

Allocating Capital Gain to DNI; Optimal Fiduciary Income Tax Planning/New Basis Reporting Rules

Examples: Treasury Regulations § 1.643(a) – 3(e)

DELAWARE TAX INSTITUTE

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- I. T.D. 9102 (December 30, 2003) promulgated the final regulations revising the definition of income under section¹ 643(b). The examples illustrating the rules set forth in the final regulations are as follows:**

(e) Examples. The following examples illustrate the rules of this section:

Example 1.

Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has \$5,000 of dividend income and \$10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the \$10,000 capital gain to principal. During the year, Trustee distributes to A \$5,000, representing A's right to trust income. In addition, Trustee distributes to A \$12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the \$10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example 2.

The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the \$10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

Example 3.

The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

¹ Unless otherwise indicated, all "section" references are to sections of the Internal Revenue Code of 1986, as amended (the "Code")

Example 4.

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

Example 5.

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

Example 6.

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

Example 7.

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

Example 8.

The facts are the same as Example 7, except Trustee is directed to pay B \$10,000 before distributing the remainder of Trust assets to A. Because the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1), none of Trust's distributable net income that includes all of the capital gains realized during the year of termination is allocated to B's distribution.

Example 9.

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

Example 10.

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

Example 11.

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

Example 12.

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

Example 13.

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

Example 14.

Trustee is a corporate fiduciary that administers numerous trusts. State statutes provide that a trustee may make an election to distribute to an income beneficiary an amount equal to four percent of the annual fair market value of the trust assets in full satisfaction of that beneficiary's right to income. Neither state statutes nor the governing instruments of any of the trusts administered by Trustee has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. With respect to some trusts, Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by not including any capital gains in distributable net income on the Federal income tax returns for those trusts. With respect to other trusts, Trustee intends to follow a regular practice of treating any net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds the trust's ordinary and tax-exempt income. Trustee will evidence this treatment by including net capital gains in distributable net income on the Federal income tax returns filed for these trusts. Trustee's decision with respect to each trust is a reasonable exercise of Trustee's discretion and, in future years, Trustee must treat the capital gains realized by each trust consistently with the treatment by that trust in prior years.

II. Comments on examples.

A. Overall observations.

1. All examples (although Example 6 does not so specifically state) involve mandatory income trusts.
2. None of the examples state that the trustee making the determination is a beneficiary.
3. None of the examples which permit the trustee to make discretionary principal distributions refer to a HEMS standard.
4. Most of the examples deal with distributions of principal in specific situations:
 - (a) Distributions based on the sale of a specific asset.
 - (b) Distributions upon trust termination.
 - (c) Distributions based upon attainment of certain ages.
 - (d) Distributions based upon realized capital gains.
 - (e) Distributions based upon sales proceeds.
5. The preamble to the final regulations noted that examples were added in response to comments following the issuance of the proposed regulations.
6. The preamble to the final regulations refers to situations where examples were not added to the final regulations although requested by commentators.
 - (a) T.D. 9102 noted that “[t]wo commentators requested examples of the inclusion of capital gains to DNI when the trustee exercises a power to adjust between income and principal under applicable law...Because of the potential variations in the circumstances and ramifications of exercising a power to adjust under applicable state statutes, additional examples would be unlikely to provide meaningful or complete guidance; thus the final regulations contain no additional examples concerning inclusion of capital gains in DNI when the trustee exercises the power to adjust.”
 - (b) T.D. 9102 noted that “[o]ne commentator requested examples of the effect on DNI of capital gains from a passthrough entity and income from a passthrough entity

that is more or less than the trust accounting income from that entity. These issues are beyond the scope of this project.”

B. Comments on specific examples.

1. Examples 1, 2, and 3.

(a) Each example focuses on the second exception which is that the capital gains is “[a]llocated to corpus but treated consistently by the fiduciary on the trust’s books, records, and tax returns as part of a distribution to a beneficiary...”

(b) The example uses the word “deem” in its analysis, although not used in the regulation itself.

(c) Example 3 focuses on a specific class of investments and the consistency requirement only applies to certain specified assets or a particular class of assets.

2. Example 4: The trust agreement provides that capital gains are allocated to income (rare) so there is no trustee discretion.

3. Example 5:

(a) Is consistency required? The proposed regulations used the words “reasonable and consistent” whereas the final regulations use the words “reasonable and impartial.” Thus, there does not seem to be an explicit consistency requirement requiring the trustee to “utilize” capital gains to determine distributions in the future.

(b) Focuses only on one year.

4. Example 6: The trustee is directed to hold Blackacre for ten years and then sell it and distribute all sales proceeds to beneficiary A.

5. The preamble to the final regulations noted that Examples 7 through 10 [replacing Examples 6 through 8 in the proposed regulations] “have been updated to take in account the new rules.”

(a) Example 7: All assets of the trust, including all capital gains, will be actually distributed to beneficiary A upon attainment of age 35, at which time the trust will terminate, so all capital gains realized in the year of termination are included in DNI.

(b) Example 9:

- (i) All of the sales proceeds are actually distributed to beneficiary A upon his attainment of age 35, so all of the capital gain is included in DNI under the regulatory exception of capital gain being allocated to corpus but actually distributed to the beneficiary.

- (ii) There is no consistency requirement.

- (c) Example 10: Situation where there is more gain than is required to be distributed pursuant to the terms of the trust.

6. Examples 11, 12, and 13 deal with unitrusts.

- (a) The preamble to the final regulations states as follows:

“One commentator requested that the final regulations also provide that administration of an exempt trust as described in these regulations will not cause any trust beneficiary to be treated as making a gift and will not result in any taxable exchange by the trust or any of its beneficiaries. Another commentator requested that the final regulations clarify that changing the situs of a trust from a state with only a traditional definition of income to a state that permits unitrusts or powers to adjust will not affect the exempt status of the trust. *Examples 11 and 12* have been revised to address these and similar concerns. The same conclusions apply to a change of situs in the opposite direction, from a state that permits unitrusts or the power to adjust to a state that has only the traditional definition of income.”

- (b) In Examples 12 and 13, since state law does not have a unitrust ordering rule, the allocation of capital gains must be exercised “consistently.”

7. Example 14 permits a corporate trustee administering many trusts to allocate capital gains to DNI differently for different trusts as long as there is consistency with respect to each trust.