Income Tax Consequences of Funding a Bequest: Specific, Pecuniary, and Residuary Distributions

WEDNESDAY, AUGUST 11, 2021, 1:00-2:50 pm Eastern

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August 11, 2021

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Income Tax Consequences of Funding Bequests

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What We’ll Cover – Income Tax Consequences of Funding Bequests

• Background
• Bequests – 6 Issues
  – Does the Distribution Carry Out DNI?
  – If DNI Carried Out, How Much?
  – Is the Estate/Trust Required to Recognize Gain?
  – Can the Estate/Trust Elect to Recognize Gain?
  – What is the Basis of Property to Distributee Beneficiary?
  – What is the Holding Period for Distributee Beneficiary?
• Specific Bequests
• Funding and the §267 Related Party Rules
• §1223(2) Holding Period
• §643(e) Election/Planning Possibilities
• IRD and Separate Share Rule
Income Taxation of Trusts and Estates - Background

- Income Taxed to Either Entity or Beneficiary
  - If income is *accumulated* and not deemed distributed, it is taxed to the trust or estate
  - If income *distributed*:
    - Trust gets deduction for amount of distribution, limited to DNI
    - Beneficiary accounts for income distributed on his own tax return, limited to DNI
Distributable Net Income (DNI) Governs:

- Amount of trust or estate’s distribution deduction
- Amount beneficiary accounts for on his own return
- Character of income in beneficiary’s hands
Income Taxation of Trusts and Estates

DNI acts as ceiling on entity’s distribution deduction

Trust/Estate

DNI acts as ceiling on amount beneficiary accounts for on his return

Beneficiary
DNI - Sec. 643(a)

- Start with Taxable Income and . . .
  - Add back the distribution deduction
  - Add back the personal exemption
  - Subtract out capital gains/add back capital losses allocable to principal (except in the year of termination)
  - Subtract out extraordinary dividends and taxable stock dividends allocated to corpus for simple trust
  - Add back net tax-exempt income
DNI–Sec. 643(a)

• Note: Capital Gains Generally Taxed to Trust or Estate
  – Exceptions:
    • 3 situations under Reg. 1.643(a)-3
    • Paid to or set permanently set aside for charity. Reg. 1.643(c)
    • Year of termination

• Note: The Rules Regarding DNI and the Distribution Deduction Are Applied Differently to Simple Trusts versus Complex Trusts and Estates

• Distributions of Principal As Well As Income Will “Carry Out” DNI
  – Exception: Specific bequests under Sec. 663(a)(1)
Distributions—Simple Trust

Beneficiary Taxed on Lower of TAI or DNI

Gains Taxed to Trust

Trust Gets Distribution Deduction
Equal to DNI

Beneficiary Accounts for DNI

Trust Income Retains its Character in
Beneficiary’s Hands

Simple Trust

Gains

DNI

Beneficiary
Distributions–Complex Trusts and Estates

Trust/Estate Accumulates Income

Gains and DNI Taxed to Trust

Complex Trust

Gains

DNI
Distributions – Complex Trusts and Estates

Beneficiary Taxed on Distributions up to DNI

Gains Taxed to Trust

Trust Gets Distribution Deduction Equal to Distributions up to DNI

Beneficiary Accounts for Distributions up to DNI

Trust Income Retains its Character in Beneficiary’s Hands
FUNDING BEQUESTS “IN KIND” - 6 ISSUES

• Does the distribution carry out DNI?

• If DNI carried out, how much?

• Is the Estate/Trust required to recognize gain?

• Can the Estate/Trust elect to recognize gain?

• What is the basis of property to distributee beneficiary?

• What is the holding period for distributee beneficiary?
FACTS

- Funding trust makes a specific bequest of $100,000 painting to A
- Funding trust distributes balance to marital and family trust
- Marital is pecuniary formula bequest and family trust is residuary bequest
- Value of Funding trust is $2,100,000
- Marital and family trust each get $1,000,000
- Fund both trusts “in-kind” with 25,000 shares of stock
  - Basis of stock: $20/sh
  - FMV of stock: $40/sh
- Shares have long-term holding period in funding trust
- Painting distributed to A and marital trust funded in 2018
- Family trust funded in 2019
- Funding trust DNI is $150,000 in 2018, $75,000 in 2019
- Separate share rule applies
2018 DNI = $150,000

Funding Trust

- $1MM Pecuniary Bequest
- $1MM Residuary Bequest

Marital Trust
- $100,000 Painting to A

Family Trust
- $100,000 Painting
- 50,000 sh of stock
  - $40/sh FMV ($2,000,000)
  - $20/sh Basis ($1,000,000)
THREE TYPES OF BEQUESTS

• Specific bequest

• Pecuniary bequest

• Residuary (or fractional) bequest
2018 DNI = $150,000

- Funding Trust
  - $100,000 Painting to A
  - $1MM Pecuniary Bequest
  - Marital Trust
    - HP $100,000
      - HP Carryover
  - Family Trust
    - $1MM Residuary Bequest

DNI 0
Gain 0
Basis $100,000
SPECIFIC BEQUESTS

• Not part of distribution system if distribution is:
  – Specific property or a specific sum of money
  – Paid all at once or in not more than three installments
  – Not paid from income
Funding Trust

2018 DNI = $150,000

Marital Trust

$1MM Pecuniary Bequest

Family Trust

$1MM Residuary Bequest

$100,000 Painting to A

Each trust gets 25,000 sh of stock with FMV of $1,000,000 and basis of $500,000
2018 DNI = $150,000

Funding Trust

- $100,000 Painting to A
- $1MM Pecuniary Bequest

Marital Trust

- $75,000
- $500,000
- $1,000,000

Family Trust

- $1MM Residuary Bequest

DNI: 0
Gain: 0
Basis: $100,000
HP: HP Carryover
New HP: $100,000

Amount of DNI carried out is $40/share or $1,000,000, limited to trust’s $75,000 share of DNI
2018 DNI = $150,000

Funding Trust

$100,000 Painting to A

$1MM Pecuniary Bequest

Marital Trust

Family Trust

$1MM Residuary Bequest

DNI 0 $75,000

Gain 0 $500,000

Basis $100,000 $1,000,000

HP HP Carryover New HP

Why does it carry out DNI? Isn’t it a specific bequest???
2018 DNI = $150,000

Funding Trust

$100,000 Painting to A

$1MM Pecuniary Bequest

Marital Trust

Family Trust

$1MM Residuary Bequest

DNI 0 $75,000
Gain 0 $500,000
Basis $100,000 $1,000,000
HP HP Carryover New HP

Marital trust gets 25,000 sh of stock with FMV of $1,000,000 and basis of $500,000
Funding Trust

$100,000 Painting to A

$1MM Pecuniary Bequest

Marital Trust

2018 DNI = $150,000

$75,000

$500,000 gain taxed to Funding Trust

Family Trust

$500,000

$1MM Residuary Bequest

DNI 0

Gain 0

Basis $100,000

HP HP Carryover

New HP

$1,000,000
§267 – LOSS DENIED ON SALE TO RELATED PARTY

• Relevant if:
  
  – Fiduciary funds a pecuniary bequest with an asset whose basis exceeds its FMV
  
  – Fiduciary incurs loss as a result of a §643(e) election
§267 – LOSS DENIED ON SALE TO RELATED PARTY

• Result:
  • Loss not lost forever
  • Gain not recognized on subsequent sale to extent of previously disallowed loss
  • Fiduciary must maintain two sets of cost basis for the same asset
    – For loss purposes, the date of distribution value is the asset’s cost basis
    – For gain purposes, the estate tax value is the asset’s cost basis
    – If the subsequent sales price is between the date of distribution value and the estate tax value, neither a gain nor a loss is recognized
§267 – LOSS DENIED ON SALE TO RELATED PARTY

- Related Parties:
  - Fiduciary of trust and fiduciary of another trust with same grantor §267(b)(5)
  - Fiduciary and beneficiary of same trust §267(b)(6)
  - Fiduciary of trust and beneficiary of another trust with same grantor §267(b)(7)
  - After 8/5/97, Estate and estate beneficiary §267(b)(13)
    - Exception: estate funding a pecuniary bequest
2018 DNI = $150,000

Funding Trust

$100,000 Painting to A

$1MM Pecuniary Bequest

Marital Trust

DNI 0 $75,000

Gain 0 $500,000

Basis $100,000 $1,000,000

HP HP Carryover New HP

Family Trust

$1MM Residuary Bequest
§1223(2) – TACKING OF HOLDING PERIOD

Transferor’s holding period tacks onto Transferee’s holding period if the Transferee’s basis is determined in whole or in part by reference to the Transferor’s basis
2018 DNI = $150,000

- Funding Trust
  - $100,000 Painting to A
  - $1MM Pecuniary Bequest
  - Marital Trust
    - $75,000
    - $500,000
    - $1,000,000
    - New HP
  - Family Trust
    - $1MM Residuary Bequest

DNI: 0
Gain: 0
Basis: $100,000
HP: HP Carryover

$1MM Residuary Bequest
SECTION 643(e) ELECTION – RESIDUARY BEQUEST(S)

• Estate/Trust may elect, but is not required, to recognize G/L

• Distribution carries out DNI, but amount of DNI depends on whether the Section 643(e) election was made
  – No election: DNI carried out is lesser of basis or FMV of distributed property
  – Election: DNI carried out is FMV of distributed property

• Basis of property to beneficiary is basis of property to estate/trust plus or minus any gain or loss the estate/trust elects to recognize on the distribution

• Holding period tacks if basis is same “in whole or in part” as transferor’s basis, otherwise, holding period starts anew
2019 DNI = $75,000

Funding Trust

Marital Trust

Family Trust

$100,000 Painting to A

$1MM Pecuniary Bequest

DNI 0 $75,000

Gain 0 $500,000

Basis $100,000 $1,000,000

HP HP Carryover New HP

No 643(e) $75,000

No Gain

$500,000

HP Tacks

Amount of DNI carried out is $20/share or $500,000, limited to trust’s $75,000 share of DNI
2019 DNI = $75,000

Funding Trust

$100,000 Painting to A $1MM Pecuniary Bequest

Marital Trust

DNI 0 $75,000 $75,000
Gain 0 $500,000 No Gain $500,000
Basis $100,000 $1,000,000 $500,000 $1,000,000
HP HP Carryover New HP HP Tacks HP Tacks

Family Trust

$1MM Residuary Bequest

No 643(e) 643(e)

Amount of DNI carried out is $40/share or $1,000,000, limited to trust’s $75,000 share of DNI
### 2019 DNI = $75,000

<table>
<thead>
<tr>
<th></th>
<th>Funding Trust</th>
<th>Marital Trust</th>
<th>Trust Family</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>$100,000</strong> Painting to A</td>
<td></td>
<td>$1MM Pecuniary Bequest</td>
<td></td>
</tr>
<tr>
<td><strong>DNI</strong></td>
<td>0</td>
<td>$75,000</td>
<td>$75,000</td>
</tr>
<tr>
<td><strong>Gain</strong></td>
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<tr>
<td><strong>Basis</strong></td>
<td>$100,000</td>
<td>$1,000,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>HP</td>
<td>HP Carryover</td>
<td>New HP</td>
<td>HP Carryover</td>
</tr>
</tbody>
</table>

Gain taxed to family trust. **Reason:** year of termination of Funding Trust so gains are included in DNI and passed out to the beneficiary.

No 643(e) $75,000

643(e) $500,000

643(e) $1,000,000
IRD PAYABLE TO AN ESTATE OR TRUST
FUNDING SUB-TRUSTS

IRD

Trust

Marital Trust

Family Trust
SEPARATE SHARE RULE

Solely for purposes of computing DNI, substantially separate and independent shares of different beneficiaries of a trust are treated as separate trusts.

Effect: Treat multiple beneficiaries of single trust or estate as if each were the sole beneficiary of a single trust solely for determining how much DNI each distribution carries out.
A distribution will carry out DNI only to the extent there is DNI properly allocated to the beneficiary’s separate share
ISSUE: APPLICATION OF SEPARATE SHARE RULE TO IRD REG. 1.663(c)-2(b)(3)

• Final separate share regs provide that IRD “is allocated among the separate shares that *could potentially be funded* with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law.”

• “The amount of gross income allocated to each share is based on the relative value of each share that could *potentially be funded* with such amounts.”

• Result: Allocation of IRD could shift income tax liabilities to trusts protected from Federal estate tax or GST. *Docs should state that, to the extent possible, applicable exclusion amount and GST exemption should be funded with non-IRD assets.*
IRD PAYABLE TO AN ESTATE OR TRUST
FUNDING SUB-TRUSTS

$1,000,000 IRA

$1,000,000 R/E

Trust

Marital Trust

Family Trust

$1,000,000 (Fractional)

$1,000,000

IRA

R/E
IRD PAYABLE TO AN ESTATE OR TRUST FUNDING SUB-TRUSTS

IRD not allocated to one share by document

IRA

Marital Trust

Taxed on $500,000 of IRD

Trust

Family Trust

Taxed on $500,000 of IRD

R/E
IRD PAYABLE TO AN ESTATE OR TRUST
FUNDING SUB-TRUSTS

IRD allocated to Marital Trust by document

Trust

IRA

Marital Trust
Taxed on $1,000,000 of IRD

Family Trust
Not Taxed on IRD

R/E
IRD PAYABLE TO AN ESTATE OR TRUST
AFECT ON FIDUCIARY INCOME TAX CHARITABLE DEDUCTION

$1,000,000 IRA
$1,000,000 R/E

Trust

R/E
Individual
$1,000,000

Charity

IRA

$1,000,000
(Residuary or Fractional)
IRD PAYABLE TO AN ESTATE OR TRUST
AFFECT ON FIDUCIARY INCOME TAX CHARITABLE DEDUCTION

IRD not allocated to Charity by document

Trust

Trust gets only $500,000 § 642(c) deduction

R/E

Individual $1,000,000

IRA

Charity

$1,000,000 (Residuary or Fractional)
IRD PAYABLE TO AN ESTATE OR TRUST AFFECT ON FIDUCIARY INCOME TAX CHARITABLE DEDUCTION

IRD allocated to Charity by document

Trust

Trust gets $1,000,000 § 642(c) deduction

IRA

Individual

$1,000,000

Charity

$1,000,000

R/E

$1,000,000

IRD allocated to Charity by document

Trust

Trust gets $1,000,000 § 642(c) deduction

IRA

Individual

$1,000,000

Charity

$1,000,000

R/E
IRD PAYABLE TO AN ESTATE OR TRUST
ALTERNATIVE - HOW TO AVOID THE SEPARATE SHARE RULE

Have the Trust “Assign” the IRA directly to the beneficiary.*

Trust

$1,000,000

Individual

Trust gets $1,000,000 § 642(c) deduction

$1,000,000 (Residuary or Fractional)

Charity

* Authority: PLRs 200234019, 200452004, 200511174, 200520004, 200526010, 200617020, 200618023, 200620025, 200633009, 200644020, 200652028, 200803002, 200826028, 200845029, 200850004, 201013033, 201027031, 201128036, 201210045, 201210047, 201208039, 201330011, 201330011
CONCLUSION
FUNDING BEQUESTS “IN KIND” - 6 ISSUES

• Does the Distribution Carry Out DNI?

• If DNI Carried Out, How Much?

• Is the Estate/Trust Required to Recognize Gain?

• Can the Estate/Trust Elect to Recognize Gain?

• What is the Basis of Property to Distributee Beneficiary?

• What is the Holding Period for Distributee Beneficiary?
Thank You!!!