Professor Reinsein
Spring 2001
College of Business
Administration & Economics
CSUN

BUSINESS 635 TAX
INCOME TAXATION
OF
TRUSTS AND ESTATES

TEXTS:

Federal Income Taxation of Trusts and Estates;
2000 Supplement Thereto in Binder Format (Handout or Download from Web)
Authors: Ascher, Mark L.

(Commerce Clearing House or Prentice Hall, most recent edition)

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FINAL

The class will be graded on the plus/minus (+/-) basis (i.e., A, A-, B+, B-, C+, etc.).

There will be a final exam only. This exam, along with class participation, will be the basis for your grade in this course.

Additional Requirements: You are responsible for all problems that you encounter as you go through the chapters. The problems are interspersed throughout the chapters and should be dealt with as you reach them since they will be discussed in class.
2000 Supplement

to

Federal Income Taxation of Trusts and Estates:
Cases, Problems, and Materials
(Second Edition)

Mark L. Ascher

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PREFACE

This supplement deals with developments I would have included in the casebook, had it gone to press in December 1999.

Anyone who uses the casebook in class may reproduce this supplement for distribution to his or her students at cost.

This was my last semester at the University of Arizona. Beginning next month, I shall be at the University of Texas at Austin.

Mark L. Ascher

Tucson, Arizona
December 12, 1999
There are new editions of several of the recommended readings:


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

Regarding the reading assignment:

In the assigned readings, substitute Treas. Reg. §301.7701-6(b) for Treas. Reg. §301.7701-6, which has been revised. Delete Treas. Reg. §301.7701-7, which has been removed. T.D. 8697, 1997-2 I.R.B. 11.

At the end of note 4, add the following:

The Technical and Miscellaneous Revenue Act of 1988 enacted section 468B(g), dealing with "escrow accounts," "settlement funds," and "similar funds." According to the I.R.S., Rev. Rul. 71-119 and Rev. Rul. 70-567 are, therefore, now obsolete. Rev. Rul. 92-51, 1992-2 C.B. 102. Section 468B(g) states: "Nothing in any provision of law shall be construed as providing that" such an arrangement "is not subject to current income tax." Congress, however, left it to the regulations to determine whether any given account or fund was taxable "as a grantor trust or otherwise." Prior to promulgation of pertinent regulations, the Tax Court, in *Johnson v. Commissioner*, 108 T.C. 448 (1997), aff'd in part and rev'd in part, 184 F.3d 786 (8th Cir. 1999), relying on legislative history, determined that investment income from amounts held in escrow by an automobile dealer, in connection with multi-year vehicle service contracts, was taxable directly to the dealer, as grantor, under section 677. In REG-209619-93, 1999-10 I.R.B. 28, the I.R.S. announced proposed regulations under section 468B(g).

In line 15:

Substitute "[predecessors of Treas. Reg. §§ 301.7701-2 and -4]" for "[predecessors of Treas. Reg. § 301.7701-2]."
Page 24. In line 1 of note 1:
Substitute "For years, former Treas. Reg. § 301.7701-2(a)(1) listed" for "Treas. Reg. § 301.7701-2(a)(1) lists".

Page 24. In line 5 of note 1:
Substitute "Former Treas. Reg. § 301.7701-2(a)(2), however, stated" for "Treas. Reg. § 301.7701-2(a)(2), however, states".

Page 25. In line 17 from the bottom of note 1:
Substitute "[Former] Section 301.7701-2(a)(3)" for "Section 301.7701-2(a)(3)".

Page 25. At the end of note 1, add the following:

The much-heralded check-the-box regulations finally appeared as proposed regulations in 1996 and became final later that same year. T.D. 8697, 1997-2 I.R.B. 11, corrected, Ann. 97-43, 1997-17 I.R.B. 19. Though the new regulations drastically alter the categorization of business entities, they have little effect on the definition of a "trust" for tax purposes. Treas. Reg. § 301.7701-4(a), which defines a trust as an arrangement whose beneficiaries are "not associates in a joint enterprise for the conduct of business for profit," is unamended. Thus, the explanation accompanying the new regulations states that the test for whether an entity is taxable as a trust remains the same:

An organization that is recognized as a separate entity for federal tax purposes is either a trust or a business entity . . . . The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations.

1997-2 I.R.B. at 12. If, however, under the usual two-part test, an entity is not taxable as a trust, the new regulations generally allow classification as either a partnership or a corporation.

Page 26. At the end of the page, add the following:

4. In Private Letter Ruling 9547004 (1995), six grandchildren pooled their own funds with those of two of their grandparents to create a trust that would terminate upon the death of the last to
die of all eight. The Service determined that the participants were "associates who ha[d] pooled their assets with an object to carry on business and divide the gains therefrom." The Service therefore ruled that the trust was instead taxable as an association.

Page 28. At the end of the last full paragraph, add the following:

Upon finalization of the proposed regulations on the application of the separate share rule to estates, Rev. Rul. 71-167 will be obsolete. REG-114841-98, 1999-11 I.R.B. 41, 42 (proposing new Reg. §§ 1.663(c)-4 and 1.663(c)-6 and proposing amendments to Reg. §§ 1.663(c)-1 to 1.663(c)-5).

Page 31. Immediately before Section B, insert the following:

In Estate of Machat v. Commissioner, 75 T.C.M. (CCH) 2194 (1998), a temporary estate administrator received distributions from a qualified retirement plan but claimed they were not taxable upon receipt because of the administrator's limited powers under local law. The court disagreed, holding that the estate was taxable on the distributions in the year the temporary administrator received them, under the usual rules. The court noted that the temporary administrator could, and did, use the funds to pay various estate liabilities, including taxes and administration expenses. Thus, "the benefits of the temporary administrator's receipt of the pension funds immediately inured to the estate." Id. at 2199. The fact that the temporary administrator was unable to disburse funds to the residuary beneficiary did not constitute a "substantial restriction" for this purpose.

Page 32. At the end of the first full paragraph, add the following:

In the proposed regulations regarding the applicability of the separate share rule to estates, the I.R.S. took a similar position. See Proposed Reg. § 1.663(c)-5, Ex. 3(iii) ("interest" payment on a surviving spouse's elective share).

Page 32. Regarding the second full paragraph:

After amendment by the Taxpayer Relief Act of 1997, section 163(h)(2)(E) no longer excludes from the definition of "personal interest" interest incurred because of deferral of the federal estate tax under either section 6166 or former section 6166A. The exclusion continues only as to interest incurred under section
6163. I.R.C. § 163(k) (disallowing interest on estate taxes deferred under section 6166).

Page 54. At the beginning of the first paragraph of the "Illustrative Material" add "1."

Page 56. At the end of the "Illustrative Material" add the following:

2. In Stevens v. Commissioner, 78 T.C.M. (CCH) 230 (1999), the court denied deductibility under section 212 of expenses a successor trustee incurred in defending a lawsuit against the trust. The lawsuit derived from "allegations that [the settlor] was mentally incompetent and that [the taxpayer] caused, induced, deluded, misled, forced, and/or otherwise unduly influenced [the settlor] to execute the Trust. None of the claims included allegations of mismanagement or waste of Trust assets, or diversion of Trust income." 78 T.C.M. (CCH) at 234. Thus, according to the court, the lawyer's fees involved "had their origin in a dispute over title to property. Therefore, those fees must be capitalized." Id. at 235.

Page 71. At the end of subdivision 4, add the following:

In the Taxpayer Relief Act of 1997, Congress enacted a new section 645, which allows an election by both the executor and the trustee of the decedent's revocable trust to treat the trust, for income tax purposes, as part of the estate, rather than as a separate trust. If no estate tax return is due, this consolidation is effective only during the estate's taxable years that end prior to two years after the decedent's death. If an estate tax return is due, the consolidation remains effective until six months after final determination of estate tax liability. Such a trust apparently qualifies for neither the $300 nor the $100 exemption; instead, such a trust "shares" the estate's $600 exemption. Rev. Proc. 98-13, 1998-4 I.R.B. 21, sets forth procedures and requirements for making the section 645 election.

Page 71. After the first sentence of the carryover paragraph at the bottom of the page, add the following:

Crestar Bank v. Internal Revenue Service, 47 F. Supp. 2d 670 (E.D. Va. 1999);

Page 72. At the end of the third full paragraph, add the following:
In the Taxpayer Relief Act of 1997, Congress enacted a new section 645, which allows an election by both the executor and the trustee of the decedent's revocable trust to treat the trust, for income tax purposes, as part of the estate, rather than as a separate trust. If no estate tax return is due, this consolidation is effective only during the estate's taxable years that end prior to two years after the decedent's death. If an estate tax return is due, the consolidation remains effective until six months after final determination of estate tax liability. Such a trust apparently can qualify for the set-aside charitable deduction. Rev. Proc. 98-13, 1998-4 I.R.B. 21, sets forth procedures and requirements for making the section 645 election.

Page 84. At the end of note 5, insert the following:

; Private Letter Ruling 9840025 (1998) (estate may deduct income paid to or set aside for private foundation not in existence at decedent's death, once estate notifies Service of foundation's existence and application for tax-exempt status).

Page 101. In note 2, there is an omission in the quoted sentence. In the last line on the page, between the words "waiver" and "of", insert the following omitted material: "under section 642(g) of the Code constitutes a relinquishment".

Page 102. In note 3, delete the fourth sentence, and insert, in lieu thereof, the following:

See also Kitch v. Commissioner, 103 F.3d 104, 108 (10th Cir. 1996) ("We have no doubt that § 682 applies to the extent it permits a decedent's estate to claim a deduction on its [income] tax return for alimony payments made to a spouse, even for arrearages.").


Page 120, third full paragraph. In the Taxpayer Relief Act of 1997 Congress amended section 663(c) to make the separate share rule available to estates, as well as to trusts. In 1999 the I.R.S. published proposed regulations on the application of the separate share rule to estates. REG-114841-98, 1999-11 I.R.B. 41 (proposing new Reg. §§ 1.663(c)-4 and 1.663(c)-6 and proposing
amendments to Reg. §§ 1.663(c)-1 to 1.663(c)-5). For helpful commentary, see Cantrell, Separate Share Regulations Propose Surprising Changes, Tr. & Est., March 1999, at 56; Kasner, Proposed Regs on Separate Shares in Estates Raise More Questions, Tax Practice, March 8, 1999, at 292.

Page 133, footnote 2. The reference to former section 645(a) is now obsolete. The Taxpayer Relief Act of 1997 repealed former section 644 and renumbered former section 645 as new section 644.

Page 144. After note 2, insert the following:

3. In Private Letter Ruling 9811037 (1997) and Private Letter Ruling 9811036 (1997), the I.R.S. ruled that short-term capital gains designated as "ordinary dividends" on a trust's Form 1099-DIV from a mutual fund were includible in DNI, even though they were properly allocable to principal under state law. The Service explained that § 852, pertaining to mutual funds, provides for only two types of income--capital gain dividends, which the recipient treats as gains from the sale or exchange of capital assets held for more than a year, and ordinary dividends, which include short-term capital gains. According to the I.R.S., the latter are includible, in their entirety, in DNI.

Page 152. In the first sentence of Problem 3-2, delete "that was not subject to taxation under section 644". The Taxpayer Relief Act of 1997 repealed section 644, effective for sales and exchanges after August 5, 1997. TRA 97 § 507(c)(2).

Page 153. Immediately before duPont, insert the following:

Brigham v. United States

160 F.3d 759 (1st Cir. 1998)

ALDRICH, Senior Circuit Judge.

This is an action to recover income tax payments that, allegedly, were not due. On cross motions for summary judgment the court ruled for the United States. We affirm.

In 1988 Kendal Ham died leaving a will with several provisions for his wife. Seasonably she chose, instead, to waive her rights under the will and elect the share of his estate permitted by the New Hampshire statute, N.H.Rev.Stat. Ann. § 560:10, in her case a one-third "portion of the estate remaining after the payment of debts and expenses of administration." In 1990 and 1991 Mr. Ham's
executor made payments to Mrs. Ham on account of the principal of her elected share. These payments included amounts equivalent to the total income received by Mr. Ham's estate during those two years. His executor classified these inclusions as "distributable net income" (DNI) pursuant to 26 U.S.C. § 643(a) and claimed a deduction from the estate's gross income pursuant to 26 U.S.C. § 661, which the government allowed. Mrs. Ham, in turn, reported and paid an income tax on the received DNI pursuant to 26 U.S.C. § 662.

Mrs. Ham's executor, plaintiff Paul Brigham, Jr., Esq., now claims it was inappropriate to apply the tax transfer of §§ 661 and 662 to payments in satisfaction of a widow's elective share and that the income tax on Mr. Ham's estate's 1990 and 1991 earnings should not have been passed on. No income tax was required of Mrs. Ham on the portion of the payments that exceeded Mr. Ham's estate's income, see 26 U.S.C. § 662(a), but, obviously, to the extent that payments to her were taxable, Mrs. Ham was paid her elected share in funds subject to depreciation through taxes.

Unreasonable and unfair as this might seem, plaintiff has an impossible row to hoe here. If a payee within the 26 U.S.C. § 643(c) definition of "beneficiary" receives DNI pursuant to § 661 that is an "other amount properly paid, credited, or required to be distributed to such beneficiary for the taxable year," § 662(a)(2), then she is bound to pay an income tax even if the payment was in satisfaction of a principal obligation.

Sections 661 and 662 are lengthy. . . . We believe these statutes sufficiently clear as to need no history, but we remark that they are the product of the difficulty . . . of tracing the source of distributions from estates with many beneficiaries. See S.Rep. No. 83-1622, at 83 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4715 ("The approach adopted by the bill eliminates the necessity, in determining the taxability of distributions, of tracing such distributions to the income of the estate or trust for the current taxable year."). While the solution may over-simplify, it has never been found beyond the federal taxing power. Obviously the taxpayer must adjust to the government, not the government adjust to accommodate him.

Plaintiff, accordingly, claims that Mrs. Ham, as the receiver of a one-third portion of Mr. Ham's estate, was not a "beneficiary" within the meaning of § 662. This contention, however, fails. For definition, 26 U.S.C. § 643(c) provides that "the term 'beneficiary' includes heir, legatee, devisee." The word "elector" (of a spouse's share) does not appear, but "includes" is not limiting. Rather, "the terms 'includes' and 'including' . . . shall not be deemed to exclude other things otherwise within the

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^1^He can, of course, negotiate with the other estate.
meaning of the term defined." 26 U.S.C. § 7701(c). In light of this we apply the principle that a list of terms should be construed to include by implication those additional terms of like kind and class as the expressly included terms. Surely the widow has elected to be within the group. In common parlance, is not any person who gratuitously receives estate assets a beneficiary? If there is no will, the widow is an heir, and she receives a portion of the estate as determined by the legislature. If there is a will, she may be a legatee, or she may waive her rights under it and receive a different portion. But, in all cases, on its face, the §§ 661-662 tracing purpose applies precisely.

Plaintiff's remaining argument is that the payments in satisfaction of Mrs. Ham's elective share were not § 662(a)(2) distributions because the elective share is a state law interest not subject to the estate income distribution provisions in §§ 661 and 662. He has found in his favor the case of Deutsch v. Commissioner of Internal Revenue, 74 T.C.M. (CCH) 935, 1997 WL 633208 (1997) (holding that the Florida elective share is not subject to the entire Subchapter J, 26 U.S.C. §§ 641-692). We disagree fully.

The Deutsch court would draw comparisons between elective shares and the Florida dower. Assuming that Florida dower may be exempt, which we may doubt, this would be because it is directly involved with real estate title which, like jointly owned property may, in a technical sense, not pass through the estate, a claim that plaintiff here cannot make. By definition, Mrs. Ham received "a portion of the estate." Next, standing with one foot on the dower concept, Deutsch reasons that in enacting a provision for elective shares the state was protecting the interests of its widows. Passing the fact that $800,000 is a good deal of protection, the proposition that, simply by fiat, a state may preserve its citizens from federal taxes is absurd. The list of exclusions in 26 U.S.C. § 663 clearly does not exclude an elective share, and we note that the Treasury Regulations expressly deny exclusion even to a widow's temporary allowance. 3

Plaintiff's appeal is without merit.

Page 158. At the end of paragraph c, add the following:

Proposed Reg. § 1.663(c)-5, Ex. 3(iii), takes the position that an "interest" payment on a surviving spouse's elective share is taxable to the surviving spouse as interest, rather than in accordance with §§ 661 and 662. I am apparently not the only one who believes this position is misguided. See Kasner, Proposed Regs

3See Treas. Reg. § 1.662(a)-3(b)(6) . . . .
on Separate Shares in Estates Raise More Questions, Tax Practice, March 8, 1999, at 292, 293.

Page 158. At the end of paragraph d, add the following:

The Tenth Circuit affirmed but used entirely different analysis. *Kitch v. Commissioner*, 103 F.3d 104 (10th Cir. 1996). The court expressly rejected the notion "that § 682(b) is merely a timing provision." 103 F.3d at 107. Instead, the court held that, because section 682(a) applies literally only when the payor is a trust—not when the payor is an estate, section 682(b) did not apply. Thus, the payor estate's distributable net income neither limited nor characterized the amount on which the payee was subject to taxation. Instead, the amounts the payee estate received were exclusively income in respect of its own decedent, taxable in full as ordinary income. In dictum, the Tenth Circuit continued: "We have no doubt that § 682 applies to the extent it permits a decedent's estate to claim a deduction on its [income] tax return for alimony payments made to a spouse, even for arrearages." 103 F.3d at 108. In short, it may be that an alimony payee can be an estate beneficiary for purposes of entitling the payor estate to a distribution deduction, but not for purposes of limiting or recharacterizing income in respect of of its own decedent. The Tenth Circuit clearly considered and seems to have applied post-1984 versions of all relevant statutes.

Page 159. At the end of paragraph f, add the following:

In contrast, in *Deutsch v. Commissioner*, 74 T.C.M. (CCH) 935 (1997), the court held that satisfaction of a Florida surviving spouse's elective share did not constitute a distribution for purposes of Subchapter J. The court relied on Rev. Rul. 64-101, which involved Florida dower, the predecessor of Florida's elective share. But the court also emphasized that, under Florida law, the elective share could not participate in estate income. Of course, neither the Code nor the regulations rely on participation in the estate's income. For exactly the opposite conclusion, with respect to the New Hampshire elective share, see *Brigham, supra*. See generally Hart, Electing Against the Will—The DNI Problem for Spousal Shares, J. Tax'n, March 1998, at 164 (written by taxpayer's lawyer in *Deutsch*). Upon finalization of the proposed regulations on the application of the separate share rule to estates, both Rev. Rul. 64-101 and Rev. Rul. 71-167 will be obsolete. REG-114841-98, 1999-11 I.R.B. 41, 42 (proposing new Reg. §§ 1.663(c)-4 and 1.663(c)-6 and proposing amendments to Reg. §§ 1.663(c)-1 to 1.663(c)-5).

Page 159. At the end of paragraph g, add the following:
Similarly, when an estate borrows from a testamentary trust, the amounts the estate thereafter pays to the trust are not necessarily beneficiary distributions within the scope of the subchapter J conduit rules. Instead, they may be interest taxable directly to the trust in its capacity as creditor. See Geftman v. Commissioner, 72 T.C.M. (CCH) 816 (1996), rev'd, 154 F.3d 61 (3d Cir. 1998) (holding that no bona fide loan existed between trust and estate).

Page 174, note 3. Replace each reference to former section 645 with a reference to new section 644. The Taxpayer Relief Act of 1997 repealed former section 644 and renumbered former section 645 as new section 644.

In the Taxpayer Relief Act of 1997, Congress also enacted a new section 645, which allows an election by both the executor and the trustee of the decedent's revocable trust to treat the trust, for income tax purposes, as part of the estate, rather than as a separate trust. If no estate tax return is due, this consolidation is effective only during the estate's taxable years that end prior to two years after the decedent's death. If an estate tax return is due, the consolidation remains effective until six months after final determination of estate tax liability. Such a trust apparently can, in conjunction with the estate, elect a fiscal year. Rev. Proc. 98-13, 1998-4 I.R.B. 21, sets forth procedures and requirements for making the section 645 election.

Page 184, note 4. Replace the reference to former section 645 with a reference to new section 644. The Taxpayer Relief Act of 1997 repealed former section 644 and renumbered former section 645 as new section 644.

Page 184. At the end of note 5, add the following:

6. In Geftman v. Commissioner, 72 T.C.M. (CCH) 816 (1996), rev'd on other grounds, 154 F.3d 61 (3d Cir. 1998), the issue was whether the sole beneficiary of a discretionary trust was taxable on any portion of the amounts he received from the trust. The Tax Court explained:

[T]o determine whether petitioner is subject to income tax on his receipt of the $46,936 distribution, we must first determine whether [the trust] had DNI equal to or greater than $46,936 for its taxable year ended February 28, 1985. If [the trust] had DNI equal to or greater than $46,936 for its taxable year ended February 28, 1985, then petitioner must include a percentage of the $46,936 distribution in his 1985 gross income, equal to
the proportion of [the trust's] DNI that consists of taxable items.

Id. at 819. This appears to be a truncated, but nonetheless accurate, explanation of the workings of section 662, as applied to a particular fact pattern. Do you understand it?

Page 186, "Illustrative Material." In the Taxpayer Relief Act of 1997 Congress amended section 663(c) to make the separate share rule available to estates, as well as to trusts. In 1999 the I.R.S. published proposed regulations on the application of the separate share rule to estates. REG-114841-98, 1999-11 I.R.B. 41 (proposing new Reg. §§ 1.663(c)-4 and 1.663(c)-6 and proposing amendments to Reg. §§ 1.663(c)-1 to 1.663(c)-5). For helpful commentary, see Cantrell, Separate Share Regulations Propose Surprising Changes, Tr. & Est., March 1999, at 56; Kasner, Proposed Regs on Separate Shares in Estates Raise More Questions, Tax Practice, March 8, 1999, at 292.

Pages 187-194. Regarding subdivision 3:

The Taxpayer Relief Act of 1997 basically repealed the throwback rule. Effective with respect to taxable years beginning after August 5, 1997, section 665(b) and (c) limit applicability of the throwback rule to foreign trusts, domestic trusts that were once foreign trusts, and pre-March 1, 1984, domestic trusts that section 643(f) would aggregate, if it applied.

Page 205. As the new first paragraph of the "Illustrative Material," add the following:

In Serv. Ctr. Adv. 1998-012 (Apr. 7, 1998), however, the I.R.S. ventured thoughtful analysis of the changing status of real property in estate administration and concluded that "only specifically devised real property, in New York and New Jersey, continues to enjoy the special treatment traditionally accorded real property."


Page 230, note 2. Replace the reference to former section 645 with a reference to new section 644. The Taxpayer Relief Act of 1997 repealed former section 644 and renumbered former section 645
as new section 644.

In the Taxpayer Relief Act of 1997, Congress also enacted a new section 645, which allows an election by both the executor and the trustee of the decedent's revocable trust to treat the trust, for income tax purposes, as part of the estate, rather than as a separate trust. If no estate tax return is due, this consolidation is effective only during the estate's taxable years that end prior to two years after the decedent's death. If an estate tax return is due, the consolidation remains effective until six months after final determination of estate tax liability. Such a trust apparently can, in conjunction with the estate, adopt a fiscal year. Rev. Proc. 98-13, 1998-4 I.R.B. 21, sets forth procedures and requirements for making the section 645 election.

Page 240. At the end of note 3, add the following:

The Tenth Circuit affirmed. Kitch v. Commissioner, 103 F.3d 104 (10th Cir. 1996).

Page 252, footnote 3. After amendment by the Taxpayer Relief Act of 1997, section 267 now applies to transactions between an executor of an estate and any of its beneficiaries, except for sales or exchanges in satisfaction of pecuniary bequests. I.R.C. § 267(b)(13).

Page 254. At the end of the page, add the following:

ILLUSTRATIVE MATERIAL

In Private Letter Ruling 9625020 (1996), the I.R.S. declined to treat in kind non-pro rata distributions as pro rata distributions of each asset, followed by taxable exchanges between the recipients, where the governing instrument expressly authorized the non-pro rata distributions. Thus, neither the entity nor the recipients realized gain. The same result occurs if local law provides the authorization. See generally Private Letter Ruling 9537011 (1995), Private Letter Ruling 9523029 (1995), and Private Letter Ruling 9422052 (1994).

Page 268. After note 2, add the following:

3. In Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999), taxpayers donated corporate shares to charity while a tender offer and merger were pending. The court held that, when the gifts became final, the tender offer and merger were so likely to succeed that the shares had already ripened into rights to receive cash.
Thus, the donors were subject to taxation on the gain inherent in the donated shares, under the assignment of income doctrine.

Page 274. In line 9 of the second paragraph, insert the following citation just before the citation to Floyd G. Paxton:

Johnson v. Commissioner, 108 T.C. 448 (1997), aff’d in part and rev’d in part, 184 F.3d 786 (8th Cir. 1999);

Page 278. Regarding paragraph 2 of note 2:


Page 281. At the end of the "Illustrative Material," add the following:

In REG-209619-93, 1999-10 I.R.B. 28, the I.R.S. announced additional proposed regulations under section 468B.

In Meek v. Commissioner, 71 T.C.M. (CCH) 3055 (1996), aff’d mem., 133 F.3d 928 (9th Cir. 1998), the taxpayers simultaneously created a trust and sold property to it, in exchange for the trustees' promissory note. Deductibility of a loss the taxpayers incurred on the sale depended on whether they were the trust's "grantors." See ch. 5, sec. E, infra. The court held that the taxpayers were "grantors," notwithstanding the fact that the trustees, on behalf of the trust, had provided the consideration for its creation. The court noted that the trustees were unrelated to both the taxpayers and the trust beneficiaries, and that the trustees "did not participate to any degree in the dispositive provisions of the trust." 71 T.C.M. at 3058.

In Private Letter Ruling 9831005 (1998), co-guardians of an incompetent proposed to use his property to fund a revocable trust for his benefit. The I.R.S. ruled that the incompetent would be the grantor of the proposed trust. Section 671 would attribute all of the trust's income, deductions, and credits to the incompetent, despite the fact that the co-guardians would nominally create the trust.

Page 304. At the end of the "Illustrative Material," add the following:

In Zand v. Commissioner, 71 T.C.M. (CCH) 1758 (1996), aff’d on
other grounds, 143 F.3d 1393 (11th Cir. 1998), the Tax Court found section 675(3) inapplicable to certain loans from certain trusts to their grantor. Instead, the loans qualified under the statutory safe harbor: they provided for adequate interest and adequate security, and a majority of the trustees who made the loans were neither related nor subordinate to the grantor under the section 672(c) definition, though they were the grantor's lawyers.

A second aspect of Zand also merits attention. The I.R.S., apparently relying on an extension of Rev. Rul. 85-13, asserted grantor trust status, through non-compliance with the statutory safe harbor of section 675(3), in an effort to deny the grantor deductions for the interest on the loans. After determining that the safe harbor applied, and that section 675(3) itself therefore did not, the Tax Court continued, in dictum:

Moreover, even if section 675(3) did apply, its effect by its terms is to tax all or a portion of the trust income to petitioner. It does not provide for the disallowance of the interest expenses claimed by him. Indeed, the net result to the grantor may be no increase in tax because the trusts' interest income taxed to the grantor may be offset by a deduction for interest on the loans.

71 T.C.M. at 1824. This analysis is conceptually at odds with Rev. Rul. 85-13. It is also flatly contrary to Private Letter Ruling 9535026 (1995), which ruled that grantor trusts could not deduct interest they paid on indebtedness to their grantors; neither were the grantors subject to taxation on the interest their grantor trusts paid them on the indebtedness. It is also inconsistent with Proposed Reg. §1.671-2(f), announced in 1996, which states:

For purposes of subtitle A of the Internal Revenue Code, a person that is treated as the owner of any portion of a trust under subpart E is considered to own the trust assets attributable to that portion of the trust.

An accompanying explanation states that a person treated as owner of any portion of a trust under subpart E "is considered to own the trust assets attributable to that portion of the trust for all federal income tax purposes." REG-209826-96, 1996-42 I.R.B. 10, 14 (emphasis added).

Page 313. At the end of note 3, add the following:

See generally Hader, Planning to Avoid the Reciprocal Trust Doctrine, 26 Est. Plan. 358 (1999); Marty-Nelson, Taxing Reciprocal Trusts: Charting a Doctrine's Fall from Grace, 75 N.C. L. Rev. 1781 (1997).
Page 315. At the end of note 3, add the following:

4. Though section 677(a)(3) seems to apply whenever the grantor or a nonadverse party can apply trust income to the payment of premiums on an insurance policy on the life of either the grantor or the grantor's spouse, the courts have substantially limited its scope. In order for section 677(a)(3) to apply, a specified life insurance policy must actually exist. Corning v. Commissioner, 104 F.2d 329, 333 (6th Cir. 1939); Genevieve F. Moore, 39 B.T.A. 808 (1939), acq., 1939-2 C.B. 25. Even when such a policy does exist, the grantor is subject to taxation on only the income actually used to pay the premiums. Joseph Weil, 3 T.C. 579 (1944), acq., 1944 C.B. 29.

Page 322. At the end of note 6, add the following:

Likewise, section 677(a) may apply when an automobile dealer uses a trust to service multi-year vehicle service contracts. See Johnson v. Commissioner, 108 T.C. 448 (1997), aff'd in part and rev'd in part, 184 F.3d 786 (8th Cir. 1999).

Page 341. At the end of note 5, add the following:


Page 341. Regarding Revenue Ruling 69-70:


Page 342. At the end of the "Illustrative Material," add the following:

See also Private Letter Ruling 9646014 (1996) (applying Rev. Rul. 77-230 to a similar trust, notwithstanding the fact that the trust was also a qualified settlement fund under Treas. Reg. §1.468B-1). Proposed Reg. §§ 1.468B-1(k) and 1.468B-5(c), however, will require an election for such treatment after they become final.

Page 344. At the end of note 4, add the following:

See also Stussy v. Commissioner, 73 T.C.M. (CCH) 3194 (1997).
Page 344, note 5. Replace the reference to former section 645 with a reference to new section 644. The Taxpayer Relief Act of 1997 repealed former section 644 and renumbered former section 645 as new section 644.

Page 345, note 6. Replace the reference to former section 645 with a reference to new section 644. The Taxpayer Relief Act of 1997 repealed former section 644 and renumbered former section 645 as new section 644.

Page 346. At the end of note 8, insert the following:

9. Operation of the "2% haircut." In Bay v. Commissioner, 76 T.C.M. (CCH) 866 (1998), the court held that a grantor who was apparently treated as owner of all portions of her grantor trust was subject to the "2% haircut" under section 67 on various deductions from the trust attributed to her by section 671. These deductions were on account of expenses, such as investment advisory fees, that, under William J. O’Neill Irrevocable Trust v. Commissioner, 994 F.2d 302 (6th Cir. 1993), nonacq., 1994-2 C.B. 1 (ch. 2, sec. B(3)(a)), might, under section 67(e), have escaped the "haircut," had they been incurred by the trustee of a non-grantor trust. The court explained:

[S]ection 67(e) does not and cannot apply to grantor trusts. Because the items of income and deductions are passed through to the grantor, the adjusted gross income of a grantor trust, in effect, is not a viable notion either conceptually under the relevant statutory scheme, or for reporting purposes. . . . These items are treated as though received or paid by her, instead of by the trust. Sec. 1.671-2(c), Income Tax Regs.

The court also quoted and relied on Temp. Reg. § 1.67-2T(b)(1).

Pages 369-378. Regarding these pages:

The Taxpayer Relief Act of 1997 basically repealed the throwback rule. Effective with respect to taxable years beginning after August 5, 1997, section 665(b) and (c) limit applicability of the throwback rule to foreign trusts, domestic trusts that were once foreign trusts, and pre-March 1, 1984, domestic trusts that section 643(f) would aggregate, if it applied.

Page 373. Regarding the second and third full paragraphs:

The court's discussion of the minimum tax is obsolete.
Sections 55 to 59 now set forth the alternative minimum tax, which has replaced the minimum tax.

Page 381. Regarding the first full paragraph:

The Taxpayer Relief Act of 1997 basically repealed the throwback rule. Effective with respect to taxable years beginning after August 5, 1997, section 665(b) and (c) limit applicability of the throwback rule to foreign trusts, domestic trusts that were once foreign trusts, and pre-March 1, 1984, domestic trusts that section 643(f) would aggregate, if it applied.

Page 386. At the end of note 2, add the following:

In Buckmaster v. Commissioner, 73 T.C.M. (CCH) 2821 (1997), the Tax Court upheld the Commissioner's assessment of an accuracy-related penalty, as well as a penalty for instituting a frivolous proceeding, against a taxpayer who had employed a family trust.

Page 387. After note 7, add the following:

8. See generally Notice 97-24, 1997-16 I.R.B. 6 (alerting taxpayers to a variety of abusive trust arrangements that purport to reduce or eliminate taxes in impermissible ways, and discussing the tax (and other) consequences of using such arrangements); Serv. Ctr. Adv. 1998-006 (March 6, 1998) (addressing filing requirements and tax status of so-called "pure trusts").

Page 406, note 2. But after amendment by the Taxpayer Relief Act of 1997, section 267 now applies to transactions between an executor of an estate and any of its beneficiaries, except for sales or exchanges in satisfaction of pecuniary bequests. I.R.C. § 267(b)(13).

Page 406. At the end of the "Illustrative Material," add the following:

3. In Meek v. Commissioner, 71 T.C.M. (CCH) 3055 (1996), aff'd mem., 133 F.3d 928 (9th Cir. 1998), taxpayers simultaneously created a trust and sold property to it, in exchange for the trustees' promissory note. Deductibility of a loss the taxpayers incurred on the sale depended, under section 267(b)(4), on whether they were the trust's "grantors." The court held that the taxpayers were "grantors," notwithstanding the fact that the trustees, on behalf of the trust, had provided the consideration for its creation. The court noted that the trustees were unrelated
to both the taxpayers and the trust beneficiaries, and that the trustees "did not participate to any degree in the dispositive provisions of the trust." 71 T.C.M. at 3058. As a result, the court denied deductibility of the loss.

Page 424. Regarding note 1:

_Estate of Gavin v. United States_, 113 F.3d 802 (8th Cir. 1997), is also to the same effect.

Page 430. Regarding note 1:

Rev. Rul. 70-467 (cited in this note) has been declared obsolete, though apparently on grounds that are not relevant here. Rev. Rul. 95-71, 1995-2 C.B. 323.

Page 453. Regarding note 2:

After amendment by the Taxpayer Relief Act of 1997, application of section 121 is automatic, unless the taxpayer elects out.

Page 458. Regarding footnote 11:

The Small Business Job Protection Act of 1996 repealed section 101(b).

Page 467. Regarding note 1:

The Small Business Job Protection Act of 1996 repealed section 101(b).

Page 467. Regarding note 2:

The Small Business Job Protection Act of 1996 repealed section 101(b).

Page 467. Regarding note 3:

In the first paragraph, between the citations to _Bernard_ and _Ballard_, insert:

_Estate of Machat_, 75 T.C.M. (CCH) 2194 (1998);
Regarding the very end of note 3:

The Small Business Job Protection Act of 1996 repealed section 101(b).

At the end of the "Illustrative Material," add the following:

9. In Estate of Cartwright v. Commissioner, 71 T.C.M. (CCH) 3200 (1996), aff'd in part and remanded, 183 F.3d 1034 (9th Cir. 1999), a lawyer who owned more than 70% of the stock in his law firm died. Thereafter, pursuant to a buy-sell agreement, the firm paid his estate more than $5 million. Applying the agreement, the court held that approximately $1 million was in redemption of decedent's stock and, under Treas. Reg. § 1.691(a)-2(b), Ex. (4), was therefore not taxable as income in respect of a decedent. But the rest, which the court determined was on account of decedent's claims against the firm for "cases or work in progress," was. Consequently, almost $4 million was taxable to the estate as income in respect of a decedent.

At the end of note 3, add the following:


At the end of note 5, add the following:

To the same effect as Stanley are Johnson v. United States, 64-2 U.S.T.C. ¶ 9655 (N.D. Tex. 1964), and Holt v. United States, 39 Fed. Cl. 525, 97-2 U.S.T.C. ¶ 60,293 (1997).

At the end of note 1, add the following:

To similar effect is Private Letter Ruling 9549023 (1995).

At the end of note 8, add the following:

The Tenth Circuit affirmed but seems to have applied post-1984 versions of all relevant statutes. Kitch v. Commissioner, 103 F.3d 104 (10th Cir. 1996).

Regarding Revenue Ruling 67-305:
The Taxpayer Relief Act of 1997 amended section 706(c), effective for partnership taxable years beginning after December 31, 1997, to require automatic termination of a partnership's taxable year "with respect to a partner whose entire interest in the partnership terminates (whether by reason of death, liquidation, or otherwise)." Thus, a deceased partner's share of distributive partnership income or losses for the period prior to death is now includible on the decedent's final return and no longer constitutes income in respect of a decedent. Revenue Ruling 67-305 is, therefore, obsolete. Similarly, much of the material in note 1, on page 503, is either also obsolete or superfluous for these purposes.