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All You Really Need to Know About Subchapter J You Learned from This Article

*Jeffrey G. Sherman**

Homer tells us that Odysseus, during his epic voyage home, had to sail his ship through a narrow straight, only as wide as a bowshot, guarded by two monsters. On one side was Scylla, an enormous creature with six heads and twelve feet, who devoured whatever came within reach and who had a distinct partiality for fresh mariners. On the other side lay Charybdis, who, like a monstrous whirlpool, swallowed the sea's waters and then spewed them forth again three times a day. Evading the jaws of Scylla only brought one closer to Charybdis and vice, I need hardly say, versa.[1]

Time was when the intrepid law scholar or practitioner having to come to grips with a problem involving the Rule Against Perpetuities likewise found herself between Scylla and Charybdis, obliged to choose between terse, reductive summaries calculated to leave her feeling dangerously overconfident, and lengthy, punctilious treatises offering far more detail than was promptly comprehensible.[2] In 1938, Professor W. Barton Leach charted a happy course

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* Professor of Law, Chicago-Kent College of Law, Illinois Institute of Technology; A.B. 1968, J.D., 1972, Harvard. This Article has benefitted immensely from the challenging questions and thoughtful suggestions of Mark Ascher and, thanks to a splendid Internet automated mailing list called TAXPROF, John Bogdanski and Joseph Dodge. I must also thank my student research assistants, Mark Berggren and James Goodrich, for their exceptional skill and diligence. And I should like to thank the Marshall D. Ewell Research Fund for providing support for writing this article.

1. How did Odysseus overcome these twin perils? Read the book.

2. The first edition of John Chipman Gray's classic treatise, *The Rule Against Perpetuities*, published in 1886, ran to 499 pages. By 1942, the date of the fourth edition, the work had expanded to 895 pages.

between these two extremes with his classic article *Perpetuities in a Nutshell*,[3] and a half-century later Professor Jesse Dukeminier renewed and reinvigorated the enterprise with his *Modern Guide to Perpetuities*.[4] These splendid articles offered the reader a thorough, accessible guide to perpetuities law, uncluttered but rigorous and free of oversimplification.

I hope in this article to do for Subchapter J of the Internal Revenue Code[5] what Professors Leach and Dukeminier did for the Rule Against Perpetuities. Subchapter J deals with the income taxation of trusts and estates, and its daunting reputation for abstruseness and complexity make it a fit analog indeed to the R.A.P. Yet however abstruse and complex Subchapter J may be, the scholar and the practitioner often need to ply its choppy waters, and this article is presented to give the scholar or practitioner, in a single sitting, a command of the essentials of the income taxation of estates and noncharitable trusts.[6]

I. ESTATES AND TRUSTS AS SEPARATE TAXABLE ENTITIES

When we speak of a decedent's "estate," we are using a technical term of property law whose meaning is best approached by considering the two kinds of assets that a decedent might own at death: nonprobate assets and probate assets.

A nonprobate asset is an asset created by an instrument that specifies where the asset is to pass upon the death of the current owner. Joint tenancies are perhaps the simplest example of nonprobate assets. Suppose O conveyed Blackacre to A and B in joint tenancy. When A dies, her undivided one-half interest in Blackacre is a nonprobate asset because the very instrument that created A's interest in Blackacre—the deed from O—specifies where that interest is to pass upon A's death: to B, by right of survivorship. Similarly, if A purchased a $100,000 life insurance policy on her own life and designated C as the beneficiary, the $100,000 policy proceeds upon A's death are a nonprobate asset of A's because the instrument that "creates" or manifests that $100,000 asset—the insurance contract with its associated designation-of-beneficiary form—specifies where that asset is to go upon A's death: to C by the terms of A's contract with the insurer.

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3. 51 HARV. L. REV. 638 (1938). Some years later, Professor Leach wrote an updated version, *Perpetuities: The Nutshell Revisited*, 78 HARV. L. REV. 973 (1965).

4. 74 CAL. L. REV. 1867 (1986). I am indebted to Professor Dukeminier's article for the device of beginning with a tale from Greek mythology.

5. I.R.C. §§ 640-91 (West Supp. 1997).

6. The scholar or practitioner in need of further elaboration can choose from among three excellent treatises: M. CARR FERGUSON ET AL., FEDERAL INCOME TAXATION OF ESTATES, TRUSTS, AND BENEFICIARIES (2d ed. 1997); JOHN L. PESCHEL & EDWARD D. SPURGEON, FEDERAL TAXATION OF TRUSTS, GRANTORS AND BENEFICIARIES (2d ed. 1989); NORMAN M. LANE & HOWARD M. ZARITSKY, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS (2d ed. 1993).

A probate asset is an asset that is *not* represented by a document specifying an order of succession. If O conveyed Whiteacre to A in fee simple absolute, Whiteacre is a probate asset of A's upon A's death because the conveyance that created A's interest in Whiteacre does not name a successor in interest upon her death. Similarly, if A opened a bank account in her own name alone, then, upon her death, the money in that account is a probate asset.

A decedent's "estate" is the combined probate assets that she owned at death. Sometimes practitioners use the phrase "probate estate" instead of "estate" to distinguish the property law term from a confusingly similar tax law term: "gross estate." "Estate" and "probate estate" are interchangeable expressions, but "gross estate" means something quite different.

In the case of probate assets, we need to look to some extrinsic document—either a will or an intestacy statute—to identify the persons authorized to succeed to the decedent's title to the property. In the case of nonprobate assets, on the other hand, recourse to a will or intestacy statute is unnecessary inasmuch as the embodying document, such as the deed or life insurance contract, identifies the successors in interest. Thus, when an individual dies, her will (or, if none, then the applicable intestacy statute) controls only the devolution of her probate assets: only the devolution of her estate. If A, in our example, had executed a will providing, "I devise and bequeath all my property to X," all of A's probate assets (such as Whiteacre and the bank account) would indeed be distributed to X. But A's one-half interest in Blackacre would pass not to X but to B, and the $100,000 of insurance proceeds would be distributed to C, because Blackacre and the insurance proceeds are not part of A's "estate."

When an individual dies, a court of probate appoints a "personal representative"[7] to collect and take charge of the decedent's probate assets; pay debts, expenses, and taxes; and then distribute the remaining assets to the persons designated by the decedent's will or the applicable intestacy statute. Several years may elapse between the date of the decedent's death and the date on which the personal representative makes final distribution of the estate assets to the decedent's heirs or legatees. During that time, the assets in the estate, if they were income-producing before the decedent's death, continue to produce income.

Who is required to pay the income tax on the income realized during the period of estate administration? In fashioning a statutory answer to this question,

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7. If the decedent died intestate, the personal representative's title is *administrator*. If the decedent left a valid will nominating someone to serve as personal representative and the probate court appoints the person so named, the person's title is *executor*. If the decedent left a valid will but the probate court appoints as personal representative someone not nominated in the decedent's will (either because the will nominates no one or because the person nominated in the will is unable or unwilling to serve), the person's title is *administrator c.t.a.*. C.t.a. stands for "*cum testamento annexo*," which means "with the will annexed."

Congress had a number of options available to it. One option would have been to require the personal representative to pay the income tax out of his own pocket, but such a regime would discourage disinterested nonfamily parties (such as professional fiduciaries) from accepting fiduciary appointments. A second option would have been to treat the estate like a partnership under Subchapter K[8] and impose the income tax on the estate's beneficiaries, who ultimately would inherit the property. But such a rule would tax an individual on income prior to its receipt; indeed, if the beneficiary died before the date of actual distribution of the income, he would have paid tax on income that he never lived to receive.

The regime that Congress adopted, set forth in Subchapter J of the Internal Revenue Code, treats the estate as a separate income-tax-paying entity, like an individual or a corporation. Trusts, too, are treated as separate income-tax-paying entities, except for grantor trusts[9] and "Mallinckrodt" trusts,[10] which are not discussed in this article. Trusts and estates have "gross income" and "deductions," and when the latter are subtracted from the former, the trust or estate's "taxable income" remains. The trust or estate pays income tax on that taxable income, using the tax rates set forth in Section 1(e).[11] Any receipt that would be includable in an individual's gross income if received by an individual is includable in a trust's or estate's gross income if received by the trust or estate.[12] And, with a few exceptions and refinements, any expense that would

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8. I.R.C. §§ 701-761 (West Supp. 1997).

9. A "grantor trust" is a trust over which the grantor has retained so much control, or in which the grantor has retained so great an interest, that the trust's gross income and deductions are taxed or imputed directly to the grantor; the trust is not treated as a separate taxable entity. I.R.C. §§ 673-77 (West Supp. 1997).

10. A "Mallinckrodt" trust is a trust one of whose beneficiaries has been given so great a power of control over the trust's income that the trust's gross income and deductions are taxed or imputed directly to such beneficiary; the trust is not treated as a separate taxable entity. I.R.C. § 678 (West Supp. 1997). This statutory provision codifies a doctrine announced in *Mallinckrodt v. Nunan*, 146 F.2d 1, 5 (8th Cir.), *cert. denied*, 324 U.S. 871 (1945).

11. I.R.C. § 1(e) (West Supp. 1997).

12. Treas. Reg. § 1.641(a)-2 (1960). Under the law of a few states, title to certain assets of a decedent (land, in the case of intestacy; specifically devised or bequeathed property, in the case of testacy), instead of vesting initially in the personal representative and subsequently passing to the heir or devisee when the personal representative distributes the property, passes directly from the decedent to the heir or devisee without first vesting in the personal representative. While the personal representative takes possession of such an asset, she holds it only as agent for the heir or devisee until distribution. Local law may also dictate that any income earned by such an asset, while the asset is in the hands of the personal representative, is deemed to have been realized directly by the heir or devisee. Under such circumstances, even though the personal representative is the actual recipient of such income, she is deemed to have received it only as agent for the heir or devisee; the income is included in the heir's or devisee's

be deductible from an individual's gross income if paid by the individual is deductible by a trust or estate if paid by the trust or estate.[13]

The tax rates applicable to trusts and estates are more steeply graduated than those applicable to individuals. An unmarried individual (other than a head of household) does not reach the highest marginal income tax rate of 39.6% in 1997 until he has received $271,050 of taxable income.[14] A trust or estate, on the other hand, reaches the top 39.6% bracket after only $8,100 of taxable income.[15] Consequently, trusts and estates no longer offer the income-splitting advantages that they once did; the maximum annual income tax saving that can be derived from having income taxed to a trust rather than to an individual is $920.[16] Nonetheless, trusts offer so many administrative advantages that they will continue to be a popular device for transferring or holding property. Estates will continue to be necessary, if not popular.

An estate generally continues its existence as a separate taxable entity for as long as the estate remains "open," *i.e.*, for as long as there remain undistributed probate assets in the hands of the executor or administrator. In cases where a legal dispute exists as to the proper heirs or legatees or as to the proper amount of death taxes due, the estate will be kept open until the dispute is resolved, for an executor or administrator can be held personally liable to the IRS for unpaid estate taxes,[17] and personally liable to the decedent's intended beneficiaries for estate assets improperly paid to unauthorized transferees.[18] Back in the era when an estate was likely to be in a lower tax bracket than the beneficiaries, executors often were tempted to prolong the administration of the estate to maximize the number of taxable years during which the decedent's

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gross income, not in the estate's gross income. *See* Treas. Reg. § 1.661(a)-2(e) (as amended in 1973).

13. Treas. Reg. § 1.641(b)-2 (as amended in 1961).

14. I.R.C. § 1(c) (West Supp. 1997).

15. The 20% cap on the marginal tax rate imposed on gains from the sale of capital assets held for longer than 18 months and the 28% cap imposed on gains from the sale of capital assets held for more than 12 but not more than 18 months apply in the case of estates and trusts.

16. Since a trust or estate reaches the top 39.6% bracket after only $8,100 of taxable income, income tax saving (by shifting income from an individual to a trust) is possible only with respect to the first $8,100 of income. If a beneficiary is in the 39.6% bracket, an additional $8,100 of income taxed to him will give rise to an additional $3,207 of tax. If, instead, the asset yielding that $8,100 of income had been placed in trust and the $8,100 taxed to the trust, the income tax liability of the trust would have been $2,287, a saving of only $920 in income taxes.

17. United States v. Cruikshank, 48 F.2d 352, 354 (S.D.N.Y. 1931); Leigh v. Commissioner, 72 T.C. 1105, 1109 (1979).

18. Madden v. Phelps, 671 A.2d 870, 871 (Del. Ch. 1995); Shepherd v. Townsend, 162 So. 2d 878, 881 (Miss.), *suggestion of error overruled by* 163 So. 2d 746 (Miss. 1964); Pourney v. Seabaugh, 604 S.W.2d 646, 651 (Mo. Ct. App. 1980).

family benefitted from the income-splitting opportunities afforded by the estate. Although changes in the tax rates have eliminated much of the tax incentive to prolong administration, the regulations continue to warn that if the administration of an estate is unduly prolonged, the estate is considered terminated for federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration, even if state probate law permits the continuation of administration beyond that period.[19]

The regulations provide a similar rule for trusts:

> A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust . . . . However, the winding up of a trust cannot be unduly prolonged and if the distribution of the trust corpus is unreasonably delayed, the trust is considered terminated for [f]ederal income tax purposes after the expiration of a reasonable period for the trustee to complete the administration of the trust.[20]

When an estate or trust is treated, under the above regulation, as terminated for income tax purposes before it is terminated in fact, "the gross income, deductions, and credits of the estate or trust are, subsequent to the [tax-law] termination, considered the gross income, deductions, and credits of the person or persons succeeding to the property of the estate or trust."[21]

A. Combining Multiple Trusts

Suppose a grantor owns some stock that produces $13,200 of income per year. If she places all the stock in a single trust and the income is taxed to the trust, only the first $1,650 of income will be taxed at the 15% rate; the next $2,250 will be taxed at 28%; the next $2,050 at 31%; the next $2,150 at 36%; and the last $5,100 at 39.6%. The total tax will be *$4,307*. If, however, she divides the stock into eight equal portions, placing each portion in a separate trust, each trust's $1,650 of income will be taxed at the 15% rate, so the total tax will be only *$1,980*. To prevent the use of multiple trusts as a device for exploiting the lowest bracket by dividing income, Section 643(f) provides that the separate trusts are regarded as a single trust for income tax purposes if: (1) they have substantially the same grantor or grantors and substantially the same

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19. Treas. Reg. § 1.641(b)-3(a) (1964).

20. Treas. Reg. § 1.641(b)-3(b) (1964). The regulation under Section 641 does not define the term "person or persons succeeding to the property of the estate or trust," but the regulation under Section 642 does. We shall discuss that term at Examples 6 and 7, *infra*.

21. Treas. Reg. § 1.641(b)-3(d) (1964).

primary beneficiaries; and (2) a principal purpose (not necessarily *the* principal purpose) of such trusts is the avoidance of income tax.[22] For purposes of the multiple trust rule, a husband and wife are considered one person.

B. Filing Returns

The trust's or estate's income tax return (Form 1041) is filed and the tax paid by the fiduciary, but the taxpayer primarily liable for the tax is the estate or trust. Thus, in the first instance, the fiduciary pays the tax not out of her own pocket but out of the income or principal (sometimes called "corpus"[23]) of the trust or estate, state law being consulted to determine what portion of the income tax is to be paid out of principal and what portion out of income.[24] In certain exceptional circumstances, however, secondary liability for unpaid income taxes may be imposed personally on the fiduciary or on the beneficiaries of the trust or estate.[25]

Suppose Smith dies on March 5, 1998. Smith's executor or administrator will have to file Smith's "final income tax return" for the short taxable year running from January 1, 1998, through March 5, 1998. The due date for the return for this short year is the filing date that would have applied had the taxpayer lived—April 15, *1999*. If Smith owned some dividend-paying stock as a probate asset at her death, any dividends received on that stock in 1998 while Smith was alive will be reported on that final individual return (Form 1040); any dividends received after Smith's death will be reported as estate income on the estate's fiduciary income tax return (Form 1041).

While trusts are required to use the calendar year as their taxable year, estates may elect their taxable year. In the case of Smith's estate, the shortest permissible initial taxable year would run from March 6, 1998, through March

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22. Before Section 643(f) was added to the Code in 1984, the Service sought to foreclose this tax-avoidance opportunity by regulation, but a number of Tax Court decisions held the regulation invalid. *E.g.*, Stephenson Trust Co. v. Commissioner, 81 T.C. 283, 294 (1983); *see also* Estelle Morris Trusts v. Commissioner, 51 T.C. 20, 44 (1968), *aff'd*, 427 F.2d 1361 (9th Cir. 1970).

Originally, the rule of Section 643(f) applied "to tax years beginning after March 1, 1984." Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 82(b), 98 Stat. 494, 598 (current version at 26 U.S.C. § 643 (West Supp. 1997)). But, two years later the effective date was modified so that in the case of a trust which was irrevocable on March 1, 1984, Section 643(f) applies only to that portion of the trust which is attributable to contributions to corpus made after March 1, 1984. Tax Reform Act of 1986, Pub. L. 99-514, Sec. 1806(b).

23. Familiarity with correct Latin plurals bespeaks intellectual refinement. Be advised, then, that the plural of *corpus*, a Latin third-declension neuter, is *corpora*: like *genera* for *genus* and *opera* for *opus*.

24. *See* UNIF. PRINCIPAL & INCOME ACT §§ 505-06 (1997).

25. *See* LANE, *supra* note 6, ¶ 16.04.

31, 1998, with the first Form 1041 being due July 15, 1998; thereafter, future taxable years would end on each March 31. The longest permissible initial taxable year would run from March 6, 1998, through February 28, 1999, with the first Form 1041 being due June 15, 1999; thereafter, future taxable years would end on each February 28 or 29.

The executor's power to select a taxable year for the estate provides an early post-mortem estate planning opportunity, and tax-deferral certainly is one of the considerations to be weighed in making that selection. Because the Subchapter J rules make it impossible for a beneficiary who receives a distribution from a trust or estate to calculate her income tax until the trust or estate has calculated *its* income tax for the year of distribution, Sections 652(c) and 662(c) provide that if a beneficiary's taxable year is different from that of the trust or estate, all distributions to the beneficiary made during the trust's or estate's taxable year are deemed to have been received by the beneficiary on the last day of that taxable year. If the executor wishes to choose a taxable year that produces the greatest deferral period for beneficiaries who report income on a calendar-year basis, the best choice is the fiscal year ending January 31. In that event, if the estate distributes property to a beneficiary on February 1, 1998, the beneficiary will be deemed to have received it on January 31, 1999, and accordingly the beneficiary will report that income on her 1999 return, which is not due until April 15, 2000.[26] The executor's selection of a January 31 taxable year allows the beneficiary to defer her tax for almost two years.

C. The Meaning of "Income"

Drafting income tax rules applicable to estates and trusts is complicated by the fact that the word "income" has two meanings: income for fiduciary accounting purposes and income for tax purposes. Fiduciary accounting income comprises the receipts that, under local fiduciary law or practice, are allocated to the trust's or estate's income account. Suppose the terms of a trust direct that all the trust's income is to be paid to A, and that upon A's death, the trust corpus is to be distributed to B. If the trustee receives a particular sum and concludes that the sum constitutes income for fiduciary accounting purposes, then the sum must be distributed currently to A. If, on the contrary, the sum is principal, it must be added to the corpus for eventual distribution to B. (During the time that the sum constitutes part of the trust's corpus, the sum will yield income distributable to A.)

The rules determining what is income for fiduciary accounting purposes differ from those determining what is income for tax purposes. For example, although the interest paid on municipal bonds clearly is not income for federal

26. Actually, the date would be April 17, inasmuch as the 15th falls on a Saturday.

income tax purposes,[27] it is income for fiduciary accounting purposes.[28] Conversely, if the corpus contains a capital asset and the trustee sells the asset for a profit, the profit ("capital gain") is income for federal income tax purposes but is considered an addition to the trust's principal. Thus, when the word "income" appears in a Section of the Code dealing with the income taxation of trusts or estates, the question arises: does the word refer to fiduciary accounting income or to income for federal income tax purposes? Section 643(b) provides that for purposes of Sections 641 to 667, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means income for fiduciary accounting purposes.

No necessary correlation exists between a trust's or estate's fiduciary accounting income and its taxable income. To the extent expenses that are deductible as a matter of tax law are charged to principal as a matter of fiduciary accounting law or practice, the fiduciary accounting income may exceed taxable income. Similarly, if the trust or estate receives tax-exempt interest, the entity's fiduciary account income may exceed its taxable income. To the extent, however, that the trust or estate recognizes capital gains, which are allocable to principal, the entity's taxable income may exceed its fiduciary accounting income.

D. Special Rules Regarding Deductions

In general, the rules for determining deductibility are the same for trusts and estates as for individuals, but several special rules do apply:

1. Trusts and estates are not permitted to claim the standard deduction; they must "itemize."[29]

2. Instead of the personal exemption deduction granted to individual taxpayers by Section 151, a much smaller personal exemption deduction is granted to trusts and estates by Section 642(b): $600 in the case of an estate; $300 in the case of a trust whose governing instrument requires all of its income to be distributed currently to the beneficiaries; and $100 in the case of any other trust.

3. Trusts and estates are allowed a deduction for items included in the trust's or estate's gross income but distributed to beneficiaries in the year received. We shall examine this distribution deduction in more detail, shortly.[30]

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27. I.R.C. § 103 (West Supp. 1997).

28. *See* UNIF. PRINCIPAL & INCOME ACT §§ 401, 412(a) (1997).

29. I.R.C. § 63(c)(6)(D) (West Supp. 1997). A trust's or estate's itemized deductions are not subject to the Section 68 limitations. Those limitations, which reduce a taxpayer's allowable itemized deductions as the taxpayer's income increases, apply only to individuals.

30. *See infra* text accompanying note 60.

4. Some expenses or losses incurred in administering a decedent's estate, which are deductible for income tax purposes, likewise are deductible for estate tax purposes pursuant to Section 2053 or 2054. As a condition of deducting all or part of such an expense or loss on the estate's income tax return, the executor must file with the Service a formal written waiver of the right to claim the corresponding estate tax deduction.[31]

5. A taxpayer may not claim any "miscellaneous itemized deductions,"[32] such as unreimbursed employee expenses and expenses incurred for the production of income,[33] except to the extent the total of such deductions exceeds 2% of the taxpayer's adjusted gross income.[34] This 2% floor does not apply, however, with respect to "costs which are incurred in connection with the administration of [an] estate or trust and would not have been incurred if the property were not held in such trust or estate."[35] For example, if an individual paid someone to prepare her individual income tax return (Form 1040), that expense would be a miscellaneous itemized deduction, deductible pursuant to Section 212(3) and therefore subject to the 2% floor. If a fiduciary pays someone to prepare the estate's or trust's fiduciary income tax return (Form 1041), that expense, though a miscellaneous itemized deduction, may be deducted in full, without regard to the 2% floor, because the expense of preparing the Form 1041 is incurred only because the property producing the income is "held in such trust or estate."[36]

Fiduciaries' fees present a more difficult case under Section 67(e). The portion of a fiduciary's fee attributable to his preparation of annual accounts for the beneficiaries is deductible without regard to the 2% floor, inasmuch as that cost would not have been incurred had the property not been held in a trust or estate. But suppose a portion of the fee is attributable to the furnishing of investment advice, either by the trustee himself or by someone he hired. Would such a cost, though clearly deductible pursuant to Section 212, be subject to the

31. I.R.C. § 642(g) (West Supp. 1997).

32. The term is defined in I.R.C. § 67(b) (West Supp. 1997).

33. *See* I.R.C. § 212 (West Supp. 1997).

34. I.R.C. § 67(a) (West Supp. 1997).

35. I.R.C. § 67(e) (West Supp. 1997).

36. Were it not for the rule establishing the 2% floor, the concept of "adjusted gross income" would have no role to play in the taxation of estates and trusts. Indeed, the customary definition of "adjusted gross income" applies only to individuals. *See* I.R.C. § 62(a) (West Supp. 1997). A special Code provision defining the term for Subchapter J purposes is needed so that the 2% floor can be applied to estates and trusts, and that special provision is Section 67(e). The distribution deduction described in item 3 is an "above-the-line" deduction: allowable in arriving at the estate's or trust's adjusted gross income. It is also an expense that, because of Section 67(e)(1), is deductible without regard to the 2% floor and is likewise allowable in arriving at adjusted gross income.

2% floor? The Tax Court, in *O'Neill Irrevocable Trust v. Commissioner*,[37] held that the costs of investment advice are subject to the 2% floor, since taxpayers other than fiduciaries often incur investment advice expenses: "We believe that the thrust of the language of section [67(e)] is that only those costs which are *unique* to the administration of an estate or trust are to be deducted from gross income without being subject to the 2% floor . . . ."[38]

This holding was reversed by the Court of Appeals for the Sixth Circuit, which noted that state law imposes on fiduciaries an obligation to invest prudently the assets in their charge and, inasmuch as none of the trustees of the trust at bar had any experience in investing large sums of money, the trustees would have acted imprudently had they *not* paid for investment advice:

> Where a trustee lacks experience in investment matters, professional assistance may be warranted. The trustees here lacked experience in investing and managing large sums of money and, therefore, sought the assistance of an investment advisor [WPHA]. Without WPHA's management, the co-trustees would have put at risk the assets of the Trust. Thus, the investment advisory fees were necessary to the continued growth of the Trust and were caused by the fiduciary duties of the co-trustees.[39]

This language, taken by itself, implies that the result of the case was attributable solely to the particular trustees' lack of investment experience, suggesting that full deductibility depends on the nature and extent of the trustees' expertise. Later language in the opinion, however, suggests that the result would have been the same regardless of the trustees' experience:

> [While individual investors often pay for investment advice,] they are not required to consult advisors and suffer no penalties or potential liability if they act negligently for themselves. Therefore, fiduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust.[40]

The Service does not acquiesce in the *O'Neill* decision and intends to litigate the issue in cases arising in circuits other than the Sixth.[41] In the interest of simplicity, however, all the numerical examples that follow will assume that trustees' and executors' fees are deductible without regard to the 2% floor.

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37. 98 T.C. 227 (1992), *rev'd*, 994 F.2d 302 (6th Cir. 1993).
38. *O'Neill*, 98 T.C. at 230 (emphasis in original).
39. *O'Neill*, 994 F.2d at 304.
40. *Id.*
41. 1994-2 C.B. 1.

II. THE "CONDUIT" THEORY OF SUBCHAPTER J

Unlike corporations, estates and trusts (except to the very limited extent that the throwback rule still applies) do not give rise to double taxation: one tax at the entity level and one at the beneficiary level. Nor are they treated altogether like partnerships: a tax only at the beneficiary level, imposed on the beneficiary's proportionate share of the entity's income. Rather, trusts and estates are treated like, well, trusts and estates. In its simplest terms, Subchapter J provides that if a trust or estate receives a gross income item but distributes the item to a beneficiary in the same year, the beneficiary must pay the income tax on the item; but if the trust or estate accumulates (*i.e.*, retains) the item for distribution to beneficiaries in a later year, then the trust or estate must pay the income tax. This apportionment of the tax burden between entity and beneficiaries is accomplished through the distribution deduction.

Trusts and estates are treated like partnerships (*i.e.*, like conduits) to this extent: distributions retain their proportionate character in the hands of beneficiaries. To take an over-simplified example, if a trust receives $10,000 of municipal bond interest and $20,000 of taxable dividends in a given taxable year and distributes $12,000 to a beneficiary, the beneficiary is deemed to have received $4,000 of municipal bond interest and $8,000 of taxable dividends, since municipal bond interest and taxable dividends made up, respectively, one-third and two-thirds of the trust's receipts. This proportionate pass-through principle is known as the "character rule."

Both the distribution deduction and the character rule depend, for their operation, on a tax concept called distributable net income, more commonly referred to as DNI. A trust's or estate's DNI for a taxable year (reduced, as we shall see, by any nontaxable components) constitutes the ceiling on the amount of its distribution deduction for the year and on the amount that beneficiaries must include in their gross incomes for the year. Section 102 exempts from income taxation property that a taxpayer acquires by gift or inheritance, but it does not exempt the income earned from that gift or inherited property.[42] The rules of Subchapter J are designed in part to distinguish between the gift property itself and the income from that property. If a trust's DNI for a year is $10,000 (consisting entirely of taxable components) and the trust distributes $12,000 to the beneficiary, the trust may deduct only $10,000 and the beneficiary pays income tax on only $10,000. Thus, the distribution of the excess $2,000 is treated as a gift of property (exempt under Section 102 principles), while the distribution of the first $10,000 is treated as a gift of the income from property (taxable under Section 102(b)(1) principles).

DNI is an arithmetic abstraction, merely a variable that appears in the several formulas used by Subchapter J to allocate the income tax burden between

42. I.R.C. § 102(b) (West Supp. 1997).

entity and beneficiaries.[43] An estate's or trust's DNI for a given taxable year is equal to the entity's taxable income, but with several adjustments, of which only five are of importance:

1. The distribution deduction, authorized by Sections 651 and 661, is not taken into account in calculating the trust's or estate's DNI (*i.e.*, although the amount of the distribution deduction is subtracted from the entity's gross income to arrive at taxable income, it is not subtracted from gross income to arrive at DNI). This exception is vital to the smooth operation of Subchapter J. We need to know a trust's or estate's DNI in order to calculate its distribution deduction; if we needed to know the entity's distribution deduction in order to calculate its DNI, we would be faced with an insoluble circularity problem.
2. The personal exemption deduction, authorized by Section 642(b), is not taken into account in calculating the trust's or estate's DNI.
3. Capital gains are not included in DNI[44] except to the extent that the governing instrument or local law requires that capital gains be: (1) allocated to the trust's or estate's fiduciary accounting income; (2) distributed to a beneficiary; or (3) used to calculate the dollar amount of a distribution.[45] These are rare circumstances; in the overwhelming majority of cases, DNI will not include capital gains.[46]

This special treatment for capital gains is hostile to the "no tracing" philosophy of Subchapter J. Money is a fungible commodity; when a fiduciary writes a check, he does not note whether the source of the money being paid out is interest or dividends or royalties. Pursuant to the character rule, if a trust receives $10,000 of municipal bond interest and $20,000 of taxable dividends in a given taxable year and distributes $12,000 to a beneficiary, the beneficiary is deemed to have received $4,000 of municipal bond interest and $8,000 of taxable dividends, regardless of which particular dollars (the municipal bond interest dollars, the taxable dividend dollars, or even corpus dollars) the trustee chose to distribute to the beneficiary; we do not trace the $12,000 distribution back to particular sources of trust income. But capital gains are treated specially; we *do* trace back to see whether a distribution was in fact a distribution of realized capital gains. Because capital gains, though includable in the trust's or

43. DNI is defined in I.R.C. § 643(a) (West Supp. 1997).

44. Capital gains paid or permanently set aside for a charitable purpose are included in DNI.

45. The mere fact that the fiduciary makes a distribution of corpus for a year in which the entity realized capital gains does not suffice to establish that capital gains were in fact distributed. Treas. Reg. § 1.643(a)-3(d), Ex. 1 (as amended in 1975).

46. In the year of a trust's or estate's termination, realized capital gains will have to be distributed to beneficiaries even though, as a matter of fiduciary accounting, the gains are principal. Accordingly, those distributed gains will have to be included in the entity's DNI for that year of termination.

estate's taxable income, typically are allocated to principal and accumulated rather than distributed, we want to tax the gains to the trust or estate without cluttering up the DNI computation with them. The way to assure that a taxable income item like capital gains is taxed to the trust or estate rather than to the beneficiaries is to keep the gains out of DNI. Excluding them from DNI lowers, by the amount of the gains, what would otherwise be the trust's or estate's distribution deduction and thereby assures that the gains will be taxed to the entity.[47]

Capital losses likewise are disregarded for DNI purposes except to the extent that the governing instrument or local law requires that such losses be taken into account for purposes of calculating the amount of capital gain, in circumstances where the gain would be included in DNI.

4. In the case of trusts whose governing instrument requires that all income[48] be distributed currently, DNI excludes extraordinary dividends or taxable stock dividends that the fiduciary allocates to corpus based on a good faith reading of the governing instrument or local law.

5. Tax-exempt interest on state and local bonds, since it invariably is allocated to income, is included in DNI even though it is not included in taxable income. This inclusion requires an adjustment, however. Section 265(a)(2) denies a taxpayer any Section 212 deduction for expenses attributable to the production of tax-exempt interest, on the theory that expenses not designed or incurred to produce taxable income should not be deducted for purposes of determining taxable income. But because tax-exempt interest is included in *DNI*, the logic of Section 265(a)(2) does not apply; the Section 212-type expenses attributable to producing that interest must be subtracted to reach a soundly-calculated DNI. Accordingly, Section 643(a)(5) states that there shall be included in DNI "any tax-exempt interest to which section 103 applies, reduced by any amounts which would be deductible in respect of disbursements allocable to such interest but for the provisions of section 265." Thus, in calculating DNI, all expenses that either (1) are deductible, or (2) would be deductible but for Section 265(a)(2), are taken into account (*i.e.*, subtracted from gross income).

47. This tracing process allocates the burden of the tax on capital gains between the entity and the beneficiaries. But if it is determined that any capital gains are distributed and accordingly taxed to the beneficiaries, no tracing is involved in allocating *among* the beneficiaries the tax burden attributable to those gains.

48. Remember, the word "income" in this portion of Subchapter J means fiduciary accounting income, unless the word is preceded by one of the words or phrases listed in Section 643(b).

III. TAXATION OF DISTRIBUTIONS FROM SIMPLE TRUSTS

Subchapter J prescribes one set of rules for so-called "simple trusts" and a second set of rules for estates and so-called "complex trusts." A simple trust is a trust with three characteristics: (1) its governing instrument requires that all income be distributed currently; (2) the trust in fact makes no corpus distributions during the current taxable year; and (3) for the current year it makes no disbursements deductible as charitable contributions pursuant to Section 642(c).[49] A trust that does not meet the definition of a simple trust is a complex trust. The terms "simple trust" and "complex trust" do not appear as such in the Code or regulations; rather, the Code and regulations use more elaborate locutions like "a trust described in section 651."[50] But the terms "simple trust" and "complex trust" are the preferred terms among practitioners and scholars. Observe that the same trust may be a simple trust in one year and a complex trust in the next. If the trust instrument requires the trustee to distribute all income currently and authorizes the trustee, in its discretion, to make distributions of corpus, the trust will be a simple trust for years in which the trustee does not exercise that discretion and a complex trust for years in which the trustee does. Even when the trust is a complex trust because of the corpus distribution, it still will be entitled to a personal exemption deduction of $300 instead of $100, since the trust instrument requires that all trust income be distributed currently.[51]

A. Illustration

The following illustration of the Subchapter J rules applicable to a simple trust is based on these facts: The terms of a trust provide that the trustee must distribute annually to Smith from the trust's income the lesser of $12,000 or all the income of the trust. Any income in excess of $12,000 in any year must be distributed to Jones in that year. The trust's receipts for its first taxable year are: (1) $9,000 of tax-exempt interest on municipal bonds; (2) $11,200 of cash dividends on common stock of domestic corporations; and (3) $8,000 of long-term capital gains. The trustee's fee for the year is $1,200. Under the terms of the governing instrument, $200 of the fee is chargeable against income and $1,000 is chargeable against the principal. Under local law, capital gains are allocated to corpus. For simplicity's sake, we assume that no portion of the fee is subject to the 2% deductibility floor of Section 67.

49. I.R.C. § 651(a) (West Supp. 1997). Special rules are in place to prevent a trust from getting both a Section 170 charitable deduction and a Section 651 or Section 661 distribution deduction for the same distribution of income to charity.

50. *See, e.g.*, § 652(a) (West Supp. 1997).

51. I.R.C. § 642(b) (West Supp. 1997).

Question 1: What is the trust's fiduciary accounting income?

Tax-exempt interest		9,000
Dividends		11,200
		20,200
Less:	Trustee's fee chargeable to income	200
		20,000

The trust's income is $20,000. Accordingly, the trustee will distribute $12,000 to Smith and $8,000 to Jones. Keep in mind that the fact that $200 of the fee is chargeable to income and $1,000 to principal does not affect the tax consequences of the fee. If an expense is deductible for income purposes, it is deductible whether fiduciary law requires the expense to reduce the income beneficiary's current distribution or to reduce the remainderman's ultimate distribution.

Question 2: What is the trust's distributable net income?

DNI is taxable income with a few adjustments.[52] In order to calculate taxable income, we shall need to determine the portion of the Section 212 expenses (in this case, the trustee's fee) applicable to the production of the tax-exempt interest. Since no portion of this year's expenses is demonstrably attributable to the production of a specific class of income, we use a proportionate arithmetic formula to determine the amount of the fee that is "constructively" attributable to the production of the tax-exempt interest. The receipts that enter into DNI total $20,200—$9,000 of tax-exempt interest and $11,200 of dividends. Since tax-exempt interest represents 45% of that $20,200 total, 45% of the trustee's fee (45% x $1,200 = $540) is deemed attributable to the production of the tax-exempt interest, and 55% of it ($660) is deductible pursuant to Section 212.

52. I.R.C. § 643(a) (West Supp. 1997).

Now we calculate a "tentative taxable income" as a step toward calculating DNI.[53]

Dividends		11,200
Capital gains		8,000
		19,200
Less:	Trustee's fee, less the portion attributable to the tax-exempt interest	660
Tentative taxable income		18,540

Now we calculate DNI by subtracting from the tentative taxable income the $8,000 of capital gains (since they are allocated to corpus and not distributed)[54] and by adding to the tentative taxable income the figure $8,460, which represents the $9,000 of tax-exempt interest minus the $540 of trustee's fee attributable to the production of that tax-exempt interest:[55] $18,540 - $8,000 + $8,460 = $19,000. The trust's DNI for the year is $19,000.

A more direct method of calculating DNI generally is employed. Start with the tax-exempt interest ($9,000). Then add all items that go into gross income (except for capital gains not actually distributed or allocated to fiduciary accounting income) ($11,200). Then subtract all expenses that either (1) are deductible, or (2) would be deductible but for Section 265(a)(2) ($1,200): $9,000 + $11,200 - $1,200 = $19,000. Again, the trust's DNI is $19,000.

Question 3: What must Smith include in his gross income as a consequence of the $12,000 distribution?

Since this is a simple trust, the applicable provision is Section 652. Section 652(a) provides, in effect, that, except as the character rule of Section 652(b) may require, Smith is subject to income taxation on the lesser of (1) his proportionate share of the trust's DNI; or (2) the amount of trust income required to be distributed to Smith. .Since 60% of the trust's fiduciary accounting income is required to be distributed to Smith ($12,000/$20,000 = 0.60), Smith's proportionate share of the trust's DNI is 60%: 60% x $19,000 = $11,400. The lesser of Smith's proportionate share of the trust's DNI ($11,400) and the amount of trust income required to be distributed to him ($12,000) is $11,400. Let us call that $11,400 "the Section 652(a) amount," although that is a term of my invention, not a standard term of art.

53. "Tentative taxable income" is not a term of art; it is a term I have concocted to refer to this particular way station on the path to DNI.

54. This adjustment is required by I.R.C. § 643(a)(3) (West Supp. 1997).

55. This adjustment is required by I.R.C. § 643(a)(5) (West Supp. 1997).

Section 652(b)—the character rule—provides that Smith's Section 652(a) amount ($11,400) will be deemed to be made up proportionately of all the receipt items that enter into DNI. DNI comprises two receipt items: tax-exempt interest and cash dividends; and the expenses used in the calculation of DNI ($1,200) must be allocated between those two kinds of receipts in accordance with regulations.[56] If the trust has no expenses directly attributable to one class of income (*e.g.*, repair expenses on property held for rental income by the trust), but rather (as we have here) only general deductible expenses, the regulations require only that a proportionate amount of the deductions be allocated to the tax-exempt interest.[57] We must therefore allocate $540 of expenses to the tax-exempt interest. The remaining $660 of expenses may be allocated to either the tax-exempt interest or the cash dividends. Allocating the $660 of expenses to the tax-exempt interest component reduces the portion of Smith's $12,000 that is deemed to be tax-exempt interest. Allocating the $660 of expenses to the dividend component reduces the portion of Smith's $12,000 that is deemed to be taxable dividends. Accordingly, if we wish to minimize Smith's income tax burden, we should allocate the $660 to the dividends. The receipt items (with deductions allocated thereto) that make up DNI are as follows:

Tax-exempt interest = 9,000 less 540 =	8,460
Dividends = 11,200 less 660 =	10,540
	19,000

Thus, the trust's $19,000 of DNI is deemed to be made up of $8,460 of tax-exempt interest and $10,540 of cash dividends.

Smith's $11,400 "Section 652(a) amount" is deemed to be made up of tax-exempt interest and cash dividends in the same proportions as those items constitute DNI:

$$\frac{8{,}460}{19{,}000} \times 11{,}400 = 5{,}076 \text{ tax-exempt interest}$$

$$\frac{10{,}540}{19{,}000} \times 11{,}400 = 6{,}324 \text{ cash dividends}$$

Thus, as a result of receiving $12,000 from the trust, regardless of what particular funds the trustee actually used to pay him the $12,000, Smith must include $6,324 of dividends in his gross income. He will be deemed also to have received $5,076 of tax-exempt interest. The remaining portion of his distribution will be treated like a gift of property—tax-exempt pursuant to Section 102.

56. See the last sentence of I.R.C. § 652(b) (West Supp. 1997).

57. Treas. Reg. § 1.652(b)-3(b) (1960).

The fiduciary income tax return (Form 1041) includes information schedules (Schedule K-1) to be sent to each beneficiary who received a distribution in the year for which the return is filed. Thus, the trustee will send Smith a Schedule K-1 advising Smith that he must report $6,324 of dividend income on his Form 1040.[58] The trust, like all trusts, must be a calendar-year taxpayer. Assuming that Smith also is a calendar-year taxpayer, if the $12,000 was distributed in 1998, Smith must report the $6,324 on his 1998 return, due April 15, 1999. If, for some reason, the trustee does not get around to distributing 1998's $12,000 distribution until early in 1999 (because, say, it took the trustee some time to calculate the dollar amount to which Smith was entitled), nonetheless Smith will be taxed as if the $12,000 actually was distributed to him in 1998 since the trust instrument requires the distribution to be made in 1998.[59]

Question 4: What must Jones include in her gross income as a consequence of the $8,000 distribution?

Jones's "Section 652(a) amount" is the lesser of her proportionate share of DNI (40% x $19,000 = $7,600) or the amount of trust income required to be distributed to her ($8,000). The lesser of those two amounts is $7,600. Then, pursuant to the character rule, that $7,600 must be broken down into the components of DNI:

$$\frac{8{,}460}{19{,}000} \times 7{,}600 = 3{,}384 \text{ tax-exempt interest}$$

$$\frac{10{,}540}{19{,}000} \times 7{,}600 = 4{,}216 \text{ cash dividends}$$

Thus, as a result of receiving $8,000 from the trust, Jones must include $4,216 of dividends in her gross income. She will be deemed also to have received $3,384 of tax-exempt interest. The remaining portion of her distribution will be treated like a gift of property—tax-exempt pursuant to Section 102.

58. The Schedule lists the various kinds of income and deductions that the beneficiary must report and indicates the lines on the beneficiary's Form 1040 on which to report those items.

59. Section 652(a) provides for inclusion in the gross income "of the beneficiaries to whom the income is required to be distributed, whether distributed or not." I.R.C. § 652(a) (West Supp. 1997).

Question 5: What is the trust's distribution deduction?

Since this is a simple trust, the applicable provision is Section 651. This provision states that the distribution deduction is the lesser of (1) the amount of trust income required to be distributed currently ($20,000) or (2) DNI as adjusted pursuant to Section 651(b). The Section 651(b) adjustment requires that we exclude from DNI those receipts (and the deductions allocable thereto) that are not included in the gross income of the trust. This adjusted DNI figure is $19,200, computed as follows:

DNI		19,000
Less:	Tax-exempt interest component	8,460
		10,540

The lesser of $20,000 and $10,540 is $10,540, which is the trust's distribution deduction.[60]

Question 6: What is the trust's taxable income?

Dividends			11,200
Long-term capital gains			8,000
			19,200
Less:	Trustee's fee (minus portion attributable to tax-exempt interest)	660	
	Personal exemption	300	
	Distribution deduction	10,540	11,500
			7,700

The trust's taxable income is $7,700. The soundness of this result can be demonstrated by reflecting on Subchapter J's method of allocating the tax burden between entity and beneficiaries. All taxable income items that are distributed to the beneficiaries are taxed to the beneficiaries; all taxable income

60. The language of Section 651, as illustrated in this example, calls for a reduction (in the amount of the tax-exempt components) in DNI but not for a reduction in "income required to be distributed currently." Where such income exceeds DNI, as in this example, the statutory language produces a sound result. But where DNI exceeds income, soundness requires a comparable reduction in "income required to be distributed currently." The regulations recognize the need for this comparable reduction, *see* Treas. Reg. § 1.651(b)-1 (1960), but fail to explain how such a reduction is to be calculated. Presumably, a proration approach would be required. Suppose the trust's income was only $7,000. The reduction in DNI from $19,000 to $10,540 was a reduction of 44.53%. Therefore, we would reduce the $7,000 figure by 44.53% and arrive at a distribution deduction of $3,883.

items that are accumulated are taxed to the trust. In this example, the $8,000 of capital gains was the only taxable income item not distributed to the beneficiaries. Therefore, the trust must pay the income tax on the $8,000 of capital gains: $8,000, less the trust's $300 personal exemption deduction, is $7,700.

Thus, in the case of a simple trust, each distribution carries out with it a proportionate share of DNI. To the extent the beneficiaries' shares include taxable components of DNI, the beneficiaries include the components in gross income and the trust claims a distribution deduction.

B. Digression Regarding Depreciation and Depletion Deductions

The Subchapter J rules allocate income and deductions between the trust or estate on the one hand and the beneficiaries on the other, and the allocation generally is made arithmetically by using the DNI calculations, rather than by allocating specific income or expense items to the beneficiaries or to the entity. Depreciation and depletion deductions, however, are allocated specially, and the rules are to be found in Section 642(e), which refers to Section 167(d) for depreciation and to Section 611(b) for depletion. In the case of an estate, these deductions are allocated between the beneficiaries and the entity "on the basis of the income of the estate allocable to each."[61] In the case of a trust, these deductions are allocated in accordance with the directions of the trust instrument; only if the trust instrument is silent on the point will the deductions be allocated on the basis of income.[62]

The case of a trust faced with depletion allowances furnishes a useful illustration. Consider a trust requiring that all income be distributed to A for life, with the principal going to B upon A's death. If the trust corpus consists of corporate bonds, the payments that A receives from the trust do not reduce the value of the remainder that B is to receive upon A's death, because the bonds' generation of income does not reduce the bonds' remaining value. If, however, the trust corpus consists of oil-producing property, a very different case is presented. Here, the income that is paid to A is royalty income generated from the extraction and sale of the oil under the land. If all the oil is extracted during A's lifetime, the remainder will turn out to be worthless when B finally takes possession. In other words, unlike distributions of interest on corporate bonds, the distribution of oil royalty income reduces the principal. (For this reason, the oil is called a "wasting asset.") Grantors (or state trust law) generally respond to this problem by directing the trustee to withhold from the income beneficiary part of the royalty income and to add that part to the trust's corpus.[63] The trustee

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61. I.R.C. §§ 167(d), 611(b)(4) (West Supp. 1997).
62. I.R.C. §§ 167(d), 611(b)(4) (West Supp. 1997).
63. *See* UNIF. PRINCIPAL & INCOME ACT § 503 (1997).

is said to have thereby "established a reserve for depletion," adding to the trust's corpus the withheld portion of the royalty income and investing that addition to corpus in such a way as to preserve the value of B's remainder, much as the value of B's remainder would be preserved if the income being paid to A were simply the interest on corporate bonds.

Income tax law reflects this understanding that when the owner of an income-producing wasting asset receives a "piece" of income derived from that asset, the value of the asset decreases, with the result that the income payment increases the owner's net worth by an amount that is less than the full amount of the income payment. Since the value of the underlying asset theoretically will be reduced substantially by the time the income stream is exhausted, a portion of each income payment is, in substance, a return to the owner of her capital investment in the asset and should, therefore, like any other return of one's investment, be tax-free. Accordingly, Sections 611 to 613A authorize the deduction of an "allowance for depletion" in the case of mines, oil wells, and similar income-producing stores of natural resources.

Let us return to our example: a trust of oil-producing property where the income is to be paid to A for life, remainder to B. Suppose the trust receives $10,000 of royalty income, and, pursuant to Sections 611 to 613A, a depletion deduction of $2,000 is available. Who is entitled to claim that income tax deduction: A or the trust? Where the governing instrument requires the trustee to maintain a reserve for depletion, the deduction for depletion must be "allocated to the trustee to the extent that income is set aside for a depletion reserve."[64] Thus, if as a matter of fiduciary accounting, the trustee withholds from current income (and allocates to corpus as a reserve for depletion) at least $2,000 of that $10,000 income payment, then the $2,000 depletion deduction is to be claimed by the trust.[65] If the trustee withheld, say, only $1,500 as a reserve for depletion, the remaining $500 of depletion deduction would be allocated between A and the trust "on the basis of the trust income from such property allocable to each."[66]

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64. Treas. Reg. § 1.611-1(c)(4) (as amended in 1973).

65. A still derives some benefit from the trust's deduction inasmuch as the trust's deduction reduces the trust's DNI and thereby reduces the amount of A's $8,000 distribution that is taxable to A.

66. Treas. Reg. § 1.611-1(c)(4) (as amended in 1973).

IV. TAXATION OF DISTRIBUTIONS FROM ESTATES AND COMPLEX TRUSTS

A. The "Tier"[67] System

Just as Sections 652 and 651 deal, respectively, with the beneficiaries' tax burden and the trust's distribution deduction in the case of a simple trust, so Sections 662 and 661 deal, respectively, with those issues arising in the case of an estate or complex trust. In its most general terms, Section 662 operates like Section 652: each beneficiary must include in gross income the lesser of his share of DNI or the amount of the distribution, and then that amount is broken down into its component parts in accordance with the character rule. But what is the beneficiary's "share" of DNI? In the case of a simple trust, that share is based simply on the proportion of the trust's income that is distributed to the beneficiary.[68] In the previous example, since the income required to be distributed to Smith represented 60% of the trust's income, Smith's "share" of DNI was 60%. Thus, in the case of a simple trust, every distribution carries out with it a proportionate share of DNI.

In the case of an estate or complex trust, the distributions do not share DNI proportionately; some distributions (so-called "first-tier" distributions) are deemed to carry out DNI before others (so-called "second-tier" distributions). A first-tier distribution is a mandatory distribution of income; all other distributions (*i.e.*, distributions of corpus and discretionary distributions of income) are second-tier distributions.[69] But once a beneficiary's share of DNI is determined by this allocation method, the character rule is applied to that share in the same way that it was applied in the case of a simple trust. The method of allocating DNI is illustrated in the following examples:

> *Example 1.* During the year in question, a complex trust makes a $12,000 first-tier distribution to A, an $8,000 first-tier distribution to B, a $2,000 second-tier distribution to C, and a $4,000 second-tier distribution to A. The trust's DNI for the year is $30,000. Since there is enough DNI to "cover" all the first-tier distributions in full, each first-tier distribution's share of DNI is the full amount of the distribution: A is deemed to have received $12,000 of DNI with her first-tier distribution, and B is deemed to have received $8,000 of DNI. That leaves $10,000 of DNI remaining for the second-tier distributions. Since there is enough remaining DNI to

67. The term "tier" does not appear in the Code or regulations but is regularly and uniformly used by practitioners and scholars.

68. Treas. Reg. § 1.652(a)-2 (as amended in 1972).

69. In the case of an estate, all distributions probably are second-tier distributions; only in the most unusual circumstances would a will, as a matter of law, effectively require an executor to make a particular distribution of income during a given year.

"cover" all the second-tier distributions in full, each second-tier distribution's share of DNI is the full amount of the distribution: C is deemed to have received $2,000 of DNI, and A is deemed to have received $4,000 of DNI with her second-tier distribution.

Example 2. Same facts as *Example 1* except that the trust's DNI for the year is $23,000. There still is enough DNI to cover all the first-tier distributions in full, so $12,000 of DNI is deemed to go out to A with her first-tier distribution, and $8,000 of DNI is deemed to go out to B with his first-tier distribution. This leaves $3,000 of DNI remaining, and $3,000 is not enough to cover all the second-tier distributions in full. Therefore, the remaining $3,000 is allocated proportionately between the two second-tier distributions: $1,000 to C and $2,000 to A's second-tier distribution.

Example 3. Same facts as *Example 1* except that the trust's DNI for the year is $10,000. Now there is not even enough DNI to cover all the first-tier distributions in full, so the $10,000 will be allocated proportionately between A's first-tier distribution and B ($6,000 to A and $4,000 to B), and no DNI will be allocated to the second-tier distributions. Thus, the second-tier distributions will be entirely tax-free to the recipients and nondeductible by the trust.

Observe that a distribution's share of DNI (that is, the extent to which the distribution carries DNI out from the trust or estate to the beneficiary) is determined by the distribution's dollar value and its tier, not by the nature of the asset distributed, although Section 663(a)(1), as we shall see, constitutes an exception to this principle.[70]

The following illustration of the Subchapter J rules applicable to estates and complex trusts is based on these facts: A trust instrument provides that $20,000 must be paid to Ben annually from income to the extent the income is sufficient; to the extent the income is insufficient the balance is to be paid from corpus. The trustee is authorized to make such distributions of corpus to Sue as the trustee in its discretion may determine to be appropriate. During the year in question, the trust receives $16,000 of cash dividends on the common stock of domestic corporations, $6,000 of tax-exempt interest on municipal bonds, $12,000 of long-term capital gains (allocable to corpus), and $18,000 of rental income from a fully-depreciated apartment building. The trustee's fee is $3,000, of which $2,000 is chargeable to income and $1,000 to corpus. The trustee also pays $4,000 of real estate taxes on the apartment building, fully chargeable to income. For simplicity's sake, we assume that no portion of the fee is subject to the 2% deductibility floor of Section 67.[71] For the first year of the trust, the

70. *See supra* text accompanying notes 82-92.

71. The real estate taxes are deductible pursuant to Section 164 and, therefore, are

trustee makes the required $20,000 distribution to Ben and makes a discretionary distribution of $15,000 of corpus to Sue.

Question 1: What is the trust's fiduciary accounting income?

Dividends			16,000
Tax-exempt interest			6,000
Rent			18,000
			40,000
Less:	trustee's fee chargeable to income	2,000	
	real estate taxes	4,000	6,000
			34,000

The trust's fiduciary account income is $34,000. Since there is enough income to pay Ben his entire required $20,000 distribution, that distribution is, by the terms of the trust, regarded as a distribution of income.

Question 2: What is the trust's DNI?

As a prelude, we need to determine the portion of the trustee's fee that is allocable to the tax-exempt interest. (Clearly, no portion of the real estate taxes is allocable to the production of the tax-exempt interest.) In cases such as this, where some expenses (the real estate taxes) are attributable to a specific class of income and some expenses (the trustee's fee) are not attributable to a specific class, the regulations prescribe two different and inconsistent ways of making the calculation. According to the language of Treasury Regulation § 1.652(b)-3(b), the calculation is made first by subtracting from the receipts that enter into DNI ($40,000, consisting of $16,000 of dividends, $6,000 of tax-exempt interest, and $18,000 of rent) the expenses directly attributable to a specific class of income (the $4,000 of real estate taxes): $40,000 - $4,000 = $36,000. Of that $36,000, the $6,000 of tax-exempt interest represents one-sixth (16.67%). Therefore, one-sixth of the trustee's $3,000 fee ($500) is attributable to the production of the tax-exempt interest.

The example in Treasury Regulation § 1.652(c)-4, which is intended to illustrate the rule of Treasury Regulation § 1.652(b)-3(b), shows, oddly enough, a somewhat different method of calculating the portion of the trustee's fee allocable to the tax-exempt interest. Under this second method, unlike the first, we do not begin by subtracting out the expenses directly attributable to specific classes of income. Rather, we look at the total of the receipts entering into DNI—$40,000. Of that $40,000, the $6,000 of tax-exempt interest represents

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not "miscellaneous deductions" subject to the rules of Section 67. *See* I.R.C. § 67(b)(2) (West Supp. 1997).

15%. Therefore, 15% of the trustee's $3,000 fee ($450) is deemed allocable to the tax-exempt interest. Surprisingly, it appears that the IRS will accept either method of calculation. In this particular example, where all the DNI is distributed, there is no difference in the result. Using the lower figure ($450 instead of $500) increases the trust's Section 212 deduction for trustee's fees but correspondingly decreases the trust's Section 661 distribution deduction. For purposes of this illustration, we shall use $450 as the amount of trustee's fee allocable to the production of tax-exempt interest.

Now we can calculate the trust's tentative taxable income:

Dividends			16,000
Long-term capital gains			12,000
Rent			18,000
			46,000
Less:	trustee's fee (less the portion attributable to tax-exempt interest)	2,550	
	real estate taxes	4,000	6,550
Tentative taxable income			39,450

Now we calculate DNI by subtracting from tentative taxable income the long-term capital gains (the Section 643(a)(3) adjustment) and by adding the tax-exempt interest reduced by the trustee's fee allocable to the tax-exempt interest (the Section 643(a)(5) adjustment): $39,450 - $12,000 + ($6,000 - $450) = $33,000. The trust's DNI for the year is $33,000. As we shall see, since the $20,000 distribution to Ben is a first-tier distribution while the $15,000 distribution to Sue is a second-tier distribution, Ben's share of DNI will be $20,000, and Sue's share will be $13,000.

Question 3: What must Ben include in his gross income as a consequence of the $20,000 distribution?

Since the $20,000 is required to be distributed from income currently, the distribution to Ben is a first-tier distribution. The applicable provision therefore is Section 662(a)(1).

Section 662(a)(1) provides that, subject to the character rule of Section 662(b), Ben is subject to income taxation on the lesser of (1) his allocable share of the DNI, or (2) the amount of income required to be distributed to him. Since Ben is the only first-tier distributee, all the DNI is at least provisionally allocable to him. Therefore, the lesser of his share of DNI or the amount of income required to be distributed to him is $20,000. His "Section 662(a)(1) amount" is $20,000.

Section 662(b)—the character rule—requires first that we break up the $33,000 of DNI into its component receipt types, with deductions and expenses allocated thereto. We must allocate the entire $4,000 real estate tax expense to

the rental income portion of DNI (since the real estate taxes are directly attributable to the production of the rental income), and we must allocate $450 of the trustee's fee to the tax-exempt interest component. The remaining $2,550 of the trustee's fee may be allocated to any of the three receipts (tax-exempt interest, dividends, and rent) entering into DNI. We do not want to allocate it to the tax-exempt interest, since that allocation would reduce the portion of the distribution that is tax-exempt to the beneficiary. Which kind of income would Ben prefer to receive, dividends or rent? If he has any preference at all, it is likely to be for the rent; if he has excess passive activity losses, the receipt of rental income will permit him to deduct a portion of those losses, while the receipt of dividend income will not. Accordingly, to reduce the dividend component and increase the rent component, we allocate the remaining $2,550 of the trustee's fee to the dividend component. The receipt items (with deductions allocated thereto) that make up DNI are as follows:

Tax-exempt interest = 6,000 less 450 =	5,550
Dividends = 16,000 less 2,550 =	13,450
Rent = 18,000 less 4,000 =	14,000
	33,000

Section 662(b) now says that Ben's $20,000 Section 662(a)(1) amount is deemed to be made up of tax-exempt interest, corporate dividends, and rent in the same proportion as they enter into DNI:

$$\frac{5,550}{33,000} \times 20,000 = 3,364 \text{ tax-exempt interest}$$

$$\frac{13,450}{33,000} \times 20,000 = 8,152 \text{ cash dividends}$$

$$\frac{14,000}{33,000} \times 20,000 = 8,485 \text{ rent}$$

Thus, Ben must include $8,152 of dividends and $8,485 of rent in his gross income. He will be deemed also to have received $3,364 of tax-exempt interest.

Question 4: What must Sue include in her gross income as a consequence of the $15,000 distribution?

Since the $15,000 is not required to be paid currently out of income (indeed, it is not required to be paid at all), it is a second-tier distribution, taxable to Sue pursuant to Section 662(a)(2).

The first sentence of Section 662(a)(2) says that Sue must include the $15,000 (*i.e.*, the amount actually distributed) in gross income, subject to the second sentence of Section 662(a)(2) and the character rule of Section 662(b).

Since the sum of all distributions made from the trust ($35,000) exceeds DNI, the second sentence of Section 662(a)(2) applies. This sentence says that notwithstanding the first sentence of Section 662(a)(2), Sue need not include in gross income an amount greater than the amount by which DNI exceeds the total first-tier distributions: $33,000 less $20,000 equals $13,000. Thus, $13,000 is Sue's Section 662(a)(2) amount.

The character rule of Section 662(b) now requires that we break up Sue's Section 662(a)(2) amount ($13,000) into its component parts, just as we did with Ben's Section 662(a)(1) amount:

$$\frac{5,550}{33,000} \times 13,000 = 2,186 \text{ tax-exempt interest}$$

$$\frac{13,450}{33,000} \times 13,000 = 5,298 \text{ cash dividends}$$

$$\frac{14,000}{33,000} \times 13,000 = 5,515 \text{ rent}$$

Thus, Sue must include $5,298 of dividends and $5,515 of rent in her gross income. She will be deemed also to have received $2,186 of tax-exempt interest. The remaining portion of her distribution will be treated like a gift of property: tax-exempt pursuant to Section 102.

Question 5: What is the trust's distribution deduction?

Since this is a complex trust, the applicable provision is Section 661. The theory of Section 661 is that the trust may claim a distribution deduction only for the distribution of items that will be taxable to the beneficiaries:

8,152 of dividends distributed to Ben
8,485 of rent distributed to Ben
5,298 of dividends distributed to Sue
5,515 of rent distributed to Sue
27,450 distribution deduction

Let us see how we arrive at that $27,450 figure using the language of Section 661.

Section 661(a) says that the distribution deduction is the lesser of (1) the total amount of the distributions ($35,000), or (2) DNI ($33,000). So the Section 661(a) figure is $33,000. But then Section 661(b) and (c) requires some adjustments in the figure we get from Section 661(a).

These adjustments operate as follows. When we applied the Section 662(b) character rule to the trust's $33,000 of DNI, we determined that the DNI consisted of $5,550 of tax-exempt interest, $13,450 of dividends, and $14,000

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of rent. Thus, of the $33,000 of DNI, $27,450 (which represents 83.18% of DNI) is taxable. The distribution deduction is therefore 83.18% of the figure we get from Section 661(a): 83.18% x $33,000 = $27,450.

Question 6: What is the trust's taxable income?

Dividends			16,000
Long-term capital gains			12,000
Rent			18,000
			46,000
Less:	Trustee's fee (less portion attributable to tax-exempt interest)	2,550	
Real estate taxes		4,000	
Personal exemption		100[72]	
Distribution deduction		27,450	34,100
			11,900

The trust's taxable income is $11,900: the $12,000 of undistributed long-term capital gains minus the $100 personal exemption deduction.

B. The "Sixty-five-Day" Election

The fiduciary of an estate or complex trust may elect to treat any distribution, or portion of a distribution, properly paid or credited to beneficiaries during the first sixty-five days of the estate's or trust's taxable year as if it had been paid or credited on the last day of the previous taxable year of the estate or trust.[73] The regulations limit the amount that may be so treated to the greater of: (1) the amount of the trust's income for that earlier year; or (2) the amount of the trust's DNI for that earlier year; reduced by any amounts paid, credited, or required to be distributed in such year (other than amounts treated as having been distributed in a still earlier year through an earlier exercise of this Section 663(b) election).[74] The purpose of the sixty-five-day rule is to allow a fiduciary, who discovers shortly after the close of the year that she has distributed less than the estate's or trust's DNI, retroactively to increase that year's distributions so as to take full advantage of the estate's or trust's potential distribution deduction.

Example 4. A trust has $10,000 of income and $8,000 of DNI for 1998. The trustee distributes $6,000 to Smith on August 20, 1998, and $5,000 on

72. The terms of the trust do not require that all income be distributed currently. Consequently, the allowable personal exemption deduction is $100.

73. I.R.C. § 663(b) (West Supp. 1997).

74. Treas. Reg. §1.663(b)-1(b) (as amended in 1972).

January 21, 1999. The trustee may elect to treat up to $4,000 ($10,000 - $6,000) of the January 1999 distribution as having been paid on December 31, 1998. If the trustee makes the election in order to take full advantage of the trust's 1998 distribution deduction and thus minimize the amount that will be taxed at the trust level for 1998, only $2,000 of the January 1999 distribution should be pushed back to 1998, since the trust cannot claim a 1998 distribution deduction in excess of its $8,000 DNI.

C. The "Separate Share" Rule

If a single trust or estate has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts or estates for the purpose (and only for the purpose) of determining the amount of DNI allocable to the respective beneficiaries under Sections 661 and 662. This rule is mandatory, not elective, but does not apply to simple trusts.

Example 5. A grantor establishes a trust for her two children, A and B. A one-half share of the corpus is earmarked for each child, and the trustee has the discretion to distribute to each child, in any amounts, income or corpus from that child's share. On the death of a child, any remaining corpus and accumulated income in his share will be distributed to his children. Suppose that in a given year, the trust's income is $10,000 and its DNI is $8,000. Suppose further that the trustee distributes $5,000 of income and $7,000 of corpus to A and nothing to B. Under the normal no-tracing principle of Subchapter J, A would have to include $8,000 in gross income even though half of the DNI was generated by the trust's receipt of income accumulated for future distribution to B. This problem is addressed by the separate share rule of Section 663(c). Under the separate share rule, if a single trust has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for the sole purpose of determining the amount of DNI allocable to the respective beneficiaries. The separate share rule, applied to our example, would hold that the DNI attributable to A's share of the trust is only one-half the DNI—$4,000. Accordingly, when the trust distributes $12,000 to A ($5,000 of income and $7,000 of corpus), the ceiling on the amount on which A is subject to income taxation (and the ceiling on the trust's distribution deduction) is that same one-half of DNI—$4,000.

D. Treating Certain Revocable Trusts as Part of the Estate

If the grantor, the grantor's spouse, or a "nonadverse party" possesses the power to revoke a trust and send the trust property back to the grantor, the trust

is a grantor trust, rather than a separate income-tax-paying entity.[75] If a trust is a grantor trust because of a revocation power possessed by the grantor herself (as opposed to a power possessed by a nonadverse party or by the grantor's spouse), then, upon the grantor's death, the grantor's executor and the trustee of the trust jointly may irrevocably elect to treat the trust as part of the grantor's estate (rather than as a separate trust) for income tax purposes.[76] If made, this election applies for the estate's first taxable year and for all subsequent taxable years of the estate up through, and including, the last taxable year that ends before the date that is six months after the date of the final determination of the decedent's estate tax liability.[77] The separate share rule may be applied when a revocable trust is combined with an estate pursuant to this election.

E. "Excess" Deductions Remaining on Termination

Ordinarily, unused deductions cannot be transferred from one taxpayer to another. Section 642(h), however, grants this unusual privilege when an estate or trust terminates at a time when it has unused net operating loss or capital loss carry-overs, or when its deductions (other than the personal exemption and the charitable deduction) exceed its gross income for its last taxable year.[78] The unused carry-overs may be used by "the beneficiaries succeeding to the property of the estate or trust" as if those beneficiaries had themselves incurred the losses giving rise to the carry-overs.[79] The other unused deductions of the estate or trust may be claimed as itemized deductions[80] by, again, "the beneficiaries succeeding to the property of the estate or trust."[81]

Suppose an estate whose taxable year is the calendar year receives $10,000 of gross income in 1998 and expects to receive $9,000 of gross income in 1999, the year in which the executor plans to terminate the estate. Suppose further that the estate eventually must pay the executor her $14,000 commission. If the

75. I.R.C. § 676 (West Supp. 1997).

76. I.R.C. § 646 (West Supp. 1997).

77. I.R.C. § 646 (West Supp. 1997). If no estate tax return is due, the last taxable year of the election period is the last taxable year of the estate that ends before the second anniversary of the decedent's death.

78. An estate's or trust's Section 642(b) personal exemption deduction is lost in its year of termination. Since the Section 642(b) deduction is ignored for DNI purposes, the deduction is of use only for years in which the estate or trust retains items of taxable income.

79. Treas. Reg. § 1.642(h)-1 (as amended in 1978).

80. That is, they are not allowed in computing the beneficiary's adjusted gross income. Treas. Reg. § 1.642(h)-2(a) (as amended in 1978). Moreover, such itemized deductions will be subject to the Section 67 2% floor on miscellaneous deductions, IRS Publication 559 (1995), presumably because Section 642(h) deductions are not among those listed in Section 67(b).

81. Treas. Reg. § 1.642(h)-2 (as amended in 1978).

estate pays the commission in 1998, the benefit of $4,000 of potential deduction will permanently be lost, inasmuch as the estate may not claim deductions of more than its gross income. But if the estate is to terminate in 1999, the executor would do well to delay paying the fee until the year of termination. If indeed the estate terminates in 1999, and the estate's 1999 gross income is $9,000, and the estate pays that $14,000 executor's commission in 1999, the $5,000 "excess" deduction, instead of being permanently lost, will be deductible by the "beneficiary succeeding to the property of the estate" on his 1999 return.

Just who are these "beneficiaries succeeding to the property of the estate or trust"? In the case of an estate, these generally are the residuary legatees, rather than specific or general legatees. The phrase includes any beneficiary whose share of the estate, under the will or under fiduciary practice, is reduced by the net operating loss, capital loss, or deductions in question.

Example 6. A decedent's will bequeaths $100,000 to A, and then divides the residue into two shares: 40% of the residue is to be paid to B and 60% is to be paid to First National Bank as trustee of a trust, created by the decedent's will, for the benefit of C, D, and E. The decedent's net probate estate amounts to $300,000—enough to pay the full $100,000 bequest to A, and then $80,000 (40% of the $200,000 residue) to B and $120,000 (60% of the $200,000 residue) to First National Bank as trustee. The executor makes all three distributions during the estate's last taxable year. There is a $5,000 excess of deductions over gross income for the estate's last taxable year, and there is a $15,000 capital loss carryover. Only B and First National Bank are "beneficiaries succeeding to the property of the estate." Accordingly, B is entitled to the benefit of $2,000 (40% x $5,000) of the excess deductions and $6,000 (40% x $15,000) of the capital loss carryovers; the testamentary trust is entitled to the benefit of 60% of the excess deductions and 60% of the capital loss carryover.

Example 7. Same facts as *Example 6* except that the decedent's net probate estate amounts to only $96,000. Under the applicable law of abatement, the $96,000 will be paid entirely to A, leaving no residue, so B and the trust receive nothing. A is a "beneficiary succeeding to the property" to the extent of $4,000, and since the total of the excess deductions and the loss carryover is $20,000, A is entitled to the benefit of one-fifth ($4,000 ÷ $20,000) of each excess deduction and one-fifth of the loss carryover. The benefit of the remaining four-fifths of each item will be shared 40% by B and 60% by the testamentary trust.

A similar definition of "beneficiaries succeeding to the property" obtains in the case of trusts. In general, it will be the trust's remaindermen, not the income beneficiaries, who meet the definition.

V. SPECIAL RULE FOR DISTRIBUTIONS OF "SPECIFIC PROPERTY"

Section 102 states that the value of property gratuitously transferred, whether by gift or by inheritance, is excluded from the gross income of the transferee; the transferor may not claim an income tax deduction for the gratuitous transfer, except in the case of business gifts deductible pursuant to Sections 274(b). On the other hand, Section 102(b) states that the *income* from gratuitously transferred property is included in the transferee's gross income. The rules of Sections 652, 651, 662, and 661 provide a method of distinguishing between property and the income from property, a method that does not rely on tracing; a distribution will be taxable to the recipient to the extent of the distribution's share of DNI even if, in fact, the fiduciary uses principal rather than income to make the distribution. Some distributions, however, are regarded by the Code as so clearly distributions of principal that they are treated like Section 102 property transfers: nontaxable to the recipient and nondeductible by the transferor.

Section 663(a)(1) identifies the distributions that are treated as transfers of principal only. If a distribution comes within Section 663(a)(1), then the distribution is treated as carrying out with it no DNI at all; for Subchapter J accounting purposes, the Section 663(a)(1) distribution is disregarded. If an estate whose DNI is $10,000 (consisting entirely of taxable components; no tax-exempt interest) makes a Section 663(a)(1) distribution of $4,000 to A and a non-Section 663(a)(1) distribution of $6,000 to B, no DNI is deemed distributed to A, while $6,000 of DNI is deemed distributed to B. A will not have to include anything in gross income by reason of the $4,000 distribution, while B will have to include $6,000 in gross income. The estate will be entitled to a distribution deduction of $6,000.

Section 663(a)(1) applies to any distribution properly paid in satisfaction of a gift or bequest of (1) a specific sum of money; or (2) specific property. An amount that, pursuant to local law or the governing instrument, can be paid only from fiduciary accounting income is not considered a gift or bequest of a "specific sum." More important, in order to qualify for Section 663(a)(1) treatment, the gift or bequest must be "paid or credited all at once or in not more than 3 installments."

Observe that the $20,000 distributions to Ben in our illustration of a complex trust do not qualify for the Section 663(a)(1) benefit. As a practical matter, Section 663(a)(1) is of more importance for estates than for trusts. It is highly unusual for a trust to provide for the distribution of a particular asset or a nonrecurring distribution of a specific sum,[82] but wills provide for such estate

82. Perhaps the occasional trust will provide for a one-time distribution (from principal) of a specific dollar amount when a beneficiary attains a stated age.

distributions all the time, and proper drafting of a will can assure that the benefits of Section 663(a)(1) are realizable.

Example 8. Decedent's will provides, "I devise and bequeath my entire estate to my daughter, Dora." In the estate's first taxable year, the executor distributes to Dora the decedent's car, the only distribution made for that year. If the estate's DNI is $10,000 (consisting entirely of taxable components), and the value of the car is $6,000, Dora will have to include $6,000 in her gross income, because under Subchapter J every distribution (unless exempted by Section 663(a)(1)) carries out DNI with it, regardless of the nature of the distributed asset. (The estate will, of course, enjoy a $6,000 distribution deduction.) This may not be a bad tax result if Dora is in a lower tax bracket than the estate, but for the transfer of a car to give rise to income tax liability is inconvenient as a practical matter and awkward as a client-relations matter. Suppose instead that the decedent's will had read: "Article I: I bequeath my car, my furniture, and my clothing to my daughter, Dora. Article II: I devise and bequeath the residue of my estate to my daughter, Dora." Now the estate's distribution of the car to Dora will be a Section 663(a)(1) distribution (a bequest of "specific property"), so Dora will not have to include anything in gross income by reason of her receipt of her parent's car.

A. The Requirement of a "Specific" Sum or Property

In order to qualify as a Section 663(a)(1) distribution, "the amount of money or the identity of the property must be *ascertainable* under the terms of a testator's will *as of the date of his death*, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust."[83]

Example 9. Testator's will provides, "I devise my house to Smith, and I bequeath a sum of money equal to the value of my house to Jones." The bequest to Smith will be a Section 663(a)(1) distribution because the words of the will allow us to identify at the testator's death the asset to which Smith is entitled.[84] The bequest to Jones likewise qualifies under Section 663(a)(1). The regulation does not require that the amount of Jones's bequest actually be ascertained on the date of the testator's death, merely that it be "ascertainable as of" the date of death. An appraiser can determine the value of the house "as of" that date, perhaps by considering such evidence as sales of comparable properties that occurred on or very near the date of death.

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83. Treas. Reg. § 1.663(a)-1(b)(1) (1960) (emphasis added).
84. *But see supra* note 12.

Example 10. If testator's will provides, "I direct my executor to sell my house at my death and to deliver to Jones the proceeds of the sale," the distribution to Jones will not qualify under Section 663(a)(1). Unlike *Example 9*, here we must wait until an actual buyer is found and an actual sale price agreed upon in order to determine the dollar amount that will be paid to Jones; we cannot determine that amount "as of" the date of death.

B. The "Three-Installment" Rule

Section 663(a)(1) is designed to distinguish trust or estate distributions that are equivalent to gifts or inheritance of property (and therefore, by analogy to Section 102(a), tax-free to the recipients) from distributions that are equivalent to the payments of income from gifted or inherited property (and therefore, by analogy to Section 102(b), taxable to the recipients). A series of periodic payments, such as an annuity, is much more closely analogous to a taxable Section 102(b) gift of income than to a nontaxable Section 102(a) gift of property. Accordingly, the three-installment rule was enacted to prevent a testator or settlor from using the cover of Section 663(a)(1) to convert an annuity into a tax-free property-transfer. Clearly, a bequest of $200,000 should, and does, qualify for Section 663(a)(1) treatment and is tax-free to the beneficiary. But without the three-installment rule, a bequest of $20,000 per year for ten years likewise would be tax-free to the beneficiary.[85]

If a will requires that a bequest of a specific asset or a specific sum of money be paid in, say, five installments, all five installments are denied Section 663(a)(1) treatment, not merely the installments in excess of three.[86] The executor cannot qualify the five-installment bequest for Section 663(a)(1) treatment by accelerating payments so as to distribute the property in only, say, two installments. Suppose the opposite: that the will directs a bequest of a specific asset or sum to be paid in two installments but the executor in fact pays it in five. Although the statutory language seems to say that the benefit of Section 663(a)(1) is lost if the asset or sum is in fact distributed in more than three installments, the regulations take the position that the benefit is lost only if *the governing instrument requires* payment in more than three installments.[87] This position, though perhaps a somewhat free reading of the statutory language,

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85. The regulations provide that specific gifts of articles for personal use (such as jewelry, automobiles, clothing, furniture and other household effects) satisfy the 3-installment rule automatically and therefore qualify for Section 663(a)(1) treatment, regardless of the time for their distribution specified in the will. Treas. Reg. § 1.663(a)-1(c)(1)(i) (1960).

86. Observe that Section 663(a)(1) speaks of installments, not necessarily annual installments. If the will specifies that the bequest is to be paid in five monthly installments, the bequest will fail to qualify under Section 663(a)(1) even if all five installments are received by the beneficiary in the same taxable year.

87. Treas. Reg. § 1.663(a)-1(a) (1960).

rests on solid policy ground; if the decedent makes a $100,000 bequest (clearly a gift of property, not of the income from property), why should the Section 663(a)(1) benefit be lost merely because the estate is illiquid and the executor's difficulty in obtaining cash requires her to spread the $100,000 distribution over four installments?

In most cases, of course, the will does not specify a particular time for the payment of bequests of specific assets or specific sums; under the governing instrument or local law they simply are to be paid in the ordinary course of administration of the decedent's estate. All such bequests to a beneficiary are treated as a single installment even if, in fact, the executor pays them in more than three installments.[88]

Example 11. The decedent's will bequeaths $10,000 to A, Blackacre[89] to A, one-hundred shares of ABC stock to A, a bond issued by XYZ to A, and the residue to B. The bequests of the cash, the land, the stock, and the bond constitute a single installment and accordingly qualify for Section 663(a)(1) treatment, even if the executor in fact makes four separate distributions to A. The residuary bequest to B, of course, is not a bequest of specific property or of a specific sum.[90]

The three-installment rule is applied on a beneficiary-by-beneficiary basis.

Example 12. Smith's will bequeaths $10,000 to be paid to A six months after Smith's death, two-hundred shares of ABC stock to be paid to A seven months after Smith's death, one-hundred shares of XYZ stock to be paid to A eight months after Smith's death, certain specified United States Savings Bonds to First National Bank as trustee, and the residue to B. Under the terms of the trust, $10,000 in cash is to be distributed to A when he reaches the age of twenty-five, $15,000 in cash is to be distributed to A when he reaches the age of thirty, and $20,000 in cash is to be distributed to A when he reaches the age of thirty-five. In determining whether the distributions from the estate to A and to the testamentary trust qualify for Section 663(a)(1) treatment, A and the trust are considered different beneficiaries. The bequests directly to A satisfy the three-installment rule (and qualify for Section 663(a)(1) treatment) since the will expressly directs that A's bequests be paid in no more than three installments. The distribution of the savings bonds to the testamentary trust satisfies the three-installment rule (and qualifies for Section 663(a)(1) treatment) because the will does not

88. Treas. Reg. § 1.663(a)-1(c)(1)(iii) (1960).

89. If, under local law, title to Blackacre passed directly from the decedent to A, we would disregard Blackacre, since the distribution of Blackacre would not constitute an amount paid, credited, or required to be distributed under Section 661. *See* Treas. Reg. § 1.663(a)-1(c)(1)(ii) (1960); *supra* note 12.

90. Treas. Reg. § 1.663(a)-1(b)(2)(iii) (1960).

specify the time of payment, and the bequest is of such a nature that it is to be paid in the ordinary course of administration of the Smith's estate.

When the testamentary trust makes distributions to A, the question will arise whether those distributions qualify for Section 663(a)(1) treatment with respect to the trust: whether they carry out the trust's DNI to A. For this purpose, Smith's estate and the testamentary trust are treated as separate entities; we do not aggregate the three installments paid by the estate to A with the three installments paid by the trust to A.[91] Accordingly, the three distributions made by the trust to A qualify for Section 663(a)(1) treatment with respect to the trust.

Example 13. Jones's will bequeaths $10,000 to be paid to A six months after Jones's death, two-hundred shares of ABC stock to be paid to A seven months after Jones's death, one-hundred shares of XYZ stock to be paid to A eight months after Jones's death, and the residue to First National Bank as trustee. Under the terms of the trust, $10,000 in cash is to be distributed to A when he reaches the age of twenty-five, $15,000 in cash is to be distributed to A when he reaches the age of thirty, and $20,000 in cash is to be distributed to A when he reaches the age of thirty-five. As in *Example 12*, all the bequests to A satisfy the three-installment rule and qualify for Section 663(a)(1) treatment. The distribution of the residue to First National Bank, however, though it satisfies the three-installment rule, does not qualify for Section 663(a)(1) treatment inasmuch as it is a bequest of residue.[92] Accordingly, the distribution of property from Jones's estate to the testamentary trust will carry out DNI; the estate will be entitled to claim a distribution deduction, while the trust will realize gross income. Subsequently, however, when the trust makes the distributions of trust property to A, those distributions will qualify for Section 663(a)(1) treatment as in *Example 12.*

VI. THE REPEALED "THROWBACK RULE" FOR TRUSTS THAT ACCUMULATE INCOME

Until the Tax Reform Act of 1986 redesigned the income tax rates, a trust beneficiary often was in a higher income tax bracket than the trust itself. Suppose a trust was in the 28% bracket, and the beneficiary was in the 36% bracket. If the trust received a $10,000 piece of taxable income in Year 1 and distributed that income to the beneficiary in Year 1, the beneficiary would net $6,400, since the income would be taxed to the beneficiary (at 36%). If, however, the trust accumulated the $10,000 piece of income and did not distribute it until Year 2, the income would be taxed to the trust (in Year 1, at

91. Treas. Reg. § 1.663(a)-1(c)(1) (1960).
92. Treas. Reg. § 1.663(a)-1(b)(2)(iii) (1960).

28%), not to the beneficiary, and accordingly the beneficiary would receive a tax-free distribution of $7,200 in Year 2. The trustee could reduce the family unit's overall income tax burden by storing in the trust the income items received by the trust and then distributing them as corpus in a year subsequent to the year of receipt. The throwback rule of Sections 665 to 667—which applied only to trusts, not to estates—was designed to nullify this incentive to store income by compelling the beneficiary, when he received the $7,200 distribution in Year 2, to pay an additional tax which approximated the additional tax ($800) that would have been payable had the $10,000 been distributed to him in (and taxable to him for) the year it was received by the trust.

In general terms, the throwback rule applied whenever a trust made distributions in excess of its DNI for a year subsequent to a year in which it distributed less than its DNI. The rule first was enacted in 1954, but now that trusts in 1997 reach the maximum tax bracket after $8,100 of taxable income while individuals reach it only after $271,050, little reason exists for preserving such a complex regime. Accordingly, the throwback rule, as applied to domestic trusts, was repealed in 1997.[93] However, with respect to any domestic trust created before March 1, 1984, the throwback rule continues to apply unless it is established that the trust would not be aggregated with other trusts pursuant to Section 643(f) (if such Section applied to such trust).[94]

VII. BASIS ISSUES

A. *Basis of Property Acquired by Inter Vivos Gift*

1. The "Transferred Basis" Rule

Section 1015(a) provides that, for all purposes except determining the amount of the donee's loss, the basis of property acquired by a donee is, immediately after the gift, the same as the donor's adjusted basis immediately prior to the gift: a so-called "transferred" basis. The same rule applies to gift transfers made in trust; the trust takes the grantor's basis. Suppose A's basis in a capital asset is $30,000; she gives the asset to B when the asset is worth $90,000, and B sells it one day later. Since gifts are not income to the donee,[95] if we assigned a fair-market-value basis of $90,000 to that asset in B's hands, the $60,000 of appreciation realized while A held the asset would go permanently

93. The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 507, 111 Stat. 788, 856-57. The repeal under this act is effective for distributions made in taxable years beginning after August 5, 1997.

94. The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 507, 111 Stat. 788, 856-57.

95. I.R.C. § 102 (West Supp. 1997).

untaxed.[96] Under the transferred basis rule of Section 1015(a), however, B must recognize a $60,000 capital gain when he sells the asset for $90,000. Because the property has, in B's hands, "the same basis in whole or in part . . . as it would have in the hands of" A, Section 1223(2) provides that B's holding period is determined by "tacking on" A's holding period to B's actual holding period. Thus, if A had held the capital asset for 362 days before giving it to B, and then B held the asset for five days before selling it for a gain, B's capital gain would be long-term (though subject to the "mid-term" 28% cap).

If the donee sells the asset for a *loss*, Section 1015(a) provides a different rule: the donee's basis is the lesser of the donor's adjusted basis or the asset's fair market value at the time of the gift. This special rule prevents a low-bracket property-owner from shifting a loss deduction to a high-bracket donee: one for whom, in any event, the transfer occasioned an increase, not a decrease, in economic worth.[97] If A's adjusted basis in an asset is $30,000, and he gives the asset to B at a time when the asset's fair market value is $20,000, B's economic worth has increased by $20,000, so it would be anomalous to allow B a loss deduction if he sold the asset immediately after the gift. Section 1015(a) provides, instead, that B's basis will be $20,000 if he sells the asset for, say, $19,000, and $30,000 if he sells it for $31,000 or makes a gift of it. If B sells the asset for $25,000, a figure higher than fair market value at the time of gift ($20,000) but lower than the donor's basis ($30,000), B recognizes neither gain (since the basis for determining gain would be $30,000) nor loss (since the basis for determining loss would be $20,000).

2. Increase in Basis for Gift Tax Paid

In the case of gifts made after 1976, a further adjustment must be made to the figure obtained by applying the rules of Section 1015(a); that figure must be increased by the amount of any gift tax paid with respect to the asset's "net appreciation" while in the hands of the donor.[98]

> *Example 14.* A owns an asset with an adjusted basis of $30,000. When the asset's fair market value has appreciated to $90,000, A gives the asset to B and pays a gift tax of $28,000 with respect to the gift. The "net

96. Even taxing B on $60,000 of gain leaves untaxed $30,000 of the increase in B's net worth effected by A's gift. Some commentators, therefore, have suggested a more robust response to gratuitous wealth-shifting than a mere transferred basis rule. *See* Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978).

97. I.R.C. § 1015(a) does not apply to gift transfers between husband and wife; instead, Section 1041(b)(2) applies. I.R.C. § 1015(e) (West Supp. 1997). Section 1041(b)(2) provides in all events for a transfer of the donor spouse's basis to the donee spouse, whether the donee sells the asset for a gain or a loss.

98. I.R.C. § 1015(d)(6) (West Supp. 1997).

appreciation" in the asset's value is $60,000 ($90,000 - $30,000), and that $60,000 of net appreciation represents 75% of the amount of the gift. (The amount of the gift for this purpose is $80,000: $90,000 less the $10,000 annual exclusion.[99] $60,000/$80,000 = 75%.) Accordingly, Section 1015(d)(6) provides that B's basis in the asset equals $30,000 (A's adjusted basis) plus 75% of the gift tax paid (75% x $28,000 = $21,000), or $51,000. Had no gift tax been due, B's basis would have been $30,000. Had B purchased the asset from A for its fair market value, B's basis would have been $90,000.

Inasmuch as the donor in *Example 14* had made only one taxable gift during the year in question, calculating the Section 1015(d)(6) adjustment was fairly simple. If, however, a donor makes more than one taxable gift during the year, his total gift tax paid must be allocated among all the taxable gifts for that year in the manner described in Treasury Regulation § 1.1015-5(b)(1)(ii). Only after that allocation is made may one calculate the portion of a particular gift's allocable share of the total gift tax that is attributable to the "net appreciation" of that particular gift.

If a property-owner plans to make a series of noncash gifts over a period of years and expects each gift to generate gift tax liability, the rule of Section 1015(d)(6) suggests that she should transfer the assets having little or no "net appreciation" earlier in the series and the assets having more "net appreciation" later. A donor's gift tax bracket is determined by her lifetime gifts, so a gift in a later year is likely to be subject to a higher top marginal rate and generate more gift tax than a gift in an earlier year. Since the payment of gift tax (to the extent the tax is attributable to "net appreciation") raises the donee's basis and correspondingly lowers the donee's capital gain tax exposure, a donor should pair the higher gift tax payment (a later gift) with an asset having more built-in gain.

B. Basis of Property Acquired from a Decedent

1. The "Stepped-Up" Basis Rule

The basis of property in the hands of a transferee who has "acquir[ed] the property from a decedent or to whom the property passed from the decedent" is the fair market value of the property at the date of the decedent's death.[100] Any capital gain or loss recognized by the transferee upon selling or exchanging the

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99. *See* N. Allen Ford and Margaret Reed, *The Effect of Gift Taxes on the Basis in Property Received as a Gift*, 71 TAX NOTES 527 (1996).
100. I.R.C. § 1014(a) (West Supp. 1997).

asset so acquired or so passing will be a long-term gain or loss, regardless of the decedent's or the transferee's actual holding period.[101]

Example 15. A purchases a capital asset for $30,000 in November, 1998. At her death in January 1999, the fair market value of the asset is $40,000. If A's estate sells the asset for $60,000 in July 1999, the estate recognizes a long-term capital gain of $20,000 ($60,000 - $40,000).

In an era of inflationary expectations, the basis dictated by this rule has come to be known as a "stepped-up" basis, but it could just as easily be a stepped-down basis if an asset depreciated between the date the decedent purchased it and the date of her death. The stepped-up basis rule allows unrealized appreciation that accrued between the decedent's purchase and the

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101. I.R.C. § 1223(11) (West Supp. 1997). Determining whether the 20% rate cap or the 28% rate cap will apply to such long-term gain is a different matter. Section 1223(11) provides that if the transferee disposes of the asset within 1 year after acquiring it, the transferee "shall be considered to have held such property for more than 1 year," and Section 1222(3) defines "long-term capital gain" as "gain from the sale or exchange of a capital asset held for more than 1 year." But while holding an asset "for more than 1 year" is enough to assure that the gain is long-term, that is not enough to assure the availability of the most favorable tax rate. Holding an asset for, say 13 months, is enough to make the gain long-term for purposes of such provisions as Section 170(e) or Section 1231, but it is not enough to qualify the gain for the lowest 20% tax rate. Section 1(h) states that the asset must be held for more than 18 months in order to qualify for that rate. *In other words, some gains that meet the Section 1222 definition of long-term gain are subject to the 28% cap and some the 20% cap.*

If a transferee who has acquired property from a decedent sells the property after 13 months, Section 1223(11) does not apply. Accordingly, the transferee's actual holding period will be determinative, and his gain will be subject to the 28% cap applicable to property held for 12 to 18 months. But if the transferee sells the property after only 5 months, Section 1223(11) *does* apply; Section 1223(11) tells us that the property is treated as having been held by the transferee "for more than 1 year," but does that phrase mean "6 months more than 1 year" (so that the 20% cap applies) or "slightly more than 1 year" (so that the 28% cap applies)? The latter reading seems sounder; otherwise an asset sold after 5 months would be subject to the 20% cap while an asset held for 13 months would be subject to the 28% cap. It is clear, of course, that when Congress, in 1997, amended the tax rates applicable to capital gains, it gave no thought to Section 1223(11).

A much-needed technical correction is, as of this writing, making its way through Congress. The bill would amend Section 1223(11) to provide that if the transferee sells the property within 18 months of the decedent's death, the property is treated as having been held by the transferee for more than 18 months; consequently, any gain will be subject to the 20% cap. Tax Technical Corrections Act of 1997, H.R. 2645, 105th Cong. 1st Sess. § 5(d)(4). The amendment would be effective retroactively to the date the 20% cap became effective. Tax Technical Corrections Act of 1997, H.R. 2645, 105th Cong. 1st Sess. § 20.

decedent's death to escape income taxation, and for that reason Congress experimented with a rule providing for a transfer of the decedent's basis to the transferee. This rule, called the "carryover basis on death" rule, was enacted as part of the Tax Reform Act of 1976, but was retroactively repealed in 1980 when it was found to be unworkable.[102]

What sort of property is considered to have been acquired from or to have passed from a decedent? Section 1014(b) provides the answer: all—or, at least, substantially all—the property includable in the decedent's gross estate for federal estate tax purposes. The value of an asset as of the date of the decedent's death as appraised for federal estate tax purposes is the Section 1014(a) basis of that asset in the transferee's hands.[103] If the personal representative elects to use the Section 2032 alternate valuation date or the Section 2032A special use valuation,[104] those alternative values constitute the Section 1014(a) basis. If no federal estate tax return is required to be filed under Section 6018, the value of the property appraised as of the date of the decedent's death for the purpose of state inheritance taxes is presumptively the Section 1014(a) basis of that asset in the transferee's hands.[105]

2. Community Property

If H and W own Blackacre as community property, and H predeceases W, one-half of Blackacre is includable in H's probate estate; he can devise that one-half to anyone by his will. (The other one-half belongs to W, both before and after H's death.) Accordingly, one-half of Blackacre, but only one-half, is included in H's gross estate. In such circumstances, Section 1014(b)(6) bestows a date-of-death basis not only on the one-half of the community property asset

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102. Carryover basis on death was by no means the only short-lived estate-related tax reform that was repealed retroactively when it was found to be unworkable. The Tax Reform Act of 1976 also contained an almost incomprehensible generation-skipping transfer tax, which was retroactively repealed in 1986 and replaced by a more workable regime. And in 1987, Congress, to neutralize so-called "estate-freezing" techniques, enacted Section 2036(c), which likewise proved so unwieldy that it was repealed retroactively in 1990 and replaced by Chapter 14 of the Code.

103. The regulations state that the appraised value for federal estate tax purposes "shall be deemed" to be the Section 1014(a) basis. Treas. Reg. § 1.1014-3(a) (1960). In a revenue ruling, however, the Service stated that the appraised estate tax value is merely "a presumptive value" for Section 1014(a) purposes, a presumption that can be rebutted by clear and convincing evidence. Rev. Rul. 54-97, 1954-1 C.B. 113.

104. I.R.C. § 2032 (West Supp. 1997) prescribes an alternate valuation date, which generally is six months after the date of the decedent's death; and Section 2032A permits certain assets used in some small businesses and farms to be valued at a figure below fair market value.

105. If no estate tax return is required to be filed, the personal representative may not make the Section 2032 or Section 2032A election.

that passes from the deceased, H, but also on the one-half that W retains, even though W's one-half was not included in H's gross estate.

3. Exceptions

Under certain circumstances, the basis of an asset included in a decedent's gross estate will not be granted a Section 1014(a) value-at-death basis:

a. *Income in respect of a decedent.* Section 1014(c) denies items of income in respect of a decedent a value-at-death basis.

b. *Dispositions before death.* Sections 2035 to 2042 include in a deceased individual's gross estate certain assets that the individual transferred during her life. If the transferee of such an asset disposes of the asset before the transferor's death, the value-at-death basis rule of Sections 1014(a) does not apply.

Example 16. D owns some XYZ stock having an adjusted basis of $40,000. In 1997, when the stock is worth $60,000, D transfers it to First National Bank as trustee. Under the terms of the trust, the trust's income is to be paid to A for life, and upon A's death the trust principal is to be distributed to B. D retains the right to revoke the trust at any time during D's life. In 1999, on a date when the value of the stock is $70,000, D dies. The trust property (the XYZ stock) is included in D's gross estate pursuant to Section 2038. Accordingly, the trust's basis in the stock becomes $70,000. If the bank sells the stock for $75,000 two months after D's death, the trust must recognize a $5,000 long-term capital gain.

Suppose instead that the bank sells the XYZ stock for $71,000 two months *before* D's death. The trust's basis in the stock is $40,000, a Section 1015(a) transferred basis, so the trust must recognize a $31,000 long-term capital gain. When D dies one month later, the trust property is included in D's gross estate pursuant to Section 2038, but no adjustment is made in the previously calculated $31,000 gain. If the bank took the $71,000 obtained from the sale of XYZ stock and used it to purchase $71,000 of QRS stock, and that QRS stock was worth $75,000 on the date of D's death, the trust's basis in the QRS stock would become $75,000.

c. *Gifts within one year of the donee's death.* The owner of appreciated property might be tempted to give the property to a close relative who is near death, with a view to that relative's bequeathing the property back to the donor, giving the donor a stepped-up basis in the very property that the donor had owned but a short time earlier—a macabre but

nonetheless successful tax-avoidance device. To reduce the incentive for such stratagems, Section 1014(e), enacted in 1981,[106] provides that if:

> (A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and (B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), [then] the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.

C. The Beneficiary's Basis in Noncash Assets Distributed by an Estate or Trust

1. Distribution of a Specific Asset Bequeathed or Given as Described in Section 663(a)(1)

D's will provides, "I devise Blackacre to C." D purchased Blackacre, a capital asset, for $20,000 in August 1999. D died in October 1999, at which time Blackacre was worth $50,000. The estate distributed Blackacre to C in November 1999, at which time Blackacre was worth $55,000. Because of Section 663(a)(1), the estate does not get a distribution deduction for the distribution of Blackacre, and C does not have to include anything in gross income as a result of C's receipt of Blackacre. C's basis in Blackacre is a Section 1014(a) basis, because C "acquir[ed] the property from a decedent." Thus, C's basis in Blackacre is $50,000, its value for estate tax purposes.[107] If C sells Blackacre for $60,000 in December 1999, C will recognize a $10,000 capital gain. Because C's basis in Blackacre is a Section 1014(a) basis, Section 1223(11) provides that C's gain is a long-term gain even though C held Blackacre for only one month.

2. Satisfaction of a Section 663(a)(1) Pecuniary Gift or Bequest by Distribution of Noncash Assets

If X owes A $10,000 payable on April 1, the simplest way of discharging the debt is to pay A $10,000 in cash on April 1. If A is willing, X also can discharge the debt by making payment "in kind:" for example, giving A stock

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106. Until 1981, the gift tax law may have served as a disincentive for this tax-avoidance device, since the gift tax (or the reduction in the donor's unified credit) occasioned by the donor's gift often outweighed the income tax advantage of a stepped-up basis. The 1981 enactment of an unlimited marital deduction, however, made this device more tempting, at least where the donee is the donor's spouse.

107. Assume that D's executor did not elect alternate valuation pursuant to Section 2032; consequently, Blackacre's value for estate tax purposes is its date-of-death value.

worth $10,000 on April 1. If the stock that X uses to discharge the $10,000 debt on April 1 is stock that X purchased for $7,000 two years earlier, then X must recognize a $3,000 long-term capital gain, just as if X had sold the stock for $10,000 on April 1 and immediately paid the realized cash to A. When A releases X from a $10,000 debt in exchange for X's transfer of stock to A, A has effectively bought X's stock for $10,000. After the stock transfer discharges X's debt, A's basis in the stock will be $10,000.

This same principal applies when an estate or trust (most likely an estate) uses noncash assets to pay a pecuniary bequest or gift. Suppose D's will provides, "I bequeath $55,000 to A." D purchased some XYZ stock for $20,000 in August, 1999. D died in October 1999, at which time the stock was worth $50,000. In November 1999, when the stock was worth $55,000, the estate distributed the stock to A in full satisfaction of A's bequest. Because of Section 663(a)(1), the estate does not get a distribution deduction for distributing the stock to A, and A does not have to include anything in gross income as a result of A's receipt of the stock. The estate's basis in the stock is a Section 1014(a) basis, which is $50,000—the value of the stock for estate tax purposes. When the estate uses property having a basis of $50,000 to discharge a $55,000 obligation, the estate realizes a $5,000 capital gain.[108] Since the estate's basis in the stock was a Section 1014(a) basis, Section 1223(11) provides that the estate's capital gain is a long-term gain even though the estate held the stock for only one month (from October to November). A's basis in the stock, unlike the estate's basis in the stock, is not a Section 1014(a) basis. Rather, it is a cost basis of $55,000; A effectively "purchased" the stock from the estate for $55,000 by accepting the stock in full satisfaction of his $55,000 claim (pecuniary bequest) against the estate. Since A's basis is not a Section 1014(a) basis, A's holding period will be determined in accordance with the normal rules, rather than pursuant to the special rule of Section 1223(11). Thus, if A sells the stock for $59,000 in December 1999, A will recognize a $4,000 short-term capital gain: short-term because A held the stock for only one month (from November to December).

While the principle of the *Kenan* case applies to the recognition of losses as well,[109] Section 267 denies trusts (but not estates) a deduction for such losses. If an estate uses an asset with an adjusted basis of $60,000 to satisfy a Section 663(a)(1) pecuniary request of $55,000, the estate recognizes a $5,000 loss. A trust, however, would not be able to recognize a loss in those circumstances inasmuch as Section 267 expressly denies a deduction for losses realized on a sale or exchange of property between a trust and a beneficiary of the trust.[110] By

108. Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940).

109. Rev. Rul. 86-105, 1986-2 C.B. 82.

110. Section 267(a) disallows a deduction for losses incurred from sales or exchanges of property between taxpayers related to each other in any manner specified in Section 267(b); and Section 267(b)(6) indicates that "[a] fiduciary of a trust and a

way of compensation for the denial of the trust's $5,000 loss deduction, the beneficiary who received the asset would be permitted to exclude from his gross income up to $5,000 of any gain he realized upon a subsequent sale of the asset.[111]

3. Noncash Distributions That Do Not Come Within Section 663(a)(1)

D's will provides, "I devise and bequeath the residue of my estate to B." In 1996, D buys some Alpha stock for $15,000. D dies in 1998, at which time the Alpha stock is worth $40,000. In 1999, when the Alpha stock is worth $50,000, the estate distributes the Alpha stock to B, the only distribution made in 1999. The bequest of residue is not a Section 663(a)(1) bequest, and under pre-1984 law (which Treasury Regulation § 1.661(a)-2 still reflects) the estate was entitled to a $50,000 distribution deduction even though the estate's basis was only $40,000.[112] (B would, under pre-1984 law, include $50,000 in his gross income pursuant to the normal Section 662 rules.) The failure of the pre-1984 tax system to tax this $10,000 of unrealized gain was a distortion, for had the estate sold Alpha for $50,000 cash and then distributed the $50,000 cash to B, the estate would have had to pay income tax on the $10,000 gain,[113] yet the estate's distribution deduction would have remained at $50,000. There would have been no offsetting increase in the distribution deduction, and the amount includable in B's gross income likewise would have remained at $50,000.

The Tax Reform Act of 1984 added Section 643(d) (now codified as Section 643(e)) to the Code to prevent this distortion. It applies when a fiduciary makes a distribution in kind, other than a Section 663(a)(1) distribution,[114] and

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beneficiary of such trust" are related taxpayers for purposes of the Section 267(a) disallowance rule. In 1997, Congress enacted Section 267(b)(13), which adds to the list of related taxpayers "an executor of an estate and a beneficiary of such estate," except in the case of "a sale or exchange in satisfaction of a pecuniary bequest." Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1308(a), 111 Stat. 788, 1041. Because of the exception for pecuniary bequests (*i.e.*, bequests of a specific sum of money as described in Treas. Reg. § 1.663(a)-1(b) (1960)), the estate in our example would continue to be allowed to recognize the $5,000 loss, even after the 1997 amendment.

111. I.R.C. § 267(d) (West Supp. 1997).

112. We assume here that the estate has, for the year in question, at least $50,000 of DNI, consisting entirely of taxable items. Under pre-1984 law, the distribution was deemed to carry out $50,000 of DNI even though the estate's basis was $40,000 and the estate recognized no gain.

113. Presumably, the capital gain would be added to the estate's corpus and taxed to the estate; it would not enter into the estate's DNI.

114. The most common kinds of distributions that give rise to a Section 643(e) election are: (1) distributions of noncash assets to the heirs of an intestate decedent; (2) distributions of noncash assets to a residuary beneficiary of an estate; (3) discretionary noncash distributions from a trust (whether charged to principal or to income); and (4)

it does two things. First, it provides that the beneficiary takes the estate's or trust's basis in the distributed asset, adjusted for any gain or loss recognized by the estate or trust on the distribution (*i.e.*, increased for gain; decreased for loss). Why, you may ask, would a trust or estate *have* to recognize gain or loss when it distributes a noncash asset in a non-Section 663(a)(1) distribution? That brings us to the second feature of Section 643(e): it allows a fiduciary to elect to recognize gain or loss on the distribution as if the trust or estate had sold the asset to the distributee at the asset's date-of-distribution value.[115]

Let us return to the original example. D's will provides, "I devise and bequeath the residue of my estate to B." In 1996, D bought some Alpha stock for $15,000. D dies in 1998, at which time the Alpha stock is worth $40,000. In 1999, when the Alpha stock is worth $50,000, the estate distributes the Alpha stock to B, the only distribution made in 1999. Again, we assume that the estate has, for the year in question, at least $50,000 of DNI, consisting entirely of taxable items. If the executor does not make the Section 643(e) election, B's basis in Alpha is the same as the estate's basis—$40,000.[116] Then Section

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distributions of noncash assets upon the termination of a trust.

115. The election must be made, if at all, with respect to all noncash non-Section 663(a)(1) distributions made during the taxable year.

116. The estate recognizes no gain or loss on the distribution; therefore, under Section 643(e)(1), B takes simply a transferred basis.

What would be B's holding period for determining whether any capital gain or loss recognized by B on a subsequent sale or exchange is long-term or short-term and, if the gain is long-term, for determining the applicable marginal rate? Until Congress makes technical corrections to Section 1223(11) to take account of the two separate marginal rate caps applicable to long-term gains, see *supra* note 101, only educated guesses are possible, inasmuch as the 1997 amendments to Section 1 rendered Section 1223 ambiguous. First, consider the case where the estate distributes Alpha to B less than 1 year after D's death. Had the estate sold Alpha instead of distributing it to B, the estate's holding period automatically would have been more than 1 year (Section 1223(11)), and it is inconceivable that B's holding period after the distribution could be shorter than the estate's holding period before the distribution. Accordingly, B's holding period must be at least more than 1 year no matter when B sells Alpha. There are two statutory ways of reaching that result. It might be argued that B "acquired" Alpha from the decedent within the meaning of Section 1014(b) and took the estate's basis pursuant to Section 1014(a), and that B therefore was entitled to a holding period determined under Section 1223(11). By this reasoning, if B sold Alpha within 1 year of D's death, the gain would be long-term subject to the 28% cap; and if B sold Alpha more than 1 year after D's death, B's actual holding period would be determinative. Instead of relying on Section 1223(11), one might rely on Section 1223(2). That is, one might argue that B's transferred basis was "the same basis in whole or in part as it would have been in the hands of" the transferor estate, with the result that B could "tack on" his holding period to the estate's automatic 1-year holding period. By that reasoning, if B sold Alpha not more than 6 months after the date of distribution, B's gain would be subject to the 28% cap; and if B sold Alpha more than 6 months after the date of distribution, B's gain would be subject to the 20% cap.

643(e)(2) provides that the distribution will be deemed to carry out no more DNI than the lesser of (a) B's transferred basis ($40,000), or (b) the fair market value of the property at the date of distribution ($50,000). Thus, the distribution of Alpha will carry out only $40,000 of DNI, so the estate will be entitled to a distribution deduction of only $40,000, and B will have to include only $40,000 in his gross income pursuant to Section 662.

If the fiduciary makes the Section 643(e) election, then Section 643(e)(3) provides that the estate must recognize gain as if the property had been sold to B at its date-of-distribution fair market value. Thus, the estate will recognize a $10,000 capital gain when it distributes Alpha to B.[117] (The gain will be long-term gain, pursuant to Section 1223(11).) Consequently, B's basis in Alpha will be $50,000, pursuant to Section 643(e)(1): the estate's basis ($40,000) plus gain recognized by the estate on the distribution ($10,000).[118] Therefore, the distribution of Alpha can carry out $50,000 of DNI rather than only $40,000;[119] the estate, therefore, will be entitled to a distribution deduction of $50,000, and B will have to include $50,000 in his gross income.

To recapitulate: if the fiduciary does not make the Section 643(e) election, the estate gets a $40,000 distribution deduction, B must include $40,000 in his gross income, and B's basis is $40,000; recognition of any gain or loss is deferred until B sells the property. If the fiduciary does make the Section 643(e) election, the estate must recognize a $10,000 long-term capital gain but gets a $50,000 distribution deduction, while B must include $50,000 in his gross income but gets a $50,000 basis in Alpha.

In most circumstances, the fiduciary probably will refrain from making the Section 643(e) election, but the election occasionally can be useful. Suppose the residue of the testator's estate is bequeathed to A and B in equal shares, and the executor proposes to distribute $50,000 of Alpha stock to A and $50,000 of Beta

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If the estate distributed Alpha to B 1 year or more after D's death, or if the distribution of Alpha to B had been made by a trust, Section 1223(11) would not apply; but Section 1223(2) would apply, allowing B to tack on to his actual holding period the actual holding period of the trust or estate.

117. Had the estate's basis in Alpha been higher than Alpha's fair market value at the date of distribution to B, the estate would have been barred from recognizing the loss, since an estate and a beneficiary of the estate are "related taxpayers" for purposes of the Section 267 rule disallowing certain losses. *See supra* note 110. Section 267(b)(13) allows an estate to recognize a loss arising from the satisfaction of a pecuniary bequest, but not a loss arising from a deemed sale to a beneficiary of a nonpecuniary bequest.

118. Inasmuch as B's basis is "the same basis . . . in part in his hands as it would have been in the hands of" the transferor estate, Section 1223(2) would apply, allowing B to "tack on" his holding period to the estate's holding period. One could argue, however, that since B's basis works out in fact to be simply the asset's fair market value at the time of distribution, Section 1223(2) should not apply, and B's holding period should be his actual holding period beginning on the day following the day of distribution.

119. *See* I.R.C. § 643(e)(2) (West Supp. 1997).

stock to B during the current taxable year. If the estate's basis is $20,000 in the Alpha stock and $45,000 in the Beta stock, the executor's failure to make the Section 643(e) election would, in violation of the executor's duty of impartiality, put B in a more advantageous position than A; for if both stocks thereafter doubled in value and the legatees sold, A would have to recognize an $80,000 gain while B would have to recognize only a $55,000 gain. If, however, the executor made the Section 643(e) election, giving A and B each a $50,000 basis, the two legatees would be placed in the same position respecting subsequent changes in their legacies' values.[120]

120. .The "price" of the executor's Section 643(e) election would be the estate's payment of the income tax on the $35,000 net capital gain. Inasmuch as capital gains generally are excluded from DNI, the tax would be paid by the estate. Presumably, the tax would be paid from the estate's residue, so A and B would bear equally the income tax burden resulting from the election.

This use of the Section 643(e) election allows the executor to fulfill its duty of impartiality, but at the expense of its duty to minimize taxes. A pro rata distribution—$25,000 of Alpha stock and $25,000 of Beta stock to each beneficiary—would allow the executor to fulfill both duties at once, so this particular use of the election may be confined to situations where pro rata distributions are impracticable or undesirable.