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THE FINAL 'INCOME' REGULATIONS: THEIR MEANING AND IMPORTANCE

By Jonathan G. Blattmachr and Mitchell M. Gans

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In this report, Blattmachr and Gans explain how new regulations promulgated in January make reaching and fundamental changes to some tax rules that are dependent on the concept of fiduciary accounting income (FAI) under local law. The new regulations, they write, generally will respect a determination of income made by (1) a trustee's power granted under state law to adjust from the income account to the corpus account or the reverse, (2) a conversion of a "pay all income" trust to a unitrust one pursuant to state law, or (3) an allocation of capital gain to FAI in some cases. The regulations also provide that those conversions will not cause a beneficiary to be

treated as having made a gift or any party to have made an income taxable exchange if the powers are exercised or the conversion occurs pursuant to a state statute. But, the authors note, the regulations indicate that adverse consequences may ensue if the safe harbor boundaries in defining income under the new regulations are not followed. In addition, the regulations probably have created a substantial advantage for administering trusts pursuant to a power of adjustment rather than converting them to unitrusts, in many cases.

Blattmachr and Gans believe it is hard to overemphasize the importance of the new regulations. Unfortunately, they write, the new regulations appear to contain direct contradictions on important matters, which will likely perplex trustees and their advisors until clarifications are made. Also, although the new regulations provide significant new guidance as to when capital gain of a trust may form part of DNI and, therefore, may be taxed to a beneficiary, no guidance is provided as to when, how, and to what degree the exercise of a power to adjust from the corpus account to the income account may result in capital gain becoming part of DNI. The authors conclude that this omission means it will be difficult for trustees and their advisors to determine, in some situations, how much the adjustment should be.

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Fiduciaries are increasingly operating under a so-called unitrust or equitable-adjustment regime.¹ Recognizing the importance of that pervasive change in the trust-administration landscape, the Treasury recently promulgated regulations designed to clarify the tax consequences when one of these regimes is used.² This article examines those new regulations.

I. Introduction

It may seem surprising that often the tax consequence turns on the meaning of income, not in a tax sense, but rather on its meaning in a state law fiduciary-accounting sense. Perhaps even more surprising, the tax consequence is often dependent on the meaning of fiduciary accounting income as determined under applicable local law or the terms of the governing instrument (income will sometimes be referred to as FAI). That means, of course, that the tax consequence may be different if the transaction is governed by the law of one jurisdiction as opposed to another or under the terms of one document as opposed to another. In many ways, the new final regulations reinforce those disparate results.

The reason that the tax law is so connected to state law definitions of income and corpus (as well as to the governing document) is a combination of policy and simplicity. The concept of a trust paying its income to current (income) beneficiary and preserving corpus for remainder beneficiary is so ingrained in our common law that prescribing or relying on rules for tax matters relating to trusts and estates, without regard to local law notions of income and corpus, would have complicated much of the tax law. In terms of policy, as in other areas, the code³ seeks to impose the tax burden on the beneficiary entitled to receive the corresponding economic benefit. (Usually the tax result will be the same whether a rule is applied to a decedent's estate and its beneficiaries, or a trust and its beneficiaries.)

Examples of when the notion of fiduciary accounting income plays a significant role in determining a federal tax result include determining: (1) whether tax income of a trust will be taxed to the trust or a beneficiary; (2) which beneficiary of a trust will be taxed on trust tax income; (3) how much of a trust's tax income may be taxed to a trust beneficiary; (4) how much of a depreciation or depletion deduction will be allowed to a trust beneficiary; (5) whether transfers to a trust qualify for the gift or estate tax marital deduc-

tion; (6) whether a trust qualifies as a charitable remainder trust under section 664 of the code; (6) whether a trust or other fund is a pooled income fund within the meaning of section 642(c)(5); and (7) whether a trust is an eligible shareholder of a subchapter S corporation. The list is not complete.

II. Different Notions

Subchapter J of the code sets forth the primary rules for the income taxation of estates, trusts, and their beneficiaries.⁴ Section 643(b) provides that the term "income" (unless preceded by some other word or words, such as "gross") means income as determined under local law and the terms of the governing instrument. That meaning had long been fleshed out in the regulations under section 643 and had provided that provisions of the governing instrument that "depart from fundamental notions of income under local law" would not be respected for purposes of subchapter J. At the time those rules went into effect (in the 1954 code), trusts generally faced the same graduated income tax brackets as individuals. As a result, it was usually preferable for the tax income of a trust to be taxed to the trust rather than any trust beneficiary (who might have other income). The regulations under section 643(b) reflected a concern that trusts would be structured so distributions to a beneficiary could be minimized or that some classes of income could be taxed to the trust rather than to the beneficiary. The regulations addressed that concern, providing that fundamental notions of accounting income could not be ignored. They included an example illustrating how an attempt to treat as corpus an item that would clearly be defined as income under state law (such as interest or dividends) would not be respected for subchapter J purposes.⁵

Indeed, that concern about limiting the income that would be taxed to the beneficiaries led to the development of the concept of "distributable net income," or "DNI" as it is commonly called, under section 643(a). DNI is the taxable income of the estate or trust, subject to adjustments. The adjustments reflect notions of what should be taxable to the beneficiary and the trust or estate. For example, because capital gain (a tax concept

¹See generally Robert B. Wolf, "Total Return Trusts — Meeting Human Needs and Investment Goals Through Modern Trust Design," *10th Annual Estate Law Institute*, Pennsylvania Bar Institute, Vol. 1, at 450 *et seq.* (2003).

²Barbara A. Sloan, "Section 643 Regulations: Use of Non-Charitable Unitrusts and Other Issues Raised Under the Final Regulations," 30 *ACTEC Journal* 33 (2004); Linda B. Hirschson, "Final Section 643 Regulations Issued at Last, Permitting Total Return Investing," *New York Law Journal*, May 1, 2004, Trusts and Estates Special Section 1.

³Except where otherwise noted, "code" refers in this article to the Internal Revenue Code of 1986, as amended. Section references are to the code except where otherwise noted.

⁴However, many other rules on the income taxation of estates, trusts, and their beneficiaries are in other subchapters. See, e.g., section 167(d), setting forth rules for the apportionment of a depreciation deduction between income beneficiaries of trusts and of estates and their fiduciaries.

⁵The concern about using trusts as separate and independent taxpayers was also reflected by the earlier adoption of the so-called "grantor trust" rules in subpart E of part 1 of subchapter J (under which the tax income of the trust may be attributed directly to the grantor or sometimes to a beneficiary essentially as though the trust does not exist) and later adoption of the so-called "throwback" rules contained in subpart D of part 1 of subchapter J (under which some tax income not currently distributed to a trust beneficiary is taxed later to the beneficiary when it is deemed distributed). The throwback rules generally now apply only to non-U.S. (or foreign) trusts.

and not one traditionally found in state law notions of FAI) is typically part of the proceeds of the sale or exchange of an asset and, because under traditional common-law notions proceeds of sale are principal (or corpus), capital gain is not part of DNI as a general rule. See section 643(a)(3). An item of tax income of an estate or trust that is not part of DNI cannot be taxed to a beneficiary but only to the estate or trust.

In short, by tying the taxation of trusts and estates on one side, and beneficiaries on the other, to fundamental notions of income and corpus under state law, the tax law reflected a reasonable method of administering the income tax system concerning those entities and their beneficiaries.

The connection between FAI and tax consequence goes beyond the income taxation of fiduciaries and beneficiaries. Treatment for other tax purposes is dependent on FAI and, therefore, its meaning. For example, the most common forms of trusts that may qualify for the estate or gift tax marital deduction turn on the current payment of FAI to the surviving spouse. See, for example, section 2056(b)(7) and 2523(f). Nevertheless, for those (and some other) purposes, neither the code nor the regulations prescribed rules or limitations based on the definition of accounting income. For example, for a trust to qualify for the marital deduction under sections 2056(b)(5) or (7) and 2523(e) or (f), the trust must provide for the “income” to be paid at least annually to the spouse. But, rather than defining income, the regulations had simply provided that the trust must be structured so that the spouse is given “substantially that degree of beneficial enjoyment of the trust property during . . . life which the principles of law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust” and provided rules to establish that beneficial enjoyment (for example, the spouse has to be able to make the trust reasonably productive of income, as a general rule). Treas. reg. section 20.2056(b)-5(f)(1).⁶

In any case, it is clear that different latitude (perhaps in one sense more narrow, but in another sense more broad) had been permitted in defining income in a marital deduction trust than for purposes of subchapter J. The mandatory treatment of income (actually, the required treatment or status of the income beneficiary) for marital deduction trust-qualification purposes might be contrasted with the treatment of a so-called “income-only” charitable remainder trust described in section 664(b)(3), when qualification is not dependent on the treatment or status of the unitrust-income beneficiary but, apparently, on the meaning of income under section 643(b). Perhaps it is because the charitable remainder trust provisions are part of subchapter J that such a trust’s treatment was prescribed using the meaning of FAI as opposed to the treatment of the unitrust recipient, but interests in charitable

remainder trusts may also qualify for the estate and gift tax marital deduction. See section 2523(g) and 2056(b)(8).

That in turn might be contrasted with the treatment of fiduciary accounting income for purposes of qualified domestic trusts (QDOTs) (a trust that may qualify for the estate tax marital deduction when the surviving spouse is not a U.S. citizen). With a QDOT, estate tax is collected when the surviving spouse dies or, if earlier, when corpus is distributed (subject to exceptions) to the spouse. Sections 2056(d), 2056A. Income, in a fiduciary accounting sense, distributed by the QDOT trustee to the surviving spouse is not subject to estate tax (although it may be included in the spouse’s gross income for U.S. income tax purposes).

For QDOTs, a new type of rule was adopted to reduce tax avoidance that might occur by having distributions be deemed FAI (which would not be subject to estate tax) rather than corpus. The original QDOT regulations provided, in effect, that the meaning of income for QDOT purposes is the same as that under section 643(b) but does not include capital gain. In addition, the regulations provided that FAI does not include any other item that would be allocated to corpus under applicable local law, regardless of any trust provision to the contrary.⁷

III. The World of Trusts Changes

Most trusts provide that all income shall be distributed currently to a beneficiary — that is, they provide for a “straight” income interest. Corpus generally is preserved for successor beneficiaries, although often the trustee is given the discretionary authority to invade, or pay, corpus to the income beneficiary for any purpose or a specified purpose. Hence, whether a receipt or expense is allocated to income or corpus is critical in determining what each class of beneficiaries receives. Generally, income beneficiaries prefer greater income and remainder beneficiaries prefer greater corpus, all other things being equal. Indeed, income beneficiaries frequently “lobby” the trustee for more income and urge the trustee to invest a greater portion of the trust estate in fixed-income securities (for example, bonds), while corpus beneficiaries ask the trustee to invest for more growth in value (for example, equities).

⁷When there is no specific statutory or case law regarding the allocation of such items under the law governing the administration of the QDOT, the allocation was to be governed by general principles of law (including any uniform state acts, such as the Uniform Principal and Income Act, or any *Restatements* of applicable law). Reg. section 20.2056A-5(c)(2). Those regulations went on to provide that except as otherwise provided in the regulations or IRS guidance (e.g., in a revenue ruling), FAI does not include income in respect of a decedent (IRD) within the meaning of section 691 (gross income to which the decedent was entitled at death but not properly included on the decedent’s final, or any other predeath, income tax return). Additional rules were provided for the allocation of income and corpus for payments from an IRA or qualified plan to a QDOT.

⁶Reg. section 20.2056(b)-5(f)(3) sets forth rules as to the meaning of “income” for purposes of the marital deduction. It is unclear to what degree, if any, those special rules for the marital deduction continue to apply in light of the new final regulations under section 643(b) defining income.

COMMENTARY / SPECIAL REPORT

Generally, a fiduciary must administer the trust impartially between the two classes of interests.⁸ Hence, a fiduciary typically would invest a percentage of the trust's assets to earn growth and the balance to earn income. Traditionally, the fiduciary tried to find a "reasonable" balance between the two broad classes of investments so as not to favor either class.

Several developments have changed the notion of what is fairest to both classes of beneficiaries. The first was the discovery (or acknowledgement) that overall return will often be reduced if the reasonable balance of fairness between the income and corpus beneficiaries is maintained. The reason, based upon empirical studies and theory, is that equity interests tend to outperform debt interests in the long term (that is, produce a greater overall return) and, in some periods, different classes or mixes of assets produce the greatest growth (consistent with a chosen level of risk). Simply put, investments should be chosen based on anticipated return and risk, not whether they will generate corpus or income as a matter of FAI. Also, increased sensitivity to the effect of inflation on the real (or spending) value of both income and corpus has occurred. As indicated, studies show that investing the trust primarily in fixed income probably means that the true spending power value of income is eroded by inflation just as the real value of corpus probably will be. One must also take into account the different tax treatment that different types of income attract. All other things being equal, long-term capital gain is more favorably taxed than is ordinary tax income.⁹ Also, making a decision to take action to obtain greater FAI can be detrimental for both the income and the remainder beneficiaries. For example, converting a growth stock into cash so it can be invested to produce greater FAI usually means payment of capital gains (or ordinary income) tax, and that erodes what is in the trust. In a sense, when that occurs, both the income beneficiary and remainder beneficiary suffer: There is a smaller base of wealth from which to derive current profits (income) for the income beneficiary and, likewise, the remainder beneficiary will have less value generating a return. The reason is that the remaining proceeds have to "work" so much harder just to "get even" with the prior holdings.¹⁰ Further, investments

in assets that produce lower *taxable* returns (such as long-term capital gain and, until 2009, qualified dividends) produce a greater net return, all other things being equal.¹¹ Yet almost all states had adopted the Prudent Man (or, in some jurisdictions, the Prudent Person) Act, which directed the trustee to invest so as to produce a reasonable rate of income while preserving the corpus.

As a consequence, most states have now adopted the Prudent Investor Act, which allows much more flexibility in investing and, essentially, directs the trustee to pursue an overall investment strategy to enable the trustee to make appropriate current and future distributions to or for the benefit of the beneficiaries under the governing instrument, in accordance with risk and return objectives reasonably suited to the entire portfolio. See, for example, New York EPTL 11-2.3. That, of course, enables the trustee to focus on maximizing return and risk, rather than on whether the return will constitute FAI.

Also, many states have also adopted statutes under which more flexibility in investing and fair treatment of income and remainder beneficiaries is provided. See, for example, New York's EPTL article 11-A and Alaska Statute 13.38.200 *et seq.* In a broad sense, those statutes typically offer two choices to achieve those results.

First, they permit the trustee of a trust, subject to limitations such as when a marital deduction trust is involved, to adjust the amount of income and corpus (essentially, by transferring assets in corpus to income or vice versa) when an adjustment would be fair and reasonable to all beneficiaries. For example, when a larger portion of the trust is invested in growth (as opposed to current generation of fiduciary accounting income) than would traditionally occur, the fiduciary may allocate proceeds of sale of growth assets to income to make up for the shortfall in income production by the growth investment regime the trustee has adopted. It also appears that the trustee may exercise the power to adjust from corpus to income even if there are no proceeds of sale. Similarly, if the trustee has invested a larger portion in income production (which might occur when short-term interest rates again increase dramatically as they did in the late 1970s and early 1980s), the trustee might allocate part of what would be income (for example, interest) to corpus at least to the extent that corpus may maintain its spending power. It appears certain that the amount allocated from the corpus account to the income account becomes income and the amount allocated from the in-

⁸Restatement of Trusts (Third) section 183.

⁹For federal tax purposes, qualified dividends through 2008 will be taxed at the same rate as is some long-term capital gain. Section 1(h)(11). Capital gain has another advantage: timing of when the profit will be taxed. As a general rule, no tax is due until the property is sold or exchanged, which usually is in the control of its owner. That generally is not true for other types of income received, such as dividends and interest.

¹⁰For example, the trust holds a highly appreciated asset worth \$1 million. If the trust sells the asset and incurs a 25 percent gains tax, it will have only \$750,000. Even if the asset sold remained at \$1 million, the \$750,000 would have to experience approximately the following net after-tax rates over the following time-frames to get "back" to \$1 million: 33 percent in one year; 15.5 percent each year for two years; 11 percent each year for three years; 7.5 percent each year for

four years; 6 percent each year for five years; 5 percent each year for six years. As indicated, those are after tax returns. If the trust faced a 25 percent tax, the gross returns (pretax) would have to be increased by one-third. Also, if the original asset grew at any rate (e.g., 2 percent per year), the \$750,000 would have to work that much "harder."

¹¹Although many perceive municipal bonds as producing tax exempt income (see section 103), the return on them typically is already "tax affected." That is, the fact that the yield is not subject to tax means, all other things (such as risk) being equal, the tax-exempt bonds pay a lower yield.

(Footnote 10 continued in next column.)

come account to the corpus account becomes corpus.¹² Hence, an adjustment from the corpus account to the income account is not an invasion of corpus. This treatment under local law of the adjustment payment is important for several tax reasons, as will be discussed below.

It is important to note that the power to adjust is not dependent on realized or unrealized appreciation in the trust estate but rather a reasonable determination by the trustee that a portion of corpus should be allocated to income or the reverse based upon the trustee's duty of impartiality to the income and corpus beneficiaries. Thus, an equitable adjustment from corpus to income pursuant to a power to adjust may be made in any of the following contexts: (1) when gain has been realized; (2) when gain has occurred but not yet been realized; or (3) when no gain has occurred.

Second, legislation enacted in some states (for example, New York and Alaska)¹³ contemplates that the trustee (or the court) will be permitted to convert a conventional income trust to a unitrust, which redefines FAI so that it is equal to a fixed percentage of the value of the trust's assets. See, for example, New York EPTL 11-2.4. The unitrust will pay the amount determined by its percentage and current value regardless of whether the FAI, as conventionally understood, is greater or less than the unitrust amount and regardless of whether there is realized or unrealized appreciation.¹⁴

IV. The Treasury Responds

The widespread adoption of unitrust and equitable-adjustment legislation has had such a profound effect on the administration of trusts that the Treasury Department has adopted new regulations that deal with the meaning of FAI for purposes of section 643(b) and other sections of the code. Generally, the regulations are effective January 2, 2004, and apply to tax years ending after that date. The balance of this article will discuss these new regulations and point out planning opportunities and potential adverse consequences that they may produce.

V. New Meaning of 'Income'

The final regulations are thorough and were obviously carefully considered, although it seems that sometimes alternative treatment might have been preferable. In any case, they present new tax risks in some situations and provide new planning oppor-

tunities in others. Sometimes they create the need for prompt action.

The regulations adopt, in defining FAI, the same first sentence as in the prior regulations: Income is to be determined "under the terms of the governing instrument and applicable local law." Reg. section 1.643(b)-1. However, the next sentence contains what may be a subtle but important change. The prior regulations provided that provisions in the governing instrument that "depart fundamentally from *concepts of local law in the determination of what constitutes income* are not recognized" for federal tax purposes. (Emphasis added.) The new regulations provide that trust provisions that "depart fundamentally from *traditional principles of income and principal* will generally not" be recognized for those purposes. (Emphasis added.) Hence, there may be a shift from the specific local law that governs the trust to some general "traditional" notion of income and principal untethered to the law of the jurisdiction governing the trust. The preamble, however, appears to deny that a shift has occurred. It claims that reg. "section 1.643(b)-1 has always provided that the allocation to principal, under the terms of the governing instrument, of items that *traditionally* would be allocated to income will not be respected for purposes of section 643(b)."¹⁵ (Emphasis added.) But unlike the prior regulations, which contained no exception,¹⁶ the final regulations, by use of the word "generally," seem to imply some new or added flexibility.

One of the issues that apparently had previously perplexed the IRS in that regard concerned the nearly universal rule under state law permitting the instrument to override the default statutory rule. Virtually all state statutes defining income and principal provided that the definitions or rules under the governing instrument were controlled.¹⁷ See, for example, New York EPTL 11-2.1(a). The state statutes then provided various default rules. The reliance by the new regulations on "traditional" notions of income and principal seems to suggest that the IRS will focus on traditional default state rules. It is uncertain whether those rules will be general ones (such as those in the Uniform

¹⁵The preamble mentions the standard of "traditional" three times.

¹⁶That is, under the prior regulations, no departure from a fundamental local law determination of income would be respected in any case.

¹⁷See, e.g., LTR 8521060, concluding that a provision specifying for the increase in value of a zero coupon bond (that is, one that pays no current interest, is sold at a discount from face value and pays face value at maturity) to be fiduciary accounting income in an income-only charitable-remainder unitrust would be respected (that is, the trust would be a valid charitable-remainder trust under section 664(b)(3)) when the default state law rule would have allocated the increase in value of the bond to corpus, but that was the default rule to the primary state rule that the provisions of the governing instrument determine what is income and what is corpus. Neither a private letter ruling nor a technical advice memorandum may be cited or used as precedent. Section 6110(k)(3).

¹²See Uniform Principal and Income Act, section 104 and underlying commentary.

¹³The Uniform Principal and Income Act includes no unitrust conversion provision.

¹⁴It is interesting that in New York, the statute prohibits a trustee from exercising the power to adjust that reduces the income interest in a trust that requires all income to be paid at least annually to a spouse and for which an estate or gift tax marital deduction is claimed, but no such restriction is included for the conversion of a marital deduction trust to a unitrust. Compare New York EPTL 11-2.3(b)(5)(C) with 11-2.4.

Principal and Income Act) or the traditional rules (as opposed, perhaps, to the current rules) of the jurisdiction involved.¹⁸

However traditional notions of income and corpus are determined, the new regulations reflect two emerging concepts under local law. First, they embrace the unitrust regime. Specifically, they provide that an allocation of amounts between income and corpus under applicable local law will be respected if it provides for a reasonable apportionment between the income and remainder beneficiaries of the total return, including ordinary and tax-exempt income, capital gains, and appreciation. The regulations specify that a state *statute* that provides for a unitrust amount of no less than 3 percent and no more than 5 percent of the trust's fair market value is a reasonable apportionment of the trust's total return. Apparently, it is not necessary that the statute fix the unitrust rate. The IRS has already ruled that, when the statute permits the trustee to choose a rate between 3 percent and 5 percent, any rate chosen by the trustee within that range will satisfy the regulation.¹⁹ Second, the regulations provide that a state *statute* that permits the trustee to make adjust-

ments between income and principal to fulfill the trustee's duty of impartiality between income and remainder beneficiaries is generally a reasonable apportionment of the trust's total return (implying that it will be respected for tax purposes so that after any adjustment, fiduciary accounting income will be treated as being paid).

Given the regulations' rejection of an instrument-authorized unitrust or power-to-adjust regime, they take a surprisingly flexible approach in permitting discretionary allocations of realized gain to FAI.

The preamble to the final regulations goes on to acknowledge that other actions may constitute applicable state law, such as a decision by the highest court of the state announcing a general principle or rule of law that would apply to all trusts administered under that state's laws. *Cf. Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).²⁰ However, the regulations themselves contain examples involving only state statutes and fail to track the reference to case law in the preamble. That suggests, as a matter of caution, that anyone creating a trust who intends that it be administered under a power to adjust or a unitrust regime should create it under the laws of a state that has adopted those rules by statute if adverse tax effects could otherwise arise. In any case, conversion to a unitrust or the exercise of a power to adjust, at least under a state statute (if not under state case law), will be respected, according to the regulations, whether or not the trust requires fiduciary accounting income to be distributed.²¹

As indicated, the preamble rejected a request by commentators that a unitrust or equitable-adjustment power be respected if authorized solely by the governing instrument. In other words, if an instrument authorizes the trustee to make adjustments between income and corpus exactly as the Uniform Act specifies or defines income as a unitrust amount exactly as some state statutes do but state law does not grant that authority, the trust will not be treated as either being required to pay all of its FAI or as having paid it (if the

¹⁸The new rules, in contrast to the prior ones, set forth some of the consequences of having a provision in a governing instrument defining income and corpus that will not be respected for tax purposes. The final regulations state that a trust required to distribute its FAI currently will not be treated as such for purposes of determining its level of personal exemption under section 642(b) (under which the trust receives a larger personal exemption than one that is not required to distribute its income currently) or for purposes of determining the tax treatment under section 651 of distributions to the beneficiary by the trust, if the governing instrument defines ordinary dividends and interest as principal.

¹⁹See LTR 200417014, *Doc 2004-8774*, 2004 TNT 80-53. In the ruling, the state statute authorized a conversion to a unitrust with a payout of between 3 percent and 5 percent. The trustee converted the trust to a 3 percent unitrust. The IRS concluded that the conversion would not cause a loss of grandparenting for GSTT purposes and would not cause any party to be treated as making a taxable gift or an income-taxable exchange. As will be discussed, different circumstances probably will determine whether a conversion at all is appropriate and, when it is, what rate should be selected. For example, as is discussed below, it may be appropriate for a QDOT to be converted to a 5 percent payout. That will tend to maximize the amount that may be distributed to the surviving spouse free of estate tax. On the other hand, it might be appropriate to convert a QSST to a 3 percent unitrust where it is desirable to minimize distributions to the current income beneficiary to maximize the amount in a trust that is exempted from generation-skipping transfer taxation. Similarly, if the trust must distribute all of its income currently and is not subject to state and local income tax but the income of the income beneficiary is subject to those taxes, it might be better, if a conversion occurs, to choose only a 3 percent payout percentage. Given that the choice of an optimal unitrust rate will depend on the circumstances in each case, locating a trust in a state with legislation authorizing a 3-5 percent range may prove to be advantageous. Indeed, to compete more effectively, states with fixed-rate unitrust statutes may eventually decide to adopt a more flexible 3-5 percent approach.

²⁰The preamble indicates that a trust-specific lower court decree will not be respected if not supported by developed state case law.

²¹Reg. section 1.643(b)-1. This latter point is important, for example, for reasons other than the treatment of distributions under section 651 or the personal exemption under section 642(b). For example, to constitute a qualified subchapter S trust (an eligible shareholder of an S corporation), the trust must distribute all of its fiduciary accounting income even if not required to do so by its terms. Also, depreciation experienced by a trust is allocated between the trust and the beneficiaries based on the FAI allocated to each, although the regulations provide no example of such an effect for a trust other than one required to distribute its income currently. See section 167(d).

amount paid is more or less than traditionally determined FAI). The regulations probably should have adopted a different rule and provided that the trust will be treated as being required to pay all of its FAI or having paid it. Indeed, one might argue that the adoption of the “traditional income” rule, which smacks of a historic income rule, is arguably inconsistent with the adoption of the new rule that permits FAI to be defined using new rules (power to adjust and unitrust), neither of which is traditional. In fact, the regulations’ limited acceptance of a power to adjust and the unitrust rules will force property owners who wish their trustees to be able to administer the trust under the rules to forum shop — that is, create trusts under the laws of states that have expressly adopted those rules by legislation. And in policy terms, the regulations’ overemphasis on state law will have the unintended consequence of forcing states to enact unitrust and power-to-adjust legislation to avoid the loss of trust business.²²

Given the regulations’ rejection of an instrument-authorized unitrust or power-to-adjust regime, they take a surprisingly flexible approach in permitting discretionary allocations of realized gain to FAI. Even if neither state statutes nor case law grants the trustee a discretionary power to allocate gain to FAI, the regulations will respect the allocation if the governing instrument permits it (if state law does not prohibit it). The only requirement is that the trustee exercise that power reasonably and impartially. As will be discussed below, this authorization creates planning opportunities that other aspects of the regulations were apparently designed to preclude. As a result, the regulations unwittingly create an incentive to create trusts with that kind of discretionary provision rather than a unitrust. Accordingly, the regulations may have unintentionally created a competitive disadvantage for the unitrust regime.

The regulations create a safe harbor permitting a “switch” between methods of determining trust income authorized by state statute without triggering a recognition event for income tax purposes under section 1001. They further provide that the switch will not be a taxable gift by the grantor or by any of the beneficiaries. On the other hand, they provide that a switch not authorized by state statute but valid under state law may constitute a recognition event under section 1001 or a taxable gift, depending on the facts and circumstances. In other words, if a local court authorizes a switch from a straight income trust to a unitrust trust or authorizes a trustee of a straight income trust to exercise a power to adjust that is not authorized by state statute, the IRS may take the position that the beneficiary has made an income-taxable exchange (for example, of an income interest for a unitrust interest) or has made a taxable gift (such as when the beneficiary’s income interest has a greater value than the value of the unitrust interest). The generation-

skipping transfer tax regulations issued earlier had provided that a conversion of an income interest to an interest providing the beneficiary with the greater of income or a unitrust percentage would not cause the trust to lose “grandparenting” protection from the GSTT. No doubt many practitioners read those earlier regulations as permitting the conversion without any adverse tax consequences. Indeed, it seems that the Treasury should have warned practitioners that the conversion might have other adverse tax effects. Therefore, the Treasury or the IRS should consider an announcement providing that conversions similar to the one authorized in the GSTT regulations will be “safe harbored” from income and gift tax consequences if the conversion occurred before the date of issuance of the new income regulations.²³

As mentioned above, a state statute providing that income is a unitrust amount of no less than 3 percent or more than 5 percent of the trust’s fair market value is a reasonable apportionment of the trust’s total return and will be respected under the regulations. That seems to be a safe harbor and does not per se foreclose a lower or higher unitrust percentage from being a reasonable apportionment. If market rates of return fell off dramatically, a lower unitrust percentage might be more reasonable than 3 percent. Similarly, if market rates of return increased dramatically, a unitrust percentage in excess of 5 percent might be viewed as more reasonable. In fact, when the U.S. economy experiences high inflation in the future, a 5 percent unitrust payment to someone designated as the income beneficiary might be viewed as unreasonably and unfairly low. Perhaps when the state statute (to fall under the regulatory safe harbor) provides for the trustee or the court to convert an income interest into a unitrust payment of between 3 percent and 5 percent, the trustee could “revert” to the traditional concept of income or, if permitted by state statute, convert to the equitable apportionment between income and corpus. Nevertheless, it seems that the regulations might have acknowledged that a unitrust tied to the current interest rate under section 7520 is per se reasonable. For example, because a pure FAI interest is valued under section 7520 as equal to the current rate promulgated under that section (and is equal to 120 percent of the current midterm AFR rounded to the nearest even two-tenths of one percent), it seems that the regulations should have provided a safe harbor conversion to a unitrust equal to the current section 7520 rate.²⁴ In fact, considering that Congress prescribed in section 664 a min-

²³While the IRS took the position in LTR 200231011, *Doc 2002-17961*, 2002 TNT 150-29, after the issuance of the GSTT regulations that a court-approved settlement under which an annuitant received a unitrust interest instead of the annuity stream constituted an income-taxable exchange of the beneficiary’s interest under *Cottage Savings v. United States*, 499 U.S. 554 (1991), taxpayers could not reasonably have been expected to infer that the conversion contemplated in the GSTT regulations might also constitute a taxable event under section 1001 or constitute a taxable gift.

²⁴A rational argument may be maintained that valuing an income interest using the section 7520 rate is almost always inappropriate because the section 7520 rate actually represents a return of both income and appreciation.

²²See Mitchell M. Gans, “Federal Transfer Taxation and the Role of State Law: Does the Marital Deduction Strike the Proper Balance?,” 48 *Emory L.J.* 871 (1999) (arguing that an overemphasis on state law can be problematic).

imum 5 percent unitrust payment from a charitable remainder trust, it seems odd that the new income regulations would make 5 percent the safe harbor maximum.

VI. Distributable Net Income and Capital Gain

The regulations revise the calculation of “distributable net income” (DNI) in many cases when the trust realizes capital gain. DNI plays two roles under the code: (1) it limits the maximum amount of the trust’s (or an estate’s) income that may be allocated to (that is, included in the gross income of) a beneficiary; and (2) it determines the tax character or flavor of trust distributions that a beneficiary must include in gross income. Trust income (in a tax sense), if not included in DNI, cannot be included in the gross income of a beneficiary.²⁵ DNI is the trust’s taxable income subject to adjustments. One of the most important adjustments concerns capital gain. Under the code, capital gain is excluded from DNI²⁶ (on the theory that generally it is allocated to corpus and therefore should not be allocated to an income beneficiary for income tax purposes) unless it is allocated to FAI²⁷; or, if allocated to corpus, is paid, credited, or required to be distributed to any beneficiary during the year; or is paid, permanently set aside, or to be used for a charitable purpose specified in section 642(c).

The prior regulations provided some guidance, beyond the words in the code, for when capital gain allocated to corpus would form part of DNI and, therefore, could be included in a beneficiary’s gross income. The importance of that determination is now heightened because of the increased number of cases in which, by use of a unitrust or power to adjust, amounts in excess of DNI (if determined without regard to capital gain) will be distributed to a beneficiary. The circumstances in which capital gain will be included in DNI by having it allocated to FAI are not without limit.²⁸ The exercise of a power to ad-

just to increase the amount of FAI or the use of a unitrust regime will not necessarily cause capital gain to be included in DNI. Moreover, the circumstances in which capital gain will be included in DNI by reason of being allocated to corpus have changed.

The new regulations provide that gains from the sale or exchange of capital assets may be included in DNI, subject to additional requirements discussed below, in three circumstances: (1) when allocated to fiduciary accounting income; (2) when allocated to corpus but treated consistently by the fiduciary on the trust’s books, records, and tax returns as part of a distribution to a beneficiary; or (3) when allocated to corpus but actually distributed to the beneficiary or used by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary. However, there is an additional prerequisite. For capital gain to be included in DNI, the allocation must occur: (1) by a mandatory direction under local law and the governing instrument; or (2) pursuant to the reasonable and impartial exercise of discretion by the fiduciary under a power granted under local law or under the governing instrument (if not prohibited by local law).²⁹

But it should be noted that the regulations do not by their terms cover the circumstances when: (1) state law or the governing instrument (but not both) mandates the allocation of capital gain to income or corpus (although one of the examples is inconsistent with the text on this issue³⁰); or (2) the fiduciary has the power under state law or the governing instrument to allocate the capital gain to income or corpus but does not exercise the power³¹ or exercises it in a way that is not

²⁵One might contend that that statement is overly broad and that trust income not included in DNI can be taxed to a beneficiary under the grantor trust rules, that is section 678. However, it seems that that income is not income of the trust but income of the beneficiary from inception. *Cf.* Rev. Rul. 85-13, 1985-1 C.B. 184.

²⁶Capital gain is “automatically” added to DNI of a foreign (non-U.S.) trust.

²⁷Capital gain may, however, be allocated to income in several cases. One is when the trustee invests an asset received as income rather than immediately distributing it. Any capital gain produced by the asset while in the hands of the trustee probably would be allocated to the trust’s income account under default state rules. A second is when state law allocates a portion of the proceeds to income upon the sale of an unproductive asset and a proportionate part of the proceeds may consist of capital gain realized for income tax purposes. *See, e.g.,* Rev. Rul. 85-116, 1985-2 C.B. 174.

²⁸*See, e.g.,* TAM 8728001. Neither a private letter ruling nor a technical advice memorandum may be cited or held as precedent. Section 6110(R)(3). It is worth noting that several tax provisions deal with a power to allocate receipts (and disbursements) between FAI and corpus but without referring to an allocation of capital gain. *See, e.g.,* section 674(b)(8), reg. section 20.2041-1(b)(1); reg. section 25.2514-1(b)(1); reg. section 20.2056(b)-5(f)(4).

²⁹Prof. Ascher argues that the DNI regulation cannot be read literally. In his view, if the instrument or the statute contains the necessary mandate, it will be respected when computing DNI. As discussed, there is some support for that argument in Example 4. In the example, the instrument directs that all income be distributed currently. It also directs that capital gain be allocated to income. Based on this latter direction, the example concludes that capital gain will be included in DNI even though state law does not also require the allocation. *See also* Example 11 (in which a unitrust amount is required to be paid currently). It is not, however, clear whether Example 4 should be read as a categorical rejection of the word “and” in the text of the regulation. For example, given the considerable restrictions the regulations impose on the inclusion of gain in DNI in the case of a unitrust or a discretionary invasion of corpus, it is difficult to predict whether the IRS will extend Example 4 to a completely discretionary trust. Perhaps, a better reading of the regulation is that generally the word “and” should be understood as carrying a conjunctive meaning with an exception for the particular cases in which the examples take a contrary approach. In any event, further clarification is necessary.

³⁰*See* Example 4 of reg. section 1.643(a)-3(a).

³¹To illustrate, if the trustee has the authority to allocate gain between income and principal and fails to exercise that discretion, the gain will presumably be allocated pursuant to the state law default rule. This, however, seems to foreclose having the capital gain be part of DNI given that the allocation is not mandated by both the instrument and state law. Nor will Example 4 be of any assistance given this distinction: In the example, the instrument is mandatory, whereas in the posited hypothetical the default rule is invoked only when the trustee chooses not to, or fails to, exercise the discretion.

impartial and reasonable. In the latter two circumstances, it seems that capital gain cannot form part of DNI. That result seems odd, if not wrong, at least sometimes.

The requirement that the instrument and state law both direct how the allocation is to be made is particularly difficult to understand. Indeed, as indicated and as will be further discussed, it is inconsistent with one of the examples and with an outstanding revenue ruling.

A. Allocating Capital Gain to FAI

For capital gain to be in DNI where it is allocated to FAI, the allocation must be “pursuant to the terms of the governing instrument *and* applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law.” (Emphasis added.) Reg. section 1.643(a)-3(a). However, as noted below, at least one example provided in the regulations does not remain faithful to these rules.³²

1. Allocating capital gain to FAI by the terms of the instrument and local law. It is interesting that the regulations do not expressly provide that capital gain will be included in DNI if allocated to FAI under applicable local law (when the governing instrument is silent). It seems implausible that capital gain allocated to income pursuant to a default state law rule (when the instrument is silent on the allocation) will not cause that gain to be in DNI. The Service itself has, in the past, not required that the instrument restate the rule in the statute. In Rev. Rul. 85-116³³ the Service concluded that a portion of capital gain was included in DNI when the state underproductive property statute allocated a portion of proceeds to income.³⁴ The fact that the instrument did not echo the statutory requirement apparently was not significant.

Moreover, the apparent rejection of having capital gain included in DNI when the capital gain is required by state law to be allocated to income (but not also required by the governing instrument) may sometimes be inconsistent with the new definition of FAI under reg. section 1.643(b)-1. Because the regulations suggest that all items “traditionally” allocated to income must be treated as income for tax purposes. And yet items of capital gain traditionally treated under state law as income, if not also treated as income under the governing instrument, will not be treated as income when computing DNI.

It is also interesting to note that new Example 4 in reg. section 1.643(a)-3 is inconsistent with the text. In the example, capital gain is allocated to FAI under a provision in the governing instrument and not also

required under local law (although not in violation of local law). Despite the requirement in the text of the regulation that the allocation must be required by local law and the instrument, the example concludes that the capital gain is included in DNI. The example also seems inconsistent with the new definition of fiduciary accounting income under reg. section 1.643(b)-1. Under the regulation, as a general rule, an allocation to income or corpus that is not a traditional allocation will not be respected for tax purposes. Generally, capital gain is a tax concept that has no relevance for state fiduciary law purposes. And appreciation in the value of corpus traditionally is allocated under state law to corpus. The regulations, however, go on to create an exception under which realized capital may be allocated to income and be respected for tax purposes if under the local law and the governing instrument or under an impartial and reasonable exercise of fiduciary discretion. As indicated, however, Example 4 inexplicably respects an allocation of capital gain to FAI even though not mandated by state law and not made pursuant to the exercise of fiduciary discretion. In any case, as will be discussed below, the example may provide a significant planning opportunity for determining whether, or the extent to which, capital gain will be taxed to the trust or to the beneficiary.

2. Allocating capital gain to FAI by fiduciary discretion. In any case, as stated, for the allocation to FAI to cause gain to form part of DNI if by an exercise of discretion by the fiduciary, the discretion must be both “reasonably and impartially” exercised. Unfortunately, no definition of “reasonable” or “impartial” is offered in the regulations.³⁵ The use of the conjunctive “reasonable *and* impartial” might be contrasted with the new definition-of-income regulation. That regulation provides that “a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee’s duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust.” That suggests, in other words, that an impartial allocation is per se reasonable. On the other hand, the regulation’s last sentence tracks the language of the DNI regulation: “An allocation to [fiduciary accounting] income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument *and* applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or the governing instrument, if not prohibited by applicable local law.” (Emphasis added.) Reg. section 1.643(b)-1 (last sentence).

Perhaps when the regulations use the terms “reasonable” or “impartial” they intend to create a federal

³²See *id.*

³³1985-2 C.B. 174.

³⁴This revenue ruling was not revoked or even mentioned in connection with the promulgation of the regulations, suggesting that it remains viable.

³⁵The regulations obviously borrow the word “impartial” from section 103(b) of the Uniform Income and Principal Act. They may also borrow the word “reasonable” from that section as well, although, as discussed below, the reasonable standard and the impartial standard may be federal ones.

standard of reasonableness that will be applied independently of any state standard.³⁶ Thus, even if a federal court were to agree that the allocation was reasonable and impartial as a matter of applicable state fiduciary law, the court might nevertheless deny the allocation of capital gain to DNI on the grounds that the standard was not satisfied as a matter of federal law.

Contrary to the drafters' assumption, an allocation of capital gain to FAI in a nonunitrust context might create a tax effect without any corresponding economic effect.

The regulations distinguish between an allocation of capital gain to FAI when the trust is a unitrust as opposed to another type of trust. In a unitrust, the allocation to income (whether pursuant to requirements of local law and the instrument or pursuant to the reasonable and impartial exercise of discretion by the fiduciary) must be exercised consistently, and the amount allocated cannot be greater than the excess of the unitrust amount over DNI determined without regard to capital gain. No similar consistency requirement is imposed for an allocation of capital gain to FAI outside the unitrust context — apparently whether or not the instrument requires that FAI be distributed. In noting that one commentator said that a discretionary power to allocate capital gain to income should not have to be exercised consistently, the Preamble states that the “exercise of the power [of allocation] generally affects the actual amount that may or must be distributed to the income beneficiaries and affects whether the trust or the beneficiary will be taxed on the capital gains. Thus . . . the power does not have to be exercised consistently, as long as it is exercised reasonably and impartially.”

Contrary to the drafters' assumption, however, an allocation of capital gain to FAI in a nonunitrust context might create a tax effect without any corresponding economic effect. For example, the trust allows the trustee to distribute all or any part of income or corpus or make no distribution at all. The trust receives \$100 of interest income that will be included in DNI and is allocated under state law to FAI. The trust also realizes a \$200 capital gain that the trustee allocates to income under a power granted by state law or the governing instrument. As a result, the capital gain is included in DNI. If the trustee distributes \$300 to the beneficiary, the beneficiary will include the \$100 of interest income and the \$200 of capital gain in gross income under section 661. If the trustee distributes any lesser amount, only a proportionate part of DNI will be included in the beneficiary's gross income. It seems that amount included in the beneficiary's gross income will consist

of one-third interest and two-thirds capital gain. Perhaps the IRS will contend³⁷ that to the extent the trustee has distributed less than the sum of FAI (determined with the capital gain), the allocation of capital gain to income is not reasonable and impartial. That could mean, for instance, that in the foregoing example, if the trustee distributed only \$175, only \$75 of the capital gain (that is, the amount in excess of FAI determined without regard to the gain) would be treated as being in DNI.

3. Having capital gain included in DNI where it is allocated to corpus. As stated above, the inclusion of gain in DNI may also occur if the gains are allocated to corpus but are either: (1) treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or (2) actually distributed to the beneficiary or used by the fiduciary in determining the amount that is distributed or required to be distributed to the beneficiary. But, as in an allocation of capital gain to income, these two rules apply only if the gains are so treated or so distributed (a) under the terms of the governing instrument and applicable local law, or (b) under a reasonable and impartial exercise of discretion by the fiduciary in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law.

4. Detailed examples of when capital gain forms part of DNI. Meaningful additional guidance is provided through the 14 examples under reg. section 1.643(a)-3(e) that illustrate the foregoing principles of when capital gain will form part of DNI. The examples manifest that some exercises of discretion by a trustee must be consistent, in effect, requiring the trustee to make an irrevocable election. It is, unfortunately, unclear how these rules apply to an executor. For instance, the rule that provides for capital gains to be included in DNI when it is allocated to corpus requires that it be consistently so treated by the “fiduciary” (perhaps including an executor). But that consistent treatment must be manifested on the “trust's” (with no mention of an estate's) books, records, and tax returns as part of a distribution to a beneficiary.³⁸ Moreover, it is unclear whether an executor's treatment of capital gain would bind the testamentary trustee.

In Example 1, the trustee makes a discretionary invasion of principal for the income beneficiary, allocates

³⁶Cf. *White v. U.S.*, 853 F.2d 107 (2d Cir. 1988), cert. granted 489 U.S. 1051 (1989), and then dismissed 493 U.S. 5 (1989) (re: attorney fee deductibility under section 2053).

³⁷The argument the IRS might make could be based on two grounds. First, it might invoke the doctrine of substance over form. Second, it might argue that allocation of realized gain to income, under the regulation, contemplates an actual distribution. This second argument is consistent with Example 4 of reg. section 1.643(a)-3(a) (respecting the allocation of gain to income when the instrument required the distribution of all income).

³⁸Perhaps the thought is that an executor cannot consistently treat gain as part of distributions to beneficiaries either because an executor does not usually make multiple distributions to a beneficiary or because the administration of an estate usually is too limited in time for the treatment to be consistent.

all capital gains from a sale during the year to corpus (the example does not specify whether the trustee was permitted to allocate it to FAI) and does not exercise the discretionary power (apparently granted under the instrument) to “deem” discretionary distributions of corpus as being made from capital gains. Example 1 concludes that the capital gains are not included in DNI and states that in future years the trustee “must treat all discretionary distributions as not being made from any realized capital gains.” The latter statement is probably overly broad. If, for example, the trustee exercised the trustee’s discretion to pay corpus to the beneficiary by paying all principal and thereby to terminate the trust in one year, any capital gains realized during that year would form part of DNI as it always does in the year of termination (as the capital gain would be “actually distributed to the beneficiary” within the meaning of reg. section 1.643(a)-3(b)). That is confirmed by Example 7, which is the same as Example (4) in the prior regulations. Hence, the statement probably should be interpreted to mean that the trustee cannot exercise the discretion to deem discretionary distributions as consisting of capital gain (although the capital gain may be in DNI for other reasons).

Example 2 is the same as Example 1 except it is stated that the trustee intends to follow a regular practice of treating discretionary distributions of corpus as consisting first of net realized capital gains for the year, evidencing that treatment by including the realized gain in DNI on the trust’s federal income tax return. (It is not mentioned if the trustee also notes that allocation on the trust’s books and records.) Example 2 states that the trustee is given two discretionary powers: one to invade principal and the other to deem discretionary distributions as being made from capital gains. The example states that “[t]his treatment of the capital gains is a reasonable exercise of [the t]rustee’s discretion.” It is interesting that the example seems to assume that “deeming” the discretionary distribution as being made from capital gains falls under the regulatory language of reg. section 1.643(a)-3(b) that the gain has been allocated to corpus and is treated consistently by the fiduciary as part of the distribution to the beneficiary. But that seems to be the only conclusion that can be reached. The example goes on to provide that in future years the trustee must treat all discretionary distributions as being made first from realized capital gains. Although not stated, it seems that it must be from gains realized that year and not from a prior year. Hence, gains from a prior year and not previously deemed distributed may not be treated as funding the discretionary distribution until all gains realized from the year the discretionary distribution is made are allocated to DNI. (An allocation of a prior year’s capital gain to the distribution seems to have no practical tax effect because DNI consists only of taxable income of the current year.)³⁹ The example indicates that if the

trustee fails to treat discretionary distributions as being paid first from any net capital gains realized by the trust during a later year, those gains nonetheless will be allocated to DNI. The example involves “net” capital gain, presumably meaning it is the realized capital gain as offset by capital losses for the year (or prior loss carryover).

Example 3 is the same as Example 2 except that the trustee intends to follow a regular practice of treating discretionary distributions of corpus as being paid from any net capital gains realized by the trust during the year from the sale of specified assets or a particular class of investments. The example states that this is also a reasonable exercise of the trustee’s discretion, even though there does not seem to be any express authorization in the governing instrument to do so — on the other hand, it does not seem that action is prohibited. This example seems to permit the trustee to decide on an asset-by-asset basis whether realized capital gain allocable to corpus should be included in DNI. The only apparent constraint imposed by the example is that a trustee elects to treat gain from any particular investment or class of investment to be included or excluded from DNI.⁴⁰ The same treatment may be required in a future sale or exchange of the same investment. So, for example, if the trustee has invested in Stocks A and B, the trustee may decide to include realized gain on the sale of stock A as part of a discretionary distribution of corpus (and thereby cause it to be part of DNI) but exclude the gain realized on the sale of Stock B. If the trustee were to sell less than all of the Stock A, the trustee may be required to treat the allocation of gain from sale of all or part of the balance of Stock A to DNI. On the other hand, nothing in the example suggests that the trustee cannot treat different blocks of the same asset differently. For instance, the trustee purchases 100 shares of Stock A in 2004 and 50 more shares in 2005. In 2006 the trustee sells the block of 50 shares purchased in 2005, distributes the proceeds of sales, and “deems” the capital gain to be part of that distribution. It may well be that the trustee may choose not to “deem” any gain realized on the sale of the block purchased in 2004 as part of a distribution of the proceeds. In requiring asset-by-asset or class-by-class specification, the regulations fail to indicate the time and manner in doing so.⁴¹ For example, if the regulations intended a trustee to specify the treatment of any gain realized on the sale of an asset at the time of its acquisition by the trustee as opposed to the time of its sale, they should have specified how that “election”

³⁹At one time, the allocation of capital gain to DNI that was not distributed could have a tax effect under the old “throw-back rules.” See subpart D of part 1 of subchapter J as in effect from 1970 to 1986.

⁴⁰Technically, the trustee does not elect for some capital gains to be in DNI. Rather, the trustee “deems” gains to be part of a discretionary distribution of corpus and that makes the gains part of DNI.

⁴¹In any case, perhaps, this means that trustee, if authorized under the instrument or local law, could deem discretionary distributions as consisting only of capital gains realized on the sale of assets to the extent the overall value of the trust exceeds its original value. That type of treatment is nearly, although not exactly, compelled by the new final regulations, discussed below, concerning income-only charitable-remainder trusts.

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should have been manifested. Hence, a reasonable conclusion is that the trustee need only manifest the intention at the time of sale. If the specification need not be made until the year of sale, the trustee has much latitude on deciding year by year whether capital gain from any investment or class of investment is to be included in any discretionary distribution of corpus and, therefore, in DNI. That latitude may not have been intended given the regulations' emphasis on the "consistency" requirement.

Example 4 also is the same as Example 1 except that under the terms of the governing instrument (in a provision not prohibited by local law), capital gains are allocated to income. The example concludes that those gains, accordingly, do form part of DNI. As discussed above, this example is inconsistent with the basic rule of the regulations that to allocate capital gain to FAI to include it in DNI the allocation must be pursuant to both local law and the governing instrument.

Example 5 is also the same as Example 1, except that the trustee decides that discretionary distributions of corpus will be made only to the extent the trust has realized capital gains during the year. The example concludes that the capital gain is included in the trust's DNI for the year because the trustee "will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary." It seems, although it is not certain, that the trustee is not being compelled to distribute in future years each year's realized capital gains. Rather, it seems that because the trustee has decided that distributions — if made at all — will be made only to the extent of realized capital gains, DNI includes gains in years in which the amount of discretionary distributions are made because the trustee has committed to limit such distributions by the amount of the gains.⁴² It is uncertain whether a proportionate part of capital gains would be included in DNI if the trustee had determined to limit discretionary distributions to a fractional portion or perhaps a dollar amount of realized capital gains during the year. In that case also, the capital gains allocated to corpus would be "utilized by the fiduciary in determining the amount that is distributed" within the meaning of reg. section 1.643(a)-3(b). There is, as stated, an indication that the trustee could decide year by year whether to make any discretionary distribution, and as long as the trustee determines that amount of the year's discretionary distribution by the amount of realized capital gain, that gain will be included in DNI.

Example 6 involves a trust that requires that a specific asset be sold after 10 years and the sales proceeds be distributed to the income beneficiary. The example concludes that any gain realized on that sale

is included in DNI because the trustee "uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed" to the beneficiary. This example is the same as Example (3) of the prior regulations, except new Example 6 adds reasoning for its conclusion — that is, the capital gains are part of DNI because the trustee uses the amount of sales proceeds to determine the amount required to be distributed to the beneficiary. Old Example (3) contains no explanation, just the facts and the conclusion that the realized gains are part of DNI for the year of sale and distribution. It seems that the reasoning used in the example may not be correct. It appears that the reason that the DNI includes the gains from the sale is not because the trustee uses the amount of sales proceeds to determine the amount required to be distributed, but because the gain is "actually distributed to the beneficiary" within the meaning of reg. section 1.643(a)-3(b). Moreover, even the reasoning expressed in Example 6 seems at odds with the regulation. The regulation does not say that the gain is included in DNI when the *proceeds* that may include the capital gains are used to determine "the amount that is . . . required to be distributed to a beneficiary." Rather the regulation says the gain is in DNI when the "[g]ains . . . are . . . [a]llocated to corpus but . . . utilized by the fiduciary in determining the amount that is . . . required to be distributed to the beneficiary." (Emphasis added.) In any case, Example 6 appears to expand this regulatory rule when the proceeds (including the gains) are allocated to corpus and the proceeds are used to determine the amount that is required to be distributed to the beneficiary.

Example 7 is the same in its facts and conclusion as Example (4) of the prior regulations. In the example, when the beneficiary reaches age 35, the trust is to terminate. It is concluded that in that year all capital gains are included in DNI. Unlike old Example (4), new Example 7 provides reasoning for its conclusion: All capital gains are included in DNI because all trust assets, including all gains, are actually distributed to the beneficiary.

Example 8 is the same as Example 7 except the trustee must first distribute \$10,000 to another beneficiary before distributing the balance of the trust assets to its income beneficiary. The example concludes that none of the DNI (which includes the gains realized in the year of termination) is allocated to the distribution to the beneficiary who receives the \$10,000 because that distribution is in satisfaction of a specific sum of money, which under section 663(a)(1) cannot, in general, be deemed to consist of DNI. The example does not deal with a possible exception when the \$10,000 must be satisfied in whole or in part with capital gain because the trust has insufficient other corpus to satisfy it.⁴³

⁴²The example does not specify what occurs if the trustee later changes the discretionary distribution pattern by distributing, in a particular year, more than realized gain. Moreover, without express authority to so limit distributions in the future, it seems the trustee would be violating the trustee's fiduciary duty and any attempt to so limit distributions would be void or voidable under local law; if so, it seems questionable whether the decision would be respected for tax purposes.

⁴³For example, in the year of termination the trust incurs \$100,000 capital gain and the value of the whole trust is \$105,000. \$10,000 will be distributed to the beneficiary who is entitled to that amount and \$95,000 is to be distributed to the remainder beneficiary. Clearly, the \$10,000 bequest would be

(Footnote 43 continued on next page.)

Example 9 also is the same as Example 7 except that one-half of the principal is to be distributed to the beneficiary when attaining age 35. To satisfy that obligation, the trustee sells one-half of the trust's assets — at a gain — when the beneficiary reaches age 35 and distributes the sale proceeds to the beneficiary. The example concludes that the capital gains realized on that sale are included in DNI because all sales proceeds, including all the capital gain attributable to the sale, are actually distributed to the beneficiary.

Example 10 is the same as Example 9 except the trustee sells all the assets at a gain. The example states that if authorized by the governing instrument and the applicable state statute,⁴⁴ the trustee may determine to what extent that capital gain is distributed to the beneficiary, although the distribution must include at least the minimum amount of capital gain that in fact would be distributed and must include no more than the lesser of the distribution or the capital gains realized by the sale. The example indicates that the trustee evidences the amount of capital gains the trustee determines (subject to the minimum and maximum stated above) to include in the distribution to the beneficiary by including that amount in DNI on the trust's federal income tax return. The example says that if the trustee is not authorized by the governing instrument and the applicable state statutes to make that allocation, then one-half of the capital gain attributable to the sale is included in DNI for the year of sale. As indicated above, it is uncertain what authority must be granted under the applicable state statutes so that the trustee can allocate the DNI in accordance with this example. If state law provides that the governing instrument controls all distribution matters, then express authorization under the governing instrument should be sufficient. If the state statutes must expressly authorize a trustee to make that allocation, then it seems that the ability to use the flexibility provided in Example 10 will be limited as few, if any, state statutes provide that explicit authority to trustees. Thus, it seems that a state statute providing that the governing instrument may allocate receipts (as opposed to capital gains) between beneficiaries as directed by the trustee should be sufficient under the example. A critical point, however, is that if the trustee is given the authority under the state statute and the governing instrument, the trustee may determine how much is "actually distributed to the

funded with at least \$5,000 of capital gain. It is unclear what the result would be. If the beneficiary of the \$10,000 bequest does not have to include any portion of the capital gain (DNI) into income, and the remainder beneficiary must include only \$95,000 in gross income (because that is all the beneficiary receives), then it seems that the trust is subject to tax on \$5,000 of capital gain (perhaps reduced by the personal exemption). If the trustee must pay tax on the \$5,000 capital gain, the remainder beneficiary will receive less than \$95,000 so even more than \$5,000 will be taxed to the trust. Alternatively, the beneficiary entitled to the \$10,000 gift must include \$5,000 of the capital gain in income.

⁴⁴Under the general rules of reg. section 1.663(a)-3(b), the discretion of the trustee to allocate gain to corpus and be included in DNI must be either pursuant to a *direction* in both a state statute and the governing instrument or an *authorization* under either.

beneficiary" under reg. section 1.643(a)-3(c)(3). The only limitations seem to be that the trustee will be treated as at least allocating the minimum amount of gain the trustee must use in satisfying the bequest, and the trustee cannot be treated as allocating more than the maximum amount of gain the trustee could use in satisfying the bequest the trustee may allocate any amount between those two amounts. Finally, it seems odd that the trustee can exercise this discretion only if authorized by state statute and the governing instrument — in other words, why would not an impartial and reasonable exercise of discretion granted under either a state statute or the governing instrument be sufficient?

Example 11 involves a state statute that permits the trustee to elect to pay the income beneficiary a 4 percent unitrust amount in lieu of income. The state statute provides that the unitrust amount shall be considered paid first from ordinary and tax-exempt income (both of which are automatically part of DNI under section 643(a)), then net short-term capital gain, then net long-term capital gain, and then corpus. The governing instrument provides that the income beneficiary is to receive income as defined under the state statute. The trustee elects to pay the unitrust amount to the income beneficiary. The value of the trust is \$500,000, so the trustee distributes \$20,000 (that is, 4 percent of \$500,000) to the beneficiary in satisfaction of the unitrust amount. In that year the trust has \$5,000 of dividend income and \$80,000 of net long-term capital gain. The example states — which seems correct as far as the state statute is concerned — that \$15,000 of the gain is allocated to income pursuant to the "ordering" rule of the state statute and therefore concludes that the \$15,000 of gain is included in DNI. The example suggests that allocation of gain to income under state law is sufficient to cause it to be in DNI even if the instrument does not so specifically direct. That seems contrary to the basic rule set forth in reg. section 1.643(a)-3(b) about when capital gain allocated to fiduciary accounting income will be considered to form part of DNI.⁴⁵ Indeed, the example supports the notion that allocation of capital gain to income simply under the terms of the governing instrument is sufficient to make it part of DNI, assuming state law does not prohibit that result. In any case, as discussed below, Example 12 implies that the result in Example 11 would be the same if the governing instrument (rather than a state statute) provided the "tax character" ordering rule that is deemed to make up any unitrust payment.⁴⁶

⁴⁵Example 4 and Example 11 seem to suggest that the conjunctive requirement that capital gains can be part of DNI by an allocation pursuant to both the governing instrument and local law is really a disjunctive one: Capital gains will be in DNI when it is allocated to FAI either by the governing instrument (if not prohibited by state law) or by state law.

⁴⁶As discussed elsewhere, the Treasury rejected the suggestion that a trust should be treated as paying its income for tax purposes if the governing instrument provided for the payment of a unitrust amount rather than having it provide for the payment of income and having the trustee elect to pay a unitrust amount pursuant to an authorization under a state statute (or perhaps under state case law that correctly reflects the state's common law of trusts).

Few if any state statutes contain an explicit “tax character” ordering rule set forth in Example 11.⁴⁷ Thus, it would be prudent to address the issue in any governing instrument when it is anticipated that a conversion to a unitrust may occur. In fact, as will be discussed below, to maximize planning potential of whether to have gain taxes to the trust or to the beneficiary, it probably will be appropriate to authorize the trustee to determine, in the exercise of impartial and reasonable discretion and in accordance with Example 12 discussed below, the tax character of unitrust payments.

Example 12 is the same as Example 11 except that neither the governing instrument nor a state statute provides an ordering rule for the tax character of the unitrust payment. Although the example does not say whether the authority comes from the governing instrument, a state statute or both, it provides that the decision on determining the tax character is left to the discretion of the trustee. The example states that the trustee intends to follow a regular practice of treating the unitrust amount as comprising corpus rather than capital gain to the extent the unitrust amount exceeds the trust’s ordinary and tax-exempt income (both of which will automatically form part of DNI). The example states that the trustee will manifest the ordering rule decision by not including any capital gain in the DNI, which would be reflected on the trust’s federal income tax return including the Form K-1 sent to the beneficiary. The example concludes that that treatment of not having the capital gains form part of DNI is a reasonable exercise of the trustee’s discretion, but in future years the trustee must not allocate capital gains to income — implying, perhaps, that any attempt to do otherwise will be void as a matter of federal tax law.

Example 13 is the same as Example 12 except the trustee intends to follow a regular practice of treating the unitrust amount as comprising of capital gain to the extent the unitrust amount exceeds the trust’s ordinary and tax-exempt income. The example concludes that that treatment of having the capital gains form part of DNI is a reasonable exercise of the trustee’s discretion but in future years the trustee must treat capital gain, if any, as distributed to the beneficiary to the extent the unitrust amount exceeds the trust’s ordinary and tax-exempt income.

⁴⁷It is possible that some states at least indirectly have such a rule. For instance, some states direct that the unitrust amount be satisfied using net fiduciary accounting income to the extent thereof and then from corpus. Under applicable state law, that net income may include some classes of tax income (such as interest and dividends) as opposed to others (such as realized gains). Hence, it may be that those states will be determined to provide at least a limited tax-character rule. However, it seems likely that the unitrust payment will be deemed to consist of DNI regardless of a state-mandated tax-character ordering rule except to the extent the rule deals with realized capital gain to put it in or keep it out of DNI. In other words, it seems likely that a tax-character ordering rule in funding a unitrust payment will control only if DNI includes capital gain to the extent the unitrust payment exceeds DNI as it is determined without regard to capital gains.

Example 14 in essence combines Examples 12 and 13. In Example 14 a corporate fiduciary, acting under governing instruments and state statutes that do not provide a tax-character ordering rule for unitrust payments but leave the decision to the trustee, intends to consistently treat the unitrust amount as consisting of capital gain to the extent the unitrust amount exceeds the trust’s ordinary and tax-exempt income for some trusts and treats the unitrust amount as consisting of corpus, and not capital gain, to the extent the unitrust amount exceeds ordinary and tax-exempt income for other trusts. The example concludes that the trustee’s decision regarding each trust is a reasonable exercise of the trustee’s discretion, but that in future years the trustee must treat the capital gains consistently with the treatment in the prior years. This example is important to those who serve as trustee of several trusts. However, trustees probably should make sure that they can justify to their beneficiaries (and the local courts) why the trustee decided to include capital gain as part of the unitrust payment in one trust but not another.

The regulations do not specify the consequences of the trustee not exercising the discretion consistently when consistency in allocation is required. It seems that the likely consequence will be that the prior treatment will apply in the future for tax purposes even if the trustee does not exercise the discretion consistently. In other words, as indicated, the trustee probably would be viewed as having made an irrevocable election. For instance, a trustee decides to have the unitrust payments deemed to consist of realized capital gain to the extent the payments exceed the trust’s ordinary and tax-exempt income and follows that practice, manifesting it by that treatment on the trust’s federal income tax returns, consistently for years.⁴⁸ A new trustee is appointed who decides not to follow the treatment of the prior trustee. It seems that the regulations will cause capital gain to be treated as part of DNI to the extent the prior trustee so treated it. Nevertheless, the regulations do not specify what occurs if the trustee does not *intend* to consistently treat the make-up of a unitrust payment as including capital gain. For instance, in the first year, the trustee decides not to have any part of the unitrust amount consist of capital gain but does not intend to regularly follow that practice. In other words, the trustee intends to decide year by year whether it is preferable to have capital gain form part of the unitrust payment. When, unlike Ex-

⁴⁸While the definition-of-income regulation clearly provides that the use of a unitrust will not harm the validity of the trust for marital deduction or similar purposes if state law authorizes it, the DNI regulation is not as unequivocal. In a unitrust, the DNI regulation provides that capital gain can be included in DNI when there is authorizing legislation and the trustee makes the allocation consistently. See reg. section 1.643(a)-3(b)(1). Although not entirely clear, that would appear to suggest that, absent a statute, gain may not be included in DNI in an instrument-authorized unitrust. Thus, even assuming the instrument directed that the unitrust payment consist of capital gain to the extent that the payment exceeds the trust’s other income, the regulation implies that the gain may not be included in DNI in the absence of a statute.

ample 11, state law does not mandate the tax character make-up of the unitrust amount, but leaves the decision to the fiduciary, it is unclear what the result would be. However, it seems that the trustee will be treated as having made an irrevocable election on behalf of the trust that is binding for all future years even if the trustee did not intend to allocate or not allocate capital gain to the unitrust payments consistently.⁴⁹ The regulations obviously assume that the trustee would have the authority under state law or the instrument to make such a binding election. If a state court were to hold that the election constituted an abuse of discretion, it is uncertain how the IRS would respond.

The regulations provide no answer as to how much capital gain will be included in DNI when neither state law nor the governing instrument mandates the tax character of unitrust distributions and the trustee is not otherwise given the discretion to specify the character. Example (2) of the prior regulations may provide an answer. In that example the trustee was required to pay the beneficiary an annuity of \$15,000 each year. The example appears to conclude that even though the trustee is required to sell an asset at a profit of \$10,000 to pay the annuity amount, no portion of the capital gain is included in DNI. The example might have supported the conclusion that a unitrust amount will not be deemed to consist of capital gain unless a state statute (or possibly the governing instrument) provides otherwise or the trustee is authorized to determine the extent to which it will be deemed to consist of the gain and does so. But as indicated, old Example (2) has been eliminated, and what that means is difficult to determine. Nevertheless, state courts may well conclude that the trustee has been given tax-character ordering discretion either under state law or implicitly by the governing instrument.

5. Power to adjust and capital gain. As indicated above, one of the driving forces behind the new regulations was the adoption by many states of a law granting an equitable adjustment power to trustees who invest under the Prudent Investor Act. Under that power, the trustee, to fulfill the fiduciary obligation of impartiality to both current and successor beneficiaries, may allocate corpus to income or income to corpus. Nowhere in the Uniform Act is a trustee specifically authorized to allocate any particular type of corpus to income or any particular type of income to corpus. For example, nothing in the act specifies whether the trustee may allocate proceeds of sale that would otherwise be allocated to corpus to income. Nor does the act specifically provide that the trustee may allocate to income capital gain that would otherwise be allocated to corpus. The act does not prohibit those allocations; it just does not address them. Perhaps that should not be surprising. After all, the Uniform Act

was to serve as a model state law under which trustees could more efficiently carry out their duties; it is not a tax statute, so it is not surprising that it does not deal with tax concepts per se. The Uniform Act does, however, direct the trustee, in deciding whether and how to exercise a power to adjust, to consider tax consequences. Thus, it probably would be appropriate, if not obligatory, for a trustee, in determining how much corpus should be converted to income pursuant to the power to adjust, to consider whether or how the power-to-adjust payment would be subject to tax. But a power to convert corpus to income is not an authorization to allocate realized capital gain that otherwise would form part of corpus to income — at least, it is not a direct authorization to do so. That is not surprising inasmuch as the Uniform Act was drafted before the new regulations were even proposed and therefore without any awareness that the regulations would permit a trustee to control whether realized capital gain would form part of DNI through the allocation of the gain to income. Hence, it is uncertain, at best, whether an equitable adjustment power will be viewed as authorizing a trustee to allocate realized capital gain to income.

It seems as though the regulations view the power to allocate capital gain to income as a power distinct from a power to adjust. In the definition-of-income regulations (which contain nearly the same provision about allocating gain to FAI as do the new DNI regulations), the allocation to income of all or a part of gains from the sale or exchange of trust assets appears to be described as a separate power from the power to adjust: The sentence that deals with allocation of gain to income follows closely (and is in the same paragraph of) the discussion of the power to adjust and begins with “In addition,” suggesting that the drafters of the regulations viewed the power to allocate capital gain to income as a distinct power. Also, as mentioned above, a power to adjust will be respected, according to the regulations, only if granted by local law (the regulations indicating that an equitable adjustment power will not be respected for tax purposes if conferred solely by the governing instrument). Yet the discretionary power to allocate gain to income will be respected for tax purposes, according to the definition-of-income regulations, if granted under either local law or the governing instrument.

The definition-of-income regulation seems to have a bias toward income. First, it clearly permits the allocation of capital gain to income (if pursuant to reasonably and impartially exercised power of allocation) but not in the opposite direction. Capital gain allocated to corpus will generally be respected when that allocation would traditionally occur. Second, capital gain can be freely allocated to income even though that allocation is inconsistent with traditional rules, provided the allocation occurs pursuant to the reasonable and impartial exercise of discretion. The regulations, however, do not address whether capital gain that, under traditional notions, is allocable to income can be allocated by the trustee under a discretionary power to corpus. For example, in an underproductive property statute, a portion of proceeds of

⁴⁹It seems odd that the regulations fail to create a mechanism by which the IRS, in its discretion, could relieve the trust of an election regarding later years. It may be that the drafters of the regulations did not fully appreciate that the consistency requirement constitutes an irrevocable election as a practical matter.

sale and, therefore, a portion of realized capital gain is allocated to income as a traditional matter.⁵⁰ If, however, the trustee were to allocate, under a discretionary power, all of the proceeds (and the gain) to corpus, the definition-of-income regulation would appear not to respect that allocation.⁵¹ It sets forth as a general rule the requirement that only allocations that are consistent with traditional state law rules will be respected. It then creates three exceptions to that general rule. The first deals with a unitrust, as discussed above. The second deals with an equitable adjustment power. The third deals with a discretionary allocation of capital gain to income. Neither the general (traditional) rule nor any of the exceptions contemplates that an allocation of capital gain to corpus will be respected when, under traditional principles, it would be allocated to income.

It will be noted that none of the examples under the capital-gain-in-DNI regulations seems to deal with having capital gain form part of DNI through the exercise of a power to adjust. It seems certain that the drafters of the regulations contemplated that capital gain could be part of DNI by reason of a power to adjust. The preamble acknowledges that commentators requested examples of how that would occur. The request was rejected on the grounds that state variations of the power of adjustment were too great so as to make additional examples difficult and perhaps unhelpful.

Even though, as indicated, the definition-of-income regulation provides that the exercise of an equitable adjustment power would be respected for tax purposes and, when read against the backdrop of the preamble, implies that capital gain could as a result be included in DNI, the DNI regulation fails to explain the method by which this might occur. The DNI regulation does provide that capital gain will be included in DNI when the gain is allocated to income in the trustee's discretion.⁵² And the definition-of-income regulation confirms that the discretionary allocation of realized capital gain to income does not violate the traditional income-and-principal requirement. Given, however, that under state law, the exercise of an equitable adjustment power does not appear to permit realized gain to be allocated to income (but only permits corpus to be converted to income), it remains unclear whether a trustee operating under a state statute that confers an equitable adjustment power will be permitted to use

the power to allocate realized capital gain to income and thereby cause it to be included in DNI.⁵³

Perhaps the drafters of the regulations did not appreciate the subtle difference between the authority to allocate realized gain to income, on one hand, and the authority to convert corpus to income, on the other. Or perhaps they had the impression that an equitable adjustment power is analogous to the power to allocate receipts between principal and income, which was the focus of TAM 8728001.⁵⁴ In the TAM the instrument gave the trustee the discretionary authority to allocate receipts between income and principal. The Service concluded that the amount of realized capital gain that the trustee had allocated to income was properly included in DNI. While it is understandable that the drafters might have perceived the power at issue in the TAM to be parallel to an equitable adjustment power and that the TAM therefore became a template for the regulations, they may not be equivalent. For example, a trustee is permitted to make an equitable adjustment under the Uniform Act even when no sale has occurred and capital gain has therefore not been realized, whereas the power to allocate receipts attributable to the sale of an asset could be exercised only if a sale is made.

Even assuming that one were to conclude that a trustee with an equitable adjustment power has the same power as in the TAM, computational questions would still remain. Is the trustee, in other words, permitted to decide the portion of realized gain to be included in income? Or is the trustee required to allocate a portion of the amount realized (that is, a portion of the sales proceeds) to income, with the portion of the gain so allocated to be determined on a pro rata basis? To illustrate, assume that the trustee has a basis of \$40 in the asset and sells it for \$100. If the trustee used the equitable adjustment power and converted

⁵⁰See Rev. Rul. 85-116, *supra* note 27.

⁵¹There may be an explanation for this latter distinction between the two sets of regulations. Like the prior regulations, the new definition-of-income regulation seems to reflect a concern about allocating income to corpus rather than the reverse. Presumably, the drafters were concerned about inadvertently undermining other provisions in the code mandating that income be paid on a current basis (for example, the QTIP provision or the QSST). See section 2056(b)(7); section 1361.

⁵²See reg. section 1.643(a)-3(b).

⁵³Prof. Ascher argues that under the regulations the conversion of corpus to income under an equitable adjustment power will unquestionably cause realized gain to be included in DNI. In his view, the regulations leave no outstanding questions concerning the tax effect of equitable adjustment. While the preamble to the regulations certainly suggest that the drafters envisioned that an equitable adjustment could cause capital gain to be included in DNI, the text of the regulations unfortunately fail to confirm that suggestion and also fail to indicate how it might mechanically occur. In the absence of further guidance, in our view, trustees and beneficiaries will be uncertain about when the use of an equitable adjustment power will cause realized gain to be included in DNI. Moreover, as discussed, even assuming it does cause gain to be included in DNI, important computational questions remain.

⁵⁴One can infer from reg. section 1.642(c)-2(c) and 1.642(c)-5, which deal with the set-aside deduction for a pooled income fund, that the drafters were uncertain about the mechanics of equitable adjustment under state law. In the regulations, they appear to anticipate that the adjustment might be made in one of two ways: (i) when the trustee takes into account unrealized appreciation in deciding how much to distribute to the income beneficiary; or (ii) when the trustee allocates some or all of the sales proceeds to the income beneficiary.

\$20 of corpus to income, would that cause \$20 of the \$60 gain to be included in income and DNI? Or would it cause none of the gain to be so included on the rationale that in effect the trustee allocated a portion of the \$40 basis to income or on the rationale that the conversion of corpus to income does not bear a sufficient relationship to the sale or the gain? Or would it cause, as perhaps another alternative, a pro rata 20 percent of the gain to be included in income and DNI on the rationale that 20 percent of the proceeds were allocated to income (causing, in other words, \$12 of the gain, which is 20 percent of the total gain, to be included in income and DNI)?

Although the TAM does not address the computational question, it does imply that on these facts, a trustee having discretionary authority to allocate receipts between income and principal could choose to allocate \$20 of the sales proceeds to income and thereby cause \$20 of the gain to be included in DNI. That implication in the TAM is inconsistent, however, with the approach the Service took in Rev. Rul. 85-116. In the revenue ruling, the trustee was required by an underproductive property statute to allocate a portion of the sales proceeds to income. The Service concluded that a pro rata portion of the trust's gain should be included in income and DNI. If, using the hypothesized facts, 20 percent of the sales proceeds were allocated to income under the statute, 20 percent of the gain, or \$12 of gain, would be included in income and DNI. While the revenue ruling's pro rata approach would appear to be inconsistent with the TAM, the TAM does not acknowledge that or even cite the ruling. However, the Service is obliged to follow its published guidance.⁵⁵ And because it has not revoked the ruling, one might assume that it will require trustees making an equitable adjustment to use the pro rata method — if it ultimately concludes that the conversion of corpus to income under an exercise of the power constitutes an allocation of gain to income so as to permit it to be included in income and DNI.

On the other hand, in three different contexts, the regulations appear not to require the use of the revenue ruling's pro rata approach, opting instead for the method that the TAM implies is correct. The first context is when a trustee makes a discretionary distribution of principal and commits to a consistent exercise of the authority to deem distributions to consist of capital gain. Examples 2 and 5 (reg. section 1.643(a)-3(e)) conclude that the amount of realized gain deemed by the trustee as distributed is included in DNI. The second context is when the trustee is administering a unitrust. If the trustee is directed under a so-called ordering rule to treat the beneficiary as having received "net capital gain" to the extent that the sum of ordinary and tax-exempt income is less than the unitrust amount (or if the trustee has ordering discretion and commits to a consistent pattern), the gain will be included in

DNI. See Examples 11, 12, and 13. The third context is when the trustee is given the discretion to allocate realized gain to income. If the trustee reasonably and impartially exercises that discretion, the portion of gain allocated to income will be included in DNI. And unlike the first two contexts, there is no requirement that the trustee commit to a consistent pattern, permitting the trustee to decide on a yearly basis how much capital gain to allocate to income. While that strongly implies a rejection of the pro rata approach in this context as well, the regulation fails to provide any examples illustrating the computation of DNI when the trustee invokes this discretion.

In sum, given the rejection of the revenue ruling's pro rata method in the first two contexts and its tacit rejection in the third, together with the regulation's failure to embrace or even mention the pro rata method in any context, it is perhaps reasonable to assume that the Service might eventually revoke the ruling — or perhaps limit its application to allocations made under an underproductive property statute. Or the Service could conceivably clarify that the pro rata method does not apply in the case of an equitable adjustment. Or, as yet another alternative, it might extend the rationale of Examples 2 and 5, in which the trustee had the authority to deem a distribution of corpus as consisting of capital gain, and thereby permit a trustee to deem a distribution made under an equitable adjustment power as consisting of capital gain — though that would presumably trigger the requirement that the trustee commit to a consistent pattern. In the meantime, however, the Service's reticence about the effects of an equitable adjustment leaves taxpayers without clear guidance.

VII. Capital Gains and Charity

A. Pooled Income Funds

A decedent's estate, a pre-1970 trust, and a pooled income fund defined in section 642(c)(5) may be permitted a current income tax deduction for gross income set aside for charitable purposes under the terms of the governing instrument — even if the income will not be paid for the charitable purpose until a later tax year. Section 642(c). (Both estates and trusts are entitled to a current income tax deduction for gross income currently paid to charity under the terms of the governing instrument. *Id.*)

Reg. section 1.642(c)-2(c), which deals with the set-aside charitable deduction for pooled income funds, is revised by the final regulations. A pooled income fund is a trust or other fund that is maintained by a charitable organization (such as a college) that is the trustee and the remainder beneficiary, receives contributions from individuals, and provides for one or more individuals to receive the income for life. A pooled income fund is not exempt from income taxation but is permitted a current income tax deduction for long-term capital gain set aside for a charitable purpose (that is, is allocated to corpus and not to income).

New reg. section 1.642(c)-2(c) provides that no net long-term capital gain is considered permanently set aside for charitable purposes if, under the terms of the

⁵⁵See *Rauenhorst v. Commissioner*, 119 T.C. 157, *Doc 2002-22803*, 2002 TNT 195-13 (2002); *Baker v. Commissioner*, 122 T.C. No. 8, *Doc 2004-3555*, 2004 TNT 34-9 (2004).

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governing instrument *and* applicable local law,⁵⁶ the trustee has the power (whether or not it is exercised) to satisfy a beneficiary's right to income by the payment of either a unitrust amount or any other amount that takes into account unrealized appreciation in the fund's assets.⁵⁷ The regulation goes on to provide that: "no amount of net long-term capital gain shall be considered permanently set aside for charitable purposes to the extent the trustee distributes proceeds from the sale or exchange of the fund's assets as income" While the former prohibition clearly requires that the trustee be denied the authority to use a unitrust regime or to take into account unrealized appreciation, the latter provision appears to focus on how the trustee administers the trust. In other words, even if the trustee has the authority to allocate proceeds from an actual sale to income, it would appear that the set-aside deduction will be permitted if no such allocation is made. The use of that operational test in turn raises questions: whether a distribution of sales proceeds to the income beneficiary in one year will lead to a denial of the set-aside deduction in another year; or whether the distribution to the income beneficiary of sales proceeds from an asset generating short-term capital gain will preclude a deduction for the set-aside of long-term capital gain attributable to other assets. The apparent purpose for these prohibitions is to prevent funds for which the pooled income fund receives an income tax charitable deduction (limited, as indicated, to its long-term capital gain) from being subsequently distributed to an individual income beneficiary. Given that purpose, it is surprising that, after requiring a prohibition on the trustee's authority in a unitrust conversion or an allocation based on unrealized appreciation, the drafters went on to adopt the less stringent operational test for actual sales.

Most pooled income funds will not contain the necessary prohibitions, although presumably state statutes do or will contain a saving provision.⁵⁸ Thus,

⁵⁶This suggests that if the payments are made only under state law or only under the governing instrument, the denial of the set-aside deduction does not apply. That result, however, seems untenable.

⁵⁷Although it seems likely that the reference to a payment of "any amount that takes into account unrealized appreciation" means a power to adjust, the reference is incomplete. As mentioned above, a power to adjust need not take into account unrealized appreciation but may be made when there is no appreciation; similarly, it may take into account realized appreciation from a prior tax year.

⁵⁸New York Estates, Powers and Trusts Law (EPTL) 11-2.3(b)(5)(C)(iv) prohibits a fiduciary from exercising a "power to adjust" from any amount that is permanently set aside for charitable purposes unless the income therefrom is also permanently devoted to charitable purposes. Thus, in a pooled income fund governed by New York law, any long-term capital gain set aside for the charity cannot subsequently be the source of an equitable adjustment (given that the income beneficiary is not a charity). As a result, the regulations would permit the use of a set-aside deduction in the case of a New York fund. In addition, EPTL 11-2.4(c)(9) provides in effect that a trust may not convert to a unitrust regime if "pursuant to its terms . . . any amount is permanently aside for charitable purposes unless the income therefrom is also permanently devoted to charitable purposes."

depending on state law, it may be necessary to amend or reform the governing instrument to eliminate the possibility of converting to a unitrust or the possibility of making an equitable adjustment (provided payments have not already been determined under a unitrust regime or on the basis of an equitable adjustment).⁵⁹ A judicial reformation proceeding must be commenced no later than October 2, 2004, or, if later, nine months after the effective date of a state statute authorizing a unitrust conversion or the use of an equitable adjustment power.⁶⁰ Moreover, when drafting new instruments, it might be prudent to direct the trustee to comply with the operational test.

In addition to denying the income tax charitable deduction for long-term capital gain realized by a pooled income fund, in some cases, as set forth above, the new regulations change the definition of "income" for purposes of a pooled income fund. Presumably, for a trust to become or remain a pooled income fund, the new regulatory requirement must be satisfied. Before the amendment, reg. section 1.642(c)-5(a)(5)(i) provided that the "term 'income' has the same meaning as it does under section 643(b) and the regulations thereunder." Now that the final regulations have changed the meaning of income for purposes of that section, the meaning of income is changed by the new final regulations for purposes of pooled income funds. New reg. section 1.642(c)-5(a)(5)(i) provides that although the meaning of income generally has the same meaning as under section 643(b) and its regulations, income "generally may not include any long-term capital gains. However, in conformance with the applicable state statute, income may be defined as or satisfied by a unitrust amount, or pursuant to a trustee's power to adjust between income and principal to fulfill the trustee's duty of impartiality, if the state statute both provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of [reg.] section 1.643(b)-1." Nonetheless, a trustee may not, in making an equitable adjustment, allocate to income the proceeds from the sale or exchange of any asset contributed to the fund by the donor or purchased by the fund, at least to the extent of the fair market value of the asset on the date of contribution or purchase. Here again the regulations appear to adopt an operational test: As long as the trustee does not make an impermissible allocation, the regulation appears to be satisfied. The new final regulations provide this "definition of income applies for taxable years beginning after January 2, 2004." The apparent purpose of the requirement of allocating at least that portion of proceeds or a sale or exchange equal to the fair market value at the time of contribution or purchase is to

⁵⁹In the alternative, one might consider the possibility of changing the trust's situs. For a further discussion about changing a trust's situs, see below.

⁶⁰A reformation may also be effectuated by a nonjudicial arrangement if valid under local law, provided that it is completed in accordance with the period applicable to the commencement of a judicial reformation proceeding.

preserve for the charitable remainder beneficiary the amount on which the income and any gift tax deduction was based.

It seems in some ways that these two new pooled income fund rules are inconsistent. The first one denies the income tax set-aside deduction to the fund under section 642(c) if the trustee can convert the trust into a unitrust or exercise a power to adjust. But the second rule provides that a pooled income fund may, in effect, define income as a unitrust amount and pay that amount to the income beneficiaries or allow the trustee to exercise a power to adjust. Perhaps, that apparent inconsistency can be explained in the following way. Although the first rule denies the trust an income tax deduction when it can convert to a unitrust (or the trustee can exercise a power to adjust), the fund nevertheless may qualify as a pooled income fund under section 642(c)(5) so the donor is entitled to an income tax deduction under section 170(f)(2)(B). That would appear to be an appropriate reconciliation of two seemingly inconsistent concerns: (1) the interest in permitting trustees to invest for total return undeterred by adverse tax consequences; and (2) the need to prevent set-aside deductions for any amount that may pass to a noncharitable beneficiary.

B. Charitable Remainder Trusts

Earlier amendments to the regulations relating to income-only charitable-remainder unitrusts required that the proceeds from the sale or exchange of any assets contributed by the grantor be allocated to principal at least to the extent of the fair market value of those assets on the date of their contribution, for tax years ending after April 18, 1997. See reg. section 1.664-3(b)(4) (before the new final regulations). Those regulations were also expanded. First, although the regulations provide that income for such a charitable remainder trust (an income-only CRUT) generally means income as defined in the section 643(b) regulations, the new regulations provide that trust income may not be determined using a fixed percentage of the annual fair market value of the trust property (that is, cannot be determined by a unitrust regime), despite any contrary provision in state law.⁶¹ That new rule is

⁶¹State law may or may not prohibit an income-only CRUT from defining income as a unitrust amount. In New York, for example, a trust may not "convert" to a unitrust payment regime if amounts have been permanently set aside for charity and the income also is not exclusively devoted to charity. EPTL 11-2.4(c)(9). The language tracks section 642(c), which suggests that it may apply only when a charitable deduction is allowable under that section. Section 642(c) has no application to a CRT and, as a result, this provision of New York law may not prevent the use of a unitrust amount in determining income of the trust. However, EPTL 11-2.4(e)(5)(A) requires that the determination of whether the section applies (that is, whether the income may be determined by a unitrust amount) depends on many factors, including the intention of the person who created the trust. Presumably, the person who created the CRT wanted it to qualify for CRT treatment under section 664 and its regulations. The use of a unitrust amount to define

(Footnote 61 continued in next column.)

applicable for tax years ending after January 2, 2004. The rule that proceeds from the sale or exchange of any assets contributed by the grantor must be allocated to corpus at least to the extent of fair market value at the date of contribution is expanded to apply also (similar to the rule made applicable to pooled income funds) to the proceeds from a sale or exchange of any assets purchased by the trust. That change regarding purchased assets applies to tax years ending after January 2, 2004. Otherwise, proceeds from the sale or exchange may be allocated to income, under the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make that allocation may be granted to the trustee under the terms of the governing instrument, but only to the extent that the state statute permits the trustee to make adjustments between income and corpus to treat beneficiaries impartially. Those changes also are applicable to years ending after January 2, 2004.

It seems in some ways that these two new pooled income fund rules are inconsistent.

It seems that that requirement concerning sale proceeds has the effect of overriding an otherwise applicable state law. For example, state law provides under its "unproductive property" provision that a portion of the proceeds of sale (whether or not at a gain or loss) is allocated to income when the property while held by the trust has produced no income. If the trustee were to comply with the state statute and, as a result, allocate proceeds to income, even when the asset is sold for less than its value at the time of contribution or purchase, a violation of the regulation would occur. That operational defect might result in the IRS taking the position, as it did successfully in *Estate of Atkinson v. Commissioner*,⁶² that a failure to administer a charitable remainder trust should cause a forfeiture of all tax benefits from the trust's inception. It would seem that, in the case of a new instrument, it would be prudent to override any applicable unproductive property statute and to include language that mirrors the requirement in the regulation. In addition, legislation that would render any such statute inapplicable to an income-only CRUT should be considered.⁶³

income would seem to frustrate that intention (because it would disqualify the trust) and, as a result, this provision of the EPTL may be construed as prohibiting the use of a unitrust amount as the income of the trust. Nevertheless, the matter does not appear certain. It therefore would be safer expressly to prohibit in the instrument the use of a unitrust amount as income rather than relying on uncertain state law. In any case, states probably should amend their statutes to prohibit the application of their unitrust-amount-as-income laws from applying to income-only CRUTs.

⁶²309 F.3d 1290, *Doc 2002-23464*, 2002 TNT 202-20 (11th Cir. 2002).

⁶³Indeed, any new governing instrument probably should mandate that proceeds from the sale or exchange of any assets be allocated in accordance with the regulation.

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1. Summary of charitable changes. As noted, the new charitable changes are applicable for tax years after January 2, 2004. However, it may be that the trust or pooled income fund was created previously, and either applicable state law or the terms of the instrument provide for or authorize an allocation that is prohibited by the new regulations. Although the trustee might refuse to distribute proceeds of the sale to the income beneficiaries, that could violate the terms of the trust or local law — in other words, the income beneficiaries may be entitled to those proceeds. If the governing instrument or local law provides that the trustee may amend the governing instrument to ensure qualification, then presumably the trustee could cure that deficiency. But if the governing instrument does not so provide, the appropriate course of action for the trustee is unclear. Perhaps, the fiduciary should commence a proceeding seeking a reformation, although not all states permit a reformation. The trustee might consider a construction (interpretation) proceeding to have a court rule that the provision of state law or the governing instrument authorizing the allocation that is now prohibited shall no longer apply. Of course, that might eliminate rights of the beneficiaries to payments. It would be difficult to argue that that elimination is a gift by the beneficiaries (and perhaps therefore an improper additional contribution to the CRUT) or is an income-taxable event, but it would be a change in the quality of what the beneficiaries were entitled to receive. As noted above, the new regulations provide only narrow relief from gift and income tax consequences by reason of a “conversion” in the type of interest a beneficiary held (for example, from a “straight” income interest to a unitrust interest). It probably would have been appropriate for the regulations to have been made prospective so that they would not apply to preexisting trusts or funds. Unfortunately, that was not done.

VIII. New Deemed Gain Rules

Reg. section 1.651(a)-2 is expanded by adding a new subparagraph (d). It provides that if a trust distributes noncash property as part of its requirement to distribute all of its income, the trust is treated as having sold the property (with realization of gain or loss) for its fair market value on the date of that distribution. The requirement that gain be recognized when property is distributed by a fiduciary to a beneficiary was first adopted by the courts. See, for example, *Kenan v. Commissioner*.⁶⁴ It was later embraced in the regulations. The new version of this regulation expands the circumstances when a distribution will trigger the recognition of gain. While the gain-recognition rule under the case

law and the earlier version of the regulation applied only when the beneficiary was entitled to receive a fixed dollar amount or specific property, the new rule triggers gain when a noncash distribution is made to an income beneficiary if the trust requires the distribution of income. Thus, whether a unitrust regime or a conventional income approach is used, a noncash distribution to the income beneficiary in a trust mandating the distribution of income will trigger gain. Similarly, although not entirely clear, it would seem that if a trustee of that trust were to convert principal to income and make a noncash distribution to an income beneficiary under an equitable adjustment power, gain will be triggered.

It should be emphasized that the expansion effected under the new rule is not inconsiderable. In *Kenan*, a foundational case on the issue, the court was at pains to distinguish the fiduciary's discharge of a fixed, pecuniary obligation — which the court held triggered gain — from a distribution in discharge of a residuary gift or a gift of trust corpus, both of which tend to vary in value during the period of administration. In other words, the court determined that gain recognition would be inappropriate if the amount of the gift depended on circumstances evolving during the trust's administration. And, as indicated, the earlier version of the regulation adopted the same distinction between fixed and varying gifts. Under the new rule, that distinction is abandoned, with distributions of income — a varying gift — now treated in the same fashion as a fixed gift.

What accounts for this expansion? Perhaps the drafters started with the premise that in a charitable remainder unitrust, an existing regulation triggers gain where a noncash distribution of appreciated property is made in satisfaction of the unitrust amount.⁶⁵ The charitable-remainder-unitrust rule was itself, however, a considerable expansion of the *Kenan* principle. For it would seem that a beneficiary entitled to receive, say, 6 percent of the trust's assets each year is, in substance, in the same position as a remainderman entitled to receive 6 percent of the corpus at the termination of the trust.⁶⁶ In both cases, the gift is not fixed but will vary based on events occurring during the trust's administration. In any event, having decided to extend the rule beyond the charitable-remainder-unitrust context, the drafters were presumably concerned about discriminating between distributions made to conventional income beneficiaries and those entitled to receive a unitrust amount. It is understandable, therefore, that they made the new gain-triggering rule applicable in both cases. After all, the choice that trustees and settlors must make between the use of a conventional income approach and a unitrust approach should not be dictated or influenced by tax rules but by nontax objectives.

⁶⁴114 F.2d 217 (2nd Cir. 1940). Note, however, that the subparagraph goes on to state that a trust will not fail to be treated for purposes of section 651 as one that must distribute all of its income and makes no other distribution by reason of distributing a noncash asset in satisfaction of the beneficiary's right to the trust's income for the year, provided the trust makes no distribution in excess of the income as defined in section 643(b) and its regulations.

⁶⁵See reg. section 1.664-1(d)(5).

⁶⁶*Cf.* Rev. Rul. 69-486, 1969-2 C.B. 159; LTR 9401030, 94 TNT 6-52; LTR 9324015, 93 TNT 131-60; LTR 9830017, Doc 98-23347, 98 TNT 143-52.

Yet the regulation does unfairly discriminate on another critical issue in a manner that will unquestionably impinge on how trusts are drafted: It makes the new gain-triggering rule inapplicable to discretionary trusts. As a consequence, if the trust is not designed to satisfy the marital deduction provision (or some other provision that similarly requires that the instrument mandate a current distribution of income), a planner might well suggest the use of a discretionary trust to avoid any possible acceleration of gain on appreciated property held in the trust. The new gain-triggering rule also creates a more subtle form of discrimination. While a distribution of appreciated property by a QTIP trustee to the surviving spouse will trigger gain even though the asset is to remain in the family (that is, in the hands of the surviving spouse), no such acceleration of gain would be required if the marital bequest had been outright instead. A surviving spouse receiving an outright bequest would not be required to recognize gain on appreciated assets until he or she decided to dispose of it by sale or exchange. That violates the notion that the choice between the QTIP and an outright marital bequest should be made by the spouses without regard to tax consequences.⁶⁷

Another criticism of the regulation is that it is overbroad. For example, if a nontaxable stock dividend is received by a trust and under state law the dividend is allocated to income,⁶⁸ the distribution of that stock to the income beneficiary should not be treated as a sale. In other words, it would seem that gain recognition should be triggered only if the noncash asset is not inherently income. As indicated above, there is even a danger that the distribution of noncash assets pursuant to a power to adjust (for example, the trustee converts an appreciated share of stock from the corpus account to the income account) may be regarded as a sale. That result would seem unfair and unwarranted. Nevertheless, the deference the courts have shown to regulations and the interpretation of ambiguous regulations by the agency that promulgated them (here the Treasury Department) may mean that construction would be upheld.⁶⁹ Because the definition-of-income regulations will treat as the trust's fiduciary accounting income the amount of that income determined not just by traditional principles but after the application of a state authorized power to adjust, it seems that it may be best not to mandate the distribution of FAI from a trust (unless required as with some marital deduction

trusts).⁷⁰ However, it may not be possible to avoid gain recognition if the trustee has converted a "straight" income trust to a unitrust.

The realization-of-gain rule in reg. section 1.661(a)-2(f) is similarly revised. That regulation has long required that gain or loss is realized by an estate or trust if a noncash distribution is made in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed. As revised, the regulation expands the gain-triggering rule to cover noncash distributions if income is required to be distributed currently. As with the new regulation under section 651, this new gain/loss realization rule probably should not apply when the noncash asset already is part of income but might be so construed. Finally, the regulations fail to address the consequences to the beneficiary when the fiduciary distributes cash in satisfaction of the beneficiary's right to a noncash asset. It may well be that the beneficiary is treated as realizing gain or loss if the fiduciary is authorized to make the cash distribution in that satisfaction.

IX. Marital Deduction Matters

As mentioned above, the marital deduction regulations (other than those dealing with QDOTs) had focused on the status of the beneficiary-spouse as the income beneficiary rather than on the definition of income.⁷¹ But the new regulations add an apparent safe harbor, under which the beneficiary-spouse will be deemed to have the requisite income interest. Specifically, reg. sections 20.2056(b)-5(f)(1) and 25.2523(e)-1(f)(1) are amended to provide that the interest of the beneficiary-spouse is sufficient if the spouse is entitled to the fiduciary accounting income as determined by applicable local law providing for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust (assuming it meets the requirements of the reg. section 1.643(b)-1 rules).

That means that the spouse's income interest in a trust that qualifies for the marital deduction may be a unitrust interest with a payment of between 3 percent and 5 percent per year if provided under state law.⁷² The final regulations do not deem a unitrust to satisfy

⁶⁷ Parenthetically, note that the courts have construed the QTIP provision in a way that creates unfortunate discrimination as between this type of marital bequest and an outright bequest. See *Estate of Mellinger*, 112 T.C. 26, Doc 1999-3887, 1999 TNT 17-6 (1999), acq. AOD 1999-0006, Doc 1999-29234, 1999 TNT 173-11. And there may be other differences as well — as, for example, when the QTIP realized capital gains, which remain taxable to the trust rather than to the spouse.

⁶⁸ That was the rule under New York law, for example, for stock dividends not in excess of 6 percent, before it adopted EPTL art. 11-A (the new Uniform Income and Principal Act). EPTL 11-2.1(e)(3)(A).

⁶⁹ See Mitchell M. Gans, "Deference and the End of Tax Practice," 36 *Real Prop. Prob. & Tr. J.* 731 (2002).

⁷⁰ For example, to constitute a qualified subchapter S trust (QSST), the trust must distribute all of its FAI annually, but it need not be required by its terms to do so. Hence, it may be better to authorize the distribution of FAI in a QSST — it seems that should avoid gain recognition if appreciated assets are distributed to the sole beneficiary of the QSST.

⁷¹ It is possible that this developed because the sections refer to the spouse getting a life estate and not all of the income.

⁷² As mentioned earlier, reg. section 1.643(b)-1 creates a 3 percent minimum and 5 percent maximum unitrust percentage. Sometimes, a percentage lower than 3 percent or higher than 5 percent might be deemed to constitute an income interest under the regulation but, as stated earlier, consideration might be given to obtaining a private letter ruling to that effect in the absence of further guidance from the IRS or the Treasury Department.

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the safe harbor unless state law explicitly permits it. Thus, even if the instrument calls for a unitrust of between 3 percent and 5 percent, the safe harbor is not satisfied unless the unitrust amount is dictated by state law.⁷³

Similarly, the safe harbor will be available even if, under state law, the fiduciary is authorized to make equitable adjustments between income and principal. As with the unitrust, the mere inclusion of the power in the governing instrument will not suffice.

Under a QTIP trust described in section 2057(b)(7) or 2523(f), the marital deduction is not permitted if anyone has the power to distribute trust property to a person other than the spouse. Reg. section 20.2056(b)-7(d)(1) has been amended to clarify that the trustee's authority to adjust between income and corpus to fulfill the trustee's duty of impartiality, as contemplated in reg. section 1.643(b)-1, will not violate that requirement.⁷⁴

As mentioned above, the QDOT regulations had provided detailed rules about what constitutes fiduciary accounting income (distributions of which avoid the imposition of estate tax). The regulation⁷⁵ now provides that distributions will be considered income from a QDOT to the extent that they are made in conformance with applicable local law that defines income as a unitrust amount (or permits a right to income to be satisfied by that amount) or that permits the trustee to adjust receipts between principal and income to fulfill the fiduciary's duty of impartiality (assuming the local-law requirement in reg. section 1.643(b)-1 is satisfied).

These changes provide two potential significant new opportunities for the spouse who is the beneficiary of QDOT. First, it permits the trust to distribute an amount in excess of what had been fiduciary accounting income as limited under the prior regulations without the imposition of estate tax. For example, if the trustee converts the QDOT to a 5 percent unitrust under state law, no estate tax is imposed on the distribution even though it exceeds what FAI would have been (i) without regard to the unitrust conversion and (ii) without regard to the limitations in the prior QDOT regulations. Similarly, the increased amount of FAI payable to the beneficiary spouse of a QDOT pursuant

to exercise of a power to adjust (granted under state law) is not subject to estate tax. Second, although the prior QDOT regulations had provided that in no event could capital gain be considered to be part of FAI, it seems nearly certain that capital gain can be allocated to FAI if the definition-of-income regulations are satisfied.

As indicated above, the allocation of gain to FAI may cause it to form part of DNI. (Capital gain is always included in DNI if the trust is not a U.S. trust. It is understood that most QDOTs are U.S. trusts.) Having capital gain included in DNI provides the opportunity to allow the trust a deduction for that gain and for its inclusion in the gross income of the trust beneficiary.⁷⁶ If the trust beneficiary is not a U.S. income taxpayer, the capital gain included in DNI and distributed to the beneficiary may not be subject to U.S. income taxation.⁷⁷

X. Foreign Trusts

Under what are known as the "throwback" rules, DNI accumulated in a foreign trust and not currently treated as paid to a trust beneficiary so as to be included in the beneficiary's gross income and then may be later taxed to a beneficiary when it is ultimately paid or treated as paid to a trust beneficiary.⁷⁸ Those "accumulation distributions" are subject to a harsher tax regime than current distributions. All tax income (except tax-exempt income) forming part of an accumulation distribution is treated as being ordinary income and an interest charge is imposed on the tax due.⁷⁹ However, an accumulation distribution can be treated as having occurred only to the extent the distribution exceeds FAI for the year.⁸⁰ Hence, if FAI is increased by the conversion of the trust to a unitrust, by the exercise of a power to adjust, or by the allocation of gain to FAI from the sale or exchange of trust assets, as authorized in the definition-of-income regulations, more may be distributed without being treated as an accumulation distribution for purposes of the throwback rule.

XI. Generation-Skipping Transfer Taxation

The Tax Reform Act of 1986 enacted section 2601, which imposes a tax on all generation-skipping transfers. The tax generally does not apply to any trust that

⁷³Under section 2056(b)(8) and 2523(g), the value of a unitrust interest may qualify for the estate or gift tax marital deduction. It may be appropriate to note that under reg. section 20.2056(b)-5(f)(1) the unitrust interest causes the value of the entire trust to qualify for the marital deduction rather than just the value of the unitrust interest. It seems certain, however, that the marital deduction trust could provide for the beneficiary-spouse to receive the greater of income (as defined under state law) or a unitrust amount.

⁷⁴Apparently because the regulations promulgated under section 2523(f) (on lifetime QTIPs) make reference to the regulations under section 2056(b)(7), the Treasury Department determined that it was not necessary to revise the regulations under section 2523(f) as they were under section 2056(b)(7). See reg. section 25.2523(f)-1(c)(1).

⁷⁵See reg. section 20.2056A-5(c)(2).

⁷⁶See section 651-652, 661-662.

⁷⁷Presumably, a U.S. tax will be imposed on gain realized on the sale of U.S. real estate: The capital gain is either taxed to the trust or is subject to withholding pursuant to section 1445 on account of its distribution to a foreign beneficiary. See reg. section 1.1445-5(c). Parenthetically, note that in determining whether the capital gain is treated as having been distributed to the beneficiary for purposes of withholding, the concept of DNI is not used. Instead, reg. section 1.1445-5(c) creates a separate mechanism for making that determination.

⁷⁸Section 665-668.

⁷⁹Section 667(a), 668(a).

⁸⁰Section 665(b).

was irrevocable before 1987 or other “grandparented” trusts, except to the extent of subsequent additions. In 2000 the Treasury Department promulgated final regulations on grandparenting of trusts from the generation-skipping transfer tax. Those regulations generally provide that a modification of a trust that does not result in shift of additional property to a person or class of persons to whom the GSTT would apply is not an addition. Thus, in the absence of that shift, the trust will not lose its exemption from the tax. Example 8 to reg. section 26.2601-1(b)(4)(i)(E) provides that a “conversion” of a trust mandating the payment of FAI to one mandating the payment of the greater of a “straight” income interest or a unitrust percentage (which percentage is not specified in the example) is not a modification that would cause the trust to lose its grandparenting.

The new final regulations amend these grandparenting rules. Reg. section 26.2601-1(b)(4)(i) is amended to state that, except as otherwise provided, the changes apply only when determining whether a trust that is exempt for GSTT purposes retains that exemption and not when determining whether a “transaction” (1) is a gift, (2) may cause the trust to be included in the gross estate of a beneficiary, or (3) may result in gain realization under section 1001. This new regulation then goes on to modify subparagraph (D)(2) of reg. section 26.2601-1(b)(4)(ii), by providing that the *administration* of a trust in conformance with applicable local law that defines income as a unitrust amount (or permits a right to income to be satisfied by that amount) or that grants the trustee an equitable adjustment power will not be considered to effect an impermissible shift (assuming the definition-of-income regulations are otherwise satisfied).

There may or may not be an important distinction between Example 8 of reg. section 26.2601-1(b)(4)(i)(E) and new reg. section 26.2601-1(b)(4)(i)(D)(2). It may be that the former determines whether the *conversion* from an income to a unitrust interest is a shift of beneficial interests so as to cause grandparenting to be lost. The latter may determine whether the *administration* of an income trust as a unitrust or the exercise of a power to adjust will cause shift of beneficial interests so as to cause grandparenting to be lost. However, this distinction does not seem to be important and probably is not intended. Certainly, if the conversion does not result in a loss of grandparenting, neither should the administration of the trust in accordance with the conversion cause it to be lost.

In any case, as mentioned above, the definition-of-income regulation provides a safe harbor unitrust range of 3 percent to 5 percent. Although, as also discussed, a conversion to a unitrust percentage lower than 3 percent or higher than 5 percent does not “automatically” mean that the regulation is violated. In any event, a conversion to a unitrust in excess of 5 percent should not cause loss of grandparenting. Example 8 of reg. section 26.2601-1(b)(4)(i)(E) sets forth no minimum or maximum unitrust percentage, although it has the “straight” income interest as the floor. The drafters obviously embraced this result because they realized that, given the floor, no impermissible shift could

occur. Parenthetically, the 3 percent minimum seems generous since section 7520 has never assigned an income interest a rate of less than 3 percent.

XII. Areas Not Covered

As emphasized above, the meaning of fiduciary accounting income is important for tax purposes outside subchapter J. For example, as discussed, its meaning is important in determining whether a transfer to a trust qualifies for the estate or gift tax marital deduction. Typically, the entire amount transferred to that trust qualifies even though the spouse may only be entitled to the income. See, for example, section 2056(b)(7). But sometimes only the interest to which the spouse is entitled qualifies. For example, the unitrust or annuity interest of the grantor’s spouse in a charitable remainder trust may qualify for the gift or estate tax marital deduction. Sections 2523(g), 2056(b)(8). Similarly, a remainder interest vested in the grantor’s spouse following an income interest for someone else qualifies for the marital deduction because the remainder is not a terminable interest. But the partial interest that so qualifies must be valued. There is no guidance as to how, for example, a remainder vested in the spouse will be valued if it follows an income interest for someone else when the income interest can be converted into a unitrust or when the trustee holds a power to adjust. Thus, it is unclear whether the remainder should be valued on the premise that it follows an income interest (valued under section 7520) or on the premise that it follows a unitrust interest (which, as explained above, probably will be limited to a range of between 3 percent and 5 percent and may be quite different from the section 7520 rate).

Section 2702 prescribes a zero value for an income interest retained by a property owner who transfers a remainder interest to or for a family member. But the section does not apply when the remainder is given to someone who is not a family member. The value of the remainder in the latter case is determined by subtracting the value of the retained income interest from the value of the property itself. No guidance is provided as to how that income interest will be valued when the trustee may convert the trust to a unitrust or may exercise a power to adjust. Similarly, no guidance is provided as to how a retained interest in a (qualified) personal residence trust (which is an exception to the “zero value” rule of section 2702) is to be determined — in addition to the use of the personal residence owned by the trust, the grantor must receive all fiduciary accounting income earned in the trust during the retained term.

The regulations fail to address other valuation questions as well. For example, the regulations are silent as to how an income interest held by a beneficiary who dies within 10 years of the decedent is to be valued for purposes of the prior transfer credit under section 2013. In other words, the regulations fail to provide a valuation method in this context that takes into account the possibility that the trustee will convert to a unitrust or exercise a power to adjust.

XIII. Changes in Trust Situs

As emphasized throughout, the exercise of a power to adjust or conversion to a unitrust payment regime will be respected only if done under a state law. Similarly, the safe harbor under which a switch between methods is permitted without adverse tax consequence is available only if made under a state statute.⁸¹

For several reasons, it may be appropriate to change the situs of a trust to a state that has a statute permitting conversions to unitrusts or the exercise of a power to adjust. The new GSTT regulations, issued in connection with the definition-of-income regulations, contain two examples (Examples 11 and 12) that conclude that such a change in the situs of a trust from a state that has no such statute to one that does (or the reverse) will not cause any beneficiary to be treated as having made a taxable gift or as having made an income-taxable exchange.

A change of situs may not necessarily alter the law governing the trust. If the instrument contains a choice-of-law provision, it may continue to control even after a change in situs.⁸² Thus, if a trust is located in a jurisdiction that does not provide for a unitrust or equitable-adjustment regime, changing its situs to a jurisdiction that does have such a regime may not be sufficient (to permit a unitrust conversion or to exercise a power to adjust) if the instrument contains a choice-of-law provision directing that the law of the original jurisdiction is to govern.⁸³ On the other hand, in the absence of a choice-of-law provision, the law of the state of administration will probably control questions concerning allocations between principal and income.⁸⁴ Thus, if the instrument fails to contain a choice-of-law provision, it may be easier to secure tax recognition for a move to a state with a unitrust or equitable-adjustment regime. This suggests that, when possible, any court order authorizing a change in the situs of the trust should include a direction also for a change in the law that governs the determination of its income and corpus.⁸⁵

⁸¹While the text of the regulation contemplates that the switch may occur without adverse tax consequence if done under state case law, the preamble provides as follows: "This provision [authorizing a switch without adverse tax consequence] does not apply to switches between methods not specifically authorized by state statute."

⁸²See *Restatement of Conflicts (Second)* section 272, comments c and e.

⁸³Even when the instrument does contain a choice-of-law provision, it may nonetheless be possible to alter the governing law. See, e.g., NY EPTL 10-6.9 (providing that the donee of a power of appointment may, in exercising the power, provide for the law of a different state to control).

⁸⁴See *Restatement of Conflicts (Second)* section 268.

⁸⁵The Uniform Income and Principal Act, as well as at least some states that have adopted a power to adjust regime, grants the trustee the power to adjust only if the trustee is investing pursuant to that state's version of the Prudent Investor Act. If the governing instrument has provided that the trustee shall not invest pursuant to that act, the ability to exercise the power to adjust is presumably foreclosed in such jurisdiction.

XIV. Some Additional Planning Thoughts

A. Allocating Gain to FAI

It is not certain that a power to adjust granted by a state statute or under the instrument authorizes the trustee to allocate realized gain to FAI. The Uniform Act merely authorizes the trustee to allocate corpus to income (or the reverse). It does not explicitly authorize the trustee to allocate realized gain to income. Realized gain is a tax concept and therefore unlikely to appear in a state statute (other than a state tax statute). Perhaps, the trustee will be permitted to allocate proceeds of sale to FAI pursuant to a power to adjust, thus causing the capital gain inherent in the proceeds to be included in DNI. But even that remains unclear. Hence, even if state law grants the trustee a power to adjust, it would be prudent to include in the governing instrument discretionary authority to allocate realized gain to FAI (reasonably and impartially) to achieve the planning advantages discussed above.⁸⁶ In fact, it seems that states should adopt a default rule granting trustees this power in those cases in which it grants a power to adjust or perhaps when the instrument authorizes a discretionary corpus invasion (thereby permitting the trustee to allocate realized gain to income through a corpus invasion).

In existing trusts, in the absence of such state legislation, it may nevertheless be possible for the trustee to use a power in the instrument to allocate receipts between principal and income to achieve the desired effect. As indicated, in TAM 8728001, the Service concluded that a trustee with that power under the instrument could cause realized gain to be allocated to FAI and, as a result, to be included in DNI. Whether that strategy remains viable is unclear, however, given the regulations' failure to either embrace or reject the conclusion reached in the TAM and the absence of any published guidance on the question.

B. Unitrusts and Receipts

Because of the uncertainty of the tax effects of having the trustee exercise a power to adjust or paying a unitrust amount when state law does not explicitly provide for it, it seems that it will be preferable to have the trust governed by the laws of a state that has a statute *expressly* authorizing the trustee to do so. Some states have express rules as to how to make their trust laws apply (see, for example, Alaska Statute 13.36.035), although it seems that this is an administrative matter and no specific nexus to that state seems to be required for the laws of a particular state to apply other than an explicit direction in the instrument. See *Restatement of Conflicts (Second)* section 268. As for a will, it may be appropriate to direct original probate in a state that permits nonresidents to do that and provide that the laws of that state will govern, including the trustee's ability to exercise a power to adjust or convert any income trust into a unitrust. See, for example, New York EPTL 3-5.1(h), Alaska Statute 13.38.300.

⁸⁶This also will ensure that the trust will be treated, for the purposes discussed above, as paying or being required to pay FAI, although the importance of that is uncertain.

It seems that a conversion of an income interest into a unitrust other than pursuant to state statute (or to a unitrust with a payout of less than 3 percent or more than 5 percent, even if pursuant to a state statute) should probably no longer be undertaken without receiving a private letter ruling from the IRS given the implication in the regulations and the preamble that a taxable gift or taxable gain might occur. Although arguments might be maintained that that conversion by the trustee cannot be a gain or gift event for the beneficiary (assuming the beneficiary is not the trustee), many will not wish to take the risk.⁸⁷

C. Having Capital Gain Form Part of DNI

When it will be preferable as a general rule to have capital gains form part of DNI so they will be included in the beneficiary's income may be difficult to discern. While the federal capital gain rate is now as low as 15 percent, this rate will no longer apply after 2008. Moreover, it is impossible to predict the impact of future legislation. Nonetheless, for smaller trusts, it may be preferable for capital gain to be taxed to the trust because the trust's tax rate may be lower than if distributed to the beneficiary. Often, the trust may be structured so as to avoid state and local income taxes that a beneficiary cannot avoid, which also suggests that it may be preferable for the gain to be taxed to the trust. On the other hand, a beneficiary may have an otherwise unused capital loss that could shelter a gain realized by the trust from tax if that gain could be allocated to the beneficiary. Or it may be preferable to tax the gain to the beneficiary if the beneficiary would not be subject to state or local income tax on a gain that would otherwise be subject to that tax in the hands of the trustee.

Given that uncertainty, it would seem that the most effective approach would be to give the trustee discretion regarding distributions (provided that doing so does not create any adverse consequence such as disallowance of the marital deduction or a disqualification of the trust for purposes of the state law rules concerning the minimum amount that must be bequeathed to a spouse). Giving the trustee that discretion may not, however, create the necessary year-to-year flexibility, because the regulations provide that a discretionary distribution of corpus will cause capital gain to be included in DNI only if the trustee is consistent (makes, as suggested, what is in effect an irrevocable election). The regulations do, however, permit capital gain to be included in DNI when the trustee is given the discretion to allocate realized gain to FAI (if exercised impartially and reasonably). And because the regulations do not impose a consistency requirement in this context, a trustee having that discretion can decide on a yearly basis whether a better tax outcome would be achieved by causing capital gain to be included in or excluded from DNI. It would therefore seem prudent, as a general matter, to include that discretion in all new instruments. Indeed, the flexibility produced by that kind of

discretionary authority creates a competitive advantage for a discretionary trust over a unitrust. In other words, while the consistency requirement that the regulations impose on a unitrust forces the trustee into making an irrevocable election at the outset regarding the treatment of capital gain for DNI purposes, the discretionary approach permits the trustee to take into account evolving circumstances. Thus, putting other considerations aside, it will not be surprising if planners tend to opt for the discretionary trust over the unitrust.⁸⁸

In addition, as indicated, the tax treatment of an equitable adjustment remains unclear. In contrast, the regulations clearly provide that realized capital gain will be included in DNI if appropriately allocated to FAI. Until further guidance is provided for the treatment of an equitable adjustment, conservative practitioners may feel more comfortable using the discretionary allocation of gains to FAI.

Of course, a well-informed trustee will consider factors beyond the tax consequence. For instance, the trustee will consider whether the invasion will cause property to face claims of creditors of the beneficiary (including any spousal right of election to a minimum share of the estate of the income beneficiary), whether the invasion will result in the diversion of the trust property to someone different from those the grantor of the trust would want to receive trust property (for example, to the income beneficiary's spouse rather than the income beneficiary's descendants), and whether taking the property out of the trust will cause it to face higher wealth transfer taxes than if it stayed in the trust (for example, the trust is "exempt" from GSTT).

All of the foregoing suggests changes in both state statutes and governing instruments. State statutes probably should authorize trustees (as well as executors, although the extent to which the new rules apply to executors is uncertain, at least in some respects) to "deem" discretionary distributions of income or corpus as consisting of realized capital gain. It does not seem that the governing instrument or state law must impose a reasonable and impartial requirement on the trustee in exercising that "deeming" authority. Also, state statutes should be revised to authorize expressly a fiduciary, as part of the power to adjust, to pay corpus to the income beneficiary (as opposed to converting corpus to income) and to select a tax-character ordering rule if the trust becomes a unitrust. The latter (that is, selection of a tax-character ordering rule) also should be in governing instruments (assuming the grantor does not wish to prohibit a conversion from an income trust to a unitrust).

D. Considerations for New Income-Only CRTs

The limitation on treating proceeds of sale as fiduciary accounting income of income-only charitable

⁸⁷See LTR 200231011, *Doc 2002-17961*, 2002 TNT 150-29 (concluding that the conversion was an income-taxable exchange).

⁸⁸In any given case, the treatment of capital gains for tax purposes may be less important than other considerations, such as "predictability" of annual distributions under a unitrust regime.

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remainder trusts may diminish their use, unless it is anticipated that the trust will produce income sufficient to fund the desired payments. Usually, those CRTs are used when the unitrust recipient wishes to delay receiving payments so the taxable income of the trust may build inside the trust income tax-free. However, depending on investment performance, the unitrust recipient may be foreclosed from receiving significant distributions. As a result, it is often appropriate to include a "flip" provision so that the trust can be converted from an income-only type to a regular unitrust. See reg. section 1.664-3(c). Although the unitrust recipient forfeits any right to "make up" payments when the "flip" occurs, the recipient would thereafter at least receive the full unitrust amount. In short, given the limitation imposed by the regulations on opportunities to allocate proceeds of sale to income in the case of an income-only trust, the regulations make it even more important to consider the use of a "flip" provision.

E. Sample Provisions

As indicated above, it may be appropriate, or sometimes necessary, to have some documents contain specific provisions in light of the final regulations.

For some noncharitable trusts (but not for charitable lead trusts if there are no continuing trusts after the charitable term) the following provisions may be considered:⁸⁹

The {TRUSTEES} (other than any Trustee who is a beneficiary hereunder and other than the grantor) may allocate within the meaning of reg. section 1.643(a)-3(b) to income or to principal, or partly to income and partly to principal, all or part of the realized gains from the sale or exchange of trust assets; provided, however, that, if income is defined under an applicable state statute as a unitrust amount and the trust is being administered pursuant to such statute, the allocation of gains to income must be exercised consis-

tently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to reg. section 1.643(a)-3(b).

The {TRUSTEES} (other than any Trustee who is a beneficiary hereunder and other than the grantor) may deem, within the meaning of reg. section 1.643(a)-3(e), any discretionary distribution of principal as being paid from capital gains realized during the year. The {TRUSTEES} (other than any Trustee who is a beneficiary hereunder and other than the grantor) may take any action that may be necessary in order for such deeming to be respected for tax purposes.

The {TRUSTEES} (other than any Trustee who is a beneficiary hereunder and other than the grantor) may, within the meaning of reg. section 1.643(a)-3(e), specify the tax character of any unitrust amount paid hereunder. The {TRUSTEES} (other than any Trustee who is a beneficiary hereunder and other than the grantor) may take any action that may be necessary in order for such specification to be respected for tax purposes.

For income-only charitable remainder trusts, the following provisions should be contained:

Limitation on Determination of Income. Notwithstanding any provision herein contained or any rule of law applicable to the Charitable Remainder Trust herein created to the contrary, (1) proceeds from the sale or exchange of assets contributed to the Charitable Remainder Trust herein created must be allocated to the principal and not to Trust income, at least to the extent of the fair market value of those assets on the date of contribution, (2) proceeds of the sale or exchange of assets purchased by the Charitable Remainder Trust herein created must be allocated to the principal and not to Trust income, at least to the extent of the Trust's purchase price of such assets, and (3) trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision of applicable state law.

⁸⁹These sample provisions are derived from Wealth Transfer Planning (a computerized document assembly and expert advise system of which Jonathan G. Blattmachr and Michael L. Graham are the authors) and are reproduced here with the permission of Interactive Legal Systems LLC (<http://www.ilsdocs.com>).

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