TRUST ACCOUNTING ISSUES

ERIC REIS
Thompson & Knight LLP

Estate Planning Council of North Texas

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I. INTRODUCTION[1]

You have been appointed the trustee of a trust with two beneficiaries, A and B. The trust agreement provides that beneficiary A receives mandatory income distributions every year. Beneficiary B is the remainderman who will receive the trust principal on the death of A. Your duty to distribute the income of the trust every year to A may seem simple enough, but you soon find yourself asking many questions. What constitutes income of the trust? Should trust expenses be paid from the income or the principal of the trust? When does A's income interest begin and end? Absent contrary terms in the will or trust agreement, Chapter 116 of the Texas Trust Code provides some answers to these questions, as discussed in Part II of this Article. Part III of this Article explores the federal taxation of simple and complex trusts, and Part IV considers the interplay between Chapter 116 of the Trust Code and the Internal Revenue Code.

II. CHAPTER 116 OF THE TEXAS TRUST CODE

Chapter 116 of the Texas Trust Code, commonly known as and based on the "Uniform Principal and Income Act," was enacted in 2003 and provides certain default rules regarding trust principal and income accounting issues.

A. Section 116.004: General Principles

The overriding principle underlying Chapter 116 is that a Trustee should administer the trust in a way that is impartial and fair to both the income and remainder beneficiary. § 116.004(b). This likely approximates the intent of most settlors, that the trust provide a reasonable income to the income beneficiary, but at the same time conserve and potentially grow the principal for distribution to remainder beneficiaries. Absent a contrary rule contained in the trust or will or a provision in the trust agreement giving the trustee discretion beyond what is contained in Chapter 116, the trustee must follow the rules contained in Chapter 116 and, to the extent there is any discretion allowed by the rules, must exercise that discretion impartially. Chapter 116.004 also provides a default rule that if there is no provision regarding whether a particular receipt or disbursement or expense should be allocated to principal or income, it is allocated to principal. § 116.004(a)(4).

If, however, the trust or will contains terms that conflict with the powers and rules contained in Chapter 116, the trustee should follow the terms provided in the trust or will. § 116.004(a)(1). For example, if the trust contains a specific provision governing what receipts and disbursements shall be allocated to income and principal, the trustee must follow the rules in the trust, rather than the rules contained in Chapter 116. Further, if the trust provides that a particular beneficiary should be favored, the trustee must favor that beneficiary, rather than exercise her powers over principal and income impartially. Finally, the trustee may exercise discretionary powers given to the trustee in the trust instrument, even if the exercise of the discretion is outside of what Chapter 116 would otherwise permit. § 116.004(a)(2).

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If the trustee is given complete discretion over principal and income accounting matters, does that mean the trustee can arbitrarily decide to allocate items to principal and income in a way that is completely contrary to what is provided in Chapter 116 of the Texas Trust Code? Likely not. The trustee is still bound by its fiduciary duties generally and is still subject to review by the court for abuse of discretion. *See* Restatement (Third) of Trusts §110 (2012), comment (c)(2) and(c)(3).

B. <u>Section 116.005: Power to Adjust.</u>

Section 116.005 grants the Trustee, under certain circumstances, the power to adjust between the principal and income account. The "power to adjust" is a response to the Uniform Prudent Investor Act, which has also been adopted in Texas as Chapter 117 of the Texas Trust Code. The Uniform Prudent Investor Act essentially liberalized the types of investments that a trustee may undertake within the scope of the trustee's fiduciary duty by providing that the trustee's investments should be evaluated as a whole portfolio with risk and return objectives, rather than on an individual basis. Under Chapter 117 of the Texas Trust Code and unless otherwise provided in the trust instrument, a trustee shall invest and manage the trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements and other circumstances of the trust. § 117.004(a). A trustee investing the assets in a way that is consistent with the standard cited in Chapter 117 based on a reasonable risk/return objective, may also be investing in a way that benefits the income or remainder beneficiary at the expense of the other, thereby violating the impartiality principle in Section 116.004. If the trustee is investing in order to achieve the highest total return in a particular environment, he may be investing in assets with high potential for appreciation, but which produce very little income from year to year, or, alternatively, in investments that produce high income from year to year but have little potential for appreciation. The power to adjust in Section 116.005 remedies this potential unfairness.

Under Section 116.005, if, due to the trustee's investment program, the trust accounting income of the trust is too small or too large (and therefore is unfair either to the income beneficiary or principal beneficiary), the trustee may adjust between principal and income. The power to adjust under Section 116.005 specifically includes the power to allocate all or a part of the trust's capital gain to income. For example, if the trustee invests in assets with high potential for appreciation of principal, but which produce very little income from year to year, the trustee may adjust from the principal account to the income account in order to provide the income beneficiary with a fair income. Similarly, if the trustee is invested in a way that produces a substantial income every year, in order to be fair to the remainder beneficiaries the trustee may adjust from the income to the principal account.

1. *Requirements*. The Trustee will have the power to adjust under 116.0005 only if:
   a. The Trustee manages the trust assets as a prudent investor (*i.e.*, as provided in Chapter 117 of the Texas Trust Code),
   b. The trust instrument describes the amount that may or must be distributed to a beneficiary by referring to trust income (*e.g.*, the trustee may distribute so much of the income as is needed to provide for beneficiary A), and

c. After applying other applicable rules in Chapter 116 or the trust instrument, the Trustee is unable to administer trust estate impartially between the beneficiaries as provided in Section 116.004(b) (unless the trust instrument manifests an intent that a particular beneficiary or class of beneficiaries be favored over another). § 116.005(a).

The underlying consideration in applying the trustee's power to adjust is to administer the trust in a way that is impartial and fair as between the income and principal beneficiaries.

2. *Factors*. In deciding whether and to what extent to exercise the power to adjust, a trustee should consider all of the facts and circumstances surrounding the trust, its creation, and the circumstances of the beneficiaries. For example, the trustee should consider the intent of the settlor in creating the trust, and whether the settlor would have wanted a beneficiary to receive more income than what is provided under the trust accounting rules. Section 116.005 provides the following non-exhaustive list of factors the trustee must consider, to the extent relevant:
   a. The nature, purpose, and duration of trust;
   b. The intent of the settlor in creating the trust (for example did he intend to benefit particular beneficiaries or preserve principal for future generations);
   c. Identity and circumstances of the beneficiaries (for example, is the income beneficiary in need of funds or are they reasonably well provided for, is the beneficiary someone whom the settlor would likely have intended to favor such as the settlor's spouse);
   d. A particular beneficiary's or group of beneficiaries' needs for liquidity, regular income and preservation or appreciation of capital;
   e. The type of assets held in the trust (liquid, illiquid, whether used by the beneficiary, etc.);
   f. The net amount allocated to income under Chapter 116;
   g. Whether the trustee has the power to invade principal or the power to accumulate income;
   h. Prevailing economic conditions, inflation, deflation, etc. and their effects on the trust; and
   i. The tax consequences of adjustment. § 116.005(b). As discussed in Part IV below, an adjustment to income may increase the trust's distributable net income (DNI), and therefore decrease the trust's income tax and increase the beneficiary's income tax.

3. *Restrictions*. The trustee is prohibited from exercising the power to adjust in situations enumerated in Section 116.005(c), namely situations where exercising the power would cause adverse tax consequences (for example, if the trust is meant to qualify for the federal estate or gift tax marital deduction), the trustee is a beneficiary, or if possessing or exercising the power would cause the trustee to be treated as the owner of a portion of the trust for income tax purposes.

4. *Power to Release*. Similarly, the Trustee can also release the power if adverse tax consequences could result. § 116.005(d).

5. *Trust Instrument Not Necessarily Determinative*. A general prohibition on the trustee adjusting between income and principal contained in the trust agreement will not affect the application of the Section 116.005 power to adjust unless the settlor specifically forbade the exercise of the power. § 116.005(f). This provision is meant to allow trustees of trusts executed before Chapter 116 was enacted to exercise the adjustment power, notwithstanding potentially contrary provisions in the trust agreement.

C. Section 116.006: Judicial Control of Discretionary Power

A trustee's decision to exercise the power to adjust will generally be respected by the courts. Section 116.006 of the Texas Trust Code provides that the court may not compel the trustee to exercise or not exercise the trustee's power to adjust unless the court determines the decision to exercise or not exercise the power constitutes an "abuse" of the trustee's discretion. If the court finds that the trustee's exercise or non-exercise of the power was an abuse of discretion, the trustee could potentially be personally liable if the court finds that it is unable to place in the position they would have occupied absent the abuse of discretion.

If the trustee has a reasonable belief that a beneficiary will object to the trustee's exercise of the power to adjust, the trustee may petition the court for a ruling that the exercise of the power is not an abuse of the Trustee's discretion. § 116.006(d). The failure of a beneficiary to sign a waiver consenting to the exercise or nonexercise without further objection does not count as reasonable grounds, standing alone, for the trustee to believe the beneficiary will object. *Id*. Costs incident to the judicial determination, including attorneys' fees and costs of the trustee of a beneficiary, are advanced from principal. However, the court may ultimately charge the trustee individually, the trust's income, the trust's principal, or the beneficiary or beneficiaries for all or a portion of the costs. *Id*.

D. Section 116.007: Provisions Regarding Noncharitable Unitrusts.

Some states adopting the Uniform Principal and Income Act allow for a trustee to convert a trust to what is called a "unitrust," which is a trust that pays a certain percentage of the trust's fair market value every year to the beneficiary. Chapter 116 of the Texas Trust Code does not permit a trustee to convert a trust to a "unitrust." Section 116.007 does however provide support under Texas law for a settlor who wants to create a noncharitable unitrust paying a unitrust amount between 3% and 5% to a beneficiary, by defining such percentage as the trust's "income" for state-law fiduciary accounting purposes, so that the classification of income might be respected by the IRS for federal income tax purposes under Section 1.643(b)-1 of the Treasury Regulations (discussed below in Part IV).

E. Decedent's Estate/Terminating Income Interest, Sections 116.051-116.052.

Sections 116.051 and 116.052 of the Texas Trust Code contain rules that apply specifically to an estate or after an income interest in a trust ends. Specifically, Sections 116.051 and 116.053

provide rules as to how net income and principal is allocated among the estate's or trust's beneficiaries.

1. *Section 116.051: Determination of Net Income.* Section 116.051 provides specific rules for determining which beneficiary is entitled to the net income and other property from an estate or at the termination of an income interest in a trust.

   a. Specific Bequests. On the termination of an estate or an income interest in a trust, a beneficiary who is to receive specific property will receive the net income and principal receipts from that specific property. For example, if Blackacre was bequeathed to a particular beneficiary, he or she would receive the net income from Blackacre received during the estate administration period. § 116.051(1). The net income and principal receipts from specific property are determined by including all amounts the fiduciary receives or pays with respect to that property, whether accruing or becoming due before or after the decedent's death or an income interest's termination. § 116.051(5). Finally, the principal and income receipts from specific property cannot be reduced by expenses of the trust or estate if the payments are required to be made (either by the trust instrument or applicable law) from other property or if the fiduciary expects to recover the expense from a third party. § 116.051(5).

   b. Net Income. After providing for the distribution of the net income and principal receipts from specifically bequeathed property, the remaining net income of the estate or trust is determined under the general rules contained in Chapter 116 plus the following additional rules: (i) the fiduciary includes in net income all income from property used to pay liabilities of the estate or trust property; (ii) the fiduciary has discretion to pay attorneys' fees, administration expenses, court costs, etc. from income or principal (however, if payment from income would reduce a marital or charitable deduction, the trustee cannot pay the expense from income); and (iii) the fiduciary shall pay from principal all other disbursements in connection with settling the estate or winding up the trust. § 116.051(2). The ability of the fiduciary to pay administration expenses from principal or income enables the fiduciary to choose to deduct estate-administration expenses either for estate or income tax purposes, and make the corresponding allocation between principal and income to charge the expense against the account that benefits from the estate or income tax deduction.

   c. Interest due on Pecuniary bequests. If the winding up of an estate or trust is delayed for a year or more before the property is ultimately distributed to the beneficiaries, a beneficiary who, under the terms of the trust or will, receives (outright or in trust) a pecuniary amount from the estate or a trust with a terminating income interest must receive interest on the pecuniary amount, which is payable from net income (or principal if net income is insufficient). For example, if a beneficiary or a trust created under a will is to receive an amount equal to the decedent's federal estate tax exemption, the beneficiary or trust receiving the pecuniary bequest will also receive interest on the same amount. The calculation of interest is determined as follows:

a. If the bequest is under a will, the interest starts accruing on first anniversary of decedent's death.

b. If the pecuniary amount is received upon the termination of an income interest in a trust, the interest starts accruing on the first anniversary of the date on which the income interest ends.

c. The rate of interest determined under Section 302.002 of the Texas Finance Code. §116.051(3).

After providing for the above distributions of net income, the remaining net income is distributed to the residuary or remainder beneficiaries as provided under Section 116.052. § 116.051(4). A charitable organization entitled to receive net income under this paragraph shall receive that amount without reduction for taxes to the extent the amount paid is allowed as a tax deduction. §116.051(6).

2. *Section 116.052: Distribution to Residuary or Remainder Beneficiaries* . Under Section 116.052 of the Texas Trust Code, each remainder or residuary beneficiary is entitled to a portion of the net income as determined under Section 116.051 equal to the beneficiary's fractional interest in the undistributed principal, using values as of the distribution date. For example, if the residue of the estate is to be distributed 50/50 between A and B, after providing for the distributions and calculating the remaining net income under Section 116.051, A and B share the net income 50/50.

F. Rules at the Beginning and End of An Income Interest, Sections 116.101-116.103

When an income beneficiary dies and the trust has a succeeding income beneficiary, when does the initial income interest end? Which beneficiary, the initial or the successor income beneficiary, is entitled to income that accrued before the initial income interest ends but is paid after the initial income interest ends? Sections 116.101 through 116.103 answer these questions by providing rules for determining when an income interest begins and ends and to which beneficiary a particular receipt of income is apportioned.

1. *Section 116.101: When Right to Income Begins and Ends.* Under Section 116.101, the income beneficiary is entitled to net income on the date interest begins – meaning the date specified in the trust agreement or the date an asset becomes subject to a trust or subject to the successive income interest. An asset becomes "subject to a trust":

a. On the date it is transferred to the trust;

b. On the testator's death if the asset becomes subject to a trust under the decedent's will, or

c. On the date of the individual's death in the case of an asset transferred to a fiduciary by a third party by reason of individual's death. §116.101(b)

In the case of a terminating income interest resulting in a successive income interest, the asset becomes subject to a successive income interest on the day *after* the preceding income interest ends. §116.101(c). An income interest ends on the day *before* the income beneficiary dies or another terminating event occurs, or on the last day of a period during which there is no beneficiary to whom income is distributable. As an example, C receives income from the trust for life. Beneficiary B becomes entitled to the income interest on the death of C. Under Section 116.101, C's income interest ends on the day before C's death, and B's income interest begins on C's date of death.

2. *Section 116.102: Apportionment when decedent dies/income interest begins.* Now that the trustee has determined when the income interest begins and ends as provided under Section 116.101, Section 116.102 provides rules for allocating income receipts and disbursements when a decedent dies or an income interest begins.

   As an initial matter, Section 116.102 divides payments into two types of payments, payments with a "periodic due date" and all other payments. Section 116.102 also defines when a payment is considered "due." A payment has a "periodic due date" if it must be paid at regular intervals under a lease or obligation to pay interest. Examples of receipts or disbursements with periodic due dates include interest, rent, dividends and annuities. A particular receipt or disbursement is considered "due" on the date the payer is required to make a payment. If a payment date is not stated in the instrument creating the obligation, there is no "due date." Distributions to shareholders are treated as due on the date fixed by the entity for determining who is entitled to a distribution or, if none, the date stated in the declaration of distribution. §116.202(c).

   In the case of an income receipt or disbursement with a "periodic due date," the trustee allocates the income receipt or disbursement to principal if the due date occurs before the decedent's death or before the income interest begins. §116.102(a). Note that this rule does not apply to income receipts or disbursements with respect to specifically bequeathed property as provided in Section 116.051(1). The trustee allocates the income receipt or disbursement to income if its due date occurs on or after the date on which the decedent dies or an income interest begins. §116.102(b)

   If a particular income receipt or disbursement does not have a periodic due date or if there is no due date, it is treated as accruing from day to day. In this case, the portion of the income receipt or disbursement accruing before the decedent's date of death or an income interest begins is allocated to principal, with the balance of the receipt or disbursement allocated to income. §116.102(b).

3. *Section 116.103: Apportionment when mandatory income interest ends.* Section 116.103 provides rules for allocating income receipts when a mandatory income interest ends. Under Section 116.103(b), the trustee must pay to the beneficiary, or the beneficiary's estate, the beneficiary's share of the "undistributed net income" that is not disposed of under the terms of the trust instrument. "Undistributed net income" is defined to mean net income received before the date on which the income interest ends. It does not include an item of income or expense due or accrued or net income that has been added or is required to be added to principal under the trust instrument. In other words, income that has accrued but has not been paid to the trust is not included in the term "undistributed net income." §116.103(a). Section 116.103(b) does not apply if

beneficiary has power to revoke more than 5% of the trust immediately before the income interest ends (otherwise this provision could require distributions to the settlor of a revocable trust). Finally, under Section 116.103(c), when the trustee's obligation to pay a fixed annuity or fixed percentage of the value of the trust ends, the trustee must prorate the final payment to the extent necessary to accomplish the settlor's income, gift, or estate tax objectives.

G. Allocation of Receipts from Entity During Trust Administration, Sections 116.151 through 116.153

You are trustee and receive dividends from shares held in the trust, or you receive a distribution from a partnership in which the trust is a limited partner. Sections 116.151 through 116.153 provide rules for determining the allocation between principal and income of receipts from entities such as corporations, partnerships and trusts.

1. *Section 116.151: Character of Receipts* Section 116.151 governs how receipts from entities such as corporations, partnerships, LLCs, and investment trusts are allocated. Section 116.151 specifically does not apply to a receipt from a trust, estate, a business activity governed by Section 116.153, or an asset backed security.

   The default rule for entities covered by Section 116.151 is that all receipts of money from an entity are allocated to income. The following are allocated to principal:

   a. Property other than money (for example, additional shares),
   b. Money received in exchange for the trust's interest in the entity,
   c. Money received in total or partial liquidation of the entity, and
   d. Money from a REIT or regulated investment company if treated as a capital gain for federal income tax purposes

   For purposes of paragraph (c), a receipt is deemed to be received in a partial liquidation of the entity if (x) the entity expressly indicates that it is a distribution in partial liquidation OR (y) the total amount of the assets received in the distribution (or related distributions) is greater than 20 percent of the entity's gross assets. § 116.151(d). Money is not received in partial liquidation or taken into account in calculating the 20 percent under (y) to the extent it does not exceed the income tax liability of the beneficiary or trustee that is attributable to the entity that makes the distribution. § 116.151(e).

   The intended purpose of this provision is that receipts that represent the income of the entity distributed to the trust should be treated as income to the trust. Receipts that more likely represent a return of the trust's capital should be allocated to principal. However, the provision is not without its faults and can create potential conflicts. A trustee could take advantage of the rule under Section 116.151 that receipts of money from a partnership by default are allocated to income to avoid Section 116.161(2) of the Texas Trust Code, which provides by default that money received in the sale or change of form of a principal asset, including realized net profit, is allocated to principal. For example, the trustee could contribute a principal asset to a partnership. The partnership might then sell the principal asset, now a partnership asset, realizing capital gain, distributing a portion of the sales proceeds to the trust. If the asset is worth less than 20% of the value of the entity and cash is distributed to the trust, it would be allocated to income under this provision, even though the sale of a partnership asset likely decreases the value of the partnership, and therefore the value of the principal account of the trust. If the trustee sold the asset outside of the partnership the proceeds would have constituted principal. Cutting the other way, a trustee could potentially invest the trust's assets in a partnership or LLC which earns income from year to year, but does not make a distribution to the trust, thereby reducing income that would otherwise be available to the income beneficiary if the trust held the assets in the partnership or LLC outright. Of course manipulating the rules in this way could be a violation of the trustee's fiduciary duty to administer a trust impartially.

If a trustee elects to reinvest dividends in shares of stock of a distributing corporation or fund, the new shares will constitute principal. However, unless the trustee's decision to reinvest the dividends in shares is to comply with the impartiality principle under Section 116.004, the trustee should transfer cash from the principal to the income account in an amount equal to the reinvested dividends. Uniform Act Comment.

2. *Section 116.152: Receipt from Trust or Estate***.** With respect to a receipt from another trust or estate distributing money to the trust, under Section 116.152, the trustee of the receiving trust must look to the characterization of the distribution from the distributing trust. If the distributing trust characterizes the distribution as a distribution of income, the receipt by the receiving trust is allocated to income. If the distributing trust instead characterizes the distribution as a distribution of principal, the receiving trust also allocates the receipt to principal of the receiving trust. This section does not apply to receipts from trusts where the receiving trust purchases an interest in the trust as an investment. Receipts from investment trusts are covered under Section 116.151 or 116.178.

3. *Section 116.153: Business Activities by Trustee*. Section 116.153 applies to a scenario when a trustee is conducting the business of the trust as a proprietorship rather than in the form of an entity. If the trustee determines that it is in the best interest of the trust to keep separate accounting records for the business activity, the trustee may maintain accounting records for the activity separate from the trust's general accounting records, whether or not the assets are segregated. If the trustee maintains separate accounting records for the activity under the terms of this section, the trustee can determine to what extent net cash receipts from the business are retained for working capital and needs of the business activity and the extent to which the remaining cash receipts are accounted for as principal or income in the trust's general accounting records. If, however, the trustee sells assets outside the ordinary course of business, the net amount received is allocated to principal in the trust's general accounting records. Examples of activities carried on by the trust to which this would apply include retail, manufacturing, farming, raising and selling livestock, management of rental properties, and timber operations. This Section would not apply to a trustee holding a portfolio of securities.

H. Receipts Not Normally Apportioned, Sections 116.161-116.178. Sections 116.161 through Section 116.178 cover receipts not normally apportioned under the terms of the trust agreement.

1. *Section 116.161: Principal Receipts***.** Assets received as gifts or contributions to the trust are allocated to principal, such as assets received from a transferor, a decedent's estate, a trust with a terminating income interest, or received pursuant to a contract naming the trust as a beneficiary are allocated to principal. Money or property received in the sale or exchange of principal asset is also allocated to principal. Eminent domain awards are generally allocated to principal, except to the extent a part of the eminent domain award is for lost income from the property during a period when there is a mandatory income beneficiary.

2. *Section 116.162: Rental Property*. Receipts from rental properties are allocated to income, including amounts received for the cancellation or renewal of the lease. Further, amounts received as a refundable security deposit or a deposit that gets applied to future rent must be added to principal and not subject to distribution until the terms of the lease have been satisfied.

3. *Section 116.163: Obligation to Pay Money.* If the trustee is the payee under the terms of a note or other obligation to pay money to the trust, interest payments received on the obligation are allocated to income. To the extent the obligation becomes due, paid off, or redeemed, or if the trustee sells the note to another party, the amount received due to such sale, redemption, or disposition is allocated to principal. This makes sense because it is likely that the sale of the obligation or the redemption constitutes a return of the trust's principal to the trust.

4. *Section 116.164: Insurance Policies and Similar Contracts***.** Generally, proceeds received from an insurance policy naming the trust as the beneficiary is allocated to principal, unless the purpose of the policy is to compensate the trust for the loss of income or profits, or the loss of occupancy by the income beneficiary, in which case the proceeds are allocated to income. Dividends received on the policy are allocated to income if the premiums are paid from income, or to principal if the premiums are paid from principal. *See Estate of Jones*, 422 S.W.3d 775 (Tex. App.-Texarkana 2013, no writ) (annuity paid in lump sum to decedent's estate as beneficiary properly characterized as principal, character as principal did not change due to purchase of additional annuity with the proceeds).

5. *Section 116.171: Insubstantial Allocations* If the allocation is insubstantial, the trustee may allocate the entire amount to principal. There is no definition of what constitutes an "insubstantial allocation," so the trustee may use its discretion. See Texas Bar Comment to 116.171 ("the trustee will be able to use its discretion in determining when an allocation is insubstantial and should not be questioned merely because its determination did not satisfy an arbitrary presumption").

6. *Section 116.172: Deferred Compensation, Annuities.* Section 116.172 applies to the allocation of receipts received from an annuity or deferred compensation arrangement, such as an IRA. Generally, to the extent the payer characterizes a payment as interest or a dividend, the payment is allocated to income. The balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment is allocated to principal. §116.172(b).

If, on the other hand, no part of the payment is characterized as interest or a dividend, and all or a portion of the payment is required to be made (in other words, the trustee is not exercising a right of withdrawal), the payment is allocated as follows:

a. The trustee allocates to income the portion of the payment that does not exceed 4% of the fair market value of the "future payment asset" less the total amount the trustee has allocated to income for all payments received from the future payment asset during the same accounting period. "Future payment asset" simply means the asset from which the payment is derived. The determination of the fair market value of the future payment asset is made on the later of (i) the date the future payment asset first becomes subject to trust, and (ii) the last day of the accounting period immediately preceding the accounting period during which the payment is made. For each accounting period a payment is received, the 4% amount is prorated on a daily basis unless the fair market value of the future payment asset is determined under (ii) above for an accounting period of 365 days or more. §116.172(c)-(e). Note that the 4% concept is unique to Texas's version of the Uniform Principal and Income Act. *See* Texas Bar Comment to §116.172. The uniform act's rule for distributions from IRAs and other retirement plans is that 90% of each distribution is principal and 10% is income.

b. The remainder of the payment is allocated to principal. § 116.172(f).

If the payment is not required to be made (in other words, because the trustee is exercising a right of withdrawal), or the payment is the entire amount to which trustee is entitled, the entire payment is allocated to principal. §116.172(g).

The outcome of the allocation changes slightly if the IRA is payable to a trust that is meant to qualify for the marital deduction as qualified terminable interest property (or "QTIP"). In order to qualify for the marital deduction when an IRA is payable to a QTIP trust, all of the IRA's income must be distributed to the QTIP, and then must be allocated by the trustee to income and distributed to the spouse. As an alternative, the spouse must have the right to withdraw the necessary amount even if the spouse does not exercise that right. Therefore, if a QTIP Trust is the beneficiary of an IRA, the rules under § 116.172(j) and (k) will apply instead of 116.172(c) to determine the allocation between principal and income, namely:

a. The trustee must determine the internal income of the separate fund IRA as if it were a separate trust. If the spouse demands payment of the income, the trustee must demand the payment of the internal income of the fund to the trust. The internal income of the fund received by the trust is allocated to income, and the remainder of any payment is allocated to principal. If the internal income of the fund is not paid to the trust and the spouse requests, the trustee must allocate to income from principal to the extent the internal income of the fund is exceeds payments made to the trust from the fund. §116.172(j)

b. If trustee cannot determine the internal income of the fund but knows the value, the "internal income" will be 4% of the fund's value, determined by the most recent statement of value before the accounting period. §116.172(k)

7. *Section 116.173: Liquidating Asset.* Section 116.173 governs allocations of payments received from a "liquidating asset", which is an asset expected to produce receipts for limited period- *e.g.,* a leasehold, patent, copyright, or royalty. For a receipt from a liquidating asset, 10% of the receipt is allocated to income, with the remainder allocated to principal.

8. *Section 116.174 Minerals, Water, Natural Resources.* Section 116.174 governs the allocation of receipts from mineral interests as well as water rights and natural resources. It essentially abolishes the "open mine doctrine" under common law with respect to a beneficiary's interest in mineral interests, wherein the consumption and depletion of the natural resources by the income beneficiary would not constitute waste if the depletion was within the normal use of the land (in other words, if the land was used for the activity before the life estate began). Section 116.174, absent a contrary provision in the trust or will, requires the trustee to allocate payments from such resources instead in accordance with Chapter 116.

   If the trust owned the mineral interest before January 1, 2004, the trustee may allocate receipts in accordance with Chapter 116 or in any lawful manner used by the trustee before January 1, 2004. With respect to interests acquired after January 1, 2004, the trustee must follow Chapter 116. § 116.174(d).

   Under Section 116.174, a receipt for a delay rental or annual rent on a lease of a mineral or similar interest is allocated to income. § 116.174(a)(1). A receipt from a production payment is allocated to income to the extent the agreement creating the production payment provides a factor for interest, with the remainder of the receipt allocated to principal. § 116.174(a)(2). A receipt that is a royalty, shut-in-well, take-or-pay payment, or bonus is allocated "equitably" between principal and income. § 116.174(a)(3). This is in contrast to the provision under the Uniform Act, which provides that only 10% of a royalty payment is allocated to principal with the rest to income. *See* Uniform Principal and Income Act 1997 § 411. A receipt from an interest in water is allocated to income if the interest in water is renewable, otherwise the receipt is allocated "equitably." Texas Trust Code § 116.174(b). A receipt or allocation is presumed to be equitable if the amount allocated to principal is equal to the amount allowed as a deduction for depletion of the interest for federal income tax purposes. § 116.174(e).

9. *Section 116.175: Timber.* Net receipts from timber are allocated to income (if there is a mandatory income beneficiary), to the extent that the amount removed does not exceed the rate of growth of the timber. Net receipts from timber are allocated to principal to the extent the amount removed exceeds the rate of growth of the timber. In determining net receipts, a trustee must deduct and transfer to principal a reasonable amount for depletion. § 116.175(b). This section contains a similar effective date provision as Section 116.174, such that if a trustee acquired the interest in timberland before January 1, 2004, the trustee may continue to allocate receipts as the trustee did before January 1, 2004 if the trustee so chooses.

10. *Section 116.176: Property Not Productive of Income.* If the trust qualifies for the marital deduction, this section allows the trustee to convert property unproductive of income to property productive of income in order to provide the surviving spouse with the requisite level of beneficial enjoyment to qualify for the marital deduction.

11. *Section 116.177: Derivatives and Options* If receipts are not accounted for as a separate "business activity" under Section 116.153, receipts and disbursements from derivatives and options are allocated to principal. Derivative means a contract or financial instrument giving the trust the right or obligation to participate in the changes in price in of an asset or group of assets. The comments to Section 116.177 provide that a gain or loss occurring because the trustee marks securities to market or to another value during an accounting period is not a transaction in a derivative that is income or principal; only cash receipts and disbursements, and the receipts of property in exchange for a principal asset, affect a trust's principal and income accounts. § 116.177 (Uniform Act Comment).

12. *Section 116.178: Asset-Backed Securities* "Asset-backed security" is an asset the value of which is based on the right to receive distributions from the proceeds of financial assets providing collateral for the security. §116.178(a). A portion or all of the payment from an asset backed security that is classified as interest or current return by the payer is allocated to income with the remainder of the payment allocated to principal. If the payment is received in exchange for trust's entire interest in the security in one accounting period, the payment is instead allocated to principal. If the payment is made over more than one accounting period, 10% is allocated to income, with the remainder allocated to principal.

I. <u>Allocation of Disbursements/Expenses, Sections 116.201-116.206</u>.

The prior Sections govern receipts or payments to the trust. Sections 116.201 through 116.206 govern the allocation of expenses, also called disbursements, from the trust. The general theme is that expenses that enhance the value of both the income and principal interest will be shared by the income and principal account. Expenses that tend to increase the value of only the income interest or only the principal interest will tend to be allocated accordingly.

1. *Section 116.201: Disbursements From Income.* Trust expenses allocated to income are as follows:

a. One-half of the compensation of trustee, investment advisors, and custodians is allocated to income unless the trustee determines a different portion or all of the compensation should be allocated to income.
b. One-half of all expenses for accountings, judicial proceedings, and general matters involving both the income and principal interest are allocated to income.
c. All other ordinary administration expenses are allocated to income.
d. Recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of asset are allocated to income.

2. *Section 116.202: Disbursements From Principal*. 116.202 governs expenses allocated to principal. The following expenses are allocated to principal:
   a. The other one-half of the compensation discussed in 1(a) above is allocated to principal (unless the trustee determines a different portion should be allocated to income, in which case principal pays the remainder).
   b. The other one-half of the expenses for accountings, judicial proceedings, and general matters involving both the income and principal interest are allocated to principal.
   c. All of trustee's compensation that is calculated on principal as a fee for acceptance, distribution, or termination of the trust is allocated to principal. For example, if part of the trustee's compensation is based on principal distributions made in a year, that portion of the compensation will be paid from principal.
   d. Expenses to prepare property for sale are allocated to principal, because the expenses to prepare the property for sale will likely increase the proceeds from the sale, which are allocated to the principal account.
   e. Expenses of a proceeding concerning primarily the principal interest, such as a proceeding to construe the trust or protect the trust or its property are allocated to principal.
   f. Premiums on insurance policies of which the trust is the owner and beneficiary (other than policy described in 1(d) above) (including title policy, life insurance policy) are paid from principal.
   g. Estate, inheritance, and other transfer taxes are allocated to principal.
   h. Disbursements relating to environmental matters are allocated to principal.
   i. If principal asset is encumbered with obligation requiring income from the asset to be paid to the creditor, the trustee will transfer from principal to income an amount equal to the income paid to the creditor.

3. *Section 116.203: Permissive Transfers From Income to Principal for Depreciation.* Section 116.203 permits the Trustee to transfer to principal a "reasonable amount" of net cash receipts from a principal asset that is subject to depreciation EXCEPT (i) for depreciation on real property used by beneficiary as a residence or tangible personal property used by beneficiary, (ii) during the administration of a decedent's estate or (iii) if the trustee is accounting under Section 116.153 for a business activity in which the asset is used.

4. *Section 116.204: Permissive Reimbursements to Principal.* Under 116.204 the trustee may reimburse the principal account from the income account if the trustee makes certain principal disbursements including:

   a. Amounts that would otherwise be chargeable to income.
   b. Capital improvement to a principal asset.
   c. Disbursements made to prepare property for rental, which presumably will increase the value of the income interest.
   d. Periodic payments on an obligation secured by principal.
   e. Disbursements relating to environmental matters.

J. *Section 116.205/116.206: Income Tax.* Income taxes payable on receipts allocated to income must be paid from income and income taxes payable on receipts allocated to principal must be paid from principal. Section 116.205(a) and (b). The tax on a trust's share of an entity's taxable income is paid:

   a. From income if the entity's receipts are only allocated to income;
   b. From principal, if entity's receipts are only allocated to principal;
   c. If receipts from the entity are allocated to both income and principal, the tax is apportioned proportionately; or
   d. From principal if the tax exceeds total receipts.

Under Section 116.206(a) the trustee may make adjustments between the principal and income account to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder. For example, take a trust that qualifies as a qualified sub-chapter S trust (or a "QSST") and holds an interest in an S-corporation. The QSST's interest in the S-corporation's income will be taxable to the beneficiary, regardless of whether or not the S-corporation makes a distribution to the trust. Section 116.206 allows the trustee to make adjustments between income and principal in order to offset the income beneficiary's tax liability attributable to the income from the S-corporation.

Section 116.206(b) provides for a mandatory adjustment from income to principal to the extent needed to preserve the marital or charitable deduction when a fiduciary chooses to deduct amounts paid from principal for expenses for income tax purposes instead of deducting it for estate tax purposes. When the fiduciary chooses to deduct an expense for income tax purposes instead of estate tax purposes, it will increase the amount of estate tax due, thereby potentially decreasing the marital or charitable deduction. Therefore Section 116.206(b) provides that the estate, beneficiary, or trust that benefits from the decrease in the estate's income taxes shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent the principal used to pay the increase would have qualified for the marital deduction or charitable deduction.

III. FEDERAL TAXATION

A. Types of Trusts.

There are two types of trusts for federal income tax purposes, grantor trusts and non-grantor trusts. Grantor trusts are trusts that are treated as owned in whole or in part by the settlor of the trust (or certain other individuals) who retain certain powers over the trust. The taxation of grantor trusts is not discussed in this article. Non-grantor trusts are further divided into simple trusts and complex trusts, both of which result in different income tax consequences.

B. Taxation and Definition of a Simple Trust.

1. *Definition*. A simple trust is a trust that (i) is required to distribute all of its income currently (whether the distribution is required to be made to one or multiple beneficiaries), (ii) has no current charitable beneficiaries, and (iii) does not actually make distributions during a particular year other than its income required to be distributed (therefore, even if the trust has a mandatory principal beneficiary, if the distribution is not actually made in a tax year, it will qualify as a simple trust for that tax year). Internal Revenue Code of 1986, as amended ("I.R.C.") § 651(a). Income in this context means fiduciary accounting income, which is the income of the trust determined under state law. The status of the trust as a simple or complex trust may change from year to year. For example, a trust may have a mandatory income beneficiary, but may have discretion whether or not to distribute principal. In a year in which a principal distribution is made, the trust will be classified as a complex trust. A simple trust will not lose its status as a simple trust if as a matter of convenience it does not make the income distribution until after the close of the tax year, so long as it is required to make the income distribution currently. Treas. Reg. § 1.651(a)-2(a). Further, a trust will not be disqualified as a simple trust solely because the amount of income allocated to a particular beneficiary is not specified in the trust agreement, for example, if the trustee is required to distribute all the income but may sprinkle the income among a class of beneficiaries or a group of particular beneficiaries. Treas. Reg. § 1.651(a)-2(b).

2. *Taxation*. Distributions of income that are required to be distributed by the simple trust are deductible by the trust and included in the income of the beneficiary receiving the distributions. I.R.C. § 651(a) and § 652(a). In other words, the deduction by the trust of the income distributed and the inclusion in the income of the beneficiary are based on the amount of income required to be distributed instead of the amount actually distributed. Further, the deduction and inclusion are limited to the trust's "distributable net income" (discussed below). I.R.C. §651(b). Simple trusts are allowed a personal exemption of $300 and must use the calendar year as the simple trust's tax year.

C. Definition and Taxation of a Complex Trust

1. *Definition*. A complex trust is a trust that is not a simple trust (because it has no mandatory income beneficiary or distributes principal in a particular year) and is not a grantor trust. Estates are also taxed like complex trusts.

2. *Taxation*. Complex trusts with income in excess of $12,500 are taxed at the top marginal rate. Generally, distributions from complex trusts are deductible by the trust, but only if the distribution is required to be paid that year, or if the distribution is properly paid or credited that year to a beneficiary. I.R.C. §661(a). The distribution is similarly included in the beneficiary's income. I.R.C. §662. Therefore, it is beneficial for the trust to distribute its income to the trust beneficiaries if the beneficiaries are in a lower tax bracket than the trust's high tax bracket. However, both the deduction by the trust and the inclusion in the beneficiary's taxable income is limited by the trust's distributable net income ("DNI") and other special limitations discussed below.

   a. DNI. The trust is permitted a deduction for distributions only up to the amount of the trust's DNI, and the beneficiary has taxable income only up to the same amount. I.R.C. §§ 661(a), 662(a). DNI is roughly equivalent to fiduciary accounting income, or the income of the trust determined under state law. More precisely, DNI equals the trust's taxable income, plus tax exempt interest, minus certain items that are allocated to principal under state law. I.R.C. § 643.

      Generally, DNI does <u>not</u> include capital gains unless the gains are (i) allocated to income under the terms of the governing instrument or local law, (ii) 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 (iii) allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to the beneficiary. Treas. Reg. § 1.643(a)-3(b). A more extensive discussion of inclusion of capital gains in the trust's DNI is discussed below in Part IV. If capital gains are paid for purposes specified in I.R.C. § 642(c) so that a charitable deduction is allowed in respect of the gains, they must also be included in the computation of the trust's DNI. Treas. Reg. § 1.643-3(c). Capital losses are not taken into account in determining DNI, except to the extent they reduce the amount of capital gains actually paid or credited to beneficiaries. Treas. Reg. 1.643(a)-3(d). Therefore, capital losses are normally netted against capital gains at the trust level, meaning that capital gains included in DNI are usually net capital gains unless the capital gain is "actually" distributed to the beneficiary.

      With respect to simple trusts only, DNI excludes extraordinary dividends (whether paid in cash or in kind) or taxable stock dividends which are not distributed or credited to a beneficiary because the fiduciary determines under the instrument or local law that the dividends are allocable to corpus. Treas. Reg. 1.643(a)-4.

      In summary, the trust's DNI in many instances will be close to the trust's fiduciary accounting income. To the extent income is taxable but is allocated to principal under the terms of the trust or state law, DNI may be more than the trust's fiduciary accounting income. To the extent a trust's expenses are deductible for income tax purposes by the trust but are allocated to principal under the terms of trust or state law, DNI will be less than the trust's fiduciary accounting income.

b. Allocation of DNI among beneficiaries. To the extent distributions to the trust beneficiaries are less than or equal to the trust's DNI, the DNI is allocated pro-rata first among the beneficiaries who are entitled to receive mandatory income distributions (called "first-tier beneficiaries"). To the extent the distributions to the first tier beneficiaries are less than the trust's DNI, any remaining DNI is allocated pro-rata among distributions made to discretionary beneficiaries (called "second-tier beneficiaries"). If a complex trust has no mandatory income beneficiaries, all the trust's beneficiaries will be classified as second-tier beneficiaries. These principles may be modified by the separate share rules, discussed below.

c. Character of Distributions. In determining the gross income of a beneficiary (for both a simple and complex trust) the amounts includable in the beneficiary's income from the trust distribution have the same character in the hands of the beneficiary as in the hands of the trust (in other words, the income retains its character as tax exempt interest, dividends, capital gains, etc.). For example, to the extent the amount distributed consists of tax exempt income, such amount is not included in the gross income of the beneficiary. Also, the amounts required to be included in the income of the beneficiary are treated as consisting of the same class of each items entering into the DNI calculation of the trust as the total of each class bears to the total DNI, unless the terms of the trust or state law specifically require allocation of different classes of income to different beneficiaries. Treas. Reg. §§ 1.662(b)-1, 1.652(b)-2(a). For example, if the trust does not provide for a specific allocation of a particular type of income, and if there are two trust beneficiaries A and B, of a trust with dividends and tax exempt interest in a particular year, with A entitled to receive 80% of the income and B 20%, A will be treated as receiving 80% of the trust's dividends, and 80% of the trust's tax exempt interest, with B receiving the remainder.

The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries, entirely or in part, only to the extent the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of income tax consequences. Treas. Reg. § 1.652(b)-2(b). For example, if the trustee has discretion to allocate different classes of income to different beneficiaries, such discretion is not considered a specific allocation in the trust, therefore the items must be allocated in accordance with § 1.652(b)-2(a). Treas. Reg. § 1.652(b)-2(b)(1). Further, if the trust directs that a particular class of income first be allocated to satisfy a particular beneficiary's share, that also will not be considered a specific allocation contained in the trust agreement. However, the trust may direct a portion of a particular class of income to be distributed to a particular beneficiary, with the balance to the other beneficiary, and that will be deemed a specific allocation under the terms of the trust. Treas. Reg. § 1.652(b)-2(b)(2).

d. Deductions. In calculating DNI, items of deduction directly attributable to a particular class of income are allocated to that class of income. Treas. Reg. § 1.652(b)-3(a). To the extent the deduction exceeds the income, the excess may be applied to other classes of income included in calculating DNI, except that deductions attributable to tax exempt income cannot be applied against any other type of income. Deductions which are not directly attributable to a particular class of income may be allocated to any item of income in calculating DNI, but a portion must be allocated to tax exempt income. Treas. Reg. 1.652(b)-3.

e. Specific Bequests Rule. Distributions from the trust that constitute specific bequests are not deductible by the trust, nor are they included in the income of the beneficiary receiving the property. For example, if a beneficiary is to receive Blackacre on his 25th birthday, the distribution of Blackacre to the beneficiary is not included in his or her income, and the distribution is not deductible by the trust. To qualify as a specific bequest, the bequest must be a specific amount of money or a specific item of property, must be payable in no more than three installments, and the amount of money or identity of the property must be ascertainable from the inception of the trust. Because of the latter requirement, not all "formula" bequests qualify. For example, an optimum marital deduction bequest generally does not qualify, because decisions of executor will affect the amount of the bequest, and therefore the bequest will not be ascertainable from the inception of the trust.

f. Separate Share Rule. Historically, the timing of distributions from an estate could affect the tax liability of each beneficiary. For example, take a decedent who leaves ½ of his estate to John and ½ to Jane. Estate has $10,000 of income in year 1, no income in year 2, and $10,000 of income in year 3. Estate distributes $10,000 to John in year 1, $10,000 to Jane in year 2, and $5,000 to each of them in year 3. John's total income (under the old rules) for all 3 years is $15,000. Jane's total income (under the old rules) for all 3 years is $5,000. They each receive the same amount, but John pays more tax. The separate share rule attempts to remedy this problem, by providing that separate shares of an estate or trust will be treated like separate estates or trusts when computing DNI and distribution deductions. Under the separate share rule in the example above, John will be taxed on only $5,000 of income in year 1, because that is his share of the estate's DNI.

g. Distributions In Kind. If an estate or trust distributes appreciated property to a beneficiary in satisfaction of a pecuniary bequest (e.g., $10,000 to Sue), the estate or trust will recognize gain. Alternatively, if an estate distributes depreciated property to a beneficiary in satisfaction of a pecuniary bequest, the estate will recognize loss.

h. Charitable Contributions. Distributions of income to a charitable beneficiary are generally deductible if made pursuant to the will or trust instrument. Trusts get the deduction for amounts paid to charity, estates will get a deduction for amounts paid or permanently set aside for charity.

i. Exemption. The exemption for a trust is $300 if all income is required to be distributed currently, and $100 if the income is not required to be distributed currently. An estate has a $600 exemption.

j. Calendar Year. Trusts must use the calendar year, but an estate may use a fiscal year instead.

k. 65 day Rule. Under I.R.C. § 663, the trustee can elect to treat discretionary distributions made within the first 65 days of the tax year of a complex trust as paid in the preceding year for purposes of calculating the trust's deduction/the beneficiary's inclusion. This gives the trustee time to calculate the year's DNI for the previous year before making a distribution. Under the Treasury Regulations, the amount that may be elected under the 65 day rule cannot exceed (i) the greater of (a) fiduciary accounting income for the prior year or (b) DNI for the prior year; less (2) payments made, credited, or required to be made in the prior year.

IV. INTERPLAY BETWEEN FEDERAL TAXATION AND STATE LAW

A. Fiduciary Accounting Income.

As noted above, fiduciary accounting income will often be close to the trust's DNI, but not always, depending on the terms of the trust and state law. Fiduciary accounting income is defined under I.R.C. § 643(b) as the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Therefore, the trustee must look to the terms of the governing instrument or state law, whichever is applicable, to determine what constitutes income of the trust. For a trustee of a Texas trust, as discussed above, the trustee must first look to the trust instrument to determine what expenditures and receipts are allocated to income. If the trust instrument is silent, Chapter 116 of the Texas Trust Code will govern the allocation of the receipt or expenditure. To what extent will the IRS respect a trustee's determination of income under the trust instrument or state law? For example, if the trustee exercises his or her discretionary power to adjust between income and principal under Section 116.005 of the Texas Trust Code, will the IRS respect that determination of the trust's income? To what extent will the IRS respect the settlor's direction in the trust agreement to allocate a particular receipt, such as capital gain, or an expenditure to principal or income?

Treasury Regulation § 1.643(b)-1 provides that trust provisions that "depart fundamentally from traditional principles of income and principal will generally not be recognized." For example, if a trust instrument provides that ordinary dividends will be allocated to principal, even if the trust otherwise provides that all income must be distributed to the beneficiary, for purposes of determining the trust's taxation, the trust will not be treated as a trust requiring that all income be distributed currently. As another example, if the trustee charges principal payments made by the trust on mortgage indebtedness against income, this allocation will not be respected for federal income tax purposes. Rev. Rul. 90-82.

Allocation of amounts between principal and income based on local law will generally be respected for federal income tax purposes if the local law allows for a "reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation." Treas. Reg. § 1.643(b)-1. For example, a state statute defining income as no less than 3% of the trust's fair market value and no more than 5% of the trust's fair market value will be respected. Similarly, a trustee's adjustment between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiary will be respected. Therefore, by and large a trustee's "reasonable" exercise of the powers under Chapter 116 of the Texas Trust Code will be respected for income tax purposes, including the power to adjust between principal and income. If the trustee's exercise is "unreasonable," for example, if the trustee allocates 100% of the proceeds from the sale of a trust asset to income, it will not be respected for federal income tax purposes.

B. Treatment of Capital Gain

One area in which the interplay between income tax laws and state laws is readily apparent is the trustee's decision to allocate capital gains to income rather than principal, and whether the capital gain will therefore be included in the trust's DNI for the year (and therefore deductible by the trust and included in the income of the beneficiary). It may be beneficial for the trustee in some years, in a situation where the beneficiary is in a lower tax bracket, to allocate the capital gains of the trust to income, and distribute the gain as a part of the trust's DNI.

Capital gain is generally not included in the trust's DNI unless one of several exceptions is met:

1. Allocated to Income. If pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion, the trustee allocates capital gain to income, the capital gain will be included in DNI. Treas. Reg. § 1.643(a)-3(b)(1). So, for example, if the trustee exercises the trustee's adjustment power under Section 116.005 or pursuant to the terms of the trust, to allocate capital gain to income, the capital gain will be included in the trust's DNI if the exercise is reasonable and impartial. Texas law specifically allows the trustee to exercise the power to adjust under Section 116.005 to allocate all of the trust's capital gain to income. Also, if the trust agreement requires that capital gain be allocated to income, the capital gain will be included in DNI. Treas. Reg. § 1.643(a)-3(e), Example 4. In *Crisp v. U.S.*, 34 Fed.Cl. 112 (1995), the Court ruled against the IRS, allowing the trustee to include in its DNI calculation capital gains credited to the trust's capital account in a limited partnership, because the terms of the trust dictated that the capital gains be allocated, and distributable, to the income beneficiary.

2. Allocated to Corpus But Treated as Part of a Distribution. If pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and

impartial exercise of discretion, the trustee allocates capital gain to principal but consistently treats the gain as a part of a distribution to a beneficiary, it will be included in DNI. Treas. Reg. §1.643(a)-3(b)(2). For this exception to apply, the trustee must follow a regular and consistent practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by the trust during the year. Treas. Reg. § 1.643(a)-3(e), Example 2. In future years, the trustee must continue to treat all discretionary distributions as being made first from any realized capital gains. The requirement that all future discretionary distributions be treated as first coming from net capital gains might not be beneficial if the tax brackets of the beneficiary and the trust change.

3. Allocated to Corpus but Actually Distributed. Similarly, if the trustee actually distributes the gain to a beneficiary or uses it to determine the amount that is distributed to the beneficiary, it will be included in DNI. Treas. Reg. §1.643(a)-3(b)(3). This exception is much more limited than it sounds. For amounts "actually" distributed to be included in DNI under this exception, the distribution must be a mandatory distribution upon a particular event (such as 50% of the trust at age 35, a terminating distribution, or a direction to distribute the proceeds from the sale of a particular asset to a beneficiary). *See* Private Letter Ruling 8324002. Whether a trustee uses the capital gain to determine the amount distributed to a beneficiary is murky at best. An example in the Treasury Regulations of a trustee using the capital gain to determine distributions is a trustee of a discretionary trust who decides that discretionary distributions will be made only to the extent that the trust realizes capital gain in a particular year. Treas. Reg. § 1.643(a)-3(e), Example 5. Further examples of the application of this exception are as follows:

a. Trustee is to distributed 50% of trust assets when A reaches 35, the remainder at 45. The trust consists entirely of appreciated shares. When A reaches 35, trustee sells 50% of the shares, and distributes the proceeds to A. All of the proceeds, including capital gain, are distributed to A, therefore capital gain is included in the trust's DNI. Treas. Reg. § 1.643(a)-3(e), Example 9.

b. Same facts, but trustee sells all of the stock in the year A reaches age 35, distributing 50% of the sales proceeds to A. If the trustee is authorized under the trust instrument or local law to determine what extent capital gain is distributed to A, he may exercise that discretion. In the absence of such discretion, 50% of the capital gain from the sale is included in DNI, representing the percentage of the sales proceeds required to be distributed. Treas. Reg. § 1.643(a)-3(e), Example 10.

c. Capital gains realized in the year of the trust's termination are included in DNI because they will actually be distributed to the beneficiary. Treas. Reg. § 1.643(a)-3(e), Example 7.

d. Distributions of specific sums of money within the meaning of Section 663(a) do not carry out capital gain to the beneficiary. Treas. Reg. § 1.643(a)-3(e), Example 8.