Will the Conversion of a Trust to a Unitrust Under the New Arkansas Uniform Fiduciary Income and Principal Act Cause a Negative Tax Result?

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03/16/2022

The Arkansas Uniform Fiduciary Income and Principal Act (the "Act") became effective on January 1, 2022. Arkansas is one (1) of five (5) states, including Colorado, Kansas, Utah, and Washington, that has enacted the Uniform Fiduciary Income and Principal Act. Legislation is currently pending in California, Missouri, Tennessee, and Virginia.

Perhaps the most significant differences between the Act and its predecessor, and the focus of this article, are the flexible and innovative provisions under Article 3 of the Act, which permit a trustee, under certain conditions, to convert a traditional trust into a "unitrust" to allow for total-return investing.

Ark. Code Ann. § 28-77-303(a) provides that a trustee, without court approval, may (i) convert a trust to a unitrust; (ii) change the percentage or method used to calculate the unitrust amount; or (iii) convert a unitrust to an income trust.

Because so many of the trusts designed by tax practitioners today provide for one beneficiary to receive income earned by trust investments while designating different beneficiaries to inherit a share of the trust principal in the future, administering the trust as a unitrust will undoubtedly be appealing to many fiduciaries. However, many tax practitioners may be wondering whether the conversion of a trust to a unitrust could have a negative tax impact.

To ease practitioners' minds, this article outlines four (4) hot topic tax issues you may be concerned with if a trustee desires to take advantage of the new unitrust provisions under the Act, all of which were specifically considered by the uniform drafters.

Safe Harbor under Arkansas's Act

Pursuant to Ark. Code Ann. § 28-77-309(b), if a trust qualifies for a "special tax benefit," the unitrust rate established under § 28-77-306 may not be less than three percent (3%) nor more than five percent (5%). "Special tax benefit" is defined in Ark. Code Ann. § 28-77-102(19) to include the following: (i) the annual gift tax exclusion, (ii) eligibility as a qualified subchapter S trust (QSST), (iii) an estate or gift tax marital deduction, and (iv) exemption from generation-skipping transfer (GST) tax. This language in the Act is designed to protect trusts with special tax benefits under the safe harbor set forth in Treas. Regs. § 1.643(b)-1:

[A]n allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust.

1. The conversion of a trust to a unitrust in accordance with Arkansas's new Act will not affect the GST tax inclusion ratio of a GST exempt trust.

Treas. Regs. § 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under § 26.2601-1(b)(1), (2), or (3) will not cause the trust to lose its exempt status. Generally, a modification may not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in I.R.C. § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification may not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Treas. Regs. § 26.2601-1(b)(4)(i)(D)(2) specifically provides as follows:

[A]dministration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustees duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of [Treas. Regs. § 1.643(b)-1].

Treas. Regs. § 26.2601-1(b)(4)(i)(E), Example 11 illustrates the foregoing provisions as follows:

Conversion of income interest to unitrust interest under state statute. In 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantors child, A, and A's issue. The trust provides that trust income is payable to A for life and upon A's death the remainder is to pass to A's issue, per stirpes. In 2002, State X amends its income and principal statute to define income as a unitrust amount of 4% of the fair market value of the trust assets valued annually. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4% unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the beneficiaries consent was not required, or, if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not define income as a unitrust amount or if the situs was changed to such a state from State X.

2. The conversion of a trust to unitrust in accordance with Arkansas's new Act will not affect the qualification of a marital trust for the marital deduction.

Notwithstanding the general deduction limitations set forth in § 2056(b)(1) of the Internal Revenue Code of 1986, as amended (the "Code"), § 2056(b)(7) allows an estate tax marital deduction for "qualified terminable interest property." Under § 2056(b)(7)(B)(i) of the Code, the term "qualified terminable

interest property" means property which passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and to which an election under § 2056(b)(7)(B)(v) (i.e., the "QTIP election") applies. Section 2056(b)(7)(B)(ii) provides that the surviving spouse has a qualifying income interest for life if the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, and no person has a power to appoint any part of the property to any person other than the surviving spouse during the surviving spouse's lifetime.

Treas. Regs. § 20.2056(b)-7(d)(2) provides that the principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.

Treas. Regs. § 20.2056(b)-5(f)(1) specifically provides that the surviving spouse shall be entitled for life to all of the income from the entire interest or a specific portion of the entire interest if the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of Treas. Regs. § 1.643(b)-1.

3. No trust beneficiary will be treated as having made a gift for federal gift tax purposes as a result of consenting to the conversion of a trust to a unitrust.

Ark. Code Ann. § 28-77-304(c) contemplates that a trust beneficiary may consent to a trustee's proposed action of converting a trust to a unitrust under the Act. A practitioner may be wary of advising his or her client to consent to the trustee's proposed action for fear of a negative gift tax result to the consenting beneficiary as a result of an increased distribution amount to the income beneficiary.

However, the Internal Revenue Service (IRS), citing Treas. Regs. § 26.2601-1(b)(i)(4)(E), Example 11, ruled in PLR 200747017 that the conversion and administration of a trust pursuant to a state statute meeting the requirements of Treas. Regs. § 1.643(b)-1 and § 26.2601-1(b)(4)(i)(D) would not cause the beneficiaries of the trust to be treated as making taxable gifts for federal gift tax purposes under § 2501 of the Code.

4. Neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes as a result of the conversion of a trust to a unitrust.

In PLR 200747017, the IRS also concluded that no gain or loss would be recognized under § 61 or § 1001 of the Code by the trust or any beneficiary of the trust as a result of a conversion of a trust to a unitrust. The IRS again cited to Treas. Regs. § Treas. Regs. § 26.2601-1(b)(i)(4)(E), Example 11, which specifically states that "neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes."

Conclusion

Although tax practitioners should not fear a negative tax result stemming from the conversion of a trust to a unitrust under Arkansas's new Act, they should be mindful of the limitations on the unitrust amount.