Trust Distribution Options That Meet the Needs of Grantors, Beneficiaries, and Trustees

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Trustees are finding it increasingly challenging to generate enough trust income to support satisfactory distributions to current beneficiaries. New options are available that allow trustees to enhance and stabilize the amounts distributed to income beneficiaries each year. These options have significant implications for grantors, beneficiaries, and trustees. The tax consequences of employing the various options are often difficult to decipher, and may play a key role in deciding which option is best for any given situation.

Introduction

The approach to structuring private trusts is undergoing dramatic change. Trust provisions and trust structure remained consistent and routine for many years. Then, external provocation from the financial investment world disrupted the somewhat comfortable relationship among the parties involved in a trust. Trustees found it increasingly difficult to generate income for the current beneficiaries. When attempts at increasing income were tried, future beneficiaries became disappointed, because corpus growth did not keep up with skyrocketing equity markets. Everyone acknowledged that additional options were needed so that grantors' wishes could be addressed initially and trusts could be administered over time to fulfill those wishes. Creative new provisions were introduced into trust agreements in an attempt to address these concerns. State laws were changed to clarify a fiduciary's obligations to beneficiaries and increase flexibility in finding a resolution to the conflicts developing among beneficiaries' interests. Treasury and the IRS acknowledged the need for more flexibility. Regulations were amended to recognize the legitimacy of the new laws and trust document provisions within the federal tax framework.

Historically, most trusts were designed as income trusts. For the most part, state law defines trust "income," often referred to as "trust accounting

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income." Trust accounting income is calculated in accordance with some variation of the Uniform Principal and Income Act (UPAIA) adopted by the various states.[1] Receipts that meet the UPAIA's income definition are allocated to "income" and are distributable to current income beneficiaries. Receipts classified by the law as "principal" are added to corpus and held for the remainder beneficiaries, who receive what is left after an income beneficiary's interest terminates. Receipts of interest, dividends, rents, and royalties are usually classified as "income." Receipts from the disposition of trust assets are generally considered "principal" and are added back to corpus (even though—from a financial accounting and tax accounting standpoint—such gains would be income). Herein lies the problem. At the risk of understatement, dividend yields and bond yields have been depressed lately. Thus, generating adequate amounts of this concept of "income" for current beneficiaries has become increasingly problematic in recent years. The question is: How can trusts be structured to confer the intended benefits upon beneficiaries at all stages?

Three of the most common arrangements now available to realign more of a trust's asset value toward the current beneficiaries are:

1. *Power to invade principal:* For many years, grantors have given trustees a power to invade trust principal for the benefit of the income beneficiary. In such cases, even receipts allocated to principal can be subsequently used for a current beneficiary's needs.
2. *Power to adjust income and principal:* More recently, the UPAIA has authorized trustees to exercise an equitable power to adjust receipts between income and principal when necessary to administer the trust impartially.[2] Using this power, the trustee has discretion to deviate from the traditional definition of income and principal when equity requires a less customary way of allocating receipts between the two.
3. *Total return unitrusts:* The third and most recent development is the opportunity in most states for the trustee to convert a traditional income trust into a "total return unitrust" (TRU). Distributions to current beneficiaries from a TRU are determined

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[1] The uniform provisions of the Uniform Principal and Income Act (UPAIA) can be found at http://www.law.upenn.edu/bll/archives/ulc/upaia/2000final.htm. Most states have adopted the UPAIA, with relatively minor revisions in some cases. Technically, a grantor has the paramount power to define trust accounting income in the trust agreement, but most trust documents defer to the UPAIA rules, at least in part. Further, Treas. Reg. § 1.643(b)-1 provides that the trust agreement definitions are disregarded for federal tax purposes if they depart too much from traditional UPAIA definitions.

[2] See UPAIA § 104.

> as a percentage of the market value of trust assets. The usual definitions of trust accounting income and principal do not affect the amount distributed from such trusts.[3]

Parties involved in managing a trust have different perspectives on using the various options. However, there is agreement among almost all of them—grantors, beneficiaries, trust officers, and tax professionals charged with reporting everything after the fact—that the traditional income trust approach alone is not sufficient anymore. Despite the general agreement, they often do not share the same vision for what constitutes an ideal trust design. This article provides a brief overview of the varying points of view of grantors, beneficiaries, and trust officers in the brave new trust world and then discusses the newer trust options now available—and the tax planning concerns associated with them.

Perspectives on the Options

Grantors' Concerns. Obviously, the trust settlor plays a uniquely important role. Without the intent to create a trust, not to mention the property of the settlor, there is nothing to manage or distribute. Because the property is initially owned by the grantor, the interest of this party is often centered on retaining as much control over the property as is possible after the trust is funded. Following consultation with an estate planning attorney, the settlor often becomes less interested in trusts that offer inflexible required distributions, such as a traditional income trust or the newly fashionable TRU. The byword of the grantor is asset protection, not simplicity and mandatory income distributions to beneficiaries.

As a result, grantors are frequently convinced that discretionary trusts are their best alternative. They prefer discretionary distributions for both income and principal invasion. Restraining spendthrift beneficiaries, beneficiaries with creditor problems, beneficiaries likely to be sued, and beneficiaries leading debauched lifestyles is a bigger concern than insuring generous distributions. Many grantors worry that mandatory distributions represent too much disincentive for their beneficiaries to work and be productive. At the other extreme, a beneficiary may already have plenty of wealth, leading a grantor to feel that income tax rates and the taxable estate

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[3] Unlike the UPAIA §104 equitable power to adjust, unitrust conversion provisions have not been incorporated into the UPAIA. Instead, a variety of models have developed in a number of states. Different states have adopted their own versions, generally following one of the various models. Consequently, state statutes on conversion to unitrusts are decidedly nonuniform. The overall idea is the same everywhere, but the laws can differ significantly in the specifics. The provisions of the first unitrust statute enacted, in Delaware, can be found online at http://delcode.delaware.gov/sessionlaws/ga141/chp048.shtml.

of the beneficiary are too high as it is, and that additional distributions will worsen the problem.

In the final analysis, grantors often want to condition all distributions on some ascertainable standard. A prevalent gauge is the health, education, maintenance, and support (HEMS) standard. When it comes to maintenance and support, grantors like conservative restrictions placed on a trustee's discretion to distribute. Requiring a principal invasion to satisfy the trust agreement standard is one of the problems with relying on an invasion power to achieve a fair distribution. Often the trustee is directed to consider a beneficiary's other resources, as well as additional factors, before an invasion is justified. A distribution from principal might legitimately help to get an equitable amount to the current beneficiary. However, achieving such equity might not be the relevant standard to determine whether the extra amount is distributable. The trustee may have difficulty justifying a distribution under the applicable standard.

Although grantors may take a parsimonious approach with many beneficiaries, sometimes they are favorably partial to a beneficiary. The trust agreement can name a beneficiary who is to receive priority as to distributions. Surviving spouses in one-marriage scenarios are prime candidates. In such cases, the conservative approach is absent. But, once again, formulas and percentages are less important than directing as much as is reasonably needed to the priority beneficiary.

Allowing wide discretion for distributions is not workable in all instances. Certain types of trusts, such as marital deduction trusts and qualified Subchapter S trusts (QSSTs), require all income to be distributed to achieve the desired tax benefits.[4] If qualifying for the annual gift tax exclusion is a consideration, then a Crummey power or something beyond pure discretion will be required.[5] Still, quite often, when grantors have a chance to think it over, shifting around amounts included in trust accounting income and establishing minimum targets for distributions are not priorities. If they had their way, grantors would prefer to wait until the last possible moment to decide who gets what.

Beneficiaries' Point of View. The world view of beneficiaries tends to be the polar opposite of grantors'. The average beneficiary cares most about two things: (1) the amount of money he or she will receive in the current

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[4] See IRC § 2056(b)(7) for the requirements of a spouse's qualifying income interest for life. The requirements for QSSTs are found at IRC § 1361(d).

[5] Treas. Reg. § 25.2503-3 explains the rule that an annual exclusion is only available for gifts of present interests in property. See Example 1 of this regulation, which illustrates that transfers to discretionary trusts do not generally qualify as gifts of present interests.

year; and (2) the value of the trust's investment portfolio, particularly post-2008.

A trustee can spend considerable time attempting to explain distribution policies and investment strategies. The trustee can show charts and calculations to a beneficiary and precisely illustrate the methods used to arrive at the current year distribution. In the end, however, the beneficiary will likely understand just one thing: current year distributions versus last year's distributions. If the dollar amount of the distribution is less this year than last, the beneficiary will complain. If the percentage paid out this year is less than last, the beneficiary will complain. Needless to say, there has been a lot of complaining in recent years.

Despite all the goal-congruence objectives that total return trusts are designed to accomplish, current beneficiaries expect to receive as much as possible. They look at the trust property as theirs. They feel the grantor wanted them to have it. The formulas do not mollify them. They would be happy to have a trustee removed in favor of another who will offer a higher unitrust payout percentage. Adjusting payout percentages up *and* down theoretically may be impartial actions to take, but—practically speaking—lowering a unitrust payout percentage is almost guaranteed to prompt an uncomfortable meeting between trustee and beneficiary. Dispassionate professionals are content to allow policies and procedures to provide conclusive answers. Sometimes beneficiaries have difficulty seeing it that way.

Trust Officers' Perspective. The perspective of trustees is, by necessity, more technically based. Their fiduciary duties and responsibilities derive from state law. For many reasons, it is critical that trustees adhere to the guidelines prescribed by the applicable state statutes. An understanding of the Uniform Trust Code, the Uniform Prudent Investor Act (UPIA), and the UPAIA is essential for fiduciaries.[6] Perhaps the watershed event for modern trust management was the advent of the UPIA. Virtually all states have adopted either the UPIA or equivalent legislation. According to the UPIA, unless the trust instrument says otherwise, trustees must be prudent investors, and have a duty to diversify investments and act impartially between current and remainder beneficiaries.[7] Furthermore, the UPIA adopts modern

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[6] In addition to the UPAIA, uniform versions of the Trust Code and the Uniform Prudent Investor Act are also available on the National Conference of Commissioners on Uniform State Law website (http://www.nccusl.org/Update/); click on "Final Acts & Legislation" to search for a specific act. Individual state laws may contain non-uniform provisions.

[7] UPIA §§ 3, 6. UPAIA § 103(b) also imposes a fiduciary obligation on the trustee to administer a trust impartially for all beneficiaries when exercising a power to adjust. The trust agreement can always trump provisions of the Act and dictate the trustee's fiduciary obligations. In such cases, it is imperative for trustees to notify beneficiaries of the specific trust agreement standards for investment they are following.

portfolio theory as the required overall approach to investing. That is, investments are evaluated not as individual risks, but in the context of the trust portfolio and an overall investment strategy. The overall investment strategy must consider the expected total return of the portfolio, both from income and from the appreciation in value of capital.[8]

Trustees' Total-Return Dilemma

This creates a problem for trustees. As prudent investors, they are obligated to maximize total return from income and value growth. The idea of total return combines notions of income and capital appreciation, blurring the traditional trust distinction between income and principal. However, based on the terms of the average trust agreement, trustees are required to generate enough trust accounting income to satisfy their duty of impartiality to current beneficiaries. In the existing investment environment, with low interest rates and dividend yields, portfolios weighted more heavily toward growth-oriented equity securities are likely necessary to maximize total return for prudent investors. But this approach to maximizing total return leaves trustees with the nearly impossible task of trying to make reasonable distributions to current beneficiaries from trust income. Clearly, fiduciaries need some way to supplement the amount of trust accounting income generated by UPIA-compliant portfolios. Two relatively recent state law developments addressed this need.

Trustee's Power to Adjust. The first helpful change in state law was introduced in the third version of the UPAIA, issued in 1997. UPAIA Section 104 gives a trustee the right to make adjustments between the traditional income and principal funds. For example, among other actions, a trustee can reclassify a receipt to income that otherwise would have been principal by the standard definition, and vice versa. In other words, if appropriate, a trustee can treat capital gains on the disposition of trust assets as part of trust accounting income in the year of disposition. As conditions to exercise this power, a trustee must (1) act as a prudent investor and (2) determine that, without adjustment, it is not possible to administer the trust impartially based on what is fair and reasonable to all the beneficiaries.[9] The explicit purpose of the power is to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income.[10]

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[8] See UPIA § 2.

[9] UPAIA § 104(a).

[10] See the comments of the National Conference of Commissioners on Uniform State Laws to UPAIA § 104.

Limits on Use. The power to adjust is not available to all trustees. The grantor can forbid it, of course. In addition, a trustee who is also a beneficiary cannot exercise the power.[11] Therefore, a surviving spouse who is the trustee of a marital trust does not have an adjustment option under the UPAIA.

Critical Elements of UPAIA Section 104. A couple of features of the Section 104 power to adjust are worth emphasizing:

1. *All principal is subject to adjustment:* It is important to understand that Section 104 does not place limits on the nature of the principal that can be adjusted to income. The power to adjust encompasses a power to adjust any amount of principal to income (or vice versa) if the conditions are satisfied. The trustee is not limited to moving realized gains from principal to income. Nor is the trustee limited to adjusting principal to income only when corpus property has appreciated in value. A trustee is broadly authorized to categorize principal as income, and this is possible even when there are no realized gains and assets have declined in value overall.[12]
2. *Not a power to meet specific beneficiary needs:* There is an important distinction between the power to adjust and the power to invade principal. A power to invade principal can serve as a technique to generally augment distributions to current beneficiaries who otherwise would receive a less than reasonable and fair amount. Most often, a power to invade is probably based upon an identifiable need of the beneficiary, and its exercise is often evaluated by an ascertainable standard of health, education, maintenance, and welfare. Special circumstances of a beneficiary usually motivate a trustee to invade principal. On the other hand, a power to adjust is specifically *not* available for these uses. Section 104 does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust.[13] The power to adjust is designed to conform distributions from the trust to a level they otherwise normally would attain, based upon a reasonable return on trust assets. Section 104 adjustments are not to embellish a current

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[11] UPAIA § 104(c)(7).

[12] UPAIA § 104(b) lists factors to consider before exercising a power to adjust. One of the factors is the need for preservation and appreciation of capital. This factor may mitigate against exercising the power when the trust realizes no gains and assets have declined in value. Nevertheless, it is only one of several factors, and the UPAIA does not prohibit outright the use of an adjustment in these circumstances.

[13] Comments to UPAIA § 104, supra note 10.

> beneficiary's interest in the trust so that he or she can meet special needs. Other authority in the trust instrument is necessary to justify distributions that do this.

The power to adjust was included in the UPAIA in recognition of the fact that income generated by a prudently investing trustee may not match the amount that is fair and reasonable to distribute to current beneficiaries. Yet, the orientation of Section 104 still relies on the traditional notion of trust accounting income for its adjustment mechanism. Another, more recent, development takes further steps toward abandoning the concept of income and principal.

Total Return Unitrust. Most states now give a trustee the option to convert a traditional income trust to a TRU. Regardless of how the UPAIA otherwise allocates receipts and disbursements to income, the law defines "income" of the TRU as a designated percentage of the net fair market value of trust assets. For tax reasons, the unitrust payout percentage is usually between 3 percent and 5 percent.[14] Every year, the current beneficiary of a TRU receives a distribution equal to the payout percentage multiplied by the value of trust assets at some point during the year.[15] This amount is not in any way tied to the amount of trust accounting income received by the trust. The unitrust distribution can come from any source within the trust. The distribution can be made out of property that is traditionally considered principal, out of traditional income, or some combination. Ultimately, the idea of a TRU is that distributions to current beneficiaries will increase as the total value of trust corpus increases, and decrease as the total value of trust corpus declines. Presumably, this result aligns the interests of both the current beneficiaries and the remainder beneficiaries—i.e., to favor investing trust assets for maximum overall return.

Who Can Convert the Trust? In most cases, both trustees and beneficiaries have the ability to implement the process by which regular trusts are converted to unitrusts.[16] In most states, either the trustee or the beneficiaries also can reverse the election and reconvert a previously converted unitrust back to the traditional form. Either trustees or beneficiaries can propose to change the payout percentage at any time.

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[14] As described previously, provisions governing TRUs vary considerably from state to state. Therefore, only general characteristics of the TRU form of trust operations are reviewed here. Each state's statutes should be consulted for the specific rules that apply in any given jurisdiction.

[15] To avoid large fluctuations in distributions during volatile markets, most state statutes permit the value of trust assets to be smoothed as an average value over at least three years.

[16] Most states impose restrictions on a trustee's ability to convert when the trustee is also a beneficiary. Special procedures must be followed in those situations.

Though one trustee or one beneficiary may commence the conversion and reconversion processes, no change is unilaterally adopted if other beneficiaries or the trustee object. If there is disagreement, then the conversion and reconversion decisions are taken by a court. Ultimately the determination is based upon an analysis of the intent of the trust settlor and the purposes of the trust. In addition, if one or more trustees are also beneficiaries of the trust, then court approval is usually required when the trustees who are beneficiaries seek conversion or reconversion.

Sources of Distributions. Although the unitrust distribution is payable without regard to the level of income, many states prescribe a priority order of sources from which distributions are deemed to come. Typically, distributions are treated as paid from these sources in the following order: net income, net realized short-term capital gains, net realized long-term capital gains, and, finally, trust principal. The distribution may be from either income or principal, but it is paid first from income and gain in states with these ordering rules.

Compatibility Issues for Drafters to Consider

The availability of the TRU option raises some compatibility issues among the three alternatives examined in this article—i.e., power to invade, power to adjust, and the unitrust. Defining the distribution to current beneficiaries as a unitrust amount and concurrently allowing the trustee to invade principal for the current beneficiaries is perfectly harmonious. A TRU trust instrument can allow the trustee to invade principal in order to make additional distributions to beneficiaries receiving a unitrust payout. Similarly, because powers to adjust and invade can serve different purposes, a trustee can exercise a power to adjust principal to income in the same trust in which the trustee invades principal to meet specific needs of a beneficiary. However, a power to adjust income in a TRU does not make sense. A number of unitrust conversion statutes directly require a trustee to release the UPAIA Section 104 power to adjust upon conversion (unless the trust agreement provides otherwise). In any case, the unitrust approach and the power to adjust are not designed to coexist in the same environment. The purpose of the unitrust is to establish fixed, determinable distributions without regard to traditional trust accounting income for the year. In such a case, changing the designation of an amount from principal to income or income to principal has no effect on the unitrust amount to be distributed. Neither should it have an effect on the amount statutorily designated as income by the conversion law in most states.

Tax Issues and Consequences

While distributions from a TRU are determined without regard to the trust accounting income, the unitrust conversion statutes still define the unitrust amount to take on the meaning of "income" in the governing instrument and

under state law. Why is this important? Why are we interested in the relationship of distributions to traditional definitions of trust income? The answer is that this relationship still has significance for purposes of determining the tax consequences to a trust and its beneficiaries.

Subchapter J of the Internal Revenue Code contains the tax rules for the taxation of trusts, estates, and their beneficiaries. The primary purpose of these rules is to determine who is taxed on the income generated by a fiduciary. Will the fiduciary pay the tax or will the beneficiaries? For non-grantor trusts, this is largely determined by the amount distributed to the beneficiaries. To make this determination, two issues must be resolved:

1. The extent to which the tax law respects a trust's determination of trust accounting income; and
2. The extent to which taxable amounts in both income and principal are treated as distributable to beneficiaries.

Both of these issues are addressed in Code Section 643.

Income. Code Section 643(b) provides a general rule that income other than amounts designated as "taxable," "distributable net," "undistributed net," and "gross" income, will be the amount of income determined under the terms of the governing instrument and applicable local law. In other words, the way that trust agreements and local law construct trust accounting income will generally be respected. However, Treasury Regulation Section 1.643(b)-1 develops this idea further, with both some worrisome language and some comforting language.

The worrisome part is that the IRS will continue to not respect trust provisions that depart fundamentally from traditional principles of income and principal. To put it another way, dividends, interest, rents, and royalties should generally be allocated to income, and proceeds from the sale of assets should generally be allocated to principal.

Fortunately, the Section 643(b) regulations allow a number of exceptions to these general propositions. Other, non-traditional allocations of amounts between income and principal will be respected if local law provides for a reasonable apportionment between income and remainder beneficiaries. The regulations specifically approve of state-sanctioned powers to adjust and unitrusts with payout percentages of no less than 3 percent and no more than 5 percent as reasonable apportionments of the total return of a trust between beneficiaries.

Unable to leave well enough alone, the regulations go on to focus specifically on property dispositions. Allocating gains from the disposition of assets to income is allowed if the allocation is made pursuant to terms of the governing instrument and applicable local law. Especially in states with

ordering provisions, it appears that unitrust "income" can safely be treated as including capital gains to the extent the unitrust amount exceeds traditional net income. Allocations of gains to income are also respected if made pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by local law or by the governing instrument, if not prohibited by local law. The meaning of this is less clear, but discretionary powers to adjust under the UPAIA must be exercised impartially, by definition. If the UPAIA gives a trustee the authority to designate that the portion of principal adjusted to income is a part that includes only current year gains, then a UPAIA power to adjust can also be successfully used to include gains from the sale of property in income. A definitive conclusion about this is not readily apparent.

The same regulation contains some additional clear cut assurances, however. Even though converting to a unitrust may result in a shift of wealth between current and remainder beneficiaries, completing a conversion will not be treated as either a sale or exchange on which gain is recognized, or a taxable gift. The estate and gift tax regulations were also revised to affirm that unitrusts and trusts with powers to adjust satisfy the requirement that all income be distributed by marital power of appointment trusts and qualified terminable interest property trusts (QTIPs) in order to claim a marital deduction.[17] Similar affirmation was given for grandfathered generation skipping trusts (GSTs).[18]

Doubt surrounded the degree to which the IRS would honor definitions of trust income after adjustments were made pursuant to UPAIA Section 104 powers and income trusts were converted to unitrusts under state law. Even though greater clarity would have been ideal, the revised regulations generally sanction the use of these new trust methods for calculating trust accounting income. Doubts also surround the degree to which the new ability to apportion between income and remainder beneficiaries affect the calculation of distributable net income (DNI) for tax purposes.

Distributable Net Income. Trust accounting income is a fiduciary accounting concept that controls the amount which fiduciaries have available to distribute to beneficiaries during the year. DNI is the tax counterpart that establishes a limit on the deductibility of distributions by the trust and a limit on the taxability of those distributions to the beneficiaries. The two concepts are related, yet they are independently determined. Trust accounting income is defined by the grantor and the UPAIA. DNI is a function of trust taxable income. Hence, the amount distributed may not equal DNI. In fact, it is very unlikely that the unitrust distribution amount from a TRU will equal DNI. This means that either the beneficiary will receive a tax free distribution

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[17] Treas. Reg. §§ 20.2056(b)-5(f)(1), 20.2056(b)-7(d)(1).

[18] Treas. Reg. § 26.2601-1(b)(4)(i)(d)(2).

of principal or the trust will have taxable income. With the compressed tax rate schedule for fiduciaries, a trust's marginal tax rate on ordinary income reaches 35 percent at about $11,000 of taxable income.

If a trust is converted to a TRU, the trustee should keep a watchful eye on the distribution deduction before year end. In today's investment climate, we are conditioned to expect that traditional trust accounting income will be less than the unitrust payout. Indeed, the usual impetus for converting to a TRU is to increase current beneficiaries' distributions. However, the trust may own property that generates high returns from rents and royalties. Or, as a result of other developments, someday, in some years, the relationship may reverse. During years of reversal, a trust can incur considerable tax liability. The following examples illustrate some of the potential tax issues that may arise:

> ***Example 1:*** The terms of a trust provide that all income is paid to Beneficiary *A* for life. The trustee converts the trust to a TRU pursuant to state law. The trustee distributes $60,000 to *A* as the unitrust amount during the current year, in full satisfaction of *A*'s right to income. Trust DNI equals $100,000, consisting entirely of ordinary income. Beneficiary *A* has a marginal tax rate of 25 percent.
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> *Result: A*'s gross income includes the $60,000 trust distribution. The trust's distribution deduction totals $60,000, resulting in approximately $40,000 of taxable income in the trust. About $29,000 of trust taxable income is taxed at a 35 percent rate (as opposed to the 25 percent rate that would apply if additional DNI were distributed to *A*). Moreover, around $2,500 of trust taxable income is taxed at a 28 percent rate and another $2,500 is taxed at 33 percent rate.
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> *Bottom line:* Failure to distribute more DNI to *A* increased the aggregate tax liability by about $3,175.

Example 1 assumes that the trust continues to operate as a TRU under these circumstances. In all probability, however, if DNI and traditional trust income are expected to exceed the unitrust amount for extended periods, the beneficiaries will clamor to reconvert from a TRU back to an income trust because their distributions will increase by doing so. But even without reconversion, the trustee can act to reduce the overall tax liability in some cases. Distributions that carry out DNI and thereby generate a distribution deduction are not limited to distributions from trust income. If DNI is available, it also attaches to distributions from corpus. A trustee possessing the relevant power can equilibrate tax rates by making discretionary distributions from principal, as illustrated in Example 2:

Example 2: The facts are the same as in Example 1, except that the trust agreement grants to the trustee a power to invade principal for Beneficiary *A*. In addition to the $60,000 unitrust distribution representing income, the trustee exercises the power to invade principal and distributes another $35,000 to *A*.

Result: A's gross income includes $95,000 from trust distributions. The trust's distribution deduction totals $95,000, resulting in approximately $5,000 of taxable income in the trust. The marginal tax rate on the trust's income is 25 percent.

Inclusion of Net Capital Gains in DNI. Perhaps the trickiest DNI issue pertains to the inclusion of net capital gains in DNI.[19] Code Section 643(a) controls the calculation of DNI. Treasury Regulation Section 1.643(a)-3 more fully considers the issue of how capital gains enter into the DNI computation and provides 14 examples for illustration.

Arguably, there are some differences between the two provisions on this point, but the DNI calculation is built upon essentially the same first precondition as the accounting income determination: To include capital gains in DNI, state law and the governing instrument must compatibly either (1) specify that gains are part of DNI, or (2) give the fiduciary discretion to determine the treatment of gains. Without state law direction or approval, the treatment of capital gains is uncertain. If these preconditions are met, then capital gains are included in DNI to the extent that either state law or a sanctioned fiduciary's allocation follows one of three options:

- *Allocation Option #1:* Allocate the gain to trust accounting income;
- *Allocation Option #2:* Allocate capital gains to corpus, but consistently treat gains as part of the amount distributed to a beneficiary on trust documents and tax returns; or
- *Allocation Option #3:* Allocate capital gains to corpus, but actually distribute the gains to a beneficiary or utilize the amount of gain to determine the amount to be distributed.

Limits on Allocating Gain to Trust Accounting Income. Since a general presumption remains that capital gains are not included in trust accounting income, then unavoidably a presumption also exists that gains are not a part

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[19] Generally, the trust's capital losses are first netted against capital gains before the DNI calculation is made. See Treas. Reg. § 1.643(a)-3(d) and examine the Form 1041 Schedule D computation procedure to confirm this. However, if an identified capital gain is used to determine the amount of a beneficiary's distribution, such gain is included in DNI and distributed without reduction by any trust capital losses. Again, see Treas. Reg. § 1.643(a)-3(d).

of DNI for purposes of Allocation Option #1. But, state law and the trust instrument can rebut the presumption.

If a TRU is governed by a state statute that provides a priority ordering for payouts that include capital gains, then the matter is settled. Capital gains are considered as allocated to income by state law and, as a result, are incorporated into DNI.[20] If the state unitrust statute does not have an ordering rule, then the inclusion of gains in DNI of a TRU depends upon state law or the trust agreement empowering the fiduciary with discretion. The strength of endorsement needed from state law for this discretionary power to be valid is a bit vague. Clearly, though, if state law or the governing instrument specifically denies the authority to a trustee, then the trustee is unable to allocate gains to DNI. If a trustee has a bona fide discretionary power to designate that capital gains are included in DNI, two restrictions limit this power:[21]

1. The maximum amount of gains that a trustee can discretionarily allocate to income is the amount by which the unitrust payout exceeds DNI, without considering capital gains.
2. A trustee must exercise this allocation power consistently.

The regulations place a ceiling on the amount of gains that a trustee can allocate to income. Further, the trustee is restricted to exercising the allocation power only on a consistent basis from year to year. This means that once a trustee includes capital gains in DNI, the trustee must allocate all subsequent year capital gains to DNI in those future years. Alternatively, after a trustee first excludes capital gains from DNI, the trustee must omit capital gains from DNI in future years. In essence, a trustee makes an irrevocable election as to capital gains and DNI the first year a discretionary power is exercised (or not exercised).[22] Such is the nature of consistency in this context.

> ***Example 3:*** The terms of a trust provide that all income is paid to Beneficiary *A* for life. The trustee converts the trust to a TRU pursuant to state law. State law provides that the unitrust payout is paid from sources in the following order: (1) net income, (2) capital gains, and (3) trust principal. The trustee distributes $60,000 to *A* as the unitrust amount during the current year, in full satisfaction of *A*'s right to income. During the year, the trust receives $25,000 of ordinary income and $15,000 of net capital gain.

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[20] Treas. Reg. § 1.643(a)-3(e), Example 11.

[21] Treas. Reg. § 1.643(a)-3(b)(1).

[22] Treas. Reg. § 1.643(a)-3(e), Examples 12 and 13.

Result: A's gross income includes $40,000 from the trust distribution. The distribution to *A* consists of $25,000 ordinary income, $15,000 capital gains, and a $20,000 tax-free corpus distribution. As a result of the ordering rule, the capital gain is included in income and, thereby, in DNI. The trust's distribution deduction totals $40,000.

Issues When Gains Are Allocated to Trust Corpus. Gains do not have to be allocated to trust accounting income for them to be a part of DNI. As long as the local law and governing instrument prerequisites are satisfied, a trustee may add capital gains in corpus to DNI so long as the trustee treats the gains as distributed or bases the amount distributed on the amount of gain recognized. If Allocation Option #2 is used, then the trustee must adopt consistent treatment for capital gains in future years. In this context, the consistency doctrine is somewhat akin to substantial economic effect for partnership distributive shares. If the size of a beneficiary's distribution is dependent on the amount of capital gains recognized by a trust during the year, inconsistency in treatment of gains for DNI purposes is acceptable. If a beneficiary's distribution is an established amount regardless of how much gain is recognized during the year (such as a unitrust payout amount), then a policy of consistency is required.

Example 4: The facts are the same as in Example 2, except that DNI of $95,000 consists of $50,000 ordinary income and $45,000 net capital gain that the trustee intends to treat on trust records and on the tax return as part of Beneficiary *A*'s distribution. Total net capital gains recognized by the trust for the year amount to $70,000. Neither state law nor the trust instrument restricts the trustee's power to allocate capital gains to DNI.

Result: A's gross income includes $50,000 of ordinary income and $45,000 net capital gain ($10,000 from the unitrust payout plus $35,000 from the discretionary principal distribution). The trust's distribution deduction totals $95,000. The trust's taxable income would consist of additional recognized capital gains.

Caution: Once a trustee has proceeded in this manner, he or she must consistently treat discretionary distributions as being made from recognized capital gains in all future years.

As long as net capital gains are taxed at a lower 15 percent alternative rate, using gains to regulate the amount of DNI relative to distributions does not have the same urgency as regulating the size of distributions vis-à-vis DNI with ordinary income. Whether capital gains are taxed at the beneficiary level or at the trust level, the tax rate that applies to them will in most

circumstances be a constant 15 percent. Under current law, the aggregate tax liability of a trust and its beneficiaries will not be reduced substantially by dividing up gains between the two. Nevertheless, since decisions to allocate gains to DNI may be irrevocable and the law is subject to change in the future, some forward thinking on this issue is worthwhile.

Conclusion

With recent developments in state trust law and federal trust tax law, a number of options have become available to structure trust agreements that meet the financial and tax planning objectives of the parties involved. But along with more options comes added complexity. Because fiduciary relationships are involved and the exposure associated with such obligations can be significant, it is imperative that all professionals involved in setting up and administering trusts become familiar with the legal and tax implications of their decisions.