

Estate & Succession Planning



By Louis S. Harrison

The Treasury Creates Good Vibrations: The Final Regulations Under Code Sec. 643*

Scattered throughout the Code are archaic estate and trust tax sections crying out for change because of their inappropriate applications in a quickly evolving investment and entity planning environment. Take a close look at *A. Strangi Est. II*,¹ and ask the following question: Did Congress really consider the use of partnerships in 1931 in its desired list of evils to be curbed by Code Sec. 2036(a)? Unlikely. Code Sec. 2036 has been in need of change, or complete elimination, for the last 20 years. Whatever purpose was originally intended by that section has long gone by the wayside.²

Like Code Sec. 2036, the trust and estate income tax rules under Code Sec. 643 long have been in drastic need of an update to incorporate modern portfolio concepts into the income taxation regime. That section controls who is taxed on income—ordinary income and capital gains—as between the trust (or estate) or the beneficiaries.³ But the potential impact of Code Sec. 643 is more extensive than just this allocation concept. It also can affect the potential qualification of marital unitrusts for the marital deduction and the continued grandfathering of certain generation-skipping trusts. When originally enacted, the application of Code Sec. 643 to such far-reaching concepts was unintended and most certainly unanticipated.

The original version of Code Sec. 643 could not accommodate modern portfolio investment theory, nor could it handle the irrelevance to the investment world of distinctions between trust accounting income and capital appreciation. The old rules posed substantial problems to planners and tax return preparers because they just did not reflect modern reality.

The issuance by the Treasury on December 30, 2003, of new regulations under Code Sec. 643 was a welcome change and will help planners conform

modern investment practices to tax planning. There are many highlights to these regulations, adopted after numerous thoughtful comments to the proposed regulations by planners.

The regulations are applicable to trusts and estates for tax years ending after January 2, 2004. That means that even for older trusts, these rules will now apply for the current and subsequent tax years.

In the past, capital gains typically were excluded from distributable net income (DNI) and were thus trapped at the trust or estate level except in the year of termination.⁴ Although possible, it was very difficult to argue under the old regulations that a distribution of principal to a beneficiary constituted a distribution of capital gain to that beneficiary (resulting in that beneficiary being taxed on the capital gain).⁵ This posed substantial concerns to fiduciaries on a practical level—the distribution of principal to a beneficiary was on an after-tax basis. It also often interfered with year-end tax planning. For example, if it were possible to distribute capital gains to a beneficiary in a given year, the trustee could prevent an estimated tax payment penalty at the trust level that would otherwise have occurred because the fiduciary was not safe harbored and had not anticipated that year's capital gain for estimated tax purposes.

The regulations now provide substantial flexibility to include capital gains in DNI and thus to allow the allocation of capital gains from a trust or estate to the beneficiary in a given year.⁶ For example, to make capital gains taxable to the beneficiary, the fiduciary is now allowed to allocate those gains to income in a more liberal fashion than was permitted under the prior regulations.⁷ Or, the capital gains can be allocated to corpus but “treated consistently by the

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fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary.⁸ Or, those capital gains can be allocated to corpus, but actually distributed to the beneficiary.⁹

These standards allow substantial flexibility to the trustee in determining whether capital gains are to be taxed to the trust or to the beneficiaries, and essentially open the door to trustee discretion in this regard. When determining whether to make an allocation of capital gain to a principal distribution to a beneficiary, the fiduciary and advisor should review carefully the examples and rules in the regulations and, to the extent possible, should try to fit within one of those fact patterns. The new regulations do require that the trustee be authorized to allocate capital gains to DNI by state law or by the provisions of the trust instrument, if not prohibited by state law.

Further flexibility is created in the new regulations by an expanded definition of income.¹⁰ The definition of "income" is crucial in complying with many estate tax and other statutes such as the marital deduction provisions under Code Sec. 2056(b)(5) and (7), which require that a surviving spouse be entitled to all "income" from the trust at least annually.

Before the issuance of these regulations, there was certainly a question as to whether a unitrust interest would have satisfied this income requirement.¹¹ Now the regulations specifically provide that a unitrust amount can define trust accounting income.¹² Specifically, a spouse who is entitled to a unitrust amount of no less than three percent and no more than five percent of trust fair market value each year (rather than the ubiquitous right to all "income") in accordance with *both* a state statute and the governing instrument would qualify for the marital deduction.¹³ Further, a trustee's conversion of an income-only trust into a total return trust or unitrust should not cause the loss of the federal estate tax marital deduction and will not trigger a taxable transfer for gift tax purposes (provided, again, that the unitrust amounts are in the range of three to five percent of fair market value).

This flexibility conforms to modern investment portfolio theory that looks for total return. In other words, instead of a four-percent income interest made up of interest and dividends, the trust could provide for total capital return, and the four-percent return could

be satisfied by the fiduciary allocating capital gains to the income beneficiary to satisfy that beneficiary's income interest.

Similarly, when the trustee invests and manages the trust assets under the state's prudent investor standard and adjusts between income and principal to ensure impartiality regarding a trust investing for total return, this allocation will be respected.¹⁴

Modern portfolio theory has acted as a catalyst for states to amend their Principal and Income Acts to allow "income-only" trusts to be changed to unitrusts. That type of conversion eliminates the inherent tension between an income beneficiary's desire to invest in fixed income instruments and the remainder beneficiaries clamoring for capital appreciating assets. However, trustees have been concerned that this

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type of conversion would be argued by the IRS, *ala Cottage Savings*,¹⁵ to be a triggering event for capital gain purposes.¹⁶

The final regulations support the conclusion that this type of conversion will not be a problem if the action is provided for by state statute.

The regulations specifically provide that such a state-authorized conversion will not constitute a recognition event for purposes of Code Sec. 1001.¹⁷ Similarly, the regulations make clear that a conversion into a unitrust will not undo GST grandfathering.¹⁸

It should be noted that almost all of the flexibility given to trustees under the new regulations depend upon an authorizing state statute. Generally, it is not sufficient merely to have provisions in the trust giving the trustee authority to make the kinds of allocations discussed in the regulations.

In conclusion, the new regulations under Code Sec. 643 accomplish several positive objectives for planners. They are a "must-read," and the practitioner also may want to focus on the provisions in these regulations—not as favorable to the taxpayer but still fair in their application—pertaining to charitable remainder trusts and pooled income funds.

ENDNOTES

* The final regulations are available at 69 FR 12, T.D. 9102, (Dept. Treas.).

¹ *A. Strangi Est. II*, 85 TCM 1331, Dec. 55,160(M), TC Memo. 2003-145.

² Code Sec. 2036, in a broad brush, was intended to capture transfers with retained life estates or retained controls because such transfers were deemed in the mid-20th century to be testamentary in nature.

But that abuse—a transaction testamentary in nature, but made during life—is not a valid policy objection in 2004; and the archaic purpose of the section calls out for the section’s elimination.

- ³ The section controls the allocation of ordinary income, tax-exempt income, capital gains and other items of taxable income and expense by the use of a concept set forth in the Code section known as “distributable net income.” In its simplest format, an item included in distributable net income as set forth in the Code section is deducted by the trust and taken into account in the beneficiary’s taxable income, if a sufficient distribution of property is made to the beneficiary in that year.
- ⁴ See, e.g., former Reg. §1.643(a)-1, which provided that distributable net income did not include capital gains unless “[a]llocated to corpus and actually distributed to beneficiaries during the taxable year.”
- ⁵ See, e.g., former Reg. §1.643(a)-1, Example 1: “However, if the trustee follows a regular practice of distributing the exact net proceeds of the sale of trust property, capital gains will be included in distributable net income.”
- ⁶ Reg. §1.643(a)-3(b).
- ⁷ The prior regulations required that in order for capital gains to be allocated to income, that allocation had to be provided for “under the terms of the governing instrument or local law by the fiduciary on the books.” Former Reg. §1.643 (a)-(1). The new regulations allow an allocation to income “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).” Reg. §1.643(b). If income under the state statute consists of a unitrust amount, a discretionary power to allocate gains to income must be exercised consistently and the amount is qualified by reference to DNI.
- ⁸ Reg. §1.643(a)-3(b)(2).
- ⁹ Reg. §1.643(a)-3(b)(3).
- ¹⁰ Reg. §1.643(b)-1.
- ¹¹ To address this concern, practitioners often created marital deduction unitrusts by requiring that the trustee distribute the *greater* of “all income of the trust or [X percent] to the surviving spouse.” That type of “greater than” standard, for a variety of pragmatic reasons, is still appropriate drafting.
- ¹² Reg. §1.643(b)-1.
- ¹³ See, e.g., Reg. §20.2056(b)-5; Reg. §20.2056(b)-7.
- ¹⁴ Reg. §1.643(b)-1.
- ¹⁵ *Cottage Savings Ass’n*, SCt, 91-1 USTC ¶50,187, 499 US 554 (1991).
- ¹⁶ See LTR 200231011, ruling that a modification of an “income-only” trust into a seven-percent unitrust could be a sale or exchange triggering income tax. For a discussion of this issue, see *Total Return Trusts Give Trustees Flexibility in Ever-Changing Markets*, 91 ILLINOIS BAR JOURNAL 5 (2003).
- ¹⁷ Reg. §1.643(b)-1.
- ¹⁸ See Reg. §26.2601-1(b)(4)(i)(d)(2).