“Allocatus Eliminatus”: Liberating a Kansas or Missouri Trust’s Capital Gains from Net Investment Income Tax

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“The hardest thing in the world to understand is income taxes.”

- Albert Einstein

With the imposition of the Net Investment Income Tax (NIIT) beginning for tax year 2013, many estates and trusts are likely to be subjected to higher tax rates than expected. The Affordable Care Act imposes a 3.8% surtax on net investment income of individuals, estates and trusts.

In 2014, trusts are hit with the surtax on net investment income (including capital gains) when a trust’s AGI exceeds $12,150. But an individual taxpayer filing single is only subject to the surtax when their AGI exceeds $200,000. Given this disparity, it may make sense for

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1 The contents of this paper are not intended to be actionable advice. This paper is for educational purposes only and is not meant to constitute legal, tax, or accounting advice. Please note: CIRCULAR 230 DISCLAIMER: Pursuant to U. S. Treasury regulations, any federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. As with any trust planning endeavor, there are more factors than tax consequences to keep in mind, but those fall outside the scope of this paper. This paper will seek to explain the net investment income tax and potential methods for transferring otherwise ‘trapped’ capital gains to individual beneficiaries, with much higher NIIT thresholds. This paper owes an enormous amount to John Goldsbury’s presentation The 3.8% Surtax on Trusts and Estates, presented at the University Of Miami School Of Law Heckerling Institute on Estate Planning. Mr. Goldsbury’s thorough organization and explanation of the Code and Regulations was instrumental to the conception and formation of this paper. For a more in-depth explanation of the material, see John Goldsbury, The 3.8% Surtax on Trusts and Estates (2013) (hereafter Goldsbury, Surtax), and John Goldsbury and Robert Keebler, Practical Issues in Planning for the 3.8% Tax on Trusts/Estates (2013) (hereafter Goldsbury & Keebler, Issues in Planning).

2 This quote is anecdotal, but still quite humorous. The chronology of the quote may be found at <http://quoteinvestigator.com/2011/03/07/einstein-income-taxes/>.


4 Id.

5 Id.
trustees to distribute long-term capital gains to beneficiaries, rather than recognizing the gain inside the trust and paying the tax on the difference. But how can tax planners allocate those capital gains when they are traditionally trapped in the trust? This article will explore the federal provisions for allocation of long-term capital gains, providing examples from the new regulations. Along the way, we’ll investigate how Missouri and Kansas law (including Missouri’s new decanting statute) may factor into planning for the NIIT, and how a trust may be rescued from the surtax, even if it wasn’t drafted with the NIIT in mind.

**What is the Net Investment Income Tax, and who is affected?**

The Net Investment Income Tax (NIIT) is a surtax on the undistributed net investment income (NII) of estates, trusts and individuals in excess of certain adjusted gross income (AGI) thresholds.\(^6\) The tax is equal to 3.8% of the amount of NII exceeding $200,000 for individuals filing as single or head of household, $250,000 for MFJ and QW filers, and $125,000 for MFS filers.\(^7\) The thresholds for individual taxpayers are not adjusted for inflation.\(^8\)

For estates and trusts, NIIT applies to all undistributed NII once the trust or estate reaches the highest income tax bracket.\(^9\) In 2013, estates and trusts hit the 39.6% tax bracket at $11,950, and in 2014, the top bracket is reached at $12,150.\(^10\) The NIIT is reported on Form 8960.\(^11\) Since it is tied to the compressed income tax brackets, the threshold is inflation-adjusted.\(^12\) However, the NIIT is not deductible when computing other income taxes.\(^13\) Since estates and trusts have a

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\(^6\) I.R.C. § 1411(a)(2); Treas. Reg. § 1.1411-3(a)(1)(ii).

\(^7\) NIIT Q&A, supra note 3.

\(^8\) Id.

\(^9\) Id.

\(^10\) Id.

\(^11\) Id.

\(^12\) Id.

\(^13\) I.R.C. § 1411(a)(2).
much lower triggering threshold than individuals, the NIIT is arguably much more likely to affect the tax planning of estates and trusts than individuals.

Estate planners need to do a comparative analysis to determine what method will optimize the client’s tax savings, while still effecting their wishes. It does little good to structure a trust around minimization of tax if by doing so, the settlor’s intent is thwarted.

The NIIT generally applies to trusts normally taxable under Subchapter J.\textsuperscript{14} However, not all trusts are subject to the NIIT. The following trusts are specifically exempted:

1. A charitable trust under I.R.C. § 170(c)(2)(B).\textsuperscript{15}
2. A tax-exempt trust under I.R.C. § 501.\textsuperscript{16}
3. A charitable remainder trust (CRT) under I.R.C. § 664.\textsuperscript{17}
4. All other trusts exempt from income tax.\textsuperscript{18}
5. Grantor trusts.\textsuperscript{19} The portion of NII attributable to a grantor trust will be imputed to the individual grantor and applied against the individual threshold.
6. Foreign estates and trusts, per I.R.C. § 7701(a)(31) and Treas. Reg. § 301.7701-7(a)(2).\textsuperscript{20}
7. Cemetery Perpetual Care Funds under I.R.C. § 642(i).\textsuperscript{21}
8. Electing Alaska Native Settlement Trusts under I.R.C. § 646.\textsuperscript{22}

ELECTING SMALL BUSINESS TRUSTS (ESBTs) under § 1361(e)(3) have special rules for calculating the amount of undistributed NII.\textsuperscript{23} THE S-PORTION AND NON-S PORTION OF THE ESBT WILL BE TREATED

\textsuperscript{14} Treas. Reg. § 1.1411-3(a)(1)(i).
\textsuperscript{15} I.R.C. § 1411(e)(2); Treas. Reg. §1.1411-3(b)(1)(i).
\textsuperscript{16} Treas. Reg. § 1.1411-3(b)(1)(ii).
\textsuperscript{17} Treas. Reg. §1.1411-3(b)(1)(iii).
\textsuperscript{18} Treas. Reg. § 1.1411-3(b)(1)(iv).
\textsuperscript{19} Treas. Reg. § 1.1411-3(b)(1)(v).
\textsuperscript{20} Treas. Reg. § 1.1411-3(b)(1)(viii)-(ix).
\textsuperscript{21} Treas. Reg. § 1.1411-3(b)(1)(vii).
\textsuperscript{22} Treas. Reg. § 1.1411-3(b)(1)(vi). Since these trusts are taxed at the lowest tax bracket, they never reach the highest bracket and trigger NIIT.
\textsuperscript{23} The S-portion and non-S portion of the ESBT will be treated...
as separate trusts for calculating the amount of undistributed NII, but will be treated as a single trust for computing the applicable tax bracket, and therefore the extent to which the NIIT applies.\textsuperscript{24}

Charitable remainder trusts (CRTs) have additional rules for NIIT. CRTs must track all of their accumulated undistributed NII.\textsuperscript{25} It will maintain its character when distributed to the beneficiaries.\textsuperscript{26} NII only flows out of the CRT when it is distributed.\textsuperscript{27} NII is distributed to multiple beneficiaries in amounts apportioned to their distributed share of the trust for that taxable year.

Generally, distributions from a CRT are categorized using the tier system outlined in I.R.C. § 664.\textsuperscript{29} Under this system, there are four categories of distributable income: ordinary income, capital gain, other income and corpus.\textsuperscript{30} The first three categories are further characterized based on the applicable tax rate.\textsuperscript{31} A new subcategory is added to each class of income by adding the 3.8\% surtax to the applicable tax rate.\textsuperscript{32} Since the distributions come first from the highest taxed income, the NII will be the first amounts distributed within any one class.\textsuperscript{33}

There is a simplified method, which may be elected under the proposed regulations.\textsuperscript{34} The election to decide which method to use is irrevocable and must be made in the trust’s first tax

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\textsuperscript{23} Treas. Reg. § 1.1411-3(c)(1).
\textsuperscript{24} Id.
\textsuperscript{25} Treas. Reg. § 1.1411-3(d)(1)(iii).
\textsuperscript{26} Treas. Reg. § 1.1411-3(d)(1)(i).
\textsuperscript{27} Id.
\textsuperscript{28} Treas. Reg. § 1.1411-3(d)(1)(ii).
\textsuperscript{29} Treas. Reg. § 1.664-1(d)(1)(i)(b).
\textsuperscript{30} Treas. Reg. § 1.664-1(d)
\textsuperscript{31} Id.
\textsuperscript{32} Treas. Reg. § 1.1411-3(d).
\textsuperscript{33} Treas. Reg. § 1.1411-3(d)(2).
\textsuperscript{34} Prop. Reg. § 1.1411-3(d)(3)(iii) (2013).
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year after December 31, 2012. Rather than computing based on the § 664 tier system, a trust may include in NII from an annuity or unitrust distribution the lesser of (1) the beneficiary’s share of the total distributions for the tax year, or (2) The beneficiary’s share of the CRT’s accumulated NII. If a trust elects to use the simplified method, the trust will not be limited by Treas. Reg. § 1.1411-4(f)(1)(ii), which limits the ability of properly allocable deductions exceeding gross investment income and net gain to offset the amount of accumulated NII. The general CRT rule allowing losses in a category to carry forward and offset amounts is one compelling reason to use the simplified method. However, the simplified method has not yet been included in the Final Regulations, and the Preamble to the 2013 Proposed Regulations suggests that if there is not sufficient interest in using the simplified method, it will not be available for future tax years. Since the election is irrevocable, this may leave trusts that elect the simplified method in an uncertain limbo.

What is Net Investment Income?

The 3.8% surtax only applies to undistributed “net investment income” (NII). The regulations define net investment income by dividing it into three categories.

The first category consists of gross income from interest, dividends, annuities, royalties and rents (other than non-passive business activities [except investment trading]). Whether an activity is passive for a pass-through entity will be determined at the taxpayer level.

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35 Id.
39 I.R.C. § 1411(a)(2).
40 I.R.C. § 1411(c)(1).
41 I.R.C. § 1411(c)(1)(A)(i).
42 I.R.C. § 1411(c)(2)(A).
category includes passive rental income,\textsuperscript{43} investment income from foreign corporations,\textsuperscript{44} substitute payments,\textsuperscript{45} notional principal contracts,\textsuperscript{46} and distributions from trusts.\textsuperscript{47} Since NII retains its character when distributed,\textsuperscript{48} it will travel out to the beneficiary through DNI.

The second category is comprised of gross income from (1) a passive activity or (2) a trade or business of trading in financial instruments or commodities.\textsuperscript{49} Passive activity is defined in §469 as trade or business activity in which the taxpayer does not “materially participate.”\textsuperscript{50} For category two income, passive loss carryovers can be used to offset passive gain being treated as NII, even if they were accrued before 2013.\textsuperscript{51} Additionally, the Regulations permit “activities” to be re-grouped one time in the first year the surtax applies.\textsuperscript{52} This regrouping allows a taxpayer whose participation in two separate businesses does not rise to the level of material participation to reclassify the two businesses as one “activity.”\textsuperscript{53}

The Tax Court has recently clarified that trusts may “materially participate” in activity through the activities of its trustees.\textsuperscript{54} This enables a trust with real estate holdings to avoid the NIIT on “passive activities” by allowing for material participation.\textsuperscript{55}

\textsuperscript{43}I.R.C. § 1411(c)(1)(A)(i).
\textsuperscript{44}Treas. Reg. § 1.1411-10.
\textsuperscript{45}Treas. Reg. § 1.1411-1(d)(3)(v).
\textsuperscript{46}Treas. Reg. § 1.1411-4(g)(12); Prop. Reg. § 1.1411-4(g)(12) (2013).
\textsuperscript{47}Treas. Reg. § 1.1411-4(e)(1)(i).
\textsuperscript{48}Treas. Reg. § 1.1411-3(d)(1)(i).
\textsuperscript{49}I.R.C. § 1411(c)(1)(A)(ii).
\textsuperscript{50}I.R.C. § 469(c)(1). The IRS takes the position that a trust materially participates in business activities only if the trustee is involved in the operations of the entity’s activities on a regular, continuous, and substantial basis. Merely labeling a person involved in the business a “Special Trustee” is insufficient. Technical Advice Memorandum 201317010 (released April 26, 2013), distinguishing \textit{Mattie K. Carter Trust v. United States}, 256 F. Supp.2d 536 (N.D. Tex. 2003).
\textsuperscript{51}Treas. Reg. § 1.1411-1(a).
\textsuperscript{52}Treas. Reg. §1.469-11(b)(3)(iv).
\textsuperscript{53}Goldsbury, \textit{Surtax}, pg 12-9, 12-10.
\textsuperscript{54}\textit{Frank Aragorna Trust v. Comm’r}, 142 T.C. No. 9 (3/27/14).
\textsuperscript{55}Id.
be imputed to the trust through the actions of its trustees.\textsuperscript{56} However, the actions of non-trustee employees are unlikely to qualify the trust for the § 469(c)(7) exception.\textsuperscript{57}

The third category (and the primary focus of this paper) includes net gain “to the extent taken into account in computing taxable income.”\textsuperscript{58} This includes capital gain.\textsuperscript{59} Capital losses can be carried forward for purposes of calculating NII (including pre-2013 loss).\textsuperscript{60} Some capital gains are excluded from NII. Gain excluded from income for regular income tax purposes is not subject to the 3.8% surtax.\textsuperscript{61} This includes: the gain on the sale of a principal residence exclusion (250k/500k),\textsuperscript{62} gain on tax-free like-kind exchanges,\textsuperscript{63} gain on the sale of stock to an ESOP that is excluded due to purchase of “qualified replacement income,”\textsuperscript{64} gain on the tax-free exchange of insurance policies,\textsuperscript{65} and internal “build-up” of value inside a life insurance policy.\textsuperscript{66} Additionally, business gain is excluded from the surtax because “net gain” is defined as gain “attributable to the disposition of property other than held in a trade or business.”\textsuperscript{67}

NII from the three categories may be reduced by deductions that are “properly allocable to such gross income or net gain.”\textsuperscript{68} This nebulous concept was further expanded in the Regulations, adding: § 62 deductions, allocable gross income deductions from rents and royalties, allocable gross income deductions from trades or business that generate NII, penalties on early withdrawal of savings, net operating loss (subject to additional special rules),

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{56} Id.
\item \textsuperscript{57} Id.
\item \textsuperscript{58} I.R.C. § 1411(c)(1)(A)(iii).
\item \textsuperscript{59} Goldsberry, Surtax, pg 12-11.
\item \textsuperscript{60} Treas. Reg. § 1.1411-1(a).
\item \textsuperscript{61} Id.
\item \textsuperscript{62} I.R.C. § 121.
\item \textsuperscript{63} I.R.C. § 1031.
\item \textsuperscript{64} I.R.C. § 1042.
\item \textsuperscript{65} I.R.C. § 1035.
\item \textsuperscript{66} I.R.C. §§ 72(e), 7702(g).
\item \textsuperscript{67} I.R.C. § 1411(c)(1)(A)(iii).
\item \textsuperscript{68} I.R.C. § 1411(c)(1)(B).
\end{enumerate}
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investment interest under § 163(d)(3), investment expenses under § 163(d)(4)(C) or §212(3),
taxes described in § 164(a)(3), deductions in respect of a decedent under § 691(c), amortizable
bond premiums under § 171(a)(1), trust and estate fiduciary expenses deductible under §212,
losses under §165,\(^69\) and excess losses from the termination of a trust or estate under 642(h).\(^70\)

**NIIT in Practice**

Whether a trust has retained NII or distributed it is generally measured by DNI.\(^71\) There
are some exceptions to this general treatment. For example, municipal bond interest is tax-
exempt, but it is included in DNI.\(^72\) Meanwhile capital gains are included in taxable income
(Category 3), but are not generally included in DNI.\(^73\) Treas. Reg. § 1.1411-3(e)(5) has some
examples of how this works:

*Example (1). Calculation of undistributed net investment income (with no
deduction under section 642(c)).* (i) In Year 1, Trust has dividend income of
$15,000, interest income of $10,000, capital gain of $5,000, and $75,000 of
taxable income relating to a distribution from an individual retirement account
(as defined under section 408). Trust has no expenses. Trust distributes $10,000
of its current year trust accounting income to A, a beneficiary of Trust.

(ii) Trust’s distributable net income is $100,000 ($15,000 in dividends plus
$10,000 in interest plus $75,000 of taxable income from an individual retirement
account), from which the $10,000 distribution to A is paid. Trust’s deduction
under section 661 is $10,000. Under §1.662(b)-1, the deduction reduces each

\(^{69}\) Treas. Reg. § 1.1411-4(f).
\(^{70}\) Treas. Reg. §1.1411-4(g)(4).
\(^{71}\) Treas. Reg. § 1.1411-3(e)(2).
\(^{72}\) Treas. Reg. § 1.652(c)-4; I.R.C. §§ 651-652.
\(^{73}\) I.R.C. § 643(a)(3).
class of income comprising distributable net income on a proportional basis. The $10,000 distribution equals 10% of distributable net income ($10,000 divided by $100,000). Therefore, the distribution consists of dividend income of $1,500, interest income of $1,000, and ordinary income attributable to the individual retirement account of $7,500. Because the $5,000 of capital gain allocated to principal for trust accounting purposes did not enter into distributable net income, no portion of that amount is included in the $10,000 distribution, nor does it qualify for the deduction under section 661.

(iii) Trust’s net investment income is $30,000 ($15,000 in dividends plus $10,000 in interest plus $5,000 in capital gain). Trust’s $75,000 of taxable income attributable to the individual retirement account is excluded income under §1.1411-1(d)(4). Trust’s undistributed net investment income under paragraph (e)(2) of this section is $27,500, which is Trust’s net investment income ($30,000) less the amount of dividend income ($1,500) and interest income ($1,000) distributed to A. The $27,500 of undistributed net investment income is comprised of the capital gain allocated to principal ($5,000), the remaining undistributed dividend income ($13,500), and the remaining undistributed interest income ($9,000).

(iv) Under paragraph (e)(3) of this section and pursuant to §1.1411-4(a)(1), A’s net investment income includes dividend income of $1,500 and interest income of $1,000, but does not include the $7,500 of ordinary income attributable to the individual retirement account because it is excluded from net investment income under §1.1411-8.
As Treas. Reg. § 1.1411-3(e)(5)(ii) above makes clear, under most schemes, capital gains will always be ‘trapped’ in the trust. The thoughtful planner might seek ways to minimize the impact of the NIIT on their clients. Income may be easily be distributed, allowing the trust to minimize the NII attributable to Category 1 or Category 2 income by taking a distribution deduction. However, capital gains are usually attributed to principal, rather than income, and so are not part of DNI and are beyond the reach of the distribution deduction.74 Fortunately, there are some ways to free those capital gains within the Code.

The general rule under Code Sec. 643 is that capital gains are not included in DNI. Treas. Reg. § 1.643(a)-3(a) reads in pertinent part:

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

However, Treas. Reg. § 1.643(a)-3(b) allows for certain exceptions:

(b) Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law).

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74 Treas. Reg. § 1.643(a)-3(a).
(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph §1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

So, a trust may meet any of the three exceptions by virtue of the trust instrument, local default rules, or a discretionary power to adjust (in accordance with a power granted under local law or the governing instrument, if not contrary to local law).75

By taking each of these exceptions in turn and applying them to situations where the power to adjust is invoked, as well as situations where the trust instrument or state law would allow the allocation, we can compare the favorability of Missouri law against Kansas law and determine which better serves the interests of the trustee looking to “free” the capital gain income from the trust.

Before exploring the potential combinations, it is important to verify that a power to adjust is permitted under the Missouri and Kansas default rules, in the event that the trust instrument is silent regarding adjustments. Fortunately, the Missouri and Kansas statutes are

75 Treas. Reg. § 1.643(a)-3(b).
virtually identical on this point.\textsuperscript{76} The trustee may adjust principal and income to the extent necessary if the trustee meets three requirements: 1.) Assets must be managed in conformity with the Prudent Investor Act (emphasizing the total return, rather than achieving certain income levels), 2.) The distribution provisions of the trust instrument must describe the amount distributable with reference to income, and 3.) The trustee must have failed to meet their duty of impartiality to all trust beneficiaries after applying the terms of the governing instrument, exercising any discretion conferred by the provisions of the governing instrument, and applying the default rules of the Act.\textsuperscript{77} An adjustment pursuant to the UPIA is deemed impartial.\textsuperscript{78}

Both Missouri and Kansas allow the trustee to take the following considerations into account when determining the necessity of an adjustment:

1. \textit{The nature, purpose, and expected duration of the trust;}

2. \textit{The intent of the settlor;}

3. \textit{The identity and circumstances of the beneficiaries;}

4. \textit{The needs for liquidity, regularity of income, and preservation and appreciation of capital;}

5. \textit{The assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;}

\textsuperscript{78} Id.
(6) the net amount allocated to income under the other sections of this act and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;

(7) whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;

(8) the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation; and

(9) the anticipated tax consequences of an adjustment.79

However, there are certain limitations to the power to adjust. A discretionary power of adjustment is always subject to the limitations of the trustee’s fiduciary duties to the beneficiaries. Kansas and Missouri both impose a duty of impartiality upon the trustee, requiring equitable treatment of both income and remainder beneficiaries.80 However, the IRS will recognize an allocation by the trustee if it is reasonable, impartial, and done pursuant to a discretionary power available in the governing instrument or local law.81

Situation One: Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary

81 Treas. Reg. § 1.643(a)-3(b).
First we shall examine two examples where capital gains are distributed from corpus, but different treatment results because of the trustee’s actions.

Example (1). Under the terms of Trust’s governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A’s benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust’s first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A’s right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.\(^{82}\)

Example (2). The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year.

Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust’s federal income tax return so that it is taxed to

\(^{82}\) Treas. Reg. § 1.643(a)-3(c)(1).
A. *This treatment of the capital gains is a reasonable exercise of Trustee’s discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.*

Example 1 fails to remove the assets from the trust because the requirement to consistently treat the distributions as being made from income or principal applies from the very first time the election is made. The consistent treatment may be declared by the trustee or evidenced by the trustee’s actions even the first time a situation arises. If the trustee decides that it will consistently treat capital gains on its books, records and tax returns as part of a distribution to a beneficiary, then thereafter that portion of capital gains will be a part of DNI, whether or not distributions occur. Since the trustee attributed the capital gains to principal, they will always be treated as principal, and will not qualify as DNI.

There is no specific prohibition in Missouri or Kansas against allocating capital gains to income, if the governing instrument supports the option. However, in the absence of authority from the governing instrument to deem capital gains distributed from income, the trustee would have to use the power to adjust under the governing instrument or the default state statutes, as there is no state support for this treatment either.

This method is unlikely to benefit preexisting trusts, because of the consistency requirement. However, this method may be useful to consider for newly-established trusts.

**Situation Two: Allocated to income**

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83 Treas. Reg. § 1.643(a)-3(e)(2).
84 Treas. Reg. § 1.643(a)-3(e)(1)-(2).
Example (4). The facts are the same as in Example 1, except that pursuant to the terms of the governing instrument (in a provision not prohibited by applicable local law), capital gains realized by Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.\textsuperscript{85}

Example (11). The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.\textsuperscript{86}

\textsuperscript{85} Treas. Reg. § 1.643(a)-3(e)(4).
\textsuperscript{86} Treas. Reg. § 1.643(a)-3(e)(11).
Example 4 is somewhat self-explanatory. If the trust instrument allocates capital gains to income, it will be included in DNI. It’s unlikely that there are many successful trusts with language in the instrument including 100% of capital gains in DNI, because then the trust does not grow, which is usually a primary goal of trust planning. However, discretion to include certain distributions in income may be a potentially valuable proviso, bearing in mind the requirement for consistency when electing to treat a distribution as either income or principal.

Example 11 is a near-perfect representation of Kansas’s unitrust conversion provision. In this case, there would be no discretion; the order of payments will either be covered under the terms of the trust instrument or fall under the Kansas default unitrust distribution rules. Missouri has unitrust ordering rules as well; however capital gains are not included in the paragraph listing the unitrust distribution ordering rules. Instead, they are listed separately:

(3) Additionally, the trustee may allocate to trust income for each taxable year of the trust, or portion thereof:

(a) Net short-term capital gain described in the Internal Revenue Code, 26 U.S.C. Section 1222(5), for such year, or portion thereof, but only to the extent that the amount so allocated together with all other amounts to trust income, as determined under the provisions of this chapter without regard to this section, for such year, or portion thereof, does not exceed the unitrust amount for such year, or portion thereof;

87 Kan. Stat. Ann. § 59-9-105(a)-(f) (2010). The only distinction is that Kansas does not specifically address the ordering of tax-exempt distributions.
(b) Net long-term capital gain described in the Internal Revenue Code, 26 U.S.C. Section 1222(7), for such year, or portion thereof, but only to the extent that the amount so allocated together with all other amounts, including amounts described in paragraph (a) of this subdivision, allocated to trust income for such year, or portion thereof, does not exceed the unitrust amount for such year, or portion thereof. 90

Since they are not included within the ordering rules, it is unclear whether the trustee may determine when in the distribution order to include capital gains.

However, it is important to keep in mind that the IRS may disregard trust provisions that deviate fundamentally from traditional principles of income and principal. 91 Any allocation of different classes of income to multiple beneficiaries must be specific and must have an economic effect independent of the income tax consequences. 92 Reg. 1.652(b)-2(b) illustrates this requirement:

(b) The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation. For example:

(1) Allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.

91 Treas. Reg. § 1.643(b)-1.
92 Treas. Reg. § 1.652(b)-2(b).
(2) Allocation pursuant to a provision directing the trustee to pay all of one income to A, or $10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A’s share (to the extent there is income of that class and to the extent it does not exceed A’s share) is not a specific allocation by the terms of the trust.

(3) Allocation pursuant to a provision directing the trustee to pay half the class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

Trusts established after the effective date of the Net Investment Income Tax will likely want to include language in the trust instrument allowing the trustee a discretionary power to allocate capital gains to income. To satisfy the economic dependence requirement, the trust instrument may point to the list of factors allowed to be considered in a trustee’s power to adjust. The IRS has specifically recognized the ability of trustees to allocate capital gains to income.\(^9\)

**Situation Three: Allocated to principal, but actually distributed**

*Example (7). Under the terms of Trust's governing instrument, all income is to be paid to A during the Trust's term. When A reaches 35, Trust is to terminate and all the principal is to be distributed to A. Because all the assets of the trust, including all capital gains, will be actually distributed to the beneficiary at the termination of Trust, all capital gains realized in the year of termination are included in distributable net income. See § 1.641(b)-3 for the determination of the*

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year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.\textsuperscript{94}

Example (8). The facts are the same as Example 7, except Trustee is directed to pay B $10,000 before distributing the remainder of Trust assets to A. Because the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1), none of Trust's distributable net income that includes all of the capital gains realized during the year of termination is allocated to B's distribution.\textsuperscript{95}

Example (9). The facts are the same as Example 7, except Trustee is directed to distribute one-half of the principal to A when A reaches 35 and the balance to A when A reaches 45. Trust assets consist entirely of stock in corporation M with a fair market value of $1,000,000 and an adjusted basis of $300,000. When A reaches 35, Trustee sells one-half of the stock and distributes the sales proceeds to A. All the sales proceeds, including all the capital gain attributable to that sale, are actually distributed to A and therefore all the capital gain is included in distributable net income.\textsuperscript{96}

As the above examples demonstrate, capital gains appropriately allocated to principal but actually distributed to a beneficiary will be included in DNI.\textsuperscript{97} This may be viewed as a right in the beneficiary to receive such capital gains, and thus, such gains are actually distributed to the beneficiary. As Example 9 demonstrates, this exception does not simply apply during the year a trust terminates. It is possible that the power to invade principal may be enough to satisfy this

\textsuperscript{94} Treas. Reg. § 1.643(a)-3(e)(7).
\textsuperscript{95} Treas. Reg. § 1.643(a)-3(e)(8).
\textsuperscript{96} Treas. Reg. § 1.643(a)-3(e)(9).
\textsuperscript{97} Treas. Reg. § 1.643(a)-3(b)(3).
requirement, so long as the trustee does not have the discretion to affect the character of distributions of principal, because this may subject the trustee to the consistency requirements of Example 1. However, the “economic benefit” doctrine of Treas. Reg. § 1.652(b)-2(b) applies to actual distributions of principal. Such distributions should not be solely to influence the income taxation of the trust or beneficiary.98

**Kansas vs. Missouri – Which state is more favorable?**

Kansas and Missouri share many of the same provisions of the UPIA. However, they differ in (at least) two very important ways.

First, Kansas has the discretionary unitrust conversion rule.99 By releasing the power to adjust, the trustee creates a mandatory distribution percentage, in addition to allowing deductions under the unitrust rules.100 This provision may be useful in a situation where the trustee has already established an adverse consistency, such as in Example 1. For established trusts and trusts that are disproportionately comprised of non-allocable principal, a unitrust conversion may be an excellent means to distribute a portion of allocable NII to the beneficiary. Additionally, by removing the trustee’s discretion to distribute, the trust is no longer subject to the consistency requirements or the “economic benefit” doctrine.101 In a year with greater-than-expected capital gains, a trustee may be able to distribute (with court permission) an amount exceeding the unitrust amount, in order to “preserve a tax benefit.”102 Such an excess distribution might qualify

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98 Treas. Reg. § 1.652(b)-2(b).
100 Id.
101 A unitrust does not invoke Treas. Reg. § 1.652(b)-2, because distributions are not allocated based on classes of income. A percentage of the total value of the trust is distributed, with ordering rules set by the governing instrument or the state default rule. Since there is no trustee discretion, there is no consistency requirement.
under the “actually distributed” exception to Treas. Reg. § 1.643(a)-3(b). If so, such a
distribution would carry the NII out of the trust.

While the potential advantages of the unitrust election are difficult to top, it is possible
that Missouri may do so. The Missouri legislature recently enacted a statute allowing a trustee to
decant a trust and transfer the assets to a wholly new trust.103 For the purposes of the consistency
elections for the principal and income allocation provisions, decanting a trust may have the effect
of resetting all of the previous elections. Decisions to allocate principal and income differently
might be made, allowing the trustee to better serve the trust beneficiaries.104 An additional
benefit of a decanted trust over a converted unitrust is that a decanted trust would not necessarily
need to petition a court to make distributions in excess of 5%.105 Additionally, if the decanted
trust provides for an ascertainable standard106 some of the restrictions imposed by the statute are
waived.107

Each state has strengths and weaknesses, but by utilizing planning and foresight, a trustee
can use the federal and state provisions to minimize the consequences of the net investment
income tax, while preserving the fluidity needed to satisfy the needs of their constituent
beneficiaries.

Conclusion

With the introduction of the Net Investment Income Tax, income tax planning has
resurfaced as a major sticking point of effective trust planning. Using the allocation principles
outlined in Treas. Reg. § 1.643(a)-3(b), a trustee may be able to distribute capital gains out to the

103 See Rev. Mo. Stat. § 456.4-419.
104 Id.
105 Id.
106 Generally “health, education, maintenance or support,” per I.R.C. §§ 2041(b)(1)(A), 2514(c)(1).
107 Rev. Mo. Stat. § 456.4-419.2.(2)-(3).
beneficiary, protecting the trust from the additional 3.8% surtax. State law can also play a role in effective trust administration. Savvy planners have an entirely new set of principles to take into account while drafting trust instruments. But by planning ahead, trusts can reap the benefit of the net investment income disappearing act.