Minimize Capital Gains Tax of Estates, Trusts, and Beneficiaries

With a rise in the top tax rate on capital gains, which begins applying to trusts and estates at a fairly low income level, the need for capital gains tax planning has grown.

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For literally decades, many trusts have been administered as follows: The income beneficiary would be paid traditional income (i.e., interest and dividends) and taxed on it under Sections 652 and 662; capital gains would be allocated to corpus and taxed to the trust at the applicable rate.

Over the last two decades, the equity markets have seen continual drops in the dividend yields and continued decreases in interest rates that have continued at historical lows. Currently, the dividend yield on the S&P 500 is approximately 2% and the bond portfolio yields approximately 3½%. The yield on a 30-year Treasury Bond is less than 3%. This change in yields, coupled with current investment models—which include the objective of achieving capital gains—have resulted in two significant changes that fundamentally altered the historic operation of the determination of "income" for distribution to income beneficiaries of many trusts:

1. The adoption by many states of "trustee's power to adjust" modeled after section 104 of the Uniform Principal and Income Act of 1997.
2. Many states have adopted statutes that permit the conversion of existing trusts to a "total return unitrust." As will be discussed in greater detail below, these changes often mandate that capital gains, to some degree, need to benefit the "income beneficiary" of the trust to provide sufficient income.

These fundamental changes in trust law, together with substantial increases in the federal income taxes imposed on capital gains from 2013 forward, require significant analysis of appropriate income tax planning for capital gains that are incurred by trusts. Furthermore, as a result of the Great Recession, many beneficiaries may have substantial capital loss carryforwards and could use capital gains to offset those losses. These planning opportunities require a detailed consideration of the fundamental concept of whether a particular capital gain is included in distributable net income (DNI). In order for a capital gain to be taxed to a beneficiary, it must be included in DNI.[1]

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Increased capital gains tax rates

During 2014 and subsequent years, capital gains will reach the highest marginal bracket of 20% (increased from 15% in 2012) at taxable income to the trust or estate of $12,150. Additionally, these capital gains are now subject to Medicare tax of 3.8% at the same threshold of $12,150. Therefore, for trusts and estates that have incurred $12,150 of taxable income, the marginal tax bracket on capital gains is 23.8% instead of the 15% in 2012. For example, a trust or estate with ordinary income in excess of $12,150 and capital gains of $20,000 would pay a total capital gains tax of $4,760, whereas if the capital gains are distributed to a beneficiary whose taxable income was $150,000, the total capital gains tax would be $3,000.

The first and most basic planning decision a trustee must make is whether to attempt to plan to have the capital gains incurred by the trust to be taxed to the beneficiaries of the estate or trust instead of the estate or trust. In 2014, individuals filing joint returns are taxed at the 15% marginal rate on taxable income up to $73,800. Unmarried individuals are taxed at the same bracket for amounts up to $36,900. This amount is after personal exemptions, standard deductions, or itemized deductions. More importantly, the 3.8% Medicare tax on capital gains is applicable to only single individuals who have taxable income in excess of $200,000 and taxpayers who are married and filing jointly with income in excess of $250,000.

Therefore, for 2013 and subsequent years the capital gains generally will be taxed at a higher marginal bracket if treated as income of the estate or trust (23.8%) than if taxed to the individual beneficiaries of such entity. Certainly, there will be exceptions, primarily if the estate or trust has capital loss carryovers. However, this article focuses on the opportunity to include capital gains in DNI and thereby permit the gains to be taxed to the beneficiaries.

In order for a beneficiary to be taxed on capital gains incurred by an estate or trust, the capital gains *must* be included in DNI.

Basic capital gains planning

Appropriate planning for the taxation of capital gains requires a complete understanding of Section 643(a)(3) and the regulations promulgated thereunder, particularly Reg. 1.643(a)-3. A practitioner must understand that in order for a beneficiary to be taxed on capital gains incurred by an estate or trust, the capital gains *must* be included in DNI, as defined in Section 643(a). This determination is critical to the planning. Reg. 1.643(a)-3(b), as revised in 2004, provides as follows:

> *Capital gains included in distributable net income.* 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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> (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
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> (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."

Traditional trusts, which require that income be paid to the income beneficiary with discretionary distributions of principal either with a standard or without, have been governed by Reg. 1.643(a)-3 and the accompanying regulations (which were revised in 2004). Under normal circumstances, the vast majority of the "traditional principal and income trusts" contain investment portfolios that basically pay the interest and dividends net of related expenses to the income beneficiary, and the income beneficiary is taxed on these items under Section 662.

To the extent these trusts have incurred capital gains, they are generally allocable to corpus under state law and therefore not included in DNI as defined in Section 643(a). However, where the beneficiary is entitled to invasions of principal, the beneficiary is not taxed on the capital gain unless one of the specific exceptions set forth in the aforementioned regulations can be satisfied. In many cases, a trustee does not avail himself or herself of these alternatives except in specific planning scenarios.

[1] This article is a follow-up to the post-mortem planning article by one of the present authors, Christin, "Practical Income Tax Planning for Estates and Nongrantor Trusts," 36 ETPL 3 (November 2009). The current article, however, focuses solely on the proper tax planning for capital gains for estates, trusts, and their beneficiaries.

Choosing who bears tax burden. In some cases, the trustee may recognize that shifting the tax burden of the capital gain to the beneficiary may merely exacerbate the beneficiary's need for principal invasions. With the highest marginal capital gain rate of 15%, however, the need for extraordinary planning may well not have been deemed necessary. In contrast, now that the marginal rate is 23.8% at the trust level, specific planning for the appropriate handling of these capital gains to minimize the marginal tax imposed on these gains clearly requires more planning than occurred in past years.

Reg. 1.643(a)-3(b)(1) will be discussed with regard to the application of the payment of unitrust amounts as it applies to trusts initially drafted as a unitrust or converted pursuant to applicable total return unitrust statutes and second with regard to application of the trustee's statutory power to adjust. However, first consider basic capital gains distribution planning with respect to gains allocable to corpus under state law, which must focus on Regs. 1.643(a)-3(b)(2) and (3).

The most common situation that practitioners face are trusts that either mandate payment of all of the income or permit distribution of the income (either pursuant to a standard or in the trustee's discretion), together with the permissible invasion of principal for the benefit of the beneficiary (again either pursuant to a standard or in the discretion of the trustee).

As we can see from Reg. 1.643(a)-3(b)(2) above, the inclusion of the capital gains in DNI pursuant to this subpart hinges on whether the trustee consistently treats the capital gain which is allocable to corpus as part of the distribution to a beneficiary.

Discretionary power. This very basic planning opportunity is outlined in some detail in Reg. 1.643(a)-3(e)(2), Examples 1 and 2. That is, a fiduciary exercises his or her discretionary power to distribute principal and follows the regular practice of treating the invasion of principal first from any capital gain realized by the trust. The trustee is not basing the principal distribution on the capital gain incurred during the year, but is basing the principal invasion on either his or her discretion or the ascertainable standard governing the determination of the amount of distribution. However, the key point is that this must be a consistent practice in all future years and if it is followed, capital gains will be included in DNI of the trust in each of the future years and, therefore, ultimately deducted by the trust under Section 661 and includable in the income of the beneficiary in accordance with Section 662.

The examples in the current regulations make it relatively clear that the establishment of the practice by the fiduciary must commence in the first year in which a distribution of principal occurs and where, presumably, a capital gain exists. This may create a challenge for existing trusts that have previously not treated capital gains as part of the distribution to beneficiaries consistently.

In those circumstances, those trusts apparently are limited to attempting to avail themselves of subpart (3), which historically has been conservatively administered by the IRS, and in many cases, is inconsistent with the purpose or standard applicable invasions of principal in accordance with the governing instrument. A possible solution to this conundrum may be decanting the trust into a new trust to create consistent treatment of the "new trust" in accordance with subpart (2) of the regulation as suggested by a recent article.[2] However, decanting a trust in most states requires that the trustee have significant discretion to distribute principal, which may not exist.

Distribution amount limited to capital gains. The third possibility of capital gains being included in DNI is in accordance with subpart (3) of this regulation, which requires that capital gains be used to determine the amount of the distribution. This subpart of the regulation was interpreted pursuant to the prior (i.e., pre-2004) regulations in a somewhat disingenuous manner. Certainly, many cases took the position that the section requires a consistent practice by the fiduciary when the subpart, in fact, is silent as to that requirement. This was most clearly demonstrated in TAMs 8324002, 8506005, and 8834039.

Given the uncertainty of the application of this third subpart, there is some unpredictability in determining the IRS's position with a certain fact pattern that might evolve. In some cases, it may be the only alternative for the fiduciary to attempt to cause the beneficiary to be taxed on a capital gain incurred by the trust. Pre-2004, Example 5, may provide a blueprint. Example 5 involves a situation where the trustee intended to make a distribution of principal to the beneficiary in an amount that exceeded the capital gains for the current year. Presumably, that was either a discretionary decision or an amount determined under the applicable standard. However, the trustee decided to limit the distribution of principal to the capital gains. In that example, the gain was determined to be part of DNI.

[2] See Parthemer and Klein, "The Rising Tide of Fiduciary Taxes," 27 Probate Property 39 (September/October, 2013).

There are concerns about the operation of such a procedure if the opposite result occurred—i.e., if the trustee under the standard determined that the beneficiary was entitled to a principal distribution of an amount that is less than the capital gains realized in a given year. Would the trustee be required to distribute the entire capital gain amount in order for the gain to be "utilized to determine the amount of distribution" notwithstanding the fact that the distribution of that amount would appear to be a violation of the trustee's duty? Most states have adopted the Uniform Trust Code, which includes a "duty of impartiality." It would appear that the trustee has to weigh the consequences to the income beneficiary (who is also receiving principal and possibly the capital gains) and the remaindermen (who are in effect "paying the tax on the capital gain").

The inclusion of the capital gain in DNI has the positive effect for the remaindermen of causing the distributee of the principal to be taxable on the capital gain and relieves the trust from said obligation. The distribution of principal in excess of the amount that would have otherwise been justified under the standard or discretion of the fiduciary is to the detriment of the remaindermen. Using subpart (3) of the regulation as the basis for shifting capital gains to the beneficiaries would appear to cause not only uncertain treatment, but situations where capital gains in a given year are greater than the principal that the trustee would have been able to properly distribute under the trustee's duty given the applicable standard. This "fiduciary issue" may, as a practical matter, preclude a trustee from using this subpart of this regulation.

Reason for need to distribute principal. A separate possible solution will be discussed which is interrelated with the trustee's power to adjust. This may be an appropriate time to digress, as we have had years of low interest rates that have reduced the "income" (fiduciary accounting income) of the income beneficiaries of trusts. Presumably, this lower income (which does not include capital gains) has in many cases caused beneficiaries to require distributions of principal to satisfy their needs or benefits as defined in the operative trust document.

This causes the authors to raise the question of whether the trustee must ascertain the reason for the principal need. That is, whether it was a small amount of income caused by the factors that would permit the power to adjust (the consequences of which are discussed below) or was it merely an additional need for principal within the standard established in the trust.

As will be discussed in some detail, if the trustee found the necessary predicate for the power to adjust and exercise its discretion to adjust the income, it will be clear that the capital gain so allocated to the income beneficiary will be included in DNI and therefore deductible by the trust and taxable to the beneficiaries. As has been discussed previously, in the classic traditional trust administration where capital gains are allocable to principal and the trustee invades principal, the capital gain will not generally be included in DNI and therefore taxable to the trust unless some of the planning opportunities discussed herein are undertaken. The authors believe that the trustees must undertake this analysis to ensure that they are discharging their obligation of impartiality.

In conclusion, subpart (3) apparently is not a satisfactory resolution for the proper planning of the treatment of capital gains and will place the trust in somewhat difficult positions with respect to the determination of the capital gain to be included in DNI in various situations. Where possible, the trustee should engage in the consistent procedure of allocating capital gains to distribution of principal to satisfy subpart (2), but the trustee must have done that since the inception of the trust. As is alluded to, the exercise of the power to adjust can also be a valuable weapon in attempting to have capital gains included in DNI where the satisfactory predicate is established. The power to adjust is analyzed below in greater detail.

Power to adjust

Uniform Principal and Income Act of 1997 section 104 contains the trustee's power to adjust. The comment to the Uniform Principal and Income Act is very instructive as to the purpose of the Act. It clearly states that the purpose is to allow a trustee to select investments under the standards of the Prudent Investor Act and where the terms of the trust limit the distribution of income (fiduciary accounting income), the trustee may be required to decide to adjust the amount of the distribution considering allocating all or a portion of the capital gains to the income beneficiary. A detailed analysis of the entire statute is beyond the scope of this article. At last count, 45 states have adopted a provision similar to this section 104, with only Illinois, Iowa, Mississippi, North Dakota, and Vermont having failed to do so at the time this article was written.

The trustee's power to adjust basically requires the satisfaction of three conditions:

1. The trustee must manage the assets as an approved investor in accordance with the Uniform Prudent Investor Act. As was discussed previously, modern investment models

involve an objective of earning capital appreciation and realizing gains as part of investment models, not just earning traditional items of income (i.e., interest and dividends).
2. All of the "income" (i.e., fiduciary accounting income as determined by the applicable Principal and Income Act) must be distributed to the income beneficiary at regular intervals.
3. The various terms of the trust must permit the exercise of discretion, which involves the analysis of the duty of impartiality between the income beneficiary and the remaindermen.

The third condition is probably the most difficult to analyze. The authors believe this is an extremely important decision that the trustee must make and requires due deliberation by the trustee. Given modern models of investing, however, trustees are more likely to be following prudent investor rules and investing in financial assets whose total return will result primarily from appreciation rather than merely interest and dividends. Therefore, the trustee should make a proper adjustment and allocate a portion of the capital gains to income in order to satisfy the impartiality between the income beneficiary and the remainder beneficiaries. Once the corresponding adjustment has been made, the tax consequences of the power to adjust must be considered.

As was stated in the introductory portion of the article, it is essential for the capital gain to be included in DNI in order for the gain to be taxed to the beneficiary. Also early in the article, the operative Treasury Regulation was quoted. Subpart (b)(1) clearly anticipates the possibility that a trustee, pursuant to a reasonable impartial exercise of discretion granted to the fiduciary by local law, will permit the capital gain in question to be allocated to income (fiduciary accounting income). Therefore, if the trustee uses its power to adjust in accordance with the applicable state statute, the capital gain in question allocated to the income beneficiary will be income under Reg. 1.643(a)-3(b) and included in DNI. Consequently, it would be deductible by the trust in accordance with Section 661. None of the examples under the Reg. 1.643(a)-3 involve the power to adjust.

Capital gains relating to a total return unitrust

Practitioners are currently faced with appropriately planning taxation of long-term capital gains realized by a trust that is treated as a total return unitrust. The term unitrust is used to describe a payment to the "income" beneficiary equal to a fixed percentage of the fair market value of the trust property determined as of the beginning of the tax year of the trust.

These payments in most cases follow by analogy the rules contained in Section 664 relative to charitable remainder unitrusts. However, there are some important differences relative to this planning. State statutes do not provide for uniform application of "ordering rules" as is contained in Section 664(b). Therefore, the proper administration of these trusts, proper allocation of the capital gains to the recipients, and the corollary inclusion in DNI is an important factor to be analyzed and considered.

Practitioners may face this issue in a variety of settings. First, the trust in question might have been originally prepared as a total return unitrust. As such, the scrivener of the trust might have followed the ordering rules contained in Section 664(b) by analogy. Conceivably, the scrivener could also have given the trustee discretion to allocate capital gains to the total return unitrust, but in most cases the authors believe the scrivener would have provided the ordering rules described above.

Secondly, practitioners may be operating pursuant to a statute that permits classic income-only trusts to be converted to total return unitrusts. In such cases, their state may or may not contain the "ordering statute," which would all be treated as analogous under Section 664(b). However, all states do not have the ordering statute, and proper planning mandates that the trustee properly exercise its discretion to allocate the capital gain to the unitrust payment as discussed below.

Lastly, practitioners may be facing a "settlement agreement" that arose from a dispute between the income beneficiary and the remaindermen concerning the appropriate investment of the trust corpus that might have resulted in a compromise that converted a classic "income only" trust to a total return unitrust. Presumably, the scrivener of the settlement agreement would provide for the ordering rule contained in Section 664(b) but, if not, the trustee will be required to exercise its discretion to allocate capital gains to the total return unitrust payment that is discussed herein.

If the trust in question was originally drafted as a total return unitrust and properly set forth how the unitrust payment would be satisfied (i.e., first from fiduciary accounting income, next from short-term capital gains, next from long-term capital gains, next from tax-exempt income, and lastly from principal), the capital gains so allocated will be included in distributable net income and taxable to the beneficiary under Section 662. However, if the original trust did

not consider this issue, then the rules that will be discussed will be particularly relevant.

Converting income-only trusts. Many states have statutes that permit classic income-only trusts to be converted to total return unitrusts. At last count, 27 states had such a statute.[3] This is certainly the trend, and the number of states adopting such a statute presumably will continue to grow. The specific applicability of various statutes to various trusts is also beyond the scope of this article, but the basic concept of the conversion of an existing trust to a unitrust and the treatment of capital gain is of tremendous importance to the trust and beneficiaries of the trust.

Ordering statute. The practitioner may or may not have the benefit of an "ordering statute" in his or her jurisdiction. That is, some state statutes contain an ordering statute that mandates the source of the income to be used to satisfy the unitrust amount much like Section 664 provides for charitable remainder unitrusts. However, many state statutes do not so provide and, in fact, many statutes provide that it is within the trustee's discretion to allocate short- and long-term capital gains to the unitrust amount.

Reg. 1.643(a)-3 (quoted near the beginning of the article) specifically anticipated its application to a total return unitrust. In fact, subparagraph (B)(1) recognizes that the unitrust amount may include capital gains not in excess of the unitrust amount "if income under the state statute is defined as, or consisting of, a unitrust amount." Example 11 under the aforementioned regulation similarly confirms that where the trust is a total return unitrust and the state has a statutory ordering rule, to the extent capital gains are allocated in satisfaction of the unitrust amount (after the allocation of interest and dividends), then the capital gain amount is included in DNI for the year in question.

Therefore, where practitioners are faced with a document that provides for "ordering" similar to Section 664 or where the state in question has an "ordering statute," the result is clear that capital gains allocable in partial satisfaction of the unitrust amount will be included in DNI, deductible by the trust under Section 661 and taxable to the beneficiary pursuant to Section 662. However, practitioners face a more difficult situation where the document being dealt with does not contain the ordering provision described above and the state statute that they are dealing with does not have an ordering statute.

This most commonly occurs in situations where the state statute provides for the conversion of the "income only" trust to a "total return unitrust," but the state does not provide for an ordering statute. In those cases, many state statutes, either within the conversion statute or otherwise, give the fiduciary the discretion to allocate the capital gain in partial satisfaction of the unitrust amount.

This precise situation is dealt with in Reg. 1.643(a)-3, Example 14, which involves the administration of unitrusts, but does not contain an "ordering rule" in which the trust document in question does not require capital gain to be allocated in satisfaction of the unitrust amount.

This example indicates where a trustee intends to follow a regular practice of treating any net capital gains as distributable to the beneficiary to the extent the unitrust amount exceeds the trust's fiduciary accounting income. The trustee will therefore include capital gains in DNI as defined in Section 643(a) and, to the extent that these capital gains are included in DNI, these amounts will be deductible by the trust under Section 661 and be includable by the beneficiary pursuant to Section 662. This example restates that the trustee must treat the capital gain consistently in future years as it has in prior years. As has been discussed previously, it is important to consider this treatment in the first year of the trust and operate consistently.

Conclusion

As a result of the increased tax rates on capital gains, practitioners must focus on ways to assure that capital gains are included in DNI in order for them to be taxable to the beneficiary. The article describes a variety of situations where this can arise. Both generally and with respect to the total return unitrust, practitioners must ensure that the appropriate decision is in the first year of the trust as required by Reg. 1.643(a)-3.

With regard to capital gains allocated to corpus, the practitioner who does not make the appropriate decision in the first year of the trust will find it very difficult for the capital gain to be included in DNI and allocated to the beneficiary. When using the power to adjust, the trustee must make the appropriate analysis to make sure that the duty of impartiality is being followed. ■

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[3] Alaska, California, Colorado, Delaware, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Maine, Maryland, Missouri, Nebraska, New Hampshire, New Mexico, New York, North Carolina, Oregon, Pennsylvania, Rhode Island, South Dakota, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.