Decanting Act as enacted by Indiana in P.L. 161-2022 (House Enrolled Act 1205)
- In **Appendix 1** on p. 22, the text of the current decanting statute (I.C. § 30-4-3-36), which will be REPEALED effective July 1, 2022
- In **Appendix 2** starting on p. 24, the plain text of the Indiana version of the Uniform Trust Decanting Act, enacted as new chapter 30-4-10, effective July 1, 2022

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One separate non-decanting addition in House Enrolled Act 1205 (P.L. 161-2022)

- The first section of HEA 1205 makes a welcome insertion into the Indiana Trust Code to make it easier for 2 or more successor trustees to be appointed with division of powers and responsibilities
  - New § 30-4-3-29.3 will apply whenever a provision in a trust instrument *OR* § 30-4-3-33 gives someone the power to fill a vacancy to appoint a successor trustee
  - Such a power to appoint a successor trustee will include the power to appoint 2 or more trustees and to establish a division of labor, so that each trustee will have non-overlapping powers, duties and potential liabilities

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Uniform Trust Decanting Act provisions

- The rest of HEA 1205 repeals Indiana's existing trust decanting statute (§ 30-4-3-36) and enacts Indiana's version of the Uniform Trust Decanting Act (UTDA), which has been enacted by 12 other states
- The new Act applies to all trusts that have Indiana governing law provisions or an Indiana situs of administration, ***except***
  - Trusts that have only charitable beneficiaries
  - Trusts whose written terms explicitly prohibit decanting
- If a trustee or other fiduciary with the power to decant waits until July 1, 2022 or later to start the process, the new Act must be used

Using the old statute (before it's too late)

- Under the current (pre-2022) decanting statute, § 30-4-3-36, the trustee's possession of ***any*** discretion to invade and distribute principal gives that trustee the full power to make any permitted change in the structure and terms of the second trust (such as eliminating any remainder beneficiary), even if the discretionary distribution power is limited by some ascertainable standard such as HEMS
- But the new Indiana decanting statute limits the changes that the trustee can make through decanting if the trustee does not have "expanded distributive discretion" under the first (existing) trust's terms
- The opportunity to use the old decanting statute runs out not later than June 30, 2022

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Using the old statute (before it's too late)

- If you represent the trustee of an existing trust (first trust) that limits the trustee's discretionary distribution power by an ascertainable standard . . . .
  - Using decanting to change substantive or dispositive provisions may be possible ONLY under the old statute
  - Review the new Act to determine whether it will allow the trustee to make the desired change
  - If the desired change can be made under the old statute but NOT under the new Act, have the trustee start the decanting process ***before*** July 1, 2022 by sending out the 60-day pre-decanting notice ASAP

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Problems with the existing trust decanting statute that the Uniform Act addresses

- Existing section 36 bases the trustee's power to decant on the old conceptual model of a discretionary power to distribute principal in further trust for an existing beneficiary of the current trust
- Existing section 36 has allowed trustees to make foolish mistakes through ill-conceived decanting
- Existing § 36 does not address practical and tax issues that could result from decanting where the first or existing trust includes both charitable and non-charitable beneficiaries and interests

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Problems with the existing trust decanting statute that the Uniform Act addresses (*continued*)

- Existing § 36 is silent on whether the terms of the second trust can create or grant a power of appointment that is exercisable in favor of persons who are not beneficiaries of the existing trust
- Existing § 36 does not specifically prohibit a trustee from using decanting to increase trustee fees or to reduce the standard of liability
- Existing § 36 does not address the potential loss of tax benefits **EXCEPT** to prohibit terms in the second trust that would jeopardize or lose a gift or estate tax charitable or marital deduction claimed for a transfer to the existing trust

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Problems with the existing trust decanting statute that the Uniform Act addresses
(*continued*)

- Existing § 36 does not mention **trust beneficiaries who are disabled**
- Suppose that a **disabled beneficiary** of the existing (first) trust is currently entitled to an **outright distribution** or to a **mandatory** income, annuity, or unitrust **interest**
- Decanting arguably ***cannot be used*** to give that disabled beneficiary a discretionary interest in the second trust, because the trustee does not have a discretionary distribution power that relates to the disabled beneficiary's interest in the existing (first) trust

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Overview of the Indiana version of the Act

- Indiana’s version of the Uniform Act is new chapter 10 (I.C. 30-4-10) added to the Indiana Trust Code
- Indiana’s version of the Uniform Act makes no important changes to the national Act’s text except for added references to “trust directors” (under our I.C. 30-4-9) and the addition of a detailed definition of “beneficiary with a disability” in new I.C. § 30-4-10-6
- Indiana’s new statute, like the national Act, includes important additional definitions [“noncontingent right,” “presumptive remainder beneficiary, “vested interest,” etc.] in new § 30-4-10-41(a) thru (d)
- An “authorized fiduciary” (new § 30-4-10-4) is any trustee or trust director with the discretionary power to make or direct principal distributions

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Overview of the Indiana version of the Act

- The first main innovation in the national UTDA (and in Indiana's version) is the expanded definition of the "decanting power":
  - Includes the trustee's power to distribute property from the existing trust to 1 or more "second trusts"
  - *ALSO* includes the trustee's power to modify the terms of the first (existing) trust *without* distributing any assets to an actual "second trust" [*see* new § 30-4-10-12(2)]
- The second innovation is the distinction between "expanded distributive discretion" (if the trustee has it under the terms of the first trust) and "limited distributive discretion"

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“Expanded Distributive Discretion”

- The new statute (I.C. § 30-4-10-14) defines “expanded distributive discretion” as –

  “a discretionary power of distribution that is not limited to an ascertainable standard or a reasonably definite standard”

- If the trustee has “expanded distributive discretion,” then the decanting power can be exercised to make any change in the “second trust” that is not prohibited in the rest of new I.C. 30-4-10 [*see* new I.C. § 30-4-10-33(a)]
- A trustee with expanded distributive discretion must still exercise the decanting power in a manner consistent with the first trust’s purposes [*see* new I.C. § 30-4-10-33(b)]

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“Limited Distributive Discretion”

- The new statute (I.C. § 30-4-10-42(a)) defines “limited distributive discretion” as –

  > “a discretionary power of distribution that is limited to an ascertainable standard or a reasonably definite standard ”

- If the trustee has only “limited distributive discretion,” then the trustee can decant, but under subsection 42(c) –

  > “A second trust must grant each beneficiary of the first trust beneficial interests that are substantially similar to the beneficial interests of the beneficiary in the first trust.”

- A trustee with only limited distributive discretion can still make a wide variety of administrative changes

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Changes possible with “limited distributive discretion”

- If the trustee of the existing or first trust has only limited distributive discretion, what kinds of changes can the trustee make to a beneficiary’s interest under the second trust and still comply with the “substantially similar” requirement in I.C. § 30-4-10-42(c)?
  - If the first trust entitles beneficiary B to direct mandatory distribution(s), the second trust can permit indirect distributions for the benefit of B
  - Or if the trustee reasonably believes that B is incapacitated or under a disability, the trustee can make, in the terms of the second trust, any change in B’s interest that is permitted under any part of the Indiana Act (I.C. 30-4-10)

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Rules that the new Act is ***not*** changing

- What rules, principles and procedures for trust decanting under the pre-2022 Indiana statute are ***not changing*** under the new statute (I.C. 30-4-10)?
  - The settlor of the first or existing trust can explicitly prohibit or restrict the use of decanting
  - The settlor of the first or existing trust can include a special decanting power that would permit changes prohibited under the statute
  - A trustee who has a decanting power cannot be forced to exercise it
  - A trustee's exercise of a decanting power that complies with the statute could still be found to violate the first trust's purposes <u>*or*</u> to be a breach of a fiduciary duty owed by the trustee

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Rules that the new Act is ***not*** changing

- What rules, principles and procedures for trust decanting under the pre-2022 Indiana statute are ***not changing*** under the new statute (I.C. 30-4-10)?
  - If a beneficiary is not disabled and has any of five defined types of "vested interest" under the terms of the first trust, the second trust cannot reduce or eliminate that vested interest [section 41(f)(3)]
  - The terms of the second trust cannot ***add*** a current beneficiary who is not a current beneficiary of the first trust [section 41(f))(1)]
  - The terms of the second trust cannot ***add*** a successor beneficiary who is not a current beneficiary, successor beneficiary, or presumptive remainder beneficiary of the first trust (§ 41(f)(2))

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Rules that the new Act is ***not*** changing

- What rules, principles and procedures for trust decanting under the pre-2022 Indiana statute are ***not changing*** under the new statute (I.C. 30-4-10)?
  - A trustee can petition the probate court for instructions or guidance about whether or not to decant [new § 30-4-10-39 is more detailed]
  - Decanting does not require probate court approval
  - With limited exceptions under I.C. § § 30-4-10-46 and -48, decanting does not require the consent of any beneficiary
  - The trustee must send a pre-decanting notice 60 days in advance to all qualified beneficiaries of the first trust (and to the attorney general if there is a charitable interest) [*see* § § 30-4-10-35 and -36]

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Rules that the new Act is ***not*** changing

- What rules, principles and procedures for trust decanting under the pre-2022 Indiana statute are ***not changing*** under the new statute (I.C. 30-4-10)?
  - The 60-day waiting period (after notice and before the trustee can proceed with decanting) can be waived, but only if all persons entitled to notice sign written waivers [§ 30-4-10-35(d)]
  - After the 60-day waiting period ends or has been validly waived, the trustee actually exercises the decanting power by signing a written record with specified content [§ 30-4-10-40]
  - The written record of decanting must identify the first and second trusts and the property that is being "distributed" to the second trust

New rules added in the Indiana Act

- A non-exclusive list of ***new*** or ***clarified*** provisions that are in the new decanting statute (I.C. 30-4-10) but not in the pre-2022 statute:
  - I.C. § 30-4-10-41(g) and (h) allow the terms of the second trust to create or modify appointment powers that are exercisable by current beneficiaries or presumptive remainder beneficiaries of the first trust, even if the appointment powers can be exercised in favor of persons who are not beneficiaries of the first trust
  - I.C. § § 30-4-10-41(g) 30-4-10-42(c) allow decanting to change the governing law for the second trust unless doing so would impair a charitable interest

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New rules added in the Indiana Act

- A non-exclusive list of ***new*** or ***clarified*** provisions that are in the new decanting statute (I.C. 30-4-10) but not in the pre-2022 statute (*continued*):
  - New § 30-4-10-44 contains detailed rules which prohibit the use of decanting to diminish a charitable interest under the first trust or to alter a charitable purpose or a condition or restriction stated in the first trust
  - If a charitable interest in the first trust is a "determinable charitable interest" (as defined), then the second trust cannot change the governing law unless (a) the attorney general consents in writing, (b) the A.G. fails to object in writing before the end of the notice period, or (c) the court approves

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New rules added in the Indiana Act

- A non-exclusive list of ***new*** or ***clarified*** provisions that are in the new decanting statute (I.C. 30-4-10) but not in the pre-2022 statute (*continued*):
  - If the first trust instrument specifies the compensation of a fiduciary who has authority to decant, new § 30-4-10-46 prohibits the use of decanting to increase that fiduciary's compensation under the second trust's terms unless the probate court approves the increase ***or*** all qualified beneficiaries of the second trust consent in writing to the increase
  - New § 30-4-1-47(a) and (c) generally prohibit a reduction of fiduciary liability in the aggregate ***or*** reducing any authorized fiduciary's standard of liability under the second trust

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New rules added in the Indiana Act

- A non-exclusive list of ***new*** or ***clarified*** provisions that are in the new decanting statute (I.C. 30-4-10) but not in the pre-2022 statute (*continued*):
  - Under new § 30-4-1-47(b), the terms of the second trust can provide for indemnification of an authorized fiduciary of the first trust "for any liability or claim that would have been payable from the first trust if the decanting power had not been exercised"
  - Under new § 30-4-1-47(d), the terms of the second trust can divide and allocate fiduciary powers and responsibilities among multiple trustees and/or trust directors [*this was implied under the pre-2022 decanting statute but not explicitly stated*]

New rules added in the Indiana Act

- A non-exclusive list of ***new*** or ***clarified*** provisions that are in the new decanting statute (I.C. 30-4-10) but not in the pre-2022 statute
  - Under new § 30-4-1-48(b), if the first trust instrument gives a person the power to remove an authorized fiduciary who could decant, the terms of the second trust cannot modify that removal power unless the probate court approves or unless the power holder and/or qualified beneficiaries consent in writing
  - New § 30-4-1-49 contains long, detailed provisions intended to **prevent the inadvertent loss or impairment of tax benefits or the creation of certain tax problems** as a result of decanting

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Applying the "tax benefit" rules in Section 49

- Because the loss or impairment of tax benefits could have extremely serious adverse consequences for –
  - The settlor of the first trust, or
  - Donors who made past gifts to the first trust, or
  - Beneficiaries of the first trust,

  the rules and restrictions in new § 30-4-1-49 generally "trump" and supersede other rules elsewhere in the Act which could otherwise allow a change to be made to a beneficiary's interest
- Subsection 49(e) lists nine types of tax benefits that are protected from being lost or impaired, including –
  - Marital & charitable deductions (estate or gift tax)
  - QSST status for S corporation stock
  - Zero inclusion ratio for GST tax

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“Beneficiary with a disability” rules in new I.C. § 30-4-10-43

- If a beneficiary of the first trust fits the broad definition of “beneficiary with a disability” [in § 30-4-10-6],then **even if the disabled beneficiary has a vested interest** (such as a right to receive an immediate lump-sum distribution or a mandatory life income interest), new I.C. § 30-4-10-43 permits the trustee or a “special needs fiduciary” to decant to a second trust that functions as a discretionary special needs trust for that disabled beneficiary
- If there is no current trustee who has and is willing to exercise discretion, subsection 43(c) permits the appointment of a “special needs fiduciary” who ***can*** decant

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“Beneficiary with a disability” rules in new I.C. § 30-4-10-43

- Subsection 43(f) specifically mentions first-party (d)(4)(A) trusts and (d)(4)(C) pooled trusts
- **Practice suggestion** (no current detailed guidance):
  - If the disabled beneficiary is ***currently*** entitled to a mandatory distribution or has a ***currently*** exercisable withdrawal right, decant that beneficiary’s share to a self-settled (d)(4)(A) or (d)(4)(C) trust
  - If the disabled beneficiary has a withdrawal right or a right to a mandatory distribution that is exercisable or payable *more than 1 year in the future*, consider decanting to a discretionary spendthrift trust ***without*** a payback provision

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“Beneficiary with a disability” rules in new I.C. § 30-4-10-43

- CAUTION: The tax benefit rules in I.C. § 30-4-10-49 can trump and supersede the broad rules for disabled beneficiaries in section 43
- ***Example***:
  - The disabled beneficiary’s interest in the first or existing trust is attributable to an annual exclusion gift that was based on a Crummey withdrawal power held by the beneficiary, who is now disabled
  - One straightforward interpretation of section 49 is that decanting under section 43 cannot be used to ***eliminate*** that withdrawal power, in order to help the disabled beneficiary qualify for benefits

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How relevant is the new Act?

- ***Why should we care*** about the new Indiana Uniform Trust Decanting Act?
  - Even in the current era when non-judicial settlement agreements (NJSAs) can be used to make a wide variety of changes to irrevocable trusts, decanting is still potentially useful
  - Unless the terms of an existing irrevocable trust give someone a special amendment power that is “broad enough,” decanting is the only modification method that does not require the consent of beneficiaries, *or* unanimous consent of signing parties, *or* a petition to the probate court for modification, equitable deviation, or reformation

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Thank you for your kind attention.

See the companion paper for further details.

Jeffrey S. Dible
FROST BROWN TODD LLC
201 N. Illinois St, Suite 1900
P. O. Box 44961
Indianapolis, IN 46244-0961
O: (317) 237-3811
jdible@fbtlaw.com

Section Ten

Covering Your Client's S (Corporation)

Professor Samuel A. Donaldson
Georgia State University, College of Law
Atlanta, Georgia

Section Ten

Covering Your Client's S (Corporation)…….. Professor Samuel A. Donaldson

Covering Your Client's S (Corporation)

By
Samuel A. Donaldson

Professor of Law
Georgia State University
Atlanta, Georgia

Senior Counsel
Perkins Coie LLP
Seattle, Washington

These materials are adapted from materials originally prepared for the 42nd Annual Heckerling Institute on Estate Planning.

> "No rational, reasonably well-informed tax professional would deliberately choose subchapter S status over an LLC when there is a choice, and 99 percent of the time there is a choice. The LLC is clearly the choice of the future if you are dealing with rational people and most of the time we are dealing with rational people."[1]

S corporations continue to dominate the choice of entity debate. In 2018, for example, there were 1,734,151 tax returns filed by C corporations and 5,077,917 returns filed by S corporations.[2] For that same year, there were 4,010,000 returns filed by all entities taxed as partnerships (general partnerships, limited partnerships, limited liability companies, limited liability partnerships, and the like). Estate planners have no choice but to grapple with S corporations as they design and implement plans for their clients. Accordingly, these materials offer both an overview of the federal income tax rules related to S corporations and an overview of several strategies used by estate planners when their clients own S corporation stock.

A client's business will almost always come in one of seven forms: (1) a sole proprietorship; (2) a general partnership; (3) a limited partnership; (4) a limited liability

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[1] Comments of Donald C. Alexander (former Commissioner of the Internal Revenue Service), quoted in Amy Hamilton, *S Corporations "Most Popular Choice of Entity," IRS Finds*, 88 TAX NOTES 157 (July 10, 2000).

[2] Internal Revenue Service Statistics of Income, *available at* https://www.irs.gov/statistics/soi-tax-stats-business-tax-statistics.

partnership; (5) a limited liability company; (6) an S corporation; and (7) a C corporation. For federal tax purposes, however, there are only three types of business entities. The first form described above (sole proprietorship) is simply disregarded for federal tax purposes, so all items of income and deduction attributable to the business are added to the owner's other items of income and deduction on the owner's Form 1040.

The next three forms (general partnership, limited partnership, limited liability partnership) are treated as partnerships for federal tax purposes, meaning they will subject to the marvelous complexities of subchapter K. Any of these three forms are welcome to elect corporation status, but that is rarely done for domestic entities.

The fifth form, the limited liability company, will be treated as a sole proprietorship for federal tax purposes if it has only one owner; if it has multiple owners it will be treated as a partnership unless the owners elect to have the entity taxed as a corporation.

The last two forms, the corporations, have no choice. From a federal tax perspective, they are corporations and nothing else. Of course, an S corporation is a pass-through entity, meaning that the entity will generally not be liable for payment of federal income tax. The items of income, gain, loss, deduction, and credit of an S corporation are attributed to its shareholders in proportion to their ownership interests as if they derived such items themselves (though the character of any given item is determined at the entity level). Subsequent distributions of after-tax earnings from the S corporation are not again subject to tax as dividends. This is the major distinction between S corporations and C corporations. C corporations are separate taxable entities. Their taxable incomes are subject to a different progressive rate table, and distributions of after-tax earnings and profits are gross income to the recipient shareholders. Under current law, this "double tax" is mitigated to some extent because dividends received from domestic corporations and certain foreign corporations are taxed at the same rate as adjusted net capital gains (generally at a maximum of 23.8 percent). This preferential rate for "qualified dividend income" applies to dividends on common and preferred shares from both closely-held and publicly-traded corporations.

I. S CORPORATION ELIGIBILITY REQUIREMENTS

Not every corporation can elect to be treated as an S corporation. There are limits as to the number and types of shareholders that a corporation may have, although these limits are easily circumvented in most cases. There is also a limit as to the corporation's capital structure, a limit intended to ensure that the pass-thru of tax items remains relatively easy to administer.

As a threshold matter, only domestic corporations can elect to be treated as S corporations.[3] A domestic corporation is any corporation organized in the United States or

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[3] IRC §1361(b)(1).

under the law of the United States or any particular state.[4] A corporation organized in both the United States and a foreign country qualifies as a domestic corporation.[5]

A. Number of Shareholders

When S corporations came on the scene in 1958, the maximum number of shareholders was capped at 10. The Tax Reform Act of 1976 increased the limit to 15 shareholders for certain S corporations, and the Revenue Act of 1978 made the 15-shareholder limit applicable to all S corporations. In 1981, the Economic Recovery Tax Act increased the limit to 25 shareholders. Just a year later, the Subchapter S Revision Act of 1982 set the limit at 35 shareholders. According to the legislative history, Congress chose the 35-shareholder limit because that same limit applied to private placement exceptions to federal securities laws.[6] The 35-shareholder cap remained in force until 1997, when the Small Business Job Protection Act of 1996 increased it to 75 shareholders. The present cap of 100 shareholders was introduced by the American Jobs Creation Act of 2004 and became effective for taxable years beginning in 2005 or later.

With some exceptions, every person holding stock in an S corporation counts toward the 100-shareholder limitation.[7] Spouses and their estates are treated as one shareholder for purposes of applying the limitation,[8] regardless whether the spouses own shares jointly or separately or solely by operation of community property laws.

> EXAMPLE (1): Adam and Eve are married. Adam, Eve and 99 other unrelated individuals each own shares in S Corporation. S Corporation does not exceed the 100-shareholder limitation because Adam and Eve are treated as a single shareholder. In determining their shares of S Corporation's tax items, however, Adam and Eve are treated separately.
>
> If Adam dies, S Corporation still does not exceed the 100-shareholder limitation because Adam's estate and his surviving spouse, Eve, are still treated as one shareholder for counting purposes. This is true even if Adam's estate has multiple beneficiaries and even if Eve is not a beneficiary of Adam's estate.

[4] IRC §7701(a)(4).

[5] Treas. Reg. §301.7701-5(a). See also PLR 9512001 (corporation organized in United States and in foreign country is eligible to make S election and will not be treated as having two classes of stock).

[6] S. Rep. No. 640, 97th Cong., 2d Sess. 7 (1982).

[7] Rev. Rul. 59-187, 1959-1 C.B. 224.

[8] IRC §1361(c)(1).

If Adam and Eve divorce, however, S Corporation will lose its S election because it will have more than 100 shareholders during the taxable year of the divorce.

The American Jobs Creation Act of 2004 introduced the rule that all "members of a family" are treated as one shareholder for purposes of the 100-shareholder limitation.[9] Members of a family are the common ancestor, the lineal descendants of the common ancestor (up to a maximum of six (!) generations), and the current *and former* spouses of the lineal descendants or the common ancestor.[10] This effectively eviscerates the 100-shareholder limitation.

EXAMPLE (2): A and B are both age 85. They are married and have five children ranging in age from 50 to 60. Each of those children is married and has five children (that makes 25 grandchildren for A and B, ranging in age from 25 to 35). Each grandchild is also married and each has five children, too (that's 125 great grandchildren for A and B, ranging in age from 0 to 15). A and B have gifted shares in S Corporation over the years to each of these family members and their spouses. As a result, 187 individuals own stock in S Corporation. For purposes of the 100-shareholder limitation, however, there is only one shareholder. A and B, as a married couple, count as one shareholder, and because all of the shareholders are "members of a family." everyone is treated as a single shareholder. S Corporation could have 99 other families of the same size and composition (making for 18,700 total individuals with shares) and still not violate the 100-shareholder limitation.

Shares held by a guardian or agent are deemed to be owned by the persons for whom the stock is held.[11] So if a custodian holds shares for the benefit of three minor children, for example, each minor is counted as a shareholder in applying the 100-shareholder limitation.

[9] IRC §1361(c)(1)(A)(ii).

[10] IRC §1361(c)(1)(B). The determination of whether there is more than six generations separating the common ancestor from the youngest generation of shareholders is made on the latest of: (1) the date the S election is made; (2) the first date on which the common ancestor or a lineal descendant (or spouse) owns stock in the S corporation; and (3) October 22, 2004 (the date of enactment for the American Jobs Creation Act of 2004). *Id.*

[11] Treas. Reg. §1.1361-1(e)(1).

B. Types of Shareholders

Very generally, subchapter S welcomes most individual shareholders (and their estates[12]) but exhibits hostility toward entity shareholders.

1. No Nonresident Aliens

Most individuals are eligible S corporation shareholders.[13] A corporation cannot make an S election if it has a nonresident alien shareholder,[14] and if a nonresident alien individual becomes a shareholder in an S corporation, the corporation will lose its S election[15] and will generally be precluded from re-electing S status for five years.[16] A nonresident alien individual is an individual that is neither a citizen of the United States nor a resident of the United States.[17]

An individual is a resident of the United States if he or she meets either the "green card test" or the "substantial presence test." Both of these tests are objective; the intent of the individual and other such subjective measures (like domicile) are irrelevant. An individual meets the green card test if he or she is a lawful permanent resident of the United States at any time during the calendar year.[18] An individual meets the substantial presence test if he or she is present in the United States on at least 31 days of the current year and at least 183 total days of the current and two preceding calendar years.[19] Presence, for these purposes, is determined using a composite, weighted measure of the days of physical presence over a three-year period.

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[12] IRC §1361(b)(1)(B). There is no limitation as to how long an estate may hold S corporation stock. This is not the case for testamentary trusts, which, as discussed *infra*, must distribute S corporation stock or otherwise qualify as a permissible S corporation shareholder within two years.

[13] In Revenue Ruling 2004-50, 2004-1 C.B. 977, the Service ruled that a federally recognized Indian tribal government is not an eligible S corporation shareholder, meaning that the corporation in which the tribe owns shares cannot make a subchapter S election. The Service noted that only individuals and certain estate and trusts can hold S corporation shares under IRC §1361(b)(1). Since the Indian tribe is exempt from taxation under established authorities, and because the tribe is not subject to federal income tax as an individual under IRC §1, the Service determined that the tribe was not an "individual" for purposes of qualifying the corporation for election to subchapter S status.

[14] IRC §1361(b)(1)(C).

[15] IRC §1362(d)(2)(A).

[16] IRC §1362(g).

[17] IRC §7701(b)(1)(B).

[18] IRC §7701(b)(1)(A)(i).

[19] IRC §§7701(b)(1)(A)(ii); 7701(b)(3)(A).

All days in the current calendar year are added to one-third of the days in the first preceding calendar year and to one-sixth of the days in the second preceding calendar year.

EXAMPLE (3): Evita, a citizen of Argentina, spent 120 days in the United States in each of 2005, 2006, and 2007. Under the weighted measure, Evita is considered to have been present for only 180 total days:

Year	Days Present in the United States	x	Multiplier	=	Days
2005	120		1/6		20
2006	120		1/3		40
2007	120		1		120
					180

Accordingly, Evita is a nonresident alien individual for 2007. She is an ineligible shareholder of S corporation stock.

If a non-citizen's presence in the United States amounts to at least 183 days under this approach, the individual meets the substantial presence test and is treated as a United States resident unless he or she is present in the United States for less than 183 days during the current year and he or she has both a principal place of business in a foreign country and a "closer connection" to that foreign country than to the United States.[20]

If a current S corporation (or a C corporation or a partnership whose owners wish to make an S election) wants to pass shares to a nonresident alien individual, the S corporation and the nonresident alien should form a partnership or other pass-thru entity for federal income tax purposes. This preserves the S election while permitting the nonresident to participate in the profits and losses of the enterprise.[21]

EXAMPLE (4): Adam and Beth each own 10 shares in S Corporation. Evita, a nonresident alien individual, wants to join Adam and Beth as an equal stakeholder, and both of the existing owners want Evita involved in the business. To protect the S election of S Corporation, S Corporation and Evita form a limited liability company to be taxed as a partnership for United States income tax purposes. S Corporation contributes all of its business assets to the LLC in exchange for two-thirds of the membership interests in the LLC, while Evita makes proportionate contributions of cash and/or property in exchange for a

[20] IRC §7701(b)(3)(B).

[21] See Michael Schlesinger, S CORPORATIONS: TAX PLANNING AND ANALYSIS 12 (CCH 2000). Schlesinger notes that this structure would survive scrutiny under the partnership anti-abuse rules in Regulation §1.701-2 because the S corporation's shareholders are taxed on their shares of the S corporation's income while the nonresident alien is taxed on his or her share of the partnership's profits.

one-third interest in the LLC. The LLC's operating agreement provides that all tax items shall be allocated according to the membership interests, meaning S Corporation is taxed on two-thirds of the LLC's taxable income and that Evita is taxed on one-third of the LLC's taxable income. The share allocable to S Corporation passes through in equal shares to Adam and Beth. This structure should accomplish the objectives of Adam, Beth, and Evita without sacrificing S Corporation's S election. Of course, if the LLC distributes some of the assets contributed by Evita to S Corporation (or if the LLC distributes some of the assets contributed by S Corporation to Evita) within seven years of their transfer to the LLC, the parties may have to recognize gain under the disguised sale rules in subchapter K.[22]

Planners in community property states need to pay special attention to the nonresident alien prohibition. If an employee of an S corporation is married to a nonresident alien, the non-employee spouse may have a community property interest in any shares acquired by the employee as compensation. This would terminate the S election. Even if the shareholder-employee holds the S corporation shares as separate property, it may be possible for the non-employee spouse to acquire a community property interest in the shares to the extent the employee-shareholder otherwise receives inadequate compensation for the services he or she performs on behalf of the corporation.[23]

2. No Entity Shareholders

Corporations, partnerships, limited liability companies, and other business entities are not eligible to be shareholders of S corporation stock.[24] Disregarded entities (such as single-member limited liability companies) are permissible shareholders if their owners are eligible S corporation shareholders.

The Service will often ignore transitory ownership of S corporation stock by a partnership in the process of converting to an S corporation, even though there is no Code or regulation authority to forgive momentary ownership by an ineligible entity.[25]

EXAMPLE (5): Bert and Ernie are equal partners in the BE Partnership. In January, 2022, BE transferred all of its business assets to a newly-formed corporation in exchange for all of the corporation's stock. BE then liquidated and

[22] See IRC §§ 704(c)(1)(B); 707; 737.

[23] See William C. Staley, *S Corporations and Estate Planning*, at 6 (Glendale Estate Planning Council, Nov. 15, 2005).

[24] IRC §1361(b)(1)(B).

[25] See, e.g., PLRs 200237014, 200237011, 9010042, and 8934020.

distributed the corporation's stock to Bert and Ernie. Bert and Ernie make an S election in February, 2022. The S election is effective for all of 2022 even though BE owned the corporation's shares for a brief moment in time during January, 2022.

Since 1998, organizations described in IRC §401(a) or IRC §501(c)(3) that are exempt from tax under IRC §501(a) can be S corporation shareholders.[26] Translation? Employee stock ownership plans (ESOPs) and certain charitable organizations can hold S corporation stock. For eligible exempt organizations other than ESOPs, tax items from the S corporation pass through as unrelated business taxable income (UBTI).[27]

3. Trusts as Shareholders

Only certain domestic trusts qualify as S corporation shareholders. If S corporation falls into the hands of an "ineligible" shareholder, the S election is lost and the corporation becomes a C corporation unable to elect S corporation status for five years unless it successfully obtains discretionary relief from an inadvertent termination of the S election. Although many trusts qualify as eligible shareholders of S corporation stock, some common trust arrangements do not qualify. For instance, a charitable remainder trust is not an eligible shareholder of S corporation stock. Planners should therefore not advise clients to fund charitable remainder trusts with S corporation stock because doing so would sacrifice the S election.

Generally there are five kinds of trusts that qualify as S corporation shareholders.

The first is the **qualified subchapter S trust**, or QSST.[28] A QSST is a domestic trust[29] that has only one income beneficiary during that beneficiary's life (unless each beneficiary has a separate share of the trust[30]) who is a United States citizen or resident.[31] The trust instrument

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[26] IRC §1361(c)(6).

[27] IRC §512(e).

[28] IRC §1361(d).

[29] See IRC §§7701(a)(30)(E); 7701(a)(31)(B). Under these rules, a trust is a domestic trust only if: (a) a court within the United States has primary supervision over the administration of the trust, and (b) one or more United States fiduciaries control all substantial decisions of the trust. The regulations give some examples of the "substantial decisions" related to a trust that a fiduciary may have. Treas. Reg. §301.7701-7(d)(1)(ii). These include, among others: (1) whether and when to make distributions of income and principal; (2) the amount of distributions; (3) whether a receipt is allocated to income or principal; (4) the selection of a beneficiary; and (5) whether to appoint a successor trustee to succeed another trustee that is unable or willing to serve or continue to serve.

[30] See IRC §663(c).

[31] Spouses are treated as one current income beneficiary if they file jointly and each is a United States citizen or resident.

must require that all income be distributed currently (or such income must in fact be paid at least annually to the current income beneficiary). A QSST may permit distributions of principal only to the current income beneficiary during his or her life. No one else may be entitled to distributions of income or principal during the trust term, and no payments can be made from the trust that discharge someone else's obligation to support the current income beneficiary. The trust instrument must provide that the current income beneficiary's income interest terminates at his or her death or, if earlier, upon expiration of a fixed term. If a QSST terminates during the current income beneficiary's life, all assets must be distributed to him or her.

To become a QSST, the current income beneficiary must make a QSST election.[32] In the case of a trust owning shares in a C corporation that becomes an S corporation, the QSST election is made on Part III of the Form 2553, Election by a Small Business Corporation. If the corporation's S election is already in effect when the trust receives the shares, the QSST election is made by signing and filing a statement with the service center where the corporation files its income tax return.[33] The current income beneficiary reports all S corporation items attributable to the stock held by the QSST on his or her personal tax return.[34] For purposes of the 100-shareholder limitation, the current income beneficiary is treated as the shareholder of the stock.[35]

The second is the **electing small business trust**, or ESBT.[36] A trust can qualify as an ESBT if it has only individuals, estates, and/or qualified exempt organizations[37] as present, remainder, or reversionary beneficiaries.[38] A trust cannot qualify as an ESBT if any person has

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[32] If the corporation loses its S election solely because the current income beneficiary of an otherwise valid QSST fails to make a QSST election, the S election may be preserved if a QSST election is filed within two years of its original due date. See Rev. Proc. 2003-43, 2003-1 C.B. 998.

[33] Treas. Reg. §1.1361-1(j)(6)(ii). The statement must: contain the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation; identify the election as one made under IRC §1361(d)(2); specify the date on which the election is to become effective (cannot be more than 2 months and 15 days before the date the election is filed); specify the date(s) on which stock was transferred to the trust; and provide all information required to prove that the trust meets the requirements of a QSST.

[34] If the trust sells the S corporation stock, gain or loss is recognized by the trust (although the sale is considered to have been made by the current income beneficiary for purposes of the at-risk rules in IRC §465 and the passive loss rules in IRC §469). See IRC §1361(d)(1)(C).

[35] IRC §1361(c)(2)(B)(i).

[36] See IRC §1361(e).

[37] Any organization described in IRC §170(c)(2) – (5) is a qualified exempt organization, as is any IRC §170(c)(1) organization that holds a contingent interest and is not a potential current beneficiary.

[38] A person who may take under the exercise of a power of appointment is not considered a beneficiary of the trust for this purpose unless such power is actually exercised in that person's favor.

acquired an interest in the trust by purchase.[39] In addition, each "potential current beneficiary"[40] of the trust must be an eligible shareholder of S corporation stock if the trust is to qualify as an ESBT. The trust cannot be a charitable remainder trust or otherwise exempt from federal income tax.

An eligible trust becomes an ESBT when the trustee(s) with authority to legally bind the trust sign and file an election statement with the service center where the corporation files its income tax return.[41] While the requirements for an ESBT are easier to meet than the requirements for a QSST, the price for ease lies in the taxation of the trust's income. The trust itself must pay a flat tax of 37 percent[42] on the trust's taxable income attributable to the S corporation items,[43] the exemption amount for alternative minimum tax purposes is reduced to zero, and no capital loss carryovers are permitted.[44] For purposes of the 100-shareholder limitation, each potential current beneficiary is counted as a shareholder.[45]

In computing an ESBT's income attributable to the S corporation, the only items taken into account are: (1) the trust's shares of the S corporation's item of income, gain, loss, deduction, and credit; (2) gain or loss from the trust's sale of the S corporation stock; (3) state or local income taxes and administrative expenses allocable to the S corporation stock; and (4) interest paid or accrued on debt used to acquire stock in the S corporation.[46]

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[39] A purchase includes any transaction in which the basis of the acquired property is its cost. IRC §1361(e)(1)(C).

[40] A potential current beneficiary is one entitled to (or who may currently) receive distributions of income or principal from the trust. IRC §1361(e)(2).

[41] Treas. Reg. §1.1361-1(m)(2)(i). The statement must include: the name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the corporation; a statement that an ESBT election pursuant to IRC §1361(e)(3) is being made; the date when the trust first owned stock in the corporation; the date the election is to take effect (cannot be more than 2 months and 15 days before the date the election is filed); and representations that the trust meets all of the requirements of an ESBT and that all potential current beneficiaries are eligible shareholders of S corporation stock.

[42] Formally, the tax rate is equal to the highest rate applicable to trusts and estates under IRC §1(e). IRC §641(c)(2)(A).

[43] The trust continues to pay tax at the slightly progressive rates of IRC §1(e) on income attributable to other assets.

[44] IRC §641(c).

[45] IRC §1361(c)(2)(B)(v). During any period that there is no potential current beneficiary of an ESBT, the trust itself is treated as the shareholder for purposes of applying the 100-shareholder limitation.

[46] IRC §641(c)(2)(C).

The third kind of trust eligible to be an S corporation shareholder is a good, old-fashioned **grantor trust**.[47] A grantor trust is any trust that is deemed to be owned by the grantor or another person under any of IRC §§671-678.[48] A grantor trust is effectively disregarded for federal income tax purposes because all of the trust's tax items are reported by the deemed owner. Accordingly, if the deemed owner is an eligible shareholder of S corporation stock, transfers of S corporation stock to a grantor trust will not jeopardize the company's S election. For purposes of the 100-shareholder limitation, the deemed owner is counted as the shareholder.[49]

The fourth kind of eligible trust is a **former grantor trust**.[50] As its name implies, a former grantor trust is a trust that was a grantor trust (with a United States citizen or resident as the deemed owner) immediately before the deemed owner's death and that continues after such death. Although the trust is no longer a grantor trust because of the deemed owner's demise, the trust itself remains an eligible S corporation shareholder regardless of its dispositive scheme until the day before the second anniversary of the deemed owners death.[51] After such time, the trust will need to qualify as a QSST, ESBT, or grantor trust if the S election is to continue. The estate of the deemed owner is counted as the shareholder for purposes of the 100-shareholder limitation.

The final kind of eligible trust is a **testamentary trust**. All testamentary trusts are permitted S corporation shareholders for a two-year period beginning on the date the stock is transferred to the trust.[52] After such time, the trust will need to qualify as a QSST, ESBT, or grantor trust if the S election is to continue. During the two-year grace period, the trust itself pays the tax on the items of income, gain, loss, deduction, and credit attributable to its share of the S corporation's stock if no one is the deemed owner of the trust. The testator is treated as the shareholder for purposes of applying the 100-shareholder limitation.

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[47] IRC §1361(c)(2)(A)(i).

[48] For more on the use of grantor trusts in estate planning, see (ahem) Samuel A. Donaldson, *Understanding Grantor Trusts*, *in* 40 HECKERLING INSTITUTE ON ESTATE PLANNING 2-1 (Tina Portuando ed., 2006).

[49] IRC §1361(c)(2)(B)(i). This is true even where the trust contains *Crummey* powers that give the beneficiaries a power to withdraw some or all of the amounts contributed to the trust so that a gift of S corporation stock to the trust qualifies for the federal gift tax annual exclusion. See, e.g., PLR 200732010 (grantor trust with *Crummey* powers is an eligible shareholder of S corporation stock because the grantor's ownership of the trust under IRC §674 trumped the beneficiaries' ownership of the trust under IRC §678(a).

[50] IRC §1361(c)(2)(A)(ii).

[51] If no one is the deemed owner of the trust, the trust itself pays the tax on the items of income, gain, loss, deduction, and credit attributable to its share of the S corporation's stock.

[52] IRC §1361(c)(2)(A)(iii).

C. Single Class of Stock Requirement

An S corporation can only have one class of stock.[53] For this purpose, differences in voting rights among shares of common stock are disregarded.[54] Estate planners like to see S corporations with voting and nonvoting shares, because nonvoting shares in a closely-held business make ideal assets for gifts and other wealth transfers from a discount planning perspective.

An S corporation has a single class of stock if all shares have equal rights to distributions and liquidation proceeds.[55] Whether all shares have equal economic rights is determined with reference to what the regulations call the corporation's "governing provisions."[56] These include the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements related to distributions and liquidation.

Even if the governing provisions of an S corporation indicate only one class of stock, there is still risk that the corporation can violate the single class of stock requirement. For instance, disproportionate distributions may indicate that shares in fact have different economic rights, meaning a second class of stock exists. If a disproportionate distribution occurs, an equalizing distribution should follow soon thereafter. The Service has ruled that no second class of stock exists when disproportionate distributions are followed by equalizing distributions.[57]

In addition, constructive distributions may create a second class of stock. Constructive distributions occur when, for example, unreasonably high compensation is reclassified as a distribution[58] or the corporation makes a below-market loan to the shareholder.[59] If the constructive distribution results from something other than the corporation's governing provisions, however, the regulations are tolerant and provide that a second class of stock does not exist.

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[53] IRC §1361(b)(1)(D).

[54] IRC §1361(c)(4).

[55] Treas. Reg. §1.1361-1(l)(1).

[56] Treas. Reg. §1.1361-1(l)(2)(i).

[57] See, e.g., PLRs 200730009, 200524020, 200010023 and 9519048.

[58] Although excessive compensation is rarely an issue for S corporations (indeed, more often the concern is whether the S corporation has paid a sufficient salary to a shareholder-employee), it can arise where, for instance, an S corporation with subchapter C earnings and profits pays high compensation in order to zero-out its taxable income and, thus, eliminate its exposure to the IRC §1374 tax.

[59] IRC §7872(b)(1).

EXAMPLE (6): Shantay is an employee-shareholder of S Corporation. The compensation paid to Shantay under the provisions of her employment agreement with S Corporation is determined to be excessive. Consequently, a portion of her compensation is treated as a distribution. Assuming the employment agreement does not have a principal purpose of circumventing the single class of stock requirement, the employment agreement is not a "governing provision" of S Corporation, meaning that S Corporation does not have a second class of stock.[60]

The single class of stock requirement also becomes a thorny issue when shareholders also serve as creditors of the S corporation. Shareholder loans to an S corporation may be recharacterized as equity, which would give the S corporation an impermissible second class of stock. A loan to an S corporation will be treated as stock if the transaction constitutes equity under general principles of federal tax law or if the principal purpose of the transaction is to circumvent the single-class-of-stock or eligible-shareholder rules.[61] To be safe, all loan arrangements from shareholders to S corporations should come within one of the three safe harbors outlined in the regulations: (1) short-term unwritten advances that never exceed $10,000 in the aggregate;[62] (2) debts owed solely to the shareholders and in proportion to their stock holdings;[63] and (3) "straight debt." Straight debt is a written, unconditional obligation to pay a sum certain (on demand or on a specified due date) held by a United States citizen or resident, an estate, or an eligible trust shareholder and which does not provide for contingent interest (that is, interest computed or payable that is contingent on corporate profits, the borrower's discretion, the payment of dividends, or similar factors) and is not convertible to into stock.[64]

The debt-as-second-class-of-stock problem can arise in situations planners may not expect. For example, if an S corporation redeems a portion of the shares of a retiring or deceased shareholder, the applicable buy-sell agreement usually permits the S corporation to pay the purchase price in installments. If the buy-sell agreement requires the S corporation to pay interest on the deferred payments, the obligation may create a second class of stock unless

[60] This example is adapted from Treas. Reg. §1.1361-1(l)(2)(vi), Example 3.

[61] Treas. Reg. §1.1361-1(l)(4)(ii)(A).

[62] Treas. Reg. §1.1361-1(l)(4)(ii)(B)(1).

[63] Treas. Reg. §1.1361-1(l)(4)(ii)(B)(2).

[64] IRC §1361(c)(5); Treas. Reg. §1.1361-1(l)(5)(i). My English teacher would have a fit about that sentence, but it's all there.

it qualifies under straight debt safe harbor. Planners should review the provisions of a buy-sell agreement involving S corporation stock to make sure this situation does not arise by accident.

A split-dollar insurance arrangement between a trust and an S corporation whereby the corporation will be the owner of the policy should not give rise to a second class of stock as long as the corporation's rights are limited to recovery of any unreimbursed premiums.[65] Likewise, a deferred compensation plan will not be treated as a second class of stock provided the plan is: (1) lacking voting rights; (2) an unfunded and unsecured promise to pay cash or property in the future; (3) issued to an employee or an independent contractor in connection with the performance of services for the corporation; and (4) issued pursuant to plan under which the recipient is not currently taxed on the income.[66]

D. Election

1. Mechanics

All shareholders must consent to make a subchapter S election.[67] An election is effective for the taxable year following the year of election, except that an election made in the first two and a half months of a taxable year is effective as of the first day of the taxable year.[68]

> EXAMPLE (7): A and B are equal shareholders of X Corporation. X Corporation was formed on November 10, 2021. They wish to make an S election for X Corporation. Accordingly, A and B each sign a completed Form 2553. Unless A and B specifically request a later effective date, any election filed during the period beginning on November 10, 2021, and ending January 24, 2022, will be effective as of November 10, 2021. If the election is filed on February 1, 2022, X Corporation will not be an S corporation for the short taxable year ending December 31, 2021, but it will be an S corporation as of January 1, 2022, unless A and B specified a later effective date on the completed Form 2553.

The Service will consider requests for relief from the effects of a late election. Unless a special situation applies, however, the corporation usually must request relief through a private letter ruling that will require payment of a user fee.[69] The Service has identified a number of special situations:

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[65] See, e.g., PLR 9709027.

[66] Treas. Reg. §1.1361-1(b)(4).

[67] IRC §1362(a).

[68] IRC §1362(b).

[69] See Rev. Proc. 2008-1, 2008-1 I.R.B. 1.

• *A partnership, LLC, or other noncorporate eligible entity failed to timely file the Form 2553 and has not elected to be treated as a corporation.* If the entity can show reasonable cause for its failure to timely file the S corporation election (and the entity classification election on Form 8832), then requests for relief made within six months after the due date for the tax return for the first year the entity intended to be an S corporation will be honored and the entity will be given additional time to make the required elections.[70]

• *A corporation failed to timely file the Form 2553 but has reasonable cause for its failure to do so*. Requests for relief made within two years of the original due date for the S election will be considered by the Service provided either: (1) the corporation has not yet filed a return for the first year in which the election was intended and the request for relief comes within six months of the due date for that return; or (2) the corporation did file a return for the first year in which the election was intended and all of the shareholders have reported consistently with an S election on all of their affected returns for the year(s) in which the election was intended.[71]

• *The corporation filed a Form 1120S and, within six months, the Service did not notify the corporation or any shareholder of any problem with S corporation status*. If the shareholders reported their income consistent with S corporation status for the year(s) in which the S election was intended, then the corporation qualifies for automatic relief.[72]

EXAMPLE (8): Betty and Veronica formed X corporation on January 1, 2020. They intended to make an S election, but the Form 2553 was never filed. On March 15, 2021, X Corporation filed a Form 1120S (the S corporation income tax return) for its 2020 taxable year, and Betty and Veronica filed their individual returns as if X Corporation were an S corporation. In November, 2021, X Corporation realizes that the S election was never filed. Neither X Corporation, Betty, nor Veronica received any notification from the Service of any problem regarding X Corporation's status as an S corporation. X Corporation is entitled to automatic late S election relief provided it complies with applicable procedures.

[70] Rev. Proc. 2004-48, 2004-1 C.B. 172.

[71] Rev. Proc. 2003-43, 2003-1 C.B. 998.

[72] Rev. Proc. 97-48, 1997-2 C.B. 521. To claim the relief, a completed Form 2553 must be filed with the words "FILED PURSUANT TO REV. PROC. 97-48" printed at the top of the Form.

2. Reasons Not to Elect Subchapter S Status

Some planners assume it is always preferable for an eligible small business corporation to make an S election. After all, the S election usually causes no immediate tax consequences to the corporation or the shareholders,[73] although built-in gains on assets held by the C corporation at the time of its conversion to an S corporation may have to be recognized by the S corporation.[74] This is better than a conversion from C corporation to partnership because that requires a deemed liquidation of the corporation, a taxable event to the corporation and the shareholders.[75] Indeed, the S election may have other benefits beyond avoiding the double tax. If the C corporation is unable to use the cash method of accounting,[76] conversion to S corporation status will permit the entity to use the cash method.[77] If the C corporation is currently paying or may soon face liability for the personal holding company penalty tax in IRC §541,[78] conversion to S corporation status will eliminate the penalty tax.[79] Despite these advantages, one must consider that there may be drawbacks to the election which, in a particular case, might outweigh the benefits of pass-thru taxation.

a. Loss of 14-Percent Rate on IRC §1202 Stock Gain

First, IRC §1202(a)(1) generally excludes half of the gain from the sale or exchange of qualified small business stock held for more than five years.[80] The other half of such gain is

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[73] But see IRC §1363(d) and discussion at Part II(C) *infra*.

[74] IRC §1374. See discussion at Part II(C)(2) *infra*.

[75] IRC §§ 331(a); 336(a).

[76] A C corporation generally cannot use the cash method unless: (1) it is engaged in farming; (2) substantially all of its activities consists of the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or (3) its average annual gross receipts for the three prior taxable years does not exceed $25 million. IRC §448(b).

[77] That is, unless the S corporation is a "tax shelter." IRC §448(a). A tax shelter is any "syndicate" within the meaning of IRC §1256(e)(3)(B) or a "tax shelter" as defined in IRC §6662(d)(2)(C)(iii) (yes, a "tax shelter" means "a syndicate or a tax shelter"). IRC §§448(d)(3); 461(i)(3).

[78] A C corporation is a personal holding company if: (1) at least 60% of its "adjusted ordinary gross income" for the taxable year is "personal holding company income," and (2) at any time during the last half of the taxable year not more than five individuals own (directly or indirectly) more than 50% in value of the corporation's stock. IRC §542(a). Personal holding company income includes dividends, interest, royalties, annuities, rents, compensation for the use of corporate property by shareholders, and income from estates and trusts. IRC §543(a).

[79] IRC §1363(a).

[80] Under IRC §57(a)(7), however, seven percent of the excluded gain is an item of tax preference for purposes of the alternative minimum tax.

subject to a preferential tax rate of 28 percent.[81] In effect, then, the entirety of such gain is taxed at a rate of 14 percent (half of the gain is taxed at 28 percent, half of the gain is not taxed at all).

Under the American Recovery and Reinvestment Act of 2009, the exclusion increases to 75 percent of the gain from the sale or exchange of qualified small business stock acquired after February 17, 2009, and before January 1, 2011.[82] Where the special 75 percent exclusion applies, then, the effective rate of tax on the entire gain is only seven percent. The Creating Small Business Jobs Act of 2010, however, went one step further: qualified small business stock acquired from September 28, 2010, through December 31, 2010, was eligible for a 100-percent exclusion. The Tax Relief and Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended the 100-percent exclusion for stock acquired through 2012, and the American Taxpayer Relief Act of 2012 further extended the 100-percent exclusion to stock acquired in 2013. It was extended again through 2014 by the Tax Increase Prevention Act of 2014. Finally, the Consolidated Appropriations Act of 2016 made the 100-percent exclusion permanent for stock acquired after September 27, 2010. The following example clarifies the mechanics of the exclusion based on the acquisition date of the qualified small business stock:

EXAMPLE (9): Taylor realized $100,000 of gain from the sale of qualified small business stock. Taylor held the stock for more than five years. The amount Taylor may exclude from gross income depends on when Taylor *acquired* the stock, not the date of the sale. Specifically:

If the stock was acquired…	The amount of gain excluded is…
On or before Feb. 17, 2009	$50,000
After Feb. 17, 2009 but before Sep. 28, 2010	$75,000
After Sep. 27, 2010	$100,000

Only C corporation stock can claim this benefit. Specifically, "qualified small business stock" is any stock in a domestic C corporation originally issued after August 10, 1993, but only if such stock was acquired by the shareholder either as compensation for services provided to the corporation or in exchange for money or other non-stock property, and only if the corporation is a qualified small business.[83] A "qualified small business" is one with aggregate

[81] IRC §§1(h)(1)(E); 1(h)(4); 1(h)(7).

[82] IRC §1202(a)(3).

[83] IRC §1202(c)(1).

gross assets of $50 million or less at all times after August 10, 1993, and before the time immediately after the date of issuance.[84]

In addition to these requirements, the corporation must meet an "active business requirement" during substantially all of the shareholder's holding period in order for IRC §1202 to apply.[85] This requires that at least 80 percent of the value of the corporation's assets be used in the active conduct of at least one of these qualified trades or businesses: (1) professional services in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or other business in which the principal asset is the reputation or skill of one or more of its employees; (2) banking, insurance, financing, leasing, investing, or similar business; (3) farming; (4) extraction or production of natural resources eligible for percentage depletion; or (5) operation of hotels, motels, restaurants, or similar businesses.[86]

Depending on the applicable percentage exclusion (based on when the stock was acquired), the benefit of IRC §1202 exclusion may be significant. If IRC §1202 does not apply but the client holds the stock for more than one year, the gain will be long-term capital gain subject to a preferential tax rate generally ranging from zero to 23.8 percent. In case of IRC §1202 stock acquired before February 17, 2009, the cost of losing the 14 percent rate applicable to IRC §1202 stock may not be very significant. To the extent a client can save much more than this additional tax amount by making a subchapter S election or otherwise operating the business in a more profitable or tax-savvy manner that sacrifices the IRC §1202 exclusion, a planner should not be afraid to recommend such action. Of course, where the seven percent (or zero percent) preferential tax rate applies, the comparative benefit of IRC §1202 is stronger; depending on the amount of gain at issue, foregoing pass-through taxation or similar strategies might be desirable.

b. Detrimental Tax Consequences to the Corporation

As explained later in these materials, if a C corporation has earnings and profits and/or uses the LIFO method for tracking its inventories, the S election will come at a cost, both in the year of the election and, as long as the earnings and profits from subchapter C years remain undistributed, for the first several years thereafter.

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[84] IRC §1202(d)(1). "Aggregate gross assets" is measured as the sum of cash plus the adjusted bases of all corporate assets (assuming that the basis of all contributed property is equal to its fair market value as of the date of contribution). IRC §1202(d)(2).

[85] IRC §1202(c)(2)(A).

[86] IRC §1202(e).

3. S Elections by Partnerships

Unincorporated domestic entities (like partnerships) can elect to be treated as corporations for federal tax purposes.[87] Any such organization that elects status as a corporation can also elect to be taxed as an S corporation.[88] To the extent a partnership wants to avail itself of the benefits of S corporation status, the partners can simply make this two-step election to achieve the desired status.[89]

The key obstacle, of course, is that an electing unincorporated entity must meet the eligibility requirements of an S corporation in order for the S election to become effective. The entity, for example, cannot have more than 100 owners[90] and no owner may be a nonresident alien individual.[91] These are easy enough to spot, but the "single-class-of-stock" requirement for S corporations[92] can be harder to police. The Service will not issue rulings as to whether a limited partnership qualifies as a small business corporation eligible to elect S corporation status.[93] No doubt this is because the varying rights and obligations of general and limited partners may well constitute a second class of stock.[94] We know that a limited partnership agreement does not create a second class of stock as long as distributions to the partners are to be made in accordance with the partners' respective cumulative interests.[95] But if the

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[87] Treas. Reg. §301.7701-3.

[88] See, e.g., PLR 199942017.

[89] In fact, the process is now more streamlined. It used to be that the entity had to elect to be classified as an association under the "check-the-box" regulations by filing Form 8832 and *then* elect to be an S corporation by filing Form 2553, "*Election by a Small Business Corporation*." In practice, however, there were cases where an entity timely filed the Form 2553 but failed to file the Form 8832. When that happened, the entity had to submit a letter ruling request for an extension of time to file a late entity classification election. Now, temporary regulations provide relief for these entities by allowing the S corporation election itself to serve as a deemed election to be taxed as a corporation under the check-the-box rules. See Temp. Reg. §301.7701-3T(c)(1)(v)(C). In other cases, the Form 2553 and the Form 8832 were filed late, and the entity had to submit a ruling request to file a late entity classification election and a late S corporation election. Now, under Revenue Procedure 2004-48, 2004-2 C.B. 172, there is relief for entities that miss both deadlines, again in a manner that allows for one action to cover both elections. See also Rev. Proc. 2007-62, 2007-41 I.R.B. 786.

[90] IRC §1361(b)(1)(A).

[91] IRC §1361(b)(1)(C).

[92] IRC §1361(b)(1)(D).

[93] Rev. Proc. 2007-3, 2007-1 I.R.B. 108, §5.09.

[94] See Rev. Proc. 99-51, 1999-2 C.B. 760.

[95] See, e.g., PLRs 200326023, 200326024, and 200326025. In the last of these private rulings, the shareholders of an S corporation (S1) formed a limited liability partnership (LLP) that made a double-election to be treated as an S corporation. The shareholders then contributed their S1 stock to LLP and S1 elected to be treated as a qualified

partnership agreement requires distributions in accordance with positive capital account balances and such capital accounts are not in proportion to the partners' percentage interests, the partnership likely has more than one class of stock, making the S election unavailable.[96] Disproportionate operating distributions from the partnership should not create a second class of stock provided the entity makes corrective distributions to make distributions proportionate.[97]

4. Termination of S Election

A corporation can lose its S election in any of three ways. *First*, a majority of the taxpayers may elect to revoke the corporation's S election.[98] *Second*, the S election terminates automatically if the corporation ceases to qualify as a small business corporation.[99] *Third*, termination results if the S corporation has subchapter C earnings and profits for three consecutive years and, during each of those same years, derives more than 25 percent of its gross receipts in the form of passive investment income.[100]

A termination is effective as of the close of business on the day before the termination event occurs.[101] This creates a short S year and a short C year. The corporation can elect to allocate income items between the two short years according to its normal method of accounting. In the absence of an election, income items are allocated pro rata between the short years.

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subchapter S subsidiary corporation (or "Q-Sub"). LLP then created a wholly-owned limited liability company (LLC) that is disregarded for federal tax purposes as an unincorporated organization with only one owner. LLP transferred some of its S1 stock to LLC. Because LLC is disregarded, S1's Q-Sub election is not lost. S1 then converted to a limited partnership, with LLC as the general partner and LLP as the limited partner. As a limited partnership, S1 made a triple-election (electing to be a corporation, an S corporation, and a Q-Sub). At the end of the day, then, the shareholders owned all of the interests in LLP (an S corporation for tax purposes) which in turn held all of the limited partner interests (and, through a disregarded entity, all of the general partner interests) in a limited partnership (a Q-Sub for tax purposes). The Service approved this transaction in the ruling.

[96] See Richard B. Robinson, *Tax Audit Issues for S Corporations*, in 41ST ANNUAL SOUTHERN FEDERAL TAX INSTITUTE MATERIALS at J-7 (2006).

[97] See, e.g., PLR 200524020.

[98] IRC §1362(d)(1).

[99] IRC §1362(d)(2). This happens if, for example, the corporation has more than one class of stock, has more than 100 shareholders, has a nonresident alien shareholder, or an ineligible trust as a shareholder.

[100] IRC §1362(d)(3).

[101] Treas. Reg. §1.1362-3(a).

If an S corporation accidentally loses its S election, the Service has discretion to treat the termination as "inadvertent," thus permitting the S election to continue.[102] The Service regularly exercises this discretion in cases where the shareholders take prompt corrective action and provide a reasonable explanation for the inadvertent termination.[103]

E. Qualified Subchapter S Subsidiaries

Although an entity cannot own shares in an S corporation, an S corporation can own shares or membership interests in other business entities. If an S corporation owns all of the stock of another corporation, the S corporation can make an election to treat that corporation as a "qualified subchapter S subsidiary" ("Q-Sub").[104] If it does so, the separate nature of the Q-Sub for state law purposes is ignored for federal income purposes, and the assets, liabilities, and tax items of the Q-Sub are treated as assets, liabilities, and tax items of the S corporation.[105]

If for any reason the S corporation is no longer the sole shareholder of the Q-Sub, the Q-Sub loses its status as such and is treated as a separate corporation that, at the time of termination, acquired all of its assets and debts from the S corporation in exchange for all of its stock. If the transaction causing termination of the Q-Sub election is not a sale of the Q-Sub's stock, then as long as the S corporation parent still owns at least 80 percent of the voting and value of the new subsidiary's stock, there is no recognized gain or loss to the S corporation parent,[106] although it will take a basis in the subsidiary's stock equal to the parent's basis in the contributed property immediately before the deemed transaction.[107] If, however, the S corporation owns less than 80 percent of the voting or value of the subsidiary's stock immediately after loss of the Q-Sub election, the S corporation must recognize all of the built-in gain or loss on the Q-Sub's assets at the time of this deemed transaction.

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[102] IRC §1362(f).

[103] See, e.g., PLR 200745013 (S election inadvertently terminated when shares were issued to nonresident alien, but the Service granted inadvertent termination relief because the corporation cancelled the shares issued to the ineligible shareholder); PLR 200744009 (S election inadvertently terminated when shares were issued to limited liability company, but inadvertent termination relief granted because the LLC distributed the stock to its members—all eligible shareholders—upon discovery of the terminating event).

[104] IRC §1361(b)(3)(B).

[105] IRC §1361(b)(3)(A).

[106] IRC §351(a).

[107] IRC §358.

If the transaction causing termination of the Q-Sub election is a sale of stock by the S corporation parent, the S corporation is deemed to have sold an undivided interest in the subsidiary's assets equal to the percentage interest sold by the S corporation parent.[108] This, of course, is a taxable event. In addition, the subsidiary is deemed to have purchased the remainder of its assets from the S corporation parent in a transaction to which IRC §351 applies, meaning the S corporation parent does not recognize this gain or loss.[109]

> EXAMPLE (10): As of 2022, S Corporation owns all of the single class of stock of Q Corporation. In 2020, S Corporation properly elected to treat Q Corporation as a Q-Sub. In 2022, S Corporation sells 40 percent of the stock in Q Corporation to X Corporation, an unrelated third party, for cash. The sale of Q Corporation stock to X Corporation terminates the Q-Sub election made by S Corporation. S Corporation is deemed to have sold 40 percent of the assets and liabilities of Q Corporation to X Corporation, and S Corporation must recognize gain or loss accordingly. In addition, Q Corporation is deemed to have acquired the remaining 60 percent of its assets from S Corporation in a transaction that qualifies for nonrecognition under IRC §351. Neither S Corporation nor Q Corporation recognizes gain or loss from this exchange. X Corporation's basis in the Q Corporation shares it purchased from S Corporation is equal to the amount paid for those shares.

Although a Q-Sub generally is not liable for the federal tax liabilities of its owner with respect to taxable periods during which it is treated as a disregarded entity, the Q-Sub may be liable for taxes with respect to taxable periods during which it was *not* disregarded (i.e., the time period prior to the Q-Sub election). Treasury has issued proposed regulations clarifying that if a Q-Sub is liable for taxes, the Q-Sub will be treated as an entity separate from its owner for purposes of those liabilities, such that assessment may be made against the Q-Sub, its assets may be subject to lien and levy, and it may consent to extend the period of limitations on assessment.[110] In addition, the proposed regulations clarify that if a disregarded entity is entitled to a refund or credit, the Q-Sub will be treated as an entity separate from its owner for purposes of that refund or credit.

> EXAMPLE (11): X Corporation, a C corporation, owns all of the stock of Y Corporation. X Corporation makes an S election and, simultaneously, makes a Q-Sub election with respect to Y Corporation. For purposes of Y Corporation's pre-election tax matters, Y Corporation will be treated as an entity separate from X

[108] IRC §1361(b)(3)(C)(ii)(I).

[109] IRC §1361(b)(3)(C)(ii)(II).

[110] Prop. Reg. §1.1361-4(a)(6).

Corporation. Thus, if Y Corporation is entitled to a refund from a pre-election year, the refund will be paid to Y Corporation even though it is a disregarded entity at the time the refund is paid.

II. PASS-THRU RULES

An S corporation is a conduit for federal income tax purposes, meaning that the corporation itself generally pays no tax because the shareholders take into account their pro rata shares of the corporation's tax items. Part II(A) explains how the S corporation's tax items are allocated to its shareholders. Part II(B) explains the correlative adjustments to basis required to ensure that the corporation's income is attributed and taxed to the shareholders only once. Part II(C) presents the extra tax issues faced by S corporations that were formerly C corporations.

A. Pass-Thru of Tax Items and Shareholder's Share

IRC §1366 governs the "pass-thru" of tax items to shareholders, and a shareholder's pro rata portion of tax items is determined under IRC §1377. Planners should understand how these provisions operate because midstream conversions of share ownership can affect the final income reportable by all of the corporation's shareholders.

1. Pass-Thru Items

Each shareholder must take into account his, her, or its share of the S corporation's items of income, loss, deduction or credit for the taxable year, regardless of whether the S corporation makes any distributions during the year.[111] All of the S corporation's items flow through to shareholders, including tax-exempt income. The character of all items is determined at the entity level.[112] The pass-thru consists of separately-stated items and "nonseparately computed income or loss," a general "basket" of ordinary income or loss. Separately-stated items are those that "could affect the shareholder's tax liability for that taxable year differently than if the shareholder did not take [them] into account separately."[113] Examples of separately-stated items include short-term capital gains and losses, regular long-term capital

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[111] Treas. Reg. §1.1366-1(a)(1).

[112] IRC §1366(b); Treas. Reg. §1.1366-1(b)(1). If shareholders contribute ordinary income property like inventory to an S corporation in order to convert the ordinary income into long-term capital gain, however, the character of the gain will be ordinary income. Treas. Reg. §1.1366-1(b)(2). Thus, if a dealer in real estate contributes a parcel of appreciated real property held for several years to an S corporation that will hold the property for investment purposes, the S corporation's sale of the property will result in ordinary income, not long-term capital gain. Likewise, if shareholders contribute capital loss property to an S corporation in order to convert capital losses into ordinary losses, the built-in loss will be treated as capital loss. Treas. Reg. §1.1366-1(b)(3).

[113] Treas. Reg. §1.1366-1(a)(2).

gains and losses, collectibles gains and losses, IRC §1231 gains and losses, charitable contributions, foreign taxes paid, credits, gambling losses, IRC §179 items, miscellaneous itemized deductions, passive activity income and losses, and income exempt from tax.[114]

EXAMPLE (12): S Corporation has two shareholders, A and B. A owns 60 percent of S Corporation's stock, while B owns the remaining 40 percent. For the most recent taxable year, S Corporation had the following items of income, loss, and deduction:

Gross income from business operations	$250,000
Long-term capital gains	$ 25,000
Short-term capital gains	$ 10,000
Tax-exempt interest income	$ 15,000
IRC §1231 gains	$ 50,000
Administrative expenses	($40,000)
Interest expense	($10,000)
Charitable contributions	($12,000)
Long-term capital losses	($ 5,000)
IRC §1231 losses	($60,000)

The nonseparately computed income or loss is $200,000, consisting of the gross income from business operations, the administrative expenses, and the interest expense. The long-term capital gains and losses are netted against each other, as are the IRC §1231 gains and losses. Accordingly, the pass-through to the shareholders consists of the following:

Item	A (60%)	B (40%)
Long-term capital gains	$ 12,000	$ 8,000
Short-term capital gains	$ 6,000	$ 4,000
Tax-exempt interest	$ 9,000	$ 6,000
Nonseparately computed income	$120,000	$80,000
IRC §1231 losses	($6,000)	($4,000)
Charitable contributions	($7,200)	($4,800)

While each of these items retains its character in the shareholders' hands, the ultimate treatment of these items may vary. For instance, suppose A has IRC §1231 gains of $10,000 from another activity but that B has no other IRC §1231

[114] Income exempt from tax includes life insurance death benefits (excluded under IRC §101) and interest on certain state and local bonds (excluded under IRC §103). Income that is deferred or temporarily excluded, however, is not treated as tax-exempt income for this purpose. Thus, certain income from the cancellation of indebtedness temporarily excluded under IRC §108 is not treated as tax-exempt income. Treas. Reg. §1.1366-1(a)(2)(viii).

gains or losses for the year. A will offset the $6,000 IRC §1231 loss from S corporation against the $10,000 of IRC §1231 gains, producing a net §1231 gain of $4,000 that will be treated as long-term capital gain. B, on the other hand, has only the IRC §1231 loss of $4,000 from S Corporation, so this item will be treated as ordinary loss.

The pass-thru is deemed to occur on the last day of the corporation's taxable year.[115] If a shareholder dies (or, in the case of an estate or trust, terminates) before the end of the taxable year, the shareholder's share of S corporation items must be reflected on the shareholder's final return.

2. Shareholder's Share

A shareholder's pro rata share of the S corporation's pass-thru items is determined under IRC §1377. Under that provision, an equal portion of every income and deduction item is allocated to each day in the taxable year and then the portion allocable to each day is divided by the number of shares outstanding on that day.[116] If a shareholder terminates his, her, or its interest during the taxable year, that shareholder and all other shareholders (including the terminated shareholder's assignees, if any) may consent to a termination of the taxable year as of the date of termination.[117] Such an election results in the S corporation having two short taxable years.

EXAMPLE (13): At the beginning of 2021, S Corporation had three equal shareholders: Mother, Son, and Daughter. On June 30, 2021, S Corporation redeemed all of Mother's shares. For 2021, S Corporation had no deductions and only two items of income: a $300 gain in March and a $900 gain in November. If the shareholders make no election, both gains are allocated equally to each day in the taxable year, and each day's portion is divided by the number of shares outstanding on that day. Thus, both gains are spread throughout the year. Because Mother is a one-third shareholder for one-half of the year, Mother is allocated one-sixth (one-third of one-half) of both gains, while Son and Daughter split the remaining five-sixths equally between them. Accordingly, each shareholder's pro rata share of S Corporation's taxable income for the year is as follows:

[115] Treas. Reg. §1.1366-1(a)(1).

[116] IRC §1377(a)(1).

[117] IRC §1377(a)(2).

Shareholder	Share of March Gain	Share of November Gain	Total
Mother	$ 50	$150	$200
Son	$125	$375	$500
Daughter	$125	$375	$500

On the other hand, if Mother, Son, and Daughter consent to an election to terminate S Corporation's taxable year as of June 30, 2021, S Corporation will have two taxable years: one from January 1, 2021 through June 30, 2021, and a second from July 1, 2021, through December 31, 2021. Mother is allocated one-third of all items from the first short year but no portion of the items from the second short year. Son and Daughter each receive one-third of the items from the first short year and one-half of the items from the second short year. As a result, each shareholder's pro rata share of S Corporation's taxable income for the year would be as follows:

Shareholder	Share of March Gain	Share of November Gain	Total
Mother	$100	$ 0	$100
Son	$100	$450	$550
Daughter	$100	$450	$550

If a shareholder holds S corporation stock as community property, his or her pro rata share is determined with reference to community property laws.[118]

EXAMPLE (14): Jessica is the sole shareholder of S Corporation. Jessica is married to Nick, and they reside in California, a community property state. The S Corporation shares are community property under California law. Jessica and Nick file separate returns. If S Corporation has $50,000 of nonseparately computed income for the taxable year, Jessica will report $25,000 of income on her return and Nick will report $25,000 of income on his return even if Nick has no involvement in S Corporation.

Note that the mechanical operation of IRC §1377 offers some opportunity to assign income to lower-bracket taxpayers. When a shareholder contributes property with a value in excess of its adjusted basis to an S corporation, the corporation generally takes the contributing shareholder's basis in the property.[119] When the S corporation subsequently sells the appreciated property, the gain from the sale, like any gain, is apportioned proportionately among the shareholders. The built-in gain is not allocated automatically to the contributing

[118] Treas. Reg. §1.1366-1(d).

[119] IRC §362(a).

shareholder, which is not the case for a partnership.[120] This provides contributing shareholders with an opportunity to shift gain to other, lower-bracket taxpayers without having to worry about the assignment of income doctrine.

> EXAMPLE (15): Monica and Ross form an S corporation when Monica contributes inventory worth $100,000 (in which her basis is $10,000) and Ross contributes $100,000 cash. Monica and Ross are given equal shares in the corporation's single class of stock. If the corporation sells the inventory for $100,000 to an unrelated party, the corporation's $90,000 gain (ordinary income if the property is inventory in the hands of the corporation) will be allocated equally among Monica and Ross. Notice that $45,000 of the gain attributable to the period during which Monica held Blackacre is effectively shifted to Ross. If Ross is related to Monica and is in a lower tax bracket than Monica, this could be a beneficial result. Of course, Ross may not see it that way, so an "opportunity" for Monica is an "obstacle" for Ross.

3. Limitation on Pass-Thru of Losses

An S corporation shareholder may claim his or her share of the corporation's deduction and loss items to the extent of the shareholder's stock basis and debt basis.[121] If the shareholder's share of deduction and loss items exceeds the shareholder's stock basis and debt basis, the excess carries over to the next taxable year.[122] The suspended loss carryover items retain the same character.[123]

> EXAMPLE (16): At the beginning of 2021, Carrie's basis in her S Corporation stock was $10,000. Carrie has made no loans to S Corporation. Her pro rata share of S Corporation's nonseparately computed loss for 2021 is $15,000. Carrie can deduct $10,000 of the $15,000 loss on her 2021 return; the remaining $5,000 will carry over to 2022. Carries' stock basis is reduced to zero. If Carrie's share of S Corporation's net income for 2022 is at least $5,000, she can claim the $5,000 suspended loss from 2021 at that time.

[120] IRC §704(c)(1)(A).

[121] IRC §1366(d)(1).

[122] IRC §1366(d)(2).

[123] Treas. Reg. §1.1366-2(a)(2).

Deductible losses count first against stock basis, then debt basis.[124] When the S corporation has net income in subsequent years, such income will first restore debt basis, then stock basis.[125]

> EXAMPLE (17): At the beginning of 2021, Charlotte's basis in her S Corporation stock was $10,000. Charlotte also has $12,000 in debt basis from a 2018 loan she made to S Corporation. Her pro rata share of S Corporation's nonseparately computed loss for 2021 is $15,000. Charlotte can deduct the entire $15,000 loss on her 2021 return. Formally, her stock basis is reduced to zero and her debt basis is reduced from $12,000 to $7,000. If, in 2022, Charlotte's share of S Corporation's net income is $8,000, the first $5,000 will be used to restore her debt basis to $12,000. The remaining $3,000 will be used to increase her stock basis.

Suspended losses carry over only "with respect to that shareholder," meaning the person who held the shares during the year in which the losses originally arose. When shares pass to another, suspended losses allocable to those shares are lost unless the transferee is the spouse of the transferor (or the former spouse of the transferor, if the transfer is incident to the divorce).[126]

> EXAMPLE (18): At the beginning of 2021, Miranda's basis in her 100 shares of S Corporation stock was zero and she had a suspended loss carryover of $13,000. On January 1, 2021, Miranda transferred all of her S Corporation stock in equal shares to her son, Brady, and her husband, Steve. Both assignees took a zero basis in the shares they received from Miranda. In 2021, S Corporation had nonseparately computed income of $20,000 for the year. Brady's 2021 return will include his $10,000 share of the S Corporation income and no portion of Miranda's suspended loss. Steve's 2021 return will include his $10,000 share of the S Corporation income and $6,500 of Miranda's suspended loss, the portion allocable to shares he received from his spouse.

Although losses in excess of stock basis and debt basis are carried forward to subsequent taxable years, time value of money considerations suggest we should do what we can to give the shareholder enough basis in the year the loss passes through to the shareholder. Planners should explore techniques to give the client sufficient basis to claim the loss currently. A simple solution is for the client to make a loan or capital contribution to the S corporation,

[124] IRC §1367(b)(2)(A).

[125] IRC §1367(b)(2)(B).

[126] IRC §1366(d)(2)(B). For guidance as to what transfers are "incident to the divorce," see IRC §1041(c).

but the client may not have the dollars immediately available or may want to get basis now but pay later. It is not enough for the client to contribute a promise to pay to the corporation; there is no basis credit for the client's own note until actual payments are made on the note. But if the corporation has another shareholder, the client could consider giving a note to the other shareholder in exchange for some or all of the other shareholder's stock. Paying for stock with a note gives the client immediate stock basis that can be used to claim the loss flowing from the S corporation, while deferring the actual out-of-pocket cost to the client.[127]

B. Basis Adjustments Under IRC §1367

Basis is always important, of course, but in the S corporation context it takes on an additional critical role. Distributions from an S corporation will generally be tax-free to the shareholders to the extent they have enough stock basis; distributions in excess of stock basis will be taxable as capital gain.[128] A shareholder's stock basis therefore reflects the items of income and deduction that have already flowed through and accounted for by the shareholder.

1. Stock Basis

At the close of each taxable year, an S corporation shareholder's stock basis is adjusted to reflect both the shareholder's pro rata share of the S corporation's pass-through items and any distributions made during the year.[129] The adjustments to basis occur in this order:[130] (1) increase stock basis by the shareholder's share of income items; then (2) decrease stock basis by the amount of nontaxable distributions; then (3) decrease stock basis by the shareholder's share of noncapitalized, nondeductible expenses;[131] then finally (4) decrease stock basis by the shareholder's share of loss and deduction items.

EXAMPLE (19): TP owned 100 shares of S Corporation stock throughout 2021. TP's stock basis as of the beginning of 2021 was $7,000. TP's pro rata share of S Corporation's tax items for 2021 is as follows:

- Ordinary income $3,000

[127] See Jeanne E. Sullivan, *Structure and Techniques for S Corporations for 2007 and Beyond*, 31ST ANNUAL AMERICAN INSTITUTE ON FEDERAL TAXATION, Outline 11 (2007) at 61.

[128] See Part III, *infra*.

[129] IRC §1367(a).

[130] Treas. Reg. §1.1367-1(f).

[131] Examples of noncapital, nondeductible expenses include illegal bribes, fines, penalties, expenses related to tax-exempt income, disallowed losses under IRC §267, and the disallowed portion of meal and entertainment expenses under IRC §274.

- Tax-exempt income $1,000
- Long-term capital gain $2,000
- §1231 loss ($3,000)
- Long-term capital loss ($1,000)
- Nondeductible expenses ($2,000)

TP received a distribution of $10,000 from S Corporation on June 4, 2021. Because TP had sufficient stock basis to absorb the distribution, the distribution was free of tax. TP must adjust stock basis as follows:

Starting Stock Basis	$ 7,000
+ Income Items	$ 6,000
	$13,000
- Distribution	($10,000)
	$ 3,000
- Nondeductible Expenses	($ 2,000)
	$ 1,000
- Deduction Items	($ 4,000)
	zero

Because TP's stock basis is less than the share of the deduction items, TP may deduct only $1,000 of the $4,000 in deduction items on TP's 2021 return. The remaining $3,000 will carry over to 2022 and will consist of $2,250 in §1231 loss and $750 in long-term capital loss.[132]

A shareholder can elect to reverse the order of steps (3) and (4) above, but such an election is irrevocable unless the Commissioner grants permission to revert back to the general rule.[133]

EXAMPLE (20): Assume the same facts as the immediately preceding example, except that TP validly elects to decrease basis first by the deduction items and then by the nondeductible expenses. TP's stock basis adjustments would change as follows:

Starting Stock Basis	$ 7,000
+ Income Items	$ 6,000
	$13,000
- Distribution	($10,000)

[132] The suspended loss is allocated among the deduction items on a proportionate basis. Treas. Reg. §1.1366-2(a)(4).

[133] Treas. Reg. §1.1367-1(g).

	\$ 3,000
- Deduction Items	(\$ 4,000)
	zero

On these facts, only \$1,000 of deduction items will be disallowed for 2021 and carried over to 2022 (the suspended loss will consist of \$750 in ordinary deductions and \$250 in long-term capital loss). In addition, TP's \$2,000 share of the nondeductible losses for 2021 will carry over to 2022.[134] This is a drawback to the election, because normally nondeductible expenses in excess of basis do *not* carry over.

2. Debt Basis

We all know that partners in a partnership get basis credit for their shares of partnership debt.[135] Such is not the case for shareholders of an S corporation; however, shareholders can get basis credit for loans made directly to the corporation. Although loans to the corporation do not affect the shareholder's stock basis, they do give the shareholder *debt basis*, and a shareholder's share of an S corporation's deductions and losses is deductible by the shareholder to the extent of his or her stock basis *plus debt basis*.[136]

As a general rule, debt basis does not arise merely from a shareholder's guarantee of the S corporation's debt to an outside creditor. For instance, in *Maloof v. Commissioner*,[137] the taxpayer's S corporation generated substantial losses for many years. In 1993, the corporation borrowed \$4 million from a bank. The taxpayer was co-obligor and guarantor on the loan, jointly and severally liable for the debt. When the corporation defaulted on the loan in 2002, the taxpayer claimed a \$4 million increase in the taxpayer's stock basis—sufficient to permit deduction of the losses—even though the bank never called upon the taxpayer to make good on the guarantee. The Service disallowed the claimed deductions on the grounds that the taxpayer lacked sufficient stock basis or debt basis. The Tax Court agreed, observing as it often has that an S corporation shareholder must make an economic outlay for a loan to create basis.[138] The Tax Court also held that the taxpayer's pledge of personal assets or stock does not by itself increase the basis in debt or stock.

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[134] Id.

[135] IRC §752(a).

[136] IRC §1366(d)(1). See Part II(A)(3), *supra*.

[137] 456 F.3d 645 (6th Cir. 2006).

[138] *Maloof v. Commissioner*, T.C. Memo. 2005-75. The Tax Court cited a number of cases to support the proposition that "[a] taxpayer must make an economic outlay for a loan to create basis." The cited cases included *Estate of Bean v. Commissioner*, 268 F.3d 553 (8th Cir. 2001); *Estate of Leavitt v. Commissioner*, 875 F.2d 420 (4th Cir. 1989); *Brown v. Commissioner*, 706 F.2d 755 (6th Cir. 1983); and *Underwood v. Commissioner*, 535 F.2d 309 (5th Cir. 1976).

On appeal, the Sixth Circuit affirmed. The taxpayer did not have debt basis, for the corporation owed the bank, not the taxpayer. And the taxpayer did not have stock basis from guaranteeing the bank loan, because the taxpayer could not prove how doing so was effectively a capital contribution to the company. The court distinguished *Selfe v. United States*,[139] a case from the Eleventh Circuit that allowed a shareholder to add the amount of a guarantee to stock basis, noting that the *Selfe* decision applies only where the lender looks to the shareholder as the real obligor despite the formal listing of the S corporation as the borrower.[140]

To make sure an S corporation shareholder gets basis credit for funds to be loaned to an S corporation, the preferred approach is for the lender to make the loan to the shareholder who then loans those proceeds to the S corporation. By structuring the loan arrangement in this fashion, the shareholder makes a loan to the corporation, which expressly entitles the shareholder to basis credit.[141] It is worth noting that to the extent the shareholder incurs personal liability in order to have the loan structured in such a way as to give the shareholder basis credit for the debt, the shareholder bears a genuine risk that a direct loan to the corporation would not present. But since many loan arrangements with closely-held S corporations require personal guarantees from the shareholders already, structuring the loan to pass through the shareholder may not affect the shareholder's liability for repayment.

C. Worldly S Corporations

A "worldly S corporation" is an S corporation that used to be a C corporation.[142] Planners must proceed carefully when working with a worldly S corporation or an existing C

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[139] 778 F.2d 769 (11th Cir. 1985).

[140] See *Sleiman v. Commissioner*, 187 F.3d 1352, 1359 (11th Cir. 1999).

[141] As long as proper formalities are observed and the shareholder in fact assumes liability for servicing the debt, the refinancing of an entity debt into a shareholder debt can give the shareholder debt basis. See *Miller v. Commissioner*, T.C. Memo. 2006-125 (restructuring of corporation's line of credit under which shareholder assumed the debt gave shareholder basis credit to the extent of the shareholder's liability). As the *Miller* court observed, "The same result as a 'back to back' loan is reached where a shareholder substitutes his own note for the note of his S corporation on which he was a guarantor, thereby becoming the sole obligor on the new indebtedness. In such 'note substitution' scenarios, so long as the S corporation's indebtedness to the third-party lender is extinguished, so that the shareholder becomes the sole obligor to the lender, the shareholder's assumption of what was formerly the S corporation's legal burden serves as a constructive furnishing of funds to the S corporation for which the S corporation becomes indebted to repay to the shareholder."

[142] This is a term I created with a study partner back when we were enrolled in the Taxation of S Corporation course taught by the late Professor James J. Freeland at the University of Florida College of Law. Professor Freeland used several interesting terms for various tax concepts, and their tendency to stick with me over the years is a testament to Professor Freeland's unique gift for teaching. He referred to corporations that had an S

corporation that is considering an S election. Four separate Code provisions come into play for former C corporations, although the last three are more significant because they may haunt the former C corporation for quite a while following the subchapter S election.

1. LIFO Recapture

The first provision is IRC §1363(d), which forces a corporation using the LIFO method of inventory valuation to recapture as gross income the excess of the FIFO value of its inventory over the LIFO value of its inventory at the close of the corporation's last taxable year as a C corporation. The recapture amount is treated as gross income in such last taxable year, but the increase in tax caused by this recapture is payable in four equal annual installments without interest. Unless the planner is helping the business to elect S corporation status, the planner will likely not have to address this issue.

2. Tax on Built-in Gains Under §1374

The second provision is IRC §1374, proof that the S election does not provide a perfect conduit for former C corporations. This provision imposes a tax on the disposition of "built-in gains." It is the S corporation that is liable for payment of this tax. The basic theme behind the IRC §1374 tax on built-in gains is that gains and losses attributable to taxable years prior to the S election should be taxed as though the corporation were still subject to subchapter C.

> EXAMPLE (21): *X* Corporation purchased raw land for $100 three years ago. Today, the land is worth $500, and *X* wants to sell the land to an unrelated purchaser. If *X* sells the land, *X* will be taxed on the $400 gain. If *X* then distributes the after-tax proceeds of the sale to its shareholders (as a dividend), the after-tax profit will be taxed again. The shareholders of *X* thus have an incentive to make the S election prior to the sale. If *X* makes an S election prior to the sale, the $400 gain will pass to the shareholders under IRC §1366, and subsequent distribution of the proceeds will be tax-free under IRC §1368. But for the application of IRC §1374, the election would permit *X* to convert two levels of tax into one level of tax.

Congress reacted by enacting IRC §1374. Now, when the gain occurs during years in which the corporation was subject to two layers of tax, it is appropriate to tax that gain twice even though the entity is currently a valid S corporation.

The IRC §1374 tax applies to any "net recognized built-in gains" during each of the first several years following the former C corporation's subchapter S election (known as the

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election in effect at all times as "virgin S corporations." He never had a term for S corporations that used to be C corporations, but my study partner and I decided that he would have liked "worldly S corporations."

"recognition period"). Legislation in 2009 shortened the recognition period to seven years for 2009 and 2010 only.[143] Under the Creating Small Business Jobs Act of 2010, the recognition period for taxable years beginning in 2011 only was shortened to five years, and the American Taxpayer Relief Act of 2012 extended the five-year recognition period through 2013. The Tax Increase Prevention Act of 2014 extended the five-year recognition period through 2014. Finally, the Consolidated Appropriations Act of 2016 made the five-year recognition period permanent.

The tax is computed by applying the highest rate under IRC §11 (now 21 percent) to the net recognized built-in gain for the taxable year or, if less, the corporation's taxable income for the taxable year.[144] The cumulative amount of net recognized built-in gains during the recognition period cannot exceed the corporation's "net unrealized built-in gain" as of the date of the S election.[145] Note that the tax applies to any disposition that results in a recognized built-in gain, whether in the form of a sale or a distribution to the shareholders.[146]

The tax imposed under IRC §1374 passes through to the S corporation's shareholders as a loss with the same character as the corresponding gain giving rise to the tax.[147] This lessens the impact of the double tax to some extent.

> EXAMPLE (22): ACME Corporation is an S corporation with subchapter C earnings and profits of $500. Wiley, an individual, owns all of ACME's stock with a basis of $400. On its first day an S corporation, ACME owned Blackacre, a $300 parcel of real property held for investment purposes, with a basis of $200. If ACME sells Blackacre for $300 to an unrelated buyer during the recognition period, ACME recognizes a $100 capital gain and will pay IRC §1374 tax of $21. Both the $100 gain and the $21 tax will pass through to Wiley. Because the $21 tax passes through as a capital loss, Wiley will pay tax of $18.80 (23.8 percent of the $79 net gain). Wiley's stock basis will increase from $400 to $479. The total tax paid by ACME and Wiley is $39.80. Note that the same results will occur if ACME distributes Blackacre to Wiley instead of selling it to a third party.

There are several ways to avoid or lessen the burden of the IRC §1374 tax. Perhaps the most common solution is to wait out the recognition period: the tax does not apply to

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[143] IRC §1374(d)(7)(B).

[144] IRC §§1374(b)(1); 1374(d)(2)(A).

[145] IRC §1374(c)(2).

[146] IRC §§311(b); 1374(d)(3).

[147] IRC §1366(f)(2).

dispositions of built-in gain property that occur after the recognition period expires. The tax can be deferred if the corporation effects a like-kind exchange of the built-in gain property under IRC §1031, although the IRC §1374 taint is preserved in the asset(s) received in the like-kind exchange.[148] Also, regulations provide that if an S corporation acquires some asset before or during the recognition period with a principal purpose of reducing or eliminating the IRC §1374 tax (because the asset will generate a loss, deduction, or credit that can be used to reduce the corporation's taxable income below the amount of net recognized built-in gain), such loss, deduction or credit shall be ignored for purposes of computing the IRC §1374 tax.[149]

Finally, one could consider a charitable contribution of the built-in gain property. The S corporation does not recognize gain upon making the gift to charity (so the IRC §1374 tax cannot apply), and the deduction flows through to the shareholders. The shareholders reduce their stock bases by their shares of the corporation's adjusted basis in the contributed property,[150] which insures that the lurking gain is not later taxed upon sale of the shares or liquidation of the corporation. First introduced in 2006, this rule expired four times before being made permanent by the Protecting Americans from Tax Hikes Act of 2015.

> EXAMPLE (23): Assume the same facts as the prior example, except that ACME Corporation donates Blackacre to a public charity. ACME incurs no tax under IRC §1374 because there is no recognized built-in gain. The contribution results in a \$300 charitable contribution deduction which passes through to Wiley. If Wiley's stock basis is reduced by the \$300 deduction, then ACME's built-in gain is effectively preserved at the shareholder level, for Wiley will pay extra tax upon disposition of his ACME shares. But Wiley reduces his stock basis only by ACME's \$200 basis in Blackacre. As a result, Wiley's basis is reduced from \$400 to \$200. The \$100 of built-in gain is thus not preserved at the shareholder level.

3. Tax on Excess Net Passive Income Under §1375

The third provision is IRC §1375, which imposes a penalty tax at the entity level when two conditions exist: (1) an S corporation has "accumulated earnings and profits" (which by definition only applies if the S corporation was formerly a C corporation), and (2) the S corporation's "passive investment income" exceeds 25 percent of its total gross receipts. Why

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[148] IRC §1374(d)(6).

[149] Treas. Reg. §1.1374-9.

[150] IRC §1367(a). As of this writing, this rule will expire at the end of 2007. If the rule is not extended beyond this sunset date, contributions in 2008 and later will require shareholders to reduce their stock bases by the amount of the deduction, which in many cases could be the fair market value of the contributed property. See IRC §170(e). Although there is still no gain to the corporation (and, thus, no IRC §1374 tax exposure), the extra reduction in stock basis effectively preserves such gain at the shareholder level.

are we so concerned with the amount of passive income generated by a corporation? One treatise explains the policy of these rules as follows:

> These statutory measures restrict attempts to use S corporations as incorporated pocketbooks for their shareholders by investing the corporations' retained earnings in marketable securities and other passive investments of a type that the shareholders would have purchased had the earnings been paid out as dividends. This ploy is particularly likely to happen when the C corporation has liquidated its business assets. The passive-investment-income limitation can also be viewed as a rough-and-ready offset to the fact that a C corporation can be converted to S status without subjecting its accumulated earnings to tax at the shareholder level as if the earnings were distributed in a quasi-liquidation.[151]

The mechanics of the IRC §1375 tax are relatively simple. The corporation's "excess net passive income" is multiplied by the highest rate of tax under IRC §11 (still 35 percent).[152] Excess net passive income is computed under this formula:

$$\frac{(\mathbf{PII}) - (\mathbf{25\%\ of\ GR})}{(\mathbf{PII})} \times (\mathbf{NPI}) = \textbf{Excess Net Passive Income}$$

PII = **passive investment income** (royalties, rents, dividends, interest, and annuities)[153]
GR = **gross receipts** (the total amount received or accrued under the corporation's accounting method)[154]
NPI = **net passive income** (passive investment income less those deduction directly connected with the production of passive investment income other than net operating loss carryovers and dividends-received deductions)[155]

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[151] Boris I. Bittker & James S. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (7th student ed. 2000) at 6-19.

[152] IRC §1375(a).

[153] IRC §§1362(d)(3)(C)(i); 1375(b)(3). Prior to May 25, 2007, "gains from sales or exchanges of stock or securities" were included as passive investment income. The Small Business and Work Opportunity Tax Act of 2007 removed this component of the definition for taxable years beginning after May 25, 2007.

[154] Treas. Reg. §1.1362-2(c)(4)(i).

[155] IRC §1375(b)(2).

The corporate-level taxes are coordinated because built-in gains and losses are taken out of the definition of passive investment income.[156] Instead of passing through as a loss, the amount of IRC §1375 tax serves to reduce the amount of each item of passive investment income passing through to the shareholders.[157]

There are some planning suggestions for minimizing exposure to the IRC §1375 tax. If the corporation had relatively little earnings and profits at the time of the S election, it may be advisable to distribute the subchapter C earnings and profits to the shareholders, especially since those earnings will be taxed at 15 percent to the shareholders in the hopes of avoiding a 35 percent tax imposed on the corporation.[158] Once the subchapter C earnings and profits are gone, the IRC §1375 tax (and the risk of the death penalty under IRC §1362(d)(3)) cannot apply. Alternatively, the shareholders can try their very best to manage gross receipts so that the amount of passive income does not cross the 25 percent threshold.

4. Death Penalty Under §1362

The IRC §1375 tax is often referred to as a "sting tax," but it is also helpful to think of it as a "three strikes" tax, for if the IRC §1375 tax is imposed for three consecutive years, the corporation will face the "death penalty": under IRC §1362(d)(3) its S election is terminated and the corporation will revert to C corporation status. An S corporation with a terminated S election must usually wait for five taxable years before making another S election.[159]

III. DISTRIBUTION RULES

Under IRC §1368, the tax treatment of distributions from S corporations depends upon whether the S corporation has accumulated earnings and profits. Only C corporations can have "earnings and profits."[160] Corporations that have always been S corporations do not have accumulated earnings and profits. Accordingly, the taxation of distributions from "pure" S corporations is determined by application of IRC §1368(b), while distributions from "worldly" S corporations are tested under IRC §1368(c).

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[156] IRC §1375(b)(4).

[157] IRC §1366(f)(3).

[158] IRC §1368(e)(3) permits the shareholders to declare that distributions come first from subchapter C earnings and profits and then from subchapter S earnings (the accumulated adjustments account), although the default distribution rules apply the opposite assumption.

[159] IRC §1362(g).

[160] IRC §312.

A. Pure S Corporations

Distributions from "pure" S corporations are tax-free to the extent of the shareholder's stock basis.[161] Any distributions in excess of a shareholder's basis is treated as gain from the sale or exchange of property (i.e., as long-term capital gain if the stock has been held for more than one year, or short-term capital gain if the stock has been held for one year or less).[162] Whether a shareholder has sufficient stock basis to absorb a distribution is tested at the end of the year, after all items of income and other increases to basis occur, but before any reductions to stock basis due to losses, deductions, and nondeductible expenses.[163] This ordering rule maximizes the chances that any particular distribution will be tax-free.

> EXAMPLE (24): Ralph owns 20 percent of the stock in S Corporation, a corporation with no earnings and profits. Ralph's stock basis at the beginning of 2021 was $10,000. On October 1, 2021, S Corporation distributed $25,000 to Ralph. For the 2021 taxable year, Ralph's pro rata share of S Corporation's nonseparately computed income was $18,000, and his share of S Corporation's long-term capital loss, the company's only separately stated item, was $5,000. Ralph's basis is increased from $10,000 to $28,000 by his $18,000 share of the corporation's income. The $25,000 distribution is then applied against the $28,000 adjusted stock basis, meaning the entire distribution is tax-free. The distribution reduces Ralph's stock basis from $28,000 to $3,000. Finally, Ralph can claim only $3,000 of the $5,000 long-term capital loss item on his 2021 return because he has only $3,000 of stock basis remaining. The remaining $2,000 of long-term capital loss allocable to Ralph will carry over to 2022 as a long-term capital loss item.

If an S corporation distributes appreciated property instead of cash, the distribution triggers gain to the corporation.[164] Like any gain, it passes through pro rata to the shareholders, with resulting increases to stock basis.

> EXAMPLE (25): Linus and Lucy each own half of the shares of S Corporation. Each shareholder has a stock basis of $1,000. S Corporation distributes a capital asset worth $700 to Linus. S Corporation's basis in the distributed asset was $100. The distribution causes S Corporation to recognize a capital gain of $600. Each shareholder has a $300 share of this gain, which increases each

[161] IRC §1368(b)(1).

[162] IRC §1368(b)(2).

[163] Treas. Reg. §1.1367-1(f).

[164] IRC §§1371(a); 311(b).

shareholder's stock basis from $1,000 to $1,300. Linus must then reduce his stock basis from $1,300 to $600 to reflect the $700 distribution from S Corporation. Notice that the effect of these simultaneous adjustments to stock basis is that his stock basis is reduced by the basis of the distributed property. Still, only half of S Corporation's gain is reported by Linus; Lucy, who received nothing from S Corporation, must still report her share of the capital gain.

Where the distributee of appreciated property has a freshly stepped-up basis, the impact of the distribution is minimized as to that shareholder.

EXAMPLE (26): Sally's gross estate includes half of the shares of S Corporation. The shares had a fair market value of $500,000 at Sally's death. S Corporation redeemed Sally's shares from her estate. As payment for the shares, S Corporation distributed an asset with a basis of $100,000 and a value of $500,000. The distribution resulted in a gain of $400,000 to S Corporation, and half of that gain ($200,000) flowed through to Sally's estate. The gain increased the basis of the shares held by Sally's estate from $500,000 to $700,000, so the distribution of property worth $500,000 to Sally's estate in complete redemption of the stock resulted in a loss of $200,000 ($500,000 amount realized less $700,000 basis). Note that the loss serves to offset the $200,000 of gain that flowed through to the estate as a result of the distribution. The other shareholders, however, have $200,000 of gain but no step up in basis to soften the blow.

B. Worldly S Corporations

If an S corporation has accumulated earnings and profits, the distribution rules are slightly more complicated. A three-tier regime applies to such distributions. *First*, that portion of the distribution not in excess of the corporation's "accumulated adjustments account" ("AAA") is taxed under the rules applicable to distributions from S corporations without earnings and profits (i.e., tax-free to the extent of stock basis, with any excess treated as capital gain).[165] *Second*, the remainder of the distribution is treated as a dividend to the extent of the corporation's accumulated earnings and profits.[166] *Third*, if the distribution exceeds accumulated earnings and profits, the balance is treated under the rules applicable to distributions from S corporations without earnings and profits.[167]

[165] IRC §1368(c)(1). If an S corporation makes more than one distribution during the taxable year, and if the total amount of such distributions exceeds the positive balance in the corporation's AAA, the AAA is allocated proportionately to all of the distributions. Treas. Reg. §1.1368-2(b).

[166] IRC §1368(c)(2).

[167] IRC §1368(c)(3).

The AAA is an entity-level account that begins at zero when the corporation's S election takes effect.[168] It is then adjusted upward and downward, generally by the same items that adjust a shareholder's basis under IRC §1367.[169] There are some differences, however, between the adjustments to the AAA and the adjustments to stock basis. For one thing, the AAA can go below zero.[170] And, importantly, no adjustment is made to the AAA for tax-exempt income or for expenses related to tax-exempt income.[171] Also, taxes paid by the corporation for years attributable to the corporation's period as a C corporation can adjust stock basis but such amounts do not affect the AAA.[172] As these exceptions suggest, AAA is generally a reflection of the S corporation's items of income and deduction of tax consequence that have been passed through to the shareholders (in other words, perhaps, the corporation's previously taxed income).

EXAMPLE (27): Nelson is the sole shareholder in S Corporation, a corporation that made an S election effective January 1, 2021. Nelson's stock basis as of the beginning of 2021 was $13,000. S Corporation has $4,000 in accumulated earnings and profits from its years as a C corporation. On August 15, 2021, S Corporation distributed $25,000 to Nelson. For the 2021 taxable year, S Corporation's nonseparately computed income was $6,000, and it had $500 in tax-exempt income (S Corporation's only separately stated item). Based on these facts, S Corporation's AAA at the end of 2021 is $6,000. Nelson's stock basis is increased from $13,000 to $19,500 because of his shares of the corporation's nonseparately computed income and tax-exempt income. The first $6,000 of the distribution (to the extent of AAA) is taxed under IRC §1368(b). Nelson has enough stock basis to absorb this portion of the distribution so it comes out tax-free. Nelson's stock basis is reduced to $13,500, and the corporation's AAA is reduced to zero. The next $4,000 of the distribution will be treated as a dividend to Nelson and will reduce the corporation's accumulated earnings and profits to zero. The remaining $15,000 of the distribution is taxed under IRC §1368(b). This portion of the distribution exceeds Nelson's remaining stock basis, so his stock

[168] Treas. Reg. §1.1368-2(a)(1).

[169] IRC §1368(e)(1)(A); Treas. Reg. §§1.1368-2(a)(2), -2(a)(3).

[170] IRC §1368(e)(1)(A).

[171] *Id.* Thus, for example, death benefits received by an S corporation generally do not affect AAA even though the corporation has an increase in cash because the death benefits are excluded from gross income under IRC §101(a). Likewise, premium payments on life insurance policies should not affect AAA if the corporation will receive the death benefits on a tax-free basis.

[172] *Id.*

basis will be reduced to zero and the excess ($1,500) will be treated as capital gain.

Redemptions carry out a ratable share of the corporation's AAA if the redemption is treated as a sale or exchange under either IRC §302(a) or IRC §303(a).[173] If the corporation makes both regular distributions and redemption distributions in the same taxable year, the AAA is adjusted first for ordinary distributions and then for any redemption distributions.[174]

EXAMPLE (28): A and B are the unrelated shareholders of S Corporation. As of the beginning of 2021, A owned 80 shares with a basis of $12,000 and B owned 20 shares with a basis of $3,000. S Corporation's AAA as of the beginning of 2021 was $3,000, and its accumulated earnings and profits as of that date was $2,000. On June 30, 2021, S Corporation redeemed ten of B's 20 shares in exchange for $10,000 cash. For 2021, S Corporation's nonseparately computed income was $12,000.

As of the date of the redemption, S Corporation's AAA was $9,000, consisting of the $3,000 balance plus $6,000 of the nonseparately computed income allocable to the first half of 2009. B's redemption qualifies for sale treatment under IRC §302(a),[175] meaning B recognizes a capital gain of $8,500.[176] In addition, because ten percent of the corporation's shares are redeemed, the redemption sucks out ten percent of the AAA and ten percent of the accumulated earnings and profits. The AAA is therefore reduced to $8,100 and the accumulated earnings and profits are reduced to $1,800. The AAA is then increased by the $6,000 of nonseparately computed income allocable to the second half of 2021, bringing the year-end balance to $14,100.

A's pro rata share of the corporation's $12,000 of income is $10,133 ($4,800, eight-tenths of the $6,000 allocable to the first half of the year, plus $5,333, eight-ninths of the $6,000 allocable to the second half of the year) and B's pro rata share is $1,867 ($1,200, which is two-tenths of the $6,000 allocable to the first half of the year, plus $667, which is one-ninth of the $6,000 allocable to the second half of the year).

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[173] Treas. Reg. §1.1368-2(d)(1)(i).

[174] Treas. Reg. §1.1368-2(d)(1)(ii).

[175] Specifically, the redemption is "substantially disproportionate" under IRC §302(b)(2).

[176] B's amount realized ($10,000) exceeds half of his stock basis ($1,500) by $8,500.

EXAMPLE (29): Same facts as the immediately preceding example, except that S Corporation redeems ten shares from A and no shares from B. Thus, S Corporation paid $10,000 to A on June 30, 2021. A's redemption does not qualify for sale treatment under either IRC §302(a) or IRC §303(a).[177] Consequently, the redemption will be treated as a distribution to A.

S Corporation's AAA is increased to $15,000 at the end of 2021. A's stock basis is increased from $12,000 to $21,467 because A's share of the corporation's nonseparately computed income is $9,467 ($4,800, which is eight-tenths of the $6,000 allocable to the first half of the year, plus $4,667 seven-ninths of the $6,000 allocable to the second half of the year). The entire redemption distribution is taxed under IRC §1368(b) because the amount distributed ($10,000) does not exceed the AAA ($15,000). A has enough stock basis to absorb the who distribution so it comes out tax-free. A's stock basis is reduced to $11,467, and the corporation's AAA is reduced to $5,000.

Shareholders seeking to avoid the complexity of IRC §1368(c) may consider distributing the entire amount of the corporation's accumulated earnings and profits. This "purging" distribution permits future distributions to be tested under the simpler regime of IRC §1368(b). There are two ways to make a purging distribution. First, the corporation can elect to treat any distributions as coming first from accumulated earnings and profits and then from the AAA.[178] In effect, this election swaps the first two tiers of the three-tier regime. The practical effect of this election is that distributions are includible as dividends to the extent of earning and profits and *then* tax-free to the extent of stock basis. If one expects the preferential rates for qualified dividend income to expire in the near future, the election might be beneficial to the distributee-shareholders in the long term. At the same time, the election can be beneficial to the other shareholders.

EXAMPLE (30): Father, Son, and Daughter are related parties, and each owns an equal number of shares in S Corporation. S Corporation has subchapter C earnings and profits of $100,000, and its AAA at all times relevant to the example is also $100,000. S Corporation redeems all of the shares held by Father in exchange for $100,000. Because the shares owned by Son and Daughter are attributed to Father for purposes of IRC §302, the redemption will be treated as a distribution to Father.[179] Absent an election, the $100,000 distribution will

[177] Because Joanie is still holds a commanding interest in the corporation after the redemption, the redemption does not qualify under any of IRC §§302(b)(1) – (3).

[178] Treas. Reg. §§1.1368-1(f)(1)(i); 1.1368-1(f)(2)(i).

[179] This assumes Father, Son, and Daughter make no election to waive the family attribution rules under IRC §302(c)(2). If they make such an election, the redemption will be treated as a sale or exchange instead of a distribution, but Father has to agree not to become a shareholder for another ten years.

come from AAA and will not be taxable to Father. The earnings and profits are untouched, and all of that lurking income will shift to Son and Daughter. But if corporation elects to treat the distribution as coming first from earnings and profits, Father will pay $15,000 tax (15 percent on the $100,000 dividend) but S Corporation is purged of its earnings and profits. This will be beneficial to Son and Daughter, as neither IRC §1374 nor IRC §1375 will apply.

The second way to make a purging distribution is for the corporation to elect a deemed dividend distribution. Under this approach, the corporation makes no actual distributions but the shareholders are taxed as though the corporation made a pro rata distribution of its accumulated earnings and profits at a time when its AAA is zero, followed by the shareholders' contribution of those same dollars back to the corporation, all on the last day of the taxable year.[180] This alternative keeps capital within the corporation's hands but may leave the shareholders without the dollars required to pay the tax associated with the deemed dividend.

IV. OTHER INCOME TAX RULES FOR S CORPORATIONS

A. At-Risk Rules

Under IRC §465(a), losses from an activity are limited to the extent the taxpayer is "at risk" with respect to that activity. Thus, even if an S corporation shareholder has enough stock basis or debt basis to claim losses and deductions passing through from the S corporation, such amounts may be disallowed if the shareholder is not sufficiently at risk.[181] In *Van Wyk v. Commissioner*,[182] for example, the Tax Court upheld the Service's determination that losses and deductions were not currently allowable to an S corporation shareholder because that shareholder was not "at risk" with respect to contributed capital or loan amounts. In the case, the taxpayer made loans to an S corporation in which he was a 50-percent shareholder. The Tax Court held that the loans did not create debt basis because the taxpayer was not at risk for purposes of IRC §465. The funds loaned by the taxpayer had been borrowed from the other 50-percent shareholder of the same S corporation.

The at-risk rules apply at both the shareholder and S corporation levels, meaning that losses are deductible only to the extent that both are at risk in the activity.[183] A shareholder's

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[180] Treas. Reg. §§1.1368-1(f)(1)(ii); 1.1368-1(f)(3).

[181] Any losses amounts disallowed under IRC §465 carry over to subsequent taxable years and thus are deductible when there is a sufficient amount at risk to absorb the carryover. IRC §465(a)(2).

[182] 113 T.C. 440 (1999).

[183] See Prop. Reg. §1.465-10(a). See also Richard B. Robinson and Arthur A. Weiss, TAX PLANNING FOR S CORPORATIONS §5.05 (2007).

at-risk amount with respect to any activity is equal to the amount of money and the basis of other property contributed to that activity, including amounts borrowed with respect to that activity.[184] The S corporation's at-risk amount is similarly computed, but loans from a shareholder will increase the amount at risk.[185] For a shareholder to be "at risk" with respect to amounts borrowed in connection with the S corporation, the shareholder must be personally liable for repayment or have pledged property outside of the S corporation stock as security for the loan.[186] A shareholder is not at risk with respect to amounts borrowed if the shareholder's lender also has an interest in the S corporation or is related to a person having a non-creditor interest in the S corporation.[187] This is what doomed the taxpayer in *Van Wyk*. Accordingly, shareholders should be careful about borrowing from related parties to make investments in S corporations, whether in the form of capital contributions or loans to the corporation.

B. Two-Percent Shareholder-Employees

There is additional risk where shareholder-employees receive stock in the S corporation.[188] If an employee of an S corporation owns more than two percent of the corporation's outstanding stock (or more than two percent of the total combined voting power of the corporation's stock) on any day of the taxable year, the employee is no longer eligible to receive "employee fringe benefits" on a tax-free basis.[189] If the majority shareholder seeks to reward key employees with stock, it might have the unintended consequence of forfeiting some of these important benefits.

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[184] IRC §465(b).

[185] Prop. Reg. §1.465-10(b).

[186] IRC §465(b)(2).

[187] IRC §465(b)(3).

[188] Remember that if a married employee in a community property state receives S corporation shares, the S election is lost if the non-employee spouse is a nonresident alien with a community property interest in the shares. This is discussed in Part I(B)(1), *supra*.

[189] IRC §1372(a); Reg. §1.707-1(c). To be more precise, IRC §1372(a) states that so-called "2-percent shareholders" of an S corporation are to be treated as partners in a partnership for purposes of applying Code provisions related to employee fringe benefits. Regulation §1.707-1(c) treats fringe benefits paid to employee-partners as "guaranteed payments" because they are paid without regard to the partnership's income for services rendered. The same regulation states that a partner who receives guaranteed payments is not, by virtue of the payments, regarded as an employee of the partnership. Accordingly, the value of a fringe benefit "is not excludible from the partner's gross income under the general fringe benefit rules (except to the extent the Code provision allowing exclusion of a fringe benefit specifically provides that it applies to partners) because the benefit is treated as a distributive share of partnership income … for purposes of all Code sections other than sections 61(a) and 162(a), and a partner is treated as self-employed to the extent of his or her distributive share of income." Rev. Rul. 91-26, 1991-1 C.B. 184. See also Albert B. Ellentuck, *S Corporation's Treatment of Employee-Shareholder Fringe Benefits*, THE TAX ADVISER (May 2003).

Examples of benefits not excludable by so-called "2-percent shareholders" are: (1) the cost of accident and health insurance plans under IRC §§105 and 106; (2) meals and lodging furnished on the business premises for the convenience of the employer under IRC §119; (3) the cost of group-term life insurance coverage under IRC § 79; and (4) cafeteria plans under IRC §125. When a 2-percent shareholder receives one of these taxable fringe benefits, it is to be treated as additional compensation subject to Federal withholding and employment taxes.[190] That means the S corporation likely gets a deduction for the extra compensation, and this deduction will pass through to the shareholders *pro rata* like any other deduction item.

Not all fringe benefits excluded from the gross incomes of employees are lost; benefits that remain excludable include: (1) dependent care assistance under IRC §129;[191] (2) educational assistance programs under IRC §127;[192] and (3) several of the fringe benefits listed in IRC §132, including no-additional-cost services, qualified employee discounts, de minimis fringes, working condition fringes, and on-premises athletic facilities.[193]

V. TAX PLANNING STRATEGIES FOR S CORPORATIONS

A. Recapitalize Shares Into Voting and Nonvoting Classes

As previously discussed, in determining whether an S corporation has more than one class of stock, differences in voting rights are disregarded. Accordingly, S corporations can have "voting common" and "nonvoting common" stock. Nonvoting shares are eligible for greater valuation discounts,[194] and clients can give nonvoting shares but still retain control over the S corporation through the voting shares. Therefore, nonvoting shares are more attractive for wealth transfer planning. If a client's S corporation has only one class of common stock issued and outstanding, the planner should recommend a tax-free recapitalization of the shares into voting and nonvoting classes.

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[190] Rev. Rul. 91-26, 1991-1 C.B. 184.

[191] IRC §129(e)(3) provides that the exclusion is available to self-employed individuals as well as employees. Because partners in a partnership and 2-percent shareholders in an S corporation are deemed to be self-employed, as discussed *supra*, the exclusion is available to partners and 2-percent shareholders in an S corporation.

[192] IRC §127(c)(2).

[193] Reg. §§1.132-1(b)(1); 1.132-1(b)(2)(ii); 1.132-1(b)(3); 1.132-1(b)(4).

[194] A shareholder with a controlling interest in voting stock would not be eligible for a minority interest discount. In fact, the shares would be subject to a control premium. Nonvoting shares, however, would be eligible for minority interest discounts even if the shares represent over half of the corporation's equity. This is because the minority interest discount reflects an inability to control corporate decisions. See John A. Bogdanski, FEDERAL TAX VALUATION §4.03[3] (1996).

EXAMPLE (31): J.R. and Sue Ellen, a married couple, own all 100 shares of S Corporation's single class of common stock. A recent appraisal values the shares at $5,000,000. If J.R. and Sue Ellen transfer 60 percent of S Corporation's stock to their child, the fair market value of the transferred shares would be $3,750,000 (assuming a 25 percent control premium and no other valuation adjustments). J.R. and Sue Ellen lose voting control over S Corporation and, if the transfer takes the form of a gift, they pay a gift tax premium to boot.

Suppose instead that J.R. and Sue Ellen recapitalize the shares of S Corporation before making the transfer. In a recapitalization transaction, J.R. and Sue Ellen exchange the common stock for ten shares of Class A stock and 90 shares of Class B stock. Class A shares and Class B shares have equal rights to distributions and at liquidation; the only difference between them is that only Class A shares have voting rights. If J.R. and Sue Ellen transfer 60 percent of S Corporation's Class B stock to their child, the value of the transferred shares would be $2,400,000 (assuming a 20 percent minority interest discount and no other valuation adjustments).[195] In addition to the lower transfer cost (if the transfer takes the form of a gift the value of the gift is $1,350,000 less than was the case without recapitalization), J.R. and Sue Ellen retain all of the voting control over S Corporation as they hold all of the Class A shares.

B. The Employment Tax Loophole for Single-Shareholder S Corporations

While all of the operating profits of a disregarded single-member LLC or sole proprietorship are subject to employment taxes, only the salary paid to the sole shareholder of an S corporation is considered "wages" subject to employment taxes.[196] Operating income of an S corporation not distributed in the form of salary is not self-employment income.[197] As a result, sole shareholders of S corporations have an incentive to receive no salary from their S corporations and take all of their incomes in the form of distributions.

Of course, if an S corporation pays no salary to its sole shareholder-employee, the Service may recharacterize some portion of the corporation's distributions as wages for employment tax purposes.[198] Still, it appears the Service is not exercising its recharacterization

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[195] The 20 percent minority interest discount is reasonable on these facts as it is the inverse of the 25 percent control premium (i.e., $1.00 ÷ 0.8 = $1.25, and $1.25 *x* 0.8 = $1.00).

[196] Rev. Rul. 73-361, 1971-2 C.B. 331.

[197] Rev. Rul. 59-221, 1959-1 C.B. 225. See also IRS Publication 533.

[198] Rev. Rul. 74-44, 1974-1 C.B. 287. There are many cases in which the Service has been successful in converting a portion of S corporation distributions into wages for purposes of employment taxes. See, e.g., *Mike J. Graham*

power as much as it could: one report of the Treasury Inspector General for Tax Administration claimed that some 36,000 sole shareholder-employees received no salaries from their S corporations.[199] The same report indicated that the percentage of S corporation profits paid to their sole shareholder-employees dropped from 47.1 percent in 1994 to 41.5 percent in 2001. To the extent sole proprietors and owners of disregarded entities have 100 percent of the business profits subject to employment taxes, there remains an advantage to keeping salaries modest and maximizing distributions from an S corporation.

The question becomes how much salary to pay to the sole shareholder-employee of an S corporation. The cautious approach is for the S corporation to pay its shareholder-employee the same salary that he or she would require if the shareholder-employee were only an employee of the entity.[200] More aggressive clients may prefer the lemming approach: keep salaries to about 41 – 47 percent of the S corporation's net profits so as to be consistent with other S corporations, even if a non-shareholder-employee would insist upon a higher salary from the corporation.

C. Leverage the Purchase of Additional Shares

Normally, interest paid on debt incurred to purchase investment property ("investment interest") is deductible by the borrower only to the extent of his or her "net investment income."[201] This limitation does not apply to interest paid on debt incurred to purchase stock

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Trucking, Inc. v. Commissioner, T.C. Memo 2003-49, affd in unpublished opinion (3d Cir. 2004); *Veterinary Surgical Consultants v. Commissioner*, 117 T.C. 141 (2001), affd in unpublished opinion (3d Cir. 2004). The taxpayers in both *Graham Trucking* and *VSC* argued that distributions from S corporations could not be treated as compensation because §530 of the Revenue Act of 1978 states that employment taxes do not apply if the S corporation has never treated the shareholder-employee as an employee for any period and if all filed returns are consistent with this assumption. The taxpayers conveniently forgot the language in §530 that says that employment tax relief does not apply if the corporation "had no reasonable basis for not treating such individual as an employee." The courts in both cases held that there was no precedent for treating the shareholder-employees as contractors or non-employees within their respective industries, and there were no audits of the corporations that upheld such treatment by the corporations. Accordingly, there was no basis for the corporations not to treat the taxpayers as employees, so some portion of the corporations' distributions must be treated as wages. See James A. Fellows and John F. Jewell, *S Corporations and Salary Payments to Shareholders: A Major Issue for the IRS*, 2006 THE CPA J. 46 (May 2006) (available at http://www.nysscpa.org/cpajournal/2006/506/essentials/p46.htm.)

[199] Statement of J. Russell George, Inspector General, Treasury Inspector General for Tax Administration before the Senate Finance Committee (May 25, 2005), available at http://www.treas.gov/tigta/congress/congress_05252005.htm. See also Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (2005) at 426 (estimating that treating all net income from partnerships and S corporations as self-employment income could increase revenues by $57.4 billion over the nine-year period from 2006 to 2014).

[200] See Richard B. Robinson, *Tax Audit Issues for S Corporations*, in 41ST ANNUAL SOUTHERN FEDERAL TAX INSTITUTE MATERIALS at J-3 (2006).

[201] IRC §163(d)(1).

in an S corporation or a partnership. Instead, such interest is deemed to be paid on debt incurred to purchase the pass-through entity's inside assets.[202] Accordingly, if all of the entity's assets are used in the conduct of a trade or business, the interest paid on debt incurred to buy stock in the S corporation or partnership will be considered business interest. That's good news because business interest is not subject to the same limitation applicable to investment interest (in other words, business interest is deductible without regard to the currently taxable income generated by the entity's business).[203] So if the client is thinking about purchasing additional shares (or if the client wants to help another to purchase the client's shares in the S corporation), this benefit is worth keeping in mind when running the numbers.

D. S Corporations as Partners of Family Limited Partnerships

In the vanilla family limited partnership arrangement, individuals contribute business and investment assets to a limited partnership in exchange for general partner interests and limited partner interests. The founders then transfer limited partner interests (by gift, by sale, or some combination of the two) to or for the benefit of their beneficiaries. Planners using limited partnerships instead of limited liability companies for this arrangement often recommend that a corporation (owned by the founder(s)) hold the general partner interests in order to provide liability protection. The corporate general partner is usually an S corporation in order to reduce the federal income tax bite with respect to items held by the partnership, but sometimes planners encounter a C corporation general partner. The kneejerk reaction is to have the corporate general partner become an S corporation, but the conversion from C corporation to S corporation triggers the potential application of the IRC §1374 tax on built-in gains.[204]

For purposes of the IRC §1374 tax on built-in gains, the regulations pretend that an S corporation general partner owns a proportionate share of the partnership's assets.[205] Thus, if the partnership disposes of an asset that has built-in gain as of the date the corporate general partner's S election becomes effective during the ten-year recognition period, the IRC §1374 tax will apply to the corporate general partner's distributive share of the built-in gain.

EXAMPLE (32): GP is a C corporation. All of GP's stock is owned by Mike, a United States citizen. GP was formed in 2019. Its sole asset is a ten percent

[202] Reg. §1.163-8T.

[203] IRC §§163(a); 163(h)(2)(A).

[204] For a more thorough and helpful guide to the complex regulations discussed only generally herein, see Robertson Bertrand, *C to S Conversions: Partnership Interests at BIG Discounts*, 9:5 BUSINESS ENTITIES 18 (Sept./Oct. 2007).

[205] See Treas. Reg. §1.1374-4(i).

general partner interest in FLP, a limited partnership that owns two parcels of real property: Blackacre (with a basis of $50 and a value of $500 as of January 1, 2021) and Whiteacre (with a basis of $350 and a value of $400 as of January 1, 2021). FLP was also formed in 2019. GP is the only general partner; the limited partner interests, comprising 90 percent of FLP's equity, are held in equal shares by trusts for the benefit of Mike's three sons, Greg, Peter, and Bobby. GP's basis in its general partnership interest as of January 1, 2021, is $40. The fair market value of GP's partnership interest at that date, reflecting both a discount for lack of marketability and a control premium, is $75.

On January 10, 2021, Mike filed a complete and correct Form 2553, converting GP to an S corporation as of January 1 of the current year. On July 1, 2021, FLP sold Blackacre to an unrelated third party for $500, resulting in a $450 gain to FLP. GP's distributive share of the gain is $45. For purposes of the IRC §1374 tax, GP is deemed to have sold ten percent of Blackacre because it has a ten percent interest in a partnership that sold Blackacre. The $45 is recognized built-in gain, but GP's net unrecognized built-in gain is only $35, the difference between the $70 value of its sole asset (the FLP general partner interest) and its $40 basis in that asset.[206] Thus GP must pay an IRC §1374 tax of $7.35 (21% *x* $35) attributable to its deemed sale of ten percent of Blackacre.

Note that if FLP's basis in Whiteacre was only $50 and GP's basis in its FLP general partner interest was thus only $10, the net unrecognized built-in gain would be $65, meaning that the entire $45 of gain from GP's deemed sale of Blackacre would be subject to the IRC §1374 tax, resulting in a tax liability of $9.45 (21% *x* $45).

The regulations contain a *de miminis* rule: an S corporation partner is generally not deemed to have sold its distributive share of built-in gain property held by the partnership if: (1) the S corporation partner's interest represents less than ten percent of the partnership's capital and profits interests at all times during the recognition period; and (2) the value of the S corporation's partnership interest as of the beginning of the recognition period was less than $100,000.[207] For some family limited partnerships, where the general partner interest constitutes only one percent of the partnership's capital and profits and remains subject to applicable valuation discounts, this exception may come in handy.

Planners who find themselves stuck with a corporate general partner that recently converted to S corporation status could consider forming a second partnership stuffed with

[206] See Treas. Reg. §1.1374-4(i)(2).

[207] Treas. Reg. §1.1374-4(i)(5)(i).

built-in loss assets and have the S corporation serve as a partner in that second partnership. This serves to reduce the S corporation's net unrecognized built-in gain amount (possibly to zero), thereby reducing (or eliminating) the exposure to the IRC §1374 tax. While the regulations are sensitive to loss partnerships formed or availed of to help an S corporation partner qualify for the *de minimis* rule,[208] there does not appear to be a problem with using a loss partnership to reduce exposure to the IRC §1374 tax.

E. Turn Your Head and Cough: A Checkup for the Buy-Sell Agreement

A buy-sell agreement is a contract among the shareholders and the corporation that governs the transfer of shares. It often provides a mechanism through which the corporation and the other shareholders may purchase the stock held by another shareholder upon the occurrence of identified events. These events usually include proposed transfers of the stock (with or without consideration), a shareholder's divorce, the pledging of stock to a creditor, the death or withdrawal of a shareholder, and the termination of a shareholder-employee's employment.[209] Planners should ask to review any buy-sell agreement currently in force to make sure there is no risk that the S election may inadvertently be lost. Likewise, planners should review their own form buy-sell agreements to make sure any potential problems are addressed. Here is a short checklist for use in reviewing the buy-sell agreement of an S corporation.

1. If the agreement permits the S corporation to redeem shares on an installment basis, the corporation should pay adequate interest on deferred payments to avoid application of imputed interest rules. But the payment of adequate interest carries its own risk: the obligation may create a second class of stock unless it qualifies under straight debt safe harbor.[210] Recall that "straight debt" is, generally, an unconditional written promise to pay a fixed amount on demand or on a specified date (held by a person who would be a permissible S corporation shareholder) which is not convertible into stock, and which contains an interest rate that is not contingent on profits, the borrower's discretion, or similar factors. The terms of any deferred payment obligation issued from the corporation in a redemption transaction should comply with these requirements.

2. The agreement should include provisions prohibiting actions by the corporation that would result in the accidental termination of the S election. For example, it should bar the issuance of a second class of stock, the addition of too many shareholders, and the addition of ineligible shareholders like corporations and nonqualifying trusts.

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[208] Treas. Reg. §1.1374-4(i)(5)(iii).

[209] An S corporation does not have a second class of stock simply because the buy-sell agreement permits the corporation to redeem shares upon a triggering event. Treas. Reg. §1.1361-1(l)(2)(iii).

[210] See Part I(C), *supra*.

3. Likewise, the agreement should prohibit any transfer of stock that would terminate the S election. In many cases the agreement will require shareholders to give notice of proposed transfers to the corporation. All transfers should be subject to the notice requirement, including gifts,[211] pledges, and transfers pursuant to divorce. The corporation might appoint a transfer agent to verify whether a proposed transfer would terminate the S election. If a shareholder transfers shares in violation of the agreement, the agreement should provide that the transfer is void *ab initio* if applicable state law permits.[212]

4. Remember that certain tax elections by the S corporation require the consent of all shareholders.[213] To keep a single shareholder or a small group of shareholders from holding the corporation hostage, the agreement can provide that all shareholders will consent to any tax election made by the corporation provided that a majority (or super-majority) of the voting shares approves the election.

5. If the buy-sell agreement will contain a provision requiring the corporation to make distributions to pay taxes, the language should indicate that any such distributions will be based on the shareholders' pro rata ownership and not on the basis of the varying federal income tax liabilities of the individual shareholders. If distributions are made according to the tax liabilities of the shareholders, there is a risk that the S corporation could be deemed to have a second class of stock.[214]

VI. OTHER INCOME TAX ISSUES INVOLVING S CORPORATIONS

A. Open Account Debt

We know that an S corporation shareholder can deduct his or her share of the corporation's net losses and deductions to the extent of the shareholder's stock basis and, if stock basis is insufficient, debt basis.[215] In later years, if the corporation generates net income,

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[211] Some buy-sell agreements waive the notice requirement where a shareholder proposes to gift non-voting stock to one or more family members, provided the assignees are eligible S corporation shareholders and become parties to the agreement.

[212] If a corporation may only treat an impermissible transfer as voidable, the S election is lost because shares are momentarily in the possession of an ineligible shareholder. The agreement might contain a provision whereby the transferor-shareholder indemnifies the other shareholders for the damages caused from the loss of the S election.

[213] Examples include the election to have distributions come first from subchapter C earnings and profits instead of from the AAA under IRC §1368(e)(3) and the election to close the books upon the termination of a shareholder's interest under IRC §1375.

[214] See Dwight Drake, BUSINESS PLANNING: CLOSELY-HELD ENTERPRISES 190 (2006).

[215] See Part III(A)(3), *supra*.

the shareholder's share of that net income is applied first to restore debt basis and then to increase stock basis. For purposes of these rules, all open account debts (shareholder advances not evidenced by separate written instruments) from a shareholder are treated as one single debt.

In *Brooks v. Commissioner*,[216] the taxpayer was able to manipulate these rules with some success. The taxpayer borrowed money from a bank and then advanced the funds as open account debt to his S corporation. At the end of the year, the taxpayer was able to use the debt basis to deduct net losses passing through from the S corporation. Early in the next year, the S corporation repaid the open account debt, and the taxpayer repaid the bank. Normally that would trigger gross income to the taxpayer because his debt basis had been reduced because of the losses that passed through. But the taxpayer in the same year advanced additional money as open account debt in an amount sufficient to avoid having income from the corporation's earlier repayment. Because all of the open account debt is treated as a single loan, and because the basis of such debt is computing by a netting process at the end of the year, the court had no choice but to honor the taxpayer's attempt at deferring recognition of income.

Treasury seeks to limit the benefit of this practice. Regulations[217] now change the definition of open account debt to limit the aggregate amount of principal advances to $25,000 at the close of each day of the taxable year. If at any time the total amount of advances exceeds the $25,000 threshold, no portion of such advances will be treated as open account debt. In addition, the regulations require an S corporation shareholder with open account debt to compute (at the end of the corporation's taxable year) whether the shareholder made a net advance or received a net repayment for the year. If the shareholder made a net advance, that amount is added to the opening aggregate principal balance for the year and carried forward to the next year. But if the shareholder received a net repayment, such amount must be taken into account under the general basis adjustment rules.

B. Transfers of Built-in Gain Property to NIMCRUTs

We have seen that charitable contributions of built-in gain property can help an S corporation avoid imposition of the IRC §1374 tax.[218] *Private Letter Ruling 200644013* suggests an S corporation can achieve similar results through the formation of a charitable remainder trust. In this ruling, the taxpayer, an S corporation that was formally a C corporation, intends to create a net income with makeup charitable remainder unitrust (NIMCRUT) to which it will

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[216] T.C. Memo. 2005-204.

[217] Treas. Reg. §§1.1367-2(a)(2), -2(d)(2).

[218] See Part III(C)(2).

contribute three parcels of real property that have unrecognized built-in gain. The NIMCRUT will then sell the properties and reinvest the proceeds in stocks, bonds, and other securities that will pay interest and dividends. The Service ruled that the transfer of the properties to the NIMCRUT will not trigger the entity-level tax on built-in gains under § 1374, and also that the NIMCRUT's sale of the properties will not trigger the § 1374 tax. To the extent the amounts distributed back to the taxpayer under the terms of the NIMCRUT during the 10-year recognition period consist of capital gain under § 664(b) because of the NIMCRUT's disposition of the real estate, however, the taxpayer will be liable for the § 1374 tax.

C. Valuation of S Corporation Shares

Most of the principles applicable to the valuation of closely-held C corporation stock also apply to the valuation of shares in an S corporation. But S corporation shares present their own valuation issues. For instance, the Tax Court and, by a divided court, the Sixth Circuit have held that it is not proper to deduct hypothetical corporate income taxes in valuing S corporation stock under the discounted future cash flow approach.[219]

Dallas v. Commissioner[220] is a reminder that estate planning transactions can have an affect on valuation. In a series of transactions in 1999 and 2000, the taxpayer in *Dallas* transferred a total of 55 percent of the nonvoting stock in an S corporation to various trusts for the benefit of his sons. The trusts gave the taxpayer cash and promissory notes in exchange for the shares. Each of the notes issued in 1999 contained the following self-cancellation clause:

> "In the event that Holder shall die before the Maturity Date, this note shall be deemed to have been paid, satisfied and discharged on the day before the date of the Holder's death."

This provision was intended to keep any unpaid principal amounts from being included in the taxpayer's gross estate.

The taxpayer and the trusts assumed a value of $620 for each share transferred in 1999 and a value of $650 for each share transferred in 2000. The Service, however, valued the stock at $907 per share in 1999 and $906 per share in 2000. The Tax Court concluded that each share was worth $751 in 1999 and $801 in 2000. The court observed that the sales were transactions designed to serve estate planning goals and that the sons were unrepresented parties that did not negotiate the terms of the transfers. Those facts suggested that the transfers were not at arm's length, which forced the court to conduct its own valuation analysis.

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[219] *Gross v. Commissioner,* 272 F.3d 333 (6th Cir. 2001).

[220] T.C. Memo. 2006-212 (September 28, 2006).

The court also agreed with the Service that value of each promissory note given to the taxpayer was $1,687,704, not the face value of $2,232,000, as the taxpayer contended. The Service's value correctly factored in the self-cancellation feature of the notes. The taxpayer argued that the self-cancellation feature should be ignored as a typographical error unique to the 1999 notes, but the court held that "this case involves no typographical errors. Petitioner may not disavow self-canceling clauses. They are not the result of mistake, undue influence, fraud, or duress." The court relied on testimony from the taxpayer's estate planning counsel that the clauses were intended as part of the taxpayer's estate plan.

D. ESBT Deduction for Interest Paid on Loan Used to Buy S Corporation Stock

We know that an electing small business trust (ESBT) may hold S corporation stock but it must pay a 35 percent tax on the income from the portion of the trust consisting of stock in one or more S corporations. In computing the income attributable to S corporation stock, prior law provided that the only items taken into account were: (1) the trust's shares of the S corporation's item of income, gain, loss, deduction, and credit; (2) gain or loss from the trust's sale of the S corporation stock; and (3) state or local income taxes and administrative expenses allocable to the S corporation stock. Thanks to the Small Business and Work Opportunity Tax Act of 2007, interest paid or accrued on debt used to acquire stock in an S corporation may also be deducted in determining the income attributable to the S corporation stock.[221] This provision is effective for all taxable years beginning after 2006.

E. Filing Bankruptcy Does Not Terminate S Election

Mourad v. Commissioner[222] confirms that an S corporation may file for bankruptcy without terminating the S election, although this result was not what the taxpayer wanted. In 1996, the taxpayer's wholly-owned S corporation filed a petition for bankruptcy reorganization. The United States Bankruptcy Court appointed an independent trustee to administer the bankruptcy estate. In 1997, a plan of reorganization was confirmed, and the S corporation sold its principal assets. The bankruptcy trustee filed a Form 1120S for the corporation's 1997 tax year, which reported a large gain. The taxpayer failed to file his individual income tax return for 1997. From information disclosed by the corporation on its 1997 return, the Service determined the taxpayer's income and issued a notice of deficiency.

The taxpayer sought relief in Tax Court, arguing that the filing of a bankruptcy petition for reorganization either terminates an S corporation's tax status or creates a separate taxable entity, freeing the taxpayer from liability for tax on the income of the corporation. The Tax Court rejected the argument. On appeal, the First Circuit affirmed. While the filing of a

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[221] IRC §641(c)(2)(C).

[222] 387 F.3d 27 (1st Cir. 2004).

bankruptcy petition causes the bankruptcy trustee to step into the shoes of the debtor (the corporation), the trustee does not take the place of the debtor's shareholders. Furthermore, bankruptcy law makes clear that the filing of a petition does not change the tax status of a corporation or the relationship between the corporation and its shareholders.

F. Can Grantor Trusts with *Crummey* Powers Hold S Corporation Stock?

In a series of 12 related private letter rulings issued on the same day, the Service ruled that certain trusts were eligible shareholders of an S corporation because they qualified as grantor trusts.[223] In each of the rulings, one or more grantors created a trust that provided for discretionary distributions to other beneficiaries. The grantor(s) in each ruling retained the power (exercisable in a nonfiduciary capacity) to reacquire assets contributed to the trust by substituting property of equivalent value. This power makes the trust a grantor trust for federal income tax purposes under IRC §675(4)(C).

Each trust instrument required the trustee to divide the trust assets into sub-trusts, one for each beneficiary. Each beneficiary was also given a *Crummey* power—the limited right to withdraw amounts contributed to his or her sub-trust, up to the amount of the federal gift tax annual exclusion. Section 678(a) provides that where a beneficiary has a power to withdraw income or corpus from a trust, the beneficiary will be treated as the deemed owner of the trust. Each of the grantors wanted a ruling that they were the deemed owners of the trust for federal income tax purposes, including the 100-shareholder limitation applicable to S corporations, even though the beneficiaries had withdrawal powers that would appear to be governed by IRC §678(a).

The Service, citing IRC §678(b), gave them each the ruling they sought. Section 678(b) says that IRC §678(a) (the rule treating the beneficiary as the deemed owner) does not apply "with respect to a power over income" if the trust is otherwise a grantor trust. Sure, *Crummey* powers are powers over principal and not over income, but the Service said that IRC §678(b) applied anyway. Accordingly, the beneficiaries were not the deemed owners of the trusts.

This is consistent with private rulings in 2006 that likewise suggested that *Crummey* powers have no affect on grantor trust status.[224] The problem is that published guidance from the Service[225] states that a *Crummey* power falls within the general rule of IRC §678(a). So we have published guidance on the one hand that would encourage planners to avoid the use of *Crummey* powers in grantor trusts and informal advice on the other hand that seems to have no problem reaching the opposite result.

[223] PLRs 200729005 through 200729016.

[224] See PLRs 200606006 and 200603040.

[225] Rev. Rul. 81-6, 1981-1 C.B. 385.

G. Custodial IRAs as Shareholders

Taproot Administrative Services, Inc. v. Commissioner[226] makes it clear that a custodial Roth IRA is an ineligible shareholder. Throughout 2003, the taxpayer (a corporation) had one shareholder: a custodial Roth IRA for the benefit of one Paul DiMundo. The corporation filed a Form 1120S for 2003, but the Service issued a deficiency on the grounds that the taxpayer was not an S corporation because it had an ineligible shareholder. It computed tax liability as though the taxpayer was a C corporation. A regulation finalized in 2008 makes it clear that Roth IRAs are ineligible shareholders, but this regulation was not in effect in 2003. So the Tax Court had to determine whether a custodial IRA could be an eligible shareholder in the absence of definitive guidance.

Before the Tax Court, the taxpayer argued that the custodial Roth IRA was effectively a custodian or agent for DiMundo and that, therefore, DiMundo should be viewed as the shareholder. The court (in a 12-4 decision) rejected this line of reasoning, distinguishing a custodial Roth IRA from traditional custodial arrangements where the beneficiary is incapacitated or a minor. The taxpayer also argued that the custodial IRA was a grantor trust and thus an eligible shareholder, but the majority rejected this argument too, citing a 1992 revenue ruling that "sensibly distinguishes IRAs from grantor trusts governed by sections 671-679. 'When a grantor or another person is treated … as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion.' That, of course, is not the case with traditional and Roth IRAs--earnings accrue tax free in both entities. It follows that the tax relationship between an individual beneficiary and a traditional or Roth IRA is not governed by the grantor trust provisions." Further, the majority found no compelling evidence that Congress ever intended for IRAs to be eligible S corporation shareholders.

In dissent, Judge Holmes states that since the custodial relationship is clear in this case, the real shareholder is DiMundo and not the IRA. "In various custodial account agreements preapproved by the IRS, the depositor (owner) is responsible for providing information to the custodian; he can combine IRAs to satisfy the minimum distribution requirements under section 408(a)(6); he can replace the custodian at any time; he is himself responsible for any fees, taxes and administrative expenses; and he directs and controls the investments in the account. Such agreements—while obviously not controlling here—at least suggest in their apparent uniformity that custodial account IRAs would likely be found at trial to be under the control of their owners. It is hard to see how they could be considered 'persons' of their own, instead of channels through which their owners direct and manage their investments."

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[226] 133 T.C. No. 9 (2009).

Section Eleven

The Estate Planner's Guide to the Income Taxation of Partnerships and Limited Liability Companies

Professor Samuel A. Donaldson
Georgia State University, College of Law
Atlanta, Georgia

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The Estate Planner's Guide to the Income Taxation of Partnerships and Limited Liability Companies................................ Professor Samuel A. Donaldson

THE ESTATE PLANNER'S GUIDE TO THE INCOME TAXATION OF PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

By

Samuel A. Donaldson

Professor
Georgia State University College of Law
Atlanta, Georgia

Senior Counsel
Perkins Coie LLP
Seattle, Washington

The following materials are adapted from materials originally prepared for the 39th Heckerling Institute on Estate Planning, sponsored by the University of Miami School of Law

This outline considers many of the federal income tax aspects of partnerships and limited liability companies used in estate planning. This is not the first careful examination of these issues,[1] but it attempts to provide a summary reference for the estate planning professional. Estate planners often

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[1] See, e.g., Carol Cantrell, *Income Tax Problems When the Estate or Trust is a Partner*, ALI-ABA COURSE OF STUDY MATERIALS, PLANNING TECHNIQUES FOR LARGE ESTATES (April 2010); Samuel A. Donaldson, *Super-Recognition and the Return-to-Sender Exception: The Federal Income Tax Problems of Liquidating the Family Limited Partnership*, 35 CAP. U. L. REV. 15 (2006); Scott Bieber, Robert R. Pluth, Jr., Katherine J. Levy, and Theodora P. Karnegis, *Tax Effect of Redeeming a Partnership Interest*, 31:10 ESTATE PLANNING 505 (October 2004); Mark P. Gergen, *Potential Tax Traps in Liquidating a Family Limited Partnership*, 101 TAX NOTES 1431 (December 22, 2003); Thomas I. Hausman, *Mixing Bowls and Marketable Securities in a Family Limited Partnership*, 101 TAX NOTES 373 (October 20, 2003); Richard B. Robinson, *"Don't Nothing Last Forever"—Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 302 (2003); Louis A. Mezzullo, *Family Limited Partnerships and Limited Liability Companies*, ALI-ABA COURSE OF STUDY MATERIALS, ESTATE PLANNING FOR THE FAMILY BUSINESS OWNER (July 2003); Michael V. Bourland, Kenneth L. Wenzel, P. Michelle Eaton, and Stephanie M. Bourland, *Hot Topics Under the 2001 Tax Act and Transfer Planning: Maintaining/ Operating the Family Limited Partnership*, ALI-ABA COURSE OF STUDY MATERIALS, ESTATE PLANNING FOR THE FAMILY BUSINESS OWNER (August 2002); Paul Carman, *Unwinding the Family Limited Partnership: Income Tax Impact of Scratching the Pre-Seven-Year Itch*, 96 J. TAX'N 163 (2002); David Keene, *Beyond Valuation Discounts: What You Should Know and Tell Your Clients About FLPs and LLCs*, in Materials from Understanding Business Entities in the Estate Planning Area, Washington State Bar Association CLE #01447B (February, 2001).

focus on the federal and state wealth transfer tax advantages to be gained from the use of partnerships, but they sometimes neglect to consider the income tax consequences associated with these entities.

I. FORMATION OF THE PARTNERSHIP

A threshold issue for the new partnership is its characterization for federal tax purposes. By default, an unincorporated entity engaged in an activity for profit with two or more members will be treated as a partnership. But the entity owners can elect to have the entity treated as a corporation. Most every entity will cling to partnership treatment, however, for three important reasons.

First, corporations are still subject to a “double tax” on entity income. Undeniably, the significance of the double tax has become less significant now that most dividend distributions are taxed at the same rate as long-term capital gains. Still, it exists. The double tax can be mitigated to some extent through a subchapter S election, but even for S corporations there is recognition of gain upon distributions of appreciated property, a result that does not necessarily apply to partnerships. *Second*, corporations lack the flexibility of partnerships in making special allocations of income, gain, loss, deduction, and credit items. It turns out that most partnerships do not make special allocations of tax items anyway in order to preserve their transfer tax benefits, but once the founding partners are out of the picture and the beneficiary partners are left with complete ownership of the entity, the ability to be flexible is attractive. *Third*, shareholders do not get any basis credit for the debts of the corporation, while partners of a partnership get basis credit for the partnership’s debts. Added basis credit helps in deducting losses of the partnership.

Assuming the entity will remain a partnership for federal tax purposes, the number of tax issues at formation of the entity are relatively few. Founding partners must be aware of the risk of gain recognition under §§721(b) and 752, though this risk can be avoided fairly easily with proper planning. Also as part of formation, the founding partners must consider the entity’s appropriate tax year and accounting method.

A. Investment Company Partnerships [§721(b)]

1. Gain Recognition

Generally, the formation of a partnership is not a taxable event, as §721(a) provides nonrecognition of gain or loss on the contribution of property to the partnership in exchange for an interest in the partnership’s capital. Section 721(b), however, requires recognition of gain (but not loss) in certain cases where the partnership would be treated as an “investment company” under §351 if the entity were taxed as a corporation. A corporation is treated as an investment company if more than 80% of the value of its assets consists of “portfolio assets” (generally, stocks, securities, cash, notes, options, foreign currency, certain financial instruments, interests in real estate investment trusts, and ownership interests in entities holding such assets) held for investment. If a shareholder’s contribution of property to an investment company results in diversification of the shareholder’s capital interest, the shareholder must recognize gain.

In the estate planning context, then, a transfer of investment assets in exchange for a capital interest in the partnership can be taxable if the transfer diversifies the contributing partner's investment.

EXAMPLE (1): Mom and Daughter decide to form an entity to be taxed as a partnership. Mom transfers stock in ABC Corporation (worth $800,000) to the entity in exchange for a 4% general partner interest and a 76% limited partner interest. Daughter transfers $200,000 cash to the entity in exchange for a 1% general partner interest and a 19% limited partner interest. Because more than 80% of the value of the entity's assets consists of portfolio assets (remember that cash is a portfolio asset under this rule), the entity would be considered an investment company if it were taxed as a corporation. Because the transfers by Mom and Daughter result in the diversification of their investments (the parties transferred non-identical assets to the entity in exchange for the interests[2]), Mom and Daughter must recognize any realized gain, but do not recognize any realized loss.

2. Planning to Avoid §721(b)

The easiest way to avoid the application of §721(b) is to make sure that marketable securities and other portfolio assets comprise no more than 80% of the total value of the assets to be contributed to the partnership. Assets like real estate and collectibles do not count as portfolio assets, and their contribution to a partnership helps in avoiding §721(b).[3] As will be explained later, however, contributing non-portfolio assets to the entity will increase the risk of gain recognition upon a distribution of marketable securities from the entity to any partner other than the contributing partner. So this easy technique is not without some wrinkles.

What about the client who lacks a sufficient amount of non-portfolio assets? There are three ways to avoid the application of §721(b) for these clients, each of which involves some planning prior to formation of the entity. *First*, if the founding partners are married, the planner could have each partner transfer an undivided one-half interest in all of the assets to be transferred to the partnership. Any transfers made between the founding partners in anticipation of the partnership's formation will not give rise to adverse tax consequences,[4] so these "equalizing" transfers are an easy way to ensure neither partner's interest is diversified by formation of the entity.

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[2] Treas. Reg. §1.351-1(c)(5).

[3] Yet we will see that avoidance of §721(b) through the transfer of non-portfolio assets may make it difficult to distribute any portfolio assets out of the partnership without recognition of gain. See Part III(B)(3) *infra*.

[4] Transfers between spouses do not give rise to recognized gains or losses, and the transferee spouses take the transferor spouse's basis in the property transferred. I.R.C. §1041. Such transfers also qualify for the unlimited marital deduction for federal gift tax purposes. I.R.C. §2523. Accordingly, there is no tax consequence to any intra-spousal transfer of property.

EXAMPLE (2): Husband and Wife, residents of a separate property state,[5] decide to form an entity to hold Husband's stock in ABC Corporation (worth $500,000) and Wife's notes from various debtors (also worth $500,000). If each spouse transfers his or her assets to the partnership in exchange for a 50% interest, then because more than 80 percent of the value of entity's assets consists of portfolio assets, the entity would be considered an investment company if it were taxed as a corporation. Furthermore, because the transfers by Husband and Wife result in the diversification of their investments (the parties transferred non-identical assets to the entity in exchange for the interests, as in Example (1) above), Husband and Wife would recognize any realized gain, but would not recognize any realized loss. To avoid this result, Husband should convey an undivided one-half interest in the ABC stock to Wife, and Wife should convey an undivided one-half interest in the notes to Husband. Then, each spouse would transfer a one-half interest in all of the assets to the FLP in exchange for a 50% interest in the entity. Since each partner contributes identical assets to the entity in exchange for a proportionate interest in the entity, there is no diversification of any partner's investment and, thus, §721(b) does not apply.

Second, if the founding partners are unmarried, the planner can advise each founding partner to contribute substantially identical assets to the partnership. Where one partner controls the other partner (like where the two partners are a corporation and its sole shareholder), equalization of the contributions in this context is generally feasible. In considering this option, planners should remember that "insignificant" transfers of non-identical assets can be ignored for purposes of determining whether diversification has occurred.[6] Treasury has formally stated that where a founding partner contributes non-identical assets worth only 0.99% of the total amount transferred to the entity at formation, the *de minimis* contribution could be ignored.[7] Informally, the Service has ruled that a transfer of non-identical assets comprising less than 5% of total value contributed at formation is likewise insignificant.[8] Beyond that, one is left to guesswork, although the Service has ruled that a transfer of non-identical assets worth 11% of the total contribution at formation is *not* insignificant.[9]

EXAMPLE (3): Mom forms Private Corporation by transferring stock in Public Corporation (worth $600,000) in exchange for all of Private Corporation's stock. Mom, Private Corporation, and Daughter then decide to form an entity to be taxed as a partnership. Mom transfers additional stock in Public Corporation (worth $390,000) to the entity in exchange for a 39% limited partner interest. Private Corporation transfers all of its holdings in Public Corporation to the entity in exchange for a 1% general

[5] If they resided in a community property state, no pre-formation equalization of assets may be required by operation of community property laws.

[6] Treas. Reg. §1.351-1(c)(7), Ex. (1).

[7] Id.

[8] Private Letter Ruling 200006008.

[9] Rev. Rul. 87-9, 1987-1 C.B. 133.

partner interest and a 59% limited partner interest. Daughter transfers $10,000 cash to the entity in exchange for a 1% limited partner interest. Because Daughter's contribution is only one percent of the total consideration transferred to the entity at formation, her non-identical contribution of cash is ignored for purposes of determining whether any partner has diversified under §721(b). Moreover, since Mom and Private Corporation each contributes identical assets to the partnership in exchange for a proportionate interest in the entity, there is no diversification of any partner's investment and, thus, §721(b) does not apply.

Finally, perhaps the best solution to avoiding §721(b) is to have each partner transfer already-diversified portfolios to the entity at formation. Treasury says no diversification occurs if each partner transfers a diversified portfolio of stocks and securities.[10] A contributing partner's portfolio is diversified if no more than 25% of the portfolio's value is invested in any one issuer and if no more than half of the value of the portfolio is invested in five or fewer issuers.[11] For purposes of this rule, government securities count as part of the value of the portfolio but are not considered to be securities of an issuer.

EXAMPLE (4): Mom and Daughter decide to form an entity to be taxed as a partnership. Mom transfers stock in ten blue-chip, publicly traded corporations (worth a total of $800,000) to the entity in exchange for a 4% general partner interest and a 76% limited partner interest. Daughter transfers stock in ten different publicly traded corporations (worth a total of $200,000) to the entity in exchange for a 1% general partner interest and a 19% limited partner interest. No one issuer comprises more than 25% of the value of either partner's portfolio. Although more than 80% of the value of the entity's assets consists of portfolio assets, §721(b) does not apply because each partner contributed a diversified portfolio of marketable securities.

In any case where portfolio assets will dominate a partnership's holdings and more than one person will be a founding partner, the founders must be careful not to trigger §721(b). Hopefully, a satisfactory answer lies in at least one of the above suggestions.

B. Contributions of Encumbered Property [§752]

While §721 generally provides that no partner recognizes gain upon the transfer of money or other property to a partnership in exchange for an interest in the partnership, a partner *may* recognize gain if any debt or encumbrance attached to the contributed property exceeds the partner's adjusted basis in such property. That is because §752(b) treats a reduction in a partner's share of partnership liabilities as a cash distribution to such partner, and §731 generally provides that a cash distribution is taxable to the extent it exceeds a partner's basis in his or her partnership interest (the partner's "outside basis"). Since a partner's outside basis is determined with reference to the adjusted basis of the property contributed to the partnership in exchange for the interest, gain recognition is a distinct

[10] Treas. Reg. §1.351-1(c)(6).

[11] I.R.C. §368(a)(2)(F)(ii).

possibility where the amount of the debt exceeds the contributing partner's basis in the underlying property.

Of course, if the entire debt is allocated to the contributing partner under the regulations to §752, there is no deemed cash distribution to the contributing partner. Thus, gain recognition is not a certainty whenever debt exceeds basis, but the chance of recognition should cause planners to proceed with caution.

If the amount of debt exceeds the *value* of the contributed property (that's some contribution!), additional issues arise. Most notably, §752(c) limits the contributing partner's outside basis to the value of the contributed property, even if all of the property's debt is allocated to the contributing partner under the §752 regulations.

C. Use of the Cash Method

So long as the chosen method of accounting clearly reflects income, partnerships are free to use the cash method, the accrual method, or any combination of the two methods.[12] There are three important limits in this regard.

First, a partnership with a C corporation partner (a common technique prior to the popular ascension of the LLC was to incorporate the general partner of a limited partnership to insure limited liability to all partners) cannot use the cash method unless its average annual gross receipts for a three-year period do not exceed $25 million or unless the FLP is engaged in the business of farming. The vast majority of family partnerships do not generate more than $25 million in average annual gross receipts over a three-year period, so this restriction applies to few entities.

Second, a partnership cannot use the cash method if it constitutes a "tax shelter."[13] The term "tax shelter" is broadly defined to encompass any entity "if a significant purpose of such [entity] is the avoidance or evasion of Federal income tax."[14] Most partnerships are not designed to avoid federal income taxes, but this broad definition might give pause to planners in cases where the partnership might be expected to generate losses. If the Service determines that a *significant* (not "principal" but presumably more than "incidental") purpose of the partnership arrangement is to avoid federal income taxes, the entity may be prohibited from using the cash method.[15] Even if the partnership is not a tax shelter, it may qualify as a "syndicate," and thus prohibited from use of the cash method.[16] A syndicate is a partnership where more than 35% of its losses are allocated to limited partners who do not actively participate in the partnership's management.

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[12] I.R.C. §446(c).

[13] I.R.C. §448(a)(3).

[14] I.R.C. §§448(d)(3); 461(i)(3); 6662(d)(2)(C)(iii).

[15] Though that is probably the least of the planner's (and partners') concerns.

[16] I.R.C. §§448(a)(3); 461(i)(3)(B); 1256(e)(3)(B).

Third, a partnership may not use the cash method if and to the extent it purchases and sells inventories. Because the plain-vanilla partnership formed for estate planning purposes does not engage in the manufacture, purchase, or sale of inventory, an extensive discussion of the inventory accounting rules is omitted here. The key for now is to recognize that the cash method may not be available to the partnership in all events.

II. OPERATION OF THE PARTNERSHIP

Once the partnership is up and running, the benefits of pass-through taxation become apparent. The entity is not liable for any tax on its taxable income; instead, such income is treated as the income of the partners. Subsequent distributions of the income from the entity are generally tax-free, resulting in a single layer of tax on the entity's income. Of course, the devil is in the details; indeed, some of the exceptions and limitations applicable to this general scheme of pass-through taxation are downright satanic.

A. Income and Deduction Allocations

1. Generally

Partners are generally free to allocate the income, gain, loss, deduction, and credit items of the partnership among themselves however they may agree, subject to the constraint in §704(b) that such allocations have "substantial economic effect." Detailed regulations give guidance for ensuring that allocations meet this amorphous standard. The regulations provide two safe harbors under which an allocation will be deemed to have "economic effect."[17] Both safe harbors require the entity to maintain capital accounts using specific accounting rules set forth in the regulations.[18] In some cases, compliance with these accounting rules proves to be difficult (i.e., expensive). Because the typical partnership arrangement does not involve the use of special income or deduction allocations (indeed, the use of

[17] Treas. Reg. §1.704-1(b)(2)(ii). The first safe harbor applies where the partnership agreement requires: (1) the determination and maintenance of capital accounts in accordance with specific rules provided elsewhere in the regulations; (2) that liquidating distributions be made in accordance with the positive capital account balances of the partners; and (3) that any partner with a deficit balance in his or her capital account at liquidation be required to restore the deficit balance to the partnership within a stated period. Treas. Reg. §1.704-1(b)(2)(ii)(b). The second safe harbor applies where the partnership agreement requires: (1) both of the first two conditions of the first safe harbor (maintenance of capital accounts according to specific rules and liquidating distributions according to positive capital account balances); (2) the operation of a "qualified income offset" provision; and (3) that no allocation to a partner may cause or increase a deficit balance to that partner's capital account in an amount greater than the amount that partner is obligated to restore upon liquidation of the entity. Treas. Reg. §1.704-1(b)(2)(ii)(d).

[18] Treas. Reg. §1.704-1(b)(2)(iv).

special allocations might run afoul of §2701[19] or §704(e)[20]), it might be better *not* to follow the capital account rules in the regulations, provided the partnership agreement requires all allocations to be in accordance with the partners' interests in the partnership. Remember: failure to fall within one of the two safe harbors for economic effect means only that the Service can reallocate items if it determines that an allocation with not made in accordance with the partners' interests in the partnership. It does not mean that all allocations are *per se* invalid.

2. Special Rule for Family Partnerships [§704(e)(2)]

Section 704(e)(2) states that where there has been a gift of a limited partner interest in a partnership, the recipient's distributive share of the partnership's income is limited in two ways. *First*, the donor must be adequately compensated for any services rendered to the entity. In other words, the donor cannot perform services at no charge for the partnership and pass along the savings to the recipient.

> EXAMPLE (5): Dad gives Daughter a 40% limited partner interest in a family partnership, retaining a 10% general partner interest and a 50% limited partner interest. The partnership's taxable income for the year is $100,000. In that same year, Dad performed services for the entity valued at $40,000. An allocation of $40,000 of the $100,000 taxable income to Daughter would violate §704(e)(2) because it does not consider the services performed by Dad. Instead, the $40,000 in services should be treated as compensation to Dad, leaving $60,000 to be allocated according to the partner's interest in the partnership. In sum, Dad would be allocated income totaling $76,000 ($40,000 for Dad's services plus 60% of the partnership's remaining $60,000 income, or $36,000), while Daughter would be allocated $24,000 of income (40% of the partnership's $60,000 income after services).

Second, if the recipient's interest was funded with donated capital, the donor and the recipient must be allocated income in proportion to the donated capital. In effect, the maximum income allocable to a recipient partner is the income allocable to the recipient partner's interest in partnership capital.

> EXAMPLE (6): Mom and Dad formed a partnership when each contributed investment assets in exchange for general and limited partner interests. Mom and Dad each gave

[19] Section 2701 values certain retained interests in an FLP at zero for purposes of valuing subordinate equity interests transferred to certain family members. If all interests in an FLP have identical distribution and liquidation rights, §2701 does not apply. Accordingly, estate planners usually advise the partners to make sure all income and deduction allocations are made according to the partners' interests in the partnership, regardless of whether such interests have voting or management rights. Differences in voting and management rights (as well as differences in liability for entity debts) do not by themselves create subordinate equity interests, so creating voting and nonvoting partnership interests does not trigger application of §2701's zero-value rule. Treas. Reg. §25.2701-1(c)(3).

[20] In an FLP, income must be allocated in a manner proportionate to the capital interests of the partners (after allocating compensation to partners for services rendered to the partnership). Treas. Reg. §1.704-1(e)(3). See also the discussion *infra* at II(A)(2).

Son a 10% limited partner interest (a total 20% limited partner interest). Under §704(e)(2), the income allocation to Son must be proportionate to the income allocated to Mom and Dad, so Son must be allocated 20% of the income attributable to the contributed assets. Mom and Dad cannot agree to divert more (or less) income to Son.

Combining the two rules under §704(e)(2), the regulations state that family partnership income must be distributed proportionate to capital interests after distributing reasonable compensation to the donor for services rendered to the partnership.[21]

3. The Peril of Restricting Transfers and Distributions

Planners seeking maximum marketability discounts for transfer tax valuation purposes are tempted to draft a partnership agreement with all kinds of restrictions on a limited partner's ability to transfer his or her partnership interest. While a limited partner in a regular partnership might normally be required to offer his or her interest to the other partners before selling that interest to a non-partner, limited partners in some partnerships are prohibited from making any transfer of a partnership interest without the consent of the general partners (or, in some cases, all of the general partners *and the other limited partners*). Likewise, planners often try to maximize the minority interest discount for transfer tax valuation purposes by imposing increased restrictions on a limited partner's ability to compel a distribution. Although limited partners in an ordinary partnership arrangement might have the power to compel a distribution by a super-majority vote, limited partners in a partnership formed for estate planning purposes may be stripped of this power altogether in order to remove any semblance of control over the management of the entity's affairs.

While these added restrictions on transfers and distributions can be effective in enhancing the applicable valuation discount, they may come at an income tax cost to the founding partners. Regulations under §704(e) provide that if a donee-partner's right to transfer his or her partnership interest is subject to "substantial restrictions," or if the donor-partner "retains any other control which substantially limits any of the rights which would ordinarily be exercisable by unrelated limited partners in normal business relationships," the restrictions will be considered "strong evidence" that the donee-partner does not really own the partnership interest.[22] For federal income tax purposes, of course, that means that the donor-partner would be taxed on the donee-partner's share of the partnership's income. This may be an acceptable risk to clients seeking maximum valuation discounts, particularly where the partnership's assets do not yield significant income. But one should be careful about restricting transfers and distributions without considering the potential federal income tax ramifications.

B. Distributions

Section 731(a)(1) generally provides that no gain is recognized upon a distribution from a partnership except to the extent that any cash received in the distribution exceeds the recipient partner's outside basis immediately prior to the distribution. Thus, to the extent a partner receives an

[21] Treas. Reg. §1.704-1(e)(3).

[22] Treas. Reg. §1.704-1(e)(2)(ix).

in-kind distribution of property, there is no recognition of gain or loss. The recipient partner generally takes the partnership's basis in distributed property.[23]

Property distributions are treated as cash distributions in two cases. First, to the extent a property distribution reduces a partner's share of partnership liabilities, the reduction is treated as a cash distribution under §752(b). Second, a distribution of marketable securities will be treated as a distribution of cash in most cases under §731(c). A detailed examination of §731(c) appears below in the context of partnership liquidations.

C. Gift Transfers of Partnership Interests

1. Giving the Gift of Basis

No matter how many different types of interests a partner may have in any one entity, and no matter how or when such interests were acquired, each partner for federal income tax purposes has a single outside basis.[24] When a founding partner gives part of his or her entire interest in the partnership to a beneficiary, part of the founding partner's outside basis also carries over to the beneficiary. It is well accepted that the portion of the founding partner's outside basis allocable to the given interest is proportionate to the value of the given interest relative to the value of the founding partner's entire pre-transfer interest.[25] The use of valuation discounts in *inter vivos* gift planning limits the amount of outside basis that carries over to a founding partner's beneficiary.

EXAMPLE (7): Mom and Dad are the general and limited partners of a partnership. Each partner has an outside basis of $150,000 ($300,000 total). An expert's appraisal determines the value of the 5% general partner interest to be $50,000 (or $10,000 for a 1% general partner interest) and the value of the 95% limited partner interest to be $475,000 (or $5,000 for a 1% limited partner interest). Mom and Dad together transfer a total 20% limited partner interest to Son. The discounted value of the gift is $100,000. Son's outside basis in the gifted interest is $57,143, *not* $60,000 (or 20% of their combined $300,000 outside basis), as shown below:

$$\frac{\text{FMV gift}}{\text{FMV pre-transfer interests}} \times (\text{donor's outside basis}) = \text{outside basis allocable to gift}$$

[23] I.R.C. §732(a)(1). The basis of distributed property may not, however, exceed the recipient partner's outside basis immediately prior to the distribution (reduced by any cash received in the same distribution). I.R.C. §732(a)(2). Allocation rules are provided in §732(c) where a partner receives more than one asset and the §732(a)(2) limitation comes into play.

[24] See, e.g., *Rev. Rul. 84-53*, 1984-1 C.B. 159.

[25] Treas. Reg. §1.61-6(a).

$$\frac{\$100{,}000}{\$525{,}000} \times (\$300{,}000) = \$57{,}143$$

The result in this Example may not be bad. To the extent the founding partners retain more of their outside basis, a sale of the partnership assets followed by a distribution of the cash proceeds will be taxed more to the beneficiary than to the founding partners. If the beneficiary is in a lower tax bracket, this may result in less tax.[26] Whether the result is good or bad, the practitioner should be careful to apportion the donor's outside basis correctly for purposes of determining the allowable portion of each partner's distributive share of partnership losses[27] as well as the amount of cash that can be distributed to each partner without recognition of gain.[28]

2. Transferring Interests Where Debt Exceeds Basis

Where a donor partner transfers partnership interests subject to liabilities in excess of the outside basis allocable to the transferred interests, the donor partner recognizes gain.[29] To the extent the liabilities remain allocable to the donor partner, however, no gain should be recognized since no portion of the debt is allocable to the transferred interests.

EXAMPLE (8): Dad owns voting and nonvoting interests in a partnership comprising a total 50% interest in the entity. Dad's outside basis for his interests is $50,000, and Dad's share of entity liabilities is $250,000. If Dad transfers a 10% nonvoting interest in the partnership to Son, the outside basis allocable to the 10% interest is $10,000, and 10% of the partnership's debts is $50,000. Accordingly, Dad will recognize a gain of $40,000 on the transfer unless Dad is still liable for the entity's debts (e.g., because Dad is the general partner or because Dad expressly provides that Son does not take his interest subject to the liabilities).

To ensure that no debt travels to the donee along with the gifted interest, donor-partners could transfer the interest to a defective grantor trust.

[26] One should also keep in mind that if the gift triggers liability for federal gift tax, the donee will receive additional basis under §1015(d).

[27] I.R.C. §704(d).

[28] I.R.C. §731(a)(1).

[29] Treas. Reg. §§1.1001-2(a)(1); 1.1001-2(a)(4); 1.1001-2(c), Example (5).

D. Death of a Partner

1. Close of Taxable Year

Upon the death of a partner, §706(c)(2)(A) provides that the taxable year of the partnership closes with respect to the deceased partner. The deceased partner's final income tax return includes all pass-through items for the short taxable year ending at death, either through an interim closing of the books or through a *pro rata* allocation based on the number of days in each period.[30]

EXAMPLE (9): Mom, Son, and Daughter are equal general and limited partners in a partnership. Mom dies on July 1, Year One. The entity's income for Year One consists of two gains: a $900 gain in March and a $300 gain in November. If the partnership makes an election to close its books on July 1, the proportionate shares of the partners would be as follows:

Partner	March Gain Share	November Gain Share
Mom	$300	zero
Son	$300	$150
Daughter	$300	$150

If, on the other hand, the partnership does not close its books, the proportionate shares of the partners for Year One would be as follows:

Partner	March Gain Share	November Gain Share
Mom	$150	$50
Son	$375	$125
Daughter	$375	$125

In this example, Son and Daughter are inclined to close the books, for their proportionate shares under a closing of the books ($450) is less than their shares if no such election is made ($500). Of course, if the November gain were larger than the March gain, the incentive would be the opposite.

The fiduciary and the surviving partners should work together to determine which approach is better.

2. Adjustment to Basis

If the partnership makes an election under §754, the entity's basis in its assets ("inside basis") will be adjusted, but only with respect to the transferee partner. Specifically, the entity will increase its inside basis by the excess of the transferee partner's outside basis (freshly stepped-up under §1014, mind you) over his or her share of the partnership's inside basis. Alternatively, if the transferee partner's outside basis was stepped-*down* under §1014, the entity will reduce its inside basis by the excess of the transferee partner's share of inside basis over his or her outside basis. This adjustment to inside basis

[30] Treas. Reg. §1.706-1(c)(2)(ii).

affects not just the allocation of gain and loss to the transferee partner upon a disposition of a partnership asset. It determines the partner's share of inside basis for purposes of depreciation deductions and distributions, as well.

Here again, zealous preoccupation with valuation discounts can have an adverse income tax result (though usually not to such an extent that the valuation discounts have no net value).

> EXAMPLE (10): Mom dies holding a 5% general partner interest and a 20% limited partner interest in a partnership. The entity's assets have a combined liquidation value of $1,000,000 and an aggregate inside basis of $200,000. Mom's estate values the 5% general partner interest at $40,000 (assuming a 20% blended valuation discount against the $50,000 liquidation value attributable to the general partner interest) and it values the 20% limited partner interest at $120,000 (assuming a 40% blended valuation discount against the $200,000 liquidation value attributable to the limited partner interest). Both interests pass to Son. Son's aggregate outside basis is $160,000, the sum of the date-of-death values of the general and limited partner interests included in Mom's estate.
>
> If the partnership has a valid §754 election in effect, the $50,000 of aggregate inside basis (that portion of the inside basis attributable to Mom's interests) is increased to $160,000, *not* to its $250,000 liquidation value. Thus, while the §754 election eliminates the disparity between inside and outside bases with respect to Son, the election does not completely eliminate the inherent gain attributable to the interests now held by Son; if the entity sells all of its assets, $90,000 of gain will be allocable to Son. Of course, this beats the $200,000 gain that would have been allocable to Son had no §754 election been made. And the estate tax savings from an aggregate $90,000 discount likely exceeds the income tax burden from $90,000 of extra gain. But it shows that the higher the discount, the less beneficial the §754 election becomes to the decedent's successor in interest.

Note that if the deceased partner's surviving spouse is also a partner in the partnership, and if the spouses owned their interests as community property, the surviving spouse's interest in the entity also triggers an adjustment to inside basis if a §754 election is in effect.

III. LIQUIDATION OF THE FLP

Owners of partnership interests have two basic options for unwinding or dissolving the entity: sell the entity's assets and distribute the cash remaining after payment of debts to the partners, or distribute the entity's assets in kind to the partners. Why would the partners seek to dissolve a partnership formed as part of an estate plan? Dissolution is common where the partnership assets are under-performing, and it also tends to occur shortly following the death of the surviving founder. Moreover, a high "basic exclusion amount" for federal wealth transfer tax purposes may undermine some of the transfer tax savings from the use of partnerships, and that may prompt the early liquidation of some entities. Yet no matter whether the founding partners are alive, income tax traps are ready to spring if liquidation occurs within seven years of the founding partners' contributions to the entity.

A. Asset Sale and Final Distributions

Section 704(c) requires any gain from the sale of appreciated property contributed to a partnership to be allocated among the partners in a manner that takes into account the property's built-in gain at contribution. Generally, such built-in gain must be allocated to the contributing partner;[31] any gain in excess of the built-in gain (attributable to post-contribution appreciation) may be allocated as the partners agree.[32] Those who succeed to all or a portion of a contributing partner's partnership interest inherit that share of the built-in gain attributable to the interest received.[33]

Following recognition and pass-through of gains and losses from the sale of the entity's assets, a distribution of the remaining cash proceeds to the partners is taxable only to the extent that the distributed cash exceeds a partner's outside basis (the partner's basis in his or her partnership interest).[34]

B. In-Kind Distributions to Partners

In lieu of a sale of the partnership's assets, the partners might decide to dissolve the entity by distributing the assets to the partners. In this regard, the owners again have two options: proportionate (or "*pro rata*") distributions of each asset, wherein each partner receives a share of every asset according to the partner's interest in the partnership, or disproportionate ("cherry-picking") distributions of the assets, where entire assets are distributed to one partner to the extent possible.

> EXAMPLE (11): At the time of liquidation, a partnership owns two assets: Blackacre, a parcel of investment property worth $600,000, and $400,000 in marketable securities. The partnership has two partners: Dad, with a 5% general partner interest and a 35% limited partner interest, and Son, with a 60% limited partner interest. If Dad, as general partner, opts for a proportionate distribution of the assets, Dad will receive a 40% interest in Blackacre and a 40% interest in the marketable securities, while Son will receive a 60% interest in both assets. If Dad opts for disproportionate distributions, Dad could receive all of the marketable securities while Son takes all of Blackacre.

Depending on this choice and upon the composition of the FLP's assets, up to three Code provisions can come into play upon an in-kind distribution to a partner.

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[31] Treas. Reg. §1.704-3. If the built-in gain has already been accounted for through the use of "remedial allocations," there is no need to allocate the built-in gain a second time to the contributing partner.

[32] In most cases, FLP agreements provide that any gain in excess of the §704(c) built-in gain must be allocated to the partners in proportion to their partnership interests. This allows the partnership interests to avoid the "zero-value" rule of §2701.

[33] Treas. Reg. §1.704-3(a)(7).

[34] I.R.C. §731.

1. Section 704(c)(1)(B) Built-in Gain

Section 704(c)(1)(B) provides that if property distributed to one partner was contributed to the partnership by another partner within seven years of the distribution, and if that property had built-in gain at the time of contribution, then the contributing partner must recognize the built-in gain at the time of the distribution.

> EXAMPLE (12): In Year One, Dad and Daughter formed a partnership when Dad contributed farmland worth $500,000 and with an adjusted basis of $300,000 in exchange for a 5% general partner interest and a 45% limited partner interest, and Daughter contributed cash in the amount of $500,000 for a 50% limited partner interest. In Year Five, the partnership distributed the farmland to Daughter. Assuming the value of the land has not changed since contribution, Dad must recognize his $200,000 built-in gain from the farmland in Year Five.

Recognition of the built-in gain is avoided if the property is distributed back to the contributing partner. For this purpose, any assignee or successor to the contributing partner's interest is treated as the contributing partner to the extent of the built-in gain allocable to the assignee-successor's interest.[35]

> EXAMPLE (13): Assume the same basic facts from Example (12), except that in Year Four, Dad gave his general and limited partner interest to Son. In Year Five, the partnership distributed the farmland to Son. Neither Dad nor Son recognizes gain from this distribution under §704(c)(1)(B) since Son was Dad's successor in interest.

Recognition of the built-in gain is also avoided where all partners have §704(c) built-in gain in proportion to their partnership interests and the partners effect a proportionate distribution of the entity's assets.[36]

> EXAMPLE (14): In Year One, Mom and Dad formed a partnership by contributing farmland worth $1 million. Their basis in the contributed property was $200,000. In Year Five, Mom and Dad gave all of their interests in FLP in equal shares to Son and Daughter. In Year Six, the partnership distributed the farmland in equal shares to Son and Daughter in liquidation of their interests in the entity. Because Son and Daughter are treated as the contributors of the farm under the successor-in-interest rule, and because the property is distributed to the partners in proportion to their shares of the built-in gain, §704(c)(1)(B) does not apply.

But what if not every partner has a proportionate amount of §704(c) gain and it is not possible (or desirable) to transfer the built-in gain property back to the contributing partner or his or her successor in interest? The easy solution is to wait seven years before making any distributions of contributed property that carry §704(c) gain. Alternatively, consider a sale of the contributing partner's

[35] Treas. Reg. §1.704-4(d)(2).

[36] Treas. Reg. §1.704-4(c)(6).

partnership interest to remove the §704(c) taint altogether.[37] It should be kept in mind, too, that a §754 election might reduce the sting of §704(c)(1)(B) to some extent, if the successor in interest is lucky enough to acquire the partnership interest by bequest.

2. Section 737 Gain Recognition to Contributing Partner

Section 737 generally provides that if a partner contributes appreciated property to the partnership and, within seven years of such contribution, receives a distribution of non-cash property, the contributing partner must recognize the §704(c) built-in gain (or, if less, the excess of the distributed property's value over the partner's outside basis immediately prior to the distribution minus any cash received in the same distribution).

> EXAMPLE (15): In Year One, Dad and Daughter formed a partnership when Dad contributed farmland worth $500,000 and with an adjusted basis of $300,000 in exchange for a 5% general partner interest and a 45% limited partner interest, and Daughter contributed cash in the amount of $500,000 for a 50% limited partner interest. The partnership used the cash to acquire a small parcel of vacant land in the suburbs. In Year Five, the partnership distributed the suburban land to Dad. Assuming the value of the contributed properties has not changed since contribution, Dad must recognize his $200,000 built-in gain from the farmland in Year Five.

As was the case with §704(c)(1)(B), an assignee-successor to a contributing partner's interest is treated as a contributing partner for purposes of §737's general rule.[38]

> EXAMPLE (16): Assume the same facts as the preceding example, except that in Year Four, Dad gifted his general and limited partner interests to Son. In Year Five, the partnership distributed the suburban land to Son. Assuming the value of the contributed properties has not changed since contribution, Son "steps into Dad's shoes" and must recognize in Year Five the $200,000 built-in gain from Dad's contribution of the farmland in Year One.

On its face, §737 would apply if the contributing partner received back from the partnership the appreciated property originally contributed to the partnership. Regulations recognize that because such a "return-to-sender" distribution is not taxable under §704(c)(1)(B), §737 does not apply if the contributing partner receives the property he or she originally contributed to the partnership.[39] Oddly, however, there is no rule providing that an assignee-successor to the contributing partner's interest likewise qualifies for this exception. It is therefore possible that an assignee-successor must recognize gain under §737 upon receipt of property originally contributed to the partnership by the assignee-

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[37] Because a sale of a partnership interest would trigger tax for the contributing partner, any such sale should be structured as an installment sale to defer the reporting of gain.

[38] Treas. Reg. §1.737-1(c)(2)(iii).

[39] Treas. Reg. §1.737-2(d)(1).

successor's predecessor in interest—even though the receipt of the contributed property by the same party is expressly *not* subject to §704(c)(1)(B).[40]

The moral of the story here is to postpone any distributions of §704(c) property until the partnership has held such property for seven years, as §737 only applies to distributions made within seven years of contribution.

3. Section 731(c) Treatment of Marketable Securities as Cash

Section 731(a)(1) provides that no gain is generally recognized upon a distribution from a partnership except to the extent that any cash received in the distribution exceeds the recipient partner's outside basis immediately prior to the distribution. For purposes of this rule, however, §731(c) provides that marketable securities are treated as cash (valued at fair market value as of the date of distribution).

EXAMPLE (17): Mom and Son formed a partnership when Mom contributed a collectible with a value of $100,000 and a basis of $20,000 and Son contributed $100,000 cash. The partnership used $50,000 of the cash to purchase Microsoft stock. It then distributed the Microsoft stock to Mom. Under §731(c), the stock distribution is treated as a cash distribution in the amount of $50,000, the value of the Microsoft shares distributed. Mom must recognize a gain of $30,000 because the amount of deemed cash distributed exceeds her $20,000 outside basis.

By its terms, §731(c) does not apply if one of the following events is presented: (a) the marketable securities received by the partner were those contributed by the same partner; (b) subject to some limitations, the marketable securities distributed were acquired by the entity in a nonrecognition transaction;[41] (c) the distributed securities were not marketable when first acquired by the partnership and did not become marketable for at least six months;[42] or (d) the entity is an "investment partnership" and is making a distribution to an "eligible partner."

This last exception requires elaboration. A partnership will qualify as an investment partnership if it has never been engaged in a trade or business and 90% or more of its assets, measured by value,

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[40] For a contrary view, *see* Ellen K. Harrison and Brian M. Blum, *Another View: Responding to Richard Robinson's 'Don't Nothing Last Forever'—Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 313, 315 (2003).

[41] Treas. Reg. §1.731-2(d)(1)(ii). The total cash and marketable securities acquired by the FLP in the nonrecognition transaction must be less than 20% of the value of the assets transferred by the FLP in the transaction. Furthermore, the distribution of the marketable securities must be occurring within five years of the FLP's acquisition of the securities (or, if later, within five years of the date upon which the securities became marketable).

[42] Treas. Reg. §1.731-2(d)(1)(iii). Also, the FLP must be distributing the securities within five years of the date upon which they became marketable. Moreover, the issuer of the securities must not have issued any marketable securities prior to the time the FLP first acquired the distributed securities. Isn't this fun?

have always consisted of portfolio assets.[43] And an eligible partner is any partner that contributed nothing but such portfolio assets to the partnership.[44] Notice that if the partners avoid §721(b) gain at formation by using any of the three techniques listed in Part I(A)(2) of this outline, the partnership may well be an investment partnership for purposes of §731, and the partners will likely be eligible partners. But if the partnership avoids §721(b) because 20% or more of its assets at formation do not consist of portfolio assets, as discussed in Part I(A)(1) of this outline, the entity is likely not an investment partnership, meaning this last exception to §731(c) cannot apply.

Now let's return to the first exception: marketable securities will not be treated as cash for purposes of §731 if they are distributed to the same partner that contributed them to the partnership. This is consistent with the exceptions under §§704(c)(1)(B) and 737. But here, too, just like §737, there is no rule extending the exception to a distribution of marketable securities to an assignee-successor to the contributing partner's interest.[45] In other words, those who receive a partnership interest by gift may have to recognize gain upon a distribution of marketable securities from the partnership even if those securities were contributed to the entity by the donor. And the application of this rule does not expire after seven years.

EXAMPLE (18): Mom and Dad formed a partnership by a contribution of many assets, including stock in Amazon.com. Mom and Dad gave a 10% limited partner interest to Daughter. Long after the gift, the entity distributed the Amazon.com stock to Daughter in liquidation of her interest. Daughter will be considered to have received a distribution of cash in an amount equal to the value of the Amazon.com stock pursuant to §731(c) because none of the exceptions to §731(c) apply.

As mentioned above, waiting seven years is not effective to avoid application of §731(c). One solution is to effect a proportionate distribution of any marketable securities. By doing so, one makes better use of the limitation in §731(c)(3)(B), which reduces the amount of the deemed cash distribution by the recipient partner's share of gain on the distributed securities.

EXAMPLE (19): In Year One, Mom, Son, and Daughter formed a partnership. Mom contributed stock in Starbucks Corporation worth $900,000 (in which she had a basis of $720,000) in exchange for a 4% general partner interest and an 86% limited partner interest, while Son and Daughter contributed their undivided, one-half interests in a parcel of raw land worth a total of $100,000 (in which each child had a basis of $20,000) in exchange for a 10% limited partner interest (5% held by Son and 5% held by Daughter).

[43] Treas. Reg. §1.731-2(c)(3)(i).

[44] Treas. Reg. §1.731-2(e)(2)(i).

[45] Regulation §1.731-2(d)(1) states, in relevant part that "section 731(c) and this section do not apply to the distribution of a marketable security if-(i) the security was contributed to the partnership by the distributee partner…." No mention is made of a successor in interest here.

Mom died in Year Ten, leaving her general and limited partner interests in equal shares to Son and Daughter. At the date of Mom's death, the Starbucks stock is worth $1.5 million, and the raw land is worth $500,000. Mom's estate claims a 50% combined discount on the value of the partnership interests passing to Son and Daughter, reporting a combined value of $900,000 on Mom's federal estate tax return (90% interest in a total liquidation value of $2 million, less 50%). Each child's aggregate outside basis in the partnership is now $470,000 ($450,000 attributable to the 90% interest from Mom that was stepped-up under §1014 plus $20,000 attributable to the 10% interest acquired through their contribution).

If the partnership distributes the Starbucks stock in equal shares to Son and Daughter, each child is deemed to receive a cash distribution of only $360,000 (not $750,000), because the $390,000 gain that would be allocated to each child from the entity's sale of the stock reduces the deemed cash distribution pursuant to §731(c)(3)(B).[46] This deemed distribution is not taxable to either child because each has an outside basis in excess of the deemed distribution amount. The distribution will reduce each child's outside basis to $110,000 ($470,000 minus $360,000 deemed cash).[47]

If, instead, FLP distributes the raw land plus $500,000 of the Starbucks stock to Son ($1 million total) and the remaining $1 million of Starbucks stock to Daughter, the result changes. Daughter is deemed to receive a cash distribution of $610,000 (not $1 million), because the $390,000 gain that would be allocated to her from the partnership's sale of the stock reduced the deemed cash distribution under §731(c)(3)(B). Because Daughter's outside basis immediately prior to the distribution is $470,000, Daughter must recognize $140,000 of gain thanks to the deemed cash distribution. The disproportionate distribution of the Starbucks stock to Daughter in this case forced the recognition of gain that would not have occurred in a proportionate distribution of the stock.

Notice here that a §754 election might be detrimental to the successors in interest. An increase in inside basis lessens the benefit of the §731(c)(3)(B) reduction for the distributee's distributive share of gain on the property. If the partnership would realize no gain if it sold the distributed property, there is no reduction in the amount of the deemed cash distribution. Thus, while the §754 election is generally beneficial in the context of §§704(c)(1)(B) and 737, it can be disadvantageous for purposes of §731(c).

The §731(c)(3)(B) gain limitation is handy where the partnership distributes marketable securities with a low inside basis. Partners should therefore be reluctant to distribute freshly-purchased marketable securities with an inside basis (nearly) equal to their value. Likewise, marketable securities that have recently declined in value are less attractive candidates for distribution to donee-partners.

[46] For convenience, this Example assumes no §754 election is in place.

[47] Note that §704(c)(1)(B) does not apply in this Example because the distribution occurs after the seven-year period during which §704(c)(1)(B) is alive.

While a proportionate distribution of marketable securities may be helpful in avoiding §731(c), it presents problems outside of the tax realm. Beneficiaries are often reluctant to hold assets as tenants in common (proof that the minority interest discount and, to a greater extent, the marketability discount are quite real). If so, then perhaps the best solution to the §731(c) problem lies back in the exceptions: where possible, the FLP should own only portfolio assets at all times and care should be taken to make sure each partner is an "eligible partner." Contributions of non-portfolio assets by children at formation of the FLP, sometimes used as a formation strategy in lieu of giving fractional interests in one or more of the contributed assets prior to formation, can be fatal in qualifying for the investment partnership exception since the children are not eligible partners.

One *bad* solution would be to reallocate the FLP's gain to the distribute partner in an effort to maximize use of the §731(c)(3)(B) gain limitation. Regulations give the Service the power to disregard a blatant attempt to avoid §731(c)(1) through a change in partnership allocations.[48]

4. Ordering Rules

Because one, two, or all three of the Code provisions described above may be triggered upon the liquidation of a family partnership, there must be some mechanism for sorting out how these provisions interact so that the same targets are not taxed twice. Regulation §1.731-2(g)(1)(i) provides such an ordering rule. It says that one must *first* apply <u>§704(c)(1)(B)</u>, which, again, provides that a contributing partner recognizes the built-in gain or loss from contributed property if such property is distributed to another partner within seven years of the contribution. Remember that §704(c)(1)(B) does not apply to the extent the contributed property is distributed back to the contributing partner or to the contributing partner's transferee.[49]

Second, one applies <u>§731(c)</u>, which treats a distribution of marketable securities to a partner as a distribution of cash. Accordingly, under §731(a), the distribution will be taxable to the extent it exceeds the recipient partner's outside basis immediately prior to the distribution. Under §731(c)(3)(B), the amount of the deemed cash distribution can be determined under the following formula:

Fair market value of distributed securities
less Distributee's share of net *gain* on sale of all similar partnership marketable securities
<u>*plus* Distributee's share of net *gain* on sale of *retained* similar partnership marketable securities</u>
Amount of deemed cash distribution

The effect of this formula is to tax the recipient partner on *all but* his or her share of the built-in gain attributable to the distributed securities. The gain portion will be taxed under §737 in the next (and final) step.

Finally, one applies <u>§737</u>, in which a contributing partner recognizes built-in gain (not loss) from contributed property if the contributing partner receives a non-cash asset in a distribution within seven

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[48] Treas. Reg. §1.731-2(h)(1).

[49] Treas. Reg. §1.704-4(d)(2).

years of the contribution. The amount of gain recognized by the contributing partner is the *lesser of* the following two amounts:

§737(a)(1) Amount: EXCESS DISTRIBUTION

Fair market value of non-cash property distributed to contributing partner
less Contributing partner's "reduced outside basis" (OB less cash in same distribution)
"Excess distribution"

§737(a)(2) / §737(b) Amount: NET PRECONTRIBUTION GAIN

Amount of §704(c)(1)(B) gain allocable to contributing partner
if all §704(c) assets were distributed to other partners

Two examples illustrate how this ordering rule operates in the typical family partnership setting.

EXAMPLE (20): Lear formed a limited liability company in Year One by transferring the following three assets in exchange for all of the voting and nonvoting interests in the entity:

Asset	Value	Adjusted Basis
Raw Land	$1,800,000	$1,200,000
Painting	$1,800,000	$1,500,000
Yacht	$2,400,000	$1,200,000

Over the course of Years One through Six, Lear effects gift transfers of LLC interests in equal shares to his three daughters, Regan, Goneril, and Cordelia. By the end of Lear's inter vivos giving, the daughters own all of the interests in the LLC (each has a one-third interest).

The daughters decided to liquidate the LLC in Year Seven. At the time of liquidation, the assets had the same values they had at the time of Lear's contribution in Year One. Regan received the raw land, Goneril received the painting, and Cordelia received the yacht. To calm the "tempest," Cordelia contributed $400,000 to the LLC immediately prior to liquidation, and the cash was split between Regan and Goneril. That way, everyone walked away with $2 million in goodies. At the time of liquidation, each daughter's outside basis was $1.3 million.

In this Example, §731(c) does not apply because the LLC does not own any marketable securities. Thus, Example 20 illustrates only the application of §§704(c)(1)(B) and 737. The analysis is presented separately for each partner.

Example 20 Consequences to Regan: Section 704(c)(1)(B) applies to the painting distributed to Goneril and to the yacht distributed to Cordelia. From §704(c)(1)(B)'s perspective, Regan (through her predecessor-in-interest, Lear) contributed a share of these assets to the partnership and watched the partnership distribute those interests to other partners within seven years of contribution. Section 704(c)(1)(B) does not apply to the raw land she receives because the return-to-sender exception that would apply to Lear if he got back the land he contributed applies to Regan as Lear's successor-in-interest. If the partnership sold the painting for its fair market value, the partnership would recognize a

$300,000 gain (amount realized $1,800,000, less $1,500,000 inside basis). As a one-third partner (and a one-third successor to Lear's interest), Regan's share of that gain would be $100,000. Accordingly, Regan must recognize a $100,000 gain from the distribution of the painting to Goneril, although the character of that gain on these facts is likely long-term capital gain. With respect to the yacht, the partnership would recognize a $1.2 million gain if it were sold ($2.4 million amount realized, $1.2 million inside basis). Regan's share of that gain would be $400,000, so she must also recognize this gain from the distribution of the yacht to Cordelia. Thus, Regan recognizes a total $500,000 gain under §704(c)(1)(B), $100,000 attributable to the painting and $400,000 attributable to the yacht.

It is important here to consider the effect of §704(c)(1)(B) on Regan's outside basis. Specifically, Regan's outside basis is increased by the $500,000 gain recognized.[50] This brings her outside basis to $1.8 million.

Under §737, Regan must recognize the lesser of the "excess distribution" amount and the "net precontribution gain." The excess distribution amount is determined by subtracting her "reduced outside basis" from the value of the property received in the distribution. Regan's reduced outside basis is her outside basis after the application of §§704(c)(1)(B) and 731(c), reduced by any cash received in the "same transaction." Here, the $200,000 cash payment from Cordelia is part of the same transaction as the land distribution to Regan, so Regan's reduced outside basis would be $1.6 million (the $1.8 million outside basis computed in the preceding paragraph less $200,000). The land, worth $1.8 million, exceeds this reduced outside basis by $200,000, and thus the excess distribution amount is $200,000.

The "net precontribution gain" amount is simply Regan's share of the gain to the partnership had it sold the land instead of distributing it to her. Had the partnership sold the land, its gain would have been $600,000 ($1.8 million amount realized, $1.2 million inside basis), and Regan's share of that gain would have been $200,000. The net precontribution gain amount thus equals the excess distribution amount, meaning Regan must recognize $200,000 gain under §737. Had the property been distributed to the original contributing partner, Lear, §737 would not apply at all because of the return-to-sender exception. There is no express authority that would permit Regan to claim this exception as Lear's successor, although some commentators take the position that Regan can (or at least should be able to) claim this exception.

The Example 20 analysis for Regan is summarized in Fig. 1.

[50] Treas. Reg. §1.704-4(e)(1).

FIG. 1 – EXAMPLE 20 TAX CONSEQUENCES TO REGAN

(1) §704(c)(1)(B):

* Painting (distributed to Goneril) →	if the partnership sold the asset for FMV, there would be $300,000 of gain to the partnership. Regan's share of that gain would be **$100,000**.
* Yacht (distributed to Cordelia) →	if the partnership sold the asset for FMV, there would be $1,200,000 of gain to the partnership. Regan's share of that gain would be **$400,000**.

*Therefore, Regan recognizes a total **$500,000 gain** under §704(c)(1)(B).*

(2) §731(c): → does not apply because no marketable securities

(3) §737: * Raw Land (received by Regan)

737(a)(1) Excess Distribution		737(a)(2)/(b) Net Precontrib Gain
FMV	1,800,000	If the partnership sold the asset for FMV
- reduced OB	(1,600,000)	there would be $600,000 of gain to the
ED	***200,000***	partnership, ***$200,000*** allocable to Regan

*Therefore, Regan likely recognizes a total **$200,000 gain** under §737.*

As far as Regan is concerned, this is a fair result. Under §732(b), Regan's basis in the raw land will be $1.8 million. Specifically, Regan's basis in the land is her outside basis immediately prior to the distribution ($1.3 million) plus the gain recognized under §704(c)(1)(B) ($500,000), plus her gain recognized under §737 ($200,000), less the cash received in the same transaction ($200,000).[51] If she sells the raw land the next day for its fair market value, $1.8 million, she will recognize no further gain or loss. This is fitting since she has already recognized the difference between the $2 million received in the liquidation ($1,800,000 of land plus $200,000 cash) and her pre-liquidation outside basis ($1.3 million).

Example 20 Consequences to Goneril: Fortunately, the results for Goneril are similar to those for Regan. Section 704(c)(1)(B) applies to the raw land distributed to Regan and to the yacht distributed to Cordelia. Section 704(c)(1)(B) does not apply to the painting she receives because the return-to-sender exception that would protect Lear from taxation if he received the painting in a distribution applies to Goneril as Lear's successor-in-interest. If the partnership sold the raw land for its fair market value, the partnership would recognize a $600,000 gain (amount realized $1.8 million, less $1.2 million inside basis). Goneril's share of that gain would be $200,000. Accordingly, Goneril recognizes a $200,000 gain from the distribution of the raw land to Regan. With respect to the yacht, the partnership would recognize a $1.2 million gain if it were sold (as shown in the analysis for Regan). Goneril's share of that gain would be $400,000, and this amount too is recognized. Thus, Goneril recognizes a total $600,000 gain under §704(c)(1)(B), $200,000 attributable to the raw land and $400,000 attributable to the yacht. This would increase Goneril's outside basis to $1.9 million ($1.3 million plus the $600,000 of gain recognized under §704(c)(1)(B)).

[51] Treas. Reg. §§1.704-4(e)(1); 1.737-3(b)(1).

Under §737, Goneril must compare the "excess distribution" amount and the "net precontribution gain." The excess distribution amount in turn requires a determination of Goneril's "reduced outside basis," meaning her outside basis after the application of §§704(c)(1)(B) and 731(c), reduced by any cash received in the same transaction. Again, the $200,000 cash payment from Cordelia is part of the same transaction as the distribution of the painting to Goneril, so Goneril's reduced outside basis would be $1.7 million (the $1.9 million outside basis computed in the preceding paragraph less $200,000). The painting, worth $1.8 million, exceeds this reduced outside basis by $100,000, so the excess distribution amount is $100,000. The "net precontribution gain" amount is likewise $100,000, for that would be Goneril's share of the gain to the partnership had it sold the painting instead of distributing it to her. Had the partnership sold the painting, its gain would have been $300,000 (as computed in the analysis for Regan), and Goneril's share of that gain would have been $100,000. Goneril must therefore recognize $100,000 of gain under §737. Had the property been distributed to the original contributing partner, Lear, §737 would not apply at all because of the return-to-sender exception. There is no express authority that would permit Goneril to claim this exception as Lear's successor; again, however, some commentators take the position that she can (or at least should be able to) claim this exception.

Fig. 2 summarizes the analysis for Goneril.

Fig. 2 – Example 20 Tax Consequences to Goneril

(1) §704(c)(1)(B):

* Raw Land (distributed to Regan) →	if the partnership sold the asset for FMV, there would be $600,000 of gain to the partnership. Goneril's share of that gain would be **$200,000**.
* Yacht (distributed to Cordelia) →	if the partnership sold the asset for FMV, there would be $1,200,000 of gain to the partnership. Goneril's share of that gain would be **$400,000**.

*Therefore, Goneril recognizes a total **$600,000 gain** under §704(c)(1)(B).*

(2) §731(c): → does not apply because no marketable securities

(3) §737: * Painting (received by Goneril)

737(a)(1) Excess Distribution		737(a)(2)/(b) Net Precontrib Gain
FMV	1,800,000	If the partnership sold the asset for FMV
- reduced OB	(1,700,000)	there would be $300,000 of gain to the
ED	***100,000***	partnership, ***$100,000*** allocable to Goneril

*Therefore, Goneril likely recognizes a total **$100,000 gain** under §737.*

Here, too, this is a fair result. Under §732(b), Goneril's basis in the painting will be $1.8 million. Specifically, her basis in the painting is her outside basis immediately prior to the distribution ($1.3

million) plus the gain recognized under §704(c)(1)(B) ($600,000), plus her gain recognized under §737 ($100,000), less the cash received in the same transaction ($200,000).[52] If she sells the painting the next day for its fair market value, $1.8 million, she will recognize no further gain or loss, again because the $700,000 difference between the $2 million Goneril receives in the liquidation ($1.8 million of painting plus $200,000 in cash) and her $1.3 million pre-liquidation outside basis is recognized upon liquidation.

Example 20 Consequences to Cordelia: Even less explanation is needed for Cordelia. Section 704(c)(1)(B) will apply to the raw land distributed to Regan (like Goneril, Cordelia will have to recognize $200,000 of gain) and to the painting distributed to Goneril (where, like Regan, Cordelia will recognize $100,000 of gain). Cordelia's total gain under §704(c)(1)(B) is $300,000. This gain will increase her outside basis from $1.3 million to $1.6 million.

Under §737, Cordelia must compare the "excess distribution" amount and the "net precontribution gain." The excess distribution amount requires a determination of Goneril's "reduced outside basis," meaning her outside basis after the application of §§704(c)(1)(B) and 731(c), reduced by any cash received in the same transaction. Here, the $400,000 cash *paid* by Cordelia should be considered as part of her outside basis under §722. Cordelia receives no cash in the liquidation, so her "reduced outside basis" really is not reduced at all—it's $2 million (the $1.6 million outside basis computed in the preceding paragraph plus $400,000). The painting, worth $2.4 million, exceeds this reduced outside basis by $400,000, so the excess distribution amount is $400,000. The "net precontribution gain" amount is also $400,000, for that is Cordelia's share of the $1.2 million gain to the partnership had it sold the yacht instead of distributing it to her. Cordelia will therefore recognize $400,000 of gain upon receipt of the yacht. Had the yacht been distributed to the original contributing partner, Lear, §737 would not apply at all because of the return-to-sender exception. Once again, there is no express authority that would permit Cordelia to claim this exception as Lear's successor, although some commentators take the position that she can (or at least should be able to) claim it.

Fig. 3 (on the next page) summarizes the results for Cordelia under Example 20.

[52] Treas. Reg. §§1.704-4(e)(1); 1.737-3(b)(1).

FIG. 3 – EXAMPLE 20 TAX CONSEQUENCES TO CORDELIA

<u>(1) §704(c)(1)(B)</u>:

* Raw Land (distributed to Regan) →	if the partnership sold the asset for FMV, there would be $600,000 of gain to the partnership. Cordelia's share of that gain would be **<u>$200,000</u>**.
* Painting (distributed to Goneril) →	if the partnership sold the asset for FMV, there would be $300,000 of gain to the partnership. Cordelia's share of that gain would be **<u>$100,000</u>**.

*Therefore, Cordelia recognizes a total **<u>$300,000 gain</u>** under §704(c)(1)(B).*

<u>(2) §731(c)</u>: → does not apply because no marketable securities

<u>(3) §737</u>: * Yacht (received by Cordelia)

<u>737(a)(1) Excess Distribution</u>		<u>737(a)(2)/(b) Net Precontrib Gain</u>
FMV	2,400,000	If the partnership sold the asset for FMV
- reduced OB	<u>(2,000,000)</u>	there would be $1,200,000 of gain to the
ED	***400,000***	partnership, ***$400,000*** allocable to Cordelia

*Therefore, Cordelia recognizes a total **<u>$400,000 gain</u>** under §737.*

Under §732(b), Cordelia's basis in the yacht is $2.4 million, her outside basis immediately prior to the distribution ($1.3 million) plus the gain recognized under §704(c)(1)(B) ($300,000), plus her gain recognized under §737 ($400,000), plus the cash paid to the other partners as part of acquiring the asset ($400,000). If she sells the yacht the next day for its fair market value, $2.4 million, she will recognize no further gain or loss. Again, this is correct because §§704(c)(1)(B) and 737 force Cordelia to recognize the entire $700,000 difference between the amount Cordelia received in the liquidation ($2,400,000 of yacht) and her cost to acquire the property (her pre-liquidation outside basis of $1.3 million and her $400,000 of cash).

Example 21 illustrates the impact of adding §731(c) to the mix by introducing marketable securities into the picture. It also illustrates how the distribution of loss property can wreak havoc on the recipient partner, probably unintentionally.

EXAMPLE (21): Lear formed a limited liability company in Year One by transferring the following three assets in exchange for all of the voting and nonvoting interests in the entity:

Asset	Value	Adjusted Basis
Microsoft Stock	$1,500,000	$ 300,000
United Airlines Stock	$1,500,000	$2,100,000
Raw Land	$1,500,000	$ 600,000

Over the course of Years One through Six, Lear effects gift transfers of LLC interests in equal shares to his three daughters, Regan, Goneril, and Cordelia. By the end of Lear's inter vivos giving, the daughters own all of the interests in the LLC (each has a one-third interest).

The daughters decided to liquidate the LLC in Year Seven. At the time of liquidation, the assets have the same values they had at the time of Lear's contribution in Year One. Regan receives the Microsoft shares, Goneril receives the United Airlines shares, and Cordelia receives the land.

What are the federal income tax consequences of the liquidating distributions, assuming each daughter's outside basis immediately prior to the liquidation was $1 million?

As with Example 20, the analysis here will be presented for each partner.

Example 21 Consequences to Regan: Section 704(c)(1)(B) will apply to the distributions of the United stock to Goneril and the raw land to Cordelia. Because the return-to-sender exception applies to Regan as Lear's successor in interest, §704(c)(1)(B) has no effect on Regan's receipt of the Microsoft stock. The analysis here is similar to the analysis for Example 20: Regan must recognize her share of the partnership's gain upon a hypothetical sale of the raw land (her share of the $900,000 gain would be $300,000) and her share of the partnership's loss upon a hypothetical sale of the United stock (her share of the $600,000 loss would be $200,000). Combined, the gain and the loss change Regan's outside basis to $1.1 million ($1 million plus $300,000 gain minus $200,000 loss).[53]

Under §731(c), Regan must treat the non-gain portion of the Microsoft stock as a deemed cash distribution from the partnership. According to §731(c)(3)(B), the non-gain portion is the excess of the stock's value ($1.5 million) over Regan's share of the gain if the partnership had sold the stock instead of distributing it in liquidation. This adjustment is required because §737 will tax Regan on her share of this hypothetical gain (unless those commentators who insist that the return-to-sender exception applies to transferees are correct). If the partnership sold the Microsoft stock for fair market value, it would realize a $1.2 million gain ($1.5 million amount realized, $300,000 basis), and Regan's one-third share of that gain would be $400,000. Thus, the deemed cash distribution amount to Regan is $1.1 million ($1.5 million less $400,000). Since the amount of the deemed cash distribution exactly equals Regan's outside

[53] Treas. Reg. §1.731-2(g)(1)(ii).

basis as adjusted for the gain and loss under §704(c)(1)(B), she recognizes no gain from this deemed cash distribution, although her outside basis is reduced to zero.[54]

Finally, §737 applies to the $400,000 gain portion of the Microsoft stock that was not treated as deemed cash for purposes of §731(c).[55] Because her outside basis was reduced to zero through the combined operation of §§704(c)(1)(B) and 731(c), the excess distribution amount for §737 purposes is the full $400,000. Not surprisingly, this is also the amount of net precontribution gain, for the $400,000 at play here represents pure gain, all of which is attributable to Regan. Consequently, Regan recognizes $400,000 of gain under §737. The results for Regan under Example 21 are summarized in Fig. 4.

FIG. 4 – EXAMPLE 21 TAX CONSEQUENCES TO REGAN

(1) §704(c)(1)(B):

* United (distributed to Goneril) →	if the partnership sold the asset for FMV, there would be $600,000 of loss to the partnership.
	* Regan's share of that loss would be **($200,000)**.
* Land (distributed to Cordelia) →	if the partnership sold the asset for FMV, there would be $900,000 of gain to the partnership.
	* Regan's share of that gain would be **$300,000**.

Therefore, Regan recognizes **($200,000) of loss** and **$300,000 of gain** under §704(c)(1)(B).

(2) §731(c): → Microsoft shares

Fair Market Value:	$1,500,000	
less Share of Net Gain:	(400,000)	← if partnership sold for FMV, her
Deemed Cash Distribution:	***$1,100,000***	share of the $1,200,000 gain

Beginning Outside Basis:	1,000,000		
704(c)(1)(B) Gain:	300,000		
704(c)(1)(B) Loss:	(200,000)		
Pre-Cash Outside Basis:		1,100,000	[see Reg. §1.731-2(g)(1)(ii)]
731(c) Cash		***(1,100,000)***	
Remaining Outside Basis:		0	

So Regan recognizes **no gain** under §731(c).

(3) §737: → applies to the $400,000 portion of the Microsoft shares that was not treated as cash [Reg. §1.731-2(g)(1)(iii)(A)]

* Microsoft (received by Regan)

737(a)(1) Excess Distribution		737(a)(2)/(b) Net Precontrib Gain
FMV	400,000	If the partnership sold the asset for FMV
- reduced OB	(0)	there would be $1,200,000 of gain to the
ED	***400,000***	partnership, ***$400,000*** allocable to Regan

Therefore, Regan recognizes a total **$400,000 gain** under §737.

[54] Treas. Reg. §1.737-1(b)(3)(i).

[55] Treas. Reg. §1.731-2(g)(1)(iii)(A).

Under §732(b), Regan's basis in the Microsoft stock will be $1.5 million (her $1 million outside basis, increased by the $100,000 net gain under §704(c)(1)(B) and the $400,000 gain under §737). If she sells the stock the next day for its fair market value, also $1.5 million, she will recognize no further gain or loss. In summary, then, the $500,000 difference between the amount Regan receives in the liquidation ($1.5 million in stock) and her pre-liquidation outside basis ($1 million) is recognized entirely upon receipt of the shares. Importantly, however, that net gain comes in the form of $700,000 of gain and $200,000 of loss, and these two items may not perfectly offset for federal income tax purposes.

Example 21 Consequences to Goneril: Though some have little sympathy for Shakespeare's Goneril, this Example's Goneril is a tragic figure. Like Regan, Goneril will recognize a $300,000 gain from the distribution of the land to Cordelia under §704(c)(1)(B). Section 704(c)(1)(B) also requires Goneril to recognize a $400,000 gain from Regan's receipt of the Microsoft shares, for a sale by the partnership of the Microsoft stock would trigger a $1.2 million gain, and $400,000 of that gain would be allocable to Goneril. Altogether, Goneril recognizes $700,000 of gain under §704(c)(1)(B). This substantial gain will be added to Goneril's outside basis, raising it to $1.7 million.

Section 731(c) will treat Goneril's receipt of the $1.5 million in United stock as the receipt of cash. Because the United stock is loss property, there is no "gain portion" to carve out from the value of the shares. Accordingly, the full $1.5 million in value will be treated as cash. While a $1.5 million deemed cash distribution would normally cause the oxygen masks to release from their overhead compartments, Goneril suffers no loss of cabin pressure here because her outside basis had swollen to $1.7 million thanks to the $700,000 gain from the application of §704(c)(1)(B). In fact, the deemed cash distribution leaves Goneril with $200,000 of outside basis.

Section 737 does not apply to Goneril at all because the entirety of the United stock was treated as a deemed cash distribution under §731(c).[56] This makes sense because there is no "net precontribution gain" on this loss property, meaning the "lesser of" amount for purposes of §737(a) would necessarily be zero. But Goneril is left with $200,000 of unused outside basis. One might think that Goneril could deduct this amount as a loss under §731(a)(2) because Goneril received a deemed distribution of cash from the partnership in liquidation of her interest. Unfortunately, such is not the case. Section 731(c)(1) expressly provides that Goneril's receipt of the United stock is treated as cash *only* for purposes of §§731(a)(1) and 737. Goneril's stock is not treated as cash for purposes of §731(a)(2), so she cannot claim the loss.

The loss will be preserved in her basis in the United shares. Under §732(b), Goneril's basis in the United stock will be $1.7 million (her $1 million original outside basis plus the $700,000 total gain under §704(c)(1)(B)). If she later sells the stock for its fair market value at liquidation, $1.5 million, she can finally recognize the $200,000 loss. In effect, the $500,000 difference between the value of the United Stock and her pre-liquidation outside basis is accounted for in the harshest of ways: she must recognize $700,000 of gain first and then sell the distributed property to claim what hopefully proves to be an offsetting $200,000 loss. Congress gets more than the pound of flesh to which it is entitled.

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[56] Treas. Reg. §1.731-2(g)(1)(iii)(A).

The results for Goneril are summarized in Fig. 5.

FIG. 5 – EXAMPLE 21 TAX CONSEQUENCES TO GONERIL

(1) §704(c)(1)(B)

* Microsoft (distributed to Regan) → if the partnership sold the asset for FMV, there would be $1,200,000 of gain to the partnership.

Goneril's share of that gain would be **$400,000**.

* Land (distributed to Cordelia) → if the partnership sold the asset for FMV, there would be $900,000 of gain to the partnership.

Goneril's share of that gain would be **$300,000**.

Therefore, Goneril recognizes **$700,000 of gain** under §704(c)(1)(B).

(2) §731(c): → United shares

Fair Market Value:	$1,500,000	
less Share of Net Gain:	(0)	← if partnership sold for FMV,
Deemed Cash Distribution:	***$1,500,000***	there would be no gain!

Beginning Outside Basis:		1,000,000	
704(c)(1)(B) Gain:	700,000		
Pre-Cash Outside Basis:		1,700,000	[see Treas. Reg. §1.731-2(g)(1)(ii)]
731(c) Cash		***(1,500,000)***	
Remaining Outside Basis:		200,000	

So Goneril recognizes **no gain** under §731(c).

(3) §737: → does not apply because the entire United distribution was treated as cash [Treas. Reg. §1.731-2(g)(1)(iii)(A)]

The numbers prove this to be true anyway:

737(a)(1) Excess Distribution		737(a)(2)/(b) Net Precontrib Gain
FMV	0	If the partnership sold the asset for FMV
- reduced OB	(200,000)	there would be no gain to the partnership
ED	***0***	

Therefore, Goneril recognizes **no gain** under §737.

Example 21 Consequences to Cordelia: The analysis here is not novel, for Cordelia is the only partner that does not receive marketable securities, rendering §731(c) moot. Under §704(c)(1)(B), Cordelia will recognize a $400,000 gain from the distribution of the Microsoft shares to Regan (just like Goneril), and Cordelia will recognize a $200,000 loss from the distribution of the United shares to Goneril (as was the case for Regan). The net $200,000 gain from application of §704(c)(1)(B) will increase Cordelia's outside basis to $1.2 million.

Section 737 will tax Cordelia on her receipt of the land, again because the return-to-sender exception likely does not apply to Cordelia as Lear's successor in interest. The excess distribution amount is $300,000 ($1.5 million value of the land less Cordelia's $1.2 million outside basis), and that is also the amount of the net precontribution gain (if the partnership sold the land instead of distributing it, the partnership would realize a $900,000 gain, $300,000 of which would be allocated to Cordelia). Therefore, Regan recognizes a $300,000 gain under §737.

These results are summarized in Fig. 6.

FIG. 6 – EXAMPLE 21 TAX CONSEQUENCES TO CORDELIA

(1) §704(c)(1)(B):

* Microsoft (distributed to Regan) →	if the partnership sold the asset for FMV, there would be $1,200,000 of gain to the partnership. Cordelia's share of that gain would be **$400,000**.
* United (distributed to Goneril) →	if the partnership sold the asset for FMV, there would be $600,000 of loss to the partnership. Cordelia's share of that loss would be **($200,000)**.

Therefore, Cordelia recognizes **$400,000 of gain** and **($200,000) of loss** under §704(c)(1)(B).

Beginning Outside Basis:	1,000,000	
704(c)(1)(B) Gain:	400,000	
704(c)(1)(B) Loss:	(200,000)	
Pre-Cash Outside Basis:	1,200,000	[see Treas. Reg. §1.731-2(g)(1)(ii)]

(2) §731(c): Does not apply because Cordelia received no marketable securities.

(3) §737: → * Land (received by Cordelia)

737(a)(1) Excess Distribution		737(a)(2)/(b) Net Precontrib Gain
FMV	1,500,000	If the partnership sold the asset for FMV
- reduced OB	(1,200,000)	there would be $900,000 of gain to the
ED	***300,000***	partnership, ***$300,000*** allocable to Cordelia

Therefore, Cordelia recognizes a total **$300,000 gain** under §737.

Under §732(b), Cordelia's basis in the land will be $1.5 million ($1 million outside basis plus the $200,000 net gain under §704(c)(1)(B) plus the $300,000 gain under §737). If she sells the land the next day for its fair market value, $1.5 million, she will recognize no further gain or loss. In summary, then, the $500,000 difference between the amount Cordelia receives in the liquidation ($1.5 million in land) and her pre-liquidation outside basis ($1 million) is recognized entirely upon receipt of the land.

5. Thoughts on the Ordering Rules

Although §731(c) applied to the partners who received marketable securities in Example 21, neither partner recognized any gain because taxable distributions to other partners under §704(c)(1)(B) increased outside basis to the point that the deemed cash distributions were not taxable. In what situations, then, would §731(c) trigger a recognized gain for the partner receiving marketable securities from a liquidating family partnership? Three scenarios come readily to mind. First, if the partnership's other assets were loss properties, §704(c)(1)(B) would reduce outside basis, increasing the risk of taxation from the receipt of deemed cash. Second, if the aggregate outside bases of the partners were substantially less than the aggregate inside bases of the partnership's assets, there is a much greater chance for a taxable deemed-cash distribution. This scenario can happen if the partners have not agreed to a §754 election, for instance. Finally, and perhaps most likely, a deemed cash distribution would be taxable if the liquidation occurred more than seven years after the date when the partnership received its assets via contribution. At such time, §704(c)(1)(B) would no longer apply, thus preventing a build-up of outside basis.

Where marketable securities are not involved, §§704(c)(1)(B) and 737 by themselves effectively transform the liquidation of a family partnership into a completely taxable event. Example 20 showed that the partners recognized all of their pre-liquidation gain at the time of liquidation, even though the general principle states that in-kind partnership liquidations are tax-free. The results in Example 20 should not be read to mean that all family partnership liquidation transactions will be completely taxable. Had there been a disparity between the aggregate inside bases and aggregate outside bases, for instance, the partners may well have been able to defer some portion of the pre-liquidation gain. But in the traditional family partnership setting, such a disparity is rare. In most cases, then, the moral of the story is to make sure seven years pass between the contribution of appreciated property to the family partnership and liquidating distributions to the founding partners' successors in interest.

IV. CONCLUSION

A partnership can offer significant wealth transfer tax advantages. With proper planning throughout the life of the entity, estate planning clients can also maximize the advantages of pass-through taxation without significant risk of falling into the federal income tax traps applicable to all partnerships and those specifically designed for family partnerships.