THE INCOME DISTRIBUTION DEDUCTION OF TRUSTS AND ESTATES

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Introduction

In computing taxable income, trusts and estates generally are allowed the same deductions against gross income as are individuals.1 However, an additional deduction, not available to individuals, is allowed to trusts and estates. This additional deduction is for distributions of income made by the trust or estate to beneficiaries.2 Thus, although trusts and estates are recognized for income tax purposes as separate tax-paying entities, and as such are required to file annual income tax returns and pay an income tax, trusts and estates are not taxed on income distributed to beneficiaries.3 With regard to such income distributions, trusts and estates operate not as separate tax-paying entities but as conduits for income to pass through to beneficiaries. The tax on distributed income, in effect, is shifted to the beneficiaries who receive the income. Through the use of distributions the fiduciary can allocate the overall tax due on the trust’s or estate’s taxable income among the trust or estate and its beneficiaries. Such use allows for private ordering of the tax consequences of income realized by the trust or estate. Such private ordering may in certain cases minimize the overall tax liability on the trust’s or estate’s income.

The availability of the income distribution deduction to trusts and estates with moderate annual income is of particular importance today in light of

2. I.R.C. §§ 651(a) & 661(a) (Supp. IV 1986).
3. In determining the taxable income of the trust or estate, the deduction for income distributions to beneficiaries is taken on line 17 of Form 1041. See supra note 1. The deduction itself is computed on Schedule B.—Income Distribution Deduction, page 2 of I.R.S. Form 1041. For guidance on the preparation of Form 1041, see PRACTICING LAW INSTITUTE, PREPARATION OF THE FIDUCIARY INCOME TAX RETURN—1988 (1988).
the restructuring of the tax rates by the Tax Reform Act of 1986 (Act). A stated purpose of the Act was to reduce the tax-saving benefits available when income is accumulated at the trust or estate level. To achieve this purpose, the Act substantially increased the tax rates applicable to trusts and estates in comparison to those applicable to individuals. This increase was achieved through two steps. First, the Act reduced the number of tax brackets applicable to trusts and estates from fourteen to two and, in doing so, significantly flattened the progressivity of the tax rates applicable to trusts and estates. The new rate structure now provides for an initial tax bracket of 15 percent on


In addition to altering the rate schedule of trusts and estates, the Tax Reform Act of 1986 also revised the taxation of trusts and estates in a number of other significant ways dealing with grantor trusts, taxable year of trusts, estimated payments of income tax by trusts and estates, and generation-skipping trusts. See General Explanation, supra, at 1246-51, 1259-68. For a more detailed discussion of these changes and their planning repercussions, see Smith & Olsen, Structuring Trusts and Estates after Tax Reform, 1 Prac. Tax Law. 29 (1987) and Westfall, Grantors, Trusts, and Beneficiaries Under the Income Tax Provisions of the Internal Revenue Code of 1986, 40 Tax Law. 713 (1987) [hereinafter Westfall]. These further changes do not affect the income distribution deduction directly and will not be discussed in this article.

Some commentators have opined that the changes to the taxation of trusts and estates brought about by the Tax Reform Act of 1986 are among the most important changes in this area in the history of the federal income tax. See Westfall, supra at 713; A. Michaelson & J. Blattmachr, Income Taxation of Estates and Trusts 1 (12th ed. Supp. 1987).

5. See General Explanation, supra note 4, at 1245. The tax savings achieved under prior law were possible because trusts and estates are taxable entities separate and apart from their beneficiaries. Consequently, retained income was taxed on the trust’s or estate’s separate progressive rate schedule, beginning with the lowest tax bracket; in contrast, had such income been distributed to a beneficiary, it would have been taxed at the beneficiary’s applicable marginal rates determined by taking into account income from all other sources. The benefit in retaining or trapping income at the trust or estate level was the double use of the lower brackets in the progressive rate schedule. This tax-minimizing use of trusts and estates was greatest when the accumulated or retained income was taxed at the entity’s lowest tax rate, but would have been taxed at the beneficiary’s highest marginal rate if distributed. See Westfall, supra note 4, at 713, 720, 724, & 728. The pre-1986 Act maximum savings in tax liability achieved through accumulations were $8,450 per year per entity, calculated as follows: The tax liability on taxable income of $79,500 (the level of income at which a trust or estate reached its 50% maximum rate under prior law) was $31,300 if accumulated by the trust or estate, or $39,750 if distributed to a beneficiary already taxed at the 50% marginal rate. The choice to accumulate the income and tax the $79,500 amount on the separate, progressive schedule of the trust or estate rather than the flat 50% rate of the beneficiary resulted in the $8,450 savings in tax liability.

For tax-savings calculations through the use of accumulations based on a number of assumptions as to amounts of income accumulated, type of income, tax rates, number of trusts, years of accumulation, and ages of beneficiaries, see J. McGaffey, The Inexact Throwback Rule and Multiple Trusts, Inst. on Est. Plan. ch. 13 (1979). The throwback rule was intended to prevent this potential for tax avoidance by additionally taxing accumulation distributions. For a general explanation of the throwback rule, see 3 B. Bittker, Federal Taxation of Income, Estates and Gifts § 81.5 (1981). See also Staff of the Joint Comm. on Int. Rev. Tax’n, 83d Cong., 2d Sess., Report of the Advisory Group on the Taxation of Estates and Trusts 3 (Comm. Print 1954).
the first $5,000 of taxable income, followed by a top bracket of 28 percent on taxable income over $5,000. In comparison to prior law, trusts and estates now reach their top marginal rate on a smaller amount of accumulated income. Moreover, the 15-percent rate is phased out in the case of taxable income between $13,000 and $26,000 with the imposition of a 5-percent surcharge on income within that range. Thus, trusts and estates with taxable income over $26,000 do without the benefit of the lower rate and are in effect subject to a flat tax rate of 28 percent on such income.

Second, the Act plays against this change in the rate structure applicable to trusts and estates a dissimilar change in the tax rates applicable to individuals. Individuals now enjoy a much wider initial 15-percent tax bracket. While trusts and estates are subject to this lower rate only on taxable income under $5,000, individuals enjoy the lower rate on taxable income under $29,750 on joint returns and $17,850 on single returns. Moreover, while the lower rate for trusts and estates is phased out beginning with taxable income of $13,000, the threshold amounts for individuals are set much higher: $71,900 on joint returns and $43,150 on single returns. As a result, trusts and estates reach their surcharge phase-out tax rate of 33 percent much sooner than do individuals.

The effect of this new rate structure is to reduce the attractiveness of trusts and estates, but particularly trusts, as devices for minimizing the progressivity of the tax rates through the accumulation of income. Not only are there no longer steep progressive rates to be minimized, but more significantly, the new rate structure with its higher marginal tax rates applicable to trusts and estates provides a disincentive to accumulate income and an incentive to distribute trust or estate income over $5,000.

7. Under prior law, trusts and estates reached their top rate with $79,500 of taxable income.
8. I.R.C. § 1(g) (Supp. IV 1986).
9. I.R.C. § 1(f), (g) (Supp. IV 1986).
11. The tax-minimizing use of estates is somewhat limited in that a decedent is required for each use, an inherent limitation of one per taxpayer. The number of trusts, on the other hand, is only limited by the multiple trust rule in I.R.C. § 643(f) (Supp. IV 1986). Furthermore, estates will be recognized as separate taxable entities only during the time required for proper administration (Treas. Reg. § 1.641(b)-3(a) (1988)), a period usually much shorter than the period delimited by the Rule Against Perpetuities during which a valid trust may exist.
13. The reduction in the attractiveness of the tax shelter effect of the use of trusts and estates was the desired result of the new rate structure. See GENERAL EXPLANATION, supra note 4, at 1245; Westfall, supra note 4, at 713, 720, 724-28. Given the new rates, the tax saved in shifting from the top marginal rate of 28% to the lowest marginal rate of 15%, available only to the first $5,000 of taxable income, is $650 ($5,000 x 13 percentage point differential between the two rates). Compare this to the $8,450 savings in tax liability under prior law. See supra note 5.
The Tax Reform Act of 1986, in contrast to prior law, thus makes trust and estate distributions relatively more attractive than accumulations, thereby shifting the discussion away from issues dealing with income accumulations and toward issues dealing with income distributions. This article will address the deduction available to trusts and estates for income distributions. It will discuss how this income distribution deduction is calculated, when it is available, and which distributions are not eligible for the deduction.

For purposes of this article, it is assumed that a valid and proper trust or estate exists. Such legal entities create fiduciary relationships by which the fiduciary holds property and income from that property for distribution to

14. A. Michaelson & J. Blattmachr, supra note 4, at 1-2; Westfall, supra note 4, at 713, 720, 730 & 732.

The Committee on Income of Estates and Trusts of the American Bar Association Section of Taxation is currently considering a legislative initiative to repeal the throwback rule on accumulations. See agenda for the committee meeting at the 1988 Annual Meeting of the ABA.

In addition to the new rate structure, two other recent legislative changes, one dealing with estimated tax payments under the Tax Reform Act of 1986, the other with multiple trusts under the Tax Reform Act of 1984, operate to encourage distributions of trust income but in a less significant way. Before 1986, trusts were not required to make estimated tax payments. As a result, the tax on accumulated income was imposed on a less current basis than it would have been had the income been distributed to the trust's beneficiaries. I.R.C. § 6654(l)(1) (Supp. IV 1986) now requires that trusts make installment payments of estimated taxes in the same manner as individuals. I.R.C. § 643(g) (1982) allows the trustee to elect to treat any portion of an estimated tax payment as a tax payment made by a beneficiary. This new provision added by the 1986 Act removes any incentive to accumulate income solely to defer installment payments of estimated taxes.

Likewise, the limitation on the use of multiple trusts in I.R.C. § 643(l) (Supp. IV 1986), under the Tax Reform Act of 1984, removes the incentive to accumulate income in separate trusts in order to maximize the use of the resultant separate tax schedules. Staff of the Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 255-56 (Comm. Print 1985). Any incentive to accumulate income in multiple trusts is also negated by the subsequent tax treatment of the distributions of such accumulations under the throwback rule. Accumulation distributions from more than two trusts are doubly taxed as a result of I.R.C. § 667(c) (1982), once at the trust level and again at the beneficiary level. See 3 B. Bittker, supra note 5, ¶ 81.5.3.

Not all recent legislative changes, however, have worked to promote distributions rather than accumulations of income. The requirement in I.R.C. § 645 (Supp. IV 1986), enacted as part of the Tax Reform Act of 1986, that all noncharitable trusts use a calendar-year accounting period, has removed the incentive previously available to fiscal-year trusts to distribute income to calendar-year beneficiaries in order to take advantage of deferral of income recognition by the beneficiaries. See 3 B. Bittker, supra, at ¶ 81.1.6; Westfall, supra note 4, at 730-31. Distributions from a calendar-year trust to a fiscal-year beneficiary, although less likely to occur, continue to offer the deferral benefits and thus encourage distributions. Changes in the rules governing distributions of property in-kind, enacted as part of the Tax Reform Act of 1984, also may work to deflate the incentive to distribute. In-kind distributions no longer are able to carry out distributable net income in an amount of the fair market value of the property distributed without the cost of tax recognition to the distributing trust or estate.

The effect of these latter two legislative changes, however, are of marginal impact on the decision to distribute in that they are not reflected in the decision to distribute ongoing and recurring trust or estate income receipts.
beneficiaries under the applicable governing instrument and local law.¹⁵ Issues of agency, bailment, and guardian relationships will not be discussed.¹⁶ Neither will classification issues of trusts or estates.¹⁷ For purposes of the income distribution deduction, the applicable provisions do not differentiate between trusts and estates, with the exception of the 65-day rule and the separate-trust-share rule.¹⁸ This uniformity in treatment should be expected, given the similarities between the fiduciary natures of trusts and estates. Likewise, for purposes of the income distribution deduction, the distinction between simple trusts and complex trusts has little significance.¹⁹ The major distinction be-

15. 1 A. Scott, THE LAW OF TRUSTS § 2.3 (W. Fratcher 4th ed., 1987); Commissioner v. Beebe, 67 F.2d 662 (1st Cir. 1933) (estate); Treas. Reg. §§ 1.641(a)-2, 1.641(b)-3(a), and § 301.7701-4(a), -6 (1988).

16. For a discussion on the taxation of such relationships, see 3 B. Brittker, supra note 5, at ¶ 82.4. Generally speaking, transactions and income are reported by the principals and wards directly on their own individual returns, not on fiduciary returns. Treas. Reg. §§ 301.7701-7, 1.641(b)-3(d) (1988). See also Commissioner v. Bollinger, 108 S. Ct. 1173 (1988) (nominee corporation treated as agent and not taxed). Because the income is taxed directly to the principal and ward, the mechanism of an income distribution deduction is not needed to allocate the tax between the agent and principal.


18. The 65-day rule and the separate-trust-share rule are discussed later in the article. An estate is a fiduciary relationship created under local law upon the death of the decedent pursuant to which the estate holds property for distribution to beneficiaries under the direction of a probate court. Commissioner v. Beebe, 67 F.2d 662 (1st Cir. 1933). For income tax purposes, income from property held by the estate and realized during the administration of the estate is subject to taxation. I.R.C. § 641(a)(3) (1982); Treas. Reg. §§ 1.641(a)-1, -2(d); 1.641(b)-2, -3(a) (1988). Such income is generally taxed in the same manner as the income realized by complex trusts. Treas. Reg. § 1.661(a)-1 (1988). The simple trust model was not chosen because it is usually not applicable; unlike simple trusts, estates are rarely required to distribute income currently. On the distinction between simple and complex trusts, see infra note 19.


19. The terms "simple trust" and "complex trust" are not used in the Tax Code. The terms, however, are used in the regulations and are a part of the tax jargon in this area of the tax laws. Treas. Reg. §§ 1.651(a)-1, 1.661(a)-1 (1988). A simple trust is generally a trust that distributes current income only. Treas. Reg. § 1.651(a)-1 (1988). A complex trust is defined negatively as any nongrantor trust that is not a simple trust. Treas. Reg. § 1.661(a)-1 (1988). Thus a complex trust is a trust that under its governing instru-
tween these two types of trusts for tax purposes lies in the two-tier structure applicable to complex trusts. This tier system, however, functions only to allocate the tax on distributed trust income between different types of beneficiaries. It has no effect on the calculation of the income distribution deduction at the trust level. That deduction is calculated without reference to the type of beneficiary receiving the deduction.\(^2\)

I. Basic Concept: A Hybrid Taxable Entity

As a general principle, trust or estate income that is or must be distributed to beneficiaries when realized by the trust or estate is taxed to the beneficiaries.\(^1\) Income that is neither distributed nor required to be distributed is taxed to the trust or estate on its own tax return using its separate tax-rate structure.\(^2\) This basic concept is implemented by allowing the trust or estate, in computing its taxable income, a deduction for income distributions that are made or that should have been made to beneficiaries.\(^3\) As a result, trust

\(^{20}\) See 3 B. Bittker, supra note 5, at \(\S\) 81.4.4; M. Ferguson, J. Freeland & R. Stephens, Federal Income Taxation of Estates and Beneficiaries 386-93, 393-466 (1970) [hereinafter M. Ferguson].

\(^{21}\) I.R.C. \(\S\S\) 652, 662 (1982).

\(^{22}\) I.R.C. \(\S\S\) 1(e) (Supp. IV 1986) and 641 (1982); Treas. Reg. \(\S\S\) 1.641(a)-1, -2 & 1.641(b)-1, -2 (1988).


or estate income is taxed only once as such income makes its way to the beneficiaries. Under this single tax scheme, whatever income is distributed is taxed only to the beneficiaries and whatever income is not distributed is taxed only to the trust or estate.\textsuperscript{24} This basic concept carries out the conduit mechanism of the income taxation of trusts and estates.\textsuperscript{25}

To illustrate this concept, assume that a trust (or estate) has gross income from rental property of $13,000 and rental expenses of $3,000. Under the terms of the trust instrument (or the will), the trustee (or executor) distributes $4,000 each to beneficiaries B and C. The trust (or estate) is taxed on $2,000 of income ($10,000 net income less $8,000 total distributions). The beneficiaries are each taxed on their respective $4,000 distributions. The income distribution deduction thus allocates the single tax on the net taxable income of $10,000 between the fiduciary entity and its beneficiaries. This single tax scheme is in contrast to the double taxation of corporate earnings and profits. To the extent trust or estate income is distributed, the taxing scheme described above resembles the conduit approach of partnership taxation.\textsuperscript{26} To the extent the trust or estate income is retained and not distributed, the taxing scheme imposed and described above resembles corporate taxation with its entity level tax, but without its double tax effect.\textsuperscript{27} Trusts and estates thus are hybrid

\textsuperscript{24} \S 219(b)(2) (1924). This fundamental design is still the law today. The process of determining the amount of the deduction available has occasionally changed through the years, most recently under the Tax Reform Act of 1984, but the fundamental theory has remained the same. The Tax Reform Act of 1986 did not enact any changes in this basic policy. For all its ferment in this area, the 1986 Act left unchanged the definition of distributable net income and the mechanism of the income distribution deduction as a means of allocating the tax liability on trust or estate income between the entity and its beneficiaries. \textit{General Explanation, supra} note 4, at 1245 (marginal tax rates increased to curb unjustified use of trusts and estates while still retaining existing structure—separate table unit, DNI, income distribution deduction—of taxing such entities).

\textsuperscript{25} 24. When income previously taxed to a trust or estate is later distributed to beneficiaries, such distributions of accumulated income do not result in an income distribution deduction to the trust or estate. However, to preserve the single tax concept of the income taxation of trusts and estates, these subsequent distributions are not taxed to the beneficiaries. If the throwback rule is triggered and the beneficiary pays additional taxes on the distribution of the accumulated income, such income is not reported and taxed again, but rather not enough tax was initially withheld from the trust when such income was accumulated and taxed to the trust. Again, for a general explanation of the throwback rule, see 3 B. Bittker, \textit{supra} note 5, at ¶ 81.5. For historical development of the rule, see Acker, \textit{The Throwback Rule: Its Historical Development and How It Works}, 10 REV. TAX’N INDIVIDUALS 107 (1986).


\textsuperscript{27} 27. I.R.C. §§ 11, 301 (1982). The double taxation of trust income is possible in the case of distributions of accumulated income by multiple trusts subject to the throwback rule. I.R.C. §§ 667(c), 667(b)(1) (1982). \textit{See also} 3 B. Bittker, \textit{supra} note 5, at ¶ 81.5.3.
taxable entities resembling parts from each of these two opposing models of taxable units.

Because this scheme for the taxation of fiduciary income applies only to nongrantor trusts and estates, the income distribution deduction is not available to grantor trusts.28 Grantor trusts thus will not be discussed in this article. This does not mean, however, that the income of grantor trusts is taxed twice, once at the trust level (benefit of the distribution deduction) and again at the beneficiary level. The single tax scheme is again carried out without the need to resort to the income distribution deduction because whether or not the income is distributed, such income is taxed to the grantors.29 Grantor trusts are thus pure conduits, whereas nongrantor trusts are a hybrid tax entity, switching from conduit to entity taxation with the availability of the income distribution deduction.

The basic concept described above does not apply to all trust and estate distributions and, hence, not all fiduciary distributions result in a deduction. Distributions of corpus and of specific gifts or bequests are not eligible for the income distribution deduction. Also, distributions to nonbeneficiaries and distributions to beneficiaries outside their role as beneficiaries fall outside this scheme of taxation, as discussed below.

II. Definition of Distribution

Trust or estate distributions eligible for the income distribution deduction are distributions made to beneficiaries in their capacity as beneficiaries. Distributions to nonbeneficiaries and distributions to beneficiaries not in their capacity as beneficiaries are not eligible for the income distribution deduction. Moreover, even if made to beneficiaries as such, certain distributions, such as distributions of specific gifts or bequests, charitable donations, and distributions of items of income in respect of a decedent (IRD), do not qualify for the deduction.

The tax provisions providing for the income distribution deduction do not define "distributions" that qualify for the deduction.30 However, the mirror provisions to these sections31 provide, in carrying out the distribution scheme, that as a prerequisite to the deduction the distributions must be included in the income of the recipient who receives such amounts as a beneficiary. Accordingly, trust or estate distributions eligible for the deduction are distributions made to persons in their capacity as beneficiaries. Distributions to persons who have no interest in the fiduciary relationship are not distributions for purposes of the deduction-inclusion rules. Therefore, distributions that are mere disbursements by the fiduciary in payment for services or property are not distributions qualifying for the income distribution deduction. Thus, the payment of fiduciary fees, funeral expenses and interest, payment for tax and investment advice and services, the repayment of loans, and the purchase

30. I.R.C. §§ 651(a) and 661(a) (1982) only speak of distributions of income or of any other amounts.
of property are not distributions for purposes of the income distribution deduction. Their deductibility, if any, to the trust or estate is determined under other provisions of the tax laws. To do otherwise might result in a double deduction for such disbursements.

A beneficiary to whom deductible distributions are made is defined to include heirs, legatees, and devisees. Identifying the recipients of deductible distributions and determining the amount of such distributions is done with reference to the governing instrument expressing the intent of the settlor or decedent and with reference to applicable local law. Moreover, only proper payments qualify as distributions. Improper payments made to beneficiaries under mistake of law or fact are not eligible for the income distribution deduction.

Distributions eligible for the deduction are not limited to beneficiaries named in the governing instrument. A person whose legal obligation is discharged or satisfied with amounts distributed by the trust or estate is a beneficiary. The amount so used is considered distributed to the person whose legal obligation is discharged and the distribution is eligible for the income distribution deduction. Also, distributions need not be actually made to be considered “distributions.” The following two constructive distributions are eligible for the income distribution deduction: distributions required by the will or trust instrument but not made, and distributions relating back to a previous year under the 65-day rule discussed later in this article.

35. Treas. Reg. §§ 1.643(c)-1(a), 1.661(a)-2(d), 1.662(a)-4 (1988). Thus, if pursuant to the terms of the will or trust instrument, the fiduciary pays off a debt owed by the grantor's or decedent's child, the payment is deemed a distribution to the child. However, if the legal obligation discharged is that of the grantor or the grantor's spouse, the grantor trust rules override the application of the distribution rules. See supra text at note 28. But see I.R.C. §§ 677(b) and 678(c) (1982), applying the complex trust distribution rules to amounts paid by a trust out of corpus or out of sources other than income for the taxable year. Treas. Reg. § 1.661(a)-2(c) (1988). The term “legal obligation” includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources. Treas. Reg. §§ 1.661(a)-2(d), 1.662(a)-4 (1988).
Again, the identity of the beneficiary receiving the actual or constructive distribution is immaterial for calculating the income distribution deduction and is only legally significant in the application of the two-tier system.\(^{37}\) The identity of the recipient-beneficiary only resolves the question of who among the beneficiaries is ultimately taxed on the amounts distributed. The trust or estate, in any event, will not be taxed on such distributed amounts.

Finally, an assumption that a distribution made to a beneficiary as such is automatically a distribution eligible for the deduction is erroneous. The following are nondeductible distributions to beneficiaries discussed later in this article: (1) distributions of a specific sum of money or property; (2) distributions of property passing directly to beneficiaries; (3) distributions to charitable donees; (4) distributions deducted in prior years; and (5) distributions of a right to receive income in respect of a decedent.

**Distributions in Payment of Grantor’s or Decedent’s Debts**

As discussed above, only distributions to beneficiaries as such are eligible for the income distribution deduction. Disbursements to creditors are not eligible.\(^{38}\) In this regard, however, although a legacy or a family support allowance may be characterized as a debt under local law, for tax purposes such disbursements are treated as distributions made to a beneficiary as such.\(^{39}\) Alimony payments are similarly treated as distributions to a beneficiary even though made in discharge of the payor’s debt obligation. Family support allowances and alimony payments are discussed below.

This treatment of disbursements in payment of the grantor’s or decedent’s debts is consistent with the purposes of the income distribution deduction. The deduction, as noted, allocates the tax on the income of a trust or estate between the fiduciary and the beneficiary, thereby ensuring that such income is taxed only once. Income distributed by the fiduciary outside the beneficiary relationship should be taxed under the general tax rules just as any other transaction between two unrelated and separately taxed entities dealing at arm’s-length would be taxed. As a result, such amounts may in some cases be taxed twice, to the recipient and also to the fiduciary if not deductible by the fiduciary when paid. For example, the decedent’s final medical expenses paid by the estate are not deductible by the estate.\(^{40}\) Funeral expenses paid by the estate are likewise not deductible.\(^{41}\) Payments by the estate of these and other similar

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\(^{37}\) See supra note 20.

\(^{38}\) Thomas Lonergan Tr. v. Commissioner, 6 T.C. 715 (1946) (payments made by a testamentary trust were in discharge of decedent’s obligations incurred prior to his death as part of a property purchase). See also Alfred I. DuPont Testamentary Tr. v. Commissioner, 574 F.2d 1332 (5th Cir. 1978), aff’g 66 T.C. 761 (1976) (payments not for the benefit of beneficiary as such but rather made by virtue of recipient’s rights under a lease).


\(^{40}\) I.R.C. § 213(c)(1) (1982). Such expenses may be deducted on the decedent’s last tax return if paid within one year of decedent’s death. Of course, such expenses are deductible for estate tax purposes. I.R.C. §§ 213(c)(2) (Supp. IV 1986) and 2053(a)(3) (1982).

\(^{41}\) They are deductible, however, for estate tax purposes. I.R.C. § 2053(a)(1) (1982).
death costs remain nondeductible even if made to a residuary legatee and are applied against the legatee’s share of the residuary estate.⁴² Similarly, the payment of fiduciary fees may not be fully deductible in some cases by the trust or estate.⁴³ However, a deduction may be afforded the trust or estate under a different provision of the tax laws. Thus, expenses, interest, and taxes owed by the decedent and attributable to the period prior to the decedent’s death are deductible by the estate when paid by the estate but only as deductions in respect of the decedent.⁴⁴

Where the recipient of the fiduciary distribution is also a beneficiary, the resolution is not as straightforward. If a beneficiary has a dual relationship with the trust or estate, such as a creditor-beneficiary relationship arising out of a separate and independent contractual arrangement, distributions are not eligible for the income distribution deduction if made to the beneficiary in any capacity other than that of a beneficiary. Similarly, if a beneficiary is compensated for services rendered to the trust or estate, such distributions may be deductible under the general provisions of the tax laws but are not deductible distributions under the distribution rules.⁴⁵

The issue raised in such instances involves the characterization of the recipient receiving the disbursements made by the trust or estate. The resolution of this issue depends on the facts and circumstances that gave rise to the payment. If the facts reveal that the distribution is to compensate the recipient for services rendered to the decedent prior to his death, the income distribution deduction is not available.⁴⁶ Moreover, that the creditor successfully enforces this claim against the estate is immaterial.⁴⁷ The result is similar for distributions made pursuant to settlement of a claim against the estate based on services rendered to the decedent.⁴⁸

⁴² Harkness v. United States, 469 F.2d 310 (Cl. Ct. 1972).
⁴³ I.R.C. § 212 is now subject to the limitation in I.R.C. § 67(a) & (e) (Supp. IV 1986), which imposes a 2% floor on certain itemized deductions.
⁴⁴ I.R.C. § 691(b) (Supp. IV 1986).
⁴⁵ Although in most cases, the amounts paid out will be deductible in any event under other tax provisions, this distinction in the status of the recipient is becoming more important as Congress is increasingly curtailing the availability of general deductions. These new limitations on deductions cannot be overcome by characterizing the disbursement as a “distribution” eligible for the as yet unlimited income distribution deduction.
⁴⁶ Welder v. Commissioner, 493 F.2d 608 (2d Cir. 1974); Braddock v. United States, 434 F.2d 631 (9th Cir. 1970); Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959); Wallace v. Commissioner, 219 F.2d 855 (5th Cir. 1955).

A distribution to a beneficiary in appreciation of his long and devoted service to the decedent in his declining years, without more, is eligible for the income distribution deduction. The bequest appears to proceed out of affection and is made to an heir in fact. Commissioner v. Duberstein, 363 U.S. 278 (1960) (defining a gift in the statutory sense as a transfer that proceeds out of affection, respect, admiration, charity, or like impulses). But compare Rev. Rul. 57-398, 1957-2 C.B. 93.
Resolving the beneficiary-creditor conundrum is more difficult when an heir in fact is also appointed an executor of the decedent’s estate. Where the decedent appoints one of his children as executor of his estate for which services the child is paid a sum certain under the terms of the will, the amount so distributed is not a deductible distribution.\(^49\) The resolution is less certain, however, where the decedent appoints his child as executor of his estate and bequeaths a sum certain to the child in lieu of all compensation for services rendered as an executor. The amount distributed is most likely not a deductible distribution. In 1923, the United States Supreme Court held in United States v. Merriam that because the beneficiary received such an amount as an inheritance, it would for our purpose become a deductible distribution.\(^50\) However, given the subsequent case law, the continued vitality of the Merriam decision is in doubt.\(^51\) In reaching its decision, the Court found controlling the fact that the services rendered as an executor were not required as a condition for the payment.\(^52\) Hence, the amounts received were not income derived from labor, which at that time was a necessary element within the definition of income.\(^53\) That narrow definition of income has since been repudiated by the Supreme Court. Today, the Court includes nondonative windfalls, even if received without the exchange of services, in its definition of income.\(^54\)

Congress attempted to resolve part of the creditor-beneficiary conundrum when it provided, as part of the Tax Reform Act of 1986, that as a matter of law, payments to an employee can never be classified as gifts or bequests.\(^55\) Although this new provision was intended to put an end to the extensive litigation based on the employee-donee dichotomy,\(^56\) the remaining issue is what constitutes an employer-employee relationship. Whether the definition is broad enough to include an independent contractor, an agency relationship, and an executor relationship is unclear. Furthermore, it is also unclear whether the provision applies only to life-time transfers or whether it should also include testamentary transfers. The new provision, however, does indicate a continuing congressional distrust of gifts or bequests with a service overtone.

The unavailability of the income distribution deduction in the creditor context need not necessarily be mourned by the fiduciary. Quite the contrary, in some cases structuring the distributions in such a way that they are treated

\(^{49}\) On the possibility of taking an estate tax deduction for such an expense, see I.R.C. §§ 642(g) and 2053(a)(2) (1982). On the income tax consequences of a waiver of the fees, see Rev. Rul. 66-167, 1966-1 C.B. 20.

\(^{50}\) 263 U.S. 179 (1923).

\(^{51}\) See, e.g., Wolder v. Commissioner, 493 F.2d 608, 611 (2d Cir. 1974) (Merriam was inapplicable because there was no question that the services were actually rendered).

\(^{52}\) United States v. Merriam, 263 U.S. 179, 185 (1923).


\(^{56}\) For two recent cases, see Abdella v. Commissioner, T.C. Memo 1983-616 and Runyon v. Commissioner, T.C. Memo 1984-623. Both cases found that amounts paid to former employees were gifts.
as payments to a creditor, such as a payment of executor’s fees, may be helpful. The advantage lies in the fact that such expenses are deductible on the estate tax return\textsuperscript{57} against tax rates much higher than the income tax rates.\textsuperscript{58} In addition, this characterization of the expenses preserves the estate’s distributable net income for application to other deductible distributions to beneficiaries without wasting a deduction for the administrative expenses paid.\textsuperscript{59}

\textit{Family Support Payments}

A widow’s allowance\textsuperscript{60} and a family support allowance\textsuperscript{61} paid by an estate are deductible by the estate. Amounts paid or required to be paid by an estate pursuant to a court order or decree, or under local law as an allowance or award for the support of the decedent’s widow or other dependent for a limited period during the administration of the estate, are distributions eligible for the income distribution deduction.\textsuperscript{62} The deduction is available whether the allowance is payable from income or corpus.\textsuperscript{63} Support allowances paid by

\begin{itemize}
\item[57.] I.R.C. § 2053(a)(2) (1982). If taken against the estate tax, such expenses may not again be deducted against the income of the estate. I.R.C. § 642(g) (1982).
\item[58.] Compare I.R.C. § 2001(c)(1) (1982) and (2) (Supp. IV 1986) with rates ranging from 37%–55% in the case of decedents dying before 1993 (after taking the unified credit into account) with I.R.C. § 1 (Supp. IV 1986) with rates of 15% and 28%. Moreover, in the case of taxable estates of more than $21,040,000 ($18,340,000 in the case of decedents dying after 1992), the graduated estate tax rates are phased out and the estate tax is imposed at a flat 50% rate. I.R.C. § 2001(c)(3) (1982).
\item[59.] The choice in treatment is between deducting the payment as an administrative expense on the estate tax return or treating the payment as a bequest of a specific sum of money. In the former choice, the estate tax savings from the estate tax deduction under I.R.C. § 2053(a)(2) (1982) is compared with the income tax cost from the income inclusion to the estate under I.R.C. § 61(a)(1) (Supp. IV 1986). In the latter choice, the foregone benefit of the estate tax deduction is compared to the negated income tax cost to the beneficiary who receives a tax-free inheritance under I.R.C. § 663(a) (Supp. IV 1986). In neither case is the estate entitled, however, to an income tax deduction. In the former choice, the estate is not entitled to an income tax deduction because of I.R.C. § 642(g) (1982), supra note 57; in the latter choice, because of I.R.C. § 663(a) (Supp. IV 1986).
\item[60.] Whether the payment is characterized as a payment of an estate debt or a distribution of a specific bequest, the estate is not entitled to an income distribution deduction for the payment. As a corollary because the payment is not an income deductible distribution, either because it is not a “distribution” to a beneficiary or because it is nondeductible under I.R.C. § 663(a) (1982), it also does not drain the estate's distributable net income.
\item[61.] Moreover, although the payment of the executor’s fees represents an economic outlay, it does not reduce DNI by an equal amount. This is because the starting point for the calculation of DNI is taxable income. I.R.C. § 643(a) (Supp. IV 1986). Payments allowed as a deduction in computing the taxable estate are disallowed as a deduction in computing taxable income, I.R.C. § 642(g) (1982). Likewise, payments of specific bequests to beneficiaries are not deductible in computing the estate’s taxable income, I.R.C. § 663(a) (Supp. IV 1986), referring to § 661(a) (1982).
\item[62.] Estate of McCoy v. Commissioner, 50 T.C. 562 (1968) (invalidating a prior rule in the regulations).
\item[63.] Cameron v. Commissioner, 68 T.C. 744 (1977).
\item[64.] Treas. Reg. § 1.661(a)-2(e) (1988), issued as T.D. 7287 (Sept. 26, 1973) and adopting the decision in Estate of McCoy v. Commissioner, 50 T.C. 562 (1968). The retroactive application of the regulation was upheld in Schaefer v. Commissioner, T.C. Memo 1983-465.
\item[65.] Treas. Reg. § 1.661(a)-2(e) (1988).
\end{itemize}
a trust, however, are not subject to this rule. They are instead governed by the grantor trust rules.\textsuperscript{64}

\textbf{Alimony and Child Support Payments}

A trust is a useful device for securing legal obligations arising out of a divorce.\textsuperscript{65} A trust can be specifically created, or utilized if already in existence at the time of divorce or legal separation, for purposes of making alimony payments, providing for child support, or dividing marital property. Such trusts are referred to in tax parlance as "alimony trusts." It is a term, however, that is not used in the Internal Revenue Code and hence lacks a statutory or technical meaning.\textsuperscript{66}

An alimony trust is a trust required by a divorce or separation instrument under the terms of which the payor-spouse transfers a specified amount of money or property to the trust and the income of which is to be paid to the payee-spouse for the payee's life or until the payee remarries, the remainder over to payor or others.\textsuperscript{67} Likewise, a support trust created incident to a prenuptial agreement may be used to discharge support obligations imposed by a subsequent divorce.\textsuperscript{68} Moreover, a payee-spouse may also be the assignee of a beneficial interest in a preexisting trust created for the benefit of the payor.\textsuperscript{69} For example, the payor in discharge of his support obligation under a divorce assigns a part or all of his income interest in a trust previously created for him by another.

The tax consequences of these various alimony trust payments are governed by section 682. That provision provides rules for determining the taxability of a trust's income as between the trust and the spouses who are now divorced or legally separated. Under these rules, the spouse actually entitled to receive income payments from the trust is considered the beneficiary of the trust.\textsuperscript{70} The presence of a beneficiary to whom trust distributions are made then triggers the application of the normal deduction-inclusion rules for the taxation of trusts.\textsuperscript{71} The distributed income of the alimony trust is taxed to the payee-spouse as a beneficiary of the trust. The trust is then allowed a deduction for the distribution. The same treatment applies to the estate of the payor which continues to make support payments to a surviving payee.\textsuperscript{72}

Section 682 thus designates whether the payor or the payee-spouse is the taxed beneficiary of the trust income. The provision allocates the tax on the

\textsuperscript{64} I.R.C. § 677(a) (Supp. IV 1986), (b) (1982).

\textsuperscript{65} Trusts can also be used to avoid marital claims. See Westfall, \textit{supra} note 4, at 732, pointing out the usefulness of trusts in avoiding equitable distribution of property upon divorce.


\textsuperscript{67} See example in Treas. Reg. § 1.682(b)-1 (b) (1988).

\textsuperscript{68} See examples (1) and (2) in Treas. Reg. § 1.682(a)-1(a)(4) (1988).

\textsuperscript{69} Treas. Reg. § 1.682(a)-1(a)(3) (1988).

\textsuperscript{70} I.R.C. § 682(b) (Supp. IV 1986); Treas. Reg. §§ 1.682(a)-1(a)(1), 1.682(b)-1(a) (1988).

\textsuperscript{71} Treas. Reg. § 1.682(b)-1(a) (1988).

\textsuperscript{72} I.R.C. § 682(b) (Supp. IV 1986), referring to trusts as well as estates.
income in much the same way that sections 71 and 215 allocate the tax on alimony payments made directly and without the use of trusts.\textsuperscript{73} In doing so, section 682 treats an alimony trust as a mere accounting and accommodating device that is not taxed on the income it distributes.

Before the Tax Reform Act of 1984, the tax treatment of alimony trusts was, in certain cases, governed by former section 71(d), depending upon whether the trust predated the divorce.\textsuperscript{74} The uncertainty in the overlap between the two provisions was resolved by the 1984 Act with the repeal of section 71(d).\textsuperscript{75} With respect to trust transfers made after July 18, 1984, section 682 applies exclusively to alimony trusts. Despite the uncertainty and difficulty under prior law in deciding which section applied to alimony payments, the availability of the income distribution deduction was not affected. While the 1984 amendment applies section 682 exclusively to alimony trusts, the amendment did not change the application of the income distribution deduction. The difference between the prior and amended provision is in the treatment of the beneficiary, an irrelevant factor for purposes of the income distribution deduction.

By its own terms, section 682(a) does not apply to payments for support of minor children. Specifically, section 682(a) provides that it shall not apply to that part of any trust income which the terms of the decree, written separation agreement, or trust instrument fix in terms of an amount of money that is payable for the support of minor children of the payor-spouse.\textsuperscript{76} As a result, the payee-spouse is not treated as the beneficiary of the trust income so distributed because section 682(b) treats the payee as the beneficiary only if section 682(a) applies. Therefore, the payor-spouse whose legal obligation is discharged by the payments becomes the beneficiary under either the grantor or nongrantor trust rules.\textsuperscript{77} If the payments are not adequately earmarked or "fixed"\textsuperscript{78} or if paid for the support of children of majority age, the payments will be treated as payments to which the payee-spouse is entitled as a beneficiary under section 682(a).

73. Alimony payments received by a payee as a beneficiary, however, benefit from the qualitative flow-through of the taxation of trusts and estates, discussed infra part III. Payee-spouses thus may, in some cases, prefer payments from an alimony trust rather than direct alimony payments. This choice is independent of the availability of the income distribution deduction.

74. J. PESCHEL & E. SPURGEON, supra note 25, at ¶ 8.05.
78. There is a question whether the term "fixed" should be read in the broader, anti-\textit{Lester} sense of I.R.C. § 71(c)(2) (Supp. IV 1986). For purposes of the income distribution deduction, the issue is not material, however. Whether or not the payments are sufficiently fixed, the alimony trust will not be taxed on the income it distributes. If the payments are sufficiently fixed, the trust will be allowed a deduction for making income distributions to the payee-spouse. If the payments are not sufficiently fixed, the trust will either be ignored under the grantor trust rules or it will be allowed a deduction for making constructive income distributions to the payor-spouse.
This treatment accorded child support payments made pursuant to a trust is consistent with the treatment accorded direct child support payments under section 71(c): the payee is not taxed; rather the payor is taxed in that he is denied a section 215 deduction. Because the payor-spouse is taxed on such income, the trust (or estate) should not be taxed with regard to such income.

Section 682 designates which person will be treated as the beneficiary of an alimony trust. The tension in the provision is over who the beneficiary is, not over whether there is a beneficiary. In all events, assuming the distributions are properly made under the governing instrument, such distributions will be eligible for the income distribution deduction.

Finally, section 682 by its own terms applies only to distributions of trust "income" which the payee-spouse is entitled to receive. Although the term "income" is not defined in the section, it should not be extended to include distributions made to carry out a settlement of marital property rights. Whether a preexisting trust is used, or a trust is specifically created for this purpose, the transfer of the property by the trust is in discharge of the transferor-spouse's legal obligation to transfer a share of the marital property. In such cases, the transferor is the beneficiary of the trust, leaving the trust again untaxed. This reading of section 682 is consistent with the nonrecognition treatment accorded spouses on property transfers incident to a divorce under section 1041.

III. The Income Distribution Deduction

The income distribution deduction initially equals the amount of income and property distributed by the trust or estate to the beneficiaries. The amount of the deduction so determined, however, is limited to the trust's or estate's distributable net income (DNI). As a result, any distributions in excess of the trust's or estate's DNI are not deductible. In the case of distributions of property in kind, special rules discussed below apply to determine the amount of the distributions as well as the effect of the distributions on DNI.

An exception to this statutory scheme is property or money transfers specifically donated or bequeathed. Such transfers fall outside the deduction-inclusion scheme which includes the income distribution deduction and are discussed later in this article.

Amount of Deduction Limited to Amount of Distribution

In any given year, a trust or estate may make mandatory as well as discretionary distributions to its beneficiaries. The beneficiaries who receive these

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80. This is in harmony with the single tax concept that as to all the parties involved, only one should be taxed on the trust income. See Treas. Reg. § 1.102-1(e) (1988).


distributions can never be charged with realizing a financial benefit for that year greater than the amounts so distributed. As a result, the maximum amount of reported income is limited to the amounts distributed.\textsuperscript{83} Consistent with this result and consistent with the single tax concept the income distribution deduction is implementing, the distributing trust or estate can never deduct an amount greater than the amount of distributions made to beneficiaries. The income distribution deduction is thus limited to the sum of the following amounts: (1) the amount of required distributions of current fiduciary accounting income;\textsuperscript{84} (2) the amount of discretionary distributions of current fiduciary accounting income;\textsuperscript{85} and (3) the amount of required or discretionary distributions of accumulated income or corpus.\textsuperscript{86}

In computing the ceiling on the income distribution deduction, the source of the distributions is thus not material. The source of the distributions becomes important only when considering how the distributed DNI is to be allocated to the recipient-beneficiaries. That is, the source of the distributions is relevant only for purposes of the two-tier structure that provides a mechanism for determining which beneficiary gets what amount of DNI.\textsuperscript{87}

Use of the income distribution deduction is elective in that it depends on whether distributions are required or are discretionary. If fiduciary accounting income is accumulated pursuant to fiduciary direction or discretion given in the governing instrument and if DNI is not otherwise distributed through required or discretionary distributions of accumulated income or corpus, then the trust or estate is not allowed a deduction and is taxed on its taxable income for the year. Whether to make distributions depends on whether it is desirable to recognize the trust or estate as a taxable entity with respect to its income or whether it is desirable to shift that tax to the beneficiaries. This choice in allocating taxable income between different taxpayers, each with their own progressive tax rates, depends on the parties' respective marginal tax rates. As discussed earlier, the benefits of income splitting through the use of trusts or estates have been substantially lessened since the Tax Reform Act of 1986. The benefits would return quickly, however, if the tax rates were raised in the future.

\textit{Amount of Deduction Limited to Amount of Distributable Net Income (DNI)}

As already noted, the overall scheme of the taxation of trusts and estates is to tax the trust's or estate's taxable income only once, either to the

\textsuperscript{83} In Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), the Supreme Court equated income with an accession to wealth, here the amounts distributed and received by the beneficiaries. This expression is reflected in I.R.C. §§ 652(a) and 662(a) (1982) with respect to distributions to beneficiaries, and in I.R.C. § 301(b) (1982) with respect to distributions to shareholders.

\textsuperscript{84} I.R.C. §§ 651(a), 661(a)(1) (1982).

\textsuperscript{85} I.R.C. § 661(a)(2) (1982).

\textsuperscript{86} \textit{Id.}

\textsuperscript{87} The tier structure is found in I.R.C. § 662(a)(1) and (2) (1982) and is masterfully discussed in M. FERGUSON, supra note 20, at 386-93 in general terms and at 393-466 in detailed terms. \textit{See also} 3 B. BITTKER, supra note 5, at ¶ 81.4.4.
beneficiary or to the entity depending on whether such taxable income is distributed. This scheme is carried out by the deduction-inclusion rules which allocate the tax between the beneficiaries and the trust or estate. Taxable income in the current year that is distributed is taxed to the recipient-beneficiary. The income distribution deduction allowed the trust or estate for the amount distributed prevents a second tax at the trust or estate level. To avoid determining whether a particular distribution consists of current income, accumulated income—or corpus, that is, to avoid tracing the taxable income distributed—the deduction-inclusion rules provide for a conclusive presumption that any distribution is considered a distribution of the trust’s or estate’s taxable income to the extent of such income for the year.88 This presumption is implemented through the use of the concept of distributable net income.

Under this concept, all distributions, whether made from current income, accumulated income or corpus, are taxed to the recipient-beneficiary and are deductible by the trust or estate to the extent of the trust’s or estate’s DNI for the year. Every distribution is conclusively presumed to have been made from DNI to the extent of DNI for the year. As a result, all distributions are treated as first coming out of taxable income to the extent of DNI.89 For cash distributions, the amount of DNI distributed is the amount of the cash distributed. For property distributed in kind, special rules discussed below apply to measure the amount of DNI distributed.

In this statutory scheme, DNI then has a dual function. It measures the amount deductible by the trust or estate as well as the amount taxable to the beneficiary. Since the income reported by the beneficiary cannot exceed the amount of DNI carried out by the distribution, the income distribution deduction likewise is limited to the amount of DNI distributed. This result is at the heart of the allocative function of DNI. This dual function of DNI implements the quantitative flow-through approach to the taxation of trusts and estates.

Accordingly, the amount of the income distribution deduction available to a trust or estate for distributions made to beneficiaries, initially limited to the amounts so distributed, is further limited to the amount of the trust’s or estate’s DNI for the year. The working rule thus states that the income distribution deduction is the lower of (1) the amount distributed or (2) the trust’s or estate’s DNI for the year.90 Furthermore, the deduction so determined is allowed only net of tax-exempt items.

Adjustment for Items Not Included in Gross Income

The amount of DNI available to trigger the income distribution deduction is reduced by any item in the composition of DNI that is not included in

90. I.R.C. § 661(a) (1982). Compare the similar treatment of corporate distributions in I.R.C. §§ 301(b) and 301(c)(1) (1982). Dividend income received by a shareholder cannot exceed the lower of (1) the amount distributed or (2) the corporation’s earnings and profits.
the gross income of the trust or estate.91 This is the rule if, under the governing instrument, all current income is distributed, as in the case of simple trusts.92 If, however, the amount distributed is less than DNI for the year, as is possible with complex trusts and estates, the reduction is applied to the lower of (1) the amount distributed or (2) the DNI for the year.93 If the distribution of the tax-exempt income is not specifically earmarked,94 it is deemed distributed on a pro-rata basis for purposes of calculating the adjustment to the income distribution deduction.95

The effect of the downward adjustment to the income distribution deduction is to prevent the trust or estate from deducting items distributed which if retained by the trust or estate would not have been taxed to it. This rule thus prevents a double tax benefit accruing to the entity—a deduction as well as an exclusion with regard to the same item of income. This treatment is in harmony with the conduit function of the income distribution deduction. Since that function is to allocate the tax on trust or estate income between the entity and the beneficiary, it has no role to play when income is not subject to taxation. Consequently, the income distribution deduction cannot exceed the portion of the distribution consisting of income subject to taxation.

91. This rule is based on the qualitative flow-through function of DNI in I.R.C. §§ 652(b), 661(b), and 662(b) (1982).

92. I.R.C. § 651(b) (1982). Thus, if under the terms of the trust instrument, income is to be distributed currently to beneficiary B, and if during the taxable year the trust reports $40,000 of rental income, $10,000 of tax-exempt income, and no expenses, the income distribution deduction equals $40,000: the lower of (1) $50,000 amount distributed, or (2) $50,000 DNI less the $10,000 tax-exempt income item in DNI that is not included in the gross income of the trust.

93. I.R.C. § 661(c) (1982). By contrast I.R.C. § 651(b) (1982) applies the reduction in the case of simple trusts solely to DNI, supra note 92. The phrasing in section 651(b) (1982) is possible because, generally speaking, distributions from simple trusts will equal DNI.

94. To illustrate, assume that the trust reports during the taxable year $40,000 of rental income, $10,000 of tax-exempt income, and no expenses. Under the terms of the trust instrument, trust income may be accumulated or distributed to beneficiary B in the trustee's discretion, but that trustee must distribute all tax-exempt income. The trustee distributes $30,000 to B during the year. The income distribution deduction will equal $20,000: the lower of (1) the amount distributed ($30,000) reduced by the tax-exempt item ($10,000), or (2) DNI ($50,000).

Alternatively, if no tax-exempt income may be distributed and the trustee distributes $30,000 to B, the income distribution deduction equals $30,000. No reduction is made because no tax-exempt item is passed through to the beneficiary.

95. Thus, if in the previous example the trustee distributed $30,000, the income distribution deduction will equal $24,000, calculated as follows: first, the reduction applied to the lower of the amount distributed ($30,000) or DNI ($50,000) is the amount of tax-exempt income distributed; second, the amount of the tax-exempt income distributed bears the same ratio to the total amount distributed as the total amount of tax-exempt items (the total potential reduction) bears to DNI. Thus,

\[
\text{tax-exempt income distributed} = \frac{\text{total tax-exempt items, or}}{\text{total distribution}} \times \frac{\text{DNI}}{\text{distribution}}
\]

\[
\text{reduction} = \frac{\text{all tax-free items} \times \text{all distributions}}{\text{DNI}}
\]

\[
\text{reduction} = \frac{\$10,000 \times \$30,000}{\$50,000} = \$6,000.
\]

See example in Treas. Reg. § 1.661(c)-2, especially ¶ (e) (1988).
cannot exceed the portion of the distribution consisting of income subject to taxation.

Given the purpose for the adjustment, tax-free receipts that do not enter into DNI are not taken into account when making the adjustment. This includes tax-free receipts such as life insurance proceeds, gifts and bequests, and corpus distributions received from other trusts or estates. These items do not make up DNI and are thus not part of the adjustment. One tax-free receipt that does enter into DNI, however, is tax-exempt income. This means that the type of item that reduces DNI for purposes of the income distribution deduction is generally limited to tax-exempt income.

Furthermore, only the net amount of the tax-exempt income distributed reduces the income distribution deduction. Accordingly, expenses incurred by the trust or estate allocable to the tax-exempt income are taken into account when determining the adjustment because even though such expenses are disallowed for tax purposes, they nevertheless enter into the DNI calculations and help characterize the net amounts distributed.

For purposes of the DNI adjustment, how trust or estate expenses are allocated to tax-exempt items in DNI becomes very important. Moreover, the interest of the entity on the one hand and that of the beneficiaries on the other are in opposition with regard to the manner of allocation. That is because taking expenses allocable to tax-exempt income into account does not alter the total amount of DNI. Because total DNI is not affected, the allocation of such expenses affects only the mix of the net amounts of tax-exempt and taxable-income items in DNI. To the extent trust or estate expenses are allocated to tax-exempt income, a lesser amount of such expenses remain to be allocated to the taxable income. The fewer the expenses allocated to taxable income, the more such income may be distributed and deducted by the trust or estate because the income distribution deduction is keyed to the portion of the distribution consisting of income subject to taxation. From the point of view of the trust or estate, reducing the tax-exempt items, and hence the adjustment to the income distribution deduction, is beneficial. This means, however, that a greater amount of income will be taxed to the beneficiaries.

If the trust or estate distribution is equal to or greater than DNI, this allocation has a neutral effect on the computation of the income distribution deduction. Since all of the income is distributed, it is not material for purposes of the deduction to note the net items comprising DNI. The method of

98. Tax-exempt receipts generally do not form part of DNI because the starting point for computing DNI is taxable income, I.R.C. § 643(a) (1982). For a detailed discussion of the rules for determining which items enter into DNI, see M. FERGUSON, supra note 20, ch. 5.
100. I.R.C. § 265(a)(1), (2) (Supp. IV 1986).
101. I.R.C. §§ 643(a)(5) (1982); 643(a) (Supp. IV 1986); 651(b) (1982); 661(b) and (c) (1982).
102. M. FERGUSON, supra note 20, at 333-34, 484.
103. Of course, the beneficiaries might care about the mix of net items in DNI.
allocation becomes consequential only in cases when all income is not distributed. In such cases, the general rules for allocating expenses to items comprising DNI are followed.\textsuperscript{104} Thus, an expense is taken into account even if for fiduciary accounting purposes it is chargeable to corpus.\textsuperscript{105} The effect of an additional expense is to further reduce the net tax-exempt income, lowering the adjustment and hence increasing the available income distribution deduction. Also, because general expenses are not allocated to tax-free items that do not enter DNI (such as life insurance proceeds and capital gains), the allocation of general expenses is not diluted by the presence of such corpus items.\textsuperscript{106} The result, again, is a lower net tax-exempt item and a larger income distribution deduction.

Finally, general expenses, such as fiduciary fees, state income taxes, and attorney’s fees for general services, are allocated on a pro-rata basis to the tax-exempt income on the basis of the ratio such income bears to the total amount of fiduciary accounting income.\textsuperscript{107} However, when allocating general expenses, whether gross fiduciary accounting income or such income less direct expenses is used in the ratio is not altogether clear.\textsuperscript{108} The choice may be significant. The use of the gross amount dilutes the amount of expenses allocated to the tax-exempt items and thus increases the amount of the available income distribution deduction.\textsuperscript{109}

\textsuperscript{104} M. Ferguson, supra note 20, at 484-85.
\textsuperscript{105} Treas. Reg. §§ 1.643(d)-2(a)(2) (example); 1.662(c)-4(c) (1988) (example).
\textsuperscript{106} The allocations are exclusively to DNI items per I.R.C. § 651(b); 661(c) (1982); Treas. Reg. §§ 1.652(b)-3(b), 1.652(c)-4 (1988) (example). See also Tucker v. Commissioner, 322 F.2d 86 (2d Cir. 1963), aff’d 38 T.C. 955 (1962); Rev. Rul. 77-355 C.B. 82.
\textsuperscript{109} To illustrate, assume that under the terms of the trust instrument, income may in the trustee's discretion be accumulated or distributed to beneficiary B. Also, expenses are allocated against income, and the trust instrument requires a reserve for depreciation. During the year the trustee distributes $20,000 of income to B and allocates general expenses to rental income except for amounts required to be allocated to tax-exempt income. The trust has the following receipts and expenses for the year:

\begin{tabular}{lcc}
| Life insurance proceeds & $200,000  \\
| Rental income & 60,000  \\
| Dividends & 10,000  \\
| Tax-exempt income & 30,000  \\
| Rental expense & 46,000  \\
| Depreciation & 4,000  \\
| Trustee's fees & 10,000  \\
\end{tabular}

The trust's DNI for the year is $40,000, composed as follows:

\begin{tabular}{lccc}
<table>
<thead>
<tr>
<th>Rental Income</th>
<th>Dividends</th>
<th>Tax-Exempt Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>$60,000</td>
<td>$10,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>$46,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$4,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$7,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
$3,000         | $10,000   | $27,000             |

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2-Percent Floor on Itemized Deductions

As part of the Tax Reform Act of 1986, Congress limited the use of certain itemized deductions. The income distribution deduction, however, is not limited by this new provision. The General Explanation of the Tax Reform Act of 1986 confirms this and notes that a technical correction to the Act may be necessary for the statute to reflect this intent. This interpretation is appropriate given the different purposes of the income distribution deduction and the limitation on certain itemized deductions.

Distributions in Kind

The Tax Reform Act of 1984 fully revised the treatment of distributions of property (other than cash) made by trusts or estates to beneficiaries. Regarding the income distribution deduction, the rule as amended now provides that the amount of the distribution eligible for the deduction is the lesser of (1) the basis of the property distributed in the hands of the beneficiary or (2) the fair market value of such property. The basis of the distributed property in the hands of the beneficiary is the same as the basis of such property in the hands of the trust or estate immediately before the distribution, adjusted for any gain or loss recognized to the trust or estate on the distribution. Generally speaking, a trust or estate does not recognize gain or loss on distributions of property, unless the fiduciary elects otherwise. Thus, the general rule can be restated as follows: the amount of the distribution eligible for the distribution deduction is the lower of (1) the property's basis to the trust or estate or (2) its fair market value.

If gain property is distributed, the amount of the distribution is as a general rule the trust's or estate's basis in that property. For purposes of calculating

If gross fiduciary accounting income is used in the allocation ratio, the portion of general expenses allocated to tax-exempt interest is based on the following ratio:

\[
\frac{\text{Gross tax-exempt interest}}{\text{Gross fiduciary income}} \times \text{Amount of general expenses}
\]

Because the trustee distributes $20,000 to beneficiary B, the beneficiary receives one-half of each item in DNI. The potential distribution deduction is then the lower of (1) $20,000 or (2) DNI of $40,000. This amount is reduced by $13,500 (1/2 of $27,000 net tax-exempt income item in DNI) to $6,500. The distribution deduction consists of $1,500 rental income and $5,000 dividend income, the items in DNI distributed and subject to taxation.

If the allocation is based on net fiduciary accounting income, the ratio would be 30/50, after taking into account the direct expenses of rental and depreciation. As a result, $6,000 of the general expenses are allocated to the tax-exempt income and $4,000 to the taxable income. This leaves the trust with a $24,000 tax-free item in DNI and a $12,000 adjustment to the distribution deduction, which now is $8,000 (compared to $6,500 in the gross ratio example above).

11. General Explanation, supra note 4, at 80. This correction was made with the Technical and Miscellaneous Revenue Act of 1988; see I.R.C. § 67(e)(2), as added by Pub. L. No. 447, 100th Cong., 2d Sess., § 1001(f)(3) (1988). Thus, the deduction will be calculated before the application of the 2-percent floor.
the amount of the distribution, an amount equal to the property’s basis is treated as distributed. The effect of this new rule is to limit the amount of income carried out to a beneficiary with the distribution of an appreciated asset and hence also to limit the income distribution deduction available to the entity with respect to such a distribution.\textsuperscript{115}

A collateral effect is to preserve DNI for other distributions during the year. If loss property is distributed, the amount distributed is always the fair market value of such property, even when taxability is elected.\textsuperscript{116}

The general rule applies unless the fiduciary, in his judgment, elects to treat the distribution as a taxable sale to the beneficiary.\textsuperscript{117} In such an event, the amount of the distribution will always equal the fair market value of the property.\textsuperscript{118} Once made, the election to intentionally incur gain applies to all distributions made by the trust or estate during the year.\textsuperscript{119} The fiduciary is not allowed an asset-by-asset election and thus cannot pick and choose the mix in his amounts of distributions. The election is made on the trust’s or estate’s tax return for the year of the distribution. Any election, once made, may be revoked only with the consent of the Commissioner.\textsuperscript{120}

If the fiduciary elects to recognize the gain on the transfer, such gain probably will be capital gain, will be allocated to corpus and will not enter into DNI, except in cases of terminating distributions.\textsuperscript{121} Accordingly, the election itself will not be a separate source of additions to DNI that could potentially trigger a larger income distribution deduction.\textsuperscript{122}

Unless the fiduciary elects taxability, distributions of property in kind will carry out DNI and will be deductible in the amount of the bases in the properties

115. This new rule overrules Treas. Reg. § 1.661(a)-2(f)(2) (1988), which called for an amount of distribution equal to the property's fair market value. Under prior law, this result also allowed the beneficiary a step-up in basis to the property's fair market value. This result, too, is overturned by the new rule, which allocates the beneficiary a carryover basis. I.R.C. § 643(e)(1) (Supp. IV 1986).

116. I.R.C. § 643(e)(2)(B), (3)(A)(ii) (Supp. IV 1986). To illustrate, assuming the distribution is not a taxable event, if a trust or estate distributes property with a fair market value of $100 and an adjusted basis at the time of the distribution of $60, the amount of the distribution, subject to available DNI, is $60. Had the fair market value of the property been $40, the income distribution deduction accordingly would have been limited to $40. Note that to treat the distribution as a sale of the loss property will not result in loss recognition to the entity per I.R.C. § 267(a)(1), (b)(5).


118. I.R.C. § 643(e)(3)(A)(iii) (Supp. IV 1986). This treatment accorded the trust or estate is analogous to the treatment of corporate distributions of appreciated property after the repeal of the General Utilities doctrine in I.R.C. §§ 311 & 336 (Supp. IV 1986). To illustrate, if a trust or estate distributes property to a beneficiary with a basis of $60 and fair market value of $100 and if the fiduciary elects to recognize the gain on the distribution, the amount of the distribution eligible for the deduction steps up to $100.


122. To continue the corporate tax analogy, see the different treatment accorded in-kind corporate distributions in I.R.C. § 312(b) (Supp. IV 1986). The appreciation in the asset distributed increases earnings and profits.
in the hands of the entity. This is the result even if the properties distributed are equal in value. To illustrate, if the fiduciary distributes two assets each worth $100 but with bases of $20 and $60, respectively, the entity's income distribution deduction cannot exceed $80, even though economically speaking the distributions are level.\footnote{123} The beneficiaries will have a particular interest in who gets what asset since they will receive the properties with a carryover basis. To maximize his income distribution deduction, and at the same time neutralize any undue influence from the beneficiaries, the fiduciary may wish to choose the year in which a particular asset will be distributed.

The new approach to property distributions enacted by the Tax Reform Act of 1984 overturns prior law on this point found in the regulations.\footnote{124} To what extent these regulations not specifically in conflict with the new rules remain viable, however, is unclear.\footnote{125} Specifically, the regulations provide for a cash-first rule applicable when the total amount of cash and property distributed during the year exceeds the DNI for the year. In such instances, the DNI is applied first to the cash, with any excess available applied to the property distributed. Under the regulations, DNI is not applied proportionately to each separate distribution.\footnote{126}

If the cash-first rule still applies, the income distribution deduction may remain limited even if the fiduciary elects to recognize gain on the distribution. To illustrate, assume the fiduciary distributes $10,000 in cash and $10,000 worth of property with a $6,000 basis. DNI for the year is $16,000. The distribution deduction is limited to $16,000 and is comprised of the $10,000 cash and $6,000 basis. The answer remains the same if the fiduciary elects taxability because the first $10,000 in the deduction is attributable to the cash. For purposes of the income distribution deduction, the election becomes irrelevant and the gain is unnecessarily incurred.

The new in-kind distribution rules affirmatively provide for the determination of the amount of the distribution. The amount is specifically stated to be either the basis in the property or its fair market value, depending upon the applicable scenario. By its own terms, the rules do not provide any guidance on how to treat distributions of encumbered property. A reasonable argument is that despite the silence in the statute, the amount of the distribution eligible for the deduction should reflect a net position. This interpretation is suggested and supported by the treatment of corporate distributions of mortgaged property to shareholders.\footnote{127} This interpretation is also consistent with the adjustment to the income distribution deduction for items not included in gross income discussed earlier. For purposes of that adjustment, only the net amount of
the tax-free item in DNI was taken into account because only the net amount accurately reflects the economic value distributed. 128

The in-kind distribution rules discussed here do not apply to property transfers falling outside the purview of the general distribution rules, such as charitable transfers or specific gifts or bequests of property. 129 Nor do they apply to transfers of property in satisfaction of a specific bequest of another property. For example, if Whiteacre is distributed instead of a specific bequest of Blackacre, the trust or estate is treated as having first made a constructive transfer of Blackacre in satisfaction of the specific nondeductible bequest, followed by the taxable sale of Whiteacre for Blackacre. 130 Likewise, prior law rules governing gifts of appreciated property to charitable organizations will continue to apply. 131

The amendment to the in-kind distribution rules by the Tax Reform Act of 1984 did not change the treatment under prior law of transfers made in satisfaction of pecuniary bequests. 132 Such transfers will continue to be treated as first consisting of a constructive distribution of the dollar entitlement, followed by a taxable purchase by the beneficiary of the property actually transferred. 133 The availability of the income distribution deduction, and the application of the property distribution rules, depends on the specificity of the pecuniary bequest. If the pecuniary bequest is a specific dollar amount, the trust is not allowed an income distribution deduction for the transfer and the property distribution rules are neither triggered nor needed. 134 However, if the dollar entitlement of the beneficiary is not specific, then the constructive cash distribution is deductible subject to available DNI. 135

To summarize, the in-kind distribution rules do not apply to property transfers in satisfaction of specific property or pecuniary bequests. They do apply to property distributions in satisfaction of pecuniary bequests of undetermined dollar amounts or of bequests of unidentified property because the

128. See supra notes 83 and 84.
129. I.R.C. § 643(e)(4) (Supp. IV 1986), referring to transfers governed by I.R.C. § 663(a) (1982). The in-kind distribution rules need not apply since such property transfers are not deductible by the trust or estate.
132. Id. at 255-56.
134. I.R.C. § 643(e)(4) (1982), referring to I.R.C. § 663(a) (1982). To illustrate, assume the fiduciary transfers property in satisfaction of an obligation imposed by the governing instrument to distribute $20,000 to a beneficiary. The property has a fair market value of $20,000 and a basis of $8,000. The fiduciary is deemed first to have made the specific cash distribution, which is not eligible for the income distribution deduction as a specific bequest, followed by a sale of the property in exchange for $20,000 in cash. The fiduciary thus must report a gain of $12,000 on the sale without an offsetting deduction for the distribution.
135. In the above example, the fiduciary will thus report a $20,000 income distribution deduction in addition to the $12,000 gain. See Rev. Rul. 67-74, 1967-1 C.B. 194.
income distribution deduction is available for such distributions. Formula bequests, particularly marital deduction clauses, are illustrative of the latter two types of transfers.138 Whether the transfer is called for under a pecuniary formula clause or a fractional share formula, the transfer is eligible for the income distribution deduction.137 Under a pecuniary formula, the cash deemed constructively distributed is the amount of the distribution.138 Under a fractional share formula, the lower of the property’s basis or fair market value is the amount of the distribution.139 Since the distribution is not a taxable exchange under the Kenan doctrine,140 in the case of gain property distributed the basis figure is not adjusted upward to fair market value,141 unless the fiduciary elects to treat the distribution as a taxable sale.142 In such event, the income distribution deduction equals the fair market value of the property, subject to available DNI.143

A further illustration of a pecuniary bequest of an undetermined dollar amount is a tier-one distribution of a complex trust or estate.144 If the fiduciary satisfies the obligation to distribute all current income with the distribution of property, the distribution is again treated as a cash distribution followed by a sale of the property to the beneficiary.145 Because this is a cash distribution, the in-kind distribution rules are not needed. This is why the in-kind distribution rule only applies to tier-two distributions, such as fractional share or residual formula distributions of property.146

Two final points must be made, one dealing with installment obligations and the other with income in respect of a decedent (IRD). If the trust or estate distributes an installment note from a sale made by the fiduciary (thus not an IRD item), the distribution of the note to the beneficiary is a taxable disposition of the note accelerating the gain to be reported on the installment sale.147 Because gain is recognized by the trust or estate on the distribution, the amount of the income distribution deduction will always be the fair market value of the note, subject to available DNI.148 This will be the result whether or not the fiduciary makes the election to treat the distribution as a taxable sale. As a result, the election is meaningless in this situation. To give the

136. Formula bequests are not within the inheritance exclusion of I.R.C. § 663(a) (1982).
140. See authority supra at notes 133 and 137.
146. I.R.C. § 643(e) (Supp. IV 1986) only refers to § 661(a)(2)-type distributions, i.e., tier-two distributions.
election vitality, however, an argument could be made that distributions of installment notes should be governed after enactment of the Tax Reform Act of 1984 by the more specific rules applicable to in-kind property distributions by trusts or estates, rather than by the installment sales rules applicable to dispositions of installment notes generally. The issue at hand is the timing with regard to the gain inherent in the installment note. If the gain on the installment note is not accelerated, then the income distribution deduction is limited to the basis in the installment note distributed.

A similar issue is raised concerning the applicability of two opposing statutory schemes with regard to income in respect of the decedent (IRD). The weight of decisional authority currently provides that distributions of IRD items fall outside the in-kind distribution rules.149 If the property distribution rules were to apply, the fiduciary could elect to accelerate the income represented by the IRD. In such case, the income distribution deduction would equal the amount of the income, the same amount that would then be taxed to the recipient-beneficiary. If IRD is treated separately and apart from the distribution rules, then the fiduciary will report no deduction on the transfer of the IRD and the beneficiary will report the income when the IRD is actually collected in later years. Again, the issue is a matter of timing.

Character of Amounts Distributed

The income distribution deduction allowed to a trust or estate is a nondeductible deduction taken by the entity in its final calculations in arriving at its taxable income.150 The deduction is not allocated as such against different types of income. The Code does speak, however, of the character of the amounts distributed151 and the regulations of the character of the amounts retained by the trust or estate.152 This does not mean that the income distribution deduction is to be prorated to different categories of income and allowed only against such income. Rather, the characterization called for by the statute is related to the qualitative flow-through of the conduit approach to the taxation of trusts and estates. The characterization of the income distribution deduction is part of a larger computation of the character of the net amounts that comprise DNI.153 As to the income distribution deduction, the character

149. See discussion infra in part VI.
150. The income distribution deduction is taken on line 17 of the Fiduciary Income Tax Return. See supra note 1. In calculating its taxable income, a trust or estate first determines its tentative taxable income (gross income less deductions other than deductions under I.R.C. § 661 (1982 & Supp. IV 1986), 642(b) (Supp. IV 1986), 691(c) (1982), and then turns to the distribution deduction, followed by the personal exemption in I.R.C. § 642(b) and deduction for estate taxes paid in I.R.C. § 691(c).
151. I.R.C. § 661(b) (Supp. IV 1986). No counterpart is found in I.R.C. § 651(b) (1982). None is needed because, generally, a simple trust distributes all its DNI. Attention to the character of amounts distributed and retained is only called for when not all of the DNI is distributed, as is possible with complex trusts and estates.
153. See M. FERGUSON, supra note 20, at 333, 468-76.
of the amounts distributed are relevant only for purposes of determining the adjustment to the DNI limitation on the deduction previously discussed.\textsuperscript{154}

IV. Taxable Year of Income Distribution Deduction

The timing of the income distribution deduction allowed a trust or estate depends on the tier source of the distribution. Required distributions of current income, tier-one distributions, are deducted in the year the distributions are required to be made, whether or not actually made. This is so even if the distributions are actually made in the subsequent year for reasons of administrative convenience.\textsuperscript{155}

Tier-two distributions, on the other hand, are deducted in the year actually made.\textsuperscript{156} Again, to facilitate administrative convenience, tier-two distribution made by a trust (but not an estate) will be deemed actually made in a prior year if the trustee so elects under the 65-day rule discussed below. The timing of the income distribution deduction is thus independent of the method of accounting used by the trust or estate for purposes of reporting other items of income and disbursements.

Complex Trust Distributions: 65-Day Rule

Although complex trust distributions are deductible in the year actually made, they may be retroactively applied to the previous year if the trustee so elects. A trustee may, in his discretion, elect to treat an amount paid within the first 65 days of any taxable year as actually paid on the last day of the preceding taxable year.\textsuperscript{157}

The election allows the trustee an opportunity to monitor distributions on account of a taxable year after the close of that year and to make such distributions with a fuller understanding of that year’s income and DNI amounts. The election enables the trustee to retroactively avoid accumulating income and avoid the possible application of the throwback rules to such income.\textsuperscript{158} Because the throwback rules do not apply to estates, the 65-day rule is needed only with respect to complex trust distributions to tier-two beneficiaries.\textsuperscript{159} Similarly, tier-one distributions are not covered by the 65-day rule because their timing is determined without reference to whether actual distributions are made.\textsuperscript{160}

The election is made on an annual basis and is effective only with respect to the taxable year for which the election is made.\textsuperscript{161} The election with respect to a taxable year of a trust is applicable only to those amounts properly paid

\textsuperscript{154} Note that I.R.C. \$ 661(c) (Supp. IV 1986) refers to I.R.C. \$ 661(b) (Supp. IV 1986).

\textsuperscript{155} I.R.C. \$\$ 651(a), 661(a)(1) (Supp. IV 1986) and Treas. Reg. \$\$ 1.651(a)-2(a), 1.663(a)-3 (1988).

\textsuperscript{156} I.R.C. \$ 661(a)(2) (1982).

\textsuperscript{157} I.R.C. \$ 663(b)(1) (1982); Treas. Reg. \$ 1.663(b)-1 (1988).

\textsuperscript{158} For reading on the throwback rule, see supra note 24.

\textsuperscript{159} By its own terms, I.R.C. \$ 663(b)(1) (1982) applies only to trust distributions.

\textsuperscript{160} See authority supra at note 155.

\textsuperscript{161} Treas. Reg. \$ 1.663(b)-1(a)(2)(f) (1988).
or credited within the first sixty-five days following the close of such year and so designated by the fiduciary in his election. The amount so designated cannot be greater than: (1) the amount of the fiduciary accounting income of the trust for the year for which the election is made; or (2) the amount of DNI for such year. The year for which the election is made is the previous year to which the distribution will be related, not the year in which the distribution was otherwise made within the 65-day period. The cap on the amount deemed retroactively distributed is applied with respect to this previous year’s income and DNI amounts. Moreover, the cap on the amount to which the election applies is reduced by any amounts paid, credited, or required to be distributed in such previous year. This limitation on the amount eligible for the election carries out the purpose of the election, which is to retroactively prevent unintended accumulations of income in the previous year whose later distribution would trigger the throwback rules. Such undue accumulations arise only if the greater of fiduciary accounting income or DNI is not fully distributed.

Once a proper election is made with respect to any distribution, such distribution shall be treated as actually having been made in the previous year for all other purposes. This makes the previous year the relevant year for determining the amount of the income distribution deduction as well as the timing of the deduction. This also means that the amount is not deemed distributed within the 65-day period for purposes of applying the election cap with respect to the year within which the 65-day period ends, if such year itself becomes an election year in the future.

V. Separate Trust Shares as Separate Trusts

For the sole purpose of computing DNI, separate shares of a trust will be

164. The trustee must elect for the designation under the 65-day rule on the tax return for the year for which the election is made. Thus the election must be made no later than the time prescribed for filing the return for the previous year, including extensions thereof. Once made, the election is irrevocable after the last day for filing the return. I.R.C. § 663(b)(2) (1982); Treas. Reg. § 1.663(b)-2(a)(1) (1988). If no return is required for the year, a statement must be filed in lieu of a return in the same manner and time. Treas. Reg. § 1.663(b)-2(a)(2) (1988). If the trustee does elect, he is not committed to the election in subsequent years. Treas. Reg. § 1.663(b)-1(a)(2)(i) (1988).
165. Id.
166. See 3 B. Bittker, supra note 5, at ¶ 81.5.2.
168. Treas. Reg. § 1.663(b)-1(a)(2)(i) (1988). To illustrate, assume that in year one a trust has DNI of $10,000 and fiduciary accounting income of $9,000. The trustee distributes $5,000 within the first sixty-five days of year one and elects to designate the amount as distributed in a previous year. The trustee further distributes $3,000 during year one and another $8,000 within the first sixty-five days of year two. The maximum amount of the year two distribution that may be designated as distributed in year one is $7,000 ($10,000 — $3,000). The trustee, of course, is not bound to designate the maximum amount and may elect a smaller amount. See also example in Treas. Reg. § 1.663(b)-1(a)(2)(i) (1988).
treated as separate trusts.\textsuperscript{169} This rule limits the income distribution deduction where income is accumulated for two or more beneficiaries, but a distribution is made to a beneficiary in excess of that beneficiary's share of income to which he would have been entitled had he been a beneficiary of a separate trust.\textsuperscript{170}

The separate share rule is triggered whenever distributions of a trust are made in substantially the same manner as if separate trusts had been created.\textsuperscript{171} This occurs whenever payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any other beneficiary. In other words, this occurs whenever the trustee may not dip into one beneficiary's share for the benefit of another beneficiary unless substantially proper adjustment is made so that substantially separate and independent shares exist.\textsuperscript{172} The rule also may apply to successive interests in point of time.\textsuperscript{173}

This rule is not elective\textsuperscript{174} and applies even though separate books of account are not maintained by the trustee and no physical segregation of assets is made or required.\textsuperscript{175} In determining whether a separate share exists, it is not material that more than one beneficiary has an interest in a separate share, or that the same beneficiary has an interest in more than one share.\textsuperscript{176} Likewise, it is not material to whom a separate share will be distributed upon the death of the beneficiary of that share.\textsuperscript{177}

In applying the separate share rule, the DNI for each separate share is computed separately. Deductions and losses applicable to one share are thus not available to any other share of the same trust.\textsuperscript{178} The separate share rule only relates to the computation of DNI and hence to the income distribution deduction. The trust will be treated as a single entity for all other purposes, including the filing of returns and payment of taxes.\textsuperscript{179} The rule does not apply

\begin{itemize}
\item[169.] I.R.C. § 663(c) (1982). A separate share rule also exists for the generation-skipping tax in I.R.C. § 2654(b) (Supp. IV 1986), and for grantor power to control beneficial enjoyment over corpus in I.R.C. § 674(b)(5)(B) (1982).
\item[170.] Treas. Reg. § 1.663(c)-1(a) (1988); Rev. Rul. 74-299, 1974-1 C.B. 154.
\item[171.] Treas. Reg. § 1.663(c)-3(a) (1988).
\item[172.] Treas. Reg. § 1.663(c)-3(b) and (d) (1988). To illustrate, assume that under the terms of the trust instrument, income is to be distributed to three equal beneficiaries. Also, the trustee may invade corpus for the benefit of any beneficiary to the extent of that beneficiary's share in the trust. In such event, the beneficiary's right to future income and corpus will be proportionately reduced. During the year, the trust has DNI of $30,000 and distributes $20,000 to beneficiary B. The trust's income distribution deduction is limited to $10,000, the amount of DNI in B's separate, one-third share of the trust. See example in Treas. Reg. § 1.663(c)-4 (1988).
\item[173.] Treas. Reg. § 1.663(c)-3(c) (1988).
\item[174.] Treas. Reg. § 1.663(c)-1(c) (1988).
\item[175.] Treas. Reg. § 1.663(c)-1(d) (1988).
\item[176.] Treas. Reg. § 1.663(c)-3(c) (1988).
\item[177.] Treas. Reg. § 1.663(c)-3(a) (1988).
\item[178.] Treas. Reg. § 1.663(c)-2 (1988).
\item[179.] Treas. Reg. § 1.663(c)-1(b) (1988).
\end{itemize}
to estates,\textsuperscript{180} simple trusts,\textsuperscript{181} or situations in which the trust instrument itself creates separate trusts.\textsuperscript{182}

VI. Non deductible Distributions

Distributions of specific gifts or bequests are not deductible by the trust or estate. Neither are charitable transfers or transfers of property passing directly to heirs without administration by the executor. Finally, distributions to beneficiaries of a right to receive income in respect of the decedent likewise are nondeductible distributions.

\textit{Gifts or Bequests of a Specific Sum of Money or of Specific Property}

Gross income of an individual does not include the value of property acquired by gift, bequest, devise, or inheritance.\textsuperscript{183} This exclusion does not apply, however, to a gift, bequest, devise or inheritance of income from property.\textsuperscript{184} The DNI concept is intended to distinguish between these two types of receipts in the context of transfers made by trusts and estates.\textsuperscript{185} Distributions by a trust or estate in excess of DNI or distributions of corpus as specific gifts or bequests are not transfers of income from property and hence are not income to the recipients. If such distributions are not income to the beneficiaries who receive them, then accordingly such distributions are not deductible by the trust or estate. This result is in harmony with the purpose of the income distribution deduction, which is to allocate the tax with regard to taxable income between the trust or estate and the beneficiaries. The treatment of distributions that come out of DNI was discussed earlier. The topic discussed here deals with the treatment of specific gifts and bequests.

In general, no income distribution deduction is allowed a trust or estate for a gift or bequest of a specific sum of money or of specific property required to be made by the specific terms of the will or trust instrument and properly paid or credited to a beneficiary.\textsuperscript{186} If under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the beneficiary in more than three installments, however, the disallowance will not apply and the general distribution rules will apply.\textsuperscript{187} The prerequisites for the disallowance of the income distribution deduction are as follows: (1) the transfer of

\textsuperscript{180} Treas. Reg. \textsection 1.663(c)-3(f) (1988).

\textsuperscript{181} By its own terms I.R.C. \textsection 663(c) (1982) only refers to the computation made under section 661 and 662, the provision dealing with the income distribution deduction of complex trusts.

\textsuperscript{182} See Robert L. Moody Tr. v. Commissioner, 65 T.C. 932 (1976).

\textsuperscript{183} I.R.C. \textsection 102(a) (Supp. IV 1986).

\textsuperscript{184} I.R.C. \textsection 102(b)(2) (Supp. IV 1986).

\textsuperscript{185} I.R.C. \textsection 102(b) (Supp. IV 1986); Treas. Reg. \textsection 1.102-1(d) (1988). See also Irwin v. Gavit, 268 U.S. 161 (1925).

\textsuperscript{186} I.R.C. \textsection 663(a)(1) (1982), referring to the nonapplicability of I.R.C. \textsection 661, which provides for the income distribution deduction.

\textsuperscript{187} I.R.C. \textsection 663(a)(1) (1982).
money or property must be properly paid or credited under the terms of the
governing instrument as a gift or bequest; (2) the transfer must be specifically
identifiable; (3) the transfer must be paid or credited all at once or in not
more than three installments; and (4) the transfer must not be paid or credited
only from the income of the estate or trust. Each of these prerequisites is
discussed later in the article.

The effect of the disallowance is to treat specific gifts and bequests as trust
or estate distributions that fall outside the general distribution rules. In receiving
predesignated property, the beneficiary does not have any interest in any other
item of the trust or estate, particularly its income. Consequently, the transfer
does not become part of the deduction-inclusion regime of the taxation of
trusts and estates. A collateral effect is that to the extent a transfer of prop-
erty or money is not deductible by the trust or estate, the trust's or estate's
DNI is preserved to be applied to other distributions made by the entity during
the year.

Gift or Bequest

Transfers that are nondeductible distributions by the trust or estate must
be properly made pursuant to specific terms of the will or trust instrument. A valid will is thus a prerequisite for the disallowance of the income distribution
deduction. Accordingly, neither intestate transfers nor transfers of property
that pass directly to beneficiaries outside the will or trust instrument are
within the reach of this rule.

Under the rule, the transfers must be made by a gift or bequest. Because
these are terms of art in a federal statute, they must be given their federal
meaning rather than local law characterization. The transfers must proceed
from a detached and disinterested generosity, out of affection, respect, admira-
tion, charity, or like impulses. Transfers to creditors as such are not within
this rule. This does not mean, however, that transfers to creditors otherwise
convert to deductible distributions, as discussed earlier.

Finally, although the provision refers only to bequests, a term that technically
applies only to transfers of personal property, it no doubt also applies to
devises of real property. This interpretation is consistent with the disallowance
of the income distribution deduction regarding direct transfers of realty.

188. Compare I.R.C. § 102(a) (Supp. IV 1986) with § 102(b) (flush language).
189. Because the nondeductible distribution does not use up DNI (see I.R.C. § 663(a) (1982)
making § 661 inapplicable), more DNI is available for the application of the inner ceiling limi-
tation in I.R.C. § 661(a) (Supp. IV 1986) (flush language).
as a result then become eligible for the deduction.
192. Intestate transfers, as a result, are governed by the general distribution rules and are
eligible for the income distribution deduction to the extent of available DNI, Treas. Reg. §
1.661(a)-2(e) (1988), unless they are deemed to pass directly to a beneficiary.
196. BLACK'S LAW DICTIONARY 145 (5th ed. 1979).
Specific Sum of Money or Specific Property

To be disallowed as deductible distributions, transfers must be specifically called for under the terms of the will or trust instrument. The high degree of specificity required is inherent in distinguishing between the inheritance of property and the inheritance of income from property that may be carried out through in-kind property distributions. Only the latter type of transfer is eligible for the income distribution deduction. Thus a trust or estate will not be allowed the income distribution deduction if the amount of money or the identity of the specific property is ascertainable under the terms of the will as of the date of the decedent’s death, or under the terms of the trust instrument as of the date of the inception of the trust.\(^{197}\)

Transfers do not become deductible simply because the exact amount payable cannot be ascertained with certainty under the terms of the will.\(^{198}\) It is not material that the value of the bequest is determinable only at the time of the decedent’s death.\(^ {199}\) As long as the identity of the property is specified in the governing instrument, pre-death events and conditions that affect the value of the property do not make the transfer eligible for the deduction. Thus, if under the terms of his will, the decedent bequeaths his interest in a partnership to his son and a sum of money equal in value to the partnership interest to his daughter, sufficient specificity is present and the distributions are not deductible. As long as the identity of the property and the dollar value of the bequest are not dependent on the post-death exercise of the fiduciary’s discretion, the transfers are specific and are not deductible. Pre-death conditions affecting valuation, such as encumbrances on the partnership properties, are not material.\(^{200}\) Likewise, pecuniary bequests remain nondeductible even though the dollar amount is not stated in the will as long as they are ascertainable as of the date of death.\(^ {201}\)

\(^{197}\) Treas. Reg. § 1.663(a)-1(b)(1) (1988); Rev. Rul. 78-24, 1978-1 C.B. 196. To illustrate, assume that under the terms of the will, a legacy of $5,000 was left to A, a designated number of shares of X Co. stock was left to B, and the balance of the estate was divided between C and D. During the year the estate had income of $20,000, and the executor paid the legacy to A and transferred the designated shares of X Co. stock to B. If no other distributions were made, the estate is not entitled to a distribution deduction. See example (1) in Treas. Reg. § 1.663(a)-1(b)(3) (1988).

\(^{198}\) Treas. Reg. § 1.663(a)-1(b)(4) (1988).


\(^{200}\) Treas. Reg. § 1.663(a)-1(b)(1) (1988). However, post-death events become material. Thus a bequest of so many shares of stock equal in value at the date of distribution to a designated dollar amount is not specific and is thus deductible. The number of shares bequeathed was determinable only at the date of distribution, not at the date of death, as is required for the disallowance. Rev. Rul. 72-295, 1972-1 C.B. 197.

\(^{201}\) Treas. Reg. § 1.663(a)-1(b)(1) (1988). Thus a pecuniary bequest made pursuant to an equalization clause in the will is not a deductible distribution. Rev. Rul. 82-4, 1982-1 C.B. 99 (To equalize the interests of two beneficiaries in the residue of the estate, the decedent’s will called for a transfer out of the residuary assets to one of the beneficiaries who did not receive a lifetime transfer from the decedent in an amount equal to the value at the date of death of the lifetime transfer. The transfer was not deductible because the amount of the bequest was ascertainable as of the date of decedent’s death.).

Moreover, giving the fiduciary the power in his discretion to select the mix of assets and cash to distribute in satisfaction of a bequest of a specified dollar amount stated in the will does
Similarly, conditions imposed on the transfer do not make the transfer deductible, as long as the conditions affect only the timing of the transfer and not the dollar amount or the identity of the property to be transferred. For this purpose, the conditions imposed on the transfer must not be within the control of the fiduciary. 202

A distribution of assets out of the residuary estate is, however, deductible by the estate. Residuary bequests are not ascertainable as of the date of death and lack the specificity required for the disallowance of the deduction because the value and composition of the residuary estate are both dependent on post-death events, such as the payment of administrative expenses. 203 Consequently distributions of the decedent’s personal effects as part of the residuary estate, such as the family car, are deductible by the estate, subject to available DNI, even though they have the overtone of corpus distributions.

Other transfers deductible by the trust or estate as bequests of undetermined dollar amounts or unidentified property include bequests of: (1) amounts paid pursuant to formula clauses, such as marital deduction formula bequests; 204 (2) amounts which can be paid only from current or accumulated income; (3) amounts paid as an annuity or having the effect of an annuity; 206 and (4) amounts required to be paid under the terms of the governing instrument in more than three installments. 207 These transfers are discussed below.

Installment Payments

To be disallowed as distributions deductible by trusts and estates, gifts or bequests of a specific sum of money or of specific property must be paid or credited all at once or in no more than three installments. 208 By requiring that the transfers not be paid in too many intervals, the provision attempts to equate the transfers with distributions to beneficiaries who lack any in-

not convert the pecuniary bequest into a deductible distribution. The presence of the fiduciary’s discretion does not alter the fact that the monetary value of the bequest remains ascertainable under the terms of the will as of the date of the decedent’s death. Rev. Rul. 86-105, 1986-2 C.B. 82. Also, the fact that there may not be enough assets in the estate to satisfy the bequest is not material. An abatement of the bequest does not transform the bequest into a deductible bequest of the residue. Rev. Rul. 66-207, 1966-2 C.B. 243.

202. Thus, if under the terms of the trust instrument, $10,000 is to be distributed to A when he reaches age twenty-five, and another $10,000 when he reaches age thirty-five, with payment over to B of any amount not paid to A because of his death, the payments to A are not deductible. Alternatively, if A dies and the payments are made to B, such payments are likewise not deductible. Treas. Reg. § 1.663(a)-1(b)(4) (1988).

203. Treas. Reg. § 1.663(a)-1(b)(2)(iii) (1988). Thus, if the executor in the example in note 197 distributed in accordance with an agreement with C and D part of the assets of the estate to C and D having a value of $50,000, the distributions to C and D are deductible as distributions made out of the residuary estate. The distribution deduction is limited, however, to $20,000, the amount of DNI for the year. Treas. Reg. § 1.663(a)-1(b)(3) (1988) (example (2)).


terest in the trust’s or estate’s income. To the extent the transfers are in lump sum, or lump sum equivalents, rather than periodic, they do not resemble payments out of income, which are taxable to the beneficiaries and deductible by the trust or estate. 209

In determining the number of installments, the number of payments called for in the governing instrument controls. This means that the number of transfers in fact made by the fiduciary are immaterial. Thus a lump sum payment by the fiduciary in satisfaction of a periodic bequest will not convert an otherwise deductible bequest into a nondeductible distribution. The reverse is equally true. A periodic payment of a lump sum specific bequest will not alter the disallowance of the deductibility of such a transfer. 210

Whether a gift or bequest is required to be paid in more than three installments is determined without regard to specific gifts or bequests of articles for personal use. 211 Thus transfers of household furniture, a watch, an automobile, and other personal and household effects specifically provided for in the governing instrument are nondeductible distributions regardless of the number of transfers. 212 Moreover, such transfers do not affect the treatment of other gifts or bequests. Thus, if a will provides for a bequest of a specific sum of money to be paid out in three installments and additionally a specific bequest of articles for personal use to be paid out in four installments, neither transfer is a deductible distribution by the estate. 213 Similarly disregarded for purposes of the installment rule are transfers of property, title to which passes directly to beneficiaries by operation of law or as a result of the form of ownership. 214

If a will provides only that the time of payment occur in the ordinary course of administration of the estate, the transfers will be considered as made in a single installment. 215 The regulations further provide that all gifts and bequests payable at any one specified time under the terms of the governing instrument are considered paid in a single installment. Thus, the aggregate number of payments and not the number of separate unrelated assets within each payment is controlling for purposes of determining the number of installments. 216

212. Treas. Reg. § 1.663(a)-1(c)(2) (1988) (example (1), pt. (ii)).
213. Id.
215. Treas. Reg. § 1.663(a)-1(c)(1)(iii) (1988). To illustrate, assume that under the terms of the will, $10,000 in cash, a designated number of shares of X Co. stock, specifically identified realty, and an interest in a partnership are bequeathed to A. The transfers are considered made in a single installment, regardless of the manner of payment or distribution by the executor because no time of payment was specified in the will. Had the will provided for four separate distribution dates, the transfers would then be considered payable in more than three installments and would become deductible distributions by the estate. Treas. Reg. § 1.663(a)-1(c)(2) (1988) (example (1), pt. (iii)).
216. Treas. Reg. § 1.663(a)-1(c)(1)(iv) (1988). To illustrate, assume that under the terms of the decedent’s will a trust is created for the benefit of A pursuant to which a specified amount
The not-more-than-three installments rule applies separately to estates and their testamentary trusts.217 Likewise, the installment rule applies separately on a beneficiary-by-beneficiary basis. Thus, specific bequests of money payable to four separate beneficiaries at four different times are not transfers payable in more than three installments. The transfers remain nontaxable distributions of four separate single installments.218 Finally, the installment rule applies whether the installment payments occur all in one year or over a number of years.219

**Interest or Income on Gifts or Bequests**

Under applicable local law, an executor may be required to pay an amount to a pecuniary legatee to compensate the legatee for any delay in paying the legacy.220 Similarly, under local law, the executor may be required to pay to a legatee of specific property the income from that property earned from the date of the decedent's death.221 Neither payment is a payment of a nontaxable specific gift or bequest. Such additional payments can be made only with reference to the date of distribution and are thus not ascertainable as of the date of the decedent's death, as required for specificity.

The tax treatment of such additional payments by the estate depends on their characterization as interest payments on a pecuniary bequest or as income payments on a specifically bequeathed property. In the former case, the payment is made to a creditor of the estate and as such is governed by the interest paid rules.222 In the latter case, the additional payment is a distribution to a beneficiary as such and is subject to the general distribution rules. This also means, however, that if the income is retained by the estate, to be distributed in a subsequent year along with the specific property that gave rise to the income, such income is taxed to the estate. Furthermore, only so

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of cash and a specified number of shares of stock are to be distributed to A at age twenty-five, age thirty, and age thirty-five. The distributions are not deductible by the trust. Each cash and stock distribution in the aggregate is treated as one installment payment by the testamentary trust. Treas. Reg. § 1.663(a)-1(c)(2), example (1), part (iii). Had the will called for an additional trust distribution of cash only at age forty, all the distributions become deductible, not just the cash distributions. Treas. Reg. § 1.663(a)-1(c)(2) (1988) (example (2)).

217. Thus, in the example in the previous note, although the trust distributions become deductible in the second variation of the example, the nontaxable treatment of the estate in funding the testamentary trust remains unchanged. Treas. Reg. § 1.663(a)-1(c)(1) (1988).

218. Treas. Reg. § 1.663(a)-1(c)(2) (1988) (example (3)).

219. I.R.C. § 663(a)(1) (1982) by its terms does not prohibit payments solely over three years, but prohibits any payments in more than three installments regardless of the number of years in which the installments are made. Compare the three-year requirement with respect to alimony payments in I.R.C. § 71(f) (1982).


221. A. SCOTT, supra note 220, at § 234.1.

much of the subsequent distribution of the accumulated income is deductible as is deemed to come out of the DNI for that subsequent year.

The above discussion assumes that the property subject to the bequest is part of the estate and does not pass directly to the beneficiary. If the property is to pass directly to the beneficiary, the estate would hold the property as agent of the beneficiary and would not be subject to taxation on the income earned from the property.223

Marital Deduction Bequests

Bequests made pursuant to formula clauses in the governing instrument lack the specificity needed for the inheritance exclusion. Thus, neither pecuniary nor fractional share formula bequests are specific bequests that fall outside the general distributions rules. Distributions made under either formula clause are eligible for the income distribution deduction.

A formula pecuniary bequest in an amount equal to a fraction of the decedent’s adjusted gross estate is not a nondeductible specific bequest because the determination of the value of the adjusted gross estate is dependent on facts and events occurring after the date of death. The identity of the property and the amount of the money to be distributed are dependent both on the exercise of the executor’s discretion, such as the election of the valuation date and the election to deduct expenses against the income tax,224 and the payment of death costs and administrative expenses. Thus neither the identity of the property nor the dollar amount is ascertainable as of the date of decedent’s death as required for the disallowance of the distribution deduction.225

The same would be true of a pecuniary bequest of the entire adjusted gross estate made to take advantage of the unlimited marital deduction. As long as the bequest is made with reference to the decedent’s adjusted gross estate, the determination of the amount of the bequest is subject to facts not existing at the date of death.226 Bequests pursuant to a fractional share or residuary formula clause are likewise eligible for the income distribution deduction because what assets are finally distributed is again dependent upon post-death events and the exercise of the executor’s discretion.227

The treatment of specific bequests coupled with formula bequests is somewhat less clear. This situation would arise where a bequest of specific property is applied to reduce the amount passing under the formula clause. If form it not followed and the two formally separate bequests are collapsed, the answer remains the same: both types of bequests are distributions deductible to the extent of DNI.

223. The income earned would be taxed directly to the beneficiary as principal and owner of the property. See supra note 16.
224. I.R.C. §§ 2032 and 642(g) (1982).
225. Treas. Reg. § 1.663(a)-1(b)(1) and Rev. Rul. 60-67, 1960-1 C.B. 286. However, such bequests are specific enough to trigger realization upon distribution under the Kenan principle discussed earlier.
226. Id.
Amounts Payable Only Out of Income

To remain nondeductible, a specific gift or bequest must not be payable only from the income of the estate or trust. Thus an amount which can be paid or credited under the terms of the governing instrument only from the income of a trust or estate, whether from current or accumulated income, is eligible for the income distribution deduction. Such payments resemble deductible periodic installments more than nondeductible corpus distributions that are deemed not to have any economic interest in the income of the trust or estate.

Property Passing Directly to Beneficiaries

Property not part of the estate but inherited directly and without administration by the executor either by operation of law or as a result of the form of joint ownership with the decedent is not subject to the distribution rules. The property is inherited directly and not through the estate. Hence, the beneficiary has no economic interest in the estate assets or income.

Accordingly, a deductible distribution does not include the value of any interest in real estate owned by the decedent, title to which passes directly under local law from the decedent to his heirs or devisees. Although the provision on its face is limited to realty, no doubt all property passing outside the estate is similarly treated. Any income earned from the property inherited directly is taxed outright to the heir entitled to the property. Such income is not the estate’s and a distribution deduction is not needed to allocate the tax burden on such income.

This rule applies even if the property is subject to the claims of the decedent’s creditors, very much like probate assets subject to the distribution rules. However, if the property and its income are used by the executor during the administration of the estate, the income earned from the property is taxed to the estate and if distributed is eligible for the income distribution deduction.

Charitable Distributions

The income distribution deduction is not available for distributions which otherwise are deductible as amounts paid, permanently set aside, or used for charitable purposes; otherwise such distributions would be deducted twice.

228. I.R.C. § 663(a)(1) (1982); Treas. Reg. § 1.663(a)-1(b)(2)(i) (1988). To illustrate, assume that a trust is to accumulate all income until beneficiary A reaches age twenty-one. At that time $10,000 of the accumulated income is to be paid to beneficiary B and the balance to A, with all current income to be paid to A until age twenty-five when the trust is to terminate and distribute corpus to A. All the distributions are deductible to the extent of available DNI. Treas. Reg. § 1.663(a)-1(b)(3) (1988) (example (3)). A specific distribution out of income or corpus, however, is nondeductible. Id.


Moreover, the regulations further provide that the two deductions are mutually exclusive. Charitable transfers are deductible by trusts and estates only as charitable distributions under section 642(c). If the elements of that provision are not met, no resort may be had to the income distribution deduction under section 661(a).\textsuperscript{233} Case law, with one exception, has so far upheld the validity of this interpretation in the regulations.\textsuperscript{234}

\textit{Distributions Subject to Prior Deduction}

No income distribution deduction is allowed for any amount actually distributed in the current year if such amount was eligible for the distribution deduction in a previous year.\textsuperscript{235} This scenario could occur in two instances: first, when amounts are deemed distributed in the previous year under the 65-day rule discussed above; and second, when amounts required to be distributed currently and not actually distributed for reasons of administrative convenience until after the close of the current year are deemed distributed in the current year and not the subsequent year.\textsuperscript{236} Thus a trust or estate will not receive a double tax benefit for a single distribution simply because the date of the crediting for tax purposes and the date of the actual distribution are in separate years.

\textit{Distributions of Accumulated Income}

Distributions of previously accumulated income should not be again taxed when later distributed and hence should not be deducted when made by the trust or estate, if the single tax concept of the taxation of such entities is to be carried out. Distributions of previously accumulated income should be treated as nondeductible corpus distributions. However, to the extent of the current year's DNI, such distributions are deemed to be distributions of current income and as such are deductible to that extent. Hence, distributions of accumulated income are not deductible by the trust or estate only to the extent they exceed available DNI for the year of the distribution, as discussed earlier.

\textit{Distributions of IRD}

Since the Tax Reform Act of 1984, distributions of property are now governed by section 643(e). This section seems to include distributions of the right to receive income in respect of the decedent (IRD) because the provision applies to any interest in property distributed by a trust or estate. If this interpretation is correct, then the fiduciary could, pursuant to that provision, elect to treat the distribution as a taxable sale and accelerate the reporting

\textsuperscript{233} Treas. Reg. § 1.663(a)-2 (1988).
\textsuperscript{235} I.R.C. § 663(a)(3) (1982).
\textsuperscript{236} Treas. Reg. § 1.663(a)-3 (1988).
of the IRD item. The income distribution deduction will then equal the amount of the IRD item, which amount would also be included in the income of the beneficiary receiving the distribution. If the fiduciary does not so elect, the income distribution deduction would be limited to the basis of the IRD item in the trust or estate, usually zero. The income on the IRD item would be reported by the beneficiary when actually collected in a subsequent year. The flexibility in the election thus is the timing with respect to reporting the income on the IRD item by the beneficiary. In neither case, however, will the trust or estate be taxed on the IRD. If the election is made and the reporting in income of the IRD is accelerated, the resultant income is canceled by an income distribution deduction of equal amount. If the election is not made, no deduction (but also no income) is reported by the trust or estate with regard to the IRD item. The absence of the deduction does not disadvantage the trust or estate because the distribution of the IRD item does not accelerate the reporting of its income.

To date, however, a number of cases have held that distributions of IRD items fall outside the general distribution rules applicable to the taxation of trusts and estates. The effect of this case law is to deny the election under section 643(e) with regard to IRD items and thus remove the flexibility with regard to the timing of IRD income in the hands of the beneficiary. In either event, however, the treatment of the trust or estate remains the same. It will not be subject to tax on the IRD income, and the income distribution deduction is correspondingly applied to reflect that fact. The cases on point, however, all predate the enactment of section 643(e). Their continued vitality thus could be doubtful. Nevertheless, it is still valid to point out that the scheme of IRD taxation is antagonistic to the income distribution deduction with respect to timing and the character of the income reported.

Conclusion

The income distribution deduction allowed to trusts and estates distinguishes these legal entities from all other taxable units. The deduction allows trusts and estates to avoid taxation on their income by shifting such taxation to their beneficiaries at the direction of the governing instrument or at the discretion of the fiduciary. The deduction thus provides for private ordering of the tax consequences of income realized by trusts and estates and puts a premium on sophisticated planning and on the sophisticated executor or trustee.

240. IRD is acquired with a carryover basis. I.R.C. § 1014(c) (1982).
241. I.R.C. § 691(a)(1) and (2) (1982).
243. Id.
The changes brought about by the Tax Reform Act of 1986 have encouraged the distribution of income by trusts and estates. By contrast, prior to that Act, a common tax-planning device was to minimize overall taxes by accumulating income at the trust or estate level. A stated purpose of the 1986 Act was to reduce the tax-saving benefits from such a use of trusts and estates. The Act achieved this purpose by substantially increasing the tax rates applicable to trusts and estates in comparison to those applicable to individuals. The higher marginal tax rates of trusts and estates now discourage accumulations and provide an incentive to distribute income to beneficiaries. This turn of events has revived interest in the income distribution deduction. This article attempts to provide a road map drawn exclusively from the perspective of the use and availability of the income distribution deduction.