U.S. TRUST

Planning for the 3.8% surtax and the 20% tax on trust capital gains: 21 ways (and counting) to have a trust's capital gain taxed to the beneficiary

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Summary. Historically, having a trust's capital gains taxed to the beneficiaries has been a challenge. With the recent increase to the long-term capital gain rate (i.e., the addition of a top bracket of 20%) and the advent of the 3.8% surtax, there will be a renewed focus on that challenge. This article explores several ways this can be achieved.

The regular income tax treatment of capital gains is not a new matter; the surtax treatment of trusts is. So, this paper will first review the new 3.8% surtax and how it applies to trusts and beneficiaries. The rest (and majority) of this paper will then explore how a trust's capital gains can be taxed to the beneficiary.

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I. Intro

Section 1411 of the Internal Revenue Code ("IRC") and the regulations[1] thereunder impose a 3.8% surtax on (i) individuals, (ii) trusts and (iii) estates. In the case of trusts, Section 1411 applies to trusts that are subject to the provisions of part I of subchapter J of chapter 1 of subtitle A of the Internal Revenue Code, unless specifically exempted.[2] For our purposes, we can have in mind the many non-charitable trusts that are often used in estate planning, both grantor[3] and non-grantor.

A. What is subject to the 3.8% surtax?

The surtax is imposed on "net investment income" (NII), which is defined to consist of three categories of income. These are then reduced by "the deductions . . . properly allocable to such gross income or net gain." [4]

Category #1 NII consists of gross income from interest, dividends, annuities, royalties and rents (other than income derived in the ordinary course of a non-passive business other than trading in financial instruments or commodities).[5] Category #2 NII consists of gross income from (1) a passive activity, or (2) a trade or business of trading in financial instruments or commodities.[6] A "passive activity" is defined to be a trade or business in which you do not "materially" participate.[7] Category #3 NII consists of net gain "to the extent taken into account in computing taxable income."[8] This would include capital gain.

B. What is not subject to the 3.8% surtax?

1. Retirement Plans. The statute expressly states that distributions from the following retirement plans are not NII[9]:

1. qualified pension, profit-sharing, and stock bonus plans;

[1] Proposed regulations (the "2012 Proposed Regulations") were published in the Federal Register on December 5, 2012 (REG–130507–11; 77 FR 72612). Corrections were published in the Federal Register on January 31, 2013, (78 FR 6781). Final regulations (the "Final Regulations") were published as TD 9644 in the Federal Register on December 16, 2013, 78 FR 72394. The 2013 Proposed Regulations were published in the Federal Register on December 16, 2013 (REG–130843–13).

[2] Final Reg. § 1.1411-3(a)(1)(i).

[3] A grantor trust is disregarded for surtax purposes, just as it is for regular income tax purposes. That is, for each item of income or deduction taken into account for purposes of calculating taxable income for regular tax purposes under the grantor trust rules, that income/deduction is also taken into account by that same person for purposes of calculating "net investment income" for surtax purposes. Final Reg. §1.1411-3(b)(1)(v).

[4] IRC §1411(c)(1)(B). For a fuller discussion of "net investment income," see my paper "*The 3.8% Surtax on Trusts and Estates*," presented the 48th Annual Heckerling Institute on Estate Planning.

[5] IRC §1411(c)(1)(A)(i). This statutory list is expanded by the Final Regulations.

[6] IRC §1411(c)(1)(A)(ii).

[7] IRC §469, Final Reg. § 1.1411-5(b).

[8] IRC §1411(c)(1)(A)(iii).

[9] IRC § 1411(c)(5).

2. qualified annuity plans;
3. annuities for employees of tax-exempt organizations or public schools;
4. IRAs;
5. Roth IRAs;
6. deferred compensation plans of state and local governments and tax-exempt organizations.

By singling out qualified retirement plans, it was initially unclear whether nonqualified retirement plans might receive different surtax treatment. However, the 2012 Proposed Regulations' introductory text indicates that nonqualified deferred compensation is also not NII.[10]

2. Net Unrealized Appreciation (NUA). The Final Regulations add that "net unrealized appreciation" attributable to employer securities within the meaning of IRC section 402(e)(4) remains considered a distribution from a qualified plan, even upon subsequent disposition.[11]

3. Incentive Stock Options (ISOs). Generally, the exercise of an ISO is not subject to regular income taxation, though it is taxed as compensation for purposes of the alternative minimum tax. Because this income is not subject to regular income tax, it is not NII. Note, however, that if the stock is later sold, it would generate capital gain at that time, and that gain will be NII.

4. Other Income. Any income not within the definition of NII would not be subject to this tax. This would include the following:

1. wages, salary and other compensation income;
2. income on the exercise of compensatory options;
3. income on the vesting of restricted stock;
4. Social Security benefits;[12]
5. Alimony[13]

All of these, however, would still be included in "modified" AGI, which can significantly affect the surtax results, as discussed in Section I(E) below, "How Much NII is Surtaxed?"

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[10] Preamble to the 2012 Proposed Regulations, Section 5A(vii): "For example, amounts paid to an employee under a nonqualified deferred compensation plan for such employee (or that otherwise become includible in income under section 409A, 457(f), 457A, or other Code section or tax doctrine) that include gross income from interest or other earnings are not treated as net investment income, regardless of whether such amounts are not subject to Federal Insurance Contributions Act tax due to the earlier application of section 3121(v)(2)."

[11] Final Regulation §1.411-8(b)(4)(ii).

[12] FAQ #8, released by the IRS Nov. 29, 2012, with the Proposed Regs. I cannot find a cite for this document anywhere. It's available at Tax Analysts Doc 2012-24655, 2012 TNT 232-47. This was slightly modified subsequently. See Tax Analysts Doc 2013-25259. See also the definition of "excluded income" at Final Reg. § 1.1411-1(d)(4).

[13] Ibid.

C. How is a trust surtaxed?

For non-grantor trusts, taxable income is taxed just once for regular tax purposes (either to the trust or to the beneficiaries) depending on whether it is retained or distributed. To determine whether a trust has retained or distributed income, a trust keeps track of its "Distributable Net Income," or DNI, which is defined in IRC Section 643(a). For most trusts, DNI is the same as taxable income, with some exceptions. Two well-known exceptions are: (i) municipal bond interest is not included in taxable income but is included in DNI,[14] and (ii) capital gains are in taxable income but generally are not included in DNI.[15] Once DNI is calculated, distributions to beneficiaries generally "carry out" DNI, and the components of income that make up the DNI are reported by the beneficiaries on their income tax returns.

This review of the DNI rules is important because those rules are the basis for determining the NII results of a trust. The Final Regulations adopt the following approach (this is my paraphrase).

1. Step #1: A trust calculates its DNI under the usual rules;
2. Step #2: A trust must now also track whether each item of income in DNI is NII or not;
3. Step #3: Items of income that both (i) are considered distributed for regular income tax purposes under the established DNI rules, and (ii) are items of NII, are considered distributions of NII (the maximum amount of NII that can be considered distributed is capped at DNI);
4. Step #4: The beneficiary includes distributed NII in his/her NII; and
5. Step #5: The trust's undistributed NII will be (i) the total NII of the trust, less (ii) the amounts deemed distributed under #3.

This 5-step process can be summarized as: The DNI results dictate the NII results.

1. Example 1 From the Final Regulations.

The following example is from the Final Regulations.[16] Assume a trust has the following income (no expenses):

Dividend income	$ 15,000
Taxable Interest income	$ 10,000
Capital gain	$ 5,000
IRA taxable distribution	$ 75,000
TOTAL	$105,000

The trust makes a discretionary distribution of $10,000 to A, a beneficiary.

[14] This allows the tax-exempt nature to pass through to a beneficiary.

[15] If certain conditions are met, it is possible for a trust to include capital gain in DNI. This is the main point of this paper and will be discussed in sections II and III.

[16] Final Reg. § 1.1411-3(e), Example 1.

Steps 1 and 2: The trust calculates its DNI under the usual rules; the trust also tracks whether each item of income in DNI is NII or not. The following chart summarizes Example 1's calculations.

	Total Income	**In DNI**	**In NII**
Dividend	$15,000	$15,000	$15,000
Interest	$10,000	$10,000	$10,000
Capital Gain	$ 5,000		$ 5,000
IRA Distribution	$75,000	$75,000	
TOTAL	$105,000	$100,000	$30,000

Step 3: Items of income that both (i) are considered distributions of DNI under established rules, and (ii) are items of NII, are considered distributions of NII. From the chart above, only the dividends and interest are both in DNI and NII. Therefore, to the extent a distribution "carries out" these dividends and interest for regular income tax purposes, those same dividends and interest are considered distributed for NII purposes. In this example, there is a $10,000 distribution to the beneficiary. That is 10% of the total DNI of the trust. Under the DNI rules, that is considered to be a distribution of 10% of each item of income that comprises DNI. As a result, for regular income tax purposes, the beneficiary includes in income $1,500 of dividends, $1,000 of interest, and $7,500 of IRA distribution.

Steps 4 and 5. For surtax purposes, the beneficiary includes $1,500 of dividends and $1,000 of interest in his/her NII. The trust's undistributed NII will be the total NII of $30,000, less the $2,500 considered distributed, or $27,500. The following chart summarizes what is considered distributed for income tax/DNI purposes, and that in turn determines what is considered distributed for surtax/NII purposes.

	Income tax (DNI) results		**Surtax (NII) results**		
	DNI	**Distributed**	**Total**	**Distributed**	**Retained**
Dividend	$ 15,000	$ 1,500	$15,000	$ 1,500	$13,500
Interest	$ 10,000	$ 1,000	$10,000	$ 1,000	$ 9,000
Capital Gain			$ 5,000	$ 0	$ 5,000
IRA Distribution	$ 75,000	$ 7,500			
TOTAL	$100,000	$10,000	$30,000	$ 2,500	$27,500

2. Example 2 From the Final Regulations

The following example is from the Final Regulations.[17] Assume a trust has the following income (no expenses):

Dividend income	$ 15,000
Taxable Interest income	$ 10,000
Capital gain	$ 5,000
IRA taxable distribution	$ 75,000
TOTAL	$105,000

This is the same fact pattern as Example 1. In addition, the Trustee makes a required distribution of $30,000 of its current year trust accounting income to A (a "first tier" beneficiary); a discretionary distribution of $20,000 to B (a "second-tier" beneficiary); and a charitable distribution of $10,000 for which there is a deduction under 642(c).

Steps 1 and 2: The trust calculates its DNI under the usual rules; the trust also tracks whether each item of income in DNI is NII or not. The following chart summarizes these first two steps.

	Total Income	In DNI	In NII
Dividend	$ 15,000	$ 15,000	$15,000
Interest	$ 10,000	$ 10,000	$10,000
Capital Gain	$ 5,000		$ 5,000
IRA Distribution	$ 75,000	$ 75,000	
TOTAL	$105,000	$100,000[18]	$30,000

Steps 3 and 4: Items of income that both (i) are considered distributions of DNI under established rules, and (ii) are items of NII, are considered distributions of NII. From the chart above, only the dividends and interest are both in DNI and NII. Therefore, to the extent a distribution "carries out" these dividends and interest for regular income tax purposes, those same dividends and interest are considered distributed for NII purposes.

In this example, there is a $30,000 distribution to the beneficiary A. That is 30% of the total DNI of the trust. Under the DNI rules, that is considered to be a distribution of 30% of each item of income that comprises DNI. As a result, for regular income tax purposes beneficiary A includes in income $4,500 of dividends, $3,000 of interest, and $22,500 of the IRA distribution.

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[17] Final Reg. § 1.1411-3(e), Example 2.

[18] I believe Example 2 is technically incorrect, but it doesn't change the answer. Because the charitable deduction reduces income in this Example 1, it must be deductible under 642(c) when calculating "taxable income," which means the charitable deduction would be deducted in calculating the trust's DNI, which would be $90,000. This does not change the final result and so I repeat the Example's numbers here.

In this example, there is next considered the $10,000 distribution to charity. That is 10% of the total DNI of the trust. Under the DNI rules, that is considered to be a pro rata deduction against each item of income that comprises DNI. Technically this does not "carry out" DNI to the charity, but it produces the same mathematical result as if the distribution to the charity is considered to "carry out" NII of $1,500 of dividends, $1,000 of interest and $7,500 of the IRA distribution.[19]

After the $100,000 of DNI is reduced by $30,000 for the distribution to A and by $10,000 for the distribution to charity, next is considered the $20,000 distribution to the beneficiary B. That is 20% of the total DNI of the trust. Under the DNI rules, that is considered to be a distribution of 20% of each item of income that comprises DNI. As a result, beneficiary B includes $3,000 of dividends, $2,000 of interest and $15,000 of the IRA distribution in income for regular income tax purposes.

Step 5. The trust's undistributed NII will be the total NII of $30,000, less (1) the $7,500 of NII distributed to A, (2) the $2,500 deduction attributable to the charitable distribution, and (3) the $5,000 of NII distributed to B. That leaves $15,000 of undistributed NII of the trust.

The following chart summarizes what is considered distributed for Surtax/NII purposes.

	Total NII	**Distributed to A**	**"Distributed" to Charity**	**Distributed to B**	**Trust's Undistributed NII**
Dividend	$15,000	$ 4,500	$ 1,500	$ 3,000	$6,000
Interest	$10,000	$ 3,000	$ 1,000	$ 2,000	$4,000
Capital Gain	$ 5,000	$ 0	$ 0	$ 0	$5,000
IRA Distribution					Not NII
TOTAL	$30,000	$ 7,500	$ 2,500	$ 5,000	$15,000

D. How does a beneficiary treat trust distributions?

Above, the 5-step process of determining the surtax results of trust distributions was summarized as: The DNI results dictate the NII results. This is further confirmed when the Final Regulations state that a beneficiary reports as NII whatever s/he reports under the DNI rules, if the item of income is also NII.

[19] Example 2 does not expressly state whether the charitable distribution is from income. However, it is clear from Example 2 that the charitable distribution does indeed reduce DNI before the Example addresses the consequences of the discretionary distribution to beneficiary B. This would indicate the charitable distribution was indeed from income, otherwise it would not have affected the analysis of the distribution to B.

"(e) Distributions from estates and trusts. (1) In general. Net investment income includes a beneficiary's share of distributable net income, as described in sections 652(a) and 662(a), to the extent that, under sections 652(b) and 662(b) [Note: those are the DNI rules], the character of such income constitutes gross income from items described in paragraph (a)(1)(i) and (ii) of this section or net gain attributable to items described in paragraph (a)(1)(iii) of this section [Note: those are the sections defining NII], with further computations consistent with the principles of this section, as provided in §1.1411-3(e)."[20]

This would include the 65-day rule of Section 663(b). That is, a distribution within 65 days of the end of a trust's tax year would, if the election were made, carry out both DNI and, therefore, NII as of December 31 of the previous year. Final Reg. § 1.1411-3(e), Example 3 expressly invokes the 65-day rule as suggested here. For 2013 and later years, the 65-day rule would allow a trust to make an informed decision about making distributions to minimize the surtax.

E. How much NII is surtaxed?

Not all of a taxpayer's NII is necessarily surtaxed. In order to calculate how much is surtaxed, we need to know a taxpayer's threshold amount ("Threshold") for a tax year, which depends on filing status, as set forth in the chart below.

Filing Status	Threshold
Married filing jointly, or Qualifying Widow[er]	$ 250,000
Single, Head of Household	$ 200,000
Married filing separately	$ 125,000
Trusts and Estates	$ 12,150 *
* This is not called a "threshold" in the statute, but it works the same way. It's the dollar amount at which the highest marginal rate begins for trusts/estates. In 2013, that was $11,950. For 2014 it is $12,150. This amount is indexed for inflation; **the thresholds for individuals are NOT.**	

For individuals, we also need to know a taxpayer's "modified adjusted gross income" as defined for purposes of Section 1411. "Modified adjusted gross income" (MAGI) is adjusted gross income increased by the net amount of foreign-sourced income that was exempt for regular tax purposes under Section 911(a)(1).[21]

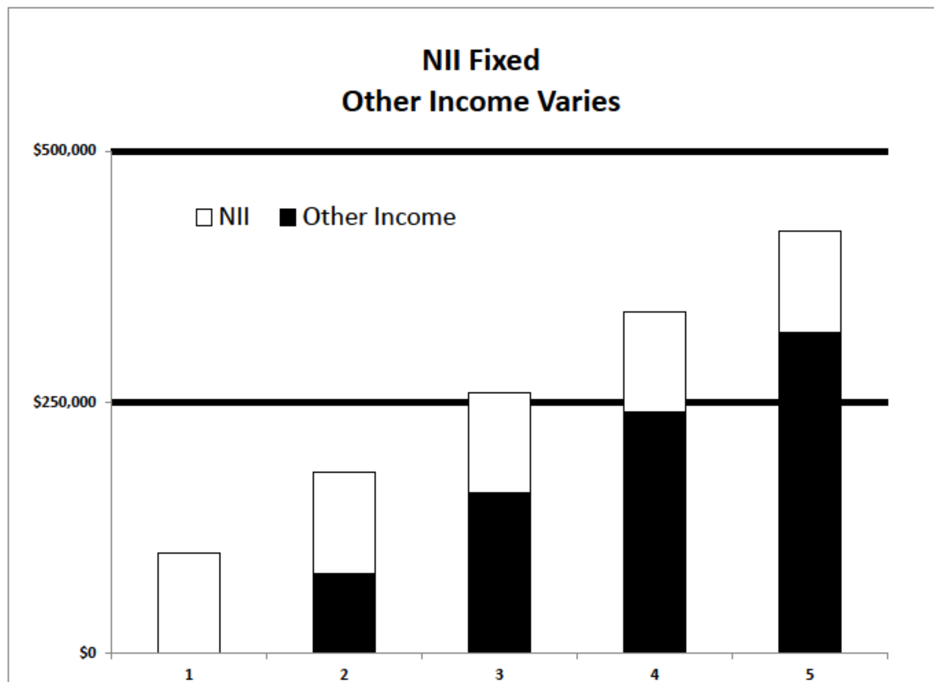
In the case of an individual, the surtax is imposed on the lesser of: (i) NII and (ii) the excess of MAGI over the Threshold. In the case of a trust or estate, the surtax is imposed on the lesser of: (i) Undistributed NII and (ii) the excess of AGI over the Threshold.[22] These three numbers, NII, (M)AGI, and the Threshold, are inter-related. It is not always easy to

[20] Final Reg. § 1.1411-4(e).
[21] IRC § 1411(d).
[22] IRC § 1411(a)(1).

"see" how they inter-relate when reading a text example. Following are some charts that give a good visual summary of how these three interact.

Chart for individuals

The following chart contains five examples/columns. In each case there is $100,000 of NII represented by the white rectangle. All other income that is not NII but goes into MAGI (e.g., salary) is represented by the dark rectangle ("Other Income"), which increases from column 1 to column 5. The horizontal line at $250,000 represents the Threshold applicable to taxpayers filing jointly.



<u>Columns 1 - 2</u>: Even though NII is $100,000, until the combined Other Income and NII (which together are MAGI) reach the Threshold, the surtax is not triggered.

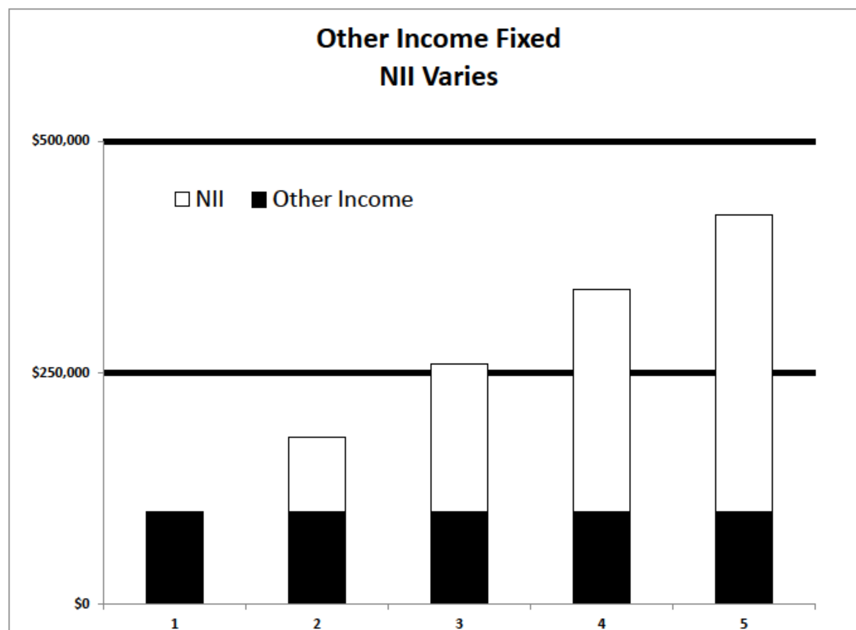
<u>Columns 3 - 4</u>: Once you have sufficient Other Income, you will begin incurring the surtax because the Other Income will "push" the NII above the Threshold. When that happens, only the excess over the Threshold is subject to the surtax.

This also illustrates a useful warning, illustrated as follows. Consider the following question: Is my taxable Required Minimum Distribution (RMD) from a traditional IRA going to be subject to the 3.8% surtax? One answer would be that no, it is not included in NII, which is true. However, that overlooks the relationship between NII and Other Income such as the RMD. If your surtax situation before the RMD is described by Column 2 but after the RMD is described by Column 4, the RMD will indeed cause more of your NII to be "pushed" above the Threshold, triggering the surtax.

Column 5: After a certain amount of Other Income, your NII might be fully exposed to the surtax.

> **Example**. Husband and Wife have a fixed amount of NII, $100,000. Both work and their combined salaries are $320,000, represented by the dark rectangle in Column 5. That level of salary will push their NII fully above the Threshold, meaning they have exposed 100% of their NII to the surtax. In that case, it is useful to know that exposure to the surtax has maxed out and additional Other Income will not generate additional exposure.

The chart above assumes that NII was fixed at $100,000 and Other Income varies. Now assume the reverse: Other Income is fixed at $100,000 and NII varies.



Columns 1 - 2: Until the combined Other Income and NII reach the Threshold, the surtax is not triggered. This is the same dynamic as in the previous chart.

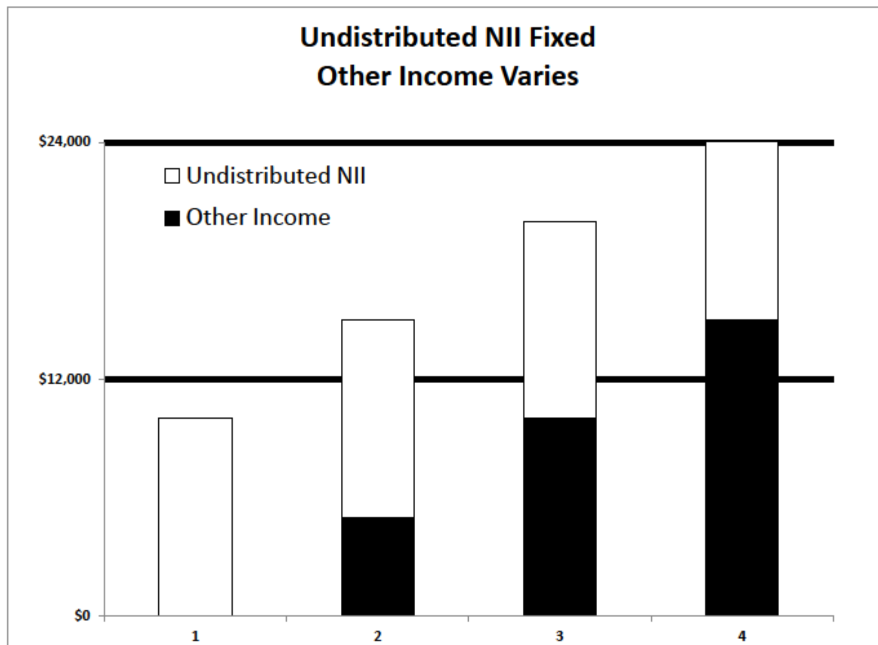
Columns 3 - 5: Once the surtax applies (when enough NII has been recognized to cause MAGI to exceed the Threshold), the dynamics here are very different than in the prior example. Here, the amount of NII exposed to the surtax does not hit a maximum. Rather, as NII increases, the amount of income exposed to the surtax increases, without a limit.

Chart for trusts and estates

The concepts for trusts and estates are the same as for individuals, with two noteworthy differences. First, the "threshold" for trusts/estate is quite low; it is the dollar amount at which the highest marginal rate begins for trusts/estates.[23] In 2013, that was $11,950. In

[23] IRC §1411(a)(2)(B)(ii).

2014, it is $12,150. **This amount is indexed for inflation; the thresholds for individuals are not.** Second, a trust/estate is surtaxed only on the NII that it retains (its "undistributed net investment income"). NII that is distributed to beneficiaries (under the rules discussed above) is surtaxed to the beneficiaries. The chart below contains four examples/columns. In each case there is $10,000 of undistributed NII represented by the white rectangle. All other income that is not NII but goes into AGI (e.g., an IRA distribution) is represented by the dark rectangle ("Other Income"), which increases from column 1 to column 4. The horizontal line at $12,000 represents the Threshold applicable to trusts (rounded down from $12,150 due to my Excel limitations!)



Columns 1: Until the combined Other Income and undistributed NII (which together are AGI) reach the Threshold, the surtax is not triggered.

Columns 2 - 3: Once a trust has sufficient Other Income, it will begin incurring the surtax because the Other Income will "push" the undistributed NII above the Threshold. When that happens, only the excess over the Threshold is subject to the surtax.

Column 4: After a certain amount of Other Income, the undistributed NII might be fully exposed to the surtax.

This chart follows the same approach as the first chart above for individuals. However, as a practical matter, many/most trusts will have only undistributed NII as income. In that case, all undistributed NII in excess of the threshold will be surtaxed.

II. Having Capital Gains Taxed to Beneficiaries - Preliminaries

A. Introduction

Three new developments have increased the likelihood of there being a rate differential between trusts/beneficiaries.

First, the highest marginal tax rate on ordinary income is now 39.6%. While trusts continue to reach the highest bracket very quickly, that bracket begins at a high level of taxable income for beneficiaries, making it more likely that there will be an even greater rate differential between a trust and a beneficiary with respect to ordinary income.

Second, the maximum federal tax rate on long-term capital gains has been 15% for many years. Furthermore, this rate applied unless the taxpayer (trust or individual) was in a bracket lower than 25%, in which case the capital gain rate was 0%. As a result, the maximum federal tax rate on long-term capital gains was likely 15% both for trusts and beneficiaries. Beginning in 2013, however, the new 20% maximum rate on long-term capital gains begins at quite high levels for individuals while the threshold for trusts remains low. So, it is more likely that a beneficiary will be in the 15% bracket for long-term capital gains while the trust will be in the 20% bracket.

Third, beginning in 2013 the 3.8% Medicare surtax will apply to most long-term capital gains, beginning at differing levels of "modified" adjusted gross income.

These three changes in rates and thresholds have a significant impact on planning for trust distributions; now there is a bigger likelihood of a bigger tax rate difference, depending on whether the trust retains or distributes income/gain. As a simple example, consider a trust with income of $50,000 and a single beneficiary who has income of $150,000. The trustee, when considering whether to make a distribution to the beneficiary, is of course primarily bound by the terms of the trust. However, often there is much room for discretion, and another factor is (i) the tax result of distributing, vs. (ii) the tax result of not distributing. Beginning in 2013, that rate differential can be significant.

	Trust has $50,000 of taxable income; beneficiary has $150,000			
	Federal Ordinary Income Bracket		**Federal Capital Gain Bracket**	
	Beneficiary	**Trust**	**Beneficiary**	**Trust**
Regular Tax	28%	39.6%	15%	20%
Surtax	0%	3.8%	0%	3.8%
Total	28%	43.4%	15%	23.8%
Difference	**-15.4%**	**15.4%**	**-8.8%**	**8.8%**

In the case of trust income that is ordinary income (including qualified dividends), generally that income will be included in DNI. In such a case, distributions will generally "carry out" DNI and be taxed to the recipient beneficiary. In such a case, the question of

whether to distribute **is** the question of who will be taxed; they go hand in hand. In the case of capital gains, however, it is a very different analysis.

Historically, capital gains have not been included in DNI and therefore do not get "carried out" by distributions. With investment theory evolving to acknowledge the "total return" philosophy, the lines between "income" and "principal" have become blurred. In response, the regulations under Section 643 governing the inclusion of capital gain in DNI were revised. Final regulations under Section 643 were issued in 2004 (the "643 Regulations"), addressing when and how capital gains can be included in DNI, in which case distributions to beneficiaries can indeed "carry out" the capital gain.[24] With the new increase in rate differential between trusts and beneficiaries, this is now much more important a planning issue than in the recent past.

B. Law of unintended consequences

To repeat, when considering whether to make a distribution to the beneficiary, the trustee is primarily bound by the terms of the trust. In addition to fiduciary duties, the trustee must be aware of other tax consequences of such a distribution. Below is a list of other matters that could be affected by increasing the beneficiary's income.

1. The non-income tax consequences must be considered. For example, by making a discretionary distribution from a "bypass" trust to a surviving spouse, that might increase the surviving spouse's taxable estate.

2. In 2013 the "Pease" limitations returned.[25] These limitations phase-out the deductibility of certain itemized deductions and personal exemptions when "adjusted gross income" (AGI) exceeds certain thresholds. Increasing the beneficiary's AGI could cause additional itemized deductions to be phased-out.

3. The ability to contribute to a Roth IRA is phased out as "modified" AGI exceeds certain thresholds.[26] (The ability to "convert" a traditional IRA to a Roth is not affected by "modified" AGI.) Increasing the beneficiary's AGI could increase this phase-out.

4. The deductibility of contributions to a traditional IRA can be affected by AGI.[27]

5. Medicare premiums for Parts B and D are increased when AGI exceeds certain limits.[28]

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[24] See <u>*The Final 'Income" Regulations: Their Meaning and Importance*</u>, by Jonathan G. Blattmachr and Mitchell M. Gans, Tax Notes Today, May 17, 2004; <u>*Interaction of Total Return Trusts and the Definition of Income Regs*</u>, by Byrle Abbin, Estate Planning Journal, August 2005; <u>*Using a Unitrust or a Power to Adjust Under the Section 643 Regs*</u>, by Laura Howell-Smith, Estate Planning Journal, October 2004; <u>*Total Return Trusts Approved by New Regs., but State Law is Crucial*</u>, by Robert Wolf and Stephan Leimberg, Estate Planning Journal, April 2004; <u>*Redefining Income: Section 643(b) Final Regulations,*</u> by Christopher Cline, 29 Estates, Gifts and Trusts Journal 95 (3/11/04).

[25] IRC § 68.

[26] IRC § 408A.

[27] IRC § 219.

6. The taxability of Social Security benefits is affected by AGI. [29]
7. Amounts that can be contributed to a Coverdell education savings account (formerly known as an Education IRA) are phased out if "modified" AGI exceeds certain thresholds. [30]
8. The interest income recognized on the redemption of EE bonds can be excluded from income if used to pay higher education expenses and if other requirements are met. This exclusion is phased-out if AGI exceeds certain thresholds. [31]
9. For regular income taxes, medical expenses are deductible as an itemized deduction only to the extent they exceed a "floor" of 7.5% of AGI. (Beginning in 2013, this threshold for medical expense deductions increased to 10% of AGI, unless you or your spouse is 65 as of the end of the year.) A distribution from a trust could increase the recipient's "floor." [32]
10. For regular income taxes, "miscellaneous itemized deductions" are deductible only to the extent they exceed 2% of AGI. A distribution from a trust could increase the recipient's "floor." [33]
11. Up to $25,000 of passive losses from real estate can be deducted against non-passive income if you are "active" and other requirements are met. This exclusion is phased out if AGI exceeds certain thresholds. [34]

Such a distribution could also have beneficial tax consequences, such as the following:

12. The ability to deduct charitable contributions as an itemized deduction is limited based on AGI.[35] An increase in AGI could allow a larger charitable income tax deduction.
13. Investment interest is deductible only to the extent of "net investment income" (defined differently in that statute).[36] A distribution of NII from the trust could allow a larger investment interest deduction for the beneficiary if that NII is also "net investment income" under Section 163.

C. Having Capital Gains Taxed to Beneficiaries – An Alternative Mindset

As mentioned above, all of this tax planning assumes any distribution is consistent with the terms of the trust document and the trustee's fiduciary obligations. The reason this is an important element to keep in mind is because it can be very tempting, in the never-ending quest to minimize taxes, to try to achieve that by making a distribution from a trust that, in

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[28] See www.Medicare.gov.
[29] IRC § 86.
[30] IRC § 530.
[31] IRC § 135.
[32] IRC § 213.
[33] IRC § 67.
[34] IRC § 469.
[35] IRC § 170.
[36] IRC § 163(d).

the absence of tax considerations, might not otherwise be made. However, there can also be a very different mindset involved with this issue.

Under the rules discussed below governing how to determine whether a trust's capital gains can be taxed to a beneficiary, many of the examples will start with, as an assumed fact, that it has already been determined that a distribution will be made, *based on non-tax considerations*. That's a given. Given that a distribution will be made, it is then considered whether, under the rules we are about to look at, that distribution can be considered to "carry out" the trust's capital gain. That is an important distinction. The first approach mentioned in the preceding paragraph is: (i) consider tax planning first; (ii) distribute accordingly second. The alternative mentioned in this paragraph is (i) determine the distribution first; (ii) consider tax planning second.

Example. Consider a trust such as a Family Trust commonly established under the estate plan of a married couple at the death of the first-to-die. Assume (i) the trust requires that income be paid to the surviving spouse; (2) the trust allows for discretionary principal distributions; and (3) the trustee has decided to make a discretionary distribution of $100 of principal. Assume for any principal distribution, consistent with the rules described later in this paper, there is the ability to either include capital gains in DNI or not. We are assuming the dollars distributed are the same either way, so the question is "Given that there is to be $100 distributed, is it better or worse to have that distribution carry out capital gain?" Consider the following two scenarios to illustrate this different mindset.

Scenario #1. Trust has $100 of capital gain. Trust distributes $100 as a discretionary principal distribution, and that distribution does not carry out any capital gain. In that case, the $100 of capital gain would be taxed to the trust. Assuming the top capital gain rate of 20% and assuming the 3.8% surtax applies, the trust would pay $23.80.

Scenario #2. Trust has $100 of capital gain. Trust distributes $100 as a discretionary principal distribution, and that distribution does indeed carry out capital gain. In that case, the $100 of capital gain would be taxed to the surviving spouse. Assuming the top capital gain rate of 20% and assuming the 3.8% surtax applies, the surviving spouse would pay $23.80, the same as the trust.

Note that although there is no tax savings (the tax due is $23.80 in both cases), Scenario #2 would spare the trust from having to pay the $23.80 of tax. In other words, the surviving spouse has in effect paid the tax for the trust, and that was accomplished by having the capital gains included in the DNI. This is the same thinking behind an intentionally defective grantor trust, though here it is limited to a particular distribution rather than the entire trust.

D. The Section 643 Regulation

The key regulation is Final Regulation §1.643(a)-3 (the "643 Regulation"), which states as follows:

(a) In general. Except as provided in §1.643(a)-6[37] and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

(b) Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) –

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph §1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

E. Organizing the Regulation

The Regulation set out above is quite short, but there's a lot packed in there. I find it useful to organize it by noting that it has two requirements -- two elements must be present in order for capital gain to be included in DNI: (1) the capital gain must be properly allocated; and (2) such allocation must be properly authorized.

1. Properly allocated. Properly allocated means allocated in one of five[38] ways:

1. Allocation Method #1(a): [39] Allocated to income;
2. Allocation Method #1(b): Allocated to income as a matter of discretion in the case where "income under the state statute is defined as, or consists of, a unitrust

[37] That regulation refers to the DNI of a foreign trust.

[38] Regulation §1.643(a)-3(b)(1) and (3) each contains two separate allocation methods. Because the Examples under §1.643(a)-3 do not always make it clear precisely which method is involved, it's better to keep these separate and always [try to] understand which one is being applied.

[39] I'm using this numbering to track the regulation. There are three subparagraphs, but (1) and (3) contain two allocation rules, so I subdivide both into an (a) and (b), etc.

amount," in which case such an allocation to income "must be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph §1.643(a)-3(b));"

3. Allocation Method #2: Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary;
4. Allocation Method #3(a): Allocated to corpus but actually distributed to the beneficiary;[40]
5. Allocation Method #3(b): Allocated to corpus but utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

2. Properly authorized. Properly authorized means it is pursuant to one of two ways:

1. Authorization Method #1: Pursuant to the terms of the governing instrument and applicable local law. There is no discretion involved.
2. Authorization Method #2: Pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law).

There are 14 Examples under this Regulation. Each of the 14 Examples is an illustration of a combination of a particular Allocation Method and a particular Authorization Method, producing the following grid:

	Authorization Method #1 (no discretion)	**Authorization Method #2 (discretion)**
Allocation Method #1(a)	Example 4, 11	
Allocation Method #1(b) (discretion)		Example 12, 13, 14
Allocation Method #2 (discretion)		Example 1, 2, 3,
Allocation Method #3(a)	Example 6[41], 7, 8, 9	Example 10 (unclear)
Allocation Method #3(b)		Example 5

There are several important reasons to keep these many different methods organized and separate, as in this grid.

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[40] It's interesting to note that this "actually distributed" method of allocation was not in the 2001 643 proposed regulations, and its addition to the 643 Final Regulations is not commented on in the Preamble.

[41] It is not always clear under the Examples which allocation method is being illustrated. (I will confess I've changed my categorization of some Examples more than once.) Example 6 can also be read as illustrating allocation method 3(b). For a fuller discussion, see *The Final 'Income" Regulations: Their Meaning and Importance*, by Jonathan G. Blattmachr and Mitchell M. Gans, Tax Notes Today, May 17, 2004.

1. Reason #1. In the case of Authorization Methods, if it's mandated by the trust/statute, that's sufficient (being method #1). However, for Authorization Method #2 there are additional requirements: (1) it must be a "reasonable and impartial exercise of discretion by the fiduciary," and (2) that exercise must be in accordance with (a) a power granted by applicable local law, or (b) a power granted by the governing instrument if not be prohibited by applicable local law.
2. Reason #2. In the case of Allocation Methods, which of the 5 methods applies will determine: (1) whether discretion is required, or even allowed;[42] (2) whether there must be "consistency;" (3) whether there must be a determination that capital gains have been "actually" distributed; and (4) whether there must be a determination that capital gains have been "utilized" in determining the amount to be distributed.
3. Reason #3. Although the grid above lets us pigeon-hole each Example, it would be wrong to assume that because there's an Example in a square in the grid, that exhausts the possibilities for that square. For example, Examples 4 and 11 are listed in the upper left square in the grid. But if we isolate the two components that make up that square (Authorization Method #1 and Allocation Method #1(a)), we can brainstorm other scenarios that would also fit. We'll do that below, where the grid is expanded to cover more scenarios than those covered by the 14 Examples in the 643 Regulations.
4. Reason #4. Notice that not all the squares in the grid above are filled in. The 14 Examples do not cover all possibilities, so there's a benefit to brainstorming what scenarios would fall within the empty squares, and the grid provides a framework for doing that. We'll do that next, though as you will see I was still not able to fill in all the squares.
5. Reason #5. In the examples that follow, there will be times when I extrapolate from an example set forth in the 643 Regulations, suggesting that by coming within the same Allocation Method but a different Authorization Method, capital gains can be included in DNI. It's very easy to be confused by the 643 Regulations (believe me!), but an important element is that (i) coming within a proper Allocation Method and (ii) coming within a proper Authorization Method are two separate matters. I find the set up of the grid helps keep this distinction in mind.

F. Having Capital Gains Taxed to Beneficiaries – A Summary of the 21 ways

We are now prepared to survey the many possible ways that a trust's capital gains can be taxed to a beneficiary. The 21 ways can be summarized as follows: [43]

1. 18 of the following 21 ways are pursuant to the rules/examples set forth in the 643 Regulations. Following the grid set forth above, the 18 opportunities under the 643

[42] In several of the following examples, there is no choice – capital gains must be included in DNI.

[43] In this next grid I've found it useful to further divide each Authorization Method depending on whether the source of the mandate or the discretion, as the case may be, is state law or the trust document.

Regulations are (the #s in the following grid refer to the 21 ways listed in the text following this grid, with only the first 18 ways being in this grid):

2. The remaining examples, #19 through #21, are "off the grid."

<table>
<tr><th></th><th colspan="2">Authorization Method #1 (no discretion)</th><th colspan="2">Authorization Method #2 (discretion)</th></tr>
<tr><th></th><th>Mandated by Document</th><th>Mandated by Law</th><th>Granted by Law</th><th>Granted by Document</th></tr>
<tr><td>Allocation Method #1(a)</td><td>#1, #2</td><td>#3, #4</td><td>#5</td><td>#6</td></tr>
<tr><td>Allocation Method #1(b)</td><td colspan="2" rowspan="2">See footnote 44</td><td>#7</td><td>#8</td></tr>
<tr><td>Allocation Method #2</td><td>#10</td><td>#9, #11</td></tr>
<tr><td>Allocation Method #3(a)</td><td>#12</td><td></td><td></td><td>#13, #14, #15</td></tr>
<tr><td>Allocation Method #3(b)</td><td>#17</td><td></td><td></td><td>#16, #18</td></tr>
</table>

III. 21 ways (and counting) to have a trust's capital gain taxed to the beneficiary

#1: The capital gains are allocated to fiduciary accounting income by the trust document (Allocation Method 1(a) and Authorization Method 1). This is illustrated by Example 4 of the Regulations.[45]

> **Example (4).** The facts are the same as in Example 1,[46] except that pursuant to the terms of the governing instrument (in a provision not prohibited by applicable local law), capital gains realized by Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

Here, capital gains are not allocated to "principal" and then considered distributed. Rather, capital gains are in "income" from the start. Once an item of federal taxable income is in fiduciary accounting "income," it is in DNI. Note there is no discretion involved here; the capital gains are in "income" because the trust instrument mandates that result. There's no choice to allocate gains to "principal;" there is no ability to prevent capital gains from being in DNI. There is also no "consistency" requirement, which makes sense because there's no discretion of which to require consistency.

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[44] These combinations would involve (i) a mandatory directive under Authorization #1 but (ii) discretion that is exercised "consistently." That's contradictory. Understandably, there are no Examples in the 643 Regulations, nor are any offered here. There's nothing wrong with that; there's no reason every square on this grid must be filled in.

[45] Regulation §1.643(a)-3(e), Example 4.

[46] Example 1 of the 643 Regulations is discussed at #9.

Planning Opportunity. This method could be relevant for trusts that are fully discretionary (i.e., all distributions, both income and principal, are discretionary). For such a trust, drafting the trust to require that capital gain be allocated to income will cause that capital gain to be in DNI. This method seems akin to the total return philosophy: there's no distinction between principal/income or ordinary income/capital gain. A dollar distributed is a dollar taxed. There's something to be said for simplicity.

#2: Unitrust: the capital gains are allocated to fiduciary accounting income by the terms of the trust (Allocation Method 1(a) and Authorization Method 1). [I suggest you read #4 before reading this #2. The "flow" I've chosen for this paper, which follows my grid above, is not always the order of the Examples under the 643 Regulation.]

This is the same analysis as #4 below, except the mandate that the unitrust payout be considered sourced from capital gains is not contained in state law but rather is contained in the trust document itself. That this can be the case is implied by Example 12 of the Final Regulations, which begins: "The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount . . .." In other words, even though Example 11 only refers to a state statute imposing the result, its logic would also apply if it was the trust document imposing the result.

Planning Opportunity. This seems a drafting opportunity. If you want your unitrust to require that capital gains be considered the source of the unitrust payout, you can put such a provision in the trust document.

#3: The capital gains are allocated to fiduciary accounting income by state law (Allocation Method 1(a) and Authorization Method 1). This is similar to #1, except the mandate for allocating capital gain to income comes from state law rather than the trust document. It might sound a bit counterintuitive that state law would mandate that capital gain be allocated to income.

Investing in mutual funds. Under Section 401(b) of the UPIA, money received from a mutual fund is allocated to fiduciary accounting income, unless a more specific rule applies. UPIA Section 401(c)(4) allocates to fiduciary accounting principal "money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes." However, a "capital gain dividend" for federal income tax purposes encompasses only long-term capital gain. Mutual fund dividends attributable to short-term capital gain are considered "income" for fiduciary account principals and, as a result, are include in DNI.[47]

Planning Opportunity. Probably none. No one seeks out short-term capital gain, which is taxed at the same rates as ordinary income. Rather, this is an example that

[47] From the Commentary to UPIA Section 401: "Capital gain dividends. Under the Internal Revenue Code and the Income Tax Regulations, a "capital gain dividend" from a mutual fund or real estate investment trust is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act." See also PLR 9811037.

sometimes there is no choice; sometimes capital gain must be included in DNI under the 643 Regulations.

#4: Unitrust: the capital gains are allocated to fiduciary accounting income by state law (Allocation Method 1(a) and Authorization Method 1). The 643 regulations address unitrusts, also called "total return unitrusts." A unitrust is a trust where the distribution to the beneficiary is described in terms of a certain percentage of the trust's value (e.g., 4% per year) rather than in traditional terms of "income" or "principal." If state law dictates how such unitrust payments are sourced for tax purposes, then that dictates the extent to which capital gains are in DNI. This is illustrated by Example 11 of the Regulations. [48]

> **Example (11)**. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.

In this case, the state statute mandates that unitrust distributions be considered sourced from capital gains, and that will cause such capital gains to be in DNI and carried out. As with the prior example, (i) capital gains are not allocated to "principal" but rather are in "income" from the start; (ii) no discretion involved here; there is no ability to prevent capital gains from being in DNI; and (iii) there is no "consistency" requirement.

Planning Opportunity. In the case of a unitrust, if the trust document does not produce this result (see #2), presumably this result could be achieved by having the trust sitused in, and therefore governed by, a state whose laws mandate that unitrust distributions will be considered paid from capital gain.

#5: Allocated to income by exercise of discretion granted under state law: the exercise of a power of adjustment under the UPIA (Allocation Method 1(a) and Authorization Method 2). Under the Uniform Principal and Income Act (UPIA), a trustee has the power (if certain conditions are met), to transfer "principal" to "income."[49] The creation of this power was in response to the evolution in the investment world, away from narrow concepts such as "income," "yield," "appreciation," etc. and towards a "total return"

[48] Regulation §1.643(a)-3(e), Example 11.

[49] UPIA Section 104.

philosophy.[50] This evolution to a "total return" could cause there to be plenty of total return, but not much "income," which would be to the detriment of an income beneficiary. UPIA Section 104 allows a trustee to transfer "principal" to "income" to avoid such a detriment, when appropriate.

There are no examples in the 643 Regulations illustrating this particular combination: Allocation Method 1(a) (allocated to income) and Authorization Method 2 (pursuant to discretion).[51] However, from the Preamble to the 2001 proposed 643 regulations it is clear this particular aspect of the 643 Regulations is aimed at an exercise of a trustee's power of adjustment under a state's version of the UPIA to transfer principal to trust income. From the Preamble to the 2001 proposed 643 regulations:

> To ensure that the income beneficiary is not penalized if a trustee adopts a total return investment strategy, many states have made, or are considering making, revisions to the definitions of income and principal. Some state statutes permit the trustee to make an equitable adjustment between income and principal if necessary to ensure that both the income beneficiary and the remainder beneficiary are treated impartially, based on what is fair and reasonable to all of the beneficiaries. *Thus, a receipt of capital gains that previously would have been allocated to principal may be allocated by the trustee to income if necessary to treat both parties impartially*.

Emphasis added. The emphasized sentence is confusing. The power of adjustment under the UPIA has only to do with "principal" and "income" (both fiduciary accounting terms), not "capital gain" (which is a federal tax term, not a fiduciary accounting term). Consider the following example:

> **Example**. Trust has $1,000,000 of principal, including $50,000 of principal cash. The only investment return received for the year is interest totaling $20,000 (2%); there are no capital gains. At the end of the year, for fiduciary accounting purposes, there is (i) $1,000,000 of principal, including $50,000 of principal cash,

[50] From the introductory commentary to the UPIA 2000 version: "The law of trust investment has been modernized. See Uniform Prudent Investor Act (1994); Restatement (Third) of Trusts: Prudent Investor Rule (1992) (hereinafter Restatement of Trusts 3d: Prudent Investor Rule). Now it is time to update the principal and income allocation rules so the two bodies of doctrine can work well together. This revision deals conservatively with the tension between modern investment theory and traditional income allocation. The starting point is to use the traditional system. If prudent investing of all the assets in a trust viewed as a portfolio and traditional allocation effectuate the intent of the settlor, then nothing need be done. The Act, however, helps the trustee who has made a prudent, modern portfolio- based investment decision that has the initial effect of skewing return from all the assets under management, viewed as a portfolio, as between income and principal beneficiaries. The Act gives that trustee a power to reallocate the portfolio return suitably. To leave a trustee constrained by the traditional system would inhibit the trustee's ability to fully implement modern portfolio theory."

[51] The Preamble to the Final Regulations declined requests to include examples, stating that the possible scenarios were too numerous to allow an example or two to be helpful.

and (ii) $20,000 of income cash. The trust requires that "income" be paid the beneficiary annually. The applicable state law grants trustees a power of adjustment as in UPIA Section 104. Under the applicable state law, the trustee exercises that power of adjustment and transfers $10,000 from principal cash to income cash, and the trustee then distributes that $30,000 of "income" (3%) to the beneficiary.

This is a very simple example of the power of adjustment, but note there are no capital gains involved here. That is fine, because "capital gain" is a tax term, not a fiduciary accounting term, and the power of adjustment in the UPIA is not concerned with "capital gain;" it's concerned with "principal" and "income." Granted, if a trust sells an asset for a gain, the proceeds are typically then allocated to trust accounting principal.[52] But the inverse is simply not true: principal amounts need not involve any capital gain, and because of that it is very unclear how to interpret the Preamble's statement: "*a receipt of capital gains that previously would have been allocated to principal may be allocated by the trustee to income if necessary to treat both parties impartially*." Is this saying that the power to adjust is deemed, by the 643 Regulations, to be the power to allocate capital gain to income? Or must that allocation power be bestowed from some other source (state law and/or the document)?

Consider the following example, which is the previous example but with the added complication of capital gain:

Example. Trust has $1,000,000 of principal assets, including $50,000 of principal cash. The only investment returns received for the year are (i) $30,000 of capital gains, which is part of the $50,000 of principal cash; and (ii) interest income totaling $20,000 (2%). At the end of the year, for fiduciary accounting purposes, there is (i) $1,000,000 of principal, including $50,000 of principal cash, and (ii) $20,000 of income cash. The trust requires that "income" be paid the beneficiary annually. The applicable state law grants trustees a power of adjustment as in UPIA Section 104. Under the applicable state law, the trustee exercises a power of adjustment and transfers $10,000 from principal cash to income cash, and the trustee then distributes that $30,000 of "income" (3%) to the beneficiary.

Here's the rub: did the $10,000 of principal cash that was transferred to income come from the $30,000 capital gain component of the $50,000 of principal cash, or did it come from "other" $20,000 in principal cash? If it didn't even come from the capital gain, it would seem the trustee could not claim to have allocated capital gain to income, absent some other power to do so. The UPIA does not answer this question because the power of adjustment is not concerned with capital gains. So, we're left with the rather incomplete rule that (i) if the trustee is granted the discretionary power to include capital gain in income, then that gain will be in DNI, but (ii) such a discretionary power can't be found in the UPIA![53]

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[52] UPIA Section 404(2).

[53] For a fuller discussion of this uncertainty, see <u>*The Final 'Income" Regulations: Their Meaning and Importance*</u>, by Jonathan G. Blattmachr and Mitchell M. Gans, Tax Notes Today, May 17, 2004.

Planning Opportunity. Depending how you resolve the uncertainty noted above, this could be a planning opportunity. If you believe that under the 643 Regulations the power to adjust **is** the power to allocate capital gain, then exercising the power of adjustment would cause capital gain to be included in DNI (though as the last example illustrates, there can be an issue as to how much). Another issue is whether such an allocation of capital gain to income must occur every time the power of adjustment is exercised, or can it be used or not as the trustee chooses?

#6: Allocated to income by exercise of a discretionary power granted by the trust document (Allocation Method 1(a) and Authorization Method 2). Consider if the trust document simply states: "the trustee shall have the power to allocate capital gains to income, whenever the trustee feels like it." There's no need for any consistency; the trustee could theoretically make such an allocation one year but not the next. That's maximum flexibility; perhaps too good to be true. Let's call it the TGTBT (Too Good To Be True) Example. Would that allow capital gains to be included in DNI under the 643 Regulations? It appears that (i) under a straightforward reading of the regulations, yes, but (ii) this was not the intended result.

The 643 Regulation states that capital gains are included in DNI if "pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by . . . the governing instrument if not prohibited by applicable local law) – . . . allocated to income." That would cover the TGTBT example where the trust document simply states: "the trustee shall have the power to allocate capital gains to income, whenever the trustee feels like it" (I am assuming the requirement that the exercise of discretion is "reasonable and impartial"). But this would eat up the rule and basically allow capital gains to be included in DNI whenever a trustee wanted that. How can that be? Because they didn't mean it.

Under the 2001 proposed 643 regulations, every exercise of a trustee's discretion had to be "consistent;" it couldn't be changed year to year.[54] That requirement of consistency would have applied to (i) discretionary allocations of capital gain to principal distributions; (ii) discretionary allocations of capital gain to unitrust distributions; (iii) discretionary allocations of capital gain to income via an exercise of a power of adjustment; and (iv) discretionary allocations of capital gain to income in the TGTBT Example. Such a requirement of consistency would have prevented the TGTBT Example.

In the case of discretionary allocations of capital gain to principal distributions (the first two items in the list of four just enumerated), the Final Regulations maintain the requirement of consistency. As for the allocation of capital gain to income, a very different result happened. Comments to the 2001 proposed 643 regulations suggested that because of all the requirements "built in" to the UPIA's power to adjust, this wasn't really abuseable and so there was no need to require consistency. The IRS agreed. From Preamble to the Final Regulations:

> One commentator suggested that a discretionary power to allocate capital gains to income should not have to be exercised consistently. The exercise of the power generally affects the actual amount that may or must be distributed to the

[54] This "consistency" requirement is discussed at #7 and #9 below.

income beneficiaries and affects whether the trust or the beneficiary will be taxed on the capital gains. Thus, the IRS and the Treasury Department agree that the power does not have to be exercised consistently, as long as it is exercised reasonably and impartially. However, if the amount of income is determined by a unitrust amount, the exercise of this discretionary power has no effect on the amount of the distribution, but does affect whether the beneficiary or the trust is taxed on the capital gains. Under these circumstances, a discretionary power must be exercised consistently.

It seems clear from this that the IRS understood that the exercise of a discretionary power to adjust under the UPIA need not be consistent because of all the accompanying requirements. It seems just as clear the IRS did not realize the same rule would cover the TGTBT Example, where the discretionary power to allocate capital gains to income (not a unitrust) is granted, not by state law, but simply by the document. Both of those scenarios are covered by the same combination of Authorization Method 2 and Allocation Method 1(a). Therefore, when the Final Regulation removed the requirement that the use of discretion be "consistent," it removed that requirement from both scenarios – the UPIA power of adjustment scenario and the TGTBT scenario. That leaves us with the regulation allowing capital gain to be allocated to income if (i) that is done via a discretionary power granted by the document, and (ii) it need not be consistent (though it does need to be reasonable and impartial). That seems an incredibly broad and flexible opportunity.[55]

Planning Opportunity. Although this particular combination (Allocation Method 1(a) (allocated to income) and Authorization Method 2 (pursuant to discretion)) is aimed at the exercise of a power to adjust under the UPIA, there is nothing in the wording of the final regulation itself that limits it to that. As a result, in addition to an exercise of a power to adjust, this method also seems to be quite broad and allow a trustee to allocate capital gain to income (thus including it in DNI) . . . just because. That is, if a trust instrument (or state law) grants the trustee the discretion to allocate capital gains to income, that alone would seem to bring it under this requirement. (The regulation does require that any such allocation be "reasonable and impartial.") That seems an incredibly broad and flexible drafting opportunity.

#7: Unitrust: the capital gains are allocated to fiduciary accounting income by reason of the exercise of discretion granted by state law (Allocation Method 1(b); Authorization Method 2). This is illustrated by Examples 12 and 13 of the Regulations.[56] Both examples involve a "unitrust," also called a "total return unitrust," where the distribution to the beneficiary is described in terms of a certain percentage of the trust's value (e.g., 4% per year) rather than in traditional terms of "income" or "principal."

If the trust document and state law dictate how such unitrust payments are sourced for tax purposes, then that dictates the extent to which capital gains are in DNI. This is Example 11 of the Regulations, which was discussed previously at #4 above. If the result is not dictated by the trust/statute but rather is left to the trustee's discretion as to the source of the

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[55] See also *The Final 'Income" Regulations: Their Meaning and Importance*, by Jonathan G. Blattmachr and Mitchell M. Gans, Tax Notes Today, May 17, 2004.

[56] Regulation §1.643(a)-3(e), Examples 12, 13.

unitrust payment, this is Example 12 (where capital gains are not treated as distributed) and 13 (where they are treated as distributed).

> **Example (12).** The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.

> **Example (13).** The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

Under this method, such an allocation to income must be exercised "consistently." These two examples illustrate that "consistently" means one bite at the apple. In Example 12, the fiduciary does not elect to treat capital gain as part of the distribution the first time that choice is available, and that first-time failure precludes the fiduciary from treating capital gains as being included in DNI in future years (at least under this allocation method). In Example 13, the opposite happens: the fiduciary does elect to treat capital gain as part of the distribution the first time that choice is available, and this commits the fiduciary to doing the same in future years.

QUERY: The consistency requirement in Allocation Method #2 is imposed on "the fiduciary," not the trust. If a successor fiduciary is appointed, does that "wipe the slate clean" so that the new fiduciary can choose differently than did the predecessor?

Planning Opportunity. If the trust document does not grant the trustee sufficient discretion (as in #8 below), then changing the trust situs to a state whose laws allow the discretion described in Examples 12 and 13 of the Regulations should allow the trustee to allocate capital gains to income, causing it to be include in DNI. Alternatively, if changing a trust's situs is not easily achieved, a change in the state law to allow for the discretion described in Examples 12 and 13 of the Regulations would allow the trustee to allocate capital gains to income, causing it to be included in DNI.

#8: Unitrust: the capital gains are allocated to fiduciary accounting income by reason of the exercise of discretion granted by the trust document (Allocation Method 1(b); Authorization Method 2). This is the same analysis as the preceding #7, except the discretionary power is in the trust document itself rather than derived from state law. Examples 12 and 13 don't specify the source of the discretionary power; it matters only that there is discretionary power. The preceding section addressed discretion resulting from of state law. The analysis would be the same if instead that the discretion was the result of the trust document itself.

Planning Opportunity. If the trust document is being created, and if state law does not grant the trustee sufficient discretion, then this is a drafting opportunity to include in the trust document the discretionary powers described in Examples 12 and 13 of the Regulations, empowering the trustee to consider unitrust distributions to be sourced from capital gains, causing it to be included in DNI.

#9. Discretionary distributions of principal per discretion granted by the trust document (Allocation Method 2; Authorization Method 2). This is illustrated by Examples 1 and 2 of the Regulations.[57]

> **Example (1).** Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.
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> **Example (2).** The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

Like Examples 12 and 13 discussed at #7, Examples 1 and 2 illustrate that "consistently" means one bite at the apple. In Example 1, the fiduciary does not elect to treat capital gain as part of the distribution the first time that choice is available, and that first-time failure

[57] Regulation §1.643(a)-3(e), Examples 1, 2.

precludes the fiduciary from treating capital gains as being included in DNI in future years (at least under this allocation method). In Example 2, the opposite happens: the fiduciary does elect to treat capital gain as part of the distribution the first time that choice is available, and this commits the fiduciary to doing the same in future years.

Planning Opportunity. In Examples 1 and 2, one of the assumed facts is that the Trustee is given discretionary powers to invade principal and to deem discretionary distributions to be made from capital gains realized during the year. That is not a common term of a trust, but there's no reason it can't be. It can simply be included in the trust document, as in Examples 1 and 2.

Observation. Notice that in Examples 2, the trustee first makes discretionary distributions of principal (presumably at various time during the year), and after-the-fact, on the trust's tax return for the year, deems capital gain to be the source. This is an example of the alternative mindset discussed at II(C) above. However, after that initial after-the-fact treatment, the "one bite at the apple" rule would require similar treatment in future years, which could reverse that mindset. That is, in future years it could indeed be the case that a decision is made to minimize taxes, and knowing that a discretionary distribution of principal will "carry out" capital gain, a tax-motivated decision might be made to distribute.

#10. Discretionary distributions of principal per discretion granted by state law (Allocation Method 2; Authorization Method 2). The preceding #9 was premised on the requisite discretion being a term of the trust document itself. Alternatively, the source of the discretion to deem distributions to be made from capital gains could be state law, as states enact this power in response to this issue. See, for example, North Carolina's G.S.36C-8-816(16); Alaska Sec. 13.36.109. It appears these were enacted because of the 643 Regulations. That is, if the IRS says having a certain power works, then why not make sure all trustees have that power.

Planning Opportunity. If the trust document does not grant the trustee sufficient discretion (see #9), then changing the trust situs to a state whose laws allow the discretion described in Examples 1 and 2 of the Regulations should allow the trustee to treat capital gains as being distributed with discretionary principal distributions. Alternatively, if changing a trust's situs is not easily achieved, a change in the state law to allow for the discretion described in Examples 1 and 2 of the Regulations would allow the trustee to treat capital gains as being distributed with discretionary principal distributions.

#11 Discretionary distributions of gain from sales of "certain specified assets" or a "particular class of investments" -- a variation on #9 and #10 (Allocation Method 2; Authorization Method 2). Both #9 and #10, and the Examples 1 and 2 from the Regulations, treat the issue of being "consistent" as applying to all capital gains. The consistency need not be so broad. Example 3[58] offers a fascinating variation:

> **Example (3).** The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of *certain specified assets* or a *particular class of*

[58] Regulation §1.643(a)-3(e), Examples 3.

> *investments*. This treatment of capital gains is a reasonable exercise of Trustee's discretion. [Emphasis added.]

As discussed in #9, this Allocation Method #2 requires consistency -- one bite at the apple. But, what's the "apple?" Consider the following examples.

> **Example**. Assume a Trustee has the power to allocate capital gains to distributions. In Year 1, Trustee sells ABC stock for capital gain and declares (by including it in DNI on the tax return) that capital gain to be part of a discretionary distribution of principal. Must the trustee "consistently" treat capital gains as being distributed in the future? If this comes under Examples 1 and 2 of the 643 Regulations, discussed above at #9 and #10, then yes. This is the "one bite at the apple" rule. Choosing to treat the capital gains as being distributed in Year 1 commits the trustee to doing the same in the future. However, if this comes under Example 3, set out above in this #11, then perhaps no. There's still only one bite at the apple, but Example 3 allows us to re-define the "apple." If the ABC stock can be considered a "certain specified asset" or "a particular class of investment," then the consistency requirement will apply only to ABC stock but not other capital gains recognized in the future.[59]
>
> **Example**. As another example, assume a Trustee has the power to allocate capital gains to distributions but has never done so for the first 10 years. In Year 11, Trustee sells ABC stock for the first time, for capital gain. Can the trustee treat that capital gains as being distributed in Year 11? If this comes under Examples 1 and 2, discussed above at #9 and #10, then no. This is the "one bite at the apple" rule. Failing to treat the capital gains as being distributed in Year 1 precludes the trustee from treating them as distributed in the future. However, if this comes under Example 3 set out in this #11, then possibly yes. There's still only one bite at the apple, but Example 3 allows us to re-define the "apple." If the ABC stock can be considered a "certain specified asset" or "a particular class of investment," then the consistency requirement will apply only to ABC stock when it is first sold, so in Year 11 that **is** the first bite at this apple.

Planning Opportunity. This seems not so much a drafting opportunity as an implementation opportunity. Assuming a trustee has the requisite discretion described in Examples 1 and 2 of the Regulations, then the requirement of "consistency" can be navigated by judicious determination of which "certain specified assets" or "particular class of investments" is the object of the discretion.

Observation. This Example 3 raises an interesting issue. Assume that a trust and trustee meet all the particulars of Example 3. The Trustee "intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets." How do you

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[59] Perhaps the consistency requirement need not even apply to ABC stock if different lots can be considered different "specified assets." This is discussed in *The Final 'Income" Regulations: Their Meaning and Importance*, by Jonathan G. Blattmachr and Mitchell M. Gans, Tax Notes Today, May 17, 2004.

know whether that's been done? Assume the net capital gain from the "certain specified asset" is $15,000 in 2014; that would be known on the day the asset is sold, and let's assume that's early in the year. There's nothing in the 643 Regulations or Example 3 that limits the trustee's ability to make discretionary principal distributions, and there's nothing suggesting any additional distributions would somehow render Example 3 inapplicable. So, assume throughout the year the Trustee makes total discretionary distributions of $35,000. Also assume that there were many other sales of other capital assets, and total capital gains for the year total $100,000. At the end of the year, all we know is that (i) there's $100,000 of capital gain; (ii) $15,000 of that came from that sale of the "certain specified asset;" and (iii) there are total discretionary principal distributions of $35,000. All that is consistent with falling within Example 3. There's nothing inherently incorrect with all that, but it does seem to result in a quite generous rule: At the end of each year, principal distributions can be considered to carry out the capital gain from any sale of asset(s) during the year, as long as the asset(s) are "certain specified assets" or a "particular class of investments." Based on Examples 1 and 2 of the 643 Regulations, presumably such a choice is made simply by including the capital gain in DNI on the tax return.

> **Example**. Trust receives a mutual fund distribution that represents $15,000 of long-term capital gain. Under the state law, that is allocated to principal. During the year, trustee makes discretionary principal distributions totaling $35,000. Can the trustee consider this to fall under Example 3 and include the $15,000 in DNI on the theory that it is gain from a "particular class of investments" (the mutual fund)? It would seem so; it would seem it should not matter whether the trustee also made other distributions (in this case the additional $20,000 of discretionary principal distributions).

Now what if the opposite happens; what if distributions are made throughout the year, as is common, and the expectation is that such distributions will end up being the amount of capital gain recognized with the "particular class of investments," but the expectation is exceeded?

> **Example**. Trust expects to receive a mutual fund distribution in December that represents $15,000 of long-term capital gain. Under the state law, that is allocated to principal. During the year, trustee makes discretionary principal distributions totaling $15,000, planning to have that regularly considered to be a distribution of the mutual fund capital gain. In December, the mutual fund pays a dividend of $17,500. Does that mean the trustee has failed the requirement of "consistency"? Could that be (must it be?) remedied if the trustee distributed an additional $2,500 so that the amount of the discretionary distribution and the amount of capital gain desired to be included in DNI are the same? Ex. 3 doesn't address such timing issues.

QUERY: Example 3 of the 643 Regulations begins with "The facts are the same as in Example 1." What exactly does that mean? Recall from #9 that Example 1 (and 2) of the 643 Regulations has as an assumed fact that the "Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year." That's an uncommon power, discussed at #9. Is that assumed fact carried over to Example 3, so that Example 3 will apply only if the Trustee has

that power to "deem discretionary distributions to be made from capital gains realized during the year?" It's unclear. Example 4 of the 643 Regulations (discussed at #1) also begins "The facts are the same as in Example 1." However under Example 4 it's clear that the discretionary power is irrelevant to that Example (the result is mandated without any discretion being involved). So in the case of Example 4, presumably the reference to "the facts are the same as in Example 1" refers to the other facts, such as the amount of the gain and the amount of the distributions. It is unclear (at least to me) whether Example 3 similarly does not incorporate the requirement that the trustee have the power to "deem discretionary distributions to be made from capital gains realized during the year."

#12: Capital gains from sales to fund the payment of "step outs" mandated by the trust document (Allocation Method 3(a); Authorization Method 1).

Trusts commonly have a "step out" provision (also called "age of attainment distributions"). For example, a trust for beneficiary might provide that until age 30, all distributions are discretionary. At age 30, one half of the trust is to be distributed. At age 35, the balance of the trust is to be distributed. The treatment of capital gains resulting from sales to fund such step outs is illustrated by Examples 7 and 9 of the 643 Regulations.[60]

Final Step outs. In the case of a final step out distribution, selling all the trust's assets and distributing the proceeds will carry out the capital gain. This is Example 7 of the Regulations

> **Example (7).** Under the terms of Trust's governing instrument, all income is to be paid to A during the Trust's term. When A reaches 35, Trust is to terminate and all the principal is to be distributed to A. Because all the assets of the trust, including all capital gains, will be actually distributed to the beneficiary at the termination of Trust, all capital gains realized in the year of termination are included in distributable net income. See § 1.641(b)-3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.

This Example illustrates Allocation Method #3(a): "allocated to corpus by actually distributed to the beneficiary." Under this particular Allocation Method, the result is required; there is no discretion involved or allowed; there is no consistency required.

Planning Opportunity. Even if this result is not optional, perhaps it could be made so by timing the sale. That is, if the stock were sold in the tax year prior to when A reaches 35 and no distributions were made that prior tax year, the trust would be taxed on the capital gains. Those post-tax amounts could then be distributed in the next year when the step out occurs. So, if having the trust taxed is preferred, this can be accomplished by timing the sale, Example 7 notwithstanding.

Interim Step outs – selling precisely enough. If it's not the final step out and the trustee sells precisely enough assets to fund the interim step out, that would cause capital gain to be included in DNI and carried out by the step out distribution. This is Example 9 of the Regulations. Like the previous example, this would fall within the rule that if the capital

[60] Regulation §1.643(a)-3(e), Examples 7, 9.

gains are "allocated to corpus but actually distributed to the beneficiary," then capital gains are included in DNI.

> **Example (9).** The facts are the same as Example 7, except Trustee is directed to distribute one-half of the principal to A when A reaches 35 and the balance to A when A reaches 45. Trust assets consist entirely of stock in corporation M with a fair market value of $1,000,000 and an adjusted basis of $300,000. When A reaches 35, Trustee sells one-half of the stock and distributes the sales proceeds to A. All the sales proceeds, including all the capital gain attributable to that sale, are actually distributed to A and therefore all the capital gain is included in distributable net income.

This Example 9 assumes "Trust assets consist entirely of stock." Because of that, it's easy to follow that if exactly one-half of the stock is sold, and if all of those proceeds are distributed (i.e., every dollar distributed can only be from the sales proceeds), then the capital gain from the sale has been "actually" distributed. However, this is an extremely over-simplified example; trust assets are never this clean.

Consider if the Trust owned $900,000 of stock and $100,000 cash already on hand, and $500,000 of stock is sold, generating capital gain of $350,000. This results in $600,000 of cash -- $500,000 of sales proceeds and $100,000 already on hand. Assume $500,000 is distributed. How much of the $350,000 of capital gain has been "actually" distributed? Is the $500,000 distribution considered to come solely from the proceeds of the sale? Or is $100,000 of the distribution from the cash already on hand? Pro rata? If pro rata, determined as of what date? Example 9 does not answer this.[61]

#13 Interim Step outs – but selling more than you need (Allocation Method 3(a); Authorization Method 2). This is illustrated by Example 10 of the Regulations.[62]

> **Example (10)**. The facts are the same as Example 9, except when A reaches 35, Trustee sells all the stock and distributes one-half of the sales proceeds to A. If authorized by the governing instrument and applicable state statute, Trustee may determine to what extent the capital gain is distributed to A. The $500,000 distribution to A may be treated as including a minimum of $200,000 of capital gain (and all of the principal amount of $300,000) and a maximum of $500,000 of the capital gain (with no principal). Trustee evidences the treatment by including the appropriate amount of capital gain in distributable net income on Trust's federal income tax return. If Trustee is not authorized by the governing instrument and applicable state statutes to determine to what extent the capital gain is distributed to A, one-half of the capital gain attributable to the sale is included in distributable net income.

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[61] Example 10 doesn't help here. Example 10 does provide a default rule, but it assumes all assets are sold, so there are no proceeds that aren't the result of a sale. It does not address how to treat cash already on hand.

[62] Regulation §1.643(a)-3(e), Example 10. I'll confess, I sometimes find it hard to determined exactly which Allocation Method and/or Authorization Method is at work; this Example I find hard.

<u>Planning Opportunity</u>. In this example, the trustee has flexibility to determine how much capital gain has been "actually" distributed, "if authorized by the governing instrument and applicable state statute." [63] So, this is a drafting opportunity to include such an authorization in the trust document, to provide maximum flexibility.

#14 Distributions in-kind to meet income or unitrust distribution obligations (Allocation Method 3(a); Authorization Method 2). Assume a trust either must distribute "income" annually to a beneficiary or must distribute unitrust percentage. Assume that via a proper exercise of discretion, that required distribution is satisfied in-kind with appreciated property. That would trigger the built-in capital gain.[64] Furthermore, it would seem that such capital gain has been "actually" distributed to the recipient, which is Allocation Method 3(a). After all, it was the distribution to the recipient that was the recognition event! In that case, the capital gain must be included in DNI.

Planning opportunity. If a trust either must distribute "income" annually to a beneficiary or must distribute unitrust percentage, there may be a choice between (i) selling assets to raise the necessary cash, or (ii) distributing in-kind. Selling the asset to raise the cash would cause the trust to recognize capital gain. Whether or not that capital gain would be included in DNI depends on all the issues raised in this paper. If the capital gain would not be in DNI, that result should be obtainable by a distributions in-kind, which would both trigger the capital gain and include it in DNI, having been "actually" distributed.

#15 Discretionary distributions in-kind, with a 643 election to recognize gain (Allocation Method 3(a); Authorization Method 2). Under Section 643(e), if a distribution of appreciated property does not trigger gain, an election can made to nevertheless recognize gain. Such an election would apply to all distributions for that tax year. If there's a discretionary distribution in-kind and an election is made to recognize the gain under 643(e), it would seem difficult to deny that the capital gain has "actually" been distributed, which <u>requires</u> that the capital gain be included in DNI under Allocation Method 3(a). There is no discretion required (or allowed), and there is no requirement that this be done "consistently." Rather, if the capital gain is "actually" distributed, that alone requires that the gain be in DNI, and distribution of the property would "carry out" DNI pro rata.

<u>Planning opportunity</u>. Making a 643(e) election should be compared with a distribution in-kind where no such election is made, which is discussed at #19. There could be a choice as to whether the capital gain might be fully allocated to the recipient of the in-kind distribution or only pro rata (i.e., if there have been multiple distributions to multiple beneficiaries). If the goal is to have the capital gain fully allocated to the recipient, that could be accomplished by a distribution in-kind where no election was made to recognize gain. The capital gain would remain "built in," to be fully recognized by the recipient beneficiary when sold. If the goal is to have the capital gain allocated to all distributees pro rata, that

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[63] Throughout the 643 Regulations, it is unclear whether the reference to the trust "and" state law really means "or". For a discussion of this, see in *<u>The Final 'Income" Regulations: Their Meaning and Importance</u>*, by Jonathan G. Blattmachr and Mitchell M. Gans, Tax Notes Today, May 17, 2004.

[64] Reg. §1.651(a)-2(d); Reg §1.661(a)-2(f).

would be accomplished by electing to recognize the capital gain, which should result in the capital gain being in DNI because the gain has been "actually distributed," in which case Allocation Method #3(a) requires that in be in DNI. (If there is only one distributee for the year, then electing to recognize the capital gain would seem to carry that capital gain out to that sole distributee.)

#16: "Utilizing" the amount of capital gain to determine principal distributions (Allocation Method 3(b); Authorization Method 2). This is illustrated by Example 5 of the Regulations.[65]

> **Example (5).** The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use [viz. "utilize"] the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

This Allocation Method #3(b) has no "consistently" requirement. There is not any requirement, not in the regulation or this Example 5, that commits the trustee to "utilize" the capital gains to determine distributions in the future. Rather, this seems to stand for the proposition that if, in any one year, discretionary principal distributions are limited to net capital gains, then for that year they are "utilized by the fiduciary in determining the amount that is distributed" and therefore are in DNI for that year.

Planning Opportunity. For any year, capital gains can be somewhat controlled. By choosing when to sell, what to sell and harvesting capital losses, a trustee might very well be able to come close to having a year's net capital gain be a particular dollar amount. If that is accomplished, the result is that capital gains might be included in DNI.

QUERY: Example 5 of the 643 Regulations begins with "The facts are the same as in Example 1." What exactly does that mean? Recall that Example 1 (and 2) have as an assumed fact that the "Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year." Is that assumed fact carried over to Example 5, so that Example 5 will apply only if the Trustee has that power to "deem discretionary distributions to be made from capital gains realized during the year?" This same idea was discussed at #11. In this case, there are additional reasons to conclude that Example 5 does not depend on such a discretionary power.

Examples 1 and 2 illustrate Allocation Method 2. Allocation Method 2 has the requirement that it be done "consistently," which Example 2 equates with a "regular practice." Example 5, however, illustrates a completely different Allocation Method: #3(b): "allocated to corpus but utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." In addition, Example 6 of the 643 Regulations (discussed next at #17) invokes the very same Allocation Method 3(b) but without any reference to such a discretionary power as is assumed in Example 1. Thus, there seems no

[65] Regulation §1.643(a)-3(e), Example 5.

reason to read into Allocation Method 3(b) the requirement that the trustee have discretionary power that was used to illustrate an unrelated Allocation Method. Rather, as was the case with Example 4 of the 643 Regulations (#1), the reference to the same "facts" as Example 1 seems to be a reference only to the amounts involved, amounts distributed, etc.

#17: Utilizing *proceeds* of asset sales to determine distributions (Allocation Method 3(b); Authorization Method 1). Example 5 of the Regulations (discussed in #16 above) is then expanded by Example 6. Example 5 assumes that the amount of "capital gain" is what determines a particular year's discretionary principal distributions. Because the capital gains are allocated to corpus but "utilized" by the fiduciary in determining the amount that is distributed, those gains must be included in DNI under Allocation Method #3(b). Example 6 of the Regulations broadens this approach. [66]

> **Example (6).** Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses [viz. "utilizes"] the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

The 643 Regulations refer only to "gain." It is "gain" that is "allocated;" it is "gain" that is "actually distributed;" it is "gain" that is "utilized." However, this Example 6 refers to the "proceeds that includes any realized capital gain." This example seems to expand Allocation Methods #3(a) and (b) to include when the *proceeds* of a sale (not the net gain) are used/utilized to determine a principal distribution. [67]

So, Example 6 tells us that if the trust document mandates that when quantifying a distribution, the trustee "utilize" "the amount of the sales proceeds that includes any realized capital gain," the result will be that the capital gain must be included in DNI, under Allocation Method 3(b) and Authorization Method 1. That would suggest the same result would happen if the trust document provided: "Each year, the trustee shall distribute to the beneficiary the proceeds from the sale of [a certain asset]." While this does seem to be how it would work, it's not clear that this really presents a planning opportunity. It's offered here as an example of how the Examples in the 643 Regulations can be expanded by (i) first understanding which Allocation and Authorization Methods are at work, and (ii) then brainstorming other scenarios that would invoke the same Allocation and Authorization Methods.

#18. Utilizing proceeds of asset sales to determine *discretionary* distributions (Allocation Method 3(b); Authorization Method 2). This is simply an extrapolation from #17. In #17, it was mandated by the trust document that the trustee "utilize" sales proceeds in determining the amount to be distributed. That's an example of Authorization Method #1. Here I'm suggesting that it could be a matter of discretion, which is Authorization Method

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[66] Regulation §1.643(a)-3(e), Example 6.

[67] See also the discussion in *The Final 'Income" Regulations: Their Meaning and Importance*, by Jonathan G. Blattmachr and Mitchell M. Gans, Tax Notes Today, May 17, 2004.

#2. That would not affect the applicability of Allocation Method 3(b), as approved by Example 6 discussed above. Let's re-write Example 6, but using Authorization Method 2:

> **Example.** Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is given discretion to ~~directed to hold Blackacre for ten years and then~~ sell it and distribute all the sales proceeds to A. Because Trustee uses [viz. "utilizes"] the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

A possible objection to this is that Example 6 requires the distribution whereas in this # 17 I am suggesting it can be discretionary. This is an example of why I believe it's helpful to have a grid summarizing each Authorization Method and each Allocation Method. To say that Example 6 *requires* the distribution is only to say it illustrates Authorization Method 1. Fine; it does. It is a separate matter that Example 6 also illustrates Allocation Method 3(b) by "utilizing" the proceeds. That valid illustration of Allocation Method 3(b) does not become invalid when Authorization Method 2 is involved; they are two separate matters.

Planning Opportunity. I don't think the regulation-writers had this example in mind, but it does seem to fall within "the rules." Consider a trust with the following terms: "The trustee shall have the discretionary power to distribute to a beneficiary the proceeds from the sale of an asset." Assume the trustee sells ABC stock for $100, triggering $35 of capital gain. Assume pursuant to the power granted by the trust document, the trustee distributes the $100 to the beneficiary. Has that occurred pursuant to a valid exercise of discretion? Seems the answer is yes, meaning this is a valid example of Authorization Method 2. Has the trustee "utilized" the proceeds to determine the amount of distribution? Clearly yes, which is a valid example of Allocation Method 3(a), as illustrated by Examples 5 and 6 of the 643 Regulations. Therefore, it seems the $35 of capital gain must be included in DNI.

#19. Discretionary distributions in-kind that do not trigger gain. Now we have left behind the "grid" of the many different ways the 643 Regulations allow capital gains to be included in DNI. There are additional ways to get the same result that capital gains are taxed to the trust beneficiary. Here is one.

Assume the trustee of a trust wants to make a $10,000 discretionary principal distribution to a beneficiary, assume the trust has no net capital gains for the year as yet, and assume the trust owns stock with a value of $10,000 and basis of $7,500. Consider the following two choices.

1. The trustee could sell the stock to raise the $10,000 to make the distribution, and recognize $2,500 of capital gain. If the trustee then distributes the $10,000, the $2,500 of capital gain recognized would remain in the trust for tax purposes, unless that capital gain can be included in DNI under the 643 Regulations. Assume that capital gain would not be includible in DNI and so would be income taxed and surtaxed to the trust.

2. Alternatively, the trustee could distribute the stock in-kind. Under Section 643, the $2,500 of capital gain would not be recognized[68] and would not be NII to the trust; the recipient beneficiary would have a carryover basis of $7,500. If the beneficiary subsequently sold the stock, the $2,500 of capital gain would be taxed to the beneficiary, which is the same result "as if" the trust had been able to recognize and then distribute the capital gain.

The second choice might be appropriate if: (1) the beneficiary plans to sell the stock but has capital losses to offset that gain; (2) the beneficiary plans to sell the stock but has capacity to recognize NII without triggering the surtax because of the beneficiary's higher threshold; (3) the beneficiary plans to sell the stock and will pay the surtax, but that spares the trust from incurring that surtax, which could be a benefit for the other trust beneficiaries; or (4) the beneficiary does not plan to sell the stock

#20 Investing via a flow through entity, such as a partnership or LLC.[69] In a nutshell, any capital gain "flowing through" to a trust from such an entity will be in DNI. This is a fascinating and, I believe, little understood result.

> **Example**. Donor makes a gift of a Family LLC interest into a trust. During the year, the trust's share of capital gains recognized by the Family LLC is $100,000. That $100,000 will "flow through" and will be included in the trust's taxable income. In addition, that $100,000 will be included in the trust's DNI. This is the result regardless of distributions from the LLC to the trust.

As a starting point for understanding this result, it is incorrect to say that capital gains are excluded from DNI unless you can find a reason to include them. That might be a loose summary of the rules, but technically that states the statute backwards. The statute, IRC Section 643(a), defines "distributable net income" as "the taxable income of the estate or trust computed with the following modifications . . ." If we stop right there, all capital gains begin "in" DNI for the simple reason they are in taxable income. IRC Section 643(a)(3) then goes on to state:

> Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

Thus, capital gains are in DNI to begin with, and they are then excluded, but only if certain conditions are met. That's a crucial nuance because now the focus is not whether capital gains are "in" DNI (they always start in DNI) but rather whether the requirements of exclusion have been satisfied. In the case of a non-charitable distribution from a trust, IRC Section 643(a)(3) tells us that capital gains can be excluded from DNI only if two conditions

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[68] Gain will indeed be triggered if the distribution in-kind is to satisfy an obligation to distribute "income." See Regulations 1.651(a)-2(d) and 1.661(a)-2(f). In fact, that's a planning opportunity. See #14.

[69] This is not my discovery; I learned of this fascinating nuance from Carol Cantrell's paper: *Income Tax Problems When the Estate or Trust is a Partner*, ALI-ABA Planning Techniques for Large Estates, Nov. 15-19, 2010.

are both satisfied: the gains must be "allocated to corpus," and the gains must not be "paid, credited, or required to be distributed to any beneficiary during the taxable year." [70] Let us consider that first requirement to exclude capital gain from DNI: it must first be allocated to corpus.

"Corpus" is not a tax term; it is a fiduciary accounting term. A trustee can only allocate what is in fact received by the trustee; this is simply a truism. In the case of "phantom" capital gain flowing through from the Family LLC in this example, the trustee has nothing to allocate. When there is an actual distribution from the Family LLC, then there will be a receipt for the trustee to allocate, and under the UPIA, distributions from entities are deemed to be trust accounting "income."[71] In sum, it is an actual distribution that will trigger a fiduciary accounting allocation to income or corpus, not phantom income/gain. There's nothing unusual or counterintuitive about that.[72]

This means that the phantom capital gain flowing through from the LLC cannot be allocated to fiduciary accounting corpus (it's literally impossible to do so), which in turn means it therefore cannot be excluded from DNI, having failed to meet the first of the two requirements for exclusion. As a result, the capital gain begins in DNI, as does all capital gain, and it never becomes excluded. The result is that all capital gain flowing through from an LLC is in DNI. It is a separate matter whether there is sufficient cash flow to support a distribution to trust beneficiaries that would allow that capital-gain-in-DNI to be carried out.

Note the drastically different result, potentially, if the LLC instead distributed an asset in-kind to the trust and the trust then sold the asset. The distribution itself of property would be deemed principal/corpus under UPIA Section 401(c)(1).[73] Because of that, a sale of the asset would cause the resulting capital gain to be allocated to principal/corpus under UPIA Section 404(2).[74] Whether or not that capital gain would be in DNI would depend on the rules discussed earlier in this paper.

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[70] All the Authorization Method and Allocation Method analysis in this paper can be understood as these two requirements. If capital gains are allocated to "income" (Allocation Method 1), that addresses the first requirement. Allocation Methods 2, 3(a) and 3(b) address the second requirement – whether the capital gain has been "paid, credited, or required to be distributed to any beneficiary during the taxable year."

[71] See UPIA Section 401(b). The trust document or state law might deviate from this UPIA treatment.

[72] For those still unconvinced, consider this example. Assume a trust requires that "the trustee shall distribute to the beneficiary all capital gain, whether allocated to principal or income." Assume the trust has one asset: an interest in an LLC. Assume for the year the trust's share of capital gain is $100 but there are no distributions from the LLC. If the phantom capital gain were indeed "allocable," the trustee would be required to distribute $100, but there are no funds to distribute. The solution is to recognize that the capital gain here cannot be "allocated," and so the distribution requirement is not triggered. Only actual receipts can be allocated.

[73] Of course, state law or the trust document would impose a different result.

[74] For an interesting read on this issue, see *Crisp v. U.S.*, 76 AFTR 2d 95-6261 (34 Fed Cl 112), where the Federal Court of Claims considered this very argument: that there is too

Planning opportunity: Investing via an LLC would appear to allow for a helpful choice. If the capital gain is desired to be allocated to trust principal because it would not be included in DNI, that can be achieved via a distribution in-kind, followed by a trust-level sale. In contrast, if the capital gain is desired to be included in DNI, that can be achieved by a LLC-level sale of asset, causing the capital gain to "flow through" to the trust, in which case in will be in DNI.

#21 Causing part of the trust to be a "grantor" trust. All of the discussion so far has assumed a non-grantor trust, and the quest has been to understand how the trust's capital gain might be taxed to the beneficiary. Another possible avenue to that end result is to cause some or all of the trust to be taxed to the beneficiary under the "grantor trust" rules. That will not cause the trust's capital gain to be included in DNI, but it reaches the same mathematical result by having the capital gain taxed to the beneficiary. Here are two examples.

5-and-5 withdrawal powers. It is a common feature of a trust to grant a beneficiary the right to withdraw each year the greater of $5,000 or 5% of the trust. These parameters are intended to fall within the rules of Sections 2041(b)(2) and 2514(e), in which case there will be no gift tax consequence if the withdrawal power is not exercised in a year. For income tax purposes, however, a portion of the trust would be considered a "grantor" trust under Section 678. Because it is a "grantor" trust, if the power is exercised and a distribution made, the distribution will not carry out DNI[75]. But it is still a grantor trust, which means the capital gain allocated to the grantor portion of the trust, will be taxed to the "grantor." None of this involves including DNI in capital gain. However, it's offered as possibly another way to have part of a trust's capital gain taxed to a beneficiary.

Targeted creation of grantor powers. The following is an idea-in-progress, tossed out for consideration. Consider the following planning idea, illustrated by a "usual" Family Trust established under the estate plan of the first-to-die spouse. Assume it is a sprinkle trust for the benefit of the surviving spouse and descendants. Assume the trust has a value of $2,000,000 and plans to sell stock worth 5%, or $100,000, which will generate capital gain of $80,000. Assume that $80,000 will not be included in DNI, and the trust will owe 23.8% tax on that gain ($19,040).

Assume the trust document grants to someone (e.g., an independent trustee, an adult child, a trust protector) the power to grant a 5-and-5 power to a beneficiary. That's not unusual. Now further assume that when granting such a power to a beneficiary, the trust document allows (but doesn't require) that such withdrawal power can be limited to a specific asset.[76] Assume such a power is granted to the surviving spouse, but only with

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drastic a difference between a trust investing directly vs. through a partnership. Although the issues in _Crisp_ were a bit different than what's being discussed here, it's interesting (to me) how the court swatted this one away. I'll also add that there's nothing inherently wrong with having what appears to be an "easy" choice from among two very disparate tax results; ;just look at the 643(e) election discussed at #15, where this choice is statutory!

[75] See Revenue Ruling 67-241.

[76] Under Regulation 1.671-3(a)(2), a "grantor" trust can be grantor with respect to specific assets.

respect to the stock described. The trustee sells the stock, causing the withdrawal power to cease. If the power is limited to the greater of $5,000 or 5% of the trust, that would fall within the rules of Sections 2041(b)(2) and 2514(e), in which case there will be no gift tax consequence if the withdrawal power is not exercised in a year. But what is the income tax result?

The initial conversion of part of this trust from "non-grantor" to "grantor" should have no tax consequence. Although there are tax consequences when a trust goes from "grantor" to "non-grantor,"[77] the inverse is not true.[78]

Next, because the surviving spouse has a withdrawal power over this particular asset, under 678 and Regulation 1.671-3(a)(2), the trust should be considered a "grantor" trust only for that particular asset. If that's correct, the $80,000 of capital gain should be taxed to the surviving spouse. The result seems to be that this capital gain will be taxed to the surviving spouse, which spares the trust from being depleted by the $19,040 of taxes. This is the same motivation behind defective grantor trusts, but instead of applying to an entire trust, it could perhaps be more targeted as set forth in this example.

If there's a concern that the power could be deemed to continue to apply to the proceeds of the sale, then the power granted could perhaps be limited when created so that it applied only to the asset but not to any proceeds. That's analogous to an ademption by extinction, where a specific devise of property will fail if the property is no longer owned by the testator at death (unless the testator intended otherwise).[79]

None of this involves including DNI in capital gain. However, it's offered as possibly another way to have a trust's capital gain taxed to a beneficiary.

Planning Opportunity. First, I repeat: this is an idea-in-progress. I do not find much in the literature addressing the idea of a grantor trust status applying to a particular asset. Second, if this idea is sound, this presents a drafting opportunity to include in the trust such a power to grant a 5-and-5 power to a beneficiary and allow the grantor of the power the ability to limit the 5-and-5 power to particular assets.

[77] See Revenue Ruling 77-402; Treasury Regulation §1.1001-2(c), Example 5.
[78] Chief Counsel Advice 2009-23024 (Dec. 31, 2008).
[79] See Uniform Probate Code Section 2-606.