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The Fundamentals of the Separate Share Rule

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Section 663(c) of the Internal Revenue Code ("IRC") sets forth a special rule for the allocation of income tax liability for income earned by certain estates and trusts with more than one beneficiary. IRC § 663(c); see Treasury Regulations ("Treas. Reg.") §§1.663(c)-1—1.663(c)-5. Perhaps one word best summarizes the purpose of such rule: fairness. [*See* Acker, 852-3rd T.M., *Income Taxation of Trusts and Estates*, at A-108 (Tax Management Inc. 2007) (citing H.R. Rep. 148, 105th Congress, 1st Sess. 380-381 (1997)). This is not to suggest that the absence of the rule would necessarily be detrimental to the beneficiaries. Indeed, before the separate share rule applied to estates, there was more opportunity for post-mortem planning, since "executors could time distributions to carry out a disproportionate share of DNI to certain beneficiaries" (Alan S. Halperin, *The Separate Share Rule: It's Not Just the Residue Anymore*, published in seminar materials for PLI seminar, Valuation, Taxation & Planning Techniques for Sophisticated Estates, at 5 (2002)). For example, if the residue of an estate were split in substantially separate but equal shares for each of a surviving spouse and child, in Year 1 the executor could make all distributions to the spouse such that they would carry with them all of the income tax liability of the estate for Year 1, half of which would have been borne by the child had equal distributions been made. Instead, the wife succeeded to all of the liability. This was, in effect, a tax-free gift from the surviving spouse to the child in the amount of the income tax attributable to one-half of the income for Year 1. It is conceivable that a wealthy surviving spouse would desire this result.] The rule, which is commonly known as the "separate share rule," generally prevents one beneficiary from being liable for income tax for which another beneficiary should be liable under the terms of the governing instrument. In order to appreciate the impact of the separate share rule, it is helpful to recall some of the fundamentals of income taxation of trusts and estates.

Some Fundamentals of Trusts and Estates Income Taxation. Trusts and estates are subject to a hybrid of two different income tax concepts: conduit taxation (under which the income tax burden passes from the trust or estate to the beneficiaries) and entity taxation (under which the income tax burden remains with the trust or estate, and does not pass to the beneficiaries). "An estate or trust is taxed like an individual, with certain exceptions [such as] a deduction for certain distributions it makes to beneficiaries. This

deduction makes the estate or trust a pass-through entity because the beneficiaries … are required to report as income the amount of the deductible distribution." (Acker, 852-3rd T.M., *Income Taxation of Trusts and Estates*, at A-5 (Tax Management Inc. 2007).)

Within this hybrid system, trusts, but not estates, are divided into two categories: simple trusts (see IRC §§ 651—652) and complex trusts (see IRC §§ 661—662). A trust is simple if, in any given year, all of the following apply: (1) its terms require the trustee to distribute the trust's fiduciary accounting income ("FAI") (see IRC § 643(b) and Treas. Reg. § 1.643(b)-1 for definition of income) currently; (2) its terms do not require a charitable distribution; and (3) no distributions of principal are made. See IRC § 651; Treas. Reg. §§ 1.651(a)-1—1.651(b)-1. A trust is complex if, in any given year, merely one of the following applies: (1) its terms do not require current distribution of FAI; (2) its terms require a charitable contribution to be made; (3) a charitable contribution is, in fact, made; or (4) a distribution from principal is, in fact, made. See IRC § 661; Treas. Reg. §§ 1.661(a)-1—1.661(c)-1. Estates are always treated like complex trusts for income tax purposes. Treas. Reg. §§ 1.651(a)-5 and 1.661(a)-1.

Taxation of simple and complex trusts rests on a unique income tax concept called "distributable net income" ("DNI"). See IRC § 643(a). DNI is basically FAI but with certain modifications, which are beyond the scope of this article. (See IRC § 643(a); see also Acker, 852-3rd T.M., *Income Taxation of Trusts and Estates*, at A-5 and A-64 (Tax Management Inc. 2007).)

DNI serves quantitative and qualitative purposes. Quantitatively, it measures the gross income of a trust or estate that is deemed distributed to the beneficiaries, who, in turn, report such income on their respective income tax returns. Qualitatively, it designates the character of the gross income that is deemed distributed to the beneficiaries, which characterization, in turn, is also reported on the beneficiaries' respective income tax returns.[1] For example, $100 of gross income could consist of $50 of taxable rental income and $50 of non-taxable income from municipal bonds.

As the name suggests, taxation of simple trusts is relatively straightforward. By definition, all of a simple trust's FAI is deemed to be distributed currently to the beneficiaries. The trustee deducts this deemed distribution on the fiduciary income tax return.[2] The

1. *See* Acker, 852-3rd T.M., *Income Taxation of Trusts and Estates*, at A-5 (Tax Management Inc. 2007).

beneficiaries report on their respective income tax returns that portion of the distribution to which each is entitled under the instrument.[3] This is true even if the trustee, for whatever reason, fails to distribute a single dollar to the beneficiary; if the instrument requires the distribution, the beneficiary thereof must report it.[4]

The taxation of estates and complex trusts is less straightforward, in part, because of the possibility that a fiduciary has the discretion to accumulate or distribute income. For example, if in Year 1 a complex trust has FAI that the trustee does not distribute in accordance with the discretion afforded it under the instrument, and no charitable contributions are made,[5] the trustee will be liable for the tax on the FAI. However, to the extent that the trustee distributes the FAI, it receives a distribution deduction[6] and the recipients (beneficiaries) bear the income tax liability on the distributed FAI.[7] Thus, unlike the beneficiaries of a simple trust, who are always liable for the tax on the trust's FAI, the beneficiaries of a complex trust may or may not be liable for the trust's FAI, depending on whether the trustee accumulates or distributes the FAI.

Complex Trust Taxation and the Separate Share Rule. Not every distribution from an estate or complex trust is subject to income tax. For example, if in Year 1 a complex trust under which the trustee has complete discretion to accumulate or sprinkle FAI among multiple beneficiaries has $100,000 of DNI attributable solely to taxable ordinary income, which the trustee distributes to Beneficiary A,[8] the trustee gets a distribution deduction of $100,000 and therefore is not liable for any income tax, all of which liability passed to Beneficiary A. Therefore, Beneficiary A nets less than $100,000. Beneficiary B, who received no distributions that year, is not liable for any income tax. If, in Year 2,

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2. *See* IRC § 651 and Treas. Reg. § 1.651(b)-1. The distribution deduction for simple trusts is generally equal to FAI, unless FAI exceeds the distributable net income, in which case the distribution deduction is capped at the DNI (*see id.*).

3. *See* IRC §§ 651—652; Treas. Reg. §§ 1.651(a)-1—1.652(c)-4. However, the inclusion of FAI on the beneficiary's return is generally capped at amount of DNI (*see* IRC § 652(a)).

4. *See* Treas. Reg. § 1.652(a)-1.

5. Different rules apply when a charitable contribution is made (*see* Treas. Reg. § 1/662(b)-2).

6. *See* IRC § 661. The amount of the distribution deduction is capped at the trust's DNI (*see id.* and Treas. Reg. §§ 1.661(a)-2—1-661(c)-1).

7. *See* IRC § 662. The amount includable by the beneficiaries is capped at the trust's DNI (*see id.* and Treas. Reg. §§ 1.662(a)-1—1-662(c)-4).

8. Assuming the trustee makes no other distributions.

the same trust has no DNI but the trustee nevertheless distributes $100,000 to Beneficiary B,[9] neither Beneficiary B nor the trustee owes any income tax, since no income tax accrued. Unlike Beneficiary A in Year 1, Beneficiary B in Year 2 nets the full $100,000, even though the trustee distributed the same amount of money to each. If, in Year 3, the trust again has $100,000 of DNI attributable to taxable ordinary income, but the trustee makes no distributions, the trustee cannot utilize a distribution deduction and therefore is liable for all of the income tax on such income.

Thus, to the extent that a trustee of a complex trust has the discretion to accumulate or distribute FAI and principal to one or more beneficiaries, the manner in which it exercises such discretion could potentially result in disparate income tax liabilities among the various beneficiaries. Thus, by carefully timing the distributions to the various beneficiaries, the trustee is able to control which beneficiary bears the tax on income earned by trust assets. This type of control offers tremendous opportunities for tax planning.[10]

However, depending on the testator's or grantor's intention as expressed in terms of the governing instrument, the disparate income tax liabilities resulting from a trustee's exercise of discretion might not be appropriate. For example, it might not be appropriate when the instrument restricts distributions of FAI and corpus to any one beneficiary to that portion (or share) of the trust to which the particular beneficiary is entitled under the instrument. [11] In this example, the instrument directed the creation of separate shares, which are the object of the separate share rule.[12]

Most often, separate shares are created when the governing instrument provides that different beneficiaries have substantially separate and independent shares[13] "such that their economic interests (*e.g.*, rights to income or gains from specified items of property) are not affected by economic interests accruing to another separate beneficiary or class

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9. Assuming the trustee makes no other distributions.

10. *See, e.g.,* Note 3, above.

11. *See* Treas. Reg. § 1.663(c)-5, Example 1.

12. It is important to note that separate shares could be created in other ways, including, but not limited to, when an election under IRC § 645 is made, which makes a qualified revocable trust a separate share of the estate (Treas. Reg. § 1.663(c)-4)(a) or when an elective share is present (Treas. Reg. § 1.663(c)-5, Example 7)).

13. *See* IRC § 663(c) and Treas. Reg. § 1.663(c)-1.

of beneficiaries."[14] Beneficiaries have substantially separate and independent shares when "distributions of the trust are to be made in substantially the same manner as if separate trusts had been created."[15] Technically, "a separate share comes into existence upon the earliest moment that a fiduciary may reasonably determine, based on the known facts, that a separate economic interest exists."[16] Not every estate or trust mandates the creation of separate shares; their existence usually depends on the terms of the governing instrument. Moreover, it is important to note that separate shares could be created in other ways, including, but not limited to, when an election under IRC Section 645 is made, which makes a qualified revocable trust a separate share of the estate,[17] and when an elective share is present.[18] The Treasury Regulations pertaining to IRC Section 663(c) set forth detailed explanations of when separate shares are created.

The separate share rule, which is set forth in Section 663(c) of the IRC and the appurtenant Treasury Regulations, eliminates the disparate income tax liability among multiple beneficiaries with separate shares of estates and complex trusts.[19] The separate share rule is not applied to estates or trusts

> "subject to a power to distribute, apportion, or accumulate income, or … distribute corpus[,] to … one or more beneficiaries…, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of [same] of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist."[20]

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14. Acker, 852-3rd T.M., *Income Taxation of Trusts and Estates*, at A-108 (Tax Management Inc. 2007).

15. *See* Treas. Reg. § 1.663(c)-3.

16. Treas. Reg. § 1.663(c)-2(a).

17. *See* Treas. Reg. § 1.663(c)-4)(a).

18. *See* Treas. Reg. § 1.663(c)-5, Example 7.

19. *See* Acker, 852-3rd T.M., *Income Taxation of Trusts and Estates*, at A-109 (Tax Management Inc. 2007).

20. Treas. Reg. § 1.663(c)-3(b).

If the terms of the instrument create separate shares, the application of the separate share rule is mandatory, not elective.[21] The rule applies "even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust (or estate), and even though no physical segregation of assets is made or required."[22]

Mechanical Operation of the Separate Share Rule. Mechanically, the separate share rule operates by allocating the trust's DNI, deductions, and losses to (*i.e.*, by dividing them among) each separate share in accordance with each share's entitlement[23] to the trust's gross income that is includible in DNI.[24] Since DNI can be constituted by various types of gross income, calculating each share's entitlement to gross income requires consideration of the various types of gross income includible in DNI.

Allocation of that portion of gross income includible in DNI that is constituted by FAI is made "in accordance with the amount of [FAI] that each share is entitled to under the terms of the governing instrument or applicable local law."[25]

Allocation of that portion of gross income includible in DNI that is constituted by income in respect of a decedent ("IRD") within the meaning of IRC Section 691(a) "is based on the relative value of each share that could potentially be funded with such amounts."[26] This rule applies "irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law."[27] In other words, the rule is based on potential funding, not entitlement to income. Estate planners should note that provisions in a will or trust that direct how a particular separate share is to be funded (*e.g.*, without any IRD) will be respected by Internal Revenue Service when ap-

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21. *See* Acker, 852-3rd T.M., *Income Taxation of Trusts and Estates*, at A-108 (Tax Management Inc. 2007).

22. Treas. Reg. § 1.663(c)-1(c) and (d).

23. Such entitlement is based on the governing instrument and local law (Treas. Reg. § 1.663(b)-2).

24. *See* Treas. Reg. § 1.663(c)-2(b).

25. Treas. Reg. § 1.663(c)-2(b)(2).

26. Treas. Reg. § 1.663(c)-2(b)(3).

27. Treas. Reg. § 1.663(c)-2(b)(3).

plying the separate share rule.[28] Such a provision could, for example, prevent the under-funding of a credit shelter trust due to unanticipated income tax liability.[29]

Allocation of that portion of gross income includible in DNI that is not attributable to cash received by the estate or trust (*e.g.*, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items), commonly referred to as "phantom income," is made in a manner similar to the allocation of IRD, *i.e.*, based upon the relative value of each share that could potentially be funded with such amounts.[30]

Example of the Practical Effects of the Separate Share Rule. The separate share rule merely results in a trust's DNI and deductions being allocated among its separate shares. It does not permit the treatment of separate shares as separate trusts or estates for purposes of filing tax returns and making payments of tax liability.[31]

The effects of the separate share rule can be seen by returning to the above example with Beneficiary A and Beneficiary B. Had the trust instrument created two separate and equal shares for each of Beneficiary A and Beneficiary B, application of the separate share rule would have been mandatory. Thus, in Year 1, one-half of the trust's DNI, or $50,000, would have been allocated to each of Beneficiary A's and Beneficiary B's respective separate shares. The trustee would have been deemed to have distributed $50,000 of DNI and $50,000 of principal to Beneficiary A, and thus would have received only a $50,000 distribution deduction, even though he actually distributed $100,000. Beneficiary A, in turn, would have been liable for the income tax on only $50,000, even though he actually received $100,000. The trustee would have been liable for the income tax attributable to the other $50,000, but such liability would have been charged against Beneficiary B's separate share. This charge could have potentially affected the trustee's ability in Year 2 to distribute $100,000 to Beneficiary B, depending on the level of funds present in Beneficiary B's separate share. In Year 3, the trustee would still have been liable for all of the income tax on the $100,000 of DNI, but one-half of such

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28. *See, e.g.,* Treas. Reg. § 1.663(c)-5, Examples 9 and 10.

29. *See* Alan S. Halperin, "The Separate Share Rule: It's Not Just the Residue Anymore", at p. 19 (2002).

30. *See* Treas. Reg. § 1.663(c)-2(b)(4).

31. Treas. Reg. § 1.663(c)-1)(b)(2).

liability would be charged against each of Beneficiary A's and Beneficiary B's respective separate shares. Ultimately, application of the separate share rule would have resulted in Beneficiary A's share being enlarged by $50,000. It is likely that this result better complies with the grantor's intentions, given the fact that he directed the creation of separate shares.

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