STRUCTURING AND ADMINISTERING TRUSTS TO OWN INTERESTS IN CLOSELY HELD ENTITIES

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I. WHY USE TRUSTS AND HOW ARE THEY TAXED 1

A. Introduction. 1

B. Common Trust Purposes. 1
1. Third Party Management for Beneficiary. 1
2. Creditor Protection. 1
3. Marital Property Considerations. 2
4. Transfer Tax Savings. 2

C. Different Issues When Trusts Own Business Interests 3
1. Preserving Voting Control. 3
2. Retaining Ownership Within Family. 3
3. Ensuring Effective Management. 3
4. Minimizing Family Conflicts. 3

D. Key Points of Trust Income Taxation. 3
1. Grantor Trusts. 3
2. Non-Grantor Trusts. 4
3. Tax on Net Investment Income. 4

II. OVERVIEW OF TAX AND ORGANIZATIONAL ISSUES FOR BUSINESS ENTITIES 5

A. Introduction. 5

B. Corporations. 5
1. Generally. 5
2. Income Tax Status. 6

C. Partnerships 6
1. Generally. 6
2. Income Tax Status. 6

D. Limited Liability Companies 6
1. Generally. 6
2. Income Tax Status. 7

III. IMPORTANCE OF TRUSTEE DESIGNATION FOR TRUSTS WITH BUSINESS INTERESTS 7

A. Introduction. 7

B. Options for Designation of Trustees 7
1. Trustee for All Purposes. 7
2. Advisory Committee. 7
3. Special Trustee. 8

C. Options for Trustee Appointment, Removal and Replacement 8
1. Generally. 8
2. Transfer Tax Considerations of Trustee Appointment, Removal and Replacement. 9

D. Control Alternatives Outside of Trust Instrument 9

1. Voting Trust. 9
2. Equal Equity but Unequal Control. 10

IV. **TRUST OWNERSHIP OF S CORPORATION STOCK** **10**

A. Introduction. 10

B. Permissible Trust Shareholders. 11
1. Grantor Trusts. 11
2. Grantor Trusts Terminated Upon Grantor's Death. 11
3. Testamentary Trust. 11
4. Qualified Subchapter S Trust. 12
5. Electing Small Business Trust. 12
6. Qualified Voting Trust. 12

C. Trust Provisions Specific to S Corporation Stock. 13
1. Obligation to Maintain S Corporation Election. 13
2. Power to Convert a Trust to Qualify as a QSST. 13

V. **TRUST DISTRIBUTIONS** **14**

A. Introduction. 14

B. Limitations of Principal Distributions. 14

C. Trust Accounting for Closely Held Interests. 15
1. Cash Distributions 15
2. Power to Adjust. 15

D. Trust Ownership of Interests in Pass-Through Entities. 16
1. Introduction. 16
2. Mandatory Income Complications. 16

E. Special Considerations for QTIP Trusts. 18

F. Decanting. 18

G. Impact of Turning Off Grantor Trust Status. 19

VI. **TRUST ADMINISTRATION** **19**

A. Investment, Generally. 19

B. Overriding Prudent Investor Rule. 20

C. Marital Property Considerations for Efforts on Behalf of Trust Owned Business Interests. 20

D. Power of Substitution 21
1. Code Section 2036(b) 21
2. Flexible Income Tax Planning Tool 22

E. Compensation. 22

F. GST Tax and 6166 Deferral. 23
1. Generally. 23
2. Planning Considerations 23

STRUCTURING AND ADMINISTERNG TRUSTS TO OWN INTERESTS IN CLOSELY HELD ENTITIES

Closely held businesses have long been the signature element of the American economy.[1] Nothing is more classically American than developing an idea and then monetizing it into a successful business enterprise. Closely held businesses raise unique estate planning issues and opportunities, particularly when the estate plan incorporates trusts. Individuals routinely use trusts, motivated by tax and non-tax reasons, to achieve their estate planning goals and objectives. This paper addresses both technical and practical issues that arise when structuring and administering trusts that own interests in closely held entities. In some cases, this paper identifies particular issues for consideration and, for more through discussion, provides citation to detailed articles on that specific issue by other authors. Ultimately, through thoughtful trust planning for business owners, estate planning practitioners can weave the estate planning structures into clients' overall business plans without any meaningful disruption of the operation of the businesses themselves.

I. WHY USE TRUSTS AND HOW ARE THEY TAXED

A. Introduction.

This initial section describes common reasons why individuals create trusts and specific reasons that business interests may require special trust planning. Additionally, this section summarizes some key aspects of the income taxation of trusts that commonly impact trusts that own closely held business interests. It does not attempt a comprehensive discussion of the income taxation of trusts.[2]

B. Common Trust Purposes.

1. Third Party Management for Beneficiary.

At its core, a trust is a relationship with property. A trustee administers property for the benefit of the beneficiary. The trustee holds legal title to the property and the beneficiary holds equitable title.[3] In many cases, the trust allows a third party to manage property for a beneficiary who lacks the skill, judgment or real world life experience to handle the trust property without assistance. Trusts structured in this manner may benefit a minor or disabled beneficiary or a beneficiary whom the grantor suspects would deplete his or her inheritance for inappropriate expenditures.

Alternatively, the grantor may feel comfortable giving property to a beneficiary, free of trust, but elects to gift the property in trust so that the beneficiary may receive the benefits that an irrevocable trust may provide, as described below. In those cases, the beneficiary may serve as his or her own trustee with broad, but not unlimited, access to and control over the assets of the trust.[4]

2. Creditor Protection.

Properly structured irrevocable trusts may provide the trust assets with meaningful protection from the claims of a beneficiary's creditors.[5] Creditor protection flows primarily from the inclusion of a "spendthrift clause" in the trust instrument. A spendthrift clause prevents a beneficiary from voluntarily or involuntarily transferring the beneficiary's interest in the income or principal of the irrevocable trust before payment of funds from the trust to the beneficiary.[6]

A beneficiary who is not the grantor of the trust may have broad, but not unlimited, access to the trust property while still retaining the benefits of the spendthrift clause. For example, the beneficiary may serve as trustee and have discretion to make distributions for his or her benefit

subject to an ascertainable standard (such as health, education, maintenance and support).[7] The beneficiary may possess a lifetime power to appoint property to any person or entity other than the beneficiary, the beneficiary's estate, the beneficiary's creditors, or creditors of the beneficiary's estate.[8] The beneficiary may hold any testamentary power of appointment.[9]

While some states allow certain self-settled irrevocable trusts (*i.e.*, where the grantor is also a beneficiary) to protect the trust assets from claims of the grantor's creditors, Texas law currently offers no such protection.[10] However, recent Texas legislation has clarified that a spendthrift provision may be respected for certain trusts when the grantor becomes a beneficiary after the death of the grantor's spouse.[11]

3. Marital Property Considerations.

Marital property characterization affects the property rights of married couples upon divorce and at death. The estate of a deceased married person consists of all of the deceased person's separate property plus one-half of the couple's community property. Upon divorce, each spouse receives all of his or her respective separate property and community property is divided between the spouses as the court deems just and right, having due regard for the rights of each spouse and any children of the marriage.[12]

Property received by gift or inheritance is separate property,[13] but income from separate property is community property.[14] A properly structured marital agreement can allow income from separate property to remain separate property of the recipient.[15] For a variety of reasons, individuals may refuse to broach the subject of a premarital agreement with their bride/groom to be, thereby exposing income from separate property to community property treatment. Absent careful sweeping of income from separate property into a community property account, separate and community property can become commingled, making the task of sorting out the spouses' property rights more difficult. This can be problematic because Texas law presumes that all property of a married couple is community property, and the spouse who claims separate property treatment bears the burden of establishing the separate property character.[16]

A marital agreement generally provides greater protection than an irrevocable trust with respect to marital property claims for income from inherited property. However, grantors may transfer property into trusts for their chosen beneficiaries to minimize potential marital property claims to inherited property from the beneficiary's spouse. Texas courts have held that a properly structured irrevocable trust for the benefit of a non-settlor beneficiary will not create any community property interest in the trust property although the courts have not been unanimous on the issue.[17] In an ideal situation, the trust would enable trust income to be accumulated without any community property consequences and for all distributions from the trust to the beneficiary to be deemed separate property. The grantor may bolster potential marital property protection by express language in the trust instrument that the grantor intends for no community property to be created while property remains in the trust, and that all distributions from the trust are intended to be the beneficiary's separate property.

4. Transfer Tax Savings.

The significant increase in transfer tax exemptions, combined with the portability of estate tax exemptions between certain spouses, has reduced the number of individuals who may owe federal estate, gift or generation-skipping transfer (GST) tax. Nevertheless, for the segment of the population faced with transfer tax concerns, properly structured trusts continue to facilitate potential transfer tax savings.

C. **Different Issues When Trusts Own Business Interests.**

When structuring trusts to own significant business interests, practitioners must consider additional issues beyond the traditional reasons for creating trusts.

1. Preserving Voting Control.

Business owners frequently value control of business operations over the economic benefits that ownership of the business provides. For inter vivos trusts funded with business interests, planners should ensure that the trustee appointment, removal and replacement provisions meet with the grantor's desire for control while not causing negative tax consequences. Once the grantor is deceased, trusts that own business interests should be structured to facilitate the grantor's goals for who should "control" the business. Frequently, the preferred business decision maker differs from the individual or entity who otherwise may serve as trustee of the trust.

2. Retaining Ownership Within Family.

Owners of closely held businesses routinely strive to keep ownership of the business within the family. Entity level agreements (such as shareholder and partnership agreements) play a central role in implementing the goals for family control, but those agreements may be insufficient to maximize the level of control over ownership that some owners wish to impose. Common trust provisions for discretionary principal distributions and powers of appointment must be evaluated and, potentially, adjusted to account for the trust's ownership of a business interest.

3. Ensuring Effective Management.

The principal owner of the closely held business typically ensures that the business functions effectively. When that principal owner steps away from the day-to-day operations (whether by retirement, death or otherwise), someone must step forward to manage the business. As ownership of the business becomes dispersed among multiple family members, the management structure becomes more critical to ensuring that the business continues to function effectively. Trust provisions can either enhance or detract from achieving this goal.

4. Minimizing Family Conflicts.

The transition of ownership and control from one generation to the next presents opportunities for conflict. These conflicts can be especially pronounced when some but not all members of the family work for the business. Family members often have differing cash flow needs, which ownership of an interest in a closely held business may not fulfill. Careful practitioners must consider mechanisms when funding trusts with business interests that may enable family members to preserve family harmony without disrupting efficient operation of the business.

D. **Key Points of Trust Income Taxation.**

1. Grantor Trusts.

A grantor trust is a trust that, for income tax purposes, is taxable to the trust's grantor.[18] All income of the grantor trust is reportable on the grantor's personal income tax return, which allows the trust assets to grow undiminished by income taxes. In other words, for income tax purposes, the assets of the trust are treated as owned by the grantor. Lifetime wealth transfer strategies often involve gifts and/or sales of closely held business interests to trusts that are structured as grantor

trusts for income tax purposes but without the trust assets being included in the grantor's estate for estate tax purposes (*i.e.*, the "intentionally defective" grantor trust). Note, also, that such trusts may be structured so that the beneficiary is treated as the grantor of the trust and, therefore, taxable on all of the trust's income (the "beneficiary intentionally defective" grantor trust).[19]

2. Non-Grantor Trusts.

Non-grantor trusts are irrevocable trusts that are treated as separate taxpayers for income tax purposes. Non-grantor trusts reach the highest marginal income tax rates at very low levels. For calendar year 2014, trusts reach the top tax rate for taxable income over $12,150.[20]

In calculating taxable income for a trust, the trust receives a deduction for distributable net income ("DNI") distributed to the beneficiaries.[21] The distribution deduction generally is limited to items of income distributed to the beneficiary and not to items of capital gain. However, under certain circumstances, the trustee may elect to treat capital gains as part of DNI, thereby allowing such capital gain to be included on the beneficiary's personal income tax return and subject to income tax at the beneficiary's applicable income tax rates for capital gains. Capital gains may be included in DNI to the extent the gains are, pursuant to the trust instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the trustee:

- allocated to income,
- allocated to principal but treated consistently by the trustee on the trust's books, records and tax returns as part of a distribution to a beneficiary, or
- allocated to principal but actually distributed to the beneficiary or utilized by the trustee in determining the amount that is distributed or required to be distributed to a beneficiary.[22]

3. Tax on Net Investment Income.

As part of the *Health Care and Education Reconciliation Act of 2010*, trusts (other than grantor trusts) must also pay a 3.8% tax on net investment income ("NII"). This tax is in addition to regular income tax on taxable income, which could result in some income being subject to federal tax at a rate as high as 43.4%.

Non-grantor trusts must pay the 3.8% tax on the lesser of (i) the trust's undistributed NII for the taxable year or (ii) the excess (if any) of the trust's adjusted gross income for the taxable year over the dollar amount at which the highest income tax bracket for trusts begins for such year ($12,150 for 2014).[23]

The 3.8% tax only applies to NII. NII means the following items of income or gain, reduced by allowable deductions properly allocable to such income or gain:

- gross income from interest, dividends, annuities, royalties, and rents, other than such income derived from the ordinary course of a trade or business that is not a "nonqualified trade or business";
- other gross income derived from a nonqualified trade or business; and

- net gains attributable to the disposition of property other than property held in a trade or business that is not a nonqualified trade or business.[24]

A "nonqualified trade or business" is either (i) a passive activity with respect to the taxpayer, or (ii) a trade or business of trading in financial instruments or commodities.[25] The Internal Revenue Code (the "Code") defines a passive activity as any activity that involves the conduct of any trade or business and in which the taxpayer does not materially participate.[26] A taxpayer generally is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a regular, continuous and substantial basis.[27]

The IRS has taken a narrow view of how a trust might satisfy the material participation requirement. Specifically, the IRS requires that material participation in the business must be done by the trustee, in the trustee's capacity as a trustee and not in any other capacity (*e.g.*, a trustee who also happens to be an employee of the business may only count his or her activities as trustee when determining material participation), and the activities of agents of the trustee will not be considered in determining material participation. The IRS position has been rebuked in two separate court decisions. In *Mattie K. Carter Trust v. United States,* the United States District Court held that the material participation of a trust for purposes of the passive activity rules should be determined by reference to the people who conduct the business on behalf of the trust, namely the trustee and the trustee's agents.[28] More recently, the United States Tax Court in *Frank Aragona Trust v. Commissioner* held that the activities of three of six trustees were sufficient to constitute material participation in the business owned by the trust, even though the three trustees were employees of the entity that operated the business.[29]

II. OVERVIEW OF TAX AND ORGANIZATIONAL ISSUES FOR BUSINESS ENTITIES

A. Introduction.

As with the summary above regarding trust income taxation, this paper does not contain an in-depth discussion of entity formation and taxation of business entities.[30] Instead, the summary below seeks to facilitate a discussion on trust owned business interests by noting some key aspects of entity formation, administration and taxation for corporations, partnerships and limited liability companies that arise when trusts own interests in those entities.

B. Corporations.

1. Generally.

Ownership of a corporation is represented by stock. Corporate stock can be common or preferred;[31] it can have full voting rights (voting stock) or no voting rights (non-voting stock).[32] The hallmark of the corporate structure is that shareholders generally are not liable for the debts of the corporation, unless a plaintiff can successfully "pierce the corporate veil" and ignore the corporate structure. Texas law further limits claims against shareholders for piercing the corporate veil to cases when the shareholder caused the corporation to be used for perpetrating and did perpetrate an actual fraud primarily for the direct personal benefit of the shareholder.[33] Management of a corporation resides with the board of directors (who are elected by the shareholders)[34] and the officers (who are elected by the board).[35] Corporations and their shareholders can enter into shareholder agreements to, among other things, limit the transferability of shares and impose certain rights and obligations to buy or sell stock.[36]

2. Income Tax Status.

A corporation can be classified for federal income tax purposes as a "C corporation" or an "S corporation". A C corporation must pay income tax on its taxable income. Further, if a C Corporation distributes a dividend to its shareholders, the shareholders must pay income tax on that dividend, and the corporation does not receive an offsetting income tax deduction for the dividend distribution. Therefore, C corporation income effectively incurs two levels of income tax: one at the corporation level and one at the shareholder level.

In contrast, the taxable income of an S corporation, in most cases, is taxed directly to each shareholder in proportion to the shareholder's ownership interest.[37] Distributions of cash from the S corporation are typically not taxable to the shareholder so long as they do not exceed the shareholder's basis. However, there are some circumstances when (1) income tax may be incurred at the S corporation level and (2) distributions of cash to a shareholder may be taxable to the shareholder.[38]

C. Partnerships

1. Generally.

Partnerships can be structured as general partnerships or limited partnerships. In a general partnership, all partners generally are jointly and severally liable for the obligations of the partnership.[39] With a limited partnership, the general partners are jointly and severally liable for debts of the partnership but the limited partners generally are not.[40] Ownership in a partnership is represented by partnership interests.[41] Distributions from a partnership can be made on a pro rata basis or with preferred distribution rights to some partners. Management of a partnership is handled by the general partner or a managing general partner. Partnership agreements govern the rights and obligations of the partners and the partnership.[42] As with a shareholder agreement, a partnership agreement may limit the transferability of partnership interests and impose certain rights and obligations to buy or sell partnership interests.

2. Income Tax Status.

Partnerships do not pay income tax on their income. Instead, each partner typically reports his or her allocable share of the partnership's taxable income on that partner's personal income return. The amount of taxable income that a partner must report is not dependent on actually receiving distributions from the partnership.[43]

D. Limited Liability Companies

1. Generally.

A limited liability company ("LLC") acts as a hybrid of a partnership and a corporation. Like a corporation, all members of an LLC have limited liability for the debts of the corporation absent a successful piercing of the corporate veil. However, LLCs require fewer corporate formalities when compared to a corporation. Ownership in an LLC is represented by membership interests, which can be structured with different voting rights (*i.e.*, voting and non-voting membership interests).[44] As with a partnership, distributions to members can be on a pro rata basis or with preferred distribution rights for certain members.[45] An LLC is managed either by its members (a member-managed LLC) or by one or more managers selected by the members (a manager-managed LLC).[46] The rights and obligations of the members are set forth in a company agreement and, like a partnership agreement,

can limit the transferability of membership interests and impose certain rights and obligations to buy or sell membership interests.[47]

2. Income Tax Status.

An LLC with at least two members is taxed as a partnership for income tax purposes unless the LLC elects to be taxed as a corporation by filing IRS Form 8832. Note, however, that an LLC with a single member will be disregarded for income tax purposes and, instead, will be taxed directly to the sole member, unless it elects to be taxed as a corporation.[48]

III. IMPORTANCE OF TRUSTEE DESIGNATION FOR TRUSTS WITH BUSINESS INTERESTS

A. Introduction.

The selection and succession of trustees for any trust merits careful study and analysis.[49] Trustees must administer trust property for the benefit of the trust's beneficiaries and determine if and when to make distributions as directed by the terms of the trust instrument. When a grantor intends for a trustee to administer a trust that owns significant interests in a closely held business, the grantor should evaluate the trustee appointment provisions from a different perspective. Consider a trust that owns a valuable membership interest in an LLC. The trustee would exercise all voting rights associated with that membership interest, including decisions on whether to liquidate the entity, amend the governing documents, remove the manager(s) or approve a sale of the company.[50] Additionally, if the trust instrument authorizes the distribution of trust principal, the trustee may have discretion to distribute part or all of the trust's business interests to the beneficiaries, thereby removing the business interest from the trust structure entirely. The trustee's decisions on these matters could significantly affect the operations and success of the business itself.

B. Options for Designation of Trustees

1. Trustee for All Purposes.

The simplest approach is to grant the trustee all powers over all trust property. In this approach, the trustee would exercise all investment and distribution powers over all trust property. This approach fits for a grantor that is comfortable with decisions on a trust's closely held assets being made by the same person(s) who exercise control over the trust's other assets.

If the grantor of the trust elects to designate an officer, director or employee of a closely held entity as the trustee of a trust funded with interests in such interest, such individual's dual roles (as a representative of the company vs. as trustee of a trust) present a number of potential conflicts that must be navigated. The individual's responsibly as an officer, director or employee for the business may not always align with what is in the best interests of the trust beneficiaries.[51]

2. Advisory Committee.

The trust instrument could establish an advisory committee of individuals who could consult with the trustee on matters related to trust-owned business interests. In this approach, the trustee would retain final decision-making authority. The advisory committee could be staffed with anyone the grantor deems appropriate, such as family members, individuals familiar with the specific business in which the trust owns an interest, or trusted general business advisors. The trust instrument should set forth procedures to fill vacancies in the advisory committee, establish

guidelines on who may serve as a successor trustee, and who could adjust the size of the committee and identity of the committee membership.[52]

3. Special Trustee.

A client may prefer that one trustee exercise trust powers with respect to a trust's business interests and another trustee exercise trust powers with respect to other trust assets. In this case, the trust instrument could designate a primary trustee and a special trustee. The primary trustee would exercise all powers of the trustee except for those specifically allocated to the special trustee. The trust instrument should designate which powers that the special trustee (and not the regular trustee) would exercise. The powers allocated to the special trustee might include (1) exercising all voting rights associated with any trust owned business interests and (2) approving any distributions of trust owned business interests to the beneficiaries. The special trustee could even be structured as a committee of special trustees in much the same as the advisory committee above, except that the committee of special trustees would have real power as opposed to serving as an advisor to the trustee.

Texas law would benefit from more clarity on the consequences of the bifurcation of trustee roles and responsibilities. It would seem desirable to limit any potential liability of the main trustee for the acts of the special trustee to the maximum extent possible. To that end, the trust instrument should expressly designate certain activities as the sole responsibility of the special trustee and state that the primary trustee has no authority over or responsibility for those activities or for the actions taken by the special trustee. To the extent that the primary trustee could be deemed to have any liability with respect to the action or inaction of the special trustee, the trust instrument could exculpate the primary trustee for any such liability other than a breach of trust by the primary trustee committed in bad faith, intentionally, or with reckless indifference to the interests of the beneficiary.[53] While not exactly on point with bifurcated trustee roles, Texas law provides that a trustee who does not join in an action of a co-trustee is not liable for the co-trustee's action unless the trustee does not exercise reasonable care to prevent the co-trustee from a serious breach of trust and compel the co-trustee to redress the serious breach of trust.[54]

C. Options for Trustee Appointment, Removal and Replacement

1. Generally.

All trust instruments should address who may remove trustees without cause or court approval and fill trustee vacancies. Furthermore, if the trustee role is bifurcated between a primary and special trustee, it may be prudent to structure the removal and replacement provisions differently, depending on which type of trustee is being removed or replaced. If the trust instrument does not grant someone a power to remove a trustee without cause, then a trustee may still be removed for cause by a court following a petition by an interested person and a hearing by the court.[55] Similarly, if the trust instrument does not provide a mechanism for the appointment of a successor trustee, the court may appoint a successor trustee upon petition of any interested person.[56]

If the fiduciary roles are bifurcated (with a special trustee exercising the powers over business interests), consider whether the individual(s) with removal and replacement powers as to the special trustee will be likely to exercise those powers consistent with the business objectives. It may be prudent to have different powerholders with respect to changing the regular trustee versus changing the special trustee. Additionally, consider limiting the class of potential successor special trustees who can be appointed to those who will fulfill the goals for the business interest. Again, the class of preferred successor special trustees may differ considerably from the preferred regular trustees.

2. Transfer Tax Considerations of Trustee Appointment, Removal and Replacement.

The identity of the trustee and of who can remove and replace the trustee may have significant transfer tax consequences, regardless of the nature of the trust assets. If the grantor creates an irrevocable trust for the benefit of third parties (*i.e.*, the grantor is not a beneficiary) and designates himself as trustee, care must be taken to ensure that the trust assets are not included in the grantor's gross estate for federal estate tax purposes.[57] Distributions by the grantor/trustee to third parties must be limited to an ascertainable standard (typically, health, education, maintenance and support) and cannot be made to discharge the grantor's legal obligations of support.[58] The grantor/trustee may not have the ability to exercise any powers over life insurance on the grantor's life that is owned by the trust.[59] The grantor/trustee may not have the ability to exercise any voting powers over stock in a controlled corporation.[60]

If a trust beneficiary is serving as trustee, the trust instrument should be structured to prevent such beneficiary's status as trustee from causing adverse transfer tax consequences to the beneficiary.[61] Distributions by the beneficiary/trustee to himself must be limited to an ascertainable standard (again, health, education, maintenance and support) and cannot be made to discharge the beneficiary's legal obligation of support to a third party. If the rights of the beneficiary-trustee are too broad, the beneficiary may be treated as having a general power of appointment, which can cause all or part of the trust assets to be included in the beneficiary's estate for federal estate tax purposes[62] or for a distribution from the trust to someone other than the beneficiary to be treated as a lapse of general power of appointment.[63]

Even if a grantor or beneficiary is not serving as trustee, the powers of the trustee can be attributed to the grantor or beneficiary if he or she has overly broad powers to remove and replace trustees. Specifically, the IRS has ruled that if a person can remove a trustee without cause and replace that trustee with another trustee that is either the person with the removal power or someone "related or subordinate" to the person with the removal power, such powerholder will be deemed to hold the powers of the trustee.[64]

D. Control Alternatives Outside of Trust Instrument

1. Voting Trust.

A voting trust is a written trust arrangement by which an owner transfers title in an interest in a domestic entity to a trustee who will exercise all voting powers applicable to such interests while the owner retains all beneficial rights to the interest.[65] If the owner desires to transfer the closely held interest, the donee must take the interest subject to the voting trust agreement. The voting trust is established through a stand-alone trust instrument. The beneficial owner of the business interests would receive voting trust certificates from the voting trustee, which would entitle the owner to all economic benefits of the business interest.[66]

A voting trust might prove particularly useful for married clients when one spouse owns a business interest as his or her sole management community property and, at his or her death, does not want his or her spouse to exercise any voting control over the spouse's one-half community property interest. To implement such approach while both spouses are living, the non-managing spouse would likely need to consent to the transfer of the interest into the voting trust and should be fully advised of the potential control he or she is giving up. The initial voting trustee of the voting trust would be the spouse who originally owned the business interest as sole management community property and successors could be appointed consistent with the desired goals for voting control. This approach

should allow the managing spouse to determine who exercises voting control while preserving the non-managing spouse's economic rights in the business interest itself.

2. Equal Equity but Unequal Control.

The ownership structure of business entities may be restructured so that the equity is divided into two classes: voting and non-voting. The two interests can be identical except that the voting interest carries voting powers and the non-voting interests would not. This distinction can facilitate important business planning.

Consider this common fact pattern. Parents own a closely held business. They desire to treat all of their children "equally" in their estate plan, but not all of the children either have the desire or ability to be actively involved in business decisions once their parents are out of the picture. One potential solution to this dilemma is for the parents to bifurcate their current ownership structure into voting and non-voting interests. The overwhelming bulk of the equity would take the form of non-voting interests. In their estate plan, they could fund trusts for each child with an equal equity percentage of the business but leave the voting interests to the trusts for the child(ren) that the parents want to vest with voting control.

As with most strategies, vesting voting control in some but not all beneficiaries can produce negative consequences in certain cases. Assume in the above example that the parents' estate plan leaves the business equally into separate trusts for each of the children (with each child as his or her own trustee) but funds one child's trust with all of the voting interests. While each trust would be entitled to equal distributions from the business, only one child controls when those distributions occur. Each child may have differing needs for cash flow. The child with voting control might receive his or her cash flow from the business through compensation for working for the business, which that child with voting control sets, and would instead prefer to retain cash in the business for future operations. This approach can lead to tremendous family tension.

One way to mitigate the possibility of family tension is to build in a provision in the trust instrument (or a separate entity level agreement) that grants any non-voting trust the right to put its interest back to the business or to the trust with voting control. Consideration should be given to (1) how to determine the purchase price, (2) how much must be paid in cash versus with a note, and (3) how to structure the terms of a note given for payment (term, interest rate, payment schedule, and security). This approach could even be used if the interests are not bifurcated with respect to voting control but the trust designates a non-beneficiary special trustee to exercise decisions with respect to the business interests. In that case, the beneficiary (who may also be the primary trustee but not special trustee) would have the ability to exercise the put right on behalf of the trust.

IV. TRUST OWNERSHIP OF S CORPORATION STOCK

A. Introduction.

Trust ownership of stock in a corporation taxed as an S corporation requires special planning. All shareholders of an S corporation must be individuals (none of whom can be a nonresident alien), estates, certain tax-exempt entities or certain qualified trusts. An S corporation generally may not have more than 100 shareholders.[67] An S corporation may only have one class of stock,[68] although differences in voting rights for two series of stock would not be treated as separate classes of stock.[69] This section will focus on the specific trusts that may own stock in an S corporation.[70]

B. **Permissible Trust Shareholders.**

1. Grantor Trusts.

Wholly grantor trusts may own S corporation stock, if the grantor is a U.S. citizen or resident.[71] This includes all sorts of grantor trusts, including revocable living trusts, traditional intentionally defective grantor trusts and beneficiary defective grantor trusts.

2. Grantor Trusts Terminated Upon Grantor's Death.

If a trust ceases to be taxed as a grantor trust, the ability for the trust to retain S corporation stock depends on the reason for termination of grantor trust status.

a) *Termination from Grantor's Death.* If grantor trust status terminates upon the grantor's death, the trust can continue to own the S corporation stock for up two years following the grantor's death without jeopardizing the S corporation status of the corporation.[72] Thereafter, the trust must transfer the shares to a qualified S corporation shareholder. For example, this situation would occur with an irrevocable grantor trust if the trust is still treated as a grantor trust when the grantor dies. It could also occur with a revocable living trust at the grantor's death. However, with a revocable trust, a Code section 645 election would cause the trust to be treated as an estate, which may extend the qualification period for a post-death revocable trust beyond two years, as discussed in IV.B.3 below.

b) *Termination Prior to Grantor's Death.* While some irrevocable grantor trusts may retain grantor trust status until the grantor's death, other irrevocable grantor trusts may be structured so that the grantor trust feature may be turned off prior to the grantor's death. If grantor trust status is turned off prior to the grantor's death, the trust may only continue to own S corporation stock if it elects to be taxed as either an ESBT or QSST, discussed below, which elections must be made within 2 months and 15 days from the date grantor trust status terminates.[73]

3. Testamentary Trust.

A trust that receives stock transferred to it pursuant to the terms of a Will may hold S corporation stock for up to two years beginning on the day when the stock is transferred to it.[74] Note that this temporal limitation refers to the date when the stock is transferred to the trust and not to the date of the deceased shareholder's death. This distinction may allow a longer period of time to ensure qualified S corporation shareholder compliance following the death of an individual if the stock is owned personally by the individual (and, therefore, included in the probate estate) as opposed to being owned by the individual's revocable trust.

A decedent's estate is a qualified S corporation shareholder.[75] Federal tax law does not impose a specific time for when a probate estate can continue to be taxed as an estate. Instead, an estate is taxed as an estate during a reasonable period of administration. Once that reasonable period ends, the estate will be deemed terminated under federal tax law even if the estate remains open for state probate purposes. A revocable trust that makes a Code section 645 election would be treated as an estate for this purpose. The treasury regulations define a reasonable period of administration as the time actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates.[76]

Thus, if S corporation stock flows from the probate estate to a trust pursuant to a Will, more than two years can elapse (and perhaps considerably more than two years) from the date of death until making a qualified trust election since the trust's election clock does not start until the trust receives the stock from the estate, which can occur after a reasonable period of administration.

4. Qualified Subchapter S Trust.

A trust that elects to be taxed as a qualified subchapter S trust ("QSST") may hold S corporation stock.[77] A QSST requires that during the life of the current income beneficiary, such beneficiary is the only income beneficiary of the QSST. Any principal distributed during the current beneficiary's life must be distributed only to the sole income beneficiary. The income interest of the current beneficiary must terminate on the earlier of the beneficiary's death or termination of the trust. Upon termination of the QSST during the current beneficiary's life, the trust must distribute all of its assets to the current beneficiary.[78]

All S Corporation income is taxable, for income tax purposes, to the current income beneficiary of a QSST at the beneficiary's individual rates. From an asset protection and wealth transfer standpoint, a trust structured as a QSST may not be as preferable because of the inability to accumulate income. All income of a QSST must be distributed to the beneficiary, taking it out of the trust's protective wrapper. However, a QSST may provide better income tax treatment if the beneficiary is not taxed at the highest marginal income tax rate.

The current income beneficiary must file an election with the IRS for a trust to be taxed as a QSST.[79] If the trustee is not the current income beneficiary, the trustee must be mindful of the need (in almost all cases) to ensure that the trust qualifies as an eligible S corporation shareholder. If the trustee determines that the beneficiary will not file a timely QSST election, the trustee may wish to consider making an ESBT election, as described below. If the beneficiary later desires to make a QSST election, Treasury regulations set forth procedures for converting an ESBT to a QSST.[80]

5. Electing Small Business Trust.

A trust that elects to be taxed as an electing small business trust ("ESBT") may hold S corporation stock.[81] Generally, there are no limitations on distributions from an ESBT, except that the only beneficiaries can be individuals, estates or certain charities, and an ESBT cannot be a QSST, a tax-exempt trust or a charitable remainder trust.[82] The trustee must file an election with the IRS for a trust to be taxed as an ESBT.[83]

An ESBT pays income tax on its S corporation income at the highest rate of tax without any deduction for S corporation income distributed to the beneficiaries.[84] By allowing the accumulation of income, a trust structured as an ESBT may be preferable over a QSST from an asset protection and wealth transfer standpoint. However, it may provide a higher income tax cost on S corporation income as compared to a QSST if the beneficiary is not in the highest income tax bracket.

6. Qualified Voting Trust.

A qualified voting trust may own S corporation stock.[85] Treasury regulations require that the beneficial owners of the voting trust be treated as the owners of their respective portions of the trust pursuant to the grantor trust rules.[86] The initial grantors of the voting trust clearly would be treated as the grantors under the grantor trust rules. However, what happens upon subsequent transfers of voting trust certificates? Although the regulations could benefit from more clarity on this point, the

beneficial owner of the voting trust certificates should be treated as the substitute grantor and, therefore, such beneficial owner should be an eligible S corporation shareholder.[87]

A qualified voting trust is a trust created primarily to exercise the voting power of the stock transferred to it. The trust must have been created pursuant to a written trust agreement entered into by the shareholders that does the following:

- delegates to one or more trustees the right to vote,
- requires that all distributions with respect to the stock held by the trust be paid to or on behalf of the beneficial owners of the stock,
- requires title and possession of the stock to be delivered to those beneficial owners upon termination of the trust, and
- terminates under its terms or by state law on or before a specific date or event.[88]

C. Trust Provisions Specific to S Corporation Stock.

1. Obligation to Maintain S Corporation Election.

Corporations taxed as S corporations frequently utilize shareholder agreements that attempt to prevent any actions by the shareholders that might disqualify the corporation from being taxed as an S corporation. Some trust instruments will include language in the administrative provisions that require a trustee to take all actions necessary to ensure that a trust that owns S corporation stock is an eligible S corporation shareholder. In many circumstances, such language will prove consistent with the best interests of the trust beneficiaries.

However, circumstances could arise when including such language in the trust instrument might not serve the best interests of the beneficiaries. For example, consider a trust that receives a small number of shares of S corporation stock. What if the corporation does not make distributions sufficient to cover the shareholders' income tax liabilities? If the trust is a minority shareholder, the trust may have little recourse to force distributions. The ability to disqualify the corporation from S corporation status by refusing to consent to make appropriate tax elections may provide the trustee with the only available leverage to compel fair treatment to the beneficiaries.[89]

2. Power to Convert a Trust to Qualify as a QSST.

As discussed earlier, the benefit of a QSST over an ESBT is that the trust's S corporation income may be taxed at the beneficiary's marginal income tax rate. In contrast, an ESBT pays income tax on its S corporation income at the highest marginal income tax rate, even if the income is distributed to the beneficiary. In contrast, individuals reach the top income tax bracket at much higher levels (for 2014, the top income bracket is $406,750 for individuals and $457,600 for married couples filing jointly).[90] Thus, if the beneficiary is not in the highest income tax bracket, the use of a QSST (which distributes and taxes S corporation income directly to the beneficiary) may result in less overall income tax as compared to an ESBT.

Consider including a provision in the trust instrument that would allow modification of a trust to segregate S corporation stock into a separate trust that qualifies as a QSST. For example, consider a lifetime trust for the primary benefit of a child that authorizes discretionary distributions of income and principal to the child and the child's descendants, with the child's interest given priority over his or her descendants. Such a trust would not qualify as a QSST because current distributions could be made to more than one person.

The trustee with the power to covert a trust to a QSST should not be a beneficiary of the trust. For example, if the primary beneficiary was the trustee, he or she could convert a discretionary trust into a mandatory income trust for his or her benefit, which raises numerous transfer tax considerations. Keep in mind, too, that the beneficiary will be deemed to have the powers of the trustee if he or she can remove a trustee without cause and replace it with a trustee who is related or subordinate to the beneficiary. Additionally, the exercise of the amendment power should not be contingent on the beneficiary making the QSST election, as there is some risk that such limitation would effectively treat the amendment power as being held jointly by the beneficiary and the trustee, which would raises transfer tax issues.[91] Instead, such amendment power should provide that if the beneficiary does not exercise the QSST election, the amendment will still be made but instead the trustee will elect for such trust to be taxed as an ESBT.

Query, however, as to the willingness of an independent trustee to exercise such a power. The practical effect would be to take away the current rights of the child's descendants to discretionary income and principal and instead give the primary beneficiary mandatory income from the S corporation stock. While limitations of liability in the trust instrument might give the trustee some comfort, the obvious conflict between the interests of the two classes of trust beneficiaries may give the trustee trepidation in exercising the power. In such case, the trustee may wish consider obtaining a release from the beneficiaries affected by the conversion and an indemnification from the primary beneficiary against claims from other beneficiaries made because of the conversion.

V. TRUST DISTRIBUTIONS

A. Introduction.

The trustee implements the distribution provisions of the trust instrument. The trust instrument can either impose an obligation to make specific distributions or grant discretion to make certain distributions. It can differentiate between income and principal, both as to whether such distributions are mandatory or discretionary and as to which beneficiaries may/shall receive which type of trust property. It can direct whether the trustee should or must consider the beneficiaries' other resources or sources of income in deciding whether to make discretionary distributions. The nature of a trust's distribution provisions depends on the grantor's goals and objectives for establishing the trust, with tax considerations also influencing how the grantor may best achieve those goals and objectives. When structuring and administering a trust that will own interests in a closely held business, additional factors come into play that merit close consideration.

B. Limitations of Principal Distributions.

Trust instruments frequently allow distributions of principal out of the trust and into the hands of the beneficiaries or others, such as the following:

- Discretionary distributions of principal to the beneficiaries, either based on an ascertainable standard (*e.g.*, health, education, maintenance and support) or through a broader discretionary distribution power,
- Mandatory distributions of principal at certain ages (*e.g.*, 1/3 at age 25, ½ at age 30 and balance at age 35),
- Withdrawal rights for the beneficiary over certain portions of trust principal, and
- Inter vivos or testamentary powers of appointment.

When a trust will own significant closely held business interests, these common trust provisions may run counter to the grantor's overall business planning goals. The grantor may prefer that the trust-owned

business interests remain in the trust structure and, ultimately, stay within the family line. In some cases, the business entity agreements (*e.g.*, shareholder agreements, partnership agreements or LLC agreements) may contain the necessary transfer restrictions to satisfy the grantor. However, this merits close study.

For example, consider a trust that grants the beneficiary the broadest possible non-general testamentary power of appointment (excluding only the beneficiary, the beneficiary's estate, the beneficiary's creditors and the creditors of the beneficiary's estate). The grantor may feel comfortable granting such a power over non-business assets but may want to limit the power to a narrower class of permissible appointees for business interests with certain requirements that the interests remain in trust.

C. **Trust Accounting for Closely Held Interests.**

Many trusts do not distinguish between income and principal for distribution purposes, instead authorizing discretionary distributions of income and principal, with undistributed income added to principal. However, for some trusts (most commonly marital deduction trusts), this distinction is quite important. The *Texas Uniform Principal and Income Act* sets forth how to allocate receipts between income and principal. Trustees that administer trusts with closely held business interests should have a firm understanding of these rules.

1. Cash Distributions

All cash received by a trust from an entity is allocated to income,[92] subject to three exceptions discussed below.

First, cash received by a trust should be allocated to principal if received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity.[93] In other words, if the interest is purchased by a third party or redeemed by the entity itself, the sale proceeds should be classified as principal.

Second, cash received by a trust should be allocated to principal if received from a regulated investment company or real estate investment trust ("REIT") and the money distributed is a capital gain dividend for federal income tax purposes.[94]

Third, cash received by a trust should be allocated to principal if the money received is in total or partial liquidation of the entity.[95] Money is received in partial liquidation of an entity:

- To the extent the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or
- If the total amount of money and property received in distribution or series of related distributions is greater than 20% of entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt.

However, money is not received in partial liquidation (and cannot be taken into account under the 20% rule), to the extent it does not exceed the amount of income tax a trustee or beneficiary must pay on taxable income of the entity that distributes the money.[96]

2. Power to Adjust.

If distribution is large but is not treated as a partial liquidation, then the distribution will be treated as income for trust accounting purposes, which may be inconsistent with the grantor's intentions for

distributions from the trust. In such case, the trustee may consider to what extent it may utilize the statutory power to adjust between principal and income to reclassify a portion of the distribution as principal.[97]

A trust may adjust between principal and income to the extent it considers necessary if (1) the trustee invests and manages trust assets as a prudent investor, (2) the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to trust income and (3) the trustee determines that an investment is required to treat the beneficiaries fairly and impartially.[98]

The *Texas Uniform Principal and Income Act* lists nine factors that the trustee should consider in deciding whether to exercise the adjustment power.[99] It also identifies seven circumstances when a trustee may not exercise the adjustment.[100] In particular, a trustee may not exercise the adjustment power if he is a beneficiary of the trust, would benefit directly or indirectly from the adjustment, or the power would cause estate tax inclusion for the trustee. In those cases, however, a co-trustee who would not be prohibited from exercising the power may do so without the participation of the co-trustee who is prohibited from exercising the power.[101]

D. Trust Ownership of Interests in Pass-Through Entities.

1. Introduction.

Just like an individual partner of a partnership or shareholder of an S corporation, it is possible that distributions from the entity will be insufficient to cover the owner's income tax liability associated with the owner's share of the entity's taxable income. This forces the trust to use its other cash resources to pay income tax associated with its interest in the flow-through entity. As a protection, the governing documents for the entity (*e.g.*, partnership agreement, LLC agreement or shareholder agreement) may require a minimum distribution from the entity to the owners in an amount sufficient to cover income tax liabilities.

2. Mandatory Income Complications.

Trusts that provide for mandatory distributions of income require special analysis when they own interests in flow-through entities.[102] To illustrate the potential complexity, consider an income-only trust that owns a limited partnership interest in a Texas limited partnership. The taxable income attributable to the trust's partnership interest is $100,000. Since the partnership is a flow-through entity for income tax purposes, the trust must report all $100,000 of partnership income on its trust income tax return.

If the partnership does not make any distributions to its partners, then the trust will be faced with paying income tax on $100,000 of income without cash from the partnership to foot the bill. In such case, the trust must either look to other trust assets to find cash to pay the tax or borrow cash from a third party.

The tax situation becomes different if the partnership makes distributions to its partners. The cleanest situation is if the partnership makes distributions to its partners equal to each partner's share of the partnership's taxable income. In our hypothetical, this would result in the trust receiving a $100,000 distribution from the partnership. Assuming such distribution is not a liquidating distribution from the partnership, it should be treated as trust accounting income to the trust, which the mandatory income trust must then distribute to the beneficiary. The trust will receive a $100,000 income distribution deduction (reducing its taxable income from the partnership to $0). The

beneficiary will report $100,000 of partnership income on his or her personal income tax return and can use the cash distribution to pay the associated income tax.

What if the partnership distributions to the partners are less than the total taxable income from the partnership? Section 116.205 of the *Texas Uniform Principal and Income Act* essentially provides that a mandatory income trust will use the minimum amount of cash distributions received from a pass-through entity to pay its associated income tax and then will distribute the balance of the cash received from the entity to the beneficiary. The following examples from the comments to the Uniform Principal and Income Act illustrate how section 116.205 would be applied:

> *"Example (1) – Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $100,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket. Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c) T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire $100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing.*
>
> *Example (2) - Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $500,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket. Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses $350,000 of the $500,000 to pay its taxes and distributes the remaining $150,000 to B. The $150,000 payment to B reduces T's taxes by $52,500, which it must pay to B. But the $52,500 further reduces T's taxes by $18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B.*
>
> *Alternatively, T can apply the following algebraic formula to determine the amount payable to B:*
>
> $D = (C-R*K)/(1-R)$
>
> *D = Distribution to income beneficiary*
>
> *C = Cash paid by the entity to the trust*
>
> *R = tax rate on income*
>
> *K = entity's K-1 taxable income*
>
> *Applying the formula to Example (2) above, Trust T must pay $230,769 to B so that after deducting the payment, T has exactly enough to pay its tax on the remaining taxable income from P."*[103]
>
> *Taxable Income per K-1 1,000,000*
>
> *Payment to beneficiary 230,769*
>
> *Trust Taxable Income $ 769,231*

35 percent tax 269,231

Partnership Distribution $ 500,000

Fiduciary's Tax Liability (269,231)

Payable to the Beneficiary $ 230,769

In addition, B will report $230,769 on his or her own personal income tax return, paying taxes of $80,769. Because Trust T withheld $269,231 to pay its taxes and B paid $80,769 taxes of its own, B bore the entire $350,000 tax burden on the $1 million of entity taxable income, including the $500,000 that the entity retained that presumably increased the value of the trust's investment entity.

E. **Special Considerations for QTIP Trusts.**

A qualified terminable interest property ("QTIP") trust is a trust for the benefit of the grantor's spouse that is intended to qualify for the federal gift tax marital deduction (with respect to lifetime gifts) or the federal estate tax marital deduction (with respect to testamentary bequests).

The fundamental element of a QTIP trust is that the spouse must possess a qualifying income interest for life in the trust property.[104] A qualifying income interest for life means that the spouse is entitled to all net trust income for his or her life (payable at least annually) and no person has the power to appoint the principal to any person other than the spouse during the spouse's lifetime.[105]

A trust may qualify as a QTIP trust even if the trustee has the power to retain assets that are unproductive of income so long as the spouse has the power to compel the trustee to make the trust assets productive of income.[106] The trust will not satisfy this requirement if the primary purpose of the trust is to safeguard property without providing the spouse with the required beneficial enjoyment.[107] Clearly, a trust that expressly provides for the accumulation of income violates this rule, but so too would a trust that indirectly accomplishes a similar purpose.[108] Trusts funded with closely held business interests must pay particular attention to these rules if QTIP treatment is desired, given that these interests may produce few current distributions and significant limitations on transferability.

The trust instrument creating the QTIP should grant the spouse the power to make the trust assets productive of income. However, consideration should be given to the ability of the spouse to effectively exercise such power. For example, *Technical Advice Memorandum 200339003* addressed a QTIP trust funded, in part, with non-dividend producing private stock. The trust instrument provided that the spouse had the right at any time to require the trustee to make the trust assets productive or to convert the trust assets into productive assets. It also contained a requirement that any determinations by the trustee in connection with the sale or exchange of stock required the consent of 80% of the shareholders. The Service concluded the spouse's express power to make the stock productive was not subject to the 80% requirement and, therefore, concluded that the trust instrument granted the trustee sufficient authority to sell the stock to make it productive. It also pointed to a general saving clause provision that the trust was intended to qualify for QTIP treatment.

F. **Decanting.**

Texas law authorizes the trustee of a trust to distribute trust property to a second trust (a process referred to as "decanting"), subject to a variety of limitations.[109] If the existing trust grants a trustee full discretion to distribute principal, the decanting process effectively allows distributions to a second trust

for the benefit of one or more of the beneficiaries of the first trust with entirely different administrative provisions.[110] If the existing trust does not grant a trustee full discretion to distribute principal, the decanting process effectively allows distributions to a second trust that mirrors the first trust except that the administrative provisions of the second trust can be different.[111]

Differing administrative provisions could affect the business planning goals associated with trust ownership, although the Texas decanting statute includes certain protections. For example, the trustee may not decant into a second trust that materially reduces the trustee's fiduciary duties.[112] The trustee may not decant S stock to a second trust that is not a qualified S corporation shareholder.[113] If desired, the Texas decanting statute states that the trust instrument may prevent decanting by an express prohibition in the trust instrument.[114]

G. Impact of Turning Off Grantor Trust Status.

The intentionally defective grantor trust ("IDGT") can provide tremendous wealth transfer benefits by allowing the trust assets to grow undiminished by income taxes. Grantors commonly fund IDGTs with closely held business interests because (1) such assets may have tremendous upside potential and (2) the leverage from valuation discounts associated with closely held business interests can greatly enhance the wealth shifting potential for the IDGT. Recognizing the transfer tax benefits of grantor trust status, grantors may become tired of footing the income tax bill for property transferred to their family members via the grantor trust and wish to turn off the grantor trust status.

In some cases, turning off grantor trust status may be more difficult than merely releasing a traditional grantor trust power (*i.e.*, a power of substitution).[115] Grantor trust status may also be caused by the identity of the beneficiaries (such as trusts with a spouse as a discretionary beneficiary), the distributions that can be made to them, and the identity of the trustee. Eliminating grantor trust status caused by those situations may be difficult or even impossible.

If grantor trust status cannot be turned off, care should be taken to provide arrangements to obtain cash from the trust, if necessary to fund income tax payments, without jeopardizing the transfer tax benefits. For example, a substitution power would enable the grantor to add in additional illiquid assets to the trust in exchange for trust cash of equivalent value. A trustee could also lend trust funds to the grantor if the trustee charges adequate interest. While some commentators have debated the risk/reward of including a power of an independent trustee to reimburse the grantor for income taxes associated with grantor trust status, this author feels such a provision raises too much risk of unfavorable estate tax consequences, particularly if the provision were actually utilized to reimburse the grantor.

VI. TRUST ADMINISTRATION

A. Investment, Generally.

Trustees must evaluate trust ownership of closely held business interests in light of the rules and restrictions on trust investments set forth in the trust instrument and under applicable state law. Absent contrary direction in the trust instrument, a trustee must invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust.[116] This direction requires the trustee to exercise reasonable care, skill and caution.[117] This "prudent investor rule" dictates that a trustee evaluate an individual asset in the context of a trust portfolio as a whole and as part of an overall investment strategy.[118] Texas law sets forth a variety of factors to consider in applying the prudent investor rule, including an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.[119] A trustee must diversify the

trust's investments unless the trustee reasonably determines that, due to special circumstances, the trust's purposes are better served without diversifying.[120]

Upon accepting appointment as trustee, the trustee must within a reasonable time implement decisions regarding the retention and disposition of trust assets as needed to bring the trust portfolio into compliance with the purposes, terms, distribution requirements and other circumstances of the trust, including compliance with the prudent investor rule (to the extent the trust instrument does not override the rule).[121] The trustee must invest and manage trust assets solely in the interest of the trust's beneficiaries[122] and must act impartially between the interests of the various beneficiaries.[123]

B. **Overriding Prudent Investor Rule.**

The trust instrument can expand, restrict, eliminate or otherwise alter the terms of the prudent investor rule.[124] For trusts intended to hold significant interests in closely held businesses, deviating from the prudent investor rule – particularly as it relates to diversification – may be a critical feature of accomplishing the grantor's overall business and estate planning objectives.

Unfortunately, case law has demonstrated the extraordinary difficulty of constructing effective language that exonerates trustees from retaining large concentrations of a single asset. Michael Cenatiempo and Kimberly Carter authored an outstanding article on these difficulties and analyzed how to proceed with drafting retention clauses in light of the perplexing case law on this topic.[125] Their article provides a number of useful suggestions for drafters as they attempt to structure retention clauses, which are quoted below:

- "retention clauses will be strictly construed;
- general retention clauses will not work;
- general clauses intended to negate the duty to diversify are questionable...;
- clear, customized language should work...;
- the retention clause should state that it is intended to moderate or obviate the duty to diversify;
- specific, precise, explicit and unique clauses should work;
- the settlor's intent is the cornerstone of trust construction...."[126]

As the above makes clear, grantors who want to allow their trustees to retain specific business interests contributed to the trusts should use specifically crafted language, mentioning the businesses by name, and not simply rely on generic administrative language that allows trustees to ignore the prudent investor rule.

As an additional protection, trust instruments can limit trustee liability except for (i) a breach of trust committed in bad faith, intentionally or with reckless indifference to the interest of the beneficiary or (ii) any profit derived by the trustee from a breach of trust.[127]

C. **Marital Property Considerations for Efforts on Behalf of Trust Owned Business Interests.**

Trust ownership of closely held business interests raises complicated marital property considerations, beyond the basic questions about the marital property character of trust property and distributions from the trust.

If the beneficiary-trustee is married and is a significant employee of the closely held business of which the trust is also a significant shareholder, care should be taken to insure that the beneficiary is being adequately compensated for his or her services to the company. The community estate is entitled to reimbursement for the reasonable value of time, toil and effort of the beneficiary-spouse expended to

enhance the value of the business interest owned by the trust, other than that reasonable and necessary to manage and preserve such property, which contributed to the increase, if any, in the value of the business interest. This reimbursement right is reduced by the compensation paid to the beneficiary-spouse for such time, toil and effort.[128]

For example, consider an irrevocable trust that owns a significant closely held business interest, including a majority of the voting control of the business entity. Assume, further, that the primary beneficiary of the trust serves as trustee of the trustee and works full-time for the business. Finally, assume that the trust is structured so that the property inside the trust has no marital property character and that all distributions from the trust to the beneficiary are the beneficiary's separate property. The beneficiary-trustee may prefer to receive a modest salary from the business (which would be community property) in exchange for larger distributions from the business to the owners (which, if first made to the trust, should be separate property). In addition to raising potential income tax issues, such a strategy could raise a reimbursement claim to the community estate. These sorts of issues are best addressed through a marital property agreement.

D. **Power of Substitution**

Trusts that are intended to be taxable as grantor trusts for federal income tax purposes frequently provide the grantor a power, acting in a nonfiduciary capacity, to reacquire trust property by substituting other property of equivalent value.[129] These sorts of powers – commonly referred to as "swap powers" – can prove quite helpful for trusts funded with closely held business interests, although some cautions should be noted.

1. Code Section 2036(b)

Historically, practitioners have feared that the possession of a swap power held by the grantor might result in estate tax inclusion under Code section 2036, particularly as it applied to stock in a closely held corporation.

Section 2036(a) provides that the gross estate includes the value of all property to the extent of any interest therein of which the decedent made a transfer (except for a bona fide sale for adequate and full consideration in money or money's worth), under which the decedent retained for his or her life or any period not ascertainable without reference to his or her death or any period which does not in fact end before his or her death:

- The possession or enjoyment of, or the right to the income from the property, or
- The right, either alone or in conjunction with any other person, to designate the persons shall possess or enjoy the property or the income therefrom.[130]

Section 2036(b) provides that the right to vote (directly or indirectly) shares of stock in a controlled corporation is considered a retention of the enjoyment of the transferred property. A corporation is a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the decedent's date of death, the decedent owned (with the application of Code section 318), or had the right (either alone or in conjunction with any person) to vote stock possessing at least 20% of the total combined voting power of all classes of stock.

Code section 318 sets forth certain family attribution rules. Stated simply, stock owned by a decedent's spouse, children, grandchildren or parents will be attributed to the decedent, as well as stock owned through entities for the benefit of such persons.[131]

In Revenue Ruling 2008-22, the IRS ruled that a swap power, by itself, would not result in estate tax inclusion under Code section 2036. However, that ruling did not specifically address the application of section 2036(b) to a swap power applicable to stock in a controlled corporation. Therefore, some planners (a class of people who are frequently compulsive worriers) have expressed concern that Revenue Ruling 2008-22 might not avoid estate tax inclusion if the swap power applies with respect to stock in a controlled corporation.

For those with a desire to include a swap power but who still are concerned about section 2036(b), grantor trust status may still be obtained by granting the swap power to a third party (keeping in mind attribution under section 318).[132] However, query whether clients would be eager to granting a third party the ability to acquire a significant voting stake in the family business.

2. Flexible Income Tax Planning Tool

Grantors frequently contribute closely held business interests to IDGTs because of the significant upside valuation potential for those interests. A swap power is commonly included in the IDGT to cause grantor trust status, meaning that transactions between the grantor and the IDGT are ignored for income tax purposes.

The closely-held interests may have low income tax basis as compared to their fair market value. Assets included in a decedent's gross estate for estate tax purposes receive a new income tax basis equal to fair market value for estate tax purposes (either date of death value or, if applicable, alternative valuation date value).[133] Note, also, that both halves of community property receive a new income tax basis, even though only one-half of such community property is included in the estate of the first spouse to die.[134]

The retention of a swap power by the grantor until his or her death may facilitate end of life income tax planning. Specifically, the swap power could allow the grantor to contribute cash or high basis assets to the IDGT in exchange for low basis assets of equivalent value. If a grantor's life expectancy is diminished, a swap of this sort using low basis business interests held in the IDGT could produce significant income tax savings, by enabling the swapped out assets (with low income tax basis) to receive a new income tax basis at the grantor's death. Obviously, timing is critical – one would not want to implement such swap and then have the swapped out business interest rapidly appreciate in value between the date of the swap and the date of the grantor's death.

E. **Compensation.**

The trust instrument should address the compensation, if any, a trustee will be entitled to receive for serving as trustee. Absent a different direction in the trust instrument, a trustee is entitled to "reasonable compensation" from the trust for acting as trustee.[135] For trusts funded with significant closely held business interests, trustee compensation can raise a number of usual circumstances. If grantor selects an employee of the grantor's closely held business to serve as trustee, care should be taken not to duplicate compensation for the individual in his or her capacity as trustee with the compensation the individual receives as an employee.

Additionally, some trustees calculate their fees based on the value of the assets of the trust. With a closely held business interest, this presents some practical problems. First, what is the value of the interest? Is it going to be appraised to determine such value? If so, how frequently? Second, what if the trust instrument and the entity documents severely limit the trustee's ability to transfer the business interest and provide direction that the business interest should be retained in the trust? It is possible that the trustee's liability for and involvement in issues associated with the business interest may be

considerably less than with other trust assets. If the grantor intends for the trustee to receive compensation, the grantor should think through what that means with respect to the trustee's role over trust owned business interests.

F. GST Tax and 6166 Deferral.

1. Generally.

Code section 6166 allows estates that are concentrated in interests in certain closely held entities to defer the payment of federal estate tax, at favorable interest rates, for up to 15 years, with interest only payable for the first 5 years. Section 6166 also allows for the deferral of GST tax attributable to direct skips at a taxpayer's death. However, the IRS has ruled that GST tax from a taxable termination of a trust consisting primarily of interests in certain closely held entities cannot utilize Code section 6166 to defer payment of the GST tax.[136]

In *Private Letter Ruling 200939003*, grandparent created a trust for child and transferred S corporation stock to the trust. The trust was a QSST. The trust assets would be distributed outright to child if child attained a certain age. If child died before the designated age, child possessed a formula testamentary general power of appointment. The portion of the trust not subject to the formula testamentary general power of appointment at child's death would be administered in trust for child's descendants. No GST exemption had been allocated to the trust by grandparent. At child's death, no portion of the trust was subject to the formula general power of appointment. The Service ruled that even though the trust consisted of the type of assets covered by section 6166, the trust was nevertheless ineligible for 6166 deferral on the GST tax payable upon the taxable termination.

The Service reasoned that section 6166(i) provides for the application of 6166 deferral to the extent an interest in a closely held business is subject to a direct skip occurring at the same time as, and because of, a decedent's death. Since no reference was made to deferral of GST tax under 6166 in any other manner (*i.e.*, taxable distributions or taxable terminations), the Service ruled that such omission means that 6166 deferral is only available for GST tax attributable to direct skips.

The Service was not persuaded by the fact that Code section 2661(2) states that the provisions of Subtitle F of the Code (which includes section 6166) apply in the case of a GST transfer occurring at the same time and as a result of the death of an individual insofar as applicable and not inconsistent with the provisions of chapter 13.

2. Planning Considerations

The potential limitation on 6166 deferral for taxable terminations of trusts with considerable closely held business interests raises important planning considerations.

Planners frequently include a formula general power of appointment that would subject that portion of a trust to inclusion in the powerholder's estate if doing so would minimize the combined amount of both estate and GST tax payable because of the powerholder's death.

For example, if the powerholder's personal estate – when combined with the assets of the trust – would not be large enough to incur estate tax, then the power of appointment would apply to the trust (avoiding GST tax through the power of appointment and avoiding estate tax because of the powerholder's available estate tax exemption). However, if the powerholder's personal estate would be subject to estate tax even if none of the trust assets were included in his or her estate, the power of appointment would not apply and, instead, the assets would be subject to GST tax. Since the estate

tax and GST tax utilize the same tax rate (40%), no tax savings would occur in this case by subjecting the assets to estate tax rather than GST tax.

While subjecting the assets to GST tax rather than estate tax might not result in more total transfer tax, it will prevent the ability to defer the GST tax associated with the trust assets if the Service's analysis in *Private Letter Ruling 200939003* is correct. This result could increase the financial hardship in paying the transfer tax that might have been minimized through favorable tax deferral under section 6166.

Additionally, subjecting the assets to estate tax rather than GST tax would allow the trust assets to receive a new income tax basis at the beneficiary's death. If the trust assets have built in gain at the beneficiary's death, the gain will be eliminated by causing the trust assets to be included in the beneficiary's estate.

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[1] For an interesting illustration of the importance of family businesses and their relevance to the U.S. economy, see Morton A. Harris, "Planning for the Successful Transition of a Family Business to the Next Generation: A Family Business Survival Guide for Owners and Advisors," AMERICAN BAR ASSOCIATION, JOINT MEETING OF SECTION OF TAXATION AND SECTION OF REAL PROPERTY, TRUSTS AND ESTATES (Sept. 2013).

[2] For a comprehensive article on the income taxation of trusts and estates, see Mickey R. Davis, "Income Taxation of Trusts and Estates," 33RD ANNUAL ADVANCED ESTATE PLANNING AND PROBATE COURSE (June 2009).

[3] Tex. Prop. Code § 112.004(4).

[4] For an excellent discussion of how to structure a flexible irrevocable trust with the primary beneficiary serving as trustee, see John F. Bergner, "Drafting for Flexibility," 22ND ANNUAL ADVANCED ESTATE PLANNING AND PROBATE DRAFTING COURSE (October 2011).

[5] Tex. Prop. Code § 112.035.

[6] Tex. Prop. Code § 112.035(a). Note that a statement in the trust instrument that the beneficiary's interest in the trust shall be subject to a "spendthrift trust" is sufficient to create such a trust. Tex. Prop. Code § 112.035(b).

[7] Tex. Prop. Code § 112.035(f)(1)(A)(ii).

[8] Tex. Prop. Code § 112.035(f)(1)(B).

[9] Tex. Prop. Code § 112.035(f)(2).

[10] Tex. Prop. Code § 112.035(d).

[11] *See* Tex. Prop. Code § 112.035(g).

[12] Tex. Fam. Code § 7.001.

[13] Tex. Fam. Code § 3.001(2).

[14] Tex. Fam. Code § 3.101(2).

[15] Tex. Fam. Code § 4.103.

[16] Tex. Fam. Code § 3.003.

[17] For an excellent synopsis of marital property issues in Texas (including trust ownership of property), see Thomas M. Featherston, Jr., "Asset Protection Planning – Getting Ready for Marriage in Texas," PROBATE, TRUST AND ESTATE SECTION OF DALLAS BAR ASSOCIATION (Feb. 25, 2014).

[18] IRC § 671.

[19] *See* IRC § 678.

[20] Rev. Proc. 2013-35.

[21] *See* IRC § 661.

[22] Treas. Reg. 1.643(a)-3(b).

[23] IRC § 1411(a)(2).

[24] IRC § 1411(c).

[25] IRC § 1411(c)(2).

[26] IRC § 469(c).

[27] IRC § 469(h).

[28] 256 F. Supp. 2d 536 (N.D. Tx. 2003).

[29] 142 T.C. 9 (2014). For a thorough discussion of the impact of the NII tax on trusts, see Jonathan G. Blattmachr, Mitchell M. Gans, and Diana S.C. Zeydel, "Imposition of the 3.8% Medicare Tax on Estates and Trusts," ESTATE PLANNING JOURNAL (April 2013).

[30] For a comprehensive discussion of the tax issues associated with choice of entity, see William H. Hornberger and Steven D. Moore, "Tax Considerations in Choice of Entity," 12TH ANNUAL CHOICE & ACQUISITION OF ENTITIES IN TEXAS COURSE (May 23, 2014).

[31] Whenever equity interests are bifurcated into common and preferred (whether in a corporation, partnership or LLC), practitioners must be especially sensitive to potential issues under Code section 2701. For a thorough summary of section 2701, see Louis A. Mezzullo, "Special Valuation Rules: Section 2701," ABA MEETING OF THE SECTION OF TAXATION (May 2013).

[32] TBOC § 21.152.

[33] TBOC § 21.223(b).

[34] TBOC § 21.401(a).

[35] TBOC § 21.417.

[36] TBOC § 21.101.

[37] IRC § 1366(a)(1).

[38] For a summary of the taxation of S corporations and planning issues with S corporation stock, see Jeanne L. Newlon and Brian S. Masterson, "Estate Planning with S Corporations," ABA JOINT MEETING OF THE SECTION OF TAXATION AND SECTION OF REAL PROPERTY, TRUST AND ESTATE LAW (Sept. 2012).

[39] TBOC § 152.304.

[40] TBOC § 153.102.

[41] TBOC § 154.001.

[42] TBOC § 152.002.

[43] For an excellent summary on partnership income taxation, see Michael Threet, "Partnership Taxation Basics," NUTS AND BOLTS TAX WORKSHOP (Aug. 2008)

[44] TBOC § 101.104.

[45] TBOC § 101.607.

[46] TBOC § 101.251.

[47] TBOC § 101.052.

[48] Treas. Reg. § 301.7701-2(a).

[49] For a thoughtful discussion on trustee provisions generally, see Sarah Patel Pacheco, "Selection and Drafting of Trustee Provisions," 20TH ANNUAL ADVANCED ESTATE PLANNING AND PROBATE DRAFTING COURSE (Oct. 2009).

[50] *See* Tex. Prop. Code § 113.008, which provides that a "trustee may invest in, continue, or participate in the operation of any business or other investment enterprise in any form, including a sole proprietorship, partnership, limited partnership, corporation, or association, and the trustee may effect any change in the organization of the business or enterprise."

[51] For a detailed discussion, see Mary C. Burdette, "Fiduciary Duties within Fiduciary Duties: Trust Owned Stock in a Closely held Corporation," 36TH ANNUAL ESTATE PLANNING AND PROBATE COURSE (June 2012).

[52] *See* Charles D. Fox, IV "Putting the Horse Before the Cart: Non-Tax Issues in Business Succession Planning," 21ND ANNUAL ADVANCED ESTATE PLANNING AND PROBATE DRAFTING COURSE (January 2010).

[53] Tex. Prop. Code § 114.007.

[54] Tex. Prop. Code § 114.006.

[55] *See* Tex. Prop. Code § 113.082, which provides that the court may order a trustee removed if (1) the trustee materially violated or attempted to violate the terms of the trust and the violation or attempted violation results in a material financial loss to the trust, (2) the trustee becomes incapacitated or insolvent, (3) the trustee fails to make an accounting required by law or the trust instrument or (4) the court finds other cause for removal.

[56] Tex. Prop. Code § 113.083.

[57] For an excellent discussion of drafting irrevocable trusts with a grantor serving as trustee, see Santo Bisignano, Jr., "When the Only One You Trust Is Yourself: Drafting and Planning with Self Trusteed Irrevocable Nongrantor Trusts," 32ND ANNUAL ADVANCED ESTATE PLANNING AND PROBATE COURSE (June 2008).

[58] These limitations seek to avoid inclusion under sections 2036 and 2038 of the Internal Revenue Code.

[59] This limitation seeks to avoid inclusion under section 2042 of the Internal Revenue Code.

[60] This limitation seeks to avoid inclusion under section 2036(b) of the Internal Revenue Code.

[61] For an excellent discussion of drafting irrevocable trusts with a beneficiary serving as trustee, see John F. Bergner, "Drafting for Flexibility," 22ND ANNUAL ADVANCED ESTATE PLANNING AND PROBATE DRAFTING COURSE (October 2011).

[62] IRC § 2041.

[63] IRC § 2514.

[64] Rev. Rul. 95-78.

[65] *See* TBOC § 6.251 for Texas law requirements for a voting trust.

[66] *See* Gregory J. Sergesketter, "Shareholder Agreements, Buy/Sell Agreements and Voting Trusts," STATE BAR OF TEXAS ESSENTIALS OF BUSINESS LAW (April 2010).

[67] IRC § 1361(b)(1)(A). However, a husband and wife (and their estates) and all "members of a family" (and their estates) are each treated as one shareholder. IRC § 1361(c)(1)(A). The Code defines members of a family as a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant. IRC § 1361(c)(1)(B)(i). The term "common ancestor" excludes any individual if he or she is more than six generations removed from the youngest generation of shareholders who would (but for this limitation) be members of the family. IRC § 1361(c)(1)(B)(ii). A spouse (or former spouse) is treated as being of the same generation as the individual to whom such spouse is (or was) married. IRC § 1361(c)(1)(B)(ii).

[68] IRC § 1361(b)(1).

[69] Treas. Reg. § 1.1361-1(l)(1).

[70] For a comprehensive discussion of estate planning issues associated with S corporations, see Carol A. Cantrell, "Estate Planning and Administration for S Corporations," 2009 JOINT FALL MEETING OF THE AMERICAN BAR ASSOCIATION – SECTION OF TAXATION AND SECTION OF REAL PROPERTY, TRUST AND ESTATE LAW (Sept. 25, 2009).

[71] IRC § 1361(c)(2)(A)(i).

[72] IRC § 1361(c)(2)(A)(ii).

[73] Treas. Reg. §§ 1.1361-1(j)(6)(iii), 1.1361-1(m)(2)(iii).

[74] IRC § 1361(c)(2)(A)(iii).

[75] IRC § 1361(b)(1)(B).

[76] Treas. Reg. § 1.641(b)-3(a).

[77] *See* IRC § 1361(d).

[78] *See* IRC § 1361(d)(3)(A).

[79] *See* IRC § 1361(d)(2).

[80] Treas. Reg. § 1.1361-1(m)(7).

[81] IRC § 1361(c)(2)(A)(v).

[82] *See* IRC 1361(e)(1)(A), 1361(e)(1)(B).

[83] *See* IRC § 1361(e)(3).

[84] *See* IRC § 641(c)(2).

[85] IRC § 1361(c)(2)(A)(iv). Certain trusts that constitute an individual retirement account under section 408(a) also qualify. IRC § 1361(2)(A)(vi).

[86] 1.1361-1(h)(v).

[87] *See* PLR 201226019.

[88] 1.1361-1(h)(v).

[89] See Bergner, "Drafting for Flexibility," note 61, *supra*.

[90] Rev. Proc. 2013-35

[91] IRC § 2514(c)(3)(C).

[92] Tex. Prop. Code § 116.151(b).

[93] Tex. Prop. Code § 116.151(c)(2).

[94] Tex. Prop. Code § 116.151(c)(4).

[95] Tex. Prop. Code § 116.151(c)(3).

[96] Tex. Prop. Code § 116.151(e).

[97] Tex. Prop. Code § 116.005.

[98] Tex. Prop. Code § 116.005.

[99] Tex. Prop. Code § 116.005(b).

[100] Tex. Prop. Code § 116.005(c).

[101] Tex. Prop. Code § 116.005(d).

[102] For an excellent article on these issues, see Steven B. Gorin and Carol A. Cantrell, "UPIA Amendment Clarifies Tax Allocation Between Income and Principal When Mandatory Income Trust Owns Pass-through Entity," PROBATE & PROPERTY MAGAZINE, Vol. 23, No. 1 (Jan/Feb 2009).

[103] Comments to *Uniform Principal and Income Act* § 505 (2008).

[104] IRC §2056(b)(7)(B)(i); §2523(f)(2)(B).

[105] IRC §2056(b)(7)(B)(ii).

[106] Treas. Reg. § 20.2056(b)-5(f)(4).

[107] Treas. Reg. § 20.2056(b)-5(f)(5).

[108] Treas. Reg. § 20.2056(b)-5(f)(5).

[109] *See* Tex. Prop. Code §§ 112.071 – 112.087.

[110] Tex. Prop. Code § 112.072.

[111] Tex. Prop. Code § 112.073.

[112] Tex. Prop. Code § 112.085(3).

[113] Tex. Prop. Code § 112.086(c).

[114] Tex. Prop. Code § 112.084.

[115] For a detailed discussion of various methods for achieving grantor trust status, see Steve R. Akers, "Transfer Planning, Including Use of GRATs, Installment Sales to Grantor Trusts, and Defined value Clauses to Limit Gift Exposure," 32ND ANNUAL ADVANCED ESTATE PLANNING AND PROBATE COURSE (June 2008).

[116] Tex. Prop. Code § 117.004(a).

[117] *Id.*

[118] Tex. Prop. Code § 117.004(b).

[119] Tex. Prop. Code § 117.004(c)(8).

[120] Tex. Prop. Code § 117.005.

[121] Tex. Prop. Code § 117.006.

[122] Tex. Prop. Code § 117.007.

[123] Tex. Prop. Code § 117.008.

[124] Tex. Prop. Code § 117.003(b).

[125] Michael J. Cenatiempo and Kimberly J. Carter, "What have six years of the UPIA's done, if anything? Should we 'draft' around, 'modify,' or just punt?", 34TH ANNUAL ADVANCED ESTATE PLANNING AND PROBATE COURSE (June 2010).

[126] Cenatiempo & Carter, *supra* note 125 at page 9.

[127] Tex. Prop. Code § 114.007(a).

[128] *See* Jensen v. Jensen, 665 S.W.2d 107 (Tx. 1984).

[129] IRC § 675(4)(C).

[130] IRC § 2036(a).

[131] IRC § 318(a).

[132] See Rev. Proc. 2007-45 (the IRS form inter vivos grantor charitable lead annuity trust that relies on a third party substitution power to obtain grantor trust status).

[133] IRC § 1014(a).

[134] IRC § 1014(b)(6).

[135] Tex. Prop. Code § 114.061.

[136] PLR 200939003.