

Federal Income Taxation of Trusts and Estates

Federal Income Taxation of Trusts and Estates

Cases, Problems, and Materials

FOURTH EDITION

Mark L. Ascher

HAYDEN W. HEAD REGENTS CHAIR FOR FACULTY EXCELLENCE
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Robert T. Danforth

JOHN LUCIAN SMITH, JR. MEMORIAL PROFESSOR OF LAW
WASHINGTON AND LEE UNIVERSITY SCHOOL OF LAW



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Preface

This book began as a set of course materials prepared by Professor Ascher when he first went into teaching in 1982. Professor Danforth joined the book as a co-author for the third edition. Now in its fourth edition, the book has new cases, problems, and other materials; the essential approach of the book, however, remains the same. Over the years the book has profited from comments and criticisms of numerous classes taught by the authors at the University of Arizona, the University of Miami, the University of Missouri, New York University, the University of Texas, and Washington and Lee University, as well as from the suggestions of our faculty colleagues at other schools. To all those who have contributed to the success of this book, we extend our warmest thanks.

This book is not solely for the relatively few instructors who presently teach classes on subchapter J. The earth-shattering changes in the federal wealth transfer taxes (particularly with respect to the unified credit) that began with the Tax Reform Act of 1976 and blossomed in the Economic Recovery Tax Act of 1981 had as a central feature a congressional intention to make those taxes applicable to fewer and fewer taxpayers. Twenty years later, the Economic Growth and Tax Relief Reconciliation Act of 2001 implemented a phased-in increase of the estate tax exclusion to \$3,500,000. Most recently, the Tax Cuts and Jobs Act of 2017 again increased the base amount of the exclusion, to \$10,000,000, through 2025. As a result, the estate tax now applies to an incredibly small number of estates.

Yet the federal income tax rolls merrily along. We all know that the income tax applies to trusts and estates. Still, almost all of us—even the I.R.S.—have frequently underestimated the importance of income tax considerations in both our practices and our teaching. Section 1(e) of the Code subjects trusts and estates to an onerously compressed rate schedule. Section 1411 imposes an additional tax equal in many instances to 3.8 percent of the “undistributed net investment income” of the trust or estate. One therefore ignores at one’s peril such topics as the distribution deduction and the grantor trust rules—mechanisms designed to shift the income tax liability of an estate or trust to one or more individuals, who are often taxed at considerably lower rates. Teachers in the wealth transfer area thus face a challenge. They can continue to focus exclusively on the decreasingly relevant taxes on gratuitous transfers or broaden their teaching packages to include the subjects of this course.

This course is not easy to teach. However, we really do believe that this book takes student and teacher alike firmly enough in hand that any teacher reasonably well-grounded in the basics of federal income taxation can successfully survive a first

run through the course. A teacher's manual is available from the publisher. For those who wish to do additional reading, we recommend the following:

B. Abbin & F. Schafer, *Income Taxation of Fiduciaries and Beneficiaries* (2017).

L. Boyle & J. Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* (16th ed. 2015).

M. Ferguson & M. Ascher, *Federal Income Taxation of Estates, Trusts & Beneficiaries* (4th ed. 2016).

H. Zaritsky, N. Lane & R. Danforth, *Federal Income Taxation of Estates and Trusts* (3d ed. 2001, supplemented semi-annually).

We also recommend an article that nicely attempts to summarize subchapter J: Sherman, *All You Really Need to Know About Subchapter J You Learned from This Article*, 63 Mo. L. Rev. 1 (1998).

Unless otherwise indicated, all section references are to the Internal Revenue Code. In a deliberate effort to force students to deal directly with the Code, we have deleted from the reproduced materials almost all quotations of Code provisions. Students must, therefore, possess and be willing frequently to refer to a current version of the Code. References to obsolete Code provisions are, unfortunately, unavoidable, but we have tried hard to identify such references for the reader. We have tried to indicate all omissions, except footnotes, in reproduced materials. The remaining footnotes retain their original numbering.

In past editions, we have included the most recent version of the Uniform Principal and Income Act as an appendix. At the time of publication of this fourth edition, however, the National Conference of Commissioners on Uniform State Laws was poised to adopt the Uniform Fiduciary Income and Principal Act (2018). It is likely therefore that, during the life of this fourth edition, many jurisdictions will adopt the new uniform act, while others will continue to follow its predecessor, the Uniform Principal and Income Act (1997). Because both uniform acts are readily available in electronic form, we leave it to the judgment of individual instructors which of the two uniform acts they wish for their students to consult. The fourth edition includes citations to both uniform acts where relevant.

Mark L. Ascher
Austin, Texas

Robert T. Danforth
Lexington, Virginia

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Introduction

This book examines federal income taxation of trusts and estates. It does not deal with federal estate and gift taxation. The federal estate and gift taxes are excise taxes on the transfer of property at death or by gift. They are imposed by chapter 11 (sections 2001 to 2210) and chapter 12 (sections 2501 to 2524) of subtitle B (“Estate and Gift Taxes”) of the Internal Revenue Code. The estate and gift taxes have little to do with how the income of trusts and estates is taxed. They are taxes on gratuitous transfers of property, not on income generated by that property.

Trusts and estates pay income taxes much as the rest of us do. Each year we add up what we take in, subtract out various exclusions and deductions, and pay a percentage of the remainder to the federal government. The basic system for taxing the income of trusts and estates is the same as that for taxing the income of individuals. Section 641(b) makes this very clear: “The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part.” Thus, everything the student (may have) learned in the basic course on individual income taxation, which generally deals almost exclusively with chapter 1 (sections 1 to 1400Z-2) of subtitle A (“Income Taxes”) of the Internal Revenue Code, is potentially relevant.

This book is not, however, a review of the basic course on individual income taxation (although it is possible to view chapter 2 that way). More than anything else, it is an examination of the ways in which the income taxation of trusts and estates differs from that of individuals. Section 641(b) acknowledges these differences when it refers to “this part.” That reference is to part I (“Estates, Trusts, and Beneficiaries”), which consists of sections 641 to 685. Part I, along with the two sections (691 and 692) of part II (“Income in Respect of Decedents”), make up subchapter J (“Estates, Trusts, Beneficiaries, and Decedents”). Thus, subchapter J is the primary focus of this book. Like it or not, an alternative title for the book would have been “Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code.”

Individuals bear the full tax consequences of their income. Thus, they are pure taxpayers. Partnerships and S corporations, on the other hand, generally pay no taxes on their income; the Code shifts their income to the partners or shareholders for taxation. Partnerships and S corporations, then, are pure conduits. Subchapter J blends these two, distinct modes of taxation into a unique system for taxing the income of trusts and estates. Such entities are, simultaneously, both taxpayers and conduits. They are taxpayers insofar as section 641(b) treats them as individuals.

But part I of subchapter J allows trusts and estates a deduction for distributions to beneficiaries. This is the mechanism by which such entities also serve as conduits.

There is another major wrinkle. Subchapter J directs that some trusts, because of interests or powers retained by their grantors, are not treated as taxpayers at all. Their items of income, deductions, and credit are attributed directly to their grantors. These trusts are commonly referred to as “grantor trusts.”

This book very deliberately follows the organization of subchapter J. Thus, one, fairly accurate, way of visualizing the book is:

Chapter 1 Section 641(a)

Chapter 2 Sections 641(b), 642

Chapter 3 Sections 643, 651–663

Chapter 4 Sections 671–678

Chapter 6 Section 691

Strong pedagogical and thematic concerns are, however, also present in the book’s organization. Chapter 1 asks the logically first question, “Which entities are subject to income taxation under subchapter J?” Chapter 2 examines the entity as taxpayer, i.e., how the familiar principles of basic income taxation apply to entities. Chapter 3 then examines the entity as conduit, i.e., how the distribution deduction works to shift some of the income taxation of entities to their beneficiaries. Chapter 4 inquires into when the entity is to be ignored, either under assignment-of-income principles or the grantor trust rules. Chapter 5 provides the student with an opportunity to reconsider the complete picture in the context of manipulative and, arguably, abusive use of entities. Chapter 6, which deals with income and deductions in respect of decedents, mars the organization of the book, just as it does that of subchapter J, but contains obviously important material that fits better in this course than in any other.

The provisions of subchapter J are the core of this book. Its overwhelming first priority is understanding of those provisions and how they work. Likely criticisms are the book’s detail and attention to mechanics. But, clearly, such is stuff tax lawyers are made of. Those who wish to pursue tax policy more thoroughly than the book at first seems to must start somewhere. This book can be that springboard. Even the most unabashed would-be technical expert ought to be willing to pause over the concept of “distributable net income” after reading *Irwin v. Gavit* alongside *Harkness* (ch. 3, sec. A). Three series of cases, far longer than the would-be technical expert needs, are not included just to acquaint students with the anguish of the common law or even with the interaction of judicial and legislative lawmaking. These series are included primarily to force the student to ask tough “why” questions. (In tax law “why” questions are especially tough for many students (and teachers) to ask because they often have only “because” for an answer.) The *Manufacturers Hanover Trust Co.-Tucker-Whittemore-Fabens* series (ch.2, sec. B(3)(b)) ought to stimulate questions about why entities are not taxed exactly as individuals are. It also ought

to focus attention on why distributable net income occupies the role it does in subchapter J. The *Trust Company of Georgia-Keck-Sidles-Peterson* series (ch. 6, sec. A(2)) should force analysis of whether there is a need for a concept similar to “income in respect of a decedent” and whether the current concept either fills that need or is worth the candle. Moreover, it should prompt students to question the soundness of section 1014. *Estelle Morris* and *Stephenson* (ch. 5, sec. A) have survived the Tax Reform Act of 1984 not only to illustrate the potential operation and flaws of section 643(f), but also to necessitate analysis of whether there remains a need for section 643(f) after the Tax Reform Act of 1986. Most importantly, *Estelle Morris* and *Stephenson* should force each student to ask the central policy question of a course on the income taxation of trusts and estates: Should trusts and estates have separate income tax existences?

We offer the following suggestions for coming to terms with these challenging materials:

1. Your starting point should always be the words of the Internal Revenue Code.
2. Use the Treasury Regulations as your primary tool for understanding the Code.
3. Use the cases, the rulings, the Illustrative Material, and the problems strictly as tools to understand the Code and regulations.
4. Ask whether the regulations, cases, etc. fairly and accurately interpret the Code.
5. Ask whether the Code makes sense and, if not, whether there is a better alternative.