# § 643 REGULATIONS: USE OF NON-CHARITABLE UNITRUSTS AND OTHER ISSUES RAISED UNDER THE FINAL REGULATIONS[1]

**BARBARA A. SLOAN**

McLaughlin & Stern, LLP
New York, New York

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## I. INTRODUCTION.

### A. Final Regulations Finally Issued.

Nearly three years after proposed regulations were issued under § 643 of the Code,[2] the Internal Revenue Service issued final regulations on December 30, 2003. For the most part, the final regulations are not substantially different than the proposed regulations, although several of the problem areas identified in the proposed regulations were addressed. A few new questions were raised which may be addressed by additional guidance as the regulations are administered. The preamble to the regulations is particularly important in providing a context to the regulations and should be mandatory reading.

### B. Low Dividend Returns.

In recent years, the significant decline in dividend yields on common stocks, including yields on high quality "blue-chip" stocks that are commonly used as trust investments, coupled with a prolonged period of low interest rates, made it difficult for trustees to achieve both reasonable income levels and reasonable growth in the same portfolio. This economic development exacerbated tensions between income beneficiaries and remaindermen, particularly when the two groups had no continuing family relationship (e.g., surviving spouse and children from a prior marriage). And, while the impact of low income rates can be mitigated by granting the Trustee discretionary power to distribute principal if needed, the creator of the trust may not have foreseen this need or may not have felt comfortable conferring such discretion. Thus professional trustees found themselves facing potentially contentious beneficiaries on both

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[1] This outline is based in part on an article by the author, her partner, T. Randolph Harris, and George L. Cushing, of Kirkpatrick & Lockhart, Boston, MA, that was published in the June 2001 issue of The Journal of Taxation, Vol 94, No. 6.

[2] Unless otherwise provided, all references to the Code or IRC sections are to the Internal Revenue Code of 1986, as amended.

sides; the trustee's duty, in this new investment climate, has been described as "the duty to disappoint equally." [3]

C. Modern Portfolio Theory.

Simultaneously, modern portfolio theory introduced the idea that investments should be made as part of a total portfolio which is balanced with respect to potential risk and potential return; that investments can be diversified to reduce risk without necessarily reducing return; and that judging investments individually, as provided by traditional fiduciary law, is no longer appropriate. Measuring success in terms of the "total return" of a portfolio, modern portfolio theory encourages fiduciaries of discretionary trusts to seek the highest overall portfolio return consistent with prudent investment standards through the trust's investment program and not to focus on the production of trust accounting income. If the portfolio achieves a 20% total return with only 1.5% representing interest and dividends, the trustee has power to distribute principal so that the income beneficiaries receive a "reasonable" annual distribution (perhaps 3% to 5% of the portfolio's market value). The remaindermen generally do not object, since the major portion of the portfolio return is retained within the trust. Such trusts are commonly referred to as "total return trusts."

D. Corresponding Changes in Law.

Along with the growing acceptance of modern portfolio theory, three legal developments in the past ten years have significantly changed the landscape of fiduciary investing for all trusts, including traditional "income-only" trusts: The Restatement (Third) of Trusts; the Prudent Investor Act (approved by the ABA in 1995) and the third revision of the Uniform Principal and Income Act ("UPIA") (approved by the ABA in 1998). The results of these developments is that trustees in many states may now pursue a "total return" investment strategy for all trust portfolios and use a portion of the return to meet the income needs of the income beneficiaries, whether or not that return consists of traditional income or capital gains. The Restatement (Third) of Trusts, which formulates legal principles for guidance of trustees in carrying out their fiduciary duties defines the trustee's duty to invest as a "prudent investor" in the "context of a trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suited to the

[3] Robert B. Wolfe "Defeating the Duty to Disappoint Equally: The Total Return Trust," 32 Real Prop. Probate & Tr. J. 45 (Spring 1997).

trust."[4] This duty also includes a duty to diversify the investments of the portfolio, "unless, under the circumstances, it is prudent not to do so."[5] The Prudent Investor Act establishes these investment principles as a matter of state law on a state-by-state basis.[6]

E. Traditional Tax Rules.

Traditional federal fiduciary income tax rules are based on traditional state law concepts of "income" and "principal." Historically, trustees were required to distribute only the income to the income beneficiaries, retaining the principal and all capital gains realized by the trust for the ultimate benefit of the trust's remaindermen. In light of this history, even where trustees are granted discretion to distribute principal to the income beneficiary, the existing federal income tax rules severely restrict the ability of the trustee to include distributed capital gains in distributable net income ("DNI") taxable to the income beneficiaries.

## II. THE UNIFORM PRINCIPAL AND INCOME ACT.

A. General Overview.

The UPIA provides authority for trustees to make investment decisions following the new investment principles while allowing greater flexibility in the allocation of investment return between income and principal. UPIA is being adopted by an ever increasing number of states, although the actual version adopted by each state varies.

B. Specific Provisions.

1. Adjustment Power. Specifically, UPIA § 104 permits a trustee to "adjust" the financial returns actually achieved with respect to the trust portfolio between income and principal in order to enable the trustee to administer the trust "impartially, based on what is fair and reasonable to all of the beneficiaries" except to the extent that the governing instrument manifests a contrary intention.[7]

a. This adjustment power has the greatest significance when applied to trusts which require or permit the trustee to

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[4] Restatement (Third) of Trusts § 227. *See* EPTL § 11-2.3(3)(C)(requiring trustees to diversify assets "unless the trustee reasonably determines it is in the best interests of the beneficiaries not to diversify. . ."

[5] Restatement (Third) of Trusts § 227.

[6] *See* UPIA Section 103(b). *See also* EPTL § 11-2.3.

[7] *See* UPIA § 103(b). *See also* EPTL § 11-2.3(b)(5)(adding language that adjustment must be "fair and reasonable to all of the beneficiaries, so that current beneficiaries may be given such use of the trust property as is consistent with preservation of its assets.")

distribute only the trust income, since, if discretionary powers to distribute principal are conferred on the trustee, the trustee can supplement the income distribution by making supplemental distributions from principal, as appropriate.

b. To the extent that the income return is unreasonably low, UPIA § 104 will authorize the trustee to allocate a portion of the capital gains realized by the trust - whether realized in the current year or in a prior year – to income so that the income beneficiary can receive a reasonable income distribution.

2. Unitrust Provision. In about a third of the states, the UPIA's adjustment provisions are supplemented by an alternative, namely: permitting trustees of trusts which are subject to the laws of those states to elect to treat a trust as a non-charitable "unitrust" with income determined as a fixed percentage of the trust's market value (instead of being subject to the UPIA). The concept behind the unitrust alternative was to relieve the trustee of the weighty responsibility of determining when and to what extent to adjust the income of a trust. Interestingly, a few states have enacted a unitrust statute without enacting the UPIA.

a. For example, in New York, the law creates a statutory unitrust percentage of 4% of the market value of the trust assets, valued annually;[8] if a unitrust election is made, a trustee would treat the 4% unitrust amount as "income" for trust accounting purposes, regardless of the trust's actual trust income determined under traditional fiduciary accounting principles.[9]

b. If the trust instrument requires that trust income be distributed, the unitrust election would produce a mandatory 4% distribution to the income beneficiaries; if the trust permits, but does not require, trust income to be distributed, the unitrust election would cause the trustee to apply the 4% unitrust formula in determining the trust's income for each year but such income could be distributed or accumulated, based on the standards governing the exercise of the trustee's discretion over income in the trust instrument.

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[8] EPTL § 11-2.4(b)(1) and (2).

[9] EPTL § 11-2.4(a).

III. FINAL REGULATIONS UNDER SECTION 643.

A. Overview of Impact of Final Regulations.

1. Purpose of New Regulations. When property is owned in trust, the rights in and benefits of trust property are divided between the income beneficiary and remainderman in a variety of ways. If the income beneficiary is a spouse or the remainderman is a charity, the government has an interest in ensuring that the special tax benefits for spouses[10] and charities[11] are accorded only if the special beneficiary has sufficient rights under the trust to warrant it. The definition of an income beneficiary's right to income has a substantial impact on the determination of the beneficiaries' rights under a trust and affects whether special tax benefits should be accorded to the trust. A change in the state law definition of income requires the government to identify the limits necessary to obtain the special tax benefits under the new definition. If the definition of income is modified to permit a fiduciary to meet its obligation of fairness to all beneficiaries when it engages in total return investing of trust assets, then the question of the taxation of the distributions made to a beneficiary from the trust must also be addressed.

2. Purpose of Definition of Income. Property interests generally are determined under state law. The right to income is a property interest – an entitlement to the economic benefit generated by the property on a current basis and thus is appropriately determined under state law. The purpose of these regulations is to ensure that the amount paid out to an income beneficiary, where the income beneficiary is entitled to all of the income from the trust, is adequate for the trust to receive any special tax benefits accorded to the trust or the donor under the new nontraditional state law definitions of income.

B. Impact on Taxation of Trusts and Beneficiaries.

1. Trusts and beneficiaries are taxed at different rates and the government thus has an interest in regulating how and when a trustee can shift income between them. Under the adjustment provision of the UPIA and the principal and income acts enacted by many states, a trustee has the power, in his or her discretion, to shift income and corpus between the income beneficiary and the remainderman. To the extent that this power permits the trustee to

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[10] See §§ 2056 and 2523.

[11] IRC §§ 642(c), 2055 and 2522.

shift the tax burden associated with the income between the income beneficiary and the remainderman, it potentially could permit the trustee to minimize the total tax paid on income earned in the trust.

2. In contrast to this concern, notions of fairness require that the issue of the allocation of the economic burden associated with the tax on the income be reexamined in light of the new definition of income. Clearly, the general rule is to allocate the tax burden to whomever receives the economic benefit associated with it. When the definition of income under state law departs from the definition of ordinary income, it is necessary to rethink the manner in which the tax burden for capital gain is typically allocated. Although the initial task posed to the government by the new investment theory and revised state law definition of income had to address the definition of income under the tax code, the government's analysis then also had to include the issue of when capital gain should be required to be included in DNI and/or when it may be included in DNI at the trustee's discretion. This is covered in the regulation under section 643(a).

C. Definition of Income under the Final Regulations. Section 643(b) of the Code, the source of authority for the definition of income in the regulations, provides substantial flexibility since it looks solely to the terms of the governing instrument and applicable state law.[12]

1. Treas. Reg. § 1.643(b)-1 provides that for purposes of the taxation of estates, trusts (other than grantor trusts) and beneficiaries, generally, the definition of income continues to be determined under traditional principles of income and principal, allocating ordinary income to trust accounting income and capital gain to principal.

2. However, if local law permits a different allocation, trust provisions following that law will be respected for tax purposes if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year.

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[12] IRC § 643(b) provides:

For purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means 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.

3. The regulations provide what is in effect a safe harbor for such a reasonable apportionment by clarifying that a state law providing for a unitrust amount which is no less than 3% and no more than 5% of the annual fair market of the trust is held to be a reasonable apportionment,[13] as is a state law which permits the trustee to make adjustments between the income and remainder beneficiaries under the same circumstances in which it is permitted under the UPIA:

    a. the trustee invests the trust's assets under the state's prudent investor standard,

    b. the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income and

    c. the trustee cannot administer the trust impartially without making an adjustment between income and principal.

4. The regulation expressly authorizes the use of a smoothing rule in determining the amount to be distributed as a unitrust percentage by permitting the value of the assets to be averaged on a multiple year basis for this purpose.

5. The regulation also clarifies that a switch between methods of determining the income of a trust which complies with all requirements of the applicable state statute for switching methods will not constitute a recognition event for purposes of IRC § 1001 and will not be treated as a gift from the trust's grantor or any of the trust beneficiaries. However, the regulation left open the possibility of a *Cottage Savings* analysis being applied to a switch to a method not specifically authorized by a state statute, including a switch authorized by judicial decision or non-binding judicial settlement, which could give rise to a recognition event or taxable gifts. *See* PLR 200231011 (May 6, 2002).

    a. This is a change from the proposed regulations and is a direct response to commentator requests for clarification on this issue following the release of PLR 200231011.

    b. PLR 200231011 had unusual facts but generally provided that the conversion of an income interest in a trust to a unitrust interest in the trust pursuant to the settlement of a

[13] Although the reference to a unitrust payment of no less than 3% and no more than 5% as a reasonable apportionment of the total return of the trust is stated as an example, it serves as a safe harbor for unitrust rates.

bona fide controversy over the trust resulted in a recognition event of gain in the income beneficiary's interest in the trust because the income beneficiary's interest was materially different following the conversion of his interest to a unitrust interest. Under § 1001(e), the income beneficiary's basis in his income interest was treated as zero.

6. Finally, the regulation expands the trustee's ability to include realized capital gain in trust accounting income by providing that an allocation of capital gain to income will be respected if the allocation is made pursuant to the terms of the governing instrument and local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the trustee by local law or by the governing instrument, if not prohibited by local law.[14]

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[14] Treas. Reg. § 1.643(b)-1 provides:

For purposes of subparts A through D, part I subchapter J, chapter 1 of the Internal Revenue Code, "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principles will generally not be recognized. For example, if a trust instrument directs that al the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides 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. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits a trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods. A switch between methods of

a. This provision is also changed from the proposed regulations and is slightly broader in application.

b. The proposed regulations required that the trustee exercise discretionary powers reasonably and *consistently*. Commentators noted that the requirement of these two terms were potentially mutually exclusive since what may have been reasonable upon the first exercise of the power might not be reasonable in the future, but the consistency requirement would prevent any alteration in the method. The use of the term, "impartial," rather than, "consistent," permits continued application of the reasonableness requirement.

c. In addition, the proposed regulations permitted the trustee to allocate capital gain to income "if not inconsistent with local law." In response to comments that local law generally does not address the allocation of capital gain to income, the final regulation now states that such an allocation must not be *prohibited* by local law.

D. Practical Effect of Treas. Reg. § 1.643(b)-1.

1. Putting aside the treatment of capital gain momentarily, the clear intent of the regulation is to permit a trustee to invest in a manner that will maximize investment performance without shortchanging the income or remainder beneficiaries.

2. Assuming local law permits it, the regulation gives the trustee four ways to define income in the trust:

a. as ordinary income under the traditional rules;

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determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift form the trust's grantor or any of the trust's beneficiaries. A switch to a method not specifically authorized by state statute, but valid under state law (including) a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor or beneficiaries, based on relevant facts and circumstances. In addition, an allocation to income of all or part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law. This section is effective for taxable years of trusts and estates ending after January 2, 2004.

b. as a unitrust interest, if authorized by state statute;

c. as ordinary income modified by the exercise of an adjustment power, if authorized by a state statute; and

d. as ordinary income plus capital gain when trustee discretion to make the allocation is authorized under a state statute or trust instrument (if not prohibited by local law), using a reasonable and impartial allocation of realized capital gain to income.

(1) This provision addresses the question of whether principal allocated to income may be composed of capital gain and is in effect a recognition of the fact that even under the old regulations, there were circumstances in which capital gain could be allocated to income.

(2) If local law does not provide authority for an adjustment power or a unitrust definition of income, a trustee who does not have authority to distribute principal to an income beneficiary (or who prefers not to exercise her discretion to distribute principal) may nevertheless increase the amount passing to an income beneficiary by reasonably and impartially allocating capital gain to income, if local law gives the trustee discretion to do so[15] or if such discretion is contained in the governing instrument and state law does not prohibit the allocation of capital gain to income. This could provide some flexibility in determining the amount to be distributed to an income beneficiary, even in a state which has not adopted a form of the revised UPIA or unitrust statute. However, because the regulation provides that a switch to a method of determining income not specifically authorized by state statute may give rise to a recognition event or to gifts, guidance from the Service that use of this technique would not be considered a switch in methods of determining income would be helpful.

(3) This provision is significant because capital gain which is allocated to income, one way or another, is

[15] It is unlikely that many state statutes give a trustee this discretion.

automatically included in DNI[16] and taxed to the income beneficiary to the extent distributions to the income beneficiary are made. This aspect of the regulation will be discussed more fully below.

E. Definition of DNI under the Regulations. Given the change in the definition of income under Treas. Reg. § 1.643(b)-1, as noted above, it is also necessary for the regulations to address the inclusion of capital gain in DNI if trust accounting income is in excess of ordinary income (thus requiring the distribution of some form of traditional corpus to the income beneficiary). Treas. Reg. § 1.643(a)-3 does this.

1. Subparagraph (a) of the regulation states the traditional rule that capital gain ordinarily will be excluded from DNI.[17] This mirrors the default provision of Treas. Reg. § 1.643(b)-1 which provides that trust provisions that depart fundamentally from traditional principles of income and principal generally will not be recognized.

2. Subparagraph (b) addresses the treatment of capital gain under standards that are more consistent with practices under the Prudent Investor Act and provides:

> "Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law) –
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> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));

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16 See Treas. Reg. § 1.643(a)-3(b)(1).

17 Treas. Reg. § 1.643(a)-3(a) provides: "Except as provided in section 1.643(a)-6 and in paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinary considered as paid, credited, or required to be distributed to any beneficiary."

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records and tax returns as part of a distribution to a beneficiary; or

(3) 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 a beneficiary.

3. It is clearly the intent behind this regulation to permit capital gain to be included in DNI when the trustee has determined that it regularly will be distributed to the income beneficiary (whether or not it is included in "income") and to require its inclusion in DNI when local law includes it in a distribution (*e.g.*, under an ordering provision in a unitrust statute). The final regulation has been modified from the proposed regulation to make clear that capital gain is included in DNI where a trustee has reasonably and impartially allocated it to income under an apportionment power, if permitted by local law and the governing instrument or by a power granted to the trustee under local law or the governing instrument, if not prohibited by local law. However, the regulation does maintain the consistency requirement for allocations of capital gain to DNI where it is not included in the definition of income or where the trust is a unitrust. The preamble clarifies that the consistency rule applies in the case of a unitrust because, under that circumstance, the allocation of capital gain to income (and thus to DNI) has no affect on the amount distributed to the income beneficiary, but does affect whether the beneficiary or the trust is taxed on capital gain.

4. To determine the effect of Treas. Reg. § 1.643(a)-3 where a trustee invests for total return, it is necessary to analyze the potential inclusion of capital gain in DNI under each of these provisions in light of the ways a trustee can include amounts in excess of ordinary income in income under Treas. Reg. § 1.643(b)-1.

5. Under Treas. Reg. § 1.643(a)-3(b), the requirement that the inclusion of capital gain in DNI be (1) pursuant to local law and the governing instrument, or (2) pursuant to exercise of a fiduciary's discretion in accordance with local law or the governing instrument (if not prohibited by local law) modifies all three ways in which capital gain can be included.

   a. For the first method ("allocated to income"), capital gain will be included in DNI if the trustee has a direction or authority to include capital gain in income, and does so.

This is, of course, the same authority required to include capital gain in income under Treas. Reg. § 1.643(b)-1.

b. For the second method ("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"), capital gain will be included in DNI if, even though it is allocated to principal, the trustee has a direction or power to distribute it to the income beneficiary and does so consistently.

c. The third method ("allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount which is distributed or required to be distributed to a beneficiary") requires the trustee to have the same direction or power as the second method.

6. Here is where the definition of income under Treas. Reg. § 1.643(b)-1 becomes important. The provision including capital gain in DNI where it is "allocated to income" is designed to pick up all capital gain included in trust accounting income under Treas. Reg. § 1.643(b)-1. Thus, it clearly requires inclusion of capital gain in DNI if capital gain is included in the definition of trust accounting income under Treas. Reg. § 1.643(b)-1, subject to the requirement that the trustee exercised a discretionary power to do so in a reasonable and impartial manner.

7. Result for Unitrusts.

a. Under an Ordering Provision.

(1) The terms of the governing instrument and local law are read together to determine whether the necessary requirement or authorization exists. Where the state statute contains an ordering provision and the governing instrument requires that the trust look to the state definition of income, capital gain will be included in DNI.

(2) This reading of the text of the regulation is supported by example 11 of the regulation. Example 11 deals with the situation where a state unitrust statute includes an ordering provision directing that unitrust amounts shall be treated as distributed first from ordinary and tax-exempt income, then from net short-term capital gain, then

net long-term capital gain, and finally return of principal. The only information that the example provides about the terms of the trust's governing instrument is that it provides, "A is to receive each year income *as defined under state statute*." The trustee makes the election for the trust to be treated as a unitrust under state law. The example clearly states that net long-term capital gain is allocated to income pursuant to the state law ordering rule and is included in DNI for the taxable year. Thus, it appears under the example that if local law provides the necessary language, it is not necessary for the trust to contain a precise statement defining the income of the trust.

b. Without an Ordering Provision.

(1) In a situation where a trustee is using a unitrust definition of income provided under state law which does not include an ordering provision, a power to include capital gain in DNI must be exercised consistently.

(2) Example 13 of the proposed regulation provides that, "The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee." The example does not specify whether the authority for this discretion is located in local law, the governing instrument or both. In this example, there is no statement that long-term capital gain is allocated to income or principal. Rather the example merely states that the "Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years, Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-

exempt income." If the state unitrust statute gives the trustee discretion to include capital gain in income or DNI or if the governing instrument gives her this discretion and she exercises it in a reasonable and consistent manner (i.e., the trustee routinely distributes that amount of capital gain necessary to make up the unitrust amount), capital gain will be included in DNI.[18]

(3) The regulation also clarifies in example 14 that a corporate trustee which administers numerous trusts can exercise its discretion to include capital gain as a part of a unitrust amount differently for different trusts, although it must act consistently for each trust.

8. Few existing wills and trusts are likely to give the fiduciary the specific power to allocate capital gain to income or to DNI.

a. If broad language, such as the general power to make tax elections, is considered sufficient to allocate capital gain to DNI, most instruments should qualify. This is because, in the case of an exercise of a discretionary power to allocate capital gain to income or DNI, the power need be granted either by local law or by the governing instrument (if not prohibited by local law. Although the amount of capital gain distributed as a part of the unitrust amount would vary from year to year, the "reasonable and consistent" requirement should be met by the fact that the total unitrust distribution each year is a defined amount. Thus, as soon as the amount of ordinary income for the year is determined, the amount of capital gain that would be included in income would also be determined. Guidance from the Service on whether the power to make tax elections is sufficient authority to make this allocation would be helpful.

b. It is not entirely clear under the regulations whether capital gain would be included in DNI where a state has adopted a unitrust regime that does not include an ordering rule, and the trust does not include a provision giving the trustee discretion to allocate capital gain to income or DNI.

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[18] See Treas. Reg. § 1.643(a)-3(e), Example 13.

(1) States considering enacting a unitrust statute should consider including a provision that clearly gives the fiduciary the discretion to allocate capital gain to income.

(2) In addition, in drafting new documents, consideration should be given to including this discretion. However because it affects the amount the income beneficiary will receive on a net basis, it is a topic to explore with the client, and likely should not be automatically included in the "boilerplate" provisions.

c. If a trust contains a unitrust provision that includes a mandatory ordering provision and state law authorizes the unitrust treatment but includes neither an ordering provision nor a grant of discretion to the trustee to allocate capital gain to income, the ordering provision should be effective to include capital gain in DNI since it is not prohibited by state law.

9. Result under Adjustment Provisions.

a. If a state has adopted a form of the UPIA, which typically does not include a provision directing allocation of capital gain to income or DNI or granting the trustee the discretion to allocate capital gain to income or DNI, the only way to include capital gain in DNI when the trustee exercises an adjustment power will be if the trust agreement gives the trustee the discretion to allocate it to income or to DNI.

b. On a going forward basis, it seems prudent to expressly address this power in the governing instrument. This will of course require consultation with the client on her preferences.

c. With regard to state statutes, it will be important, at a minimum, to be sure that the exercise of such a power will not be prohibited by state law. In addition, states may want to consider including such a power in their state statutes.

10. Distributions from Discretionary Trusts.

a. Treas. Reg. § 1.643(a)-3(b) also applies to discretionary trusts and makes the allocation of DNI to capital gain under

these circumstances easier than under the current regulation. However, questions arise in this context also.

b. The regulations include an important new concept applicable to discretionary distributions of principal, although it is incorporated only as an example. Example 3 relates to a trust which requires all income to be distributed to A and gives the trustee discretionary powers to invade principal for A's benefit. The trustee also has the power to deem that discretionary principal distributions are made from realized capital gains. The example provides, "Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from *the sale of certain specified assets or a particular class of investments*. This treatment of capital gains is a reasonable exercise of Trustee's discretion." (Emphasis added).

(1) This example acknowledges that a trustee may have reasonable and significant reasons for treating capital gain realized from the sale of different assets differently and provides the flexibility to treat these gains differently. However, the example raises many questions since the term, "particular class of investments" is not defined.

(a) It seems very likely that real property would be recognized as a class of investments the realized gain from which may be treated differently than the gain realized from the sale of marketable securities.

(b) It also seems reasonably likely that a block of closely-held stock would be treated as a different class of investments than marketable securities.

(c) A more difficult question would be whether a large block of a single publicly traded stock which the trustee is under a duty to diversify would be treated as a different class of investment than other publicly traded stock which the trustee has no duty to sell.

(d) Finally, there is the question of whether low basis assets are a different class of investment than high basis assets.

(2) Clearly, this is an area where the Service will provide guidance over time. In the meantime, if a trustee wishes to take advantage of this opportunity, prudence suggests requesting a private letter ruling prior to filing the trust's tax return, if possible.

11. Shifts in Treatment of Capital Gain as Included in DNI.

a. With regard to the inclusion of capital gain in DNI when distributing amounts in excess of ordinary income, the preamble to the regulations provides that, "[i]n implementing a different method for determining income under a state statute, the trustee may establish a pattern for including or not including capital gains in DNI to the extent that the amount of income so determined is greater than the amount of DNI determined without regard to capital gains."

b. Most significantly in this regard, the preamble also clarifies that the decision regarding the inclusion of capital gain in DNI when distributions of income are made from the trust can be treated separately from the manner in which the trustee has treated capital gain when making discretionary distributions of principal from the trust while administering the trust under a prior definition of income.

c. It appears that for existing trusts that have been treating discretionary distributions of principal without allocating capital gain to DNI, no change in such treatment is authorized by the final regulations.

F. In Kind Distribution of Property in Satisfaction of Required Income Distribution.

1. Under the traditional rules of income and principal, the trustee generally received ordinary income in the form of cash, such as dividends or interest. The cash was then distributed to the income beneficiary without the need to liquidate any trust assets. In a unitrust or adjustment situation, however, where the trustee makes a distribution to the income beneficiary in excess of the trust's ordinary income based on the trust's total return, the trustee may decide not to liquidate assets, but instead make a distribution of trust property to the income beneficiary in satisfaction of the

additional amount required to be distributed to the income beneficiary.

2. Treas. Reg. §§ 1.651(a)-2(d) (for simple trusts) and 1.661(a)-2(f) (for complex trusts) address this issue by providing that property distributed in satisfaction of a requirement to distribute income (as defined under section 643 and the applicable regulations) currently will be a realization event. Thus, capital gain will be realized upon the distribution of appreciated property as part of a unitrust distribution or an adjustment distribution.

3. In addition, Treas. Reg. § 1.651(a)-2(d) provides that even though amounts in excess of ordinary income are distributed, if done so as a part of a distribution of all income of the trust, the trust will continue to qualify as a simple trust.

G. Effect on Marital Deduction.

1. Treas. Regs. §§ 20.2056(b)-5(f)(1) and 1.2523(e)-1(f)(1) specify that the requirement that a spouse be entitled to all of the income from a general power of appointment trust or a qualified terminable interest property trust will be met if the spouse is entitled to income as defined by a state statute that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of Treas. Reg. § 1.643(b)-1.

   a. Thus, a trust that provides for the spouse to receive a unitrust amount of no less than 3% and no more than 5% of the annual fair market value of the trust will be considered to require all trust income to be distributed to the spouse and, assuming the other statutory and regulatory requirements are met, will qualify for the marital deduction.

   b. A similar result will be available for trusts administered under an adjustment provision.

   c. It is important to note that if a trust for a spouse contains a unitrust provision in a state that has not adopted a unitrust statute, the trust will not qualify for the marital deduction unless the trust requires distribution of the greater of ordinary income or the unitrust amount.

2. Query whether, if a marital trust is administered under a unitrust statute or an adjustment provision, it is still necessary to provide that a spouse can require that any non-income producing property

held in the trust be converted to income producing property. It would also be helpful to have guidance on the amount which must be distributed from an IRA held in such a marital trust to ensure that the spouse is receiving all of the income from the IRA.

3. Qualified domestic trusts ("QDOT") present a unique issue because distributions of principal are subject to estate tax.

   a. Treas. Reg. § 20.2056A-5(c)(2) explicitly provides that distributions to a spouse as the income beneficiary of a QDOT made "in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount), or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries, will be considered distributions of trust income, if the applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of section 1.643(b)-1 of this chapter."

   b. Thus, no estate tax will be due on amounts in excess of ordinary income distributed to a spouse from a QDOT in satisfaction of a unitrust amount or an adjustment under UPIA.

H. Effect on Charitable Deduction.

1. Two types of charitable vehicles are exempt from income tax but also permit a noncharitable individual to have an income interest in the vehicle: net income charitable remainder unitrusts ("NICRUTs") and pooled income funds.[19] In both cases, the government has strict requirements to ensure that the remainder interest which passes to charity (for which the donor received a charitable income and/or gift or estate tax deduction) is not encroached upon by the income beneficiary to such an extent that the charitable benefits accorded the donor and the trust are not unwarranted. A change in the definition of income impacts these requirements and the regulations have special rules which apply to each. Unfortunately, the new concept of income does not appear

[19] A third type of split-interest charitable vehicle, the charitable remainder annuity trust, is not impacted by a change in definition of income or the proposed regulations because the amount the noncharitable income beneficiary receives is determined by the initial funding of the trust and does not change thereafter.

to work well in either case (for entirely different reasons) and the regulations have limited its application with respect to these charitable vehicles.

2. Charitable Remainder Unitrusts.

a. In its simplest form, a charitable remainder unitrust ("CRUT") is a trust which pays an annual unitrust amount specified in the trust agreement (not less than 5%) to one or more noncharitable beneficiaries for a term of years or for a measuring life and then pays the remainder to charity. The unitrust amount is based on the value of the CRUT assets each year.

b. The Net Income Problem with State Unitrust Statutes.

(1) In a NICRUT, the unitrust amount to be paid to the noncharitable beneficiary is the lesser of the unitrust amount or the net income of the trust. NICRUTs may also contain a "make-up" provision which can direct the trustee, in years when the income of the trust exceeds the unitrust amount, to pay additional amounts of income to the noncharitable beneficiary to make up the amounts of income not paid in years when income was less than the unitrust amount (known as "NIMCRUTs"). Both of these types of CRUTs minimize eroding the charity's interest if the income earned by the trust is less than the unitrust amount required to be distributed.

(2) The regulation regarding CRUTs generally adopts the definition of income under section 643(b) and the regulations issued thereunder, but then goes on to substantially limit the applicability of unitrust and adjustment provisions to CRUTs. The net effect is that NICRUTs and NIMCRUTs will generally still be subject to the old definitions of trust accounting income.

(3) Under a NICRUT or NIMCRUT, in a given year, the income beneficiary may indeed receive less than 5% if trust earnings are low,[20] but this would not

[20] IRC § 664(d)(3) provides:

Notwithstanding the provisions of paragraphs (2)(A) and (B), the trust instrument may provide that the trustee shall pay the income beneficiary for any year – (A) the amount of

necessarily be predictable or consistent. However, if a state unitrust statute defines income as a unitrust amount of 4% and the CRUT is a NICRUT or NIMCRUT, the income beneficiary would always receive exactly 4% as income from the trust, in contravention of the statutory 5% requirement. As a result, the regulations provide that "trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property."[21] The requirement under the proposed regulations that CRUT's contain their own definition of income if state law authorizes unitrusts was deleted since traditional concepts of principal and income still apply to such trusts unless an affirmative act is made by the trustee.

c. Adjustment Power.

(1) Treas. Reg. § 1.664-3(A)(1)(i)(b)(3) also includes a provision modifying the allocation of capital gain to income under the 643(b) regulation: only proceeds from the sale or exchange of assets in excess of the assets' fair market value on the date of contribution to the trust and proceeds from the sale or exchange of assets in excess of the trust's purchase price of the assets (in the case of assets purchased by the trust) may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by local law.

(2) The trustee may be given the discretionary power to make this allocation under the terms of the governing instrument only if the applicable state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

(3) The preamble explains that these restrictions have no effect on the determination of trust accounting

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the trust income, if such amount is less than the amount required to be distributed under paragraph (2)(A), and (B) any amount of the trust income which is in excess of the amount required to be distributed under paragraph (2)(A), to the extent that (by reason of subparagraph (A)) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

[21] Treas. Reg. § 1.664-3(a)(1)(i)(b)(3).

income under state law which gives the trustee the power to adjust to apportion the total return of the trust. Rather, they limit a trustee's discretion to allocate capital gain to income in some years and not in others to maintain consistency with the requirement that a trustee may not have discretion to determine whether a CRUT should distribute the lesser of the stated percentage payout or trust income.

3. Pooled Income Funds.

a. Many practitioners consider a pooled income fund the functional equivalent of a "poor man's charitable remainder trust." It permits a donor who does not wish to contribute an amount large enough to warrant a separate trust the benefit of contributing a low basis asset to charity and receiving the income earned on the fair market value of the asset undiminished by the capital gain tax which would have been due if the donor had sold the asset.[22]

b. A pooled income fund is a trust which is maintained by a charity and which distributes a pro rata share of the income of the assets currently held by the fund (based on the donor's contribution which is commingled with the contributions from all of the other donors) to noncharitable beneficiaries. At the death of the income beneficiary, the donor's pro rata share of the fund's assets pass to the charity.[23] The value of the charitable contribution to a pooled income fund is determined using the highest rate of return earned by the fund for any of the three taxable years immediately prior to the year in which the donor makes the contribution to the fund.[24]

c. Treas. Reg. § 1.642(c)-5(a)(5)(i) provides that for purposes of a pooled income fund, "'income' has the same meaning as it does under section 643(b) and the regulations thereunder, except that income generally may not include any long-term capital gains."

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22 Treas. Reg. § 1.642(c)-5(a)(3).

23 See IRC § 642(c)(5); Treas. Reg. § 1.642(c)-5(b)(8).

24 Id.

d. The regulation expressly states that income may be defined as a unitrust amount or determined pursuant to a trustee's power to adjust, with the requirement that the trustee allocate to principal any capital gain realized at least to the extent of the asset's contribution date fair market value or the purchase price, if purchased by the fund. However, this is in fact an unattractive alternative for pooled income funds as explained below.

e. A pooled income fund generally does not pay income tax. Although a pooled income fund is subject to income taxation under section 641, the fund receives a distributions deduction for amounts of income distributed to non-charitable beneficiaries (not to exceed the DNI of the fund),[25] and under a special provision in IRC § 642(c), it receives a charitable income tax deduction for realized long-term capital gain "which pursuant to the terms of the governing instrument is, during the taxable year, permanently set aside for a purpose specified in section 170(c)."[26] It is this provision that is affected by the regulations.

f. Treas. Reg. § 1.642(c)-2(c) provides that,

> No amount of net long-term capital gain shall be considered permanently set aside for charitable purposes if under the terms of the fund's governing instrument and applicable local law, the trustee has the power, whether or not exercised, to satisfy the income beneficiaries' right to income be satisfied by the payment of either: an amount equal to a fixed percentage of the annual fair market value of the fund's assets (whether determined annually or averaged on a multiple year basis) or any amount that takes into account unrealized appreciation in the value of the fund's assets. In addition, no amount of net long-term capital gain shall be considered permanently set aside for charitable purposes to the extent the trustee distributed proceeds from the sale or exchange of the fund's assets as income within the meaning of § 1.642(c)-5(a)(5)(i).

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[25] IRC § 661(a).

[26] IRC § 642(c)(3).

g. The preamble to the regulations explains that if a pooled income fund pays a unitrust amount or uses an adjustment provision, there is a possibility that realized long-term capital gains eventually could be used to pay a portion of the unitrust amount or be included in the excess amount distributed to the income beneficiary under an adjustment provision. This means that no charitable deduction is available under these circumstances because such gain could not be said to have been permanently set aside for a charitable use. This is an unfortunate result because it will make pooled income funds much less attractive to donors in comparison to charitable remainder trusts and imposes a significant disadvantage on less wealthy charitably inclined taxpayers who cannot afford to create charitable remainder trusts. Nonetheless, since the requirement to qualify for the charitable deduction for long-term capital gains is contained in the Code, there is not much flexibility in overcoming this result.

h. For a pooled income fund held in a state that has adopted unitrust or power to adjust statutes and whose income beneficiaries potentially could receive a unitrust amount or an amount based on unrealized appreciation in the fund's assets, if the fund wants to continue to avoid taxation on long-term capital gains, the preamble explains that the fund must not have determined income in this manner and must commence a judicial proceeding to reform the fund's governing instrument or complete a nonjudicial reformation that is valid under state law by the date that is 9 months after the later of January 2, 2004 or the effective date of the statute authorizing the determination of income in such a manner.

I. Grandfathered Generation-Skipping Transfer Trusts.

1. A major concern raised by a change in the local law definition of income is the effect of this change on trusts that are grandfathered from the generation-skipping transfer tax ("GSTT") enacted in 1986. If such trusts require the distribution of the income from the trust, would a change to a unitrust definition of income under state law or the adoption of a law permitting an adjustment provision be considered a shift in a beneficial interest in the trust, thus making the trust subject to the GSTT?

2. The regulation specifically provides that administration of a trust using a unitrust definition of income or using an adjustment provision "will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of section 1.643(b)-1 of this chapter."[27] Thus, in states which have adopted a unitrust statute or UPIA, grandfathered trusts will be able to take full advantage of total return investing without concern that the change in the definition of income will impact on their grandfathered status, and the flexibility under state law to opt in or out of a unitrust environment will not make a difference in this result.

3. The examples included in the regulation also make clear that a change in the situs of the trust from a state which has not adopted a unitrust or adjustment power statute to one that has will not affect the grandfathered status of GST trust. It is important to note that these examples do not establish that a change in situs would necessarily make a unitrust or adjustment option available to a trust governed by state law that does not include these provisions. The determination of whether the applicable law that defines income or grants the power to adjust changes when a trust changes situs is a matter of state law, dependent on whether these provisions are determined to be administrative (in which case they would change) or substantive (in which case they would not). Moreover, not all states may categorize these provisions in the same way, giving rise to conflicts of laws issues. The regulation simply makes clear that a change in situs would not affect grandfathered status in the event that the provisions were to be considered to be administrative and the law of the new state were to apply to the trust.

## IV. STATES WITHOUT STATUTES

### A. Applicable Local Law.

1. The preamble to the regulations specifically acknowledges local law may be established other than by state statute, "such as a decision by the highest court of the state announcing a general principle or rule of law that would apply to all trusts administered under the laws of that state." The preamble makes clear, however, that a court decision applicable only to the trust before the court would not constitute applicable local law for the purposes of the regulation.

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[27] Treas. Reg. § 26.2601-1(b)(4)(i)(D)(2).

2. The government's concern, and the reason it has, in effect, required a state statute in order to take advantage of the new flexibility in the definition of income available under the regulations, is that an allocation to principal of traditional items of income potentially jeopardizes the tax benefits accorded certain trusts which are based on the assumption that the income beneficiary will receive what is traditionally considered income.

3. Note that Treas. Reg. § 1.643(b)-1 states that allocations between income and principal pursuant to applicable local law will be respected IF the local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year. The regulation does not require that a state have adopted the prudent investor rule in order to permit allocations between income and principal nor does it require that the power to adjust be limited to the limitations contained in § 104 of the UPIA. However, it is not inconceivable that a state statute would not meet the requirement of the regulation that it provide for a reasonable apportionment between the income and remainder beneficiary of the total return of the trust.

B. Protections Afforded by Applicable Local Law under the Regulations.

1. Specific Tax Benefits. The regulations make clear that if there is a state statute which provides for the reasonable apportionment between the income and remainder beneficiaries of the total return of a trust,

   a. A trust administered in accordance with the statute will qualify for the marital deduction for US beneficiary spouses and foreign beneficiary spouses;

   b. A QSST administered in accordance with the statute will continue to qualify as an eligible S corporation shareholder;

   c. GST grandfathered trusts administered in accordance with the statute will not lose their grandfathered status.

2. The regulations also provide that for trusts administered in accordance with a state statute, the grantor, trustee and beneficiaries will not be treated as having made gifts and, in the case of a change in method of defining income, no gain will be realized under IRC § 1001.

C. Consequences of Using a New Definition of Income without a Statute.

1. For Existing Trusts.

   a. Typically, in the absence of a state statute, conversion to use of a new definition of income would likely require a court proceeding of some kind. Alternatively, if the Service issues guidance that the power to make tax elections includes the power to allocate realized capital gain to DNI and/or income, many trusts could alter their definitions of income without the need for a judicial proceeding, although using a unitrust definition of income would probably continue to require a judicial proceeding. Note that the power to allocate capital gain to DNI would require the trustee to exercise the power consistently, a substantial reduction in flexibility, even in light of the undefined (as yet) ability to treat gain realized from the sale of different classes of investment assets differently.

   b. For marital trusts for US spouses and grandfathered GST trusts which require that all of the income be distributed to the income beneficiary, the prudent course would be to require the greater of the unitrust amount or the traditional income received by the trust to be distributed to the income beneficiary. Under these circumstances, the income beneficiary will never receive less than all of the income under a traditional definition and may receive a more reasonable amount from a trust that is invested for total return and does not receive much in the way of interest, dividends and rent. This does NOT work for a QDOT, since the government's interest in that case is to be sure that the foreign surviving spouse does not receive MORE than the income from the trust without paying estate tax on the excess.

   c. However, the author is concerned that there is no protection for these trusts from an analysis that the beneficiaries may be making gifts or the conversion is not a realization event under section 1001.[28] In the case of GST grandfathered trusts, such an analysis could lead to a conclusion that there has been a shift in beneficial interests and the grandfathered status could be jeopardized. In the author's conservative

[28] Treas. Reg. § 1.643(b)-1 provides, *inter alia*, "A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances."

opinion, such a change should not be undertaken without obtaining a private letter ruling in advance.

d. In the case of a conversion of a non-marital trust to a unitrust (which could be desirable where a trust for a child requires distribution of income and does not provide for discretionary distributions of principal, for example), the risk of gift treatment and possible realization treatment remains.

2. For New Trusts.

a. In drafting new marital trusts for US spouses, a provision which requires the greater of a unitrust amount or all of the income as defined under traditional purposes will qualify for marital deduction treatment and, because no conversion would be needed to use this definition of income, there should be no risk of gift treatment or realization of gain under IRC § 1001.

b. The same should also be true for a trust which is exempt from GST tax as a result of the allocation of GST tax exemption to it.

c. In the case of a non-marital trust which is drafted a unitrust, there is of course no need to provide that the trustee will distribute any amount other than the unitrust amount and there should be no risk of gifts or realization treatment. An interesting question could be raised as to whether such a trust is a simple trust or a complex trust. The safer route would be to treat it as a complex trust to the extent that amounts in excess of ordinary income are distributed.

## V. DRAFTING CONSIDERATIONS

### A. Income Related Considerations.

1. Relevance.

a. For trusts that are intended to be entirely discretionary, both with respect to income and principal, the definition of trust accounting income is not likely to have much impact.

b. For trusts that permit discretionary distributions of income but do not permit distributions of principal, the definition may have greater relevance, since the trustee may want to

distribute larger amounts to the beneficiary if her need is great. In this case, the definition of income places a ceiling on the amount that can be distributed.

c. For trusts that include mandatory income distribution provisions but also permit discretionary distributions of principal, the definition of income will take on even greater relevance because it represents the amount to which the beneficiary is entitled and need not ask the trustee to distribute.

d. The case where the definition of income will have the greatest impact is of course the trust that requires distribution of all of the income and does not permit distributions of principal (or permits them only for very limited purposes).

2. State Statute Enacted.

a. Where a state statute has been enacted and the client wants to create a trust, during life or under her Will, which is not entirely discretionary with regard to distributions of income and principal, it is important to explain the statute to the client so that the client can determine whether she prefers to limit its application to the trust. If she decides that the trustee should be permitted to exercise her discretion in determining whether to elect unitrust treatment, and state law so allows, it may at a minimum be prudent to include exculpatory language protecting the trustee for electing and for not electing unitrust treatment. Alternatively, the client may choose to incorporate the unitrust definition of income into her documents. State statutes conferring the power to adjust may provide that the grantor or testator can negate this power by specific reference to it. This too should be explored with the client.

b. In the event that a client prefers to allow a trustee to exercise a power to adjust, it may be prudent to limit the grantor's and beneficiaries' ability to serve as trustee and to exercise that power. On the one hand, the power to adjust, which must be exercised "impartially," could be seen to be similar in concept to an ascertainable standard and not the type of unfettered discretion that could give rise to a taxable power under IRC §§ 2036 or 2038 in the hands of the grantor as trustee and a general power of appointment or taxable gift in the hands of beneficiary as trustee. On the

other hand, the power to shift property between income and principal will affect the amounts and timing of beneficiaries' interests in the trust, and could be considered a taxable power. The regulations do not specifically address tax consequences of exercising the power to adjust, only the tax consequences of shifting between methods of determining income. Guidance from the Service on this question would be helpful and, until then, it may be prudent to provide that the power can only be exercised by an independent trustee, if state statute does not include this limitation. In an abundance of caution, it also may be prudent to provide that only an independent trustee can exercise an election to treat a trust as a unitrust.

3. No State Statute Enacted.

a. A major drafting question is whether to include provisions dealing with unitrust treatment and the power to adjust in states that have not enacted statutes because the client may move, trusts created under the document may change their situs, or the state in which the client resides may change its law after the client has become incompetent and cannot change her Will. This is really a client relations issue that depends on a client's tolerance to address potential issues which may never materialize.

b. At a minimum, it may be prudent to discuss with the client whether the trustee should have a power to allocate capital gain to income in a reasonable and impartial manner, since that adjustment can be made without a state statute, so long as it is not prohibited by state law.

B. DNI Related Considerations.

1. Many state statutes do not include an ordering provision that provides that the unitrust amount is paid first from ordinary income and tax-exempt income, then from capital gain, and finally from principal. The question of who should bear the tax on capital gain in a unitrust in part depends on the unitrust rate. In a state with a fairly high unitrust rate, including an ordering provision in the document appears prudent, so long as it is not inconsistent with or prohibited by state law. If the client prefers to give the trustee flexibility, then the trustee should be given the express power to allocate capital gain to DNI.

2. The power to allocate capital gain to DNI gives the trustee the power to shift the burden for the tax from the trust to the income beneficiary and should be discussed with the client. Assuming the client wants the trustee to have this discretion (which must be exercised consistently under the regulations), it should be stated broadly so that a trustee can take full advantage of the flexibility in the regulation that permits allocation of capital gain from the sale of different classes of investment assets differently.

## VI. SUMMARY

All in all, the IRS regulations present a thorough response to the current change in investment standards and the general shift toward a total return philosophy. The final regulations address many of the issues raised by the proposed regulations. Now that the final regulations have been issued, it is time to review forms to be sure that fiduciaries will have the necessary powers to take full advantage of the new definitions of income afforded by the various forms of state statutes and the additional flexibility to allocate the burden of tax for realized capital gains.