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SELECTED INCOME TAX ISSUES
OF INTEREST TO ESTATE PLANNERS

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I. INTRODUCTION

A. It is the author's premise that insufficient attention is paid by practitioners to income tax minimization in estate planning and the administration of trusts and estates. Income tax issues impact almost all decedents and survivors (not just those very wealthy clients with gift and estate tax problems).

B. Significant dollar savings can be achieved by taking advantage of perfectly legal and appropriate income tax planning steps. On the other hand, not taking such steps will subject the fiduciary and fiduciary's professional advisors to substantial malpractice exposure.

C. Estate planning and the administration of trusts and estates should be a team effort, and it is essential that the fiduciary obtain both accounting and legal advice in order to minimize income taxes.

II. GRATUITOUS TRANSFERS (i.e., GIFTS)

A. Introduction. Clients are routinely encouraged to make gifts. Gifts are made for a variety of reasons (for junior to have funds for college or a start in life, to allow junior to gain experience in handling investments, to minimize income taxes and transfer taxes, for asset protection planning, etc.).

B. Obvious Tax Issues. When a client makes a gift, certain income tax consequences are generally assumed to occur: (1) the donor gets no income tax deduction; (2) the donee has no taxable income; and (3) in the case of an in-kind gift, the donee will have the donor's acquisition date and cost basis, with an adjustment if gift taxes were paid.

C. Income May Result. It is possible for the donor to have income as a result of making a gift.

1. Imputed Interest Income. Gift loans (i.e., those containing a below market rate of interest) cause the lender to have imputed interest income for income tax purposes, subject to a *de minimis* rule. IRC §7872.

2. Gift of Installment Note Receivable. The transfer of an installment obligation by lifetime gift will constitute a disposition and will cause an acceleration of the deferred gain for income tax purposes. IRC §453B.

3. Assets With Debt in Excess of Basis. Where a gift is made of property subject to nonrecourse indebtedness, the donor will realize gain to the extent that indebtedness exceeds the basis of the property. Winston F. C. Guest, 77 T.C. 9 (1981). The "amount realized" is equal to the outstanding balance of the non-recourse obligation, and the fair market value of the property is irrelevant to the computation. Tufts v. Commissioner, 103 S.Ct 1826 (1983).

4. Certain Net Gifts. Where a "net gift" is made (i.e., the gift taxes on the transfer, which are the legal obligation of the donor, are instead to be paid by the donee), the donor will realize gain to the extent the gift tax paid by the donee exceeds the donor's adjusted cost basis in the property. Diedrich v. Commissioner, 643 F.2d 499 (8th Cir. 1981).

D. Computation of Basis.

1. Adjustments for Gift Tax and GST Tax Paid.

a. The donee of property which is received in a lifetime gift transaction where no gain is recognized receives such property with a carryover of the donor's cost basis and acquisition date. IRC §1015.

b. The basis of gifted property is increased for pre-1977 gifts by the gift tax paid. For gifts made after 1976, the basis of gifted property is increased by that portion of the gift tax paid attributable to the donor's net appreciation in the gifted assets. IRC §1015. ***Example:*** Assume that in 2000 the donor gives stock having a basis of $200 and a fair market value of $1,000 to child, and pays $400 of gift tax. The basis adjustment for the gift tax paid is [($1000 minus $200)/$1000] times $400, or $320. The donee's basis becomes $200 plus $320, for a total basis of $520.

c. The basis of gifted property is increased (but not to above fair market value) by generation-skipping taxes paid. IRC §2654. This basis adjustment for GST taxes paid is applied after the basis adjustment for gift taxes paid pursuant to IRC §1015.

2. Dual Basis is Possible. For purposes of determining loss in a subsequent sale of a gifted asset by the donee, the donee's basis cannot exceed the fair market value of the gifted property at the time of its receipt by the donee. IRC §1015. ***Example:*** Donor gives stock having a basis of $100X and a fair market value of $50X to Child. No gift tax is paid on the gift. Child has a $100X basis for gain purposes and a $50X basis for loss purposes.

3. PAL Losses Are Added to Donee's Basis. The transfer of a passive-activity asset by lifetime gift does not trigger the recognition of suspended passive activity losses. IRC §469(j)(6).

E. Conflicting Code Provisions. In the case of the gratuitous forgiveness of indebtedness, the Code contains conflicting provisions relating to whether or not the donee has received gross income. IRC §§61(a)(2) and 102(a). It has been held that the forgiveness of indebtedness which is a true gift made gratuitously and with donative intent is not included in gross income. Helvering v. American Dental, 318 U.S. 322 (1943).

III. TRANSFERS FOR VALUE (i.e., SALES)

A. Introduction. Clients often engage in sales transactions for value with family members or family-controlled entities. Sales are made for a variety of reasons (to freeze transfer tax values, to get the family business to the children and cash for retirement to the parents, etc.).

B. Obvious Tax Issues. When a client sells an asset, certain income tax consequences are generally assumed to occur: (1) the seller has either gain or a loss; (2) such gain or loss can either be treated as short-term or long-term gain or loss; and (3) well-known rules apply to transactions qualifying as a 1031 tax-free exchange or as an installment sale.

C. Some Transactions are Ignored.

1. Sales Between a Husband and a Wife. No gain or loss is recognized upon the transfer for value (i.e., the sale) by an individual to such individual's spouse. The transaction is treated as a gift, and transferee has the transferor's cost basis. IRC §1040.

2. Sales Between a Grantor and a Grantor Trust. The deemed owner (i.e., the "grantor") of a trust under the so-called "grantor trust" rules will not recognize gain or loss in a sales transaction between such grantor and grantor trust. Rev. Rul. 85-13, 1985-1 C.B. 184.

D. Gain and Loss Issues Result.

1. Ordinary Income Results if Depreciable Property is Sold. Any gain recognized by the transferor upon the sale or exchange of property between specially defined related persons will result in ordinary income (i.e., not capital gain) to the transferor if the property is depreciable property in the hands of the transferee. IRC §1239.

2. Capital Gain Results if Depletable Property is Sold. The IRS has determined that IRC §1239 does not apply to the sale of depletable property between specially defined related persons (i.e., the transferor can have capital gain). PLR 8139052 (June 30, 1981).

3. Losses are Disallowed if Sale is to a Related Party. Any loss recognized by the transferor upon the sale or exchange of property between specially defined related persons will be disallowed. However, any gain subsequently recognized by the transferee will be reduced by the amount of such previously disallowed loss. IRC §267.

4. Sale of Term Interests in Trusts. The basis of the owner of a term interest (i.e., a life estate, term of years, or remainder interest) will be considered zero if it is sold by itself, but shall be its portion of the entire adjusted outside basis of all trust interests if such sale is part of a transaction in which all interests in such trust are being sold. IRC §1001(e).

E. Unusual Timing Issues.

1. Installment Sale to Related Party. If an installment sale is made to a related party who subsequently resells such property before the original seller has been fully paid (with a 2-year cutoff for property other than marketable securities), the sale by the second party accelerates the recognition of gain to the original seller. IRC §453(e).

2. 1031 Exchange with Related Party. If a taxpayer enters into a tax-free exchange with a related party and, within two years of the last transfer which was part of the exchange, either party disposes of the property received by that party in the exchange, then the original transaction does not qualify for the non-recognition of gain or loss under IRC §1031 for either party. IRC §1031(f).

F. Who Reports the Income? Who is liable to report any income is not clear where the asset sold was owned by a life tenant and remainderman. See United States v. DeBonchamps, 278 F.2d 127 (9th Cir. 1960); Robinson v. United States, 192

F.Supp. 253 (ND Ga. 1961); Rev. Rul. 61-102, 1961-1 CB 245; Hirschmann v. United States, 309 F.2d 104 (2nd Cir. 1962); West v. United States, 310 F.Supp. 1289 (ND Ga. 1970); Gaskill v. United States, 188 F.2d 507 (ND Tex. 1960).

IV. BASIS ADJUSTMENTS AT DEATH

A. Introduction. All assets included in a decedent's gross estate for federal estate tax purposes potentially qualify for basis adjustment, or for other special income tax-related relief, upon a decedent's death.

B. Obvious Tax Issues. When a client dies, certain income tax consequences are generally assumed to occur: (1) the decedent's assets (except IRD) are stepped up (or down) in basis to their fair market value as of date of death; and (2) the recipients of IRD ("Income in Respect of a Decedent") deduct the federal estate tax attributable to such IRD as it is collected.

C. General Rule. The basis of property acquired from a decedent generally becomes the fair market value of that property at date of death unless one of the exceptions outlined below applies. IRC §1014.

D. Property Acquired From a Decedent. Property acquired from a decedent includes virtually any property deemed owned by the decedent for estate tax purposes (i.e., included in the decedent's gross estate), including probate and non-probate property, whether or not the decedent's gross estate was large enough to require the filing of a Form 706, Federal Estate Tax Return.

1. Property in Which the Decedent Had an Interest. Any property owned by the decedent (i.e., probate property) is caught under this provision. IRC §2033.

2. Transfers With Retained Life Estate. Property given away by the decedent is nevertheless included as a part of the decedent's estate where the use of (or income from) such property was retained until the decedent's death. IRC §2036.

3. Transfers Which Take Effect at Death. Property given away by the decedent is nevertheless included as a part of the decedent's estate where the decedent retained a reversion worth more than 5% and someone else can get the property by surviving the decedent (i.e., Donor to Beneficiary for life, remainder to Donor if then living, otherwise to Beneficiary's descendants). IRC §2037.

4. Revocable Transfers. Property given away by the decedent is nevertheless included as a part of the decedent's estate where the decedent retained a

prohibited power to alter, amend, or revoke the transferred property until the decedent's death. IRC §2038.

5. <u>Gifts Made Within Three Years of Decedent's Death</u>. Certain property and rights no longer held by the decedent are taxed as part of the decedent's estate, including life insurance on the decedent's life where incidents of ownership were given away within three years of the decedent's death, gift taxes on gifts made within three years of the decedent's death, and property in which the decedent released an IRC §2036, 2037, or 2038 power or interest within three years of his or her death. IRC §2035.

6. <u>Joint Interests</u>. Some portion of property in which the decedent has an interest as a joint tenant (or tenant by the entirety) is included in the decedent's estate. IRC §2040.

7. <u>Powers of Appointment</u>. Property over which the decedent held too broad a power of appointment (as defined in this section) will be deemed owned by the decedent for estate tax purposes. IRC §2041.

8. <u>QTIP Property</u>. The assets in a QTIP marital trust established by a prior spouse of the decedent for the decedent's benefit are taxable as assets of the decedent at the decedent's death. IRC §2044.

E. <u>Exceptions to General Basis Rules</u>.

1. <u>Alternate Valuation Exception</u>. If alternate valuation has been elected under IRC §2032, the IRC §2032 value becomes the new basis. IRC §1014.

   a. Alternate valuation can only be elected where the gross estate and estate tax due are both reduced as a result of the election.

   b. If alternate valuation is elected, all estate assets are subjected to the alternate valuation rules (i.e., no "pick and choose").

   c. Alternate valuation causes the value of the assets six months after date of death to be used, unless the assets are disposed of or distributed sooner, in which case their value at such earlier date of disposition or distribution is used.

   d. Joint tenancy property is treated like probate property for alternate valuation purposes. Death (and the resulting passage of ownership to the surviving joint tenant) is not a disposition for alternate valuation purposes, but the subsequent disposition (by gift or sale) by the surviving joint tenant within the six months after the decedent’s death is such a disposition. Rev. Rul. 59-213, 1959-1 CB 244.

2. Special Use Valuation Exception.

a. If special use valuation has been elected under IRC §2032A, the §2032A value becomes the new basis. IRC §1014.

b. If the special use property is disposed of so as to result in additional estate tax being due, making an election is necessary to increase the property's basis to its date of death value. IRC §§1016(c)(1) and 1016(c)(5)(B); Treas. Reg. §301.9100-4T(f).

c. If no election is made, there is no adjustment to the property's basis. Conf. Rept. No. 97-215 (PL 97-34), p. 251.

d. It should be noted that no similar provision applies to IRC §2057 qualified family-owned businesses receiving a valuation break (that provision is structured as an exclusion, rather than as a deduction), so such qualified family-owned businesses get full date of death fair market value basis.

3. Income in Respect of a Decedent (“IRD”) Exception.

a. General Rule. Items of income in respect of a decedent under IRC §691 are not entitled to stepped-up basis at the decedent's death. Examples of such items include IRA and pension plan proceeds, renewal commissions, deferred compensation, and installment notes receivable.

b. Special Rules for Partnerships. The basis of a partnership interest acquired from a decedent is the date of death (or alternate) value, increased by the estate's (or other successor's) share of partnership liabilities and reduced by the income in respect of a decedent attributable to such partnership interest. Treas. Reg. §1.742-1.

c. Special Rules for S Corporations. The basis of S corporation stock is date of death or alternate value, reduced by the income in respect of a decedent attributable to such stock. IRC §1367(b)(4), effective with respect to decedents dying after August 20, 1996

d. Certain Lifetime Constructive Sales. Certain lifetime constructive sales, amounting to hedging (constructive sale) transactions, such as going “short against the box” during lifetime in order to lock in profit and pull out cash, will no longer be able to be closed out income tax free after death, as the pre-death portion of the gain will be considered IRD taxable to the estate or other successor. TRA ‘97, §1001(d)(3), adding IRC §1259, effective (with complex exceptions and effective date rules) to constructive sales made after June 8, 1997.

4. Exception for Qualified Conservation Easement. A carryover of the decedent’s income tax cost basis will occur with respect to that portion of a property which is excluded from the decedent’s estate by reason of a qualified conservation easement. TRA ‘97, §508, amending IRC §§170,1014, 2031, and 2032A, effective for decedents dying after 1997.

5. Exception for Certain Recently Gifted Property. Property received as a gift by the decedent within one year of the decedent's death which is gifted by the decedent back to the donor will not receive an adjustment to basis by reason of the decedent's death. IRC §1014(e).

6. Exception for Previously Gifted Property.

   a. Property gifted during lifetime that is nevertheless included in the decedent's estate for estate tax purposes (such as IRC §§2035, 2036, 2037, or 2038 property) will be entitled to an IRC §1014 basis adjustment by reason of the decedent's death, but the transferee must reduce such new date of death basis by any depreciation, depletion, or amortization taken by such transferee. Treas. Reg. §1.1014-3(d).

   b. Conceptually difficult issues are raised when previously gifted property included in the decedent’s estate (such as IRC §§2036, 2037, or 2038 property) has been sold and reinvested in something else prior to the decedent’s death. For estate tax purposes, the original property is deemed included in the decedent’s estate. But if it has been sold prior to the decedent/donor’s death, can the donee file an amended income tax return and claim the date of death value as the adjusted basis? See Humphrey’s Estate v. Commissioner, 162 F.2d 1 (5th Cir), cert. denied, 332 US817 (1947); Rev. Rul. 72-282, 1972-1 CB 306.

7. Exception for Certain Spousal Joint Tenancies.

   a. The current rules relating to estate taxation of joint tenancy interests provide that one-half of a spousal joint tenancy asset is included in the deceased spouse's estate under IRC §2040, which results in the deceased spouse's one-half of the asset having its basis adjusted under IRC §1014 and the surviving spouse's one-half of the asset being left with its historic cost basis.

b. Prior to 1982, the portion of a spousal joint tenancy asset included in the deceased spouse's estate was determined with reference to the deceased spouse's relative contribution to the acquisition of the asset (the so-called "tracing of contribution" test). Accordingly, before 1982 as little as 0% or as much as 100% of a spousal joint tenancy asset might have been included in the deceased spouse's estate under IRC §2040 (and have its basis adjusted in IRC §1014).

c. The IRS has recognized that 1981 amendments to IRC §2040(b)(2) did not repeal the effective date of IRC §2040(b)(1), the net impact of which is to still apply the tracing of contribution rules to spousal joint tenancy assets acquired before 1977. See Gallenstein v. U.S., 975 F.2d 286 (6th Cir. 1992); Patten v. U.S., 116 F3d 1029 (4th Cir., 1997); Anderson v. U.S., 78 AFTR 2d 96-6557 (DC MD 1996), and Hahn v. U.S., 110 TC 14 (1998).

8. Exception for Community Property Interests.

a. The survivor's one-half interest of community property, as well as the decedent's one-half interest in such property, gets new basis (equal to the fair market value of such assets) at the decedent's death. IRC §1014(b)(6).

b. It is thus essential to ascertain whether or not the decedent and his or her spouse ever lived in one of the community property states (i.e., Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), and if so, if community property was thereby created (and subsequently preserved) --- even if the client resided in a non-community property state at death. Additionally, Alaska has adopted an elective form of community property.

c. Some states now allow community property to be held in joint tenancy, and it is unclear whether the joint tenancy or community property rules will apply to such arrangements. See Estate of Wayne-Chi Young, 110 TC No. 24, Doc. 98-14934 (1998).

F. <u>Special Basis Transitional Dates</u>. A number of special basis transitional dates exist to deal with changes in the law. IRC§1014(b).

1. <u>Death After 12-31-51</u>. IRC §1014 applies to property transferred to a revocable trust.

2. <u>Death After 10-21-42 But Before 12-31-47</u>. Basis of surviving spouse's share of community property was the greater of its adjusted basis or its estate tax value.

3. <u>Death After 12-31-47</u>. The surviving spouse's one-half share of community property assumes the same basis as the decedent's share.

4. <u>Death Between 1-1-51 and 12-31-53</u>. The survivor's interest in a joint and survivor annuity received a basis adjustment if the decedent's interest was includable in his/her gross estate.

5. <u>Death After 12-31-53</u>. All property acquired from a decedent by reason of death receives a stepped-up basis.

6. <u>Death After 8-26-37</u>. The decedent's stock or securities in a foreign corporation which is a foreign personal holding company receives a basis which is the lower of the fair market value at date of death or the decedent's basis.

G. <u>Other Basis Issues</u>.

1. <u>Appraisal Necessity</u>. The applicable date for determining fair market value is "as of" the decedent's date of death, unless alternate valuation date is elected under IRC §2032. The appropriate values will appear on the Form 706.

2. <u>Where No Form 706 Required</u>. Successors to the decedent's property are entitled to new basis even if no estate tax was due by reason of the decedent's death. The fiduciary should obtain an appraisal or other proof to support the new cost basis even if no Form 706 is required (i.e., because the decedent's gross estate totals less than the estate tax exemption-equivalent).

3. <u>Impact on Depreciation, Depletion, etc</u>. Be mindful of the need to recompute future depreciation, depletion, and amortization relative to assets (or that portion of an asset) included in the decedent’s gross estate for federal estate tax purposes. Such assets will get a new basis and date of acquisition after the decedent's death, which may also result in a new

life and method of depreciation as to such asset (or portion of an asset). Consider electing cost depletion where appropriate.

4. <u>Elective Partnership Basis Adjustments</u>. A partnership (or other entity taxed as a partnership, such as an LLC) may elect to adjust the inside basis of its assets to reflect the outside basis adjustment occurring by reason of a partner’s death. IRC §754.

5. <u>Appreciated Undistributed Devises Due Decedent</u>. The death of a beneficiary due undistributed appreciated assets as beneficiary of another estate may or may not result in such undistributed assets having their basis adjusted, depending upon which authority you believe. <u>Compare Manufacturers Hanover Trust Company v. U.S.</u>, 410 F.2d 77 (1969) and <u>Connecticut National Bank v. U.S.</u>, 937 F.2d 90 (1991).

6. <u>Post-Death Capital Gains and Losses</u>.

   a. All capital gains or losses that occur after death are long-term capital gains or losses if the property sold was included in the gross estate of the decedent, regardless of the length of the post-death holding period. IRC §1223(11).

   b. Such long-term treatment may be valuable where a gain occurs, inasmuch as long-term capital gains have historically been afforded favorable tax treatment.

   c. Such long-term treatment may be unfavorable where a loss occurs, inasmuch as long-term capital losses in excess of offsetting capital gains can only be utilized to offset ordinary income to the extent of $3,000 per year.

   d. It is common to have post-death capital losses. For example, imagine a decedent owning only a home appraised at $100,000 which is sold 1-2 months after date of death for a net of $92,000 after commissions and other selling expenses of $8,000. The $8,000 of selling expenses, which will be taken on the income tax return (after all, there is no estate tax return due to deduct such expenses on), cause an $8,000 long-term capital loss on the seller's income tax return.

7. <u>Certain Joint Spousal Trusts</u>.

a. It has been suggested that husband and wife can create a single trust with their collective assets (called a "joint spousal trust"), wherein the first to die has a general power of appointment over the entire trust, with the result that all of the their collective assets will have their basis adjusted to fair market value upon the death of the first spouse to die.

b. The IRS has ruled that this doesn't work, because of IRC §1014(e), by reason of the simultaneous passage to the decedent and return to the surviving spouse as of the decedent's death of that portion of the assets owned by the surviving spouse prior to the decedent's death. PLR 200203045 (January 5, 2001); 200210051 (December 10, 2001).

c. It may be possible to draft the will or trust in a manner so that the property is not deemed to pass back to its original owner.

8. <u>Impact of Distributions to Beneficiaries</u>.

a. <u>Timing of Beneficiary's Tax Consequences</u>.

(1) Where the beneficiary has the same year end as the estate or trust, the beneficiary reports the distribution in the beneficiary's tax year in which the estate or trust deducts the distribution.

(2) Where the beneficiary has a different year end from the estate or trust, the beneficiary reports the distribution in the estate's year which ends within the beneficiary's taxable year. IRC §§652(c) and 662(c).

(3) In the year of a beneficiary's death, all income actually received (even if from a trust with a fiscal year ending after the date of decedent's death) is reported on the beneficiary's final Form 1040.

b. <u>Distributions From Simple Trusts</u>.

(1) A simple trust is one which is required to distribute all of its income currently, which does not make any corpus distributions during the taxable year, and which does not have any charitable beneficiary. IRC §651.

(2) Income required to be distributed currently is taxed to

beneficiaries even if not actually distributed. IRC §652(a).

(3) Income currently distributable but accumulated because of a contest re beneficiary identity is retroactively currently taxed to actual beneficiary. Higgenson v. U.S., 238 F.2d 439 (1st Cir. 1956).

(4) DNI and the various types of income received are allocated ratably among multiple beneficiaries in proportion to their respective income interest, unless otherwise specifically allocated under the terms of the trust. IRC §652(b).

(5) A simple trust will be entitled to a distribution deduction in order to avoid having the same income taxed to both the trust and its beneficiary or beneficiaries.

(6) For simple trusts the distribution deduction, for regular income tax purposes under IRC §651, is limited to the lower of:

(a) Income (i.e., net fiduciary accounting income) required to be distributed currently, whether or not actually distributed, or

(b) Distributable net income.

(7) The income beneficiary will benefit from any deductible principal expenses.

(8) Items which are charged to income for accounting purposes, but which are not fully deductible for income tax purposes, can cause the estate or trust which distributes all of its accounting income to have phantom income for tax purposes. Such a result may occur because of suspended passive activity losses, nondeductible investment interest, or nondeductible "miscellaneous itemized deductions".

(9) **Example:** Assume that a simple trust is to pay 1/2 of its income to Mary, 1/4 of its income to Sam, and 1/4 of its income to Bill. It has $30,000 of dividends, $40,000 of taxable interest, $50,000 of capital gains, and pays a trustee's fee (charged 1/2 each to principal and income) of $20,000.

(a) Accounting income is $60,000, which is the amount distributable to the beneficiaries. This is because the $70,000 of dividends and interest is reduced by the $10,000 of trustee fees charged to income. Mary will get $30,000, Sam will get $15,000, and Bill will get $15,000.

(b) Taxable income of the trust, disregarding the distributions deduction and personal exemption, is $100,000. This is because the $30,000 of dividends, $40,000 of taxable interest, and $50,000 capital gains, totaling $120,000 of income, are to be reduced by the $20,000 trustee fees.

(c) Distributable net income is $50,000. This is the trust's $100,000 taxable income, disregarding the distributions deduction and personal exemption, less the $50,000 capital gain which is not included in distributable net income.

(d) The trust will get a distributions deduction of $50,000 (i.e., equal to the lower of its $60,000 accounting income or $50,000 distributable net income. The trust will thus have $50,000 of taxable income, less the $300 exemption to which it is entitled. The $50,000 taxable income of the trust will be taxed at the rates then in effect pursuant to IRC §1(e).

(e) The beneficiaries will have $50,000 of taxable income, of which Mary will have $25,000, Sam will have $12,500, and Bill will have $12,500. This is because, although they got $60,000, they are entitled (for tax purposes) to get the benefit of the $10,000 of trustee fees charged to principal.

(f) The trustee can offset an indirect expense such as trustee fees against any category of income in this case, as there is no exempt income against which a portion must be allocated. Assuming that dividends are reduced by the trustee fees, $10,000 of dividends and $40,000 of taxable interest will be allocated 1/2 to Mary, 1/4 to Sam, and 1/4 to Bill.

c. Distributions From Complex Trusts.

(1) A complex trust is one which may accumulate income, which distributes corpus during the taxable year, or which has a charitable beneficiary. IRC §661.

(2) Complex trusts are substantially identical to simple trusts for income tax purposes, except as to distributions of amounts other than "income required to be distributed currently."

(3) For complex trusts the distributions deduction, for regular income tax purposes, under IRC §661(a) is limited to the lower of:

(a) The aggregate of: (a) income (i.e., net fiduciary accounting income) required to be distributed currently, whether or not actually distributed, and (b) other amounts paid, credited, or required to be distributed (whether out of income or principal); or

(b) Distributable net income.

(4) Where current income and principal distributions are made, the taxable portion of the distribution is allocated among the different beneficiaries under the tier system provided in IRC §661(a):

(a) First tier distributions include the amount of income required to be distributed currently. The distributees who receive such distributions are deemed to receive DNI to the extent thereof.

(b) Charitable contributions reduce DNI after first tier distributions are taken into account.

(c) Second tier distributions are all other distributions (i.e., discretionary income and principal distributions). The distributees who receive such distributions, to the extent that first tier distributions and charitable contributions have not absorbed all of the DNI, are taxed to the extent thereof.

(5) **Example:** Assume that a complex trust must pay $10,000

to John each year, and the trustee is also given the discretion to make additional distributions to John and/or Mike if deemed appropriate. It has $20,000 of dividend income and no expenses.

(a) If the trustee makes only the required $10,000 distribution to John, John will have received a $10,000 tier one distribution. John will have $10,000 of dividend income since there is $20,000 of DNI to allocate.

(b) If the trustee makes the required $10,000 distribution to John and a $10,000 discretionary distribution to Mike, John will have received a $10,000 tier one distribution and Mike will have received a $10,000 tier two distribution. Each will have $10,000 of dividend income since there is $20,000 of DNI to allocate.

(c) If the trustee distributes the required $10,000 distribution to John, a $20,000 discretionary distribution to John, and a $30,000 discretionary distribution to Mike (i.e., they each get a total of $30,000), John will have received a $10,000 tier one distribution and a $20,000 tier two distribution, and Mike will have received a $30,000 tier two distribution. John will have $14,000 of dividend income (i.e., $10,000 because of the tier one distribution, and $4,000 as his proportionate share of all tier two distributions) and Mike will have $6,000 of dividend income (as his proportionate share of all tier two distributions).

(6) The trustee of a complex trust can elect to treat distributions made within the first sixty-five (65) days of a taxable year as having been distributed in the preceding taxable year. IRC §663(b).

(7) For tax years beginning prior to 1998, income accumulated in a complex trust and distributed to a beneficiary in later years may be subject to the complex (and often changed) throwback rules on accumulation distributions. These rules eliminate most domestic trusts from being subject to the throwback rules for years beginning after 1997. IRC §§665-668. See, IRS Form 4970 and printed

instructions which are used to compute the tax on accumulation distributions from trusts.

d. Distributions From Estates.

(1) Estates are generally taxed like complex trusts (but the throwback rules were never applicable to estates).

(2) Income from an estate is generally not required to be distributed currently, so all income and principal distributions are second-tier distributions.

(3) Widow's allowances paid from principal result in a distribution deduction to the estate and count as a second-tier distribution to the widow. Treas. Reg. §1.661(a)-2(e).

(4) In a much criticized decision, interim distributions from an estate were excluded from the DNI mechanism on the ground that the estate could recapture them prior to the decree of final distribution, and that they were not "properly" paid. Bohan v. United States, 456 F.2d 851, 72-1 USTC ¶9286 (8th Cir. 1972); non-acq., Rev. Rul. 72-396, 1972-2 C.B. 312.

(5) For estates of decedents dying after 8/5/97, the executor of an estate can elect to treat distributions made within the first sixty-five (65) days of a taxable year as having been distributed in the preceding taxable year. IRC §663(b).

e. Recognition of Gain Or Loss When Making Distributions.

(1) Income Taxation of Specifically Gifted Assets.

(a) No gain or loss is recognized by the estate or trust when it distributes specifically gifted property (e.g., 100 shares of AT&T stock, the family home, etc.).

(b) The estate or trust gets no distributions deduction, nor is the beneficiary deemed to receive DNI, upon distribution of specifically gifted property. IRC §663(a)(1).

(c) The distributee succeeds to the estate's or trust's income tax basis upon the distribution of specifically gifted property.

(2) Income Taxation of Non-Formula Pecuniary Gifts.

(a) A non-formula pecuniary gift is a gift of a specific amount of money (e.g., "I give $50,000 to Joe").

(b) The estate or trust gets no distribution deduction, nor is the beneficiary deemed to receive DNI, upon the distribution of a specific amount pecuniary gift (e.g., $10,000 to Sally). IRC §663(a)(1).

(c) The estate or trust does get a distribution deduction, and the beneficiary will be deemed to receive DNI, upon distribution of a specific amount payable in more than three installments under the terms of the governing instrument (e.g., $10,000 to John, which is required under the terms of the will or trust to be paid in 4 quarterly installments, the first to commence upon the grantor's death). IRC §663(a)(1).

(d) The distribution of appreciated property in satisfaction of a pecuniary gift will trigger gain or loss to the distributing estate or trust. Treas. Reg. §1.1014-4(a)(3).

Example: The decedent's will leaves $100,000 to David. The estate gives David stock worth $100,000, but having a basis of $80,000, in satisfaction of such gift. The estate will be deemed to have sold the stock to David, resulting in a $20,000 capital gain. David has no taxable income, and will have a $100,000 basis in such property.

(3) Income Taxation of Formula Pecuniary Gifts.

(a) A formula pecuniary gift is one which uses a formula to back into the amount of the gift (i.e., "I give Joe an amount equal to one-half of my federal gross estate, valued as of my date of death."). Formula pecuniary gifts are often used to determine the amount of marital deduction gift to be made.

(b) Gain or loss (unless IRC §267 prevents a loss from being recognized upon the distribution from a trust) <u>will</u> be recognized when a formula pecuniary gift is satisfied with property, rather than cash, based upon the fair market value of such property at the date of distribution. IRC §1.1014-4(a)(3).

(c) However, under a much criticized (and seemingly inconsistent) Subchapter J regulation, a formula pecuniary gift is not deemed to be a gift of a specific sum. Accordingly, the estate or trust making such a distribution will get a distributions deduction, and the recipient will be deemed to receive DNI. Treas. Reg. §1.663(a)-1(b).

(4) <u>Income Taxation of Fractional Share and Residuary Gifts</u>. A distribution made pursuant to a fractional or percentage share formula, or a distribution of the residue or a share of the residue, is not "a gift or bequest of specific property or of a specific sum of money". Treas. Regs. §1.663(a)-1(b)(2). Accordingly, such gifts will carry out the income of the estate or trust, if any, to the beneficiary.

(5) <u>Income Taxation of In-Kind Distributions</u>.

(a) Distributions in kind generally don't result in the recognition of gain or loss, unless the distribution is in satisfaction of a pecuniary or fixed dollar gift. Treas. Reg. §1.1014-4(a)(3). In the case of in-kind distributions where no gain or loss is recognized, the beneficiary gets the estate's or trust's income tax basis in the property so distributed and a second tier distribution takes place in an amount equal to the lesser of the property's basis or fair market value at the time of such distribution. IRC §643(e).

(b) The executor or trustee can make an irrevocable election to recognize gain or loss upon the making of a distribution in satisfaction of a fractional or percentage share formula, or a distribution of the residue or a share of the residue. If such election is made, the property will be deemed sold to the beneficiary at its fair market value on the date of its distribution, and a second tier distribution will take place equal in amount to such fair market value. IRC §643(e)(3).

(c) It is often desired to make non-pro rata distributions in kind to beneficiaries. For example, two equal beneficiaries may decide to let one take all of the AT&T stock and the other take all of the GM stock, with cash being used to equalize the distributions to the extent necessary, rather than splitting each and every asset. Such non-pro rata distributions can be taxed as constructive taxable exchanges between the two beneficiaries unless either the governing instrument (i.e., the will or trust) or applicable local law specifically allow non-pro rata distributions to be made.

(6) Distributions of Installment Obligations and IRD Items.

(a) An in-kind distribution by an estate of an installment obligation which was created prior to the decedent's death, unless the distribution is in satisfaction of a pecuniary or fixed dollar gift, will not be a disposition of such installment obligation for the purpose of acceleration of gain. IRC §453(e)(6).

(b) No such exception exists for in-kind distributions of an installment obligation created after the decedent's death, and any distribution of such an installment obligation will trigger gain.

(c) When doing estate planning for a person whose assets consist of a great deal of installment obligations receivable and IRD items, it will be desirable to avoid pecuniary formula gifts under the estate planning documents that must be funded with such items and/or to make specific gifts of such items to the desired individuals or sub-trusts.

(d) When administering an estate or trust with a highly appreciated asset which is about to be sold on an installment basis, consider first distributing the asset to the beneficiary and then letting the beneficiary enter into the installment sale. This will avoid

avoid having the gain accelerated upon the subsequent distribution of the installment obligation to the beneficiary of the estate or trust.

(e) When administering an estate or trust that has a substantial installment obligation receivable that was created after the decedent's death, it may be desirable to find some excuse to keep the estate or trust open for as long as possible to avoid having to distribute the installment note and thus accelerating the gain.