

# What You Need To Know About Recent Changes To The Concept Of “Trust Income” Under State Law And The Code

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**This is another in a continuing series of articles written by members of the ABA Tax Section in which a senior member of the section teams up with a member selected from the Young Lawyers Forum.**

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**THIS ARTICLE PROVIDES** a general overview of the mechanics of trust accounting income, and how the implementation of the revised Uniform Principal and Income Act in a majority of states necessitated the revision of the Internal Revenue Code’s treatment of trust income. Specific changes to the definition of trust income, treatment of capital gains, and provisions regarding marital trusts, generation-skipping transfer tax trusts, charitable remainder trusts, and pooled income funds are also addressed. The discussion contained herein is intended to benefit practitioners not familiar with trust accounting income concepts as well as experienced practitioners in the field with a history of and practice tips relating to the 2004 IRS regulations.

**FORMATION AND TAXATION OF TRUSTS: GENERAL CONCEPTS** • Trusts are separate legal fiduciary entities created under state law, and operate as title holders of assets through a fiduciary (trustee) for

their management and administration pursuant to the governing documents and applicable state law. When a trust's controlling instrument is unclear or ambiguous concerning the nature or scope of the authority or powers granted to the trustee, the default provisions pursuant to state law (i.e., principal and income act) will govern.

As in the case of corporations, partnerships, and other entities created under applicable state law, federal law merely outlines the taxation of trusts. Subchapter J of the Internal Revenue Code ("Code") establishes the rules for the federal taxation of trusts. Although the Code provides no specific definition of a "trust," Treas. Reg. §301.7701-4(a) refers to an arrangement created either by will or by lifetime transfer whereby a trustee takes title to property for someone's benefit (i.e., a beneficiary). The trustee has a fiduciary responsibility to protect and conserve the trust property for the beneficiaries under the laws applied by the state courts.

For federal income tax purposes, the basic characteristic of a trust is that of a conduit; the entity is a vehicle designed to pass items of income along to another taxpayer. To the extent income is distributed to the beneficiary, it is taxed to the beneficiary; to the extent it is not distributed, it is taxed to the trust. Income that is earned by a trust is allocated to individual beneficiaries for federal income tax purposes based on the concept of distributable net income ("DNI"). An item of DNI that is passed out to a beneficiary has the same character in the hands of the beneficiary as it did in the trust (e.g., interest income earned by a trust is interest income to the beneficiary). In order to avoid potential double taxation, a trust is allowed a deduction for any amount it distributes to the beneficiaries up to the amount of current DNI. The beneficiaries of the trust include the income distributed to them on their respective income tax returns as part of their adjusted gross income.

To calculate DNI, a trustee uses a particular method of accounting known as trust accounting income ("TAI"), sometimes referred to as fiduciary accounting income ("FAI"), which represents the amount of net receipts that are available for current or future distribution to the income beneficiaries. The allocation of receipts and expenditures to the income or principal accounts is made pursuant to a set of rules generally referred to as "fiduciary accounting."

### **Independent Rules**

When dealing with fiduciary accounting it is important to understand that these rules: (i) are independent of, and often unrelated to, federal and state fiduciary income tax concepts; (ii) are unrelated to, and typically very different from, generally accepted accounting principles ("GAAP") accounting; and (iii) can vary from state to state since each state has tended to slightly modify the Uniform Principal and Income Act.

Fiduciary accounting differs from federal income tax accounting in that there are three separate calculations of income that must be made to prepare one fiduciary income tax return (IRS Form 1041): (i) TAI; (ii) DNI; and (iii) taxable income ("TI"). TAI is not a tax concept, but strictly an accounting concept (with no relevance to GAAP) that is determined with relation to local law. It specifies the amount that the trustee has available to distribute to the income beneficiaries, as directed by the terms of the trust agreement. In general, it is calculated by subtracting the total trust expenditures that are allocated to income from the total trust receipts that are credited to income.

DNI is an income concept created within Subchapter J that is unique to fiduciary income taxation. Section 643(a) provides that DNI is the amount used in determining the portion of the fiduciary's annual income that is transferred to the income beneficiaries and the portion that remains with the fiduciary. The allocation of DNI also determines

the character of income items (such as tax-exempt income) that are passed through to those beneficiaries receiving current income distributions. A trust's TI is the base amount defined in section 641(b) and applicable regulations for calculating the fiduciary's annual income tax liability.

The proper allocation of receipts and disbursements between trust income and principal is the primary objective of trust accounting, and is necessary to determine TAI, which then determines the maximum amount that the trustee is required (or allowed) to distribute to the income beneficiaries according to the terms of the trust agreement. For example, if a trust agreement provides that all of the net income of the trust shall be distributed to the income beneficiary at least annually, then the trustee is required to annually distribute 100 percent of TAI. Accordingly, the amount that the trustee is required to distribute will vary depending on how TAI is calculated.

**UNIFORM STATE LAW ACTS** • Several uniform acts drafted in recent years have been adopted by many of the states.

### **Uniform Principal And Income Act**

As part of the statutory regime governing the creation and regulation of trust entities, all states have principal and income statutes that provide guidance with regard to what items should be allocated to income or to principal for trust accounting purposes. As of January 31, 2007, 41 states have adopted some version of the 1997 Uniform Principal and Income Act ("P&I Act"), as amended in 2000. The P&I Act, originally promulgated by the Uniform Law Commissioners in 1931, was revised in 1962, and completely revised to its current ver-

sion in 1997, which was amended slightly in 2000 (all references to the P&I Act will assume the 1997 Act as amended). The basic purpose of the P&I Act is to ensure that the intention of the trust creator is the guiding principle for trustees. The P&I Act distinguishes between property that is principal, which will be distributed to remainder beneficiaries (persons entitled to trust assets when an income interest ends), and property that is income, distributed to income beneficiaries.

### **Uniform Prudent Investor Act**

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Investor Act (1994), which incorporates the Prudent Investor Rule in the Restatement (Third) of Trusts (1992). The introductory comments to the current P&I Act explain that the revision deals conservatively with the tension between modern investment theory and traditional income al-

location, and is designed to ensure that, when a trust invests in assets that may generate little "traditional" income (i.e., dividends, interest and rents), the income and remainder beneficiaries are allocated reasonable amounts of the total return of the trust (including both traditional income and capital appreciation of trust assets) so that both classes of beneficiaries are treated impartially. The Act also permits the trustee to pay an income beneficiary a "unitrust" amount, where the trustee determines income as a percentage of the annual fair market value of the trust's assets, as well as the discretion to make adjustments between income and principal to treat the income and remainder beneficiaries impartially.

For example, Virginia's Principal and Income Act is closely modeled after the P&I Act and includes statutes authorizing a fiduciary to make adjustments between principal and income (Va. Code §55-277.4) and elect a "total return unitrust" method of income distribution (Va. Code §55-277.4:1). The fiduciary power to adjust is permitted only if the fiduciary believes that under the governing instrument it is not possible to administer the trust impartially, based on what is "fair and reasonable" to all of the beneficiaries, except to the extent that the terms of the trust clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. The statutory unitrust election is generally allowed if the trustee drafts a written policy adopting the unitrust method and neither the grantor (if applicable) nor the beneficiaries (both income and remainder) object.

### **Trustee Power To Reallocate**

The starting point for the updated law of trust investment began with the "traditional system," which viewed all the assets in a trust as a portfolio and assumed that the grantor intended the income beneficiaries to receive a substantial stream of income through dividends, rents, and other interest-producing investments. Although such assets may produce sizeable current income, the assets are often underperforming long-term investments, to the detriment of the remainder beneficiaries. Accordingly, the 1994 Prudent Investor Act was designed to help the trustee who has made a prudent, modern portfolio-based investment decision that has the initial effect of skewing returns from all the assets under management, viewed as a portfolio, as between income and principal beneficiaries. The Prudent Investor Act gives that trustee a power to reallocate the portfolio return suitably.

In light of the new Uniform Prudent Investor "portfolio theory" method of investing, the revised P&I Act provides updated guidance for trustees when allocating trust assets to principal or income.

The drafters do not provide a general definition in the P&I Act, but instead create a group of rules that establish what is principal and what is income with respect to specific kinds of assets.

Of particular importance to the area of taxation of trusts and fiduciary accounting is the trustee's ability to make adjustments between principal and income, which was a catalyst for the updated IRS regulations discussed herein. The discretionary ability to adjust raised concerns among practitioners that such adjustments may be treated as taxable recognition events under section 1001. Because fiduciary accounting rules are exclusively under state law jurisdiction, as states began adopting the revised P&I Act there was an immediate disparity between the treatment of trust income in adopting states and the then-current federal taxation regime. Consistent with the constitutional principle of federalism, the federal government typically respects states' rights to independently draft and adopt their own laws. Because of the consistent treatment afforded by the adoption of the Uniform P&I Act and Prudent Investor Act in a majority of states, the IRS and Treasury were able to react quickly to update the federal income taxation regime to adapt to the state level changes.

**2004 IRS FINAL REGULATIONS** • In response to the national modifications of the P&I and Prudent Investor Acts, Treasury issued proposed regulations on February 1, 2001, which were slightly revised and issued as final regulations effective January 2, 2004, that revised the definition of income under section 643(b) (hereinafter the "Final Regulations"). In addition, the Final Regulations also clarify the situations in which capital gains are included in DNI under section 643(a)(3). Confirming amendments also affect ordinary trusts, pooled income funds, charitable remainder trusts, trusts that qualify for the gift and estate tax marital deduction, and trusts that are exempt from generation-skipping transfer (GST) taxes.

### **Modified Definition Of "Income": Requirements Of §1.643(b)-1**

The Final Regulations rewrite the definition of income for regular trusts. The term "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross" means the amount of income of a trust for the taxable year determined under the terms of the governing instrument and applicable local law. Also, trust provisions departing fundamentally from "traditional principles of income and principal" generally are not recognized. Although these provisions of the section 643(b) regulations remain unchanged, Treas. Reg. §1.643(b)-1 explicitly adopts the modern portfolio theory method of trust administration and provides that 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.

### **Reasonable Apportionment**

This "reasonable apportionment" approach takes into account two significant changes in the P&I Act: the "unitrust" option (where the trustee determines income as a percentage of the annual fair market value of the trust's assets) and the trustee's ability to make adjustments between income and principal to fulfill the trustee's "duty of impartiality" to the beneficiaries. Regarding the unitrust feature, Treas. Reg. §1.643(b)-1 states that a state statute providing the option to determine income as a unitrust amount of no less than three percent and no more than five percent of the fair market

value of the trust assets (the three to five percent represents the IRS's and Treasury's parameters for a "reasonable apportionment" of a trust's total return, being the equivalent of income over a long period of time and encompassing wide variations in economic conditions), whether determined annually or averaged on a multiple-year basis, is a reasonable apportionment of the total return of the trust. The comments to the Final Regulations explain that the IRS and Treasury believe that an allocation to principal of traditional income items should

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be respected for Federal tax purposes only if applicable state law has specifically authorized such an allocation in certain limited circumstances, such as when necessary to ensure impartiality regarding a trust investing for total return. Under the Final

Regulations, a state statute specifically authorizing unitrust payments in satisfaction of an income interest or certain powers to adjust would satisfy that requirement. The IRS and Treasury acknowledge that other non-statutory actions may constitute applicable state law, such as a decision by the highest court of the state announcing a general principle or rule of law that would apply to all trusts administered under the laws of that state. However, a court order applicable only to the trust before the court would not constitute applicable state law for purposes of the unitrust allowance under the Final Regulations.

With a policy rationale similar to the unitrust provision, Treas. Reg. §1.643(b)-1 acknowledges that allocations under state statute that permit the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries are generally a reasonable apportionment of the to-

tal return of the trust. Generally, these adjustments are permitted by state statutes when: (i) the trustee invests and manages the trust assets under the state's prudent investor standard; (ii) the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income; and (iii) the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal is unable to administer the trust impartially.

### **Apportioning Total Return**

Treasury Regulation §1.643(b)-1 also provides that allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part (regardless of which alternative permitted method is actually used), provided the trust complies with all requirements of the state statute for switching methods.

### **Switching Between Methods Generally A Nonrecognition Event**

A significant tax-specific development in the Final Regulations is the section of Treas. Reg. §1.643(b)-1 establishing the rules for switching between methods of distributing income (i.e., to or from a unitrust distribution schedule). If the methods for switching are authorized by state statute and the trust complies with all requirements of that statute, then the switch will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. However, this provision does not apply to switches between methods not specifically authorized by state statute, including a switch via judicial decision or a binding non-judicial settlement. Under those circumstances, the IRS may deem the switch to constitute a recogni-

tion event for purposes of section 1001 and may result in taxable gifts, based on the relevant facts and circumstances.

### **2002 Ruling: Switch To Unitrust A Recognition Event**

This clarification was a relief to many practitioners in light of a 2002 private ruling from the IRS (Pvt. Letter Rul. 200231011), which generally indicated that converting to a unitrust or to a regime in which principal was frequently adjusted to be deemed to be income would result in taxable gain. The private letter ruling dealt with a testamentary trust that was the subject of dispute regarding the administration of the trust. To resolve the conflict, the trustee proposed that it would seek a court order modifying the trust so that the current income beneficiary (who was entitled to income, subject to a floor and a ceiling) would become the beneficiary of a seven percent unitrust interest. The IRS ruled that this modification would result in a section 1001 recognition event because the properties exchanged were materially different under the Supreme Court analysis as set forth in *Cottage Savings Ass'n. v. Comm'r.*, 499 U.S. 554 (1991).

### **Additional Clarifications To "Income"**

The comments to the Final Regulations also clarify the revised definition of "income" for purposes of Qualified Subchapter S Trusts ("QSSTs"), which under Treas. Reg. §1.1361-1(j) are required to distribute all of their income as defined in Treas. Reg. §1.643(b)-1. The comments clarify that the new revisions to the section 643(b) regulations are incorporated into the QSST rules with no additional amendment to the Subchapter S required.

The comments also address the trustee's requirement to make allocations of capital gains to income "consistently" as suggested in the proposed regulations. The Final Regulations qualify the "consistently" requirement and now state that such power does not have to be exercised consistently, as long as it is

exercised "reasonably and impartially." However, if the amount of income is determined by a unitrust amount, the exercise of this discretionary power has no effect on the amount of the distribution, but does affect whether the beneficiary or the trust is taxed on the capital gains. Under these circumstances, the IRS and Treasury will require that the discretionary power must be exercised consistently. Although the Final Regulations do not specify a safe harbor for the unitrust requirement of consistency, the trustee must determine the most pragmatic method and apply it consistently every year.

### Capital Gains And DNI

As a general rule, section 643(a) provides that gains from the sale or exchange of capital assets are generally excluded from DNI to the extent that these gains are allocated to trust principal. Two exceptions are found under sections 643(a)(3)(A) and (B): capital gains that are (i) either paid, credited, or required to be distributed to a beneficiary during the year; or (ii) paid, permanently set aside, or to be used for charitable purposes, although allocated to principal, will still be included in DNI. In certain situations it is easily ascertained whether capital gains are paid to a beneficiary, such as if the trust instrument provides that the proceeds from the sale of a certain asset are to be paid to a beneficiary upon sale; however, such circumstances are relatively rare.

More frequently, a trustee has discretionary power under the trust instrument to make distributions of principal, or the trustee is in a jurisdiction that has adopted the P&I Act and is either making statutorily authorized adjustments between principal and income or is distributing a unitrust amount following a statutory conversion to the unitrust distribution method. In such cases, the amount dis-

tributed does not depend upon how much capital gain is realized during a year and it is difficult to ascertain whether proceeds from sales are actually paid to a beneficiary.

The general rule under revised Treas. Reg. §1.643(a)-3(a) states that 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 any beneficiary. Two exceptions to the general rule apply. The first, concerning the income of foreign trusts under Treas. Reg. §1.643(a)-6, remains unchanged. The second exception is found in §1.643(a)-3(b), which now provides that gains from the sale or exchange of capital assets are included in DNI to the extent they fall, pursuant to the terms of the governing

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instrument and applicable 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 govern-

ing instrument if not prohibited by local law) in any one of three circumstances:

- If such gains are allocated to income, but if income under the applicable 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 or the unitrust amount over the amount of DNI determined without regard to Treas. Reg. §1.643(a)-3(b);
- If such gains are allocated to principal but treated consistently by the trustee on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
- If such gains are allocated to principal but are actually distributed to the beneficiary or used

by the trustee in determining the amount that is distributed or required to be distributed to a beneficiary.

The examples found under Treas. Reg. §1.643(a)-3(e) provide clarification regarding the trustee's "consistency" and "reasonable" standards for making adjustments between principal and income and electing a unitrust distribution method.

### **Trusts Qualifying For The Marital Deduction**

The Final Regulations amend the rules governing marital deduction treatment for transfers to trust in both the gift and estate contexts. Generally, a spouse will be treated as entitled to receiving all net income from a trust, as required for the trust to qualify for the gift and estate tax marital deduction under Treas. Reg. §§20.2056(b)-5(a)(1) and 25.2523(e)-1(f)(1), if the trust is administered under applicable state law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of Treas. Reg. §1.643(b)-1 as discussed herein. Thus, a spouse who, as the income beneficiary, is entitled in accordance with the state statute and governing instrument to a unitrust amount of no less than three percent and no more than five percent would be entitled to all the income from the trust for purposes of qualifying the trust for the marital deduction. Again, in the absence of a state statute, or, for example, a decision of the highest court of the state applicable to all trusts administered under that state's law, the "applicable law" standard will not be satisfied.

The Final Regulations also apply to qualified terminable interest property (QTIP) elections under section 2056(b) and qualified domestic trusts ("QDOTs") under section 2056A. The revised Treas. Reg. §20.2056(b)-7 QTIP election requirements

state that a power under applicable local law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between income and remainder beneficiaries, and that meets the requirements of Treas. Reg. §1.643(b)-1, will not be considered a power to appoint trust property to a person other than the surviving spouse. Similarly, Treas. Reg. §20.2056A-5 allows for the same treatment for QDOTs, and also allows for a unitrust amount if permitted under applicable local law.

### **Marital Trusts**

Regarding marital trusts that are the named beneficiary of a decedent's individual retirement account (IRA) or other qualified retirement plan under section 4974(c) (a defined contribution plan), Rev. Rul. 2006-26, 2006-22 I.R.B. 939, addresses the issue of determining under what circumstances the surviving spouse is considered to have a qualifying income interest for life in an IRA or qualified plan, and also in the trust for purposes of a QTIP election. The ruling provides practical guidance concerning when such assets meet the QTIP requirements in three situations: (i) when a trustee is authorized under state law to make adjustments between income and principal; (ii) when the trustee is authorized under state law to determine the income of the trust as a unitrust amount of a fixed percentage of the trust assets; and (iii) when the trust operates in a state that has not adopted the current P&I Act.

### **GST Tax Exempt Trusts**

Pursuant to the Tax Reform Act of 1986, trusts that were irrevocable on September 25, 1985, are exempt from the GST tax, and such trusts are referred to as "grandfathered" trusts. Accordingly,

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**The Final Regulations also apply to qualified terminable interest property (QTIP) elections under section 2056(b) and qualified domestic trusts ("QDOTs") under section 2056A.**

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a grandfathered trust may make distributions to people two generations or more below the original transferor without the imposition of GST tax, and it is often critical to maintain their grandfathered status, because the GST tax rate on transfers after December 31, 2006, and before January 1, 2010, is 45 percent. Similar to the concerns regarding section 1001 recognition after the 2002 private letter ruling discussed above, many practitioners were concerned that, by changing a grandfathered trust that distributed all income to a beneficiary to a unitrust under the state statute, or by adjusting between income and principal for such a trust, the trust would lose its grandfathered status.

As allowed in the section 643(b) regulations, the applicable GST Final Regulations allow trustees of grandfathered GST trusts to make a unitrust election if available under statute, as well as adjustments between income and principal, also if allowed under the governing instrument and state law. Specifically, Treas. Reg. §26.2601-1(b)(4)(i)(D)(2) provides that administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of Treas. Reg. §1.643(b)-1. For additional guidance, Treas. Reg. §26.2601-1(b)(4)(i)(E) Examples 11 and 12 provide illustrations of conversions of income interests to a unitrust and to an equitable adjustment regime, respectively.

### **Charitable Remainder Trusts**

Only charitable remainder trusts that make distributions partially by reference to "income" are affected by the Final Regulations, including Net In-

come Charitable Remainder Unitrusts (NICRUTs) and Net-Income-with-Makeup Unitrusts (NIMCRUTs). Neither Charitable Remainder Annuity Trusts (CRATs) nor Charitable Remainder Unitrusts (CRUTs) that pay only a unitrust interest are affected.

Under Treas. Reg. §1.664-3(a)(1)(i)(b)(3) as amended under the Final Regulations, although trust income generally means income as defined under section 643(b), trust income for affected charitable remainder trusts may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law. Further, gains from the sale of assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust. Also, capital gains may not be allocated to trust income at least to the extent of the trust's purchase price of those assets. These exceptions are directed at discretion given the trustee under the terms of the governing instrument to allocate capital gains to income in some years and not others. As explained in the Final Regulation introductory comments, allowing the trustee this type of discretion is inconsistent with the requirements for NICRUTs and NIMCRUTs as discussed in their applicable legislative history.

Except for the two circumstances described above, Treas. Reg. §1.664-3(a)(1)(i)(b)(3) provides that proceeds from the sale or exchange of any assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

It should be noted that the current P&I Act fails to adequately address the calculation of TAI when the trust holds certain assets such as hedge funds or similar limited partnership interests. Although the P&I ACT provides that receipts received from an entity are all treated in the same manner, the nature of hedge funds and similar pass-through entities makes an accurate TAI calculation nearly impossible for NICRUTs and NIMCRUTs. Accordingly, a trustee may elect to avoid holding such assets in these types of trusts.

### **Pooled Income Funds**

Although the Final Regulations regarding pooled income funds (“PIFs”) keep the same section 643(b) (and applicable regulations thereunder) definition for the term “income,” Treas. Reg. §1.642(c)-2(c) is amended to provide that no amount of net long-term capital gain shall be considered permanently set aside for charitable purposes if, under the terms of a PIF’s governing instrument and applicable local law, the trustee has the power, whether or not exercised, to satisfy the income beneficiaries’ right to income by the payment of either: (i) an amount equal to a fixed percentage of the fair market value of the fund’s assets (whether determined annually or averaged on a multiple-year basis); or (ii) any amount that takes into account unrealized appreciation in the value of the fund’s assets. In other words, the charitable deduction for a contribution of long-term capital gain property is unavailable if the income beneficiary’s right to income may be satisfied

either as a unitrust amount or by adjusting between income and principal.

If applicable state law allows a unitrust definition of income for PIFs that would disqualify a contribution to a PIF from receiving the charitable deduction, the fund had until September 2, 2004, to reform the fund’s governing instrument. Accordingly, practitioners establishing new PIFs should be aware of any potential state law conflict in the jurisdiction of the newly formed entity and incorporate such restrictions in the governing document.

**SUMMARY** • The Final Regulations are an important reconciliation of changing state law trust concepts and the federal income tax regime. In addition to the clarifications regarding trust income, trustees are expressly authorized to make statutorily

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ly authorized adjustments between principal and income or elect a unitrust distribution method without fear that such actions will give rise to a taxable recognition event under

section 1001 or jeopardize a grandfathered GST trust status. Also, the revisions clarify the income tax treatment of capital gains for trustees and beneficiaries when such income adjustment and unitrust conversion statutes are used.

Specific to marital trusts, drafters can now craft marital deduction trusts as unitrusts, so long as the unitrust amount to the spouse falls within the three to five percent range (or the percentage specifically authorized by state statute) if allowed under applicable state law.

**PRACTICE CHECKLIST FOR**  
**What You Need To Know About Recent Changes To The Concept**  
**Of "Trust Income" Under State Law And The Code**

In light of the new Uniform Prudent Investor "portfolio theory" method of investing, the revised P&I Act provides updated guidance for trustees when allocating trust assets to principal or income. Of particular importance to the area of taxation of trusts and fiduciary accounting is the trustee's ability to make adjustments between principal and income, which was a catalyst for the updated IRS regulations. The discretionary ability to adjust raised concerns among practitioners that such adjustments may be treated as taxable recognition events under section 1001.

- The Final Regulations rewrite the definition of income for regular trusts.
  - \_\_\_ The term "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross" means the amount of income of a trust for the taxable year determined under the terms of the governing instrument and applicable local law.
  - \_\_\_ Also, trust provisions departing fundamentally from "traditional principles of income and principal" generally are not recognized.
  - \_\_\_ Although these provisions of the section 643(b) regulations remain unchanged, Treas. Reg. §1.643(b)-1 explicitly adopts the modern portfolio theory method of trust administration and provides that 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.
- With a policy rationale similar to the unitrust provision, Treas. Reg. §1.643(b)-1 acknowledges that allocations under state statute that permit the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries are generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when:
  - \_\_\_ The trustee invests and manages the trust assets under the state's prudent investor standard;
  - \_\_\_ The trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income; and
  - \_\_\_ The trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal is unable to administer the trust impartially.

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