

BLAZING TRAILS AROUND PEAKS AND VALLEYS—

TOTAL RETURN TRUST STRUCTURING

Estate Planning Council of Birmingham

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I. INTRODUCTION.

Traditional trusts frequently instruct trustees to pay net income but retain principal. The dividend yield in 1980 on the Standard & Poor’s 500 Index was almost 6%. Now, it is around 2%. If a 1.25% trustee fee is subtracted, net dividend income falls to 0.75% before income taxes. If the trustee invests in non-dividend paying stocks, the trustee’s or financial advisor’s fee creates negative net income even when the value of the trust grows substantially.

Typical returns for a pay all income trust invested 60% in stocks and 40% in bonds produced the following income for income beneficiaries in the following years:

	<u>1982</u>	<u>1992</u>	<u>2002</u>	<u>2012</u>
Yield	8.8%	4.7%	2.9%	1.7%

Similarly, a portfolio balanced between blue-chip stocks from the list of DOW 30 Industrials and treasury bonds, coupled with a 1.25% trustee fee, could have produced the following results for a recent 12 month period:

* Unless otherwise indicated—

Section references refer to the Internal Revenue Code of 1986, as amended; and Regulation references refer to sections of the Treasury Regulations.

The reader is cautioned that there can be uncertainty in the interpretation and application of tax and other law, and much of what is expressed herein is the opinion of the authors and others. The reader must make an independent determination as to the proper interpretation and application of tax and other law to the matters discussed herein. The reader is further cautioned not to rely on forms and clauses in these materials “as is” but to determine independently the appropriateness of each form and clause together with its compliance with applicable law.

<u>Shares</u>	<u>Stocks</u>	<u>Value</u>	<u>Gain Percent</u>	<u>Div. / Int. Yield</u>	<u>1.25% Fee Net Inc</u>
500.00	Visa	116,090	39,020 50.63%	801.02 0.69%	1,451.13 (650.10)
1,000.00	Am. Exp.	90,970	32,270 54.97%	918.80 1.01%	1,137.13 (218.33)
600.00	Gold. Sachs	105,768	23,394 28.40%	1,322.10 1.25%	1,322.10 0.00
1,300.00	Nike Inc.	95,407	26,754 38.97%	1,249.83 1.31%	1,192.59 57.24
1,300.00	Disney	96,174	28,340 41.78%	1,115.62 1.16%	1,202.18 (86.56)
Totals Stocks:		<u>504,409</u>	149,778 42.23%	5,407.37 1.07%	6,305.11 (897.74)
<u>Treasuries</u>					
	One year	100,000		110.00 0.11%	1,250.00 (1,140.00)
	Two year	100,000		400.00 0.40%	1,250.00 (850.00)
	Three year	100,000		750.00 0.75%	1,250.00 (500.00)
	Five year	100,000		1,640.00 1.64%	1,250.00 390.00
	Ten year	100,000		1,840.00 1.84%	1,250.00 590.00
		<u>500,000</u>		4,740.00	6,250.00
Totals Treasuries:				0.95%	(1,510.00)
Stocks + Treasuries:		<u>1,004,409</u>	149,778 14.91%	10,147.37 1.01%	12,555.11 (2,407.74)

Although the stocks appreciated 42.23%, the portfolio's net income is only 1.01% before fees and is a deficit when the fees are factored in.

Many people believe that a steady return of 4% or 5% coupled with principal growth to compensate for inflation is a better result. This leads to the concept of "total return trusts" or "unitrusts." They provide for a payout calculated by multi-

plying value of the trust by a fixed percentage. This concept is as important for trusts for children as it is for spousal trusts.

If the income plus growth in normal years is more than the unitrust amount, the beneficiary will receive a reasonably steady return while principal grows to compensate for inflation. For example, if a \$100,000 trust has income plus growth of 6% per year, and the unitrust percentage is 4%, and the adjustment for inflation is illustrated as follows:

	Beginning			Ending
<u>Year</u>	<u>Balance</u>	<u>Return</u>	<u>Payout</u>	<u>Balance</u>
1	100,000.00	6,000.00	(4,000.00)	102,000.00
2	102,000.00	6,120.00	(4,080.00)	104,040.00
3	104,040.00	6,242.40	(4,161.60)	106,120.80
4	106,120.80	6,367.25	(4,244.83)	108,243.22
5	108,243.22	6,494.59	(4,329.73)	110,408.08
6	110,408.08	6,624.48	(4,416.32)	112,616.24
7	112,616.24	6,756.97	(4,504.65)	114,868.57
8	114,868.57	6,892.11	(4,594.74)	117,165.94

II. ALABAMA’S TOTAL RETURN TRUSTS STATUTE.

Total return trusts, also known as unitrusts, provide for the payment of an established percentage to the current beneficiary without regard to the characterization of the distribution as income, principal or capital gain. ALA. ACTS 2013, No. 13–336 (Aug. 1, 2013) amended the Alabama Principal and Income Act to provide for two types of total return trusts — express unitrusts and converted unitrusts. *See* ALA. CODE §§ 19-3A-105 and 106. The amendment became effective on August 1, 2013.

A. Express Unitrusts.

An express unitrust is a trust that is established by its governing document as a unitrust. *See* ALA. CODE § 19-3A-105. As with other provisions of the Alabama Principal and Income Act, the governing document can be drafted with provisions that are different than the provisions of the Alabama Principal and Income Act. *See* ALA. CODE §§ 19-3A-103(a)(1) and 105.

B. Converted Unitrusts.

A converted unitrust is a trust that was written as a pay-all-income, sprinkle or similar trust that has been converted into a total return trust by the

trustee, the beneficiaries or a court in accordance with a statutory procedure. *See* ALA. CODE § 19-3A-106.

III. DESIGN OF TOTAL RETURN TRUSTS.

Matters to consider when designing a total return trust include the following:

A. Unitrust Amount.

In a total return trust, both “income” and “net income” are redefined to be a unitrust amount. The trustee is then instructed to pay a unitrust amount each year determined by applying a fixed unitrust percentage (typically between 3% to 5%) to the net fair market value of the trust assets each year instead of paying traditional net income. *See* ALA. CODE § 19-3A-102(16).

1. **No Power to Adjust.** Unlike pay-all-income trusts, the trustee of a total return trust does not have the power to adjust between income and principal, even if it is a converted unitrust that gave that power to the trustee prior to the conversion. ALA. CODE § 19-3A-104(c)(9).
2. **Separate Funds — Deferred Compensation, Annuities and Similar Payments.** The rules for determining unitrust amounts are complex when deferred compensation, annuities and similar payments are involved. *See* ALA. CODE § 19-3A-409. The Alabama Principal and Income Act refers to these investments as “separate funds.”
 - (a) **Governing Document Controls.** The first rule for separate funds is that income from separate funds (*i.e.*, the unitrust amount) is determined by the rules in the governing document if it addresses separate funds. ALA. CODE § 19-3A-409(i)(1).
 - (b) **Value of the Separate Fund is Determinable.** If the governing document is silent but the value of the separate fund is determinable, the unitrust amount is determined by multiplying the unitrust percentage times the value of the separate fund in the same manner that the unitrust percentage is otherwise applied to assets that are not separate funds. ALA. CODE § 19-3A-409(i)(2). Separate funds in this category include most individual retirement accounts as well as most 401(k), profit sharing, and other defined contribution and separate account plans.

- (c) **Value is Not Determinable.** If the above rules do not apply (*e.g.*, payments are being received from a life annuity), the rules that apply to pay-all-income trusts are applied. ALA. CODE § 19-3A-409(i)(3). As a result, the calculation depends upon whether the trust is a marital deduction trust.
- (i) **Not a Marital Deduction Trust.** If the trust is not a marital deduction trust, income is based on what the payor characterizes as income [ALA. CODE § 19-3A-409(b)] or if it is not characterized by the payor, then 10% of the payment is income (*i.e.*, the unitrust amount) [ALA. CODE § 19-3A-409(c)].
- (ii) **Marital Deduction Trusts.** If it is a marital deduction trust, income is based upon the internal income of the separate fund if it can be determined. ALA. CODE § 19-3A-409(f). If not, it is determined by multiplying the § 7520 interest rate times the § 7520 value of the stream of payments to be received. ALA. CODE § 19-3A-409(g).¹

3. **Date to Determine Asset Values.** There can be administrative problems if assets values are tied to the last or first day of a year because valuations on such days might not be published. It is a better practice to use something like the last business day of the preceding year. A provision with desirable flexibility might be the following;

The net fair market values of one or more trust assets may be determined on days other than the last business day of a year if the Trustee determines that different valuation days are more appropriate

¹ There is a provision in ALA. CODE § 19-3A-409(g) that, in the case of a trust that is not a total return trust, the trustee will multiply the value of a separate fund with a determinable value by 4% to determine income, but this provision does not apply because the unitrust amount will be determined using the unitrust percentage. *See* ALA. CODE § 19-3A-409(i)(2).

4. **Smoothing Period.** The effects of peaks and valleys are frequently minimized by using a moving average value of trust assets instead of current year value. An example using a three average is as follows:

Average Net Fair Market Value. The average net fair market value of the assets of the trust shall be the average of the net fair market values of the trust assets determined as of the close of the last business day of each of the three (3) preceding years of the trust. In the case of the first year of the trust, however, it shall be based solely on the initial net fair market value of the assets. For the second year, it shall be based upon the average of the initial net fair market value of the assets and the net fair market value of the assets as of the close of the last business day of the first year of the trust. For the third year, it shall be based upon the average of the initial net fair market value of the assets and the net fair market values as of the close of the last business days of the first and second year of the trust. The average net fair market value shall be determined by the Trustee in the Trustee's sole and absolute discretion, and the decision of the Trustee as to such value shall be final and binding on all persons.

5. **Illiquid and Other Hard to Value Assets.** Assets lacking published market values present special difficulties. These include closely held business interests, real estate and mineral interests. Language to address their valuation might be the following:

The Trustee may use reasonable estimates to value non-liquid assets or hard to value assets

6. **Personal Use Assets.** Personal use assets can be excluded from the calculation of the value of the assets. The following is language used for this purpose:

Tangible Property. I anticipate that the assets of the trust may include, in whole or part, an interest in my homeplace and perhaps other tangible property, which I wish to be available for the beneficiary. Accordingly, in addition to the foregoing, the Trustee may make available for the use of the beneficiary rent-free any tangible real or personal property owned by the

trust. Such property shall be made available for the use of the beneficiary rent-free, however, it shall not be included in the fair market value of the trust assets when determining the average net fair market value of the assets of the trust.

7. **Principal Invasions.** The trustee can be authorized to invade principal if the unitrust amount is insufficient for the beneficiary's needs. Alternative paragraphs to either allow or deny principal invasions are:

Additional Payments from Principal. If at any time during the lifetime of my spouse, the foregoing payments from the trust are insufficient for the health, maintenance, support, and education of my spouse, the Trustee shall pay to or for the benefit of my spouse such additional sum or sums out of the principal of the trust as the Trustee, in the sole discretion of the Trustee, shall deem necessary or desirable for said purposes. My primary concern during the continuation of the trust is the health, maintenance, support, and education of my spouse rather than the preservation of principal for ultimate distribution to the remaindermen, and the Trustee shall not consider the interest of the remaindermen when making decisions concerning investments, distributions or any other matter.

OR

No Additional Payments from Income or Principal. Except as provided herein, the Trustee shall not invade principal for the benefit of my spouse, it being my desire to preserve the remainder of the principal for ultimate distribution to the remaindermen.

8. **Additions to and Distributions from Principal.** Adjustments to the unitrust amount should be made to reflect any additions to the trust or any principal distributions from the trust. A provision relying on the trustee's good judgment is:

Net fair market value shall be adjusted to reflect the effect of additions to the trust or distributions of additional payments from the trust.

9. **Qualified Subchapter S trusts.** Only certain trusts are permitted to be shareholders of a corporation that elects to be taxed under subchapter S of the Internal Revenue Code. A prevalent type of permitted trust is a qualified subchapter S trust (“QSST”).

(a) **Mandatory Income Distributions.** To qualify as a QSST, all income of the trust must be distributed currently to the one current beneficiary of the trust. § 1361(d)(3)(B). Income for this purpose is not taxable income; but it is income determined under local law (*i.e.*, the Alabama Principal and Income Act). Ordinarily, income from the corporation is the dividends that it pays to the trust. Payment of a unitrust amount, however, likely will be inappropriate, particularly if no dividends are paid thus leaving the trust without funds to pay the unitrust amount.

(b) **QSST Split-Off Trust or Share.** In order to facilitate QSST elections, it is a common practice to provide that stock in an S corporation will be segregated into a separate trust or share to be treated independently of the remainder of the trust. It generally is desirable for the form of the separate trust or share to be a pay all income trust or share and not a unitrust.

(c) **Sample Clause.** The following is a clause to calculate income from S stock held in a QSST using traditional concepts of principal and income.

Notwithstanding any other provision hereof, if the trust is a total return trust or a unitrust, as defined in ALA. CODE §§ 19-3A-105 and 106 or any similar law, income and net income with respect to shares of stock of any corporation for which an election under 26 U.S.C. § 1362(a) (*i.e.*, an S corporation) is in effect shall be determined in accordance with the applicable principal and income act and other laws as though the trust was not a total return trust or unitrust.

IV. MARITAL DEDUCTION TRUSTS.

Reg. § 1.643(b)-1 contemplates total return trusts as qualifying for the gift tax and estate tax marital deductions by defining “income” for that purpose as a unitrust amount *if the governing state law* authorizes income to be defined in that manner.

A. The Regulation.

The provision in the regulation includes the following:

Sec. 1.643(b)-1 Definition of income

. . . . 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. . . .* (emphasis added)

B. The Local Law Requirement.

Alabama’s Act, as well as a majority of the other states, has a provision that permits income to be defined as a unitrust amount. *See* ALA. CODE § 19-3A-409. It also has a statute that permits existing income trusts to convert to unitrusts thereby redefining income to be a unitrust amount. *See* ALA. CODE § 19-3A-106.

V. EXPRESS UNITRUSTS.

ALA. CODE § 19-3A-105 was added to the Alabama Principal and Income Act to be an “applicable local law” that complies with the alternate local law definition of the term “income” set forth in Reg. § 1.643(b)-1. Typically, this section will be relied upon by trusts that are intended to satisfy the “pay all income” requirement of marital deduction trusts.

A. Non-Exclusive Provisions.

ALA. CODE § 19-3A-105 does not prohibit the creation of trusts that fail to satisfy its requirements. However, a trust that does not satisfy the requirements might fail to meet the requirements needed to qualify for the marital deduction.

B. Unitrust Percentage.

To be consistent with the example in the Treasury Regulation, an express unitrust should require that the trustee distribute a unitrust amount each year equal to a fixed percentage of not less than three or more than five percent per year of the net fair market value of the trust assets. The trust, of course, can provide for distributions in addition to the annual unitrust amount without disqualifying the trust for the marital deduction because such excess distributions are in nature to a principal distribution. ALA. CODE § 19-3A-105(a) confirms this by providing:

If the unitrust amount is more than 5% of the net fair market value of the trust assets, the income and net income shall be 5% of the net fair market value of the trust assets, and the excess over 5% shall be considered to be principal of the trust.

C. Impact of Expenses.

The unitrust amount is not reduced by expenses which would be deducted from income if the trust were not an express unitrust. ALA. CODE § 19-3A-105(b).

D. Default Provisions.

This section contains default provisions that address some of the trustee's discretion unless it is addressed in the governing instrument. ALA. CODE § 19-3A-105(c). They include the following:

1. The frequency of payment of the unitrust amount during the year;
2. Any adjustments to be made to the unitrust amount due to other payments from or contributions to the trust;
3. The valuation dates to use;

4. How nonliquid or hard to value assets shall be valued, how frequently to value them and whether to estimate their value;
5. Whether to omit from the calculations the value of trust property occupied, used or possessed by a beneficiary; and
6. Any other matters necessary for the proper functioning of the unitrust that are not inconsistent with the governing instrument.

VI. SAMPLE PROVISIONS FOR EXPRESS UNITRUSTS.

The following are provisions that might be used for an express unitrust:

(a) *Distributions to the Beneficiary During Continuance of Trust.* During the continuance of the Trust for the Beneficiary, the Trustee shall pay to or for the benefit of the Beneficiary each year an amount equal to four percent (4%) of the average net fair market value of the assets of the trust, said payments to be made in installments convenient to the Beneficiary, preferably monthly in arrears but at least annually. In determining the amount to be paid for a short year, the Trustee shall prorate the same on a daily basis.

(b) *Additional Payments.* If at any time during the lifetime of the Beneficiary, the foregoing payments from the trust are insufficient for the health, maintenance, support, and education of the Beneficiary, the Trustee shall pay to or for the benefit of the Beneficiary such additional sum or sums (“additional payments”) as the Trustee, in the sole discretion of the Trustee, shall deem necessary or desirable for said purposes; provided, however, that the Trustee is discouraged from making additional payments to the Beneficiary, as my primary concern during the continuation of the trust is preservation of the remainder of the trust for ultimate distribution to the remaindermen. In exercising its discretion to make additional payments to or for the benefit of the Beneficiary, the Trustee is encouraged to consider income, resources, or other financial assistance available to the Beneficiary from other sources and such other circumstances and factors as are reasonably known to the Trustee.

(c) *Tangible Property.* I anticipate that the assets of the trust may include, in whole or part, an interest in my homeplace and perhaps other tangible property, which I wish to be available for the

Beneficiary. Accordingly, in addition to the foregoing, the Trustee may make available for the use of the Beneficiary rent-free any tangible real or personal property owned by the trust. Such property shall be made available for the use of the Beneficiary rent-free, however, shall not be included in the fair market value of the trust assets when determining the average net fair market value of the assets of the trust.

(d) *Average Net Fair Market Value.* The average net fair market value of the assets of the trust shall be the average of the net fair market values of the trust assets determined as of the close of the last business day of each of the three (3) preceding years of the trust. In the case of the first year of the trust, however, it shall be based solely on the initial net fair market value of the assets. For the second year, it shall be based upon the average of the initial net fair market value of the assets and the net fair market value of the assets as of the close of the last business day of the first year of the trust. For the third year, it shall be based upon the average of the initial net fair market value of the assets and the net fair market values as of the close of the last business days of the first and second year of the trust. The average net fair market value shall be determined by the Trustee in the Trustee's sole and absolute discretion, and the decision of the Trustee as to such value shall be final and binding on all persons.

(e) *Trustee's Discretion.* The Trustee may, in the Trustee's sole and absolute discretion, from time to time, determine the following:

(1) Notwithstanding the preceding paragraph, the net fair market values of one or more trust assets may be determined on days other than the last business day of a year if the Trustee determines that different valuation days are more appropriate;

(2) Net fair market value may be adjusted to reflect the effect of additions to the trust or distributions of additional payments from the trust;

(3) The Trustee may use reasonable estimates to value non-liquid assets or hard to value assets; and

(4) The Trustee may determine any other matter that is necessary or desirable for the proper functioning of the trust that is not inconsistent with the terms herein.

(f) *Termination of Trust for the Beneficiary.* The Trust shall terminate upon the first to occur of the Beneficiary's death, remarriage, or cohabitation with a member of the same or opposite sex who is not related to the Beneficiary by blood or by marriage.²

VII. CONVERSIONS OF EXISTING TRUSTS.

In addition to providing for express unitrusts, the new statute permits existing trusts to convert to unitrusts. The effect of a conversion is to substitute the unitrust amount for the terms "income" and "net income" in the governing instrument. Other provisions concerning distributions remain unchanged. For example, directions to make discretionary distributions subject to a standard such as health, education, maintenance and support or distributions upon the occurrence of an event such as the attainment of a designated age continue to apply. A provision to sprinkle income or net income among beneficiaries will become a provision to sprinkle the unitrust amount among beneficiaries. If the governing instrument provides for monthly payments of net income, the unitrust amount will be paid monthly.

A. Limitation on Unitrust Percentage.

Unless otherwise ordered by a court, the unitrust percentage for a converted unitrust is to be not less than three percent or more than five percent. ALA. CODE § 19-3A-106(d).

B. Distributions of Principal By a Converted Unitrust.

A conversion to a unitrust does not affect provisions in the governing instrument directing or authorizing the trustee to distribute principal or authorizing a beneficiary to withdraw a portion or all of the principal. ALA. CODE § 19-3A-106(f). Thus, a trustee with discretion to make distributions from principal for support and maintenance will continue to have that discretion.

² A provision terminating the trust upon remarriage or cohabitation will disqualify trust for the marital deduction.

C. Methods to Convert a Pay-All-Income Trust to a Total Return Trust.

ALA. CODE § 19-3A-106 was been added to the Alabama Principal and Income Act to provide procedures for the conversion of an existing trust into a unitrust. There are three conversion methods: nonjudicial conversion upon notice, nonjudicial conversion by consent, and judicially approved conversion.

1. Nonjudicial Conversion Upon Notice by the Trustee. A nonjudicial conversion upon notice is initiated by the trustee. ALA. CODE § 19-3A-106(a). The governing instrument can provide that a nonjudicial conversion upon notice cannot be initiated by the trustee or anyone else.

(a) Required Notice. To make the conversion, the trustee must give written notice to the qualified beneficiaries (within the meaning of ALA. CODE § 19-3B-103(14)) of the trustee's intention to convert the trust into a unitrust.³ The written notice must include—

- (i)** An explanation of how the unitrust will operate;
- (ii)** The effective date of the conversion to a unitrust;
- (iii)** The unitrust percentage to be used;
- (iv)** The provisions for prorating a unitrust distribution for a short year in which a beneficiary's right to payments commences or ceases;
- (v)** Whether the trust assets will be valued annually or more frequently; and

³ A qualified beneficiary is a living beneficiary who, on the date the beneficiary's qualification is determined (A) is a distributee or permissible distributee of trust income or principal; (B) would be a distributee or permissible distributee of trust income or principal if the interests of the distributees described in (A) terminated on that date, but the termination of those interests would not cause the trust to terminate; or (C) would be a distributee or permissible distributee of trust income or principal if the trust terminated on that date. ALA. CODE § 19-3B-103(14).

- (vi) Whether the net fair market value of the trust's assets will be averaged over a designated multiple year smoothing period.
- (b) **Permissive Provisions.** The written notice can, but is not required to, also include other matters for the proper functioning of the unitrust, such as
 - (i) Whether to omit from the calculation of the unitrust amount trust property occupied, used or possessed by a beneficiary,
 - (ii) How nonliquid or hard to value assets will be valued,
 - (iii) How frequently to value nonliquid or hard to value assets, and
 - (iv) Whether to estimate the value of nonliquid or hard to value assets.
- (c) **Beneficiary Requirements.** For a trustee to use a nonjudicial conversion upon notice, there must be at least one *sui juris* income beneficiary and at least one *sui juris* presumptive remainder beneficiary.
 - (i) **Effect of Objections.** The conversion will be made if no beneficiary, or person who may represent and bind a beneficiary who is not *sui juris*, objects to the conversion within 60 days of the mailing of the notice.
 - (ii) **Optional Consent Requirements.** At the option of the trustee, the trustee can also require that specific beneficiaries provide consents to the conversion as opposed to merely not objecting.
- (d) **Trustee's release of power to convert.** A trustee may release, permanently or for a specified period including a period measured by the life of an individual, the power to convert to a unitrust if any of the following apply:
 - (i) The trustee is uncertain about whether possessing or exercising the power will cause an individual to be

treated as the owner of all or part of the trust for Federal income tax purposes, will cause all or part of the trust assets to be subject to Federal estate or gift tax with respect to an individual or will result in the disallowance of a Federal estate or gift tax marital or charitable deduction.

- (ii) The trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subsection (i).

ALA. CODE § 19-3B-106(1).

2. Nonjudicial Conversion by Consent of Qualified Beneficiaries.

A nonjudicial conversion by consent is initiated by the qualified beneficiaries delivering a written instrument to the trustee. ALA. CODE § 19-3A-106(b)(1).

- (a) **Contents of the Consent.** The consent must address the following matters:⁴

- (i) A representation by the qualified beneficiaries that the conversion will enable the trustee to better carry out the intent of the settlor or testator and the purposes of the trust;
- (ii) The effective date of the conversion to a unitrust, which shall not be earlier than 60 days after the date the written instrument is delivered to the trustee, unless the trustee consents to an earlier date, provided that such earlier date is not earlier than the date the written instrument is delivered to the trustee;
- (iii) The unitrust percentage to be used;
- (iv) The provisions for prorating a unitrust distribution for a short year in which a beneficiary's right to payments commences or ceases; and

⁴ These are the same matters that must be addressed when a conversion is made by a nonjudicial conversion upon notice is initiated by the trustee.

- (v) Whether the net fair market value of the trust's assets will be averaged over a designated multiple year smoothing period.
- (b) **Permissive Provisions.** The written instrument can, but is not required to, include other matters for the proper functioning of the unitrust, such as
- (i) Whether to omit from the calculation of the unitrust amount trust property occupied, used or possessed by a beneficiary,
 - (ii) How nonliquid or hard to value assets will be valued,
 - (iii) How frequently to value nonliquid or hard to value assets, and
 - (iv) Whether to estimate the value of nonliquid or hard to value assets.
- (c) **Execution by All Qualified Beneficiaries and the Trustee.** The written instrument must be executed by all qualified beneficiaries and the trustee, whether directly or by representation.
- (d) **Permissive Court Review.** The trustee is permitted, prior to the effective date of the conversion, to seek court confirmation that the foregoing requirements have been satisfied, in which case the conversion will not be effective before the conversion is confirmed by the court.
3. **Judicially Approved Conversions.** A judicially approved conversion is initiated by the trustee or a qualified beneficiary petitioning the court.
- (a) **Criteria.** The court is to order the conversion if the court concludes (i) that the conversion will enable the trustee to better carry out the intent of the settlor or testator and the purposes of the trust or (ii) all qualified beneficiaries have consented to the conversion. ALA. CODE § 19-3A-106(c)(2). The conversion can be approved by the court even if—

- (i) A beneficiary timely objects to the conversion to a unitrust, or
 - (ii) There are no *sui juris* income beneficiaries or *sui juris* presumptive remainder beneficiaries. ALA. CODE § 19-3A-106(c)(1).
- (b) **Required Findings and Provisions of the Court's Order.** The court must make the following decisions to be set forth in the order of the court approving the conversion:
- (i) The effective date of the conversion to a unitrust;
 - (ii) The unitrust percentage to be used;
 - (iii) The provisions for prorating a unitrust distribution for a short year in which a beneficiary's right to payments commences or ceases; and
 - (iv) Whether the net fair market value of the trust assets will be determined annually or averaged over a designated multiple year smoothing period.
- (c) **Permissive Provisions.** The order can, but is not required to, also include other matters as the court deems appropriate for the proper functioning of the unitrust, such as
- (i) Whether to omit from the calculations trust property occupied, used or possessed by a beneficiary,
 - (ii) How nonliquid or hard to value assets shall be valued, how frequently to value them and whether to estimate their value, or
 - (iii) Whether the trust assets will be valued annually or more frequently.
- (d) **Court Costs.** Court costs shall be charged to the trust or as otherwise determined by the court.

D. Conversions that are Not Permitted.

Not all trusts can be converted.

- 1. Prohibited Conversions.** A trust may not be converted into a unitrust in any of the following circumstances:
- (a) If payment of the unitrust amount would change the aggregate annual amount payable to a beneficiary as a fixed annuity;
 - (b) If the trust is an "Institutional Fund" governed by the provisions of ALA. CODE § 19-3C-1, *et seq.*;
 - (c) If the conversion would reduce any amount permanently set aside for charitable purposes under the governing instrument which is not expressed under the governing instrument as "income" or "net income" or determined pursuant to the terms of the governing instrument by reference to "income" or "net income";
 - (d) If the conversion would reduce the value of any interest for which a Federal estate or gift tax charitable deduction has been taken, or would cause the reduction of an amount being disbursed or to be disbursed to a charity for which an income, estate or gift tax deduction has been taken;
 - (e) If possessing or exercising the power to convert would cause an individual to be treated as the owner of all or part of the trust for Federal income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to convert;
 - (f) If possessing or exercising the power to convert would cause all or part of the trust assets to be subject to Federal estate or gift tax with respect to an individual, and the assets would not be subject to Federal estate or gift tax with respect to the individual if the trustee did not possess the power to convert; or
 - (g) If the conversion would result in the disallowance of a Federal estate or gift tax marital or charitable deduction which would be allowed if the trustee did not have the power to convert.

ALA. CODE § 19-3A-106(i).

2. **Exceptions.** If the conversion is prohibited because a trustee possesses the power to convert but there are other trustees, the conversion can be made by the co-trustees whose power is not otherwise be prohibited. ALA. CODE § 19-3A-106 (j)(1). If all trustees or prohibited from exercising the power, the trustees may petition the court to direct the conversion or the beneficiaries may convert without the participation of the trustees. ALA. CODE § 19-3A-106 (j)(2).

E. Rules Governing the Trust After the Conversion.

All of the following apply during the period of time that the trust is a converted unitrust:

1. The term "income" or "net income" in the governing instrument will mean the unitrust amount.
2. The frequency of distributions will be determined in accordance with the governing instrument.
3. If the notice, instrument or order converting the trust provides that the net fair market value of the trust assets are to be averaged over a designated smoothing period, the net fair market value of the trust assets for purposes of determining the unitrust amount will be the average of the net fair market value of the trust assets over the designated smoothing period.
4. Any distribution in excess of the unitrust amount will be deemed to have been paid out of the principal of the trust.
5. Expenses which would be deducted from income if the trust were not a unitrust will not be deducted from the unitrust amount.

ALA. CODE § 19-3A-106(e).

F. Matters Within Trustee's Discretion.

Except as provided in the governing instrument or in the notice, instrument or order converting the trust, the trustee will have the discretion to time determine the following:

1. **Frequency of Payments.** The frequency of payment of the unitrust amount during the year;

2. **Payments to or from the Trust.** Any adjustments to be made to the unitrust amount due to other payments from or contributions to the trust;
3. **Valuation Dates.** The valuation dates to use;
4. **Nonliquid and Hard to Value Assets.** How nonliquid or hard to value assets shall be valued, how frequently to value them and whether to estimate their value;
5. **Property Used by a Beneficiary.** Whether to omit from the calculations the value of trust property occupied, used or possessed by a beneficiary; and
6. **Other Matters.** Any other matters necessary for the proper functioning of the unitrust that are not inconsistent with the notice, instrument or order converting the trust.

ALA. CODE § 19-3A-106(g).

G. Modification after Conversion to a Unitrust.

1. **Persons Who Can Modify a Converted Unitrust.** The unitrust provisions of a converted unitrust may be modified by the trustee, the qualified beneficiaries or the court.
2. **Procedure to Modify.** The procedures to modify a converted unitrust are:
 - (a) A modification by the trustee is accomplished by following the same procedures as those for converting a trust into a unitrust with the exception that the written notice must state the modifications.
 - (b) A modification by the qualified beneficiaries is accomplished by following the same procedures as those for converting a trust into a unitrust with the exception that the written instrument must state the modifications.
 - (c) A modification by the court is set forth in an order of the court.

3. **Permitted Modifications.** The modifications may include any of the following:
- (a) Changes or additions to any of the matters set forth in, or that could have been set forth in, the original notice, written instrument or court order, as the case may be, or any subsequent modifications thereto;
 - (b) Provisions for a distribution of net income, as would be determined if the trust were not a unitrust, in excess of the unitrust distribution if such distribution is necessary to preserve a tax benefit; or
 - (c) Reversion from a unitrust, in which case the trust will be administered in accordance with its provisions prior to its conversion to a unitrust.

ALA. CODE § 19-3A-106(h).

VIII. INCOME TAXATION OF TOTAL RETURN TRUSTS AND THEIR DISTRIBUTIONS.

The most significant difference between taxation of individuals and taxation of trusts is that trusts are allowed a deduction for income distributions made to their beneficiaries. §§ 651 and 661. The taxable income that comprises the distribution deduction is taxed to the beneficiaries. §§ 652 and 662. The result of the distribution deduction is a conduit or pass-through effect to the extent of the taxable income included therein.

A. **Fiduciary Accounting Income.**

The amount of the distribution deduction is based in substantial part on the trust's fiduciary accounting income ("FAI"). FAI is determined under local law (*e.g.*, the Alabama Principal and Income Act) and the applicable will or trust document, not the Internal Revenue Code.

B. **Distributable Net Income.**

The distribution deduction for FAI paid, credited or required to be distributed to a beneficiary is limited to the entity's distributable net income ("DNI"). In addition to limiting the distribution deduction, DNI also determines the amount and character of the beneficiary's income inclusion.

1. **Definition.** DNI is equal to the trust's taxable income computed with the following modifications:
 - (a) **No Distribution Deduction.** The distribution deduction is not taken.
 - (b) **No Personal Exemption.** The personal exemption is not allowed.
 - (c) **Exclusion of Capital Gains and Losses.** Capital gains are excluded unless they are properly includable in the beneficiary's income, as discussed, *infra*. Capital losses are not allowed except to the extent they are taken into account in determining capital gains.
 - (d) **Tax Exempt Interest.** Tax exempt interest is included, but it is reduced by disallowed expenses allocable thereto.

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2. **Limitation.** Tax exempt items are excluded from DNI. §§ 651(b) and 661(b).
3. **Character of Amounts of Income.** The amounts of DNI chargeable to a beneficiary have the same character in the hands of the beneficiary as in the hands of the entity, and they consist of a prorata portion of each class of income, unless the governing instrument provides differently §§ 652(b) and 662(b).
4. **Allocation of Deductions.** Deductions, however, are allocated in accordance with the following rules:
 - (a) **Deductions Attributable to a Class of Income.** Deductions directly attributable to one class of income (*e.g.*, taxes, repairs and expenses related to rental property) are allocated to that class of income. Reg. § 1.652(b)-(3)(a).
 - (b) **Other Deductions.** Deductions that are not attributable to one class of income can be allocated to any income in the DNI, except that a portion must be allocated to any nontaxable income included in the DNI. Reg. § 1.652(b)(3)(b).

C. Simple and Complex Trusts.

Trusts, other than grantor trusts and charitable remainder trusts, are classified as either simple or complex.

1. **Simple Trusts.** A simple trust is a trust required to distribute all of its income currently and which does not distribute principal during the current tax year. § 651(a). A trust is not a simple trust simply because the trustee elects, but is not required, to distribute all FAI during the tax year.
 - (a) **Year-to-Year Consistency is Not Required.** A trust can be a simple trust one year, but not a simple trust the next year.
 - (b) **Trusts that Pay or Set Aside Amounts for Charity.** A trust is not a simple trust if it pays or sets aside amounts for charitable deduction purposes.
 - (c) **Income and Principal.** State trust law (*e.g.*, Alabama UPIA) governs the concept of “income” and “principal” for this purpose, and the tax concepts of gross income and taxable income are irrelevant. § 643(b). Thus, the income of an Alabama unitrust is the unitrust amount, and distributions in excess of that amount are principal distributions.
 - (d) **Distribution Deduction.** The distribution deduction for a simple trust is the amount of FAI required to be distributed currently, whether or not actually distributed. § 651(a). The deduction cannot exceed DNI. § 651(b). The amount deductible by a simple trust is included in the beneficiaries’ income, and the taxable amount retains the same character it had in the hands of the trust. § 652. In this manner, the beneficiary is taxed on the FAI that the beneficiary was supposed to receive during the tax year as though the beneficiary had earned it. The trust is taxed only on any taxable income that remains. This usually includes capital gains from asset sales because they typically are allocated to principal and not FAI.
 - (e) **Actual Distributions Not Required.** For a trust to be a simple trust, it is not necessary that the trustee actually distribute the income during the year. All that is necessary is that the trustee be required under the instrument and state law

to distribute currently the FAI for the tax year. Reg. § 1.651(a)-2(a).

- (f) **Mere Power to Distribute Principal.** A trust does not fail to be a simple trust merely because the trustee has authority to distribute principal. The trust is disqualified as a simple trust only for the years that it actually distributes principal. Reg. § 1.651(a)-3(b).

2. **Complex Trusts.** A complex trust is a trust which is not a simple trust. § 661(a).

- (a) **Distribution Deduction.** The distribution deduction for complex trusts is the sum of the amount of FAI required to be distributed currently, whether or not distributed, plus any other amounts actually distributed. § 661(a) (1). As with simple trusts, the deductible amount is included in the beneficiaries' income, and it retains the character it had in the trust. § 662(a) and (b). The amount is similarly limited by the DNI concept. § 661(b) and 662(a).

- (b) **The Tier System.** If the total amount deemed distributed exceeds DNI, the items required to be distributed currently (the "first tier") are charged to the beneficiaries before the remaining items (the "second tier") are taxed to the beneficiaries. The tier system overrides trust law concepts in determining distributions of FAI. For example, a trust has \$10,000 of FAI, all of it taxable, and \$90,000 of principal. It distributes the \$10,000 FAI to the income beneficiary and the \$90,000 of principal to a successor trust. Rationally, the income beneficiary should be taxed on the \$10,000 FAI distribution, and the successor trust should receive the \$90,000 of principal without tax liability. However, both distributions generally are second tier distributions made during the year. Accordingly one tenth (1/10) (\$10,000/\$100,000) was distributed to the income beneficiary, and the remaining nine tenths (9/10) was distributed to the successor trust. One tenth of the taxable income is charged to the income beneficiary, and nine tenths (9/10) is charged to the successor trust.

- (c) **First Tier Distributions.** Section 662(a)(1) provides that the amount of FAI required to be distributed currently is included

in the gross income of the beneficiaries to whom this amount is required to be distributed. The amount is included in gross income whether or not the distribution is actually made. The amount of the inclusion is limited to DNI.

- (d) **Annuity Payments.** With respect to amounts payable either out of income or corpus (*e.g.*, an annuity), the distribution is regarded as a first tier distribution to the extent it is paid out of income. § 662(a)(1). The wording of the Internal Revenue Code appears to give the trustee some discretion in this regard by permitting the trustee to select whether the distribution will be treated as made from corpus or income. The regulations, however, state that to the extent that there is income which has not been paid, credited, or required to be distributed currently, the payment is treated as being made from income. Reg. § 1.662(a)-2(c).

D. Total Return Trusts Taxation Illustrations.

1. **Simple Trusts.** Assume that the trust requires that net income be distributed no less often than annually, and it is a 4% unitrust. No amounts in excess of the unitrust amount are distributed in the current year. If the net asset value is \$1 million, the unitrust amount is \$40,000.00.

(a) **DNI Less than Unitrust Amount.**

Interest	\$30,000.00	
Capital gains	\$ 0.00	
DNI is \$30,000.00, unitrust amount is \$40,000.00		
Taxed to beneficiary	\$30,000.00	ordinary income
Taxed to trust	\$ 0.00	

(b) **DNI Greater than Unitrust Amount.**

Interest	\$50,000.00	
Capital gains	\$ 0.00	
DNI is \$50,000.00, unitrust amount is \$40,000.00		
Taxed to beneficiary	\$40,000.00	unitrust amount
Taxed to trust	\$10,000.00	remainder of DNI

(c) **Trust has Capital Gains.**

Interest	\$50,000.00	
Capital gains	\$30,000.00	
DNI is \$50,000.00, unitrust amount is \$40,000.00		
Taxed to beneficiary	\$40,000.00	unitrust amount
Taxed to trust	\$10,000.00	ordinary income
	\$30,000.00	capital gains

2. **Complex Trusts.** Assume that the trust requires that net income be distributed no less often than annually, and it is a 4% unitrust. The trust makes distributions that exceed the unitrust amount. If the net asset value is \$1 million, the unitrust amount is \$40,000.00. The trustee in each of these examples distributes \$60,000.00.

(a) **There are no Capital Gains.**

Interest	\$50,000.00	
Capital gains	\$ 0.00	
DNI is \$50,000.00, unitrust amount is \$40,000.00		
Taxed to beneficiary	\$40,000.00	tier 1 ordinary inc.
	\$10,000.00	tier 2 ordinary inc.
Taxed to trust	\$ 0.00	

(b) **Capital Gains are not Allocated to DNI.**

Interest	\$50,000.00	
Capital gains	\$30,000.00	
DNI is \$50,000.00, unitrust amount is \$40,000.00		
Taxed to beneficiary	\$40,000.00	tier 1 ordinary inc.
	\$10,000.00	tier 2 ordinary inc.
Taxed to trust	\$30,000.00	capital gains
Capital gains are prorated between beneficiary and trust.		

(c) **Capital Gains are Allocated to DNI.**

Interest	\$50,000.00	
Capital gains	\$30,000.00	
DNI is \$50,000.00, unitrust amount is \$40,000.00		
Taxed to beneficiary	\$40,000.00	tier 1
	\$20,000.00	tier 2
Taxed to trust	\$20,000.00	
Capital gains are prorated between beneficiary and trust.		

IX. DISTRIBUTIONS OF CAPITAL GAINS.

Capital gains are excluded from DNI to the extent they are allocated to corpus and are not paid, credited or distributed to a beneficiary during the taxable year. § 643(a)(3). The historical effect of this rule is that capital gain income generally is taxed to the estate or trust, not to the beneficiary. The preamble to regulations effective January 2, 2004 that were issued to clarify the rules described the prior rules by stating that “[t]he circumstances in which capital gains are considered paid or credited to a beneficiary during the year, and therefore included in distributable net income, are not entirely clear.”

A. General Rule.

Gains from the sale or exchange of capital assets are ordinarily excluded from DNI and are not ordinarily considered as paid, credited, or required to be distributed to the beneficiaries. Reg. § 1.643(a)-3(a).

B. Circumstances Where the General Rule Does Not Apply.

If permitted or required by 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), gains from the sale or exchange of capital assets are included in DNI (and therefore are taxed to the beneficiary) to the extent they are—

1. Allocated to income;
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.

Reg. § 1.643(a)-3(b).

C. Sample Language.

Language that can be used in a will or trust to make clear that the fiduciary has the power to include capital gains in DNI is as follows:

Distributions of Capital Gains and Other Distributable Net Income Elections. I authorize, but do not require, my Personal Representative and my Trustee, in the sole discretion of my Personal Representative and Trustee, to make elections with respect to income for federal income tax purposes, such as the election to consider some or all the net gains from the sale of capital assets to be part of distributable net income.

D. Effect of Allocating Capital Gains to DNI.

The effect of allocating capital gains to DNI has nothing to do with the determination of the amount that the beneficiary will receive — that is controlled by the governing instrument, the fiduciary’s exercise of discretion and controlling local law. The allocation of capital gain to DNI determines who pays the tax resulting from the capital gain income.

E. Rules Ascertained from Examples in the Regulations.

Some rules that can be discerned from some of the examples in the regulations (other than those applicable to unitrusts) include the following:

1. If a trust realizes capital gain and makes a discretionary distribution of principal without exercising a discretionary power to deem the distribution of principal as being paid from capital gains realized during the year, the capital gains are not included in DNI. Thereafter, the trustee must treat all discretionary distributions of principal as not made from realized capital gains. Reg. § 1.643(a)-3(e), *example 1*.

For example, assume that a trust has the following items of income:

Taxable interest and dividends	\$20,000.00
Capital gains from securities in brokerage account	10,000.00
Capital gains from individually held securities	15,000.00
Capital gains from sale of real estate	<u>25,000.00</u>
Taxable income	<u>\$70,000.00</u>

The trustee distributes the \$20,000.00 of fiduciary accounting income together with a discretionary \$80,000.00 distribution of principal. The trust has not previously distributed principal. If the trustee does not deem the principal as coming from the capital gains, the capital gains tax will be paid by the trust, not the beneficiary.

2. The trustee in *example 1* could have treated discretionary distributions of principal as paid first from net capital gains if the trustee intends to follow a regular practice of doing so. If so, the trustee must thereafter treat all discretionary distributions of principal as made first from realized capital gains. Reg. § 1.643(a)-3(e), *example 2*.
 - (a) If the trustee in the previous illustration elects to adopt a regular practice of treating principal as paid first from net capital gain, the \$80,000.00 principal distribution will include all \$50,000.00 of capital gain. The beneficiary will pay the tax on the capital gain although it does not affect the amount distributed to the beneficiary. All discretionary distributions of principal in future years will include capital gains realized during such years, if any.
 - (b) If the principal distribution was only \$40,000.00, the beneficiary would pay the capital gains tax on \$40,000.00, and the trust would pay the capital gains tax on the remaining \$10,000.00.
3. The trustee can adopt a regular practice of treating discretionary distributions of principal as being paid from net capital gains realized by the trust from the sale of certain specified assets or a particular class of investments. Reg. § 1.643(a)-3(e), *example 3*.
 - (a) For example, assume that the trustee in the previous illustration elects to adopt a regular practice of treating principal as paid first from capital gain realized from the securities in the brokerage account. The beneficiary will pay the tax on the capital gain from the securities in the brokerage account, and the trust will pay the tax on the remaining capital gains.
 - (b) If the principal distribution was only \$5,000.00, the beneficiary would pay the capital gains tax on \$5,000.00, and the trust would pay the capital gains tax on the remaining \$45,000.00.
4. If capital gains realized by a trust are allocated to income pursuant to the terms of the governing instrument in a provision permitted by applicable local law, the realized capital gains are included in the trust's DNI. Reg. § 1.643(a)-3(e), *example 4*.

5. If a trustee decides that discretionary distributions will be made only to the extent the trust has realized capital gains during the year, realized capital gains are included in DNI because the trustee uses the amount of realized capital gain to determine the amount of the discretionary distribution to the beneficiary. Reg. § 1.643(a)-3(e), *example 5*.
6. If a trust's governing instrument directs the trustee to sell certain property and distribute all the sale proceeds to a beneficiary, any capital gain realized from the sale of the property is included in the trust's DNI because the trust uses the amount of the sales proceeds to determine the amount required to be distributed to the beneficiary. Reg. § 1.643(a)-3(e), *example 6*.
7. If a trust is to terminate and the entire principal is to be distributed to a beneficiary at a certain age, all capital gains realized in the year of termination are included in DNI because all the assets of the trust, including all capital gains, will actually be distributed to the beneficiary. Reg. § 1.643(a)-3(e), *example 7*.
8. If the trust in *example 7* is to pay a specific sum to a second beneficiary before distributing the remainder of trust assets to the first beneficiary, none of the capital gains realized during the year of termination is allocated to the trust's DNI with respect to the second beneficiary because the distribution to the second beneficiary is a gift of a specific sum of money. Reg. § 1.643(a)-3(e), *example 8*.
9. If a trust directs the distribution of one-half of the principal to the beneficiary at a certain age and the balance at a later age, and the trustee sells one-half of the assets at the first age and distributes the sales proceeds, those sales proceeds, including all the capital gain attributable thereto, are deemed to be distributed to the beneficiary and all the capital gain is included in DNI. Reg. § 1.643(a)-3(e), *example 9*.
10. If the governing instrument and the applicable state statute of the trust in *example 9* authorize the trustee to determine the extent that the capital gain is distributed to the beneficiary and all of the assets are sold, the distribution to the beneficiary may in the alternative be treated (i) as including all of the capital gain up to the amount of the distribution, (ii) as first being made from basis to the extent thereof, or (iii) as including any amount in between, if the trustee evidences

the treatment by including the appropriate amount of capital gain in DNI on the trust's federal income tax return. For example, if the sole asset of a trust is stock with a value of \$1,000,000 and a basis of \$300,000 that is sold, the trust can treat the distribution of one-half thereof as \$300,000 of principal and \$200,000 of capital gain, as all capital gain, or as capital gain in an amount between \$200,000 and \$300,000. One-half of the capital gain attributable to the sale, however, is included in DNI if the trustee is not authorized by the governing instrument and applicable state statutes to determine the extent that capital gain is distributed to the beneficiary. Reg. § 1.643(a)-3(e), *example 10*.

F. Capital Losses.

Losses from the sale or exchange of capital assets are netted against capital gains at the trust level, other than capital gains that are utilized in determining the amount that is distributed or required to be distributed to a particular beneficiary. Reg. § 1.643(a)-3(d).