



A GUIDE TO INCLUDING CAPITAL
GAINS IN DISTRIBUTABLE
NET INCOME (DNI)

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INTRODUCTION

Substantial changes in Federal tax law effective in 2013 have expanded the importance of considering discretionary distributions to trust and estate beneficiaries.

The new higher tax rates of 39.6% on ordinary income and 20% on capital gains and qualified dividends, and the new 3.8% Net Investment Income Tax affect trusts and estates at a very low taxable income level (approximately \$12,000). On the other hand, beneficiaries may be in lower tax brackets, may not be subject to the Net Investment Income Tax, and may have capital losses to offset distributed capital gains. In the case of beneficiaries living in low or no income tax jurisdictions, discretionary distributions to beneficiaries may achieve additional tax savings.

Notwithstanding such potential income tax savings, making discretionary distributions may not be in accordance with the wishes of the grantor or may not be appropriate to the beneficiary's circumstances from a fiduciary point of view. However, where discretionary distributions are made or anticipated, the ability to remove capital gains from taxation at the trust or estate level could be quite important.

Capital gains are taxed at the trust or estate level, even if they are part of a distribution to a beneficiary, unless they are considered to be included in Distributable Net Income (DNI) under the provisions of IRC 643(a) and Reg. 1.643(a)-3. (See Note 1.) This Guide provides four approaches (sections I to IV) to including capital gains in DNI, some general comments (section V), and an Illustration of Potential Tax Savings.

I. FOR NEW INSTRUMENTS, DRAFT TO ALLOCATE CAPITAL GAINS TO ACCOUNTING INCOME

REGULATIONS: If capital gains are specifically allocated to income under terms of the governing instrument (and applicable local law), they are included in Distributable Net Income (DNI). (Reg. 1.643(a)-3(b)(1))

EXAMPLE: See Example 4 of Reg. 1.643(a)-3(e). (Note 2)

COMMENTS:

- (1) Certainty: This approach results in maximum certainty that the capital gains will be included in DNI (as long as the provision in the instrument is not inconsistent with local law).
- (2) Flexibility: This approach leaves little room for flexibility since all capital gains throughout the term of the trust will be considered fiduciary accounting income. (Depending on other terms of the trust agreement, this approach could have the unintended effect of substantially increasing distributions to current beneficiaries to the detriment of remainder beneficiaries.)

II. FOR NEW INSTRUMENTS, DRAFT TO GIVE THE FIDUCIARY THE DISCRETION TO ALLOCATE CAPITAL GAINS TO ACCOUNTING INCOME

REGULATIONS: If capital gains can be allocated to income pursuant to a reasonable, impartial exercise of discretion by a fiduciary under a power granted by applicable local law or by the governing instrument, if not prohibited by local law, they are included in DNI. (Reg. 1.643(a)-3(b)(1)) (See Note 3 regarding unitrusts.)

EXAMPLE: See Example 4 of Reg. 1.643(a)-3(e) (assuming that the facts are modified to provide that the allocation of capital gains to income would be at the discretion of the fiduciary, rather than pursuant to the mandatory provisions of the governing instrument).

COMMENTS:

- (1) Certainty: This approach provides a high degree of certainty but it is open to challenge if it can be shown that the fiduciary abused the discretionary allocation power.
- (2) Flexibility: This approach retains flexibility since the fiduciary has the power to determine what portion of capital gains in a particular year is allocated to income and can vary the portion allocated to income from year to year. (There is no requirement for consistency under Reg. 1.643(a)-3(b)(1), except in the case of a unitrust.) (See Note 3.)

III. WHEN CAPITAL GAINS ARE ALLOCATED TO CORPUS, TREAT CONSISTENTLY AS PART OF A DISTRIBUTION TO A BENEFICIARY

REGULATIONS: Even though capital gains are allocated to corpus under the terms of the governing instrument and/or local law, they will be included in DNI if they are treated consistently by the fiduciary on the trust's or estate's books, records and tax returns as part of a distribution to a beneficiary. (Reg. 1.643(a)-3(b)(2))

EXAMPLE: See Examples 1 and 2 of Reg. 1.643(a)-3(e). (Note 4)

COMMENTS:

- (1) Certainty: This approach provides a fair degree of certainty if the fiduciary begins in the first year of the estate or trust to treat capital gains as part of a distribution to a beneficiary. Examples 1 and 2 (above) include the fact that the governing instrument specifically gives the trustee the power "...to deem discretionary distributions to be made from capital gains realized during the year." However, such specific authority does not appear to be required by Reg. 1.643(a)-3(b)(2). (See Note 5.)
- (2) Flexibility: This approach is not very flexible since it requires consistency. Treatment of capital gains in the first year of the trust or estate, determines treatment for all succeeding years. (But see item 1 under "Modifying the Effects of Existing Instruments" in Part V, below.)

IV. WHEN CAPITAL GAINS ARE ALLOCATED TO CORPUS, ACTUALLY DISTRIBUTE OR UTILIZE IN DETERMINING THE AMOUNT OF DISTRIBUTIONS

REGULATIONS: Even though capital gains are allocated to corpus under the terms of the governing instrument and/or local law, they will be included in DNI if they are actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary. (Reg. 1.643(a)-3(b)(3))

EXAMPLE: See Example 5 of Reg. 1.643(a)-3(e). (Note 6)

COMMENTS:

- (1) Certainty: There is a fair degree of certainty under this approach if proper calculations are made and records are retained showing that capital gains are actually distributed to a beneficiary or how capital gains are utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary. (Note 7) It does not appear that specific authority is required in the governing instrument or under local law for these actions by the fiduciary. (Note 5)

- (2) Flexibility: Most commentators believe that consistency is not required under Reg. 1.643(a)-3(b)(3). (This is supported by the omission of the words "treated consistently" which are specifically included in the requirements under 1.643(a)-3(b)(2).) Under that interpretation, the fiduciary has the ability to vary the inclusion of capital gains in DNI from year to year. (Note 8)

V. GENERAL COMMENTS

COMPARISON OF ALTERNATIVES:

The approaches in I and II (capital gains are allocated to accounting income) provide the highest degree of certainty. Therefore, inclusion of appropriate language regarding the allocation of capital gains should be considered for all new governing instruments. For existing instruments, approach III (capital gains are allocated to corpus but treated consistently as part of a distribution to a beneficiary) is simple to apply but approach IV (capital gains are allocated to corpus but are actually distributed or utilized to determine distributions) appears to be preferable over approach III in many cases since it provides greater flexibility. Approach IV is not required to be applied in the first year of the trust or estate and can be applied differently from year to year.

IN-KIND DISTRIBUTIONS:

Another approach to including capital gains in DNI exists in certain limited circumstances in which distribution of appreciated assets to beneficiaries is appropriate. For example, if a specific income distribution is required and that requirement is met by distributing appreciated assets, this could trigger a "built in capital gain" under Reg. 1.651(a)2(d) and 1.661(a)-2(f). In this situation, a strong argument exists for including the capital gain in DNI under approach IV since this capital gain would actually have been distributed to the beneficiary.

Alternatively, if appreciated assets are used to make a discretionary distribution of corpus, capital gain will not be recognized by the trust or the estate under IRC 643(e). In this situation, the beneficiary receives a carryover basis and will recognize the capital gain if and when the beneficiary sells the assets. (Note 9)

MODIFYING THE EFFECTS OF EXISTING INSTRUMENTS:

- (1) Perhaps an existing trust could be decanted (or otherwise modified) to make it clear that the fiduciary has the authority to include capital gains in DNI as described in approaches III and IV, or to provide a new opportunity to begin a fiduciary practice when consistency is required, as under approach III.

- (2) Perhaps some or all of the assets of the trust could be placed in a partnership or limited liability company (taxed as a partnership). Generally, distributions from a partnership are treated as fiduciary accounting income whether or not the partnership has realized capital gains for the year (with certain exceptions involving liquidations or partial liquidations). (Note 10)

POWER TO ADJUST AND UNITRUST PROVISIONS:

Although the power to adjust and unitrust provisions authorized under state law may result in a re-allocation from accounting principal to accounting income, this alone may not be sufficient for capital gains to be included in DNI. Further authority may be required under a provision of the governing instrument which mandates this result (approach I) or under discretionary authority of the fiduciary provided under the governing instrument (approach II). (See Note 11 for sample trust provisions.)

NOTES

1. The pertinent paragraphs of Reg. 1.643(a)-3 read as follows:

- (a) In general. Except as provided in Reg. 1.643(a)-6 (relating to income of foreign trusts) and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

- (b) Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)—
 - (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph Reg. 1.643(a)-3(b));
 - (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
 - (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

2. Example 4 states that: The facts are the same as in Example 1 (see Note 4 below), except that pursuant to the terms of the governing instrument, in a provision not prohibited by applicable local law, capital gains realized by the Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the \$10,000 capital gain is included in Trust's distributable net income for the taxable year.

3. If income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to capital gains. (Reg. 1.643(a)-3(b)(1))

4. Example 1 states that: Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has \$5,000 of dividend income and \$10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the \$10,000 capital gain to principal. During the year, Trustee distributes to A \$5,000, representing A's right to trust income. In addition, Trustee distributes to A \$12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the \$10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example 2 states that: The facts are the same as in Example 1 (above), except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the \$10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years, Trustee must treat all discretionary distributions as being made first from any realized capital gains.

5. A plain reading of Reg. 1.643(a)-3(b) indicates that the prerequisite language (related to the required authority under the instrument or local law), which applies to all three of its subparagraphs, refers only to the allocation of capital gains to income or corpus. In subparagraphs 2 and 3, the words "Allocated to corpus" are followed by the word "but" which separates the allocation action from the specific action required of the fiduciary ("treated consistently by the fiduciary... as part of a distribution to a beneficiary", in subparagraph 2, and "actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed...", in subparagraph 3). Discussions with the I.R.S. Chief Counsel's Office confirm this interpretation. However, for new instruments, prudence suggests that specific authority be given to the trustee to take the actions necessary to "deem" discretionary distributions to be made from capital gains under Reg. 1.643(a)-3(b)(2)&(3). (See Note 11 for sample trust provisions.)

6. Example 5 states that: The facts are the same as in Example 1 (see Note 4), except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is \$10,000, rather than \$12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the \$10,000 capital gain is included in Trust's distributable net income for the taxable year.
7. The "actually distributed" alternative apparently requires tracing of capital gains realized during the year to specific distributions to a beneficiary. (This could be a challenge if, for example, distributions of principal are required early in a year, before capital gains for the year are determined.)

The "utilized" alternative apparently requires the fiduciary to maintain a record of the policy and the calculations utilized to determine the amount of discretionary distributions, and specifically the impact of capital gains on this determination.
8. For further discussion of this interpretation, see Steve R. Akers, "Heckerling Musings 2014 and Current Developments" (April 2014) at page 64. Also, see Frederick Sembler, "Including Capital Gains in Trust or Estate Distributions After ATRA", TRUSTS & ESTATES 23 (March 2013).
9. See Mark R. Parthemer and Sasha A. Klein, "Taking Control", PROBATE AND PROPERTY (November/December 2014, Vol. 28, No. 6) at page 35.
10. See Steve R. Akers, "Heckerling Musings 2014 and Current Developments" (April 2014) at page 63.
11. In "Final Income Tax Regulations: Their Meaning and Importance", by Jonathan G. Blattmachr and Mitchell M. Gans, TAX NOTES TODAY, May 17, 2004, the following sample provisions are offered for consideration:

- (1) The Trustees (other than any Trustee who is a beneficiary hereunder and other than the grantor) may allocate within the meaning of reg. section 1.643(a)-3(b) to income or to principal, or partly to income and partly to principal, all or part of the realized gains from the sale or exchange of trust assets; provided, however, that if income is defined under an applicable state statute as a unitrust amount and the trust is being administered pursuant to such statute, the allocation of gains to income must be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to reg. section 1.643(a)-3(b).

- (2) The Trustees (other than any Trustee who is a beneficiary hereunder and other than the grantor) may deem, within the meaning of reg. section 1.643(a)-3(e), any discretionary distribution of principal as being paid from capital gains realized during the year. The Trustees (other than any Trustee who is a beneficiary hereunder and other than the grantor) may take any action that may be necessary in order for such deeming to be respected for tax purposes.

- (3) The Trustees (other than any Trustee who is a beneficiary hereunder and other than the grantor) may, within the meaning of reg. section 1.643(a)-3(e), specify the tax character of any unitrust amount paid hereunder. The Trustees (other than any Trustee who is a beneficiary hereunder and other than the grantor) may take any action that may be necessary in order for such specification to be respected for tax purposes.

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