

Reproduced with permission from Tax Management International Journal, 51 Tax Mgmt. Int'l J. No. 4, 04/01/2022. Copyright © 2022 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Income Tax Planning for Foreign and Domestic Trusts Holding Beneficiary-Occupied Real Estate

By Robert E. Ward, J.D., LL.M.*

WardChisholm, LLP

Vancouver, British Columbia and Bethesda, Maryland

INTRODUCTION

A previous article appearing in this space discussed the relative advantages and disadvantages of foreign ownership of U.S. real estate through trusts, partnerships, and corporations.¹ Although professional opinions may differ and circumstances may make one entity a preferable choice over others, the author's preference where circumstances allow is to use a trust. Home country tax considerations (such as the availability of a foreign country tax credit for U.S. taxes paid) will determine whether the trust's residence is foreign or domestic.² However, regardless of trust situs, consideration should be given to the U.S. income

tax consequences to which a trust owning U.S. real estate occupied by its beneficiaries will be exposed. Regardless of whether the trust satisfies the definition of a domestic trust under §7701(a)(30)(E) or a foreign trust under §7701(a)(31)(B), the trust will have income subject to U.S. income taxation. If the U.S. property owned by the trust is rented, the foreign beneficiary may have U.S. income tax consequences, as well.

A brief overview of the income taxation of trusts and their beneficiaries will be helpful to provide an understanding of the discussion that follows. For those conversant with the income taxation of trusts and their beneficiaries, the next paragraphs may be mercifully skipped.

A REFRESHER ON TRUST INCOME TAXATION

U.S. rules governing income taxation of trusts and estates are found in subchapter J of the Internal Revenue Code.³ Section 641(b) provides that the taxable income of a trust will be computed in the same manner as the taxable income of an individual subject to the variances provided in part 1 of subchapter J. Differences between the income taxation of trusts and individuals include a rather stingy personal exemption of \$100 provided to a trust by §642(b)(2)(A). The beneficent nature of trusts is complemented by an unlimited charitable deduction under §642(c)(1) if the contributions made by the trust are "pursuant to the terms of the governing instrument" for purposes specified in §170(c). However, the most significant departure from the income taxation of individuals is the distributions deduction for which trusts are eligible under §651 and §661 for distributions to beneficiaries.⁴ This deduction for distributions to beneficiaries is limited only by the distributable net income of the trust.

* Robert E. Ward, J.D., LL.M. is a fellow of the American College of Tax Counsel who advises businesses and individuals on U.S. international and domestic tax matters from his firm's offices in Vancouver, British Columbia and Bethesda, Maryland.

This article may be cited as Robert Ward, *Income Tax Planning for Foreign and Domestic Trusts Holding Beneficiary-Occupied Real Estate*, 51 Tax Mgmt. Int'l J. No. 4 (Apr. 1, 2022).

¹ See Robert E. Ward, *Impulse Buying in the Wake of Tax Reform: Reconsidering Structures for Foreign Ownership of U.S. Real Estate*, 47 Tax Mgmt. Int'l J. 475 (July 13, 2018).

² Section 7701(a)(30)(E) defines a domestic trust as one which is subject to primary supervision by a U.S. court and one with respect to which U.S. persons control all substantial decisions. Foreign rules governing trust situs will likely be very different. Many countries apply a "mind and management" concept. See, e.g., *Paul Antle v. Her Majesty the Queen* (2010 FCA 280) and *St. Michael Tr. Corp. v. Her Majesty the Queen* (2010 FCA 309).

All section references are to the Internal Revenue Code, as amended, unless otherwise indicated.

³ 26 U.S.C. §641–§692.

⁴ The distribution deductions of §651 and §661 are coordinated with the requirement of §652 and §662 that the amount distributed be included in the gross income of the beneficiaries receiving it.

COMPUTATION OF DISTRIBUTABLE NET INCOME OF THE TRUST

Computation of distributable net income (DNI) starts with the taxable income of the trust as modified by the other provisions of part 1 of subchapter J with further refinements set forth in §643(a) including:

- no deduction for distributions to beneficiaries (perhaps confusing until one considers DNI is the cap which limits the amount of distribution deductions a trust may claim);
- no deduction for personal exemptions provided by §642(b);
- no inclusion of capital gains and losses allocated to corpus unless “paid, credited, or required to be distributed” to a beneficiary during the taxable year in which realized or “paid, permanently set aside, or to be used for charitable purposes”;⁵ and
- inclusion of tax-exempt interest.⁶

The rules for computation of DNI are equally applicable to foreign trusts with minor variations.

- Foreign source income is included.
- Gross income from U.S. sources is determined without regard to §894 (treaty-exempt income).
- Gains from sale or exchange of capital assets are included without regard to allocation to corpus or income and reduced by losses from such sales and exchanges but not in excess of the amount of gains realized.⁷

Thus, the essence of trust income taxation is simply this: trusts are generally subject to income taxation in the same manner as an individual; however, trusts may claim an income tax deduction for distributions to beneficiaries to the extent of a trust’s DNI. The effect of the distributions deduction is to shift income otherwise taxable to the trust to the beneficiary thereby changing the taxpayer to whom that income is taxed and in most cases the rate at which that income is taxed.

UNCOMPENSATED USE OF TRUST PROPERTY BY A BENEFICIARY

With the preceding background, how does a beneficiary’s use of a trust asset affect the computation of

that trust’s taxable income? In the case of a residence owned by a trust which a beneficiary occupies rent-free on a seasonal or permanent basis, is the fair rental value of the beneficiary’s use of that trust asset a deemed distribution taxable to the beneficiary and deductible subject to the limitations of DNI by the trust or is it without tax effect? A related question is whether the expenses (deductible or not) incurred by the trust to maintain property occupied by a beneficiary will be taxable to the beneficiary? The answers to these questions are surprisingly uncertain to the consternation of trustees and beneficiaries and possible delight of those who advise them.

If the residence which the beneficiary occupies is the sole or primary asset of the trust, tax reporting is simplified, and unanticipated outcomes are likely mitigated. However, when the trust additionally holds income-producing assets or the property itself is rented to generate income, any net income may be taxable either to the trust or to the beneficiary, depending upon whether income is actually or constructively distributed. The possibility of a constructive distribution of trust income — while likely unforeseen in most cases — should not be a surprise or cavalierly dismissed. It is well settled that a shareholder’s rent-free use of corporate assets is taxable as a constructive dividend.⁸ Surprisingly, authority squarely addressing the analogous circumstance of a beneficiary’s use of trust assets is sparse.

Technical Advice Memorandum 8341005⁹ involved a trust settled by one spouse for the benefit of another spouse with shares of stock. The settlor’s spouse was the income beneficiary and was to be paid trust income as it accrued. The trustees exercised their investment discretion to acquire residential property which the settlor’s spouse occupied on a seasonal basis. Apparently, the residence was never rented to third parties. Instead, the trust used income from other assets to pay the real property taxes and provide a year-round caretaker for the property. The TAM notes that no trust income was used to pay for electricity, heating, or personal expenses of the settlor’s spouse. The trust deducted the real property taxes in computing trust income but claimed no deduction for the cost of the caretaker. It claimed no distribution deduction for the real property taxes or the cost of the caretaker.

The TAM concluded that the expenditures of the trust with respect to the residence occupied by the

ing the distribution, subject to the limitation of DNI.

⁵ §643(a)(3). Losses from sale or exchange of capital assets are excluded from the computation of DNI except to the extent such losses are taken into account in determining the amount of net gains from the sale or exchange of capital assets paid, credited, or required to be distributed to a beneficiary during the taxable year of realization.

⁶ §643(a).

⁷ §643(a)(6).

⁸ See, e.g., Rev. Rul. 58-1, 1958-1 C.B. 173; *Nichols, North, Buse Co.*, 56 T.C. 1225 (1971).

⁹ The TAM has been cited as authority that a beneficiary’s rent-free use of trust property is not taxable to the beneficiary. See Byrle M. Abbin and Frances Way Schafer, *Income Taxation of Fiduciaries and Beneficiaries* (2021), §506 at n. 1; Howard M. Zaritsky and Lane, *Federal Income Taxation of Estates and Trusts*, para. 4.09 at n. 121 (2d ed. 1993).

grantor's spouse were not applied for the use of the beneficiary but were, instead, "employed in maintaining a capital asset of Trust. Therefore, Grantor's spouse was not taxable on the income of Trust used to pay the real property taxes and the caretaker." This statement is curious because the issue framed by the TAM was "whether the rent-free use of trust property, by an income beneficiary, is taxable to the beneficiary under section 652 of the Internal Revenue Code." The TAM reaches no conclusion on its stated issue.

Perhaps the reason the TAM reached the conclusion that it did — instead of answering the issue to which the TAM was formally addressed — is that it relied heavily on the opinion of the Circuit Court of Appeals for the Second Circuit in *Plant v. Commissioner*.¹⁰ Indeed, almost all the authorities which have considered a beneficiary's rent-free use of trust assets focus on the income used by the trust to pay costs of maintenance of trust property: the deductibility of such expenses by the trust and the income tax effect to the beneficiary.¹¹ The will of Morton F. Plant divided the residue of his estate among three trusts established for the benefit of his wife and two sons. Article 10 of the will directed the trustees to use the income of the trusts to maintain the decedent's home "with all its appurtenances so long as my son Henry Bradley Plant may wish to occupy the same as a permanent or summer residence and to charge the expense of such maintenance proportionately against the income of the trusts hereby created for the benefit of my wife and sons, before ascertaining the net income for such trusts."¹²

The Commissioner determined that the income used by the trusts to pay the expenditures necessary to maintain the residence was taxable to Henry Bradley Plant and assessed tax thereon. Mr. Plant petitioned the Board of Tax Appeals for a redetermination that the expenditures were not taxable to him as beneficiary but, instead, were properly taxed to the trustees. The Board of Tax Appeals agreed holding the income collected by the trustees and applied to maintain the residence "did not represent 'income' distributed or distributable to [Mr. Plant] within the meaning of that term as laid down by the Supreme Court in *Eisner v. Macomber*, 252 U.S. 189, and the respondent

erred in determining otherwise."¹³ Commissioner appealed to the Second Circuit and was rebuffed.

The issue as framed by the Second Circuit "is not whether the income thus expended was taxable at all, for the trustees treated it as taxable to themselves and so returned it, but is whether it constituted income that was properly taxable to the son." The view of the Second Circuit was that the cost of maintaining the residence would have been incurred by the trustees regardless of the occupancy of that property by Mr. Plant. While Mr. Plant benefited indirectly from the trust's payment of the costs of upkeep, "the expenditures were not applied to the use of the taxpayer, but employed in maintaining a capital asset of the trust estate."¹⁴

Cases examining circumstances similar to *Plant* in which trust income has been applied to maintain trust property occupied by beneficiaries have been consistent in denying deduction of such expenses by the trustees.¹⁵ None of these cases reached the issue of whether such expenses paid by the trust represented income taxable to a beneficiary. However, this issue was presented to the Tax Court on remand of *Alfred I. duPont Testamentary Trust v. Commissioner* from the Fifth Circuit.¹⁶ In the earlier proceedings, the issue of deductibility of the expenses by the trust under §651 and §661 (and corresponding inclusion in Mrs. duPont's income under §652 or §662) had not been raised. On remand, the Tax Court deftly dodged the issue by determining that the payments for maintenance of the residence occupied by Mr. duPont's widow were made pursuant to a contractual agreement with the corporation to which the residence had been transferred several years before Mr. duPont's death.

On remand of *duPont* to the Tax Court, the government raised a second issue on which it challenged the deductibility of the expenses incurred by the trust to maintain the property occupied by the beneficiary. The Commissioner maintained that the expenses in-

¹⁰ 76 F.2d 8 (1935), *aff'd* 30 B.T.A. 133 (1934).

¹¹ A related question on which early cases focus is the proper allocation between trust income or corpus as a matter of local law of the expenses incurred by a trust in maintaining a residence occupied by a beneficiary. See *Mary Def. Harrison Geary v. Commissioner*, 9 T.C. 8 (1947); *Catherine E.T. Horn v. Commissioner*, 5 T.C. 597 (1945); *Commissioner v. Lewis*, 141 F.2d 221 (3d Cir. 1944).

¹² *Plant v. Commissioner*, 30 B.T.A. 133, 143 (1934).

¹³ 30 B.T.A. 133 at 143.

¹⁴ 76 F.2d 8 at 9–10.

¹⁵ The expenses were not deductible because the trust property was not held for the production of income or for the management, conservation, or maintenance of property held for the production of income as required by §212 of the 1954 Internal Revenue Code and its predecessors. See *Alfred I. duPont Testamentary Trust v. Commissioner*, 62 TC 36 (1974), *aff'd*, 514 F.2d 917 (5th Cir. 1975), *aff'd and rem'd*, 574 F.2d 1332 (5th Cir. 1975), *on remand*, 66 T.C. 761 (1976), *aff'd per curiam*, 574 F.2d 1332, (5th Cir. 1978); *Frederick H. Prince Trust v. Commissioner* 35 TC 974 (1961); *Estate of Fuller* 9 T.C. 1069 (1947); *St. Louis Union Tr. Co. v. Commissioner*, 40 B.T.A. 165 (1939); *Sparrow v. Commissioner* 18 B.T.A. 1 (1929).

¹⁶ 62 T.C. 36 (1974), *aff'd*, 514 F.2d 917 (5th Cir. 1975), *aff'd and rem'd*, 574 F.2d 1332 (5th Cir. 1975), *on remand*, 66 T.C. 761 (1976), *aff'd per curiam*, 574 F.2d 1332, (5th Cir. 1978).

curred by the trust, like those in *Plant*, could not be properly regarded as being made for the benefit of the beneficiary.¹⁷ The Tax Court felt constrained to follow *Plant*, finding the facts of *duPont* and *Plant* to be “virtually indistinguishable.” The Tax Court noted that neither beneficiary in *Plant* or *duPont* occupied the residence in question as a principal residence and could have avoided the benefits of the property simply by residing elsewhere. If the beneficiary had so acted, the trustees would have nonetheless been obligated to maintain trust property as doing so was clearly an objective of the testator in each case.

CONTEMPORARY PLANNING

Much has changed since the 1983 TAM and the decision of the Second Circuit in *Plant* on which it relied. The last substantive decision in the *duPont* saga is more than 45 years old. Dicta in that decision clearly suggests that, with the right factual premise, the expenses incurred to maintain trust property occupied by a beneficiary could be deemed distributions deductible by the trust under §651 and §652 with implicit income recognition by the beneficiary occupying the trust property under §652 and §662. The most significant change since the 1983 TAM has been the flattening of trust income tax brackets by the 1986 Tax Reform Act. The effect of that statutory change is that in 2022 income of a trust in excess of \$13,450 is taxable at the highest marginal income tax rate. In contrast, the taxable income of unmarried individuals is not taxed at the highest marginal rate until it exceeds \$539,900 (\$647,850 in the case of married individuals filing joint returns). Thus, qualifying trust expenditures as a deemed distribution deduction is a higher priority than was the case in the years at issue in the existing authorities. Moreover, qualifying a beneficiary’s rent-free use of trust property as a distribution deductible by the trust under §651 and §661 will often be beneficial in circumstances in which trust income exceeds the expenses of maintaining a residence owned by a trust and occupied by a beneficiary.

Ancient as it is, one case explicitly held that a beneficiary occupying trust property is not taxable on the fair rental value of that property. The Board of Tax

Appeals reached that result in 1934 in *Plant*.¹⁸ Although the 1983 TAM does not conclude that the rent-free use of trust property by an income beneficiary is not taxable to the beneficiary under §652, the Board of Tax Appeals in the case on which the TAM relies clearly did reach such a conclusion. In many circumstances (such as where the residence occupied by a beneficiary is the only asset of the trust), such a conclusion is highly desirable. In other cases (such as where a trust has income-producing assets that yield net income in excess of that required to maintain beneficiary-occupied property) the holding in *Plant* results in a higher rate of income tax than if the fair rental value were taxable to the beneficiary and deductible by the trust under §651 and §661.

PLANNING

In circumstances in which a beneficiary is seeking to avoid a deemed distribution of trust income applied to pay the expenses of maintaining a residence owned by the trust but occupied by the beneficiary, minimizing the duration of the beneficiary’s residence in the trust property brings the situation closer to the facts of *Plant* and *duPont*, as well as the 1983 TAM. The trustees may reasonably maintain that the principal purpose of the expenditures is not to benefit the beneficiary but, instead, to maintain a capital asset of the trust. In this regard, specific allocation of such expenses to trust principal by the trust instrument may be helpful. In contrast, in circumstances in which the goal is to reduce income taxable to the trust, establishing the trust asset as the beneficiary’s principal residence combined with provisions in the trust instrument allocating such expenses to trust income, confirming the beneficiary’s right to year-long occupancy, and providing for distribution of net rental income from others’ use of the residence may be helpful in supporting a trust position that such expenses and the fair rental value are properly deductible by the trust as distributions under §651 and §661.

Tax advisors should rejoice. The authorities cited above are old enough and the language in the second Tax Court opinion in *duPont* is broad enough, that support may be found for return positions which do or do not treat the fair rental value of beneficiary-occupied trust property and the expenses associated with it as a distribution deduction by the trust and taxable to the beneficiary.

¹⁷ 66 T.C. at 768.

¹⁸ 30 B.T.A. 133 at 142–143.