Report 1B

A complete listing of the proceedings and speakers is available on **the Institute's Web site**

Monday, January 5
2:10 - 5:15 p.m.
Recent Developments in Estate, Gift and Income Taxation - 2003 Part One
Dennis I. Belcher
Carol A. Harrington
Jeffrey N. Pennell
Materials by Richard B. Covey and Dan T. Hastings

Reporter: Gene Zuzpann Esq.

IRC 643 Regulations:

Carol Harrington discussed the new 643 regs that were issued last week in T.D. 9102. Excellent summaries of these are available on the Leimberg LISI service (Archive Message 624 1/5/04 under Free Resources at http://www.leimberg.com) and in the RIA Newsstand for 1/6/04. As a bonus, a full text version of the LISI message is posted below.

Date: Mon, 05 Jan 2004 23:13:42 -0600
From: stevesletters@leimbergservices.com
Subject: T.D. 9102 - Definition of Income for Trust Purposes Steve Leimberg's Estate Planning Newsletter

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #624
Date: 05-Jan-04 07:13 PM
From: Steve Leimberg's Estate Planning Newsletter
Subject: T.D. 9102 - Definition of Income for Trust Purposes

If you are involved in sophisticated trust planning (private or charitable), you'll be very interested in the following report from Bob Wolf of Tener, Van Kirk, Wolf & Moore, P.C. Pittsburgh, PA. It involves what in my opinion is one of the single most important income tax Regulations of the decade. And there's no question Bob Wolf is one of the most knowledgeable, creative, and forward-thinking minds in the country on the subject.

In a word, Bob says the new regulations are TRU-iffic! (To learn more about TRUs - total return unitrusts - and their pros and cons -
and the state laws recently enacted to enable conversion to TRUs - and a sample TRU document, go to our sister site, http://www.leimberg.com/ Look under FREE RESOURCES.)

TRU-iffic! That's how one might describe the very planning-positive Final Regulations issued December 30th, 2003 (effective January 2, 2004) governing the definition of income under Section 643(b), the composition of DNI under 643(a), a qualifying income interest for the estate tax marital and QDOT deductions under 2056(b)-7 and 2056A-5 and for the gift tax under 2523(e)(1).

The regulations alleviate concerns and protect the tax benefits under recent state law changes

providing for a unitrust definition of income and/or the power to adjust between principal and income.
In a very informal nutshell, these new rules make it clear that - if the transaction falls within the very reasonable parameters of the final regulations - a conversion of a classic trust into a TRU or a trustee's exercise of a power to adjust will NOT:

1. Cause a loss of the federal estate tax marital deduction,
2. Trigger a taxable transfer for gift tax purposes,
3. Result in a taxable sale or exchange (ala Cottage Savings), and
4. Undo GST grandfathering.

EXECUTIVE SUMMARY:
The Treasury has released Final Regulations that expand upon their Proposed Regulations issued February 15, 2001 allowing for conversion of existing trusts into unitrusts pursuant to state statute (available today in 17 states) or the use of the power to adjust between principal and income where such power is granted under state law (available today in 35 states plus D.C.). We are now free to use those statutes without worrying about our marital deduction, our GST grandfathered status, or that such use might be considered to be a sale or exchange under the Cottage Savings doctrine.

COMMENT:
WHY WE COULDN'T RELY ON PROPOSED REGS:
While the Proposed Regulations were very favorable and suggested that Treasury would look kindly on these new state laws adapting our trust income and principal rules to the modern investment era, the Proposed Regulations were not in effect, and we were not free to rely on them - since by their express terms, they were to go into effect the year after the Regulations were made final.
So in some regards, the ability to confidently employ the new state laws was still in the future. Well, the future is now!

WHY THE CONCERN?
A surprising amount of the income tax law turns on state law definitions of what is "income" and what is "principal". So when the Uniform Principal and Income Act was promulgated in 1997 (7B U.L.A. 131,141 (2000) ("UPAIA"), allowing the trustee to "adjust" from principal to income or income to principal, there was a lot of concern as to whether the IRS would allow the trustee to have or exercise that power, by which one might either increase or decrease accounting income, and still qualify for the marital deduction (you might reduce the spouse's income interest), whether the exercise of such a power might constitute a gift, or whether the grandfathered status of GST trusts might be jeopardized.

And when a number of states started to consider allowing trusts to be converted into unitrusts which paid out a set percentage of the trust value, without regard to the accounting income in the trust, a dialogue was started with Treasury through the New York Legislative Committee, requesting guidance from the Service prior to enacting its proposed new law allowing an alternative unitrust definition of income and the power to adjust as contained in the UPAIA.

PROPOSED REGS A VERY PROMPT AND POSITIVE START!
The Treasury responded promptly and helpfully with its Proposed Regulations, which resulted in a dozen states enacting unitrust conversion statutes in one 12 month period subsequent to the announcement of the Proposed Regulations. This trend continued at a slower pace thereafter despite the lack of Final Regulations and a severe three year bear market in stocks.

WHAT'S AHEAD?
It is quite likely that that issuance of these Final Regulations may prompt more state law changes, because it is now completely clear that the benefits of the new rules only apply to those states that have the newer more favorable statutes which grant trustees the power to adjust and the power to convert to a unitrust.

The Proposed Regulations, while extremely helpful guidance that was largely followed and expanded upon in the Final Regulations, were not law, and as such, many trustees and practitioners were not yet using the new laws that had been enacted in many states. This was particularly apparent in the case of Marital Trusts and GST Exempt trusts, where practitioners and trustees alike were afraid of losing the all-valuable GST grandfathering, or having a Marital Trust disqualified or a "transfer" having been made by the surviving spouse by converting the trust to a unitrust or exercising the power to adjust.

The issuance of PLR 200231011 added another fearsome concern where a trust modification into a 7% unitrust (along with many, many other changes to the trust) was held to be a "sale or exchange" under Cottage Savings. This caused other practitioners to draw back from exercising these new powers until the tax dust had cleared. That dust has now cleared.

THE GORY DETAILS OF THE NEW REGS:
Generally, federal tax law follows local state law with respect to the definition of income, with the anti-games proviso that trust provisions which depart fundamentally from traditional principles of income and principal will not be recognized.
State law definitions of income which provide for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year including ordinary income and tax exempt income, capital gains, and appreciation, will be respected.

SAFE PARAMETERS - AND UNCHARTED WATERS:
A state unitrust statute allowing the payout of no less than 3% nor more than 5% of the fair market value of the trust assets will be respected.

However, the final regulations expressly left open what would happen if the rate were less than 3% or more than 5%. Don't count on the same blessing if you draw outside of these lines, taking into account what trust interests are being protected by the choice of rate. For example, if the rate were less than 3%, the marital deduction might be in trouble because you may have reduced the spouse's interest. If you converted to an 8% rate, the marital deduction should be fine, but you may have a gift transfer from the remainder beneficiaries to the spouse.

The final regulations expressly allow for the use of a multi-year valuation method. Most of the unitrust statutes have a 3 year "smoothing rule" and this is O.K.

If a conversion is made to a unitrust under state law, without the benefit of an express unitrust definition of income by statute it is possible that you will qualify, but you will have to satisfy the standard under the Bosch (387 U.S. 456 (1967)) decision (requirement of a decision of the highest court of the state). In my opinion, that isn't likely.

And it's even more unlikely that you could obtain the benefits of the power to adjust principal to income or income to principal without enacting UPAIA Section 104. The state law background just isn't there. But if your state has adopted the power to adjust, variations in the exact requirements under state law should not present a problem from a tax perspective. So the lack of the word "Equitable" in a state statute, or the absence of an express requirement that the trustee be investing as a "prudent investor" does not create a tax problem. The trustee must meet whatever state law requirements are imposed; state laws are not required to be homogenized as a matter of tax policy.

Both the power to adjust and the power to convert to a unitrust can be applied to sprinkle or spray trusts, as well as the more traditional "hold the principal and pay the income" style trusts.

Where there are alternative methods of determining income under applicable state law, a change in method can be made in either direction without fear of a recognition event or the loss of grandfathering. Since there are currently a dozen states that expressly allow both the power to adjust and the unitrust as alternatives, this is important.

The Final Regulations governing the application of Chapter 13 (GST Tax) to trusts expressly provide that the conversion of a trust into a unitrust or using the power to adjust under a state statute specifically does not prejudice GST grandfathering.

SITUS SHOPPING MAKES SENSE!

Attention K Mart Shoppers! The Final Regulations do not stop at assuring us we lose no GST grandfathering, that there is no taxable sale or exchange, and that there is no gift: In two examples the final regs make clear that if the situs of a trust is moved to another state with a different state law in this regard, that is fine also. So if you are in Massachusetts or North Dakota, where you don't have a favorable total return trust law, you can move your trust next door to Maine or South Dakota, which have unitrust legislation, and take advantage of their laws to convert the trusts to unitrusts.

This should significantly increase the pressure on states which do not have total return legislation to put it on their agenda or suffer the financial consequences to their trust industry.

Portability has never been greater.

WHAT ELSE IS NEW?

In sync with the changes to the definition of income for trust purposes, the ability of trustees to include capital gains in Distributable Net Income has also changed from the traditional to allow ordering rules in state statutes and the power of the trustee to either allocate capital gains to a distribution to an "income" beneficiary or not, provided that the exercise of the power is done consistently. In some regards, this is the most complicated and least significant of the changes.

The Reg 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).

(1) Allocated to income [but if discretionary for a unitrust, the power must be exercised consistently]. . .
(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of the 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."

SAY WHAT?
Part of the theory of total return trusts and total return investing is that the trustee will be free to invest for capital gains or interest or dividends, whichever will produce the most return. But if the income beneficiary is getting an increased payout because of the application of a unitrust statute or the power to adjust, it stands to reason that the recipient ought to pay the capital gains tax on the distribution, at least if there are capital gains to distribute.

But the hang-up is that capital gains are not traditionally a part of distributable net income unless the amount distributed is determined by the amount of capital gains, or let's say the capital gains are actually distributed (and this may not be obvious, since cash is, as they say, cash.)

WHY DOES THIS MATTER?
If the capital gains taxes are all paid by the trust, the trust cannot afford to pay out as much to the beneficiary as if the beneficiary were paying his or her fair share of the taxes. So if the trust is paying the tax freight, the value of the trust is more likely not to keep up with inflation than if capital gains can be distributed to the income beneficiary along with his or her increased income share. In addition, the beneficiary is more likely to be in a lower tax bracket than the trust, since the top tax bracket is reached in a trust or estate at only $9,550.

Also, if the capital gains taxes are paid by the trust, it produces a conflict between choices for achieving total return as between bonds and stocks more commonly than if it is allocated to the income beneficiary as much as possible, after the ordinary income after expenses is distributed (and for an equity oriented account, the net dividend income won't be much).

WHAT DOES IT MEAN?
If you live in a state that has an ordering rule as part of your total return legislation, such as in Alaska, Pennsylvania, Oregon and Washington, to name a few, then capital gains will come out of the trust first, with short term gains coming out before long term gains (the Regs don't expressly state that short term gains can be ordered out first, but Example 11 under 1.643(a)-3(e) includes such a statute without adverse comment).

So if you have a direction that requires the ordering in your trust document and applicable state law, the unitrust amount will include capital gains.

Other states, such as Delaware, give the trustee express discretion to decide whether to include capital gains in DNI, and there, for the unitrust, the exercise must be consistent, once the opportunity to exercise the discretion is presented. The Regs expressly allow this exercise if the trustee is given the power under state law, such as in Delaware, or by the trust instrument, if it is not prohibited by state law.

So if you do have discretion given to the trustee to make this determination, then the trustee can go either way. But the Regs clearly require that, as respects a unitrust, the exercise of discretion has to be consistent, since the allocation of the capital gains to a unitrust distribution does not affect the amount of the distribution.

WHAT ABOUT THE POWER TO ADJUST?
If the trustee has the discretion to decide whether to include capital gains in a distribution, it is likely

that the exercise will have to be consistent, unless the allocation of capital gains to a distribution actually determines the payout, which is not normally the case for the power to adjust. The power to adjust is not the power to distribute capital gains, but the power to adjust from principal to income and vice versa. It is not clear whether the Regulation writers understood this nuance.

DISTRIBUTIONS MADE IN KIND :
If distributions are made in kind to satisfy a unitrust payout, the property is deemed to have been sold for its fair market value on the date of distribution, just as if a distribution were made to satisfy an "income" obligation.

IMPACT ON POOLED INCOME TRUSTS AND NIM-CRUTS :
Here the news is not as favorable. For a pooled income trust, the charitable deduction is unavailable under 642(c)-2 if under the governing instrument and applicable state law, the income beneficiary's right to income may be satisfied by the payment of a unitrust amount or that takes into account unrealized appreciation in the value of the funds assets.

Strangely, the definition of a pooled income fund does not prohibit a unitrust definition of income or the power to adjust under applicable state law, but the Regulation requires that in exercising the power to adjust, the trustee has to allocate to principal the proceeds from the sale or exchange of any assets contributed or purchased in the fund to the extent of basis. This is an odd requirement, because to my knowledge, no state law has that provision in it. In fact, the UPAIA itself, and all of the state laws adopting it so far prohibit the use of the power to adjust to pay "(4) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside".

It would seem however, that one could retain the status of a pooled income trust, without the benefit of the charitable deduction for capital gains tax purposes, but only with the power to adjust, which does not seem to be available under the Uniform Act, unless state laws were changed to allow it.

And for the NICRUT and NIMCRUT twins to continue to qualify for their special tax treatment, they must have an alternative definition of income that is not a unitrust definition, either in the document or applicable state law. This seems reasonable, since the payout of a lesser of two unitrust amounts makes little conceptual sense. Post contribution gains may be defined to be part of income, and the Reg states that a discretionary power to determine that allocation of capital gains to income may be given to the trustee under the governing instrument, but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

If state law would allow a unitrust definition of income which would disqualify the pooled income fund's charitable deduction, the trust will have 9 months to reform the governing instrument to eliminate this definition from applying the trust starting from January 2, 2004, or such later date of a state statute authorizing determination of income in such a manner. Since so far as I know, no state has such a law, that shouldn't be much of a problem, unless your faithful reporter is missing something!

Bob Wolf
Edited by Steve Leimberg
CITE AS:
Steve Leimberg's Estate Planning Newsletter # 623 at http://www.leimbergservices.com

CITES:
T.D. 9102 (To view the actual text of this ruling, click on Recent Entries and look under Actual Text for Final Regulations on Definition of Trust Income). Cottage Savings doctrine. (499 U.S. 554 (1991).

GENERAL INFORMATION ABOUT INSTITUTE:
Inquiries/Registration:
University of Miami School of Law
P.O. Box 248087
Coral Gables, FL 33124-8087
Telephone: 305-284-4762 / FAX: 305-284-6752
Web site: www.law.miami.edu/heckerling
E-mail: heckerling@law.miami.edu
===
Headquarters Hotel - Fontainebleau Hilton
4441 Collins Avenue
Miami Beach, FL 33140
Telephone (305) 538-2000, FAX (305) 674-4607
==