

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-118387-02/CC:PSI:B2

Director
SBSE

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Husband =

Wife =

Trust =

Date =

Date =

Farm =

Property =

X% =

Y% =

Z% =

ISSUE:

Whether income of a QTIP Trust and a Credit Bypass Trust that is generated by farming activity and distributed by the trusts to an individual who is both the beneficiary and trustee of each trust is considered net earnings from self-employment to the individual and subject to self-employment tax under section 1402 of the Internal Revenue Code.

CONCLUSION:

The income of the QTIP Trust and the Credit Bypass Trust that is derived from operations of a farm and distributed by the trusts to an individual who is both the beneficiary and trustee of each trust is not, in itself, considered net earnings from self-employment to that individual and subject to self-employment taxes under section 1402 of the Internal Revenue Code. However, to the extent that the distributions are payments for any services that the individual is providing to the trusts as part of any trade or business of that individual, such amounts will generally be considered net earnings from self-employment subject to self-employment taxes. A determination should be made as to whether the payments received by the individual for any services that he or she provided as part of her trade or business to the Trust were reasonable and of sufficient amount.

FACTS:

According to the trust instrument and other information provided to us, Husband and Wife owned and operated a Farm. On Date 1, Husband and Wife created the Trust, a revocable trust, which was funded with the Farm. Husband and Wife were trustees of the Trust. According to the trust instrument, all property placed in the Trust while both Husband and Wife were alive was the community property of the trustors. Upon the death of the Husband, on Date 2, Wife became the sole trustee of the Trust. Under the terms of the Trust, upon Husband's death, three trusts were created: Survivor's Trust; the QTIP Trust; and the Credit Bypass Trust. The Survivor's Trust is a revocable trust, the QTIP Trust and the Credit Bypass Trust are irrevocable trusts. The estate of the Husband was generally allocated one-half to the Survivor's Trust and one half to the QTIP Trust. A parcel of land, Property, was allocated X% to the QTIP Trust, Y% to the Credit Bypass Trust and Z% to the Survivor Trust.

The Wife is the sole fiduciary and beneficiary of both the QTIP Trust and the Credit Bypass Trust. The Wife is engaged in the trade or business of farming and as part of that business also participates in the operations and management of the Farm. Trust distributions from the QTIP Trust and the Credit Bypass Trust were reported on the Wife's Form 1040, Schedule E, Supplemental Income and Loss, Part III. The Wife paid Self-Employment Contributions Act (SECA) tax on the distributions made by the Survivor Trust of Farm income, however SECA tax was not paid on the distributions

from the QTIP Trust or the Credit Bypass Trust of Farm income.

LAW AND ANALYSIS:

Internal Revenue Code section 1402(a) generally defines net earnings from self-employment as “the gross income derived by an individual from any trade or business carried on by such individual, less deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member,” with certain exceptions that are not applicable here. Section 1.1402(a)-2(b) of the Income Tax Regulations provides that a trade or business must be carried on by the individual, either personally or through agents or employees. The regulation further provides “[a]ccordingly, income derived from a trade or business carried on by an estate or trust is not included in determining the net earnings from self-employment of the individual beneficiaries of such estate or trust.”

When the employment-tax provisions were enacted, the Congressional committee reports provided:

The trade or business must be carried on by the individual, either personally or through agents or employees, in order for the income to be included in his net earnings from self-employment. Accordingly, gross income derived by an individual from a trade or business carried on by him does not include income derived by a beneficiary from an estate or trust even though such income is derived from a trade or business carried on by the estate or trust.

S. Rep. No. 1669, 81st Cong., 2nd Sess. 155 (1950), 1950-2C.B. 354.

The requirement that income, for purposes of section 1402 of the Code, must be from the trade or business carried on by the individual is illustrated in Rev. Rul. 59-162, 1959-1 C.B. 224. The example in the revenue ruling involves distribution of an insurance renewal commission. Under the terms of a contract between the husband and his insurance company, following the death of the husband, the insurance renewal commission earned by the husband would be paid to the wife. Although the insurance renewals would be net earnings from self-employment for the husband, the ruling found that the insurance renewals would not be considered net earnings from self-employment for the widow because they were not derived by a trade or business carried on by her. See also, Rev. Rul. 59-168, 1959-1 C.B. 625.

Section 1402 of the Code, and the regulations thereunder, provide that income derived from a trade or business maintained by trust is not included in determining net earnings from self-employment by the individual beneficiaries. Thus, where a trade or business is carried on by a trust, and not an individual, the income derived from property maintained by the trust would not be includible in determining the net earnings from self-employment of an individual beneficiary unless there is basis for disregarding the trust for purposes of the Code and finding that the net earnings are actually derived from a trade or business maintained by the individual beneficiary.

Section 301.7701-4(a) of the Procedure and Administration Regulations addresses “ordinary trusts” and provides that the term “trust” as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of either protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

Section 671 of the Code provides that where a grantor shall be treated as the owner of any portion of a trust under subpart E, part I, subchapter J, chapter 1 of the Code, there shall be included in computing the taxable income and credits of the grantor those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against tax of an individual.

Generally, a grantor is treated as the owner of any portion of a trust in which the grantor has certain powers or interests described in sections 673 through 677 of the Code.

Based solely on the facts submitted and the representations made, we conclude that the QTIP Trust and Credit Bypass Trust qualify as trusts under § 301.7701-4(a). Prior to the death of Husband, Husband and Wife were treated as the owners of the Trust under sections 671 through 677 of the Code. However upon the death of Husband, the Trust corpus was distributed into three separate trusts, the QTIP trust, the Credit Bypass Trust, and the Survivor’s Trust. Wife is treated as the owner of Survivor’s Trust under sections 671 through 677 of the Code. The QTIP Trust, and the Credit Bypass Trust, the trusts in question, are irrevocable trusts created at the death of Husband.

The QTIP Trust and the Credit Bypass Trust are not business trusts under § 301.7701-4(b). See Estate of Bedell v. Commissioner, 86 TC 1207 (1986). Income received from these trusts is separate from any income Wife should receive for the performance of services as part of a trade or business on behalf of these trusts.

Although we have found that the QTIP Trust and the Credit Bypass Trust qualify as trusts under § 301.7701-4(a), there could be an issue of whether the Wife received adequate payments for the services she performed for the QTIP Trust and the Credit Bypass Trust as part her trade or business of farming. In this regard, we suggest that a determination be made whether the Wife received payments that were reasonable and of sufficient amount for services that she provided to the QTIP Trust and the Credit Bypass Trust as part of a trade or business.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.