Session IV-C

Advising the Fiduciaries of Trusts and Estates Holding Business Interests--Balancing Tax Objectives with State Law Duties

Presenters: Edward F. Koren, Richard L. Dees, Karen Sandler Steinert and Robert J. Turnipseed
Presenter: Michelle R. Mieras

A fiduciary owning a closely-held business faces unique legal, tax, ethical and practical issues. This panel explored those issues, including the proper tax elections for trusts holding S stock; the application of the evolving material participation requirements on a fiduciary; fiduciary liability for tax issues involving the business prior to its acquisition; the impact of the Prudent Investor Rule; the emergence of divided decision-making among fiduciaries, including directed trusts; and the conflicts that can arise between the duties of the trustee as a director or shareholder and the fiduciary duties to the beneficiaries. Here are the significant highlights from this presentation.

Mr. Koren greeted the audience with grim statistics regarding the longevity of closely held businesses passed from generation to generation. He said only about 12% of closely held businesses survive to the third generation. Notwithstanding this unfortunate statistic, he noted that by 2040, over $10,000,000,000,000 of closely held businesses will be transferred, making this a significant topic.

Mr. Turnipseed began the presentation with the facts of a hypothetical that served as the underlying theme for the four panelists' consecutive presentations. It involved a long-term client who has been appointed executor of his brother's estate. His brother left a wife, two adult children, a mistress, and significant assets including an 80% interest in a closely held timber company valued at $30 million. He stated that this type of cash poor, high value estate is not uncommon when discussing closely held businesses. The decedent's will gave placed the timber company into trust for the benefit of his spouse and children, and instructed the trustee (also the long-term client) to preserve the business interest, which was structured on a slow-growth timber process that would ensure slow but steady income for decades to come. Of course, the business itself had a few issues, including delinquent payroll taxes and independent contractors that were historically paid in cash.

The panelists took turns discussing four general areas implicated by the terms of the hypothetical:

1. Tax Issues,
2. Duty to Diversify and the Prudent Investor Rule,
3. Conflicts of Interest, and
4. Section 1411 issues.

Mr. Turnipseed began with tax issues. He noted that fiduciaries cannot just ignore the past. The federal priority statute provides that the claims of the US government shall be paid first.

Distributions that render an estate insolvent after notice of a tax debt subject the personal representative to personal liability for the unpaid US government debts. The battleground is notice. The statutes have broad inquiry notices, meaning notice existed if the fiduciary had notice or there were facts that would lead a reasonable person to inquire into whether there was a tax debt outstanding. Generally, the fiduciary must use due diligence to determine whether there are unpaid tax liabilities.

There are a few defenses to the imposition of personal liability. First, an executor could prove that there was not sufficient notice. This is a question of fact. Mr. Turnipseed pointed out O'Sullivan v. CIR, T.C. Memo 1994-17 (U.S. Tax Ct. 1994), in which the fiduciary had in her possession a copy of a signed tax return. Even though the return had never been filed, the fiduciary did not have an obligation to inquire further because she had the signed tax return. Second, a fiduciary could assert reliance on counsel. This is not absolute however, as Mr. Turnipseed explained that in a recent case, where the executor had notice of the debt, the court found that the client had received bad advice from the attorney but that wasn't enough for relief.

What if there is a probate order permitting a distribution? Mr. Turnipseed noted that this does not generally help your client. For the IRS's purposes, the probate court basically does not exist. Look to the federal priority statute. There is some exception for administrative expenses, and the IRS will defer to state law as to what administration expenses are appropriate to pay out before the tax liability. But a probate court order will not mean the fiduciary is not liable for the tax debts.

Mr. Turnipseed explained that the fiduciary (and really anyone who has possession of assets) has a duty to object to levy or attachment actions. If the fiduciary stands back and does not try to protect the assets, there is potential for the fiduciary to personally liable if there are then insufficient assets to pay the tax debt.

After quickly discussing the business tax issues of the hypothetical and ways to avoid discharge liability, Mr. Turnipseed dismissed the usefulness of the Request for Assessment under Section 6501 due to the number of exceptions.

Ms. Sandler Steinert then discussed the next issue raised by the hypothetical: how the duty to diversify and the Prudent Investor Rule intersect with the decedent's testamentary trust provision directing the trustee to retain the interests in the closely held business.

From a planning perspective, there are arguments for and against including such a provision. Consider how a mandatory provision to hold an asset would interfere with the trustee's ability to dispose of the asset if, for example, of one of the beneficiaries has an emergency need. If Ms. Sandler Steinert cautions that if you are going to include a provision to hold an asset, don't just allow the trustee to hold the asset without diversifying. Also be sure there is a waiver of the trustee to adhere to the Prudent Investor Rule, and an indemnification of the trustee for holding and any loss in value while the asset is held (but be cautious of whether applicable state law will uphold this indemnification).

The hypothetical presents good facts to permit the trustee to keep the asset: it is a specific asset, there is good rationale as to why they would want to keep the asset (proven production

of income, family business, etc.). But the business is not handling the timber land in the most profitable manner, which creates tension with the trustee's duty to support the surviving spouse per the terms of the document.

Even with the language discussed above, the best option may be to have all beneficiaries give consent to hold the asset. The more they know about the asset, the more weight given their consent. Another option is to seek court approval to hold the asset, but jurisdictions differ as to whether the court would hear this action. Yet another option would be for the trustee to move the trust administration to a more favorable jurisdiction. Mr. Koren warned that depending on the jurisdiction, the UTC has a provision regarding the developing are of "benefit of the beneficiary rule." That subsumes all of this and makes the Prudent Investor Rule mandatory, so make sure you are looking at your particular governing law.

Mr. Koren then turned to conflicts of interest. In the hypothetical, there are multiple possible conflicts. There could be conflicts between the trustee and the beneficiaries because of their interests in the family business. There are also conflicts inherent to carrying on the business in the same conservative manner as the decedent did, because the surviving spouse needs funds to live on and there are estate taxes that need to be paid. There is a conflict between retaining the stock, and diversifying into income producing assets to support the spouse.

When a business is involved, the trustee doesn't just have to worry about the beneficiaries; the trustee may also have duties to the other business owners. Decisions will need to be made at the entity level which may conflict with decisions that the trustee would make solely in his capacity as trustee. Where the trustee is also an owner of the business in his individual capacity, the business decisions he would make may be skewed by his own personal interests.

The doctrine of minority shareholder oppression is an evolving subject. Mr. Koren points out that if the trust's business interest is a minority interest, the trustee needs to be on the lookout for being disadvantaged or oppressed by majority interests. Similarly, if the trust is a majority owner, it must be cautious about being the oppressor. These could include such things as ignoring business formalities, individuals taking away business opportunities, excess compensation issue, perks for controlling shareholders, lack of business information and participation, or sales of personal property to the business. Note that the oppressors don't have to be solely in control, they just have to be part of "those in control".

Mr. Dees then discussed the Section 1411 issues for trustees. He joked that he usually does not get through his materials, but today he was likely breaking a record as he would not get past the table of contents of his very detailed 64-page outline.

Who reaps the benefit when a trustee materially participates in a business? If the trustee is running the business and meets the 500 hour test, it will count for the trustee for his own individual taxes (assuming the trustee is also an owner as in the hypothetical), but what about the income going into the decedent's estate? Look at Section 469. Basically, as long as the fiduciary is acting in a fiduciary capacity (i.e., subject to fiduciary duties) while carrying out the business activity that meets a material participation test, the trust or estate will not have passive income and can avoid the NIIT.

Mr. Dees briefly covered how income mineral interest would be affected (inherently passive), and the implications of the Aragona case. He then posed unresolved questions about what would happen if the surviving spouse was co-trustee and did not participate at all. Or what if the surviving spouse had veto power over the business administration of the trustee?

Remember that under the Section 1411 regulations, the character of income at the trust or estate level carries out to the beneficiaries who receive the income. If you can change who the trustee is, you have a lot of power over how this could be implemented.

Ms. Sandler Steinert commented that there could be situations where the estate holds on to S corp stock for as long as possible, and in light of NIIT, QSSTs are gaining speed.

Mr. Koren asked how the application of the 1411 rules would be affected if a corporate trustee was appointed. Mr. Dees responded that in most cases, the corporate fiduciary would not be running the business, and material participation becomes unlikely. What if employees of the business went to work for the corporate trustee? They would thereby become the agents of the corporate trustee and their work with the business could fulfill a material participation test for the corporate trustee. Mr. Dees noted that it doesn't seem like this it should work (but it probably does) because it turns on who employs the people doing the active work with the business.