American College of Trust and Estate Counsel
Fiduciary Income Tax Committee
2025 Annual Meeting – La Quinta, CA
Farhad Aghdami, Chair and Justin Miller, Vice-Chair
Saturday, March 22, 2025 – 3:30 pm - 5:45 pm

AGENDA

3:30 pm 1. Call to Order and Welcome – 5 min.

3:35 2. Administration – 5 min.

- **a.** Appointment of Secretary
- **b.** Attendance Announcement and Sign-In – Remember to Sign-in on App
- **c.** Executive Committee Report
- **d.** ACTEC Foundation Report
- **e.** Welcome to Red Dots, Blue Dots, and Meeting Sponsors
- **f.** Approval of 2024 Fall Meeting Minutes Prepared by Arielle Prangner
- **g.** Subcommittees

3:40 3. Planning with Trust Guarantees – 30 min.

Eric Reis

4:10 4. State Income Tax Update – 30 min.

Dick Nenno

4:40 5. 645 Elections and PLR 202423002– 25 min.

Arielle Prangner and Greg Gadarian

5:05 6. Final Partnership Basis Shifting Regulations – 15 min.

Gray Edmondson and Gene Wolf

5:20 7. Upstream Basis Planning with Trusts – 25 min.

Carl King

5:45 8. Adjourn

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American College of Trust and Estate Counsel
Fiduciary Income Tax Committee
2024 Fall Meeting – Chicago, Illinois
Farhad Aghdami, Chair
Saturday, September 21, 2024 – 12:15 pm - 2:45 pm

1. Call to Order. The meeting of the Fiduciary Income Tax Committee (the "Committee") was called to order by Farhad Aghdami, Chair (the "Chair") at 12:15 pm on Saturday, September 21, 2024. The committee meeting materials (the "Materials") were previously distributed to the members of the Committee.

2. Administration.

    a. Appointment of Secretary. Arielle Prangner was appointed to serve as Secretary for the Committee's 2024 Fall Meeting.

    b. Executive Committee Report. The Chair stated that the Executive Committee Report can be viewed in the Materials.

    c. ACTEC Foundation Report. The Chair stated that the ACTEC Foundation Report can be viewed in the Materials.

    d. Introduction of Blue Dots and Red Dots. ACTEC Fellows with red dots and blue dots were recognized by the Chair.

    e. Approval of Minutes from 2024 Summer Meeting. The Minutes from the Committee's 2024 Summer Meeting in Toronto, Canada were approved as submitted.

    f. Subcommittees. The Chair reported that an email was sent out to committee members requesting that members express their interest in one or more Subcommittees. He encouraged all attendees to join Subcommittees, and noted that it is not necessary to be a member of the Committee in order to participate on a Subcommittee. The Subcommittees for the 2024-2025 year, and their respective chairs, are as follows:
        i. Grantor Trust – Carl King
        ii. S Corporation – Jeanne Newlon
        iii. IRD/Employee Benefits – Jennifer Shirkey
        iv. Foreign Trust – Raj Malviya
        v. Charitable Trust – Larry Katzenstein
        vi. State Income Tax – Dick Nenno
        vii. Blue Dots – Arielle Prangner

3. What We See with 642(c) and IRD. The Materials included an article by Larry Katzenstein and an outline prepared by Jennifer Shirkey summarizing the IRC § 642(c) deduction outcomes and planning pointers for various retirement account scenarios. Also included in the materials was a copy of the discussion about the topic on the ACTEC-PRAC listserv in July 2024 and an article from the September 2024 Probate Practice Reporter.

    a. Overview of § 642(c). Larry gave a basic overview of § 642(c). IRC § 642(c) permits estates and trusts to deduct from income amounts distributed to charity, but the rules are not often misunderstood by practitioners. Deductions are allowed in two cases where income is actually distributed to charity and where income is set aside for future distributions to charity. The general rule is that a deduction in these circumstances is allowed in lieu of deduction under IRC § 170(a). This is notable because unlike a deduction under § 170(a), the deduction under § 642(c) does not have any percentage limitations. Additionally, the deduction under § 642(c) is available for distributions to foreign charities, unlike deductions under § 170(a). Also, § 642(c) allows for an election to treat distributions in one year as if they were made in the prior year. This is similar to the 65-day rule applicable to trusts under § 170, except it is in effect a 365-day rule.

       One of the most litigated issues in this area is the question of what the governing instrument provides, since the distribution must be made pursuant to the terms of the governing instrument in order to qualify for the deduction. It was noted that this doesn't seem like it should be a big issue because there is not much opportunity for abuse. Another question that has been litigated for decades if you can't deduct income under § 642(c), can it be deducted as a regular distribution under § 661? A reading of the Code doesn't make clear that the two deductions are exclusive, but rulings on this have come out differently. *Estate of O'Connor v. Commissioner*, 69 T.C. 165 (1977), is the case most frequently cited in this area. However, that was decided before the separate share rule was applicable. Now that the separate share rule is applicable to estates, we would hope that *O'Conner* would be decided differently, but for now we are stuck with the ruling.

       One of the trickiest issues in connection with distributions to charity is the requirement that a distribution be from the estate or trust's gross income. This seems to be inconsistent with the general philosophy of Subchapter J of the Code, which does not require tracing of sources of income in most cases. Accordingly, it is important for the fiduciary to document that for fiduciary accounting purposes, distributions to charity actually be made from gross income.

       Another notable aspect of the § 642(c) deduction is the deductions for amounts not currently distributed but set aside for future distribution to charity under § 642(c)(2), which allows all income during administration to be deductible if it will eventually be distributed to charities. Note that this deduction applies to estates

but does not apply to trusts except for certain grandfathered trust. Therefore, the trustee of a revocable trust and the executor (if any) of an estate must make a § 645 election to treat both entities for income tax purposes as part of the estate to benefit from the set-aside deduction under § 642(c)(2).

Larry noted the *Green* case decided by the United States Court of Appeals for the Tenth Circuit in 2018 (2121 AFTR 2d 2018-427), which reversed a surprising earlier decision by the United States District Court for the Western District of Oklahoma (118 AFTR 2d 2016-6056). In *Green*, the trust distributed appreciated real property to charity and deducted the full fair market value of the property – including unrealized appreciation - as a § 642(c) charitable deduction. The *Green* court made clear that § 642(c) only allows deduction for amounts of gross income distributed to charity, and unrealized income is not gross income.

Larry then also briefly discussed *Hartwick College vs. United States*, 801 F.2d 608 (2d Cir. 1986), *aff'g* 611 F. Supp. 400 (N.D.N.Y. 1985). He noted the interesting question in the *College* case – If trust residue is distributable to charity, must the income tax charitable deduction be reduced by income taxes payable out of the residue? For the estate tax charitable deduction, you have to perform an interrelated computation to take into account the reduction. However, the *College* court held that for purposes of § 642(c), an interrelated calculation is not necessary because that section does not include a corollary to the disallowance language of § 2055(c) which provides that no estate tax charitable deduction is allowed for any portion of a charitable bequest which is used for payment of estate taxes.

b. <u>Planning for Retirement Account Scenarios and the § 642(c) Deduction</u>. Larry and Jennifer Shirkey then discussed § 642(c) deduction outcomes and planning pointers for various retirement account scenarios inspired by a lively listserv discussion.

The idea is that if we have an estate that involves charities and has that has IRD assets (specifically retirement accounts) how can we set ourselves up for success to make sure that the IRD can be pushed to non-taxable beneficiary? What tools do we have at our disposal to maximize this income tax result?

There will be different considerations depending on (i) whether there is a pecuniary bequest to charity versus a residuary bequest, (ii) whether all of the beneficiaries are charitable or if there are a mix of charitable and non-charitable beneficiaries; (iii) the types of income involved (e.g., ordinary income vs. capital gains vs. tax exempt income), and (iv) if you have a mixture of assets (for example, if you distribute one type of asset to a beneficiary can you take the deduction for another type?).

It was noted that one way to get around many of these issues is to name a charity directly as a beneficiary on the retirement account so you don't have any § 642(c) issues. However, Larry and Jennifer discussed a few scenarios in which that planning has not been done.

i. Residuary Bequest to Charity. The original scenario presented on the listserv was that a Will left the residue of an estate 15% to charity and 85% to individuals. The residue consisted of an IRA and cash. The Will provided that any charitable shares are to be funded with IRAs before funding them with non-IRA funds. The discussion's consensus was you should be able to cleanly get a § 642(c) deduction by fully funding the noncharitable gifts in one year and then drawing down and distributing the IRAs to the charitable beneficiaries in the next year to satisfy them, but the reverse order (charitable beneficiaries first, non-charities second) is less supportable. Is the direction in a Will to fund a charitable gift with IRD enough alone? Maybe, but it is probably safest to take the two-year approach.

   There was a discussion regarding the "economic effect" rule. Treas. Reg. 1.642(c)-3(b)(2) requires economic effect in determining the *character* of an amount deductible under § 642(c) if a provision in the Will or trust directs payment out of a specific "source." Because other language in the same subsection indicates that "source" is referring to a "class of items of income" (i.e., the type of income—ordinary income, capital gains, tax-exempt, etc.), this rule doesn't prohibit a charitable deduction per se. Rather, it means the deduction will be applied proportionately against different "classes" (i.e., types) of income. It was noted that to have economic effect, the Will or trust provision must affect the amount given to the charity rather than merely affecting the funding source without changing the ultimate amount the charity receives. However, it was noted that some of the IRS rulings are inconsistent on economic effect issue.

   A commentator questioned whether the economic effect rule dealing with charitable deductions overrides Example 9 in the § 663 regulations which addresses a situation in which the instrument provides how a specific asset is allocated between residuary beneficiaries and requires imposition of the separate share rule. It was noted that Example 9 does not deal with a charitable beneficiary, and this creates some uncertainty regarding whether you can trump the economic effect rule with language in the Will. It was commented that Example 9 may be incorrect.

   How does the separate share rule apply to charitable bequests? If the charity is a partial residuary beneficiary, it may constitute a separate share, so in the listserv example the portion passing to charity would have a 15% separate

share of the residue and the portion passing to the other beneficiaries would constitute the remaining share. The default rule is that absent language in the instrument, if you have separate shares, the IRD item should be allocated proportionately. Again, the consensus was that splitting distributions into a in a two year transaction (fully funding the noncharitable gifts in one year and then charitable gifts in a second year) makes it very clean.

ii. Pecuniary Bequest to Charity. The presenters offered another example in which the Will provides a specific bequest of $100,000 to charity and one of the assets of the estate is an IRA that you would like to use to fund the pecuniary bequest. It was noted that this presents a different wrinkle because of the pecuniary bequest concept that if you assign out IRA, it can trigger gain to the trust or estate and a charitable deduction won't be permitted. In CCA 200644020, *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir.1940) was cited to support this result. Best practice would be to have specific language in the Will or trust directing payment not just from income from IRD but also from income generated by satisfying pecuniary obligations to charity.

    The materials provide sample of funding language provided by Christopher Hoyt- include not only IRD income but any income generated by making charitable bequest. If you use the retirement account drafting approach, exclude ROTH accounts

    If the Will does direct funding from IRD, the general consensus is that you do get the § 642(c) deduction, but note the previous discussion regarding the economic effect requirement that could result in the estate or trust not achieving a full offset if the trust has tax-exempt income. Most commentors noted that they were comfortable that the Treasury Regulation would not have a negative effect, though.

iii. Charitable Gifts Pursuant to Exercise of Power of Appointment. Again, a charitable deduction is only allowed under § 642(c) if it is authorized by the governing instrument. The question often arises about what the governing instrument is. What about the exercise of a power of appointment? A judicial modification of an instrument? The materials contain a summary of IRS guidance that indicate that deduction will be permissible for a distribution made pursuant to a non-general power of appointment where the only permissible appointees were charities. However, no deduction will be allowed for exercise of a general power of appointment appointing withdrawn amounts to charities. Additionally, the Chief Counsel's office has refused to recognize a court's order modifying a power of appointment

to appoint in favor of charities as being pursuant to the terms of the governing instrument.

One commentator noted that they believed that the issue in the Treasury Regulations with respect to the exercise of a power of appointment is only with respect to pre-death income, and should not apply to post-death income that is clearly covered by the § 642(c) deduction.

It was noted that of the few IRS Form 1041 audits that have been seen, many are triggered by § 642(c) issues, so anecdotally this seems to be an area of interest.

iv. Miscellaneous Issues. Another question that was brought up is that of tracing. The question was posed whether IRA proceeds should be placed in a separate account so that you can make very clear that distribution to charity came from the IRA?

Another listserv hypothetical was also discussed. A trust had a mix of both types of assets and types of beneficiaries (charitable and non-charitable). The trust agreement provided for specific bequests to non-charities. The remainder of the estate passed equally to two charities. One estate asset was the proceeds from an IRA, some of which was used to pay specific bequests. The accountant advised that the trust could receive a § 642(c) deduction for the full amount even if other in-kind assets were distributed to the charity, but is that true? Cash is fungible but the same is not true for other assets- can't just willy nilly swap out other assets.

v. Conclusion. Note that many of these issues can be avoided by naming charities directly as beneficiaries on the IRA.

4. State Income Tax Update. Dick Nenno prepared slides that were reviewed during the presentation. Dick mentioned that he and his colleague published a comprehensive book about state income taxes, so if you would like a book please email him and he will get you a copy. At Heckerling, some of the speakers mentioned that they did not believe there was a duty to minimize state income taxation of trusts, but Dick disagrees – December 2023 issue of Trusts & Estates magazine articulates his argument.

   The discussion covered four topics: State income tax laws in Illinois, Arizona, and Pennsylvania, and *Zilka v. Tax Review Board City of Philadelphia*, 304 A.3d 1153 (Pa. 2023) (a state income taxation case).

   a. Illinois. Illinois follows all of the federal grantor trust rules. In 2023 the tax rate was a flat 6.45% on trust income. There is a 4.95% net income tax, but there is also a 1.5% personal property tax replacement income tax that gets you to 6.45%

(relatively high- higher than Virginia). Illinois defines resident trust as a trust that is created by an Illinois domiciliary testator or trustor.

In *Linn v. Dep't of Revenue* (IL 2013), the appellate court held that the due process clause prevents taxation of trust that had no Illinois trustee, asset, source income or beneficiaries. Three information letters since *Linn* but they weren't good cases for trying to escape Illinois tax because they had Illinois assts and contacts that *Linn* case didn't have. One of them was filed because trustee was concerned about requirement that trustees administer trusts in appropriate jurisdictions per statute.

Resident trust taxed on all Illinois net income and nonresident trust taxed on Illinois source income. Estimated payments are not required.

An ING is an incomplete gift, non-grantor trust. This is theoretically available in Illinois, but the IRS has put it on the no-ruling list, so be very careful.

An example was presented of a trust with $1M in long-term capital gain. Structuring the trust to eliminate tax saves $64,500, so it is a fair amount. If the trustee has not taken steps to minimize tax it could be a big issue. If you elect to include capital gains in Illinois it can cost $12,000 if you have an Illinois beneficiary.

b. <u>Arizona</u>. Arizona follows all federal grantor trust rules. In 2023 tax rate is flat 2.5% (tied with North Dakota for having lowest rate for states that tax trusts). However, there may be higher rates coming since the state is electing more democrats.

A resident trust in Arizona is a trust with one or more resident trustees- a trustee is a resident trustee if in Arizona for more than transitory purpose or is a domiciliary- presumed to be resident if there for more than 9 months. A corporate fiduciary is a resident trustee only if it conducts administration of the trust in Arizona.

Resident trusts are taxed on all Arizona taxable income and nonresident trusts are taxed on all Arizona source taxable income. Estimated payments are not required.

ING trusts are available but again, but if implementing should be very careful.

For planning purposes, the simplest way to avoid tax is to appoint a non-Arizonian trustee. An example was presented of a trust with $1M in long-term capital gain. If Arizona tax is not imposed, it is a savings of $18,500. Including in DNI for Arizona beneficiary saves $12,615, but there may be other reasons not to include long term capital gain in DNI.

There was a discussion inquiri9ng whether trustee has a duty to minimize income state taxation. For example, is there potential liability if an Arizona attorney with Arizona clients names an Arizona trustee for the clients' child in Florida where there is no trust income tax? There are some cases coming up in New York asking these

questions, so everyone Is there potential liability if AZ attorney with AZ parents names AZ trustee for child in Florida where there is no AZ trust income? There are some cases coming up in New York to look out for on this topic.

Query: can you get into trouble if there is a trust protector in Arizona? The Arizona statute says trust protectors are not fiduciaries, but the state where the trust was created might impose fiduciary duties on trust protectors.

So should attorneys be having conversations with clients not only about initially naming a trustee in a taxing jurisdiction but also the implications of mobile fiduciaries? What about if person moves? This is a very slippery slope for attorney responsibility.

c. Pennsylvania. Pennsylvania does not have grantor trust rules for irrevocable trusts, but starting in 2025 grantor trust rules will be applicable to irrevocable trusts. The trust tax rate in 2023 was 3.07%. The materials suggest a few ways to plan to lower income tax in Pennsylvania.

d. Zilka Case. In *Zilka v. Tax Review Board City of Philadelphia*, 304 A.3d 1153 (Pa. 2023), the taxpayer lived in Philadelphia and worked in Wilmington. She had to pay both Pennsylvania and Delaware income tax, Philadelphia wage tax, and Wilmington wage tax. The taxpayer tried to deduct excess of income taxes. The court held that denial of that reduction was not double taxation in violation of dormant Commerce Clause. The Pennsylvania supreme court affirmed and the taxpayer has filed a petition for cert. This is very relevant in states that are close together in which many residents live in one state and work in another.

5. RMD Final Regulations. AK Moody, Kathy Sherby, and Jennifer Shirkey prepared an outline that was included in the materials. The long-awaited final regulations under the SECURE Act (and follow-up SECURE 2.0 Act) were issued by Treasury on July 19, 2024. The regulations are applicable for calendar years beginning on or after January 1, 2025. The presenters outlined several notable changes covered by the final regulations.

   a. Continuing RMDs After Employee's Post-RBD Death. Before the issuance of the regulations, we all thought that the 10-year rule should work the same when the employee dies on or after the employee's required beginning date ("RBD") as when the employee dies before the RBD. However, it is now very clear that once required minimum distributions (RMDs) begin, they must continue after the death of the employee. Accordingly, if the participant dies on or after the RBD, the RMDs have to be taken at least as rapidly as the employee would have taken them.

   b. No Make Ups Required for 2021-2024. What if you RMDs have not been taken in this interim period (2021-2024)? Do they need to be made up? The final regulations have made clear in a footnote in the preamble that that make up

distributions don't have to be taken for past years. The beneficiary is still required to take distribution of the entire account no later than the end of the 10-year period from the employee's death, you just don't have to take make ups.

c. Penalty Reduction for Missed RMDs. Pre-SECURE 2.0, the penalty for missed RMDs was 50%. The SECURE 2.0 Act reduced that penalty to 25%, but the regulations provide that penalty is further reduced to just 10%, if the taxpayer takes corrective distribution within correction window (earliest of the end of the 2nd year following year of missed RMD, deficiency mailed, or when a deficiency notice regarding the tax is mailed or the date the 25% penalty is assessed) and files a return (Form 5329) reflecting the 10% penalty. Query: will we see as many reasonable cause waivers as we were seeing before?

   The final regulations still provide for an automatic waiver of the penalty for failing to take the RMD in the year of the employee's death without having to file a Form 5329 as long as distribution is taken in the post death distribution window by any beneficiary. This window is through the end of the year following the year of death.

d. RMDs in Employee's Final Year. The final regulations authorize the distribution of the employe's final year RMD to any beneficiary. The RMD does not have to be taken proportionately if there are multiple beneficiaries. Also, if the employee has multiple IRAs, the IRAs may be aggregated and paid out of one of the IRAs as long as all of the beneficiaries of the separate IRAs are the same. However, if the beneficiaries are different between the IRAs, the RMDs have to be paid out proportionately among the beneficiaries, and the final regulations contain an example illustrating how the proportionate distribution works.

e. IRS Relents on Shorter Distribution Period for Older EDBs. Under the proposed regulations, for post-RBD deaths, there could be situation where certain EBDs would be worse off than non-DBs because of an odd provision that said that you had to complete distributions by time the EDB's life expectancy had gone down to 1 year or less. This provision has been removed in the final regulations.

f. Treatment of Designated Roth Accounts. The RMD rules don't apply to amounts in ROTH accounts. The proposed regulations accompanying the final regulations provide that lifetime distributions from Roth IRAs don't count toward satisfying the employe's RMDs and thus are eligible for rollover.

g. Trust Documentation Requirements Reduced for IRAs. The final regulations reduce the documentation required when trusts are beneficiaries. If trust is a beneficiary, you no longer have to provide a copy of the trust agreement to the IRA custodian. This makes sense because the IRA custodian is not responsible for

policing RMDs. However, it remains important to qualify a trust as a see-through trust in order to be able to rollover the qualified plan to an inherited IRA.

h. Separate Account Rule Broadened for Trusts. There was a surprise in the final regulations. When a trust is a beneficiary, previously, the separate account rule did not apply. Accordingly, if you named revocable trust as a beneficiary, every beneficiary of the revocable trust as of the beneficiary designation date would be countable. However, the final regulations provide that the separate account rule is now applicable to a trust so long as the trust "is to be divided immediately upon the death of the employee." A trust qualifies as meeting the requirement to be divided immediately even if there are administrative delays in making the division. There is no indication of the time by which the division should be made, btu probably should be made by September 30th following the year of death. The second requirement is that the trustee can't have any discretion in allocating the plan or IRA benefits among the various beneficiaries when making the division. This will need to be drafted into all of our documents. Lots of documents provide that a trustee can satisfy gifts on a non-pro rata basis so it may be necessary to counter both such a provision and state law in order to eliminate trustee discretion as to division. It is permissible to provide that all retirement benefits are allocated to charity/marital trust etc., but you cannot give the trustee discretion. The proposed regulations clarify that this rule applies where the beneficiary's interest is held outright as well as in a continuing separate see-through trust.

i. Trustee Can Make Elections for Trusts. The question of who is to make elections when retirement benefits are paid to a trust is partially answered in the examples in final regulation § 1 .401(a)(9)-4(f)(6), which provides that when a trust is the beneficiary, any election that is available is made by the trustee. However, there is no example in which an election is made by the trustee when the spouse is the sole beneficiary of a conduit trust, so this may still be a bit unclear.

j. Countable Beneficiaries in Sprinkling Trusts. Previously, if a trustee had "sprinkling" discretion among beneficiaries, there was a question about how deep you have to go to determine countable beneficiaries. Contrary to what we had hoped, the final regulations clarify that all permissible distributees of a discretionary trust will be considered current beneficiaries and not contingent beneficiaries or beneficiaries whose interest is delayed until the death of another.

k. "Child" Expanded to Included Stepchildren and Foster Children; Use of Custodial Accounts for Minors; Delayed Conversion to 10-Year Rule for Child EDB Trusts. The final regulations expanded definition of child to include stepchildren and eligible foster children.

Another nice clarification is the inclusion of a provision that provides that distributions can be made from a conduit trust to a custodial account for a minor

child. Accordingly, if the document allows distributions to an UTMA account in the facility of payment provision, distributions to the UTMA would be deemed to be paid to the EDB under the final regulations.

Under the old proposed regulations, if there were multiple minor EBDs, you converted from life expectancy to the 10-year rule when oldest EDB reached age 21. However, under the final regulations, the conversion to the 10-year rule does not occur until the youngest child reaches majority (age 21). This provides much more protection for the younger children.

l. Catch-Up RMDs for Spousal Rollovers Following Employee's Death Before RBD. The final regulations expand the anti-abuse provisions for the surviving spouse relating to spousal rollovers after electing to use the 10-year rule when the employee died before the RBD. Without any catch-up obligation, a surviving spouse could avoid RMDs by waiting to roll over funds from an inherited account to his or her own IRA prior to the 10th year but after reaching the applicable age for RMDs. These rules provide further guidance on determining the catch-up distributions before the surviving spouse can complete the IRA rollover.

m. Changes to "Applicable Multi-Beneficiary Trusts." The proposed regulations provided guidance on trusts for the benefit of one or more disabled or chronically ill beneficiaries, referred to as an Applicable Multi-Beneficiary Trust ("AMBT"). There were two types of AMBTs in the proposed regulations: (1) type I AMBT occurred when a trust divided into separate shares for each beneficiary immediately on death of participant and (2) a type II AMBT occurred when a pot trust prohibited any beneficiary not disabled or chronically ill to benefit prior to the death of all beneficiaries wo are disabled or chronically ill. Because of the final regulations regarding separate accounts, the final regulations don't include a definition of a type I AMBT. Therefore, an AMBT only occurs in the context of a type II AMBT as described in the proposed regulations. SECURE 2.0 also provided that certain charities may be treated as DBs for AMBTs.

n. New Proposed Regs for the SECURE 2.0 Act's Spousal Election. In ACTEC's comments to the proposed regs, it requested guidance on the spousal election enacted with SECURE 2.0. However, there were no final regulations issued on the spousal election but instead are covered in the proposed regulations.

The proposed regulations provide for three situations. § 1.401(a)(9)-5(g)(3)(ii)(A) provides that if the employee dies before the RBD, the spouse is treated as having made the spousal election automatically. § 1.401(a)(9)-5(g)(3)(ii)(B) provides that if the employee dies on or after the RBD, the spouse is not automatically treated as having made the election. § 1.401(a)(9)-5(g)(3)(ii)(C) seems to contemplate that a surviving spouse could elect out of the automatic application of the spousal election

because it makes the use of the Uniform Lifetime Table contingent on the spousal election applying when the employee dies before the RBD. However, if the spousal election is truly an election to be made or not made, there are no provisions in the proposed regulations providing guidance on how and when the election would be made.

It was noted that a question was posed in the Employee Benefit Committee Meeting: If you have a conduit trust named as a beneficiary of a Roth IRA and the employee dies before the RBD such that under the proposed regulations the surviving spouse would be treated as automatically having made the spousal election, does that mean you never have to take distributions during life of the surviving spouse? The answer is yes. You can defer until such time as when the employee would be required to take distributions and with a Roth, you never have to withdraw.

The Treasury answered two additional practitioner questions regarding the spousal election in the preamble to the proposed regulations. First, it sated that a spousal election to be treated as the employee does not extend other provisions of the Code. For example, the spouse who has made a spousal election would not be subject to 10% tax for taking distribution before attaining age 59 ½. Second, footnote 6 stated that making the spousal election does not preclude the spouse from later making a rollover of the inherited IRA to the spouse's own IRA or treated the IRA as the surviving spouse's own IRA.

These spousal options are even more complex then they used to be. There is a chart included in the materials that illustrates these spousal options. However, in reality, if you run the numbers for most beneficiaries, taking all distributions in year 10 is probably not the most tax efficient solution, so in most cases it will probably make sense to spread out the distributions anyway. While this may be annoying it is generally not a bad result.

o. Discussion of NYT Article. There was a brief discussion regarding an article in the New York Times regarding a method for back-door cleansing of an IRA. The article discussed that if pre- and post-tax contributions were made, the IRA could be rolled into a 401(k) with special provisions and then could be "cleansed" by converting that into a Roth IRA. Discussion about back door IRA cleansing in NYT article. Is this legitimate? The answer is for this to work, the plan would have to have exactly the right provisions in place, and the provisions are not ones that are typically in place in these types of plans.

6. ACTEC Comments to Partnership Basis Shifting Regulations. Gray Edmondson, Paul Lee, and Gene Wolf discussed ACTEC's comments on proposed regulations issued under Code § 6011. The ACTEC comments and the proposed regulations were included in the materials.

It was noted that several things are happening in an IRS campaign targeted at partnerships. There was a Notice issued that announced future proposed regulations that may or may not be finalized which will dramatically change how Subchapter K of the Code works with respect to family partnerships. Second, a Revenue Ruling came out providing that the IRS will apply the economic substance doctrine (dealing with active trades or businesses) on audit. Additionally, on June 18, 2024, Treasury dropped proposed rules identifying "Related-Party Basis Adjustment Transactions" as transactions of interest that would require taxpayers that participate in Related-Party Basis Adjustment Transactions and substantially similar transactions to disclose such transactions in accordance with regulations issued under § 6011.

Treasury has the idea that all related parties are really one taxpayer, and if you are doing something that moves things around such that it would benefit one related party, you should not be able to get any benefit of the inside/outside basis discrepancy. Under the partnership tax rules, various transactions may result in basis adjustments. There are essentially four flavors based on adjustments allowed under Code Sections § 734(b), § 743, § 732(b), and § 732(d).

If you have a § 754 election in place, basis is being moved, and the IRS is worried that if basis moves over to an asset that is a depreciable asset, more opportunity has been created for depreciation deductions that can be used to offset income. Another concern that they have is parties moving basis over to an asset that will be sold in the short term.

The ACTEC comments to the proposed regulations stated that the objectives of Subchapter K are simplicity, flexibility, and equity among partners. There are already lots of anti-abuse rules in place, so Subchapter K already addresses what the Service is trying to call "transactions of interest." The ACTEC comments summarized these anti-abuse rules already in place.

The proposed regulations would be applicable when you have a related party, an inside/outside basis disparity (generally on death or sale), a distribution or a transfer of the interest, and a gross adjustment of $5M or more. If all of those are in place, the transaction must be reported on a Form 8886. Reporting could be required for prior years or transactions happening far in the past, not only to IRS, but also to the Office of Tax Shelter Analysis ("OTSA").

ACTEC's comments stated that the principal concern with the proposed regulations is their overbreadth. The length of time a party may be required to report, both backward looking and forward looking, is overly cumbersome. If a partnership interest was obtained decades ago and is sold, decades of reporting may be required. It is assumed that the IRS doesn't want that much paper. If they received that quantity of reporting every year, they wouldn't be able to identify their real concerns. To curtail the overbreadth, the following suggestions were made:

- Limit the application to situations in which basis is being shifted from a capital asset to a depreciable asset;

- With respect to sales, don't require reporting unless property is sold in a 2-year window (consistent with § 453(e) and § 1031(f));
- Rather than requiring reporting as a listed transaction by the filing of a Form 8886 to the OTSA, modify IRS Form 1065 to require taxpayers to disclose related party basis adjustments as part of the partnership's annual income tax return filing
- The disclosure mechanism should be on a prospective basis only and not require disclosure for transactions occurring before the effective date of the regulations.

In defining transactions to which the regulations would apply, there is a parenthetical that says "other than transfers on the death of a partner." It is unclear what that means? Do transfers to at trust that converts from a grantor trust to non-grantor trust on death count? We don't know. What about transfers during estate administration that don't occur at death or trusts that terminate on death of someone else? Because of this lack of clarity, the ACTEC comments asked for clarification and for certain transfers and distributions to be specifically exempted.

To be identified as a transaction of interest under the proposed regulations, the transaction must be one specifically described and must meet the $5M threshold or must be a substantially similar transaction. The ACTEC comments suggest that the proposed regulations be modified to allow netting of the basis adjustment, rather than just looking at the gross adjustment. Additionally, it is not clear whether certain "substantially similar transactions" must meet the $5M threshold to be included. To avoid unduly expanding the number of transactions considered transactions of interest, the comments request that the Treasury specify that all substantially similar transactions meet the $5M threshold.

Lastly, in defining certain transactions considered substantially similar to a transaction of interest, a transaction is considered a transaction of interest if it is one described elsewhere in the regulations "except that the partners of the partnership are not related and one or more partners of the partnership is a tax-indifferent party that facilitates, by receiving a distribution of property from the partnership or otherwise, an increase in the basis of partnership property or an increase in the basis of property held by another partner in the partnership." This would include, for example, a tax-exempt organization that doesn't care what their basis is. However, the definition could be construed more broadly, so the ACTEC comments request confirmation that the definition of a tax-indifferent party does not include a party who is protected from Federal income tax liability for the year in which gain is recognized simply due to that party holding a capital loss carryover.

7. Final Regulations on Basis Consistency. Carl King and Gregg Simon included an outline with highlights of the Final Regulations "issued" September 16, 2024. These regulations are not yet published in the Federal Register, but once they are published in the Federal Register they will be effective for decedents dying on or after July 31, 2015.

The speakers gave a shout-out to those ACTEC fellows who helped to write the comments to the proposed regulations, including Ron Aucutt, Greg Gadarian, Lora Davis, and Melissa Willms.

The speakers outlined the main changes from the prior proposed regulations to the final regulations.

a. First, the Zero Basis Rule for after-discovered property or property omitted from the Form 706 was removed except in the case of fraud.

b. The final regulations significantly (but not totally) removed the subsequent transfer report requirement. Now this requirement only applies to trustees, and only when they distribute an asset to a beneficiary if the basis of that asset relates to the Form 706 value. There are still some questions that remain open. For example, if a distribution is made to a grantor trust, should the trustee really be the one with the reporting obligation when the human is the one with the tax obligation? There is also a difference between a charitable organization and a charitable trust which might be subject to ongoing reporting obligations.

c. The final regulations defined "acquiring" for purposes of when a Form 8971 needs to be provided to a beneficiary. Rather than giving the beneficiary information on all assets the beneficiary might possibly receive, now you can wait to provide the beneficiary with the Schedule A when the exact asset is distributed to the beneficiary. You still need to File Form 8971 with the IRS, and then a supplemental 8971/Schedule A must be filed once the distribution(s) are actually made. The due date for supplementals is January 31st of the year following the need for the supplements. For beneficiaries who acquired assets on or before the Form 8971 due date, the deadline is still 30 days from the earlier of the due date or the date of the filing of the Form 706.

d. The final regulations clarified the exceptions and added exceptions for other types of property.

    i. The previous "Cash" exception is now called "United States Dollars" exception and includes:

        1. Coins/dollars with value equal to face value,
        2. US dollar denominated demand deposits (e.g. bank accounts, money market funds and CDs),
        3. Cash collateral denominated in US dollars held by 3rd parties to secure a liability (e.g., security deposits),
        4. Life insurance proceeds paid in a lump sum in US dollars, and
        5. Federal, sate and local tax refunds and other refunds payable in US dollars.

6. Not included in "United States Dollars" if it has numismatic value, is foreign currency, is US savings bonds, is crypto currency, is life insurance not paid in US dollars, is life insurance paid annually or at some other interval following death, promissory notes unless forgiven in full by the decedent at death, or accounts receivable (unless 100% IRD).

ii. The IRD exception is now known as property whose basis is unrelated to Federal estate tax value of the property exception and includes:
   1. Retirement plans and deferred compensation plans,
   2. Annuity contracts,
   3. 100% IRD item (however if asset is only part IRD, needs to be reported), and
   4. If IRC §1014(f) applies, do not need to report that property (as basis in hands of beneficiary not derived from 706 value).

iii. Exception for property sold, exchanged, or disposed of prior to distribution.
   1. This exception doesn't apply if new property derives basis from property that was includable in gross estate (e.g., 1031 exchange property).
   2. The exception includes property distributed in satisfaction of a pecuniary bequest if estate recognizes gain or loss on the distribution and property for which § 643(e) election was made to recognize gain or loss.
   3. The exception also includes business interests redeemed for US dollars prior to distribution.

iv. Tangible personal property exception is now known as the household and personal effects exception.
   1. Still need to report if over the Form 706 appraisal requirement ($3,000).
   2. Now there is an IRD exception- you do not need to report property that does not derive basis in whole or in part from 706 value.

e. Supplemental Reporting (this is different than subsequent basis reporting). Before a final 706 value is determined (e.g., audit, litigation), the value on the 706 controls.

f. For distributions in trust, the Form 8971/Schedule A should be furnished to the trustee (but can also give it to the beneficiary with copy to the trustee).

g. Form 8971 changes include that only one Co-Executor needs to sign. It is likely that a new form and Instructions will be issued.

h. As a reminder, the consistent basis rules of IRC §1041 (f) only apply to property that "causes" and estate tax, but the IRC §6035 reporting requirements apply when a 706 is required to be filed, irrespective of whether any estate tax is due.

8. Subcommittee Breakout Discussions. There was no time remaining in the meeting for breakout discussions

9. Adjourn. The meeting was adjourned at 2:45pm.

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GUARANTEED WEALTH? A NEW WAY OF THINKING ABOUT THE GIFT TAX TREATMENT OF LOAN GUARANTEES

by

*Eric Reis**

ABSTRACT

Wealthy parents have found an ingenious way to magnify their children's assets without paying gift tax. Rather than transfer assets to the children directly, a parent may encourage her children (or trusts for the children's benefit) to borrow funds as needed to make investments. The parent stands behind that debt by making a personal guarantee, assuring the lender of repayment and thereby allowing the children to borrow and invest far more than they otherwise could. The Internal Revenue Service clearly believes that such guarantees should be treated as gifts but has hesitated to press that position or develop a framework for doing so. This Article provides that framework, drawing on analogous corporate tax cases to show the way.

For gift tax purposes, when a person guarantees a loan to a related party, the loan would be recharacterized as a loan from the

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lender to the guarantor, followed by a second loan on the same terms from the guarantor to the ultimate borrower. Each loan would then be tested under existing doctrines to see whether it should be respected as debt. In most cases, the second deemed loan (from the guarantor to the ultimate borrower) would not be respected as debt, because the ultimate borrower lacks the income or resources to justify the extension of credit. As a result, the second deemed loan would be recharacterized as a gift to the ultimate borrower rather than a loan. This framework would severely curtail the use of guarantees to grow dynastic wealth.

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I. Introduction

Nearly 40 years ago, the Supreme Court declared in *Dickman v. Commissioner* that a no-interest loan between family members or their companies would be treated as a gift of the forgone interest.[1] Congress codified this decision in section 7872, which calculates the amount of the gift by comparing the interest (if any) charged by the lending family member to a specified minimum interest rate.[2] Intra-family loans are sometimes controversial; former President Trump's loans to family members, for example, drew negative attention from Congress in its investigation of his tax returns.[3] Despite such controversies, these loans remain a staple of estate planning.[4]

Section 7872 leaves important gaps in its regulation of intra-family loans. It does not address circumstances where the borrower could not have obtained a loan from a disinterested party at *any* interest rate (because the borrower lacks sufficient resources to justify the extension of credit on any terms).[5] That issue is partly addressed by doctrines that recharacterize such "impossible" loans as something other than debt (e.g., an equity or other interest), typically with adverse tax consequences for the lender or borrower or both.[6] But those

1. Dickman v. Comm'r, 465 U.S. 330, 344 (1984).

2. § 7872(a), (e)(2).

3. J. Comm. on Tax'n, 117th Cong., Rep. to the H. Comm. on Ways & Means Chairman Richard Neal 7 (2022).

4. Steven R. Akers & Philip J. Hayes, *Estate Planning Issues with Intra-Family Loans and Notes*, 38 ACTEC L.J. 51, 54 (2012) [hereinafter Akers & Hayes].

5. *See* § 7872(a) (providing that this section applies to certain loans, without defining the term "loan" or explaining how to determine whether a purported loan should be respected as such).

6. *See In re* Larson, 862 F.2d 112, 117 (7th Cir. 1988) (recharacterizing a purported loan to an entity as a capital contribution where the entity had a debt-to-equity ratio of more than 43 to 1); Roth Steel Tube Co. v. Comm'r, 800 F.2d 625, 630–32 (6th Cir. 1986) (recharacterizing a purported loan to an entity as a capital contribution where the entity had a debt-to-equity ratio in excess of 300 to 1); Astleford v. Comm'r, 33 T.C.M. (CCH) 793 (1974) (recharacterizing purported

doctrines seem to leave a loophole: another wealthy family member may add substance to an otherwise dubious loan by guaranteeing the debt. The Internal Revenue Service ("Service") has been flummoxed by such guarantees between family members or their trusts or companies. The Service clearly believes that these guarantees should be treated as gifts but has hesitated to press that position—likely because it has no good theory for how these gifts should be valued, and no solution for the administrative difficulties taxing these gifts would present.[7]

This article proposes a new framework for addressing these issues. Part II describes the problem in more detail, illustrating how taxpayers have used guarantees to benefit their families without reporting those guarantees as taxable gifts. Part III argues that many such guarantees should be treated as gifts under the rationale of *Dickman*, notwithstanding older contrary authority. Part IV considers past proposals for valuing such gifts and concludes that these proposals are difficult to apply and inconsistent with the policy behind section 7872.

Finally, Part V suggests a path out of this administrative quagmire, drawing on analogous corporate tax cases to approach the problem in a different way. For gift tax purposes, when a person guarantees a loan to a related party, the loan would be recharacterized as a loan from the lender to the guarantor, followed by a second loan on the same terms from the guarantor to the ultimate borrower. Each loan would then be tested under existing doctrines to see whether it should be respected as debt. The interest rate actually charged would not be considered in that inquiry, so long as it exceeds the minimum rate required by section 7872; rather, the relevant question would be whether a

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loans to an entity as capital contributions where the entity had a debt-to-equity ratio in excess of 165 to 1), *aff'd*, 516 F.2d 1394, 1395 (8th Cir. 1975) (per curiam); I.R.S. Tech. Adv. Mem. 1992–51–004 (Dec. 18, 1992) (recharacterizing a purported sale of stock to an unfunded trust, in exchange for promissory notes issued by the trust, as a gift of the stock to the trust subject to a retained income interest). *Cf.* Estate of Rosen v. Comm'r, 91 T.C.M. (CCH) 1220 (2006) (recharacterizing purported loans by an entity to an individual as distributions, where the individual was unable to meet her financial obligations without these funds).

7. *Compare* P.L.R. 1991-13-009 (Mar. 29, 1991) (declaring that a taxpayer's guarantees of debts of his children's company "are transfers (subject to gift tax) of the economic benefit conferred") *with* P.L.R. 1994-09-018 (Mar. 4, 1994) (withdrawing P.L.R. 1991-13-009 and declaring that "no opinion is expressed as to the federal tax consequences" of the guarantees), *and* I.R.S. F.S.A. (Jun. 17, 1994), 1994 WL 1865994 ("The Service's position on this issue is still being reconsidered.").

disinterested lender would make a loan to the particular borrower at *any* interest rate. In most cases, the first deemed loan (from the lender to the guarantor) would survive this test, because the guarantor would have the wherewithal to support the debt. However, the second deemed loan (from the guarantor to the ultimate borrower) often would not survive this test, because the ultimate borrower lacks the income or resources to justify the extension of credit on any terms. As a result, the second deemed loan would be recharacterized as a contribution to the ultimate borrower rather than a loan, generally resulting in a gift by the guarantor in the full amount of the guaranteed debt. This article describes how this framework avoids the theoretical and administrative problems posed by past proposals and avoids imposing undue tax consequences on routine guarantees of everyday credit transactions, while impeding the more strategic use of guarantees to grow dynastic wealth.

II. The Problem

As discussed below and in Part III, cases and rulings in this area typically involve loans to family *companies* or *trusts* rather than to individuals directly. This reflects, first, the estate-planning truism that benefactors wish to retain some influence over how the wealth they generate is used;[8] second, the fact that benefactors do not want their family members to suffer personally if the loan cannot be repaid;[9] third, the desire in some cases to protect funds from divorcing spouses or other creditors of the intended beneficiary;[10] and fourth, the desire in most cases to protect funds from estate tax upon the death of the intended beneficiary.[11] Accordingly, this Part considers how these arrangements are commonly structured in actual practice.

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8. Kay W. Abramowitz, *Planning for the Less-Wealthy Client (With Forms)*, Prac. Tax Law. 53 (2008) ("Most clients want to retain control of their assets even from the grave.").

9. Gary A. Zwick, *Intra-Family Loans*, Ohio Prob. L.J., 9 (Nov./Dec. 2013) (suggesting that clients lend funds to a trust without significant net worth, in order to make the loan a "no lose" proposition for their beneficiaries).

10. John J. Scroggin, *Protecting and Preserving the Family—the True Goal of Estate Planning, Part I: Reasons and Philosophy*, Prob. & Prop., May/June 2022, at 29, 31 ("Clients . . . use trusts to restrict the claims of creditors. Asset protection also focuses on the potential claims of divorcing spouses.").

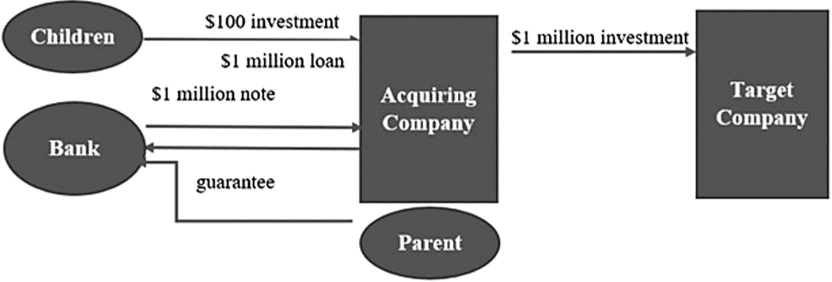
11. *Id.* at 29 (acknowledging this traditional purpose, while suggesting that planners should give more attention to other concerns); Abramowitz,

A. Loans to Family Companies

1. Guarantee of Third-Party Loan to Company

The Service considered one common arrangement, a loan to a family company, in Private Letter Ruling (P.L.R.) 1991-13-009.[12] In this ruling, the taxpayer's adult children wished to acquire various "target" companies.[13] Rather than do so individually, they would form an acquiring company to make each purchase.[14] The acquiring company, in turn, would obtain a bank loan to fund its acquisition of the target.[15] The bank would require a personal guarantee, which the taxpayer would provide.[16] The transactions were substantial, sometimes in excess of $1 million (at a time when the amount exempt from federal estate or gift tax was $600,000[17]).[18] It appears that the acquiring company was only nominally funded apart from the loan, in view of the structure of the transactions and the bank's insistence on the taxpayer's personal guarantee, though the ruling does not specifically mention this. A typical transaction might appear as follows:

Figure 1: Guarantee of Bank Loan to Children's Company



supra note 8, at 53 ("Most clients want . . . to avoid estate and inheritance tax.").

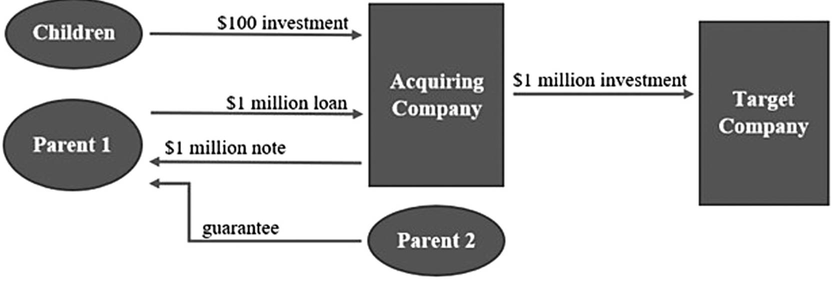
12. P.L.R. 1991-13-009 (Mar. 29, 1991).
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. § 2010 (as in effect prior to August 5, 1997).
18. P.L.R. 1991-13-009 (Mar. 29, 1991).

This arrangement created a no-lose proposition for the taxpayer's children. If the investments they made through their acquiring company appreciated, they could repay the loan and pocket the excess. If the investments they made through their acquiring company declined in value, they could abandon the acquiring company, allow the lender to reclaim what it could, and require the lender to recover any deficiency from the taxpayer as guarantor. Under these circumstances, the Service concluded that "valuable economic benefits [had been] conferred" by the taxpayer, and these benefits should be subject to gift tax.[19] Further, the Service determined that a gift occurred at the time the guarantee was made, rather than only if and when the guarantor was required to make good on the guarantee.[20] However, the ruling was conspicuously silent on how the amount of the gift would be computed. Perhaps for that reason, the Service withdrew the ruling three years later and has not addressed the issue since then, leaving its current position unclear.[21]

2. Guarantee of Family Loan to Company

While P.L.R. 1991-13-009 involved bank financing, taxpayers can easily construct similar arrangements with intra-family debt, avoiding the potential leakage of value to a third-party lender. Consider, for example, a married couple, each of whom has substantial assets and income, who wish to benefit their adult children. As in the ruling, the children could form and nominally fund a company to make investments. One spouse could then lend funds to that company while the other spouse guarantees repayment. The transaction would appear as follows:

Figure 2: Guarantee of Spouse's Loan to Children's Company



19. *Id.*
20. *Id.* (citing Rev. Rul. 84–25, 1984–1 C.B. 191).
21. P.L.R. 1994-09-018 (Mar. 4, 1994).

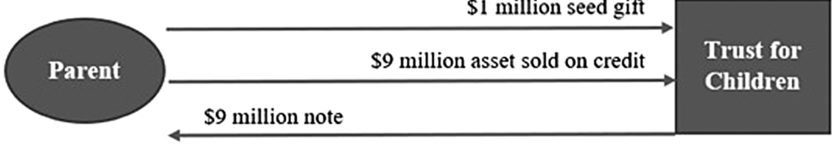
This arrangement would again create a no-lose proposition for the couple's children. If the investments they make through the acquiring company increase in value, the children benefit, and if the investments lose value, the guarantor spouse bears the loss (resulting in a transfer between the spouses, which generally is not subject to gift tax[22] or income tax[23]).

B. Loans to Family Trusts

1. Loan to Adequately Funded Trust

As appealing as the above transactions may be to taxpayers wishing to shift wealth to their descendants, taxpayers may construct even more favorable variations using family trusts. These transactions are often structured as a sale of existing assets to an irrevocable trust for the benefit of the taxpayer's descendants.[24] In a typical transaction, the taxpayer would first create the trust, then seed it with a moderate gift, and finally sell a much more valuable asset to the trust *on credit*, i.e., for a promissory note from the trust.[25] If the amount of the seed gift is $1 million and the assets sold to the trust are worth $9 million, this may be visualized as follows:

Figure 3: Leveraged Sale to Children's Trust



22. § 2523(a).
23. § 1041(a), (b).
24. Akers & Hayes, *supra* note 4, at 54.
25. *Id.* at 136–41. Strictly speaking, the note would be executed by the trustee of the trust, acting in the trustee's fiduciary capacity. *See* Americold Realty Trust v. Conagra Foods, 577 U.S. 378, 383 (2016) (explaining that a trust traditionally is classified as a fiduciary relationship rather than an entity, so the trustee acts for the trust).

In the above example, the trust has substantial assets independent of the loan, and immediately after the financed sale has a debt-to-equity ratio of nine to one. While there is no set rule for what amount of leverage is permissible for debt to be respected as such for tax purposes, there is some authority supporting a debt-to-equity ratio of nearly twenty to one,[26] and practitioners commonly employ leverage of up to nine to one.[27] Thus, this structure may allow taxpayers to provide substantial benefits to their descendants even without making use of guarantees. If the assets appreciate, the descendants benefit through the trust; if the assets decline, the descendants have "only" $1 million at risk of being clawed back in repayment of the debt.

2. Loan to Nominally Funded Trust, Supported by Spousal Guarantee

The preceding arrangement is not favorable enough, however, for some taxpayers. If the taxpayer has previously exhausted the gift tax credit available to him or her under the Internal Revenue Code, making even a $1 million gift may incur a substantial gift tax.[28] And if the asset is even more valuable than the $9 million assumed above, maintaining a nine-to-one debt-to-equity ratio would require a proportionately larger seed gift. With this in mind, a taxpayer may be tempted to employ much

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26. Akers & Hayes, *supra* note 4, at 138; McDermott v. Comm'r, 13 T.C. 468 (1949), *acq.*, 1950–1 C.B. 3.

27. Akers & Hayes, *supra* note 4, at 137–38. *But see* Matthiessen v. Comm'r, 16 T.C. 781 (1951) (recharacterizing a purported loan to an entity as a capital contribution where the entity appears to have had a debt-to-equity ratio of nine to one), *aff'd*, 194 F.2d 659 (2d Cir. 1952); Note, *Thin Capitalization & Tax Avoidance*, 55 Colum. L. Rev. 1054, 1061 n.51 (1955) (specifying the debt-to-equity ratio of the entity in *Matthiessen*). In addition to the debt-to-equity ratio, the Tax Court in *Matthiessen* also looked to the fact that the purported loans were unsecured. *Matthiessen*, 16 T.C. at 786 ("Aside from the relationship of [the entity's] capital to the amount of advances, the lack of any adequate security for the advances negatives completely petitioners' insistence that they were bona fide loans and not capital contributions. The possibility is remote indeed that a disinterested lender of money would have made the initial unsecured loan . . . .").

28. *See* §§ 2502(a), 2001(c) (imposing gift tax at a 40% rate once all credit has been exhausted, resulting in a tax of $400,000 on the $1 million gift).

higher leverage. For example, if the taxpayer gives only $10,000 to the trust and sells a $9.99 million asset to it for a promissory note, the same basic arrangement yields a debt-to-equity ratio of 999 to one—far in excess of what can ordinarily be justified as debt.[29] Absent something more, the taxpayer may be treated instead as having made a *contribution* to the trust (the $9.99 million asset) subject to a retained beneficial interest (the promissory note).[30] The consequences of that characterization would be dire, because a retained beneficial interest is valued for gift tax purposes only if it takes one of a handful of permitted forms, which the note does not.[31] As a result, the note would be deemed to have no value and the taxpayer would be treated as having made a $9.99 million gift.[32] Nevertheless, the existence of the note would be recognized for estate tax purposes as a retained interest, causing the trust assets to be subject to estate tax upon the taxpayer's death.[33]

This disastrous result might be avoided, though, through the use of a guarantee. As in Part II.A above, that guarantee may be provided by the taxpayer's spouse, as follows:

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29. *See, e.g.*, *In re* Larson, 862 F.2d 112, 117 (7th Cir. 1988) (recharacterizing a purported loan to an entity as a capital contribution where the entity had a debt-to-equity ratio of more than 43 to 1); Roth Steel Tube Co. v. Comm'r, 800 F.2d 625, 630–32 (6th Cir. 1986) (recharacterizing a purported loan to an entity as a capital contribution where the entity had a debt-to-equity ratio in excess of 300 to 1); Astleford v. Comm'r, 33 T.C.M. (CCH) 793 (1974) (recharacterizing purported loans to an entity as capital contributions where the entity had a debt-to-equity ratio in excess of 165 to 1), *aff'd*, 516 F.2d 1394, 1395 (8th Cir. 1975) (per curiam). In addition to the debt-to-equity ratio, courts consider other factors that may be unfavorable to family loans. *See Roth Steel Tube Co.*, 800 F.2d at 630 (explaining that courts are less inclined to treat a purported loan as such if the loan is unsecured and the debtor is unable to obtain financing from outside lending institutions, among other factors).

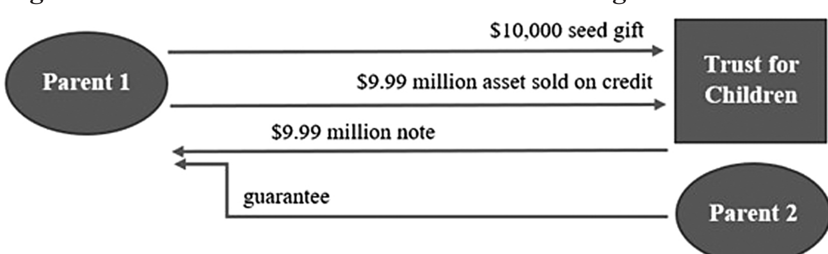
30. T.A.M. 1992–51–004 (Dec. 18, 1992); *see also* Rev. Proc. 2013–3 § 4.01(55), 2013–1 I.R.B. 113 (declining to rule on whether a trust beneficiary's sale of property to the trust will be treated as a gift if, inter alia, "the trust purchases the property with a note and . . . the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased").

31. § 2702(a)(2)(A), (b).

32. § 2702(a)(2)(A).

33. § 2036(a); I.R.S. Tech. Adv. Mem. 9251004 (Dec. 18, 1992).

Figure 4: Guarantee of Debt Incurred in Leveraged Sale



Assuming the taxpayer's spouse has the wherewithal to bear this level of debt, the trust's note would now seem to have substance. Accordingly, the taxpayer's loan should not be treated as a contribution to the trust and should not give rise to a gift (at least, not by the taxpayer). The taxpayer's descendants clearly benefit, however. As in the prior examples, they enjoy a larger trust if the trust's assets grow at a faster rate than the interest on its debt—but in this case they suffer virtually no loss if the trust assets decline in value, because the trust was only nominally funded. Unless the taxpayer's spouse's guarantee is treated as a gift, they enjoy this favorable position without anyone's suffering a gift tax consequence.

3. Loan to Nominally Funded Trust, Supported by Beneficiary Guarantee

Another variation on this structure is noteworthy because it has become popular among estate-planning practitioners for families with multi-generational wealth.[34]

Suppose a single taxpayer and her adult children are all wealthy (with far more assets than any of them will consume in their lifetimes) and wish to coordinate their planning to minimize the family's long-term estate tax liability. The taxpayer could minimize her own estate tax exposure by selling assets directly to her children in exchange for promissory notes issued directly by her children. Thereafter, her estate would grow only at the interest rate specified in the notes and would not include

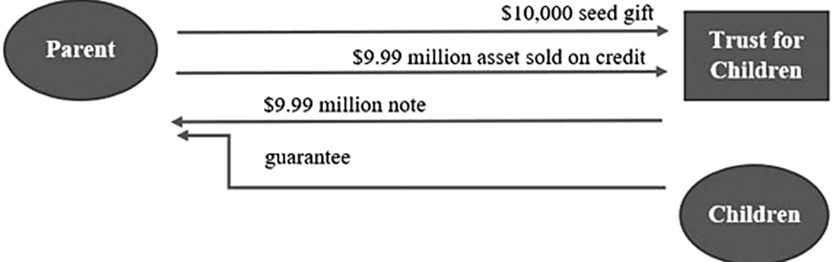
34. *See generally* Milford B. Hatcher, Jr. & Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. Tax'n 152 (2000) [hereinafter Hatcher & Manigault].

any further appreciation in the value of the sold assets. These financed sales would presumably be respected as such because the children have the wherewithal to service the debt. Over time, this arrangement might be expected to slow the growth of the taxpayer's estate (minimizing the estate tax due at her death) while accelerating the growth of her children's estates (increasing the estate tax due at their deaths).

The family in this example is better off from a tax perspective than if it had done no planning, as the taxpayer is likely to die decades earlier than her children. Still, the family would be even better positioned if the taxpayer could sell assets to a trust for her descendants (as in Part II.B.1 above) rather than to the children directly. That way, the trust assets could avoid estate tax not just at the taxpayer's death, but at her children's deaths too. Further, the family would be ideally positioned if the taxpayer could sell assets to a *nominally funded* trust for her descendants (as in Part II.B.2 above), as this would avoid the need for her to make a taxable gift of any significant amount to the trust.

In this case, however, the taxpayer does not have a spouse who could guarantee the trust's debt. Further, assume that she does not have any siblings or other collateral relatives who are willing and able to do so. To address this problem, she decides to create a trust for her descendants, fund it with a nominal amount, sell assets of enormous value to it in exchange for a promissory note, and have *the children themselves* guarantee the trust's debt. This would appear as follows:

Figure 5: Children's Guarantee of Debt Incurred in Leveraged Sale



This structure does not offer the children a "no-lose" proposition, as in other examples discussed above. If the trust assets decline in value, the children will suffer a real loss as they must make good on their guarantees. However, in many cases the likelihood of such a decline is minimal (e.g., because the asset is sold at an

already-depressed value, or the family has private information suggesting that it will become worth much more than the market currently recognizes).[35] In these circumstances, the family's priority is to shift the future growth away from the parent's taxable estate, without adding that value to the children's taxable estates. This arrangement would seem to do just that, again without gift tax consequences for anyone—assuming the guarantee itself is not treated as a gift.

If the guarantee *is* treated as a gift, the arrangement is much less favorable, as the beneficiaries would then be considered to have made a contribution to the trust (valued at whatever amount the guarantee is deemed to be worth) while retaining an interest in that contribution (their interest as beneficiaries of the trust).[36] That, in turn, would subject at least a portion of the trust's assets to estate tax at the children's deaths.[37] But in view of the Service's quiescence over the past 32 years and some arguably favorable authority (discussed in Part III below), using beneficiary guarantees has become increasingly popular with taxpayers and their advisors.[38]

III. The Legal Rationale for Treating Guarantees as Gifts, and Objections Thereto

To address the policy problems created by guarantees, one must either persuade Congress to amend the Code (a herculean task) or establish that these problems can be addressed under current law. This Part explores the conceptual basis for treating a loan guarantee as a gift by (i) establishing that making property *available* to a donee is a gift and (ii) establishing that incurring a contractual obligation is a gift, while (iii) distinguishing contrary authority.

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35. *But see* I.R.S. Chief Couns. Mem. 2021–52–018 (Oct. 4, 2021) (advising IRS personnel that private information regarding a pending merger should have been considered in valuing a particular taxpayer's gift of stock).

36. *See* P.L.R. 1991-13-009 (Mar. 29, 1991).

37. § 2036(a).

38. *See* Hatcher & Manigault, *supra* note 34, at 154 (asserting that "the clear weight of authority seems to support the absence of any gift by the beneficiaries to the trust"); Akers & Hayes, *supra* note 4, at 140–41 (stating more cautiously that "the guarantee arguably is not a gift to the trust" and suggesting alternatives for planners who are "squeamish").

A. Making Property Available to a Donee Is a Gift Under Dickman v. Commissioner

The strongest, albeit indirect, conceptual support for treating guarantees as gifts comes from the Supreme Court's decision in *Dickman v. Commissioner*.[39] During the years at issue in that case, an individual could make gifts of up to $3,000 per year per recipient,[40] and additional gifts of up to $30,000 (total) to all recipients over the course of the donor's lifetime,[41] without incurring gift tax. These limits created a strong incentive for taxpayers to provide benefits to their descendants in indirect ways. The taxpayers in *Dickman* employed one such scheme: they lent hundreds of thousands of dollars to their son and to a company owned by the taxpayers and their son, daughter-in-law and grandchildren.[42] The loans bore no interest and had no fixed maturity; instead, they were payable upon demand.[43] The taxpayers contended, and the Tax Court agreed, that this arrangement did not constitute a "transfer of property by gift" within the meaning of section 2501(a)(1).[44]

In analyzing this claim, the Supreme Court began with a related provision, section 2511(a).[45] Then as now, this section explains that "the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, *whether the gift is direct or indirect*, and whether the property is real or personal, tangible or intangible . . . ."[46] The Court also looked to the congressional committee reports accompanying the precursors of these sections, which explain that "[t]he terms 'property,' 'transfer,' 'gift,' and 'indirectly' are used in the broadest and most comprehensive sense; the term 'property' reaching every species of right or interest protected by law and having an exchangeable value."[47] Finally, the Court cited sweeping language from its own

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39. Dickman v. Comm'r, 465 U.S. 330 (1984).

40. § 2503(b) (as in effect for gifts on or before December 31, 1981); § 2521 (as in effect for gifts made on or before December 31, 1976).

41. § 2521 (as in effect for gifts made on or before December 31, 1976).

42. *Dickman*, 465 U.S. at 332.

43. *Id.* at 322–23.

44. *Id.* at 333.

45. *Id.* at 333–34.

46. § 2511(a) (emphasis added).

47. *Dickman*, 465 U.S. at 334 (citing H.R. Rep. No. 708, 72d Cong., 1st Sess., 27–28 (1932) and S. Rep. No. 665, 72d Cong., 1st Sess., 39 (1932)).

prior decisions, explaining that "Congress intended to use the term 'gifts' in its broadest and most comprehensive sense . . . [in order] to hit all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech" and that the gift tax statute "is broad enough to include property, however conceptual or contingent."[48] Having laid such an expansive predicate, it is unsurprising that the Court concluded that "the gift tax statutes clearly encompass within their broad sweep the gratuitous transfer of the *use* of money."[49]

The *Dickman* decision does not by its terms address loan guarantees. However, it establishes the principle that a gift may arise from making property available for the *use* of a beneficiary. Further, the decision notes that its conclusion does not depend on the taxpayer's suffering any diminution of his or her assets.[50] Specifically, the opinion observes that taxpayers are free "to waste the use value of money," by not taking advantage of that value themselves, and that in itself does not trigger gift tax; but "[i]f the taxpayer chooses not to waste the use value of money . . . but instead transfers the use to someone else, a taxable event has occurred."[51] In the context of the *Dickman* case, this meant that the taxpayers could leave their money uninvested (e.g., in a non-interest-bearing checking account) without tax consequences; but when they chose to make no-interest loans to their son and his descendants, that did have consequences as a taxable gift.[52] In the context of the guarantees considered by this Article, the analogy would be: a taxpayer is free not to use her borrowing capacity to make investments herself; but if she chooses to transfer that borrowing capacity to her descendants, that is a gift.

Foreshadowing one of the concerns discussed in Part IV below, the majority in *Dickman* also briefly noted, but chose not to address, concerns that the "use value" of money would be difficult to determine.[53] The dissenting justices, by contrast, emphasized

48. *Id.* at 335 (citing Comm'r v. Wemyss, 324 U.S. 303, 306 (1945) and Smith v. Shaughnessy, 318 U.S. 176, 180 (1943)) (brackets in original).

49. *Id.* at 337 (emphasis added).

50. *Id.* at 340.

51. *Id.*

52. *Id.*

53. *Id.* at 344 n.14.

> the valuation problems that certainly will result from the Court's holding. . . . In the three decided cases in which the Commissioner belatedly pursued the theory that the Court adopts today, the Service used three different methods for determining the interest rate that should be used to establish the use-value of the borrowed money.[54]

Likewise, the majority was untroubled by the suggestion that its rule might extend to "such commonplace transactions as a loan of the proverbial cup of sugar to a neighbor or a loan of lunch money to a colleague," or to parents providing their adult children "with such things as the use of cars or vacation cottages."[55]

The majority simply "assume[d] that the focus of the Internal Revenue Service is not on such traditional familial matters" and declared that "[w]hen the Government levies a gift tax on routine neighborly or familial gifts, there will be time enough to deal with such a case."[56] (The majority also noted that the gift tax statutes' large annual and lifetime exclusions would make the issue moot for many small transactions.[57])

The majority's bottom line was that the policy of the gift tax statutes is clear, and it is up to the Service to decide how far to take that policy and up to Congress to decide what limits, if any, to place on it. Congress accepted that invitation a few months after the Court issued the *Dickman* decision by codifying the majority rule for loans between related parties while making it easier to apply (by specifying the interest rate that should be used to establish the use value of borrowed money).[58] The statute also clarified that these principles would apply not just for gift tax purposes, as in *Dickman*, but also for income tax purposes.[59]

B. Incurring a Contractual Obligation Is a Gift Under Key Decisions of the Fifth and Second Circuits

As further support for treating guarantees as gifts, key decisions of the Fifth and Second Circuit Courts of Appeal hold that incurring a

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54. *Id.* at 350.
55. *Id.* at 340–41.
56. *Id.* at 341.
57. *Id.* at 341–42; *see* §§ 2503(b), 2505(a), 2510(c).
58. § 7872.
59. *See* § 7872(a)(1), (b)(1) (stating that these rules apply "[f]or purposes of this title," i.e., the entire Code).

contractual obligation for less than full and adequate consideration is a gift for federal gift tax purposes.[60] A decision of the Seventh Circuit also supports that conclusion, albeit more weakly.[61]

In *Autin v. Commissioner*, the taxpayer wished to transfer a business to his son while still presenting himself to customers as the owner for public relations purposes.[62] Accordingly, he retained record ownership of a majority of the company's shares, but entered into an "agreement to convey" obligating himself to execute transfer documents in favor of his son whenever the son "called upon [him] to do so."[63] The agreement was made in 1978, but the parties did not change record ownership of the shares until 1988.[64] The Fifth Circuit held that a "legally enforceable promise to give is subject to gift tax at the time the promise is made, not when the property is actually transferred," so for tax purposes the gift was made in 1978, not 1988.[65]

In *Harris v. Commissioner*, a divorcing couple entered into a settlement under which the wife was obligated to make ten annual payments to the husband.[66] Under current law, transfers incident to a divorce would generally be exempt from gift tax,[67] but at the time, the Second Circuit held that they were taxable.[68] The court then had to determine whether the gift occurred "at the time when the divorce decree [incorporating the settlement] passed," or if instead the payments represented "a series of independent gifts, each maturing when made."[69] The court concluded that the gift occurred at the time of the divorce decree, based on the "present actuarial value" of the payments to be made later.[70]

In *Commissioner v. Copley's Estate*, a man entered into a premarital agreement with his fiancée, contractually obligating him to pay

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60. Autin v. Comm'r, 109 F.3d 231 (5th Cir. 1997); Harris v. Comm'r, 178 F.2d 861 (2d Cir. 1949), *rev'd on other grounds*, 340 U.S. 106 (1950).

61. Comm'r v. Copley's Estate, 194 F.2d 364 (7th Cir. 1952).

62. *Autin*, 109 F.3d at 232–33.

63. *Id.* at 233.

64. *Id.*

65. *Id.* at 235–36.

66. Harris v. Comm'r, 178 F.2d 861, 864 (2d Cir. 1949), *rev'd on other grounds*, 340 U.S. 106 (1950).

67. § 2516.

68. *Harris*, 178 F.2d at 865.

69. *Id.*

70. *Id.*

her $1 million after their wedding.[71] They married as expected, and he made payment thereafter in two installments.[72] Crucially, they entered into the premarital agreement (and married) *before* the federal gift tax was enacted, but the payments were made *after* the federal gift tax was enacted.[73] Further, the early gift tax applied even to gifts between spouses.[74] Thus, the Service asked the court to determine that a gift occurred when the taxpayer actually made payment under the agreement.[75] The Seventh Circuit emphasized instead that the man incurred "a binding and legally enforceable obligation" upon marriage.[76] Accordingly, no gift tax was due on the later transfers he made in discharge of that obligation.[77] The court declined to determine whether incurring the obligation was itself a gift, as it could not have been taxable regardless.[78] However, that conclusion seems consistent with the court's reasoning.

Thus, two Circuit Courts of Appeal agree that a gift occurs when an individual gratuitously incurs a contractual obligation for another person's benefit, and the Seventh Circuit's decision in *Copley's Estate* is at least consistent with that conclusion. The Service also now accepts this principle.[79] This would seem to provide a strong basis for treating a binding loan guarantee as a gift at the time the guarantee is made.

A loan guarantee does differ from the contractual obligations considered by these cases in that it is a *contingent* obligation. Arguably, that could justify postponing the taxable event until and unless the obligation becomes certain.[80] However, as noted above in Part III.A, the Supreme Court has firmly stated its view that the gift tax

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71. Comm'r v. Copley's Estate, 194 F.2d 364, 364 (7th Cir. 1952).

72. *Id.* at 364–65.

73. *Id.* at 365, 366, 367.

74. *Cf.* § 2523 (allowing an unlimited marital deduction for most gifts between spouses who are citizens of the United States, but only for gifts made after December 31, 1981).

75. *Copley's Estate*, 194 F.2d at 365.

76. *Id.*

77. *Id.* at 369.

78. *Id.* at 368–69.

79. *See* Rev. Rul. 84–25, 1984–1 C.B. 191 (holding that a taxpayer made a gift at the time the taxpayer issued a promissory note to a donee, obligating the taxpayer to pay a specified amount in the future).

80. *See* Bradford v. Comm'r, 34 T.C. 1059, 1065 (1960) (suggesting that contingent contractual obligations should be treated differently than fixed

applies even to "conceptual or contingent" rights, making this distinction dubious.[81] Further, in other contexts it is well-established that contingent rights may be the subject of a gift. For example, a taxpayer who gratuitously transfers a term life insurance policy has made a gift, notwithstanding that the policy has no cash surrender value, and notwithstanding that the recipient will benefit from the policy only in the unlikely event that the insured dies during the policy term.[82] Similarly, a taxpayer who gratuitously transfers an option to purchase property has made a gift, notwithstanding that the recipient will realize a benefit from the option only if the property's value rises above a certain level during the option term.[83] Outside the realm of contract, a taxpayer who gratuitously transfers a reversionary interest in property has made a gift of the actuarial value of that interest, notwithstanding that the reversion will occur only if an individual does not survive a specified period.[84] Valuing a loan guarantee poses more *practical* difficulties than valuing these other contingent interests, as discussed below in Part IV, but a guarantee does not seem fundamentally different on a conceptual level.

C. Contrary Authority

As a counterpoint to these authorities, estate planning attorneys look primarily to three lines of authority to challenge the proposition that a

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obligations, and distinguishing *Copley's Estate* on that basis), *acq.* 1961–2 C.B. 4. The *Bradford* case is considered in more detail in Part III.C, *infra*.

81. Dickman v. Comm'r, 465 U.S. 330, 335 (1984) (citing Smith v. Shaughnessy, 318 U. S. 176, 180 (1943)).

82. *See* Reg. § 25.2511–1(h)(8) (explaining that the taxpayer has made a gift at least "to the extent of the premium paid"); Rev. Rul. 76–490, 1976–2 C.B. 300 (applying this regulation to a more complex contractual division of rights in a life insurance contract).

83. *See* Rev. Proc. 98–34, 1998–1 C.B. 983 (providing for the valuation of options for gift, estate, and generation-skipping transfer tax purposes, using a model incorporating factors similar to those established by the Financial Accounting Standards Board); *but cf.* Rev. Rul. 98–21, 1998–1 C.B. 975 (postponing the taxable event in cases where the option's effectiveness depends on the transferor's own voluntary future actions).

84. *See* Reg. § 25.2512–5 (providing for the valuation of such interests for gift tax purposes).

guarantee is a gift.[85] First, and most directly on point, is the Tax Court's decision in *Bradford v. Commissioner*, holding on the particular facts of that case that a (deemed) guarantee was not taxable as a gift.[86] Second, as to loan guarantees provided by the *beneficiaries* of a trust, is the Tax Court's decision in *Pleet v. Commissioner*, holding that a beneficiary's expenditures to preserve trust assets are not gifts.[87] Finally, as to guarantees generally, are a series of income tax cases concerning whether a guarantor who is required to make good on the guarantee may claim a tax deduction, or if the deduction should be denied on the grounds that the guarantor's payment is a gift.[88] On closer inspection, however, each line of authority is of doubtful current relevance.

1. Bradford v. Commissioner

Bradford's facts are unusual and unrepresentative of common estate planning transactions. In this case, the taxpayer's husband ran an investment firm that was a member of the New York Stock Exchange.[89] During the latter part of the Great Depression, the exchange adopted a rule requiring the general partner of each member firm to submit a detailed statement of accounts.[90] The taxpayer's husband had borrowed hundreds of thousands of dollars from a bank, and worried that if this debt appeared on his balance sheet, his firm would lose its seat on the exchange.[91] The court noted that this would "seriously curtail his earning power," which was a problem for the taxpayer's husband, but also presumably for the bank as his creditor.[92]

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85. *See* Akers & Hayes, *supra* note 4, at 139–40; Hatcher & Manigault, *supra* note 34, at 153–56 (both citing cases on which practitioners commonly rely).

86. Bradford v. Comm'r, 34 T.C. 1059, 1064–65 (1960), *acq*. 1961–2 C.B. 4.

87. Pleet v. Comm'r, 17 T.C. 77 (1951).

88. Shiman v. Comm'r, 60 F.2d 65 (2d Cir. 1932); Fox v. Comm'r, 14 T.C. 1160 (1950), *rev'd on other grounds*, 190 F.2d 101 (2d Cir. 1951); Pierce v. Comm'r, 41 B.T.A. 1261 (1940). *See also* Ortiz v. Comm'r, 42 B.T.A. 173 (1940) (relying on the holding and rationale of *Shiman* to reach a similar result on similar facts).

89. *Bradford*, 34 T.C. at 1060.

90. *Id.* at 1060–61.

91. *Id.* at 1061.

92. *Id.*

To address this problem, the bank agreed to accept a promissory note from the taxpayer in substitution for a note previously signed by her husband.[93] On paper, this moved the liability from the husband's balance sheet to hers, and on that basis, the Internal Revenue Service tagged the taxpayer with a taxable gift to her husband in the full amount of the note ($205,000).[94] However, the note was 13 times larger than her assets ($15,780, consisting mostly of her interest in the family home), she had no independent source of income, and she had "no prospects of acquiring any [additional assets] except through her husband."[95] As the court observed, "it seems incredible that a person having a net worth of only $15,780 could make a gift of $205,000."[96]

Rejecting that premise, the court suggested instead that the transaction should be recast as, effectively, a guarantee, explaining that "it is reasonable to assume that all parties involved looked to [the husband's] assets and his earning power to liquidate the loan" and the taxpayer "only made a promise to pay in the future if called upon to do so."[97] In other words, the court treated the taxpayer's husband as the primary obligor on the debt, and treated the taxpayer as a mere guarantor of that obligation.

This deemed guarantee differed greatly from a normal guarantee, under which the lender obtains meaningful reassurance from a creditworthy guarantor. The taxpayer in *Bradford* did not confer a significant economic benefit, in the sense that a typical guarantor would, but merely facilitated a reporting sham (though the court was too polite to describe it as such). Unsurprisingly, then, the court found she provided nothing of value for gift tax purposes.[98]

To be fair, the court's conclusion did not *rely* on the unusual facts of this case. Indeed, the court suggested more broadly that a mere "promise to pay in the future if called upon to do so" is not property for gift tax purposes.[99] That comment, however, is consistent with the Tax Court's general reluctance in the mid-1900s to characterize indefinite

93. *Id.*
94. *Id.* at 1062.
95. *Id.* at 1062, 1064.
96. *Id.* at 1065.
97. *Id.* at 1064–65.
98. *Id.* at 1065 ("We hold that petitioner did not make a transfer of property by gift in 1938.").
99. *Id.*

interests as "property" under the gift tax— a reluctance the Supreme Court later criticized.[100] Further, the *Bradford* case has been cited only once in the 62 years since it was issued (by the Tax Court itself, in a nonprecedential memorandum decision that also predated *Dickman*, and that did not concern loan guarantees).[101] So it is a slender reed to which to tie the proposition that guarantees are not taxable as gifts.

The Service acquiesced in the *Bradford* decision, suggesting that it would not further litigate the issue of whether a guarantee is a gift.[102] This provides some encouragement to taxpayers who wish to invoke it.[103] However, the Service has stated that "[c]aution should be exercised in extending the application of [an acquiescence] to a similar case unless the facts and circumstances are substantially the same." [104] Few cases will satisfy that requirement, considering how unusual the "facts and circumstances" were in *Bradford*. Further, the Service is free to revoke its acquiescence at any time and may do so retroactively in some cases.[105] In any event, the Service's past acquiescence has little bearing on how it should approach the issue *prospectively*.

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100. *Compare id.* at 1064–65 (conceding that property may be "conceptual or contingent," but nevertheless declining to impose gift tax on contractual promises unless "there was a definite obligation to pay a fixed amount") *and* Crown v. Comm'r, 67 T.C. 1060, 1064 (1977) (holding, prior to *Dickman*, that no-interest loans were not taxable as gifts, because all that was transferred was a hypothetical "profit [that] could have been made from a wise investment" by the donor) *with* Dickman v. Comm'r, 465 U.S. 330, 340 (1984) (explaining that *Crown*'s focus on hypothetical profit "misses the mark" by placing undue emphasis on the indefinite nature of what the donor may be giving up rather than the benefit the donor is providing).

101. *See* Powe v. Comm'r, 25 T.C.M. (CCH) 218 (1966) (citing *Bradford* only for the proposition that the gift "tax is measured by the value of the property passing from the donor and not the value of the property received by the donee").

102. 1961–2 C.B. 4.

103. *See* Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View from Within*, 46 Duquesne L. Rev. 323, 365–66 (2008) (noting that "the acquiescence program . . . keep[s] [taxpayers] informed of the Commissioner's current litigating position").

104. Dixon v. U.S., 381 U.S. 68, 73 n.6 (1965) (quoting 1964–1 C.B. 3).

105. *Id.* at 79–80 ("Insofar as petitioners' arguments question the policy of empowering the Commissioner to correct mistakes of law retroactively when a taxpayer acts to his detriment in reliance upon the

2. *Pleet v. Commissioner*

As to guarantees issued by the *beneficiaries* of a trust, taxpayers have also relied on cases holding that a beneficiary may incur expenses to safeguard the trust's interests without incurring gift tax, notably *Pleet v. Commissioner*.[106] However, a careful examination of this authority indicates that it has been displaced by later developments in the law.

In *Pleet*, a family patriarch transferred life insurance policies to a trust for the primary benefit of his wife and two sons, though the trust made provision for other individuals as well.[107] Thereafter, the three primary beneficiaries began paying the premiums on these policies in equal shares.[108] The Internal Revenue Service pursued at least one of these beneficiaries (the plaintiff in this case), contending that his premium payments were taxable gifts.[109] That beneficiary, in turn, protested that his payments were "made purely for the protection of [his] own substantial pecuniary interest as a beneficiary of the trust which held the insurance policies and therefore did not constitute a taxable gift."[110] The court agreed, and added that "if other beneficiaries of the trust indirectly derived a benefit through a payment to the insurance companies as a consideration for maintaining the policies in full force, that is an immaterial circumstance."[111]

The court's conclusion in *Pleet* is reasonable, and consistent with the approach of other cases of that era.[112] However, these cases would seem to be nullified by the enactment of Chapter 14 of the Code in 1990.[113] The provisions of this chapter are notoriously complex, but

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Commissioner's acquiescence in an erroneous Tax Court decision, their arguments are more appropriately addressed to Congress. Congress has seen fit to allow the Commissioner to correct mistakes of law, and in § 7805(b) has given him a large measure of discretion in determining when to apply his corrections retroactively.").

106. Akers & Hayes, *supra* note 4, at 140 (citing Pleet v. Comm'r, 17 T.C. 77 (1951)).

107. Pleet v. Comm'r, 17 T.C. 77, 79–80 (1951).

108. *Id.* at 81.

109. *Id.*

110. *Id.*

111. *Id.* at 83.

112. *See, e.g.*, Seligman v. Comm'r, 9 T.C. 191 (1947) (reaching the same conclusion on similar facts).

113. §§ 2701–2704.

provide a new framework for determining whether a gift has been made, and the amount of the gift, in cases where the taxpayer makes a transfer of property in or to an entity or trust while retaining an interest in the entity or trust.[114] If a taxpayer contributes property to a trust that benefits both the taxpayer and members of the taxpayer's family, in most cases the value of the taxpayer's retained interest is deemed to be zero.[115] Thus, taxpayers can no longer claim an offset (or deny that a gift has been made at all) merely because they also benefit from their contributions to a trust, since that reciprocal benefit is *deemed* to be valueless.

Against this backdrop, *Pleet* would appear to be good law only for the narrow subset of trusts where the beneficiary's interest in the trust is so tightly circumscribed that it satisfies one of the statute's exceptions. Generally, this would require that the trust distribute only a fixed dollar amount or fixed percentage of its assets to the beneficiary each year and satisfy an exhaustive set of technical requirements set forth in Treasury regulations.[116] In that case, a beneficiary might guarantee the trust's debt and argue under *Pleet* that she is merely protecting her own interest. But for the vast majority of trusts, where the settlor wishes for the trustee to have some discretion over the timing and amount of distributions, *Pleet* and related cases appear to have little relevance.

3. *Income Tax Cases*

Finally, taxpayers have relied on a series of early income tax cases for the proposition that a guarantee is not a gift.[117] However, these cases provide only weak support, if any, for that contention.

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114. *See generally* §§ 2701(a)(1), (e)(5); 2702(a)(1).

115. § 2701(a). Exceptions apply if the contribution is revocable or the retained interest fits within certain limited statutory niches. § 2702(a)(2)(B), (3).

116. § 2702(b); Reg. § 25.2702–3. A trust that distributes only a fixed dollar amount to the grantor each year is commonly known as a grantor retained annuity trust, or "GRAT," while a trust that distributes only a fixed percentage of its assets to the grantor each year is commonly known as a grantor retained unitrust, or "GRUT." *See, e.g.*, Reg. § 20.2039–1(e) (using this terminology).

117. Hatcher & Manigault, *supra* note 34, at 153–56 (citing Shiman v. Comm'r, 60 F.2d 65 (2d Cir. 1932); Fox v. Comm'r, 14 T.C. 1160 (1950),

In *Shiman v. Commissioner*, the taxpayer guaranteed his brother-in-law's brokerage accounts to enable his brother-in-law to speculate in stocks on margin during the 1920s.[118] The brother-in-law later became insolvent and the taxpayer was required to make good on the guarantee.[119] The taxpayer claimed an income tax deduction for this payment, which the Internal Revenue Service denied.[120] Among other objections, the Service claimed that the taxpayer's payment was nondeductible because it was a gift.[121] The Second Circuit rejected that position, noting that the taxpayer's *issuance* of the guarantee may have been voluntary, but his *performance* under the guarantee was not: "[I]t is absurd to treat the performance as it would have been had it been freely made at the time. That cannot be a gift which the putative giver was powerless to withhold."[122] The court observed that the brother-in-law was solvent at the time the guarantee was issued, but the court made that observation, it seems, only to support the idea that the guarantee was a valid contractual obligation and not a sham from the start.[123] Thus, *Shiman* is authority for the proposition that performing under a guarantee is not a gift, but does not really speak to whether making the guarantee in the first place can be a gift.

Fox v. Commissioner presents a somewhat similar fact pattern. In this Depression-era case, the taxpayer lent securities to her husband to use as collateral for securities investments.[124] When those investments went poorly, the taxpayer threw good money after bad by guaranteeing his accounts, in the hope that this would allow him to recover and repay her.[125] After her husband died insolvent, she made payments on the guarantee over a period of years, and claimed an income tax deduction for at least those payments that she made in the year at issue in the

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rev'd on other grounds, 190 F.2d 101 (2d Cir. 1951); Pierce v. Comm'r, 41 B.T.A. 1261 (1940); Ortiz v. Comm'r, 42 B.T.A. 173 (1940)).

118. Shiman v. Comm'r, 60 F.2d 65, 66 (2d Cir. 1932).

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. Fox v. Comm'r, 14 T.C. 1160, 1160 (1950), *rev'd on other grounds*, 190 F.2d 101 (2d Cir. 1951).

125. *Id.* at 1161 ("The petitioner executed the guaranty because . . . she thought she would protect the securities she had theretofore loaned him.").

case.[126] As in *Shiman*, the Service rejected that deduction, this time suggesting that the whole arrangement was gratuitous from beginning to end.[127] The Tax Court addressed that directly: "Petitioner was not making a gift to her husband, but rather was making him a loan of some of her securities and through the guaranty of his account *a loan of her credit*."[128] At first glance these comments seem helpful to taxpayers who wish to argue that a guarantee is not a gift, but the court's characterization of a guarantee as a "loan" rather than a gift is self-refuting in view of the Supreme Court's later holding that an interest-free loan *is* a gift (of "the reasonable value of the use of the money lent").[129]

The Depression era was fertile ground for cases of this type, and *Pierce v. Commissioner* presents another permutation of the same theme. In this case, a man and his son both owned stock in a corporation.[130] The son had pledged his stock as collateral on a bank debt, but the bank later demanded additional collateral.[131] To prevent the sale of the son's stock, the father guaranteed the debt, and the father was later required to make payment on this guarantee.[132] The father claimed a bad-debt income tax deduction because his son was unable to repay him.[133] The IRS denied the deduction on the grounds that the father had made a gift, but the Board of Tax Appeals (the predecessor to the Tax Court) disagreed.[134] First, the Board noted that the son was "solvent by a safe margin at the time of the original guarantee."[135] (By contrast, in the type of loans discussed in Part II of this article, *supra*, the debtors are solvent only by the thinnest of margins, not remotely "safe.") Second, the Board noted that the father's "primary objective" in making the guarantee was "to protect the market value of [his own] securities" from being depressed by a forced sale of his son's stock in the same corporation.[136] Thus, the father was protecting his own interest—not

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126. *Id*. at 1162.
127. *Id*. at 1164.
128. *Id*. (emphasis added).
129. *See* Dickman v. Comm'r, 465 U.S. at 344 (1984).
130. Pierce v. Comm'r, 41 B.T.A. 1261, 1262 (1940).
131. *Id.*
132. *Id.* at 1262–63.
133. *Id.* at 1263.
134. *Id.* at 1264–65.
135. *Id.* at 1265.
136. *Pierce*, 41 B.T.A. at 1265.

making a gift—under the same rationale as in *Pleet v. Commissioner*.[137] For the reasons discussed above in Part III.C.2, that rationale should provide little comfort to taxpayers under current law.

Finally, from the same era, *Ortiz v. Commissioner* rounds out this group of cases. In *Ortiz*, the taxpayer (a member of the DuPont family) guaranteed her husband's margined brokerage accounts after the crash of 1929 to prevent his holdings from being liquidated.[138] At the time of this guarantee, the value of his securities exceeded the margin debt by about 5.5%, though she was later required to renew the guarantee at a time when the securities were worth less than the debt.[139] After her husband's securities declined in value yet again, she terminated the arrangement, had the securities liquidated, required her husband to pay her what he could (including by deeding his remaining real estate to her) and paid the deficiency to the brokerage firm.[140] She claimed a bad debt deduction for this deficiency on her income tax return.[141] The Service challenged her deduction by advancing the same argument as in *Shiman* (that her payment under the guarantee was a gift), and the Board ruled for the taxpayer in reliance on *Shiman* and applying the same reasoning (that making a payment under a guarantee is not a gift).[142] Accordingly, *Ortiz*, like *Shiman*, does not provide meaningful support for the idea that *issuing* a guarantee is not a gift. Further, the facts of *Ortiz*—where the debtor initially had a 5.5% "cushion" of equity before the guarantee would be called upon—were more favorable to the taxpayer than in many of the planning scenarios discussed in Part II of this article, *supra*.

Thus, there seems to be little in this collection of Depression-era cases, mostly from the Tax Court and Board of Tax Appeals, to weigh against the modern-era Supreme Court's support in *Dickman* for treating transfers of the "use value" of property as a gift.

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137. *Id.*

138. Ortiz v. Comm'r, 42 B.T.A. 173, 180 (1940).

139. *Id.*

140. *Id.* at 180–81, 186.

141. *Id.* at 181.

142. *See id.* at 187 ("The facts and circumstances [here] are so similar to the facts and circumstances existing in *Shiman v. Commissioner*, and the arguments advanced in the two cases are so alike, that a detailed analysis of the Circuit Court's decision will be helpful in disposing of the present issue.") (internal citation omitted).

IV. Approaches to Valuing Guarantees

As the Supreme Court noted in *Dickman*, Congress intended for the gift tax to reach "every species of right or interest protected by law *and having an exchangeable value*."[143] That raises the question of whether a loan guarantee has an "exchangeable value." If not, then arguably *Dickman* would not apply and a guarantee could not be taxed as a gift. However, property should not be considered to lack an "exchangeable value" merely because that value is difficult to determine,[144] and *Dickman* itself waved away concerns that the Service had used a different method for determining the use value of property every time it considered the issue.[145] Accordingly, this Part considers various ways a guarantee might be valued. Several of the methods described in this Part provide a valid basis for valuing a guarantee and therefore for treating a guarantee as a gift, though Part V ultimately suggests a different approach for reasons of administrative convenience and conceptual consistency with other Code provisions.

A. Proposed Valuation Approaches

1. Credit Default Swap Model

One commenter has noted that guarantees closely resemble financial instruments known as "credit default swaps" (CDSs), and suggested that "[t]he IRS should treat guarantees and CDSs similarly for tax purposes . . ."[146] He describes the basic structure of a CDS as follows:

> Suppose Company A issues $100 in corporate bonds. Company B buys those corporate bonds, yet worries about Company A's financial stability. So Company B negotiates an agreement with Company C where Company C would pay a specified sum if the bonds

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143. Dickman v. Comm'r, 465 U.S. at 334 (1984) (citing H.R. Rep. No. 72–708 (1932) and S. Rep. No. 72–665 (1932)) (emphasis added).

144. *See, e.g.*, Reg. §§ 25.2512–2(f), 25.2512–3 (providing for a case-by-case, facts-and-circumstances analysis of the value of unmarketable securities or business interests).

145. *Dickman*, 465 U.S. at 344 n.14, 350.

146. Caleb Sainsbury, *Taxation of Credit Default Swaps: A Guaranteed Solution*, 30 Rev. Banking & Fin. L. 443, 459 (2010).

> default. That contract is a CDS, the bonds are the reference obligation and the default of the bonds is a credit event. For that protection guarantee, Company B would pay Company C a specified premium.[147]

This arrangement is similar to several of the examples described in Part II of this article, *supra*. In those examples, a family trust or company (in the role of "Company A") issued a promissory note to a family's matriarch or patriarch as lender (in the role of "Company B"), and that note was guaranteed by another family member (in the role of "Company C"). The difference, of course, is that in the examples from Part II the guarantor was not paid for providing its assurance. The market for CDSs provides a measure of the value of this uncompensated benefit. Similarly, if the guarantor is paid for making the guarantee, the market for CDSs provides a means for evaluating whether the amount paid is appropriate.

Unfortunately, the market for CDSs is still "relatively young," even as to debts far less obscure than intra-family loans.[148] However, pricing models may be used to estimate an appropriate price.[149] These models can be quite complex and mathematically dense, but the key point is that "valuation of a credit default swap requires estimates of the risk-neutral probability that the reference entity will default at different future times."[150] For a public entity, the probability of default may be calculated by comparing the price of the entity's bonds to the price of similar U.S. Treasury bonds.[151] For a family trust or closely held family business, of course, such pricing data generally is not available. Instead, an appraiser faces the unenviable task of *estimating* the probability of default based on the nature of the trust's or business's assets and the likelihood that such assets will appreciate or

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147. *Id.* at 446.

148. Antulio N. Bomfim, *Credit Default Swaps* 1 (Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series 2022–023, May 2022).

149. *See, e.g.*, John C. Hull & Alan White, *Valuing Credit Default Swaps I: No Counterparty Default Risk*, J. Derivatives, Fall 2000, at 29 (providing "a methodology for valuing credit default swaps," testing whether such methods "give accurate valuations" and "provid[ing] an example of the application of the methodology to real data").

150. *Id.* at 30.

151. *Id.*

depreciate.[152] That process is difficult and subjective, but does not seem inherently more so than the risk assessment required in any business valuation.[153] Further, it does not seem fundamentally different than the risk assessment the Supreme Court contemplated in *Dickman* in determining the appropriate interest rate for a loan between family members.[154]

2. *Bank Letter of Credit Model*

Guarantees have also been compared to a bank letter of credit.[155] Letters of credit have been used for centuries to facilitate transactions between businesses that would otherwise lack confidence in each other's performance.[156] In a typical transaction, a bank would issue a letter of credit on behalf of a buyer of goods, to assure the seller of those goods that payment will be forthcoming (from the bank itself, if necessary).[157] The bank is willing to provide that assurance (for a fee) because it is familiar with the buyer, while the seller is not.[158] However, bank letters of credit may be given in connection with a variety of credit transactions.[159]

The "going rate" for a bank letter of credit has been reported as between one and two, or possibly three, percent of the loan balance, payable annually.[160] The relatively narrow range of fees, however, points to a problem with using letters of credit as a point of comparison. Letters of credit are generally issued in cases where the bank does not perceive substantial risk, and is providing the requested reassurance

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152. *Cf.* Rev. Rul. 59–60, 1959–1 C.B. 237 (setting forth factors an appraiser should consider in valuing a business for which market quotations are not available and observing that "[u]ncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the future" and "[t]he appraiser must exercise his judgment as to the degree of risk attaching to the business").

153. *See id.*

154. *See* Dickman v. Comm'r, 465 U.S. 330, 344 n.14 (1984).

155. *See* Hatcher & Manigault, *supra* note 34, at 153 ("Probably the closest commercial analogy is a bank's charge for a letter of credit.").

156. Carl A. Mead, *Documentary Letters of Credit*, 22 Colum. L. Rev. 297, 298 (1922).

157. *Id.*

158. *Id.*

159. *Id.* at 298–99.

160. Akers & Hayes, *supra* note 4, at 141.

just to accommodate a third party who lacks the bank's detailed knowledge of the debtor's financial condition.[161] By contrast, in the estate planning transactions described above in Part II of this Article, a guarantee is made not merely to address an information asymmetry, but to mitigate an objectively serious risk of default. Thus, the fees typically charged for a bank letter of credit may understate the value of guarantees in the estate planning context.

3. Option Model

A guarantee may also be compared to an option:

> A guarantee's value is the present value of future contingent events that can result in either a large loss, if the guarantee requires full payment by the guarantor, or no loss. These contingent states lend themselves to either binomial or Black-Scholes option modeling, two widely accepted methods for valuing options.[162]

Or in plain English: the guarantor is giving the borrower the right to sell its illiquid assets to the guarantor for a set price (specifically, the amount by which the borrower's debt exceeds its liquidity). That type of option is commonly known as a "put,"[163] and, like the CDSs discussed above, can be valued by plugging risk estimates into a mathematical model.[164] If the debtor's assets appreciate, the debtor keeps all the gain, while if the debtor's assets decline in value, the guarantor bears all the loss (at least in those cases where the debtor is too thinly capitalized to have a meaningful amount of its own capital at risk).

On closer inspection, however, the analogy between an option and a guarantee is imperfect. Once the debtor is in default and the

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161. *See* Martin Shenkman*, Role of Guarantees and Seed Gifts in Family Installment Sales*, 37 Est. Plan. 3, 5 (2010) (noting that some practitioners "reject the letter of credit paradigm based on the circumstances that often accompany their issue," including "an ongoing commercial banking relationship").

162. William S. Forsberg & Randall Schostag, *Valuing Loan Guarantees in a Sale to an Intentionally Defective Grantor Trust*, 7 Valuation Strategies 20, at *5 (2003).

163. Black's Law Dictionary 1237 (6th ed. 1991).

164. Forsberg & Schostag, *supra* note 162, at *5.

guarantee comes into play, the debtor does not just have the *right* to sell its remaining assets to the guarantor for the amount of the outstanding debt, it has an *obligation* to do so.[165] The debtor cannot choose to sit on its rights (e.g., to see if the value of its assets will recover), because the required transfers are not in fact "optional." Ignoring that aspect of the arrangement may overstate the value of the benefits the debtor derives from the guarantee. Further, the term of the arrangement—a key factor in option valuation[166]—is uncertain. The guarantee may remain in place for as long as the underlying debt is outstanding, or may terminate earlier in the event of a default or if the debtor acquires enough equity to refinance the debt and extinguish the guarantee. With these issues in mind, it seems appropriate to use the "option value" of a guarantee as one factor, but not the only factor, in determining the guarantee's actual value.

4. Cost of Equity Capital Model

Finally, the value of the guarantee might be determined by reference to the return that an investor making an *equity* investment in the debtor would require to make the investment.[167] Under this approach, described by two commenters as the "most definitive method" of calculating a guarantee fee,[168] the appraiser would determine the amount the guarantor actually has at risk (recognizing that the debtor's assets are unlikely to fall to zero), multiply that amount by the probability that the risk will occur, and then multiply the result again by difference between the rate of return an equity investor would expect here and the rate of return an investor could obtain from a risk-free alternative.[169] For example, suppose the loan amount is $1 million but the debtor's assets assuredly would not fall below $250,000 even in extreme conditions, so the

165. *See* Brian D. Hulse, *After the Guarantor Pays: The Uncertain Equitable Doctrines of Reimbursement, Contribution, and Subrogation*, 51 Real Prop. Tr. & Est. L.J. 41, 50 (2016) (explaining that the debtor is obligated to reimburse the guarantor on "the due date of the underlying obligation" or when the guarantor makes payment, whichever comes later).

166. Lynn Curtis, *Valuation of Stock Options in Dividing Marital Property upon Dissolution*, 15 J. Am. Acad. Matrim. L. 411, 440–41 (1998).

167. *See* Forsberg & Schostag, *supra* note 162, at *4.

168. *Id.*

169. *Id.*

amount actually at risk is only $750,000.[170] Assume further that there is a five percent chance the debtor will default over the term of the loan.[171] Finally, assume that an equity investor would expect a 25% return from such a risky venture over the term of the loan, but could earn a ten percent return from a risk-free alternative investment like a U.S. Treasury bond.[172] In that case, the guarantor's "average" (or probability weighted) liability under the guarantee would be five percent of $750,000, or $37,500, and the profit the guarantor would demand for incurring that liability would be 15% of $37,600, or $5,625.[173] Thus, the price the guarantor should demand under this model would be $37,600 plus $5,625, or $43,225. That is about 4.3% of the guaranteed loan balance, which (depending on the term of the loan) may not be dramatically different from the one to three percent annual fee described for bank letters of credit in Part IV.A.2. Of course, the result will depend greatly on the probability of default and the expected rate of return that are input into the model, so this method of computing value still requires an appraiser to make highly subjective judgments.

B. Conceptual Objection to Use of Valuation Models

The models described above provide feasible (though difficult) methods for valuing loan guarantees, with the credit default swap approach appearing most realistic since it is derived from actual pricing of similar financial instruments in real-world arm's-length transactions. One may reasonably question, however, whether guarantees *should* be valued "realistically," given the more taxpayer-friendly approach the Supreme Court suggested for determining the use value of money in *Dickman*, and the even more taxpayer-friendly approach Congress adopted in response to that case.

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170. *Id.* More precisely, the amount at risk is *up to* $750,000, as there would be default scenarios in which the losses are lower. For ease of discussion and calculation, however, assume here that the loss will be either $750,000 or zero.

171. *Id.*

172. *Id.*

173. *See* Forsberg & Schostag, *supra* note 162, at *4. The authors actually refer to the $5,625 figure as the *value* of the guarantee, but that appears to be an error as the guarantor should expect to receive an amount equal to the average liability it incurs plus a profit.

In *Dickman*, the Supreme Court suggested that the value of an interest-free loan could be determined by reference to the rate the donor could have earned on the lent funds: "to support a gift tax on the transfer of the use of $100,000 for one year . . . it is sufficient for the Commissioner to establish that a certain yield could readily be secured. . . ."[174] That measure of value—focusing as it does on the *donor's* alternative investment options—does not reflect the rate at which the *debtor* could borrow from a third party. If the debtor could otherwise obtain credit only at a very high interest rate, determining the use value of money in this manner would seem to understate the benefit provided.

Nevertheless, Congress doubled down on that approach when it enacted section.[175] Section 7872 provides that the use value of money is determined by reference to the "applicable federal rate," which is based on the average yield of U.S. Treasury securities.[176] The interest rate at which the debtor could have borrowed is irrelevant, and even the interest rate at which the donor typically invests is irrelevant. Instead, the statute assumes that the donor would have purchased only U.S. Treasury securities (which are among the lowest-yielding investments) and uses the interest rate on such securities as the measure of the donor's gift.[177]

Section 7872 by its terms applies only to the valuation of actual loans between related parties,[178] not to the valuation of loan guarantees. Nevertheless, if one assumes as a policy matter that the gift tax treatment of loans and loan guarantees should be similar, section 7872 poses a problem for the use of any of the guarantee valuation models described above. Conceptually, a guarantee offers two sources of value to a borrower: First, it may allow a loan to be made that otherwise could not be justified at *any* interest rate. Second, in cases where a loan could still have been made at some high rate without a guarantee, the guarantee may allow that loan to be made at a lower rate. It is appropriate to take the first source of value into account under the gift tax, but taxing the second source of value is problematic. If a donor can make a

174. Dickman v. Comm'r, 465 U.S. 330, 344 n.14 (1984). The Court's discussion of this question is dicta, however, as the Court also noted that "[t]he valuation issue is . . . not presented on the record before us." *Id.*

175. § 7872.

176. §§ 7872(f)(1), (2), 1274(d)(1)(C).

177. § 7872(a)(1), (e), (f)(1).

178. § 7872(a)(1).

loan directly at the artificially low rate allowed by section 7872, without making a taxable gift, then arguably a donor should be able to induce a third party to make a loan at that same low rate, without making a taxable gift.

Unfortunately, this objection makes hash of any market-based valuation model, as those models do not separate out the component of a "market" guarantee's value that is attributable merely to the reduction in the interest rate at which a loan can be made. One must either ignore the problem (which the Service might do, because section 7872 does not by its terms apply to loan guarantees and the objection is just conceptual), build a new valuation model from the ground up . . . or find a way to avoid having to value the guarantee.

V. A New(ish) Path Forward

As it happens, there is a way to appropriately account for guarantees in the gift tax system, without having to value the guarantee itself. The path forward draws on an approach the Fifth[179] and First[180] Circuits have applied to an analogous problem in corporate tax. These Circuits have declared that the guarantor of an impecunious *corporate* debtor's obligations should be treated as having incurred those obligations directly and then retransferred the amount at issue to the debtor.[181] In the particular cases at issue, the debtor lacked substantial resources of its own, so the courts had no difficulty determining that the guarantor's deemed transfer to the debtor should be characterized as a capital contribution rather than a loan.[182] Although not directly on point, a Supreme Court case also seems to support the same general approach.[183]

This approach can be readily adapted for gift tax purposes. In an estate planning context, the debtor would typically be a trust rather than a corporation, but that does not seem to be an important detail. A guarantor of an impecunious trust's debt may still be treated as having incurred that debt directly and then retransferred the amount at issue to

179. Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712 (5th Cir. 1972).

180. Casco Bank & Trust v. U.S., 544 F.2d 528 (1st Cir. 1976).

181. *Casco*, 544 F.2d at 533–34; *Plantation Patterns*, 462 F.2d at 722–23.

182. *Casco*, 544 F.2d at 533–34; *Plantation Patterns*, 462 F.2d at 722–23.

183. Putnam v. Comm'r, 352 U.S. 82 (1956).

the trust. In cases where that deemed transfer cannot be justified as a loan, the guarantor would be deemed simply to have made a gift to the trust. The guarantor has retained an interest in that gift—the guarantor's right to be repaid by the trust (to the extent possible) if the guarantor is required to make good on the guarantee—but that retained interest is *deemed* to be worthless for federal gift tax purposes.[184] This neatly avoids the valuation difficulties discussed in Part IV, above. It also avoids imposing gift tax on guarantees that merely reduce the interest rate at which a borrower may obtain credit, maintaining conceptual consistency with section 7872.

A. Plantation Patterns

The Fifth Circuit illuminated this path with its decision in *Plantation Patterns, Inc. v. Commissioner*.[185] The facts of *Plantation Patterns* are complex, involving layers of subordinated debts, some of which the court respected as debt and some of which the court did not.[186] At its core, though, the case concerned the efforts of an individual taxpayer, John Jemison, to help a new company incorporated in his wife's name acquire assets far in excess of what its meager resources would otherwise permit.[187] Mrs. Jemison contributed a total of $5,000 to the company; the company, in turn, incurred a vastly larger amount of debt to finance various acquisitions.[188] The company's debt-to-equity ratio may be determined in different ways, depending on how one accounts for a tranche of debt that was paid off fairly quickly, but was conservatively calculated by the Service as in excess of 125 to 1.[189] Mr. Jemison guaranteed most of the company's debt.[190] When the company later attempted to deduct its interest payments on the debt, the Service demurred.[191] The Service argued, and the Tax Court agreed, that most

184. § 2702(a)(2)(A).

185. *Plantation Patterns*, 462 F.2d 712.

186. *See id.* at 723 ("Our holding does not require that we find [another debt of the same company] to be equity interests. . . . We agree with the Tax Court that [the other debt] was a legitimate loan.").

187. *Id.* at 714–16.

188. *Id.*

189. *Id.* at 721.

190. *Id.* at 715–16.

191. *Id.* at 717.

of the debt was really Mr. Jemison's, not the company's.[192] Therefore, not only could the company not deduct its interest payments, those payments constituted taxable dividends to the Jemisons as owners.[193]

On appeal, the Fifth Circuit first referenced a prior case's listing of factors to consider in evaluating whether a purported loan to a corporation should be respected as such:

> (1) the names given to the certificates evidencing the indebtedness;
> (2) the presence or absence of a maturity date;
> (3) the source of the payments;
> (4) the right to enforce the payment of principal and interest;
> (5) participation in management;
> (6) a status equal to or inferior to that of regular corporate creditors;
> (7) the intent of the parties;
> (8) "thin" or adequate capitalization;
> (9) identity of interest between creditor and stockholder;
> (10) payment of interest only out of "dividend" money; and
> (11) the ability of the corporation to obtain loans from outside lending institutions.[194]

The Fifth Circuit also mentioned an additional "critical" factor: whether the borrowed funds were used to acquire capital assets (which was the case here).[195]

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192. *Id.* at 717–18.

193. *Id.* at 718. Neither the Service nor the Tax Court appears to have thought it significant that *Mrs.* Jemison was the only owner of record, though the Fifth Circuit took note of that fact. *See id.* at 714 (implying that the stock may have been the Jemisons' community property, as "[t]he record does not indicate whether or not the funds for the purchase of the stock came from the separate estate of Mrs. Jemison"), 715 (observing nevertheless that "Mrs. Jemison was the sole shareholder of record"), 722 (characterizing Mr. Jemison as "the 'constructive' owner" of the stock).

194. *Id.* at 718–19 (citing Montclair, Inc. v. Comm'r, 318 F.2d 38, 40 (5th Cir. 1963)).

195. *Id.* at 722.

The taxpayers invoked several of these factors in their favor, noting among other things that the company paid the notes when due (touching on the third, fourth and seventh factors) and that the lender had the same rights as at least a general creditor (touching on the sixth factor).[196] However, the Fifth Circuit zeroed in on the eighth and eleventh factors: "[c]entral to this appeal is the taxpayers' contention that the Tax Court erroneously concluded that New Plantation was thinly capitalized. . . . While the sellers were ostensibly to look to the corporation for payment of the debt, it is apparent from the meager capital position of the company that Mr. Jemison's guarantee was regarded as the real undergirding for the deal.[197] The court also pointedly noted Mr. Jemison's role as the prime mover behind the company, relevant under the fifth factor.[198] These facts led the court to conclude that the transaction should be recast:

> The guarantee enabled Mr. Jemison to put a minimum amount of cash into [the corporation] immediately, and to avoid any further cash investment in the corporation unless and until it should fall on hard times. At the same time he exercised total control over its management . . . [W]e think that the result is that Mr. Jemison's guarantee simply amounted to a covert way of putting his money "at the risk of the business." Stated differently, the guarantee enabled Mr. Jemison to create borrowing power for the corporation which normally would have existed only through the presence of more adequate capitalization of [the corporation].[199]

Finally, the court was unimpressed by "the fact that ultimately things progressed smoothly . . . and [the corporation's] debts were paid without additional financing," as "[t]he transaction must be judged on the conditions that existed when the deal was consummated," when the corporation could not plausibly have obtained financing on its own.[200] Thus, the transaction was treated for income tax purposes as if

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196. *Id.* at 719–20.
197. *Id.* at 719, 722.
198. *Id.* at 722.
199. *Id.* at 722–23.
200. *Id.* at 723.

Mr. Jemison had borrowed the funds and transferred them to the company.[201] That transfer could not be justified as a loan, only as a capital contribution.[202] Mr. Jemison retained an indirect interest in the deemed contribution, but only as an *owner* of the company (directly or through his wife), not as a *creditor*.[203]

The analogy to loans made and guaranteed in the estate planning context is clear. A trust with only "a minimum amount of cash," and no other assets, would be unable to obtain loans from an outside lending institution. If a family member facilitates a loan to the trust by offering her personal guarantee, the family member is "putting [her] money 'at the risk of the [trust's] business'" and "creat[ing] borrowing power for the [trust] which normally would have existed only through the presence of more adequate capitalization."[204] Further, in many cases the guarantor will exercise significant influence, if not "total control," over the trust's management, though savvy planners might avoid this factor.[205] As in *Plantation Patterns*, it is appropriate in these circumstances to treat the guarantor, not the trust, as the actual borrower, and to treat the guarantor as having transferred the borrowed funds to the trust.

B. Casco Bank & Trust Co.

The First Circuit followed the Fifth Circuit's lead in *Casco Bank & Trust Co. v. United States*.[206] In this case, the taxpayer, William Preston, owned substantially all the stock in a construction company, M & P.[207] The company had only a modest amount of capital, so it was unable to obtain bonds for construction projects without Preston's personal guarantee.[208] The company's fortunes waned, complications arose on pending projects, unpaid contractors filed liens, and the issuer of the bonds, Maine Bonding & Casualty Company, began fielding complaints from aggrieved parties and directed Preston to make good on his guarantee.[209] Preston

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201. *Id.* at 721–22.
202. *Id.* at 721–22.
203. *Id.* at 722.
204. *See id.* at 722–23.
205. *See id.* at 722.
206. Casco Bank & Trust v. United States, 544 F.2d 528 (1st Cir. 1976).
207. *Id.* at 529.
208. *Id.* at 529–30.
209. *Id.* at 530.

did so by making advances to his company to enable it to meet its obligations, but the company ultimately collapsed and he wrote off these advances as a bad business debt.[210] The Service disallowed his claimed income tax deduction and the district court upheld that determination, finding that Preston had made capital contributions, not true loans, to his company.[211]

On appeal, the First Circuit focused more closely on the effect of Preston's guarantee, because his advances were made pursuant to that guarantee.[212] The court observed that in making the guarantee he "did not loan money" but rather "his personal credit," and found that this arrangement was "similar to the personal guarantee made by [the taxpayer] in [*Plantation Patterns*]."[213] As in *Plantation Patterns*, the arrangement was best viewed as Preston obtaining capital using his credit and transferring that capital to his company.[214] Under the circumstances, neither the guarantee nor any payments made thereunder could "be viewed as establishing a meaningful debtor-creditor relationship" between Preston and his company.[215] While Preston may have "hoped, if business improved, to recover" the payments he made under this arrangement, that hope indicated only that he retained an equity interest in the company.[216]

Here, too, the analogy to loans made and guaranteed in the estate planning context seems reasonably close. Preston's corporation was unable to obtain credit without his personal backing, much as a nominally funded family trust is unable to obtain (or at least justify) credit without a family member's personal backing. Preston's guarantee, and the money he later advanced pursuant to that guarantee, were recast as contributions in which he retained an equity interest; in the context of a family trust, the family member's guarantee would be

210. *Id.*

211. *Id.* at 532.

212. *See id.* at 533 ("[W]hether or not the advances to M & P were technically in discharge of his obligations under the indemnity agreement, Preston had to pay; his only choice was as to the form and timing of the payments. It seems unrealistic, therefore, to view the advances in isolation from the indemnity agreement which compelled them.").

213. *Id.* at 533.

214. *Id.*

215. *Id.*

216. *Id.* at 535.

recast as a gift in which the guarantor retained a beneficial interest (valued at zero under section 2702).

C. Putnam v. Commissioner

Finally, the Supreme Court's decision in *Putnam v. Commissioner* seems generally consistent with the reasoning of *Plantation Patterns* and *Casco Bank*.[217] In this case the taxpayer, Max Putnam, established a publishing company that ultimately failed.[218] The company financed its operations in part through bank loans that Putnam personally guaranteed.[219] The company liquidated but was unable to pay its debts in full, so Putnam paid the deficiency and claimed an income tax deduction for the loss.[220] Importantly, the Service did not dispute that this loss related to a debt rather than an equity interest: the only issue for the Court to decide was whether it was a *business* debt ("incurred in [a] transaction . . . for profit") or a *nonbusiness* debt, as that distinction affected the manner in which Putnam could deduct the loss.[221] In the course of resolving that issue, the Court made a striking observation:

> There is no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan. The tax consequences should in all reason be the same. . . .[222]

Thus, while the Court was not asked to, and did not, recharacterize the guarantee as a capital contribution, it did indicate that the guarantee should be viewed in the same manner as if the guarantor had provided the funds to the borrower directly.[223] That seems consistent with the

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217. Putnam v. Comm'r, 352 U.S. 82 (1956).

218. *Id.* at 84–85.

219. *Id.* at 85.

220. *Id.* at 83–85.

221. *Id.* at 83–84; *see also* Casco Bank & Trust v. United States, 544 F.2d 528, 534 (1st Cir. 1976) ("The Court was not called upon in *Putnam* to distinguish, as we are here, between a business . . . debt and an advance in the nature of a capital contribution.").

222. *Putnam*, 353 U.S. at 92–93.

223. Interestingly, two other commenters recognize this aspect of *Putnam* but do not follow it through to the same conclusion. *See* Hatcher &

treatment of guarantees for income tax purposes in *Plantation Patterns* and *Casco Bank*, and with this article's suggested treatment of guarantees for gift tax purposes.

D. Benefits of the Proposed Approach

As noted in the introduction to this Part, the primary benefit of this Article's suggested approach to loan guarantees is that it avoids the need to value the guarantee for gift tax purposes. But it also has other notable advantages.

First, it avoids tagging the guarantor with a taxable gift in cases where the debtor could have borrowed funds on its own without a guarantee, just at a higher interest rate. In such cases, the arrangement would be recast as two *valid* loans (one from the lender to the guarantor and one from the guarantor to the debtor on the same terms). Assuming the interest rate exceeds the very modest "applicable federal rate" under section 7872, as would nearly always be the case, no gift would result.[224] This may help shelter everyday non-abusive loan guarantees among family members. For example, parents may guarantee their adult son's car loan, to allow the son to finance the car on reasonable terms. So long as the son could have obtained financing without the guarantee, perhaps at an onerous, loan-shark rate from the seediest car lot around, the guarantee could be made without gift-tax implications.

Second, this approach can make use of (and if necessary expand upon) existing safe harbors under section 7872 for non-abusive intra-family loans. For example, section 7872(c)(2) waives any imputed gift so long as the aggregate outstanding loan amount does not exceed

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Manigault, *supra* note 34, at 156 (citing *Putnam* to suggest that "[t]here should be no difference . . . between the gift tax consequences of back-to-back loans and the gift tax consequences of a guaranteed loan," but not acknowledging that a "back-to-back" loan would itself be vulnerable to challenge when the intermediate lender is extending credit to a very shaky borrower). *Cf.* Smith v. Comm'r, 23 T.C.M. (CCH) 1689 (1964), *aff'd*, 370 F.2d 178 (6th Cir. 1966) (holding that where an individual borrowed funds from a bank and re-lent these funds to his thinly capitalized corporation, the second loan should be recharacterized as a capital contribution).

224. *See* § 7872(e)(2) (defining the amount of "forgone interest" that is taxable as a gift as the amount by which the applicable federal rate exceeds the interest actually charged).

$10,000.[225] Further, section 7872(i)(1)(C) gives regulatory authority to the Treasury to exempt "any class of transactions the interest arrangements of which have no significant effect on any Federal tax liability of the lender or the borrower."[226] This provision might be used to exempt guarantees of car loans and home loans (capped at a level high enough to accommodate the needs of all but the wealthiest families), and exempt guarantees by a trust of its beneficiaries' debts (of any magnitude). While guarantees arguably relate to more than just "interest arrangements," the Treasury has invoked its regulatory authority under this section liberally: for example, by exempting most home loans made by an employer to an employee, and by exempting student loans and other government-guaranteed loans, even though some of these loans are surely made to individuals who are not otherwise creditworthy.[227] It would not seem difficult to extend similar relief to routine guarantees of debt incurred by family members, nor would anyone appear to have standing to object to such relief.[228] Further, the Supreme Court has all but invited the government to take a practical approach to taxing the use value of property, noting that "[w]e assume that the focus of the Internal Revenue Service is not on such traditional familial matters" as providing "adult children with such things as the use of cars or vacation cottages."[229] Accordingly, it should be possible to implement this Article's suggested approach to guarantees while still formally or informally exempting innocuous everyday transactions.

Third, this approach can incorporate additional safe harbors to provide greater certainty in the administration of tax laws. For example, the Treasury could use its regulatory authority under section 7872(i)(1)(C) to exempt guarantees of loans where the borrower has a debt-to-equity ratio of at least nine-to-one.[230] Establishing safe harbors of this

225. § 7872(c)(2).

226. § 7872(i)(1)(C).

227. Temp. Reg. § 1.7872–5T(b)(5), (c)(1)(i).

228. *See* Freedom From Religion Foundation v. Lew, 773 F.3d 815, 819 (7th Cir. 2014) (holding that the plaintiff lacked standing to object to a tax benefit allowed to ministers, because it did not suffer a "concrete and particularized" injury from this benefit being provided to others, beyond just "every citizen's interest in proper application of the Constitution and laws").

229. Dickman v. Comm'r, 465 U.S. 330, 341 (1984).

230. *Cf.* Petter v. Comm'r, 98 T.C.M. (CCH) 534 (observing that the planner in that case "believed there was a rule of thumb that a trust capitalized with a gift at least 10 percent of its assets would be viewed by the IRS

type would accommodate conservative estate planning and avoid unnecessary litigation over the boundaries of what is permitted, while chilling more aggressive planning techniques.

VI. Conclusion

The Internal Revenue Service tolerated no-interest family loans for decades, before finally imposing gift tax on these arrangements with the approval of the Supreme Court.[231] The Service has now tolerated no-fee family guarantees for decades more, without seeking to impose gift tax on these arrangements since an ill-fated trial run in the early 1990s.[232] It is time for the government to act, relying on the Supreme Court's recognition that a gift may arise when a taxpayer makes property available for another's use,[233] and accepting the Fifth Circuit's invitation to recharacterize a guaranteed loan as a loan from the lender to the guarantor followed by a transfer from the guarantor to the borrower.[234] The recharacterization approach is simple and administratively feasible, and would bring the gift tax treatment of loan guarantees in the estate planning context into harmony with the income tax treatment of loan guarantees in the corporate tax context. Accordingly, the Service should revoke its acquiescence to *Bradford*,[235] the Treasury should issue regulations adopting the recharacterization approach suggested by *Plantation Patterns*[236] while establishing appropriate exemptions and safe harbors, and, following the issuance of such regulations, the Service should begin recharacterizing abusive loan guarantees as gifts.

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as a legitimate, arm's-length purchaser in [a] later sale"); Akers & Hayes, *supra* note 4, at 137–38 (noting that this rule of thumb is common "lore" among practitioners).

231. *Dickman*, 465 U.S. at 342–44.

232. *See* P.L.R. 1991-13-009 (Mar. 29, 1991) (ruling that a guarantor is subject to gift tax on the value of the guarantee); P.L.R. 1994-09-018 (Mar. 4, 1994) (withdrawing P.L.R. 1991-13-009); F.S.A. (Jun. 17, 1994), 1994 WL 1865994 (declaring that "The Service's position on this issue is still being reconsidered.").

233. *Dickman*, 465 U.S. at 344.

234. Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712, 722–23 (5th Cir. 1972).

235. Bradford v. Comm'r, 34 T.C. 1059 (1960), *acq.* 1961–2 C.B. 4.

236. *Plantation Patterns*, 462 F.2d at 722–23.

MANAGING CALIFORNIA INCOME TAXES WITH TRUSTS

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California clients often ask whether there is any way to eliminate, reduce, or at least defer that hefty California income tax. The answer is "yes" in many situations through the proper use of trusts. And the potential savings are not insignificant. For example, via a properly constructed nongrantor trust, over $100,000 of California tax can be saved on a $1 million long-term capital gain! This paper will summarize the rules and offer planning ideas.

The Basics

In California, trustees are cautioned: "Do not file Form 541 if there are no California fiduciaries, California noncontingent beneficiaries, or California sourced income."[1] Otherwise, a trustee must file a return if the trust has gross income of more than $10,000, net income of more than $100, or alternative minimum tax liability.[2]

California adheres to most but not all of the federal grantor-trust rules. Hence, although one statute provides that "Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code,

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[1] Instructions to 2024 Cal. Form 541 at 5 (emphasis in original). California Franchise Tax Board (FTB) rulings, publications, and other releases as well as California Office of Tax Appeals decisions may be viewed at www.ftb.ca.gov. California State Board of Equalization decisions may be viewed at www.boe.ca.gov.

[2] Instructions to 2024 Cal. Form 541 at 5. See Cal. Rev. & Tax. Code § 18505(e)–(f). See also In the Matter of the Appeal of: Gary M. and Patricia B. Orman Irrevocable Tr. 2012, 2021 WL 1895586, at *3 (Cal. Off. Tax App. Mar. 4, 2021) (trustee did not establish reasonable cause for late filing of return); In the Matter of the Appeal of: Est. of V. Baker, 2020 WL 8084625 (Cal. Off. Tax App. Nov. 23, 2020) (same); In the Matter of the Appeal of: Merrill L. Mago Tr. 14, 2014 WL 3414962, at *2 (Cal. St. Bd. Eq. Mar. 25, 2014) (same); Cal. Franchise Tax Bd. Info. Ltr. 2015-02, 2015 Cal. FTB I.L. Lexis 2 (Apr. 21, 2015) (trust having California trustee but no California source income or noncontingent beneficiary has filing requirement for California nonsource income). See Eric J. Coffill & Alexandra M. Louderback, Sourcing Problems and Pitfalls Involving the California Taxation of Trusts, 30 J. Multistate Tax'n & Incentives 8 (June 2020). Effective January 1, 2018, appeals from the California Franchise Tax Board are heard by the California Office of Tax Appeals rather than by the California State Board of Equalization (2017 Cal. A.B. 102). In In the Matter of the Appeal of La Paloma Nevada Trust, 2022 WL 16934769, at *6 (Cal. Off. Tax. App. Aug. 29, 2022), the California Office of Tax Appeals held that "Appellant failed to establish that the property was held for investment to satisfy the qualified purpose requirement for a tax-free exchange, pursuant to IRC section 1031." See Andrea Muse, Trust Property Was Not Held For Investment, California OTA Finds, 106 Tax Notes State 596 (Nov. 14, 2022).

relating to estates, trusts, beneficiaries, and decedents, shall apply, except as otherwise provided,"[3] another statute says:[4]

> Unless otherwise specifically provided, when applying any provision of the Internal Revenue Code for purposes of this part, a reference to any of the following is not applicable for purposes of this part:
>
> . . .
>
> (6) A foreign trust, as defined in Section 679 of the Internal Revenue Code.

Accordingly, a trust that is classified as a grantor trust under IRC § 679 will be a grantor trust for federal but not for California tax purposes.[5] The Golden State permits trustees of nongrantor trusts to take a distribution deduction.[6] Thanks to Proposition 30 (2012),[7] which increased the top marginal rate to 12.3%, and the additional 1.0% Mental Health Services Tax,[8] California taxed the taxable income (including accumulated ordinary income and capital gains) of nongrantor trusts at rates up to 13.3% in 2024 (the 13.3% rate applied starting with such income over $1 million),[9] and, thanks to Proposition 55 (2016), the top 13.3% rate is scheduled to apply through 2030.[10] The state also assesses an AMT equal to 7% of the excess of the tentative minimum tax for the taxable year over the regular tax for the taxable year.[11]

Beginning in 2024, California taxes some taxpayers at rates up to 14.4%. A commentator explains how this can happen:[12]

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[3] Cal. Rev. & Tax. Code § 17731(a).

[4] Cal. Rev. & Tax. Code § 17024.5(b)(6).

[5] See Mark E. Mullin, Having Your Cake and Eating It Too: California and Federal Hybrid Trusts, 115 Tax Notes State 81 (Jan. 13, 2025).

[6] See Cal. Rev. & Tax. Code § 17731(a); Instructions to 2024 Cal. Form 541 at 11, 15-16, 25–28.

[7] Cal. Const. art. XIII, § 36(f)(2)(A)(iii).

[8] Cal. Rev. & Tax. Code § 17043(a); Instructions to 2024 Cal. Form 541 at 12.

[9] Cal. Const. art. XIII, § 36(f)(2); Cal. Rev. & Tax. Code §§ 17041(a)(1), (e), (h), 17043(a); Instructions to 2024 Cal. Form 541 at 9.

[10] Cal. Const. art. XIII, § 36(f)(2); Cal. Rev. & Tax. Code § 17041(a)(1).

[11] See Cal. Rev. & Tax. Code §§ 17062, 17062.3, 17062.5, 17063. See also Instructions to 2024 Cal. Form 541 at 12.

[12] Billy Hamilton, A Half Year of California Tax Issues, 112 Tax Notes State 731, 731 (June 3, 2024).

> The year kicked off on January 1 with a tax increase on some of the state's high earners because of a change in the payroll tax used to pay for State Disability Insurance (SDI).
>
> Before this year, California residents paid a 0.9 percent SDI tax on wages up to $153,164 in annual income, resulting in a maximum individual contribution of $1,378 annually. Earnings above the $153,164 cap weren't taxed. Under S.B. 951, which was enacted in 2022 and took effect in January, that wage cap was removed, and the tax rate was nudged up to 1.1 percent. The primary effect of the change was on high earners whose SDI tax liability had been capped because of the wage ceiling.
>
> The change translates into an increase in California's top marginal tax rate on income to 14.4 percent from 13.3 percent for those earning over $1 million. The 14.4 percent rate is a combination of the highest marginal personal income tax rate (12.3 percent), a 1 percent mental health tax, and now the uncapped SDI tax rate of 1.1 percent.

Under California's sui generis system, a trust is taxed on its California non-source income using two criteria—the residences of the fiduciaries and the residences of the noncontingent beneficiaries—as follows:[13]

> Except as otherwise provided in this chapter, the income of . . . [a] trust is taxable to the . . . trust. The tax applies to the . . . entire taxable income of a trust, if the fiduciary or beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident, regardless of the residence of the settlor.

Effective January 1, 1963, the pertinent statute was amended to add "other than a beneficiary whose interest in such trust is contingent,"[14] and another statute stipulates that the amendment

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[13] Cal. Rev. & Tax. Code § 17742(a). See Cal. Rev. & Tax. Code §§ 17743–17744; Cal. Code Regs. tit. 18, §§ 17743–17744.

[14] Cal. Rev. & Tax. Code § 17743, as amended by 1963 Cal. Stat. 1142.

was effective for post-1962 tax years only.[15] As covered below, though, the constitutionality of the pre-1963 statute was questionable then and now.

In this paper, a "Resident Trust" is a trust that has a California resident fiduciary and/or a California resident noncontingent beneficiary, whether or not the trust has California source income.

Note that an individual is a resident of California if the individual is in the state for other than a temporary or transitory purpose or if the individual is domiciled there during the year.[16] An individual who spends more than nine months in the state during the tax year is presumed to be a resident.[17]

The Resident Fiduciary Test

Note that taxation is based on the residence of a fiduciary, which is a "trustee. . .or any person, whether individual or corporate, acting in any fiduciary capacity for any person. . .or trust," [18] not of a trustee. As noted previously, rules are provided for determining whether an individual (presumably including an individual fiduciary) is a resident,[19] but the State Board of Equalization of the State of California ruled that California resident individual trustees who delegated their duties to nonresident corporate fiduciaries were not California resident fiduciaries.[20] The residence of a corporate fiduciary is determined as follows:[21]

> For purposes of this article the residence of a corporate fiduciary of a trust means the place where the corporation transacts the major portion of its administration of the trust.

A commentator explains:[22]

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[15] Cal. Rev. & Tax. Code § 17745.1.

[16] Cal. Rev. & Tax. Code § 17014(a); Cal. Code Regs. tit. 18, § 17014.

[17] Cal. Rev. & Tax. Code § 17016; Cal. Code Regs. tit. 18, § 17016. See Cal. Franchise Tax Bd. Publ. 1031, 2023 Guidelines for Determining Resident Status (2023). See also Timothy P. Noonan, et al., The Nuts and Bolts of State Residency Rules Part 1 (Non-N.Y. Edition), 110 Tax Notes State 555, 557–60 (Nov. 20, 2023).

[18] Cal. Rev. & Tax. Code § 17006.

[19] Cal. Rev. & Tax. Code § 17014.

[20] Appeals of Yolanda King Fam. Tr. & Mary L. Tunney Junior Tr., 2007 WL 3275357, at *1 (Cal. St. Bd. Eq. Oct. 4, 2007).

[21] Cal. Rev. & Tax. Code § 17742(b). See Ronald Fam. Tr., 2000 WL 1137423 (Cal. St. Bd. Eq. May 4, 2000).

[22] Kathleen K. Wright, The Demise of the Incomplete Gift Non-Grantor Trust, 109 Tax Notes State 911, 913 (Sept.

> For corporate fiduciaries, the non-California-source income is sourced to the location where the major portion of the trust administration occurs. Trust administration duties include paying the trust's bills, maintaining insurance for trust property, developing an investment strategy that balances cash flow with potential for asset growth with minimal or reasonable risk, overseeing the investments, maintaining detailed records, reporting promptly to beneficiaries, and making timely distributions to beneficiaries.

If a trust has California and non-California fiduciaries, tax is apportioned in the following way:[23]

> Where the taxability of income under this chapter depends on the residence of the fiduciary and there are two or more fiduciaries for the trust, the income taxable under Section 17742 shall be apportioned according to the number of fiduciaries resident in this state pursuant to rules and regulations prescribed by the Franchise Tax Board.

As a result, tax may be diluted by appointing one or more non-California fiduciaries.

In a 2018 decision involving the Paula Trust, a California trial court held that this tax apportionment extends to source income as well as to nonsource income.[24] Unfortunately, the California Court of Appeal, First District, reversed the lower court's decision in 2020.[25] On October 14, 2020, the Supreme Court of California denied the taxpayers' petition to review that decision.

If the California resident trustee of a nongrantor trust is succeeded by a nonresident trustee during a tax year, the trust is taxed as a resident trust for the portion of the year during which it has a resident trustee and as a nonresident trust for the rest of the year. On this issue, the tax

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18, 2023) (footnote omitted).

[23] Cal. Rev. & Tax. Code § 17743. See Cal. Code Regs. tit. 18, § 17743.

[24] Paula Tr. v. California Franchise Tax Bd., No. CGC-16-556126 (Cal. Super. Ct. Jan. 11, 2018).

[25] Steuer v. Franchise Tax Bd., 265 Cal.Rptr.3d 216, 225 (Cal. Ct. App. 2020). See Roxanne Bland, California's Tangled Trust Tax Laws, 98 Tax Notes State 295 (Oct. 19, 2020); Andrea Muse, Appeals Court Rules Trust Taxable on California Source Income, 97 Tax Notes State 76 (July 6, 2020).

return instructions[26] direct trustees to a California Franchise Tax Board publication that provides in pertinent part under the heading Part-Year Resident:[27]

> If you changed your residency during 2009, compute income and deductions using resident rules for the period of the year you were a California resident and nonresident rules for the period of the year you were a nonresident.

The Resident Noncontingent Beneficiary Test

Even if a Californian is a beneficiary of a trust that has a non-California trustee, the trustee should be able to defer or eliminate California taxation of accumulated ordinary income and capital gains if distribution of such income and gains is within the trustee's discretion. In this connection, the California State Board of Equalization ruled that a beneficiary who could receive distributions only on a corporate trustee's exercise of discretion was a contingent beneficiary.[28] Furthermore, in a 2006 Technical Advice Memorandum,[29] that agency ruled that: (1) A resident beneficiary of a discretionary trust has a noncontingent interest in the trust only as of the time, and to the extent of the amount of income, that the trustee actually decides to distribute; (2) Accumulated income is taxable to a trust when it is distributed or distributable to a resident beneficiary; and (3) The conclusion in (1) above is unaffected if the trustee may or does distribute principal (capital gains) to the current beneficiary.[30]

Moreover, in a 2014 case, an Ohio intermediate appellate court refused to surcharge a trustee for failing to pay California income taxes for 1970 through 2006 because it concluded that:[31]

> In our view the trial court did not err in ruling that Mr. Lisle's interest in the Trust was contingent and did not create any California

[26] Instructions to 2024 Cal. Form 541 at 5, 25, 27.

[27] Cal. Franchise Tax Bd. Publ'n 1100, Taxation of Nonresidents and Individuals Who Change Residency (Rev. May 2020).

[28] Yolanda King Fam. Tr., 2007 WL 3275357, at *1.

[29] Cal. Franchise Tax Bd. Technical Advice Memorandum 2006-0002, Clarification of California Revenue & Taxation Code § 17742, 2006 Cal. FTB TAM Lexis 14 (Franchise Tax Bd. Feb. 17, 2006).

[30] Cal. Franchise Tax Bd. Technical Advice Memorandum 2006-0002. For authority that the receipt of current income does not warrant imposition of an ad valorem tax on the entire principal, see Brooke v. City of Norfolk, 277 U.S. 27, 28–29 (1928); Safe Deposit & Tr. Co. v. Virginia, 280 U.S. 83, 93 (1929); N.C. Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Fam. Tr., 588 U.S. 262, 271, n.6 (2019).

[31] Newcomer v. Nat'l City Bank, 19 N.E.3d 492, 514–15 (Ohio Ct. App. 2014).

> income tax liability under Cal Rev & Tax 17742(a). Mr. Lisle's interest in the trust was subject to a condition precedent either under the Trust's own terms or by imposition of an ascertainable standard by operation of R.C. 1340.22(B), now re-codified as R.C. 5808.14(B)(1) . . ..

Finally, the California Court of Appeal, First District, held in 2020 that a beneficiary's interest was contingent because "[t]he settlor intended the trustees to have absolute discretion."[32]

If a trust has California and non-California beneficiaries, tax is apportioned as follows:[33]

> Where the taxability of income under this chapter depends on the residence of the beneficiary and there are two or more beneficiaries of the trust, the income taxable under Section 17742 shall be apportioned according to the number and interest of beneficiaries resident in this state pursuant to rules and regulations prescribed by the Franchise Tax Board.

The Throwback Tax

Rules are provided for the taxation of California resident beneficiaries on untaxed income from prior years through a throwback tax:[34]

> (a) If, for any reason, the taxes imposed on income of a trust which is taxable to the trust because the fiduciary or beneficiary is a resident of this state are not paid when due and remain unpaid when that income is distributable to the beneficiary, or in case the income is distributable to the beneficiary before the taxes are due, if the taxes are not paid when due, such income shall be taxable to the beneficiary when distributable to him except that in the case of a

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[32] Steuer v. Franchise Tax Bd., 265 Cal.Rptr.3d 216, 227 (Cal. Ct. App. 2020).

[33] Cal. Rev. & Tax. Code § 17744. See Cal. Code Regs. tit. 18, § 17744.

[34] Cal. Rev. & Tax. Code § 17745. See Instructions to 2024 Cal. Form 541 at 11. See also McCulloch v. Franchise Tax Bd., 390 P.2d 412 (Cal. 1964); In the Matter of the Appeal of the First Nat'l Bank of Chicago, 1964 WL 1459 (Cal. St. Bd. Eq. June 23, 1964); In the Matter of the Appeal of C. Pardee Erdman, 1970 WL 2442 (Cal. St. Bd. Eq. Feb. 18, 1970). The U.S. Supreme Court did not address the validity of the throwback-tax structure in its 2019 N.C. Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Fam. Tr. decision (588 U.S. 262, 278 n.13 (2019)) ("The Trust also raises no challenge to the practice known as throwback taxation, by which a State taxes accumulated income at the time it is actually distributed. See, e.g., Cal. Rev. & Tax. Code § 17745(b)").

nonresident beneficiary such income shall be taxable only to the extent it is derived from sources within this state.

(b) If no taxes have been paid on the current or accumulated income of the trust because the resident beneficiary's interest in the trust was contingent such income shall be taxable to the beneficiary when distributed or distributable to him or her

(c) The tax on that income which is taxable to the beneficiary under subdivisions (a) or (b) is a tax on the receipt of that income distributed or on the constructive receipt of that distributable income. For purposes of this section income accumulated by a trust continues to be income even though the trust provides that the income (ordinary or capital) shall become a part of the corpus.

(d) The tax attributable to the inclusion of that income in the gross income of that beneficiary for the year that income is distributed or distributable under subdivision (b) shall be the aggregate of the taxes which would have been attributable to that income had it been included in the gross income of that beneficiary ratably for the year of distribution and the five preceding taxable years, or for the period that the trust accumulated or acquired income for that contingent beneficiary, whichever period is the shorter.

(e) In the event that a person is a resident beneficiary during the period of accumulation, and leaves this state within 12 months prior to the date of distribution of accumulated income and returns to the state within 12 months after distribution, it shall be presumed that the beneficiary continued to be a resident of this state throughout the time of distribution.

Other Rules

A "Nonresident Trust" is a trust that is not a "Resident Trust."[35] California taxes the taxable income of trustees at the amount for an individual having the same amount of taxable income.[36] The tax return instructions offer the following guidance: [37]

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[35] See Cal. Rev. & Tax. Code §§ 17015, 17742(a).

[36] Cal. Rev. & Tax. Code § 17041(e), (a)(1). See Instructions to 2024 Cal. Form 541 at 15–16, 27.

[37] Instructions to 2024 Cal. Form 541 at 16.

There are five different situations that can occur when determining the taxability of a trust. The situations and treatment are:

1. If the trustee (or all the trustees, if more than one) is a California resident, the trust is taxed on all income from all sources (R&TC Section 17742).

2. If the noncontingent beneficiary (or all the noncontingent beneficiaries, if more than one) is a California resident, the trust is taxed on all income from all sources (R&TC Section 17742).

3. If at least one trustee is a California resident and at least one trustee is a nonresident and all beneficiaries are nonresidents, the trust is taxed on all California source income plus the proportion of all other income that the number of California resident trustees bears to the total number of trustees (R&TC Section 17743). Complete Schedule G.

4. If all of the trustees are nonresidents and at least one noncontingent beneficiary is a California resident and at least one noncontingent beneficiary is a nonresident, the trust is taxed on all California source income plus the proportion of all other income that the number of California resident noncontingent beneficiaries bear to the total number of noncontingent beneficiaries (R&TC Section 17744). Complete Schedule G.

5. If the trust has resident and nonresident trustees and resident and nonresident noncontingent beneficiaries, both situations 3 and 4 apply. Complete Schedule G.

Computation of tax is quite complicated in situation 5 where a trust has source income, resident and nonresident fiduciaries, and resident and nonresident noncontingent beneficiaries. In such a situation, California taxes all of the California source income of the trust, regardless of the residence of the trustees or beneficiaries. After that, the taxation of the non-California source income depends first on the residences of the trustees and then on the residences of the noncontingent beneficiaries. To illustrate, if a trust has non-California source income of $90,000, three trustees of whom only one is a California resident, and two noncontingent beneficiaries of whom one is a California resident, California taxes $60,000 of the non-California source income ($30,000 attributable to the one resident trustee and an additional $30,000 (one-half of the

remaining $60,000 of the non-California source income) attributable to the one resident beneficiary).[38]

In a 2022 decision, a California Court of Appeal held that "the nonresident trust shareholders of Pabst, a unitary multistate S corporation, are taxed on their pass-through pro rata share of the gain" from the sale of a wholly owned subsidiary.[39] In a 2023 decision, a California Court of Appeal held that "the FTB has not shown there is no triable issue of fact as to the source of the Trust's income."[40] On remand, the trial court held that not all income was apportionable to California, entitling the trusts to a $5.4 million refund.[41]
In California, trustees must make estimated tax payments for trusts[42] and must withhold tax from distributions to nonresident beneficiaries in certain circumstances.[43]

CRTs

A CRT generally is exempt from California income tax in accordance with the following statute:[44]

> For taxable years beginning on or after January 1, 2014, Section 664(c)(2) of the Internal Revenue Code, relating to excise tax, shall not apply and, in lieu thereof, the unrelated business taxable income, as defined in Section 23732, of every charitable remainder annuity

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[38] Cal. Franchise Tax Bd. Legal Ruling 1959-238, Trusts: Accumulated Income; Taxation When There are Both Resident and Nonresident Trustees and Beneficiaries (Oct. 27, 1959). See Instructions to 2024 Cal. Form 541 at 16.

[39] J.P. Morgan Tr. Co. of Delaware v. Franchise Tax Bd., 294 Cal. Rptr. 3d 557, 561 (Cal. Ct. App. 2022). See also Christopher T. Lutz, California's Taxation of Sales of Flow-Through Interests, 108 Tax Notes State 1065 (June 26, 2023); Robert Willens, Holding Company and Operating Subsidiary Were 'Unitary', 107 Tax Notes State 971 (Mar. 13, 2023); Kathleen K. Wright, The Long Arm of California Stretches Even Farther, 107 Tax Notes State 435 (Jan. 30, 2023); Robert Willens, Nonresident Shareholders Taxed on S Corporation's Business Income, 104 Tax Notes State 1329 (June 27, 2022); Andrea Muse, California Court: Shareholder Gain Apportionable as Business Income, 104 Tax Notes State 1055 (June 6, 2022).

[40] Steuer v. Franchise Tax Bd., 2023 WL 5969174, at *9 (Cal. Ct. App. Sept 14, 2023). See Cameron Browne, California Appellate Court Revives Trustees' Tax Return Claims, 109 Tax Notes State 1042 (Sept. 25, 2023).

[41] Steuer v. California Franchise Tax Bd., No. CGC-18-571122 (Cal. Super. Ct. Jan. 22, 2025). See Christopher Jardine, California Trusts Get $5.4 Million Refund on Century Theaters Sale, 115 Tax Notes State 351 (Feb. 3, 2025).

[42] See Cal. Rev. & Tax. Code § 19136; Instructions to 2024 Cal. Form 541 at 8, 13.

[43] See Cal. Rev. & Tax. Code §§ 18662–18677; Cal. Code Regs. tit. 18, §§ 17951-1(c), 17951-2, 17953; Instructions to 2024 Cal. Form 541 at 9.

[44] Cal. Rev. & Tax. Code § 17755. See Cal. Rev. & Tax. Code § 17651.

trust or charitable remainder unitrust shall be subject to tax under Section 17651.

The instructions to the California fiduciary income tax return require trustees of CRTs to file California Form 541-B.[45]

Planning

To recapitulate, a commentator summarized California's framework for the income taxation of nongrantor trusts in 2023:[46]

> The income of the trust is sourced to and taxed by California if one of three separate criteria are met:
>
> the trust has income from California sources (such as income from real or personal property in the state)
>
> a trustee of the trust is a resident of California; or
>
> A non-contingent beneficiary of the trust is a resident of California.

She continued:[47]

> In summary, all of a trust's <u>California-source income</u> is taxable by California, regardless of where the trust is managed or where the beneficiaries reside. The remaining income of a trust (that is, the non-California source income) will be taxable by California based on a residency theory if the trust has a California resident fiduciary or California resident non-contingent beneficiary. If either all the fiduciaries or all of the non-contingent beneficiaries of a trust are California residents, the trust's income will be wholly taxable by California. If none of the fiduciaries are California residents and there are no non-contingent beneficiaries (only contingent

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[45] Instructions to 2024 Cal. Form 541 at 5, 6, 7.

[46] Kathleen K. Wright, The Demise of the Incomplete Gift Non-Grantor Trust, 109 Tax Notes State 911, 913 (Sept. 18, 2023) (footnotes omitted).

[47] Id. at 913 (emphasis in original; footnote omitted).

> beneficiaries) and there is no California-source income, then there is no California tax liability.

A 2016 article advises:[48]

> Taxpayers should be wary of naming California fiduciaries if they are not prepared to pay the resulting state taxes. Beneficiaries need to be cognizant of when their contingent status vests and they become non-contingent beneficiaries (and taxable on their share of trust income).
>
> As described above, a planning opportunity might exist by reason of the disconnect between the federal and the California grantor-trust rules.

The potential tax saving for the trustee of a California Resident Trust on a $1 million long-term capital gain incurred in 2024 was at least $104,988.

The net tax cost of including $1 million of long-term capital gain in DNI for a California resident individual rather than taxing the gain to a trust that was structured to escape tax in 2024 was $64,869.

The California Franchise Tax Board may enter into voluntary disclosure agreements with certain fiduciaries and trust beneficiaries in accordance with procedures that were amended in 2017.[49]

Self-Settled Trust Option—The "ING Trust"

Many domestic asset protection trusts (APTs) are grantor trusts for federal income-tax purposes under Internal Revenue Code (IRC) § 677(a) because the trustee may distribute income to—or accumulate it for—the trustor without the approval of an adverse party. However, if clients are willing to subject distributions to themselves to the control of adverse parties, they might use a type of domestic APT known as the incomplete gift nongrantor trust (ING Trust) to eliminate income tax on undistributed ordinary income and capital gains imposed by one of the many states that have adopted the federal grantor-trust rules. In dozens of private letter rulings issued since 2013,[50] the IRS ruled that domestic APTs that followed the ING-Trust approach qualified

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[48] Kathleen K. Wright, The Wacky World of California Trusts, 80 State Tax Notes 433, 437 (May 9, 2016).

[49] Cal. Rev. & Tax. Code §§ 19191–19192. See Amy Hamilton, Franchise Tax Board Expands Voluntary Disclosure Program, 86 State Tax Notes 116 (Oct. 9, 2017).

[50] See, e.g., PLRs 202017018 (Nov. 29, 2019); 202014001–202014005 (Aug. 26, 2019); 202007010 (Sept. 18,

as incomplete gifts and as nongrantor trusts. Most—if not all—of the early rulings involved Nevada law in large part because, at the time, Nevada was the only domestic APT state that allowed a trustor to keep a nongeneral lifetime power of appointment. Alaska, Delaware, and South Dakota now offer that option as well.[51] The trustor of an ING Trust might be able to receive tax-free distributions of the untaxed income in later years.

In 2015, a Delaware institution successfully resisted the California Franchise Tax Board's efforts to tax an ING Trust, thus saving the trustor millions of dollars of California income tax. There, the Franchise Tax Board initially contended that an improperly drafted ING trust was a grantor trust for California purposes, the trustee successfully petitioned the Delaware Court of Chancery to reform the trust, and the Franchise Tax Board withdrew its objection.
Unfortunately, effective in 2023, the ING-Trust option no longer is available for California residents pursuant to a statute which says:[52]

> For taxable years beginning on or after January 1, 2023, the income of an incomplete gift nongrantor trust shall be included in a qualified taxpayer's gross income to the extent the income of the trust would be taken into account in computing the qualified taxpayer's taxable income if the trust in its entirety were treated as a grantor trust under Section 17731.

Discredited Early Cases

As mentioned above, California taxes trusts based on two criteria—the residences of the fiduciaries and the residences of the beneficiaries.

In McCulloch v. Franchise Tax Board,[53] the Supreme Court of California held that California could tax the co-trustee/beneficiary on accumulated income distributed to him from a Missouri trust because the co-trustee/beneficiary was a California resident. The court said:[54]

2019); 202006002–202006006 (Sept. 18, 2019).

[51] Alaska Stat. § 34.40.110(b)(2); Del. Code Ann. tit. 12, § 3570(11)(b)(2); Nev. Rev. Stat. § 166.040(2)(b); S.D. Codified Laws § 55-16-2(2)(b).

[52] Cal. Rev. & Tax. Code § 17082(a), added by 2023 Cal. Stat. 55. See Instructions to 2024 Cal. Form 541 at 5–6. See also Kathleen K. Wright, The Demise of the Incomplete Gift Non-Grantor Trust, 109 Tax Notes State 911 (Sept. 18, 2023).

[53] McCulloch v. Franchise Tax Bd., 390 P.2d 412 (Cal. 1964).

[54] Id. at 421.

> We conclude that California could constitutionally tax plaintiff as the resident beneficiary upon the accumulated income when it was distributed to him. But plaintiff in the instant case was simultaneously beneficiary and a trustee. No possible doubt attaches to California's constitutional power to tax plaintiff as a trustee. His secondary role as a trustee reinforces the independent basis of taxing plaintiff as beneficiary.

The United States Supreme Court confirmed in the 2019 North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust,[55] relying on Greenough v. Tax Assessors of Newport,[56] that a state may tax a resident trustee of an otherwise Nonresident Trust without violating the Due Process Clause.

In McCulloch,[57] the Supreme Court of California also addressed the taxability of a nonresident trustee based on the residence of a contingent resident beneficiary as follows: [58]

> This case involves the state income tax consequences of a [1951] terminal distribution of the income accumulated by a discretionary trust during the period of the beneficiary's residence in California [1946-1950]. Plaintiff, the beneficiary of the trust and one of the trust's three trustees, protests California's assessment of a tax deficiency upon the accumulated income distributed to him. We find that plaintiff's California residence established sufficient contact of the trust with this state to subject it to California income tax.

Although the individual in question was a trustee as well as a beneficiary, the court held that: [59]

> [T]he beneficiary's residence . . . in California during this period subjected the trust to liability for state income taxes on its undistributed income.

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[55] N.C. Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Fam. Tr., 588 U.S. 262, 270 (2019).

[56] Greenough v. Tax Assessors of Newport, 331 U.S. 486 (1947).

[57] McCulloch, 390 P.2d 412.

[58] Id. At 414.

[59] Id. At 415.

Following McCulloch, in In the Matter of the Appeal of The First National Bank of Chicago,[60] the California State Board of Equalization ruled that California could tax six trusts being administered in Illinois because all beneficiaries were California residents. It said:[61]

> Appellant also urges that section 17742 (formerly 18102) is unconstitutional if it purports to tax the non-California income of a foreign trust which is administered by a nonresident trustee. This argument has been fully answered by the California Supreme Court in McCulloch v. Franchise Tax Board, wherein the court held that California could constitutionally tax a Missouri trust on income which was payable in the future to a beneficiary residing in this state, although such income was actually retained by the trust. The fact that the resident beneficiary was also one of the trust's three trustees was not relied upon by the court in holding that the residence of the beneficiary afforded a constitutionally sufficient connection to bring the trust's income within California's tax jurisdiction.

In In the Matter of the Appeal of C. Pardee Erdman,[62] the California State Board of Equalization, following McCulloch and First National Bank of Chicago, ruled that California could require California resident remainder beneficiaries to pay California tax on accumulated income and capital gains that had not previously been paid by the trustee of two trusts being administered in Illinois.

Whatever precedential value the above cases still might have had was eliminated by the United States Supreme Court's 2019 Kaestner decision. The Court held in Kaestner that:[63]

> We hold that the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain ever to receive it.

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[60] In the Matter of the Appeal of The First Nat'l Bank of Chicago, 1964 WL 1459 (Cal. State Bd. Eq. June 23, 1964), www.boe.ca.gov/legal/pdf/64-sbe-054.pdf.

[61] Id. at *3 (citation omitted).

[62] In the Matter of the Appeal of C. Pardee Erdman, 1970 WL 2442 (Cal. State Bd. Eq. Feb. 18, 1970), www.boe.ca.gov/legal/pdf/70-sbe-0007.pdf.

[63] N.C. Dep't of Revenue v. The Kimberly Rice Kaestner 1992 Fam. Tr., 588 U.S. 262, 270 (2019).

The Hellerstein treatise explains why McCulloch was wrongly decided in 1964 and why its post-Kaestner precedential value is questionable:[64]

> The California court failed to note or explain [in McCulloch] the apparent conflict between its ruling and the U.S. Supreme Court's decision in Safe Deposit & Trust Co. Moreover, the California court's decision is difficult, if not impossible, to reconcile with Kaestner Trust.

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[64] Jerome R. Hellerstein, Walter Hellerstein & John A. Swain, State Taxation ¶ 20.09[2][a][ii] at 11 (3d ed. Dec. 2024) (footnote omitted).

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Having Your Cake and Eating It Too: California and Federal Hybrid Trusts

by Mark E. Mullin

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Having Your Cake and Eating It Too: California and Federal Hybrid Trusts

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In this article, Mullin examines a technique that appears to combine California income tax savings with gift and estate tax savings.

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This article examines a technique that appears to combine California income tax savings with gift and estate tax savings. It accomplishes this via a California/federal "hybrid" trust — a trust with inconsistent income tax treatments across jurisdictions. Although only this specific hybrid trust is analyzed herein, other hybrid trusts may be possible in other states[1] and with other types of trusts,[2] and planners may be able to analogize aspects of this article to such cases.

I. Introduction — Why Californians Want Two Different Kinds of Trusts, and How to Combine Them

When planning their estates, high-net-worth California residents often face a dilemma: They would love to make trusts that minimize the California income tax, but they also want trusts optimized for minimizing federal transfer taxes (that is, the gift, estate, and generation-skipping transfer taxes). Unfortunately, this seems to mean they want two mutually exclusive kinds of trusts:

- For these California resident trust creators, the best trusts for minimizing California income taxes are typically non-grantor trusts — trusts treated as separate taxpayers from their creators/funders (known as settlors or grantors) for income tax purposes. Such non-grantor trusts can (if correctly designed) avoid California residency,[3] even if their settlors and beneficiaries are California residents. By avoiding California residency, non-grantor trusts avoid

[1] *See* BNA Portfolio 869-2nd: State Income Taxation of Trusts, II.A. ("Where the federal and state grantor-trust rules are not identical, it might be possible to structure a trust to be a grantor trust for federal purposes but to be a non-grantor trust for state purposes and to arrange matters so that the trust is not subject to that state's tax.") (citations omitted).

[2] For example, other hybrid trusts may also exist between the California and federal tax laws. Specifically, a California grantor, federal non-grantor hybrid trust might be possible for certain foreign grantors. *See* IRC section 672(f), Cal. Rev. & Tax. Code section 17024.5(b)(11). Another place for hybridity may be incomplete gift non-grantor (ING) trusts. If such trusts are indeed generally non-grantor trusts federally, then state laws treating such trusts as grantor trusts may cause hybrid mismatches.

[3] As a technical matter, the California statutes do not generally call trusts taxable on their worldwide income by California "residents," although they are in effect taxed like residents. *See* Cal. Rev. & Tax. Code section 17742 et seq. (providing rules causing such residency-type taxation); *but see* section 18003 (for the purposes of the other state tax credit, defining trusts taxed by a state without regard to sourcing of income to be residents of such taxing statute), section 17082(d)(3) (defining, for purposes of an exception to the anti-ING trust rules, a "resident non-grantor trust" as one where the tax applies to the entire taxable income of the trust based on fiduciary or beneficiary residency).

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California income taxes on their income not considered derived in ("sourced to") California, although such accumulated income would face taxation if later distributed to California resident beneficiaries under California's "throwback" tax.[4]

- Income not sourced to California includes nonbusiness intangible income, like most dividends or gains from stock, and business income apportioned outside California.[5]
- In contrast, California-source income includes rent or gain from California real property or business income apportioned to California.[6]

- At the same time, the best trusts for saving federal transfer taxes for these California residents are a particular variety of grantor trusts called intentionally defective grantor trusts (IDGTs). Grantor trusts have their assets deemed owned by their grantors for income tax purposes. Further, IDGTs do not have their assets treated as owned by their grantor for federal transfer tax purposes; meaning, for example, they will not be estate taxable on the grantor's death. This inconsistent treatment of IDGTs across the income and federal transfer taxes permits grantors to transact with IDGTs without triggering income taxation[7] and to make transfer-tax-free gifts to the trust's beneficiaries by paying taxes attributable to the trust's income.[8] These features can produce huge tax savings.

It seems impossible for a single trust to be wholly non-grantor and wholly grantor, creating an apparent dilemma for those wanting to save on both California and federal taxes. However, on closer investigation, it appears possible to create a trust that is a non-grantor trust not residing in California for California purposes while also being an IDGT for federal purposes, achieving the best of both worlds — an outcome made possible because a federal law (IRC section 679) treats certain foreign trusts as grantor trusts, while California seemingly does not conform to that federal law. Accordingly, unlike the federal government, California appears to treat such foreign trusts as non-grantor trusts (provided they lack other features that would trigger grantor trust status).

Section II of this article discusses the laws that appear to cause this mismatch and addresses counterarguments. It also notes a reason why this hybrid trust strategy may be constitutionally protected.

A trust with these hybrid characteristics may unlock powerful state and local tax benefits while minimizing federal transfer tax costs. As a shorthand, I refer to such federal/California hybrid trusts as "FCH" trusts if they avoid California income tax residency, avoid making California-taxable distributions to California-resident beneficiaries, and avoid creating exposure to foreign income taxes.[9]

Examples may help show the utility of FCH trusts in planning for both California income taxes and federal transfer taxes. Each following example assumes no change in the existing tax laws and discusses a California resident grantor (1) facing maximum marginal California and federal income tax rates (2) with no remaining exemption amount for federal transfer taxes (which are levied at a 40 percent rate):

- Example 1: If the grantor had an IDGT generating $10 million of non-California-source ordinary income, that would generate $1.33 million of California income tax. In contrast, if an FCH trust or non-California resident non-grantor trust recognized this same income, this tax would not have applied. For calculation purposes, it is assumed the trust would avoid making

[4] Cal. Rev. & Tax. Code section 17745.

[5] *See* Cal. Rev. & Tax. Code section 17952 and 18 Cal. Code Regs. section 17951-4.

[6] 18 Cal. Code Regs. section 17951-3 and -4.

[7] Rev. Rul. 85-13.

[8] Rev. Rul. 2004-64.

[9] Avoiding foreign income tax exposure is generally a straightforward matter when the grantor and beneficiaries are all U.S. residents. Generally, in that case, one would create a foreign trust by giving one or more substantial decisions to a foreign trust company or other person located in an appropriate foreign tax haven. For how this works on the U.S. side, see Treas. reg. section 301.7701-7(a)(1)(ii), (2), (d)(1)(ii) (collectively showing how giving substantial decisions to such a tax haven trust company would create foreign trust status).

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distributions of this income that could trigger California's throwback tax.[10]

- Example 2: If, instead, that grantor's non-California resident non-grantor trust generated that $10 million of non-California-source ordinary income, the trust would bear about $4.08 million of federal income tax. The grantor's replacement of that $4.08 million via a gift taxable transfer would cost the grantor gift taxes of $1.632 million.[11] In contrast, if an FCH trust or IDGT recognized that income, that gift tax cost would not apply, as the grantor would have presently paid the $4.08 million of federal income tax (instead of the trust) without generating any federal transfer taxes.

Thus, under the facts provided, by obtaining tax savings under both examples, the FCH trust outperforms each of the IDGT and non-California non-grantor trust by $1.33 million to $1.632 million of savings — creating an approximately 80 percent to 122 percent improvement over the other trusts! (If instead federal long-term capital gains rates applied or the trust's income taxes were repaid in an estate-taxable transfer, significant improvements would still apply.)[12]

Yet, this is not the only way FCH trusts could be interesting for planning, as provided in Section III.

However, FCH trusts present administrative and substantive tax considerations. A sophisticated accountant must participate in FCH trust compliance due to its unusual California tax reporting and need to comply with federal foreign trust reporting rules, enforced by large noncompliance penalties. Similarly, the need for a foreign person to be involved in the trust administration (to create a foreign trust) can create significant practical challenges.

Additionally, many common — and useful — grantor trust powers will need to be prohibited in an FCH trust, as will anything that could create California residency for the trust. California-source income will generally be undesirable to realize in FCH trusts, as it will diminish the trust's ability to grow tax-free, and it will typically make the trust produce results inferior to an IDGT for a California resident grantor. Further, the trusts' foreign status can also create substantive U.S. tax challenges. For example, on their grantor's death, FCH trusts may trigger the built-in gain of their assets, although planning may help avoid this issue. Lastly, this article addresses economic substance concerns with using such trusts and finds such concerns to have limited relevance. Even with these considerations, FCH trusts may prove valuable for many high-net-worth individuals with California connections.

These considerations are briefly noted in Section IV before the article concludes in Section V.

II. The FCH Trust: The Legal Reasoning Behind the Hybrid Trust Solution

As noted, grantors might resolve the apparent dilemma between obtaining federal transfer tax savings and obtaining California tax savings with an FCH trust. Assuming the reasoning behind it is sound, an FCH trust is treated as a non-grantor trust for California purposes but a grantor trust for federal purposes, while being designed to avoid federal transfer taxes and California and foreign residency-based taxes.

The basic idea behind why FCH trusts work is that California seemingly does not follow all the federal rules for creating a grantor trust. Thus, a

[10] Under the California throwback tax (Cal. Rev. & Tax. Code section 17745), the avoided California tax could be triggered on a later distribution to a California resident, converting the California tax avoidance in the example to deferral.

[11] Not reimbursing the trust's income taxes and simply holding those assets in the estate would ultimately cost more because of the tax-inclusive nature of the estate tax. If the $5,712,000 that would have been used to pay the federal income tax ($4,080,000) and the gift tax ($1,632,000) in the example were instead held until death, ignoring future appreciation or depreciation, the estate tax would be $2,284,800 on this amount, leaving only $3,427,200 after the estate tax.

[12] For the estate tax treatment of replenishing ordinary income, see the previous footnote. If long-term capital gain rates applied federally, Example 1 would apply unchanged and cause $1,330,000 of savings. However, in Example 2, only $2,380,000 of federal income taxes would be paid by the trust. Replenishing that amount via a gift taxable transfer would require $952,000 in gift tax; keeping that $2,380,000 and $952,000 in the estate would create $1,332,800 of presently valued estate taxes. Assuming the gift tax approach is used, that means a 70 percent to 139 percent improvement.

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trust that meets the federal requirements to be a grantor trust, but not the California requirements, would appear to be a hybrid trust — a grantor trust for federal purposes but a non-grantor trust for California purposes. Provided the trust is treated as non-grantor for California purposes, ensuring it lacks California resident fiduciaries or noncontingent beneficiaries would prevent California taxation of any non-California-source income earned by the trust.[13]

The more specific reasoning supporting the hybridity of FCH trusts follows immediately below. I then address potential challenges to such reasoning, concluding they are insufficiently substantiated.

A. Basic Legal Argument for Hybridity of FCH Trusts

Under the federal income tax rules, a trust is a grantor trust if it meets the requirements of any of the IRC sections 673-679. Under California rules, however, a trust appears to be grantor only if it meets IRC sections 673-678, with IRC section 679 conspicuously absent. In other words, if a trust is a grantor trust for federal income tax purposes solely because of IRC section 679, it would apparently be a non-grantor trust for California income tax purposes.

To trigger IRC section 679 and its attendant federal grantor trust status, a U.S. person, or someone soon migrating to the United States, must directly or indirectly transfer property to a foreign trust having one or more U.S. beneficiaries.[14] A trust is foreign if it fails to meet either the court test, facing the primary supervision of a court of U.S. jurisdiction, or the control test, having U.S. persons control all substantial decisions associated with administering the trust.[15]

The basis for why a trust treated as grantor solely because of IRC section 679 appears to be non-grantor for California purposes is simple: Cal. Rev. &. Tax. Code section 17024.5(b)(6)[16] says that IRC section 679 is inapplicable for California purposes. More specifically, it states that, "unless otherwise specifically provided, when applying any provision of the Internal Revenue Code for purposes of this part [that is, the personal income tax], a reference to any of the following is not applicable for purposes of this part: . . . [a] foreign trust," as defined in IRC section 679. As addressed below, no California law appears to "otherwise specifically provide" for IRC section 679's application for California tax purposes.

Therefore, the straightforward reading is that IRC section 679 does not apply for California income tax purposes, making a hybrid federal-grantor/California non-grantor trust possible. Commentators who have noticed Cal. Rev. &. Tax. Code section 17024.5(b)(6) agree that the statute has this straightforward hybrid trust reading.[17]

B. Addressing Counterarguments to the Foregoing Reading

Because of the extremely favorable tax outcomes implied by the foregoing reading of Cal. Rev. & Tax. Code section 17024.5(b)(6) — some of which are addressed in Section I, above, and

[13] Cal. Rev. & Tax. Code section 17742 et seq.

[14] IRC section 679(a). Note that unlike other grantor trust provisions, IRC section 679 technically applies to cause deemed ownership by a "transferor," rather than a grantor. For simplicity, this distinction and its technical consequences are disregarded in this article. Also, in practice, the transferor and grantor are almost always (and, perhaps, are always) the same person. For determining who is a transferor, see Treas. reg. section 1.679-1(c)(1) and section 1.679-3; for who is a grantor, see Treas. reg. section 1.671-2(e).

[15] IRC section 7701(a)(30)(E) and (31)(B), and Treas. reg. section 301.7701-7(a)(1) and (2).

[16] Note that the California corporate income tax, a separate tax for state law purposes, has a comparable provision regarding section 679. *See* Cal. Rev. & Tax. Code section 23051.5(b)(6). Nonetheless, this article does not seek to address the corporate income tax in further detail as it has limited relevance to estate planning.

[17] *See, e.g.*, Cal State Tax Reporter WK Cheetah para. 15-215 ("IRC section 671 — IRC Section 678 as amended as of California's federal conformity date, concerning grantors and others treated as substantial owners, are incorporated by reference into California law (sec. 17731, Rev. & Tax. Code) without change, except for modifications making federal provisions relating to foreign trusts inapplicable to California . . . IRC section 679, which applies grantor trust rules to a U.S. person who transfers property to a foreign trust (other than an employee trust) that has a U.S. beneficiary, does not apply for California purposes because of a provision that specifically makes inapplicable to California all federal provisions relating to foreign trusts."); CEB Drafting California Irrevocable Trusts section 3.2 ("California has not conformed to IRC section 679, pertaining to foreign trusts. Cal. Rev. & Tax. Code section 17024.5(b)(6).").

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Section III, below — it makes sense to investigate potential counterarguments carefully, as this section does before noting the weakness of each counterargument.

1. No More Specific Statute Overrides Cal. Rev. & Tax. Code Section 17024.5(b)(6)

The first counterargument against the hybrid trust reading of Cal. Rev. & Tax. Code section 17024.5(b)(6) is that another statute conflicts with it. If this were true, Cal. Rev. & Tax. Code section 17024.5(b)(6) would allow that other statute to override it so long as the other section "specifically provide[s]" for a contrary rule.

While the reasoning is sound, the problem with this counterargument is the lack of any section that specifically contradicts Cal. Rev. & Tax. Code section 17024.5(b)(6). The only apparent candidate is Cal. Rev. & Tax. Code section 17731(a), which provides that "Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code, relating to estates, trusts, beneficiaries, and decedents, shall apply, except as otherwise provided." While Cal. Rev. & Tax. Code section 17731(a) does generally incorporate the grantor trust rules from the IRC, it does not "otherwise *specifically* provide" (emphasis added) a rule contradicting the more specific statute of Cal. Rev. & Tax. Code section 17024.5(b)(6). Therefore, section 17731(a) appears insufficient to override section 17024.5(b)(6).[18] Conversely, section 17024.5(b)(6) does "otherwise provide" a rule disagreeing with section 17331(a), which, under section 17731(a)'s plain language, is enough to override section 17731(a).

Thus, this first counterargument appears unavailing.

2. No Alternative Reading of Cal. Rev. & Tax. Code Section 17024.5(b)(6) Better Matches Authorities Interpreting Cal. Rev. & Tax. Code Section 17024.5(b) or California Statutory Interpretation

A second counterargument might aim to prove that the foregoing reading (that IRC section 679 does not apply for California purposes) misinterprets Cal. Rev. & Tax. Code section 17024.5(b)(6). Instead, according to this counterargument, a less intuitive reading should govern.

By way of analogy, in an Arkansas case, a taxpayer's attempt to argue that certain grantor trust rules did not apply under state laws failed because the regulations governing grantor trust status were held to incorporate all federal grantor trust rules because of cross-references contained therein.[19] This holding was made even though the conclusion was not obvious from the relevant statute or regulations.

In California, this counterargument has two significant flaws. First, the hybrid trust reading of Cal. Rev. & Tax. Code section 17024.5(b)(6) accords with the plain meaning of the text, the most likely source of the Legislature's intent and thus the statute's meaning.[20] Second, it is challenging to read Cal. Rev. & Tax. Code section 17024.5(b)(6) to have a different meaning than I have provided. If it does not turn off IRC section 679 for California tax purposes, it is hard to see what it actually does.

Further support for the hybrid trust reading comes from authorities applying the other paragraphs of Cal. Rev. & Tax. Code section 17024.5(b). Each paragraph of section 17024.5(b) works the same way as the paragraph discussing section 679 (paragraph (6)): Each provides that "unless otherwise specifically provided, when applying any provision of the Internal Revenue Code for purposes of [the California personal income tax], a reference to any of the following is not applicable for purposes of [the California personal income tax]" and then describes the IRC references deactivated for the California personal income tax. As such, authorities interpreting other subparagraphs of Cal. Rev. & Tax. Code section 17024.5(b) should also help interpret Cal. Rev. & Tax. Code section 17024.5(b)(6).

[18] *See also* Antonin Scalia and Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* ch. 28 (2012) (covering the General/Specific Canon).

[19] In the Matter of * * *, Dkt. No. 20-755 (Ark. Dep't of Fin. & Admin., Office of Hearings & Appeals Opinion, Aug. 7, 2020).

[20] *See, e.g.*, *Hoechst Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324 (Cal. 2001).

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Such primary authorities interpreting Cal. Rev. & Tax. Code section 17024.5(b) read the other paragraphs just as I have read paragraph (6),[21] although some do find the applicable paragraph to be specifically overridden by another statute.[22] Secondary California tax authorities have also interpreted other Cal. Rev. & Tax. Code section 17024.5(b) paragraphs in the same manner as I have section 17024.5(b)(6).[23]

Policy considerations further support the plain, hybrid trust reading of Cal. Rev. & Tax. Code section 17024.5(b)(6). The California income taxes consistently reject federal multijurisdictional tax rules in favor of unique state alternatives,[24] and the reading I have provided of Cal. Rev. & Tax. Code section 17024.5(b)(6) furthers this policy.

Canons of construction and related considerations also support this article's reading of Cal. Rev. & Tax. Code section 17024.5(b)(6). California has rules requiring specific conformity to the federal entity classification rules for business entities, which specifically exclude nonbusiness trusts.[25] The inclusion of this rule for business entities but not trusts should be understood to mean that trusts are intended to follow state-only classification rules that may differ from federal classification rules.[26] California and its courts also avoid statutory interpretations that are unconstitutional,[27] and if California were to apply IRC section 679 in certain contexts, it might be unconstitutional.

For example, consider a domestic non-grantor trust created by a California transferor that California could not constitutionally tax because it has no nondiscretionary beneficiaries or trustees in the state's borders and lacks other

[21] In *Owais Kazi and Surwat Kazi*, OTA No. 18042990 (July 23, 2019), the OTA interpreted the provision that is now Cal. Rev. & Tax. Code section 17024.5(b)(11) to cause nonconformity to all provisions dealing with nonresident aliens, and similarly read Cal. Rev. & Tax. Code section 17024.5(b)(8) (stripping out IRC section 911 references from conformity) in the same manner. To similar effect is *E. Marsden and M. Marsden*, OTA No. 19115489 (May 10, 2022), footnote 5, noting in passing that Cal. Rev. & Tax. Code section 17024.5(b) prevents the application of rules concerning foreign income taxes and foreign income tax credits. *See* Cal. Rev. & Tax. Code section 17024.5(b)(7).

[22] These primary authorities dealing with Cal. Rev. & Tax. Code section 17024.5(b) generally note the provision and indicate it should be read as I have read it, and then conclude that another provision "specifically provides" otherwise and overrules section 17024.5(b). *See* FTB Legal Rulings 95-1 and 2017-02 (reporting provisions required to apply only to nonresidents federally also apply to those same persons for California purposes due to the requirement of Cal. Rev. & Tax. Code section 19141.5(e) to file copies of federal returns with California).

One nonbinding primary authority finds Cal. Rev. & Tax. Code section 17024.5(b) to only apply to substantive tax rules, rather than definitional tax rules. *See* FTB Letter of Advice issued Nov. 20, 1987 (WK California State Tax Reporter para. 401-587). Even assuming this is correct, it does not disturb the conclusions reached in this article, as the rules at issue are substantive.

[23] *See, e.g.*, WK California State Tax Reporter para. 15-470 (nonrecognition under Cal. Rev. & Tax. Code section 17024.5(b)(7) of foreign tax related rules apply to IRC section 461(f)'s contested liability rules as apply to foreign taxes); para. 15-745 (nonrecognition of personal holding companies under Cal. Rev. & Tax. Code section 17024.5(b)(3) eliminates IRC section 465 rule relevant to PHCs), para. 15-745 (nonrecognition under Cal. Rev. & Tax. Code section 17024.5(b)(9) and (11) of nonresidents and foreign corporations eliminates throwback rule of IRC section 667 applying to such persons); BNA California Individual Income Tax Navigator 4 and 5 and Estate, Gifts & Trusts Navigator 5 (citing Cal. Rev. & Tax. Code section 17024.5(b) as straightforwardly causing nonconformity with the IRC rules listed).

[24] *See, e.g.*, Cal. Rev. & Tax. Code section 17024.5(b)(1) (disabling DISC rules), (4) (disabling foreign personal holding company rules), (5) (disabling foreign investment company rules), (7) (disabling rules concerning foreign income taxes), (8) (disabling IRC section 911's earned income exclusion for citizens living and working abroad), (9) (disabling foreign corporation rules outside section 367), (11) (disabling rules concerning nonresident aliens); sections 17301-17307, 17742-17745, and 17951-17955 (applying entirely different constructs for multijurisdictional taxation of individuals, trusts, and estates than applies for federal purposes); sections 25101-25141 (applying an entirely different construct for multijurisdictional corporate groups than applies for federal income tax purposes).

[25] *See* Cal. Rev. & Tax. Code section 23038(b)(2)(B) (causing conformity with federal regulations for *business entity* classification under the personal and corporate income taxes); 18 Cal. Code Regs. section 23038(a)(3) (classifying trusts), 18 Cal. Code Regs. section 23038(b)-1 through -3 (classifying business entities).

[26] *See* Scalia and Garner, *supra* note 18, ch. 10, Negative-Implication Canon (summarized as, "the expression of one thing implies the exclusion of others (*expressio unius est exclusio alterius*)").

[27] *See Newsom v. Superior Court of Sutter County ex rel. Gallagher*, 63 Cal. App. 5th 1099 (Cal. Ct. App. 2021):

> The court relied on the rule that "statutes are to be construed, if their language permits, as to render them valid and constitutional rather than invalid and unconstitutional." This rule of statutory interpretation, called the canon of constitutional doubt, applies to ambiguous statutes, i.e., statutes reasonably susceptible of two interpretations. In that circumstance, "the court will adopt the construction which, without doing violence to the reasonable meaning of the language used, will render it valid in its entirety, or free from doubt as to its constitutionality, even though the other construction is equally reasonable." [Cleaned up.]

See also Scalia and Garner, *supra* note 18, ch. 38, Constitutional-Doubt Canon.

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connections.[28] Now, grant a foreign person power to control a substantial decision of the trust, making the trust foreign and triggering IRC section 679 for federal purposes. It seems doubtful conformity to IRC section 679 could permit California to constitutionally obtain taxing jurisdiction over that trust; after all, how could adding more international, non-California contacts for the trust create such jurisdiction?[29] This point not only aids our attempt to determine Cal. Rev. & Tax. Code section 17024.5(b)(6)'s meaning but also indicates that California's nonconformity to IRC section 679 may be difficult for California to change.

Thus, this second argument against trust hybridity — that Cal. Rev. & Tax. Code section 17024.5(b)(6) does not mean what it plainly appears to mean — is weak, as the statute's plain meaning, relevant authorities, California's multijurisdictional income tax policy, and the U.S. Constitution all support trust hybridity.

3. The Fact FCH Trust Income Shows Up in a Grantor's Federal Measures of Income Does Not Mean It Should Do the Same for California Income Tax

Another argument could be that the FCH trust is hybrid, but that is irrelevant to the ultimate tax treatment of the trust's income. The only apparent way to make this argument is as follows: Assume for a moment that, like many other states, the California personal income tax statutes told us to take a federal measure of income[30] and adjust it to result in California taxable income.[31] Assume further that no listed adjustment applies to address mismatched state and federal grantor/non-grantor characterizations of trusts. Provided this is how the California tax system worked, the creation of a California non-grantor, federal grantor trust would seemingly have no beneficial tax effect. The California grantor, after all, would still have the income of the trust included in their federal (and thus state) measure of income.[32]

If the previous paragraph accurately described how California's personal income tax system worked, that might pose a problem for the FCH trust. However, the description is inaccurate. In actuality, the California income tax rules construct an entirely separate tax system, not by cross-referencing the measures of income output by the IRC and adjusting them,[33] but instead by cross-referencing, altering, and supplementing the substantive rules of the IRC. While California's form for individual income taxes, Form 540, requires taxpayers to begin with federal adjusted gross income and then make California adjustments, that is merely a method of reporting that should not disturb the substantive underlying tax statutes.

Therefore, even though income and other items from FCH trusts will show up in a grantor's federal measures of income, it apparently should

[28] *See N.C. Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust*, 139 S. Ct. 2213 (2019) (holding that the mere fact that a trust's discretionary beneficiaries reside in a state is insufficient for that state to have nexus to tax the trust).

[29] While one might think that IRC section 679's status as a federal tax statute should mean state conformity is constitutionally permissible, case law indicates no such favorable presumption exists. *See Kraft General Foods Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71 (1992) (Iowa's following of then-federal tax laws, whereby dividends received deductions were provided to dividends from domestic corporations but not foreign corporations, was nevertheless unconstitutional as it discriminated against foreign commerce; the court was unconvinced by Iowa's argument that it should not face constitutional issues for merely adopting the federal measure of corporate taxable income).

[30] For example, this federal measure of income could refer to federal adjusted gross income or federal taxable income.

[31] As one example of a state operating in this manner, see 30 Del. Code Ann. section 1105:

> The entire taxable income of a resident of this State shall be the *federal adjusted gross income* as defined in the laws of the United States as the same are or shall become effective for any taxable year with the modifications and less the deductions and personal exemptions provided in this subchapter. [Emphasis added.]

[32] *See* BNA Portfolio 869-2nd: State Income Taxation of Trusts, II.A:

> Where the federal and state grantor-trust rules are not identical, it might be possible to structure a trust to be a grantor trust for federal purposes but to be a non-grantor trust for state purposes and to arrange matters so that the trust is not subject to that state's tax. . . . Unfortunately, a number of those same states tax individuals based on federal taxable income, which captures all federal grantor-trust income, making the foregoing planning option unavailable. [Citations removed.]

[33] That said, there are some aspects of the California income tax that do directly cross-reference federal tax figures, such as the California charitable contribution deduction limitation (based on federal AGI rather than California AGI). *See, e.g.*, State of California Franchise Tax Board, "FTB Tax Deduction — Charitable Contributions and Others" (Mar. 2019). Such exceptions prove the general rule that California's tax system does not rely on federal measures of adjusted gross income or taxable income.

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not show up in the grantor's California taxable income. Instead, it should show up on a separate return for the FCH trust.

C. Conclusion of Legal Analysis

Thus, I conclude that federal/California hybrid status appears to apply to trusts that are, for federal purposes, grantor trusts exclusively because of IRC section 679.

III. Some Tax Planning Benefits and Costs of the FCH Trust

With the legal basis for FCH trusts now clarified and defended, this section provides the fun part — a selection of some of the tax benefits an FCH trust can seemingly achieve (which resemble those traditionally created by hybrid entities in international tax planning). Each of the following techniques assumes (1) that the FCH trust technique indeed will be successful and (2) that any relevant grantor or withdrawal powerholder will be a U.S. resident or citizen.[34]

A. California Income and Federal Transfer Tax Minimization

As illustrated in Section I, a standard IDGT created by a California grantor will miss out on the California income tax savings opportunities of an adequately designed non-grantor trust, while a non-grantor trust created by a California grantor will miss out on the federal transfer tax benefits of having the grantor pay for the trust's income taxes. In contrast, an FCH trust can achieve both benefits for non-California source income, creating a tax result generally superior to both standard IDGTs and non-grantor trusts. As discussed in Part IV, however, the recognition of California-source income in FCH trusts can create a result inferior to IDGTs.

B. California-Only Income Tax Transactions and Consequences Thereof

One significant benefit of IDGTs — the avoidance of income taxation when a grantor deals with the trust — will be lost for California income tax purposes in the case of an FCH trust. Thus, a sale by a California grantor to their IDGT will generate no income taxes, but the same sale from a California grantor to their FCH trust would generate California income taxes. Federal income taxes would remain inapplicable.[35]

In some circumstances, grantors may happily pay this cost. In others, the grantor can instead apply transactions causing limited gain to move assets into trusts. Examples of such transactions include unencumbered gifts, freeze partnerships, sales routed through IDGTs or GRATs (which make distributions to, or later convert to, the FCH trust after the note/annuities are paid), and installment sales that either avoid gain, by being less than the sold asset's basis, or defer it under the installment sale rules.

In other circumstances, this apparent cost may prove to be a tax planning benefit. For example, if a California grantor carefully[36] purchases an appreciated asset held by the grantor's FCH trust and the resulting gain is not California-source, the California grantor should thereafter own the purchased asset with a stepped-up basis for California income tax purposes (which, depending on the asset, could even be depreciable). This outcome would result despite causing (1) no California taxation because the trust pays no tax on its non-California source income, (2) no federal taxation because the trust is a grantor trust for federal income tax purposes, and (3) possibly no taxation from any other jurisdiction, although this will require confirmation on a case-by-case basis.

C. Possible Double State Deductions Caused by States' Mismatched Treatment of FCH Trusts

Another aspect of FCH trusts worth noting is their apparent ability to allow multiple taxpayers to benefit from the same deduction under multiple separate state and local income tax systems.[37]

[34] *See* IRC section 679 and section 672(f) for why nationality and residency have relevance for the purposes of the federal income taxation of trusts.

[35] *See* Rev. Rul. 85-13.

[36] Among other concerns, an outstanding note issued by the grantor to pay for the sale could trigger grantor trust status under IRC section 675. Planners must proceed carefully in applying the aforementioned transaction.

[37] Whether and when the constitutional issues raised in Section II.B.2 might have relevance is not addressed.

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For example, assume a U.S. grantor creates an FCH trust. Assume further this grantor resides in a state that follows all the federal grantor trust rules. Accordingly, the trust assets would be deemed owned by the grantor under the federal and applicable state income taxes. Let us further say the trust has as its sole beneficiary a Californian who can withdraw the entirety of the trust's assets. Under IRC section 678, to which California conforms, this withdrawal power should mean the California beneficiary acquires deemed ownership of the trust's assets solely for California purposes.[38] In contrast, this power would not change the federal and non-California state income taxation, the incidence of which remains with the grantor.[39] Thus, the trust's assets are apparently deemed owned by the beneficiary for the California income tax and by the grantor for purposes of other income tax systems.

If the trust makes a charitable donation, the effect would apparently be that (1) the grantor receives a federal charitable deduction, (2) the grantor receives a charitable deduction under the law of the grantor's state of residency, and (3) the beneficiary with the withdrawal power receives a charitable deduction for California purposes. Absent the FCH trust's hybrid character, (2) and (3) would not be possible to combine. Thus, we seem to have effectively increased the value of the charitable deduction by causing it to further offset up to 13.3 additional percentage points of income taxes (that is, California income taxes). Note, however, that if this trust recognized income, it would increase the effective tax rate of the income, since two separate states would tax such income while likely not crediting one another's taxes.[40]

Thus, the FCH trust can apparently enable multiple taxpayers to benefit from the same deduction — or suffer taxation for the same income with improper planning — for state and local tax purposes.

D. Avoidance of California Throwback Taxes

If a non-California resident non-grantor trust received non-California source income, it would face no California taxation on that income. Under the California throwback tax, the trust's later distribution of that accumulated net income to a California resident beneficiary would trigger California taxation. This throwback tax seeks to prevent the reduction of California taxes via the use of a non-grantor trust.

The throwback tax does not apply to distributions from entities besides non-grantor trusts. Most notably, the rule does not apply to transfers deemed to come from individuals, apparently including grantor trusts taxable to such individuals.[41] Accordingly, where a grantor resides in a low-tax state, their grantor trust for California beneficiaries seemingly avoids immediate California taxes on any non-California-source income the trust earns, as well as later California throwback taxes on distributions of the trust's non-California-source income to California beneficiaries.

However, frequently a grantor will reside in California and want to make trusts primarily for California beneficiaries. An ordinary grantor trust

[38] IRC section 678, Cal. Rev. & Tax. Code section 17731. This withdrawal power would not affect the grantor's being deemed the owner of the trust assets for federal/other state purposes. *See* IRC section 678(b) (providing that deemed ownership by the grantor under sections 673-677 and section 679 overrides deemed ownership by a beneficiary under section 678).

[39] *See* IRC section 678(b) ("Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.").

[40] *See* Cal. Rev. & Tax. Code section 18001(a)(1) (generally only providing other state tax credits to amounts taxable by another state due to the income being sourced to that other state). Although Cal. Rev. & Tax. Code section 18004 provides credits when more than one state treats a trust as a resident, that would appear to only apply to non-grantor trusts, and the one discussed in this example is not that under any tax system. Presumably the same is true under Cal. Rev. & Tax. Code section 18005 (providing beneficiaries of trusts and estates other state tax credits for taxes imposed on trusts and estates).

[41] Cal. Rev. & Tax. Code section 17745 applies throwback to income accumulated by a trust; Rev. Rul. 85-13 and IRC section 671 cause grantor trust income to be the grantor's, and thus it is the grantor, not the trust, who accumulates this income. *See also* former 18 Cal. Code Regs. section 17742-17745(d) (entitled "Estates and Trusts Taxable as Separate Entities," and making clear former articles 1-4, which included Cal. Rev. & Tax. Code section 17745's throwback rules, "do not apply" to trusts where "the corpus or income remains attributable to the creator"). The regulation was repealed in 1981-1982 during a time of cleaning up the regulations without any apparent intention to reflect the regulation was wrong. *See* FTB rulemaking file for Register 82, No. 3.

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will not work in this case. Instead, a specially designed FCH trust might avoid California throwback taxes. This trust would generally be an FCH trust with a grantor residing in California, but this time, all the trust assets would be withdrawable by a beneficiary residing in a state that either follows the federal tax characterization of trusts or does not charge an income tax. The trust would also have Californians as discretionary beneficiaries. In this case, for federal purposes, the grantor would owe taxes for the trust. However, for California purposes, under the beneficiary-deemed-owned trust (section 678) rules, it would be the withdrawal powerholder who owes taxes for the trust.

Thus, if the trust recognizes non-California-source income, California would not tax it. When the trust later makes a distribution to a California resident beneficiary, California would apparently deem the income to come from the withdrawal powerholder and not the trust. As such, the throwback tax would apparently not apply. A planner would need to attend to the federal transfer tax and practical considerations of the withdrawal power, however.[42]

E. California Drop-Off Trusts

IRC section 679 aims to (among other goals) prevent the use of "drop-off" trusts. When these trusts worked, non-U.S. persons temporarily residing in the United States would minimize U.S. income taxation by dropping their assets off in a foreign trust when immigrating — also avoiding U.S. gift tax on creating such trusts. Such trusts appear to still work for federal transfer tax purposes and can work for federal income tax purposes if made far in advance.

Because California does not follow section 679, drop-off trusts may still work for California income tax purposes. Still, this planning technique may be of limited benefit considering U.S. domestic non-grantor drop-off trusts remain possible for federal purposes.

[42]For example, the withdrawal power could constitute an IRC section 2041 power of appointment, causing inclusion in the withdrawal powerholder's estate. Having the withdrawal power resemble a hanging, lapsing *Crummey* power may help. Also, one would need to trust the withdrawal powerholder beneficiary to a significant extent to use this plan.

IV. FCH Trust Technique Considerations

Despite the apparently powerful tax planning benefits of FCH trusts discussed in the foregoing section, such trusts are not free of considerations and downsides, which revolve primarily around three points. First, the FCH trust technique requires a foreign trust meeting the requirements of IRC section 679 (and no other grantor trust power), bringing various foreign trust rules into relevance; second, the technique creates some odd California tax implications and reporting issues; and third, one might wish to consider whether the economic substance doctrine could prevent the realization of FCH trust tax benefits.

A. Grantor Trust, Foreign Trust, and Section 679 Considerations

As noted, the FCH trust requires the use of a trust meeting the requirements to trigger IRC section 679 and no other grantor trust sections. This restricts the required grantors and beneficiaries while preventing the incorporation of many useful grantor trust powers, such as the power for a nonfiduciary to purchase trust assets for FMV consideration,[43] as well as the inability for the grantor, spouse, or related persons to control certain distributions.[44]

More significantly, IRC section 679 requires that the trust at issue be a foreign trust. When using a foreign trust, one will need to consider reporting requirements (including federal foreign trust and other international tax reporting rules, enforced by significant penalties),[45] the trust's inability to hold S corporation stock,[46] the potential triggering by IRC section 684 of gain for federal income tax purposes[47] when federal grantor trust status ceases on the death of the grantor or otherwise (and whether one might be able to avoid this gain trigger), whether the

[43]*See* IRC section 675(4)(C).

[44]*See* IRC section 674(a) and (c) (only trustees who are 50+ percent independent can have fully discretionary distribution powers without necessarily causing grantor trust status); section 674(a) and (d) (power over HEMS for ascertainable standard cannot be held by grantor or spouse without causing at least partial grantor trust status).

[45]*See, e.g.*, Forms 3520 and 3520-A.

[46]Treas. reg. section 1.1361-1(h)(2).

[47]California does not follow IRC section 684. Cal. Rev. & Tax. Code section 17760.

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deemed distribution rules applicable to foreign trusts under IRC section 643(i) could apply for California purposes,[48] and many other factors. Such considerations are not simple to address, and the complexity of doing so may make the trust inappropriate for many California grantors.

Of these various concerns, the most significant may be avoiding IRC section 684's gain triggering on the grantor's death (or if grantor trust status otherwise terminates while the trust is foreign). Several potential solutions exist, including the following, although each has its own risks, uncertainties, and challenges:

- It may be possible to avoid section 684 by causing the trust to become withdrawable by a U.S. beneficiary (and thus a beneficiary-deemed-owned trust under section 678) either immediately before or upon the transferor's death. The thought here is that a trust deemed owned by a U.S. beneficiary should not be able to spring into being as a foreign non-grantor trust is needed to trigger section 684. While there are arguments this should avoid section 684 even if the withdrawal power triggers upon the grantor's death, because section 684 is deemed to cause a transfer immediately before the grantor's death, this is somewhat uncertain. It may thus make sense to have this withdrawal power trigger earlier, such as when the grantor has sufficiently low odds of survival.[49]
- Another approach for a foreign trust passing the court test — that is, being subject to the primary supervision of a U.S. court (but not the control test due to foreigners having power over at least one substantial decision of the trust) — is to timely turn off foreigners' ability to make decisions for the trust. Similar timing considerations apply as for the withdrawal concept noted immediately before: That is, should the foreign persons lose their power on the grantor's death, or immediately before it?
- If the trust's assets are included in the grantor's estate and this triggers section 1014 basis step-up, then an exception to section 684 will apply[50] (although estate tax exposure is then a concern). Alternatively, swapping out the trust's assets for high-basis assets may work, although note that section 684 will not trigger losses for assets deemed transferred to a foreign non-grantor trust.
- For all the above, consider their effect on estate taxes and California income taxes (for example, swaps of property with an FCH trust potentially trigger California income taxes; withdrawal powers may create California throwback tax and estate tax issues, as well).

Foreign trusts also bring to bear practical administrative considerations. First, one would need an accountant expert in international tax reporting for individuals — a surprisingly uncommon skill that may demand a premium. Second, to make the trust foreign, one would need some offshore person — whether a trust company, attorney, or otherwise — to have the power to control a substantial decision of the trust. Such person must accept any due diligence hassles that may be associated with taking on a U.S. client and would also need to receive commensurate compensation. Again, this may be easier said than done.

B. State Tax Implications and Reporting Issues

FCH trusts produce unusual outcomes for state tax purposes that must be considered.

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[48] Cal. Rev. &. Tax. Code section 17024.5(b)(6) oddly refers to "a foreign trust, *as defined in* Section 679 of the Internal Revenue Code" (emphasis added). The language here seems nonsensical; section 679 technically does not define the concept of a "foreign trust," but rather merely relies on that concept, which is actually defined in IRC section 7701(a)(31)(B). *See* Treas. reg. section 1.679-1(b)(3). The meaning of this odd choice of words is unclear (does this mean foreign trust rules are still incorporated for some purposes in California?), but generally this matter is of little practical import. That is, beyond turning off IRC section 679, the California rules explicitly do not conform to rules relating to outbound transfers to foreign trusts (IRC section 684, per Cal. Rev. & Tax. Code section 17760), do not follow federal rules for taxing foreigners (instead using California-specific rules), and will not apply federal throwback rules where California throwback rules also apply (Cal. Rev. & Tax. Code section 17779). That does not explicitly handle all the special rules for foreign trusts (*e.g.*, section 643(i) provides for deemed distribution rules applicable only to foreign trusts), leaving some uncertainty.

[49] *See* Ellen K. Harrison, Elyse G. Kirschner, and Carlyn S. McCaffrey, "U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their Beneficiaries," ALI-CLE International Trust and Estate Planning 2018, at 21-22 (describing this withdrawal concept to avoid section 684 and trying to time it before death) (citing Treas. reg. section 1.684-2(e), example 2 as implying that the withdrawal concept should work).

[50] Treas. reg. section 1.684-3(c).

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First, aside from adding an extra California income tax bracket, FCH trusts do not save taxes on California-source income. Even worse, they would have to pay California income taxes incurred on any of their California-source income; an IDGT would avoid this poor transfer tax result by placing the California income tax liability on the grantor. Similarly, other states may or may not respect the FCH trust as its own taxpayer. This could create negative transfer tax results or confuse the application of multistate tax rules (such as tax credits and sourcing). Other possible extra tax costs could result from different states refusing to credit one another's taxes because they disagree on who earned the taxable income.

Second, to avoid California residency and later throwback tax, the trust's fiduciaries and beneficial interests must be carefully controlled, limiting flexibility.[51]

Third, an FCH trust must file its own California Form 541 if it has any California-source income, and the grantor must use Schedule CA on its Form 540 or 540-NR to back out income attributable to the FCH trust. This reporting is likely to be quite noticeable to the Franchise Tax Board. Further, the FCH trust also creates complex recordkeeping requirements by permitting income or deductions to exist solely for California purposes when the grantor and trust engage in transactions. Taxpayers should consider using a federal grantor trust filing method under Treas. reg. section 1.671-4, requiring the grantor trust to file its own Form 1041 rather than being rolled directly into the grantor's Form 1040. Such an approach would likely best harmonize with the California tax filings, despite still often being notably different.

Fourth, one must consider possible second-order oddities resulting from an FCH trust. For example, in the case of a partnership owned partly by an FCH trust and its grantor, the California partners for tax purposes will differ from federal tax. Additionally, because only California law would recognize the partnership as having two distinct taxpayer-owners, it may be possible for a partnership to exist solely for California tax purposes in which the entity's only owners are the grantor and the grantor's FCH trust. That said, California also emphasizes it follows federal entity classifications, creating confusion on this point.[52]

Fifth, one must ensure the taxpayer's advisers understand the California/federal mismatch. It may prove all too easy for a new team member to not understand the particularities of an FCH trust, and, for example, to not recognize that a transaction between the trust and grantor might be taxable for California purposes.

Lastly, if one were to alter an FCH trust to trigger grantor trust status for California income tax purposes, consider whether that could trigger California throwback taxation of any accumulated income deemed shifted to the grantor. This same risk applies to all non-grantor trusts with living California grantors.

C. The Apparently Low Risks from the Economic Substance Doctrine

A last question is whether anything about the use of an FCH trust could draw economic substance or similar substance-over-form scrutiny.

For several reasons, it appears that FCH trusts produce no more of an economic substance or similar concern than any other standard estate

[51] *See* Cal. Rev. & Tax. Code section 17742 et seq.

[52] *See* Cal. Rev. & Tax. Code section 23038(b)(2)(B)(iii):

> If the separate existence of an eligible business entity is disregarded for federal tax purposes, the separate existence of that business entity shall be disregarded for purposes of this part [that is, the corporate tax], Part 10 (commencing with section 17001), and Part 10.2 (commencing with section 18401), other than section 17941 (relating to the tax of a limited liability company), section 17942 (relating to the fee of an LLC), section 18633.5 (relating to the return of an LLC), and sections 17039 and 23036 (relating to tax credits).

See also 18 Cal. Code Regs. sections 23038(b)-2 to -3.

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planning trust. The following analyzes the federal rules (partly codified at IRC section 7701(o)), as California appears to materially follow these rules.[53]

Nevertheless, any tax adviser needs to keep in mind the potential for courts to expand the economic substance doctrine in unexpected ways.

1. The Economic Substance Doctrine Does Not Appear *Relevant* to Trusts, Other Than Sham Trusts, Under Case Law and Section 7701(o)(5)(B)

The economic substance doctrine applies only to the extent it is "relevant," a standard determined under historical case law preceding IRC section 7701(o)'s codification of the economic substance doctrine.[54] In the case of trusts, case law indicates economic substance is only relevant in analyzing whether a trust is a sham, which is primarily a matter of trust administration rather than purpose and is discussed later. For example, the Tax Court rejected applying the concept of business purpose to determine whether to separately regard a trust, because "we know that 'business purpose' is often absent in donative dispositions of property through the device of the family trust [and, accordingly], a litmus test of 'business purpose' on the part of the grantor will not suffice."[55] The court also indicated that nothing about the language of IRC section 641(b) — the statute causing trusts to be separate taxpayers treated like individuals — implicitly pulled in a business purpose requirement. The court brought this up as a distinction from *Gregory v. Helvering*,[56] the progenitor of the modern economic substance doctrine, which found business purpose an inherent requirement of the statutory language describing the requirements to achieve a nontaxable corporate reorganization.[57] The IRC section 679 rules at the heart of the FCH trust similarly trigger without regard to any business or other purpose.

As an example of the general lack of relevance of economic substance to trusts, before IRC section 643(f) (consolidating certain similar trusts bearing indicia of tax planning), the law generally respected taxpayers' ability to create droves of separately regarded trusts for the express purpose of tax planning.[58] That said, if the taxpayers did not respect the separateness of the trusts in administration, the trusts were properly treated as a single trust.[59]

IRC section 7701(o)(5)(B) further cements that trusts work outside the economic substance doctrine by stating:

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[53] California's codification of the economic substance doctrine generally looks to IRC section 7701(o) to define noneconomic substance transactions, except modified to protect state law. Cal. Rev. & Tax. Code section 19774(c)(2)(B).

That said, the statute does bear some indicia that it goes beyond the federal statute: The statute lists further transactions that could be treated as lacking economic substance and indicates its definition of a noneconomic substance transaction is nonexclusive. Cal. Rev. & Tax. Code section 19774(c)(2) (providing that "[a] 'noneconomic substance transaction' *includes*" those listed in section 19774(c)(2)(A) and (B)) (emphasis added), section 19774(c)(2)(A) (providing that transactions included as having no economic substance are "the disallowance of any loss, deduction or credit, or addition to income attributable to a determination that the disallowance or addition is attributable to a transaction or arrangement that lacks economic substance including a transaction or arrangement in which an entity is disregarded as lacking economic substance. *A transaction shall be treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction*.") (emphasis added).

This appearance seems to be deceiving as California cases test for economic substance in the same manner as cases applying the federal economic substance standard. *See La Rosa Capital Resource Inc.*, OTA Case No. 18042988 (Cal. Off. Tax App. June 3, 2020) (applying federal case law repeatedly to analyze economic substance). Moreover, consistent with how IRC section 7701(o) is applied, the legislative history indicates Cal. Rev. & Tax. Code section 19774 did no more than codify the common law economic substance doctrine. *See* S.B. 614, 2003, Assembly Committee; S.B. 86, 2011, various bill analyses (drawing connection to federal rule). Lastly, Cal. Rev. & Tax. Code section 19774(c)(2)(A)'s statement that economic substance requires a nontax California business purpose for all transactions would, if applied literally, mean estate planning trusts *all* lack economic substance (as trusts typically lack any *business* purpose). Such a reading appears inconsistent with the fact the Legislature has retained statutes respecting and taxing trusts in Cal. Rev. & Tax. Code section 17731 et seq. The requirement of a nontax California business purpose presumably is included to prevent California tax planning from being a legitimate business purpose for avoiding the economic substance doctrine, even though it may be a legitimate business purpose for federal economic substance purposes.

[54] IRC section 7701(o)(1) and (5)(C). *See also* Notice 2010-62, 2010-40 IRB 411.

[55] *Estelle Morris Trusts v. Commissioner*, 51 T.C. 20 (1968), *aff'd per curiam*, 427 F.2d 1361 (9th Cir. 1970).

[56] *Gregory v. Helvering*, 293 U.S. 465 (1935).

[57] *Estelle Morris*, *supra* note 55.

[58] *See, e.g.*, *Estelle Morris*, *supra* note 55 (multiple mirrored trusts created simultaneously but administered as separate trusts respected as separate, despite the creation being motivated by tax avoidance, as no applicable rule would combine them, Congress had conspicuously thought about and failed to address the problem, and nothing about section 641(b)'s regard of separate trusts depended on the motivation for establishing the trusts); *Stephenson Trust v. Commissioner*, 81 T.C. 283 (1983) (pre-section 643(f) regulatory attempt to overrule *Estelle Morris* invalid).

[59] *Boyce v. United States*, 190 F. Supp. 950 (W.D. La. 1961), *aff'd per curiam*, 296 F.2d 731 (5th Cir. 1961); *Sence v. United States*, 394 F.2d 842 (Fed. Cir. 1968). This resembles the sham trust cases, which do not attack trusts because of their purpose, but because of how they were administered.

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> *Exception for personal transactions of individuals.* In the case of an individual, paragraph (1) [requiring the economic substance doctrine to apply where relevant, with both objective and subjective prongs analyzed] shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

One would think that the creation, terms, and administration of an estate planning trust, generally also taxed as an individual,[60] should fall squarely within this exception from the economic substance doctrine.

2. The Economic Substance Doctrine Does Not Appear *Relevant* to Using and Choosing Between Trusts (Other Than Sham Trusts)

Even if the economic substance doctrine could be relevant to trusts, the doctrine seems to not bear on the choice between FCH trusts and other kinds of trusts. This is shown by analogy to the legislative history of IRC section 7701(o), which provides:

> [IRC section 7701(o)] is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.[61]

Establishing and transacting with an FCH trust closely analogizes to these transactions identified by the legislative history as outside the scope of the economic substance doctrine. That is, it is difficult to see how the choice between a foreign trust and a domestic trust relevantly differs from a choice between a foreign corporation and a domestic corporation, how the design of beneficial interests relevantly differs from the choice between debt and equity, or how a grantor's transactions with an FCH trust differ from acceptable related party transactions.

All that said, details of this threshold economic substance doctrine inquiry of "relevance" are currently being litigated, and that could affect the preceding analysis.[62]

One might also be concerned about converting to or from an FCH trust. By analogy to *UPS of America*,[63] the economic substance doctrine is arguably irrelevant to such conversion. That case appears to indicate that the economic substance doctrine does not apply to midstream conversions between legal structures that would have had economic substance if used from the start.[64]

Accordingly, the FCH trust transactions appear to be the sort to which economic substance is not relevant.

3. Even If the Economic Substance Doctrine Were Relevant, FCH Trusts Could Have Adequate Substance If Appropriately Designed

Even if the economic substance doctrine were relevant, it does not appear to read on the typical FCH trust. The doctrine will not apply to a transaction if "the transaction changes in a

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[60] *See* IRC section 641(b), *Steuer v. Franchise Tax Board*, No. A154691 (Cal. Ct. App. 1st Dist. June 29, 2020) (applying Cal. Rev. & Tax. Code section 17731's general incorporation of IRC's trust income tax rules to find IRC section 641(b) applies for California purposes); *pet. for cert. denied*, No. S263728 (Cal. Oct. 14, 2020).

[61] Staff of the Joint Commission on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010" as amended, at 152.

[62] Order on Cross-Motions for Summary Judgment, *Liberty Global Inc. v. United States*, No. 1:20-cv-03501-RBJ (D. Colo. Oct. 31, 2023).

[63] *UPS of America v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001), *rev'g and rem'g*, T.C. Memo 1999-268.

[64] BNA Portfolio 508-2nd, I.F. The case is addressing corporate business structures, but it is not clear why a different analysis would apply to trusts.

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meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."[65] Here, creating a trust (other than a sham trust) would meaningfully change one's economic position,[66] and the trust could — and should — serve an estate planning purpose.[67]

4. The Only Relevant Economic Substance Concern — Sham Trust Status — Can Be Avoided with Appropriate Design and Consideration

Again, trusts only appear to lack economic substance if they are shams.[68] Whether a trust is a sham goes primarily to its administration and secondarily to its terms, with the overall inquiry focusing on whether the taxpayer's economic position truly changed.[69] State law validity of a trust is insufficient to avoid sham status.[70] Rather, whether a trust is a sham depends on the interplay of four factors centered on whether the taxpayer sufficiently gave up control of trust assets[71]:

> (1) Whether the taxpayer's relationship to the transferred property differed materially before and after the trust's creation; (2) whether the trust had an independent trustee; (3) whether an economic interest passed to other trust beneficiaries; and (4) whether the taxpayer respected the restrictions placed on the trust's operation as set forth in the trust documents.[72]

FCH trusts, then, can avoid sham trust status the same way as any other trust, provided they are appropriately administered and designed to change the grantor's economic relationship to trust assets.

5. Conclusion: Economic Substance Matters Do Not Appear Relevant to Properly Administered FCH Trusts

To conclude, an FCH trust can have just as much substance as any other estate planning trust, and such trusts are not generally understood to implicate economic substance and related judicial doctrines. When one has a trust for valid planning purposes, properly administers it, and changes one's economic relationship to the trust assets, economic substance concerns appear manageable. For such a trust, one appears to have a free hand in structuring a trust's beneficial interests and governance — even if the choices are tax-motivated.

V. Overall Conclusion

Overall, FCH trusts appear to work and may greatly improve certain high-net-worth individuals' tax planning. Such trusts are not without risk, complexity, or uncertainty, but seem well worth California tax planners' consideration. ■

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[65] IRC section 7701(o)(1).

[66] *See Estelle Morris*, *supra* note 55, because "the continuing individual economic and legal viability of the [trusts at issue] preclude the application of the . . . test").

[67] As noted earlier, it would be improper to consider a *business* purpose to be necessary for a trust, unlike for partnerships and corporations. It is worth noting, however, that partnerships and corporations with business purpose are regarded, even if they also are designed with a tax avoidance purpose. *See Estelle Morris*, *supra* note 55 ("Evidence of tax avoidance does not invalidate family partnerships. *Commissioner v. Tower*, 327 U.S. 280 (1946); *Commissioner v. Culbertson*, 337 U.S. 733, 744 n.13 (1949). Corporations are not invalidated if the creator's aim is tax reduction but are recognized for tax purposes if they engage in business activity. *See, e.g., Moline Properties v. Commissioner*, 319 U.S. 436 (1943)."). While more recent tax shelter cases do disregard certain partnerships used in tax avoidance, this tends to come down to alleged partners not truly being in business together or a lack of business purpose more generally.

[68] *See Sparkman v. Commissioner*, 509 F.3d 1149 (9th Cir. 2007) (explicitly referencing sham trust matters as economic substance matters).

[69] *See Markosian v. Commissioner*, 73 T.C. 1235 (1980) ("When the form of the [trust] transaction has not, in fact, altered any cognizable economic relationships, we will look through that form and apply the tax law according to the substance of the transaction.").

[70] *See Zmuda v. Commissioner*, 79 T.C. 714 (1982).

[71] *See* BNA Portfolio 508-2nd, VI.E. (noting that whether any entity is regarded in large part depends on the taxpayer's control over the entity — although something more than retained control is needed).

[72] *Sparkman v. CIR*, 509 F.3d 1149 (noting these *Markosian* factors). Such factors are widely used in analyzing trusts for sham status.

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Bases of State Income Taxation of Nongrantor Trusts

2025

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State	Citations	Top 2024 Rate	Trust Created by Will of Domiciliary/ Resident	Inter Vivos Trust Created by Domiciliary/ Resident	Trust Administered in State	Trust With Domiciliary/ Resident Trustee/ Fiduciary	Trust With Domiciliary/ Resident Beneficiary
Alabama revenue.alabama.gov	Ala. Code §§ 40-18-1(33), 40-18-5(1)(c); Ala. Admin. Code r. 810-3-29-.07(2)(b)–(c); Instructions to 2024 Ala. Form 41 at 2.	5.00% on taxable income over $3,000	✓[1]	✓[1]		✓[1]	✓[1]
Alaska dor.alaska.gov	No income tax imposed.						
Arizona azdor.gov	Ariz. Rev. Stat. Ann. §§ 43-1301(5), 43-1311(B)(4); Instructions to 2024 Ariz. Form 141AZ at 1, 15.	2.5% on Arizona taxable income				✓	
Arkansas dfa.arkansas.gov	Ark. Code Ann. §§ 26-51-201(b), 26-51-203(a); 2024 Ark. Indexed Tax Brackets.	3.90% on entire net income over $100,000	✓[2]	✓[2]		✓[2]	
California ftb.ca.gov	Cal. Rev. & Tax. Code §§ 17041(a)(1), 17043(a), 17742(a); Cal. Const. art. XIII, § 36(f)(2); Instructions to 2024 Cal. Form 541 at 9, 12.	13.30% on taxable income over $1 million				✓	✓[3]

[1] Trust created by Alabama testator or trustor taxed as Resident Trust only if, for more than seven months during taxable year, trust has Alabama fiduciary or Alabama beneficiary to whom distributions currently may be made.
[2] Trust created by Arkansas testator or trustor taxed as Resident Trust only if trust has Arkansas trustee.
[3] Other than beneficiary whose interest is contingent.

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Colorado cdor.colorado.gov	Colo. Rev. Stat. §§ 39-22-103(10), 39-22-104(1.7)(c); Instructions to 2024 Colo. Form 105 at 5, 8; 2024 Colo. Form 105 at 1.	4.25% on Colorado taxable income			✓		
Connecticut portal.ct.gov/drs	Conn. Gen. Stat. §§ 12-700(a)(9)(E), 12-701(a)(4)(C)–(D); Conn. Agencies Regs. § 12-701(a)(4)-1(a)(3)–(4); Instructions to 2024 Form CT-1041 at 2; 2024 Form CT-1041 at 1.	6.99% on Connecticut taxable income	✓	✓ [4]			✓ [4]
Delaware revenue.delaware.gov	Del. Code Ann. tit. 30, §§ 1102(a)(14), 1601(8); Instructions to 2024 Del. Form FID-TAX at 1–2; 2024 Del. Form FID-TAX at 2.	6.60% on Delaware taxable income over $60,000	✓ [5]	✓ [5]		✓ [5]	✓ [5]
District of Columbia otr.cfo.dc.gov	D.C. Code §§ 47-1806.03(a)(11), 47-1809.01, 47-1809.02; Instructions to 2024 D.C. Form D-41 at 7, 8.	10.75% on taxable fiduciary income over $1,000,000	✓	✓			
Florida floridarevenue.com	No income tax imposed.						

[4] Trust created by Connecticut trustor taxed as Resident Trust only to extent trust has Connecticut noncontingent beneficiary.
[5] Trust created by Delaware testator or trustor or having Delaware trustee taxed as Resident Trust only to extent trust has Delaware beneficiaries. Residences of future beneficiaries based on residences of existing beneficiaries.

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Georgia dor.georgia.gov	Ga. Code Ann. §§ 48-7-20(a.1)(1), (d), 48-7-22; Instructions to 2024 Ga. Form 501 at 8.	5.75% on Georgia taxable net income over $7,000					✓[6]
Hawaii tax.hawaii.gov	Haw. Rev. Stat. §§ 235-1, 235-51(d), (f), 235-4.5(a); Haw. Code R. § 18-235-1.17; Instructions to 2024 Haw. Form N-40 at 1, 6,10.	8.25% (7.25% for net capital gains) on taxable income over $40,000			✓[7]	✓[7]	✓[7]
Idaho tax.idaho.gov	Idaho Code §§ 63-3015(2), 63-3024(2)(a), (3); Instructions to 2024 Idaho Form 66 at 10.	5.695% on Idaho taxable income over $4,673	✓[8]	✓[8]	✓[8]	✓[8]	
Illinois tax.illinois.gov	35 Ill. Comp. Stat. 5/201(a), (b)(5.4), (c), (d), 5/1501(a)(20)(C)–(D); Ill. Admin. Code tit. 86, § 100.3020(a)(3)–(4); Instructions to 2024 Form IL-1041 at 6, 14; 2024 Form IL-1041 at 2.	6.45% on net income	✓	✓			
Indiana in.gov/dor	Ind. Code §§ 6-3-1-12(d), 6-3-2-1(a)(5); 45 Ind. Admin. Code 3.1-1-21(d); Instructions to 2024 Ind. Form IT-41 at 5, 8; 2024 Ind. Form IT-41 at 1.	3.05% on state taxable income			✓		

[6] Trustee generally taxed on income accumulated in trust for benefit of unborn or unascertained persons with contingent interests and income accumulated or held for future distribution under the terms of will or trust.
[7] Resident trust (trust being administered in Hawaii or having Hawaii trustee) may exclude “intangible income” attributable to nonresident beneficiaries; nonresident trust taxed only if has Hawaii-source income and resident beneficiary.
[8] Trust taxed as Resident Trust only if trust meets at least three of five specified factors: Idaho testator or trustor, Idaho law, Idaho real or tangible personal property, Idaho trustee, Idaho administration.

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Iowa revenue.iowa.gov	Iowa Code § 422.5(1); Iowa Admin. Code r. 701-700.3; Instructions to 2024 Iowa Form IA 1041 at 4.	5.70% on taxable income over $31,050	✓		✓[9]	✓[9]	
Kansas ksrevenue.gov	Kan. Stat. Ann. §§ 79-32,109(d), 79-32,110(a)(2)(B), (d); Instructions to 2024 Kan. Form K-41 at 2; 2024 Kan. Form K-41 at 4.	5.58% on Kansas taxable income over $23,000	✓[10]	✓[10]	✓[10]		✓[10]
Kentucky revenue.ky.gov	Ky. Rev. Stat. Ann. §§ 141.020(2)(c),141.030(1); 103 Ky. Admin. Regs. 19:010; Instructions to 2024 Ky. Form 741 at 2; 2024 Ky. Form 741 at 2.	4.00% on taxable income			✓[11]		✓[11]
Louisiana revenue.louisiana.gov	La. Stat. Ann. §§ 47:300.1, 47:300.10(3); Instructions to 2024 La. Form IT-541 at 1, 2, 4, 5.	4.25% on Louisiana taxable income over $50,000	✓		✓[12]		

[9] Trust created by Iowa testator taxed as Resident Trust, otherwise trust taxed as Resident Trust based on facts such as Iowa trustee, Iowa office, and Iowa evidence of ownership of trust assets.
[10] Trust created by Kansas testator or trustor taxed as Resident Trust only if trust has Kansas administration and, effective July 1, 2023, Kansas resident income beneficiary on last day of taxable year.
[11] Trust being administered in Kentucky taxed as Resident Trust only to extent trust has Kentucky beneficiaries.
[12] Trust created by non-Louisiana testator or by Louisiana or non-Louisiana trustor being administered in Louisiana taxed as Resident Trust in absence of governing law designation. Trust also taxed as Resident Trust if trust designates Louisiana law to govern.

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Maine maine.gov/revenue	Me. Rev. Stat. Ann. tit. 36, §§ 5102(4)(B)–(C), 5111(1-F), 5403(1)(A); Instructions to 2024 Form 1041ME at 1, 3.	7.15% on Maine taxable income over $61,600	✓	✓			
Maryland marylandtaxes.gov	Md. Code Ann., Tax–Gen. §§ 10-101(g), (n), 10-102, 10-105(a)(1)(viii), 10-106; Instructions to 2024 Md. Form 504 at i, 1, 5, 6-7.	5.75% plus county tax between 2.25% and 3.20% on Maryland taxable income over $250,000	✓[13]	✓[13]	✓[13]		✓[13]
Massachusetts mass.gov/org/ massachusetts-department-of-revenue	Mass. Gen. Laws ch. 62, §§ 4, 10(a), (c); Mass Regs Code tit. 830, § 62.10.1(1)(a); Instructions to 2024 Mass. Form 2 at 2, 4, 9; 2024 Mass. Form 2 at 2.	5.00% on taxable income; after 50% deduction, 12% on long-term capital gains from sale of collectibles; 8.5% on short-term gains; 4% on taxable income over $1 million	✓[14]	✓[14]		✓[14]	✓[14]
Michigan michigan.gov/taxes	Mich. Comp. Laws §§ 206.16, 206.18(1)(c), 206.51(1)(b); Instructions to 2024 MI-1041 at 2-3; 2024 MI-1041 at 1.	4.25% on taxable income	✓	✓[15]			

[13] Trust created by Maryland testator or trustor or being administered in Maryland taxed as Resident Trust. Deduction for nonresident beneficiaries probably of limited use because not allowed if not all remainder beneficiaries are nonresidents or if remainder beneficiaries are unborn, are unascertained, or have uncertain interests.

[14] Trust created by Massachusetts testator or trustor taxed as Resident Trust only to extent trust has Massachusetts beneficiaries. Unfortunately, unborn and unascertained persons as well as persons with uncertain interests deemed to be residents. To be taxed as Resident Trust, trust created by Massachusetts trustor must also have Massachusetts trustee.

[15] Trust created by Michigan trustor taxed as Resident Trust unless trust has no Michigan trustee, asset, or beneficiary.

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State	Citations	Top 2024 Rate	Trust Created by Will of Domiciliary/ Resident	Inter Vivos Trust Created by Domiciliary/ Resident	Trust Administered in State	Trust With Domiciliary/ Resident Trustee/ Fiduciary	Trust With Domiciliary/ Resident Beneficiary
Minnesota revenue.state.mn.us	Minn. Stat. §§ 290.01 Subd. 7b, 290.06 Subd. 2c, Subd. 2d, 290.033; Instructions to 2024 Minn. Form M2 at 1, 20.	10.85% on I.R.C. § 1411(c) net investment income, with modification, in excess of $1,000,000.	✓[16]	✓[16]	✓[17]		
Mississippi dor.ms.gov	Miss. Code Ann. § 27-7-5(1)(b)(ii); Instructions to 2024 Miss. Form 81-110 at 3, 11.	4.70% on Mississippi taxable income over $10,000			✓		
Missouri dor.mo.gov	Mo. Rev. Stat. §§ 143.011, 143.061, 143.331(2)–(3); Instructions to 2024 Form MO-1041 at 4, 11.	4.80% on Missouri taxable income over $8,911	✓[18]	✓[18]			✓[18]
Montana mtrevenue.gov	Mont. Code Ann. § 15-30-2103(1)(d), (2); Mont. Admin. R. 42.30.101(16); Instructions to 2024 Mont. Form FID-3 at 1, 6, 17–18.	5.90% on Montana taxable income over $20,500	✓[19]	✓[19]	✓[19]	✓[19]	✓[19]
Nebraska revenue. nebraska.gov	Neb. Rev. Stat. §§ 77-2714.01(6)(b)–(c), 77-2715.03(2)–(3), 77-2717(1)(a)(ii); Instructions to 2024 Neb. Form 1041N at 9.	5.84% on Nebraska taxable income over $19,670	✓	✓			

[16] Trust that became irrevocable or that was first administered in Minnesota after 1995.
[17] Trust that became irrevocable or that was first administered in Minnesota before 1996.
[18] Trust created by Missouri testator or trustor taxed as Resident Trust only if trust has Missouri income beneficiary on last day of taxable year.
[19] To be Resident Trust, trust must have sufficient connection to Montana. Relevant factors include, but are not limited to, testator's or trustor's domicile, location where trust was created, location of trust property, beneficiaries' domicile, trustees' domicile, and location of administration.

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Nevada tax.nv.gov	No income tax imposed.						
New Hampshire revenue.nh.gov	No income tax imposed on nongrantor trusts.						
New Jersey state.nj.us/ treasury/taxation	N.J. Stat. Ann. §§ 54A:1-2(o)(2)–(3), 54A:2-1(b)(7); Instructions to 2024 Form NJ-1041 at 2, 27.	10.75% on New Jersey gross income over $1,000,000	✓[20]	✓[20]			
New Mexico tax.newmexico.gov	N.M. Stat. Ann. § 7-2-7(B); Instructions to 2024 N.M. Form F1D-1 at 3, 9.	5.90% on New Mexico taxable income over $210,000			✓	✓	
New York State tax.ny.gov	N.Y. Tax Law §§ 601(c)(1)(B)(vi)–(vii), 605(b)(3)(B)–(C); 20 N.Y. Comp. Codes R. & Regs. tit. 20, § 105.23(a)-(b); Instructions to 2024 N.Y. Form IT-205 at 2,11.	10.90% on New York taxable income over $25,000,000	✓[20]	✓[20]			
New York City tax.ny.gov	N.Y. Tax Law §§ 1304(a)(3)(A), 1304-B(a)(1)(ii), 1305(c); N.Y.C. Admin. Code §§ 11-1701(a)(3)(A), 11-1704.1,11-1705(b)(3); Instructions to 2024 N.Y. Form IT-205 at 2, 21.	3.876% on New York City taxable income over $50,000	✓[20]	✓[20]			

[20] Trust created by domiciliary testator or trustor taxed as Resident Trust unless trust has no trustee, asset, or source income in state and trustee files informational return. In New York State and New York City – but perhaps not in New Jersey – small amount of source income disqualifies trust for exemption.

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State	Citations	Top 2024 Rate	Trust Created by Will of Domiciliary/ Resident	Inter Vivos Trust Created by Domiciliary/ Resident	Trust Administered in State	Trust With Domiciliary/ Resident Trustee/ Fiduciary	Trust With Domiciliary/ Resident Beneficiary
North Carolina ncdor.gov	N.C. Gen. Stat. §§ 105-153.7(a), 105-160.2; Instructions to 2024 N.C. Form D-407A at 1, 2; 2024 N.C. Form D-407 at 1.	4.50% on North Carolina taxable income					✓[21]
North Dakota tax.nd.gov	N.D. Cent. Code § 57-38-30.3(1)(e), (g); N.D. Admin. Code § 81-03-02.1-04(2); Instructions to 2024 N.D. Form 38 at 1, 2; 2024 N.D. Form 38 at 2.	2.50% on North Dakota taxable income over $11,325			✓[22]	✓[22]	✓[22]
Ohio tax.ohio.gov	Ohio Rev. Code Ann. §§ 5747.01(I)(3), 5747.02(A)(1), (A)(2), (A)(3)(b), (A)(5); Instructions to 2024 Ohio Form IT 1041 at 10,11.	3.50% on modified Ohio taxable income over $100,000	✓	✓[23]			✓[23]
Oklahoma oklahoma.gov/tax	Okla. Stat. tit. 68, §§ 2353(6), 2355(G),(C)(1)(f), 2355.1A; Okla. Admin. Code § 710:50-23-1(c); Instructions to 2024 Okla. Form 513 at 3,17.	4.75% on Oklahoma taxable income over $81,000	✓	✓			

[21] Trust not taxed as Resident Trust if trust has no North Carolina trustee and North Carolina beneficiary has not received income, has no right to demand it, and is uncertain ever to receive it (Kaestner, 588 U.S. 262 (2019)).
[22] To be Resident Trust, trust must have sufficient nexus with North Dakota. Relevant contacts include, but are not limited to, residence or domicile of beneficiary or trustee, situs of assets, place of administration, and governing law.
[23] Trust created by Ohio trustor taxed as Resident Trust only if trust has Ohio beneficiary during all or part of taxable year entitled to, or at discretion of any person may receive, distribution from trust.

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Oregon oregon.gov/dor	Or. Rev. Stat. §§ 316.037, 316.282(1)(d); Or. Admin. R. 150-316-0400(3)–(5); Instructions to 2024 Or. Form 41 at 3; 2024 Or. Form 41 at 3.	9.90% on Oregon taxable income over $125,000			✓	✓	
Pennsylvania revenue.pa.gov	72 P.S. §§ 7301(s), 7302; 61 Pa. Code § 101.1; Instructions to 2024 Form PA-41 at 5; 2024 Form PA-41 at 1.	3.07% on net Pennsylvania taxable income	✓[24]	✓[24]			
Rhode Island tax.ri.gov	R.I. Gen. Laws §§ 44-30-2.6(c)(3)(A)(II), (c)(3)(E), 44-30-5(c)(2)–(5); 280-RICR-20-55-7.7; Instructions to 2024 Form RI-1041 at 1-1; 2024 RI-1041 Tax Rate Schedules at 1.	5.99% on Rhode Island taxable income over $9,850	✓[25]	✓[25]			✓[25]
South Carolina dor.sc.gov	S.C. Code Ann. §§ 12-6-30(5), 12-6-510(B), 12-6-520; Instructions to 2024 Form SC1041 at 1, 3.	6.20% on South Carolina taxable income over $17,330			✓		
South Dakota dor.sd.gov	No income tax imposed.						
Tennessee tn.gov/revenue	Tenn. Code Ann. §§ 67-2-102(5), 67-2-110.	0.00% on income (interest and dividends only)					✓

[24] Trust created by Pennsylvania testator or trustor taxed as Resident Trust unless testator or trustor is no longer resident or is deceased and trust does not have resident trustee, Pennsylvania administration, Pennsylvania real property or tangible personal property, stock certificates, etc., in Pennsylvania, or Pennsylvania situs.

[25] Trust created by Rhode Island testator or trustor taxed as Resident Trust only to extent trust has Rhode Island beneficiaries. Residence of future beneficiaries based on residences of existing beneficiaries.

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Texas comptroller.texas.gov/taxes	No income tax imposed.						
Utah tax.utah.gov	Utah Code Ann. §§ 59-10-104(2)(b), 59-10-202(2)(b), 75-7-103(1)(i)(ii)–(iii); Instructions to 2024 UT Form TC-41 at 3, 6, 12, 25; 2024 UT Form TC-41 at 1.	4.55% on Utah taxable income	✓[26]		✓[26]		
Vermont tax.vermont.gov	Vt. Stat. Ann. tit 32, §§ 5811(11)(B), 5822(a)(5), (6), (b)(2); Instructions to 2024 Vt. Form FIT-161 at 2; 2024 Vt. Form FIT-161 at 2.	8.75% on taxable income over $11,550	✓	✓			
Virginia tax.virginia.gov	Va. Code Ann. §§ 58.1-302, 58.1-320, 58.1-360; Instructions to 2024 Va. Form 770 at 1,10.	5.75% on Virginia taxable income over $17,000	✓	✓			
Washington dor.wa.gov	Wash. Rev. Code §§ 82.87.010–82.87.150.	7.0% on long-term capital gains over $270,000		✓			
West Virginia tax.wv.gov	W. Va. Code §§ 11-21-4g, 11-21-7(c)(2)–(3); W. Va. Code R. §§ 110-21-4(4.1), 110-21-7(7.3); Instructions to 2024 W. Va. Form IT-141 at 1, 8.	5.12% on West Virginia taxable income over $60,000	✓	✓			

[26] Trust created by Utah testator or trust being administered in Utah taxed as Resident Trust unless, for post-2003 trust, trust has Utah corporate trustee and meets other requirements.

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Wisconsin revenue.wi.gov	Wis. Stat. §§ 71.06(1q), (2e)(b), 71.125(1), 71.14(2), (3), (3m); Instructions to 2024 Wis. Form 2 at 2, 26.	7.65% on Wisconsin taxable income over $315,311	✔	✔[27]	✔[28]		
Wyoming revenue.wyo.gov	No income tax imposed.						

[27] Trust that became irrevocable after October 28, 1999, or that became irrevocable before October 29, 1999, but was first administered in Wisconsin after that date.
[28] Trust that became irrevocable and that was first administered in Wisconsin before October 29, 1999.

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Section 645 Election

Arielle Prangner
Greg Gadarian

Section 645 Election

- §645 allows certain trusts created by a decedent ("qualified revocable trusts") to be treated as part of the decedent's estate for federal income tax purposes during the election period.

- A "qualified revocable trust" (QRT) is any trust (or portion of a trust) which on the date of death of the decedent was treated under §676 as owned by the decedent by reason of a power in the grantor which is determined without regard to §672(e).

Section 645 Election – State Law Implications

- **Making the 645 Election:**
  - If the 645 election is made, the income generated by the trust is treated as income of the decedent's probate estate.
  - As a result, the trust income may be subject to state income tax under the laws governing the taxation of probate estates.
  - Depending on the state, this could potentially result in a higher overall tax liability, as the probate estate may be taxed at different rates or thresholds than a trust.
  - Conversely, in certain circumstances making the 645 election may in result in less income tax exposure.
- **Not Making the 645 Election:**
  - If the 645 election is not made, the trust's income may not be subject to state income tax, especially if state laws exempt non-grantor trusts from taxation or impose different rules regarding trust income.
  - The trust may continue to be treated as a separate entity, allowing it to avoid state income taxes that would have applied to income generated in the decedent's probate estate.

Section 645 Election – State Law Implications, continued

- **Examples:**
  - **California income taxation of a probate estate of a California resident decedent is taxable by California regardless of the residence of its beneficiaries, the personal representative or any other fiduciary**
    - Decedent resided in California, but beneficiary and Trustee/Personal Representative resides in Arizona -- election triggers current California income tax
  - **California income taxation of non-grantor trusts is based on the residence of the trust's fiduciaries and beneficiaries regardless of the settlor**
    - Beneficiary lives in California, but decedent domiciled in Arizona and Trustee/Personal Representative resides in Arizona—election avoids current California income tax

Benefits of § 645 Election

Benefits of the 645 election include:

- use of fiscal year for income tax purposes;
- charitable set-aside deduction under §642(c);
- eligible S corporation shareholder;
- no estimated tax payments for 2 years after date of death;
- recognizing loss upon the satisfaction of a pecuniary bequest with assets that have a fair market value less than basis under §267(b)(13);

Benefits of § 645 Election

Benefits of the 645 election, continued…

- active participation requirements under passive loss rules waived for tax years ending less than two years after the decedent's death (§469(i)(4));
- may claim medical expense deduction under §213(c) for expenses incurred by the decedent that are paid by the estate in the one-year period after the decedent's death;
- not subject to §4947, dealing with treatment of a charitable trust as a subject to private foundation rule; and
- avoids §681(a) limitation on charitable deduction under §642(c) for amounts that are allocable to unrelated business taxable income.

Qualified Revocable Trust

- “Qualified revocable trust” means any trust (or portion thereof) which was treated under section 676 as owned by the decedent . . . by reason of a power in the grantor (determined without regard to section 672(e)). *§645(b)(1)*

- A trust that was treated as owned by the decedent under section 676 by reason of a power that was exercisable by the decedent only with the approval or consent of a nonadverse party or with the approval or consent of the decedent’s spouse is a QRT. Treas. Reg. *§1.645-1(b)(1)*

Mechanics of **Election**

- Both the executor of the decedent's probate estate (if there is a probate estate) and the trustee of the QRT must make the 645 election. Use IRS Form 8855.
- If there is no executor appointed, the QRT trustee files the election. The election must include the QRT trustee's representation that there is no executor and to the trustee's knowledge and belief, one will not be appointed.
- The election must be made by the due date (including extensions) for filing the income tax return for the first taxable year of the decedent's probate estate.
- The 645 election is irrevocable.

Mechanics of **Election**

Form **8855**
(Rev. December 2020)
Department of the Treasury
Internal Revenue Service

Election To Treat a Qualified Revocable Trust as Part of an Estate

▶ **Go to *www.irs.gov/Form8855* for the latest information.**

OMB No. 1545-1881

Part I **Estate (or Filing Trust) Information**

Name of estate (or the filing trust, if applicable (see instructions))	**Employer identification number** (see instructions)
Name of executor (or the filing trustee, if applicable)	Type of entity prior to the election: ☐ Domestic estate ☐ Foreign estate ☐ Domestic trust ☐ Foreign trust
Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)	
City or town, state, and ZIP code (if a foreign address, see instructions)	Date of executor's appointment

Under penalties of perjury, I, as executor (or filing trustee):

- Confirm that under applicable local law or the governing document, I have the authority to make this election for the estate (if executor) or trust (if filing trustee) and to agree to the conditions of the election;
- Elect the treatment provided under section 645 for the above-named estate (or filing trust, if applicable);
- Confirm that an agreement has been reached with the trustees of each qualified revocable trust (QRT) joining in the election to allocate the tax burden of the combined electing trusts and related estate, if any, for each tax year during the election period in a manner that reasonably reflects each entity's tax obligation;
- Agree to ensure that the related estate's (or filing trust's, if applicable) share of the tax obligations of the combined electing trust(s) and related estate, if any, is timely paid to the United States Treasury;
- Agree to accept responsibility for filing a complete, accurate, and timely income tax return, when required by law, for the combined electing trust(s) and related estate, if any, for each tax year during the election period;
- (If I am the filing trustee) confirm that if there is more than one QRT making this election, that I have been appointed by the trustees of each QRT making this election to be the filing trustee and I agree to accept the responsibility of filing the appropriate income tax return for the combined electing trust(s) for each tax year during the election period and all other responsibilities of the filing trustee;
- (If I am the filing trustee) represent that no executor has been appointed for a related estate and to the best of my knowledge and belief, one will not be appointed;
- (If I am the filing trustee) agree that, if an executor is appointed for the related estate after this Form 8855 is filed, that I will complete and file an amended Form 8855 if the late appointed executor agrees to the election, and I agree to cooperate with the executor in filing any amended returns required to be filed as a result of the executor's appointment; and
- Confirm to the best of my knowledge and belief, that all information contained in this election and any accompanying statements or schedules is true, correct, and complete.

Signature of executor (or filing trustee)	Date

Part II **Decedent Information**

Name of decedent	SSN of the decedent	Date of death

For Paperwork Reduction Act Notice, see page 4. Cat. No. 24542R Form **8855** (Rev. 12-2020)

Election Period

- **If there is an Executor.** If there is an executor, the electing trust is treated, during the election period, as part of the related estate.

- **If there is no Executor.** If there is no executor, the trustee treats the electing trust, during the election period, as an estate.

Termination of Election

The election begins on date of decedent's death and terminates on the earlier of:

- The day on which the electing trust and estate have distributed all assets; or
- The day before the "applicable date." If no 706 is required to be filed, the applicable date is the date which is two years after the date of the decedent's death.
  - If a 706 is required to be filed, the applicable date is the later of:
  - – The day two years after the decedent's death; or
  - – The day 6 months after the date of the final determination of the estate tax liability. Treas. Reg. §1.645-1(f)(1)and (2)

Upon termination, the electing trust must begin filing separate income tax returns. The short period for the trust return begins on the date after the termination date and ends on December 31.

Special Rules

- The QRT and the estate are treated as separate shares for the sole purpose of calculating distributable net income (DNI). Treas. Reg. §1.645-1(e)(2)(iii)(A).
- A distribution from the estate to the QRT affects the computation of the DNI of the share making the distribution and the share receiving the distribution.
- The share making the distribution reduces its DNI by the amount of the distribution deduction, and, solely for purposes of calculating DNI, the share receiving the distribution increases its gross income by the same amount. Treas. Reg. §1.645-1(e)(2)(iii)(B).

Charitable Deduction

- Sec. 642(c)(1) provides that an estate or non-grantor trust "shall be allowed as a deduction . . . any amount of the ***gross income***, without limitation, which ***pursuant to the terms of the governing instrument*** is, during the taxable year, ***paid for a purpose specified in section 170(c)."***

- The term "gross income" has been interpreted for this purpose to mean "gross taxable income."

- Sec. 642(c)(2) expands the scope of the deduction to also allow for a deduction of the gross income "permanently set aside" for charitable purposes.

Set-Aside Deduction

- Must be "permanently set aside" for charitable purposes.
- A set-aside deduction is not allowed "unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is *so remote as to be negligible."* *Treas Reg. §1.642(c)-2(d).*

Section 681

- Section 681(a)(1) provides that a non-grantor trust's §642(c) charitable deduction is disallowed for any taxable year to the extent such deduction is allocable to UBTI.

- A partial deduction is nevertheless allowed for such amounts under §512(b)(11).

- Section 512(b)(11) allows a deduction for actual payments allocable to UBTI made to organizations described in §170(c). The deduction is subject to the percentage limitations applicable to charitable contributions by an individual.

- 645 election avoids §681(a) limitation on charitable deduction under §642(c).

Relevant Case Law

- In *Green,* the Tenth Circuit held that the statutory phrase "any amount of the gross income" means that charitable donations must be made out of a trust's gross income and not from assets which have appreciated in value which were purchased with gross income. *880 F.3d 519 (10th Cir. 2018).*

- In *Estate of Belmont* the decedent made a specific bequest of $50,000 to her brother, and gave the residue to a charitable organization. The decedent's brother lived in a property owned by the estate and filed a claim for a life estate in the property. The estate denied his creditor claim in April 2008. In 2012, the probate court awarded him a life estate in the property, and because of litigation the estate no longer had sufficient funds to pay the amount previously deducted as a charitable contribution. Since circumstances not "so remote as to be negligible," court ruled amounts were not permanently set aside. *144 T.C. No. 6 (Feb. 29, 2015).*

Relevant Case Law Continued

- In *Sid W. Richardson Foundation* an estate owned stock in an S corporation. The Foundation was the residuary beneficiary of the estate.

- The estate used a fiscal year ending on Sept 30. 15 months after the beginning of its first fiscal year, the estate made a distribution of cash and property to the Foundation. The estate claimed a charitable set-aside deduction for the undistributed income of the S corporation.

- The Court stated that the "undistributed income ... had to become subject to the charitable provisions of the ... will before it could be included in the Estate's charitable deduction under Section 642(c)." *69-1 USTC Para. 9341 (1969).*

Separate Share Rule

- Treas. Reg. §1.642(c)-3(b) includes special rules concerning the allocation of the charitable deduction against specific classes of income.

- Under §643(a) and the Regulations, a charity is deemed to receive a ratable share of each class of income unless the governing instrument has a specific provision, or local law requires a different apportionment of the income.

Charitable Ordering Rules

- The charitable ordering rules in Treas. Reg. §1.642(c)-3 provide that directions in the controlling document or state law as to the source of income paid to charity, specifying a source of income to be offset by a charitable deduction, are not effective unless they have economic effect on the distributions or trust administration.

- The formula allocation of IRD should be treated as having economic effect independent of income tax consequences because the amount to be paid to the charitable organization is dependent upon the amount of IRD.

S Corporation Stock

- A QRT can hold S corporation stock for the later of two years after the grantor's death or until 6 months after the estate is settled.
- The trust receiving the S corporation stock from the QRT can hold the stock for an additional 2 years. After the expiration of the Section 645 period, the trust is treated as a testamentary trust. Treas. Reg. §1.1361-1(h)(1)(iv) (B).

PLR 202423002

- PLR involved:
  - a Qualified Revocable Trust
  - a §645 election
  - an S Corporation
  - the charitable set aside deduction
  - §681(a) denial of charitable deduction under §642(c) for amounts allocable to "unrelated business taxable income"

PLR 202423002, continued

- Involves a QRT, a Foundation which was the residuary beneficiary of the QRT, and an S corporation which owned real estate (unimproved lots) and was a dealer in real property.
- The QRT made a §645 Election.
- S corp plans to make a distribution of the unimproved lots to the QRT giving rise to §311 gain which will be includible in the QRT's income under §1366.
- QRT will permanently set aside the lots or the proceeds from the sale of lots.

PLR 202423002, continued

- If the QRT is able to sell the lots in the same taxable year that the S Corp distributes the lots to it, the QRT will distribute the net sale proceeds to the Foundation in that year, or the taxable year immediately following the taxable year it receives the proceeds.

- Taxpayer (the QRT) requested a ruling that it be allowed a charitable deduction under §642(c) to the extent that
  - the S Corp actually distributes the lots to the QRT, and
  - the QRT either pays or permanently sets aside the lots, or the net proceeds from the sale of the lots for the benefit of the Foundation.

PLR 202423002, continued

IRS ruling

- The QRT may deduct those amounts of gross income that are paid to or set aside under §642(c) to the extent that those amounts are includible in the gross income of QRT for the taxable year as a result of the distribution of the lots from the S Corp to the QRT.

- IRS did not apply §681 because of the §645 election.

Internal Revenue Service

Number: **202423002**
Release Date: 6/7/2024

Index Number: 642.03-00, 642.03-01, 642.03-02, 642.03-03

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B3
PLR-116539-23

Date:
February 20, 2024

Legend

Trust =

State =

Decedent =

Foundation =

Estate =

Will =

Corporation =

Real Property =

Dear :

This letter responds to a letter dated August 4, 2023, and subsequent correspondence, submitted on behalf of Trust, by its authorized representatives, requesting a ruling on whether Trust will be allowed a deduction for a charitable contribution under § 642(c) of the Internal Revenue Code.

FACTS

The information submitted states that Trust was established by Decedent before his death under the laws of State as a revocable trust. During Decedent's life, Trust was treated as a grantor trust under § 676 for federal tax purposes. The trust agreement provides that after payment of certain specific bequests and all taxes, administrative costs and debts, the residue of Trust is to be distributed to Foundation.

Foundation is a charitable private foundation, exempt from tax under § 501(c)(3), formed under the laws of State. Foundation is the sole remaining beneficiary of Trust. Trust represents that the likelihood that its assets will not be distributed to Foundation is negligible because pursuant to the trust agreement and the laws of State, all creditors of Trust are paid or considered paid.

Estate is the estate of Decedent. Pursuant to Decedent's Will, the residue of Estate is to be distributed to the trustees of Trust. Estate and Trust represent that they timely filed a valid election under § 645 to treat Trust as part of Estate for federal tax purposes. Trust represents that because it was a qualified revocable trust within the meaning of § 645 during Decedent's life, it was eligible to make the election under § 645.

Trust is the sole shareholder of the Corporation, a corporation formed under the laws of State, treated as an S corporation for federal tax purposes. The Corporation owns Real Property, which is located in State. The Real Property consists of parcels of unimproved land, except for one parcel which includes an office building that is leased to an unrelated person. Before Decedent's death, Corporation was considered a dealer of real property, treating gain or loss from the sale of any real property as ordinary income or loss.

The Corporation, a cash method taxpayer, intends to make a non-liquidating distribution of all the Real Property consisting of unimproved land, but not the office building, to its sole shareholder, Trust. Trust acknowledges that the distribution will result in the Corporation recognizing gain under § 311(b) equal to the excess of the Real Property's fair market value over the Corporation's adjusted basis in the Real Property in the taxable year of the distribution. Trust further acknowledges that Trust, a cash method taxpayer, will be required to take that gain into gross income under § 1366(a) in the taxable year of the distribution.

Trust represents that it intends to sell the Real Property to an unrelated purchaser. During the period before the sale, when Trust holds the Real Property, or after the sale, when Trust holds the sale proceeds, Trust represents that the Real Property or sale proceeds will be accounted for separately and permanently set aside for the benefit of Foundation.

If Trust is able to sell the Real Property in the same taxable year that the Corporation distributes the Real Property to Trust, Trust represents that it intends to distribute the net sale proceeds to Foundation in the same taxable year in which it receives the sale proceeds or the taxable year immediately following such taxable year pursuant to a valid election under § 645(c)(1).

Trust requests a ruling that it will be allowed a charitable contribution deduction under § 642(c) to the extent that the Corporation actually distributes the Real Property to Trust and Trust either pays or permanently sets aside the Real Property or the net proceeds from the sale of the Real Property for the benefit of Foundation.

LAW AND ANALYSIS

Section 642(c)(1) provides that in the case of an estate or trust (other than a trust meeting the specifications of subpart B), there shall be allowed as a deduction in computing its taxable income (in lieu of the deduction allowed by § 170(a) , relating to the deduction for charitable, etc., contributions and gifts) any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in § 170(c) (determined without regard to § 170(c)(2)(A)). If such charitable contribution is paid after the close of such taxable year and on or before the last day of the year following the close of such taxable year, then the trustee or administrator may elect to treat such contribution as paid during such taxable year. The election shall be made at such time and in such manner as the Secretary prescribes by regulations.

Section 642(c)(2) provides that in the case of an estate, there shall be allowed as a deduction in computing its taxable income any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, permanently set aside for a purpose specified in § 170(c), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit.

Section 1.642(c)-2(a) provides for an unlimited deduction for any part of the gross income of an estate which pursuant to the terms of the will—(1) Is permanently set aside during the taxable year for a purpose specified in § 170(c), or (2) Is used or to be used exclusively for religious, charitable, scientific, literary, or educational purposes,

or for the prevention of cruelty to children or animals, or for the establishment of, acquisition, maintenance, or operation of a public, non-profit cemetery.

Section 1.642(c)-2(d) provides that no amount will be considered to be permanently set aside, or to be used for a purpose described in §§1.642(c)-2(a) or (b)(1) unless under the terms of the governing instrument and the circumstances of a particular case, the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible.

Section 1.642(c)-3(b)(1) provides that, if pursuant to the terms of the governing instrument an estate, pooled income fund, or other trust pays, permanently sets aside, or uses any amount of its income for a purpose specified in § 642(c)(1) , (2), or (3), and that amount includes any items of estate or trust income not entering into the gross income of the estate or trust, the deduction allowable under § 1.642(c)-1 or § 1.642(c)-2 is limited to the gross income so paid, permanently set aside, or used.

Section 645(a) states that, if both the executor (if any) of an estate and the trustee of a qualified revocable trust elect the treatment provided in § 645, such trust must be treated and taxed as part of such estate (and not as a separate trust) for all taxable years of the estate ending after the date of the decedent's death and before the applicable date.

Section 645(b) states that the term "qualified revocable trust" means any trust (or portion thereof) which was treated under § 676 as owned by the decedent of the estate referred to in § 645(a) by reason of a power in the grantor (determined without regard to § 672(e)).

Section 645(b)(2) states that the term "applicable date" means—(A) If no return of tax imposed by chapter 11 is required to be filed, the date which is 2 years after the date of the decedent's death, and (B) If such a return is required to be filed, the date which is 6 months after the date of the final determination of the liability for tax imposed by chapter 11.

Section 645(c) provides that the election under § 645(a) must be made not later than the time prescribed for filing the return of tax imposed by this chapter for the first taxable year of the estate (determined with regard to extensions) and once made, is irrevocable.

Section 1.645-1(b)(2) states that an electing trust is a qualified revocable trust for which a valid § 645 election has been made and once a § 645 election has been made for the trust, the trust shall be treated as an electing trust throughout the entire election period.

Section 1.645-1(e)(2)(i) provides that if there is an executor, the electing trust is treated, during the election period, as part of the related estate for all purposes of subtitle A of the Code. Thus, for example, the electing trust is treated as part of the

related estate for purposes of the set-aside deduction under § 642(c)(2), the subchapter S shareholder requirements of § 1361(b)(1), and the special offset for rental real estate activities in § 469(i)(4).

Section 1.645-1(e)(2)(iv) provides that a deduction is allowed in computing the taxable income of the combined electing trust and related estate to the extent permitted under § 642(c) for—(A) Any amount of the gross income of the related estate that is paid or set aside during the taxable year pursuant to the terms of the governing instrument of the related estate for a purpose specified in § 170(c); and (B) Any amount of gross income of the electing trust that is paid or set aside during the taxable year pursuant to the terms of the governing instrument of the electing trust for a purpose specified in § 170(c).

Section 1.645-1(f)(1) states that the election period begins on the date of the decedent's death and terminates on the earlier of the day on which both the electing trust and related estate, if any, have distributed all of their assets, or the day before the applicable date. The election does not apply to successor trusts (trusts that are distributees under the trust instrument).

Section 1.645-1(f)(2) provides that the applicable date means—(i) If a Form 706 is not required to be filed as a result of the decedent's death, the applicable date is the day which is 2 years after the date of the decedent's death, (ii) If a Form 706 is required to be filed as a result of the decedent's death, the applicable date is the later of the day that is 2 years after the date of the decedent's death, or the day that is 6 months after the date of final determination of liability for estate tax. Solely for purposes of determining the applicable date under § 645, the date of final determination of liability is the earliest of the following—(A) The date that is six months after the issuance by the Internal Revenue Service of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within twelve months after the issuance of the letter; (B) The date of a final disposition of a claim for refund, as defined in § 1.645-1(f)(2)(iii), that resolves the liability for the estate tax, unless suit is instituted within six months after a final disposition of the claim; (C) The date of execution of a settlement agreement with the Internal Revenue Service that determines the liability for the estate tax; (D) The date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or a petition for certiorari is filed within 90 days after the issuance of a decision, judgment, decree, or other order of a court; or (E) The date of expiration of the period of limitations for assessment of the estate tax provided in § 6501.

Section 681(a) states that in computing the deduction allowable under § 642(c) to a trust, no amount otherwise allowable under § 642(c) as a deduction shall be allowed as a deduction with respect to income of the taxable year which is allocable to its unrelated business income for such year. For purposes of the preceding sentence, the term “unrelated business income” means an amount equal to the amount which, if such

trust were exempt from tax under § 501(a) by reason of § 501(c)(3), would be computed as its unrelated business taxable income under § 512 (relating to income derived from certain business activities and from certain property acquired with borrowed funds).

Section 1.681(a)-(2)(a) provides that no charitable contributions deduction is allowable to a trust under § 642(c) for any taxable year for amounts allocable to the trust's unrelated business income for the taxable year. For the purpose of § 681(a), the term “unrelated business income” of a trust means an amount which would be computed as the trust's unrelated business taxable income under § 512 and the regulations thereunder, if the trust were an organization exempt from tax under § 501(a) by reason of § 501(c)(3). For the purpose of the computation under § 512, the term “unrelated trade or business” includes a trade or business carried on by a partnership of which a trust is a member, as well as one carried on by the trust itself. While the charitable contributions deduction under § 642(c) is entirely disallowed by § 681(a) for amounts allocable to “unrelated business income”, a partial deduction is nevertheless allowed for such amounts by the operation of § 512(b)(11), as illustrated in §§ 1.681(a)-(2)(b) and (c). This partial deduction is subject to the percentage limitations applicable to contributions by an individual under § 170(b)(1)(A) and (B), and is not allowed for amounts set aside or to be used for charitable purposes but not actually paid out during the taxable year. Charitable contributions deductions otherwise allowable under § 170, § 545(b)(2), or § 642(c) for contributions to a trust are not disallowed solely because the trust has unrelated business income.

Section 512(b)(11) provides that to the extent a trust has unrelated business income, and a charitable deduction is disallowed under § 681, the trust is instead entitled to a charitable deduction under § 170 as if the trust was treated as an individual taxpayer having adjusted gross income equal to the amount of the trust’s unrelated business income.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that Trust may deduct those amounts of gross income that are paid to or set aside under § 642(c) to the extent that those amounts are includible in the gross income of Trust for the taxable year as a result of the distribution of the Real Property from the Corporation.

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code and the regulations thereunder.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, we are sending a copy of this letter to <u>Trust's</u> authorized representatives.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination.

Sincerely,

Richard T. Probst
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosure
Copy of this letter for § 6110(k)(3) purposes

cc:

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California Income Taxation of Trusts and Estates

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California's income taxation of trusts has unpleasantly surprised many trust fiduciaries and beneficiaries. Its unique method of taxation, based on the residence of the trust's fiduciaries and beneficiaries (and regardless of the residence of the settlor), may affect trustees and beneficiaries (as well as their lawyers and other advisors) far beyond the California borders.

For example, consider an irrevocable, non-grantor trust[1] established by an Illinois resident that is administered by two co-trustees, one of whom is an Illinois resident and the other of whom is a California resident. All beneficiaries of the trust also reside in Illinois. Despite the predominately non-California connections, and even if the Illinois co-trustee is more actively involved in the administration of the trust, *half* of the trust's undistributed net income is currently taxable by California.

Alternatively, consider another irrevocable, non-grantor trust, this time with a New York settlor. In this case, the trust is administered in New York by a New York resident serving as the sole trustee. However, the trust's sole beneficiary is a California resident with a vested (i.e., non-contingent) interest in the trust property. Despite the trust's New York origin and administration, *all* of the trust's undistributed net income is currently taxable by California.

California acknowledges other state laws regarding taxation of trust income and will allow a credit for taxes paid to another state, but only if the trust is considered to be a resident by both states *and* taxes are actu-

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* The authors acknowledge the valuable input to this article by Eric J. Coffill, Esq., a partner in the Sacramento office of Morrison & Foerster LLP, who focuses on state and local tax matters; and Danielle T. Zaragoza, an of counsel attorney at Shartsis Friese LLP, who focuses on tax, estate planning, and estate and trust administration.

[1] Consistent with federal law, the assets of both revocable trusts and other so-called "grantor trusts" are treated as owned by the settlor for California income tax purposes. *See* discussion *infra* Part B3.

ally payable to both states.[2] The credit is effective where the taxes paid to the other state are levied on the same income and at the same rates as those of California. In the examples above, if the trusts are taxed on the same income at lower rates in Illinois or New York than in California, the additional taxes paid to California (which are not offset by the credit for taxes paid in the other states) will represent additional taxation that will deplete the trust estate.

Given that California taxes net capital gains at the same rates as ordinary income – with a maximum rate of 12.3 percent (or 13.3 percent with respect to taxable income in excess of $1,000,000) – an otherwise out-of-state trust may have significant California income tax liabilities. If the tax is not paid by the trust for the year in which the income is received and if that income is subsequently distributed to a California resident beneficiary, that beneficiary will be taxable on that income. Moreover, even where a trust has not had a prior obligation to pay California income tax, a later distribution of accumulated net income to a California beneficiary is subject to the California throwback rules, which are somewhat similar to the now largely repealed federal throwback rules (under Internal Revenue Code §§ 666-668).[3] Thus, even if a non-California resident establishes a trust that is always administered outside of California by non-California trustees, and even if the trust's California beneficiaries only have contingent, non-vested interests (for example, where *all* distributions are fully discretionary), California may *still* ultimately tax the trust's income when and to the extent it is later distributed to a California resident beneficiary.

The broad reach of California's fiduciary income tax laws is an important consideration for trustees, beneficiaries and advisors, where either a trustee or beneficiary resides in California or is contemplating a move to California. This article provides an in-depth analysis of the principles of California fiduciary taxation and the manner in which they are applied. Although its focus is on the treatment of irrevocable, non-

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[2] An estate or trust is considered a resident of the state which taxes its income irrespective of whether the income is derived from sources in that state. CAL. REV. & TAX. CODE § 18003 (West 2004). Section 18004 allows a credit for California purposes for the "net income taxes" paid by an estate or trust to another state, provided the estate or trust is considered a resident of both states. *Id.* § 18004. The credit is limited in § 18004 (a)-(b) to the proportion of taxes paid to the other state on the income taxable by both states to total income and to the proportion of California taxes. *Id.* § 18004(a)-(b). Section 18005 allows California resident beneficiaries a credit for taxes paid by the estate or trust to another state subject to limitations similar to those included in Section 18004. *Id.* § 18005.

[3] *See* I.R.C. § 665(c). The federal throwback rules remain applicable to distributions of accumulated income to a U.S. beneficiary from a foreign trust and from a domestic trust that was formerly a foreign trust, and also to certain grandfathered trusts subject to the multiple trust rule under I.R.C. § 643(f). *See id.* § 667(c)-(d).

grantor trusts, it includes a brief overview of California's taxation of the income of estates and administrative trusts as well as a technical guide to complying with California income tax reporting and withholding requirements.

A. Statutory Overview

The California laws governing the income taxation of estates, trusts, beneficiaries and decedents are in the California Revenue and Taxation Code ("R&TC").[4] R&TC Section 17731 provides that the federal rules relating to such taxation (Subchapter J of Chapter 1 of Subtitle A of Title 26 of the Internal Revenue Code ("IRC"), Sections 641- 692) apply for California purposes except as otherwise provided.

The elections under IRC § 645(a) (treating a "qualified revocable trust" as part of the deceased settlor's probate estate for income tax purposes), § 663(b) (treating discretionary distributions in the first 65 days of the taxable year of an estate or trust as having been made on the last day of the preceding taxable year), and § 663(c) (treating separate shares of an estate or trust as separate estates or trusts for the sole purpose of determining the amount of distributable net income taxable to the beneficiaries) are also effective for California purposes. Any of these elections not made for federal purposes cannot be made separately for California purposes.

The main provisions relating to the income taxation of estates and trusts are R&TC Sections 17742 -17745.1 and 17779, which are set out in Appendix A of this article.

B. California Taxation of Estates, Administrative Trusts, Revocable and Other Grantor Trusts

In considering California's unique approach to the taxation of irrevocable, non-grantor trusts, it is useful to understand and compare its treatment of other similar entities, including probate estates, administrative trusts, revocable trusts and other grantor trusts.

1. *Probate Estates*

The undistributed net income of a probate estate of a California resident decedent is taxable by California regardless of the residence of its beneficiaries, the personal representative or any other fiduciary. If part of a California resident decedent's estate (such as out-of-state real estate) is subject to ancillary probate administration in another state,

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[4] *See* Rev. & Tax. Code §§ 17731-17779, 18003-18005.

California presumably would allow a credit for the income taxes paid to the other jurisdiction.[5]

If a California non-resident decedent owned assets (such as real estate) situated in California that produce California source income, the income will be taxed by California regardless of the residence of its beneficiaries, the personal representative or any other fiduciary.[6]

2. *Administrative Trusts*

While an "administrative trust" of a California decedent (i.e., a revocable trust that has become irrevocable because of the death of the settlor) is functionally the same as a probate estate (except that it is not subject to mandatory court supervision), its undistributed net income is not taxable by California in the same manner as that of a California decedent's probate estate. Instead, it is taxed by California as an irrevocable (non-grantor) trust – unless an IRC § 645(a) election is made.

An election under IRC § 645(a) to treat and tax a "qualified revocable trust" (i.e., a typical administrative trust) as part of the deceased settlor's probate estate for federal income tax purposes is treated as an election for California purposes. If such an election is not made for federal income tax purposes, it cannot be made for California income tax purposes.[7] Making an IRC § 645(a) election could have a substantial impact on a qualified revocable trust's income tax liability to California. For example, if the deceased settlor of a revocable trust was a California resident but all of the trustees and beneficiaries are nonresidents of California, all of the trust's undistributed net income will be taxable by California if the IRC § 645(a) election is made. In comparison, none of the trust's income (except for California source income)[8] will be taxable by California if the election is not made because California's unique irrevocable trust taxation laws would apply to exclude the income from taxation in California. Conversely, if the deceased settlor was a nonresident of California but all of the trustees or all of the beneficiaries are residents of California, none of the trust's non-California source income will be taxable by California if an IRC § 645(a) election is made, because the trust will be taxed as a non-California estate—whereas all of the income will be taxable by California if that election is not made because California's irrevocable trust rules will apply.

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[5] *See* REV. & TAX. CODE § 18004.

[6] *Id.* § 17734.

[7] *Id.* § 17751(b).

[8] California source income is always taxable by California. *Id.* § 17951.

3. *Revocable and Other "Grantor Trusts"*

California treats property of a so-called "grantor trust" (i.e., a trust subject to the grantor trust rules in IRC §§ 671 - 679) as owned by and taxable to its settlor (or grantor) for income tax purposes. Therefore, its income, deductions and credits generally are included in computing the tax liability of the grantor, and the trust itself is disregarded for both federal and California income tax purposes.[9]

C. Irrevocable, Non-Grantor Trusts

1. *Overview*[10]

While many states tie the income tax liability of an irrevocable, non-grantor trust to its settlor's residence, California disregards this consideration altogether.[11] Instead, California employs a unique analysis that considers (1) the source of the trust's income, (2) the residence of its trustees,[12] and (3) the residence of the trust's beneficiaries. Consistent with the tax laws of most states, California taxes all of a trust's income attributable to California sources (e.g., rental income from property located in California).[13] What makes California unique is that it also taxes *all* of a trust's taxable income if all of its trustees are California residents *or* if all of its beneficiaries are California residents with "non-contingent" (vested) interests in the trust.[14]

Where some, but not all, of a trust's trustees or vested beneficiaries are California residents, California taxes a fractional amount of the trust's taxable income.[15] For example, where two of a trust's three trust-

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[9] *Id.* § 17731.

[10] This overview of the law is drawn with permission from the following article. Sonja K. Johnson, *California Income Taxation of Trusts: Pitfalls and Considerations for Settlors, Beneficiaries and Trustees*, LexisNexis (Aug. 3, 2010, 06:59 AM), http://www.lexisnexis.com/legalnewsroom/tax-law/b/practitioners-corner/archive/2010/08/03/california-income-taxation-of-trusts-pitfalls-and-considerations-for-settlors-beneficiaries-and-trustees.aspx.

[11] *Id.*; *See also* Max Gutierrez, Jr. & Frederick R. Keydel, *Study 6: State Taxation on Income of Trusts with Multi-State Contacts*, California section authored by Richard S. Kinyon, ACTEC Studies, Sept. 2001, at 6-1, 6-14.

[12] Johnson, *supra* note 10; Rev. & Tax. Code §§ 17742-17743, 17745 (referring to "fiduciary" rather than "trustee"). Therefore, any person acting in a fiduciary capacity with respect to a trust may be treated as a trustee for purposes of apportioning accumulated income to California.

[13] Johnson, *supra* note 10; Rev. & Tax. Code § 17734.

[14] While practitioners sometimes use the term "vested" to describe non-contingent interests subject to California income tax, the taxation of that income is not dependent upon whether the income is vested in the common-law sense of that word. Rather, taxation occurs when the beneficiary's right to receive the income is not subject to a contingency other than the passage of time. *See id.* §§ 17742 – 17744.

[15] *See id.* §§ 17743- 17744.

ees are California residents (and there is no California source income and none of the beneficiaries are California residents with vested interests), California will tax two-thirds of the trust's taxable income. If a trust has no California trustees, but has a California resident beneficiary with a vested interest in 50% of the trust estate and the remainder of the trust estate is not vested or is vested in non-California beneficiaries, California will tax 50% of the trust's taxable income. California applies a two-step formula to determine the portion of the trust's taxable income subject to California tax.[16] This formula first determines the income taxable to California on the basis of the number of California trustees to total trustees; any income not allocated to California because there are one or more nonresident trustees is then allocated on the basis of vested California beneficiaries to total beneficiaries.

California incorporates the federal definition of gross income,[17] so that a California beneficiary will be taxed on the receipt of all distributions of current trust income. In addition, California imposes a tax on California beneficiaries who receive trust distributions of accumulated income if (a) the trust has been non-compliant in paying California income taxes previously due[18] or (b) the beneficiaries' interest in that income was previously contingent. An actual distribution results in the beneficiary's interest becoming vested, at least to the extent of the distribution, under California law.[19] For example, if a beneficiary's interest is unvested because the trustee has complete discretion over distributions, an actual distribution will result in the beneficiary becoming vested in the amount distributed. These provisions effectively hold beneficiaries accountable for the trust's failure to pay income tax previously owed to California *and* (with some notable, but limited, exceptions discussed below) for income taxes that would have been due to California if the beneficiary had had a vested interest in the trust when the accumulated income was earned.

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[16] Cal. Franchise Tax Bd., Legal Ruling No. 238, Tr.: Accumulated Income; Tax'n When There Are Both Resident and Nonresident Trustees and Beneficiaries (Oct. 27, 1959), *available at* https://www.ftb.ca.gov/law/rulings/active/lr238.shtml. These principles of taxation are included in the California Fiduciary Income Tax Return (Form 541) at Schedule G on side 3. *See* Cal. Franchise Tax Bd., Form 541 Sched. G, California Fiduciary Income Tax Return (2012), *available at* https://www.ftb.ca.gov/forms/2012/12_541bk.pdf.

[17] *See* Rev. & Tax. Code § 17071.

[18] *Id.* § 17745(a).

[19] *Id.* § 17745(b).

2. *Trustee-Based Taxation of Trusts: Understanding Corporate Residency*

As described above, a key factor for determining California's income taxation of a trust is the residency of the trust's fiduciaries. However, such determinations often are not straightforward. Most of the problematic issues pertain to corporate fiduciaries. Many corporate fiduciaries have a national presence, and might consider themselves residents of the state(s) in which they are incorporated or headquartered. Nonetheless, for purposes of California income taxation of trusts, the key determinant of an institution's residency is the location in which it administers the trust.

R&TC Section 17742(b) provides that "the residence of a corporate fiduciary of a trust means the place where the corporation transacts the major portion of its administration of the trust." Thus, a corporate fiduciary's residence for these purposes is tied to its activities with respect to a particular trust, rather than to its state of incorporation or other general factors. California law does not provide guidance as to what constitutes the "major portion" of trust administration activities.

Notably, the California Franchise Tax Board ("FTB") itself has indicated that California law is unclear in this respect, stating that "[t]he law does not provide guidance as to what specific activities of 'administration' will be considered in determining whether a corporate fiduciary of a trust is transacting the majority of the administration of the trust in California under section 17742(b)."[20] In its 1998 proposal to change the manner in which California taxes trust income, the FTB stated that "[t]here is uncertainty regarding what factors, and their relative weights, should be considered in determining where trusts are administered. This uncertainty is compounded by the changing nature of corporate trust administration from local (one state only) to interstate or national,"[21] concluding as a result that "[c]urrent law providing the rules to determine when a trust's taxable income is subject to California tax is seriously outdated and needs to be modified to conform to modern trust administration practices."[22] However, the FTB's accompanying proposal for an alternative approach to the income taxation of trusts has yet to be reflected in California law.

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[20] CAL. FRANCHISE TAX BD., ATTACHMENT TO LEGAL NOTICE 98-12 (last visited Oct. 10, 2010), *available at* https://www.ftb.ca.gov/law/notices/1998/98_12att.shtml.

[21] CAL. FRANCHISE TAX BD., FTB NOTICE 98-12, DRAFT LEGISLATION SYMPOSIUM – TAXATION OF TRUSTS RESULTING FROM THE TREND TOWARD NATIONWIDE TRUST ADMINISTRATION, (Aug. 12, 1998), *available at* http://www.ftb.ca.gov/law/notices/1998/n98_12.pdf.

[22] CAL. FRANCHISE TAX BD., ATTACHMENT TO LEGAL NOTICE 98-12 (last visited Oct. 10, 2010), *available at* https://www.ftb.ca.gov/law/notices/1998/98_12att.shtml.

A relatively recent California State Board of Equalization ("SBOE") opinion did not set forth the specific factors to be considered with respect to a corporate fiduciary's residence, but did comment on the intent of the "major portions" provision, stating:

> The "major portions" test represents a clear public policy to impose tax only on trust income to the extent from quantifiable activities of fiduciaries that are transacted in California. The test is also consistent with the fundamental tax law doctrine that substance must prevail over form. E.g., *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal. 4th 750, 760 (2006). The rule notably results in a higher percentage of income apportioned to California to the extent that the main business affairs of the trust are substantively conducted within the State, without regard to whether the trustee may technically be a resident of another jurisdiction.[23]

Thus, although corporate fiduciaries are not provided with any detail as to what activities would constitute a "major portion" of trust administration, this opinion provides some guidance as to how the SBOE approaches the issue. Without more specific guidance, the determination of corporate residency presumably depends on the particular circumstances of the applicable trust's administration.

3. *Beneficiary-Based Taxation of Trusts: "Non-Contingent" Interests*

In addition to trustee residence and source of income, the final basis for California's taxation of a trust's undistributed net income is the residence of its vested trust beneficiaries.[24] The case of *McCulloch v. Franchise Tax Board*[25] established that California may tax the accumulated income of an otherwise nonresident trust where a resident of California is or becomes a vested (non-contingent) beneficiary of the trust. Thus, where a trust has no California fiduciaries but does have a California beneficiary, the trust's liability for California income tax generally hinges on whether or not its California beneficiary has a non-contingent interest in the trust. Whether the beneficiary's interest is contingent or

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[23] *See* Yolanda King Family Trust, 2007 Cal. Tax LEXIS 406, at *242 (St. Bd. of Equalization Oct. 4, 2007).

[24] *See infra* section C(4)(c) (determination of an individual beneficiary's residence, which in some cases is more straightforward than determining a corporation's residence, nonetheless involves some unusual factors).

[25] McCulloch v. Franchise Tax Bd., 390 P.2d 412, 419 (Cal. 1964).

non-contingent is generally a fact-based question, the answer to which even the FTB acknowledges is often difficult to ascertain.[26]

The relevant statutes and cases do not specifically describe the conditions or circumstances required for a beneficiary's interest to be vested. However, a logical analysis of the established principles of vesting indicates that a beneficiary is only vested if he or she has an absolute right to receive the accumulated income in the future. In addition, the FTB may assert that a beneficiary has a vested interest where accumulated income will be distributed to the beneficiary's estate or the beneficiary has a general power of appointment over the accumulated income at his or her death. Thus, apparently a beneficiary's interest is contingent if a condition must be met (and that condition is not assured) before a beneficiary would be entitled to receive the accumulated income and the beneficiary does not have a general power of appointment, or the property is not payable to the beneficiary's estate following his or her death—in other words, if someone other than the beneficiary, his or her appointees, or his or her estate might receive the accumulated income.

The Ninth Circuit, in *Urquhart v. Commissioner*[27] adopted a similar view of contingency for federal income tax purposes. In that case, a trust instrument provided that a beneficiary was to receive accumulated trust income and corpus upon reaching the age of 30. If the beneficiary died prior to that time, the accumulated income and corpus was to pass to his lawful issue or to the other contingent remainder trust beneficiaries if he died without issue. The court stated that given these trust provisions, the beneficiary had "no dominion over the income accumulated for his benefit, nor [did] he have any testamentary right over it unless and until he attain[ed] the age of thirty years . . . [I]t cannot be said therefore that [the beneficiary had] a present vested interest in the accumulations."[28] Although *Urquhart* is an old federal case and more recent cases do not provide such direct analysis, the cases allowing California to tax trust income on the basis of vested resident beneficiaries are consistent.

In the Matter of the Appeal of C. Pardee Erdman,[29] the California resident transferee of a deceased California resident beneficiary of trusts (with an Illinois trustee) who received income from the trusts and paid taxes to California with respect to that income was taxable on an

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26 FTB NOTICE 98-12, *supra* note 21 ("[T]here is a continuing problem in determining whether an individual beneficiary is to be considered contingent or noncontingent (vested)").

27 Urquhart v. Comm'r, 125 F.2d 701 (9th Cir. 1942).

28 *Id.* at 704.

29 Erdman, 1970 WL 2442, at *1 (Cal. St. Bd. Eq. Feb. 18, 1970).

accumulation distribution that included the trusts' capital gains for which no taxes had been previously paid to California. The court rejected the contention that the beneficiary should not be taxed on the accumulation distribution because the beneficiary's interest was contingent when the gains were accumulated. The holding in *Erdman* is consistent with the holding in *McCulloch,* in that a beneficiary's residence was sufficient nexus for California to impose income tax on an accumulation distribution.[30]

4. *Taxation of Beneficiaries Receiving Trust Distributions*

a. *Overview*

As noted previously, the R&TC is structured so that California may levy income tax with respect to a trust's undistributed net income via two different avenues. First, the trust itself is subject to income taxation in California based on its California source income, trustees and non-contingent beneficiaries, as described above.[31] This income tax is a liability of the trust and is reportable and payable on an annual basis in accordance with normal reporting requirements. Second, where a California resident beneficiary receives an accumulation distribution from (a) a trust that has not satisfied all of its income tax liabilities to California because the taxes were not paid when due,[32] or (b) a trust in which the California resident was a contingent beneficiary and therefore the accumulation distribution was not previously taxable by California,[33] the state exacts its tax from the California beneficiary upon his or her receipt of the accumulation distribution from the trust.

Taxation of accumulated income as provided in Section 17745(a) is somewhat confusing. That income is currently taxable to the trust by California under Section 17742(a). If the tax is not paid, the FTB would have difficulty collecting it from the trust if there were no California resident fiduciary or trust property situated in California. However, instead of providing that the taxes owed but not paid by the trust for the years in which the income was taxable to it are payable by the beneficiary as a transferee of that accumulated income, as contemplated by the court in *McCulloch*,[34] together with interest and possibly penalties, Sec-

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[30] *Id.* at *3-4.

[31] *See supra* Part C(1).

[32] CAL. REV. & TAX. CODE § 17745(a) (West 2004).

[33] *Id.* § 17745(b).

[34] California taxes the trust upon that portion of the annual income which the trust holds for eventual distribution to the California resident beneficiary. If the trustee fails to pay the tax for the trust annually as it earns the income, the California resident beneficiary becomes liable for such tax [when] the previously earned income is distributed to him.

tion 17745(a) taxes that accumulated income in the year distributable to the beneficiary, if he or she is a California resident at that time, as the taxpayer and not as a transferee. Presumably, California would not be able to tax that income to the beneficiary under Section 17745(a) and also collect the tax owed by the trust from the beneficiary as a transferee under the traditional concept of transferee liability.[35]

Equally significant, but substantially more complex, is California's "throwback" taxation of trust distributions pursuant to Section 17745(b). This provision allows California to tax a resident beneficiary when the trust itself has been properly refraining from paying income tax to California because its only California beneficiaries' interests in the trust were contingent, providing that "[i]f no taxes have been paid on the current or accumulated income of the trust because the resident beneficiary's interest in the trust was contingent[,] such income shall be taxable to the beneficiary when distributed or distributable to him or her."[36] Under R&TC Section 17745(d), the accumulated net income earned while the beneficiary's interest in the trust was contingent that is included in an accumulation distribution is taxed as though it had been included in the income of the beneficiary receiving the distribution ratably in the year of distribution and the five preceding years (or if the income has been accumulated for a shorter period, during such period).

Since California's income tax law was conformed to the federal income tax law in 1983,[37] distributions of accumulated income by a trust to a resident California beneficiary generally have been subject to both federal and California tax in accordance with the throwback rules under IRC §§ 665 - 668. However, R&TC Section 17779 provides that those sections are inapplicable to distributions described in R&TC Section 17745(b), quoted in the previous paragraph. Therefore, it appears that the California throwback rules in R&TC Section 17745(d), and not the rules under IRC §§ 665 - 668, generally are applicable to an accumulation distribution received by a resident California beneficiary unless the

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McCulloch v. Franchise Tax Bd., 390 P.2d 412, 417 (Cal. 1964).

> The purpose of . . . imposing upon the beneficiary at the time of the trust distribution his personal obligation to pay taxes due, but unpaid, by the trust is to avoid the difficulties in attempting to enforce tax collection directly against foreign trustees. . . The transferee tax thus levied assures this state that resident beneficiaries of the trusts administered elsewhere obtain no special advantage over California taxpayers.

Id. at 420.

[35] Notably, the *McCulloch* court referred to "transferee tax" (*see the previous footnote)*; however, in rendering its decision, the court cited the predecessor to current Section 17745(a), which, as pointed out above, taxes the income directly to the beneficiary and not as a transferee.

[36] REV. & TAX. Code § 17745(b).

[37] CAL. REV. & TAX CODE. § 17731 (West 2004) (effective July 28, 1983)

trust is also subject to federal tax on that distribution under IRC § 667, as discussed in the last paragraph of subdivision (b) of this Subpart (4), below.

b. *Limitations on Income Subject to "Throwback" Tax*

One important limitation on the amount of accumulated income subject to tax under Section 17745(b) is that the income must have been earned by the trust while the beneficiary was a California resident. As discussed previously, the purpose of Section 17745(b) is to hold a resident beneficiary liable for income tax that otherwise would have been taxable, but was not because the beneficiary's interest was contingent.[38] Before such beneficiary became a California resident, the income would not have been taxable by California (regardless of whether the beneficiary's interest was contingent or non-contingent) because there was no connection to California. Thus, income earned in years before the beneficiary became a California resident is not included in the amount taxable under Section 17745(b).

This principle is supported not only by the R&TC itself, but also by the courts and the FTB's application of income tax rules to trust beneficiaries. As the court in *McCulloch* explains, for example, taxation of the plaintiff beneficiary upon distribution was constitutionally supported because the "[beneficiary] in the instant case has, in his role as beneficiary *during the years of his residence in this state*, enjoyed the protection accorded by California for his eventual receipt of these assets."[39] By the same token, taxation of a beneficiary on income accumulated before he or she was born or for periods during which he or she was not a California resident (and hence derived no benefits from it) would be inappropriate and perhaps unconstitutional. The FTB appears to employ this approach as well, based on its description of the assessment of income tax upon trust beneficiaries. Discussing the calculation of a credit for income tax paid in another state, the FTB, in one ruling, stated as follows:

> [T]he credit shall be based upon the tax on the income accumulated by the trust since the [beneficiary] taxpayers became California residents until the date of distribution. One-sixth of that amount shall be added to the taxpayers' income for the

[38] *See supra* notes 34-35 and accompanying text.

[39] *McCulloch*, 390 P.2d at 419 (emphasis added). Although the *McCulloch* court allowed taxation of the beneficiary for all years in which income had been earned by the trust, this was specifically permissible because the beneficiary had resided in California for this entire period. *Id.* at 415.

> year of distribution and for each of the five preceding years to determine the California tax attributable to the trust income.[40]

Thus, depending on the duration of a beneficiary's California residence, this limitation may help to limit the amount of accumulated income that is taxed upon distribution.

In addition to residency, a beneficiary's age while income accumulates may also limit the amount taxable upon a distribution that is also subject to the tax on accumulation distributions under IRC § 667 (i.e., with respect to a foreign trust and certain domestic trusts).[41] One consequence of California's general adherence to the federal throwback rules with respect to such distributions is that a beneficiary is not taxed on income that accumulated before he or she reached age 21.[42] This rule is embodied in the Specific Instructions for Part I of the FTB's Schedule J (Form 541), which provides that "[g]enerally, the beneficiary may exclude amounts accumulated before the beneficiary becomes age 21."[43] Consistently, Part I (Tax on Accumulation Distribution under IRC § 667), Section A, line 2, of FTB Form 5870A,[44] used by a beneficiary to report accumulation distributions under IRC § 667, provides for the deduction of income accumulated before the beneficiary reached age 21. Because of R&TC Section 17779 (as discussed in the last paragraph of subdivision (a) of this subpart (4), above), it appears that California might not exclude from taxation a distribution of income to a beneficiary that was accumulated while he or she was a California resident before becoming age 21 if that income is subject to the tax on accumulation distributions under R&TC Section 17745(b) rather than IRC § 667.[45] However, the absence of regulations under R&TC Section 17745(b) or other FTB guidance to provide any alternative method for calculating accumulation distributions under R&TC Section 17745(b) has caused substantial uncertainty.

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[40] Cal. Franchise Tax Bd., Legal Ruling No. 375, Tax Credit for Accumulated Distributions Made by a Nonresident Trust to Resident Beneficiaries (June 11, 1974), *available at* https://www.ftb.ca.gov/law/rulings/active/lr375.shtml (holding that the taxpayer should be allowed a credit against California income taxes for taxes paid to Minnesota while residing in California).

[41] *See* I.R.C. § 665(b).

[42] *Id.*

[43] Cal. Franchise Tax Bd., Form 541 Sched. J, Trust Allocation of An Accumulation Distribution (2011), *available at* https://www.ftb.ca.gov/forms/2011/11_541bk.pdf.

[44] Cal. Franchise Tax Bd., Form 5870A, Tax On Accumulation Distribution of Trusts (2012), *available at* https://www.ftb.ca.gov/forms/2011/11_5870a.pdf.

[45] *Id.* at Part II (Tax on Distributions of Previously Untaxed Trust Income Under Cal. Rev. & Tax. § 17745(b) and (d)).

c. *Special Considerations Regarding Beneficiary Residence*

Finally, it is important to note that beneficiaries may not avoid California's throwback tax on trust distributions simply by briefly leaving the state.

R&TC Section 17745(e) implements a rule of "deemed residency," which provides,

> In the event that a person is a resident beneficiary during the period of accumulation, and leaves this state within 12 months prior to the date of distribution of accumulated income and returns to the state within 12 months after distribution, it shall be presumed that the beneficiary continued to be a resident of this state throughout the time of distribution.[46]

Even where a beneficiary leaves the state for the requisite period of time to avoid California taxation of an accumulation distribution, it is possible that California will still consider the beneficiary to have been a California resident at the time of distribution based on its general rules for identifying residents. As this article's Appendix B describes in detail, terminating California residency is not nearly as simple as physically leaving the state and living elsewhere, or even taking basic steps such as registering to vote and obtaining a driver's license in another state. Instead, California considers a myriad of factors in determining whether an individual remains (or has become) a California resident.[47] Trust beneficiaries who have physically left California must carefully assess their remaining connections with the state to determine whether an accumulation distribution will be taxable by California.

D. Illustrations of Miscellaneous California Provisions

The following scenarios illustrate the somewhat unpredictable results under California law in several typical fact patterns. In each scenario, it should be assumed that the trust in question is an irrevocable, non-grantor trust.

1. *Minor's Trust with General Power of Appointment*

> **Scenario #1: Assume that a nonresident of California is the sole trustee of an irrevocable trust, established solely for a minor California resident beneficiary. The minor beneficiary may receive discretionary payments of income and principal and is to receive an outright distribution of all of the remaining trust property upon reaching age 21, at which time the trust**

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[46] CAL. REV. & TAX. CODE § 17745(e) (West 2004).
[47] *See infra* Appendix B, note 91 and accompanying text.

terminates. If the beneficiary dies before reaching age 21, the trust assets are to be distributed to the beneficiary's issue, per stirpes, or if there is none, to other beneficiaries; however, the beneficiary is given a general testamentary power of appointment over the trust assets on attaining age 18.

Question 1(a): Does a general power cause a beneficiary to be vested?

Because the distributions are discretionary, the beneficiary's interest is contingent, at least until age 18. Upon reaching age 18, when the beneficiary acquires a general testamentary power of appointment over the trust assets, the FTB is likely to assert that the general testamentary power of appointment is sufficient to cause the interest to become vested (non-contingent). However, vesting as a result of a general power is less clear than vesting as a result of gaining the absolute right to receive accumulated income in the future. In this case, the beneficiary has a contingent interest until age 18 and most likely has a vested interest from and after age 18.

Question 1(b): Is the undistributed net income of the minor's trust taxable by California?

A trust that has only nonresident fiduciaries and a contingent California beneficiary would not be responsible at any point for paying tax on its accumulated income, absent California source income. Under the facts presented, the minor's trust would be responsible for paying annual income tax to California only with respect to income earned after the beneficiary reaches age 18, assuming the general testamentary power of appointment is deemed sufficient to cause the beneficiary's interest to become vested (non-contingent) at age 18.

Question 1(c): Assuming that the beneficiary remains a California resident and receives a termination distribution at age 21, how will California tax any accumulated income?

Consistent with tax laws of most states, beneficiaries who reside in California are taxable on trust distributions to the extent of the trust's distributable net income ("DNI"), as reported on the Form 1041-Schedule K-1.[48] However, under California law, to the extent of accumulation distributions received by the beneficiary, the beneficiary generally will be subject to California tax on all accumulated trust income that was not

[48] Dep't of the Treasury, OMB No. 1545-0092, Form 1041 Sched. K-1, U.S. Income Tax Return for Estates and Trusts (2012), *available at* http://www.irs.gov/pub/irs-pdf/f1041.pdf.

previously taxed by California. As discussed in Part C(4), above, the termination distribution to the beneficiary could be taxed to the beneficiary under R&TC Section 17745(a) if the trust did not pay taxes to California when it was required to do so, and/or as an accumulation distribution subject to the throwback rules under R&TC Sections 17745(b) and (d).

In the case of this minor's trust, if the trustee determined that the beneficiary's interest vested upon attaining age 18 (when the beneficiary obtained the general power of appointment) and *thereafter paid income taxes to California* on accumulated income, the beneficiary would become liable, if at all, only for income taxes on the income earned by the trust prior to reaching age 18, as provided in RT&C Sections 17745(b) and (d).

If, in the case of this minor's trust, the trustee *did not pay income taxes to California* following the beneficiary's acquisition of a general power of appointment at age 18, either because the trustee determined that the power of appointment was not enough to cause the beneficiary to become vested or because the trustee was unaware of California's requirements, the FTB could assert that the income accumulated after the beneficiary reached age 18 is taxable to the beneficiary under R&TC Section 17745(a).

2. *Discretionary Accumulation Trust with Several California Resident Beneficiaries*

Scenario #2: Assume that a nonresident of California is the sole trustee of a trust with several California resident beneficiaries. The primary beneficiary and his or her issue may receive payments of income and principal for their health, education, maintenance or support, in the sole discretion of the trustee. The primary beneficiary also holds a limited (non-general) testamentary power of appointment.

Question 2(a): Are the beneficiaries' respective interests contingent or non-contingent?

As in Scenario #1, the question is whether any of the beneficiaries have either a current right to trust property or an assured testamentary right to, or general power of appointment over, trust property.

With respect to current distributions, the trustee *may*, but is not required to, make distributions for certain needs of these beneficiaries. Because such distributions are solely at the discretion of the trustee, the beneficiaries cannot assert any current rights to trust funds and may never receive them. Thus, none of the beneficiaries has a vested interest based on a present right to trust property.

With regard to testamentary rights, the primary beneficiary has a *limited* testamentary power of appointment. A limited testamentary power does not ensure that the beneficiary will receive or enjoy the trust property, and does not have the effect of causing the beneficiary to become vested, as might be the case with a general testamentary power of appointment.

Because none of the beneficiaries is guaranteed any current or future rights to trust property, all of them are contingent beneficiaries.

> **Question 2(b): Are the beneficiaries' interests still contingent if the trust makes distributions to any of the beneficiaries?**

Any distributions to the beneficiaries under Scenario #2 will result in vesting as to the distributed amounts, which will be taxable to the California beneficiaries under Section 17731 (with respect to current distributable net income) or Section 17745(b) (with respect to accumulated net income). Except with respect to an actual distribution, however, the status of a beneficiary as contingent with respect to undistributed net income would not change, because the current distribution in and of itself would not guarantee any further rights to trust distributions or property.

3. *Distributions to Current or Former California Residents*

Scenario #3: Assume the following additional facts regarding Scenario #2: The trust has been in existence for 50 years, and all beneficiaries during the term of the trust have been California residents (except as provided below with respect to the sole remaining beneficiary). Under the terms of the trust instrument, the trust will terminate soon and distribute to the sole remaining beneficiary.

> **Questions: Will the trust or sole remaining beneficiary be taxed by California on the accumulated income earned during the term of the trust upon distribution under the following circumstances:**
>
> **3(a). The sole remaining beneficiary remains a California resident through and including the date of distribution?**
>
> **3(b). The sole remaining beneficiary ceases to be a California resident two years before the date of distribution?**
>
> **3(c). The sole remaining beneficiary ceases to be a California resident six months before the date of distribution?**

In this scenario, because the sole trustee is a nonresident of California and all of the California beneficiaries have contingent interests,[49] the trust is not taxable by California (except with respect to any California source income of the trust), pursuant to the general taxation principles of R&TC Sections 17742 - 17744. Under Section 17745(b), any prior distributions made to a beneficiary of this trust would have been taxable to the beneficiary. Because there is now one remaining beneficiary and this beneficiary has been a California resident throughout his or her lifetime (except surrounding the time of the distribution, as described below), 100% of any accumulation distribution which was not previously taxed by California will be taxable to this beneficiary.

Question 3(a) is straightforward because the beneficiary is a California resident prior to and at the time of the trust distribution. As such, the beneficiary will be taxed on the accumulation distribution to the extent the trust's income was not previously taxed by California. To calculate this tax, one sixth of the accumulated income will be added to the beneficiary's gross income for the year of distribution and for each of the five preceding years, and the hypothetical additional tax liability for each of these years will be added together to determine the total amount of tax to the beneficiary.[50]

In Question 3(b) the contingent beneficiary resides in California until two years prior to the trust distribution. As described previously, R&TC Section 17745(e) was implemented to preclude California residents from avoiding income tax on a trust distribution by leaving the state for a short period of time surrounding the distribution.[51] If a beneficiary leaves within 12 months before the distribution and returns within 12 months following it, he or she will be treated as if his or her California residency were continuous for this period and will be taxed upon the distribution. The R&TC does not extend the scope of this provision, however, beyond the two specified 12-month periods. Thus,

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[49] This characterization follows the traditional notion of a vested (non-contingent) interest. However, it is worth noting that the FTB has in certain recent instances attempted to characterize a beneficiary's interest as non-contingent – even though distributions to the beneficiary were completely discretionary – when a trustee made such regular and substantial distributions that the beneficiary was characterized as having the power in fact to access trust property as if the beneficiary had a right to it. Such cases are currently being contested and it remains to be seen both where such a line might be drawn and whether the FTB will be successful in applying this approach.

[50] As discussed in Part C(4)(b) supra, the absence of regulations under CAL. REV. & TAX. CODE § 17745(b) creates uncertainty as to how an accumulation distribution under this section should be calculated. If the federal throwback rules were used for this purpose, the beneficiary would be allowed to exclude any income accumulated before he or she reached age 21. *See* I.R.C. § 665(b). However, the FTB could challenge this approach.

[51] *See supra* Part C(4)(c).

if a beneficiary moves his or her residency out of California *more than* 12 months before a distribution, the distribution would not be taxable in California under Section 17745 even if the beneficiary returns to California immediately after the distribution. Here, two years well exceeds this time frame, so neither the beneficiary nor the trust would be subject to California income tax, regardless of whether or when the beneficiary returns to California following the distribution.[52]

Question 3(c) varies this scenario with a sole remaining beneficiary who has moved his or her residence out of California only six months prior to the distribution. Because this change in residency falls within the 12-month period prior to the distribution, the beneficiary could potentially be treated as a California resident at the time of distribution under Section 17745(e). If the beneficiary resumes California residency within 12 months following the distribution, he or she will be treated as a California resident for these purposes and will be taxed upon the distribution as if he or she never left the state. If not, the beneficiary may avoid California income tax on the distribution depending on all the relevant facts and circumstances.

4. *Discretionary Accumulation Trust with No California Beneficiaries*

Scenario #4: Assume that a California nonresident is the sole trustee of a trust with several beneficiaries, none of whom currently resides in California. The beneficiaries may receive payments of income and principal for their health, education, maintenance, or support, and they have limited (non-general) testamentary powers of appointment. At the time the trust was established, the settlor and the beneficiaries all resided in California.

Questions: Should the trust continue to file California fiduciary income tax returns after all of the beneficiaries no longer reside in California? Does this requirement change if the trust makes distributions to the beneficiaries?

Under this scenario, the only connection to California is the residence of the settlor and beneficiaries when the trust was created. As explained previously, the residency of the settlor at the time a trust was created (or became irrevocable) does not bear on whether California will impose income tax on that trust.[53] Thus, the fact that the settlor was

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[52] Note, however, that care must be taken in assessing the beneficiary's state of residence given California's strict residency rules described above and in Appendix B.

[53] *See supra* note 11 and accompanying text.

a resident of California when the trust was created does not expose the trust to California income tax.

As described in Scenario #3, R&TC Section 17745(e) provides that a beneficiary will be treated as a California resident – and a distribution to him or her will be subject to California income tax – if he or she resides in California while trust income accumulates, leaves California within 12 months before a distribution is made, and then returns to California within 12 months after that distribution. Thus, if any of the trust beneficiaries leave California within 12 months prior to the distribution, receive a trust distribution, and then return to California within 12 months after the distribution, they will be subject to California income tax. In this case, it is advisable for the trust to file a fiduciary income tax return for as long as this possibility exists (i.e., for one year following the last beneficiary's departure from California).

If it has been more than 12 months since the last beneficiary left California, however, any future trust distributions would not be subject to California income tax (assuming that the trust does not have any California source income). Thus, unless at least one beneficiary returns to California and receives a discretionary distribution of income, or the trust has California source income, it does not appear necessary for the trust to continue filing fiduciary income tax returns in California.

5. *Distributions to New California Residents*

Scenario #5: Regarding Scenario #4, assume the following alternate facts: The trust has been in existence for 50 years and none of the beneficiaries during the term of the trust has been a resident of California (except as provided below with respect to the sole remaining beneficiary). Under the terms of the trust instrument, the trust will terminate soon and distribute to the sole remaining beneficiary.

Questions: Will the sole remaining beneficiary be taxed by California on the income accumulated during the term of the trust upon distribution under the following situations:

5(a). The beneficiary becomes a California resident two years before the date of distribution?

5(b). The beneficiary becomes a California resident one week before the date of distribution?

Questions 5(a) and 5(b) should be considered under R&TC Sections 17745(a) and (b).

As previously discussed, a California resident beneficiary will be taxed under R&TC Section 17745(b) upon distribution from a trust

when income tax attributable to that beneficiary's share has not been paid by the trust because of the beneficiary's contingent status. Nowhere does the Code state that a beneficiary must have been a California resident for any minimum amount of time for this tax to apply. Because Questions 5(a) and 5(b) both involve a beneficiary who is a California resident at the time of distribution, that beneficiary will be subject to California income tax upon distribution in both cases, regardless of how long the beneficiary has been a California resident. (Because this beneficiary's interest is contingent, however, the trust itself will not be subject to California income tax.)

Where the timing of the beneficiary's arrival in California will have an impact is in the calculation of *how much* (rather than whether) income tax will be due. Thus, with respect to Questions 5(a) and 5(b), although the beneficiary would be subject to tax upon distribution, it appears that the amount subject to tax would be limited to the income earned after the beneficiary became a California resident. The beneficiary in 5(a) would be subject to California income tax on all of the undistributed net income earned for the two years preceding the distribution and would be allowed a credit for taxes paid by the trust to other states on the same income. Similarly, the beneficiary in 5(b) would only be subject to California income tax on the undistributed net income earned in the one week preceding the distribution.

With respect to the distribution in Question 5(b), the amount of income accumulated during the one week of the beneficiary's California residence is likely to be nominal. If so, the adoption of California residence immediately prior to a distribution is unlikely to create significant income tax liability with respect to the accumulation distribution. Where this action could have quite an impact is in the case of a trust that has failed to satisfy its California income tax liabilities. In that event, two years' or even a week's residence in California could subject the beneficiary to income tax liability with respect to the distribution under R&TC Section 17745(a) (which, as described previously, allows California to tax a resident beneficiary receiving a distribution for a pro rata share of amounts previously due and unpaid by the trust).

A final issue regarding the scenarios in both Questions 5(a) and 5(b) is the manner in which the total amount subject to tax is allocated for purposes of calculating the amount of tax due. In situations involving the throwback rules of R&TC Sections 17745(b) and (d), the standard throwback allocation of one sixth of the income to each of the present and five preceding years is normally used to calculate the beneficiary's tax liability. However, R&TC Section 17745(d) specifically states that the untaxed income should be included either in this manner "*or for the period that the trust accumulated or acquired income for that*

contingent beneficiary, whichever period is shorter."[54] Thus, it appears likely that the throwback period would only include the time during which the beneficiary was a California resident and held a contingent interest. In Scenario #5, for purposes of calculating the beneficiary's income tax liability under the throwback rules, the trust income would be allocated ratably as if it had been included in the beneficiary's income for the two-year period (with respect to Question 5(a)) or the one-week period (with respect to Question 5(b)) during which the beneficiary was a California resident, rather than over the five years preceding the distribution.

E. Compliance

The focus of this article is to raise awareness of California's unique approach to income taxation and to help fiduciaries, beneficiaries and advisors with California connections understand how these laws are applied. However, it is also important to understand the practical implications of California's income tax rules. The last portion of this article therefore discusses the nuts and bolts of complying with the California law relating to the income taxation of trusts and estates. California Form 541 and the schedules thereto are generally similar to the federal Form 1041 and its schedules, but with important differences. The relevant forms and schedules can be accessed from the Franchise Tax Board's website at www.ftb.ca.gov.

1. *Form 541 and Related Schedules*

California decedents' estates, as well as resident and "nonresident" trusts, file FTB Form 541 *California Fiduciary Income Tax Return*.[55] California does not publish a separate nonresident fiduciary income tax return. California's Form 541 was clearly derived from the federal Form 1041 *U.S. Income Tax Return for Estates and Trusts*,[56] as the line items on the face of the return (income and deductions) appear in the same order and only vary because of differences in the applicable state and federal laws (e.g., the reference to qualified dividends on the federal return, as California has a single rate schedule applicable to all dividends and capital gains). Both returns require that pertinent questions be answered under a section titled "Other Information" and both include Schedule A "Charitable Deduction" and Schedule B "Income Distribution Deduction."

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[54] *Id.* § 17745(d).

[55] CAL. FRANCHISE TAX BD., FORM 541, CALIFORNIA FIDUCIARY INCOME TAX RETURN (2012), *available at* https://www.ftb.ca.gov/forms/2012/12_541.pdf.

[56] DEP'T OF THE TREASURY, FORM 1041, U.S. INCOME TAX RETURN FOR EST. & TR. (2012), http://www.irs.gov/pub/irs-pdf/f1041.pdf.

An important difference between Form 541 and Form 1041 is the use of Schedule G. Schedule G on Form 1041 is used to compute the tax due with the return. Schedule G on Form 541 is entitled "California Source Income and Deduction Apportionment" and is used by nonresident estates and trusts to identify the amounts taxable by California. The amounts identified on Schedule G (541) are carried forward to the taxable income computation on the first page of Form 541. Schedule G (541) is completed by reference to Form 1041 and first separates the trust's income between California source income (all of which is taxable by California) and non-California source income. The non-California source income is then apportioned to California on the basis of the percentage of trustees residing in California and the remaining non-California source income, if any, is apportioned to California on the basis of the percentage of non-contingent beneficiaries residing in California. Schedule G also directs the trustee to report the trust's deductions and to identify those allocable to California. A copy of pages 1 and 2 of Form 1041 is required to be attached to the Form 541.

Schedule K-1 (541) reports the information on the Schedule K-1 (1041), lists the California adjustments to determine the income reportable for California, and identifies California source income and credits. Importantly, Schedule K-1 (541) separately states the California source income on which nonresident beneficiaries are required to pay tax in California.

Schedule J (541), entitled "Trust Allocation of an Accumulation Distribution," is a separate form used to report and compute accumulation distributions by *domestic complex trusts* and certain foreign trusts. The instructions to Schedule J (541) acknowledge California's conformity to the repeal of the federal throwback rules, but state: "However, if the trust did not pay tax on the beneficiary's interest because the beneficiary was contingent, the income that would have been taxed is included by the beneficiary in the year it is distributable or distributed; see California Revenue and Taxation Code (R&TC) Section 17745(b)."

FTB Form 5870A (*Tax on Accumulation Distribution of Trusts*) is used by a beneficiary to report and pay the tax on an accumulation distribution and is to be attached to the beneficiary's California individual income tax return.[57] If the federal throwback rules apply, Part I of Form 5870A allows a beneficiary to exclude income accumulated before the beneficiary was "born or reached age 21." However, as discussed in Part C (4), above, the federal throwback rules are generally inapplicable to domestic trusts.

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[57] Cal. Franchise Tax Bd., Form 5870A, Tax On Accumulation Distribution of Trusts (2012), *available at* https://www.ftb.ca.gov/forms/2011/11_5870a.pdf.

2. *California Tax Withholding*

California imposes backup withholding (generally at the rate of 7%) on distributions of income to nonresident beneficiaries where the payment consists of California source income.[58] Withholding is not required on distributions to nonresident beneficiaries of California source income totaling $1,500 or less in a calendar year.[59]

The applicable California forms for withholding are:

592 Resident and Nonresident Withholding Statement[60]
592-B Nonresident Withholding Tax Statement[61]
592-V Payment Voucher for Resident and Nonresident Withholding[62]

California also imposes a three and one-third percent withholding tax on the gross proceeds from the sale of California real property (including installment sales), or the seller may elect to have the tax computed on the gain (at the highest applicable rates) withheld. If there is no gain on the sale, the seller may avoid the withholding requirement by electing the optional gain on sale method of withholding.

The applicable California forms are:

593 Real Estate Withholding Tax Statement[63]
593-C Real Estate Withholding Certificate[64]
593-E Real Estate Withholding - Computation of Estimated Gain or Loss[65]
593-V Payment Voucher for Real Estate Withholding[66]

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58 CAL. REV. & TAX. Code §§ 18662, 18664 (West 2004 & Supp. 2013); CAL. CODE REGS. tit. 18, §§ 18662-1 to -3 (2009).

59 CAL. CODE REGS. tit. 18, § 18662-2.

60 CAL. FRANCHISE TAX BD., FORM 592, RESIDENT AND NONRESIDENT WITHHOLDING STATEMENT (2013), *available at* https://www.ftb.ca.gov/forms/2013/13_592.pdf.

61 CAL. FRANCHISE TAX BD., FORM 592- B, NONRESIDENT WITHHOLDING TAX STATEMENT (2013), *available at* https://www.ftb.ca.gov/forms/2013/13_592b.pdf.

62 CAL. FRANCHISE TAX BD., FORM 592-V, PAYMENT VOUCHER FOR RESIDENT AND NONRESIDENT WITHHOLDING (2013), *available at* https://www.ftb.ca.gov/forms/2013/13_592v.pdf.

63 CAL. FRANCHISE TAX BD., FORM 593, REAL ESTATE WITHHOLDING TAX STATEMENT (2013), *available at* https://www.ftb.ca.gov/forms/2013/13_593.pdf.

64 CAL. FRANCHISE TAX BD., FORM 593-C, REAL ESTATE WITHHOLDING CERTIFICATE (2013), *available at* https://www.ftb.ca.gov/forms/2013/13_593c.pdf.

65 CAL. FRANCHISE TAX BD., FORM 593-E, REAL ESTATE WITHHOLDING COMPUTATION OF ESTIMATED GAIN OR LOSS (2013), *available at* https://www.ftb.ca.gov/forms/2013/13_593e.pdf.

66 CAL. FRANCHISE TAX BD., FORM 593-V, PAYMENT VOUCHER FOR REAL ESTATE WITHHOLDING (2013), *available at* https://www.ftb.ca.gov/forms/2013/13_593v.pdf.

3. *Other State Tax Credit*

California has complex rules regarding credits for taxes paid to other states that vary depending on whether the taxpayer is a resident, nonresident, individual or a trust or estate.[67] California allows a credit for taxes paid to another state by an estate or trust where the estate or trust is considered to be a resident of both states.[68] California will also allow its resident beneficiaries of trusts or estates to claim a credit for income taxes paid by the trust or estate to another state.[69] In general, no credit is allowed if the other state allows California residents a credit for income taxes paid to California.[70] Nonresidents of California may claim a credit only for net income taxes paid to California.[71] California Schedule S is used to claim this credit.

4. *Voluntary Disclosure*

California provides an *Application for Voluntary Disclosure* on FTB Form 4925.[72] As stated in its instructions:

> The purpose of Franchise Tax Board's (FTB) Voluntary Disclosure Program is to encourage qualified entities, qualified shareholders, qualified members, or qualified beneficiaries that have an unfulfilled California franchise/income tax return filing requirement and/or unpaid tax and/or fee liability to voluntarily come forward. In exchange, FTB is authorized by statute to limit the imposition of tax and/or fee liability to a six-year period immediately preceding the signing date of a voluntary disclosure agreement, and the discretion to waive penalties listed below under "Penalties Waived."

The requirements for participation in the Voluntary Disclosure Program are stringent and, therefore, of limited usefulness. In most situations, the applicant must have never previously filed a return with the FTB. If the entity is a trust, it must have never performed administration activities in California and had no resident beneficiaries (other than a beneficiary whose interest in that trust is contingent). A nonresident

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67 *See* Cal. Rev. & Tax. Code § 18001 (West 2004).

68 *Id.* § 18004.

69 *See id.* § 18005. The credit California resident beneficiaries of trusts or estates can receive for income taxes paid by the trust or estate to another state is subject to conditions as outlined in Section 18005(a-b).

70 *Id.* § 18001(a)(2).

71 Id. § 18002(a).

72 Cal. Franchise Tax Bd., FTB 4925-C2, Application for Voluntary Disclosure (2008), *available at* https://www.ftb.ca.gov/forms/misc/4925.pdf; *see also* Rev. & Tax. § 19191(a) (authorizing the Franchise Tax Board to enter into *voluntary disclosure agreements*) (emphasis added).

beneficiary must not have been a resident for six taxable years ending immediately preceding the date the Voluntary Disclosure Agreement is signed. In all cases, the applicant must not have been previously contacted by the FTB.

5. *Additional Assistance from the FTB Legal Division*

The Legal Division of the Franchise Tax Board is divided into five bureaus. The General Tax Law Bureau is responsible for taxation issues pertaining to trusts, and may be contacted by taxpayers or their representatives for assistance.

APPENDIX A

California Revenue and Taxation Code

§ 17742. Income taxable to estate or trust; residence of decedent, fiduciary or beneficiary

(a) Except as otherwise provided in this chapter, the income of an estate or trust is taxable to the estate or trust. The tax applies to the entire taxable income of an estate, if the decedent was a resident, regardless of the residence of the fiduciary or beneficiary, and to the entire taxable income of a trust, if the fiduciary or beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident, regardless of the residence of the settlor.

(b) For purposes of this article the residence of a corporate fiduciary of a trust means the place where the corporation transacts the major portion of its administration of the trust. *(Added by Stats.1983, c. 488, §59, eff. July 28, 1983.)*

§ 17743. Residence of fiduciary; multiple fiduciaries; apportionment of income

Where the taxability of income under this chapter depends on the residence of the fiduciary and there are two or more fiduciaries for the trust, the income taxable under Section 17742 shall be apportioned according to the number of fiduciaries resident in this state pursuant to rules and regulations prescribed by the Franchise Tax Board. *(Added by Stats.1 983, c. 488, § 59, eff. July 28, 1983.)*

§ 17744. Residence of beneficiary; multiple beneficiaries; apportionment of income

Where the taxability of income under this chapter depends on the residence of the beneficiary and there are two or more beneficiaries of the trust, the income taxable under Section 17742 shall be apportioned according to the number and interest of beneficiaries resident in this state pursuant to rules and regulations prescribed by the Franchise Tax Board. *(Added by Stats. 1983, c. 488, §59, eff. July 28, 1983.)*

§ 17745. Income taxable to beneficiaries

(a) If, for any reason, the taxes imposed on income of a trust which is taxable to the trust because the fiduciary or beneficiary is a resident of this state are not paid when due and remain unpaid when that income is distributable to the beneficiary, or in case the income is distributable to the beneficiary before the taxes are due, if the taxes are not paid when due, such income shall be taxable to the beneficiary when

distributable to him except that in the case of a nonresident beneficiary such income shall be taxable only to the extent it is derived from sources within this state.

(b) If no taxes have been paid on the current or accumulated income of the trust because the resident beneficiary's interest in the trust was contingent such income shall be taxable to the beneficiary when distributed or distributable to him or her.

(c) The tax on that income which is taxable to the beneficiary under subdivisions (a) or (b) is a tax on the receipt of that income distributed or on the constructive receipt of that distributable income. For purposes of this section income accumulated by a trust continues to be income even though the trust provides that the income (ordinary or capital) shall become a part of the corpus.

(d) The tax attributable to the inclusion of that income in the gross income of that beneficiary for the year that income is distributed or distributable under subdivision (b) shall be the aggregate of the taxes which would have been attributable to that income had it been included in the gross income of that beneficiary ratably for the year of distribution and the five preceding taxable years, or for the period that the trust accumulated or acquired income for that contingent beneficiary, whichever period is the shorter.

(e) In the event that a person is a resident beneficiary during the period of accumulation, and leaves this state within 12 months prior to the date of distribution of accumulated income and returns to the state within 12 months after distribution, it shall be presumed that the beneficiary continued to be a resident of this state throughout the time of distribution.

(f) The Franchise Tax Board shall prescribe such regulations as it deems necessary for the application of this section. *(Added by Stats.1983, c. 488, §59, eff. July 28, 1983.)*

§ 17745.1. Application of 1963 amendments of former Sections 17742, 17745

The amendments of Sections 17742 and 17745 made at the 1963 Regular Session of the Legislature shall be applicable only with respect to taxable years beginning after December 31, 1962. Whether or not the income of a trust which is or was accumulated or is or was accumulated and distributed or accumulated and distributable is taxable by California for the years prior to 1963 shall be determined as if Sections 17742 and 17745 had not been amended at the 1963 Regular Session of the Legislature and without inferences drawn from the fact that such amendments

were not made applicable with respect to taxable years beginning before January 1, 1963. *(Added by Stats.1983, c. 488, §59, eff. July 28, 1983.)*

§ 17779. Excess distributions by trusts; application of federal provisions

Sections 665 to 668, inclusive, of the Internal Revenue Code shall not apply to distributions described in subdivision (b) of Section 17745. (*Added by Stats.1983, c. 488, §59, eff. July 28, 1983.)*

APPENDIX B

California Residency Determinations

Individual California tax residency cases are intensively factual in nature. Indeed, because the FTB views residency as a question of fact, not law, the FTB will not issue written advice on whether an individual is a resident for a particular period of time.[73] The legal analysis begins with the statute. The California Code of Regulations section 17014(a) defines "resident" to include:

1. Every individual who is in this state for other than a temporary or transitory purpose; [or]
2. Every individual who is domiciled in this state who is outside the state for a temporary or transitory purpose.[74]

Any individual who is not a resident is, by statutory definition, a nonresident.[75] Presence within California for more than nine months of a taxable year creates a rebuttable presumption of California residence.[76] However, presence within California for less than nine months does not create a presumption of nonresidency.[77]

"Domicile" is a part of the definition of resident, but the concepts are not synonymous. Domicile has been defined by the courts as the "one location with which for legal purposes a person is considered to have the most settled and permanent connection, the place where he intends to remain and to which, whenever he is absent, he has the intention of returning . . . ."[78] Similarly, the FTB regulations provide as follows:

> Domicile has been defined as the place where an individual has his true, fixed, permanent home and principal establishment, and to which place he has, whenever he is absent, the intention of returning . . . . Another definition of "domicile" consistent with the above is the place where an individual has fixed his habitation and has a permanent residence without any present intention of permanently removing therefrom.[79]

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[73] *See* CAL. FRANCHISE TAX BD., FTB PUBLICATION 1031, GUIDELINES FOR DETERMINING RESIDENT STATUS, at 1 (2012), *available at* https://www.ftb.ca.gov/forms/2012/12_1031.pdf.

[74] *See* CAL. CODE REGS. tit. 18, § 17014 (2013) (defines the term "resident" in same way as Cal. Rev. & Tax. Code § 17014 (West 2010)).

[75] REV. & TAX. CODE § 17015 (West 2010); CAL. CODE REGS. tit. 18, § 17014.

[76] REV. & TAX. CODE § 17016; CAL. CODE REGS. tit. 18, § 17016.

[77] Christianson, 1972 Cal. Tax LEXIS 24, at *9 (St. Bd. of Equalization Aug. 17, 1983).

[78] Whittell v. Franchise Tax Bd., 41 Cal. Rptr. 673, 676 (Dist. Ct. App. 1964).

[79] CAL. CODE REGS. tit. 18, § 17014(c).

Accordingly, domicile denotes the one location with which a person has the most settled and permanent connections and where the person intends to remain, while residence denotes any factual place of abode of some permanency; that is, "more than a mere temporary sojourn."[80] A taxpayer may have several residences simultaneously for different purposes, as well as more than one residence for tax purposes. However, a taxpayer may have only one domicile at any given time.[81] A domicile cannot be lost until a new one is acquired.[82] Once acquired, a domicile is presumed to continue until it is shown to have changed.[83]

In order to change domicile, the California State Board of Equalization (which acts as a quasi-tax court in California for FTB matters) has required a showing that a taxpayer "(1) left the state without any intention of returning, and (2) was located elsewhere with the intention of remaining there indefinitely".[84] In determining the taxpayer's intent, the "acts and declarations of the party must be taken into consideration."[85]

The California courts recently confirmed the importance of the physical acts of the taxpayer, holding: "[t]o the extent residence and domicile depend upon intent, 'that intention is to be gathered from one's acts.'"[86] The Court of Appeal has found that when "a person actually removes to another place with an intention of remaining there for an indefinite time, and as a place of present domicile, it becomes his place of residence or domicile."[87] With specific regard to domicile, the Court stated that "our courts have held that two elements are indispensable to accomplishing a change of domicile: actual residence in the new locality plus the intent to remain there."[88]

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80 *Whittell,* 41 Cal. Rptr. at 676 (citing Smith v. Smith, 288 P.2d 497, 499 (Cal. 1955)).

81 *Id.*

82 *See In re* Estate of Philips, 75 Cal. Rptr. 301, 303 (Ct. App. 1969); Aldabe v. Aldabe, 26 Cal. Rptr. 208, 216 (Dist. Ct. App. 1962).

83 CAL. CODE REGS. tit. 18, § 17014(c) (2013); Murphy v. Travelers Ins. Co., 207 P.2d 595, 597 (Dist. Ct. App. 1949).

84 Harrison, 1985 Cal. Tax LEXIS 106, at *4 (St. Bd. Equalization, June 25, 1985); *See also In re* Peter's Estate, 12 P.2d 118, 119 (Cal. Dist. Ct. App. 1932).

85 Morgan, 1985 Cal. Tax LEXIS 88, at *5 (St. Bd. Equalization, July 30, 1985) (quoting *Phillips*, 75 Cal. Rptr. at 303); *see also Harrison*, 1985 Cal. Tax LEXIS, at *5 (stating that "[i]t is the 'intent' of the person that determines domicile"); *See also* Chapman v. Superior Court, 328 P.2d 23, 27 (Cal. Dist. Ct. App. 1958).

86 Noble v. Franchise Tax Bd., 13 Cal. Rptr. 3d 363, 368 (Ct. App. 2004) (quoting *Chapman,* 328 P.3d at 26).

87 *Id.* at 369 (quoting *In re* Weed's Estate*,* 53 P. 30, 31 (Cal. 1898)) (internal quotation marks omitted).

88 *Id.* at 369 (quoting DeMiglio v. Mashore*,* 6 Cal. Rptr. 2d 267, 272 (Cal. Ct. App. 1992)) (internal quotation marks omitted).

In most situations (and in most FTB audits), a person's domicile and residence are the same physical location. However, when domicile is an issue in a California tax residency case, domicile is always decided first. For California domiciliaries, the focus is upon whether the taxpayer is absent from California for a temporary or transitory purpose. If so, the taxpayer is a California resident. For non-California domiciliaries, the focus is upon whether he/she is in California for other than a temporary or transitory purpose. What constitutes a "temporary or transitory purpose" under California tax law is the same in either instance.[89]

Neither the California statutes, the FTB regulations, nor the decisional law provides an all-inclusive list of factors that are used to determine California residency status. No set of factors is conclusive. However, some of the factors commonly considered by the FTB in residency audits are the following: (1) the amount of time spent in California compared to the amount of time spent outside California; (2) the location of spouse, children and relatives; (3) the location of all residences and of principal residence (and any homeowners property tax exemption taken); (4) where a driver's license is issued; (5) where vehicles (and watercraft and aircraft) are registered; (6) where the individual is registered to vote and his or her voting history; (7) the location of banks where accounts are maintained; (8) where financial transactions take place; (9) the location of professionals used, e.g., doctors, dentists, brokers, accountants, attorneys, veterinarians; (10) the location of church, temple or mosque attended; (11) social ties and the location of social clubs, country clubs, and gyms of which the taxpayer is a member; (12) the location of real property (owned and rented by the taxpayer or related entities) and other investments; (13) the location of business interests; and (14) the location of tangible articles of a personal nature and any safe deposit box. A typical written determination in an FTB residency audit will organize these factors and other information into the categories of Tax Filing History (for California, federal and other states, for the years in issue and immediately preceding and subsequent years); Biographical History and Personal Profile; Real Property Interests; Personal Property Interests; Business Profile; and Financial Profile.[90]

As a general principle, an FTB audit determination is presumed correct and the taxpayer has the burden of proving it wrong.[91] Unsupported assertions are not sufficient to satisfy the taxpayer's burden of

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89 *See* CAL. CODE REGS. tit. 18, § 17014 (2013).

90 *See* CAL. FRANCHISE TAX BD., FTB PUBL'N 1031, Guidelines for Determining Resident Status (2011) *available at* https://www.ftb.ca.gov/forms/2011/11_1031.pdf.

91 *See, e.g.*, Myers, No. 41782, 2001-SBE-001 at *5, (Cal. St. Bd. of Equalization May 31, 2001), *available at* http://www.boe.ca.gov/legal/pdf/myers.pdf.

proof.[92] In the absence of "uncontradicted, credible, competent and relevant evidence" showing error in the FTB's determinations, they must be upheld.[93] The method by which one challenges an adverse audit finding is by filing a "protest" with the FTB within 60 days after the mailing by the FTB to the taxpayer of a notice of proposed deficiency assessment.[94]

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92 *See, e.g.*, Magidow, 1982 Cal. Tax. LEXIS 44, at *9 -10 (St. Bd. of Equalization Nov. 17, 1982).

93 Seltzer, 1980 Cal. Tax LEXIS 27, at *7 (St. Bd. of Equalization Nov. 18, 1980).

94 Cal. Rev. & Tax. Code § 19041(a) (West 2004); *See generally id.* § 19042.

Family Partnerships: New Reporting Obligations

ACTEC Annual Meeting

La Quinta, California

Gray Edmondson

Family Partnerships: New Reporting Obligations

By: Gray Edmondson

Treasury recently finalized regulations imposing significant reporting obligations on persons involved in what the regulations describe as “related party basis adjustment transactions.” These regulations designate such transactions as “transactions of interest,” a form of reportable transactions. Reporting obligations can apply to transactions completed prior to the date of these regulations and also may extend many, many years after the transaction that resulted in the applicable basis adjustment. The purpose of this writing is to summarize the relevant transactions and the reporting obligations that apply.

Transactions of Interest

Regulations describe five categories of “reportable transactions” for which certain disclosure, record keeping, and penalties for failure to comply will be applicable.[1] Those categories are: (1) listed transactions; (2) confidential transactions; (3) transactions with contractual protection; (4) loss transactions; and (5) transactions of interest.[2] Compliance requirements are also triggered by transactions which are “substantially similar” to any listed transaction or transaction of interest.[3]

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[1] Treas. Reg. § 1.6011-4.
[2] *Id.*
[3] Treas. Reg. § 1.6011-4(b)(2) and (6). For a definition of substantially similar, see Treas. Reg. § 1.6011-4(c)(4) which definition is intentionally broad, in order to be “broadly construed in favor of disclosure.”

When a transaction is designated as a "transaction of interest,"[4] the taxpayer is required to attach IRS Form 8886,[5] *Reportable Transaction Disclosure Statement*, to their income tax return for the relevant year and also submit Form 8886 to the Office of Tax Shelter Analysis ("OTSA").[6] When transactions already undertaken for which the taxpayer's income tax return has been filed are later designated as transactions of interest, the taxpayer must file Form 8886 with OTSA within 90 calendar days after the date on which the transaction was so designated, provided the statute of limitations for assessment of tax remains open for such year.[7] In addition, there are recordkeeping requirements obligating taxpayers to retain materials and documents related to the reportable transaction as long as the statute of limitations on assessment remains open.[8]

Beyond just taxpayers, any "material advisor"[9] with respect to the transaction of interest also has certain disclosure and recordkeeping requirements.[10] Material advisors must submit IRS Form 8918,[11] *Material Advisor Disclosure Statement*, to OTSA. Notably, Form 8918 requires material advisors to identify other parties providing material assistance (even if not necessarily meeting the definition of material advisor). Form 8918 must be filed on or before the last day of the month following the end of the calendar quarter in which the person first became a material advisor with respect to the transaction.[12] Material advisors also are obligated to maintain lists

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[4] The scope of this writing is limited to transactions of interest as covering the recently issued final regulations designating "related party basis adjustment transactions" as such.
[5] https://www.irs.gov/forms-pubs/about-form-8886
[6] Treas. Reg. § 1.6011-4(d)(1).
[7] Treas. Reg. § 1.6011-4(d)(2).
[8] Treas. Reg. § 1.6011-4(g).
[9] A person is a "material advisor" if "the person provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and directly or indirectly derives gross income in excess of" regulatory threshold amounts. Treas. Reg. § 301.6111-3(b).
[10] IRC § 6111 and Treas. Reg. § 301.6111-3.
[11] https://www.irs.gov/forms-pubs/about-form-8918
[12] Treas. Reg. § 301.6111-3(e).

identifying each person with whom the advisor has served as a material advisor along with certain other required information.[13]

Taxpayers who are required to disclose transactions of interest, or substantially similar transactions, but fail to disclose such transactions are subject to penalties.[14] The amount of the penalty is 75% of the decrease in tax shown on the return as a result of the reportable transaction, or which would have resulted from such transaction if such transaction were respected for Federal tax purposes, subject to minimum and maximum penalty amounts.[15] The minimum penalty amount is $5,000 in the case of a natural person and $10,000 in any other case. For a transaction of interest, the maximum penalty amount is $10,000 in the case of a natural person and $50,000 in any other case.[16] In addition, there is a 20% accuracy-related penalty on any understatement attributable to an adequately disclosed reportable transaction [17] which is increased to 30% if the transaction is not properly disclosed.[18]

A material advisor who fails to file a timely disclosure, or files an incomplete or false disclosure statement, is subject to a penalty of $50,000.[19] A material advisor may be subject to a penalty for failing to maintain the required information list and failing to make the list available upon written request of the Secretary within 20 business days after the date of such request.[20] The penalty for failing to provide such list is $10,000 per day for the failure to provide such list after

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[13] IRC § 6112 and Treas. Reg. § 301.6112-1. Per Rev. Proc. 2008-20, this requirement may be satisfied using IRS Form 13976 although use of that form is not required provided the required information is properly maintained.
[14] IRC § 6707A.
[15] IRC § 6707A(b).
[16] *Id.*
[17] IRC § 6662A(b)(1).
[18] IRC § 6662A(c).
[19] Section 6707(a).
[20] IRC § 6708.

the 20th day.[21] No penalty will be imposed on material advisors with respect to the failure on any day if such failure is due to reasonable cause.[22]

Related Party Basis Adjustment Transactions

The following transactions are those to which the regulations apply:[23]

(1) A partnership with two or more related partners[24]:

a. distributes property to one of the related partners in a current or liquidating distribution where the partnership increases the basis of one or more of its remaining properties due to a section 734(b) adjustment;

b. distributes property to related partner in liquidation of the person's partnership interest, causing the basis of one or more distributed properties to be increased due to application of section 732(b); or

c. distributes property to a related partner, the basis of one or more of the distributed properties is increased under section 732(d), the distributee acquired all or part of its interest in the partnership in a transaction that would have been described below if the partnership had a section 754 election in effect for the year of the transfer; to another partner (in a transaction which would be described in (2) below) causing the basis of one or more distributed properties to be increased as a result of a section 732(d) election;

[21] IRC § 6708(a)(1).
[22] IRC § 6708(a)(2).
[23] Treas. Reg. § 1.6011-18(c)(1) and (2).
[24] The term "related partner" is defined in Treas. Reg. § 1.6011-18(b)(9). I do not specifically address treatment of "tax-indifferent parties" as defined in Treas. Reg. § 1.6011-18(b)(12) in this writing, but similar concepts apply as described here with respect to "related partners" subject to certain limited differences (for example, knowledge qualifier and alterations in the calculation of the threshold amount).

(2) A partner transfers all or part of a partnership interest to a related partner in a nonrecognition transfer[25] and the basis of one or more partnership properties in increased under section 743(b); and

(3) A partner receives an interest in a recognition transaction, the basis of one or more partnership properties is increased under section 743(b), and subsequently the partner transfers the partnership interest to a person related to the transferor in a transaction that would have otherwise been a transaction of interest under (2) above.[26]

All of these transactions are limited to those transactions for which an applicable threshold has been met. There are two primary threshold amounts (although calculations of these amounts are modified in certain situations):

(1) Other than transactions subject to the "six year lookback period,"[27] the applicable threshold will be met if the sum of all basis increases resulting from all such transactions during the taxable year (without netting for any basis decrease in the same transaction or another transaction) exceeds by at least $10 million the gain recognized from such transactions during the same taxable year by any of the related partners who are a party to such transactions; or

(2) For transactions during the "six year lookback period" the same definition applies as above, substituting $25 million for $10 million.

[25] The term "nonrecognition transaction" is defined in Treas. Reg. § 1.6011-18(b)(2) as defined in IRC § 7701(a)(45) being "a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A."

[26] For this transaction, the applicable threshold, discussed below, is calculated pursuant to a special rule that limits the amount of the basis adjustment counting towards the appliable threshold amount. See Treas. Reg. § 1.6011-18(c)(2)(ii).

[27] The "six year lookback period" is the period 72 months immediately preceding the first month of the taxpayer's most recent taxable year that began before January 14, 2025.

For distributions resulting in a section 734(b) adjustment, a basis increase is only counted towards the appliable threshold to the extent of a related partner's share of the basis increase.[28] For distributions resulting in an adjustment to the basis of distributed property in a liquidating distribution, the applicable threshold calculation excludes any increase that corresponds to a decrease to the basis of property distributed to unrelated partners other than tax-indifferent parties or a decrease in such parties' share of any decrease in basis of the partnership's property under section 734(b).[29]

The regulations clarify that transactions failing to meet the applicable threshold will not be considered "substantially similar" for purposes of triggering a reporting obligation.[30]

Exception for Transfers at Death

An important exception to applicability of these rules relates to a "transfer on the death of a partner."[31] That term is defined in the regulations to mean "a transfer of a partnership interest from a partner to the partner's estate or a deemed transfer from a grantor trust owned by the partner to a trust that becomes a separate entity for Federal income tax purposes by reason of the partner's death."[32]

This exception avoids treating as transactions of interest basis adjustments that occur by reason of a section 1014 basis adjustment to the partner's interest in the partnership and corresponding inside basis adjustment to the assets of the partnership under section 743(b) for partnerships with a section 754 election in place for the year of the partner's death. Likewise, it

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[28] Treas. Reg. § 1.6011-18(c)(3)(iii).
[29] Treas. Reg. § 1.6011-18(c)(3)(iv).
[30] Treas. Reg. § 1.6011-18(d)
[31] Treas. Reg. § 1.6011-18(c)(4).
[32] Treas. Reg. § 1.6011-18(b)(13).

avoids treating a deemed transfer from a grantor trust to a non-grantor trust, even absent any section 1014 basis adjustment,[33] from constituting a transaction of interest.

It is important to note that, while these exceptions are important, this is not a broad exception for all transfers resulting from the death of a partner. For example, if a section 754 election is not applicable in the year of the partner's death, subsequent transactions resulting in basis adjustments will not be excepted. These transactions could include distributions of partnership property to the estate or transfers of partnership interests from the estate to beneficiaries. Further, other transactions applying by virtue of the death of a partner, including those occurring during estate and trust administration such as termination of a non-grantor trust in distribution to remainder beneficiaries, will also not be excepted. As such, care should be taken in administering trusts and estates following the death of a partner to determine what transactions will be excepted and which will not.

Reporting Obligations

While the general reporting obligations for transactions of interest are described above, there are some specifics to reporting with respect to related party basis adjustment transactions. In addition to filing Form 8886 for each taxable year in which a participant engaged in a transaction described in the regulations,[34] a participating partnership, participating partner, or related subsequent transferee[35] is deemed under the regulations to have participated in a listed transaction in any taxable year in which its tax return reflects the tax consequences of a basis increase.[36] As

[33] See Rev. Rul. 2023-2.
[34] There is an exception for reporting by tax-indifferent parties of substantially similar transactions for years in which the tax-indifferent party is not otherwise required to file an income tax return. Treas. Reg. § 1.6011-18(f)(1).
[35] All defined in Treas. Reg. § 1.6011-18(b).
[36] Treas. Reg. § 1.6011-18(e)(5). There is an exception for transactions completed prior to the six year lookback period. Treas. Reg. § 1.6011-18((f)(2). See also Treas. Reg. § 1.6011-18(g), Ex. 6.

such, should the property receiving the basis adjustment constitute depreciable property, each year depreciation deductions are taken with respect to the basis increase is a year in which a transaction of interest has been undertaken. Should property subject to a basis increase be sold many years later, that sale is deemed to be a transaction of interest.

All is not bad news, however. Especially given the substantial burden of determining transactions which may require reporting during the six-year lookback period, the regulations provide certain relief. First, taxpayers will be treated as having met their filing obligations as long as they file their disclosure with OTSA by July 14, 2025.[37] Second, the regulations provide material advisors who have made a tax statement[38] before January 14, 2025, are provided an additional 90 days beyond the generally applicable deadline to report to OTSA.[39]

Conclusion

These regulations became valid as of January 14, 2025. As such, any of the transactions of interest (or substantially similar transactions) identified in the regulations either after that date, or in a previous period for which the statute of limitations on assessment for the relevant year remains open, will be subject to reporting obligations. Given the ubiquity of closely-held partnerships involving family members, these reporting obligations are likely to have an effect on a large number of taxpayers and their advisors (i.e. "material advisors" for purposes of reportable transactions). Failure to report has significant consequences. As such, it is important that taxpayers and their advisors understand what transactions are covered, whether they have engaged in any

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[37] Treas. Reg. § 1.6011-18((h)(1).
[38] A "tax statement" is generally any statement, oral or written, that relates to a tax aspect of a reportable transaction. Treas. Reg. § 301.6111-3(b)(2)(ii).
[39] Treas. Reg. § 1.6011-18(h)(2).

transaction during any open year and be vigilant to properly report any future transaction of interest.

While comments to the previously proposed regulations requested many aspects of relief from these onerous filing obligations, Treasury only adopted changes with respect to certain of those comments. Thankfully, the applicable threshold amount was raised and the calculation adjusted generally only to capture the effect among related parties. However, many other requests, such as to eliminate these filing requirements and replace them with a new line on the partnership's income tax return, were not adopted.

In an almost shocking lack of awareness of how this will affect closely-held partnerships, Treasury stated that "the identification of the transactions described in these final regulations should not impact small business owners" and "if a taxpayer is engaging in one or more of the complex transactions identified by these final regulations with a related party that results in positive basis adjustments in a single taxable year that exceed the applicable threshold amounts of $10 million or more (or $25 million for later identified transactions), the taxpayer is not likely a small business owner and the reporting obligations outlined in these final regulations should not be unduly burdensome." The lack of netting in calculating threshold amounts and the fact that many closely-held family partnerships may hold real property valued well above these amounts (even if the equity, net of debt, is much less) will capture many small business owners. The is exacerbated by the ongoing obligation to report in each year where there is tax benefit from the basis adjustment (for example, 27 years for depreciable residential property and potentially longer for property sold *decades* after the basis adjustment) along with the significant penalty exposure for failure to comply.

manufactured or unmanufactured, incorporated directly into a manufactured product or, where applicable, an iron or steel product.

(ii) *Excluded materials* means *section 70917(c) materials* as defined in 2 CFR 184.3.

(iii) *Iron or steel products* means articles, materials, or supplies that consist wholly or predominantly of iron or steel or a combination of both.

(iv) *Manufactured products* means articles, materials, or supplies that have been processed into a specific form and shape, or combined with other articles, materials, or supplies to create a product with different properties than the individual articles, materials, or supplies. If an item is classified as an iron or steel product, an excluded material, or other product category as specified by law or in 2 CFR part 184, then it is not a manufactured product. However, an article, material, or supply classified as a manufactured product may include components that are iron or steel products, excluded materials, or other product categories as specified by law or in 2 CFR part 184. Mixtures of excluded materials delivered to a work site without final form for incorporation into a project are not a manufactured product.

(v) *Manufacturer,* in the case of manufactured products, means the entity that performs the final manufacturing process that produces a manufactured product.

(vi) *Predominantly of iron or steel or a combination of both* means that the cost of the iron and steel content exceeds 50 percent of the total cost of all its components. The cost of iron and steel is the cost of the iron or steel mill products (such as bar, billet, slab, wire, plate, or sheet), castings, or forgings utilized in the manufacture of the product and a good faith estimate of the cost of iron or steel components.

(vii) *Produced in the United States,* in the case of manufactured products, means:

(A) For projects obligated on or after October 1, 2025, the product was manufactured in the United States; and

(B) For projects obligated on or after October 1, 2026, the product was manufactured in the United States and the cost of the components of the manufactured product that are mined, produced, or manufactured in the United States is greater than 55 percent of the total cost of all components of the manufactured product.

(2) An article, material, or supply shall only be classified as an iron or steel product, a manufactured product, or other products as specified by law or in 2 CFR part 184. An iron or steel product must meet the requirements of paragraph (b) of this section. Except as otherwise provided in this paragraph (c), an article, material, or supply shall not be considered to fall into multiple categories. In some cases, an article, material, or supply may not fall under any of the above-listed categories. The classification of an article, material, or supply as falling into one of the categories listed in this paragraph (c) must be made based on its status at the time it is brought to the work site for incorporation into an infrastructure project. In general, the work site is the location of the infrastructure project at which the iron or steel product or manufactured product will be incorporated.

(i) With respect to precast concrete products that are classified as manufactured products, components of precast concrete products that consist wholly or predominantly of iron or steel or a combination of both shall meet the requirements of paragraph (b) of this section. The cost of such components shall be included in the applicable calculation for purposes of determining whether the precast concrete product is produced in the United States.

(ii) With respect to intelligent transportation systems and other electronic hardware systems that are installed in the highway right of way or other real property and classified as manufactured products, the cabinets or other enclosures of such systems that consist wholly or predominantly of iron or steel or a combination of both shall meet the requirements of paragraph (b) of this section. The cost of cabinets or other enclosures shall be included in the applicable calculation for purposes of determining whether systems referred to in the preceding sentence are produced in the United States.

(3) In determining whether the cost of components for manufactured products is greater than 55 percent of the total cost of all components, recipients shall determine the cost as follows:

(i) For components purchased by the manufacturer, the acquisition cost, including transportation costs to the place of incorporation into the manufactured product (whether or not such costs are paid to a domestic firm), and any applicable duty (whether or not a duty-free entry certificate is issued); or

(ii) For components manufactured by the manufacturer, all costs associated with the manufacture of the component, including transportation costs as described in paragraph (c)(3)(i) of this section, plus allocable overhead costs, but excluding profit. Cost of components does not include any costs associated with the manufacture of the manufactured product.

(4) The provisions of this paragraph (c) are separate and severable from one another and from the other provisions of this section. If any provision is stayed or determined to be invalid, the remaining provisions shall continue in effect.

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[FR Doc. 2024–31350 Filed 1–13–25; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 10028]

RIN 1545–BR07

Certain Partnership Related-Party Basis Adjustment Transactions as Transactions of Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final rule.

SUMMARY: This document contains final regulations that identify certain partnership related-party basis adjustment transactions and substantially similar transactions as transactions of interest, a type of reportable transaction. Material advisors and certain participants in these transactions are required to file disclosures with the IRS and are subject to penalties for failure to disclose. The final regulations affect participants in these transactions as well as material advisors.

DATES:

Effective date: These regulations are effective on January 14, 2025.

Applicability date: For the date of applicability, *see* § 1.6011–18(h) and (i).

FOR FURTHER INFORMATION CONTACT: Concerning these final regulations, contact Elizabeth Zanet of the Office of Associate Chief Counsel (Passthroughs and Special Industries), (202) 317–6007 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Authority

This document amends the Income Tax Regulations (26 CFR part 1) by adding final regulations under section 6011 of the Internal Revenue Code (Code). The document adds § 1.6011–18 to identify certain partnership related-party basis adjustment transactions and substantially similar transactions as transactions of interest, a type of

reportable transaction (final regulations). These regulations are issued pursuant to the authority conferred on the Secretary of the Treasury or her delegate (Secretary) under the following provisions of the Code.

Section 6001 of the Code provides an express delegation of authority to the Secretary of the Treasury or her delegate (Secretary), requiring every taxpayer to keep the records, render the statements, make the returns, and comply with the rules and regulations that the Secretary deems necessary to demonstrate tax liability, as prescribed, either by notice served or by regulations.

Section 6011(a) provides an express grant of regulatory authority for the Secretary to prescribe regulations requiring any person who is liable for any tax imposed by the Code, or with respect to the collection thereof, to make a return or statement according to the forms and regulations prescribed by the Secretary. Section 6011(a) adds that every person who is required to make a return or statement must include the information required by forms or regulations.

In addition, section 6707A(c)(1) of the Code defines the term ''reportable transaction'' for purposes of imposing penalties under section 6707A(a) relating to persons who fail to include on any return or statement any information with respect to a reportable transaction that is required under section 6011 to be included with such return or statement. In doing so, it provides an express delegation of authority to the Secretary, stating that, ''[t]he term 'reportable transaction' means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion.''

Section 6111(a) provides an express grant of regulatory authority for the Secretary to require that each material advisor with respect to any reportable transaction make a return setting forth any information as the Secretary may prescribe. Such return must be filed not later than the date specified by the Secretary.

Finally, section 7805(a) of the Code authorizes the Secretary to ''prescribe all needful rules and regulations for the enforcement of [the Code], including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.''

Background

I. Basis Adjustments Under Subchapter K

A. In General

Under subchapter K of chapter 1 of the Code (subchapter K), a distribution by a partnership of the partnership's property (partnership property) or a transfer of an interest in a partnership (partnership interest) may result in an adjustment to the basis of the distributed property, partnership property, or both. A key factor is whether an election made by the partnership in accordance with regulations prescribed by the Secretary under section 754 of the Code (section 754 election) is in effect.

Section 754 provides that if a section 754 election is in effect for a partnership, the basis of its partnership property will be adjusted, in the case of a distribution of property, in the manner provided by section 734 of the Code, and in the case of a transfer of a partnership interest, in the manner provided in section 743 of the Code. Unless a section 754 election is revoked in accordance with the regulations under section 754, the section 754 election applies to all distributions of property by the partnership and to all transfers of interests in the partnership in the taxable year for which the section 754 election was properly made and all subsequent taxable years.

In the case of a distribution of partnership property to a partner by a partnership for which a section 754 election is in effect, or with respect to which there is a substantial basis reduction as described in section 734(d), the distribution may result in an adjustment to the basis of the partnership's remaining property (remaining partnership property) under section 734(b). A distribution of partnership property may also result in an adjustment to the basis of the distributed property under section 732(a), (b), or (d) of the Code.

If a partnership interest is transferred by sale or exchange or on the death of a partner, and the partnership either has a section 754 election in effect or has a substantial built-in loss with respect to the transfer of the partnership interest as described in section 743(d), the transfer may result in an adjustment to the basis of partnership property under section 743(b) with respect to the transferee partner.

B. Basis Adjustments Under Section 732

Section 732 applies to determine a distributee partner's basis in distributed property other than money. In the case of a distribution of partnership property other than in liquidation of the distributee partner's partnership interest (current distribution), and except as provided under section 732(a)(2), section 732(a)(1) provides that the distributee partner's basis in distributed property (other than money) is equal to the partnership's adjusted basis in the distributed property immediately before the distribution. Under section 732(a)(2), however, a distributee partner's basis in distributed property is limited to the adjusted basis of the distributee partner's partnership interest reduced by any money distributed to such partner in the same transaction.

In the case of a distribution of partnership property in liquidation of the distributee partner's partnership interest (liquidating distribution), section 732(b) provides that the distributee partner's basis in distributed property (other than money) is equal to the adjusted basis of the distributee partner's partnership interest reduced by any money distributed to such partner in the same transaction.

In the case of a distribution of more than one property from a partnership, the basis of the distributed properties to which section 732(a)(2) and (b) apply must be allocated among the distributed properties under the rules of section 732(c). Section 732(d) through (f) provide additional rules applicable to certain distributed property. *See also* §§ 1.732–1 through 1.732–3.

C. Basis Adjustments Under Section 734

In the case of a distribution of property by a partnership for which a section 754 election is in effect, and for which either the distributee partner recognizes gain or loss on the distribution, or for which the basis of the distributed property in the distributee partner's hands, as determined under section 732, differs from the partnership's adjusted basis in the distributed property immediately before the distribution, section 734(b) requires the partnership to increase or decrease (as applicable) the basis of its remaining partnership property. Also, in the case of a distribution of property by a partnership that results in a substantial basis reduction under section 734(d), the basis of remaining partnership property must be adjusted under section 734(b), even if no section 754 election is in effect for the partnership.

Section 734(b)(1) requires a partnership to increase the basis of its remaining partnership property if a distribution of partnership property by the partnership results in the distributee partner recognizing gain under section

731(a)(1) of the Code, or if property (other than money) to which section 732(a)(2) or (b) applies is distributed to the distributee partner and the property's adjusted basis to the partnership immediately before the distribution is greater than the distributee partner's basis in the distributed property as determined under section 732. Section 731(a)(1) requires a distributee partner to recognize gain in a current or liquidating distribution to the extent that any money distributed to that partner in the distribution exceeds the adjusted basis of that partner's partnership interest immediately before the distribution. The amount of the basis increase to the partnership's remaining property under section 734(b)(1) following a distribution of partnership property to a partner is equal to the amount of gain recognized by the distributee partner in the distribution under section 731(a)(1), and the excess of the partnership's adjusted basis in the distributed property immediately before the distribution, over the distributee partner's basis in the distributed property as determined under section 732.

Section 734(b)(2) requires a partnership to decrease the basis of its remaining property if a distribution of property by the partnership results in the distributee partner recognizing loss under section 731(a)(2), or if property (other than money) is distributed to the distributee partner in a distribution to which section 732(b) applies and the property's adjusted basis to the partnership immediately before the distribution is less than the distributee partner's basis in the distributed property as determined under section 732. Under section 731(a)(2), a distributee partner may recognize a loss in a liquidating distribution of that partner's interest in the partnership to the extent that such partner received in the distribution only money, unrealized receivables described in section 751(c) of the Code, or inventory items described in section 751(d). In such a case, the distributee partner is required to recognize a loss to the extent that such partner's adjusted basis in the partnership interest exceeds the sum of any money distributed to that partner in the distribution and the basis to the distributee partner (determined under section 732) of any unrealized receivables or inventory items received by that partner in the distribution. The amount of the basis decrease to the partnership's remaining property under section 734(b)(2) following a distribution of partnership property to a partner is equal to the amount of loss recognized by the distributee partner in the distribution under section 731(a)(2), and the excess of the distributee partner's basis in the distributed property as determined under section 732, over the partnership's adjusted basis in the distributed property immediately before the distribution.

A partnership for which no section 754 election is in effect is subject to a mandatory basis adjustment under section 734(b)(2) if there is a substantial basis reduction with respect to a distribution of partnership property. Under section 734(d), a substantial basis reduction with respect to a distribution of partnership property occurs if the sum of the amount of loss recognized to the distributee partner on the distribution, plus any increase in basis in the distributed property to the distributee partner under section 732(b), exceeds $250,000.

D. Basis Adjustments Under Section 743(B)

Generally, if a partnership interest is transferred in a sale or exchange or on the death of a partner, the transferee partner's basis in the transferred partnership interest is determined under section 742 of the Code and the basis of partnership property is determined under section 743(a). Section 742 provides that the transferee partner's basis in a partnership interest acquired other than by contribution is determined under part II of subchapter O of chapter 1 of the Code, beginning at section 1011 of the Code and following. Thus, for example, a transferee partner's basis in a partnership interest acquired by purchase generally is the transferee partner's cost basis under section 1012 of the Code. Section 743(a) provides that, in the case of a transfer of a partnership interest by sale or exchange or on the death of a partner, the basis of partnership property is not adjusted unless either a section 754 election is in effect for the partnership, or the partnership has a substantial built-in loss with respect to the transfer of the partnership interest.

Under section 743(b), in the case of a transfer of a partnership interest by sale or exchange or on the death of a partner, a partnership for which a section 754 election is in effect or that has a substantial built-in loss with respect to the transfer of the partnership interest must increase or decrease (as applicable) the adjusted basis of partnership property with respect to the transferee partner.

Section 743(b)(1) provides that the adjusted basis of partnership property is increased by the excess of the transferee partner's basis in the transferred partnership interest, over the transferee partner's proportionate share of the adjusted basis of partnership property.

Section 743(b)(2) provides that the adjusted basis of partnership property is decreased by the excess of the transferee partner's proportionate share of the adjusted basis of partnership property, over the transferee partner's basis in the transferred partnership interest.

A partnership for which no section 754 election is in effect is subject to a mandatory basis adjustment under section 743(b) with respect to a transfer of a partnership interest if the partnership has a substantial built-in loss with respect to the transfer of the partnership interest. Under section 743(d)(1), a partnership has a substantial built-in loss with respect to a transfer of an interest in the partnership if either the partnership's adjusted basis in its property exceeds the fair market value of such property by more than $250,000, or the transferee partner would be allocated a loss of more than $250,000 if the partnership assets were sold for cash equal to their fair market value immediately after the transfer.

The flush language at the end of section 743(b) provides that, under regulations prescribed by the Secretary, a basis adjustment under section 743(b) is an adjustment to the basis of partnership property with respect to the transferee partner only. *See generally* § 1.743–1. The transferee partner's proportionate share of the partnership's adjusted basis in its property generally is determined in accordance with the transferee partner's interest in the partnership's previously taxed capital (including the transferee partner's share of partnership liabilities) under § 1.743–1(d).

In the case of a transferee partner who acquired all or part of the partner's partnership interest by a transfer with respect to which no section 754 election was in effect for the partnership, and to whom a distribution of property (other than money) is made with respect to the transferred interest within two years, section 732(d) and the regulations thereunder allow the partner to make an election to treat as the adjusted basis of the distributed property the adjusted basis such property would have if the adjustment under section 743(b) were in effect with respect to the partnership property.

Under § 1.732–1(d)(4), the special basis adjustment under section 732(d) is required to apply to a distribution of property to a partner who acquired all or part of the partner's partnership interest by a transfer from a partnership

for which no section 754 election is in effect for the taxable year of such transfer, whether or not the distribution is made within two years of such transfer, if at the time the partnership interest was transferred, (i) the fair market value of all partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership, (ii) an allocation of basis under section 732(c) upon a liquidation of the transferee partner's interest in the partnership immediately after the transfer of such interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization to property subject to such an allowance, and (iii) a basis adjustment under section 743(b) would change the basis to the transferee partner of the property actually distributed.

E. Allocation of Basis Adjustments Under Sections 734 and 743

Section 734(c) states that a basis adjustment under section 734(b) is allocated among partnership properties under the rules of section 755 of the Code. Section 743(c) states that a basis adjustment under section 743(b) is allocated among partnership properties under the rules of section 755.

Section 755(a) generally requires basis adjustments under section 734(b) or section 743(b) to be allocated in a manner that has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties or in any other manner permitted by regulations prescribed by the Secretary. In addition, section 755(b) requires these basis adjustments to be allocated to partnership property of a like character or to subsequently acquired partnership property of a like character if such property is not available or has insufficient basis at the time of the basis adjustment (because a decrease in the adjusted basis of the property would reduce the basis of such property below zero). Section 755(c) provides a special rule that prohibits allocating a basis decrease under section 734(b) to the stock of a corporation that is a partner of the partnership (or that is related to a partner in the partnership within the meaning of section 267(b) of the Code or section 707(b)(1) of the Code).

F. Common Terminology for Bases With Respect to a Partnership Interest

A partner's adjusted basis in its partnership interest commonly is referred to as the partner's ''outside basis'' in its partnership interest. A partnership's adjusted basis in its property commonly is referred to as the ''inside basis'' of the partnership's property. Each partner has a share of inside basis.

II. Proposed Regulations

On June 18, 2024, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (REG–124593–23) in the **Federal Register** (89 FR 51476) containing proposed regulations under section 6011 (proposed regulations).[1] The proposed regulations would have added § 1.6011–18 identifying certain partnership related-party basis adjustment transactions as ''transactions of interest'' for purposes of sections 6011, 6111, and 6112 and § 1.6011–4(b)(6). The provisions of the proposed regulations are explained in greater detail in the preamble to the proposed regulations.

The Treasury Department and the IRS received written comments in response to the proposed regulations. The comments are available for public inspection at *www.regulations.gov* or upon request. A public hearing on the proposed regulations was conducted in person and telephonically on September 17, 2024, during which two presenters provided comments. After full consideration of the comments received, these final regulations adopt the proposed regulations with modifications in response to the comments as described in the Summary of Comments and Explanation of Revisions.

Summary of Comments and Explanation of Revisions

This Summary of Comments and Explanation of Revisions summarizes the comments received in response to the proposed regulations, and describes and responds to comments concerning: (1) transactions of interest generally, (2) the usefulness and burden of reporting the transactions of interest identified by the proposed regulations, (3) the specific transactions of interest identified by the proposed regulations, (4) the proposed $5 million threshold amount for reporting (proposed $5 million threshold amount), (5) the relatedness standard, (6) substantially similar transactions, and (7) participation in a transaction of interest identified by the proposed regulations. In general, as described herein, the final regulations adopt several commenters' suggestions, which limit the scope of the transactions identified by the proposed regulations in an effort to exclude from additional reporting certain common business transactions that do not meet large economic thresholds.

Comments merely summarizing the statute or proposed regulations, recommending revisions to the Code, addressing unrelated issues, or recommending changes to IRS forms or procedures are generally not addressed in this Summary of Comments and Explanation of Revisions or adopted in these final regulations. Additionally, this Treasury decision does not address comments addressing the issues and rules specific to Notice 2024–54, 2024–28 IRB 24, which the Treasury Department and the IRS continue to consider. Unless otherwise indicated in this Summary of Comments and Explanation of Revisions, provisions of the proposed regulations with respect to which no comments were received are adopted without substantive change.

I. Transactions of Interest Generally

A. General Reporting Rules Under § 1.6011–4

Section 1.6011–4(e)(2)(i) requires a taxpayer to report a transaction entered into prior to the publication of guidance identifying the transaction as a transaction of interest after the filing of the taxpayer's tax return (including an amended return) reflecting the taxpayer's participation in the transaction of interest (later identified transaction) if the statute of limitations for assessment of tax is still open when the transaction becomes a transaction of interest. Under § 1.6011–4(e)(2)(i), taxpayers are generally required to report a later identified transaction by filing a disclosure statement with the Office of Tax Shelter Analysis (OTSA) within 90 calendar days after the date on which a transaction becomes a transaction of interest.

Some commenters asserted that taxpayers should not be required to report later identified transactions because taxpayers were not on notice that certain partnership related-party basis adjustment transactions would be identified as transactions of interest. These commenters asserted that certain of the transactions identified in the proposed regulations are typical business transactions for which taxpayers would not have known to keep records. Two commenters requested that the required time for filing a disclosure statement with the OTSA should be expanded to one year. Another commenter recommended that the final regulations apply prospectively to transactions of interest that occur in taxable years beginning on or after the date of the final regulations.

[1] On July 24, 2024, a notice of correction was published in the **Federal Register** (89 FR 59864) to correct minor typographical errors in the preamble of REG–124593–23.

Although the reporting required by § 1.6011–4(e)(2)(i) may apply to transactions undertaken before the identification of the transactions as transactions of interest, the disclosure obligation is prospective rather than retroactive, since it arises only when the transaction becomes a transaction of interest after the final regulations are published in the **Federal Register**. Additionally, taxpayers have been on notice since the issuance of the proposed regulations that reporting of partnership related-party basis adjustment transactions may soon be required. Nevertheless, given the additional time that taxpayers may need to identify and prepare disclosures for already-completed transactions, § 1.6011–18(h)(1) provides an extension of time of 90 additional calendar days after the date specified in § 1.6011–4(e)(2)(i) for taxpayers to meet their obligations to disclose to the OTSA their participation in such later identified transactions.

B. Material Advisor Rules

The proposed regulations provided no special rules for material advisors. One commenter requested that the final regulations add an ''actual knowledge'' qualifier for material advisors such that advisors would be required to disclose and list only those transactions described by the proposed regulations that would be reportable based on their actual knowledge. The rules for material advisors under sections 6111 and 6112, and the corresponding regulations under §§ 301.6111–3 and 301.6112–1 of the Procedure and Administration Regulations (26 CFR part 301), which apply to all transactions of interest, do not have a knowledge qualifier. After consideration of this comment, the Treasury Department and the IRS have determined that adding a knowledge qualifier for this transaction of interest is not warranted. Accordingly, this comment is not adopted in the final regulations.

One commenter requested that the final regulations apply reporting requirements for material advisors only prospectively for transactions of interest that occur in taxable years beginning on or after the date of the final regulations, or, alternatively, that material advisors be permitted to report transactions of interest to the OTSA within one year as opposed to by the last day of the month following the end of the calendar quarter in which the final regulations are published. Section 301.6111–3 sets forth the requirements for disclosures from material advisors. In particular, § 301.6111–3(e) provides that a material advisor's disclosure statement must be filed with the OTSA by the last day of the month that follows the end of the calendar quarter in which the advisor became a material advisor with respect to the transaction. Section 301.6111–3(b)(4)(iii) provides that for a transaction that was not a reportable transaction but is identified as a transaction of interest in published guidance after the occurrence of the events described in § 301.6111–3(b)(4)(i), the person will be treated as becoming a material advisor on the date the transaction is identified as a transaction of interest. Additionally, material advisors have been on notice since the issuance of the proposed regulations that reporting of partnership related-party basis shifting transactions may soon be required. However, given the additional time that may be needed for material advisors to identify and prepare disclosures for already-completed transactions, § 1.6011–18(h)(2) provides an extension of 90 additional calendar days after the date specified in § 301.6111–3(e) for material advisors to meet their disclosure obligations.

II. Usefulness and Burden of Reporting the Transactions of Interest Identified by the Proposed Regulations

A. Comments Suggesting the IRS Already Has the Information It Needs

One commenter stated that the Treasury Department and the IRS already have sufficient information to determine that the transactions identified by the proposed regulations are abusive and thus the proposed regulations are unnecessary.[2] This commenter stated that the Treasury Department and the IRS have already concluded that the transactions identified in the proposed regulations are abusive through IRS positions taken in litigation and the issuance of Rev. Rul. 2024–14, 2024–28 IRB 18 (advising taxpayers that the IRS would challenge certain partnership related-party basis adjustment transactions under the codified economic substance doctrine in section 7701(o) of the Code). The commenter also asserted that transactions of interest are reserved for transactions that have the potential for tax avoidance, but that the Treasury Department and the IRS failed to articulate a rational connection between ''the facts found and the choice made.''

Another commenter suggested that the proposed regulations relied on the application of Rev. Rul. 2024–14, implying that the proposed regulations cannot have effect if the IRS does not prevail in pending litigation.

The Treasury Department and the IRS do not agree with these comments. The final regulations identify certain partnership related-party basis adjustment transactions as transactions of interest under § 1.6011–4(b)(6), rather than as listed transactions under § 1.6011–4(b)(2). This is because the Treasury Department and the IRS have determined that these transactions have the potential for tax avoidance through the IRS's examination of certain transactions that are abusive but are not aware of the entire universe of partnership related-party basis adjustment transactions and whether every transaction is per se abusive. As explained in the preamble to the proposed regulations, the Treasury Department and the IRS have become aware of related persons using partnerships to engage in transactions that inappropriately exploit the basis adjustment provisions of subchapter K applicable to distributions of partnership property or transfers of partnership interests and wish to gather additional information. This awareness results from the IRS's examination of various partnership transactions involving related parties in which basis in distributed property or partnership property is shifted in a manner that results in significant tax benefits attributable to the basis shift for the related parties but with little or no tax or economic cost (abusive partnership related-party basis adjustment transactions), thus artificially generating (or regenerating) Federal income tax benefits that results in significant tax savings without a corresponding economic outlay. The transactions identified as transactions of interest in these final regulations have the potential for tax avoidance because they share certain indicia with these abusive partnership related-party transactions. Rev. Rul. 2024–14 contains several examples of abusive transactions discovered by the IRS, and the legal analysis it contains is independent of the requirement to disclose the transactions described in these regulations as transactions of interest. In other words, the issuance of a revenue ruling does not preclude further scrutiny of partnership related-party basis adjustment transactions by identifying those transactions as transactions of interest. Similarly, pending litigation is irrelevant to the

[2] The commenter also argued that it would be inappropriate to identify the transactions identified in the proposed regulations as listed transactions under § 1.6011–4(b)(2). This comment is not relevant to these final regulations, which solely identify certain transactions as transactions of interest and not as listed transactions.

identification of these transactions as transactions of interest. Accordingly, the final regulations do not adopt these comments.

A few commenters questioned why the Treasury Department and the IRS need to identify certain partnership related-party basis adjustment transactions as transactions of interest if these transactions are already disclosed as part of the Form 1120, *U.S. Corporation Income Tax Return,* or Form 1065, *U.S. Return of Partnership Income.* These commenters generally contended that existing reporting requirements already accomplish the objectives of the proposed regulations and that adding these transactions as transactions of interest is therefore unnecessary. One commenter recommended that instead of identifying the transactions described in the proposed regulations as transactions of interest, the Form 1065 should be modified to ask questions to determine whether partnership related-party basis adjustment transactions occurred during the taxable year.

The Forms 1120 and 1065, including statements or schedules required to be attached thereto, are filed as a part of a taxpayer's tax return and do not include all the information contained on Form 8886, *Reportable Transaction Disclosure Statement.* The Forms 1120 and 1065 also do not alert the OTSA to the taxpayer's participation in a transaction of interest, nor does the filing of a tax return result in disclosure and other obligations of material advisors to the transaction. Moreover, the purpose of the reporting requirements for a transaction of interest is to allow the OTSA and the IRS to learn detailed information about the identified transaction using limited resources, and without having to distill information obtained through annual filing requirements or to open taxpayer examinations. Accordingly, these comments are not adopted in the final regulations.

B. Comments Addressing Compliance Burdens and Costs

Several commenters asserted that complying with the reporting requirements for the transactions identified by the proposed regulations would be unduly burdensome and result in excessive costs for small businesses. One commenter asserted that the proposed regulations stray from Congressional intent of simplicity by subjecting family business owners and their advisors to substantial reporting obligations and penalties. Another commenter asserted that the proposed regulations would result in many protective disclosures that the Treasury Department and the IRS could not handle.

The impact on taxpayers who engage in legitimate business transactions with related parties resulting in positive partnership basis adjustments that meet the increased threshold amounts in these final regulations (applicable threshold amounts) discussed in Part IV of this Summary of Comments and Explanation of Revisions, or who may decide they need to file a protective disclosure, is far outweighed by the benefit of requiring disclosure for the identified transactions, which have the potential for tax avoidance. Combatting abusive tax avoidance is a priority for the Federal Government and partnership transactions that shift basis among related parties without a corresponding economic or tax impact have the potential for tax avoidance. Moreover, the identification of the transactions described in these final regulations should not impact small business owners. If a taxpayer is engaging in one or more of the complex transactions identified by these final regulations with a related party that results in positive basis adjustments in a single taxable year that exceed the applicable threshold amounts of $10 million or more (or $25 million for later identified transactions), the taxpayer is not likely a small business owner and the reporting obligations outlined in these final regulations should not be unduly burdensome. Accordingly, these comments are not adopted in the final regulations.

C. Comments Requesting That the Proposed Regulations Be Withdrawn or Reissued

A few commenters suggested that the proposed regulations be withdrawn, stating that they are overbroad. One commenter suggested that due to the number of their recommendations, the proposed regulations should be reproposed. Another commenter suggested that the proposed regulations be withdrawn and reproposed after the forthcoming proposed regulations described in Notice 2024–54 are finalized. The final regulations are narrowly tailored to identify transactions in which taxpayers may be exploiting the mechanical basis adjustment provisions in subchapter K to produce significant tax benefits with little to no economic cost to the partners. Taxpayers are able to engage in these transactions because the parties are related. In most cases, these transactions would not likely occur between partners negotiating on an arm's length basis. The purpose of the final regulations is to determine the ways in which related taxpayers are inappropriately shifting basis using the provisions of subchapter K, how they are creating opportunities to engage in transactions that generate inappropriate basis shifts (for example, how inside-outside basis disparities are being created), and the economic impact of the Federal income tax consequences created by the basis shifting transactions (for example, the extent to which gain is reduced or cost recovery is increased). It is in the interest of sound tax administration to gather this information now. As disclosures pursuant to this regulation will inform the Treasury Department and the IRS on transactions for which further examination or further guidance may be warranted, it does not make sense to withdraw the proposed regulations and wait to repropose them until the forthcoming regulations described in Notice 2024–54 are both proposed and finalized. Moreover, these final regulations are separate from, and do not rely on, the forthcoming proposed regulations described in Notice 2024–54. The comments to these proposed regulations have been helpful and have allowed the Treasury Department and the IRS to make several modifications in response to comments that limit the scope of the rules, as described in this Summary of Comments and Explanation of Revisions.

III. Transactions of Interest Identified in the Proposed Regulations

The proposed regulations would have identified four kinds of partnership related-party basis adjustment transactions as transactions of interest. A basis adjustment transaction under proposed § 1.6011–18(c)(1)(i) would occur if a partnership distributes property to a person who is a related partner in a current or liquidating distribution, the partnership increases the basis of one or more of its remaining properties under section 734(b) and (c), and a proposed $5 million threshold amount is met (section 734(b) TOI). A basis adjustment transaction under proposed § 1.6011–18(c)(1)(ii) would occur if a partnership distributes property to a partner who is related to one or more partners in liquidation of a partnership interest (or in complete liquidation of the partnership), the basis of one or more distributed properties is increased under section 732(b) and (c), and a proposed $5 million threshold amount is met (section 732(b) TOI). A basis adjustment transaction under proposed § 1.6011–18(c)(1)(iii) would occur if a partnership distributes property to a partner who is related to

one or more partners, the basis of one or more distributed properties is increased under section 732(d), the related partner acquired all or a part of its interest in the partnership in a transaction that would have been a transaction described in proposed § 1.6011–18(c)(2) if the partnership had a section 754 election in effect for the year of transfer, and a proposed $5 million threshold amount is met (section 732(d) TOI). A basis adjustment transaction under proposed § 1.6011–18(c)(2) would occur if a partner transfers an interest in the partnership to a related transferee or to a person who is related to one or more existing partners in a nonrecognition transaction (as defined in proposed § 1.6011–18(b)(6)), the basis of one or more partnership properties is increased under section 743(b)(1) and (c), and a proposed $5 million threshold amount is met (section 743(b) TOI).

A. General Reporting Exclusions

1. Tax-Avoidance Indicators

One commenter recommended requiring reporting only for transactions with defined indicators of potential tax avoidance or evasion, rather than the involvement of a related or tax-indifferent party, but did not suggest other indicators or explain how the current indicators are insufficient. The Treasury Department and the IRS have made modifications to the proposed regulations as described herein to better target the identification of transactions for which reporting is required.

2. Basis Shifts Between Assets of Like Character

One commenter recommended excluding transactions identified as a basis adjustment transaction of interest in cases in which (1) basis is shifted between assets of like character (that is, capital asset to capital asset or ordinary income asset to ordinary income asset), (2) basis is shifted from non-recoverable property to non-recoverable property or the basis adjustment does not provide a shorter recovery period, and (3) the property receiving the basis increase is not sold within two years of the basis increase. The Treasury Department and the IRS agree that a basis shift to a like-kind asset that has the same or a longer recovery period than the asset to which the basis was shifted from presents less risk of tax avoidance. However, the Treasury Department and the IRS do not agree that it would be appropriate in such circumstances to require reporting only if the property is disposed of within two years after the basis increase as there is still a potential for abuse if the property is disposed of after two years. A two-year rule would allow related taxpayers to increase the basis in property in anticipation of a future sale and would exclude transactions that present significant risks of tax avoidance. Accordingly, it is in the interest of sound tax administration to identify certain partnership related-party basis adjustment transactions as transactions of interest in the year of the basis shift and the commenter's recommendation is not adopted in the final regulations.

3. Requiring Knowledge or Intent

A few commenters recommended including an intent requirement for the transactions identified by the proposed regulations as transactions of interest. One commenter recommended that taxpayers that are unaware of or have no reason to know that a transaction identified by the proposed regulations is reportable be excused from disclosure. Another commenter recommended including a subjective test for intent and providing safe harbors and exceptions for business separations and succession-planning transactions.

Including an intent requirement for the transactions identified by the proposed regulations would introduce a subjective element, which is inconsistent with the IRS's need to gather additional information on the identified transactions to ascertain their potential for tax avoidance. Including an intent requirement in these regulations would also frustrate the IRS's ability to determine which of the basis adjustment transactions are impermissible tax avoidance transactions and to effectively and efficiently address the tax avoidance. Moreover, the general transaction of interest reporting requirements under section 6011 do not include a knowledge component; taxpayers are required to report the tax consequences of their transactions identified as transactions of interest regardless of whether they are aware of the reporting requirements. As further described in Parts III.A.4 and III.E of this Summary of Comments and Explanation of Revisions, it is not appropriate to incorporate an exception or safe harbor for business separations or succession-planning transactions into the final regulations as these transactions are no less likely to be structured to avoid tax, and thus may also have the potential for tax avoidance. Accordingly, these comments are not adopted in the final regulations.

4. Excluding Certain Basis-Adjustment Transactions

One commenter recommended excluding certain basis-adjustment transactions that cure inside-outside basis disparities created by section 734(b) adjustments, section 704(c) methods, contributions, distributions, and revaluations. Another commenter recommended that the final regulations consider common reasons why an inside-outside basis disparity might arise, such as transaction costs required to be capitalized to outside basis, certain income exclusions related to foreign corporations owned through a partnership, or the use of various section 704(c) methods. This commenter recommended that certain acquisitions of partnership businesses that may involve or create related-partner relationships, including distributions of lower-tier partnership interests to an upper-tier partnership and liquidations of blocker subsidiaries, be excluded as transactions of interest. Another commenter requested that the final regulations exclude partnership-incorporation transactions, including transactions described in Rev. Rul. 84–111, 1984–2 C.B. 88, Situation 2 (assets-up incorporation) and Situation 3 (interests-over incorporation). A few commenters requested that the final regulations exclude from the transactions identified as section 732(b) TOIs and section 734(b) TOIs any basis adjustments resulting from an actual or deemed distribution in the case of a partnership merger or division done for commercial reasons, such as to allow a partial sale and continuation of certain investments held by a private equity or other investment fund.

In response to comments received on the proposed regulations, these final regulations adopt several suggestions to limit the scope of the transactions identified by the proposed regulations to exclude from reporting common business transactions that do not meet large, economic thresholds. However, providing a blanket exclusion for certain transactions that may be common business transactions under specific circumstances, but may also have the potential for tax avoidance, would defeat the purpose of identifying the transactions as transactions of interest. For example, a partnership merger or division involving related parties may be undertaken with the intent to increase the basis of an asset that is subsequently disposed of in a recognition transaction or to increase cost recovery deductions. Moreover, one of the purposes of the final regulations is to gather additional information on

how taxpayers are creating opportunities to shift basis between related parties using the provisions of subchapter K (for example, information related to how inside-outside basis disparities are being created). Providing an exclusion from reporting for transactions that cure inside-outside disparities created through certain section 704(c) methods, contributions, adjustments, distributions or revaluations would nullify most of the disclosures required by the final regulations as these are the techniques used to create opportunities for partnership related-party basis shifting. For these reasons, the commenters' suggestions for exclusions of certain transactions are not adopted in the final regulations.

5. Publicly Traded Partnerships

One commenter expressed concern that publicly traded partnerships within the meaning of section 7704 of the Code (PTPs) are unable to identify the buyers and sellers of interests therein, making it impossible to determine whether a transfer is made between related parties. This commenter stated that PTPs frequently engage in transactions that result in section 743(b) adjustments as part of normal public trading and capital-markets transactions and that the final regulations should add carveouts for transactions of PTPs. At a minimum, the commenter recommended that the final regulations implement an ownership threshold for related partners of five percent or more of the PTP to allow such persons to be identified by disclosures required to be made to the U.S. Securities and Exchange Commission. Another commenter recommended that basis adjustments resulting from an acquisition of a unit in a PTP, including as part of any redemption of publicly traded units by the PTP, should be excluded from the transactions identified as transactions of interest.

The Treasury Department and the IRS agree that due to PTPs having a large number of PTP unitholders that are not related partners within the meaning of the final regulations, and the unlikelihood that unrelated PTP unitholders would engage in the transactions identified as transactions of interest in the final regulations, it is appropriate to exclude basis adjustments involving a transfer of or a distribution with respect to partnership interests in a PTP, except basis adjustments resulting from certain material transactions involving partnership interests held by related partners in a PTP. Accordingly, the final regulations provide that in the case of a PTP, a participating partner means a partner of the PTP but only to the extent that the partner engages in a private transfer (as described in § 1.7704–1(e)), redemption and repurchase agreement (as described in § 1.7704–1(f)), or private placement (as described in § 1.7704–1(h)) of a partnership interest with a related partner and the transaction is not otherwise excluded as a transaction of interest described in the final regulations.

B. Cash as Property for Purposes of Section 734(b) TOIs

One commenter requested that the final regulations clarify that cash is not included as "property" for purposes of a section 734(b) TOI and thus positive basis adjustments resulting from a distribution of cash be excluded from transactions identified as transactions of interest. Another commenter asked for clarification that cash distributions in excess of basis that result in positive basis adjustments under section 734(b) are identified as transactions of interest only to the extent that the distributions are made to a tax-indifferent party.

As a general matter, the text of section 734 makes no distinction between cash and other partnership property. A cash distribution to a related partner could be treated as a section 734(b) TOI to the extent that any basis increases generated under section 734(b)(1) exceed the gain recognized under section 731(a)(1) (or otherwise) with respect to which any tax imposed under subtitle A of the Code (subtitle A) is required to be paid by the related partners. However, the Treasury Department and the IRS note that if gain is recognized on a distribution of cash that results in a basis adjustment under section 734(b)(1)(A) and tax imposed under subtitle A is required to be paid on such gain by any of the related partners, that portion of the basis adjustment would not be counted towards the overall applicable threshold amount in determining whether disclosure of a transaction of interest is required.

C. Acquisition and Integration Transactions for Purposes of Section 743(b) TOIs

A few commenters recommended excluding from a section 743(b) TOI transactions in which a party purchases a partnership interest in an arm's-length transaction, receives a basis adjustment under section 743(b), then transfers the partnership interest to a related person in a nonrecognition transaction (for example, a transfer to a corporation under section 351(a) or to a partnership under section 721(a)) that causes a re-computation and re-allocation of the section 743(b) adjustment for the benefit of the related-party transferee. Under the proposed regulations, assuming the proposed $5 million threshold amount was met, such a transaction would be reportable if the nonrecognition transfer to the related transferee results in a positive basis increase.

The Treasury Department and the IRS agree that a positive section 743(b) basis adjustment acquired through an arm's-length transaction (for example, a transaction that would not be a reportable transaction under these final regulations, without regard to the six-year lookback period) to which a related transferee succeeds should not be a reportable transaction, except to the extent of any additional positive basis adjustment resulting from the nonrecognition transfer. This is because if the original section 743(b) adjustment was acquired through an arm's length transaction that would not be reportable under the final regulations, a corresponding amount of gain should have been recognized and tax imposed under subtitle A should have been paid by the original transferor. Thus, a subsequent nonrecognition transfer by the original transferee that results in the same section 743(b) adjustment has little potential for tax abuse. Accordingly, the final regulations provide that if a partner receives an interest in a partnership from a person in a recognition transaction (first transfer) and the basis of one or more partnership properties is increased under section 743(b)(1) and (c), and subsequently the partner (transferor) transfers the partnership interest to a person related to the transferor (transferee) in a nonrecognition transaction (subsequent transfer), the subsequent transfer is a transaction of interest only if the transferee's basis adjustment under section 743(b)(1) and (c) resulting from the subsequent transfer exceeds the amount of the transferor's remaining basis adjustment that is attributable to the transferred partnership interest (excess amount), and the applicable threshold amount is met. The final regulations further provide that only the excess amount is counted towards the applicable threshold amount and that a transferor's remaining basis adjustment is equal to the amount of the transferor's basis adjustment under section 743(b)(1) and (c) resulting from the first transfer as adjusted under section 1016(a)(2) to reflect any recovery of the basis adjustment or as otherwise adjusted prior to the subsequent transfer.

D. Transfers Between Unrelated Partners for Purposes of Section 743(b) TOIs

Many commenters recommended excluding transfers between unrelated parties from a section 743(b) TOI if the transferee is related to one or more existing partners. Several of these commenters recommended that the transaction identified by proposed § 1.6011–18(c)(2) should be limited to transfers between related transferors and transferees. The Treasury Department and the IRS agree with this suggestion as transfers between related parties have a clear potential for tax avoidance whereas transfers between unrelated parties if the transferee is related to one or more existing partners may be much harder to structure to achieve the desired tax avoidance. Additionally, an unrelated transferor may not have reason to know that a transferee is related to one or more existing partners. Accordingly, the definition of ''related partner'' in § 1.6011–18(b)(9) in the final regulations provides that in the case of a section 743(b) TOI, a related partner means a transferor and transferee of a partnership interest that are related to each other immediately before or immediately after a section 743(b) TOI. The definition in the final regulations does not include a transferee that is unrelated to a transferor but is related to one or more of the partners in the partnership.

E. Transfers Upon Death

For purposes of a section 743(b) TOI, proposed § 1.6011–18(b)(2) would have defined a nonrecognition transaction as defined in section 7701(a)(45)—that is, any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A—other than a transfer on the death of a partner.

One commenter requested clarification that a step up in basis that results from the transfer of an interest on the death of a partner is not a transaction of interest. Another commenter requested clarification that the following transactions are ''transfers on the death of a partner'' excluded from the definition of a nonrecognition transaction under the final regulations: (1) any deemed transfer to what had been a grantor trust, including an intentionally defective grantor trust; and (2) a transfer on the death of a beneficiary of a trust that is a partner. This same commenter requested clarification that a ''transfer on the death of a partner'' is neither a ''nonrecognition transaction,'' nor a ''recognition transaction'' as defined in the proposed regulations. Section 1.6011–18(c)(4) of the final regulations clarifies that transfers on the death of a partner are not identified as transactions of interest or as substantially similar transactions. Section 1.6011–18(b)(13) of the final regulations also provides that the term ''transfer on the death of a partner'' means a transfer of a partnership interest from a partner to the partner's estate or a deemed transfer from a grantor trust owned by the partner to a trust that becomes a separate entity for Federal income tax purposes by reason of the partner's death.

One commenter recommended excluding distributions of partnership property to transferees of an interest in a partnership owned (or deemed owned) by a decedent at the time of death that occur during the administration of the decedent's estate, or a trust created by the decedent. This commenter also recommended excluding transfers of partnership interests owned (or deemed owned) by a decedent that occur during the administration of the decedent's estate or by a trust that was created by the decedent. Although not specifically stated in the commenter's letter, presumably, both of the commenter's recommendations would not be relevant in cases in which a section 754 election was made at the time of the decedent's death because there would be no disparity between the outside basis in the decedent's partnership interest and its share of inside basis in the partnership's properties. The Treasury Department and the IRS agree that transfers of partnership interests resulting from the death of a partner should be excluded from the transactions identified as transactions of interest and thus these transfers are not identified as such by the final regulations. However, if a section 754 election is not made for the taxable year that includes the death of the partner, subsequent transactions that generate positive basis adjustments, such as distributions of partnership property to the estate or transfers of partnership interests to beneficiaries that may resolve an inside-outside basis disparity created by a step-up to the basis of the decedent's partnership interest upon death, will be included as transactions of interest, provided that the applicable threshold amount is met. The Treasury Department and the IRS appreciate that a section 754 election, once made, is irrevocable without seeking permission from the IRS, and that a section 754 election at the time of a partner's death may require the partnership to maintain a separate set of calculations of the transferee beneficiaries' distributive shares of partnership items that reflect the section 743(b) adjustment. But making a section 754 election at the time of death would be the mechanism by which to avoid the reporting requirements imposed by the regulations (assuming the applicable threshold amount is met). Providing an exception to reporting for transactions that result in basis adjustments because a section 754 election was not made on the death of a partner due to potential administrative burdens would result in additional requests for reporting exceptions in other fact patterns in which a section 754 election was not made on an original transaction due to potential administrative burdens, and a subsequent nonrecognition transaction results in a basis adjustment that would otherwise be reportable. Including such exceptions in the final regulations would defeat the purpose of identifying the transactions of interest, as there may be circumstances in which the lack of a section 754 election was part of a strategy to generate more beneficial results using a transaction identified as a transaction of interest by the regulations. Thus, these final regulations do not exclude transactions in which a basis increase arises because a section 754 election was not made for a transaction that would have provided a basis adjustment to offset an inside-outside basis disparity. The Treasury Department and the IRS note that relief under §§ 301.9100–1 through 301.9100–3 may be available for section 754 elections should a partnership fail to make the election in the time prescribed by the Code and regulations.

IV. Threshold Amount for Reporting

A. Amount Generally

Under proposed § 1.6011–18(c)(3), a partnership related-party basis adjustment transaction would have included those transactions in which the total basis increases from all transactions described in proposed § 1.6011–18(c)(1) or (2), (d)(1) or (2) engaged in by the same partner or partnership during the taxable year (without netting for any basis adjustment that results in a basis decrease in the same transaction or another transaction), reduced by the gain recognized, if any, on which tax imposed under subtitle A is required to be paid by any of the related parties to the transaction, equal or exceed $5 million. Accordingly, a transaction of a partner or partnership described in proposed § 1.6011–18(c)(1) or (2) that resulted in a basis increase of less than $5 million during the taxable year would have been a transaction of

interest under proposed § 1.6011–18(a) if, in the same taxable year, the partner or partnership participated in another transaction or transactions described in proposed § 1.6011–18(c)(1) or (2) and, in the aggregate, the transactions resulted in a basis increase that equals or exceeds $5 million, without regard to any basis decrease resulting from the transactions and after reducing the resulting aggregate amount by the gain recognized, if any, on which tax imposed under subtitle A is required to be paid by any of the related parties to the transactions.

Many commenters recommended increasing the proposed $5 million threshold amount, asserting that the $5 million threshold was too low, particularly considering the aggregation requirement, and would catch common business transactions. Several commenters recommended increasing the proposed $5 million threshold amount to an amount between $10 million and $100 million. One commenter recommended making the threshold amount $10 million for transactions of interest occurring after the applicability date of these final regulations and $50 million for transactions of interest occurring before that date.

The Treasury Department and the IRS have determined that increasing the proposed $5 million threshold amount is appropriate to reduce the administrative burden imposed on taxpayers. The purpose of these final regulations is to learn more about partnership related-party basis adjustment transactions and the Treasury Department and the IRS are conscious of overburdening taxpayers in that pursuit. Accordingly, the final regulations provide that, in the case of related-party basis adjustment transactions occurring within the six-year lookback period described in § 1.6011–18(c)(3)(ii), the applicable threshold amount is $25 million. For related-party basis adjustment transactions occurring after the six-year lookback period, the final regulations provide an applicable threshold amount of $10 million. In each case, the applicable threshold amount is met for a taxable year if the sum of all related-party basis increases (as determined under Part IV.B. of this Summary of Comments and Explanation of Revisions) resulting from all transactions described in the final regulations of a participant during the taxable year (without netting for any downward basis adjustment in the same transaction or another transaction) exceeds by at least the applicable threshold amount the gain recognized from such transactions, if any, on which tax imposed under subtitle A is required to be paid by any of the related partners (or tax-indifferent party) who are a party to such transactions. If the applicable threshold amount is met for a taxable year, all transactions of the participant described in the final regulations for the taxable year are reportable as transactions of interest regardless of whether an individual transaction meets the applicable threshold amount.

B. Calculation of Threshold Amount

Commenters also recommended changing how the threshold amount is calculated. A few commenters recommended allowing basis increases to be offset by basis decreases for purposes of determining whether the threshold amount has been reached. Another commenter recommended taking basis increases into account only to the extent that corresponding basis decreases are borne by related parties. The same commenter recommended exempting transactions from the proposed regulations for which only a small portion (for example, 10 percent) of an overall basis decrease impacts parties related to those with corresponding basis increases, or vice versa. One commenter recommended that if its recommendation to limit reporting to the year of the transaction of interest is not adopted, that the threshold amount look to net taxable income—that is, reporting should be required only if the tax benefit reduced taxable income by the threshold amount. This commenter also suggested eliminating aggregation of basis increases. Another commenter recommended using a threshold amount that is not related to basis (for example, the book value of distributed property).

The Treasury Department and the IRS agree that the calculation of the applicable threshold amount for purposes of section 734(b) TOIs should include only related partners' shares of basis increases and not the shares of unrelated parties, who can negotiate transactions at arm's length to protect their interests. The Treasury Department and the IRS also agree that the calculation of the applicable threshold amount for purposes of section 732(b) TOIs should exclude basis increases that correspond to basis decreases borne by unrelated partners (other than tax-indifferent parties) as basis decreases borne by unrelated partners should be negotiated at arm's length unless the unrelated partner is a tax-indifferent party. Accordingly, § 1.6011–18(c)(3)(iii) of the final regulations provide that in the case of a section 734(b) TOI, other than a substantially similar transaction described in § 1.6011–18(d)(1), for determining whether the applicable threshold amount is met for a taxable year, a basis increase is an increase to the adjusted basis of the partnership's property under section 734(b)(1) and (c) only to the extent of each related partner's share of the basis increase. Section 1.6011–18(c)(3)(iv) of the final regulations provides that in the case of a section 732(b) TOI, other than a substantially similar transaction described in § 1.6011–18(d)(1), for determining whether the applicable threshold amount is met for a taxable year, a basis increase is an increase to the basis of property distributed to one of the related partners under section 732(b) or (c), but excluding the amount of any basis increase that corresponds to a decrease to the basis of property distributed to unrelated partners (other than tax-indifferent parties) under section 732(b) and (c) or to unrelated partners' (other than tax-indifferent parties') shares of a corresponding decrease to the basis of the partnership's remaining property under section 734(b)(2) and (c). In the case of a substantially similar transaction described in § 1.6011–18 (d)(1), for purposes of determining whether the applicable threshold amount is met for a taxable year, a basis increase is an increase to the basis of property distributed to one of the partners under section 732(b) or (c) only to the extent of a corresponding decrease to the basis of property distributed to a tax-indifferent party under section 732(b) and (c) or to one or more tax-indifferent party's shares of a corresponding decrease to the basis of the partnership's remaining property under section 734(b)(2) and (c). For purposes of all of these rules, a partner's share of a basis decrease is determined immediately after the distribution under rules similar to the rules of § 1.197–2(h)(12)(iv)(D).

The Treasury Department and the IRS do not agree, however, that additional changes to the calculation of the applicable threshold amount, such as eliminating aggregation, calculating the applicable threshold amount based on increases to taxable income, or using an economic threshold that is based on book amounts, are appropriate in light of the modifications made. If aggregation were eliminated from the calculation of the applicable threshold amount, taxpayers would be incentivized to separate transactions described in the final regulations into multiple transactions that result in positive basis adjustments in an amount below the applicable threshold amount to avoid reporting obligations.

Incentivizing such behavior would defeat the purpose of the final regulations, which is to gather information on partnership related-party basis adjustment transactions. Additionally, calculating the applicable threshold amount based on taxable income or book amounts would introduce unnecessary complexity for both taxpayers and the IRS in identifying the transactions described in the final regulations. The calculation of the applicable threshold amount in the final regulations represents an appropriate methodology for quantifying the magnitude of partnership related-party basis adjustment transactions a taxpayer engages in for a taxable year. As described in Part IV.A of this Summary of Comments and Explanation of Revisions, the increases to the threshold amount made by these final regulations should also address concerns that the applicable threshold amount is overly inclusive.

Finally, one commenter requested clarification that substantially similar transactions are subject to the threshold amount. The Treasury Department and the IRS clarify that a transaction cannot be a substantially similar transaction if the applicable threshold amount is not met. As described in part VI of this Summary of Comments and Explanation of Revisions, transactions would be ''substantially similar'' transactions if they are (1) expected to obtain the same or similar types of tax consequences as the transactions described in the final regulations, (2) factually similar or based on the same or similar tax strategy, and (3) the applicable threshold amount is met.

V. Relatedness Standard

Proposed § 1.6011–18(b)(8) would have defined ''related'' as having a relationship described in section 267(b) (without regard to section 267(c)(3)) or section 707(b)(1). Proposed § 1.6011–18(b)(9) would have defined ''related partners'' as partners of a partnership that are related in the following manner—(i) in a transaction described in proposed § 1.6011–18(c)(1), the partnership has two or more direct or indirect partners that are related to each other within the meaning of proposed § 1.6011–18(b)(8), or (ii) in a transaction described in proposed § 1.6011–18(c)(2), the transferor of a partnership interest is related to the transferee, or the transferee is related to one or more of the partners in the partnership, within the meaning of proposed § 1.6011–18(b)(8). Under the proposed regulations, this relatedness requirement would have been met if the requisite relatedness exists either immediately before or immediately after a partnership related-party basis adjustment transaction described in proposed § 1.6011–18(c)(1) or (2).

Several commenters recommended changes to the relatedness requirement, stating that it was overbroad and difficult to comply with as partnerships and partners may not be able to identify their related parties. One commenter recommended importing concepts found in section 1563(a)(2) of the Code (related to brother-sister controlled groups of corporations) that would limit the definition of related partnerships by taking into account common ownership of capital or profits interests in the partnerships only to the extent that such ownership is identical with respect to each partnership.

In the case of transactions of interest involving section 734(b) or section 732(b) or (d), one commenter recommended requiring related partners to own 80 percent or more of the capital or profits interests of the partnership. Similarly, another commenter recommended that for all purposes of the final regulations, reporting should be required only if related parties own 80 percent or more of the capital or profits of a participating partnership. This commenter also recommended that the standard for relatedness be modified by substituting ''80 percent'' for ''50 percent'' in the relevant relationships defined within sections 267(b) or section 707(b)(1).

The Treasury Department and the IRS appreciate that the standard of relatedness used in the proposed regulations, combined with the scope of the transactions identified as transactions of interest, the proposed $5 million threshold amount, and the proposed definition of participation could result in administrative burdens on partnerships and their partners. The final regulations address these burdens by limiting the scope of the transactions identified, increasing the applicable threshold amounts, and limiting the application of the subsequent realization of tax benefit rule as described in Part VII.A. of this Summary of Comments and Explanation of Revisions. For example, in response to comments requesting that the standard of relatedness be narrowed, in the case of a section 734(b), 732(b) or 732(d) TOI, the final regulations provide that only directly related partners (and not also indirectly related partners) are considered in determining whether partners are related within the meaning of § 1.6011–18(b)(8) of the final regulation.

The final regulations do not adopt the additional changes to the standard of relatedness recommended by commenters because the Treasury Department and the IRS are concerned that counting only identical ownership as between related partnerships, or requiring related partners to own 80 percent or more of the capital or profits interests in a partnership, would more easily permit partnership structures with only marginally different ownership, including through the use of accommodation parties, to avoid such higher ownership thresholds without substantially affecting the partners' economics. Likewise, the Treasury Department and the IRS are concerned that increasing the relatedness standard from 50 percent to 80 percent could allow taxpayers to structure their affairs to stay below an 80-percent-relatedness standard, while simultaneously engaging in abusive partnership related-party basis adjustment transactions. Adding an ownership threshold or increasing the relatedness standard would frustrate the purpose of identifying the transactions described in the proposed regulations as transactions of interest. Accordingly, the commenters' recommendations are not adopted in the final regulations.

A commenter recommended excluding transactions between family members from those defined as transactions of interest and focusing instead on transactions involving controlled corporations described in section 267(f). The commenter noted that if relatedness is determined immediately before or after a transaction, parties undergoing divorce may be subject to these rules even though they have competing interests and will not be related after the divorce. Another commenter recommended excluding brothers and sisters from a person's family for purposes of determining relatedness, stating that, in the commenter's experience, siblings often have a contentious business relationship and are less likely to engage in transactions that confer large, gratuitous economic or tax benefits to one another. The Treasury Department and the IRS do not agree that familial relationships, including sibling relationships, should be excluded from the definition of relatedness. Family members, including siblings, often work in concert in ways that arm's-length parties do not. For those reasons, Congress included these familial relationships as part of the limitation rules in sections 267 and 707(b). Additionally, section 1041 of the Code is intended to address transfers of

property between spouses incident to divorce. For these reasons, the final regulations retain familial relationships, including sibling relationships, in the definition of relatedness.

VI. Substantially Similar Transactions

Section 1.6011–4(b)(6) defines a ''transaction of interest'' as a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has identified by notice, regulation, or other form of published guidance as a transaction of interest. For purposes of proposed § 1.6011–18, transactions would be ''substantially similar'' transactions if the transactions are substantially similar within the meaning of § 1.6011–4(c)(4)—that is, if they are expected to obtain the same or similar types of tax consequences and are either factually similar or based on the same or similar tax strategy. Proposed § 1.6011–18(a) would have provided that substantially similar transactions include, but are not limited to, the transactions described in proposed § 1.6011–18(d).

Some commenters recommended clarifying or narrowing the definition of ''substantially similar'' transactions generally. Several commenters noted that the broad definition of ''substantially similar transactions'' in § 1.6011–4 increases uncertainty and compliance costs. Suggestions to amend § 1.6011–4, including that provision's definition of a ''substantially similar'' transaction, are outside the scope of these final regulations. As a result, the commenters' suggestions are not adopted in the final regulations.

A. Tax-Indifferent Parties

Under proposed § 1.6011–18(d)(1), a transaction would have been substantially similar to a transaction described in proposed § 1.6011–18(c) if the transaction is a basis adjustment transaction described in proposed § 1.6011–18(c)(1) or (2), except that it does not involve related partners and one or more partners of the partnership is a tax-indifferent party. Under proposed § 1.6011–18(b)(11), a tax-indifferent party would have meant a person that is either not liable for Federal income tax because of its tax-exempt or, in certain cases, foreign status, or to which gain from a transaction described in proposed § 1.6011–18(c) would not result in Federal income tax liability for the person's taxable year within which such gain is recognized (for example, because the taxpayer has a net operating loss carryforward or capital loss carryforward).

Two commenters recommended eliminating transactions involving tax-indifferent parties from those identified as transactions of interest. Many commenters noted that partners and partnerships may be unaware that a person engaging in a transaction identified by the proposed regulations is a tax-indifferent party. Some commenters requested clarification to the definition of tax-indifferent party, such as whether it includes direct or indirect partners that are exempt from Federal income tax under section 115 of the Code (relating to the income of State, territorial, or local governments), entities treated as partnerships or S corporations for Federal tax purposes, or a person that, due to tax attributes or for other reasons, is subject to tax on only part of its income. One commenter requested confirmation that the definition of a tax-indifferent party does not include a party with a capital loss carryover. The commenter raised that a capital loss carryover may be unrelated to a partner's partnership interest and unknown by other partners, particularly if the partner is unrelated.

One commenter recommended limiting the rule to situations in which the tax-indifferent party knows or has reason to know of the tax benefits arising in connection with its participation in a basis-adjustment transaction and that the other partners that are party to the transaction know of the partner's tax-indifferent status. One commenter recommended an exception for taxpayers who do not have knowledge or reason to know that its transaction is reportable because a person that is a party to the transaction is tax-indifferent. Another commenter recommended modifying the tax-indifferent party rule to apply only to situations in which the taxpayer knowingly participates in the transaction to which the tax-indifferent party facilitates a basis step-up.

Eliminating the tax-indifferent party rule would frustrate the purpose of identifying substantially similar transactions to the identified transactions of interest that use tax-indifferent parties instead of related parties to achieve the same economic or tax results. Accordingly, the Treasury Department and the IRS decline to eliminate the tax-indifferent party rule entirely in the final regulations. However, in response to these comments, the Treasury Department and the IRS have determined that certain changes to the scope of transactions of interest involving tax-indifferent parties are appropriate.

Accordingly, the final regulations include a knowledge element in the definition of a tax-indifferent party. Section 1.6011–18(b)(12) of the final regulations provides that a tax-indifferent party means a person that is either not liable for Federal income tax by reason of its tax-exempt or, in certain cases, foreign status, or to which any gain, or portion of any gain, that would have resulted from a section 732(b) TOI or a section 734(b) TOI if the property subject to a basis decrease in such transaction were sold immediately after such transaction, would not result in Federal income tax liability for the person's taxable year within which such gain would have been recognized, and whose status as a tax-indifferent party is known or should be known to any other person that participates in the transaction or to a partner in a partnership that participates in such a transaction. Thus, a tax-indifferent party would include a person that is partially taxable, for example, due to tax attributes, to the extent that the person's status as a tax-indifferent party is known or should be known by any other person participating in the transaction or to a partner in a partnership that participates in such a transaction. Because partnerships or S corporations are generally not liable for tax, and because the tax status of their partners or shareholders could be diverse, the final regulations also provide that partnerships or S corporations are not tax-indifferent parties except in cases in which a principal purpose of the use of the partnership or S corporation is to avoid tax-indifferent party status.

Additionally, the final regulations limit the scope of a substantially similar transaction with a tax-indifferent party under § 1.6011–18(d)(1) by limiting the calculation of the applicable threshold amount to basis increases that correspond to a basis decrease to the tax-indifferent party for sections 732 and 734 TOIs. *See* Part IV.B. of this Summary of Comments and Explanation of Revisions. These modifications are intended to address concerns that the tax-indifferent party rules in the proposed regulations were overbroad.

The final regulations also clarify that a transaction with a tax-indifferent party includes a transaction in which the tax-indifferent party facilities the increase in the basis of partnership property in a section 732 TOI by having a share of a corresponding decrease to the basis of partnership property.

B. Recognition Transactions

Proposed § 1.6011–18(d)(2) would have defined as a substantially similar transaction a transaction in which a partner transfers the partner's partnership interest in a recognition

transaction to a related transferee or to a person related to one or more existing partners, and the proposed $5 million threshold amount was met. Proposed § 1.6011–18(b)(6) would have defined a ''recognition transaction'' as a transaction other than a nonrecognition transaction.

One commenter requested clarification that proposed § 1.6011–18(d)(2) applies only to transfers between related parties, meaning the transferor and transferee must be related. The Treasury Department and the IRS agree with this comment and have made clarifying changes to confirm that the rule in § 1.6011–18(d)(2) does not apply to transfers of partnership interests between persons that are not related.

VII. Participation in a Transaction of Interest Identified by the Proposed Regulations

A. Subsequent Realization of Tax Benefit Rule

Under proposed § 1.6011–18(e)(2)–(4), a participating partnership, participating partner, or related subsequent transferee would have participated in a transaction of interest in any taxable year in which it participates in a transaction described in proposed § 1.6011–18(c). Additionally, under proposed § 1.6011–18(e)(5), a participating partnership, participating partner, or related subsequent transferee would have participated in a transaction of interest in any taxable year in which its tax return reflected the tax consequences of a basis increase resulting from a transaction described in proposed § 1.6011–18(c) (subsequent realization of tax benefit rule). Therefore, under the proposed regulations, as a result of the subsequent realization of tax benefit rule, a transaction described in proposed § 1.6011–18(c) that occurred many years ago could require reporting if a taxpayer's tax return in an open tax year reflected the tax consequences (such as cost-recovery deductions) arising from the transaction of interest.

Several commenters recommended eliminating the retroactive effect of the subsequent realization of tax benefit rule. These commenters stated that complying with the rule would be burdensome given that it could require taxpayers and their advisors to reconstruct transactions and their resulting tax consequences from many years ago. Commenters asserted that, in many cases, taxpayers and their advisors will not have sufficient information to comply with the rule.

Several commenters recommended that the proposed regulations apply prospectively to transactions that occur in taxable years beginning on or after the date the final regulations are adopted, whereas one commenter recommended applying the proposed regulations solely to transactions effected on or after January 1, 2023. One commenter recommended applying the subsequent realization of tax benefit rule only to partnership related-party basis adjustment transactions that occur within partnership tax years that remain open under the period of limitations set forth in section 6235 of the Code. Section 6235 provides rules on the period of limitations for making adjustments with respect to partnerships subject to the Centralized Partnership Audit Regime under the Bipartisan Budget Act of 2015 (BBA partnerships). Under section 6235(a)(1), the time for the IRS to make an adjustment for a taxable year of a BBA partnership generally is the later of the date which is three years after the latest of (1) the date on which the partnership return for the taxable year was filed, (2) the return due date for the taxable year, or (3) the date on which the partnership filed an administrative adjustment request under section 6227 of the Code with respect to the taxable year. In the case of a BBA partnership that makes a substantial omission of gross income within the meaning of section 6501(e)(1), section 6235(c)(2) provides that the period of limitations on making adjustments is six years instead of three years.

The Treasury Department and the IRS do not agree with eliminating all reporting that would occur under the subsequent realization of tax benefit rule as this would defeat the purpose of providing the IRS with information regarding transactions with tax consequences occurring over more than one taxable year. However, the Treasury Department and the IRS agree that it is appropriate to limit the retroactive information effect of the subsequent realization of tax benefit rule because of administrative concerns with compliance for transactions that would meet the elements of § 1.6011–18(c) and (d) except that they occurred many years ago.

In determining the appropriate limitation for the subsequent realization of tax benefit rule, limiting the look back period to the prior six years as recommended by one commenter allows the IRS to preserve its ability to assess tax in cases in which the statute of limitations for assessment of tax is six years pursuant to section 6501(e) or section 6235(c)(2). In addition, a six-year lookback period aligns with the requirement under § 301.6112–1(b)(2) that material advisors of transactions of interests maintain lists of advisees, but not if the person entered into the transaction more than six years from the date the transaction was identified as a transaction of interest under published guidance. Accordingly, the final regulations adopt a six-year lookback period for required disclosures. Under the final regulations at § 1.6011–18(f)(2), for a taxable year described in § 1.6011–4(e)(2)(i), a participant must provide the information described in the final regulations only if the transaction of interest occurred within the six-year lookback period. Section 1.6011–18(b)(11) of the final regulations provides that the six-year lookback period means the seventy-two months immediately preceding the first month of the taxpayer's most recent taxable year that began before January 14, 2025. The final regulations include examples demonstrating the six-year lookback period rule.

B. Limiting the Definition of Participation

Several commenters recommended requiring reporting only in the taxable year the transaction of interest occurs and eliminating the subsequent realization of tax benefit rule. These commenters asserted that reporting only in the year in which the transaction of interest first arises would reduce compliance burdens and costs for taxpayers and limit the potential for missed reporting. One commenter suggested adopting a one-time disclosure mechanism like that adopted in Form 1065, Schedule B, questions 11 and 12 for the ''drop and swap'' or ''swap and drop'' transactions to which section 1031 of the Code applies. Another commenter recommended requiring reporting only at the partnership level to avoid duplicative reporting. Reporting by all participants in any taxable year in which the participant's tax return reflects the tax consequences of a basis increase resulting from a transaction of interest is the most appropriate for tax compliance and administration. Accordingly, the commenters' recommendations are not adopted in the final regulations.

Special Analyses

I. Paperwork Reduction Act

The collection of information contained in these final regulations is reflected in the collection of information for Form 8886 and Form 8918, *Material Advisor Disclosure Statement,* that have been reviewed and approved by the

Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. 3507(c)) under control numbers 1545–1800 and 1545–0865.

To the extent there is a change in burden as a result of these final regulations, the change in burden will be reflected in the updated burden estimates for the Forms 8886 and 8918. The requirement to maintain records to substantiate information on Forms 8886 and 8918 is already contained in the burden associated with the control number for the forms and remains unchanged.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

II. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6) requires agencies to ''prepare and make available for public comment an initial regulatory flexibility analysis,'' which will ''describe the impact of the rule on small entities.'' Section 605(b) of the RFA allows an agency to certify a rule if the rulemaking is not expected to have a significant economic impact on a substantial number of small entities.

The Secretary of the Treasury hereby certifies that these final regulations will not have a significant economic impact on a substantial number of small entities pursuant to the RFA. This certification is based on IRS data that estimates the percentage of partnerships that would have been required to file a disclosure statement under the proposed regulations and those that may be required to file a disclosure statement under the final regulations.

The IRS's Research, Applied Analytics, and Statistics division (RAAS) provided data that indicated the percentage of partnerships with gross receipts or sales of $25 million or less that might have been subject to the disclosure obligations under the proposed regulations because of a basis adjustment under section 743(b) of more than $5 million during the taxable year. In addition, RAAS provided data that indicated the percentage of partnerships with gross receipts or sales of $25 million or more that might have been subject to the disclosure obligations under the proposed regulations because of a basis adjustment under section 743(b) of more than $5 million during the taxable year. The data suggested that of all partnerships with related parties and a basis adjustment under section 743(b) of more than $5 million during the taxable year, approximately two-thirds of the partnerships would have gross receipts or sales of $25 million or less and approximately one-third would have gross receipts or sales of $25 million or more. The Treasury Department and the IRS determined that the data did not indicate that the proposed regulations would have a significant economic impact on a substantial number of small entities because not all partnerships with gross receipts or sales of $25 million or less are considered small businesses,[3] and the data did not provide information on whether the partnerships with gross receipts or sale of $25 million or less were part of larger enterprises.

As discussed in Part II of the Summary of Comments and Explanation of Revisions, several commenters stated that the scope of the proposed regulations would be overbroad and the number of entities that would be subject to disclosure was underestimated. In addition, commenters asserted that taxpayers would be subject to substantial costs for complying with the proposed regulations because compliance required reviewing transactions from prior taxable years to determine whether a continuing tax benefit was attributable to a transaction identified as a transaction of interest under the proposed regulations. These comments are addressed in Parts II and VII of the Summary of Comments and Explanation of Revisions.

One commenter asserted that the Treasury Department and the IRS underestimated the likely cost of complying with the proposed regulations. Specifically, the commenter asserted that the likely wage of tax preparers and costs of due diligence, as well as the number of parties affected by each transaction of interest were underestimated.

As indicated in the Summary of Comments and Explanation of Revisions, the final regulations include changes that should significantly limit the total number of entities and more specifically, small businesses, subject to the disclosure obligations. Most significantly, the applicable threshold amount is increased from $5 million to $10 million; the period for reporting under § 1.6011–4(e)(2)(i) is limited to a six-year lookback period and the applicable threshold amount for the six-year lookback period is $25 million; in the case of a section 734(b) TOI, the applicable threshold amount is determined by generally only taking into account only the amount of the basis increase shared by related partners; in the case of a section 732(b) TOI, the applicable threshold amount is determined by generally only taking into account only the amount of the basis increase that corresponds to a basis decrease shared by the related partners.

In addition, more recent data from the IRS indicates that, in the case of partnerships with gross assets of less than $25 million that reported basis adjustments under section 734(b) or section 743(b) for the taxable year, the average basis adjustment was less than the applicable threshold amount of $10 million or more in the final regulations. Thus, the Treasury Department and the IRS anticipate that many partnerships with gross assets of less than $25 million should not be subject to the disclosure obligations under the final regulations. Further, the data indicates that partnerships with gross assets of more than $25 million that reported basis adjustments under section 734(b) or section 743(b) for the taxable year that met the applicable threshold amount of $10 million or more in the final regulations represent less than one percent of all partnerships that filed tax returns for the taxable year. Accordingly, as a result of the changes made to the final regulations in response to comments received on the proposed regulations, the disclosure obligations in the final regulations should affect a low percentage of partnerships and most of those partnerships will be partnerships with less than $25 million of gross assets.

The final regulations should not have a significant economic impact on small entities subject to the reporting requirements of the final regulations because the final regulations merely implement sections 6011, 6111 and 6112 and § 1.6011–4 by specifying the manner in which and the time at which a transaction identified as a transaction of interest in the final regulations must be reported. Accordingly, because the final regulations will be limited in scope to time and manner of information reporting, their economic impact is expected to be minimal. The Treasury Department and the IRS expect that the reporting burden is low because the information sought is necessary for regular annual return preparation and ordinary recordkeeping. The estimated burden for any taxpayer required to file Form 8886 is approximately 10 hours, 16 minutes for recordkeeping, 4 hours, 50 minutes for learning about the law or the form, and 6 hours, 25 minutes for preparing, copying, assembling, and sending the form to the IRS.

RAAS estimated that the appropriate wage rate for complying with the proposed regulations is $102.00 (2022

[3] *See,* 13 CFR 121.201.

dollars) per hour. Thus, it was estimated that persons required to comply with the proposed regulations would have incurred costs totaling approximately $2,194.70 per filing. One commenter indicated that this per hour dollar amount is too small and that a better estimate is approximately $177.29 per hour or approximately $3,814.69 per filing (subject to the taxpayer potentially seeking specialists with a higher hourly fee to comply with the proposed regulations). Either of these amounts is small in comparison to an aggregate basis increase of $10 million or more as the result of a transaction identified as a transaction of interest under the final regulations. Thus, the relatively small cost to comply with the final regulations will not pose any significant economic impact to any small entities that would be subject to the final regulations.

For the reasons stated, a regulatory flexibility analysis under the RFA is not required. Pursuant to section 7805(f) of the Code, the proposed rule preceding this rulemaking was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

III. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. This rule does not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

IV. Executive Order 13132: Federalism

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. These final regulations do not have federalism implications and do not impose substantial direct compliance costs on State and local governments or preempt state law within the meaning of the Executive order.

V. Regulatory Planning and Review

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

VI. Congressional Review Act

Pursuant to the Congressional Review Act (5 U.S.C. 801 *et seq.*), the Office of Information and Regulatory Affairs has designated this rule as not a ''major rule,'' as defined by 5 U.S.C. 804(2).

Statement of Availability of IRS Documents

Guidance cited in this preamble is published in the Internal Revenue Bulletin and is available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at *https://www.irs.gov.*

Drafting Information

The authors of these regulations are Elizabeth Zanet and Cameron Williamson, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and the IRS propose to amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by adding an entry for § 1.6011–18 in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

* * * * *

Section 1.6011–18 also issued under 26 U.S.C. 6001 and 26 U.S.C. 6011.

* * * * *

■ **Par. 2.** Section 1.6011–18 is added to read as follows:

§ 1.6011–18 Certain partnership related-party basis adjustment transactions as transactions of interest.

(a) *Identification as transaction of interest.* Transactions that are the same as or substantially similar (within the meaning of § 1.6011–4(c)(4)) to the transactions described in paragraph (c) of this section are identified as transactions of interest for purposes of § 1.6011–4(b)(6). Transactions that are substantially similar (within the meaning of § 1.6011–4(c)(4)) to the transactions described in paragraph (c) of this section include, but are not limited to, transactions described in paragraph (d) of this section.

(b) *Definitions.* The following definitions apply for purposes of this section:

(1) *Code* means the Internal Revenue Code.

(2) *Nonrecognition transaction* means a nonrecognition transaction within the meaning of section 7701(a)(45) of the Code.

(3) *Participating partner* means—

(i) Except as provided in paragraph (b)(3)(ii), (iii), or (iv) of this section, any partner that directly receives a distribution of property from, or an interest in, a participating partnership, or directly transfers an interest in a participating partnership, in a transaction described in paragraph (c) or (d) of this section, including a person that becomes or ceases to be a partner as a result of such transaction.

(ii) In the case of a participating partnership interest held by an entity that is disregarded as separate from its owner within the meaning of § 301.7701–2(c)(2)(i) of this chapter, *participating partner* means the owner of the disregarded entity for Federal income tax purposes.

(iii) In the case of a participating partnership interest held by a trust for which the grantor or another person is treated as the owner of the trust that holds the participating partnership interest as provided in section 671 of the Code, *participating partner* means the grantor or other person designated under sections 671 through 679 of the Code as the owner of the trust that holds the participating partnership interest.

(iv) In the case of a publicly traded partnership within the meaning of section 7704 of the Code, *participating partner* means a partner of the publicly traded partnership but only to the extent that the partner engages in a private transfer (as described in § 1.7704–1(e)), redemption or repurchase agreement (as described in § 1.7704–1(f)), or private placement (as described in § 1.7704–1(h)) of a partnership interest with a related partner and the transaction is not otherwise excluded as a transaction described in paragraph (c) or (d) of this section.

(4) *Participating partnership* means any partnership—

(i) That makes a distribution of property to a participating partner in a

transaction described in paragraph (c)(1) or (d)(1) of this section, or

(ii) A partnership interest in which is transferred by a participating partner in a transaction described in paragraph (c)(2) or (d)(2) of this section.

(5) *Participating partnership interest* means any partnership interest in a participating partnership.

(6) *Recognition transaction* means a transaction other than a nonrecognition transaction within the meaning of paragraph (b)(2) of this section.

(7) *Recoverable property* means property of a character subject to an allowance for depreciation, amortization, or depletion under subtitle A of the Code (subtitle A).

(8) *Related* means having a relationship described in section 267(b) of the Code (without regard to section 267(c)(3)) or section 707(b)(1) of the Code.

(9) *Related partners* means:

(i) In the case of a transaction described in paragraph (c)(1) of this section, two or more direct partners of a partnership that are related immediately before or immediately after a transaction described in paragraph (c)(1) of this section.

(ii) In the case of a transaction described in paragraph (c)(2) or (d)(2) of this section, a transferor and transferee of a partnership interest that are related to each other immediately before or immediately after a transaction described in paragraph (c)(2) of this section.

(10) *Related subsequent transferee* means any person that is related to a participating partner and directly received in a nonrecognition transaction a transfer (including a distribution) of property that was subject to an increase in basis from a transaction described in paragraph (c) or (d) of this section.

(11) *Six-year lookback period* means the seventy-two months immediately preceding the first month of the taxpayer's most recent taxable year that began before January 14, 2025.

(12) *Tax-indifferent party* means a person that is either not liable for Federal income tax by reason of the person's tax-exempt or, in certain cases, foreign status, or to which any gain, or portion of any gain, that would have resulted from a transaction described in paragraph (d)(1) of this section if the property subject to a basis decrease in such transaction were sold immediately after such transaction would not result in Federal income tax liability for the person's taxable year within which such gain would have been recognized, and whose status as a tax-indifferent party is known or should be known to any other person that participates in a transaction described in paragraph (d)(1) of this section or to a partner in a partnership that participates in such a transaction. A tax-indifferent party does not include a partnership or S corporation except in a case in which a principal purpose of the use of the partnership or S corporation is to avoid tax-indifferent party status.

(13) *Transfer on the death of a partner* means a transfer of a partnership interest from a partner to the partner's estate or a deemed transfer from a grantor trust owned by the partner to a trust that becomes a separate entity for Federal income tax purposes by reason of the partner's death.

(c) *Transaction description.* A transaction is described in this paragraph (c) if the factual elements of the transaction described in paragraph (c)(1)(i) through (iii) or (c)(2) of this section are met.

(1) *Distributions by a partnership.* A partnership with two or more related partners engages in any of the transactions described in paragraphs (c)(1)(i) through (iii) of this section as follows:

(i) The partnership distributes property to one of the related partners in a current or liquidating distribution, the partnership increases the basis of one or more of its remaining properties under section 734(b) and (c) of the Code, and the applicable threshold described in paragraph (c)(3) of this section is met.

(ii) The partnership distributes property to one of the related partners in liquidation of that person's partnership interest (or in complete liquidation of the partnership), the basis of one or more of those distributed properties is increased under section 732(b) and (c) of the Code, and the applicable threshold described in paragraph (c)(3) of this section is met.

(iii) The partnership distributes property to one of the related partners, the basis of one or more of those distributed properties is increased under section 732(d) of the Code, the distributee acquired all or a part of its interest in the partnership in a transaction that would have been a transaction described in paragraph (c)(2) of this section if the partnership had a section 754 election in effect for the year of transfer, and the applicable threshold described in paragraph (c)(3) of this section is met.

(2) *Transfers of a partnership interest*—(i) *In general.* Except as otherwise provided in paragraph (c)(2)(ii) or (c)(4) of this section, a partner transfers all or a portion of a partnership interest to a related partner in a nonrecognition transaction, the basis of one or more partnership properties is increased under section 743(b)(1) and (c) of the Code, and the applicable threshold described in paragraph (c)(3) of this section is met.

(ii) *Subsequent nonrecognition transfers*—(A) *In general.* If a partner receives an interest in a partnership from a person in a recognition transaction (first transfer) and the basis of one or more partnership properties is increased under section 743(b)(1) and (c) of the Code, and subsequently the partner (transferor) transfers the partnership interest to a person related to the transferor (transferee) in a transaction described in paragraph (c)(2)(i) of this section (subsequent transfer), the subsequent transfer is a transaction described in paragraph (c)(2)(i) of this section only to the extent, if any, that the transferee's basis adjustment under section 743(b)(1) and (c) resulting from the subsequent transfer exceeds the amount of the transferor's remaining basis adjustment described in paragraph (c)(2)(ii)(B) of this section that is attributable to the transferred partnership interest (excess amount), and the applicable threshold described in paragraph (c)(3) of this section is met. Only the excess amount is counted towards the applicable threshold described in paragraph (c)(3) of this section.

(B) *Transferor's remaining basis adjustment.* A *transferor's remaining basis adjustment* is equal to the amount of the transferor's basis adjustment under section 743(b)(1) and (c) resulting from the first transfer as adjusted under section 1016(a)(2) of the Code to reflect the recovery of the basis adjustment or as otherwise adjusted prior to the subsequent transfer.

(3) *Applicable threshold*—(i) *In general.* Except as otherwise provided in paragraph (c)(3)(ii) of this section, for determining whether a transaction is described in paragraph (c)(1) or (2), (d)(1) or (2) of this section, the applicable threshold is met for a taxable year if the sum of all basis increases resulting from all such transactions of a partnership or partner during the taxable year (without netting for any basis adjustment that results in a basis decrease in the same transaction or another transaction) exceeds by at least $10 million the gain recognized from such transactions during the same taxable year, if any, on which tax imposed under subtitle A is required to be paid by any of the related partners (or tax-indifferent party, in the case of a transaction described in paragraph (d)(1) of this section) who are a party to such transactions.

(ii) *Six-year lookback period threshold.* In the case of a transaction described in (c) or (d) of this section that

occurred within the six-year lookback period, paragraph (c)(3)(i) applies by substituting ''$25 million'' for ''$10 million'' for determining whether the applicable threshold is met for a taxable year.

(iii) *Basis increase under section 734(b) and (c) only for shares of basis increase to related partners.* In the case of a transaction described in paragraph (c)(1)(i) of this section for determining whether the applicable threshold is met for a taxable year, a basis increase is an increase to the adjusted basis of the partnership's property under section 734(b)(1) and (c) only to the extent of a related partner's share of the basis increase. For purposes of this paragraph (c)(3)(iii), a partner's share of a basis increase is determined immediately after the distribution under rules similar to the rules of § 1.197–2(h)(12)(iv)(D).

(iv) *Basis increase under sections 732(b) or (c) only for shares of corresponding basis decreases under section 734(b) to related partners or tax-indifferent parties.* In the case of a transaction described in paragraph (c)(1)(ii) of this section for determining whether the applicable threshold is met for a taxable year, a basis increase is an increase to the basis of property distributed to one of the related partners under section 732(b) or (c), but excluding the amount of any basis increase that corresponds to a decrease to the basis of property distributed to unrelated partners (other than tax-indifferent parties) under section 732(b) and (c) or to unrelated partners' (other than tax-indifferent parties') shares of a corresponding decrease to the basis of the partnership's remaining property under section 734(b)(2) and (c). For purposes of this paragraph (c)(3)(iv), a partner's share of a basis decrease is determined immediately after the distribution under rules similar to the rules of § 1.197–2(h)(12)(iv)(D). In the case of a transaction described in paragraph (d)(1) of this section, for purposes of determining whether the applicable threshold is met for a taxable year, a basis increase is an increase to the basis of property distributed to one of the partners under section 732(b) or (c) only to the extent of a corresponding decrease to the basis of property distributed to a tax-indifferent party under section 732(b) and (c) or to one or more tax-indifferent party's shares of a corresponding decrease to the basis of the partnership's remaining property under section 734(b)(2) and (c).

(4) *Exclusion of a transfer on the death of a partner.* A transaction described in paragraph (c)(2) or (d)(2) of this section does not include a transfer of a partnership interest that is a transfer on the death of a partner within the meaning of paragraph (b)(13) of this section.

(d) *Substantially similar transaction.* A transaction that is substantially similar (within the meaning of § 1.6011–4(c)(4)) to a transaction described in paragraph (c) of this section includes, but is not limited to:

(1) A transaction that is described in paragraph (c)(1)(i) or (ii) of this section except that the partners of the partnership are not related and one or more partners of the partnership is a tax-indifferent party that facilitates an increase in the basis of partnership property or an increase in the basis of property held by another partner in the partnership by receiving a distribution of property from the partnership or having a share of a corresponding decrease to the basis of partnership property, and the applicable threshold described in paragraph (c)(3) of this section is met; and

(2) A transaction in which a transferor transfers an interest in a partnership to a transferee that is related to the transferor in a recognition transaction, and the applicable threshold described in paragraph (c)(3) of this section is met.

(e) *Participation*—(1) *In general.* Whether a taxpayer has participated in a transaction of interest described in paragraph (c) of this section or a substantially similar transaction described in paragraph (d) of this section during a taxable year is determined under this paragraph (e).

(2) *Participating partners.* A participating partner participates in a transaction of interest described in paragraph (c)(1) of this section or a substantially similar transaction described in paragraph (d)(1) of this section in any taxable year in which the partner directly receives a distribution of property, or directly transfers or receives an interest in a participating partnership, in a transaction described in paragraph (c)(2) of this section or a substantially similar transaction described in paragraph (d)(2) of this section.

(3) *Participating partnerships.* A participating partnership participates in a transaction of interest described in paragraph (c) or a substantially similar transaction described in paragraph (d) of this section in any taxable year in which the partnership makes a distribution of property to a participating partner in a transaction described in paragraph (c)(1) or (d)(1) of this section, or a participating partnership interest is transferred in a transaction described in paragraph (c)(2) or (d)(2) of this section.

(4) *Related subsequent transferees.* A related subsequent transferee participates in a transaction of interest described in paragraph (c) of this section or a substantially similar transaction described in paragraph (d) of this section in any taxable year in which the related subsequent transferee directly receives, in a nonrecognition transaction, a transfer (including a distribution) of property that was subject to an increase in basis as a result of a transaction described in paragraph (c) or (d) of this section that was required to be disclosed under paragraph (f) of this section.

(5) *Subsequent realization of tax benefit.* A participating partnership, participating partner, or related subsequent transferee also participates in a transaction of interest described in paragraph (c) or a substantially similar transaction described in paragraph (d) of this section in any taxable year in which its tax return reflects the tax consequences of a basis increase resulting from a transaction of interest described in paragraph (c) or (d) of this section, taking into account the limitations provided in paragraphs (c)(3)(iii) and (iv) of this section. For example, if a participating partner sells property the basis of which has been increased as a result of a transaction of interest described in paragraph (c) of this section during a taxable year after the taxable year in which the transaction of interest occurred, the participating partner participates in a transaction of interest described in paragraph (c) of this section in the taxable year of the basis increase and in the taxable year of the sale.

(f) *Disclosure requirements*—(1) *In general.* Except as otherwise provided in this paragraph (f)(1), participants must provide the information required under § 1.6011–4(d) and the Instructions to Form 8886, *Reportable Transaction Disclosure Statement* (or successor form), and in the manner described in § 1.6011–4(e), for each taxable year in which the participant participated in a transaction described in paragraph (c) or (d) of this section as determined under paragraph (e) of this section. For all participants, describing the transaction in sufficient detail includes describing the information described in paragraphs (f)(1)(i) through (iii) of this section, as applicable, on Form 8886 (or successor form) for the taxable year of a transaction described in paragraph (c) or (d) of this section. In the case of a participant that is a tax-indifferent party, the disclosure requirements of this paragraph (f) apply only if the tax-indifferent party is otherwise required to file a tax return (or an information return) for the taxable year of the

transaction described in paragraph (d)(1) of this section.

(i) The names and identifying numbers of all participants, including the participating partnership, participating partners and any related subsequent transferees.

(ii) All basis adjustments resulting from a transaction described in paragraph (c) or (d) of this section, including—

(A) Basis information, including the participating partnership's adjusted basis in the distributed property immediately before the distribution,

(B) Any adjustments to basis under section 732(a)(2), (b), (d) or section 734(b),

(C) Any adjustments to basis under section 743(b) with respect to a participating partner that is transferred an interest in a participating partnership, and

(D) With respect to a participating partner that transfers an interest in a participating partnership, that participating partner's adjusted basis in the participating partnership interest and share of the participating partnership's adjusted basis in its property immediately before the transfer.

(iii) Any Federal income tax consequences realized during the taxable year as a result of a transaction described in paragraph (c) or (d) of this section, including any cost recovery allowances attributable to any increase in basis as a result of a transaction described in paragraph (c) of this section, and any gain or loss attributable to the disposition of property that was subject to an increase in basis as a result of a transaction described in paragraph (c) or (d) of this section. The Federal income tax consequences attributable to an increase in basis resulting from a transaction described in paragraph (c) or (d) of this section are limited to those attributable to the increase in basis, taking into account the limitations of paragraph (c)(3)(iii) or (iv) of this section. For example, in the case of a distribution of depreciable property that was subject to an increase in basis because of a transaction described in paragraph (c) or (d) of this section, the Federal income tax consequences realized during the taxable year include the basis increase and cost recovery allowances attributable to the basis increase during the taxable year.

(2) *Six-year lookback period for taxable years described in special rule of § 1.6011–4(e)(2)(i).* For purposes of the special rule of § 1.6011–4(e)(2)(i) (describing the disclosure requirement with respect to a transaction that is identified as a transaction of interest after the filing of the taxpayer's tax return (including an amended return) reflecting the taxpayer's participation in the transaction of interest but before the end of the period of limitations for assessment of tax for such taxable year), a participant must provide the information described in paragraph (f)(1) of this section for such open years only if the transaction described in paragraph (c) or (d) of this section occurred within the six-year lookback period described in paragraph (b)(11) of this section.

(g) *Examples.* The following examples illustrate the provisions of this section.

(1) *Example 1: Reporting by a participating partner and participating partnership in the taxable year of the transaction, including cost recovery allowances*—(i) *Facts.* ABC Partnership is owned by partners A, B, and C. Partners A, B, and C are related within the meaning of paragraphs (b)(8) and (9) of this section. At the beginning of taxable year 2025, ABC Partnership distributes a depreciable asset, Property X, to Partner A in liquidation of Partner A's interest in ABC Partnership. The distribution is a transaction described in paragraph (c)(1)(ii) of this section. As a result of the distribution, the basis of Property X is increased by $10 million in Partner A's hands. On its tax return for taxable year 2025, Partner A reports deductions for depreciation expense attributable to the $10 million increase in the basis of Property X resulting from the transaction under paragraph (c)(1)(ii) of this section. In addition, ABC Partnership must reduce the basis of its remaining property under section 734(b)(2) as a result of the distribution of Property X to Partner A by $10 million. ABC Partnership and Partner A use the calendar year as their taxable year.

(ii) *Analysis.* Partner A is a participant during taxable year 2025 within the meaning of paragraph (e) of this section because it is a participating partner within the meaning of paragraph (b)(3) of this section since it directly received a distribution of property during taxable year 2025 in a transaction described in paragraph (c) of this section. ABC Partnership is a participant during taxable year 2025 within the meaning of paragraph (e) of this section because it is a participating partnership within the meaning of paragraph (b)(4) of this section since it made a distribution of property to a participating partner during taxable year 2025 in a transaction described in paragraph (c) of this section. As part of its disclosure requirements under paragraph (f) of this section and § 1.6011–4(d) and (e), Partner A must disclose the distribution as a transaction of interest under this section on Form 8886 (or successor form) and file the form with its tax return for taxable year 2025. Partner A must include the information described in paragraph (f) of this section, including the amount of the deductions attributable to the $10 million increase in the basis of Property X resulting from the transaction described in paragraph (c)(1)(ii) of this section. As part of its disclosure requirements under paragraph (f) of this section and § 1.6011–4(d) and (e), ABC Partnership must disclose the distribution as a transaction of interest under this section on Form 8886 (or successor form) and file the form with its tax return for taxable year 2025, including the information described in paragraph (f) of this section. In addition, Partner A and ABC Partnership must send a copy of their respective Form 8886 (or successor form) to the Office of Tax Shelter Analysis (OTSA).

(2) *Example 2: Reporting of the Federal income tax consequences (cost recovery allowances) of the transaction in all taxable years*—(i) *Facts.* Under the same facts as in paragraph (g)(1)(i) of this section (*Example 1),* on its tax returns for taxable years 2026 through 2030, Partner A reports deductions for depreciation expense attributable to the $10 million increase in the basis of Property X related to the transaction described in paragraph (c)(1)(ii) of this section, which occurred in taxable year 2025.

(ii) *Analysis.* As part of its disclosure requirements under paragraph (f) of this section and § 1.6011–4(d) and (e), Partner A must disclose the deductions on Form 8886 (or successor form) for taxable years 2026 through 2030 as the Federal income tax consequences of the transaction described in paragraph (c)(1)(ii) of this section. As a result, for each of taxable years 2026 through 2030, Partner A must file the form with its tax return for the taxable year with the information described in paragraph (f) of this section, including the amount of the deductions for the taxable year attributable to the $10 million increase in the basis of Property X resulting from the transaction described in paragraph (c)(1)(ii) of this section.

(3) *Example 3: Reporting by a participating partner, participating partnership, and related subsequent transferee in the taxable year of the transaction*—(i) *Facts.* The facts are the same as in paragraph (g)(1)(i) of this section (*Example 1),* except that at the beginning of taxable year 2025, instead of distributing a depreciable asset, ABC Partnership distributes a nondepreciable asset, Land with an adjusted basis of $5

million, to Partner A in liquidation of Partner A's interest in ABC Partnership. The distribution is a transaction described in paragraph (c)(1)(ii) of this section. As a result of the distribution, the basis of Land is increased to $15 million in Partner A's hands. Subsequently in the same taxable year 2025, Partner A contributes Land to another partnership, AX Partnership, in a transfer that is treated as a contribution of property under section 721(a). Partner A and AX Partnership are related within the meaning of paragraph (b)(8) of this section. ABC Partnership, Partner A and AX Partnership use the calendar year as their taxable year.

(ii) *Analysis.* Partner A is a participant during taxable year 2025 within the meaning of paragraph (e) of this section because it is a participating partner within the meaning of paragraph (b)(3) of this section since Partner A directly received a distribution of property during taxable year 2025 in a transaction described in paragraph (c) of this section. ABC Partnership is a participant during taxable year 2025 within the meaning of paragraph (e) of this section because it is a participating partnership within the meaning of paragraph (b)(4) of this section since it made a distribution of property to a participating partner during taxable year 2025 in a transaction described in paragraph (c) of this section. AX Partnership is a participant during taxable year 2025 within the meaning of paragraph (e) of this section because it is a related subsequent transferee within the meaning of paragraph (b)(10) of this section since it directly received in a nonrecognition transaction a transfer of property during taxable year 2025 that was subject to an increase in basis because of a transaction described in paragraph (c) of this section. As part of its disclosure requirements under paragraph (f) of this section and § 1.6011–4(d) and (e), Partner A must disclose the distribution as a transaction of interest under this section on Form 8886 (or successor form) and file the form with its tax return for taxable year 2025. Partner A must include the information described in paragraph (f) of this section. As part of its disclosure requirements under paragraph (f) of this section and § 1.6011–4(d) and (e), ABC Partnership must disclose the distribution as a transaction of interest under this section on Form 8886 (or successor form) and file the form with its tax return for taxable year 2025, including the information described in paragraph (f) of this section. Further, AX Partnership is subject to the disclosure requirements under paragraph (f) of this section and § 1.6011–4(d) and (e). AX Partnership must disclose that it is a related subsequent transferee within the meaning of paragraph (b)(10) of this section that received, in a nonrecognition transaction, a transfer of property that was distributed in a transaction of interest under this section on Form 8886 (or successor form) and file the form with its tax return for taxable year 2025. In addition, Partner A, ABC Partnership and AX Partnership must send a copy of their respective Form 8886 (or successor form) to the OTSA.

(4) *Example 4: Reporting of the Federal income tax consequences (reduced taxable gain) of the transaction in the taxable year of disposition of the property*—(i) *Facts.* Under the same facts as in paragraph (g)(3)(i) of this section (*Example 3),* in taxable year 2026, AX Partnership disposes of Land in a taxable sale for its fair market value of $15 million and recognizes no gain or loss.

(ii) *Analysis.* As part of its disclosure requirements under paragraph (f) of this section and § 1.6011–4(d) and (e), AX Partnership must disclose the taxable gain (zero) on the disposition of Land on Form 8886 (or successor form) for taxable year 2026 as the Federal income tax consequences of the transaction described in paragraph (c)(1)(ii) of this section. AX Partnership must file the form with its tax return for taxable year 2026. Partner A does not have a disclosure requirement with respect to AX Partnership's disposition of Land because the disposition is a subsequent realization of a tax benefit within the meaning of paragraph (e)(5) of this section with respect to AX Partnership.

(5) *Example 5. Reporting of a transaction of interest that occurred within the six-year lookback period*—(i) *Facts.* The facts are the same as in paragraph (g)(1)(i) of this section (*Example 1),* except that instead of ABC Partnership distributing Property X in taxable year 2025, the distribution is made in May of taxable year 2022, which is within the six-year lookback period described in paragraph (b)(11) of this section. That is, the distribution occurred within the seventy-two months immediately preceding January 2025, the first month of the taxpayer's most recent taxable year that began before January 14, 2025. Further, taxable year 2022 is an open taxable year subject to the special rule of § 1.6011–4(e)(2)(i). Additionally, neither Partner A nor ABC Partnership engages in any other transaction described in paragraph (c) or (d) of this section for taxable year 2022.

(ii) *Analysis.* Because the transaction occurred within the six-year lookback period described in paragraph (b)(11) of this section, the applicable threshold described in paragraph (c)(3)(i) of this section is $25 million as provided in paragraph (c)(3)(ii) of this section. The distribution of Property X to Partner A is not a transaction described in paragraph (c)(1)(ii) of this section with respect to either Partner A or ABC Partnership because the applicable threshold is not met for taxable year 2022. Had the applicable threshold for taxable year 2022 been met, all the information required by paragraph (f)(1) of this section must be reported in its disclosure for taxable year 2022 and for any subsequent taxable year for which the taxpayer's return reflected the tax consequences of the transaction.

(6) *Example 6. No reporting of a transaction of interest for transaction that occurred prior to the six-year lookback period*—(i) *Facts.* The facts are the same as in paragraph (g)(1)(i) of this section (*Example 1),* except that as a result of the distribution of Property X to Partner A, the basis of Property X is increased by $30 million, and the distribution occurred in December of taxable year 2018, which is prior to the six-year lookback period described in paragraph (b)(11) of this section. That is, the transaction occurred prior to January 2019, which is the beginning of the seventy-two-month period that ends in December 2024. In addition, taxable year 2018 is an open taxable year subject to the special rule of § 1.6011–4(e)(2)(i). Further, Partner A realized Federal income tax consequences (depreciation expense) in taxable year 2019 attributable to the $30 million increase to the basis of Property X and taxable year 2019 is an open taxable year subject to the special rule of § 1.6011–4(e)(2)(i).

(ii) *Analysis.* Because taxable year 2018 is not within the six-year lookback period, under paragraph (f)(2) of this section, neither the distribution of Property X to Partner A, nor any of the Federal income tax consequences arising in that taxable year or later taxable years (such as depreciation expense in taxable year 2019 or any later taxable year) from such distribution, is required to be disclosed under paragraph (f) of this section and §§ 1.6011–4(d) and (e).

(7) *Example 7. Corresponding basis decrease under section 734(b)(2)(B) shared by an unrelated partner*—(i) *Facts.* The facts are the same as in paragraph (g)(1)(i) of this section (*Example 1),* except Partner C is unrelated to Partners A and B and is not a tax-indifferent party. As a result of the

distribution of Property X to Partner A, and the increase to the basis of Property X by $10 million in Partner A's hands, ABC Partnership is required to reduce the adjusted basis of its remaining properties under section 734(b)(2)(B) by $10 million. Partner B's and Partner C's share of ABC Partnership's basis decrease to its remaining properties is $5 million each. Neither Partner A nor ABC Partnership engages in any other transaction described in paragraph (c) of this section for taxable year 2025.

(ii) *Analysis.* For purposes of paragraphs (c)(1)(ii) and (c)(3)(i) of this section, under paragraph (c)(3)(iv) of this section, only $5 million of the $10 million basis increase to Property X counts toward the applicable threshold because $5 million of the basis increase corresponds to unrelated Partner C's share of the decrease to the basis of ABC Partnership's remaining properties under section 734(b)(2)(B) and thus, is excluded from the calculation of the applicable threshold. Thus, the distribution of Property X to Partner A is not a transaction described in paragraph (c)(1)(ii) of this section with respect to either Partner A or ABC Partnership because the applicable threshold is not met for taxable year 2025.

(h) *Extension of time—(1) Taxpayer disclosures.* Taxpayers will be treated as having met their requirements to disclose timely under § 1.6011–4(e)(2)(i) if they file their disclosure with the OTSA by July 14, 2025.

(2) *Material advisor disclosures.* Material advisors who have made a tax statement before January 14, 2025 will be treated as having met their requirements to disclose timely under § 301.6111–3(e) of this chapter if they file their disclosure with the OTSA by the date that is an additional 90 days beyond the last day for filing specified in § 301.6111–3(e) of this chapter.

(i) *Applicability date*—(1) *In general.* This section's identification of transactions that are the same as or substantially similar (within the meaning of § 1.6011–4(c)(4)) to the transactions described in paragraph (c) of this section as transactions of interest for purposes of § 1.6011–4(b)(6) and sections 6111 and 6112 of the Code is effective January 14, 2025.

(2) *Material advisors.* Notwithstanding § 301.6111–3(b)(4)(i) and (iii) of this chapter, material advisors are required to disclose only if they have made a tax statement on or after January 14, 2019.

Douglas W. O'Donnell,

Deputy Commissioner.

Approved: January 3, 2025.

Aviva R. Aron-Dine,

Deputy Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2025–00324 Filed 1–10–25; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 10022]

RIN 1545–BM41

Classification of Digital Content Transactions and Cloud Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations modifying the rules for classifying transactions involving computer programs, including by applying the rules to transfers of digital content. These final regulations also provide rules for the classification of cloud transactions. These rules apply for purposes of the international provisions of the Internal Revenue Code and generally affect taxpayers engaging in transactions involving digital content or cloud transactions.

DATES:

Effective date: These regulations are effective on January 14, 2025.

Applicability date: For dates of applicability, see §§ 1.861–18(i) and 1.861–19(e).

FOR FURTHER INFORMATION CONTACT: Christopher E. Fulle, (202) 317–5367, or Michelle L. Ng, (202) 317–6989 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Authority

These final regulations are issued under the express delegation of authority under section 7805 of the Internal Revenue Code (Code). Section 7805(a) directs the Secretary of the Treasury or her delegate to prescribe all needful rules and regulations for the enforcement of that section and others in the Code, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

Background

On August 14, 2019, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) published proposed regulations (REG–130700–14) under section 861 of the Code in the **Federal Register** (84 FR 40317) (the proposed regulations). The Treasury Department and the IRS received written comments on the proposed regulations, and a public hearing was held on February 11, 2020. All written comments received in response to the proposed regulations are available at *www.regulations.gov* or upon request. Terms used but not defined in this preamble have the meaning provided in these final regulations.

These regulations (the final regulations) extend the classification rules in existing § 1.861–18 to transfers of digital content other than computer programs and clarify the source of income for certain transfers of digital content. The final regulations also clarify the classification of transactions involving on-demand network access to computing and other similar resources.

The final regulations retain the overall approach of the proposed regulations, with certain revisions discussed in the preamble. The preamble also discusses comments received in response to the solicitation of comments in the notice of proposed rulemaking.

Summary of Comments and Explanation of Revisions

I. General Classification Issues

A. Replacement of De Minimis Rule With a Predominant Character Rule

Section 1.861–18(b)(1), as in effect before this Treasury decision, described four transactions involving computer programs: the transfer of a copyright right, the transfer of a copyrighted article, the provision of services for the development or modification of a computer program, and the provision of know-how relating to the development of a computer program. Section 1.861–18(b)(2) required any transaction that consisted of more than one of the transactions described in § 1.861–18(b)(1) to be treated as separate transactions, unless a transaction was de minimis, in which case it would be treated as part of another transaction. The proposed regulations generally retained the four types of transactions (with the expansions described in Part II.A of this Summary of Comments and Explanation of Revisions) and preserved the de minimis rule, but for clarification purposes, § 1.861–18(b)(2) was proposed to be modified by introducing the term