TEXTS:

**West's Taxation of Business Enterprises**  
1998 Edition  
Authors: Barton, Cove, Peroni and Pugh

**Income Taxation of Fiduciaries and Beneficiaries (Handout or Download from Web)**  
1998 Edition  
Authors: Abbin, Carlson and Vorsatz

**Internal Revenue Code and Regs**  
West's Smith or Rose Edition – 2000 or 2001

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Students will be graded on a plus/minus (+/-) basis (i.e. A, A-, B+, B, etc.).

The compilation of your Final Grade shall be as follows:

Midterm Examination - 40%
Final Examination - 40%
Class participation - 20%
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Total 100%
Income Taxation of Fiduciaries and Beneficiaries

1998 Edition

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A PANEL PUBLICATION
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Overview of the Fiduciary Entity

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§101  INTRODUCTION

The fiduciary entities referred to as estates and trusts exist as a result of state law. Both operate as the title holder of assets for which a designated party (i.e., the fiduciary) has the responsibility for their management and administration pursuant to powers and authority enumerated in the controlling document—a will in the case of an estate, a trust agreement in the case of a trust. The fiduciary of an estate is formally referred to as its executor or administrator, while the fiduciary of a trust is a trustee. Where the controlling document is either ambiguous or unclear concerning the nature or scope of the authority or powers granted to the fiduciary, resort to applicable state law may be required (i.e., a probate code, principal and income act, and other relevant provisions of the governing jurisdiction).

In addition to various administrative and managerial powers, the controlling document establishes the respective rights of the equitable owners (i.e., the beneficiaries in the case of a trust, or the heirs, devisees and designees in the case of an estate). In this capacity, the will or trust agreement establishes (1) the rights of various beneficiaries, or classes of beneficiaries, to receive income, principal, or both, and (2) the conditions, terms, and time frame within which the fiduciary is to effect distributions of income and/or principal to these beneficiaries or classes of beneficiaries.

§102  THE NATURE OF AN ESTATE OR TRUST

§102.1  Relationship of State Law to Federal Tax Treatment

A trust or estate is a separate legal entity created under state, not federal, law. As in the case of corporations and partnerships, federal law merely outlines the taxation of the trust or estate entity once it has been created. Morgan v. Commissioner distilled this concept into two sentences: "State law creates legal interests and rights. The Federal revenue act designates what interests or rights, so created, shall be taxed."1

Subchapter J is the pertinent section of the Internal Revenue Code (the Code) that establishes rules for the taxation of the income earned in a trust or estate.

Subchapter J can be broken into two parts: Part I deals with the taxation of estates and trusts, and part II deals with income with respect to decedent (IRD). However, before the rules of subchapter J can be applied, it must first be determined whether or not a trust or estate exists. As noted, this is a function of state law, not of the Code. The following paragraphs discuss the underlying principles of the trust and estate entities and the federal taxation of those entities.

§102.2  **Internal Revenue Code Does Not Define a Trust or Estate**

There is no specific definition of a "trust" in the Code. The Treasury regulations, however, provide that the term "trust," as used in the Code, refers to an arrangement created either by will or by lifetime transfer whereby a trustee takes title to property for someone's benefit (i.e., a beneficiary). The trustee has a fiduciary responsibility to protect and conserve the trust property for the beneficiaries under the laws applied by the state courts. While the creator of a trust, its beneficiary, and the trustee are often different persons, a single individual may occupy two or more of these roles.

Where the beneficiary and the creator of a trust are the same person, the "trust" may, or may not, be recognized as a separate entity by the Code, depending on whether certain requirements are met. Irrespective of whether the beneficiary or a third party is the grantor, however, the purpose for creating such a trust must be the same as for any other trust—that is, to protect or conserve property for the beneficiaries. In addition, the grantor-beneficiary, in such arrangements, must maintain the same relationship with the trust as he or she would have if a third party had created the trust for him or her.

In general, an arrangement will be treated as a trust under the Code if its purpose is to give trustees the responsibility of protecting and conserving assets for beneficiaries who cannot share in the discharge of this responsibility. It is well established that no "official document" is needed to create a trust as long as there is a reasonable certainty regarding the property in trust and the beneficiaries. Oral trusts may be created, but they must be established with definiteness and the intent of the creator must not be in doubt.

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1IRD concepts are discussed in detail in Chapter 14. Income in respect of a decedent (IRD) is an asset of a decedent's estate representing a right to taxable income that has not matured as of the date of death.

2Reg. §301.7701-4(a).

3Id.

4Id.

5Id.


§102.3 Distinction Between Estates and Trusts

While a trust is created by the affirmative act, an estate automatically comes into existence on the death of a person. There are numerous similarities between a trust and an estate with regard to their legal operation. The duties of a personal representative (i.e., executor) of a decedent correspond to the responsibilities of a trustee of a trust; the property in an estate is analogous to the principal of a trust; and the persons who hold an interest in the estate are similar to a trust’s remainder and income beneficiaries. The principal differences between an estate and a trust revolve around their different purposes, as reflected by a comparison of the responsibilities of the executor with that of the trustee.

The executor’s responsibility is to wind up the decedent’s affairs, marshall the decedent’s assets, pay debts of the decedent, and distribute any surplus to the heirs. Therefore, an estate usually has a relatively short existence. A trustee’s duties, on the other hand, are to conserve and manage the trust property for the benefit of the beneficiaries for the period specified in the governing document, usually a trust agreement. Unlike an estate, a trust will normally exist for several years and, in some instances, for two or more generations. Although there are differences in the purposes and legal operation of an estate and a trust, the federal income taxation of trusts and estates is identical, subject to a few exceptions.

§103 BIFURCATED OWNERSHIP ASPECTS

Every trust has at least three parties who are associated with it: the grantor or settlor, the trustee, and the beneficiaries (income and remainder). Each party transfers or receives a specific right or duty relating to the assets placed in the trust. The trustee holds legal title to the assets placed in trust, while the beneficiaries have an equitable or “beneficial” interest in the assets. These interests of the trustee and the beneficiaries combine to form a fiduciary relationship. A fiduciary relationship is an arrangement in which one person (the trustee) holds the legal title to property (res, corpus, or principal) subject to an enforceable obligation to keep or use the property for the benefit of another (the beneficiary). A trust is a fiduciary relationship with respect to property only.

General purpose of trusts. Though a trust may be established for almost any purpose that is legal within its state of residence, trusts have been used mostly for one or more of the following purposes:

- to hold or conserve family assets
- to separate investment responsibility from the beneficial enjoyment of the assets—income, principal, or both elements
- to control the flow of income to a specific beneficiary, as well as to sprinkle income among a class of family members

An estate may also arise on the filing of bankruptcy by an individual. IRC §1398.
Chapter 1. Overview of the Fiduciary Entity

- to provide for the distribution of assets through successive generations
- to maximize federal income and estate tax benefits through the use of income- and asset-shifting techniques
- to move asset appreciation out of one estate and capture it in another, while allowing some degree of control on the part of the initial transferor
- to facilitate the transition of ownership with minimal cost and time delays
- to avoid multiple (or any) probate proceedings and to protect the family’s privacy.

§104 ELEMENTS OF A TRUST OR ESTATE

§104.1 Creator

The creator of an estate or trust is the person who transfers assets to the fiduciary. A trust or estate is created by the transfer of property to the trust or estate entity. For a trust, this transfer may take place during the lifetime of an individual (an *inter vivos* transfer) or at death (a testamentary transfer). For estates, the transfer takes place at death. Once a transfer has been made to a trust or estate, the resulting entity begins to operate based on the terms of the trust agreement or the will, as refined by state law. Transfers made during the life of the creator may be revocable or irrevocable depending on the trust document. Transfers made at death, other than by operation of law or contracts, are accomplished in one of three ways: by the will of the decedent;¹ pursuant to the local laws of descent and distribution where no will is in effect (e.g., intestacy); and under an existing trust agreement that by its terms disposes of the trust’s assets at the death of its creator.²

The most common example of the third type of transfer is where an individual establishes during his or her lifetime a revocable (or living) trust³ that provides for the creation of one or more other trusts upon the death of the individual, which trusts are funded from the corpus of the grantor trust.

§104.2 Fiduciary

The fiduciary is the person holding *legal title* to the transferred property and who performs its duties on behalf of the beneficial interest holders. The fiduciary of a trust is referred to as a trustee; the fiduciary of an estate is its executor (or its administrator, in the case of intestacy).

A trustee’s powers are granted in the trust document and refined under state law. A trustee must hold the legal capacity to function in his or her role as trustee.

¹ If the decedent dies without a will, the transfer occurs pursuant to the state’s intestacy laws.
² Estate assets passing by will or under the laws of intestacy are typically administered under the supervision of the probate court.
³ Grantor trusts are discussed in detail in Chapter 12.
§104.2 Income Taxation of Fiduciaries and Beneficiaries

(i.e., to take title to assets transferred to the trust, buy or sell new assets, and so on). Further, the trustee must legally be able to perform all the administrative functions that were performed by the creator of the trust with respect to the assets transferred (i.e., to collect and distribute income, pay taxes, and so on). A person who holds only custodial powers over assets is not treated as a trustee. ⁴ In addition, a trustee who does not hold the right to control the withdrawal of cash from the trust, or select assets for purchase by the trust, will be viewed as a custodian by the Code. ⁵ Any trust in which the trustees' powers are severely limited should be scrutinized to ensure that a fiduciary relationship exists and that funds are not simply being held in a custodial or agency relationship. Executors or administrators of an estate hold similar powers as trustees, but an executor or administrator holds the additional responsibility of collecting the decedent's assets and paying the decedent's debts.

§104.3 Beneficiaries

Beneficiaries can be divided into two major groups: current beneficiaries and remainder beneficiaries. The current beneficiary may be entitled to all of the income of the trust or only income in the discretion of the trustee. The current beneficiary may be entitled to corpus in the discretion of the trustee. The remainder beneficiary receives what is left after an event such as the death of the income beneficiary or the income beneficiary's reaching a certain age, in which case the income beneficiary and the remainder beneficiary are the same individuals.

If the current beneficiary is entitled only to income and the remainder beneficiary is entitled to everything else, great tension is created in investment policy. Most investment advisors would believe that the greatest returns can be obtained through appreciation rather than income. Investing in fixed income investments for safety may be desirable but it is not desirable to require such investment to provide adequate distribution to the current beneficiary.

If the current beneficiary and the remainder beneficiary have similar interests (e.g., the remainder beneficiary is the current beneficiary after reaching a certain age or the remainder beneficiaries are the children of the income beneficiary) it is probably desirable to give the trustee discretion in distributing income and principal to the current beneficiary. In this manner, investment policy can maximize return and the distribution policy can be set in terms of the needs of the current beneficiary. If the remainder beneficiaries are adverse to the current beneficiary (e.g., the remainder beneficiaries are children of the first wife and the current beneficiary is the second wife) the instrument should use great care in defining what is to be distributed and who is to be preferred. Providing income to the second wife and the remainder to the children of the first wife is a recipe for arguments concerning investment policy between fixed income and equity.

§104.4 Trust Corpus

All trusts must have assets (res, corpus, and principal are terms used interchangeably) that are definite and determinable. In addition, the trust must receive from the creator assets that have a market value. Consequently, promises of future profits or the promise to contribute assets at some future date will not qualify as assets. Corpus has relevance in the administration of trusts and estates, since different beneficiaries (or classes of beneficiaries) are entitled to all or a portion of income and possibly to corpus distributions of a trust.

§105 PROBATE ESTATE

A probate estate is created on the death of an individual and constitutes a separate taxable entity that holds the property subject to probate administration by the executor or administrator. Income earned by the probate estate is taxed under the subchapter J rules discussed in §108. The decedent’s tax year ends as of the date of death, and the estate’s tax year begins the next day.

The probate estate will continue to exist for the period actually required by the fiduciary to perform the ordinary duties of administration, such as collection of assets and the payment of debts, taxes, legacies, and bequests. However, the period of administration of an estate cannot be unduly prolonged. The estate’s existence as a taxpayer is considered terminated for federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. An estate will be considered as terminated when all its assets have been distributed, other than those retained in good faith to pay unascertained or contingent liabilities.

§106 REVOCAIBLE TRUSTS

Revocable trusts (also known as grantor trusts and living trusts) are characterized by the fact that the grantor retains the right to revoke the trust, change its terms, or somehow regain control of the trust property. Typically, these trusts provide that on the grantor-owner’s death the trust becomes irrevocable, and assets are then administered according to the terms of the trust agreement. Grantor trusts

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2Garcia v. United States, 421 F.2d 1231, 70-1 U.S.T.C. ¶9,226 (5th Cir. 1970).
3Brainard v. Commissioner, 91 F.2d 880, 881-882, 37-2 U.S.T.C. ¶9,388 (7th Cir. 1937); Luce v. Burnet, 55 F.2d 751 (D.C. Cir. 1932) (citing Lucas v. Earl, 281 U.S. 111 (1930)).

§105 IRC §641(a)(3). The probate estate does not include all the assets of the decedent. Certain assets pass outside of probate. These include insurance, jointly held property, benefit plans with right of survivorship, benefit plans with beneficiary designation, assets in a revocable trust, and similar assets.

1Reg. §1.443-1(a)(2).
2Reg. §1.641(b)-3(a).
are always *inter vivos* in nature, since the grantor retains the right to alter the terms of the trust while he or she is alive. These trusts may be created with either few or nominal assets, with additional assets added over the life of the grantor or on the grantor’s death (i.e., an unfunded trust), or they may be funded completely at their inception with the bulk of the grantor’s estate. Typically, this type of trust is established to provide benefits to the grantor for his or her life, to manage the grantor’s assets in the event of legal incapacity, and to avoid probate. (Even if probate is not avoided because the trust is either not funded or only partially funded during lifetime, the use of a will that “pours over” to a revocable trust established during lifetime may be advantageous in eliminating the requirement of filing accountings with the court.) All income and principal is available for distribution to the grantor, and the trust can be terminated at any time during the life of the grantor. The grantor is treated as the owner of the trust for income and estate tax purposes.¹ Thus, the grantor is taxed on all income (both income and capital gains) earned by the trust whether or not distributed.² No shifting of income or assets away from the grantor is achieved with this type of revocable trust. Consequently, it is not a device for income tax or estate tax avoidance.

A grantor trust may take the place of a will, but if no will exists at the date of death, all assets that have not been transferred to the trust will pass under the laws of intestate succession of the grantor’s state of residence. Therefore, it is strongly recommended that an individual wishing to establish a grantor trust also execute a will to provide for those assets not placed into the trust during his or her lifetime.

The main estate benefit of a grantor trust is probate avoidance. Probate, as discussed later in this book, is a legal proceeding. Its principal purpose is to clear title of a decedent’s property passing to the heirs or beneficiaries under his will or the laws of intestate succession. At the end of the probate process, the court orders the decedent’s assets to be distributed to the beneficiaries or heirs. In the case of a grantor trust, however, the trust, rather than the decedent, holds legal title to the trust assets at the time of death. As a result, they are distributed in accordance with the terms of the trust document and are not required to pass through probate.

It is fairly easy to avoid probate in most states. In addition to the use of a grantor trust, assets may be disposed of by contract, or their title may be held in joint tenancy with right of survivorship. However, holding assets in joint tenancy form has disadvantages, because the decedent must give up some control over the assets during her lifetime, and the surviving joint tenant receives the basis step-up to fair market value only for the decedent’s one-half interest in the property.³

One final benefit of a grantor trust is the possibility for reducing professional fees and court costs on the death of the grantor. In many states, probate attorney’s and executor’s fees are determined by statute as a percentage of the gross probate estate. If the assets subject to probate are small or nonexistent due to the transfer prior to death of most of the decedent’s assets into a grantor trust, these legal

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¹IRC §§671-674 and 2038.
²IRC §671.
³IRC §1014.
and administrative costs may be reduced. However, attorney's fees and costs may be higher during the life of the grantor since a trust document is required, assets must be transferred to the trust, and some tax filings may be required.

§107 IRREVOCABLE TRUSTS

Unlike a revocable trust, an irrevocable trust may be *inter vivos* or testamentary. Once established, an irrevocable trust may not be changed by the grantor without approval of the courts. Irrevocable trusts permanently shift income and assets away from the grantor to the trust or beneficiaries. These trusts tend to have an intermediate to long-term duration and may span more than one generation. Often, an irrevocable trust includes provisions to control the distribution of income to named beneficiaries, or classes of beneficiaries, and to conserve trust assets either until beneficiaries reach certain ages or to benefit future generations. If an individual wishes to leave property to a minor, either during life or at death, a trust is often used so that there is a party with significant investment powers. Gifts can be made under the UGMA, but often the donor wishes to restrict the donee's access to the property beyond the age of legal majority.

Except where the grantor has retained a right to trust income or a right to control beneficial enjoyment of the trust assets, *inter vivos* transfers to irrevocable trusts shift assets out of the grantor's estate, transferring the asset appreciation to the trust. The transfer to the trust is generally subject to gift tax. Establishment of a testamentary irrevocable trust does not shift property out of the grantor's estate, but does allow for control over the property after the grantor's death.

§108 CLASSIFICATION OF A TRUST FOR INCOME TAX PURPOSES

For federal income tax purposes, most irrevocable trusts are characterized as being either simple or complex. The distinction between simple and complex trusts is a product of subchapter J and was originally intended to provide a less complicated system of taxation for those trusts that distribute all of their income to beneficiaries currently.

A trust is considered simple if (1) under the terms of the trust agreement all income is required to be distributed currently, (2) the trust makes no charitable contributions for the taxable year that are deductible under IRC §642(c), and (3) no corpus is distributed in the current year. The first test must be met for every year that the trust may be in existence, while the second and third tests must be satisfied only for the current year. Even though a trustee may be authorized by the governing document to make discretionary distributions to charities or to make distributions out of corpus, if the trust does not make these payments in a given year and is required to distribute all income currently, then the trust is

§108 IRC §651(a); Reg. §1.651(a)-4.
§108 Income Taxation of Fiduciaries and Beneficiaries

considered simple. A simple trust, and any other trust that is required to distribute all income currently, receives a personal exemption of $300. All other trusts are allowed a personal exemption of $100. For purposes of subchapter J, trust income (generally referred to as “trust accounting income” or “fiduciary accounting income”) means the net income of the trust that is available for distribution to the income beneficiaries based on the governing document and local law. Complex trusts are trusts that do not fall into the “simple” category. Specific differences in the taxation and character of the distribution deductions related to simple and complex trusts are discussed in Chapter 4.

Conduit for tax aspects: the DNI system. For federal income tax purposes, the basic characteristic of a trust or estate is that of a conduit; that is, these entities are vehicles designed to pass items of income along to another taxpayer. To the extent the income is distributed to the beneficiary, it is taxed to the beneficiary; to the extent it is not distributed, it is taxed to the trust. Income that is earned by a trust or estate is allocated to individual beneficiaries for federal income tax purposes based on the concept of distributable net income (DNI). An item of DNI that is passed out to a beneficiary has the same character in the hands of the beneficiary as it did in the trust (e.g., interest income earned by a trust continues to be interest income in the hands of the beneficiary). In order to avoid potential double taxation, a trust is allowed a deduction for any amount it distributes to the beneficiaries up to the amount of current DNI. The beneficiaries of the trust include the income distributed to them on their respective income tax returns as part of their adjusted gross income. The numerous limitations placed on the distribution deduction and the amounts included by the beneficiaries in their income are discussed in Chapter 4.

§109 EXISTENCE OF A FIDUCIARY ENTITY

§109.1 Overview

Except for disagreements concerning the termination of an estate’s status as a separate entity, there is little contention concerning the initial creation of an estate. On the other hand, whether a trust entity has been created has drawn much attention because of a variety of personal and business actions that often have been informally structured. Is it a trust or an agency relationship? A bank appointed as a custodian pending final determination of rightful ownership must file Form

²Reg. §1.651(a)-4(a).
³IRC §642(b).
⁴Id.
⁵IRC §643(b). Most states have adopted the Uniform Principal and Income Act or some version thereof, which specifies the items that are treated as income and those treated as principal for purposes of computing trust accounting income.
⁶The concept of distributable net income is discussed at length in Chapters 2 and 4.
Chapter 1. Overview of the Fiduciary Entity §109.2

1041 when it has broad management powers.¹ Yet a trust document was not determinative and agency not trust status existed where settlors retained complete control over trust operations and income disposition.² Similarly, a bank escrowee is not a fiduciary.³ The IRS concluded that agreements creating a debtor-relationship are not trusts,⁴ nor is an executor who merely collects rents from devised property a trustee.⁵ Beneficiary’s unlimited control over trust corpus resulted in no tax status where each was a trustee for other siblings⁶—form does not control. No trust existed in a number of custodial situations involving gift-to-minors acts or where minors could not take title.⁷ Yet an incomplete will document still resulted in a tax-recognized trust, since intent to do so was evidenced.⁸ But, if real estate is subject to estate administration prior to transfer to devisees (widow and trust) the executor is a taxpayer fiduciary,⁹ as is a bank if it receives real estate proceeds as a court-appointed trustee.¹⁰

§109.2 Court-Created Relationships

Trust is deemed established. As a general rule, the Code¹¹ requires tax to be paid on income accumulated for the benefit of unborn or unascertained person(s) with contingent interests. However, the liability for such tax on an entity level first requires a determination that a trust, rather than agency, custodianship, or guardianship status, is considered to exist. In the following instances, courts have found that the facts argue for the existence of a trust.

- Discretionary powers of administration or management, provided the person holding those powers performs duties ordinarily assigned to a trustee¹² when appointed by court to hold funds pending the outcome of litigation.
- Though a bank was appointed as “custodian” of land trust shares and was the repository of income earned during a dispute over ownership, a trust was considered to exist because it had the power to vote trust shares,

reinvest earnings, retain legal counsel, and held other broad investment and administration powers.\textsuperscript{13}

- The scope of investment and management powers granted to an individual resulted in the deemed creation of a trust where that individual was ordered to hold and invest condemnation proceeds until the life tenant's death (actual period was 51 years), then pay out the proceeds to the then living issue of the life tenant.\textsuperscript{14}

**Agency or custodian status.** In the following fact patterns, courts have concluded that property was held under an agency or custodianship relationship and that a trust was not deemed to exist.

- The mere holding of funds, and earnings derived from those funds, on behalf of another without accompanying management responsibility.\textsuperscript{15}
- A trust was not considered to exist where a federal court deposited funds arising pursuant to a settlement between a corporation and its shareholders pending determination of the distributees entitled to receive the fund proceeds.\textsuperscript{16} The resulting arrangement reflected an absence of those fiduciary responsibilities typical of a trust.
- Where a court escrowed wrongful death proceeds with a bank, a trust was not considered to exist where the responsibilities of the escrowee were limited to holding the funds for future distribution and investing the proceeds for interest.\textsuperscript{17}

**§110 IRS ISSUES WARNING THAT ABUSIVE TRUST ARRANGEMENTS WILL BE IGNORED**

The apparent mass marketing of nongrantor trusts as a device to effect a transfer of business or personal assets in a manner that reduces or eliminates federal income tax, while the transferor essentially retains the full benefit from these assets, has generated the ire of the Internal Revenue Service. Recently, it issued a lengthy and strongly worded notice\textsuperscript{1} that has culminated in the Justice Department filing suit against individuals, a trust, and a corporation, alleging that they sold and distributed "abusive tax shelter" packages through financial planners, as well as held seminars for these planners informing them how to sell these "purportedly nongrantor trust documents."\textsuperscript{2} In its notice,\textsuperscript{3} the IRS cautioned taxpayers to be

\textsuperscript{13}Rev. Rul. 69-300, 1969-1 C.B. 167.
\textsuperscript{14}Buckley v. Comm., 66 F.2d 394, 1933 CCH ¶9,456, cert. denied, 290 U.S. 698, 54 S. Ct. 208 (2d Cir. 1933).
\textsuperscript{15}Priv. Ltr. Rul. 8831055.
\textsuperscript{2}Notice 97-24, 1997-6 IRB 6.
\textsuperscript{3}U.S. v. Estate Preservation Services, Henkell, Grace and Sefton, (N.D. Cal), Tax Analysts, 97 TNT 123-62 (June 26, 1997).
\textsuperscript{3}Supra note 1.
wary of what it considered to be abusive trust arrangements not allowed under current tax law that ignored the true ownership of assets or the substance of the transaction. It also stated that on occasion these arrangements involve the use of multiple trusts in an attempt to provide for various aspects of a taxpayer’s lifestyle needs. Five examples of trust arrangements that the IRS considers to be abusive were summarized in the notice as follows:

The business trust. An owner of a business transfers business assets to a trust in exchange for units of beneficial interest. The business trust then makes payments to the unit holders of the trust, purporting to reduce the taxable income of the trust, to the extent that little or no fiduciary income tax is payable. As part of the arrangement, the unit trust holder claims that self-employment tax is reduced or eliminated because of the interposition of the trust entity.

The equipment or service trust. As an ancillary to the business trust, the equipment or service trust is formed to hold equipment that is leased or rented to the business trust at inflated rental rates. As part of this arrangement, often the taxpayer and the trust take inconsistent tax positions, (e.g., (1) a claim by the former owner of the equipment that no taxable gain results on the transfer to the trust in exchange for units, since value of the units cannot be ascertained, and (2) a claim by the trust that the depreciable basis of the property is determinable with reference to its inflated “purchase” price).

A family residence trust. In this circumstance, an owner of a family residence transfers it, inclusive of all accoutrements and furnishings, to a trust that immediately leases the “residential package” back to the transferor. The trust claims depreciation deductions and other deductible expenditures in order to reduce or eliminate any taxable income. Similar to the “equipment or service trust” arrangement, inconsistent tax positions often are taken (i.e., the transfer to the trust results in a step-up in basis of the property for depreciation purposes, while no gain or loss is realized to the grantor because of a lack of an ascertained valuation with respect to the exchanged interests).

The charitable trust. Assets are transferred to what purports to be a charitable trust and the transferor claims either (1) that these sums are deductible on the individual’s income tax returns, or (2) that payments made by the trust are charitable contribution deductions to the trust in computing its fiduciary income tax liability. In most circumstances, the payments made to charitable organizations by the trust relate principally to personal education, living, or recreation costs of the transferor or members of the transferor’s family.

The final trust. Ordinarily involving the use of multiple trusts, the final trust is formed to hold trust units that the transferor receives from formation of the other trusts described above. It is a final distributee of income from these trusts. As part of the “arrangement,” the final trust usually is formed under laws of a foreign country that will impose little or no tax on its income.
The IRS has indicated that it is reviewing these trust arrangements as part of a "national compliance strategy" to (1) identify abusive trusts, and (2) consider civil and/or criminal penalties, where appropriate. This concern is based upon little meaningful change in taxpayer's control or benefit over assets placed in trust when at the same time promoters promise significant tax benefits to them. The IRS also suggests that taxpayers who have entered into these arrangements should consider filing amended returns to correct previous filings.

In conjunction with this lawsuit, the Justice Department has issued a press release stating that its action is part of an ongoing effort to halt the sale and distribution of illegal tax preparation advice designed to interfere with the IRS's proper administration of tax laws. A court order also was requested that would require the defendants to stop marketing the purported nongrantor trust documents and to cease making false statements concerning the tax aspects thereof. As part of its submission, the Justice Department set forth the whole panoply of the promoters' claims regarding these trust arrangements, essentially reiterating all of the approaches that were discussed above in the IRS notice. While, to date, none of the planners involved has been charged with wrongdoing, a Justice spokesperson has suggested that taxpayers using such "abusive tax shelter" schemes would also be subject to criminal prosecution as well as interest and penalties.

§111  COMMENCEMENT OF FIDUCIARY ENTITY FOR TAX PURPOSES

§111.1 Inter Vivos Trust

A trust created during a settlor's lifetime, often described as an inter vivos trust, typically begins its existence upon meeting the requirements of applicable state law. As a general rule, these requirements include: (1) an expressed intent to

"That business equipment can be transferred at no cost to a trust giving the trust a higher basis in the equipment than available to the taxpayer for the purposes of improperly avoiding taxes; that equipment that has been fully depreciated by a taxpayer can be transferred by the taxpayer at no cost to a trust, which can then rededicate the same equipment for the purposes of improperly avoiding taxes; that equipment transferred to a trust by a business can be leased back to the business at inflated rates thereby transferring income from the business to the trust for purposes of improperly avoiding taxes; that supplies and services can be purchased for a business through a trust at a significant mark-up to the business by the trust thereby transferring income from the business to the trust for purposes of improperly avoiding taxes; that income paid to a trust by a business at inflated rates can be "funneled" back to the personal account of the taxpayer without any tax consequences; that personal residences of taxpayers can be transferred to a trust and then depreciated as a business asset for the purposes of improperly avoiding taxes; that maintenance and upkeep on a personal residence can be fully deducted by a trust for the purpose of improperly avoiding taxes; that other personal expenses can be paid through a trust in order to improperly obtain tax benefits not available to individuals; and that individual taxpayers can set up their own charities to improperly amass assets tax-free and to hide money from the Internal Revenue Service.

establish a trust; (2) the satisfying of legal formalities, if any, required by state law; (3) the transferring of legal title in the assets to the trustee; and (4) formally establishing the existence of a trustee, whether it be the settlor or another person. As a practical matter, issues involving the exact date of the commencement of a trust’s existence rarely now arise in light of the requirement that all trusts file their tax returns on a calendar year basis. As such, the delay often occurring between trust document drafting and the completion of those other steps required for completing the execution of a trust will have little impact on tax reporting, as those steps ordinarily will be accomplished within a single calendar year. In the relatively unusual instance where an asset transfer occurs in a year subsequent to the year of document execution, the latter act (i.e., asset transfer) likely is the practical commencement of the trust for tax purposes because, without a res and resultant income therefrom, it has no tax relevance.

§111.2 Estate

Fiduciary status with respect to an estate, whether described an executor (executrix) or administrator (administratrix), commences immediately upon the first day of the period of estate administration (i.e., the decedent’s date of death). As such, federal taxation of the estate commences immediately upon the decedent’s death, even though a period of time elapses prior to the fiduciary’s formal appointment to that position and its full compliance with the requirements of applicable local law. Income tax responsibility of the estate entity extends both to income earned prior to death, but not received until thereafter by the estate (IRD under IRC §691), and income earned during the period of administration on assets for which the estate has fiduciary responsibility during that period. Since assets held in joint tenancy with right of survivorship, life insurance paid to named beneficiaries other than the estate, employee benefits payable to assigned beneficiaries other than the estate, trusts that remain in existence after the death of the decedent, etc., bypass the decedent’s probate estate, income realized on such assets during the period of estate administration is excluded from the computation of estate income.

§111.3 Overlap Between Estates and Testamentary Trusts

A typical area of contention is the identification of the appropriate taxpayer where the same person is the executor and the trustee of a trust established under the will. In such circumstances, the issue in question is “When does an estate’s tax status terminate and a successor testamentary trust’s tax status commence?” As a rule, administrative informality and undue delays in the administration of an estate tend to result in a blurred line of demarcation between acts done on behalf of the estate and those more properly attributable to the successor trust. Confusion in these areas can involve not only the proper assignment of taxable status among the various fiduciaries with respect to a transaction, but also the implementation of the subchapter J distribution system and its resultant impact on individual beneficiaries. Where the same person is named to both fiduciary
posts (executor and trustee), the executorship continues only so long as the duties of administration are required; once those have been accomplished, estate administration is considered to be completed, the estate ceases to exist as a taxable entity, and the fiduciary’s duties as trustee are deemed to have begun.\(^2\) An extreme case exemplifying this principal is that involving an executor-trustee who had continued estate administration for 14 years, in spite of the fact that the will indicated decedent’s intention that the testamentary trust was to be established as soon as practicable.\(^3\)

A second area of contention occurs where probate law and fiduciary accounting concepts are confused with tax accounting. Thus, where a fiduciary disposes of estate assets at a gain during estate administration, the estate, not the trust (or individual devisee), is taxable thereon, even though the stock was devised to the trust (or individual) and the decedent intended the income and gain attributable to that property from his date of death to be distributed to the devisees.\(^4\) The income is trust accounting income “belonging” to the devisees, but taxable only if and when distributed; the tax treatment is dependent on the estate’s DNI (and its makeup) as well as the testamentary trust’s DNI in the actual tax year of distribution.\(^5\) There is an exception to this general rule, however. Where an estate is ready and able to distribute specifically devised property to the devisee but the devisee directs the executor to sell the property and distribute the cash proceeds, courts have held that the resulting gain is taxable to the devisee, rather than the estate. Under such circumstances, the sale is deemed to have been made as an accommodation to the ultimate recipient of the property. In effect, the sale was not made by the executor pursuant to estate administration, but by the executor acting as the agent of the devisee.\(^6\)

\section*{§111.4 Testamentary Trusts}

A \emph{testamentary} trust may arise out of an estate under the terms of a will or from an inter vivos trust (usually a revocable or grantor trust). On occasion it may also arise from a newly formed split-up of an irrevocable lifetime trust whose terms provide for different distribution patterns upon the death of a life beneficiary.

The commencement of a testamentary trust’s existence is the most contentious of the entire group discussed herein. As noted below in §111, the disputes concerning the length of an estate’s federal income tax existence often involve, as well, the point in time when the testamentary trust is considered to have come into being, often on a “deemed” basis. Essentially, the end of a reasonable period for estate administration must be the commencing point for the testamentary trust

\footnotesize\(^2\)Reg. §§1.641(b)-3(a).
\(^3\)Alabama-Georgia Syrup Co. v. Commissioner, 36 T.C. 747 (1961), rev’d on other issues sub nom. Whitfield v. Commissioner, 311 F.2d 640, 63-1 U.S.T.C. ¶9,124 (5th Cir) that held the testamentary trust was taxable on income received by the estate.
\(^5\)See Chapter 5 for detailed discussion.
established under the will. This follows because a testamentary trust does not automatically come into existence upon death of an asset owner. At the earliest, it begins when an executor (or administrator) effects a distribution from the estate to the title and possession of the trust; at the latest, it occurs upon performance of the final acts of probate administration under state law, including the distribution (or deemed distribution) of the residuary estate to the testamentary trustee. The Tax Court stated that "if a residuary trust is created by a will, the determination for Federal tax purposes of when the trust begins and receives its corpus almost invariably depends on a determination of when the administration of the estate from which the residue is obtained comes to an end." Thus, an elongated 11-year period of probate administration that was required to finally discharge the debts and tax liabilities of the estate did not result in the commencement of a testamentary trust’s existence, since the trust had not been funded by distributions until after all these necessary administration responsibilities had been accomplished. The favorable holding was entirely dependent on the facts and circumstances at issue. The Tax Court concluded that the extended period of administration was dictated by the need to achieve final determination and satisfaction of the decedent’s debts and tax liabilities and that the executor had not been remiss in deferring asset distributions to the trust until such matters had been resolved.

As noted above, testamentary trusts may be established by inter vivos trust documents, usually grantor/revocable trusts that become irrevocable on the death of the settlor. In such circumstances, the testamentary trust’s existence commences immediately at death and the trustee of the predecessor entity either continues, or succeeds to, the trusteeship of an already existing entity (and its assets) that through death has obtained a different tax status. Often these entities eventually will be required to create new trusts or subtrusts after completion of a period of trust administration arising because of the settlor’s death. As a general rule, the existence of these new trusts and subtrusts will not commence until asset distributions pursuant to the funding of these new entities takes place.

§112 HOW LONG DOES THE FIDUCIARY EXISTENCE CONTINUE?

§112.1 Termination of an Estate

Most of the situations considered affect estates, since the government argues their tax existence as a separate taxpayer has been extended inappropriately. The Tax Court has concluded that an estate’s existence was not unduly prolonged, even though creditors were paid, where it continued to discharge annual administration

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United States v. Britten, supra note 4.


Id. The court held that the residuary trust did not come into existence until the residue was distributed by the trustee. This did not occur until three years after the testator’s death.

Neuman v. Commissioner, 28 T.C.M. 724, T.C. Mem. 1969-140.
and court costs,\footnote{Patton v. United States, 59-1 U.S.T.C. $9,459 (N.D. Tex. 1959).} while a will contest was pending,\footnote{Rev. Rul. 75-339, 1975-2 C.B. 244.} or where a delay occurred in corpus being transferred to a charitable foundation while waiting for executors to become trustees.\footnote{Johnson Est. v. Commissioner, 88 T.C. 225 (1987); Manufacturers Hanover Trust Co. v. United States, 410 F.2d 767, 69-1 U.S.T.C. $9,402 (Ct. Cl. 1969).} The IRS has stated that advance rulings will not be issued on whether an estate administration period is reasonable or unduly prolonged,\footnote{Rev. Proc. 92-3, 1992-2 C.B. 561.} but it has evaluated administrative activities appropriate to recognizing estate administration.\footnote{Rev. Rul. 57-133, 1957-1 C.B. 200; Rev. Rul. 59-375, 1959-2 C.B. 161; Maresca Trust v. Commissioner, 46 T.C.M. 1147, T.C. Mem. 1983-501.}

Completion of ancillary estate proceedings is not required for an estate's income tax status to end.\footnote{Miller v. Commissioner, 39 T.C. 940 (1963), aff'd on another issue, 333 F.2d 400, 64-2 U.S.T.C. $9,579 (8th Cir. 1964).} Thus, where the court approves a special bond filed by an executor as sole estate beneficiary, the IRS concluded a final asset distribution occurred that terminated the estate.\footnote{Rev. Rul. 73-397, 1973-2 C.B. 211.} Final residue estate distribution is not necessarily an act that continues the estate's existence.\footnote{Berger Est. v. Commissioner, 60 T.C.M. 1079, T.C. Mem. 1990-554.} On the other hand, the Tax Court concluded that litigation against the estate\footnote{Richards v. United States, 68-1 U.S.T.C. $9,288 (N.D. Tex. 1968); Wylie v. United States, 281 F. Supp. 180, 68-1 U.S.T.C. $9,287 (N.D. Tex. 1968).} or decedent\footnote{Russell v. Commissioner, 21 T.C.M. 1178, T.C. Mem. 1962-223.} will maintain the estate's income tax "life." Trust existence was found wanting when wills establishing them were still under estate administration.\footnote{Neuman v. Commissioner, 28 T.C.M. 724, T.C. Mem. 1969-140.}

The courts have concluded that charitable trusts established for 500 years should be recognized,\footnote{Holdeen v. Commissioner, 292 F.2d 338, 61-2 U.S.T.C. $9,580 (2d Cir. 1961).} as should similar "other long-term" trusts for noncharitable beneficiaries.\footnote{Holdeen Est. v. Commissioner, 34 T.C.M. 129, T.C. Mem. 1975-29.} Although the trust's existence generally is established by the terms of the trust instrument, they are allowed a reasonable period after that date to accomplish a "winding-up." Thus, even a 10-year delay in trust final distribution was not fatal.\footnote{Weston v. Commissioner, 24 T.C.M. 1439, T.C. Mem. 1965-264; Dominion Trust Co. of Tenn. v. United States, 786 F. Supp. 1321, 92-1 U.S.T.C. $50,136 (D. Tenn. 1992).}

**Period of estate administration—regulatory and decisional interpretations.** An executor, also named as successor trustee, is deemed to be acting in its capacity as trustee once its administrative duties with respect to the estate are complete. It was found irrelevant that the fiduciary had failed to obtain its formal discharge as executor or that a court order designating such discharge had not been received.\footnote{Reg. $1.641(b)-3; Russell v. Commissioner, T.C. Mem. 1962-223; Estate of Byron v. Commissioner, T.C. Mem. 1963-182.}
• An estate's administration period cannot be extended by engaging in activities outside of administrative duties.\(^{16}\)
• The duration of an executorship for federal tax purposes is not controlled by state law concepts.\(^{17}\)
• Actual estate settlement, not a theoretically more efficient time frame, controls the allowable duration of an estate.\(^{18}\)
  • The estate continues until a residue can be determined\(^{19}\) or all the estate's affairs are cleaned up.\(^{20}\)
  • Filing of a bond for taking over by a fiduciary does not overcome incomplete estate administrative activities.\(^{21}\)
• While capricious continuation of estate administration will be ignored,\(^{22}\) reasonable cause (even of a limited amount) will be recognized to allow/require the estate to be treated as the taxable entity.\(^{23}\)
  • The nature of assets held by an estate may justify prolongation of estate duration.\(^{24}\)
  • The settlement of disputed claims is a proper reason for continued estate administration.\(^{25}\)
• The determination as to whether the administration of an estate has been completed essentially is fact-based.\(^{26}\)

§112.2 Termination of a Trust

The termination of a trust's existence depends both on the terms of the governing document and on the actions of the trustee to effect distribution of the trust assets (res). Regulations\(^{27}\) state that the mere occurrence of a stated terminating event (e.g., a fixed date, the age of a beneficiary, the occurrence of the event by which the duration of the trust is measured, etc.) does not automatically terminate a trust's existence for federal income tax purposes. Rather, the fiduciary is allowed a reasonable time to wind up the administration of the trust and to distribute trust assets to those persons entitled to succeed to the property on termination of the trust.\(^{28}\) On the other hand, a trust may be deemed to have been terminated

\(^{16}\) Miller v. Commissioner, 39 T.C. 940, aff'd. 333 F.2d 400, 64-2 U.S.T.C. ¶9,579 (8th Cir.).
\(^{17}\) Petersen v. Commissioner, 35 T.C. 962 (1961); Neuman v. Commissioner, T.C. Mem. 1969-140.
\(^{18}\) Estate of Cohen v. Commissioner, 8 T.C. 784 (1947).
\(^{21}\) IT 3556, 1942-1 C.B. 130.
\(^{24}\) Williams v. Commissioner, 16 T.C. 893 (1951); Tuttle v. Commissioner, T.C. Mem. 1955-111.
\(^{26}\) Patton v. U.S., 59-1 U.S.T.C. ¶9,459, 3 AFTR 2d 1475 (N.D. Tex.).
\(^{27}\) Reg. §1.641(b)-3(b).
\(^{28}\) Id.
§112.2 Income Taxation of Fiduciaries and Beneficiaries

for federal income tax purposes\(^{29}\) even though not all acts of termination required by state law have been accomplished. Where the remaining acts to be performed for legal termination are purely ministerial (e.g., a final accounting), rather than substantive, (e.g., a court order required prior to a final distribution being allowed), the courts have found that a termination of the taxable entity has occurred.\(^{30}\) As noted above, the regulations\(^{31}\) allow a trustee reasonable time to complete trust administration, even after the stated termination date.\(^{32}\) However, a hold-back of some assets in good faith to pay contingent or unascertained liabilities and expenses will not per se be sufficient to assure a trust's continued existence.\(^{33}\) As in the case where an estate's administration is deemed to have been delayed excessively, the tax status of a trust will be deemed terminated when the distribution of trust corpus is considered to have been unreasonably delayed.\(^{34}\)

§113 SUMMARY

Trusts and estates are separate and distinct taxable entities under the tax law. A trust or estate is established under each state's law and is governed by the document creating it as refined by state law. The federal law serves only to determine the taxability of the income and expense items coming into and going out of the trust or estate. Trusts and estates are taxed similarly to individuals, with some notable exceptions such as the deduction allowed for income distributed to the beneficiaries and the unlimited charitable deduction. These exceptions are contained in subchapter J of the Internal Revenue Code (§§641-691), essentially a "mini IRC" within the all-encompassing tax statute. These special provisions supersede the basic Internal Revenue Code rules and control the federal income tax treatment of fiduciaries (estates and trusts) and beneficiaries and distributees thereof. Trust and estates operate using the conduit approach to taxation in that income distributed to the beneficiaries retains the same character in the hands of the beneficiaries as it had in the hands of the trust or estate.

A trust continues for as long as its instrument allows, subject to restrictions imposed by state law. At the end of that period, the trust distributes its assets to the remaindermen. An estate comes into existence at death and exists for a relatively short period of time (i.e., the main purpose of an estate is to collect and distribute the decedent's assets).

The fiduciary of a trust must have full control over the assets placed into the

\(^{29}\)Id.


\(^{31}\)Reg. §1.641(b)-3(b).

\(^{32}\)Id. Priv. Ltr. Rul. 9147022.

\(^{33}\)Id.

\(^{34}\)Reg. §1.643(b)(3)-3(b). The criteria for trust termination appear to be applied more liberally than for an estate. For instance in Weston v. Commissioner, 24 T.C.M. 1439, TC Mem. 1965-264, a trust by its terms could have been terminated 10 years earlier if the beneficiaries agreed to do so; since they did not, its tax status continued as a fiduciary. See also Dominion Trust Co. of Tenn. v. United States, 786 F. Supp. 1321, 92-1 U.S.T.C. ¶50,136 (D.C. Tenn.), aff'd in unpublished opinion Oct. 14, 1993, where undue postponement of termination of a trust was found not to exist.
trust, and those assets must have a value in order for the trust to exist. The fiduciary is obligated by state law to conserve and manage the assets of the trust for the income and remainder beneficiaries. Probate estates are similar to trusts, but their executors are charged with the additional responsibility of collecting the assets from the decedent’s estate.

§114  COMPREHENSIVE EXAMPLE

§114.1  Facts

Marco established a grantor trust on January 1, 1993, into which he placed his entire portfolio of stocks, bonds, and other investments. Marco named himself as initial trustee. On death or incapacity, XYZ bank, as custodian of Marco’s assets, was to become successor trustee with full investment powers.

The terms of the trust allowed Marco to revoke the trust at any time during his life. Concurrently with the establishment of the trust, Marco executed a will that left any remaining assets he owned to the grantor trust (i.e., a “pourover” will). Marco’s remaining assets consisted of two homes and several vintage Packard automobiles.

Marco’s only son, Brad, had a keen interest in ensuring that his father’s assets were safely kept and that they would be available for distribution on Marco’s death. Marco perceived Brad to be somewhat of a spendthrift and had serious concerns about Brad’s ability to manage the portfolio should anything happen to Marco. In addition, Marco was certain that Brad would never get a job and support himself as long as Brad had access to Marco’s money.

On May 1, 1997, Marco was permanently incapacitated with a terminal illness and XYZ bank became successor trustee. Marco was immediately hospitalized, and he died some 14 months later. During his illness, the XYZ bank, as trustee of the grantor trust, continued to buy and sell stocks and maintain Marco’s accounts based on the terms of Marco’s trust document.

On Marco’s death, both homes and the autos passed to the probate estate as they were not part of the grantor trust and were subject to the provisions of Marco’s will. Since Marco was virtually debt-free at death, the probate estate closed in nine months, and the homes and the cars were transferred to the grantor trust as directed by Marco’s will.

The terms of the grantor trust provided that an irrevocable trust be established for Brad with the balance of Marco’s estate, after the payment of debts and estate taxes. Marco named his lawyer, Linda, as the initial trustee. The trustee was directed to pay for Brad’s schooling up to age 30 and to pay for any healthcare needs Brad may have at any time during his life. Finally, Linda had the authority to distribute trust income and principal to Brad at her discretion based on any standard she chose to establish. The trust document provided that on Brad’s death, the trust corpus would be distributed to Brad’s children if they were older than 30 or remain in trust until they were 30. If Brad had no children, the trust corpus would be distributed to the other family members based on allocations made in the trust document.
§114.2 Discussion

Marco’s main concern was to control his son’s spending habits and get him to support himself. Had Marco left the money to Brad outright, this goal would not have been achieved. Marco established a grantor trust to manage his money during his lifetime and to avoid probate of his substantial investment portfolio. This proved to be beneficial since Marco became suddenly incapacitated and was unable to manage his funds for a period prior to his death. After his death, Marco’s will controlled disposition of those assets that were not transferred to the grantor trust during his life. By giving the trustee discretionary power over distributions to Brad, Marco provided the trustee with some leverage to force Brad to support himself.

§115 1997 LEGISLATION ENACTED

All but one of the proposals made in 1995 were enacted into law in 1997. (The only exception being a proposal to limit an estate’s fiscal year choice, discussed in §508.) Some of these changes liberalize treatment by allowing estates to (a) utilize the 65-day “look back” election presently available to trusts, and (b) apply separate share rules similar to those now available to trusts. On the restrictive side, estates will now be subject to the same loss disallowance rules of §§267 and 1239 that presently apply to trusts. The other changes effected by the 1997 legislation include the following:

- Revocable trusts may elect (irrevocably) to be treated as part of a decedent’s estate so that more favorable rules applicable to estates also will apply to them.
- The “throw-back” tax calculations on accumulation distributions by domestic trusts have been revoked. (Note that these rules continue for foreign trust beneficiaries.)
- The calculation of tax based on the donor’s marginal tax rate brackets for precontribution gain on trust sales made shortly after contribution have been revoked.

Pre-need funeral trusts may elect to be considered a taxable entity, rather than as a grantor trust, to simplify reporting requirements and attain overall administrative ease.

Details of these changes are reflected in the appropriate paragraph to which they relate.

2 H.R. 2517, 104th Cong., 1st Sess., §14605 (October 20, 1995).
§116 TRUST AND ESTATE INCOME TAX RATES

<table>
<thead>
<tr>
<th>1998 Taxable Income Tax Rate</th>
<th>Base Amount</th>
<th>Amount in Bracket</th>
<th>Cumulative Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>First $1,700</td>
<td>15%</td>
<td>$255</td>
<td>$255</td>
</tr>
<tr>
<td>$1,701 to $4,000</td>
<td>28%</td>
<td>$255</td>
<td>744</td>
</tr>
<tr>
<td>$4,001 to $6,100</td>
<td>21%</td>
<td>899</td>
<td>651</td>
</tr>
<tr>
<td>$6,101 to $8,350</td>
<td>36%</td>
<td>1,550</td>
<td>810</td>
</tr>
<tr>
<td>Over $8,350</td>
<td>39.6%</td>
<td>2,360</td>
<td>Indef.</td>
</tr>
</tbody>
</table>

These brackets are indexed for inflation commencing in calendar year 1994.² (Since these rates are often higher than the beneficiaries’ rates, it will be advantageous from a tax viewpoint to distribute income to the beneficiaries.)

²IRC §101(e), as amended by the Omnibus Budget Reconciliation Act of 1993, §13201(a). In 1997, fully indexed in all brackets, the rate schedule was as follows:

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $1,650</td>
<td>15% of the taxable income</td>
</tr>
<tr>
<td>Over $1,651 but not over $3,900</td>
<td>$240 plus 29% of the excess over $1,651</td>
</tr>
<tr>
<td>Over $3,901 but not over $5,950</td>
<td>$856 plus 21% of the excess over $3,901</td>
</tr>
<tr>
<td>Over $5,951 but not over $8,100</td>
<td>$1,476 plus 36% of the excess over $5,951</td>
</tr>
<tr>
<td>Over $8,100</td>
<td>$2,232 plus 39.6% of the excess over $8,100</td>
</tr>
</tbody>
</table>
2
Relationship of Fiduciary Accounting and Tax Concepts

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§201 OVERVIEW

Trust accounting income (TAI), sometimes referred to as fiduciary accounting income (FAI), represents the amount of “net” receipts (i.e., receipts allocated to the income account, offset by expenses allocated to the income account) that are available for current or future distribution to the income beneficiaries. The allocation of receipts and expenditures to the income or principal accounts are made pursuant to a set of rules generally referred to as “fiduciary accounting.” The application of these fiduciary accounting rules is, in turn, based first on the provisions contained in the applicable controlling document and second, where the controlling document is either silent or ambiguous, on applicable state law (i.e., the Principal and Income Act).

When dealing with fiduciary accounting, it is important to understand that these rules (1) are independent of, and often unrelated to, federal and state fiduciary income tax concepts, (2) are unrelated to, and typically very different from, generally accepted accounting principles (GAAP) accounting, and (3) vary from state to state since each state has tended to tinker with the Principal and Income Act. This chapter will discuss the fiduciary accounting rules generally, as well as how they interact with federal fiduciary income tax concepts. It will also review areas where ambiguities and uncertainties continue to exist and proposals to address these areas, and it will update the Uniform Act, last modified in 1962. Also analyzed is the impact of legislation adopted recently in a number of states and likely to become part of a newly revised UPIA that significantly liberalizes fiduciary investment philosophy.

§202 IMPORTANCE OF FIDUCIARY OR TRUST ACCOUNTING INCOME AND RELATIONSHIP TO IRC DEFINITIONS OF INCOME

A key concept that is often misunderstood or frequently overlooked is the difference between fiduciary and federal income tax accounting. Within this context,
it is important to realize that there are really three separate calculations of income that must be made to prepare a fiduciary income tax return: fiduciary, or trust accounting, income (TAI); distributable net income (DNI); and taxable income (TI). In addition, the 1986 Act also created the concept of distributable net alternative minimum taxable income (DNAMTI), which is discussed in Chapter 6.

Trust accounting income is an accounting concept that is determined with relevance to local law, not a tax concept.\(^1\) It specifies the amount that the trustee has available to distribute to the income beneficiaries, as directed by the terms of the trust agreement or other governing document. In general, it is calculated by subtracting the total trust expenditures that are allocated to income from the total trust receipts that are credited to income.

Distributable net income is an income concept, created within subchapter J of the Internal Revenue Code, that is unique to fiduciary income taxation.\(^2\) It is a statutorily defined amount that is used in determining the portion of the fiduciary’s annual income that is transferred to the income beneficiaries and the portion that remains with the fiduciary. The allocation of distributable net income also determines the character of income items, including tax-exempt income, that are passed through to those beneficiaries receiving current income distributions.\(^3\)

The final type of income that must be determined is taxable income. Taxable income is the base amount defined in the Internal Revenue Code for calculating the fiduciary’s annual income tax liability.\(^4\)

These three types of income must be calculated in conjunction with the preparation of any fiduciary income tax return. The purpose of this chapter is to analyze these three types of income and to highlight their differences.

§203  PRINCIPLES OF TRUST ACCOUNTING

The proper allocation of receipts and disbursements between trust income and principal is the primary objective of trust accounting. These allocations are necessary in order to calculate TAI, which determines the maximum amount that the trustee is required (or allowed) to distribute to the income beneficiaries according to the terms of the trust agreement. For example, if a trust agreement provides that all of the net income of the trust shall be distributed to the income beneficiary

\(^1\) Generally accepted accounting principles (GAAP) have no relevance to this determination. Although this chapter refers primarily to trusts, the principles discussed are equally applicable to estates.


\(^3\) IRC §§652(b) and 662(b).

\(^4\) IRC §641(b).
Chapter 2. Relationship of Fiduciary Accounting and Tax Concepts §203.2

at least annually, then the trustee is required to annually distribute 100 percent of TAI. Thus, the amount that the trustee is required to distribute will vary depending on how TAI is calculated.

§203.1 Principal and Income Acts

All states have a principal and income statute that provides guidance with regard to what items should be allocated to income or to principal for trust accounting purposes. The majority of states have adopted some version of the Uniform Principal and Income Act (P&I Act). Under the P&I Act, income is defined to be the “return in money or property derived from the use of principal.” Principal is defined as “the property which has been set aside by the owner or the person legally empowered so that it is held in trust eventually to be delivered to a remainder beneficiary while the return or use of the principal is in the meantime taken or received by or held for accumulation for an income beneficiary.”

Although the state laws may differ in some details, generally a state’s P&I Act provides that allocations are required to be made as follows: first, in accordance with the trust instrument, notwithstanding contrary provisions in the Act; next, in the absence of contrary language in the trust instrument, in accordance with the provisions of the Act; and third, if neither of the preceding rules applies, in accordance with what is reasonable and equitable in terms of those entitled to income or principal, or to both.

§203.2 Relevance of the Trust Document

The concept of trust accounting income is recognized in subchapter J. IRC §643(b) states that, for purposes of subparts A, B, C, and D of subchapter J, “the

§203 1A complete analysis can be found in Gamble, The Revised Uniform Principal and Income Act (Inst. Continuing Legal Educ. Ann Arbor, Mich. 1966); cited therein are the following articles:


At this writing, the commissioners are contemplating substantial revisions to the RUPIA, reflecting modern portfolio and investment philosophy that could blur the distinctions between income and principal. Instead, a return, possibly like a unitrust approach, could be provided to the “income beneficiary” so that total return, not income versus principal, can be emphasized.

2Revised Uniform Principal and Income Act §3(a) [hereinafter Revised UPIA].
3Id. §3(b).
4Id. §2(a).
§203.2 Income Taxation of Fiduciaries and Beneficiaries

term 'income,' when not preceded by the words 'taxable,' 'distributable net,' 'undistributed net,' or 'gross,' means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law." Thus, the federal income tax law defers to the trust instrument and state law for the determination of the amount of TAI. Further, while TAI is an accounting rather than a tax concept, it can have an affect on the trust’s taxable income. Because TAI determines the maximum amount that is required to be distributed by the trust, it affects the income distribution deduction that the trust receives.  

As a result, the determination of TAI must always begin with a reading of the trust instrument. Items specifically mentioned as allocable to income or principal in the trust instrument must be allocated in accordance with those directions. For those items not specifically identified in the trust instrument, the applicable state’s principal and income law controls. If the trust instrument and state law are both silent as to the allocation of a specific item between income and principal, the trustee must make a “reasonable and equitable” allocation. Reasonable and equitable allocations can sometimes be problematic, however, since the income and remainder beneficiaries have opposing interests with respect to the allocation of receipts and disbursements between trust income and principal and the trustee owes a fiduciary duty to both classes of beneficiaries. The courts’ interpretation of similar situations provide invaluable guidance in this regard.

§203.3 Components of Trust Accounting Income

Many trust instruments are silent with respect to allocations between income and principal or direct that the state’s principal and income act control the manner of allocation. In either case, the principal and income law of the state of the trust’s residence will control. Since most states have adopted some version of the Uniform Principal and Income Act, a review of the Act is helpful in understanding how items usually should be allocated. Examples of items allocated to trust accounting income under the Act include taxable interest, tax-exempt interest, ordinary dividends, rental income, and business (Schedule C or partnership) income. Capital gains are excluded from the computation of TAI.

With respect to expenses, the Act generally employs a matching concept by allocating to income those expenses that are reasonably related to receipts that are allocated to income. Examples of expense items allocated to income under the Act are ordinary expenses incurred in connection with the administration, management, or preservation of trust property, including regularly recurring taxes assessed against any portion of the trust property (e.g., real estate taxes), interest paid, ordinary repairs, one-half of trustee’s regular compensation, one-half of attorney’s fees for periodic accountings, and any tax levied on receipts defined

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5See IRC §§651(a) and 661(a).
6Revised UPIA §3(a).
7Id. §3(b).
as income.\textsuperscript{6} The Act also provides that the trustee may make a reasonable allowance against income for depreciation on property subject to depreciation.\textsuperscript{9}

Since TAI is not a tax concept, tax restrictions such as passive activity loss limitations, at-risk limitations, and the 2 percent miscellaneous deduction floor do not apply in the computation of TAI.

One area of continual uncertainty that envelops these tax concepts, however, is the proper treatment of a partnership investment held by a fiduciary. Generally, P&I Acts are inadequate to define what is income or principal from a partnership interest, and trust instruments frequently fail to address this matter. The routine issuance by partnerships of a "one line Form 1065 K1" does not make this challenge any easier.\textsuperscript{10}

\textbf{§203.4 Components of Trust Accounting Principal}

The most common item allocated to principal under the Act is the consideration received on the sale or other transfer of a principal asset.\textsuperscript{11} Stock dividends, insurance proceeds on property forming a part of principal, and receipts on the liquidation of a corporation are other items allocated to principal.\textsuperscript{12} In addition, extraordinary dividends that are determined by the fiduciary to be allocable to corpus, pursuant to the governing instrument or the provisions of local law, do not constitute income required to be distributed currently to income beneficiaries.\textsuperscript{13}

Charges allocated to principal include trustee's compensation not allocated to income, expenses reasonably incurred in connection with principal, costs of investing and reinvesting principal, expenses for the preparation of property for rent or sale, and extraordinary repairs.\textsuperscript{14} Taxes levied on profits, gains, or other receipts allocated to principal are also allocated to principal.\textsuperscript{15} For example, unless the trust instrument provides to the contrary, state or federal income taxes paid by a trust are allocated entirely to principal if the trust is a simple trust because the income tax liability incurred by a simple trust is usually due solely to capital gains or other items that are allocated to corpus. If the trust is a complex trust, and income is accumulated in the trust, then a portion of the trust's income tax liability would be attributable to the accumulated income and allocable to the income account, unless the trust instrument directs that accumulated income is to be added to principal.

\textsuperscript{6}Id. §13(a).
\textsuperscript{9}Id. §13(a)(2).
\textsuperscript{10}See expanded discussion of passive activity loss limitations in Chapter 7.
\textsuperscript{11}Revised UPIA §3(b)(1).
\textsuperscript{12}Id. §3(b).
\textsuperscript{14}Revised UPIA §13(c).
\textsuperscript{15}Id. §13(c)(4).
§203.5 Relevance of State Court Interpretations

As discussed above, the federal income tax treatment of fiduciaries and beneficiaries often is dependent on rights, powers, and accounting issues involving the governing instrument or state law. The question is, What emphasis is to be placed on these state court interpretations, especially to trust (or fiduciary) accounting income matters that are given recognition under subpart J? Even where state court interpretation is sought, quite often all parties in interest are in agreement with the desired result, that is, it is not adversarial. Although the Supreme Court at first required a state court proceeding to be followed, provided it was not carried out in a collusive manner or collusive in character,16 this conclusion subsequently was narrowed considerably. Thus, the often-cited landmark case, Helvering v. Bosch,17 held that only the state's highest court's decisions are conclusive. Short of that, federal interpretations must be based on a separate determination of state law, giving proper regard to other state court's rulings that are relevant.

§203.6 TAI Reduced by Required State Law Corpus Reimbursement

For purposes of computing the income of a simple trust, a fiduciary was required under a New York court decision to allocate an amount of fiduciary accounting income to fiduciary accounting corpus in order to reimburse such corpus for income taxes paid. The allocation, referred to as the "Holloway adjustment," is required under state law if the trust deed was silent or if the deed granted the trustee the general discretion to make adjustments. Thus, the trust's income that is required to be currently distributed18 is reduced in an amount equal to the adjustment.

§203.7 The Intricacies of Determining TAI

EXAMPLE

Partnership has portfolio and trade or business investments. It realizes dividend income of $10,000 and business income of $30,000, all the latter of which is retained for business expansion. The partnership distributes $9,500

16Freuler v. Helvering, 291 U.S. 35, 4 U.S.T.C. ¶1,213 (1933). This case involved determining what was properly distributable to beneficiaries.
portfolio income to trust partner that has a 95 percent profits interest. Trust accounting income is $9,500, the actual cash distribution, even though the trust's DNI must reflect its $38,000 share of total partnership income, including $28,500 of undistributed business income.

EXAMPLE

If, under the above facts, partnership made a $50,000 cash distribution to its partners, with trust receiving 95 percent or $47,500, of that distribution, its TAI would be $38,000 (i.e., its share of partnership portfolio and business income for the year), and DNI would also be the same amount. The balance of $9,500 distributed would be a return of capital and creditable to the trust principal account if this is the initial year of the partnership or if the partnership had no undistributed ordinary income or capital gains in preceding years. In the more typical situation in which the partnership had not distributed all of its prior year's ordinary and/or capital gain income, then the entire $47,500 distributed by it to the trust partner would be income (unless the partial liquidation rules apply).

EXAMPLE

Fiduciary acquires 10 percent corporation bonds at 130 and 4 percent discount bonds at 50. Under most state P&I acts, including the Uniform P&I Act, bond premiums and discounts are not reflected in the determination of TAI, so the actual coupon rates reflect income. Premium and discount amortization do have a potential impact on DNI, but ordinarily are charged to trust principal unless the controlling document states otherwise.

§203.8 Extraordinary Dividends and TAI

Extraordinary dividends paid from capital, rather than income (usually described as "return of capital" distributions), are creditable to the principal account based on law of the resident state, including its version of the Uniform Principal and Income Act.19 A distributing corporation funded such a special dividend

distribution from the receipts of significant asset sales made in conjunction with a plan in partial liquidation. Under the applicable state law, these dividend receipts were not includible in trust accounting income. Had this extraordinary dividend been paid out of the corporation’s surplus, however, it would not have been a return of capital and its characterization as income or principal would not be controlled by local law.20

§204 FIDUCIARY INVESTMENT PHILOSOPHY IS CHANGING

§204.1 Modern Portfolio Theory Is Replacing Prudent Man Rule as the Policy on Investment

§204.1.1 What Is This Change in Fiduciary Investment Approach?

Until recently, fiduciaries were required to follow the “prudent man” rule in discharging their responsibility for investing funds in a trust or estate. Although discussion of this rule is beyond the scope of this analysis, essentially it encompasses an investment policy based on the preservation of capital and attaining a “reasonable” income return. Criticism of the limitations of implementing the prudent man rule has resulted in a movement toward a more modern investment philosophy, usually described as modern portfolio theory (MPT). Its intent is to balance risk and reward through the implementation of a diversification strategy that emphasizes “total return” (e.g., interest or dividends and capital appreciation). Under this approach, the traditional distinction between income return and principal appreciation is significantly downplayed.

The adherents of MPT believe that it accords better recognition to the impact of inflation and changing economic conditions. Illinois, New York, and a number of other states have already placed into law versions of this new investment approach. Further, for more than three years a number of trust experts (drafters of proposed UPIA revisions for the National Conference of Commissioners on Uniform State Laws) have labored to update and revise the long-extant Uniform Principal and Income Act. Among the significant recommendations is a change to reflect the MPT approach toward investment. It is likely that versions of MPT will be adopted by most states in their UPIAs.


§204.1.2 MPT’s Impact on Applications of Federal Income Tax
Rules for Fiduciaries and Beneficiaries

Many applications of subchapter J (i.e., federal income tax rules affecting fiduciaries and beneficiaries) rely on the determination of trust accounting income. However, the implementation of MPT will tend to blur the distinction between annual return (e.g., dividends, interest) and capital appreciation on principal (corpus). In such circumstances, the traditional concept of TAI may no longer be an appropriate measure of a current beneficiary’s right to a current “return” from the trust. One approach being considered is to allow the trustee to ascertain the “reasonable” return to which a beneficiary is entitled under the instrument and, where traditional TAI is insufficient, permit a reallocation of current capital gains (or even unrealized appreciation) from corpus to income. This reallocated amount would then be available for distribution to the “income” beneficiary.

An essential feature of this potential revision to the UPIA is bringing the federal income tax rules into synchronization with these changing accounting and investment concepts. Presently, subpart J generally excludes capital gains from distributable net income (DNI). In order for the implementation of MPT to result in an equitable allocation of tax liability between the income and the corpus beneficiaries, it is important that the Internal Revenue Service recognize these statutorily permitted reallocations of capital gains to TAI as a part of DNI. However, up to now, the IRS has not in public or letter rulings acknowledged that possibility, except when the state law application of equitable rules for non-or under-producing property allocates a portion of capital appreciation to the income beneficiary. If the IRS fails to revise its position in recognition of MPT, it would appear that regulations will have to be amended to include state law distribution rules as one of the sanctioned situations, along with ascertainable events and termination, that cause capital gains to be included in DNI.3

Another area of the federal income law tax affected by the adoption of MPT is charitable trusts. As discussed more thoroughly in Chapter 9, a currently popular version of the charitable remainder unitrust (CRUT) is the “net income make-up unitrust” (NIMCRUT). In this vehicle, traditional TAI concepts are applied for purposes of determining the charitable trust’s income. It is very likely that MPT will have an impact on this determination.

Whether regular or charitable remainder trusts are affected, it would not appear that the proposed changes to state UPIAs to reflect MPT will encompass TAI determinations involving deemed, but undistributed, income passing to a fiduciary from flow-through entities—i.e., partnerships and S corporations. For such entities, TAI now includes only actual distributions (e.g., S corporation dividends) of cash or property. It is conjectural how any change to the “distribution” principle could be applied to flow-through entities, even when MPT is in effect.

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§205  **UNIFORM PRINCIPAL AND INCOME ACT REVISIONS IN PROGRESS ON ALLOCATION OF RECEIPTS AND DISBURSEMENTS**

For five years the drafting committee has been revising the 1962 Uniform Principal and Income Act (1) to update it by amplifying sections and reflecting responses to discrete issues that have arisen from new forms of investments or other areas that required clarification, and (2) to reflect the modern portfolio theory of investing, discussed above. Discussion of the major revisions to the prior act’s coverage follows.

Initial reference is made to overall general principles to be applied by a fiduciary (1) in allocating receipts and disbursements, and other matters within the Act’s scope dealing with apportionment of items to principal and income; and (2) in exercising the power to make adjustments when the trust instrument is silent.

§205.1  **Overall Principles of Fiduciary Duties of Administration**

§205.1.1  **Allocation Principles in General**

The following generally will be responsive in circumstances involving a fiduciary’s discharge of its duties of administration in allocating receipts and disbursements to or between principal and income and, with regard to other matters within the scope of apportionment (1) at the beginning and end of an income interest only, and (2) dealing with decedent’s estates and terminating income interests:

- The provisions of the governing instrument of an estate or a trust will control, even when an Act’s provision differs.
- A discretionary power given to the fiduciary in the governing instrument may be exercised even if that results in a determination contrary to an Act’s provision.
- The fiduciary shall follow the Act provisions if the governing instrument does not contain a different provision or does not give the fiduciary a discretionary power.
- The fiduciary shall add a receipt or change a disbursement to principal to the extent the governing instrument and the Act do not provide rules to allocate between principal and income.

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1Revised Uniform Principal and Income Act (Draft July, 1997). Further refinements were proposed in a July 1997 meeting of the uniform commissioners that discussed this 1997 draft [hereinafter Proposed Revised UPIA]. Public disclosure of the final modifications has not been made as of publication of this edition; Dobris, The Probate World at the End of This Century; Is a New Principal and Income Act in Your Future?, 28 Real Property, Probate and Trust Journal 393 (Fall 1993); Schaengold, New Uniform Principal and Income Act in Progress, 133 Trust and Estates 42 (Dec. 1994).

2Revised Uniform Principal and Income Act §102.
Chapter 2. Relationship of Fiduciary Accounting and Tax Concepts §205.1.2

- To the extent neither the governing instrument nor the Act provides a rule for any matter within the scope of the Act, other than the above requirement to credit or change principal, the fiduciary must administer an estate or trust based on what is fair and reasonable to all beneficiaries, unless the governing instrument clearly manifests an intention that one or more of the beneficiaries should be favored.

If the governing instrument (1) gives the fiduciary or another person the power to (a) decide whether a receipt or disbursement is principal or income, (b) decide any other matter for which there is a provision in the Act, or (2) provides that the Act does not apply but contains no provision about a matter for which there is a provision in the Act, the fiduciary or other person shall act impartially, based on what is fair and reasonable to all the beneficiaries, unless the governing instrument clearly manifests an intention that the fiduciary must or may favor one or more of the beneficiaries. A determination in accordance with the Act is presumed to be fair and reasonable to all of the beneficiaries.¹

§205.1.2 Trustee’s Power to Adjust (When Trust Instrument Is Silent)

Where a trustee adopts an investment philosophy that focuses on total portfolio return (e.g., Modern Portfolio theory), rather than one expressly addressing the income and principal rights of the various classes of beneficiaries, a trustee is allowed to transfer amounts from principal to income (based on what is fair and reasonable to all beneficiaries) to meet its duty to reflect the interests of the income and principal beneficiaries and its duty of impartiality.² This adjustment pertains when the trust instrument (1) fails to contain adequate discretionary powers of administration and (2) does not clearly manifest an intention that the fiduciary must or may favor one of the beneficiaries.³ Essentially, it operates as a default provision and provides a trustee with the capability of overriding other provisions of the Principal and Income Act when such authority is required to accomplish its duties and responsibilities.

Thus, if the controlling instrument is silent with regard to determining what is income and those items that should be charged or credited to principal, this section will require the Uniform Principle and Income Act to be applied. Similarly, if that instrument does not refer (positively or negatively) to the application of equitable adjustment concepts §103 will bring the Act’s provisions applying equitable adjustment concepts into operation. Because of its breadth of applicability, the commissioners conclude that this section is likely to force trustees to rethink their distribution policies. Because of IRC requirements, charitable trusts,

¹Id. As noted in note 2 supra, as of the publication date of this 1998 edition, the 1997 draft of the Revised Uniform Principal and Income Act that served as the basis for the discussion in §205 was in process of final editing.
²Revised UPIA §103(a).
³Id.
especially remainder trusts, are stated in the comments as not being subject to Uniform Principles Income Act coverage. In making this adjustment, eleven factors are set forth that are to be considered by the trustee:\textsuperscript{6}

(1) the nature, purpose, and expected duration of the trust;
(2) the intent of the settlor;
(3) the identity and circumstances of the beneficiaries;
(4) needs for liquidity, regularity of income, and preservation and appreciation of capital;
(5) the assets held in the trust, their nature and the extent trust assets are used by a beneficiary, and whether transferred by a settlor or acquired by the trustee;
(6) the net amount allocated to income under other sections of the UPJA and the increase or decrease in principal asset's value; and
(7) whether and to what extent the trustee is given the power to invade principal or accumulate income, or is prohibited to do so, under the trust terms and past history of such power exercise.
(8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation;
(9) the anticipated tax consequences of an adjustment;
(10) the total return from investments; and
(11) the assets held in the trust.

Adjustments are not to be made if this causes loss of part or all of (1) a federal or state gift tax exclusion; (2) an income, gift, or estate tax charitable deduction; or (3) an inheritance tax deduction otherwise available.\textsuperscript{7} Included in the prohibition of adjustment power exercise are (1) diminishment of an income interest involving a marital trust; (2) reduction in actuarial value of an income interest in a transfer intended to qualify for gift tax exclusion; (3) changes in the amount payable to a beneficiary as a fixed annuity or fixed fraction of trust asset's value; and (4) those affecting any amount permanently set aside for charitable purposes.\textsuperscript{8} Also adjustments may not be made if possession or exercise of that power may (a) cause an individual to be treated as owner for income tax purposes, or (b) cause all or part of the trust assets to be included in the gross estate of an individual who has the power either to remove or appoint a trustee.\textsuperscript{9} Thus a trustee can not make an adjustment for its direct or indirect benefit,\textsuperscript{10} including the satisfaction of a legal obligation. A disinterested trustee\textsuperscript{11} may make this trustee a benefiting adjustment. Equitable adjustments can be made by a trustee under this section unless the document makes it clear that the trustee is denied the power to make them.\textsuperscript{12}

\textsuperscript{6}Revised UPJA §104(b).
\textsuperscript{7}Revised UPJA §104(c).
\textsuperscript{8}Revised UPJA §104(c)(1)-(4).
\textsuperscript{9}Revised UPJA §104(c)(5)-(6).
\textsuperscript{10}Revised UPJA §104(c)(7)-(8).
\textsuperscript{11}Revised UPJA §104(d).
\textsuperscript{12}Revised UPJA §104(f).
EXAMPLES

The following five examples illustrate the application of §104:13

Example 1: T is the trustee of a trust that provides income to A for life, remainder to B. T received from the settlor a portfolio of financial assets invested 20 percent in stocks and 80 percent in bonds. In response to the Uniform Prudent Investor Act, T determines that the suitable risk and return objectives for this portfolio indicate that it should be invested 50 percent in stocks and 50 percent in bonds. As a result, the dividend and interest income is decreased. T is authorized, after considering the factors in subsection (b), to adjust between principal and income to the extent T considers it necessary to increase the amount paid to the income beneficiary.

Example 2: T is the trustee of a trust that requires the income to be paid to the settlor’s son C for his life, and the remainder to C’s daughter D. In a period of very high inflation, T purchases bonds that pay double digit interest and determines that a portion of the interest, which is allocated to income under the other provisions of this Act, is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T considers relevant, T may transfer a portion of the interest to principal.

Example 3: T is the trustee of a trust that requires the income to be paid to the settlor’s sister E for life, and the remainder to charity F. E is a retired schoolteacher who is single and has no children. The terms of the trust permit T to invade principal to provide for E’s health and to support her in her accustomed manner of living, but do not otherwise indicate that T should favor E or F. E’s income from her social security, retirement pension, and savings is more than the amount required to provide for her accustomed standard of living. Applying prudent investor standards, T determines that the trust assets should be invested entirely in growth stocks that produce virtually no dividend income. Even though it is not necessary to invade principal to maintain E’s accustomed standard of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally accorded a person who is the sole income beneficiary of a trust, and T is authorized to adjust from principal to income to provide her with the degree of enjoyment.

Example 4: T is the trustee of a trust whose situs is State X. The trust became irrevocable before State X adopted the prudent investor rule. The terms of the trust require all of the income to be paid to G for life, and the remainder to H. The trust agreement gives T the power to invade principal for the benefit of G for “dire emergencies only,” and limits the amount that can be

13Comments to Revised UPIA §104.
distributed from principal over the lifetime of the trust to an aggregate amount that does not exceed 6 percent of the trust's value at its inception. The trust's portfolio is invested 50 percent in stocks and 50 percent in bonds. After State X adopts the prudent investor rule, T determines that, to achieve the suitable risk and return objectives for the trust, the investment breakdown should be 90 percent in stocks and 10 percent in bonds, which increases the total return from the portfolio and decreases the dividend and interest income. In a year in which G does not experience a dire emergency, T may nevertheless exercise the power to adjust in §104(a) to the extent that T determines that the adjustment is exclusively from the portion of capital appreciation resulting from the change in the portfolio's asset allocation. If T is unable to determine the extent to which capital appreciation resulted from the change in asset allocation or is unable to maintain adequate records to determine the extent to which principal distributions to G for dire emergencies do not exceed the 6 percent limitation, T may not exercise the power to adjust. See Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

Example 5: T is the trustee of a trust that is the sole beneficiary of the settlor's IRA. The IRA holds a diversified portfolio of marketable financial assets. The trust receives annual distributions from the IRA that comply with the minimum distribution requirements of the Internal Revenue Code, and T allocates 10 percent of the amount received each year to income under §421 of this Act. The total return on the IRA's assets exceeds the amount required to be paid to the trust, and as a result the value of the IRA's assets at the end of the year exceeds the value at the beginning of the year. The appreciation in value of the IRA is a relevant factor that T may consider under §104(b)(6) in determining whether to exercise the power of adjustment and the extent to which an adjustment should be made to administer the trust impartially, assuming the terms of the trust do not require T to favor one or more of the beneficiaries. T may also consider, under §104(b)(9), the anticipated tax consequences of the adjustment, if the distribution will cause the beneficiary to be subject to income tax on the additional amount distributed, in determining the amount of the adjustment. In years in which the required distributions reduce the value of the IRA, the decrease in value is a relevant factor for T to consider under §104(b)(6) in determining whether and to what extent to exercise the power of adjustment.

§205.2 Specific Allocation Rules—Investments

An allocation of receipts and disbursements to principal and income based on the specific nature of a fiduciary investment follows. It is essential to note that the cash method of accounting is solely applicable in all aspects of principal and income determination.
§205.2.1 Business and Other Activities Conducted by Trustee

When, in its conduct of a business or other activities noted below, a trust determines that separate accounting is in the beneficiaries' best interest, its determination of available net cash receipts to be credited to principal or income controls. Sales of business assets or other activities, other than in the normal course of business, result in net receipts being credited to principal (or a portion of such excess may also be allocated to principal). This treatment will cover management of rental properties, retail, manufacturing, service, and other traditional business activities; farming, raising and selling of livestock and other animals, extraction of minerals and other natural resources, timber, and activities to which §426 applies (involving derivatives and options).

This section is expected to apply to a myriad of business activities previously conducted, and accounted for separately, by the transferor to the fiduciary entity—e.g., timber operations, oil and gas or other mineral exploration, or even activities described as expanded investment activities, rather than as a trade or business. This section also relates to those types of activities that are either initiated by a trustee or expanded to the point that the trustee concludes separate accounting is appropriate. The comments suggest that separate accounting will apply where the business or investment activities are such that, if conducted by a corporation, the management concept of allocating cash between that which must be retained for business needs and that which is available for distribution should be implemented. In such circumstances, allocations of cash made consistent with the above concept are relevant in determining credits to principal and income, respectively. In determining trust accounting income from business and other activities, a trustee is authorized to continue business and record keeping methods employed by a decedent or a transferor. The intent of this section is that it have broad application to overcome the narrower and more inflexible rules of other UPIA sections that otherwise would apply, if the trustee desires to exercise its authority in a more flexible manner.

Income based on GAAP will not comprise accounting income per se. A concept of cash retention required for working capital, growth, reinvestment, and so on of the business will be recognized and accounted for as if the proprietorship were a separate entity. Thus, only excess cash from earnings beyond that reinvested will be considered trust accounting income.

EXAMPLE

The Wholesaler proprietorship is owned by a testamentary trust. In 1996, its GAAP earnings amounted to $130,000. After adjusting for depreciation and other noncash items, however, its net cash receipts were $140,000. The trustee determined that inventory expansion required $20,000, and $10,000

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14Proposed Revised UPIA (Nov. 15, 1996 Draft) §403(a).
15Revised UPIA §403(b).
16Id.
17Revised UPIA §403(c).
18Generally accepted accounting principles.
additional working capital for unspecified needs was required. The trustee’s
general income accounts will be credited with $110,000 (net cash receipts of
$140,000 less $30,000 retained), unless the trustee concludes that a portion
should be allocated to principal.

EXAMPLE

The above proprietorship decides to pull out of the northeast market, selling
its building, equipment, and inventory for $450,000. Net profit on this disposi-
tion is $110,000. The entire $450,000 is credited to the trust principal account.20

§205.2.2 Receipts from Entities

Coverage under these provisions embraces all other forms of organization
in which a trustee has an interest:21 corporations, partnerships, limited liability
companies (LLCs), regulated investment companies (RICs), real estate investment
trusts (REITs), common trust funds, and any other estate or trust. Not included
are property interests owned by a trust as a tenant in common with one or more
co-owners. Determination of trust accounting income for all these distributing
entities comports with the prior Act, being based on distributions of cash, not the
entity’s GAAP or taxable income.22 Principal is credited with entity distributions
that are in property (other than cash)23 including:

• share or unit of equity or security or obligation of the distribution or another
  entity;
• a rights distribution to subscribe to equity, security, or obligations;
• an REIT or RIC capital gain dividend whether in cash or stock;24 and
• pursuant to a call merger, consolidation, or other plan under which entity
  assets are acquired by another entity, or a partial/total liquidation.

Also credited to principal are a distribution, or series of related distributions,
of cash or cash and property in exchange for part or all of the trust’s interest in
that entity,25 as well as those related to a partial or complete liquidation of such

19Revised UPIA §403(b).
20Id.
21Revised UPIA §401(a). Excepted are (a) distributions from a trust or estate covered by §402, and
(b) a business or entity to which §403 applies.
22Revised UPIA §401(b).
23Revised UPIA §401(c)(1).
24Revised UPIA §401(c)(4).
25Revised UPIA §401(c)(2).
entity. It does not apply to amounts representing tax payments a beneficiary must pay with regard to an entity’s undistributed taxable income.

A partial liquidation comprises a distribution (1) that the entity designates as such; and (2) of a series of related distributions in cash or property that exceed 20 percent (or a different amount if desired by any state adopting the Proposed Revised UPIA principles) of the entity’s gross assets (as shown by the entity’s financial statements at year-end preceding the initial distribution).

An entity’s statement at or near the time of distribution as to the source or character of a distribution may be relied on by the trustee when the entity’s board or comparably empowered group provides the communication.

Other large distributions. Some cash distributions may be quite large (for example, more than 10 percent but not more than 20 percent of the entity’s gross assets) and have characteristics that suggest they should be treated as principal rather than income. For example, an entity may have received cash from sources other than its normal business operations because it sold an investment asset; or because it sold a business asset other than one held for sale to customers in the normal course of its business and did not replace it; or it borrowed a large sum of money and secured the repayment of the loan with a substantial asset; or a principal source of its cash was from assets such as mineral interests, the net income from which would have been principal if the trust had owned the assets directly instead of indirectly through an entity. In such a case the trustee may have the power under §104(a) to make an adjustment between income and principal to take these factors into account, although §104(c) may prevent an adjustment in the case of a marital deduction trust.

EXAMPLE

Estate receives $50,000 capital gain distribution from Metropolitan RIC. Since the source was an RIC, the distribution is required to be a principal item.

EXAMPLE

Company downsizes and distributes $60,000 in cash to estate as its shareholder, designating it as a partial liquidation payment. The receipt is principal irrespective of other factors such as its ratio to assets, etc.

26Revised UPIA §401(c)(3).
27Revised UPIA §401(e).
28Revised UPIA §401(d)(1) and (2).
29Revised UPIA §401(f).
30Comments to Revised UPIA §401.
EXEMPLARY

In 1996, a partnership (or S corporation) K-1 states that trust is subject to tax on $50,000 of portfolio income and $20,000 of capital gains. The partnership (or S corporation) makes no distributions of cash or other property. Trust recognizes no amount as allocable to income since no distributions were received from the entity.31

EXAMPLE

If the same amount of cash were received from an investment partnership, that sum would be credited to income unless it is required to be treated as a partial liquidation distribution.

EXAMPLE

Assume the same facts except that partnership distributed $40,000 in cash when its total assets amounted to $500,000. The entire $40,000 is allocable to income.32 Under the general rule, the allocation will differ only if or when the trustee concludes that a power to adjust from income to principal under §104(a) should be exercised because special factors exist to indicate that in a large distribution (between 10 and 20 percent of gross assets) should be treated as principal in whole or part.33

EXAMPLE

Partnership (or S corporation) in the above fact pattern distributes $95,000, in property representing the portfolio income, capital gains, and basis recovery of $25,000. The entire distribution is allocable to principal since it was made in property.34 If distributed in cash, this sum is allocated to income, since it is less than 20 percent of the entity’s total assets of $500,000.35 If the cash distribution was $115,000, the entire $115,000 would be credited to principal.

31Revised UPIA §401(a).
32Revised UPIA §401(d)(2).
33Comments to Revised UPIA §401.
34Revised UPIA §401(c)(1).
35Revised UPIA §401(a), (d)(2).
EXAMPLE

T Trust has a 30 percent interest in I Investment partnership. The partnership operates a number of rental real estate projects. In 1996, it sells one of these properties for $2,000,000, pays off the outstanding mortgage of $500,000, and distributes the net cash proceeds of $1,500,000. I's audited financial statements for the year ended December 31, 1995 reflected gross assets of $10,000,000 and mortgage liabilities of $3,000,000. The $450,000 (30 percent of $1,500,000) received by T is considered to be income for fiduciary accounting purposes, since I's total distribution of $1,500,000 is less than 20 percent (i.e., $2,000,000) of its gross assets of $10,000,000 (note that the amount of related debt and net assets is not relevant to this determination).36

EXAMPLE

The same facts continue, but the trustee concludes that there are sufficient factors dictating that the distribution shall be treated as a partial liquidation. The distribution then will be considered to be principal, not income, even though the distribution amounted to 15 percent ($1,500,000 divided by $10,000,000) of its gross assets.37

EXAMPLE

Assume the facts as above, except that I's gross assets amounted to $6,000,000. Since the distribution of $1,500,000 exceeds 20 percent of I's gross assets, it would represent fiduciary accounting principal, not income.38

EXAMPLE

The same facts as the initial example above continue, except that in 1996 $500,000 is distributed to the partners and an additional $2,000,000 from a 1996 sale and refinancings is distributed on January 2, 1997. Since the series of distributions (i.e., $2,500,000) exceed 20 percent of the 1995 gross assets, the entire amount distributed would be considered to be fiduciary accounting principal.39

36 Revised UPIA §401(d)(2).
37 Revised UPIA §401 commentary applying the principles of §104(a).
38 Revised UPIA §401(d)(2).
39 Id.
EXAMPLE

In the S corporation situation, $30,000 is distributed so that income tax could be paid on undistributed income. Even if this amount exceeds 20 percent of the S corporation's gross assets at the end of the preceding fiscal year, it is not considered to be a principal distribution.\(^4\)

In summary, use of GAAP principles, Form K-1 reported share of taxable income, and so on are not to be reflected as determinants of trust accounting income; distributions only are reflected.

Will formula allocating portion of contingent partnership liquidation payments to income meets marital deduction requirements. An interesting "cutting edge" solution to a complex, though not atypical, fact pattern involving partnership interest liquidating payments in termination of a withdrawing or deceased partner was favorably considered by the IRS.\(^5\) The partnership proposed revising its partnership agreement to provide that, upon the death or withdrawal of a partner, payments in liquidation be changed to a combination of fixed payments and contingent payments related to partnership net profits. Following this change, a partner proposes to specify in his will that the contingent payments pass to a marital trust for the benefit of his spouse. Under the terms of his will, a portion of each contingent payment will be treated as a payment of interest and the remainder as a payment of principal. The allocation will be determined by crediting to principal the present value of each payment, discounted at the appropriate Applicable Federal Rate (AFR) from the date the payment is made back to the date of the sale or exchange. The excess of a contingent payment over the amount so deemed to be the principal is treated as interest and allocated to the income of the trust. Any contingent payments made within six months of the sale or exchange date are to be considered entirely as principal.

Under this fact pattern, the IRS evaluated the allocation between income and principal for purposes of meeting the IRC §2056 marital deduction requirements. Applicable state law contained no specific provision as to what portion of each payment would be considered principal and income, respectively, for trust accounting purposes. The IRS noted that state law permits a trust instrument to apportion and allocate receipts between principal and income in a manner that, if made with regard to the respective interest of all beneficiaries, will control irrespective of the State Trust and Fiduciaries Principal and Income Act. As a result, the IRS concluded\(^6\) that the allocation of the contingent payments between principal and income under the method described above is reasonable, consistent with Reg. §20.2056(b)-5(b), and not in conflict with state law. Thus, the proposed marital trust will meet the requirements of IRC §§2056(b)(5) and 2056(b)(7).

\(^4\)Revised UPIA §401(e).
\(^5\)Priv. Ltr. Rul. 9739017.
\(^6\)Id.
§205.2.3 Deferred Compensation, Annuities, and Similar Payments

In prior proposals deferral assets were comprehensively defined to include such diverse assets as patent rights, deferred compensation, and similar items whose receipt in cash is spread over a period of time. Under the latest proposal, however, receipts from fixed or variable annuity arrangements (from whatever source) and whether private or commercial are allocated to principal and income\textsuperscript{43} in the same manner as deferred compensation, discussed below. This section also covers payor’s separate funds for private or commercial annuities, pension, profit sharing, stock bonus, stock ownership plan and individual retirement accounts (IRAs) and similar arrangements.\textsuperscript{44}

Deferred compensation is defined as funded or unfunded receivables arising in connection with personal services that are payable in a period subsequent to the year in which earned.\textsuperscript{45} To the extent that payments are characterized as interest or dividends, or are made in lieu thereof, they are credited to income.\textsuperscript{46} Any other payments received in the same accounting period not so characterized are principal.\textsuperscript{47}

A lump sum drawdown of deferred compensation rights or other similar payments received entirely in one accounting period\textsuperscript{48} is considered to be principal, as is an excess withdrawal beyond the annual installment amount provided for by the arrangement.\textsuperscript{49} For any payout arrangement other than discussed above, 10 percent of the receipts are allocated to income.\textsuperscript{50} The balance is credited to principal.

EXAMPLE

X’s deferred compensation balance of $500,000 provides for interest, measured by the AFR plus 1 percent (assumed to be 8 percent), to be paid by his employer on any account balances. With respect to normal deferred compensation payments received under the arrangement, X’s estate or trust holding the deferred compensation rights will treat the interest element (up to $40,000 so calculated) as fiduciary accounting income; the balance of receipts, if any, are principal.\textsuperscript{51}

\textsuperscript{43}Revised UPIA §409(a).
\textsuperscript{44}Revised UPIA §409(a).
\textsuperscript{45}Id., Comments to UPIA §409.
\textsuperscript{46}Revised UPIA §409(b).
\textsuperscript{47}Id.
\textsuperscript{48}Revised UPIA §409(b).
\textsuperscript{49}Revised UPIA §409(c).
\textsuperscript{50}Id.
\textsuperscript{51}Revised UPIA §409(c).
EXAMPLE

The executor is allowed to draw down the entire $500,000 balance in X’s deferred compensation account — and does so. The entire $500,000 receipts are fiduciary accounting principal.\textsuperscript{52} If the payout is a fixed term installment of $50,000 per year, however, withdrawals in excess of the $50,000 installment are principal.\textsuperscript{53}

EXAMPLE

If none of the above factors are applicable (e.g., the arrangement does not provide for a stated interest rate to be applied against the account balance), 10 percent of an assumed receipt of $100,000, or $10,000, is allocable to income.\textsuperscript{54}

When, in order to obtain an estate tax marital deduction, a trustee must allocate a larger portion of a payment to income than provided under §409, such increased amount \textit{shall be} allocated to income.\textsuperscript{55}

EXAMPLE

Under an individual retirement account (IRA) providing for no interest on unpaid amounts a marital trust is named as the beneficiary. The plan balance of $800,000 is to be paid out over 10 years. In year one, $50,000 is distributed, so 10 percent, or $5,000, is deemed to be income under §421(c). The trustee concludes that $40,000 must be allocated to income to preserve the marital deduction so it properly allocates an additional $35,000 to income. Ten thousand dollars will be allocated to principal.

§205.2.4 Property Not Productive of Income\textsuperscript{56}

Under the prior act, special rules covered property whose income stream is less than 1 percent of the inventory value (essentially federal income tax adjusted basis) of the trust (or estate) assets. Proceeds over the amount that would have been produced if invested at 4 percent annual simple interest were to be treated

\textsuperscript{52}Revised UPIA §409(c).
\textsuperscript{53}Id.
\textsuperscript{54}Id.
\textsuperscript{55}Revised UPIA §409(d).
\textsuperscript{56}Revised UPIA §413(a).
as “delayed income.” That amount, plus carrying charges paid from income, less income receipts by the income beneficiary during the computation period, would be deemed income if the unproductive property is sold or exchanged before the income beneficiary’s interest terminates. In a complete reversal of policy, the proposal abolishes the right of a fiduciary income account to receive an allocation from sales proceeds representing delayed income on unproductive or underproductive property.\textsuperscript{57} Unaffected are state law rights of the income beneficiary to compel the trustee to make the property productive with regard to a marital transfer.\textsuperscript{58} The spouse may either exercise this right to have the trustee (a) make the property productive, (b) have the property converted, or (c) exercise the UPIA §104(b) power to adjust by transferring a sufficient amount from principal to income to assure a marital deduction.\textsuperscript{59} The trustee can decide which action or combination of actions to take.\textsuperscript{60} Other than this beneficial marital deduction exception, all proceeds from sale or other disposition are to be credited to principal.\textsuperscript{61}

**EXAMPLE**

A residuary trust (not subject to providing income to meet marital deduction requirements) holds stock in an enterprise whose working capital requirements and expansion need result in a complete reinvestment of cash flow for five years. At the end of that period the stock is sold for $4,000,000, twice its tax basis and value when the trust acquired the stock. All of the $2,000,000 gain and total proceeds of $4,000,000 are credited to principal and nothing to income, unless, in exercising its responsibility set forth in §104, the trustee determines a portion should represent an adjustment from principal to income.

§205.2.5 Minerals, Water, and Other Natural Resources

The accounting treatment accorded to receipts arising in connection with minerals, water, or other natural resources may be governed by the provisions of prior law, provided the underlying asset was acquired before the effective date of the revisions: e.g., such as 27\(\frac{1}{2}\) percent of gross receipts (not to exceed 50 percent of net receipts after expenses are paid for oil and gas properties) are allocated to principal, the balance to income.\textsuperscript{62} For these “pre-acquired” assets the trustee may

\textsuperscript{57}Revised UPIA §413(b).
\textsuperscript{58}Revised UPIA §413(a).
\textsuperscript{59}Id. A Combination of these three spousal rights can be directed.
\textsuperscript{60}Id.
\textsuperscript{61}Revised UPIA §413(b).
\textsuperscript{62}Revised UPIA §411(d).
choose to allocate receipts under the new provisions described below, or to apply prior law. The decision often is dictated by state law constitutional requirements. For assets acquired after the effective date of the revised Act to the extent that a trustee accounts for receipts from an interest in minerals or other natural resources pursuant to this section—

- Annual lease or nominal delay rentals are income.\textsuperscript{64}
- With regard to production payments, income is represented by stated interest or its equivalent and the balance is principal;\textsuperscript{65}
- Ninety percent of a royalty or bonus or delay rental that is more than nominal is principal, the balance is income;\textsuperscript{66}
- Ninety percent of receipts from a working interest, or other interest not provided for above, is principal, the balance is income;\textsuperscript{67}
- For renewable water, all receipts are income, while 90 percent is principal if the water is not renewable.\textsuperscript{68}

**EXAMPLE**

Oil Trust acquires an oil royalty interest (or bonus or working interest) for $300,000. It is anticipated to "pay out" over a 14-year period. In 1998, Oil Trust receives $28,000. Income account is credited with $2,800 (10 percent) in 1998 irrespective of the anticipated payment period.\textsuperscript{69}

If the amount of $28,000 were received as a mineral rent on a lease or from a production payment that provided for a 9.3 percent interest factor, the entire $28,000 would be allocated to income.\textsuperscript{70}

**§205.2.6 Timber**

Unless accounted for as a business activity (UPIA §403, discussed at §205.2.1 above), receipts from regular harvesting of timber (i.e., not exceeding the rate of growth) are allocated to income; if the harvesting exceeds the normal rate growth, the receipts attributable to such excess are allocated to principal,\textsuperscript{71} while that representing the extent of normal growth is allocated to income.\textsuperscript{72}

Most timber operations are expected to be under §403, accounted for by the

\textsuperscript{64} Id.
\textsuperscript{65} Revised UPIA §411(a)(1).
\textsuperscript{66} Revised UPIA §411(a)(2).
\textsuperscript{67} Revised UPIA §411(a)(3).
\textsuperscript{68} Revised UPIA §411(a)(4).
\textsuperscript{69} Revised UPIA §412(b).
\textsuperscript{70} Revised UPIA §411(a)(3) and (4).
\textsuperscript{71} Revised UPIA §411(a)(1) and (2).
\textsuperscript{72} Revised UPIA §412(b)(1) and (2).
\textsuperscript{73} Id.
Chapter 2. Relationship of Fiduciary Accounting and Tax Concepts §205.2.7

trustee as a separate business operation. Historically, owners of timberland have utilized a variety of accounting methods, covering a vast array of subjects ranging from logging to orchards to ornamental trees. Since these methods are usually well established for the timber properties that are transferred into fiduciary ownership, the trustee may continue to utilize them.

In those situations to which the above described practices do not pertain, another option is specifically provided for the sale of trees and related products (chips, by-products, etc.). When the trustee determines the net timber receipts are insubstantial, based on the presumptions in §420(1) and (2), such receipts may be allocated to principal. If neither of these two approaches is not applied or is not applicable, then the net timber receipts must be allocated to principal. When a trust owns more than one block of timber property, the trustee is afforded the flexibility to choose any of these three methods to account for net receipts from different blocks.

Net receipts from the leasing of timber land or a contract to cut trees must be allocated to principal and income, applying the rules discussed above with regard to normal growth and amounts in excess of normal growth. Advance payments, minimum royalties, and bonuses not allocated pursuant of §424(a) must be allocated to principal. Net receipts from tree sales are to be determined by transferring to principal an appropriate amount to reflect depletion. When a trust owns an interest in timberland on the effective date of the Revised Act, the trustee is authorized to choose to allocate receipts to income and principal based on the revised rules or those in effect and utilized under prior law.

§205.2.7 Liquidating Assets

Ten percent of the receipts from liquidating assets are allocated to income irrespective of the length of the anticipated distribution period. Under a prior draft of the revised UPIA, a fiduciary owning an interest in an entity making distributions produced by a liquidating asset could choose to use the above described approach in lieu of the basic entity rules discussed in §205.2.2 if that approach is considered to produce a fairer result, but that was deleted in the final draft.

Liquidating assets are those whose value diminishes in time or terminates because receipts are expected for a limited duration (e.g., copyrights, trademarks, patents, royalties, leaseholds, and rights to receive payments beyond one year where no interest is provided on the unpaid balance). Expressly excluded from the definition of “liquidating assets” are items discussed above such as deferral assets.

\footnote{Revised UPIA §412(a).}
\footnote{Id.}
\footnote{Revised UPIA §412(b)(3).}
\footnote{Revised UPIA §412(b)(4).}
\footnote{Revised UPIA §412(c).}
\footnote{Revised UPIA §412(e).}
\footnote{Revised UPIA §410(b).}
deferred compensation, natural resources, timber, or derivative and option financial instrument transactions.\textsuperscript{80}

EXAMPLE

 Patent Trust acquires a patent royalty interest for $300,000. It is anticipated to “pay out” over a 14-year period. In 1996, Patent Trust receives $28,000. Ten percent, or $2,800, is income, and the balance of $25,200\textsuperscript{81} is allocated to principal.

\section{Derivatives and Options}

In recognition of the change in investment opportunities and the desire to implement modern portfolio theory, a new section\textsuperscript{82} has been added to address derivatives and options trading.

A “derivative financial instrument” is a financial instrument or contract, or a combination of contracts and financial instruments, that gives a trust the right or obligation to participate in some or all of the price changes of a commodity or other asset, or the changes in a rate, an index of prices, or other market indicator for an asset or a group of assets.\textsuperscript{83} This section includes a type of option settled with a cash payment; when settlement is to be made solely in property, a separate rule, discussed below, is applied. To the extent a trustee accounts for derivatives and options under this section, principal receipts from and disbursements made in connection with these transactions are allocated to principal.\textsuperscript{84}

EXAMPLE

Under liberal trustee power and authority, a trust invests in a derivative portfolio, realizing ordinary income of $40,000, short-term capital gains of $20,000 and a long-term capital loss of $10,000. The net accretion of $50,000 is credited to principal.

To the extent that a trustee does not account under §403 (relating to business or similar activities conducted by a trustee) for transactions in derivative financial instruments, receipts from the disbursements made in connection with such transactions shall be allocated to principal.\textsuperscript{85} Thus §414 is a default rule.

\textsuperscript{80}Revised UPIA §410(a).
\textsuperscript{81}Revised UPIA §410(b).
\textsuperscript{82}Revised UPIA §414.
\textsuperscript{83}Revised UPIA §414(a).
\textsuperscript{84}Revised UPIA §414(b).
\textsuperscript{85}Revised UPIA §414(b).
EXAMPLE

The same facts pertain but the trustee accounts for these activities separately (under §403) and consistently determines that ordinary income from derivative transactions is income and capital gain (loss) is credited (charged) to principal. Forty thousand dollars will be credited to income and $10,000 to principal, subject to the trustee’s decision to reinvest under §403. In the latter situation, income will be credited only with the ordinary income represented by reinvested monies.

EXAMPLE

Under a trustee’s separate accounting for derivatives, one half of all transaction results are credited (or charged) to each of the income and principal accounts, so $25,000 will be credited to income and $25,000 to principal.

EXAMPLE

As a result of transactions in puts, calls, short sales, and special commodity deals, the trust realizes $60,000 in gain and income. The trustee does not employ separate accounting under §403, but determines that the general rules on derivative transactions does not comport with his duty under §104. The trust document is silent on how proceeds should be credited. The trustee determines that an adjustment of $15,000 is required under §104, so income will be credited with $15,000 and principal with $35,000. Note that such adjustments are to be made with regard to the portfolio as a whole and not to individual assets.

The grant of an option (1) to buy property from a trust (whether or not owned by the trust at the time of grant), (2) that permits another person to sell property to a trust, or (3) the acquisition by a trust of an option to (a) buy property for the trust or (b) sell an asset owned by the trust that also require settling with a delivery of property by its owner instead of a net cash payment results in the amount received for granting an option or paid to acquire the option being principal. Likewise, gain or loss realized on exercise of an option or later sale of the property acquired by option exercise is credited or charged to principal.

Options to which subsection (c) applies include an option to purchase real estate owned by the trustee in an isolated real estate transaction; a put option purchased by a trustee to guard against a drop in value of a large block of

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*Revised UPIA §414(c).
*Id.
marketable stock that must be liquidated to pay estate taxes; and a continuing and regular practice of selling call options on securities owned by the trust if delivery of the securities is required. It does not apply if the consideration received or given for the option is something other than cash or property, such as cross-options granted in a buy-sell agreement between owners of an entity.\textsuperscript{88}

When the derivatives trading activity is not conducted directly by a trustee but, as is often the case, through investment funds or similar intermediaries, the entity provisions of §401 or the business activities rules of §403 will be operative.\textsuperscript{89}

\begin{example}

The trust realizes a net gain (ordinary and capital) of $80,000 from an array of financial products such as swaps, futures, forwards, and options that meet the above definition for classification as a derivative.

\begin{enumerate}
  \item As an initial decision point, this amount will be credited to principal unless the governing instrument provides otherwise.
  \item If the trustee concludes that there is a lack of discretionary powers in the trust instrument (1) to comply with a duty to pay due regard to the interests of income and principal and (2) to exercise the duty of impartiality, he can adjust the $80,000 credit to principal by reflecting what he considers to be fair and reasonable based on the nine factors set forth in §104(b), say $20,000, as a transfer to income.
\end{enumerate}

\end{example}

\textbf{§205.2.9 Asset-Backed Securities}

This new category relates to assets whose value is based on the right the owner is given to receive distributions from the proceeds of financial assets that provide collateral for the security.\textsuperscript{90} It includes an asset providing its owner with the right only to receive (a) the interest or other current return from the collateral financial assets, or (b) the proceeds from the capital investment in such collateral financial assets.\textsuperscript{91} Trust receipts comprising interest or other current return, as well as the capital investment in the collateral financial assets, are to be allocated by the trustee as follows: (a) the interest or other current return identified by the payor is credited to income, and (b) the balance of the amount to be allocated to principal.\textsuperscript{92} When one or more payments are received by a trustee in one accounting period for the trust’s entire interest in an asset-backed security, the payments are allocated to principal.\textsuperscript{93} These assets provide value from the right (a) to participate

\textsuperscript{88} Comments to Revised UPIA §414.
\textsuperscript{89} Revised UPIA §414(b) and comments thereto.
\textsuperscript{90} Revised UPIA §415(a).
\textsuperscript{91} Id.
\textsuperscript{92} Revised UPIA §415(b).
\textsuperscript{93} Revised UPIA §415(c).
in the appreciation of, and distributions from, investment assets that provide collateral for fulfillment of the issuer’s obligation, or (b) to receive only capital appreciation, or (c) to receive only income return from other securities that provide collateral for such obligation. The first category is intended to describe deferred annuities and contractual arrangements collateralized with interests in mutual funds, stocks, mortgage-backed securities, and other traditional investment assets. The second represents stripped security arrangements, such as “primes” and “scores” issued by the Americus Trust, stripped bonds, aces, and decks, as well as zero coupon and junk bonds, etc. The third relates to mortgage-backed securities, FASITs, and credit card receivables.

When the payment(s) are part of a series that will liquidate the trust’s entire interest in the security over more than one accounting period, then 10 percent of the receipt is allocated to income and the balance to principal.

EXAMPLE

Trust invests in “Scores” for capital appreciation only. All $80,000 of 1997 proceeds will be credit to principal.

EXAMPLE

The trust invests in “Primes,” an income only right, and receives $80,000 in 1997. Regardless of the anticipated payment period, 10% or $8,000 is credited to income and the balance to principal.

§205.2.10 Distributions from Trusts and Estates

Unless a contrary provision exists in a governing instrument applying to a trust recipient, amounts received by that trust as an income distribution from an estate or trust will be treated as income. Likewise, amounts received as principal distributions from an estate or a trust will be allocated to principal. Generally the governing instrument involved is that of the distributing entity, and not that which controls the entity receiving the distributions. When the trust’s interest is in another trust that is an investment entity (e.g., an RIC or REIT), whether acquired by purchase or transfer, the §401 rules described in §205.2.1 will apply.

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“Revised UPIA §415(a).
“Revised UPIA §415(c).
“Comments to §415.
“Id.
“Revised UPIA §402.
EXAMPLE

A residuary trust receives a liquidating distribution from B estate. During the B estate administration, fiduciary accounting income of $300,000 was undistributed after reflecting federal and state income taxes of $200,000. The will was silent as to its classification. The A trust will treat the $300,000 as income and credit principal assets received from the estate to its principal account.

EXAMPLE

If the will had clearly stated that all distributions on interim or final distribution are to be treated as principal, then the $300,000 would be credited to principal.

EXAMPLE

The estate probates a REIT investment and distributes it to the residuary trust. REIT distributions of $50,000 represent capital gains under federal tax law, applying UPIA §401(c)(4). All $50,000 is credited to principal.

§205.3 Insubstantial Allocations Not Required

For specific investment items discussed in §205.2.3 through §205.2.7, the trustee may, but need not, make insubstantial allocations if one of the circumstances in §104(c) does not apply. If not made, the receipt is added to principal. Insubstantiality is presumed if:

- The allocation amount increases (decreases) net income of an accounting period, before adjustment, by less than 10 percent, or
- The value of the asset producing the receipt is less than 10 percent of the total trust asset value at the beginning of the accounting period.

When the trustee could be deemed to have a power causing ownership for income tax or estate tax purposes, an insubstantial allocation can be made by a co-trustee or released by that co-trustee applying principles set forth in §104(d) and (e).

"This section is intended to relieve a trustee from making relatively small

\(^{99}\)Revised UPIA §408.
allocations while preserving the trustee’s right to do so if an allocation is large in terms of absolute dollars. For example, if a trust’s assets have a value of $1,000,000 and annual net income of $40,000, and if the assets include a working interest in an oil well that produces net receipts of $400 a year, the trustee may allocate all of the net receipts to principal instead of allocating 10 percent, or $40, to income under §423. If, however, the net receipts from the working interest are $35,000 a year, the trustee may decide that this is a sufficiently significant amount to the income beneficiary that the allocation of $3,500 provided for by §423 should be made. This section would also relieve a trustee from having to allocate net receipts from the sale of trees in a small wood lot between principal and income.”

While the allocation to principal of small amounts under this section should not be a cause for concern for tax purposes, allocations are not permitted under this section in circumstances described in §104(c) to prevent claims that the power in this section has adverse tax consequences.\footnote{Comments to Revised UPIA §408.}  

\begin{example}
Trust income from dividends and interest amounts to $80,000. Trustee also realized net gain and profit from selling puts and other financial options of $7,000. The trustee may choose to add the $7,000 to income or principal since it is less than 10 percent of $80,000.
\end{example}

\begin{example}
Trust income from dividends and interest amounts to $80,000. Trustee also realized net gain and profit from selling oil and gas and timber of $7,000. The trustee may choose to add the $7,000 to principal since it is less than 10 percent of $80,000.
\end{example}

\begin{example}
Trust realizes lease bonus income of $10,000. Its oil and gas properties have a trust value at January 1, 1998 of $100,000. Trust’s portfolio of stocks, bonds, and other non-oil assets have an asset value of $1,500,000. Income from the non-oil and gas assets totals $60,000. Even though the lease bonus income exceeds 10 percent of the total of other assets’ source income, the trustee still has the discretion to credit the $10,000 of lease bonus to principal, since the insubstantiality of the allocation can be measured by relative asset
\end{example}

\footnote{Id.}
value, i.e., the oil property ($100,000) is less than 10 percent of total trust asset value of $1,600,000.

§205.4 Receipts Not Normally Apportioned

§205.4.1 Principal Receipts

This category includes to the extent not allocated to income under the act:

- Assets received (1) from a transferor during transferor’s lifetime, (2) by a decedent’s estate, (3) a terminating trust, or (4) a payor pursuant to a contract naming the trust as a beneficiary\textsuperscript{102} not defined above as income.
- Cash or other property received from a sale, exchange, or liquidation of a principal asset\textsuperscript{103} not otherwise defined above as income.
- Eminent domain proceeds, excluding any separate award for loss of income.\textsuperscript{104}
- Net income received, due, or receivable during an accounting period in which there is no current income interest.\textsuperscript{105}
- Other receipts credited to principal set forth above in §205.2 or §205.3.\textsuperscript{106}
- Amounts recovered from third parties to reimburse the fiduciary for environmental costs, or for other reasons not based on loss of income.\textsuperscript{107}

§205.4.2 Rental Property\textsuperscript{108}

To the extent the trustee accounts for receipts from rental property pursuant to this section, amounts received as rental of real and personal property, including amounts received for the cancellation or renewal of a lease, are income. However, refundable deposits, including security and future rent applications, are credited to principal and only distributable once the lease terms have been satisfied.

§205.4.3 Obligations to Pay Money

Receipts comprising interest on an obligation to pay sums to a trustee, including consideration for prepayment, are treated as income.\textsuperscript{109} This treatment controls whether the interest rate is fixed, floating, or variable. Consideration for preprinci-

\textsuperscript{102}Revised UPIA §404(1).
\textsuperscript{103}Revised UPIA §404(2).
\textsuperscript{104}Revised UPIA §404(4).
\textsuperscript{105}Revised UPIA §404(5).
\textsuperscript{106}Revised UPIA §404(6).
\textsuperscript{107}Revised UPIA §404(3).
\textsuperscript{108}Revised UPIA §405.
\textsuperscript{109}Revised UPIA §406(a).
Chapter 2. Relationship of Fiduciary Accounting and Tax Concepts

Principal payment is credited to income. Amounts received from any form of disposition of that obligation are principal. No provision is allowed for the amortization of the premium (or the accumulation of discount) on an obligation that provides for at least an annual interest payment if the premium or discount arises from market changes in the obligation’s price.

For obligations that do not provide for interest payments at least annually but do provide for a future repayment of an amount that is in excess of the issue price, such increment in value when realized is distributable as income only if and when the final maturity date is within one year after acquisition by the fiduciary. Otherwise, any value increment increase is credited to principal.

The above rules are not applicable to obligations arising out of minerals and other natural resources, timber, asset-backed securities, deferred compensation, liquidating assets, property not productive of income and derivatives and options as described above.

§205.4.4 Insurance Policies and Similar Contracts

The proceeds of a life insurance policy or other contract whose beneficiary is a trust (or a policy that insures the trust against loss involving a principal asset) are allocable to principal. Policy dividends are principal. The proceeds of insurance are income when the policy ensures the trust (trustee) against (a) loss of occupancy or other use by an income beneficiary, (b) the loss of income, or (c) loss of profits from a business subject to other provisions discussed in §205.2.1. This section is applicable to contracts covered by §421 discussed at §205.2.3.

§205.5 Allocation of Disbursements

§205.5.1 Income Disbursements

Except for costs incurred in winding up an estate or in terminating a trust, the following disbursements are required to be made from income:

- One-half of regular fees for trustees, investment advisors, and custodial services
- One-half of expenditures for accounting, judicial proceedings, or other matters involving both income and remainder interests
§205.5.1 Income Taxation of Fiduciaries and Beneficiaries

- *All other ordinary expenses* incurred to administer, manage, or preserve trust property and distribute income such as:
  - interest
  - ordinary repairs
  - regularly recurring taxes assessed against principal
  - expenses of a proceeding, or other matter, primarily concerning the income interest
- Recurring insurance premiums to cover loss of a principal asset or loss of income from asset use

§205.5.2 Principal Disbursements

- The balance of disbursements discussed in §205.5.1
- All trustee’s fees based on principal value from acceptance, distribution, or termination, as well as disbursements requested to prepare property for sale
- Principal payments of a trust debt
- Expenses of proceedings primarily involving principal
- Insurance premiums other than those charged to income (see §205.5.1)
- All forms of transfer taxes (estate, inheritance, GST, gift) including penalties and interest
- Life insurance premiums when a trust is policy owner but not a beneficiary
- Income required to be paid directly to a creditor on a trust principal asset encumbered with that obligation; the amount is to be transferred from principal to income in reimbursement
- Costs related to environmental matters include:
  - Costs of assessing environmental matters and items
  - Remedying and removal of contamination
  - Monitoring remedial activities and substance release
  - Preventing future substance release
  - Collecting from those liable for the costs from these activities
  - Penalties imposed by law or regulations
  - Payments made to comply with laws and regulations
  - Amounts paid to third parties based on statutory or common law claims
  - Costs of defending claims based on environmental matters

§205.5.3 Transfers for Depreciation

A trustee has discretion to transfer from income to principal a reasonable amount of net cash receipts from a principal asset subject to depreciation, but not for depreciation (1) on real estate used as the beneficiary’s residence (or on tangible property used by a beneficiary), (2) during a decedent’s estate administration, or

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116 Revised UPIA §502(a)-(c).
117 Revised UPIA §503.
Chapter 2. Relationship of Fiduciary Accounting and Tax Concepts §205.7

(3) on property held on the Revised UPIA’s effective date not previously subject to a depreciation transfer. For purposes of the UPIA, depreciation is defined as the reduction in value of a fixed asset with a useful life more than one year due to wear, tear, corrosion, or gradual obsolescence.

§205.6 Transfers from Income to Reimburse Principal

A transfer from income to principal may be made to reimburse principal for a disbursement made, or to provide a reserve for future, for such items as:

- an amount chargeable to income but paid from principal because it is unusually large, including extraordinary repairs;
- a capital improvement to a principal asset, whether in the form of changes to an existing asset or the construction of a new asset, including special assessments;
- disbursements made to prepare property for rental, including leasehold improvements and broker’s commissions;
- periodic payments on an obligation secured by a principal asset to the extent that the amount transferred from income to principal for depreciation is less than the periodic payment;
- costs incurred to comply with applicable environmental laws, other than penalties and costs incurred to defend against the imposition of penalties.

A transfer from income is inappropriate if the principal account has received reimbursement, or expects to be reimbursed from a third party.119

§205.7 Income Taxes and Equitable Adjustment for Taxes

Taxes paid by a trustee on receipts allocated to income must be paid from such income. All other taxes, even if described as income taxes, are charged to principal when (1) the taxable receipts are allocated to principal, (2) the fiduciary recognizes taxable income from an entity it owns without having received a distribution of that income on or before the accounting period in which the trustee pays the tax, (3) the tax resulted from a sale, by an entity owned by the trust and other than in the normal course of business, of noninventory fixed assets used in the entity’s business, or (4) a sale, by such an entity, of an asset not used in the entity’s business that would have been a principal asset if the fiduciary owned it directly.

118Revised UPIA §504.
119Revised UPIA §504(b).
120Revised UPIA §505.
121Revised UPIA §506.
In the case of situations (3) and (4) above, it is irrelevant whether the entity has distributed any or all of the sale proceeds to the fiduciary.\textsuperscript{122}

A trustee is permitted to make adjustments between income and principal when that is considered to be appropriate to compensate for any shift in economic interests or tax benefit between income and remainder beneficiaries occurring because:\textsuperscript{123}

- of elections and decisions made by the trustee regarding tax matters;
- federal income or any other tax is imposed upon a fiduciary or a beneficiary as a result of a transaction involving a trust or a distribution from a trust; or
- the estate or trust owns an interest in an entity whose taxable income, whether distributed or not, is includible in taxable income of the trust or one or more of its beneficiaries.

Also, an estate, trust, or beneficiary shall reimburse principal an amount equal to the decrease in a marital deduction and/or a charitable contributions deduction resulting from a trustee’s election under federal or state law to deduct on an income tax return, instead of an estate tax return, amounts that are paid from or chargeable to principal, if the trustee’s election causes an increase in the estate tax and a decrease in the amount of principal that would be eligible for a marital deduction or a charitable contributions deduction.\textsuperscript{124}

**EXAMPLE**

Trust received “portfolio” type income in 1996 amounting to $60,000. At the suggestion of the beneficiary, trustee was able to invest trust funds in a manner that generated ordinary deductions of $50,000 in 1996 and related ordinary income of $55,000 in 1997, both of which items were charged and credited to principal. The result is a reduction of DNI (but not trust accounting income) in 1996 of $50,000 and an increase of trust’s taxable income by $55,000 in 1997. Assuming top income tax rates, trust’s income tax chargeable to principal was increased by at least $20,000 (40 percent of $50,000) by the trustee’s investment/tax decision. Thus, principal is entitled to an adjustment of $20,000 to be transferred from the income account.

**EXAMPLE**

Estate earned $100,000 from its S corporation stock holding in 1996. The executor paid administration expenses and fees of $90,000 that were claimed...

\textsuperscript{122}Comments from the 1996 draft-revised UPIA.

\textsuperscript{123}Id.

\textsuperscript{124}Id.
on the fiduciary income tax return because the estate residuary was to be distributed two-thirds to surviving spouse and one-third to a charitable remainder trust. Based on the front end annuity valuation factor, this $100,000 expenditure not deducted on the Form 706 estate tax return increased the taxable estate by $60,000. As a result, estate taxes, imposed at the top rate of 55 percent, were increased by $33,000. This income tax deduction election thus will require the executor to transfer that amount of $33,000 from income to principal.

Equitable adjustment overcome by beneficiaries' agreement. A unique confluence of tax treatment and applicable state law, arising by virtue of a tax-allocation agreement signed by the estate beneficiaries, rather than being made pursuant to state statute, occurred in Hill v. Estate of Richards.125 A trust beneficiary was survived by her second husband and six children from a prior marriage. These seven individuals entered into an agreement covering residual distributions from the trust—i.e., 47 percent would go to the surviving spouse-husband and 53 percent to the six children and their children (decedent’s grandchildren). The agreement also provided that trust income would be allocated to the respective beneficiaries in the same proportion. Before the surrogate’s court granted approval to this agreement, advance distributions were made by the trustee from trust principal (i.e., $6,500,000 in cash to the surviving spouse; $100,000 in cash and 800 shares of listed stock to each child). Subsequent to the distribution, the agreement was amended to state that the parties would take tax positions consistent with the agreement. The surviving spouse, on opinion of counsel, asserted that the language of the amended agreement supported a position that the principal distributions did not carry out taxable DNI to the beneficiaries and that the trust would be taxable on all trust income. A Private Letter Ruling to this effect was requested. A Form 1041 was so filed with the expectation of receiving a favorable IRS ruling.

The IRS, in its response to the request for ruling, concluded (in an obviously correct application of IRC §§661 and 662) that the principal distributions did, in fact, carry out taxable income to the beneficiaries. An amended return was filed by the trustees to reflect that treatment. As a result of the amended return, a disproportionate amount of the trust’s DNI distribution was allocated to the husband (i.e., 91 percent, rather than the 43 percent target expressed in the agreement).

The surviving spouse sought reimbursement of the excessive income tax he paid from the children-beneficiaries. He also requested that the trust’s refund of taxes erroneously paid to the IRS be distributed to him in the 91 percent/9 percent manner that the income was taxed to him.

At the lower court, the surviving spouse was thwarted in his request for reimbursement, because (1) the agreement he signed was consistent with the proper tax treatment based on DNI being allocated relative to values actually received in the distribution, and (2) he was a willing participant in (actually the

§205.7 Income Taxation of Fiduciaries and Beneficiaries

instigator of) the agreement. The trial court, however, did approve his request to share the trust's income tax refund proceeds disproportionately. The Supreme Court agreed with the first determination, noting that state law and cases like In re Warms,126 Cooper v. Parkinson,127 and In re Holloway's Estate128 did not involve actions affirmatively taken by a beneficiary who now was complaining. On appeal, he also lost on his sharing of the refund contention, since the upper court determined that the lower court erred in applying an equitable adjustment statute to credit the tax refund disproportionately.

§205.8 Determining Right to Income: When It Begins; Apportionment at Beginning and End of Income Interest

An income beneficiary is entitled to net income from the day specified in the governing instrument.129 If no date is so specified, the commencement is the date an asset becomes subject to the trust or a successive income interest.130 The latter date refers to (a) when an asset is transferred to a trust during transferor's life, (b) the date of an individual's death for assets transferred to a fiduciary by a third party because of that individual's death, (c) the testator's death for an asset subject to a trust under terms of a will, or (d) on the date a preceding income interest ends.131

Generally, principal is credited with receipts due before a decedent dies or before the principal asset producing a receipt is subject to a trust.132 Similarly, a disbursement due before a decedent dies or an asset is subject to the trust is charged to principal.133 Income or obligations to disburse, not due when a decedent dies or an income interest begins, are to be treated as occurring from day to day so that portion occurring prior to the "cut-off" date defined above is principal; the balance is income.134

Receipts or disbursements whose due date occurs after the date a decedent dies or an income interest begins are not apportioned if that date is a periodic due date as defined under UPIA §304.135 When there is no periodic due date, "undistributed income" is defined as net income received before the last distribution date prior to that on which an income interest ends.136 To the extent necessary for a trust to qualify for a marital deduction, this term refers to net income received before the date on which this income interest ends.137 It does not include times

129 Revised UPIA §301(a), October 11, 1995 draft.
130 Id.
131 Revised UPIA §301(b).
132 Revised UPIA §302(a).
133 Id.
134 Revised UPIA §302(c).
135 Id.
136 Revised UPIA §303(c).
137 Id.
of income or expense that are (1) due or accrued, (2) related to specific bequests, or (3) added or required to be added to principal under the governing instrument terms. Annuity payments or unitrust amounts are not to be apportioned unless under applicable state law pro rate apportioning is required to qualify for income, gift, estate, or other tax deduction.

Upon the completion of a mandatory income interest, the income beneficiary if alive at that time, or such beneficiary’s estate if the beneficiary’s death terminated the interest, is entitled to the share of undistributed income not disposed of by the governing instrument.

Receipts from other trusts and estates. Amounts received from another fiduciary in which the recipient trust or estate has an income interest resulting from a donative transfer is credited to income, while principal includes distributions of principal from another fiduciary. When the principal assets are transferred from one estate or trust to another fiduciary performing as an investment entity in exchange for a beneficial interest in the investment entity (or such a beneficial interest transfer is accomplished directly by a donor or decedent), then the character of distribution rules affecting entities discussed at §205.2.2 will apply.

§206 PRINCIPLES OF TAX ACCOUNTING FOR FIDUCIARIES

§206.1 Function of the DNI Concept

The concept of distributable net income (DNI) serves several purposes. First, it establishes the maximum income distribution deduction (IDD) that the trust may receive. The IDD is the lesser of the amount distributed (required to be distributed or actually distributed) to the beneficiaries or the DNI, both adjusted for tax-exempt interest. Second, DNI (as modified for tax-exempt interest) also establishes the maximum amount of annual trust income that is taxable to the beneficiaries. Finally, the character of the trust income that is taxable to the beneficiaries is determined by the character of the items making up the DNI (e.g., the “conduit” approach).

138Id.
139Revised UPIA §303(b).
140Revised UPIA §303(a).
141Revised UPIA §402, subject to override by contrary provisions of the recipient trust’s governing instrument.
142Id.
143Id.
§206 1IRC §§651 and 661; Reg. §1.651(b)-1.
2IRC §§652(a) and 662(a).
3IRC §§652(b) and 662(b).
EXAMPLE

Trust accounting income and DNI total $1,000, which consists of taxable interest of $500, tax-exempt interest of $100, dividends of $400, and no expenses. The beneficiary, entitled to a distribution of 50 percent of TAI, is required to include in income $500 from the trust. As a result, $250 (($500 ÷ $1,000) × $500) is characterized as taxable interest, $50 (($100 ÷ $1,000) × $500) is characterized as tax-exempt interest, and $200 (($400 ÷ $1,000) × $500) is characterized as dividends.

§206.2 Distributable Net Income

Like TAI, the concept of distributable net income must also be understood in order to calculate the taxable income of a trust. Whereas TAI is an accounting concept, DNI is a tax concept. DNI is defined as taxable income with the following modifications: (1) no distribution deduction is allowed; (2) no deduction for the exemption is allowed under IRC §642(b); (3) capital gains are excluded to the extent they are allocated to corpus and are not (a) paid, set aside, or required to be distributed to any beneficiary during the tax year or (b) paid, permanently set aside, or to be used for charitable purposes and (c) capital losses are excluded except to the extent taken into account in determining the amount of capital gains paid or required to be distributed to a beneficiary; (4) extraordinary and taxable stock dividends are excluded from DNI in certain situations; (5) tax-exempt interest, reduced by allocable expenses, is included in DNI; and (6) in the case of a foreign trust, income from sources outside of the United States is included and other special rules apply. Items (4) and (6) are less common than the other modifications. Note, however, that it is not uncommon to find items of trust accounting principal included in DNI, because the definitions of TAI and DNI are not parallel.

EXAMPLE

Trust has rental and trade or business property. It disposes of the former at a gain of $100,000, $40,000 of which is ordinary income from recapture. In the same year, it realizes a loss of $45,000 from the sale of the business property. Finally, it also receives $30,000 of portfolio income. Under normal P&I rules, TAI is represented only by the portfolio income of $30,000, while the other items are reflected as a net principal credit of $55,000 ($100,000 gain on sale of the rental property, less the net loss of $45,000).

For tax purposes, however, the principal items that are realized as ordinary income or loss will be reflected in DNI. These include the §1231 loss of $45,000 from sale of the business property and the recapture income element of the

IRC §643(a).
gain on the sale of the rental property (both of which are included in DNI as a net passive income generator (PIG) item. Thus DNI is $25,000 ($40,000 recapture income + $30,000 portfolio income − $45,000 §1231 loss). As a result, the beneficiary is taxable on $25,000 DNI, even though he received $30,000 of TAI. The DNI of $25,000 represents portfolio income of $10,714 ($30,000 ÷ $70,000) × $25,000) and passive income of $14,286 (($40,000 ÷ $70,000) × $25,000).

EXAMPLE

If, in the above example, the state P&I Act, or the controlling document, required depreciation recapture to be categorized as income, then TAI would be $70,000 ($40,000 + $30,000), not just the $30,000 portfolio income. The beneficiary’s distribution in a simple trust (or a full distribution of TAI by a complex trust) would be taxable in the same amount of $25,000, since the $45,000 §1231 loss still is reflected in the DNI calculation, even though it is chargeable to principal. If there existed income accumulation in the preceding year, a throwback could be created if this trust was complex, but not if simple.

An easier method of determining DNI is to begin with the adjusted total income on line 17 of Form 1041 (on the 1994 form this represents taxable income before the income distribution deduction and the exemption) and then make modifications (3) through (6), as appropriate. This is essentially the approach that is reflected on Schedule B of Form 1041. An example of this can be observed in the case of an irrevocable inter vivos trust that distributes currently all of its net income, where state income tax was paid on capital gains retained by a trust under terms of the governing instrument for the benefit of noncharitable remainder beneficiaries. The IRS concluded that such tax was deductible in arriving at the trust’s taxable income and distributable net income. The distribution deduction was limited, however, to DNI for the taxable year.5

§206.2.1 The Place for Tax-Exempt Income in DNI

Tax-exempt income is included in DNI after reduction for those expenses allocable to such income that would have been deductible except for IRC §265.6 Expenses that are directly related to tax-exempt income are allocated in full to tax-exempt income. If an expense is indirectly related to both taxable and tax-exempt income (e.g., fiduciary fees), the expense must be allocated between the two types of

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6IRC §643(a)(5).
income on a reasonable basis. Generally, expenses are allocated to exempt income based on the ratio of exempt income to total income comprising DNI.

**EXAMPLE**

Trust receives dividends of $90,000, taxable interest of $30,000, and tax-exempt interest of $60,000. Investment advisory fees incurred on taxable investments totaled $8,000, tax-exempt advisory services charged $4,000, and trustee’s fees of $14,000 were paid. The allocation of expenses to the various classes of income, especially important with regard to tax-exempts, is:

<table>
<thead>
<tr>
<th>Character of Income</th>
<th>Gross Amount</th>
<th>Direct Allocations</th>
<th>Indirect* Allocations</th>
<th>Total Expense</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>$90,000</td>
<td>$6,000</td>
<td>$7,000</td>
<td>$13,000</td>
<td>$77,000</td>
</tr>
<tr>
<td>Interest (taxable)</td>
<td>30,000</td>
<td>2,000</td>
<td>2,333</td>
<td>4,333</td>
<td>25,667</td>
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<tr>
<td>Total taxable</td>
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<td>17,333</td>
<td>102,667</td>
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<tr>
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<td>8,667</td>
<td>51,333</td>
</tr>
<tr>
<td>Total DNI</td>
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<td>$12,000</td>
<td>$14,000</td>
<td>$26,000</td>
<td>$154,000</td>
</tr>
</tbody>
</table>

*Tax-exempt income $60,000 ÷ total income of $180,000 × indirect expenses of $14,000 = $4,667.

**§206.2.2 Capital Gains Usually Are Not Part of DNI**

Capital gains are excluded from DNI, except in certain circumstances. IRC §643(a)(3) provides that they are excluded from DNI to the extent they are allocated to corpus under the terms of the trust instrument or state law and "(A) are not 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 §642(c)." The regulations provide that capital gains are included in DNI only if they are (1) allocated to income under the terms of the governing instrument or local law by the fiduciary on its books or by notice to the beneficiary; (2) allocated to corpus, but are actually distributed to the beneficiaries during the taxable year; (3) utilized (pursuant to the governing instrument or the practice followed by the fiduciary) in determining the amount that is distributed or required to be distributed; or (4) deductible as a charitable contribution under IRC §642(c).8

7Reg. §1.265-1(c).
8Reg. §1.643(a)-3(a).
Chapter 2. Relationship of Fiduciary Accounting and Tax Concepts §206.2.3

What is a fiduciary's regular practice? The regulations indicate that capital gains are included in DNI based on the practice followed by the fiduciary only if the trustee follows a "regular practice of distributing the exact net proceeds of the sale of trust property."\(^9\) This brings into question whether the first such distribution can qualify as being part of a "regular practice." Commentators differ on this, some rationalizing that capital gains distributions can qualify if distributed on the initial realization, but not if the trustee chooses to do so after a number of accumulation years. Others interpret the treatment more liberally, saying that a capital gains distribution done once can be considered a regular practice.

In light of Crisp (discussed at §206.2.6) and the government's position in a docketed Tax Court case\(^11\) it would appear that the regulation position, as interpreted by the IRS and more conservative practitioners, that a "regular practice" of distributing capital gains must involve either the initial distribution or a pattern of more than one distribution from the trust is being eroded from all sides. It is certainly challengeable by taxpayers.

§206.2.3 The General Rule Applied

The general rule of exclusion is followed when the governing instrument is silent as to capital gains and where state law requires an allocation of such gains to corpus.\(^12\) Notwithstanding the general rule that capital gains are excluded from the DNI of an estate or trust, however, a number of special situations have been considered by both the IRS and the courts.

In a revenue ruling,\(^13\) capital gain resulting from the liquidation of a corporation, shares of which were held by a simple trust, were allocable to "beneficiary income" and includable in distributable net income in the same ratio in which the total liquidation distribution was allocated to "beneficiary income" and DNI under state law. In another revenue ruling,\(^14\) where trust income was insufficient to make an annuity payment and the trustee distributed appreciated securities to the beneficiary in satisfaction of the annuity, the capital gains resulting from the transaction were ruled to be excludable from the DNI of the trust.

In addition, DNI did not include capital gains realized by an estate where no provision for such treatment was provided in the decedent's will, since they were not considered paid, credited, or required to be distributed to the beneficiaries under Reg. §1.643(a)-3(a). In this instance, the gains were not allocated to income, nor were they utilized, either pursuant to the terms of the governing instrument or pursuant to a practice followed by the fiduciary, to determine the amount distributed or required to be distributed.\(^15\) An exception to the general rule was

\(^9\) As provided in Reg. §1.643(a)-3(a)(3).
\(^10\) Reg. §1.643(a)-3(d) example (1).
\(^12\) Id.
\(^15\) Priv. Ltr. Rul. 8506005.
made, however, where state law treated stock held by a simple trust as “underproductive property” and the income beneficiary was entitled to a statutory portion of any capital gains associated with proceeds from the disposition of the stock. That amount was includible in the distributable net income of the trust.\textsuperscript{16}

\section{Situations in Which DNI Includes Capital Gains}

\textbf{Trapping distributions.} A trapping distribution (one that carries out DNI to the distributee but represents trust principal, rather than accounting income) made by an estate to a testamentary trust was includible in distributable net income, even though it constituted principal for fiduciary accounting purposes. Neither the trust instrument nor local law provided for an allocation of different classes of income to different beneficiaries.\textsuperscript{17}

\textbf{Trustee authority.} A trustee properly allocated capital gains to income pursuant to the discretionary authority granted under the trust instrument, which was permissible under state law. The capital gains allocated to income were includible in the computation of the trust’s distributable net income.\textsuperscript{18}

\textbf{Executor authority.} It is interesting to note that the IRS has sanctioned an executor’s exercise of discretionary power set forth in a will to allocate capital gains to fiduciary accounting income.\textsuperscript{19}

\textbf{Employee’s trust lump-sum distribution.} A lump-sum distribution of an employee’s interest under a qualified employees’ profit-sharing plan, on the employee’s death, was paid to a trust established by the employee. If, during the year of receipt, such capital gain and ordinary income are utilized in determining the amount that is distributed or required to be distributed to beneficiaries of the trust, or is allocated to corpus and actually distributed during the tax year, it would be included in determining the trust’s distributable net income. Likewise, if, in the year of receipt by the trust, the grantor’s spouse dies, the trust is terminated and the principal, including such capital gain and ordinary income, is distributed to the children, such amounts would be included in computing distributable net income.\textsuperscript{20}

\textbf{Underproductive property.} Where state law treats stock held by a simple trust as “underproductive property,” the income beneficiary is entitled to a statutory portion of any capital gains associated with proceeds from the disposition of the stock, and that amount is includible in the distributable net income of the trust.\textsuperscript{21}

\textsuperscript{17}Van Buren v. Commissioner, 89 T.C. 1101 (1987).
\textsuperscript{18}Priv. Ltr. Rul. 8720001.
\textsuperscript{19}Id.
§206.2.5 Year of Fiduciary Termination

Capital gains realized by a trust or estate in the year of termination are included in DNI because the capital gains are distributed to the beneficiaries who are entitled to the principal on termination.22 Trust agreements may also provide for partial terminations, as where corpus distributions are required to be made when beneficiaries attain a specified age. The regulations indicate that in years in which a partial termination occurs, capital gains should be included in DNI to the extent the capital gains are actually distributed to the beneficiary.23 Capital gains are also required to be included in DNI where the trust instrument allocates capital gains to income.24 Other than these three situations, it is rare for capital gains to be included in DNI.

§206.2.6 Partnership Distributions of Capital Gains

Does portfolio income include capital gains? Some contend that any distributions from a partnership is trust accounting income, or at least that capital gain received by a partnership and distributed is state law income. There appears to be no authority other than experience in settling law suits on this issue. The proposed revisions to the Uniform Principal and Income Act (§204.2) would allow trustee discretion to consider all distributions up to 20 percent of principal from a partnership to be treated as accounting income. Even if trust assets are placed in a partnership, are all distributions TAI? Until the UPIA changes, there are doubts; even more conjectural is IRS recognition that capital gains automatically, then, are part of DNI.

A recent court decision concluded that the apparent rigidity of the regulations, interpreting the Code generally to exclude capital gains in the determination of DNI, may be overcome where the "right" facts are coupled with adroit draftsmanship of the trust document. In Crisp,25 a very large trust invested a small portion of its assets, $5 million, in an investment partnership; its interest was as a limited partner. The partnership was empowered to do all forms of sophisticated and risky investing, including arbitrage. An independent investment advisor was the general partner who had complete discretion to distribute profits. He was given exclusive authority to manage and control the partnership operations including execution of investment decisions. The trust's auditor from a national accounting firm allocated the gains distributed from the partnership to income, not corpus. The IRS, relying upon the Treasury regulations, assessed a deficiency based upon a finding that the capital gains were taxable at the trust, rather than beneficiary, level.

The court noted that both Reg. §1.643(a)-3(a)(1) and local law directed it to the trust agreement as the initial source of determining distributable income. In hold-

22Reg. §1.643(a)-3(d) example (4).
23Id. example (5).
24Reg. §1.643(a)-3(a)(1).
ing for the taxpayer, the court referenced the trust instrument's direction to the trustee to distribute to the income beneficiary "net profits" or "net earnings," but not trust-corpus. It concluded that if the trust document allocates capital gains to "net profits" or "net earnings," by applying the §1.643(a)-3 regulations, such allocation will be treated as one made to income. Since the trust agreement did not define these two terms, the court referred to contemporaneous law dictionaries that indicated these terms included gains. Further, the agreement did not expressly direct the trustee to treat as corpus gains distributed, such as those received from the investment partnership. The court noted that the trustee had no title or control over the partnership investments, so the IRS could not argue they were part of the trust corpus. It acknowledged that direct ownership of the securities by the trust would have resulted in a different conclusion (i.e., the security and resultant gains would be part of corpus). The IRS's argument that interposing the investment partnership between the securities and the trustee would reasonably allow the trustee to convert corpus to distributable income was rejected on the basis that such result was what the trust settlor intended in granting the trustee power to distribute "net profits" or "net earnings." This followed common law at the time the trust was formed in 1935 that allowed the trustee to utilize different investment structures (i.e., entities) to vary allocation of investment receipts between distributable income and nondistributable corpus. It also recognized the significance of the trust document providing broad discretion to the trustee and Trust Advisory Board with regard to investing and distribution of trust assets. The taxpayer was entitled to summary judgment on this basis, as well as the fact that a state trust code that would properly be interpreted to provide the same result.

The facts of the Crisp case are instructive in providing a "road map" on how a trust document and/or state law can be used to assist a trustor to include capital gain in DNI. In today's investment environment, where the use of investment partnerships are becoming more popular, as well as other forms of investment entities such as REITs, RICs, mutual funds, etc., the liberal interpretation by the Claims Court in Crisp can be beneficial. This has particular relevance in light of the current ascendancy of Modern Portfolio Theory and "total return" investing. Irrespective of Uniform Principal and Income Act provisions, it appears that appropriate attention to drafting broad definitions of distributable income in the trust document will prevail for tax purposes.

§206.2.7 Other Trust Receipts That Are Not Part of DNI: Extraordinary Dividends, Stock Dividends

Extraordinary dividends received by a trust that the fiduciary, acting in good faith and after consideration of the terms of the governing instrument and applicable provisions of local law, determined to be allocable to corpus were held not to be income required to be distributed currently (TAl). Also, those dividends were found excludable in computing the distributable net income of the trust. See Reg. §1.665(d)-1(b) for a description of the tax consequences when an extraordinary dividend or taxable stock dividend is later distributed to the income beneficiary.26

While nontaxable dividends are not includible in DNI, where an amount was distributed by a trustee to the income beneficiary that was equal to the value of a nontaxable stock dividend received by the trust, that amount was includible in the beneficiary’s gross income to the extent of distributable net income from other sources. The same is true if the trustee has discretion to distribute corpus, as well as to accumulate or distribute income, and properly distributes cash equal to the value of a stock dividend received.27

Where the beneficiaries had no right to a special dividend under the agreement and under an Orphans’ Court adjudication, this treatment was found to be binding upon the Tax Court as a determination of property rights under local law. As a result, the special dividend was not a part of distributable income.28 Yet, as noted above, a circuit court held that where the trustees receive an extraordinary cash dividend, the part paid out of surplus of the corporation existing at the date of decedent’s death is not a return of capital to the trust, but is trust accounting income. Its character is not affected by any rule of local law.29 Consistent with this decision, the IRS stated that a corporate distribution received by a simple trust that was not paid from earnings and profits (and accordingly (under IRC §301(c)(2)) reduced the basis of the stock) did not represent either trust accounting income or DNI.30

§206.2.8 Income Set Aside in Provided Reserves

A whole set of trustee decisions relating to the “set aside” of income in managing businesses or investment property or in administering the trust in general has resulted in a reduction of the amount of DNI taxable to the distributee, since these retentions reduced trust accounting income that was required to be distributed.

Business operation fund. That portion of trust income retained under the terms of a will creating a trust to operate plantation property for the next year was income of the trust and not currently distributable income taxable to the beneficiaries.31

Repairs. Income set aside in a reserve for repairs was not taxable to the beneficiary where a state court had decreed that the trustees had power to set up such a reserve.32

Legal expenses. The beneficiary of a trust was not taxable on income placed in a reserve for legal expenses, even though the cash-basis trust could not deduct the expenses because it had not paid them. The trust instrument authorized the

29Burdock v. Commissioner, 76 F.2d 672, 35-1 U.S.T.C. ¶9,234 (3d Cir. 1935).
31Rogers v. Commissioner, 16 B.T.A. 368 (1929).
trustee to set up a reserve for "indebtedness," so that the amount held in the reserve was not income required to be distributed currently.\textsuperscript{33}

**Fiduciary expense.** Amounts set aside as a reserve for trustees' commissions were not taxable to the beneficiary of the trust where the trustees acted under broad powers in the governing instrument in accumulating the reserve.\textsuperscript{34}

**Future expenses.** A reserve set up by an estate for expenses to become due the next year was not taxable to the beneficiary in view of the express provision in the will requiring the reserve.\textsuperscript{35}

\textsection{206.2.9 Trust DNI Arises from Informal Financial Arrangements with Estate}

In *Geftman*,\textsuperscript{36} an estate partially funded a testamentary trust and immediately thereafter borrowed back funds, both directly and on behalf of corporations owned by the estate. The Tax Court concluded that the trust realized taxable interest income from these loans in spite of the lack of repayment schedules, fixed loan maturity dates, or the execution of written notes. The amount of the interest income was based on receipts of the trust representing the amount of margin interest incurred by the trust in order to obtain the liquid funds that were the source of the borrowing.

The Tax Court\textsuperscript{37} rejected the argument that there was no valid debtor/creditor relationship between the estate and the trusts, finding (1) that a memo and journal entries evidenced the parties' objective intent to create a debt, and (2) that the "similarity between notations and deposits" verified that the estate paid interest to the trusts on the loans. The court did not find it significant that the trusts did not treat the estate payments as interest income on their books and that there was no repayment schedule, no fixed maturity debt, and no security. As a result, distributions from the trust to its beneficiary represented taxable income to the beneficiary, who was also found liable for tax additions due to nonfiling and nonpayment of estimated taxes that were not excused for reasonable cause just because the beneficiary was a minor.

The reported decision leaves unclear why the margin borrowing interest does not offset a like amount of interest received from the estate on its borrowing of the margin proceeds in the determination of DNI. So it appears the taxable distribution to the trust beneficiary may have been overstated. Nevertheless, the principle stated by the court needs to be heeded: Informality will not preclude the substance of a transaction from being recognized for what it is. The estate was a debtor; its lack of DNI did not make its payment to the trust tax-free.

\textsuperscript{34}Carruth, supra note 32.
\textsuperscript{35}Whitfield, Jr. v. United States, 311 F.2d 640, 63-1 U.S.T.C. ¶9,124 (5th Cir. 1963).
\textsuperscript{36}Geftman v. Commissioner, T.C. Mem. 1996-447.
\textsuperscript{37}Id.
Chapter 2. Relationship of Fiduciary Accounting and Tax Concepts §206.2.10

§206.2.10 Separate Share Rule to Determine DNI

A special treatment is provided for the determination of DNI and the implementation of the distribution rules under IRC §§661 and 662 where a single trust has multiple beneficiaries and the controlling document establishes substantially separate and independent shares for different beneficiaries. When those conditions exist, each such separate share shall be considered as a separate trust solely for application of the distribution rules[^35] but not for other purposes such as (a) filing of returns and payment of tax; (b) determination of personal exemptions; or (c) allowance of excess deductions, unused set operating losses, or capital loss carryovers to beneficiaries succeeding to trust property on termination of the trust.[^39]

When these separate shares rules apply, the result can be significant where different amounts of income and/or principal are distributed to different beneficiaries, because otherwise the beneficiary receiving the greater total distribution of income and/or principal could be taxable on amounts actually accumulated for future distribution to one or more of the other beneficiaries. This special treatment may apply even though separate and independent accounts are not maintained and no principal segregation of assets is made.[^40] There is no choice regarding separate share treatment; its use is mandated, not made elective.[^41]

Mechanically, the separate share rule is accomplished by computing distributable net income for each share as if it were a separate trust so that income, deduction, or loss applicable solely to one share of the trust is not available to any other share of that same trust.[^42]

**EXAMPLE**

A single trust was created in 1981 for the benefit of A, B, and C, who were aged six, four, and two, respectively. Under the terms of the instrument, the trust income is required to be divided into three equal shares. Each beneficiary’s share of the income is to be accumulated until she becomes 21 years of age. When a beneficiary reaches the age of 21, her share of the income may thereafter be either accumulated or distributed to her in the discretion of the trustee. The trustee also has discretion to invade corpus for the benefit of any beneficiary to the extent of her share of the trust estate, and the trust instrument requires that the beneficiary’s right to future income and corpus will be proportionately reduced. When each beneficiary reaches 35 years of age, her share of the trust estate shall be paid over to her. The interest in the trust estate of any beneficiary dying without issue and before she has attained the age of 35 is to be equally divided between the other

[^35]: IRC §663(c); Reg. §1.663(c)-1(a).
[^39]: IRC §663(c); Reg. §1.663(c)-1(a).
[^40]: Reg. §1.663(c)-1(b).
[^41]: Reg. §1.663(c)-1(c).
[^42]: Reg. §1.663(c)-1(d).
[^43]: Reg. §1.663(c)-2.
beneficiaries of the trust. All expenses of the trust are allocable to income under the terms of the trust instrument.

No distributions of income or corpus were made by the trustee prior to 1996, although A became 21 years of age on June 30, 1995. During the taxable year 1996, the trust has income from royalties of $20,000 and expenses of $5,000. The trustee in his discretion distributes $12,000 to A. Both A and the trust report on the calendar year basis.

The trust qualifies for the separate share treatment under §663(c), and the distributable net income must be divided into three parts for the purpose of determining the amount deductible by the trust under §661 and the amount includible in A's gross income under §662.

The distributable net income of each share of the trust is $5,000 ($6,667 less $1,667). Since the amount $12,000 distributed to A during 1996 exceeds the distributable net income of $5,000 allocated to her share, the trust is deemed to have distributed to her $5,000 of 1996 income and $7,000 of amounts other than 1996 income. Accordingly, the trust is allowed a deduction of $5,000 under §661. The taxable income of the trust for 1996 is $9,900, computed as follows:

| Royalties | $20,000 |
| Deductions: | |
| Expenses | $5,000 |
| Distribution to A | 5,000 |
| Personal exemption | 100 |
| Taxable income | 9,900 |

In accordance with §662, A must include in her gross income for 1996 an amount equal to the portion ($5,000) of the distributable net income of the trust allocated to her share. Also, the excess distribution of $7,000 made by the trust is subject to the throwback provisions of subpart D (§665 and following).43

What is a substantially independent and separate share? It is one for which distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Thus, if a trustee is required to divide a trust into separate shares for each of the settlor’s children (or testator’s children in the case of a residuary estate) and the trustee is given discretion to distribute or accumulate income or principal with regard to each share independent of the others, a §663(c) separate share will exist.44 The ultimate distribution of accumulated income to the beneficiary or other designated distributees is immaterial to this determination.45 Thus, upon a beneficiary’s death, the instrument could pro-

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43 Reg. §1.663(c)-4.
44 Reg. §1.663(c)-3(a).
45 Id.
vide that undistributed amounts are to be added to other beneficiaries' shares without affecting the separate share status.\textsuperscript{46}

However, when a trustee has the power to distribute, apportion, or accumulate income or distribute corpus to or for one or more beneficiaries within a group or class of beneficiaries, separate share treatment does not exist unless (1) payment of such amounts to one beneficiary cannot affect the proportionate shares of these items\textsuperscript{47} of other beneficiaries, or (2) proper adjustment must be made thereafter for such distributions. Even so, more than one beneficiary may have an interest in one separate share or the same person may be a beneficiary of more than one share.\textsuperscript{48} Powers of trust corpus invasion will not affect the separate share status when the possibility of exercise is remote.\textsuperscript{49}

\section*{§207 TAXABLE INCOME}

The taxable income of an estate or trust is computed in the same manner as in the case of an individual, with certain modifications.\textsuperscript{1} The most significant difference between an individual and a fiduciary return is that a trust or estate may receive an income distribution deduction for amounts distributed to its beneficiaries. An exemption of $600 is allowed for an estate, $300 for a trust required to distribute all of its income, and $100 for all other trusts.\textsuperscript{2} Trusts and estates are not subject to percentage limitations with regard to charitable contributions.\textsuperscript{3} The taxable income of the fiduciary is the adjusted total income (line 17 of Form 1041 (1994)) less the exemption and the income distribution deduction.

The following example shows how the three types of income—tax accounting income, distributable net income, and taxable income—are determined.

\section*{EXAMPLE}

Assume that a trust instrument is silent with respect to allocations between principal and income, and that it provides that all net income shall be distributed to the beneficiary at least annually. Assume further that the resident state has adopted the Revised Uniform Principal and Income Act. The trust had the following receipts for the taxable year: $5,000 of dividends, $4,000 of taxable interest, $6,000 of tax-exempt interest, $10,000 of capital gains. Its only expenses were fiduciary fees of $2,000.

\textsuperscript{1}Id.
\textsuperscript{2}Reg. §1.663(c)-3(b).
\textsuperscript{3}Reg. §1.663(c)-3(c).
\textsuperscript{4}Reg. §1.663(c)-3(d).
\textsuperscript{5}§207 IRC §641(b).
\textsuperscript{6}IRC §642(b).
\textsuperscript{7}IRC §642(c).
Income Taxation of Fiduciaries and Beneficiaries

<table>
<thead>
<tr>
<th></th>
<th>TAI</th>
<th>DNI</th>
<th>TI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>$5,000</td>
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<td>$5,000</td>
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<tr>
<td>Ordinary interest</td>
<td>4,000</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Tax-exempt interest</td>
<td>6,000</td>
<td>5,200</td>
<td>—</td>
</tr>
<tr>
<td>Capital gains</td>
<td>—</td>
<td>—</td>
<td>10,000</td>
</tr>
<tr>
<td>Fiduciary fees</td>
<td>(1,000)</td>
<td>(1,200)</td>
<td>(1,200)</td>
</tr>
<tr>
<td>IDD</td>
<td>—</td>
<td>—</td>
<td>(7,800)</td>
</tr>
<tr>
<td>Exemption</td>
<td>—</td>
<td>—</td>
<td>(300)</td>
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<tr>
<td><strong>Total</strong></td>
<td>$14,000</td>
<td>$13,000</td>
<td>$9,700</td>
</tr>
</tbody>
</table>

For purposes of calculating TAI, capital gains are excluded and one-half of the fiduciary fees, or $1,000, is allocated to income. This is because the trust instrument is silent with respect to allocations between income and principal so state law controls. State law also credits capital gains to principal and allocates the remaining one-half of the fiduciary fees to principal. Therefore, the amount required to be distributed to the beneficiary is $14,000.

For purposes of calculating TI and DNI, the entire amount of fiduciary fees (i.e., $2,000) must be allocated between taxable and tax-exempt income. The IRS has approved allocating the fees as follows:

\[
\frac{5,000 + 4,000}{5,000 + 4,000 + 6,000} \times 2,000 = 1,200 \text{ allocable to taxable income}
\]

\[
\frac{6,000}{5,000 + 4,000 + 6,000} \times 2,000 = 800 \text{ allocable to tax-exempt income}
\]

DNI is calculated by beginning with taxable income before the IDD or exemption ($5,000 + $4,000 + $10,000 − $1,200 = $17,800), subtracting capital gains ($10,000), and adding adjusted tax-exempt interest ($6,000 − $800 = $5,200), which equals $13,000. The IDD equals the lesser of (a) the total amount distributed to the beneficiary ($14,000) minus tax-exempt income included in the distribution ($5,600), which equals $8,400, or (b) DNI ($13,000) adjusted for tax-exempt interest ($5,200), which equals $7,800. Thus, the IDD is $7,800. The trust has taxable income of $9,700, which consists of $10,000 of capital gain, minus the exemption of $300. The beneficiary’s K-1 would report $7,800 of income that would be characterized as dividends and taxable interest. The balance of income ($600) is not subject to taxation in the hands of the beneficiary. It represents a portion of trustee’s fees chargeable to corpus but deductible in determining DNI.

The following example builds on the first.

**EXAMPLE**

In addition to the items of income and expense set out above, assume the trust has passive losses of $3,000.
Chapter 2. Relationship of Fiduciary Accounting and Tax Concepts

<table>
<thead>
<tr>
<th></th>
<th>TAI</th>
<th>DNI</th>
<th>TI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>$5,000</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Ordinary interest</td>
<td>4,000</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Tax-exempt interest</td>
<td>6,000</td>
<td>5,200</td>
<td>—</td>
</tr>
<tr>
<td>Rental loss</td>
<td>(3,000)</td>
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</tr>
<tr>
<td>Capital gains</td>
<td>—</td>
<td>—</td>
<td>10,000</td>
</tr>
<tr>
<td>Fiduciary fees</td>
<td>(1,000)</td>
<td>(1,200)</td>
<td>(1,200)</td>
</tr>
<tr>
<td>IDD</td>
<td>—</td>
<td>—</td>
<td>(6,600)</td>
</tr>
<tr>
<td>Exemption</td>
<td>—</td>
<td>—</td>
<td>(300)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$11,000</td>
<td>$13,000</td>
<td>$10,900</td>
</tr>
</tbody>
</table>

The passive losses are disallowed under IRC §469 for purposes of taxable income (and therefore for purposes of DNI as well), but are fully reflected in the calculation of TAI. This causes TAI to be less than DNI. The amount required to be distributed under the trust instrument is equal to TAI of $11,000. The amount of tax-exempt interest included in the $11,000 distribution is $4,400, computed as follows:

\[
\frac{6,000}{5,000 + 4,000 + 6,000} \times 11,000
\]

The IDD is the lesser of (a) the amount distributed to the beneficiaries ($11,000) minus $4,400 tax-exempt interest included in the distribution (i.e., $6,600), or (b) DNI ($13,000) minus $5,200 adjusted tax-exempt interest (i.e., $7,800). Thus, the IDD is $6,600.

In this situation, the trust is taxed on more than just capital gains. The passive losses are suspended and carried forward by the trust for use in future years. In a subsequent year when the trust receives passive income, the suspended losses may be utilized. TAI for a subsequent year in which passive income is realized will increase to reflect the passive income, yet DNI and TI will not increase as much because the passive income will be offset by the carryforward passive losses. Consequently, TAI will be greater than DNI. Thus, the IDD for the subsequent year will be limited to DNI, adjusted for tax-exempt income, and taxable income will be equal to capital gains, less the exemption.

As illustrated in the preceding example, the amount actually distributed to the income beneficiaries is dependent on TAI, which is unaffected by tax limitations such as passive activity losses and at-risk rules. The tax concepts serve to determine the taxability of the distributions, whereas TAI determines the amount that is to be distributed to the beneficiaries.

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4See Chapter 7 for a detailed explanation of the passive activity loss limitations on fiduciaries and beneficiaries.
§207.1  Like Kind Exchange Nontaxable to Estate

Where properties were jointly owned by decedent's private foundation, his sons, and his surviving spouse, B's marital trust and the surviving spouse's estate settled a will contest under which the estate exchanged its tenancy in common interest with the sons and B's marital trust. The IRS ruled that no gain or loss will be recognized to the estate under §1031, since it simultaneously exchanged real property held for investment solely for other real property to be held for investment.5 The like kind exchange exception to taxable income recognition will apply equally to transactions by a trust that meets the requirements of §1031 and regulations thereunder.

§207.2  Like Kind Exchange Nontaxable to Testamentary Trust

Thus, where a will contest was resolved by an exchange of real property between an estate and a testamentary trust, it was nontaxable under §1031, since the agreement required each transferee to hold the exchanged property for two years to avoid the §1031(f) related-party retransfer rules.6

§207.3  Like Kind Exchange Nontaxable to Remainder Interest

A community property surviving spouse owned one-half fee simple interest in two farm tracts and a life estate in decedent's one-half interest therein. The remainder interest went to their children. Under state law, her fee simple interest was divisible into a life estate and remainder. She proposed to exchange the remainder interest in one tract for the children's remainder in the other. After the exchange, she will have a life estate in one tract and the entire fee ownership in the other. Since the two remainder interests were of the same nature, the exchange was nontaxable, involving like kind property exchange under Reg. §1.1031(a)-1(f)(6).7 A similar result should ensue if the exchanging parties were remainder takers under a trust document.8

§207.4  Taxable Exchanges of Interests in Trusts or Estates

To be differentiated is an exchange of a life estate for a remainder interest. Rev. Rul. 72-6019 concluded (1) that a transfer of a life estate in one parcel of real

5Priv. Ltr. Rul. 9543011.
91972-2 C.B. 467.
property in return for a remainder interest in another does not qualify as a like kind exchange under §1031(a) of the Code because the remainder interest received is an advance rental in consideration for the transfer of a right to use real property for a period of years and (2) that a transfer of a remainder interest in one parcel of real property in return for a life estate with an expectancy of less than 30 years in another does not qualify as a like kind exchange under §1031(a) because the nature and character of the two property interests are not the same.

As noted in §805.10.4, when assets not qualifying as like kind property are distributed non-pro rata to remainder interests in a trust or estate without controlling document authority, a taxable exchange occurs.10

§208  FIDUCIARY ACTIVITIES MAY BE ATTRIBUTED TO BENEFICIARIES

Sometimes executors or trustees are requested to execute transactions at the behest of the beneficiary(ies) and do so as an accommodation. If they do, to whom are the tax incidences ascribed? If the actions taken clearly are the result of the beneficiary’s initiative, and primarily for its benefit, the tax results can avoid the fiduciary income and distribution system and, rather, be attributed directly to the beneficiary. In essence, the fiduciary’s acts are deemed taken on behalf of the beneficiary as its agent. Thus, sales of appreciated assets to allow the charitable beneficiaries to receive cash did not result in taxable income to an estate.1

§209  BENEFICIARY STATUS: FROM ASSIGNMENT, PURCHASE, OR BANKRUPTCY

An assignee of an interest in an estate or trust income or remainder interest (partial or total) is given the same treatment for all applications of subchapter J (tier and distribution systems) as the assignor-beneficiary enjoyed prior to the assignment.1 The continuing application of the subchapter J flow through distribution rules has even been extended to a purchaser of a trust beneficial interest,2 except in the case of excess deductions upon termination, where a narrower interpretation precludes purchasers3 and bankruptcy estate4 beneficiaries from utilizing excess deductions upon termination of the trust or estate entity. For further analysis see §§807 and 1408.

10IRC §1001(a)-(c).
2Priv. Ltr. Ruls. 8143071, 9512002.
4Richardson v. United States, 552 F.2d 291 (9th Cir.), 77-1 U.S.T.C. ¶9,390.
§210 ARE CONTRACTUAL ARRANGEMENTS TREATED AS TRUSTS OR OTHERWISE?

§210.1 Agency Versus Trust

The basic attributes of a trust are referenced in §104. An agency (defined in the glossary of terms) is an arrangement whereby a property owner (i.e., the "principal") gives authority to another (i.e., the "agent") to act on his or her behalf in dealing with specific property. This arrangement ordinarily results in an agency relationship, rather than a trust, and does not require a transfer of the ownership of the property — the agent operates on behalf of the principal.

As in other aspects of the law governing the taxation of fiduciaries, a trust may be deemed to exist under applicable state law and yet the arrangement is treated as an agency, rather than a trust, for federal income tax purposes. This is likely to occur when the principal's activities indicate, in substance, that the principal controls the property as well as the agent even though in form a trust exists. In such circumstances, the trustee is considered to be the agent of the trust creator, and not a fiduciary acting on behalf of third party beneficiaries.

On the other hand, in McCrory v. Commissioner, the court concluded that a trust, not an irrevocable agency, was created where a 10-year trust was established for 27 nephews and nieces under which property was irrevocably transferred to a trust. Specific duties, including income distributions, were delegated to the trustee. The court found that this arrangement "was a typical active trust" that distinguished it from "a mere agency . . . created to manage property" under which the grantor retained control. Whether a trust or agency is created depends upon the substance of the transaction, as contrasted to the form utilized. When making a determination on this issue, consideration is given to the degree of control or lack thereof in the trust settlor, the assigned duties of the trustee, the overall terms of the trust in providing for third party beneficiaries, and, most importantly, in spite of the first three, how the administration of the trust actually is carried out.

Agency depends on form and substance. When a developer corporation claimed that it was acting on behalf of a grantor trust as its agent, the Tax Court concluded that in form and substance no agency relationship existed. In reaching its determination the Court noted (1) a lack of disclosure that the seller was acting as agent and as to who was the principal, (2) a failure to record the real estate transfer to the trust, and (3) an inference that the trust's purpose was a financing arrangement.

§210 1Garcia v. United States, 421 F.2d 1231, 70-1 U.S.T.C. ¶9,226 (5th Cir. 1970).
2Id.
4Id.
§210.2 Is It Debt?

An unsecured debt arrangement differs from a trust since it involves only two parties. Party one (the "debtor") is the recipient of a property (tangible or intangible) transfer that is made by its owner (the "creditor") in exchange for the debtor's promise to repay a bargained-for amount or, in some situations, to return the property back to the creditor. The creditor has no special rights to the debtor's property, nor can the debtor be called upon to exercise fiduciary responsibilities on behalf of the creditor. For example, the IRS has concluded that a debt existed when a life insurance policy owner elected by settlement option to have the underwriter pay death benefits to certain beneficiaries over a stated period of time.6

A secured debt may involve the use of trusts, or deeds of trust, as a means of providing the creditor with priority position should the debtor default on the underlying debt. Usually these priority right arrangements differ from a three-party trust arrangement and are not taxed as trusts. In such instances, the creditor possesses a security interest in the specific property being pledged, but does not possess a beneficial interest in such property.

§211 POOLING OF ASSETS FOR INVESTMENT CONVERTS TRUST FORM INTO ENTITY TAXABLE AS A CORPORATION

A recent private letter ruling1 has cast a pall over the technique of using a single trust for the purpose of pooling for investment corpus transfers by multiple grantors and then paying annuities, limited to actual income, to those grantors. The specific situation involved grandparents, who contributed slightly over $1 million, and six grandchildren, who, as a group, contributed slightly less than $1 million, to a net income makeup charitable remainder unitrust (NIMCRUT). The NIMCRUT payout was to be made initially to the grandparents, then to the survivor of the two, and then to the grandchildren as a class. The IRS concluded that the entity could not qualify as a charitable remainder trust under §664 since it did not qualify as a trust because (a) the grantors' entitlement to income from the trust assets caused them to be characterized as associates, rather than beneficiaries, and (b) the trust entity constituted a device designed to allow the grantors to pool their assets for business purposes. As a result, the entity was classified as a corporation, not as a trust.2

In reaching its decision, the IRS noted that various characteristics must be considered when determining whether a trust is taxable as a trust, or as an association that is taxable as a corporation. Further, where any of these characteristics are common to both entities, they have a neutral impact upon the decision. Since centralization of management, continuity of life, free transferability of inter-

2 §211 Priv. Ltr. Rul. 9547004.
3 Reg. §§301.7701-2(a)(1) and (2).
ests, and limited liability are common characteristics of both trusts and corporations, the determination of the instant "trust's" status rested upon the presence or absence of the two remaining corporate characteristics of associates and the objective to carry on business and divide gains. The IRS stated:

If an entity has both associates and a business purpose, it cannot be classified as a trust for federal income tax purposes. In the present situation, eight individuals will each contribute his or her own funds to the proposed trust. The proposed trust will last until the death of the last survivor of the eight grantors. Throughout the term of the trust, the trustee will have the power to vary the investment of the grantors by investing and reinvesting the assets in the trust. As the recipients of the unitrust amount, the grantors will share in the profits derived from the joint investment of their assets held by the proposed trust. Under these circumstances, the grantors are associates and have pooled their assets with an object to carry on business and divide the gains therefrom. Thus, the proposed trust cannot be classified as a trust for federal income tax purposes.\(^3\)

The IRS's warning is unambiguous — joint contributions to a trust with retained interests held by multiple grantors can be hazardous. Besides CRTs with multiple contributors being at risk, a master trust created by separate residuary or inter vivos trusts that have been created by siblings, or siblings and their children, with a view toward pooling these trust assets for more efficient investment should apparently be avoided. For the latter situation, clearly an investment partnership is preferable.

With regard to a CRT, one can muse that the IRS just would not condone the kind of game playing that would be possible in a grandparent-grandchild joint effort involving a net income makeup unitrust. For example, the IRS's suspicions might extend to the likelihood of there being a very low income yield on the trust assets during the joint and separate lives of the grandparents, with a sudden increase in that yield after their deaths, which, together with the payout-makeup, would inure to the benefit of the grandchildren's generation free of any significant transfer tax.

Had the CRT involved an annuity interest, or even a fixed unitrust (not a NIMCRUT or its extension, a FLIP, discussed at §907.3.4), the game playing concern is eliminated, and one could strongly argue that the IRS's conclusion about pooling for business gain and the existence of associates in an enterprise would not be appropriate. Can this logic be extended to all multiple beneficiary trusts even if only some, or none, of the beneficiaries are grantors? Pandora's box may have been opened with this private letter ruling unless further guidance — and restriction — is forthcoming. The trust documents' provisions have more than just relevance to controlling this dire result. Thus, as discussed in §1702.7, a trust entity status was recognized where inheriting heirs placed property so received in a trust over which each had an undivided interest. The trust instrument referred to the arrangement's purpose as "proper and convenient management," and most important, it stated, "the trustees are prohibited from conducting a trade or busi-

\(^3\)Supra note 1.
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As a result, the IRS concluded trust, not association, status was appropriate. Most taxpayers’ desires could have been attained if the CRT donors set up separate trusts that pooled their investments through an investment partnership. Then association rules would not be applicable.

§212 PRE-NEED FUNERAL TRUSTS CAN ELECT TO BE TAXABLE ENTITY

The trustee of a pre-need funeral trust now can elect to have the trust essentially be treated as a nongrantor trust, to the extent the trust would otherwise be taxable as a grantor trust. This provision relates to arrangements under which an individual purchases funeral services or merchandise from a funeral home for a specific person prior to that person’s demise. Essentially it encompasses a prepayment of funeral costs to be held in trust during the covered party’s lifetime. This provision is analyzed in detail at §508.

§213 WILL OR TRUST CONTEST SETTLEMENTS: TAXABLE RECEIPT OR NOT?

Today’s litigious society reemphasizes the applicability of some long-ago-decided tax cases involving heirs and beneficiaries’ claims. J. Paul Getty provided income rights to all but one of his children in inter vivos trusts. The excluded son sued his father’s residuary beneficiary, a charity, for a promise by his father to make up this oversight. Son settled with charity for a $10 million payment. Is this a taxable receipt or a nontaxable gift? The IRS claimed the former, since the basis of the claim focused on income the other siblings received from the lifetime trusts; the Service held the compromise should be afforded the same character. The Tax Court found for the IRS because of uncertainty about what the father would have done. This was reversed, so son’s nontaxable treatment was allowed on a procedural conclusion involving the burden of proof required.

§214 SUMMARY

The purpose of this chapter has been to explain in general terms the concepts of trust accounting income and to compare tax accounting income with distributable net income and taxable income. Distributable net income and taxable income are discussed in greater detail in Chapters 4 and 8.

1Priv. Ltr. Rul. 9444030.
§213 1IRC §102(b).
2IRC §102(a).