

## Filing Tax Returns for Conservatorships (or Not)

By George W. Gregory and Neal Nusholtz

### Introduction

A conservatorship can be defined as a fiduciary-beneficiary relationship where a person receives income that ultimately belongs to someone else. That situation creates income tax reporting issues in regard to which party reports the income and whether the payor of the income should report the income under the tax identification number of the fiduciary or under the tax identification of the beneficiary. Those issues have been addressed repeatedly by the Internal Revenue Service in numerous rulings, as illustrated in the following table:

erated by the receivership property.” The Memorandum concluded

A custodial receivership is not a separate taxable entity but rather stands in the place of the individual. The individual is taxed on the income generated by the receivership property, including any gain recognized on the disposition of the receivership property. See Treas. Reg. §§1.641(b)-2(b); 1.6012-3(b)(5).

### The Lane Case

The Tax Court *Lane*<sup>1</sup> case offers guidance on the type of circumstances that will cause a conservator to be obligated to file a tax return for the

<u>Table of Rulings on Tax Filings for Quasi Fiduciaries</u>		
Description	Tax ID#	Cite
Interest on Landlord Security Deposit	Single Tenant—SS# of tenant Multiple tenants—Trust EIN	Rev. Rul. 77-260
Custodian	f/b/o SS#	Rev. Rul. 64-137
Guardian for spouse	Can file joint return	Rev. Rul. 67-191
Nominee for minor	Minor SS#	Rev. Rul. 64-331
Fund to pay creditors	Not a trust. No fiduciary	Rev. Rul. 71-119
Bank custodian pending final determination of ownership	Must file a trust return	Rev. Rul. 69-300

### The Conservator’s Duty, Based on General Control, to File and Pay the Protected Person’s Income Taxes

The question addressed in Field Service Advice Memorandum FSA 0523 was whether a custodial receiver of the entire estate of an individual is “required to file an income tax return for that individual” and report thereon “income gen-

protected person whose property they possess. The court ruled implicitly that a conservator is obligated to file and pay taxes for their protected person if the conservator is “generally responsible” for the affairs of the protected person.

The facts in the *Lane* case are as follows: Helen Lane lived in Fairmont, Minnesota. Prior to her mother’s death on May 30, 1981, Helen and her mother jointly owned a farm in Hall Coun-

ty, Nebraska. In 1977, Howard Hinman was appointed as conservator for Helen by the County Court of Hall County, Nebraska “to manage the farm property jointly owned by Helen Lane and her mother.” Mr. Hinman “was charged only with management of the farm.” He was appointed not because Helen was incompetent, but because she “was unable to manage the business affairs in conjunction with the operation of farmlands in Hall County, Nebraska.” Hinman’s periodic reports covered farm operations, bank interest, and payments for the benefit of Helen and Helen’s mother. The reports were a public record. The Internal Revenue Service audited Helen and determined that neither she nor Mr. Hinman filed tax returns for 1979-1983. They sent Helen a Statutory Notice of a proposed tax liability for each unfiled tax year. The Notice gave her 90 days to file a petition to the Tax Court or incur the proposed tax liabilities. She petitioned the Tax Court and claimed that it was Mr. Hinman, not her, who should have filed tax returns and paid the taxes owed.

The Tax Court rejected Helen’s argument about Mr. Hinman’s obligation to file and pay her taxes because, the Tax Court said, Mr. Hinman was not “responsible for petitioner’s affairs generally.” In the absence of positive law on the obligation of Mr. Hinman to file and pay Helen’s taxes, the Tax Court punted: “If petitioner believes that she had a right to have her tax returns prepared and paid by Mr. Hinman, she will have to vindicate that right in another place.”

### **Is a Conservator Required to File a Trust Return?**

The *Lane* case makes no mention of whether Mr. Hinman was obligated to file a trust tax return for the conservatorship. Two treasury regulations suggest Mr. Hinman was obligated to

file a trust tax return. Treas. Reg. 301.7701-4<sup>2</sup> specifies that a trust 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. Treas. Reg. 1.641(b)-2 requires a fiduciary<sup>3</sup> to “make and file the return and pay the tax on the taxable income of an estate or of a trust.”

Filing a trust tax return as a conservator can cause higher taxes if the conservatorship income is not distributed out by the conservator; the taxes on a trust return can be much higher than they would be if the income was instead reported on the return of the protected person. Whether income is to be taxable on a trust tax return or on the tax return of beneficiary is determined by the distributable net income deduction under IRC 643. The distributable net income deduction determines how much of the trust income is taxed at the trust level and how much is taxed to the beneficiary to whom it is distributed.<sup>4</sup>

The distributable net income deduction is affected by whether a trust is required to distribute out all of its income. Trusts that are required to distribute out all of their income are called “simple” trusts.<sup>5</sup> Trusts which can accumulate income without such distributions are called “complex” trusts. A simple trust that is required to annually distribute all of its income is entitled to a distributable net income tax deduction equal to the amount of income required to be distributed.<sup>6</sup> Complex trusts, on the other hand, are entitled to a deduction under IRC 661 only for amounts of income actually paid out to beneficiaries during the tax year.<sup>7</sup>

Who pays tax on the trust income matters because, for trusts, higher tax rates kick in at lower levels of income than they do for individuals. On the following page is a comparison of trust tax rates with single rates.

<u>Table Comparing 2020 Tax Rates of Trust and Single Income Tax Returns</u>		
2020 Tax Rate	Trust Return	Single Return
Taxable Income above which the 37% tax rate applies	\$12,950.00	\$518,400.00
Amount of Taxable Income below which there is a zero tax on long term capital gains and qualified dividends	\$2,950.00	\$54,050.00
Exemption/Standard Deduction	\$300 (Simple Trust) \$600 (Complex)	\$12,000.00
3.8% Net Investment Income Tax if Taxable Income is over this amount.	\$12,950.00	\$200,000.00
Tax on \$54,050 of Long-Term Capital Gains and Qualified Dividends (with no other income)	\$11,245	Zero

Although it depends on the levels of income for the trust and a beneficiary, the trust marginal rate could easily be 20 percent higher than the rate for a beneficiary. As a general rule, we prefer to have income taxed to the beneficiaries, but since a conservatorship is a complex trust, the income must be distributed to the protected person for that to happen, and distributing all income to the protected person is usually something we do not want to do.

**Two Methods (Under Treas. Reg. §§ 1.641(b)-2(b) and 1.671-4(b)(2)) that Can Cause Conservatorship Trust Income to Be Reported by the Protected Person Even if It Is Not Distributed**

**Method One, The Substituted Taxpayer Method**

The Substituted Taxpayer Method is found in section (b) of Treas. Reg. 1.641(b)-2. Section

(a) of that regulation requires a fiduciary to file tax returns, but section (b) provides that a conservatorship is not an entity separate from the protected individual.<sup>8</sup> Under section (b) a custodian of a taxpayer’s property is treated as if the custodian were the taxpayer. In *CHM Co v Commissioner*, 68 TC 31 (Apr 11, 1977) a shareholder of a Sub S Corporation filed bankruptcy and the IRS argued that stock ownership by a bankruptcy trustee revoked the Subchapter S Election. The Tax Court relied on section (b) of the regulation to hold that the bankruptcy trustee was not a separate entity. When the trustee files a tax return, it does not do so as a fiduciary “but for the individual in whose ‘place’ he stands.”

**Signing the Protected Individual’s Tax Return**

A conservator for a protected individual can sign the individual’s tax return per IRC 6903.

(a) **Rights and obligations of fiduciary.**—

Upon notice to the Secretary that any person is acting for another person in a fiduciary capacity, such fiduciary shall assume the powers, rights, duties, and privileges of such other person in respect of a tax imposed by this title (except as otherwise specifically provided and except that the tax shall be collected from the estate of such other person), until notice is given that the fiduciary capacity has terminated.

Notice to the IRS under IRC 6903 can be made on a Form 56 by checking the box for “conservator.” Page 14 of the IRS 2020 Publication 17 (Tax Guide 2020 for Individuals) states:

Court-appointed conservator, guardian, or other fiduciary. If you are a court-appointed conservator, guardian, or other fiduciary for a mentally or physically incompetent individual who has to file a tax return, sign your name for the individual. File Form 56.

### **Method Two, The Grantor Trust Method**

If a conservatorship is treated as a trust, for the trust income to be reported directly by the protected individual, the conservatorship trust would have to be a grantor trust under IRC 671. The grantor of a grantor trust under IRC 671 is the owner of the trust who must report trust income if they meet the circumstances listed in IRC 672-679. Grantor trust status would seem to be the case under IRC 673, which treats a trust as a grantor trust if the grantor has a reversionary interest that exceeds five percent of the value of the trust. It stands to reason that the grantor of the assets in a conservatorship is the protected person who also has a reversionary interest greater than five percent of the value of conservatorship assets.

In Rev. Rul. 83-25, a minor was awarded damages as a result of a personal injury suit filed on the minor’s behalf. Pursuant to a court order, an amount of damages was paid into the registry of the court and was transferred to a trust for the benefit of the minor. The court order designated Y, a corporation, as the trustee. The minor was treated as the owner of a trust under IRC 677 be-

cause distributions could be made to the grantor/minor without the consent of an adverse party.

### **The Middleman Rule Under Treas. Reg. 1.6049-4(b)**

IRC 6049 applies to returns regarding payments of interest, but it contains a general middleman rule. “ (i) In general. Except as provided in paragraph (b)(5) of this section, every person acting as a middleman (as defined in paragraph (f)(4) of this section) shall make an information return for the calendar year. If someone is holding property for someone else and is treated as acting as a “middleman” who receives income and turns the income over to someone else, there is a rule that requires the middleman to send 1099’s to the person for whom the person holding property is acting as a middleman. A middleman under Treas. Reg. 1.6049-4(f)(4) is any person or a nominee, who makes payment of interest for, or collects interest on behalf of, another person, or otherwise acts in a capacity as intermediary between a payor and a payee. Below is a discussion of the middleman rule in Private Letter Ruling 844075 in regard to the receipt and payment of interest by a middleman:

Section 6049 of the Code generally requires reporting of interest in excess of \$10 in a calendar year. Section 1.6049-4(b)(3) of the regulations requires, in part, every person acting as a middleman to make an information return on Forms 1096 [the cover sheet for the 1099’s submitted to the IRS] and 1099 for the calendar year whether or not the middleman receives a Form 1099 but only to the extent the payment of interest aggregates more than \$10. Section 1.6049-4(f)(4) of the regulations defines middleman, in part, as any person or a nominee who makes payment of interest for, or collects interest on behalf of, another person, or otherwise acts in a capacity as intermediary between a payor and a payee. Section 6049(b)(1)(B) defines the term “interest” as interest on deposits with persons carrying on the banking business.

Accordingly, with respect to your sixth request,

each fund would be required under section 6049 of the Code to issue information returns as a middleman showing the amount of interest paid to the extent such interest equals or exceeds \$10. Section 6041 of the Code requires ‘all persons engaged in a trade or business and making payments in the course of such trade or business to another person of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments or other fixed or determinable gains, profits and income ... of \$600 or more in a taxable year ...’ to make an information return of such, other than payments which section 6049(a) of the Code applies.

A middleman is exempt from back up withholding.<sup>9</sup>

### **Two Alternate Methods of Reporting for Grantor Trusts Under Treas. Reg. 1.671-4(b)(2): One of Which Does Not Require a Trust Return and the Other Requires a Trust Return Plus the Middleman Rule**

If a conservatorship does qualify as a grantor trust, and there is a grantor plus up to one other person, then Treas. Reg. 1.671-4(b)(2) offers two optional methods of reporting trust income.<sup>10</sup> One option is to furnish payors the name, address and social security number of the interested person. The other option is to: (a) file a trust return; and (b) follow the middle man rule and send 1099's to the beneficiary per Treas. Reg. 1.671-4(b)(2)(b)(iii).<sup>11</sup>

### **Conclusion**

Some payors may ask the conservator for an Employer Identification Number (“EIN”) on the assumption that the conservatorship is a trust. The use of that number by a payor on 1099's will control whether a trust return is needed to be filed. If an EIN is used on the 1099's, the government's computer will look for the income to be reported on a tax return under that EIN. At the end of the day, all conservatorship income will be reported on the Form 1040 of the protected person even if a trust return has to be filed.

A conservator has the following three options in the following preferred order of convenience.

1. Under Treas. Reg. 1.641(b)-2(b). Submitting a W-9 to Payors with the name, the address and the social security number of the protected person and then filing a Form 1040 on behalf of the protected person at tax time.
2. Under Treas. Reg. 1.641(b)-2(a). Filing a Form 1041 for any income reported under an EIN then using a K-1 to file the return of the protected person at tax time.
3. Under Treas. Reg. 1.671-4(b)(2). Filing a Form 1041 for any income reported under an EIN and filing 1099's with the protected person as a payee for any 1099's received by the conservator under the EIN.

The due date for sending 1099's is February 28 (on paper) or March 31 (electronically) plus a possible application for an automatic 30-day extension. The due date for trust returns is April 15 plus a possible application for an automatic 3-month extension. If all of the conservatorship income is on 1099's, then option 3 above is more likely to result in a return for the protected person being filed on or before April 15 and that may be a reason for choosing number 3 above.

### **Notes**

1. *Lane v Commissioner*, TC Memo 1994-381 (1994).
2. Treas. Reg. 301.7701-4 Trusts.
  - (a) **Ordinary trusts.** In general, 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 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