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by Russell A. Willis III

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Income Ordering Rule Shifts Benefit to Lower Generation

by Russell A. Willis III

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In this article, Willis argues that a recent letter ruling regarding a unitrust conversion should be modified or withdrawn.

Introduction

Probably some folks working at the bleeding edge of transfer tax planning would like to see a letter ruling that says you can convert a multigenerational income trust to a unitrust, with an ordering rule allocating realized gains to income, without impairing the status of the trust as exempt from the generation-skipping transfer tax.

More precisely, they would like a letter ruling that says you can do this in some scenario that falls outside what seems to be a safe harbor in reg. section 26.2601-1(b)(4)(i)(D)(2), discussed more later. And they would like it in a nonjudicial modification, if state law permits, without seeking the approval of a state court.

At first glance, LTR 201825007, released June 22, 2018, might appear to be exactly that. But the ruling gives not even a cursory analysis to the central question: whether the proposed modification would shift a beneficial interest in the trust to a beneficiary in a lower generation. It fails altogether to discuss what is evidently a significant reduction in the unitrust payout rate,[1] and it dismisses the ordering rule as merely "administrative in nature."

Also, the ruling seems to treat the proposed modification as falling squarely within Example 11 under reg. section 26.2601-1(b)(4)(i)(E), the putative safe harbor, despite a "no rule" policy on "comfort" rulings that has been in place since 2007.[2]

There are issues with the underlying regulation itself, which I explore further below. But even accepting that the regulation — finalized in 2004 — expresses the current state of the law, the letter ruling should be modified or withdrawn.

Don't Know Much About History

It took at least 18 months and some correspondence to secure the result, but if any of that correspondence involved altering the terms of the proposed modification or withdrawing one or more ruling requests, there is no indication of that in the final text.

The trust was created under the will of someone who died before the 1985 effective date of the GSTT in its present form, and thus was

[1] Although the text of the letter ruling as released redacts the "before" and "after" unitrust percentages, and the word "reduce" is not used, we know from the 2001 ruling discussed later that the "before" rate was 6 percent, and we are told that the "after" rate is within the safe harbor under reg. section 1.643(b)-1, which is 3 to 5 percent. One might have thought that this modification alone — reducing the amount of the payout to the current beneficiaries — would have been a sufficient ground for the IRS to deny the requested ruling. Clearly a reduction in the amount distributable currently will increase the amount held for distribution to lower generations.

[2] In Rev. Proc. 2007-3, 2007-1 C.B. 108, section 3.01(58), the IRS instituted a policy not to give advance determinations on whether the modification of a pre-1985 trust would cause it to lose its exempt status, "in a factual scenario that is similar to a factual scenario set forth in one or more of the examples" in the regulation. The most recent reiteration of that "no rule" policy is at Rev. Proc. 2018-3, 2018-1 IRB 130, section 3.01(104).

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grandfathered. The trustee was to distribute net income only, half to the testator's daughter and half among the daughter's three children or the descendants of a deceased grandchild. Upon the death of the survivor of these four, the trust was to be divided into separate trusts for each line of descent, with net income to be distributed among descendants until the expiration of the perpetuities period, when the remainder of each trust was to be distributed outright to whoever was left standing, and otherwise to the decedent's heirs.

This is the second letter ruling concerning this trust. In 2001, simpler times, the trustee had obtained a letter ruling to the effect that a judicial modification requiring the trustee to distribute the greater of net income or a 6 percent unitrust amount would not affect the trust's grandfathered exempt status. LTR 200150016 cited Example 8 under reg. section 26.2601-1(b)(4)(i)(E), which is directly on point. The "greater of" formulation can only benefit the current income beneficiary at the expense of lower generations.[3]

But at the time, we were not yet talking about shifting the incidence of income tax on realized gains.

For deeper background: The trust was initially funded entirely with closely held stock, and the trustee was instructed not to sell until the expiration of the perpetuities period. That arrangement did not last. At some point the trustee secured an order from a state court authorizing a sale of the stock due to changed circumstances, not specified in the text of the 2001 letter ruling.

We cannot know the dividend-paying history of the closely held corporation, but one may readily imagine it was considerably less than 6 percent. So the purpose of the "greater of" unitrust payout may have been to effect a sort of retroactive adjustment to the income beneficiaries.

Time Has Come Today

The 2001 ruling request was submitted just a few weeks after Treasury had published a notice of proposed rulemaking to revise the definition of income under section 643(b), to allow for the reasonable apportionment of total return between income and principal in determining what amounts would be deductible by the trust and taxable to the current distributees.[4]

This may seem like a digression because the definition of income was not an issue in the 2001 letter ruling, but bear with me for a moment.

Ostensibly, the regulation project was initiated in response to two emerging trends in state legislation that threatened to undermine existing regulatory mechanisms designed to tax realized gains to the trust, even when amounts exceeding ordinary income were distributed to the income beneficiary, unless there was economic substance to treating these as having actually been distributed.

More than a dozen states had already enacted the 1997 revision to the Uniform Principal and Income Act (UPAIA), and the legislation was pending in another dozen. Section 104 of the UPAIA allows a fiduciary who is investing for total return as a prudent investor to make equitable adjustments of receipts and disbursements between income and principal accounts if it would otherwise be unable to balance impartially the competing interests of income and remainder beneficiaries.

Those are inherently fact-intensive questions,[5] and as discussed below, the existing regs had already adequately dealt with the discretionary allocation of realized gains to distributable net income.

[3] In other words, this was essentially a "comfort" ruling. The state court order approving the modification had already been entered and had not been made contingent on a favorable ruling from the IRS. That is to say, LTR 200150016 would in theory not be issued today. However, because the reg literally applies only to pre-1985 trusts, the IRS still routinely issues letter rulings on analogous questions regarding post-1985 trusts that are said to have zero inclusion ratios.

[4] At the time of the 2001 ruling request, the daughter had died, as had one of the three grandchildren, with that grandchild survived by three children. The two remaining grandchildren and the three great-grandchildren would have been receiving distributions of current income, apparently in per stirpital shares, but this not made entirely clear in the text of the ruling. At the time of the 2016 ruling request, another of the grandchildren had died, without issue surviving. The remaining grandchild did not have children. He and the three great-grandchildren are the current income beneficiaries. After his death, the trust would continue for 21 more years, and if he is not survived by descendants, the remainder would then be distributed among the three great-grandchildren or their respective descendants, per stirpes.

[5] The drafters' commentary to section 104 makes reasonably clear that it is intended that the trustee exercise the power to adjust as circumstances arise, rather than implement a blanket rule that would, for example, allocate realized gains to income as a regular practice.

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This Far and No Further

But a handful of states had begun to take the next logical step, allowing a trustee to convert a trust that was required to distribute current income into a straight unitrust, typically 4 percent, and usually with a "smoothing" rule calculating the unitrust payout with reference to a rolling average of asset values over three to five years. This model obviates the problem of equitable adjustment altogether, allowing the trustee to focus its attention on total return.[6]

The existing reg. section 1.643(b)-1 had defined income with reference to applicable local law. If the trust document defined income in a manner that "departed fundamentally from concepts of local law in the determination of what constitutes income," this would be disregarded; that is, the distributions deduction would be limited to income as defined by state principal and income statutes.[7]

But if local law was now itself starting to depart from what in the preamble to the proposed regs Treasury called "traditional concepts of income and principal" — that is, "allocating ordinary income to income and capital gains to principal" — we were going to need some other mechanism to prevent the manipulation of what amounts would be deductible by the trust as distributable net income.[8]

And we were going to have to set some rules on how an equitable adjustment or a conversion to a unitrust payout might affect the eligibility of an income trust for a gift tax or estate tax marital deduction as qualified terminable interest property, or the calculation of an income tax charitable deduction under section 642(c). Or, as relevant here, the continued exemption of a grandfathered trust or a trust with a zero-inclusion ratio from the GSTT.

Let us pause to sort apples from oranges, which arguably was not done in the proposed regs that were finalized in January 2004 without significant change on these basic questions.[9]

Half the Problem Is Seeing the Problem

First, a power to adjust does not redefine income. It simply permits the trustee to allocate receipts or disbursements from one account to the other as necessary to effect impartiality between the income and remainder beneficiaries. An allocation of unrealized appreciation or realized gain or loss to income is still an allocation from principal.

So when the proposed revision to reg. section 1.643(b)-1 says that an allocation of realized gains to distributable net income in accordance with a power to adjust will be respected if three conditions are met, we are already setting off on the wrong foot.

The stated conditions are (1) that the trustee is in fact managing the trust as a prudent investor,[10] (2) that the trust document describes the amount to be distributed with reference to "income," and (3) that the trustee has determined that it is unable to balance the interests of the income and remainder beneficiaries impartially without making the adjustment.[11]

And those are paraphrased directly from section 104(a) of the uniform act. But that section deals only with the decision to make a compensating distribution or allocation of trust assets. It does not purport to — nor could it

[6] At the time of this writing, more than 30 states have enacted legislation allowing a trust to convert an income trust to a unitrust payout. Nearly all those statutes include a default ordering rule, allocating realized gains to income — short-term first, then long-term — to the extent the stated unitrust amount exceeds net fiduciary accounting income, though in several states the ordering rule is not mandatory. Just this past July, acknowledging they are late to the game, the Uniform Law commissioners approved a final draft of a complete revision of the UPAIA, which includes a mechanism for converting an income trust to a unitrust. The UPAIA does not include an ordering rule, but it does permit the trustee, in making the conversion, to set one.

[7] The example given in the former reg was to the effect that if the trust document itself allocated ordinary dividends and interest to corpus, the trust would not be treated as a simple trust under section 651. This example was omitted from the 2001 notice of proposed rulemaking but reinstated without comment in T.D. 9102.

[8] Or as Treasury expressed the point in the preamble to T.D. 9102, "The definition of income under the terms of the governing instrument and applicable local law must not depart fundamentally from traditional concepts of income and principal, if the desired federal tax treatment is to be secured." The desired tax treatment generally is to tax realized gains to the trust, even when amounts that exceed ordinary income are distributed to the income beneficiary, unless there is economic substance to treating these as having actually been distributed.

[9] T.D. 9102.

[10] This has something to do with modern portfolio theory. See the prefatory comments to the Uniform Prudent Investor Act, 1994. This in itself would seem to be a question of facts and circumstances.

[11] Oddly, in the final regs, the word "generally" is inserted at the head of the sentence enumerating the three conditions for the exercise of a power to adjust. This could imply that an allocation of realized gains to income might be respected even if the state statute authorizing adjustments does not impose these conditions.

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directly — allocate any portion of the tax burden of realized gains to the income distributee.[12]

Implicitly acknowledging that fact, section 506 of the uniform act allows the trustee to "make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries" arising from tax elections, from "phantom" income from passthrough entities, and as relevant here, from taxes imposed on either the fiduciary or a beneficiary "as a result of a transaction involving or a distribution from [the] trust."

In other words, if the trust incurs a tax on realized gains, some portion of which were in effect distributed to the income beneficiary through the exercise of a power to adjust, the trustee might make a downward adjustment to the income account to compensate the remainder beneficiary. Or she might not. The adjustment is permissive, not mandatory. And it is emphatically not a matter of recharacterizing the tax attributes of a distribution.

The Sheltering Sky

On the other hand, it might appear that redefining income as a unitrust amount does change the definition — certainly it "departs from traditional concepts." But absent an ordering rule it does not in itself imply anything about the allocation of realized gains for purposes of tax reporting.

And this is where we get to what seems to be the actual crux of the regulation project: a unitrust payout with an ordering rule. All this confused talk about a power to adjust may have just been a stalking horse.

The 2004 revision to reg. section 1.643(b)-1 says that an allocation of realized gains to a unitrust payout between 3 and 5 percent[13] will be respected as a per se reasonable apportionment of total return, if the allocation is made according to a statutory ordering rule.[14]

This is a safe harbor. Everything else — the power to adjust, the unitrust payout without an ordering rule — is still facts and circumstances, as it had been under the existing regs.[15]

The existing reg. section 1.643(a)-3 had already dealt with the allocation of realized gains to income by requiring that any such allocation be made "under the terms of the governing instrument" or state law; that it actually be distributed, typically as part of a staged distribution of principal; or that it reflect the method by which the amount to be distributed is determined, either under the terms of the instrument or through a regular practice followed by the trustee.

And the 2004 revisions to the substantive text of this section are largely a matter of clarifying the existing reg. The allocation of realized gains to income under a power to adjust is not mentioned at all. Significantly, the question of allocating realized gains to a unitrust payout appears, not in the substantive text, but only in the examples.

Specifically, Example 11 says that when a state statute permits the trustee to convert an income trust to a 4 percent unitrust, with an ordering rule allocating realized gains to the distributee to the extent the unitrust payout exceeds ordinary income, this will be respected. Period.

To emphasize the point, Example 13 says that if neither the statute nor the trust instrument has an ordering rule, the trustee may nonetheless allocate realized gains to the distributee to the

[12] In proposing and finalizing these regs, Treasury seems to have lost sight of the principle, dating back at least as far as *Helvering v. Clifford*, 309 U.S. 331 (1940), that while state law defines the legal and equitable relations between the trustee and the beneficiaries, the tax consequences of a distribution are determined by the federal tax code.

[13] The proposed revision to reg. section 1.643(b)-1 specified that a unitrust payout between 3 and 5 percent was per se a reasonable apportionment of total return. In finalizing the regs three years later, responding to public comments, Treasury extended the permissible range to include the endpoints, 3 and 5 percent.

[14] In the absence of an ordering rule, the reg says such an allocation will be respected if it is made under "a reasonable and impartial exercise of a discretionary power," unless this is expressly "prohibited by applicable local law," which of course is not the direction we are headed.

[15] The final regs included language at reg. section 1.643(b)-1 — although it does not appear from the preamble to T.D. 9102 that any commentators had requested it — to the effect that if state statutes provide a mechanism for converting from an income trust to a unitrust, the transaction will not be treated as a recognition event under section 1001, nor as a gift either by the settlor or from one beneficiary to another. But absent an express statutory mechanism — for example, if the conversion to a unitrust must be accomplished through a judicial or nonjudicial reformation — the transaction might be treated as a recognition event or a taxable gift, depending on facts and circumstances. This further safe harbor does not itself seem to be limited to a conversion to a unitrust paying between 3 and 5 percent. The trustee who sought LTR 200150016 did not ask for a ruling on whether the conversion from income only to the greater of income or a 6 percent unitrust would be treated as a recognition event or a taxable gift, and of course the IRS did not volunteer any comment.

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extent the unitrust payout exceeds ordinary income, if this is in fact a reasonable exercise of the trustee's discretion and the trustee intends to pursue this as a consistent policy in other years. Facts and circumstances.

Example 12 says that in the same situation the trustee could equally decide not to allocate realized gains to the unitrust payout, again provided this was a reasonable exercise of discretion and a consistent policy.[16] Again, facts and circumstances.

What might make the exercise reasonable or unreasonable is not indicated. One might note that if realized gains are routinely taxed to the income beneficiary, this would tend to justify a higher unitrust payout rate, and vice versa; a subtlety that is apparently beyond the scope of the regulatory project.

All of This and Some of That

But to return to the matter at hand: whether the conversion to a unitrust with an ordering rule does or does not shift a benefit to a lower generation for purposes of the grandfathering transition rule accompanying the 1986 revisions to the GSTT.

To lay the groundwork for the 2016 ruling request, the trustee had changed the situs of the trust to a state that had a unitrust conversion statute with an ordering rule. How the change in situs was accomplished, whether the beneficiaries were required to consent, etc., is not mentioned in the text of the ruling.[17]

As mentioned at footnote 4, we are now down to one grandchild, himself childless, who is presumably receiving half the income, and three great-grandchildren, who are each receiving one-third of the other half. After the death of the remaining grandchild, the trust will continue for 21 more years, and the remainder will then be distributed among the three great-grandchildren or their respective descendants, per stirpes.[18]

If one or more of the great-grandchildren dies before that date, survived by yet more remote descendants, and if the trust has pushed the liability for tax on realized gains out to the income beneficiaries without a compensating increase in the unitrust payout — quite the contrary, at least a 1 percent decrease — we will have shifted a beneficial interest to someone who occupies a lower generation than those who held beneficial interest before the modification, per reg. section 26.2601-1(b)(4)(i)(D)(1).

The question is to what extent that result is actually countenanced by the regs, or would be if we disregard the decrease in the unitrust payout.

Consulting the Cards

T.D. 9102 added a rather lengthy sentence to reg. section 26.2601-1(b)(4)(i)(D)(2) — which is to say, to the subparagraph dealing with whether the judicial or nonjudicial reformation of a trust outside the context of a live controversy[19] will "shift a beneficial interest" to a lower generation, causing the trust to lose its grandfathered exempt status — and two new examples to reg. section 26.2601-1(b)(4)(i)(E).

The existing text of subparagraph (D)(2) said that if a modification might result in an increase in the amount of a generation-skipping transfer, it would be presumed to shift a beneficial interest to a lower generation. There was already an exception in this subparagraph for a "modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes)."

[16] Omitted from these examples is the case in which the state statute does not impose an ordering rule, but the trust instrument does. As noted at footnote 6, this would be the situation with a conversion under the 2018 revision of the uniform act. An allocation of realized gains to income under such a statute would not come within the safe harbor of Example 11, and even if the allocation were consistent, it would meet the requirements of Example 13 only if it were reasonable.

[17] But as the author of the letter ruling notes, it does not matter. Example 11 under reg. section 26.2601-1(b)(4)(i)(E) expressly states that the stated conclusion, that the conversion from one definition of income to another, provided it conforms to state law, will not disturb the trust's exempt status, "would be the same if the beneficiaries' consent was not required" — or even if the change of situs was from a state that had a unitrust conversion statute to one that defined trust income in a more traditional manner.

[18] It is likely none of the great-grandchildren was alive at the testator's death, or presumably they would have been included as measuring lives for the perpetuities period.

[19] This is something of a shorthand. To be more exact, subparagraph (A) deals with the trustee's exercise of a discretionary power to decant or to delay distribution; subparagraph (B) deals with the court-approved settlement of a bona fide controversy; and subparagraph (C) deals with the judicial construction of a trust instrument to resolve an ambiguity or to correct a scrivener's error. Subparagraph (D), which we are concerned with here, deals with trust modifications under other circumstances.

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The sentence added in 2004 says, in effect,[20] that the conversion to a unitrust payout:

> will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of [reg. section] 1.643(b)-1.

The phrase "and meets the requirements" seems redundant, as the literal requirement of the cited reg is that applicable state law provide for a "reasonable apportionment." The reg says, for example, a statute defining income as a unitrust payout between 3 and 5 percent is reasonable, apparently per se.

But what should we infer from the fact that we do not also see a cross-reference here to reg. section 1.643(a)-3? It is in that section, not reg. section 1.643(b)-1, that there is a discussion of allocating realized gains to income. On its face, reg. section 26.2601-1(b)(4)(D)(ii) says nothing about an ordering rule. Nor does the putative safe harbor at Example 11.

Only Indirect

That is perhaps why the ruling instead cites the exception for a modification that is merely administrative in nature. The text does not flesh out that argument, but simply states as a summary conclusion that the imposition of an ordering rule meets this description.

We need not construct a straw man to suppose that the argument must somehow be that the shifting of the tax burden on realized gains is merely an indirect consequence of the ordering rule. But what then is the direct consequence? After all, the unitrust payout is the same.

The direct consequence is that the income distributee pays tax that would otherwise have been paid by the trust, and the amount transferred to succeeding generations is thereby increased. If the argument is more subtle — say, that shifting the tax burden on realized gains to the income distributee allows the trustee to skew investments more heavily to growth stock — this should be at least sketched in the stated rationale of the ruling.

Let's take a step back.

The exception for a modification that is merely administrative was added to the reg in December 2000,[21] as part of an earlier, unrelated regulatory project. The proposed reg[22] had simply framed a blanket exception for modifications that did not in fact shift a benefit to a lower generation or extend the time for vesting. Commentators asked for additional guidance, and paragraph (D)(2) is what they got, plus three further examples at paragraph (E). And those examples are instructive.

Example 8 somewhat anticipated the later regulatory project by illustrating the conversion of an income trust to a unitrust payout. But note that the example contemplates a payout to the income beneficiary of the greater of fiduciary accounting income or the stated unitrust amount. As noted above, that was the example cited in LTR 200150016.

Example 9 does talk about modifying a trust to allocate realized gains to income, but only in a context in which this has the effect of increasing the amount distributed. Again, the text of the example notes that this modification "can only have the effect of increasing the amount distributable to [the current distributee], and decreasing the amount distributable to" lower generations."

Example 10 is the only example that expressly refers to the exception for administrative changes. The example given is a reduction in the number of trustees, which has the indirect effect of reducing administrative expense, thereby at least marginally increasing the amount ultimately distributable to lower generations.[23]

The example illustrates a modification that clearly does have a meaningful direct

[20] The qualifier "in effect" is used here because this sentence does not itself refer directly to a conversion, but it occurs in reg. section 26.2601-1(b)(4)(i)(D)(2), which is more generally about modifications. Also, the sentence includes reference to a power to adjust, which is not our immediate concern. Similarly, this article focuses only on Example 11 under reg. section 26.2601-1(b)(4)(i)(E), which involves a conversion to a unitrust, whereas Example 12 involves equitable adjustments.

[21] T.D. 8912.

[22] REG-103841-99.

[23] Under most principal and income statutes, the income beneficiary would also benefit from a reduction in administrative expenses, which are typically allocated half to income and half to principal.

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consequence, and to which the shifting of a beneficial interest to a lower generation is in fact merely incidental. There is a stark contrast between that scenario and the modification of an income trust to impose an ordering rule on a unitrust payout — specifically for the purpose of shifting the incidence of the tax on realized gains.

Supper's Ready

When you have a fixed unitrust payout, the shifting of the tax incidence on gains you would have realized anyway has no independent economic effect. Forget taxes, you are investing for total return. Yes, you must distribute a fixed percentage of trust corpus at intervals, current income or no, but all that means is your portfolio must include a cash reserve. Which in turn means that you will probably have to harvest some gains, but that does not necessarily imply anything about the source from which income tax on realized gains should be paid.

The 2004 revision to reg. section 1.643(a)-3 says it is per se reasonable to treat a unitrust amount between 3 and 5 percent as carrying out distributable net income. And Example 11 under that reg says that a statutory ordering rule allocating realized gains to the unitrust payout is per se a reasonable apportionment of total return — a safe harbor that might almost be seen as an application of the "regular practice" exception under the existing reg.[24]

But that reg does not expressly deal with the possible collateral tax consequences of modifying an existing income trust to effect a unitrust payout. For this we turn to the revision to reg. section 1.643(b)-1, which says a switch between methods for determining income, both of which are expressly authorized by state statute, will not be treated as a recognition event, nor as a taxable gift, whereas "a switch to a method not specifically authorized by state statute" but nonetheless valid under state law might, depending on facts and circumstances.

And it is only when we get to reg. section 26.2601-1(b)(4) that we begin to look the question whether a switch between methods might be treated as a constructive addition to a grandfathered exempt trust.[25]

Again, paragraph (D)(2) cross-references only reg. section 1.643(b)-1, which allows for redefining income as a unitrust amount, but not reg. section 1.643(a)-3, which deals with the allocation of realized gains to income. And Example 11, the putative safe harbor, makes no mention of an ordering rule.

It is one thing to say that converting an income trust to a unitrust payout between 3 and 5 percent accomplishes a reasonable apportionment of total return. It is quite another to say that shifting the incidence of income tax on realized capital gains to the income distributee does not shift a beneficial interest to a lower generation.[26] It is a stretch to say that a modification effecting this shift is merely administrative.

And it is a flat-out mistake to say that reducing the payout from the greater of fiduciary accounting income or a unitrust amount of 6 percent to a straight unitrust amount of 5 percent, or possibly as little as 3 percent, does not shift a benefit. ■

[24]Except Example 13 requires, in the absence of a state statute imposing an ordering rule, that the reasonableness of an identical allocation be justified by facts and circumstances.

[25]The prefatory language to paragraph (b)(4)(i) expressly disclaims any inference regarding "for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of gain" — that is, unless specifically noted, as in Example 11.

[26]At least for that portion of the tax that could not have been charged to the income account in the exercise of an equitable adjustment power.

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