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# Income Taxation of Preneed Funeral Trusts:

## Revenue Ruling 87-127 and Other Developments

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Prepared for the Members of the
National Funeral Directors Association

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Dear NFDA Member:

We are pleased to enclose a booklet which analyzes the federal income tax issues involved in preneed funeral trusts. The booklet was prepared by Bob Wellen of Fulbright & Jaworski, NFDA's tax counsel, expressly for NFDA members and their tax advisors.

As you may know, last November IRS published a revenue ruling dealing with preneed trusts. The booklet discusses the revenue ruling in detail and provides a series of examples to illustrate how the ruling works.

The ruling states that, *for many types of programs, income earned by a preneed trust is taxed to the customer,* even though the customer does not receive the income and may never have any right to receive it. According to the ruling, the customer is taxed on this income even if it is distributed currently to the funeral director or other preneed seller. The ruling also states that the seller is taxed on this same income when it is distributed to him. In other words, according to IRS, the same income is taxed to both the customer and the seller.

The ruling applies to a variety of preneed programs, but not necessarily to all programs. The booklet explains the reasoning behind the ruling, and it should help you determine whether the tax treatment prescribed in the ruling applies to your program, as governed by your particular state law.

The booklet also discusses the complex administrative procedures for reporting preneed trust income under the ruling. IRS is working on new guidelines to streamline these procedures, but we do not yet know what these guidelines will say or when they will be published. *The ruling applies to preneed contracts entered into on or after January 29, 1988.* As a result, many of you will have to gear up for these procedures in time for the 1989 filing season.

The booklet also discusses NFDA's efforts, along with a coalition of industry representatives, to improve the taxation of preneed trusts through legislation. NFDA will be deciding shortly whether to continue these efforts in 1988.

We think you will find the enclosed booklet useful. If problems arise that the booklet does not cover, we would like to know about them. We would also like to know your ideas about whether NFDA should pursue legislation and about how you might be able to help with a legislative project.

Very truly yours,

Glenn G. McMillen

# INCOME TAXATION OF PRENEED FUNERAL TRUSTS: REVENUE RULING 87-127 AND OTHER DEVELOPMENTS

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# INCOME TAXATION OF PRENEED FUNERAL TRUSTS: REVENUE RULING 87-127 AND OTHER DEVELOPMENTS

## I. Introduction

### A. *Purpose and Content of This Booklet*

On November 17, 1987, the Internal Revenue Service ("IRS") published a revenue ruling to clarify its position on the federal income tax treatment of income earned by preneed funeral trusts. This ruling, Rev. Rul. 87-127, 1987-48 I.R.B. 5, was only the second official pronouncement ever made by IRS on this subject and the first such pronouncement in 14 years. IRS seems to have intended Rev. Rul. 87-127 as a global statement that would explain the IRS position on all types of preneed trusts, covering years past, present and future. In fact, Rul. 87-127 provides much useful information, but it also leaves numerous questions unanswered. The text of Rev. Rul. 87-127 appears in Attachment 1 to this booklet.

NFDA tax counsel has analyzed Rev. Rul. 87-127 and has consulted informally with IRS officials about preneed trust tax issues. Based on that analysis and those consultations, tax counsel has prepared this booklet to help NFDA member firms and their tax advisors understand the income taxation of preneed trusts, in light of this important ruling. The analysis and discussion in this booklet are based on tax counsel's review of the relevant authorities and on informal consultations with IRS officials knowledgeable in this area.

IRS has not reviewed or passed upon this booklet or upon any of the analysis or conclusions stated herein. Such analysis and conclusions are solely those of tax counsel.

Part II of this booklet summarizes the booklet's basic conclusions. Part III discusses the background and history of Rev. Rul. 87-127 and describes the ruling itself. Part IV discusses subjects of particular interest in some detail. These subjects are:

- The federal income tax burden to funeral directors and their preneed customers under this ruling (Parts IV. B. and C.).
- The return filing and other administrative requirements that the ruling imposes (Part IV. D.).
- The effective date of the ruling and the treatment of preneed contracts entered into before that date (Part IV. E.).
- The types of arrangements to which the ruling applies and the possible tax treatment of certain other arrangements (Part IV. F.).

Part V discusses the possibilities for legislative change in the taxation of preneed trust income, including a legislative proposal approved last year by the Senate Finance Committee.

Part VI contains several examples illustrating the application of Rev. Rul. 87-127 to various preneed trust situations.

Finally, the booklet includes, as attachments, copies of materials which will be helpful, especially to members' tax advisors working with Rev. Rul. 87-127.

Rev. Rul. 87-127 and the discussion in this booklet pertain only to the federal income tax treatment of preneed trusts. Neither the ruling nor this booklet considers state, local or foreign income taxes, estate or inheritance taxes or any other taxes. Also, neither Rev. Rul. 87-127 nor this booklet pertains to the treatment of preneed contracts under social security or public assistance rules or under state laws regulating the preneed contracts themselves.

### B. *Terminology Used in This Booklet*

This booklet uses certain uniform terminology to avoid confusion:

- The term *"preneed contract"* refers to a contract whereby a funeral director or other person agrees to provide funeral merchandise and services in the future, and the purchaser of the contract makes one or more payments in advance to pay for such merchandise and services.
- The term *"purchaser"* refers to the purchaser of a preneed contract for his or her own funeral. The booklet also will discuss briefly situations in which one person enters into a contract to provide for the funeral of a spouse, family member or other person.

- The term *"seller"* refers to the seller of the funeral merchandise and services under a preneed contract. The seller may be either the funeral director who intends to provide the merchandise and services or another person who contracts with a funeral director.
- The terms *"preneed trust"* and *"trust"* refer to a trust which is established pursuant to a preneed contract and to which the purchaser's funds are paid under the requirements of state law.
- The term *"trustee"* refers to the trustee of a preneed trust. Depending upon state law and other factors, the trustee may be the seller or may be a bank or other person. A trustee of a master trust is also a trustee for this purpose.
- The term *"principal,"* as related to a preneed trust, refers to the amounts paid by the customer and placed in the preneed trust.
- The terms *"income"* and *"accumulated income"* refer to the income earned by the preneed trust on its principal.

## II. Summary and Overview

### A. *Impact of Rev. Rul. 87-127*

Rev. Rul. 87-127 states three general conclusions:

- Preneed trusts of the types described in the ruling are "grantor trusts," subject to sections 671-678 of the Internal Revenue Code of 1986, as amended (the "Code"). The purchaser is treated for tax purposes as the grantor of the trust and as the owner of the funds in the trust.
- Income earned on funds in such a preneed trust is taxable to the purchaser as the income is earned.
- Distributions to the seller by such a preneed trust, whether out of principal, income or both, are taxed in full to the seller as ordinary income.

The ruling applies this tax treatment to a broad range of preneed trust arrangements. Because of the way the ruling is drafted, however, some preneed trust arrangements may be outside the ruling's reach.

If Rev. Rul. 87-127 applies to a preneed trust arrangement, the income earned by that preneed trust usually will be taxed twice — once to the purchaser as the income is earned and again to the seller when the income is distributed to the seller. There will be no tax credit or deduction to the purchaser, to his estate or to the trust at the time the income is distributed.

In addition, the trustee will have to file annual returns with the IRS. To file these returns properly and to avoid backup withholding and penalties, the seller and the trustee will have to keep the purchaser's social security number on file. If several trusts are commingled, as in the case of a master trust, the trustee also will have to be able to allocate the income and expense items among the trusts for the various purchasers. We expect further guidance from IRS on these administrative matters.

### B. *Effective Date*

Rev. Rul. 87-127 is generally effective only for preneed contracts entered into on or after January 29, 1988. In certain instances, however, the ruling is partly or fully retroactive.

Thus, the ruling generally will not apply to taxable years before 1988. Nor will it generally apply to trusts established under older contracts, even for future years. The ruling does not explain how these older trusts are to be treated for tax purposes. It appears, however, that the parties to older trusts may continue their historic tax treatment of these trusts.

### C. *Possible Legislative Relief*

Since late 1986, NFDA has worked with an industry coalition to secure legislation which will improve the tax treatment of preneed trust income. As a result of coalition efforts, in October, 1987, the Senate Finance Committee approved a provision relating to preneed trusts. (The proposed statutory and committee report language appears in Attachment 5 to this booklet.) Although this provision was not enacted in 1987, NFDA believes that legislative relief may be possible in the future.

## III. Rev. Rul. 87-127 in General

### A. *Background and History*

In earlier years, little attention was paid to the taxation of preneed funeral trust income. The amounts of funds set aside in preneed trusts were relatively small, and the income earned on these funds, at low prevailing interest rates at that time, did not warrant much attention from tax authorities.

In recent years, however, the preneed segment of the funeral industry has grown significantly. Incentives to enter into preneed arrangements, arising out of social security and public assistance programs, have grown, and sellers have marketed preneed products more extensively. Moreover, the income earned by preneed trusts has increased, as trustees' investment practices have become more sophisticated, and as general investment yields have increased.

Nevertheless, until 1987 the tax law relating specifically to preneed trusts consisted of only two items:

- *Angelus Funeral Home v. Commissioner,* 47 T.C. 391 (1967), *acq., aff'd,* 407 F.2d 210 (9th Cir.), *cert. denied,* 396 U.S. 824 (1969), in which the U.S. Tax Court held that a seller generally is to be taxed when a preneed trust distributes its funds to him, not when the purchaser makes payments placed in the trust.
- Rev. Rul. 73-140, 1973-1 C.B. 323, in which IRS ruled on the tax treatment of income earned in one particular type of preneed trust. In that ruling, a purchaser entered into a preneed contract. His payments were placed in a trust, but, under applicable state law, he could withdraw all or part of his funds, both principal and income, from the trust at any time. IRS ruled that, because the purchaser could withdraw his funds, the trust was a revocable trust. Thus, under section 676(a) of the Code, the trust was a grantor trust, with the purchaser treated for tax purposes as the owner of the property in the trust. Accordingly, the income earned on the funds in the trust was currently taxable to the purchaser. The text of Rev. Rul. 73-140 appears in Attachment 2 of this booklet.

Many preneed trusts are of the type described in Rev. Rul. 73-140. But many purchasers do not have the right to revoke the trusts or otherwise to withdraw their funds from trust. Other purchasers may have the right to withdraw principal but not to receive the income. In such situations most tax advisors did not regard Rev. Rul. 73-140 as controlling. Sellers and trustees adopted a variety of methods to account for and pay tax on preneed trust income. In some instances, the trust itself was treated as the taxpayer and paid tax on trust income as it was earned. In other instances, the seller paid the tax on this income, and in still other instances the trust income was considered nontaxable until distributed to someone.

Other developments affecting preneed funeral arrangements occurred in the Tax Reform Act of 1986 (the "1986 Act"). The 1986 Act amended the grantor trust rules to broaden the category of persons treated as owners of grantor trust property.[1] This amendment has an indirect bearing on the analysis of preneed trusts. Of greater direct relevance, the 1986 Act also broadened the definition of the term "life insurance contract" in section 7702(e)(2)(C) of the Code to permit the types of life insurance used to fund preneed contracts to be taxed under favorable life insurance rules.

IRS began serious examination of preneed trust taxation during the mid-1980's. By 1986 several IRS audits were underway, and the issue had come to the attention of the National Office of IRS in Washington, D.C. After considering the issue for more than a year, IRS published Rev. Rul. 87-127, to clarify its position on the taxation of preneed trust income. Because IRS recognized that its position would involve changes in historic practice to many sellers and trustees, most of the ruling is prospective, rather than retroactive, in its application.

### B. *Description of Rev. Rul. 87-127*

Rev. Rul. 87-127 focuses on four particular preneed situations, which IRS describes as follows:

*Situation 1.* The purchaser can cancel the contract with the seller at any time. Income earned on the money deposited in the trust is accumulated. Upon performance, the seller receives all of the purchaser's money that was deposited in the trust and the accumulated income. If the purchaser cancels the contract with the seller, all money deposited in the trust and the accumulated income is received by the purchaser.

*Situation 2.* The purchaser can cancel the contract with the seller at any time. Income earned on the money deposited in the trust is paid annually to the seller. Upon performance, the seller receives all of the purchaser's money that was

1. The 1986 Act amended section 673(a) of the Code to eliminate taxpayers' ability to shift income on property for ten years by use of "Clifford trusts."

deposited in the trust. If the purchaser cancels the contract with the seller, all money deposited in the trust is returned to the purchaser.

*Situation 3.* The purchaser can cancel the contract with the seller at any time. Income earned on the money deposited in the trust is accumulated. Upon performance, the seller receives all of the purchaser's money deposited in the trust and the accumulated income. If the purchaser cancels the contract, the purchaser is not entitled to receive any money from the trust but is only entitled to select a new seller to provide the funeral.

*Situation 4.* The purchaser can cancel the contract with the seller at any time. Income earned on the money deposited in the trust is accumulated. Upon performance, the seller receives all of the purchaser's money that was deposited in the trust and the accumulated income. If the purchaser cancels the contract with the seller, all the money deposited in the trust is returned to the purchaser, and the accumulated income is paid to the seller.

IRS concluded that, in all four of these situations, (1) the preneed trust is a grantor trust; (2) the purchaser is the grantor of the trust and the owner of the property in the trust for tax purposes; and (3) as a result, the purchaser is taxed currently on the income earned by the funds in the trust. IRS also concluded that all accruals or distributions to the seller from the trust, of both income and principal, are to be taxed to the seller at ordinary income rates, in accordance with the seller's method of accounting. The purchaser's tax treatment is discussed in Part IV. B., and the seller's tax treatment is discussed in Part IV. C., below.

The ruling takes full effect for preneed contracts entered into beginning on January 29, 1988. Earlier contracts are not generally subject to the ruling, even for future years. Certain aspects of the ruling, however, are retroactive. Effective date and retroactivity issues are discussed in Part IV. E., below.

Rev. Rul. 87-127 explains the basic IRS position as to how income earned by many types of preneed trusts should be taxed. Because of the way the ruling is drafted, however, it is not clear whether certain types of preneed arrangements are covered by the ruling. These issues are discussed in Part IV. F., below. Also, the ruling does not specify the return-filing and other administrative requirements applicable to preneed trusts. We expect IRS action to clarify and simplify the administrative requirements applicable to preneed trusts. These administrative matters are discussed in Part IV. D., below.

Further, NFDA and others are considering whether to continue efforts to change the tax treatment of preneed trusts through legislation. These legislative matters are discussed in Part V., below.

## IV. Discussion of Preneed Trust Tax Issues

### A. *Introduction: Significance of Revenue Rulings in General*

In this part of the booklet, the following areas will be discussed in some detail: (1) the tax treatment of a preneed trust to the purchaser; (2) the tax treatment of a preneed trust to the seller; (3) administrative matters; (4) the treatment of trusts established under contracts entered into before January 29, 1988; and (5) the scope of Rev. Rul. 87-127, particularly situations which might warrant tax treatment other than that prescribed by Rev. Rul. 87-127.

Naturally, the central text for this discussion is Rev. Rul. 87-127 itself. Thus, in reviewing the discussion which follows and applying it to particular situations, it will be important to keep in mind what a revenue ruling is, and what it is not.

IRS describes a revenue ruling as "an interpretation by the Service that has been published in the Internal Revenue Bulletin. It is the conclusion of the Service on how the law is applied to an entire set of facts." Treas. Reg. §601.201(a)(6); Rev. Proc. 88-1, 1988-1 I.R.B. 7, Section 4.07. Thus a revenue ruling states the IRS position on how the tax law operates in a particular situation. Taxpayers may rely on revenue rulings, and ordinarily IRS does not take a position inconsistent with a revenue ruling. For example, an IRS auditor or appellate officer should not assert that income earned by a preneed trust of the type described in Rev. Rul. 87-127 is taxable currently to the seller or to the trust itself, rather than to the purchaser.

On the other hand, a revenue ruling does not have the force of law, like a statute passed by Congress, a regulation adopted by the Treasury Department or a decision of a federal court. That is, the courts are not bound by revenue rulings. The courts view a revenue ruling as constituting no more than a statement of opinion by a party to the litigation. *E.g., Stubbs, Overbeck & Associates v. United States,* 445 F.2d 1142, 1146-1147 (5th Cir. 1971) ("A ruling is merely the opinion of a lawyer in the agency and must be accepted as such."); *Anselmo v. Commissioner,* 80 T.C. 872, 883 n.13 (1983) ("respondent's rulings are merely statements of a party's position and are not entitled to any particular weight."), *aff'd,* 757

F.2d 1208 (11th Cir. 1985). Of course, as a practical matter the courts pay attention to revenue rulings and accord some deference to them. But a revenue ruling is not itself the law. It is an IRS interpretation of the law.

B. *Tax Treatment of the Purchaser under Rev. Rul. 87-127*

1. *Timing and Character of Taxable Income*

Income earned on funds in a preneed trust subject to Rev. Rul. 87-127 is taxed to the purchaser currently, as the income is earned. For tax purposes, the situation is the same as that which would prevail if the funds were in the purchaser's own name. The fact that the purchaser does not receive the income and may never have the right to receive it, may make it seem strange for the purchaser to be taxed on that income. Nevertheless, that is the result IRS reached.

Consequently, the tax character of income earned on the funds in the preneed trust passes through to the purchaser. For example, interest and dividends earned by the preneed trust are taxed to the purchaser as ordinary income.[2] Similarly, if the trust sells an investment and recognizes a capital gain or loss, that capital gain or loss also passes through to the purchaser. If the trustee invests trust funds in tax-exempt securities, the income remains tax-exempt to the purchaser.[3]

2. *Life Insurance and Annuities*

Because of the 1986 Act amendment expanding the definition of the term "life insurance contract" (discussed above), a preneed contract may be funded with a life insurance policy, instead of through a trust. The death benefit may increase over the life of the policy.[4] The "inside buildup" of value in such a policy will not be taxable to the purchaser, because of general life insurance tax rules. Nor will there be any tax to the purchaser when the death benefit is paid to the seller upon performance of the purchaser's funeral. The seller still may be taxed on the proceeds of the policy, however, at ordinary income rates, when the proceeds are paid to him. Rev. Rul. 87-127 does not relate to this issue, or to life insurance generally.

Another form of investment which avoids current taxable income to the purchaser is a deferred annuity contract. Under section 72 of the Code, income earned on such a contract may be accumulated tax-free, until amounts are distributed. When the principal and income on the annuity are distributed to the seller upon the death of the purchaser, however, the accumulated income may be taxable to the purchaser. Rev. Rul. 87-127 does not speak to this issue. Again, the full proceeds of the annuity paid to the seller upon performance of the funeral may be taxable to the seller as ordinary income.

If a preneed contract is funded through a trust, the purchaser ordinarily will be taxed currently on income earned by the trust, even through the purchaser does not receive the income and may (depending upon state law) never have the right to receive it. By contrast, life insurance and annuity-funded arrangements should result in no current tax burden to the purchaser.

3. *Treatment of Trust Expenses*

Trustee fees and other expenses incurred by a preneed trust ordinarily will be deductible to the purchaser as miscellaneous itemized deductions (provided, of course, that the purchaser itemizes deductions). The Tax Reform Act of 1986 added a new "floor" on miscellaneous itemized deductions equal to 2% of adjusted gross income (section 67 of the Code). The legislative history of the 1986 Act indicates that expenses incurred by grantor trusts are subject to this new "2% floor."[5] Thus, even if the purchaser itemizes deductions, he may deduct preneed trustee fees and other trust expenses only to the extent such fees

2. This income also will constitute "investment income" for purposes of the limitation on deducting investment interest in section 163(d) of the Code and as "portfolio income" for purposes of the passive loss provisions in section 469 of the Code. The special rules pertaining to interest income, such as those pertaining to original issue discount and market discount under sections 1271-1278 of the Code, will also apply.

3. As with any tax-exempt income, tax-exempt income earned in a preneed trust may result in tax on the purchaser's social security or railroad retirement benefits under section 86 of the Code, or may result in alternative minimum tax liability to the purchaser (if the tax-exempt securities are private activity bonds subject to section 57(a)(5) of the Code).

4. Under section 7701(e)(2)(C) of the Code, the initial death benefit may not exceed $5,000, and the maximum death benefit may not exceed $25,000.

5. *See* Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 81 (May 4, 1987).

and expenses, together with all other miscellaneous itemized deductions (*e.g.*, unreimbursed employee business expenses and costs of investment income) exceed 2% of the purchaser's adjusted gross income.[6]

One other limitation on the purchaser's ability to deduct trust expenses also could apply. The 1986 Act added new section 265(a)(1) of the Code, to prohibit the deduction of expenses allocated to tax-exempt income. Thus, for example, if all of a preneed trust's funds are invested in municipal bonds generating tax-exempt interest, the trustee fees and other expenses of the trust may be subject to this rule and so may be nondeductible.

4. *Treatment of Trust Distributions*

In many preneed contracts, the purchaser has the right to cancel the contract and receive a refund of most or all of his principal. In some contracts, a purchaser who cancels is also entitled to receive some or all of the income accumulated by the trust.

Neither Rev. Rul 87-127 nor the earlier ruling, Rev. Rul. 73-140, states the tax consequences to a purchaser who cancels his contract and receives a refund from the trust. It follows from the "grantor trust" analysis of these rulings, however, that no further tax consequence should occur. That is, the purchaser already will have been taxed on all income earned by the trust. If he receives a refund of his principal plus accumulated income, he is simply receiving his own funds and his own previously-taxed income.

The result should not be different if the purchaser only receives a refund of his principal, or even part of his principal. Under the reasoning of Rev. Rul. 87-127, the purchaser should not be entitled to a tax loss or other deduction if he does not receive a refund of all his principal and income. IRS takes the position in Rev. Rul. 87-127 that amounts paid to the seller are taxable to the seller as ordinary compensation income. (See discussion in Part IV. C., below.) Presumably, IRS would view any amounts paid to the seller upon cancellation of the contract as an expenditure by the purchaser for personal services, a nondeductible expenditure under section 262 of the Code.

If the contract is not cancelled, the amounts in the trust would be paid to the seller for performance of the funeral. There appears to be no income tax consequence of this distribution to the purchaser or the purchaser's estate.

In some contracts, the seller is entitled to current distributions by the trust. The distributions may be measured by a fixed amount, by a percentage of the principal or income, or by some other formula. The income earned by the trust still would be taxable to the purchaser, even if some or all of it is distributed to the seller currently. If the distributions to the seller are trustee fees or other investment-type expenses, the distributions would then be deductible to the purchaser as miscellaneous itemized deductions, subject to the "2% floor" discussed above. In other situations, the distributions to the seller may be nondeductible personal expenses to the purchaser.

C. *Tax Treatment of the Seller under Rev. Rul. 87-127*

Under Rev. Rul. 87-127, the tax treatment of preneed trusts to the seller is simple: Amounts distributed to the seller from the preneed trust are taxed as ordinary compensation income. This treatment prevails regardless of whether the trust makes current distributions to the seller, makes a distribution to the seller at the time the funeral is performed, or makes a distribution to the seller when the purchaser cancels his preneed contract.

Before the issuance of Rev. Rul. 87-127, some sellers took the position that they were the grantors and owners of the trust for tax purposes, and that trust income was taxed to them, and not to the purchaser, as earned. As a result, these sellers treated the tax character of the income earned by the trust as passing through to them. (For example, some corporate sellers took advantage of the dividend-received deduction available to corporate stockholders.) Other sellers took the position that the trust itself was taxable on the income, and still others took the position that no one was taxable on this income until it was distributed to someone. Under Rev. Rul. 87-127, these tax treatments are not permitted. The ruling treats all distributions to sellers from preneed trusts as ordinary compensation income upon receipt or accrual, depending upon the seller's accounting method.

6. The application of the "2% floor" to expenses received by mutual funds became an issue during consideration of the Omnibus Budget Reconciliation Act of 1987. The result was a one-year postponement, from 1987 to 1988, of the "2% floor" as applied to expenses of certain publicly-held regulated investment companies. This postponement generally would not affect preneed trusts but could affect certain master trusts.

The seller generally should not be taxed when a payment is made into a preneed trust. That is, the ruling does not disturb the concept of *Angelus Funeral Home v. Commissioner,* discussed in Part III. A., above. In fact, language in Rev. Rul. 87-127 reinforces this concept. In concluding that the purchaser is the grantor of the preneed trust, the IRS states:

> The money that funds the trust comes from the purchaser. Although the purchaser's money is paid to the seller, under state law the seller does not have dominion and control over it and is not free to dispose of it except to place the money in trust. The placement of the money into the trust usually occurs soon after the purchaser's money is received by the seller. Once it is in trust, the disposition of the money, and the income earned on it, reflects the wishes of the purchaser more than those of the seller.[7]

These observations all suggest that IRS agrees with the essential concept of the *Angelus* case that the seller is not taxed on payments made into a preneed trust.

Sellers still should be careful not to handle preneed trust funds in a manner which might render the funds taxable to the seller before they are distributed to him. For example, sellers should not borrow these funds, use the funds as collateral for loans or otherwise derive benefit from the funds before the trust makes actual distributions to the seller.

### D. *Administrative Matters*

Rev. Rul. 87-127 does not address reporting or other administrative requirements applicable to preneed trusts. IRS is currently developing guidelines for reporting of preneed trust income, and IRS officials are aware of the need to publish these guidelines promptly. As of today, however, IRS has not yet decided what these guidelines will provide, and we do not know when they will be issued.

In the absence of specific guidelines, the reporting and other administrative rules relating to grantor trusts generally would apply to preneed trusts subject to Rev. Rul. 87-127. These rules are summarized below.

#### 1. *Returns and Information Reporting*

Under existing rules,[8] the trustee of a grantor trust is required to file with IRS a Form 1041, U.S. Fiduciary Income Tax Return, for each trust having either (a) any taxable income or (b) $600 or more of gross income. On the Form 1041 itself, the trustee reports only the income, if any, that is taxable to the trust. All items of income, deduction and credit attributable to the grantor (the purchaser here) are reported on a "separate statement" attached to the Form 1041. A copy of the "separate statement" is provided to the purchaser. Since all the income of a preneed trust is taxable to the purchaser under Rev. Rul. 87-127, no income would be reported on the face of the Form 1041. All income, deductions and credits would be reported on the "separate statement."[9]

There is no prescribed format for this "separate statement," although many such statements resemble IRS Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, Etc. In addition to reporting the items of income, deduction and credit attributable to the purchaser-grantor, the "separate statement" should indicate the purchaser's name, address and taxpayer identification number (social security number).

Treas. Reg. §1.6012-3(a)(4) provides that a trustee of two or more trusts must make a separate return for each trust. That regulation suggests that, in the case of a master preneed funeral trust, the trustee must make a separate return and statement for each purchaser-grantor. IRS officials have indicated informally to us that they believe each "account" of a master trust subject to Rev. Rul. 87-127 constitutes a separate grantor trust for reporting purposes.

Payors of interest, dividends and certain other payments generally must file information returns with IRS and furnish statements to the payees. For example, persons such as brokers who receive interest or dividends as nominees and make payments of the interest or dividends must file information returns and provide statements to the recipients.[10] These returns

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7. Rev. Rul. 87-127, 1987-48 I.R.B. 5, 6 (citations omitted).

8. Code section 6012(a)(4); Treas. Reg. §§1.671-4(a), 1.6012-3(a).

9. The fact that the trust itself would report no taxable income in this situation, because all the income is taxable to the grantor, would not appear to excuse the trust from having to file the Form 1041. Rev. Rul. 75-278, 1975-2, C.B. 461.

10. These requirements appear in sections 6042 and 6049 of the Code. They apply to all persons who pay $10 or more of dividends or interest, respectively, during a calendar year.

are made on IRS Form 1096, Annual Summary and Transmittal of U.S. Information Returns, and the statements are made on Form 1099-INT, Interest Income, and Form 1099-DIV, Dividends and Distributions.

These reporting requirements raise possible problems of duplicated reporting. IRS has addressed one such situation in a recent private ruling, the text of which appears in Attachment 3 to this booklet.[11] In this ruling, a bank acted as trustee of numerous grantor trusts. The bank paid interest and dividends earned by the trusts. Following the reporting requirements summarized above, the bank filed Forms 1041 and reported the portion of trust income, deductions and credits attributable to each grantor on a separate statement attached to the Form 1041. The trustee provided a separate statement to each grantor, which the trustee called a "Grantor Advice Letter." The Grantor Advice Letters contained substantially the same information as a Schedule K-1.

The issue presented in the ruling was whether, in addition to filing the separate statements with the Forms 1041 and providing those statements to the grantors, the trustee also was required to provide Forms 1099 to the grantors. IRS ruled that the Forms 1099 were not required, since the information already was being reported to IRS and the grantors by the Form 1041 and separate statement. Thus, in its private ruling IRS interpreted the regulations to eliminate duplicate reporting.[12]

If the payor of interest, dividends or other reportable payments is not also the trustee, however, Form 1099 filing requirements might apply. In the case of a master trust, the payor apparently would be permitted to furnish one Form 1099 to the master trust itself, rather than a separate Form 1099 to each grantor.[13]

In all cases, it would appear to be advisable for the trustee to provide the trust's taxpayer identification number, name and address to the payor, so that the trust, and not the purchasers, will receive the Forms 1099. This procedure will avoid the confusion that might be created by the purchasers' receiving two reports of the same income — one from the trustee on the "separate statement" to the Form 1041, and the other from the non-trustee payor on Form 1099. Instead, the purchaser would receive only the "separate statement" from the trustee.

Apparently, the reporting requirements described above will be simplified if the trust's only income is tax-exempt interest. As noted above, a trustee is required to file Form 1041 only for trusts having either (a) any taxable income or (b) $600 or more of gross income. Typically, a preneed funeral trust will not meet either of these tests if its only income is tax-exempt interest. Thus, the trust would not be required to file a Form 1041 under a literal application of these rules. In addition, payments of tax-exempt interest generally are not subject to information reporting under section 6049 of the Code.[14] Thus a trustee may be able to minimize its administrative burden by investing the trust's funds only in tax-exempt obligations.

Nevertheless, sellers may wish to provide reports to individual purchasers, for several reasons. First, section 6012(d) of the Code, as amended by the 1986 Act, requires that every person who is required to file a tax return include on that return the amount of tax-exempt interest he received or accrued during the taxable year. This requirement is intended, in part, to enable IRS and the taxpayer to calculate the correct taxable amount of social security benefits received by the taxpayer.[15] To comply with this reporting requirement, the purchaser will have to know the amount of tax-exempt interest earned by the trust.

A purchaser also may need to know the portion of the trust's administrative expenses allocable to him. As discussed in Part IV. B. 3., above, those expenses ordinarily will be deductible to the purchaser as miscellaneous itemized deductions. (The purchaser will only be able to claim these deductions, however, if he files a tax return with itemized deductions, and if the expenses, together with all other miscellaneous itemized deductions, exceed 2% of the purchaser's adjusted gross income.) The purchaser will be able to claim these deductions only if he knows the amount of these expenses.

Thus, sellers and trustees should consider providing reports to purchasers even if not required to do so by law.

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11. IRS Private Letter Ruling 8631047 (May 2, 1986).

12. Unlike a revenue ruling, a private ruling may not be relied upon by any taxpayer other than the taxpayer to whom the private ruling is issued. Nor may a private ruling be used or cited as precedent. Code section 6110(j)(3). Accordingly, trustees wishing to follow the Form 1041 requirement but not the requirements relating to Forms 1099 should consider obtaining their own private rulings.

13. See Rev. Rul. 77-260, 1977-2 C.B. 466 (regarding commingled tenant security deposits).

14. Code section 6049(b)(2)(B); Treas. Reg. §1.6049-5(b)(1)(ii).

15. *See* Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 1288 (May 4, 1987).

2. *Backup Withholding*

Payments of interest and dividends to a trust generally are subject to the "backup withholding" rules of section 3406 of the Code. Under these rules, a payor generally must withhold and pay over to IRS 20% of the payment, unless the payee has furnished its taxpayer identification number to the payor. Typically, the payee furnishes this information on IRS Form W-9, Payer's Request for Taxpayer Identification Number and Certification, or on a substitute Form W-9 which contains substantially the same information as the IRS form. A copy of Form W-9, including instructions, appears in Attachment 4 of this booklet.

Temp. Reg. §35a.9999-2, Q & A 20, provides special backup withholding rules for grantor trusts. Payments to such a trust (*e.g.*, interest earned on a certificate of deposit in which the trust's funds are invested) are subject to the general backup withholding rules. Thus, the trust itself must comply with the certification requirements by obtaining a separate taxpayer identification number and providing that number to the payor on a Form W-9 or a substitute Form W-9.

In addition, such payments to the grantor trust are deemed to be payments of the same kind made by the trust (as payor) to the grantor (as payee). In other words, any reportable payments made to the trust are also treated as reportable payments made by the trust to the grantor, and so are subject to the backup withholding requirements. As a result, if the grantor has not furnished his or her taxpayer identification number to the trust in the manner required, the trustee would be required to withhold and pay over to IRS 20% of the deemed payment (*i.e.*, generally the trust's income). There are also penalties for failure to provide taxpayer identification numbers and related matters. Those penalties are described briefly in the instructions accompanying Form W-9.

In substance, then, to avoid backup withholding under current grantor trust rules, the parties to a preneed trust will have to be sure that the following steps are taken:

a. The trustee should obtain from each purchaser a Form W-9, on which the purchaser certifies his social security number and that he is not subject to backup withholding. The easiest way to obtain this form is to have it filled out and signed at the time the parties enter into the preneed contract.

b. The trust itself should obtain a taxpayer identification number from IRS.[16]

c. The trust should provide a Form W-9 certifying its taxpayer identification number to banks, brokerage houses and other payors of income to the trust.

3. *Possible IRS Action*

The reporting and backup withholding requirements under existing law are not well-suited to the situation presented by preneed funeral trusts. IRS representatives have acknowledged this fact in informal conversations with us. Fortunately, reporting under the new system will not begin until early 1989, when reports on the 1988 tax year are due. We anticipate that IRS will promulgate guidelines to streamline the reporting procedure. We hope this project will address return filing, taxpayer identification numbers and backup withholding, and that revised procedures will be published in time for the 1989 filing season. We will monitor this IRS project closely and report to NFDA members as soon as more information is available.

In the meantime, IRS officials recommend that sellers and trustees take two steps, so that they will be able to comply with whatever procedures IRS adopts: First, sellers should obtain the social security numbers of all purchasers of contracts beginning January 29, 1988. (We believe sellers should use Form W-9 for this purpose.) Second, sellers and trustees should develop a mechanism for allocating income from any commingled trust funds among all purchasers of contracts beginning January 29, 1988.

E. *Effective Date and Retroactivity*

1. *General*

In general, Rev. Rul. 87-127 applies only to preneed contracts entered into on or after January 29, 1988. Trustees and sellers will have to comply with reporting and other requirements under Rev. Rul. 87-127 for the first time during the 1989 return filing season. The ruling has no application in earlier tax years. IRS decided on this prospective-only treatment, because the ruling represents a significant departure from prior practice for funeral directors in many parts of the country.

16. For general requirements for obtaining taxpayer identification numbers, see section 6109 of the Code and Treas. Reg. §301.6109-1(a).

2. *Exceptions*

In two respects, IRS has specified retroactive treatment for Rev. Rul. 87-127:

a. *Distributions of Principal to Seller*

One of IRS's conclusions in the ruling is that all amounts paid by a preneed trust to the seller are taxable to the seller as ordinary income. To the extent this conclusion relates to "the lump sum or installment payments that were deposited in the trust for the purchaser and that are received by the seller from the trust," this conclusion will be applied with full retroactivity. That is, to this extent the ruling applies to all contracts and all taxable years not yet closed under the statute of limitations.

The ruling does not state how payments from a preneed trust to a seller will be allocated as between principal and income. This allocation could be important in the case of a distribution from a pre-January 29, 1988, trust. Sellers should consider whether allocating such distributions to income on the records of the trust (where possible under state law) will be advantageous to them.

b. *Trusts Described in Rev. Rul. 73-140*

As discussed in Part III. A., above, IRS had ruled in 1973 on preneed trusts which were revocable at any time, with the purchaser being able to receive a refund of his principal plus accumulated income. IRS had ruled, in Rev. Rul. 73-140, that these particular preneed trusts were grantor trusts, and that their income was taxable to the purchaser as earned. As to these trusts, Rev. Rul. 87-127 simply restates the same conclusion, and it supersedes and replaces Rev. Rul. 73-140. Accordingly, IRS concluded that, as to the trusts previously subject to Rev. Rul. 73-140, the new ruling is to have fully retroactive effect.

3. *Treatment of Older Trusts*

Except as discussed above, Rev. Rul. 87-127 does not specify the proper treatment of trusts established pursuant to preneed contracts entered into before January 29, 1988 (other than those already covered in Rev. Rul. 73-140). From informal consultations with IRS, we understand that IRS will permit the parties to continue to use any reasonable historic treatment for these trusts, as to both prior and future years.

Consequently, many sellers and trustees will maintain two methods of accounting for preneed trusts — the historic method for old trusts and the method prescribed in Rev. Rul. 87-127 for new trusts.

F. *Scope of Rev. Rul. 87-127.*

Rev. Rul. 87-127 specifically addresses four "situations," each involving a type of preneed trust. Many preneed trusts differ from those described in Rev. Rul. 87-127, however. Therefore, sellers and purchasers should consider whether the conclusions stated in Rev. Rul. 87-127 apply in these other situations.

As discussed in Part IV. A., above, revenue rulings are not the law. They are IRS interpretations of the law as it applies in particular situations. Revenue rulings generally are read narrowly and govern only the particular situation or situations set forth in the ruling itself. IRS has recently stated this principle as follows:

> Since each revenue ruling represents the conclusion of the Service as to the application of the law to the entire statement of facts involved, taxpayers, Service personnel and others concerned are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same.

Rev. Proc. 88-1, 1988-1 I.R.B. 7, Section 4.07. On the other hand, the analysis set forth in a revenue ruling may provide guidance as to how the IRS National Office will approach related situations. Rev. Rul. 87-127 shows how the IRS National Office probably would respond in many preneed trust situations to a request for a private letter ruling from a taxpayer or for technical advice from an IRS district office. In other situations, however, the applicability of the Rev. Rul. 87-127 rationale is more problematic. Also, it should be noted that, if a preneed trust issue is litigated, Rev. Rul. 87-127 may be less influential to the courts if the facts presented in the litigation differ substantially from those set forth in the ruling.

Three of the four situations set forth in Rev. Rul. 87-127 — Situations 1, 2 and 4 — are relatively straightforward. All three involve preneed contracts which the purchaser may cancel at any time and receive a return of his principal. The only difference concerns the disposition of the income earned by the trust. (In Situation 1, the income is returned to the purchaser if the contract is cancelled; in Situation 2, it is paid annually to the seller; in Situation 4, it is paid to the seller if the contract is cancelled.) IRS concludes that the actual disposition of the income is irrelevant. The fact that the purchaser may cancel the contract at any time and receive a refund of his principal makes the trust "revocable," and therefore the income from the trust is taxable to the purchaser.

Thus, it appears that IRS would reach the same conclusion in any situation where the preneed contract is freely cancellable, to the extent principal is to be returned to the purchaser upon cancellation. For example, if the purchaser enters into a preneed contract for the funeral of another person (*e.g.*, a spouse or parent), and if the purchaser may freely cancel the contract and receive a refund of principal, IRS probably would conclude that the income earned on the preneed trust is taxed to the purchaser as earned. On the other hand, if a purchaser is not entitled to a return of a portion of his principal upon cancellation of the contract, the income on that portion of the principal may be taxable to the trust or the seller, rather than the purchaser. Rev. Rul. 87-127 apparently does not govern such a situation.

Situation 3 of Rev. Rul. 87-127 arguably has broader application than Situations 1, 2 and 4. In Situation 3, the purchaser may cancel his contract at any time, but if he cancels, he does not receive a refund of his principal. Rather, he "is only entitled to select a new seller to provide the funeral." The ruling also assumes that "the purchaser's estate has a legal obligation to pay for the funeral." Here too, the ruling concludes that the trust income is taxable to the purchaser. The reason is that the principal and income in the trust may be used to satisfy the estate's legal obligation to pay for the funeral. IRS reasons, under the grantor trust rules, that the purchaser, as the "owner" of the trust property for tax purposes, is taxable on trust income, if *either* principal or income may be used to satisfy this legal obligation. For example, then, it would seem that IRS would reach the same conclusion as to a fixed-price preneed contract, even though the income is not applied to satisfy the legal obligation to provide the funeral. The fact that the principal is used to satisfy this obligation probably would be enough for IRS.

The reasoning behind IRS's conclusion here may apply to some trusts which the parties consider to be irrevocable. For example, in some instances the purchaser may not revoke the trust, but upon the death of the purchaser the principal (and at times also the accumulated income) may be paid to the purchaser's estate. An IRS official who participated in the drafting of Rev. Rul. 87-127 has informed us orally that he and others believe that the Situation 3 conclusion applies to this type of contract. In other words, IRS officials apparently believe that some trusts which the parties consider to be irrevocable for other purposes (*e.g.*, for purposes of social security or public assistance rules) might be considered to be revocable for tax purposes.

But what about a truly irrevocable trust? For example, in some situations the purchaser may not cancel the contract or revoke the trust at all. Nor may the principal or income be paid to the purchaser's estate. The seller is required to provide the funeral merchandise and services, and the purchaser is entitled only to such merchandise and services. If the purchaser moves to a new location, the seller may contract with a funeral director in that location to provide the funeral, although the purchaser's estate may be able to designate the funeral director with whom the seller is to contract. Even here, if the estate has a legal obligation to provide a funeral, then the principal (and possibly the income) could be said to have been used to satisfy those obligations. Thus, IRS's reasoning in Situation 3 would apply, and IRS may treat the income from the preneed trust as taxable to the purchaser.

On the other hand, IRS's premise in Situation 3 — that the purchaser's estate has the legal obligation to pay for the funeral — may be faulty in some situations. Without analyzing particular state laws, we suggest that state law is not likely to require an estate actually to provide a funeral. An estate may have an obligation to provide and pay for proper burial or cremation, and it also may have to pay for a funeral which has actually been contracted for or conducted. State law may not, however, require the estate to provide any particular type of funeral. We recommend that counsel in various states analyze their respective state laws to determine the nature of the estate's obligations in this regard. If, in a particular state, the estate is not required to provide and pay for a funeral, IRS's analysis of Situation 3 may not apply. If it does not apply, the purchaser may not be taxed currently on the trust's income.

According to IRS official, IRS will entertain requests for private letter rulings on this subject. We anticipate that, in responding to such private ruling requests, IRS will tend to follow Rev. Rul. 87-127 and conclude that the purchaser is taxable on trust income, even in situations which differ from those described in Rev. Rul. 87-127. Whether the courts would reach the same conclusion, if these matters were litigated, remains an open question.

## V. Possible Legislative Relief

### A. *Coalition Efforts*

In late 1986 a coalition of funeral and cemetery industry representatives began efforts to secure legislation that would clarify and improve the tax treatment of preneed funeral trusts. NFDA participated extensively in the work of this coalition. Throughout 1987 coalition representatives met and corresponded with members of Congress and Congressional staff on this issue. Because of this dialogue, Congressional understanding of preneed matters increased, and coalition members learned more about the revenue and tax policy problems that Congress faces in solving the preneed trust tax problem.

The coalition convinced a number of members of Congress and Congressional staff that, in many instances, taxing preneed trust income to the purchaser, as under Rev. Rul. 87-127, is not the fairest or most efficient treatment. Nevertheless, although the coalition presented numerous proposals, none of these proposals was entirely acceptable to Congress.

B. *1987 Budget Legislation*

During late 1987 Congress began work on legislation to reduce federal budget deficits. This legislative project involved the consideration of numerous changes in the tax laws. Because of the coalition's work, the members and staff of the tax-writing committees of Congress included the preneed trust issue in their work on this legislation. When the Senate Finance Committee approved a package of proposed tax changes in October, 1987, a provision on preneed trusts was included in the package. A copy of this provision and accompanying committee report language appears in Attachment 5 of this booklet. This provision differed substantially from coalition proposals, and it was not entirely acceptable to many participants in the coalition. Nevertheless, the coalition continued its discussions with Congressional members and staff in an effort to refine and improve the Senate Finance Committee proposal.

Ultimately, Congress did not enact legislation regarding preneed trusts in 1987. In its rush to enact deficit reduction legislation during December, Congress simply postponed considering hundreds of technical corrections and miscellaneous tax provisions. The preneed provision was one of these provisions.

C. *Senate Finance Committee Provision*

The Senate Finance Committee provision would have introduced a new tax regime for preneed trusts with principal of not more than $5,000. Under this regime, the purchaser would not have been taxed on trust income as earned, and no Form 1099, Schedule K-1 or other individual reports would have been required. Instead, the trust itself would have been subject to tax at a flat 15% annual rate on its taxable income. An annual exemption of $1,000 of income per funeral home (to be allocated among all trusts of that funeral home) was provided. Each funeral home would have filed a single return relating to all its preneed trusts. The purchaser would not have been subject to any further tax if the trust made a distribution to him (for example, in the event of cancellation of the preneed contract). The seller would have been fully taxed at ordinary income rates, however, upon any distributions by the trust to the seller.

The Senate Finance Committee provision would have applied to preneed contracts entered into after the date the provision was enacted. Funeral directors also would have been permitted either to elect to apply the provision to older contracts or to continue prior practice with respect to these contracts.

Thus, in essence the Senate Finance Committee provision would have overridden Rev. Rul. 87-127, eliminated the tax to the purchaser, and substituted a flat 15% tax on preneed trust income. The treatment of the seller would have been identical to that prescribed in Rev. Rul. 87-127.

D. *Future Legislative Prospects*

NFDA believes that the coalition's efforts in 1987 were useful, even though they did not result in legislation. The coalition succeeded in educating members of Congress and Congressional staff as to the preneed trust problem. Observers expect Congress to consider again in early 1988 many of the technical corrections and miscellaneous provisions which were deleted from the 1987 budget legislation. NFDA will decide shortly whether to continue its efforts to secure legislative relief.

## VI. Examples of Operation of Rev. Rul. 87-127

The following examples illustrate how certain types of preneed trust income are taxed under Rev. Rul. 87-127. The examples discuss the actual tax burden to the purchaser and seller. They do not discuss administrative matters, such as return filing requirements and backup withholding. We have omitted these matters from the examples, because we expect IRS to clarify administrative requirements applicable to preneed trusts before the 1989 filing season. See Part IV. D. 3., above.

*Example 1.* Purchaser enters into a preneed funeral contract with Seller on January 30, 1988. Pursuant to the contract, Purchaser makes a payment of $2,000, which is deposited in a preneed trust. Purchaser may revoke the trust at any time. Upon revocation, Purchaser is entitled to the return of his principal, but Seller is entitled to any accumulated net income. During 1988 the trust earns $150 of taxable dividend income and pays $20 of trustee fees and other expenses. On January 1, 1989, Purchaser dies. Seller provides the funeral merchandise and services, and the trust distributes its entire balance of $2,130 to Seller in 1989.

In 1988 Purchaser is taxed on $150 of interest income. He is also entitled to $20 of miscellaneous itemized deduction, subject to the "2% floor." In 1989, Seller is taxed on $2,130 of ordinary income. Seller is not entitled to any dividend received deduction.

*Example 2.* The facts are the same as in Example 1, except that Purchaser does not die. Rather, on January 1, 1989, he cancels his preneed contract, revokes the trust and receives a refund of his $2,000 principal. Seller receives a distribution of the $130 accumulated net income of the trust.

As in Example 1, in 1988 Purchaser is taxed on $150 of income and is entitled to $20 of miscellaneous itemized deductions, subject to the "2% floor." In 1989, Purchaser is not taxed and is not eligible for any loss deduction upon the refund of his principal. Seller, however, is taxed at ordinary income rates on the receipt of the $130 of accumulated trust income in 1989. Seller is not entitled to any dividend received deduction.

*Example 3.* The facts are the same as in Example 1, except that, under the terms of the contract, Seller is entitled to distributions of all net income earned by the trust on a quarterly basis, and such distributions are in fact made during 1988.

The results for Purchaser are the same as in Example 1. Seller is taxed on the full $130 distribution as ordinary income when he receives the distributions in 1988. Seller is not entitled to any dividend received deduction. Seller is taxed on $2,000 of ordinary income in 1989.

*Example 4.* The facts are the same as in Example 3, except that the income earned by the trust is tax-exempt interest.

In 1988, Purchaser is not taxed on the tax-exempt interest earned by the trust, because this income retains its tax-free character for Purchaser. The trustee fees and other trust expenses are not deductible to Purchaser, however, to the extent those expenses are deemed to be allocable to the tax-exempt income under section 265(a)(1) of the Code. Seller, however, is taxed at ordinary income rates on the distribution by the trust of its $130 net income in 1988, and on the $2,000 distribution of principal in 1989. The tax-exempt character of the trust's income does not pass through to the seller.

*Example 5.* Purchaser enters into a preneed contract with Seller on January 30, 1988. Pursuant to the contract, Purchaser makes a payment of $2,000, which is deposited in a preneed trust. In 1988 the trust earns $150 of dividend income and pays $20 of trustee fees and other expenses. On December 31, 1988, the trust sells shares of stock and recognizes a $160 long-term capital loss. On January 1, 1989, Purchaser dies. Seller provides the funeral merchandise and services, and the trust distributes to Seller the full $1,970 balance of the trust ($2,000 principal, plus $150 dividend income, less $20 expenses and $160 loss).

In 1988 Purchaser is taxed on $150 ordinary income. He is entitled to a $20 miscellaneous itemized deduction, subject to the "2% floor." He also recognizes a $160 long-term capital loss, which he may deduct against capital gains or against ordinary income (but only if his total net capital losses do not exceed $3,000). Seller is taxed on $1,970 ordinary income in 1989. He is not entitled to any dividend received deduction. Nor does the capital-loss character of the $160 loss pass through to Seller.

*Example 6.* Purchaser enters into a preneed funeral contract with Seller on January 15, 1987, and pursuant to the contract makes a payment of $2,000, which is deposited in a preneed trust. Purchaser may revoke the trust at any time. During the term of the trust, Seller is entitled to quarterly distributions equal to net income of the trust during the preceding quarter. Upon revocation, Purchaser is entitled to the return of his principal. The trust earns, and distributes to Seller, dividend income of $150 in 1987, $160 in 1988 and $140 in 1989.

The contract was entered into on January 15, 1987, before the effective date of Rev. Rul. 87-127. Accordingly, the parties may use the method historically used by Seller in accounting for preneed trust income so long as the contract continues in effect.

*Example 7.* Purchaser enters into a preneed funeral contract with Seller on January 15, 1987. Pursuant to the contract, Purchaser makes a payment of $2,000, which is deposited in a preneed trust. Purchaser may revoke the trust at any time. Upon revocation, Purchaser is entitled to the return of his principal and all accumulated net income. The trust earns taxable dividend income of $150 in 1987, $160 in 1988 and $140 in 1989, all of which is accumulated.

The contract was entered into on January 15, 1987, before the general effective date of Rev. Rul. 87-127. Because Purchaser is entitled to principal and accumulated net income upon revocation, however, this trust was subject to Rev. Rul. 73-140. As a result, Rev. Rul. 87-127 applies, and Purchaser is subject to tax on the trust and dividend income in 1987, 1988 and 1989.

# INCOME TAXATION OF PRENEED FUNERAL TRUSTS: REVENUE RULING 87-127 AND OTHER DEVELOPMENTS

Fulbright & Jaworski
Washington, D.C.
January 25, 1988

## ATTACHMENTS

1. Rev. Rul. 87-127, 1987-48 I.R.B. 5
2. Rev. Rul. 73-140, 1973-1 C.B. 323
3. IRS Private Letter Ruling 8631047 (May 2, 1986)
4. IRS Form W-9 and Instructions
5. Section 6841 of the Omnibus Budget Reconciliation Act of 1987, H.R. 3545 (100th Cong. 1st Sess.), as approved by the Senate Finance Committee, October 16, 1987 (JCX-17-87) (not enacted), and accompanying Senate Finance Committee Report language

**Rev. Rul. 87-127, 1987-48 I.R.B. 5**

ISSUES

(1) In the four situations described below, is the purchaser of a preneed funeral the grantor of a preneed funeral trust?

(2) If the purchaser is the grantor of the trust, is the purchaser treated as the owner of any portion of the trust under section 671 of the Internal Revenue Code?

(3) Is any money received from the trust by a seller of a preneed funeral a payment for merchandise and services and includable as such in the seller's gross income under section 61 of the Code?

FACTS

Generally, state law provides that a decedent's estate or spouse has a legal obligation to pay for the decedent's funeral. A preneed funeral is a funeral that has been arranged for, and purchased by, the decedent prior to the decedent's death. In a preneed funeral arrangement, the purchaser of the funeral enters into a contract with the seller, which is usually a funeral home. The purchaser selects the desired merchandise and services and agrees to pay for them in a lump sum or in installments. The merchandise and services are delivered upon death by the seller.

Most states have laws or regulations that govern preneed funerals. These laws and regulations protect the purchaser and provide for the investment of the money transferred to the seller. Usually, the seller is required to deposit a percentage of the money into a preneed funeral trust for the use, benefit and protection of the purchaser; the money is invested and held by the trust until the seller performs. Based upon the purchaser's life expectancy, the present value of the right to use the deposit to pay for the purchaser's funeral exceeds 5 percent of the amount of money deposited in the trust at its inception.

Although the terms of the trust agreements may vary from seller to seller and the provisions of state law may vary from state to state, there are four preneed funeral trust arrangements that are commonly used. Each of the following situations describes one of these arrangements.

*Situation 1.* The purchaser can cancel the contract with the seller at any time. Income earned on the money deposited in the trust is accumulated. Upon performance, the seller receives all of the purchaser's money that was deposited in the trust and the accumulated income. If the purchaser cancels the contract with the seller, all money deposited in the trust and the accumulated income is received by the purchaser.

*Situation 2.* The purchaser can cancel the contract with the seller at any time. Income earned on the money deposited in the trust is paid annually to the seller. Upon performance, the seller receives all of the purchaser's money that was deposited in the trust. If the purchaser cancels the contract with the seller, all money deposited in the trust is returned to the purchaser.

*Situation 3.* The purchaser can cancel the contract with the seller at any time. Income earned on the money deposited in the trust is accumulated. Upon performance, the seller receives all of the purchaser's money deposited in the trust and the accumulated income. If the purchaser cancels the contract, the purchaser is not entitled to receive any money from the trust but is only entitled to select a new seller to provide the funeral.

*Situation 4.* The purchaser can cancel the contract with the seller at any time. Income earned on the money deposited in the trust is accumulated. Upon performance, the seller receives all of the purchaser's money that was deposited in the trust and the accumulated income. If the purchaser cancels the contract with the seller, all the money deposited in the trust is returned to the purchaser, and the accumulated income is paid to the seller.

LAW

Section 61(a) of the Code and the Income Tax Regulations thereunder provide that, except as otherwise provided by law, gross income means all income from whatever source derived.

Section 671 of the Code provides that when it is specified in subpart E of part I of subchapter J that the grantor shall be treated as the owner of any portion of a trust, 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 that 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 the tax of an individual.

Section 673(a) of the Code provides that the grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.

Section 676(a) of the Code provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as owner under any other provision of this part, if at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both.

Section 677(a) of the Code provides, in relevant part, that the grantor shall be treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of

the grantor or a nonadverse party, or both, may be distributed, or held or accumulated for future distribution, to the grantor or the grantor's spouse.

Section 1.677(a)-1(d) of the regulations provides, in relevant part, that under section 677 of the Code a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor (or his spouse in the case of property transferred in trust by the grantor after October 9, 1969).

In Rev. Rul. 73-140, 1973-1 C.B. 323, the taxpayer contracts with a funeral home for prepaid funeral services. State law provides that a seller of prepaid funeral services must deposit 90 percent of all funds collected under contracts to provide funeral services into a trust fund for the use, benefit and protection of the purchasers. The purchaser of the contract is considered to be the grantor of the trust. Since the grantor can at any time withdraw the portion of the grantor's payments paid into the trust fund, together with any interest earned thereon, the grantor is considered the owner of the trust under section 676(a) of the code. The ruling concludes that the purchaser must include in gross income the interest earned on amounts in the trust fund for the year in which such interest is earned by the trust.

In Rev. Rul. 73-251, 1973-1 C.B. 324, the taxpayer transferred certain property to an irrevocable trust established by the taxpayer on the date of transfer. One year later, the taxpayer transferred additional property to the same trust. The trust instrument directed the trustee to pay the trust net income to certain other persons during the life of the taxpayer and on the death of the taxpayer to pay all property then in trust to the taxpayer's estate. The ruling concludes that because of the reversionary interest in the trust and because of the taxpayer's life expectancies at the time of the two transfers to the trust, the taxpayer is considered the owner under section 673(a) of the Code of that portion of the trust attributable to the second transfer of property, but not the owner of the portion attributable to the first transfer of property.

ANALYSIS AND HOLDINGS

(1) In each of the four situations, the purchaser is treated for federal income tax purposes as the grantor of the trust for the following reasons. The money that funds the trust comes from the purchaser. *See, Bixby v. Commissioner,* 58 T.C. 757 (1972), *acq.*, 1975-2 C.B. 1. Although the purchaser's money is paid to the seller, under state law the seller does not have dominion and control over it and is not free to dispose of it except to place the money in trust. *See, Buhl v. Kavanagh,* 118 F.2d 315 (6th Cir. 1941). The placement of the money into the trust usually occurs soon after the purchaser's money is received by the seller. *See, Estate of Schwartz v. Commissioner,* 9 T.C. 229 (1947), *acq.*, 1947-2 C.B. 4. Once it is in trust, the disposition of the money, and the income earned on it, reflects the wishes of the purchaser more than those of the seller. *See, Smith v. Commissioner,* 56 T.C. 263 (1971), *acq.*, 1972-2 C.B. 3.

(2) In each of the four situations, the purchaser is treated under section 671 as the owner of the entire trust.

*Situation 1.* Because the purchaser can cancel the contract at any time and receive the money deposited into the trust and the accumulated income, the purchaser has the power to revoke the trust. Therefore, under section 676(a) of the Code the purchaser is treated as the owner of the entire trust and the income of the trust is includable in the purchaser's gross income in the year in which it is earned by the trust Rev. Rul. 73-140.

*Situation 2.* This trust differs from the trust in *Situation 1* in that income of the trust is paid annually to the seller. Because the purchaser can cancel the contract at any time and receive the money deposited in the trust, the purchaser has the power to revoke the trust. Therefore, under section 676(a) of the Code, the purchaser is treated as the owner of the entire trust and the income of the trust is includable in the purchaser's gross income in the year in which it is earned by the trust. The income paid annually by the trustee to the seller is a payment for merchandise and services and is includable in the seller's gross income in the year received or properly accrued depending upon the seller's method of accounting.

*Situation 3.* In those states in which the purchaser's estate has a legal obligation to pay for a funeral, the purchaser has a revisionary interest in the trust because the money deposited into the trust and the income earned thereon will relieve the estate of such obligation. See the *Example* in section 1.673(d)-1 of the regulations and Rev. Rul. 73-251 (both of which involve section 673 of the Code prior to its amendment by the Tax Reform Act of 1986). The value of this reversionary interest exceeds 5 percent of the value of that portion of the trust that includes the money deposited into the trust as of the inception of that portion. Because the value of this reversionary interest exceeds 5 percent of the value of the money deposited in the trust, the purchaser is treated under section 673(a) as the owner of the entire trust and the income of the trust is includable in the purchaser's gross income in the year in which it is earned by the trust.

In those states in which the purchaser's spouse has a legal obligation to pay for a funeral, the income earned on the money deposited into the trust may be applied in discharge of this obligation. Therefore, under section 677(a) of the Code the purchaser is treated as the owner of the entire trust and the income of the trust is includable in the purchaser's gross income in the year in which it is earned by the trust.

*Situation 4.* In this trust the income is accumulated. However, unlike the trust in *Situation 1,* the seller will receive the income even if the contract is cancelled by the purchaser. Because the trust is revocable, the purchaser is treated as the owner of that portion of the trust that includes the money deposited into the trust. Therefore,

under section 676(a) of the Code the income earned on this portion is includable in the purchaser's gross income in the year in which it is earned by the trust. The income earned on the accumulated income is not subject to revocation and is paid to the seller. However, as in *Situation 3*, this income will benefit the purchaser's estate or spouse. Therefore, under either sections 673(a) or 677(a), the purchaser is the owner of that portion of the trust that includes the accumulated income, and, thus, the income earned on the accumulated income is includable in the purchaser's gross income in the year in which it is earned by the trust.

(3) In each of the four situations the purchaser has contracted with the seller for certain merchandise and services and the money is deposited into the trust to pay for the merchandise and services. Accordingly, any payment received by the seller from the trust is a payment for merchandise and services under section 61 of the Code is includable in the seller's gross income in the year received or properly accrued depending upon the seller's method of accounting.

APPLICATION OF SECTION 7805(b)

Pursuant to the authority contained in section 7805(b), holdings (1) and (2) of this revenue ruling will not apply to contracts described in *Situations 2, 3, and 4* and entered into before January 29, 1988.

Pursuant to the authority contained in section 7805(b), holding (3) will not apply to any payment of income earned by the trust that is received by the seller from the trust under contracts described in *Situations 2, 3, and 4* and entered into before January 29, 1988; however, holding (3) will be applied with retroactive effect to the lump sum or installment payments that were deposited in the trust for the purchaser and that are received by the seller from the trust under contracts described in *Situations 2, 3, and 4*.

Holdings (1), (2), and (3) will be applied with retroactive effect to *Situation 1* because *Situation 1* involves essentially the same facts and transaction as set forth in Rev. Rul. 73-140.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 73-140 is superseded.

DRAFTING INFORMATION

The principal author of this revenue ruling is Marshall Feiring of the Individual Tax Division. For further information regarding this revenue ruling contact Mr. Feiring at (202) 566-3830 (not a toll-free call).

**Rev. Rul. 73-140, 1973-1 C.B. 323**

Advice has been requested concerning the Federal income tax consequences of the transaction described below.

A taxpayer contracts with a funeral home for prepaid funeral services. The applicable State law provides that a seller of prepaid funeral services must deposit 90 percent of all funds collected under contracts to provide funeral services into a trust fund for the use, benefit and protection of the purchasers of such contracts. Withdrawals from the trust fund may be made on the death of the purchaser in fulfillment of the contract or at any time the purchaser desires to withdraw the entire portion of the payments made under the contract that have been placed in such fund together with any interest accrued thereon.

The specific question involved is whether the interest earned on amounts held for the credit of a purchaser of a prepaid funeral services contract is includable in the gross income of the purchaser in the year that it is earned by the trust or in the taxable year it is withdrawn from the trust fund upon the event of his death or voluntary withdrawal.

Section 671 of the Internal Revenue Code of 1954 provides the general rule that where it is specified in subpart E of subchapter J, sections 671 through 677 of the Code, that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income, and credits of the grantor or the other person 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 of the Code in computing taxable income or credits against the tax of an individual.

Section 676(a) of the Code provides, in part, that the grantor shall be treated as the owner of any portion of a trust where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both.

In the instant case, the purchaser of the contract is considered to be the grantor of the trust to which a specified portion of his payments made under the contract are contributed. Since the grantor may at any time withdraw the portion of his payments paid into the trust fund, together with any interest earned thereon, the grantor will be considered the owner of the trust under section 676(a) of the Code.

Accordingly, it is held, in the instant case, that the purchaser must include in his gross income the interest earned on amounts in the trust fund for the year in which such interest is earned by the trust.

IRS PRIVATE LETTER RULING 8631047

DATE: May 2, 1986

REFER REPLY TO: CC:IND:S:1:3

Dear ***

This is in regard to a request for a ruling submitted by your authorized representative dated November 25, 1985, as appended by the letter dated December 20, 1985, concerning the reporting requirements for Form 1099 information returns by the trustee of certain grantor trusts. Specifically, the ruling requested is that Trustee is not required to file Forms 1099 with the Internal Revenue Service, nor provide such statements to payees, with respect to each grantor trust for which it acts as sole trustee, if all income, deductions, and credits of each grantor beneficiary are reported on a Grantor Advice Letter which, in addition to being attached to Form 1041 filed by Trustee with the Internal Revenue Service, is provided to each grantor beneficiary.

Trustee is a bank which acts as the sole trustee for approximately 2,000 trusts for which one or more of the grantor beneficiaries is treated as the owner of a portion of the trust under section 671, et seq. of the Internal Revenue Code. Trustee makes payments from these grantor trusts of interest and dividend amounts. Because Trustee is the sole trustee of each grantor trust, it reports the portion of trust income, deduction and credit items attributable to the grantor beneficiaries on a separate statement attached to Form 1041, in accordance with section 6012(a)(4) of the Code and section 1.671-4(a) of the Income Tax Regulations. Trustee calls this statement a Grantor Advice Letter. This Letter is provided to each grantor beneficiary of each grantor trust as well as being attached to the Form 1041. Such Grantor Advice Letter provides substantially the same information that Form 1041, Schedule K-1 would provide were it required to be filed.

Section 6012(a)(4) of the Code provides that returns with respect to income taxes under subtitle A shall be made by every trust having for the taxable year any taxable income, or having gross income of $600 or over, regardless of the amount of taxable income.

Section 1.6012-3(a)(1) of the Income Tax Regulations provides that every fiduciary must make a return of income on Form 1041 for each trust required to file a return under section 6012(a)(4).

Section 1.671-4(a) of the regulations provides that, except as provided in paragraphs (b)(1) and (2) of this section (not applicable in the instant case), items of income, deduction, and credit attributable to any portion of a trust which, under the provisions of subpart E (section 671, et seq.), part I, subchapter J, chapter 1 of the Code, are treated as owned by the grantor or another person should not be reported by the trust on Form 1041, but should be shown on a separate statement to be attached to Form 1041.

Rev. Rul. 75-278, 1975-2 C.B. 461, holds that even though some or all of the income, deductions, and credits of a trust are attributed to grantors under section 671 of the Code, if the trust has any taxable income or has gross income of $600 or over, it is required to file Form 1041 under section 6012 (a)(4) of the Code and attach a separate statement thereto showing the income, deductions, and credits attributable to the grantor. Although some exceptions to the filing requirement discussed in the Rev. Rul. were added to the regulations by T.D. 7796, 1981-2 C.B. 141, such exceptions do not apply when the trustee is the sole trustee. Therefore, the Rev. Rul. is applicable in the instant case.

Section 6042(a)(1) of the Code requires every person to make a return according to the forms and regulations prescribed who makes payments of dividends aggregating $10 or more to any other person during any calendar year, or who receives payments of dividends as a nominee and then makes payments with respect to the dividends so received aggregating $10 or more to any other person during any calendar year. Such return is made on Form 1096 and Form 1099-DIV.

Section 6042(c) of the Code requires every person making a return under subsection (a)(1) to furnish a written statement to each person whose name is set forth in such return. Form 1099-DIV is such statement.

Section 1.6042(a)(1)(ii) of the regulations provides that the filing of Form 1087 (now Form 1099-DIV) by nominees is not required if the record owner is required to file a fiduciary return on Form 1041 disclosing the name, address, and identifying number of the actual owner if the name, address, and identifying number of the record owner are included on or with the Form 1041 filed for the trust.

Section 6045(a) of the Code requires every person doing business as a broker to make a return in accordance with prescribed regulations showing gross proceeds and such other information as prescribed. Such return is made on Form 1096 and Form 1099-B.

Section 6045(b) of the Code requires every person making a return under subsection (a) to furnish a statement to each customer whose name is set forth in such return. Form 1099-B is used to satisfy such requirement.

Section 5f.6045-1(c)(3)(iv) of the Temporary Regulations provides that no return of information is required with respect to a sale effected by a custodian or trustee in its capacity as such provided the sale is otherwise

reported by the custodian or trustee on a properly filed Form 1041, and all Schedule K-1 reporting requirements are satisfied.

Section 6049(a) of the Code requires every person to make a return according to the forms and regulations who makes payments of interest as defined, or who receives payments of such interest as a nominee and who makes payments with respect to the interest so received, aggregating $10 or more during any calendar year to any other person: Such return is made on Form 1096 and Form 1099-INT.

Section 6049(c) of the Code requires every person making a return under subsection (a) to furnish a statement to each person whose name is set forth in such return. Such statement is Form 1099-INT.

Section 1.6049-4(c)(2) of the regulations provides that an information return shall not be required if the record owner is required to file a fiduciary return on Form 1041 disclosing the name, address, and taxpayer identification number of the actual owner, and furnishes Form K-1 to each actual owner containing the information required to be shown on the form.

In the instant case, Trustee is required to file a Form 1041 for each grantor trust pursuant to section 6012(a)(4) of the Code, section 1.671-4(a) of the regulations, and Rev. Rul. 75-278, supra. Also, Schedule K-1 is not required to be filed, but what is required to be filed pursuant to section 1.671-4(a) of the regulations is a separate statement to be attached to Form 1041 showing the items of income, deduction, and credit attributable to the grantor or other person.

One of the purposes of the exceptions found in section 1.6042-2(a)(1)(ii) of the regulations, section 5f.6045-1(c)(3)(iv) of the temporary regulations, and section 1.6049-4(c)(2) of the regulations, is to relieve trustees who file the required fiduciary returns from also filing Form 1099 information returns since all of the required information is already reported to the Internal Revenue Service and to the recipients when Forms 1041 and Schedules K-1 have been filed as required. To also require the filing of Forms 1099 would be unnecessary duplicative reporting of the same information and would not further the purpose of information reporting behind requiring the filing of Forms 1099.

In this case, the requirement in each exception that a proper fiduciary return on Form 1041 be filed is met because Trustee files Form 1041 for each grantor trust as required by section 6012(a)(4) of the Code, section 1.671-4(a) of the regulations, and Rev. Rul. 75-278.

The exception in section 1.6042-2(a)(1)(ii) of the regulations does not specify any other requirement that a Schedule K-1 be filed (although the filing of Form 1041 in most circumstances includes completion of Schedule K-1), but the exception in section 5f.6045-1(c)(3)(iv) requires that "all Schedule K-1 reporting requirements are satisfied", and section 1.6049-4(c)(2) requires that a properly completed Form K-1 be furnished to each actual owner.

Although in the instant case, Schedule K-1, per se, is not required to be completed, the separate statement which is required must show the items of income, deduction, and credit attributable to each grantor in a fashion not very different than if an actual Schedule K-1 were prescribed. The Grantor-Advice Letter used by Trustee is substantially a substitute for Schedule K-1. Given the variation in the language of the regulations dealing with each exception vis-a-vis Schedule K-1 requirements, and the purpose behind the exceptions overall, we do not believe that it is necessary for an actual Schedule K-1 to be used in order to meet the requirements in the exceptions in a case where the regulations prescribe the filing of a separate statement which is essentially equivalent. No purpose would be furthered by requiring Forms 1099 to be filed in this case. The Grantor Advice Letter provides more information to both the Service and each grantor beneficiary than would a Form 1099 alone, and to require Form 1099 would only duplicate the information already required to be supplied.

Therefore, in this case, Trustee meets the exceptions in section 1.6042-2(a)(1)(ii) of the Income Tax Regulations, section 5f.6045-1(c)(3)(iv) of the Temporary Regulations, and section 1.6049-4(c)(2) of the Income Tax Regulations when it complies with the filing requirement in section 1.671-4(a) and provides a copy of the Grantor Advice Letter to each grantor beneficiary.

Accordingly, Trustee is not required to file Forms 1099 with the Internal Revenue Service, nor provide such statements to payees with respect to each grantor trust for which it acts as sole trustee if all income, deductions and credits of each grantor beneficiary are reported on a Grantor Advice Letter which, in addition to being attached to Form 1041 filed by Trustee with the Internal Revenue Service, is provided to each grantor beneficiary.

This letter is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

We are providing a copy of this ruling to your authorized representative in accordance with your Power of Attorney and Declaration of Representative.

Very truly yours,

E.L. Kennedy
Chief, Specialty Tax Branch

Enclosure
Copy for section 6110 purposes

Form **W-9**
(Rev. December 1987)
Department of the Treasury
Internal Revenue Service

# Request for Taxpayer Identification Number and Certification

**Give this form to the requester. Do NOT send to IRS.**

Please print or type

Name (If joint names, list first and circle the name of the person or entity whose number you enter in Part I below. **See instructions if your name has changed.**)

Address

City, state, and ZIP code

List account number(s) here (optional) ▶

## Part I Taxpayer Identification Number

Enter your taxpayer identification number in the appropriate box. For individuals and sole proprietors, this is your social security number. For other entities, it is your employer identification number. If you do not have a number, see *How To Obtain a TIN*, below.

**Note:** *If the account is in more than one name, see the chart on page 2 for guidelines on whose number to enter.*

**Social security number**

OR

**Employer identification number**

## Part II For Payees Exempt From Backup Withholding (See Instructions)

Requester's name and address (optional)

**Certification.**—Under penalties of perjury, I certify that:

(1) The number shown on this form is my correct taxpayer identification number (or I am waiting for a number to be issued to me), **and**

(2) I am not subject to backup withholding either because I have not been notified by the Internal Revenue Service (IRS) that I am subject to backup withholding as a result of a failure to report all interest or dividends, or the IRS has notified me that I am no longer subject to backup withholding (does not apply to real estate transactions, mortgage interest paid, the acquisition or abandonment of secured property, contributions to an individual retirement arrangement (IRA), and payments other than interest and dividends).

**Certification Instructions.**—You must cross out item (2) above if you have been notified by IRS that you are currently subject to backup withholding because of underreporting interest or dividends on your tax return. (Also see *Signing the Certification* under *Specific Instructions*, later.)

**Please Sign Here** Signature ▶ Date ▶

## Instructions

*(Section references are to the Internal Revenue Code.)*

**Purpose of Form.**—A person who is required to file an information return with IRS must obtain your correct taxpayer identification number (TIN) to report income paid to you, real estate transactions, mortgage interest you paid, the acquisition or abandonment of secured property, or contributions you made to an individual retirement arrangement (IRA). Use Form W-9 to furnish your correct TIN to the requester (the person asking you to furnish your TIN), and, when applicable, (1) to certify that the TIN you are furnishing is correct, (2) to certify that you are not subject to backup withholding, and (3) to claim exemption from backup withholding if you are an exempt payee. Furnishing your correct TIN and making the appropriate certifications will prevent certain payments from being subject to the 20% backup withholding.

**Note:** *If a requester gives you a form other than a W-9 to request your TIN, you must use the requester's form.*

**How To Obtain a TIN.**—If you do not have a TIN, you should apply for one immediately. To apply for the number, obtain **Form SS-5**, Application for a Social Security Number Card (for individuals), or **Form SS-4**, Application for Employer Identification Number (for businesses and all other entities), at your local office of the Social Security Administration or the Internal Revenue Service. Complete and file the appropriate form according to its instructions.

To complete Form W-9 if you do not have a TIN, write "Applied For" in the space for the TIN in Part I, sign and date the form, and give it to the requester. For payments that could be subject to backup withholding, you will then have 60 days to obtain a TIN and furnish it to the requester. During the 60-day period, the payments you receive will not be subject to the 20% backup withholding, unless you make a withdrawal. However, if the requester does not receive your TIN from you within 60 days, backup withholding, if applicable, will begin and continue until you furnish your TIN to the requester.

**Note:** *Writing "Applied For" on the form means that you have already applied for a TIN OR that you intend to apply for one in the near future.*

As soon as you receive your TIN, complete another Form W-9, include your new TIN, sign and date the form, and give it to the requester.

**What Is Backup Withholding?**—Persons making certain payments to you are required to withhold and pay to IRS 20% of such payments under certain conditions. This is called "backup withholding." Payments that could be subject to backup withholding include interest, dividends, broker and barter exchange transactions, rents, royalties, nonemployee compensation, and certain payments from fishing boat operators, but do not include real estate transactions.

If you give the requester your correct TIN, make the appropriate certifications, and report all your taxable interest and dividends on your tax return, your payments will not be subject to backup withholding. Payments you receive will be subject to backup withholding if:

(1) You do not furnish your TIN to the requester, or

(2) IRS notifies the requester that you furnished an incorrect TIN, or

(3) You are notified by IRS that you are subject to backup withholding because you failed to report all your interest and dividends on your tax return (for interest and dividend accounts only), or

(4) You fail to certify to the requester that you are not subject to backup withholding under (3) above (for interest and dividend accounts opened after 1983 only), or

(5) You fail to certify your TIN. This applies only to interest, dividend, broker, or barter exchange accounts opened after 1983, or broker accounts considered inactive in 1983.

For other payments, you are subject to backup withholding only if (1) or (2) above applies.

Certain payees and payments are exempt from backup withholding and information reporting. See *Payees and Payments Exempt From Backup Withholding*, below, and *Exempt Payees and Payments* under *Specific Instructions*, on page 2, if you are an exempt payee.

**Payees and Payments Exempt From Backup Withholding.**—The following lists payees that are exempt from backup withholding and information reporting. For interest and dividends, all listed payees are exempt except item (9). For broker transactions, payees listed in (1) through (13), and a person registered under the Investment Advisers Act of 1940 who regularly acts as a broker are exempt. Payments subject to reporting under sections 6041 and 6041A are generally exempt from backup withholding only if made to payees described in items (1) through (7), except that a corporation that provides medical and health care services or bills and collects payments for such services is not exempt from backup withholding or information reporting. Only payees described in items (2) through (6) are exempt from backup withholding for barter exchange transactions, patronage dividends, and payments by certain fishing boat operators.

(1) A corporation.

(2) An organization exempt from tax under section 501(a), or an individual retirement plan (IRA), or a custodial account under 403(b)(7).

(3) The United States or any agency or instrumentality thereof.

(4) A state, the District of Columbia, a possession of the United States, or any political subdivision or instrumentality thereof.

(5) A foreign government or a political subdivision, agency or instrumentality thereof.

(6) An international organization or any agency or instrumentality thereof.

(7) A foreign central bank of issue.

(8) A dealer in securities or commodities required to register in the U.S. or a possession of the U.S.

(9) A futures commission merchant registered with the Commodity Futures Trading Commission.

(10) A real estate investment trust.

(11) An entity registered at all times during the tax year under the Investment Company Act of 1940.

(12) A common trust fund operated by a bank under section 584(a).

(13) A financial institution.

(14) A middleman known in the investment community as a nominee or listed in the most recent publication of the American Society of Corporate Secretaries, Inc., Nominee List.

(15) A trust exempt from tax under section 664 or described in section 4947.

Payments of **dividends** and **patronage dividends** generally not subject to backup withholding also include the following:

- Payments to nonresident aliens subject to withholding under section 1441.
- Payments to partnerships not engaged in a trade or business in the U.S. and that have at least one nonresident partner.
- Payments of patronage dividends not paid in money.
- Payments made by certain foreign organizations.

Payments of **interest** generally not subject to backup withholding include the following:

- Payments of interest on obligations issued by individuals. **Note:** *You may be subject to backup withholding if this interest is $600 or more and is paid in the course of the payer's trade or business and you have not provided your correct TIN to the payer.*
- Payments of tax-exempt interest (including exempt-interest dividends under section 852).
- Payments described in section 6049(b)(5) to nonresident aliens.
- Payments on tax-free covenant bonds under section 1451.
- Payments made by certain foreign organizations.
- Mortgage interest paid by you.

Payments that are not subject to information reporting are also not subject to backup withholding. For details, see sections 6041, 6041A(a), 6042, 6044, 6045, 6049, 6050A, and 6050N, and the regulations under such sections.

## Penalties

**Failure To Furnish TIN.**—If you fail to furnish your correct TIN to a requester, you are subject to a penalty of $50 for each such failure unless your failure is due to reasonable cause and not to willful neglect.

**Failure To Include Certain Items on Your Tax Return.**—If you fail to properly include on your tax return certain items reported to IRS, such failure will be treated as being due to negligence, and you will be subject to a penalty of 5% on any part of an underpayment of tax attributable to that failure unless there is clear and convincing evidence to the contrary.

**Civil Penalty for False Information With Respect to Withholding.**—If you make a false statement with no reasonable basis that results in no imposition of backup withholding, you are subject to a penalty of $500.

**Criminal Penalty for Falsifying Information.**—Willfully falsifying certifications or affirmations may subject you to criminal penalties including fines and/or imprisonment.

## Specific Instructions

**Name.**—If you are an individual, generally provide the name shown on your social security card. However, if you have changed your last name, for instance, due to marriage, without informing the Social Security Administration of the name change, you may enter your first name and both the last name shown on your social security card and your new last name.

**Signing the Certification.**—

**(1) Interest, Dividend, and Barter Exchange Accounts Opened Before 1984 and Broker Accounts That Were Considered Active During 1983.**—You are not required to sign the certification; however, you may do so. You are required to provide your correct TIN.

**(2) Interest, Dividend, Broker and Barter Exchange Accounts Opened After 1983 and Broker Accounts That Were Considered Inactive During 1983.**—You must sign the certification or backup withholding will apply. If you are subject to backup withholding and you are merely providing your correct TIN to the requester, you must cross out item (2) in the certification before signing the form.

**(3) Real Estate Transactions.**—You must sign the certification. You may cross out item (2) of the certification if you wish.

**(4) Other Payments.**—You are required to furnish your correct TIN, but you are not required to sign the certification unless you have been notified of an incorrect TIN. Other payments include payments made in the course of the requester's trade or business for rents, royalties, goods (other than bills for merchandise), medical and health care services, payments to a nonemployee for services (including attorney and accounting fees), and payments to certain fishing boat crew members.

**(5) Mortgage Interest Paid by You, Acquisition or Abandonment of Secured Property, or IRA Contributions.**—You are required to furnish your correct TIN, but you are not required to sign the certification.

**(6) Exempt Payees and Payments.**—If you are exempt from backup withholding, you should complete this form to avoid possible erroneous backup withholding. Enter your correct TIN in Part I, write "EXEMPT" in the block in Part II, cross out item (2) of the certification, sign and date the form. If you are a nonresident alien or foreign entity not subject to backup withholding, give the requester a completed **Form W-8**, Certificate of Foreign Status.

**(7) TIN "Applied For."**—Follow the instructions under *How To Obtain a TIN*, earlier, sign and date this form.

**Signature.**—For a joint account, only the person whose TIN is shown in Part I should sign the form.

**Privacy Act Notice.**—Section 6109 requires you to furnish your correct taxpayer identification number (TIN) to persons who must file information returns with IRS to report interest, dividends, and certain other income paid to you, mortgage interest you paid, the acquisition or abandonment of secured property, or contributions you made to an individual retirement arrangement (IRA). IRS uses the numbers for identification purposes and to help verify the accuracy of your tax return. You must provide your TIN whether or not you are required to file a tax return. Payers must generally withhold 20% of taxable interest, dividend, and certain other payments to a payee who does not furnish a TIN to a payer. Certain penalties may also apply.

## What Name and Number To Give the Requester

| For this type of account: | Give the name and SOCIAL SECURITY number of: |
|---|---|
| 1. Individual | The individual |
| 2. Two or more individuals (joint account) | The actual owner of the account or, if combined funds, the first individual on the account[1] |
| 3. Custodian account of a minor (Uniform Gift to Minors Act) | The minor[2] |
| 4. a. The usual revocable savings trust (grantor is also trustee) | The grantor-trustee[1] |
| b. So-called trust account that is not a legal or valid trust under state law | The actual owner[1] |
| 5. Sole proprietorship | The owner[3] |

| For this type of account: | Give the name and EMPLOYER IDENTIFICATION number of: |
|---|---|
| 6. A valid trust, estate, or pension trust | Legal entity (Do not furnish the identification number of the personal representative or trustee unless the legal entity itself is not designated in the account title.)[4] |
| 7. Corporate | The corporation |
| 8. Association, club, religious, charitable, educational, or other tax-exempt organization | The organization |
| 9. Partnership | The partnership |
| 10. A broker or registered nominee | The broker or nominee |
| 11. Account with the Department of Agriculture in the name of a public entity (such as a state or local government, school district, or prison) that receives agricultural program payments | The public entity |

[1] List first and circle the name of the person whose number you furnish.

[2] Circle the minor's name and furnish the minor's social security number.

[3] Show the name of the owner.

[4] List first and circle the name of the legal trust, estate, or pension trust.

**Note:** *If no name is circled when there is more than one name, the number will be considered to be that of the first name listed.*



★U.S.GPO:1987-0-183-313

**Section 6841 of H.R. 3545. Approved by Senate Finance Committee, October 16, 1987.**

SEC. 6841. FUNERAL TRUSTS

(a) In General. — Subpart F of part I of subchapter J of chapter 1 (relating to miscellaneous trust provisions) is amended by adding at the end thereof the following new section:

"SEC. 684. FUNERAL TRUSTS

"(a) General Rule. — In the case of a qualified funeral trust —

"(1) this part (other than this section) shall not apply to such trust, and

"(2) there is hereby imposed on such trust for each taxable year a tax equal to 15 percent of the taxable income of such trust.

The tax imposed under paragraph (2) shall be in lieu of the tax imposed by section 1(e).

"(b) Computation and Payment of Tax. —

"(1) Computation. — Except as provided in this section, the taxable income of a qualified funeral trust shall be computed in the same manner as in the case of an individual.

"(2) Liability for tax. — The tax imposed by subsection (a) shall be paid by the fiduciary.

"(c) Deduction for Personal Exemption. — Each qualified funeral trust shall be allowed a deduction of $1,000. The deduction allowed by this subsection shall be in lieu of the deductions allowed under section 151.

"(d) Qualified Funeral Trust. — For purposes of this section —

"(1) In general. — The term 'qualified funeral trust' means a trust established by a funeral home to which the only contributions made are amounts paid by (or on behalf of) an individual to pay for the costs of funeral services to be provided to such individual by such funeral home.

"(2) Limitations. —

"(A) Dollar limitation. — A trust shall not be treated as a funeral trust if more than $5,000 is contributed to such trust on behalf of any individual.

"(B) Only 1 trust. — No trust established by a funeral home shall be treated as a qualified funeral trust if the trust establishes more than 1 qualified funeral trust (determined without regard to this subparagraph).

"(C) Cost-of-living adjustment. — In the case of any calendar year after 1988, the $5,000 amount under subparagraph (A) shall be increased by the cost-of-living adjustment for such calendar year (within the meaning of section 1(f)(3)).

"(e) Special Rules. — For purposes of this section —

"(1) Taxation of beneficiaries. — No amount shall be included in the gross income of any individual for whom a qualified funeral trust was established (or any individual making contributions on behalf of such individual) with respect to any income of, or distributions or payments made by, such trust.

"(2) Distributions taxable to funeral home. — Any distribution or payment from a qualified funeral trust shall be includable in the gross income of the funeral home which established such trust."

(b) Conforming Amendment. — The table of sections for subpart F of part I of subchapter J of chapter 1 is amended by inserting at the end thereof the following new item: "Sec. 684. Funeral trusts."

(c) Effective Date. —

(1) In general. — The amendments made by this section shall apply to contributions to a trust under a contract sold after the date of the enactment of this Act.

(2) Election. — A taxpayer may elect to have the amendments made by this section apply to taxable years ending after the date of the enactment of this Act with respect to contributions (and income allowable thereto) made on or before such date under contracts sold on or before such date.

**Senate Finance Committee Report. Language on Section 6841 of H.R. 3545, October 16, 1987.**

1. Taxation of Preneed Funeral Trusts (sec. 6841 of the bill and sec. 684 of the Code)

Present Law

The income taxation of a trust depends on whether it is a grantor or nongrantor trust. A nongrantor trust is treated as a separate taxable entity on the income it retains and as a conduit on the income it distributes to its beneficiaries.

A grantor trust is treated as owned by the grantor, who is taxed on its income and is entitled to its deductions. A grantor trust is one in which the grantor retains certain powers or interests in the trust. One such power or interest is the power to revest the title of the trust property in himself (sec. 676).

## Reasons for Change

Individuals often contract in advance with funeral homes or cemeteries to purchase funeral or burial merchandise or services at death. The purchase price under such contracts is generally between $2,000 and $4,000.

State laws governing these contracts require that sale proceeds be placed in a trust in order to insure that funds are available on the date of the purchaser's death. These trusts often are referred to as "preneed funeral trusts." Generally, the funeral director may commingle proceeds from numerous purchases into one trust so long as he keeps adequate records of the purchasers. The purchaser is usually entitled to cancel the contract and receive back his payments.

The right to receive income earned by the preneed trust varies from State to State. In some States, the income must accumulate in the trust, and if the purchaser cancels the contract, he is entitled to receive the income earned on his payment while held in trust. In others, the income unconditionally belongs to the funeral home, which may withdraw it from the trust as it is earned.

Because of differences in State laws, the income taxation of income earned by preneed funeral trusts is unclear. Some funeral homes assert that the income should be taxed to the trust and that they are taxed only upon distribution. Others claim that the income should be taxed to them as earned and that only distribution of principal are taxable to them when distributed.

Nonetheless, the committee believes that all preneed trusts are properly treated as grantor trusts under present law where the purchaser can revoke the purchase and revest title to the trust property himself. The committee realizes, however, that treating these trusts as grantor trusts often would place administrative burden on both taxpayers and the Internal Revenue Service, given the large number of purchasers and the small size of the trusts.

Accordingly, the committee believes that a different method of taxing these trusts is appropriate. The committee believes that this method of taxation should result in roughly the same level of taxation as if the purchaser had retained the trust assets and had used the income from them to pay for the funeral services at death. The committee believes that this method of taxation properly measures the incomes of both the purchaser and the funeral home[1] and provides a simple system of taxation that avoids the administrative burdens involved in taxing such trusts as grantor trusts.

## Explanation of Provision

The committee bill sets forth exclusive rules governing the taxation of qualified funeral trusts. Such trusts are not subject to rules governing the grantor trusts (secs. 671 et. seq.). Thus, income earned by the preneed funeral trust is taxed to the trust and not the purchasers even though the purchaser has the right to recind the purchase at any time. Amounts distributed from the preneed funeral trust to purchasers are not subject to the accumulation distribution rules (secs. 665 et. sec.) and, consequently, are not subject to further tax to the purchaser at the time of distribution.

A qualified funeral trust is subject to a flat 15 percent tax on its taxable income, with a personal exemption of $1,000 per year. Generally, the trust's taxable income will be determined in the same manner as in the case of an individual.[2]

A qualified funeral trust is one established by a funeral home to which the only contributions made are amounts paid by, or on behalf of, an individual to pay for the costs of funeral and burial services which the home will provide to such individual. The costs of funeral and burial services include the cost of associated merchandise, such as coffin or flowers.

A trust is not treated as a qualified funeral trust if more than $5,000 (increased by cost-of-living adjustments) is contributed to it with respect to any individual. Moreover, each funeral home may have only one qualified funeral trust. Trusts which are separated under state law may be considered one trust for purposes of this limitation.

Distributions from the preneed trust are not taxable to the person for whom the trust was established. Instead, they are includible in the income of the funeral home as amounts paid for the funeral services.

## Effective Date

The provision is effective for amounts paid into preneed funeral trusts pursuant to contracts entered into after the date of enactment. In addition, for taxable years beginning after the date of enactment, funeral homes may elect to apply the provisions of the bill to preneed funeral trusts created pursuant to contracts entered into on or before the date of enactment.

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1. This system results in the same two levels of taxation that arise when income is earned by the individual and is spent on any personal item.

2. Because the purchase price of such services is relatively small and because the purchasers of preneed contracts are generally of modest means, the committee believes that a 15 percent rate reasonably approximates their marginal tax rate.