TAX DOINGS

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IN THIS ISSUE

I. WHAT'S DOING — The Council

a. Tax Court Luncheon

b. Institute — The Irrevocable Trust

II. THE IMPACT OF MICHIGAN LAW UPON THE FEDERAL INCOME TAXATION OF ESTATES, TRUSTS, AND THEIR BENEFICIARIES by E. James Gamble

I. WHAT'S DOING — The Council

a. The Taxation Section, in conjunction with the Taxation Committee of the Detroit Bar Association is co-sponsoring a Tax Court Luncheon May 5, 1969, the opening date of the Tax Court trial calendar. Particulars as to the place and reservations will be included in a subsequent invitation to be directed to all members of the Taxation Section.

b. The Taxation Section, in conjunction with the Probate Section is co-sponsoring a filmed presentation, The Irrevocable Trust, prepared under the direction of Professor Casner for the American Bar Association.

II. THE IMPACT OF MICHIGAN LAW UPON THE FEDERAL INCOME TAXATION OF ESTATES, TRUSTS, AND THEIR BENEFICIARIES

by E. James Gamble

Under Michigan law trustee administers the assets in his possession for the benefit of both the income beneficiaries and the remaindermen, and he differentiates between the rights of these two classes by maintaining, in effect, two sets of books – the income accounts for the income beneficiaries and the principal accounts for the remaindermen.

For federal income tax purposes, however, the trustee is taxed though he were a single taxpayer, and no distinction is made between transactions that he accounts for as income and those that he accounts for as principal. All of this would create no particular problem if we could count on Michigan law causing all items that are ordinary income for federal income tax purposes to be trust income and all items of capital gain to be trust principal. Since no one would really expect things to be that simple, one purpose of this article is to point out some of the areas where Michigan law causes trust income and principal to be different from federal income tax concepts of ordinary income and capital gain. It may also help to explain why the split personality of the trustee tends to give the preparer of his federal income tax return a persecution complex.

If the trustee is not required to make a distribution of either principal or income by the governing instrument, and if in fact he does not make any sort of distribution, then his "only" problem is to

allocate his income tax payment between the principal and income accounts, as he is required to do by Michigan law.[1] This is no problem if all of the income and deductions are entirely in the income accounts or entirely in the principal accounts. It becomes progressively more difficult, however, when there are income items and deductions in both principal and income accounts, and when capital gain items find their way into the income accounts and ordinary income items into the principal accounts. These latter situations are illustrated later in this article in connection with an examination of differences between "trust income" and "distributable net income."

It is when the trustee actually makes a distribution of income or principal, or is required to make a distribution by the governing instrument, that things can begin to get truly sticky. In computing his own income tax liability he is allowed a deduction for distributions, but the amount of the deduction depends upon a comparison of the amount of his "trust income," the amount of his "distributable net income," the amount of his actual distribution, and the amount he is required to distribute.

First let us settle the meaning of our terms. "Trust income" means the trustee's income as determined under the Michigan Revised Uniform Principal and Income Act. The Act applies only to the extent there is no provision in the governing instrument that overrides the provisions of the Act in whole or in part (but if the instrument departs fundamentally from concepts of Michigan law the Service will not regard it as controlling in determining what trust income is.)[2]

"Distributable net income" is a federal income tax concept that is in the Code to provide a measuring rod that serves three purposes:

1. It places an upper limit on the deduction of an estate or trust.

2. It determines the amount that is includable in the beneficiary's income.

3. It is used in determining the character of the distribution received by the beneficiary.

Mathematically, distributable net income is equal to the taxable income of the trust (determined by combining the taxable income and deductions that are in both the principal and income accounts), before taking any deduction for distributions, personal exemptions,

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1 §§13(a)(6) and 13(c)(4) of the Revised Uniform Principal and Income Act [Mich. Stat. Ann. §§26.79(1)-26.79(18)].

2 Regs. §1.643(b)-1.

and certain other items, but distributable net income does not ordinarily include any item of capital gain.[3]

The amount of the distributable net income **can** be computed on the 1041. The amount of the trust income **cannot** be computed on the 1041. This unfortunately makes it easy to forget that they may be different. Distributable net income and trust accounting income will frequently be different, and separate computations should be made of each.

The Distributions Deduction

If a trustee actually makes a distribution, or is required to make a distribution by the governing instrument, he is allowed an income tax deduction for that distribution and the beneficiaries who receive (or are entitled to) the distribution must include an equivalent amount of income in their returns.

Deductible distributions are classified by the Internal Revenue Code into two categories. The first category includes that portion of the trust income that the instrument requires to be distributed. The second category includes all other amounts (whether income or principal) that are properly paid, credited, or required to be distributed.

A required distribution of trust income is includable in a beneficiary's income before any amount in the second category is included, and this first category distribution is also taxable in full to the beneficiary if it does not exceed distributable net income.

A distribution that falls in the second category is then taxable to the distributee only if, and to the extent that, distributable net income exceeds the trust income that is required to be distributed.

If the instrument requires all trust income to be distributed currently and does not provide that any amount is to be paid, permanently set aside, or used for charitable purposes, and if nothing is distributed other than current income, the trust is classified as a "simple" trust, and we are concerned only with distributions that fall in the first category. All other trusts are classified as "complex" trusts, and the rules that apply to a complex trust also apply to a decedent's estate.[4] In the case of estates and complex trusts we will usually be concerned with distributions that fall in the second category.

All of this brings us to the point where we can explore some typical situations in which distributable net income and trust income

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3 Capital gain is included only when it is allocated to income under the terms of the will or trust or local law on the books of the fiduciary or by notice to the beneficiary, or is allocated to principal and actually distributed, or is utilized in determining the amount actually distributed or required to be distributed. Regs. §1.643(a)-3(a).

4 Regs. §§1.651(a)-1 and 1.661(a)-1.

will be the same and some situations in which they will be different. We will also note the reasons for these differences. In this discussion we will assume that the Act applies and there is nothing in the instrument that overrides the Act.

When Will Distributable Net Income and Trust Income be the Same?

This, for the person who is preparing the 1041, is the ideal situation because it is the simplest. Distributable net income and trust income will be the same when:

1. All items of taxable income are allocated to the income account under Michigan law.

2. There are no deductible disbursements that are allocated under Michigan law to the principal account.

3. All capital gains, if any are realized, are allocated to principal and not distributed.

Situations in which trust income and distributable net income are the same will be rare because of the provisions of the Act. For example, under section 13 of the Act, legal fees in connection with court accountings and trustees fees are to be divided equally between principal and income, which will cause trust income to exceed distributable net income whenever such fees are incurred.

When equality exists between distributable net income and trust income, a distribution of all of the trust income will be deductible in full by the trustee and will be includable in full by the beneficiary in his income tax return. If the trustee also makes a distribution of principal, it will not be taxable to the beneficiary.

When Will Distributable Net Income Exceed Trust Income?

Distributable net income will exceed trust income whenever:

1. Items that are taxable as ordinary income are allocated to the principal account. For example, income accrued prior to death (treated as income in respect of a decedent under Code Section 691) is allocated to principal when received by the executor or trustee. Other examples of ordinary income (which may or may not be income in respect of a decedent) that may be received over a fairly long period of time, and which will be allocated in part to principal (under Section 11 of the Act) include payments under a deferred compensation contract, insurance renewal commissions, and patent royalty payments received under a non-exclusive license agreement.

2. The depletion of depreciation charge provided for under Michigan law exceeds the allowable deduction for federal income tax purposes. In the case of depletion Section 9 of the Act establishes a depletion reserve of 27½% for all minerals, whereas Section 613(b)

of the Code provides a range of 5% to 27½% for a wide variety of minerals (such as 23% for sulphur, 15% for metals, 10% for asbestos, and 5% for gravel). The depreciation charge provided for by Michigan law (Section 13(a) (2) of the Act) may be based on an inventory value that is greater than the asset's tax basis, since the Act does not attempt to correlate the inventory value used for trust accounting purposes with income tax basis. The provisions for depletion and depreciation do not apply, however, unless the property subject to such a charge is acquired after January 1, 1966.

3. Nondeductible disbursements are made from income. Since there is no provision in the Act dealing with life insurance premiums, any decision to allocate a part or all of such a premium to income would be discretionary on the part of the trustee, but if he should decide to allocate any portion of it to income, this would serve to reduce trust income but not distributable net income.

Any of these circumstances will cause trust income to be less than distributable net income, and, if there are no offsetting items, a distribution of all the trust income will be entirely deductible by the trustee and entirely taxable to the beneficiary. If the trustee makes a distribution from principal in excess of his trust income, this distribution will also be deductible by him (and taxable to the beneficiaries) to the extent that distributable net income exceeds the trust income that was distributed.

When Will Trust Income be Greater than Distributable Net Income?

Trust income will exceed distributable net income whenever:

1. Deductible disbursements that are charged to the principal account exceed ordinary income items (not capital gains) that are allocated to the principal account. This will occur most commonly when a trust receives only dividend and interest income and pays a trustee fee, one-half of which is charged to principal.

2. There is a net operating loss carryover from a prior year because of a business conducted by the trustee. Even though such a loss is carried over in determining the taxable income of a later year, Section 8(a) of the Act provides that the loss is to fall on principal in the year it occurs and shall not be carried into any other year for the purpose of determining trust income in the later year.

3. Nontaxable receipts (other than tax-exempt interest, for which a special adjustment is provided[5]) are allocated to income. For example:

(a) A dividend that is partly tax-free because it is treated as a return of capital.

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5 Regs. §§1.651(b)-1 and 1.661(c)-1.

(b) The sales proceeds of underproductive property that is sold at no gain or at a loss (section 12 of the Act contains a formula under which a portion of the sales proceeds of an asset may be allocated to income if the asset has not produced an average net income of at least 1% of its inventory value for more than a year while held by the trustee).

(c) The increment on series E bonds is includable in income as it accrues under Michigan law and the actual distribution may, in the trustee's discretion, be made to the beneficiary from cash in the principal account; but if no election is in effect under Code Section 454 to treat such increment as current income, trust income will be greater than distributable net income.

4. The depreciation charge provided for under Michigan law is less than the allowable deduction for federal income tax purposes.

In any of these circumstances, if there are no offsetting items, trust income will be greater than distributable net income. If the trustee distributes all of the trust income he will receive a deduction (and the beneficiary will be taxable) only to the extent of the distributable net income, and the beneficiary will receive the balance of the trust income free from tax. By the same token, any distribution of principal that is not an actual distribution of realized capital gains will be free from tax to the beneficiary.

Tax Inequities to Remainderman or to Income Beneficiary Resulting from the Distributable Net Income Concept

When the trust income is distributed to a beneficiary and when there are items of capital gain allocated to principal, the principal may bear an increased tax burden because it will not receive the tax benefit from deductible disbursements made from the principal account. This is because the distributable net income concept gives the income beneficiary the benefit of any deductible disbursement that is charged to principal when there are no items of ordinary income allocated to principal. The 1954 Code was drafted in this manner to eliminate the loss of principal disbursements as income tax deductions, which was the result under the 1939 Code, but the 1954 Code goes too far in the other direction.

There is no provision in the Act to compensate the principal from income when the income beneficiary obtains an income tax benefit from a principal disbursement. This is because, as in the related area of adjustments arising from decisions of the fiduciary to deduct an item on the income tax return instead of on the estate tax return, the draftsmen of the Act decided that "simplicity should prevail over fairness . . ."[6]

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6 Dunham, Highlights of Revised Uniform Principal and Income Act. 102 Trusts and Estates 210 (1963).

In situations where the result is highly inequitable, the courts may afford relief. A very unusual case where an adjustment was ordered is described in Randall, Consequences of Executor's Elections as to Administrative Expenses, 15 N.Y. U. Inst. Fed. Taxation 1011, 1025, (1957) (*Estate of Eleanor Elkins Rice*, Orphan's Court, Montgomery County, Pennsylvania [1959]). Actually, however, the making of an adjustment can raise complications of its own, especially if a transfer is made from income to principal in a later year.

Depreciation – Trust Accounting v. Tax Deduction

A note of caution should be sounded in the area of depreciation. It is important to remember that the depreciation allowance taken by a trustee is not primarily a matter of an income tax deduction. There is considerable doubt that a trustee can properly use an accelerated depreciation method for trust accounting purposes and still maintain the impartiality between the income beneficiary and the remainderman that the Act requires of him. In the case of both depletion and depreciation charges, the provisions of the Act contemplate an actual transfer of cash from income to the principal account. Consequently, the accelerated depreciation will cause the income beneficiary's income to be materially reduced if the same figure is used in determining the amount of trust income. If the same figure is not used (if the accelerated method is used only for tax purposes), the tax basis of the property is reduced more rapidly than it would otherwise be, and the potential tax to be paid upon disposition of the property is thereby increased, to the ultimate detriment of the remainderman.

If the trust owns real property that is situated outside the State of Michigan, it is likely that the Michigan principal and income rules will not apply to transactions involving such property, even though the trust would otherwise be considered as a Michigan trust. In general, the principal and income rules of the state in which the real property is situated are likely to be applicable.

In summary, there is perhaps no area where the interaction of state law and the federal income tax law is more constant. The preparer of fiduciary income tax returns must be constantly attuned to the provisions of the governing instrument and the Revised Uniform Principal and Income Act. There is no escape in the belief that determinations of trust income and principal are to be determined with the aid of an accountant by reference to the mysterious rules of his discipline, for practically without exception the origin of any rule of trust accounting may be traced to a rule of law. Trust accounting principals are really nothing more than a reflection of the rules for the determination of the legal rights of the income beneficiaries and the remaindermen.