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John E. Williams

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FIDUCIARY FEDERAL INCOME TAX RETURNS FORM 1041 AND THE PROPOSED REGULATIONS FOR SECTIONS 641-663 OF THE INTERNAL REVENUE CODE OF 1954

BY JOHN E. WILLIAMS *

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* Vice-President, Tax Division, Provident Trust Company of Philadelphia; A.B., Princeton University; certified public accountant, District of Columbia.

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PART 1

ALTHOUGH both the art and the science of preparing fiduciary Federal income tax returns under the 1954 Code are relatively new, there are various sources of information available, to help in solving many of the problems that arise in completing Form 1041. The purpose of this paper is to analyze the Proposed Regulations [1] for Code Sections 641-663, and to consider their application to the return Form 1041, with reference to questions that may not be fully answered in the Proposed Regulations. The sources of information would include:

The Committee Reports on H. R. 8300.
The 1954, 1955 and 1956 Instructions for Form 1041.
The Proposed Regulations released May 2, 1956.
"Data, views of arguments" filed for the Proposed Regulations.
Addresses and articles by members of the Bar and other tax practitioners.

[1] The writer had hoped to have the benefit of the final regulations before press time. If the final regulations are issued in time for the preparation of 1956 fiduciary returns, they should of course be checked for any changes from the proposed regulations. However, it has generally been true that final regulations do not reflect many material changes from the original proposals.

PART 2

§ 1.641 (a) and (b)-1 (a): The gross income of an estate or trust is determined in the same manner as that of an individual. The deductions and credits allowed to estates and trusts are, in general, those allowed to individuals, but with certain exceptions and special rules discussed in the various parts that follow.

PART 3

§ 1.641 (b)-1 (b): This subsection refers to the liability of the fiduciary to make and file the return and pay the tax on the taxable income of the estate or trust. "Liability for the payment of the tax on the taxable income of an estate attaches to the person of the executor or administrator up to and after his discharge if, prior to distribution and discharge, he had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed." Liability for the tax also follows the assets of the estate or trust when distributed. An inference can be drawn from the Regulations that a fiduciary who distributes an estate or trust in good faith may no longer be personally liable for unexpected deficiencies. One difficulty for Pennsylvania fiduciaries is the reference to "distribution and discharge." It is not customary for local corporate fiduciaries to obtain a "discharge" even after complete distribution.

PART 4

§ 1.641 (b)-1 (c): This subsection deals with terminations of estates and trusts. The Proposed Regulations indicate that estates terminate when the fiduciary has completed the collection of assets; the payment of "debts, legacies, and bequests"; and distribution to the heirs. In comments filed for the Proposed Regulations, the Commissioner was requested to include "taxes" as one of the payments necessary to be made before administration terminated, inasmuch as settlement of the decedent's income and death taxes often takes more time than other debts. The Proposed Regulations stress the Commissioner's position that the period of administration of an estate cannot be unduly prolonged for income tax purposes, and that "an estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary)." The same rule applies to terminated trusts. This wording in the Proposed Regulations is more helpful than might have been expected under a strict interpretation of the word "terminated." Prior to the Proposed Regulations, many fiduciaries believed it was

necessary to transfer such reserves out of the estate or trust to some type of escrow account, with all the expense and trouble of another account on the books. Now it appears that an executor, administrator or trustee may retain a reasonable reserve in the estate or trust account for taxes and other liabilities or expenses and yet treat the estate or trust as terminated for the purpose of passing on excess deductions and unused loss carryovers.

Although the reference is to "unascertained or contingent liabilities and expenses," it would appear to be within the intent of the Regulations to treat an estate or trust as terminated if all assets have been distributed except for a reserve to cover an *ascertained* liability or expense.

There is still a problem when the "reserve" has income or expense in a subsequent year. Possibly the best theory is that the termination occurred in the prior year, and that the reserve should be treated as an agency account for income tax purposes in subsequent years.

The Proposed Regulations also establish rules as to when a *trust* terminates. "Generally, the determination of whether a trust has terminated depends upon whether the property held in trust has been distributed . . . rather than upon the technicality of whether or not the trustee has rendered his final accounting." Thus, if a trust terminates upon death of a life tenant, the trust is deemed to continue for income tax purposes for a period reasonably necessary to a proper winding up of the affairs of the trust. Let us assume the life tenant of a calendar year trust dies in September, 1956. The trustee prepares a final accounting which is filed or stated in November and adjudicated or approved in December. Distribution is made in January, 1957. It is clear, under the Proposed Regulations, that the trust did not terminate for income tax purposes in 1956, and therefore no excess deduction nor loss carryover may be claimed by the distributees for 1956. However, a 1956 net capital gain or other corpus income of the trust would be considered as "credited" or "required to be distributed" to the distributee, by the adjudication or account approval, and therefore includible in distributable net income of the trust. Upon death of the life tenant, the subsequent income (except accruals) and capital gains belong to the remainderman and equity can best be served by treating the trust as complex and following the separate share rule for "successive interests in point of time" (see part 41 below) so that the capital gains are included in distributable net income but taxed only to the remainderman. One difficulty would appear when distribution of corpus is not completed in the taxable year of the death of the life tenant. Under the Proposed Regulations, a trust, otherwise qualifying as a simple trust, which is required to distribute corpus upon the happening of a specified event, remains a simple trust until the year

when there is actual distribution of corpus. See Part 19 below. Also see illustrations B and C in Part 15 below. The timing of the payment of counsel fees, commissions and filing costs remains important, and the timing of sales may be important. The important general rule is that the termination for income tax purposes occurs when the assets are distributed, and not when the life tenant dies or the account is approved.

After termination of an estate or trust, the subsequent income, deductions and credits are considered as those of the distributees. These subsequent items should not be included in any fiduciary return, but would be reportable to the distributees by an agency form of tax advice letter.

PART 5

§ 1.642 (a)(1)-1: An estate or trust receives credit against *its* tax for so much of its partially tax-exempt interest as is not allocated to a beneficiary under Sec. 652 or 662, or is not allocated to gross income for charity, etc. A beneficiary is allowed the 3% credit in respect to partially tax-exempt interest allocated to him under Sec. 652 or 662. In certain situations, it appears that there is departure from the conduit theory here, and a part of the credit may be lost. This might occur, for instance, in a trust distributing all its income if expenses were allocated in whole or in part to partially tax-exempt interest.

If there has been an election by the fiduciary under Sec. 171 to amortize the premium on partially tax-exempt bonds, the credit, to the fiduciary or to the beneficiary, must be reduced by the apportioned amortization deduction for the year.

PART 6

§ 1.642 (a)(2)-1: An estate or trust receives credit against its tax for foreign taxes which are not allocated to the beneficiaries.

PART 7

§ 1.642 (a)(3)-1: An estate or trust receives credit against its tax for that portion of dividends received as is not allocated to a beneficiary under Sec. 652 or 662, or to gross income for charity, etc. Dividends allocated to a beneficiary are in general deemed to be received by him in the taxable year in which they are includible in his gross income under Sec. 652 or 662. An exception would apply in the case of time limitations under Sec. 34 (a) or 116 (a), the two to four per cent credit and the $50 exclusion, respectively. For the purpose of these two sections, the time of receipt of the dividends by the fiduciary would govern.

PART 8

§ 1.642 (b): Personal exemptions for estates and trusts are as follows:

(a) $600 for an estate.

(b) $300 for a trust required under its governing instrument to distribute all its probate [2] income currently.

(c) $100 for all other trusts.

A trust which also distributes principal in the taxable year is treated as a complex trust but retains its $300 exemption.

If a trust instrument directs that a part of its income is to be distributed to charity and the balance, if any, to other beneficiaries, it would appear that the $300 deduction is allowable. From the trust accounting viewpoint, all the income is distributable currently. From the income tax viewpoint, all the income after the charity *deduction* is distributable currently. To qualify for the $300 deduction, it does not appear to be required that all the income be distributable to a beneficiary as distinguished from a charity.

PART 9

§ 1.642 (c): Charitable contributions deduction. This deduction applies to any part of the gross income which, by the terms of the will or deed, is paid or permanently set aside for charities, etc., specified in Sec. 170 (c) or is to be used exclusively for:

1. Religious, charitable, scientific, literary, or educational purposes.
2. Prevention of cruelty to children or animals.
3. Establishment, acquisition, maintenance or operation of a public cemetery not operated for profit.

The deduction is subject to the limitations in respect to unrelated business income and prohibited transactions.

If an estate or trust has a charitable, etc., deduction from probate income, and such income includes any items not entering into the computation of the gross income of the estate or trust, the income tax deduction is to be reduced by its share of such tax-exempt income, unless the governing instrument has a specific provision that another type of income is to be used for the charity. In the absence of specific provisions in the instrument, the charitable, etc.,

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[2] The term "probate income" is used in this paper to designate the net income for trust accounting purposes, the amount of income normally distributable to a life tenant.

deduction is deemed to consist of the same proportion of each class of the items of income as the total of each class bears to the total of all classes. However, the $50 exclusion for dividends is not taken into account (not deducted in determining the numerator of the fraction). Thus, if a trust is to pay one quarter of its income to charity and receives gross rents of $4,000 and total dividends of $6,000, and its only expense is $2,000 for real estate taxes, the income is $8,000 and the charity deduction is $2,000, made up as follows:

Gross rents:	4,000/10,000 x 2,000 =	$800.00
Dividends:	6,000/10,000 x 2,000 =	1,200.00
		$2,000.00

It should be noted that fractions for both the rents and dividends reflect total amounts received, not net rents nor dividends-after-exclusion.

If the income for charity includes long-term capital gains, the charity deduction must be reduced by the 50% deduction allowed for the excess of net long-term capital gain over net short-term capital loss. Thus, if an estate or trust is to pay principal to charity after death of the life tenant, and has $10,000 net long-term capital gains and $2,000 net short-term capital losses during the year, the charity deduction is reduced from $8,000 to $4,000 and the 50% deduction under Sec. 1202 remains at $4,000.

PART 10

§ 1.642 (d): The net operating loss deduction of Sec. 172 is allowed to estates and trusts, except as to any portion of income and deductions attributable to the grantor or another person under Secs. 671 through 678, and must exclude, for the Sec. 172 deduction, the deductions for charity, etc., and for beneficiaries.

PART 11

§ 1.642 (e): Estates and trusts are allowed deductions for depreciation and depletion, to the extent not allowable to a beneficiary under Secs. 167 (g) and 611 (b). These sections allow the deductions to the beneficiaries of estates and trusts, apportioned between the fiduciary and the beneficiaries in accordance with the pertinent provisions of the instrument. If there are no such provisions, an allocation of the deduction for depreciation or depletion is required, based on the amount of "income" allocated to the fiduciary and the beneficiaries respectively.

The word "income" is not defined. The definition of "income" in Sec. 643 (b) is limited to Secs. 651-668 inclusive. However, the Proposed Regulations, in the example at § 1.662 (h), use probate income for the allocation of depreciation. See the last paragraph of Part 23, below.

It should be noted that the depreciation or depletion deduction of a life tenant or income beneficiary of property held in trust is a deduction used in determining his *adjusted gross income.* See Code Section 62 (6). This of course means that the beneficiary's share of depreciation from property held in trust is allowed as a deduction, even though the beneficiary does not elect to itemize other deductions on his own return. The Instructions for Schedule H of Form 1040 instruct the beneficiary to subtract from his share of estate or trust income any depreciation allocable to him from the estate or trust, and to show the net amount.

PART 12

§ 1.642 (f): Allocation of deductions for amortization of emergency or grain storage facilities follow the principal of apportionment of depreciation and depletion.

PART 13

§ 1.642 (g): This sub-section prohibits an estate from taking an income tax deduction for casualty losses, and administration expenses for management, conservation or maintenance of property held for the production of income, unless a statement in duplicate is filed to the effect that the items have not been allowed as deductions from the gross estate for Federal estate tax purposes, and that all rights are waived to have such items allowed at any time as estate tax deductions. Several questions might be raised, and observations made, at this point:

(a) The prohibition against double deductions specifically refers to *estates.* May it be argued that fees and filing costs, etc. of a revocable *trust* following the death of the grantor may be claimed as deductions both in the Federal estate tax return and the income tax return of the trust?

(b) Although the prohibition applies to double *deductions,* expenses incurred in the sale of property, actually treated as offsets to the selling price, are brought within the same rules in Rev. Rul. 56-43, I.R.B. 1956-7, 54. Expenses of sale may not be used as an offset against the sale price of property in determining income tax gain or loss for an estate, if they have been allowed as deductions for Federal estate

tax purposes. It may be noted that the Proposed Regulations for Federal Estate Tax, issued October 16, 1956, at § 20.2053-3-(d) allow deduction of brokerage fees for selling estate property if the sale is necessary in order to pay debts, administration expenses or taxes, or to effect distribution. In many instances, such as in the case of real estate sales, the expenses of sale may be more clearly usable for income tax than estate tax purposes.

(c) The "statement" is to the effect that the items have not been "allowed" as estate tax deductions. The new provisions drop the requirement that such items have not been "claimed" as estate tax deductions. Therefore, if a deduction has been claimed in the estate tax return, there would appear to be no impropriety in taking the item as an income tax deduction and filing a statement that the item has not been allowed as an estate tax deduction, provided that the statement is made prior to the audit of the estate tax return. If this is done, the executor or administrator would probably notify the Director of Internal Revenue, Estate Tax Section, that the item had been taken as an income tax deduction and should be disallowed as an estate tax deduction. Payment of additional estate tax and interest could be made, if significant in amount.

(d) The "statement" may be filed with the income tax return in which the items are claimed as deductions, or with the District Director for association with the return. The Proposed Regulations under the 1954 Code do not specify when the statement must be filed for association with the return. Under the 1939 Code, the Treasury issued a Special Ruling dated April 19, 1951, and Revenue Ruling 240 (1953-2 CB 79) broadening Reg. 111, Sec. 29.162-1 by providing that the waiver statement could be filed at any time prior to the expiration of the statutory period of limitations applicable to the income tax return. In comments filed for the Proposed Regulations, it was requested that the Commissioner add the substance of the 1951 ruling to the Regulations.

(e) Under the 1939 Code, the Treasury ruled, in I.T. 4048, 1951-1 CB 39, that an estate could deduct administration expenses paid in one year for income tax and those paid in another year, for estate tax. Furthermore it appears that "part items" may be deducted from income tax and the balance for estate tax. Both the 1954 Code and the Proposed Regulations refer to "amounts allowable" rather than

"items allowable." Accordingly, if a portion of the administration expenses cannot be claimed as an income tax deduction because applicable to tax-exempt income, or to conservation or management of assets producing tax-exempt income, it appears that the portion disallowed for income tax purposes may be claimed as a deduction for estate tax purposes.

(f) The prohibition against double deduction does not apply to deductions in respect of a decedent. The Code and the Proposed Regulations are specific on this point. Such items are debt deductions for estate tax, as well as expense deductions for income tax. Fees and expenses incurred in filing the account of a guardian or committee after death of the ward would seem to qualify as deductions that may be taken both for income tax and for estate tax. They are not administration expenses of the testamentary estate of the ward, and they are not expenses deductible in "the taxable period in which falls the date of his death, or a prior period."

(g) Medical expenses of the decedent, paid after death by the estate, are debts for estate tax. They may not be claimed as income tax deductions for the *fiduciary* return of the estate, but may be claimed, under the rules of Sec. 213 (d), as deductions in the last or next-to-last income tax return of the decedent, depending upon when they were incurred, if the proper statement and waiver are filed. To be claimed as income tax deductions, such expenses must have been incurred for the medical care of the *decedent,* and must be paid from the *estate* during the one year period beginning with the day after death.

(h) If the estate's administration expenses, including but not limited to counsel fees and executors' compensation, are used as income tax deductions, and if the will creates a formula for maximum marital deduction, the election to use such deductions for income tax purposes increases the adjusted gross estate and may increase the marital deduction. Rev. Rul. 55-643, 1955-2 CB 386.

(i) If administration expenses of an estate are used as income tax deductions and the Federal estate tax is thereby increased X dollars, it appears equitable to charge income with the X dollar increase in Federal estate tax. Matter of Warms; Surrogates' Court of New York County, N. Y., decided March 7, 1955.

PART 14

§ 1.642 (h): Unused loss carryovers and excess deductions on termination of an estate or trust are allowable to the beneficiaries succeeding to the property of the estate or trust. A loss carryover becomes a carryover for the beneficiary immediately, for the taxable year of the beneficiary in which or with which the estate or trust terminates. The last taxable year of the fiduciary and the first taxable year of the beneficiary to which a loss is carried over are, under the Proposed Regulations, *each* counted in determining the number of years to which a loss may be carried forward. For example: a calendar year estate or trust has a $10,000 capital loss carryover for losses in 1952. It terminates December 31, 1954 by distribution of all its assets to A, who is also on a calendar year. The carryover would, until exhausted, be available as follows:

1953—the fiduciary
1954—the fiduciary
1954—the beneficiary
1955—the beneficiary
1956—the beneficiary

The Proposed Regulations give an example of an estate that had a capital loss of $5,000 in 1954 and terminated that year by distribution of the property to A and B equally. A is on a calendar year basis and B is on a fiscal year basis ending August 31 for income tax purposes. Then the statement is made that A would have a capital loss carryover of $2,500 for *1955* and four ensuing years. B would have a capital loss carryover of $2,500 for his tax year ending August 31, 1955 and for his next four tax years. Failure to give the capital loss carryover to A in 1954, the year of termination, may be an error in the Proposed Regulations, or a strict construction of the word "carryover." In a strict sense, the loss incurred by the estate in its year ending December 31, 1954 does not become a carryover until 1955. If an estate or trust with a fiscal year ending before December 31 terminates in 1954 by distribution to a beneficiary on a calendar year basis, it would seem to follow that a net capital loss of the fiduciary in its 1954 fiscal year would be an allowable carryover loss immediately to the beneficiary in his taxable year ending December 31, 1954.

In the year of termination of an estate or trust, if allowable deductions exceed gross income, the excess is allowed as a deduction to the beneficiary succeeding to the property. It is generally assumed that the deduction to the beneficiary cannot be claimed unless he uses itemized deductions, that is, that the deduction is not of the type used in determining adjusted gross income. For the purpose of determining excess deductions, the deductions for income

distributions, personal exemption and charity are disregarded. If a trust terminates in 1956 by distribution of all its assets to B, and that year receives mortgage interest of $2,000 and pays corpus commissions of $20,000, B may claim $18,000 as a deduction in that year, but may not carry any unused portion over to a subsequent year. The five year carryover provisions apply to net operating loss carryovers and capital loss carryovers, but not to "excess deductions."

One of the difficulties in applying this section for a terminated trust arises when the life tenant of a trust dies and distribution is made to the remainderman, but expenses such as counsel fee and commissions are paid after the life tenant dies. Briefly, the arithmetic might be as follows:

John Doe—income collected to date of death	$500.00
Accrued income due the estate of John Doe	100.00
John Doe, Jr. (remainderman) $100 income, $500 deductions	(400.00)
	$200.00

It would appear equitable to pass the $400 over to John Doe, Jr. as an excess deduction and to tax the deceased life tenant and his estate with $500 and $100 respectively, but it is difficult to find authority for an excess deduction to John Doe, Jr. when the trust for its taxable period does not have an excess of deductions over income. See Part 23 below, for authority to divide the $200 distributable net income 5/7 to John Doe, 1/7 to his estate and 1/7 to John Doe, Jr., thus applying the rules for distributable net income and allocating on the basis of probate income. This method would deprive John Doe, Jr. of part of the deductions that reduced the final distribution to him, and would give the benefit of that part of the deductions to the deceased life tenant and his estate—a redistribution of expenses that seems manifestly unfair. Also compare the separate share rule for successive interests in point of time (Part 41 below).

If the time for using a net operating loss carryover expires for an estate or trust in the year of termination, the amount not absorbed by the estate or trust that year may be considered as an "excess deduction" for the beneficiary to the extent not absorbed in that taxable year by the estate or trust. Fiduciary income or expense taken into account in determining net operating loss or capital loss carryover for the last taxable year of the fiduciary may not be taken into account in determining excess deductions on termination.

Excess deductions and the two carryovers are allowed only to residuary beneficiaries, and apparently to those receiving gifts or bequests payable in more than three installments. Excluded from the benefits of excess deductions and carryovers are the following:

(a) Recipients of gifts or bequests of a specific sum of money or of specific property, payable all at once or in not more than three installments.

(b) A widow, as to her support allowance.

(c) Income beneficiaries as such.

If an individual qualifies as a residuary beneficiary, he is not disqualified because he also receives income or a legacy, but the income and legacy are disregarded in any apportionment of the excess deductions or carryovers among those succeeding to the property.

The Proposed Regulations do not cover a situation such as when $100,000 is payable to A and the residue to B, upon termination of an estate or trust, but the balance for distribution is less than $100,000. Pending a contrary ruling, it would seem to be equitable for A to claim the excess deduction or carryover. Comments on the Proposed Regulations included a suggestion that the final regulations revise the definition of residuary beneficiaries to comprise all those beneficiaries under a will or trust whose interests would be reduced or depleted by reason of items entering into the computation of the amount to be carried forward.

If an estate is distributed to a trust, or if a trust can be considered as terminating into another trust, the ensuing trust and not the income beneficiary is the beneficiary succeeding to the property, and entitled to an excess deduction or carryover. However, an excess deduction or operating loss carryover picked up by the ensuing trust reduces "distributable net income", and therefore will in most cases result in an eventual tax saving for the income beneficiary of the ensuing trust.

There may be a problem as to how to divide excess deductions and carryovers among beneficiaries succeeding to the property, if unequal partial distributions are made in a year prior to termination. Assume the life tenant of a $100,000 calendar year trust dies July 1, 1956 and corpus becomes distributable to A and B equally. A distribution of $25,000 on account is made to A before December 31. In 1957 the trust terminates and distributes another $20,000 to A and $45,000 to B, the remaining $10,000 being an "excess deduc-

tion" of fees paid in 1957. It would be equitable to prorate the excess deduction between A and B in equal shares, even though in that year A receives $20,000 and B receives $45,000. The Proposed Regulations do not cover this situation, but there is no wording to prohibit the equitable treatment suggested.

The Proposed Regulations do state, as the Code fails to do, that "beneficiaries succeeding to the property of the estate or trust" does not include an income beneficiary as such.

Form 1041 is not particularly well designed to reflect carryover losses or excess deductions for the distributees. The carryovers and excess deductions are entirely alien to "distributable net income" and "distribution deduction" and there would appear to be need to complete Schedule G or Schedule H on Page 4 of the return, for carryover losses or excess deductions to be passed on to distributees. It would seem appropriate to adopt Schedule C, "Beneficiaries' shares of income and credits" as follows:

(a) The name and address of each distributee would be shown in columns 1 and 2.

(b) Column 4 might be used to show the amounts of principal distributed to the beneficiaries entitled to carryovers or excess deductions, to support the shares used in allocating carryovers and excess deductions among the distributees, in columns 9 and 13, as suggested below.

(c) Column 9 might be used for a capital loss carryover, changing the heading from "Net long-term capital gain 100%" to "Capital loss carryover". A supplemental statement might be attached, showing the taxable years when the capital losses occurred for the fiduciary, and the extent to which the fiduciary had absorbed any carryovers itself. The distributee should also be supplied with such a statement.

(d) Excess deductions might be shown in column 13, and the heading changed from "Depreciation and depletion" to "Excess deductions".

(e) On Page 1 of the fiduciary return, no figures need be entered after Line 17, which will reflect a minus figure.

(f) In the heading of the return, under the name of the estate or trust, it may be well to call attention to the special nature of the return, by adding "This estate (or trust) terminated and was distributed by (last day of taxable year, for instance, December 31, 1956)".

(g) An additional notation might be added in Schedule C, using columns 5, 6 and 7, as follows;

This trust/estate terminated within its taxable year. See Sec. 642 (h), I.R.C. 1954: Unused loss carryovers and excess deductions on termination available to beneficiaries.

PART 15

§ 1.643: "Distributable net income" is a term new in the 1954 Code. An understanding of this new concept is of vital importance in dealing with the income taxation of estates and trusts. It often is the measure of taxable income for the beneficiaries, and therefore also the deciding factor in the amount of income that remains taxable to the fiduciary. Several of its elements of theory are drastic departures from the related philosophies of taxation under the 1939 Code, and it on occasion forsakes the rules of trust accounting. For these reasons it becomes a somewhat difficult theory to apply in practice and requires careful study and understanding.

"Distributable net income" is by definition based on taxable income (gross income less deductions) as defined in Section 63 of the Code, with the following modifications:

(a) The deduction for distributions to beneficiaries is not used.

(b) The deduction for personal exemption is not used.

(c) Gains from sale or exchange of capital assets are excluded if allocated to corpus and not paid, credited or required to be distributed to any beneficiary during the taxable year. Conversely, if capital gains are allocated to income, or actually distributed to beneficiaries, or utilized, under the terms of the trust or the practice of the fiduciary in determining the amount which is distributed or required to be distributed to the beneficiaries, they are included in distributable net income.

(d) Capital gains are *included* in distributable net income if they give rise to a deduction for charity, etc. because they are paid, permanently set aside, or are to be used for charity, etc.

(e) Losses from sale or exchange of capital assets are not used in computing distributable net income except to the extent that they enter into the determination of capital gains that are paid, credited or required to be distributed to a beneficiary during the taxable year.

(f) The 50% deduction for the excess of net long-term capital gain over net short-term capital loss under Sec. 1202 is not taken into account, except to the extent allocable to capital gains paid, permanently set aside, or to be used for charity, etc.

Paragraphs (a) through (f) above can be briefed as follows, as to whether the items are considered in arriving at distributable net income:

Distribution deduction	No
Personal exemption	No
Capital gains not distributable	No
Capital gains distributable	Yes
Capital gains for charity, etc.	Yes
Capital losses not affecting distribution	No
50% Sec. 1202 deduction for capital gains retained in corpus or allocated to beneficiaries	No
50% Sec. 1202 deduction for capital gains for charity, etc.	Yes

The following illustrations are given in the Proposed Regulations for the application or nonapplication of capital gains in determining distributable net income:

A. A trust to pay income to A for life, with power in the trustee to invade principal for A's benefit. In one year securities are sold for $10,000 at a profit and $10,000 in excess of income is distributed to A. The capital gain would not ordinarily be included in distributable net income nor taxed to A. However, if the trustee follows a regular practice of distributing "the exact net proceeds" of sales, capital gains would be included in distributable net income, and taxed to A.

B. A trust provides for retention of trust property for ten years, at which time the property is to be sold and the proceeds distributed to B. Capital gain on the sale will be included in distributable net income and taxed to B.

C. A trust provides that income shall be paid to C, with distribution of the principal to C when he reaches age 35. All capital gains in the year of final distribution are included in distributable net income and taxed to C.

Extraordinary dividends and taxable stock dividends of a simple trust (one that distributes current income only and has no charity, etc. deduction) are not taken into account in determining distributable net income if the fiduciary does not distribute or credit them to the beneficiaries, because he has in good faith determined under the trust provisions and local law that they should be allocated to principal. The allocation may be made on an item basis. Thus a certain taxable stock dividend may be allocated to principal and not included in distributable net income, although another taxable stock dividend in the

same year had been allocated to income and therefore would be included in distributable net income. The Proposed Regulations follow the Code in referring to "items", and furnish no rules as to part items, but it would be reasonable to exclude from distributable net income that part of such an item as is allocated in good faith to principal. The "good faith" immunity may possibly be applied only to the allocation of an extraordinary dividend, and not to a decision as to whether the dividend is "extraordinary".

"Extraordinary dividends" are not defined in the Code or Proposed Regulations, but the Proposed Regulations do state that such dividends may include those paid in cash or in kind.

If extraordinary dividends or taxable stock dividends are properly allocated to principal in a simple trust in one year, and in a later year are determined to be distributable to the beneficiaries, the trust in that later year is considered a complex trust distributing "other amounts". The distribution of these dividends in the later year would also qualify as an accumulation distribution if in excess of $2,000 and if not covered by the other exceptions. Furthermore, if these dividends distributed in the later year are affected by the "accumulation distribution" rules, then the trust, which was a simple trust in the year the dividends were received would be treated as a complex trust with a $100 exemption for that year, but solely for the computations required as to accumulation distributions.

The above rules for extraordinary and taxable stock dividends do not apply to estates or complex trusts, and this non-applicability could produce unexpected results. Assume that a calendar-year trust distributes all its regularly recurring annual $10,000 income to A. In January, 1956 it makes an emergency distribution of $5,000 from principal to A and the trustee informs A that the $5,000 principal distribution does not increase his taxable income. In December the trust receives an extraordinary dividend of $6,000 and properly allocates the entire amount of the dividend to principal. Nevertheless this trust has distributed more than "current income only", is a complex trust for 1956, and has to tax A with $15,000 instead of $10,000. The moral is, never assure a beneficiary that *any* distribution is non-taxable to him, until the fiduciary return for the year has been completed.

Tax-exempt interest (and foreign income in the case of a foreign trust) are included in distributable net income, but reduced by expenses allocable thereto. Both the Code and the Proposed Regulations refer to tax-exempt *interest* (reduced by allocable expenses) as being includible in distributable net income. Other tax-exempt income, such as non-taxable dividends, the $5,000

death benefit of Sec. 101, wage continuations on account of personal injuries or sickness under Sec. 105 received as income in respect of a decedent, are not included in distributable net income under the definition. However, the $50 dividend exclusion is disregarded, and the full amount of dividends before the $50 exclusion is included in distributable net income. The Proposed Regulations also state that, for the purpose of computing distributable net income, it is not necessary to compute either expenses or charity deductions allocable to the dividend exclusion.

In regard to expenses applicable to tax-exempt interest, it may be noted that the allocation should be made under Sec. 265 of the Code "whether or not any amount of such interest is received or accrued". Therefore, if a calendar year trust in 1955 received $5,000 taxable interest and $5,000 tax-exempt interest, but in 1956 received only taxable interest of $10,000, one-quarter of an income commission taken at the end of 1956 on the two years' income would be non-deductible, even though only taxable interest had been received that year.

Although tax-exempt income, other than interest, is excluded from distributable net income, expenses allocable thereto are disallowed as deductions under Sec. 265 in determining taxable income, which is the basis for distributable net income. See Secs. 641 (b), 265 and 212.

Before inclusion in distributable net income, the tax-exempt interest, and foreign income in the case of a foreign trust, both adjusted for expenses allocable thereto, must be further reduced by any portions allocable to charity, etc. deductions. In the absence of specific source provisions in the governing instrument, the allocation to the charity, etc. deduction is based on the ratio of each class of income to the total of all classes. This ratio is based on gross amounts. Thus if a trust receives $2,000 tax-exempt interest and $8,000 dividends during the year, and pays a $500 income commission and distributes one-half its balance of income or $4,750 to a charity and $4,750 to beneficiary A, distributable net income is computed as follows:

	Dividends	*Tax-exempt Interest*	*Total*
Received	$8,000.00	$2,000.00	$10,000.00
Less—allocation to charity:	....	....	4,750.00
8,000/10,000 x 4,750	3,800.00	....	....
2,000/10,000 x 4,750	....	950.00	....
	$4,200.00	$1,050.00	$5,250.00
Less—commissions	400.00	100.00	500.00
Distributable net income	$3,800.00	$950.00	$4,750.00

On Form 1041, line 2 (a) of Schedule G directs the addition of "Tax-exempt interest (as adjusted)", in computing distributable net income. It should be noted that the amount to be added is not the total tax-exempt interest as adjusted, when there is a deduction for charity, etc., but rather the tax-exempt interest as adjusted, after subtracting the portion of tax-exempt interest allocated to charity. Thus, in the example above, line 2 (a) of Schedule G would show $950 and not $1,900. This point is covered in the 1956 Instructions for Form 1041, as "Detailed directions" for completing Line 2 (a) of Schedule G, but the charity adjustment is not apparent on the form itself.

It must also be remembered that a number of miscellaneous income items, often credited to principal, are not excluded from the computation of distributable net income. Examples of such miscellaneous items would be: insurance renewal commissions, salary of decedent earned before death, and gain from the sale of a non-capital asset taxed as ordinary income.

One of the intended effects of using distributable net income as a limitation on the taxability of income to the income beneficiaries is to give these beneficiaries the benefit of corpus deductions other than capital losses. When corpus deductions do benefit the income beneficiaries and the trust pays a larger tax, for instance on capital gains, an adjustment between income and principal is indicated. Rice Estate, 6 Fid. Rep. 225.

PART 16

The word "income" is specially defined for subparts A, B, C & D of Part I of subchapter J, chapter 1 of the Code. These are the subparts that refer to the general rules for taxation of estates and trusts, trusts which distribute current income only, estates and trusts which may accumulate income or which distribute corpus, and excess distributions of trusts. When the term "income" is not preceded by the words "taxable", "distributable net", or "gross", it is defined to refer to the amount of income of an estate or trust determined under its governing instrument or applicable local law. Thus, if capital gains are not currently distributed or distributable to beneficiaries, they are "corpus" and not "income".

It should be noted that "income" includes tax-exempt interest, or even other tax-exempt income if not allocated to corpus.

Extraordinary dividends and taxable stock dividends allocated by the fiduciary in good faith to corpus are not "income". See Part 15 above for elimination of such dividends in computing distributable net income in the case

of a simple trust, and possible treatment as an accumulation distribution if distributed in a later year.

PART 17

The term "beneficiary" includes heirs, legatees and devisees. It also includes persons whose legal obligation is discharged by amounts so used under the terms of a will or deed of trust. It also includes the grantor of a trust to the extent that he is taxable with trust income under Sec. 677 because amounts are paid from the trust for support or maintenance of one whom the grantor is legally obligated to support. It includes the trustee or cotrustee of a trust when treated as a substantial owner under Sec. 678.

PART 18

"Income" may be quite different from "distributable net income", as in the case of the following trust which allocates to corpus all capital gains and losses and all expenses of the trust, and distributes its "income" currently:

		Income	*Distributable Net Income*
Qualifying dividends		$30,000.00	$30,000.00
Extraordinary dividends allocated to corpus—$20,000		———	———
Taxable interest		$10,000.00	$10,000.00
Tax-exempt interest:			
Total	$10,000.00	$10,000.00	....
Less—expenses allocable	1,000.00	....	$9,000.00
Long-term capital gains	$10,000.00	....	....
Commissions & expenses	5,000.00	....	....
Less—allocated to tax-exempt interest	1,000.00	....	-(4,000.00)
	....	$50,000.00	$45,000.00

If distributable net income is computed under the definition covered in Part 15, above, the same result would be reached, but the steps would be as follows:

Gross income:	
Qualifying dividends	$30,000.00
Extraordinary dividends	20,000.00
Taxable interest	10,000.00
Long-term capital gains	10,000.00
	$70,000.00

Deductions:	*Income*	*Distributable Net Income*
Distribution deduction	$35,950.00	
Dividend exclusion	50.00	
50% of long-term gains	5,000.00	
Trust exemption	300.00	
Expenses applicable to taxable income	4,000.00	$45,300.00
Taxable Income		$24,700.00

To determine distributable net income, taxable income is the base, and the following adjustments are made:

Taxable income		$24,700.00
Add back:		
Distribution deduction		35,950.00
Trust exemption		300.00
50% of long-term gains		5,000.00
Tax-exempt interest as adjusted		9,000.00
Dividend exclusion		50.00
		$75,000.00
Deduct:		
Capital gain 100%	$10,000.00	
Extraordinary dividends allocated to corpus	20,000.00	$30,000.00
Distributable net income		$45,000.00

The instructions for Form 1041 do not require the distribution deduction to be reduced by the $50 dividend exclusion. The distribution deduction for line 18, page 1 of Form 1041 is to be shown as $36,000. Note that the beneficiary receives $50,000 ("income" of the trust), but reports taxable income of only $36,000. In effect, the $50,000 probate income is reduced by the $10,000 of tax-exempt interest, and by the $4,000 deductible portion of commissions and expenses although paid from principal. Schedule C of Form 1041 would show $50,000 in Column 3 as the amount of income required to be distributed currently. The principles for allocation to Columns 5, etc., are set forth in the example detailed in Part 23 below.

PART 19

§ 1.651 outlines the provisions for distribution deductions and the taxation of the distributions to the beneficiaries, in the case of simple trusts, i.e.: those that are required to distribute all their income currently; may not pay, set

aside, or use any amount for charity, etc.; and do not, in the taxable year, distribute amounts other than income. The definition of "income" was considered in Part 16 above; the definition of "beneficiary" was considered in Part 17.

A trust may provide for a reserve for depreciation or "otherwise make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose" without being disqualified as a simple trust. The quoted portion above might be applied to the not infrequent occasion when the trust instrument provides that an annual trustee's compensation is to be charged to income.

Even a sprinkling trust may qualify as a simple trust, but not a trust which permits accumulation.

If a trust distributes amounts other than income in a taxable year, such as by discretionary or emergency distributions of corpus, or by distribution of corpus in the year of termination, it loses its qualification as a simple trust. On the other hand, a trust which otherwise qualifies as a simple trust but is required to distribute corpus at a certain time, remains a simple trust except in the year or years when corpus is actually distributed. Thus a simple trust on a calendar year basis has a provision for distribution of half its corpus to the beneficiary when he becomes 30 years of age. The beneficiary reaches age 30 on December 28, 1956, but distribution of corpus is not made until January, 1957. The trust is not disqualified as a simple trust in 1956; corpus was distributable in 1956 but was not actually distributed until 1957.

A simple trust is allowed a deduction, in computing its taxable income, for income required to be distributed currently to beneficiaries. If probate income exceeds distributable net income, the deduction is limited to distributable net income. In either case the deduction is reduced by items of trust income not included in gross income, adjusted for deductions allocable thereto. Thus, if a simple trust receives $90,000 in taxable income and $9,000 in tax-exempt interest, the distribution deduction is $90,000. However, Form 1041 does not require that such a reduction be made for the $50 dividend exclusion. See the final comment under Part 18 above.

For the purpose of determining the distribution deduction, distributable net income is computed without the modifications for extraordinary dividends and taxable stock dividends, tax-exempt interest (and foreign income of a foreign trust), and the $50 dividend exclusion. In the example set forth in Part 18 above, distributable net income was computed as $45,000, having added to taxable income: (a) $9,000 for tax-exempt interest as adjusted, and (b)

$50 for the dividend exclusion, and having subtracted (c) $20,000 for extraordinary dividends allocated to corpus. The two additions and one subtraction are to be reversed for determining a distribution deduction based on distributable net income, as follows:

True distributable net income		$45,000.00
Subtract:		
Tax-exempt interest as adjusted	$9,000.00	
Dividend exclusion	50.00	9,050.00
Distributable net income for the purpose of computing the distribution deduction	. . . .	$35,950.00

The taxable income distributable is $40,000 (excluding total tax-exempt interest (adjusted) of $9,000. The distribution deduction is therefore based on distributable net income as adjusted above, which gives effect to the $4,000 deductible portion of commissions, etc. charged to corpus, and the $50 dividend exclusion. For the purpose of Form 1041, the distribution would be increased by the $50 dividend exclusion, to $36,000.

PART 20

§ 1.652 (a) provides, subject to § 1.652 (b), that a beneficiary of a simple trust is to include in his gross income the amounts of trust income required to be distributed to him, whether or not such income is actually distributed to him. If however the amount of income required to be distributed exceeds distributable net income, each beneficiary should include only his proportionate share of distributable net income. Thus if $5,000 of income is distributable to A, and the balance of income, $7,000, is distributable to B, and the distributable net income is only $10,000, A includes 5,000/12,000 of $10,000, or $4,166.67, and B includes 7,000/12,000 of $10,000, or $5,833.33.

PART 21

§ 1.652 (b) provides that the amounts includible in the gross income of the beneficiary shall have the same character in his hands as in the hands of the trust. Thus income exempt from tax in the trust is excludible from the gross income of the beneficiary. Allocation of the various classes of income is based on the amount of each class of income entering into the computation of distributable net income, unless the trust specifically allocates different classes of income to different beneficiaries.

Items of trust deductions, entering into the computation of distributable net income, are allocated to the classes of income as follows:

1. Expenses directly attributable to one class of income are allocated thereto. However, it is not necessary to allocate any direct expense to the $50 dividend exclusion.

2. Expenses indirectly attributable to a business carried on by a trust are to be allocated to the business income.

3. If there is an excess of direct deductions over income of any class, the excess may be allocated to any other class of income, including capital gains, included in distributable net income. However excess deductions attributable to tax-exempt income may not be offset against other income.

4. Other deductions not directly attributable to a specific class of income may be allocated to any type of income included in computing distributable net income, but a proportion thereof must be allocated to tax-exempt income other than the $50 dividend exclusion. As examples of such indirect general expenses the Proposed Regulations list trustee's commissions, rent of safe deposit boxes, state income and personal property taxes.

In summary, the following rules are set forth in the Proposed Regulations:

(a) Direct expenses against their class of income.

(b) Excess of direct expenses against any type of income, unless such direct expenses had been attributable to tax-exempt income.

(c) Indirect business expenses against business income.

(d) Excess of indirect business expense against any type of income.

(e) Other indirect expenses, reduced by apportionment to tax-exempt income, to any type of income.

It appears that an excess of indirect business expense, under the wording of the Proposed Regulations, might have to be allocated in part to tax-exempt income, but this rule may well be contested.

Although certain deductions may properly have been charged to corpus, allocation as above is nevertheless mandatory.

It should be noted that the allocations of deductions are to be made only against income included in distributable net income. Thus there can be no

allocation against capital gains not included in distributable net income, nor to extraordinary dividends or taxable stock dividends determined in good faith to be allocable to corpus in the case of a simple trust.

§ 1.652 (c) sets forth the rules for income taxable to a beneficiary of a simple trust, when beneficiary and trust have different taxable years. The beneficiary's trust income for a certain taxable year is the amount reportable, as set forth above in Parts 20 and 21, from a taxable year of the trust ending with or within his taxable year.

If the beneficiary dies on a day other than the last day of the taxable year of a simple trust, the Proposed Regulations state his final return should include income "determined by the computations under section 652 for the taxable year of the trust in which his last taxable year ends." Assume, for simplicity, a trust that receives dividends of $100 the first day of each month throughout its fiscal years ending September 30, 1956 and September 30, 1957. The trust has no expenses and income is currently distributable to A for life and then to B for life. A is on a calendar year basis and dies December 15, 1956. His final 1956 income tax return would report $1,200 income from the trust for its fiscal year ending September 30, 1956 and also $300 income from the trust for its fiscal year ending September 30, 1957. The difficulty is, that A's return is due April 15, 1957, and his share of the distributable net income of the trust for its year ending September 30, 1957 cannot be determined until September 30. The same rules apply if the existence of a beneficiary which is not an individual terminates during the taxable year of a simple trust.

The rule from the Proposed Regulations set forth in the paragraph above is considered by some as an attempt to legislate by regulation. The Code, in Section 652 (c), would appear to tax A in his final return only with the $1,200 of income from the fiscal year of the trust ended September 30, 1956. Where the trust has deductions, or receives its income in varying amounts at different times, see the discussion in Part 14 above relating to the income for John Doe and his son.

PART 23

The Proposed Regulations give an example of the rules for a simple trust which provides for distribution of all income equally to A and B, with capital gains allocated to corpus. The trust and the beneficiaries are on a calendar year basis, and the trust makes no provision for the treatment of depreciation, which is computed to be $5,000. The following are the items of income and expense, and their allocation to "income", "distributable net income" and "taxable income":

Income:	*Amount*	*Income*	*Distributable Net Income*	*Taxable Income*
Rents	$25,000.00	$25,000.00	$25,000.00	....
Dividends (domestic corporations)	50,000.00	50,000.00	50,000.00	....
*Tax-exempt interest	25,000.00	25,000.00	25,000.00	....
Long-term capital gains	15,000.00	....	....	$15,000.00
	$115,000.00	$100,000.00	$100,000.00	$15,000.00
Deductions:				
Taxes, etc. directly attributed to rents	$5,000.00	$5,000.00	$5,000.00	....
*Commissions allocable to income	2,600.00	2,600.00	2,600.00	....
*Commissions allocable to principal	1,300.00	....	1,300.00	....
Capital gain deduction, 50%	7,500.00	....	....	$7,500.00
Exemption	300.00	....	....	300.00
	$16,700.00	$7,600.00	$8,900.00	$7,800.00
Income for trust accounting	....	$92,400.00	....	....
Distributable net income	....	....	$91,100.00	....
Taxable income	....	....	....	$7,200.00

Tax-exempt interest	*$25,000*		Deductions not directly attributable to a specific class of income	
Total income entering into computation of Distributable Net Income See Part 21 above	$100,000	x	$3,900	= $ 975.00

Tax-exempt interest	$25,000.00
Less—deductions allocated thereto	975.00
Tax-exempt interest as adjusted, includible in distributable net income	$24,025.00

The distribution deduction is computed as follows (See Part 19 above):

Distributable net income		$91,100.00
Deduct:		
Tax-exempt interest as adjusted	$24,025.00	
Dividend exclusion	50.00	24,075.00
Distributable net income adjusted		$67,025.00

* The tax-exempt interest should actually be brought into distributable net income at an amount adjusted for indirect expenses, income and principal, allocable thereto, as follows:

In the example given above, note that the distributable net income adjusted for the purpose of determining the distribution deduction ($67,025.00) is less than the income required to be distributed currently ($92,400.00), and therefore the distribution deduction is limited to the adjusted distributable net income ($67,025.00).

The distribution deduction for the purpose of Form 1041 is taken as $67,075.00 without reduction for the $50 dividend exclusion. See the last paragraph of Part 18 above.

The last step for the example given above is to compute the character of the amounts includible in the gross income of the beneficiaries, A and B. Assuming that the trustee elects to allocate to rental income the deductible portion of expenses not directly attributable to specific classes of income, the computations are as follows:

	1. *Rents*	2. *Dividends*	3. *Tax-exempt Interest*	4. *Total*
(a) Items of total income entering into the computation of distributable net income	$25,000.00	$50,000.00	$25,000.00	$100,000.00
(b) Less—Rental expenses	5,000.00	....	....	5,000.00
(c) —Trustees commissions	2,925.00	....	975.00	3,900.00
(d) Total deductions	$7,925.00	....	$975.00	$8,900.00
(e) Character of amounts in the hands of the beneficiaries	$17,075.00	$50,000.00	$24,025.00	$91,100.00

A and B are to receive the trust income in equal shares, and therefore each is deemed to have received one-half of the amounts on line (e) for columns 1, 2 and 3.

Depreciation of $5,000 is divided between A and B in proportion to the income of the trust distribution to each. In this example A and B each receive one-half of $92,400, the income of the trust for trust accounting purposes, and are deemed for income tax purposes to have received one-half of the distributable net income of $91,100, so each may deduct one-half of the $5,000 depreciation, or $2,500 each. See Part 11 above. The instructions for Form 1041 for 1956, in Specific Instruction No. 33, state that the allowable deduction

for depreciation and depletion is to be on the basis of the "trust income" allocable to the beneficiaries and the trust. In the case of an estate, the allocation is based on the "income" of the estate.

PART 24

§ 1.661 furnishes regulations for estates and complex trusts, and therefore includes:

(a) Estates.

(b) Trusts which are not required under the terms of the governing instrument to distribute all their income currently.

(c) Trusts which pay, credit or are required to distribute amounts other than income during the taxable year.

(d) Trusts which pay, permanently set aside, or use any amounts for charity, etc.

As mentioned in Part 19 above, a trust falling within the classification "c" above, if otherwise qualifying as a simple trust, remains a simple trust except in the year or years of actual distribution of amounts other than income.

PART 25

For complex trusts and estates, distribution deductions are allowed, first, for income of the taxable year required to be distributed currently (so-called "first tier" distributions), and, second, for other amounts properly paid, credited, or required to be distributed during the taxable year ("second tier" distributions). However, the distribution deduction is limited to distributable net income, adjusted as set forth below in Part 15 above.

"Income required to be distributed currently" includes any amount required to be distributed, which may be paid out of income or corpus (such as an annuity) to the extent such an amount is paid out of income for the taxable year.

"Other amounts" (second tier distributions) include payment of a widow's allowance, that part of an annuity not paid out of current income, and distributions of property in kind. Certain distributions, such as legacies, are *not* considered as "other amounts," and are described in § 1.663 (Part 37 below). If income may be accumulated or distributed in the discretion of the fiduciary, distribution of such income would be a second tier distribution. This would normally be the case for income distributed by an estate where there is no will, or where the will is silent as to distribution of income during the period

of administration, until a court has directed distributions of income and the discretion of the fiduciary has terminated.

If the fiduciary has a power to distribute corpus to a beneficiary, any such discretionary distribution of corpus would be a second tier distribution.

Second tier distributions would also include amounts applied or distributed out of corpus or out of sources other than income for the taxable year, for a grantor under Sec. 677 (b) or applied to support obligations of an individual under Sec. 678 (c).

Amounts used to discharge a person's legal obligations under § 1.662 (a)-4 also qualify as first tier or second tier distributions, as the case may be.

PART 26

§ 1.661 (b): unless the governing instrument specifically provides for allocation of the classes of income, the character of the amounts distributed is allocated as set forth in Part 21 above for simple trusts, being based on the various classes of income entering into the computation of distributable net income.

Deductions are allocated among the items of distributable net income as set forth in Part 21 above for simple trusts.

If there is a deduction for charity, etc., that deduction is *first* apportioned among each class of income entering into the computation of distributable net income, before the allocation of other deductions. See Part 15 above.

PART 27

§ 1.661 (c): no distribution deduction is allowed with respect to any item of distributable net income which is excluded from gross income, such as tax-exempt interest. Under the Proposed Regulations, a distribution deduction is not allowed with respect to the dividend exclusion. However, see the last paragraph of Part 18 above for the different treatment of the dividend exclusion on Form 1041.

PART 28

§ 1.661 **(Example)**: the Proposed Regulations furnish an example of a calendar year trust, the terms of which require $10,000 to be paid annually out of income to a designated charity. The trustee has discretion to accumulate the balance of the income or to distribute all or a portion of the balance to beneficiary A. Expenses are charged against income. The trust instrument provides that trust corpus is to be kept intact. In 1955, the trustee pays

$10,000 from income to the charity and distributes $15,000 from income to A. Income and expenses are as follows:

Income:	*Amount*	*Income for Trust Accounting*	*Distributable Net Income*
Dividends	$10,000.00	$10,000.00	$10,000.00
Partially tax-exempt interest	10,000.00	10,000.00	10,000.00
Fully tax-exempt interest	10,000.00	10,000.00	10,000.00
Rents	20,000.00	20,000.00	20,000.00
	$50,000.00	$50,000.00	$50,000.00
Deductions:			
Rental expense	$2,000.00	$2,000.00	$2,000.00
Depreciation	3,000.00	3,000.00	3,000.00
Trustee's commissions:	5,000.00	5,000.00	....
Allocated to taxable income	....	....	4,000.00
Allocated to tax-exempt interest	....	....	1,000.00
Charity	10,000.00	....	10,000.00
	$20,000.00	$10,000.00	$20,000.00
Income for trust accounting purposes		$40,000.00	....
Distributable net income			$30,000.00

With the trustee electing to allocate the deductible portion of commissions against rental income, distributable net income is computed as follows to show "character of amounts":

Rental income	....	$20,000.00	....
Less—share allocated to charity payment of $10,000, 20,000/50,000 x $10,000	$4,000.00	....	....
—Rental expense	2,000.00	....	....
—Depreciation	3,000.00	....	....
—Trustee's commission	4,000.00	13,000.00	$7,000.00
Taxable dividends	....	$9,950.00	....
Less—share allocated to the charity payment of $10,000, 10,000/50,000 x $10,000	....	2,000.00	7,950.00
Excluded dividends	....	....	50.00
Partially tax-exempt interest	....	$10,000.00	....
Less—share allocated to the charity payment of $10,000, 10,000/50,000 x $10,000	....	2,000.00	8,000.00

	Amount	*Income for Trust Accounting*	*Distributable Net Income*
Tax-exempt interest	....	$10,000.00	....
Less—share allocated to the charity payment of $10,000, 10,000/50,000 x $10,000	$2,000.00	....	....
—trustee's commissions, 10,000/50,000 x $5,000	1,000.00	3,000.00	$7,000.00
Distributable net income			$30,000.00

The distribution deduction for the $15,000 distributed to A is $11,475. The computations and the character of amounts are as follows:

Rental income	7,000/30,000 x $15,000	$3,500.00
Taxable dividends	7,950/30,000 x $15,000	3,975.00
Partially tax-exempt interest	8,000/30,000 x $15,000	4,000.00
Distribution deduction		$11,475.00

Form 1041 allows a distribution deduction of $11,500. See the last paragraph of Part 18 above.

The charity deduction for the payment of $10,000 to the charity is $8,000, computed as follows:

Payment to charity	$10,000.00	
Less—portion attributable to tax-exempt interest, 10,000/50,000 x $10,000	2,000.00	$8,000.00

The taxable income of the trust is $11,375, computed as follows:

Gross income:		
Rental income		$20,000.00
Dividends ($10,000 less $50)		9,950.00
Partially tax-exempt interest		10,000.00
		39,950.00
Deductions:		
Rental expense	$2,000.00	
Depreciation	3,000.00	
Trustee's commissions ($5,000 - $1,000)	4,000.00	
Charity	8,000.00	
Distribution deduction	11,475.00	
Exemption	100.00	28,575.00
Taxable income		$11,375.00

The trust is allowed a credit in respect to dividends of $3,975, as follows:

Total dividends		$10,000.00
Less—dividend exclusion	$50.00	
—amount deemed paid to the charity	*2,000.00	
—amount deemed distributed to A	3,975.00	6,025.00
		$3,975.00

The trust is allowed a credit in respect to partially tax-exempt interest of $4,000, as follows:

Total partially tax-exempt interest		$10,000.00
Less—amount deemed paid to the charity	*2,000.00	
—amount deemed distributed to A	4,000.00	6,000.00
		$4,000.00

PART 29

§ 1.662 (a)-1 provides that the beneficiary of an estate or complex trust is to include in his gross income the sum of (1) amounts of income required to be distributed to him currently and (2) all other amounts properly paid, credited or required to be distributed to him. The foregoing rules are subject to the rules that follow.

PART 30

§ 1.662 (a)-2: currently distributable income is first included in his gross income (so-called "first tier" distributions). However, if income currently distribuatable to all beneficiaries is greater than distributable net income computed before any charity deduction, a beneficiary includes an amount which bears the same ratio to the distributable net income so computed as the amount of his share of currently distributable income bears to the total of income currently distributable to all beneficiaries.

* Neither Schedule E of Form 1041, nor the instructions for Schedule E, reduce the dividend amount used in computing the fiduciary's credit, for the amount of dividends allocated to the charity payment. Nor do the instructions for Form 1041 indicate that the amount of partially tax-exempt interest used in computing the fiduciary's credit should be reduced by the portion attributed to the charity payment. The Code, in Section 642, refers only to a reduction of the credit bases for amounts allocable to beneficiaries, and for the $50 dividend exclusion. The charity deduction is a deduction, and not a distribution to a beneficiary. See Part 38 below. Estates and trusts are in general taxed in the same manner as individuals (see Part 2 above). An individual need not allocate dividends or partially tax-exempt interest to his charity deduction for the purpose of the credits and it is difficult to find justification for such a provision in the Regulations.

Currently distributable income ("first tier" distributions) includes any amount required to be paid out of income or corpus such as an annuity, to the extent the amount is satisfied from income for the taxable year. This is similar to the rule for § 1.661 (a)-2 (b) noted in Part 25 above. If an annuity is to be distributed free of income tax, the fiduciary paying the income tax of the annuitant resulting from the receipt of the annuity, payment of the tax by the fiduciary will be deemed to be income distributed to the annuitant to the extent the payment is made from income.

PART 31

The Proposed Regulations furnish an example of a trust that is to pay $5,000 annually to a charity from income and is to distribute $20,000 from current income to A. An annuity of $12,000 is to be paid to B from income and/or corpus. All expenses are charged against income, and capital gains are allocated to corpus. The trust has net probate income of $30,000 after payment of expenses derived from taxable interest, but its probate income is $25,000 *after* deducting the $5,000 for charity. Distributable net income *before* deducting the $5,000 for charity is $30,000, and thus exceeds probate income as computed above. Therefore the beneficiaries' income from the trust is based on probate income, as adjusted for the $5,000 paid to charity. The shares of trust income for the beneficiaries, A and B, are computed as follows:

Net probate income before charity	$30,000.00
Less—charity	5,000.00
Remaining income available for distribution of $20,000 to A, and distribution of $5,000 to B in respect to B's annuity	$25,000.00

A would report trust income of $20,000, and B would report trust income of $5,000.

If this same trust had $10,000 of administration expenses, commissions, etc., chargeable to corpus, distributable net income *before* deducting the $5,000 for charity is reduced to $20,000. Net probate income after the $5,000 charity deduction remains at $25,000, the amount treated as distributable currently. A therefore would report $16,000 (20,000/25,000 x 20,000) and B would report $4,000 (5,000/25,000 x 20,000). Following this example on Form 1041, Line 17 of page 1 would be $15,000; line 5 of Schedule G would be $15,000; line 3 of Schedule H would be $32,000; line 7 of Schedule H would be $15,000; and line 18 of page 1, the distribution deduction, would be $15,000. However, the total of column 7 of Schedule C would be $20,000, the amounts includible in gross income of the beneficiaries. It thus appears that the return is out of balance and $5,000 of the corpus deductions have been lost for the beneficiaries.

PART 32

§ 1.662 (a)-3: So called "second tier" distributions ("other amounts") may be includible in gross income of beneficiaries if they are paid or credited or required to be distributed during the taxable year, to the extent that the distributable net income of the estate or trust is large enough to support them. Payments classified as "second tier" distributions would include:

(a) Discretionary distributions, whether from income or corpus.

(b) Distributions required upon the happening of a specified event.

(c) Annuities to the extent paid from corpus.

(d) A widow's allowance.

(e) Distributions from corpus, if not within the exceptions of Sec. 663 (a).

(f) Certain payments of obligations for support.

The "first tier" distributions are deducted first from the classes of income included in distributable net income, and the balances, if any, are allocated to the "second tier" distributions in the proportion that the "second tier" amount for each beneficiary bears to the total of "second tier" distributions.

The application of the above paragraph may be illustrated by an example of a trust with income of $20,000 after deducting all expenses. $10,000 of income is required to be distributed currently to A. The trustee may accumulate or distribute the remaining income and may invade corpus for A, B, C, or D. The trustee does distribute an additional $5,000 to A, and $3,000 each to B, C and D. It makes no difference whether these discretionary distributions are from income or corpus. The amounts taxable to A, B, C and D are computed as follows:

Income of trust, after expenses		$20,000.00
Less—first tier distribution to A		10,000.00
Remaining for second tier distributions		$10,000.00
Second tier distributions:		
A—5,000/14,000 x $10,000	$3,571.43	
B—3,000/14,000 x $10,000	2,142.86	
C—3,000/14,000 x $10,000	2,142.86	
D—3,000/14,000 x $10,000	2,142.85	
		$10,000.00

Schedule C of Form 1041 will be as follows, assuming the trust's income is from taxable interest:

	Col. 3	*Col. 4*	*Col. 7*
A	$10,000.00	$5,000.00	$13,571.43
B	....	3,000.00	2,142.86
C	....	3,000.00	2,142.86
D	....	3,000.00	2,142.85
Totals	$10,000.00	$14,000.00	$20,000.00

The tier system may result in giving the benefits of corpus deductions first to undistributed income. If the corpus deductions exceed undistributed income, the excess will benefit second-tier distributions next, and first-tier distributions last.

Under the terms of a trust, half the income is payable to A; the other half may be distributed to B or accumulated.

	Income	*Principal*
Taxable income received	$10,000.00	....
Mandatory distribution to A	5,000.00	....
Distributed to B under discretionary powers	2,000.00	....
Income accumulated	3,000.00	....
Charges to Principal		$4,000.00

No tax to the trust.

A is taxed with	$5,000.00
B is taxed with	$1,000.00

If the charges to principal had been $6,000, A would be taxed with $4,000 and B would not be taxed on the $2,000 he received.

Part 33

§ 1.662 (a)-4: The Proposed Regulations provide that, if an amount is used, under the terms of a will or trust instrument, toward the discharge of a legal obligation of any person, that amount is to be included in the gross income of that person, subject to the rules of Section 662 (a) (1) or (2). See Parts 29 and 30 above. There are exceptions to this rule in the case of alimony, etc.

Payments for support of a minor child are to be taxed to a parent if the parent, having resources, under local law must use them for support of the child before using property or income belonging to the child. The opposite situation might exist where an adult child having resources is required under local law to support a parent from the child's resources without recourse to

the parent's resources. This rule in the Proposed Regulations is not restricted to trusts created by the one having a legal obligation of support, but would include income from trusts under deed or under will, created by third parties. Strong objections to this part of the proposed Regulations were filed with the Commissioner of Internal Revenue, and voiced in the public hearings held in Washington. The objections made the point that there would be no uniformity in application because of the differences in state laws as to whether a support obligation exists if the dependent has resources of his own. Reference was also made to the novelty and inequity of taxing Parent A for trust income used for support of Child B, if, for instance, the income came from a trust under the will of an aunt or other relative of Child B. Until the Regulations are issued in final form, it will not be known whether or not the Commissioner will try to maintain his position in this respect.

PART 34

§ 1.662 (b)-1 sets forth the rules for determining the character of the amounts includible in the gross income of a beneficiary of an estate or complex trust.

If there are no deductions for charity, etc., the allocation is based on the proportion of each class of income entering into the computation of distributable net income, unless the governing instrument specifically provides for allocation of different classes of income to different beneficiaries. The principles set forth in § 1.652 (b)-1 apply. See Part 21 above.

If there is a deduction for charity, etc., from current income or gains, and there is no specific provision in the instrument as to the source of the payment to charity, the payment to charity is first allocated to the various classes of probate income (not distributable net income) in accordance with the rules set forth in § 1.643 (a)-6 (c). See the last paragraph of Part 15 above. The charity allocation is to be made *before* the allocation of deductions among the items of distiributable net income. These rules apply for the charity allocation even though in comparing income required to be distributed currently with distributable net income for the purpose of § 1.662 (a)-2 (b), the charity deduction is not made in computing distributable net income. See the first paragraph of Part 30 above.

PART 35

§ 1.662 (c) for estates and complex trusts corresponds to § 1.652 (c) for simple trusts (Part 22 above) where beneficiary and estate or trusts have different taxable years. Under § 1.662 (c) the amount taxable to the bene-

ficiary is based on the distributable net income of the estate or trust and the amounts properly paid, credited or required to be distributed to the beneficiary for taxable years ending within or with the beneficiary's taxable year. If the beneficiary dies on a day other than the last day of the taxable year of an estate or simple trust, the rules correspond to those for simple trusts. See the second paragraph of Part 22 above.

PART 36

The Proposed Regulations give an example of a calendar year trust under will, one-half of the income distributable currently to W and the other half subject to the trustee's discretion to pay it to D, to charities, or to accumulate. Capital gains are allocated to corpus under local law. The will makes no provision in respect to depreciation. The income and deductions for trust accounting purposes are as follows:

		Income	*Corpus*
Income:			
Rents		$50,000.00	....
Domestic dividends		50,000.00	....
Tax-exempt interest		20,000.00	....
Partially tax-exempt interest		10,000.00	....
Long-term capital gains		....	$20,000.00
		$130,000.00	$20,000.00
Expenses:			
Depreciation	$10,000.00		
Expenses attributable to rental property	....	$15,400.00	....
Income commissions	....	2,800.00	....
Principal commissions	....	....	$1,100.00
		$18,200.00	$1,100.00
Income for trust accounting		$111,800.00	
One—half distributable to W	$55,900.00	....	
One—quarter distributed to charity	27,950.00	....	
One—quarter distributed to D	27,950.00	....	
		$111,800.00	

"Distributable net income" is determined as follows:

Rents		$50,000.00
Dividends		50,000.00
Partially tax-exempt interest		10,000.00
Tax-exempt interest	$20,000.00	....

Less—trustee's commissions allocable thereto: 20,000/130,000 x 3,900	$600.00	....	....
—Charity deduction allocable thereto: 20,000/130,000 x 27,950 ...	4,300.00	$4,900.00	$15,100.00
			$125,100.00
Less—Deductions:			
Rental expense		$15,400.00	....
Trustees commissions ($3,900 less $600 above)		3,300.00	....
Charity ($27,950 less $4,300 above)		23,650.00	....
			$42,350.00
Distributable net income			$82,750.00

Since the distributable net income of $82,750 is less than the income of $83,850 distributed to W and D ($55,900 plus $27,950), the deduction allowed to the trust is based on distributable net income, but adjusted as follows to eliminate items of income not included in the gross income of the trust (see Part 27 above):

Distributable net income		$82,750.00
Less—tax-exempt interest net of expense allocation ..	$15,100.00	
—dividend exclusion	50.00	15,150.00
Distribution deduction (See last paragraph of Part 18 above)		$67,600.00

The income taxable to the trust in this example may be easily computed by a short-cut method because all the trust "income" is distributed or paid to charity:

Long-term capital gains	$20,000.00	
Less—50% deduction	10,000.00	
		$10,000.00
Less—exemption		100.00
"Taxable income" of trust		$9,900.00

The proper method of computation, and the one necessary to use if all income were not distributable or distributed, would be as follows:

Gross income:	
Rental income	$50,000.00
Dividends, less $50 exclusion	49,950.00
Partially tax-exempt interest	10,000.00
Capital gains	20,000.00
	$129,950.00

Deductions:		
Rental expenses	$15,400.00	
Trustee's commissions ($3,900 less $600)	3,300.00	
Charity	23,650.00	
50% of long-term capital gain	10,000.00	
Distribution deduction	67,600.00	
Exemption	100.00	$120,050.00
"Taxable income" of trust		$9,900.00

The trustee elects to allocate the deductible portion of commissions against rental income, and net rental income is deemed paid or distributed as follows:

Gross rental income		$50,000.00
Less—allocation to charity: 50,000/130,000 x 27,950	$10,750.00	
—rental expense	15,400.00	
—deductible portion of commissions, income and corpus	3,300.00	29,450.00
Deemed distributed to beneficiaries		$20,550.00

Dividends are allocated as follows:

Dividends less $50 exclusion	$49,950.00
Less—allocation to charity: 50,000/130,000 x 27,950	10,750.00
Deemed distributed to beneficiaries	$39,200.00

Tax-exempt interest has a similar allocation:

Tax-exempt interest		$20,000.00
Less—allocation to charity: 20,000/130,000 x 27,950	$4,300.00	
—Trustee's commissions: 20,000/130,000 x 3,900	600.00	4,900.00
Deemed distributed to beneficiaries		$15,100.00

Partially tax-exempt interest is allocated as follows:

Partially tax-exempt interest	$10,000.00
Less—allocation to charity: 10,000/130,000 x 27,950	2,150.00
Deemed distributed to beneficiaries	$7,850.00

The total of the amounts deemed distributed to beneficiaries is therefore $82,750, computed as follows:

Rents	$20,550.00
Taxable dividends	39,200.00
Dividend exclusion	50.00

Tax-exempt interest	$15,100.00
Partially tax-exempt interest	7,850.00
	$82,750.00

The items of income making up the $55,900 distributable to W are computed as follows (note that the numerator of the fraction for dividends is increased $50 for the dividend exclusion):

Rents	20,550/82,750 x $55,900	$13,882.00
Dividends	39,250/82,750 x $55,900	26,515.00
Tax-exempt interest	15,100/82,750 x $55,900	10,200.00
Partially tax-exempt interest ...	7,850/82,750 x $55,900	5,303.00
		$55,900.00

The items of income allocated to the discretionary (second-tier) distribution of $27,950 to D are computed by reference to distributable net income, inasmuch as distributable net income ($82,750) is less than the sum of the first-tier distribution to W and the second-tier distribution to D ($55,900 plus $27,950=$83,850). D is deemed to receive $26,850, the balance of the amounts deemed distributed $82,750 less $55,900=$26,850). The items of income making up the $26,850 are computed as follows:

Rents	20,550/82,750 x $26,850	$6,668.00
Dividends	39,250/82,750 x $26,850	12,735.00
Tax-exempt interest	15,100/82,750 x $26,850	4,899.00
Partially tax-exempt interest ..	7,850/82,750 x $26,850	2,548.00
		$26,850.00

Depreciation of $10,000 is, in the Proposed Regulations, allocated in accordance with the use of trust income. W, receiving half of the trust income, may deduct $5,000 of the depreciation. D, receiving one quarter of the trust income, may deduct $2,500 of the depreciation. No one receives any deduction for the other quarter of the depreciation under the Proposed Regulations, inasmuch as the other quarter of trust income represents the charity deduction. The Proposed Regulations appear to extend the definition of "income" in Code Section 643 (b) to include the "income" referred to in Code Sections 167 (g) and 611 (b). See the second paragraph of Part 11 above.

In the example worked out above, it is apparent that the benefit of the corpus deductions inures solely to the second-tier distribution. The first-tier

distributee is taxed on what he receives, adjusted for a share of tax-exempt income; the second-tier distributee, on the other hand, has his taxability limited by what remains of distributable net income. The tier method may produce odd results, as in the case of a trust with income of $100,000 from taxable interest, one half of the income being distributable currently to W and the other half to be distributed to D or accumulated in the discretion of the trustee. Trustee's compensation of $5,000 is charged annually to corpus under the terms of the trust. The trustee regularly distributes half the income to W and half to D. W is taxed with $50,000, but D alone benefits from the corpus deduction and is taxed with only $45,000.

PART 37

§ 1.663 (a)-1 enumerates the exceptions whereby certain amounts paid to beneficiaries as legacies, etc., will not be deductible by the fiduciary nor taxed to the recipient. To qualify as an exception, the payment must represent a gift or bequest of a specific sum of money or of specific property, and must be a gift or bequest required by the specific terms of the will or trust instrument, which must require payment "either all at once or in not more than three installments." The following do not qualify as exceptions:

(a) An amount payable only from income, whether it be current or accumulated income.

(b) An annuity, or periodic gifts of specific property "in lieu of or having the effect of an annuity."

(c) Distribution of the residuary corpus.

(d) A gift or bequest paid in one, two or three installments, if the instrument requires payment in more than three installments.

(e) A widow's support allowance under local law.

The failure to include a devise as an exception in the same category with gifts and bequests was apparently an oversight in drafting the Code. The Proposed Regulations refer to a "bequest" of a house as within the exceptions.

A bequest of $100,000, a house, its furnishings, and silver, all to one person, although four separate classes of items, may be aggregated and considered an amount payable as a specific sum of money or specific property.

On the other hand, a devise of ten houses to an individual, one each year for ten years, would not qualify as an excluded distribution.

Comments filed with the Commissioner of Internal Revenue after issuance of the Proposed Regulations suggested that the final regulations include a statement of principle according to which certain formula marital deductions for Federal estate tax might be determined to be a "specific sum or a specific bequest," distribution of which would be among the exceptions to "other amounts."

It should be carefully noted that distribution of residue is not within the exceptions. The writer prepared a fiduciary return for an estate which had $2,000 of income for the taxable year. The will left everything outright to the decedent's son. Among the assets of the estate were a race horse valued at $2,500 and the decedent's watch valued at $100. These were delivered to the son during the year, and the fiduciary return had to show him taxable with the full $2,000 of income. In drafting wills, and even deeds of trust, under the 1954 Code, it may often be wise to make specific provision for distribution of personal effects, and legacies of money, even though the residue will eventually be distributed to the same distributees. Such provisions may make it possible to preserve the advantages of the estate as a separate taxpayer until the year of termination, and yet put money or other assets in the hands of the beneficiary.

PART 38

§ 1.663 (a)-2 provides that amounts allowable as charity, etc. deductions may *not* be allowed as distribution deductions. The fiduciary does *not* have the choice of deducting such amounts as distributions; he can only deduct them as amounts for charity under Section 642 (c) of the Code.

PART 39

§ 1.663 (a)-3 denies a distribution deduction to an estate or trust for any amount deemed to have been distributed to a beneficiary in a preceding year under Sections 651 or 661. A trust whose income is currently distributable may distribute income periodically, monthly, quarterly or at other times convenient to the beneficiary and to the trustee. At the end of a taxable year of the trust, recent collections of income may be on hand, awaiting the next distribution date. The subsequent distribution of these items would not give the trust a distribution deduction when distributed, inasmuch as the items under Sec. 651, would be deemed to have been distributable to the beneficiary in the year when received by the trust.

A question may arise as to whether trust income is currently distributable, and the trust therefore a simple trust, in those cases where the instrument provides for distribution of income, say April 1 and Otcober 1, to A if living,

otherwise to B. If the trust is on a calendar year basis, the trustee cannot be sure that the income collected during the period October 1-December 31 will be distributed to A. Nevertheless, it would appear that the trust is a simple trust, and all the income for the entire taxable year is currently distributable to A, unless A should die before April 1. There would seem to be an analogy here to the treatment of a sprinkling trust as a simple trust in § 1.651 (a)-1-(b)(2).

PART 40

§ 1.663 (b) provides a sixty-five day rule for certain trusts if a formal election for such treatment is made by the fiduciary. The requirements are as follows:

(a) The trust must have been in existence prior to January 1, 1954.

(b) The terms of the trust must not have a provision for distribution of an amount in excess of the income of the immediately preceding taxable year.

(c) The fiduciary must elect to have the 65-day rule under Section 663 (b) apply, by a statement attached to the return for the first taxable year of the trust subject to the Internal Revenue Code of 1954.

The election must be filed not later than the time prescribed by law for filing the return for such taxable year, including extensions thereof. The election, once filed, is irrevocable for the taxable year and all future taxable years. The effect of a valid election is to treat distributions made within the first 65 days of the taxable year of the trust as amounts paid or credited on the last day of the preceding taxable year.

PART 41

§ 1.663 (c) provides the rules for treating separate shares of different beneficiaries in a complex trust as separate trusts, but only for the purpose of determining the amount of distributable net income applicable to the respective beneficiaries. To qualify for the separate shares treatment, the beneficiaries must have substantially separate and independent shares, as when distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. An example of a trust that qualifies for separate shares treatment would be one where the residue of an estate is to remain in trust but is to be divided into separate shares for the testator's children, and the trustee is given discretion, as to each share, to distribute or accumulate income, or to distribute principal or accumulated income. Separate share treatment

applies even though the instrument provides that, upon death of a beneficiary, his share is to be added to other shares.

The separate share rule does not prohibit the filing of separate fiduciary returns for separate trusts, if the instrument does in fact create separate trusts.

The separate share rule, where applicable, is obligatory, not optional.

The separate share rule, as stated above, applies only in computing distributable net income for the separate shares of the trust and their beneficiaries. It has no application to the filing of returns; payment of tax; the $50 dividend exclusion; the trust's exemption; or the excess deductions and carryover losses allowed to distributees on termination of the trust. The separate share rule may be applicable even though no physical segregation of assets is made, and even though the trustee does not maintain separate accounts for the shares.

The effect of the separate share treatment is to compute the amount of distributable net income for each share as if each share constituted a separate trust. Any deduction or any loss which is applicable only to one separate share will be available to that share and not to any other share.

If the trustee has powers under the instrument relating to distribution, apportionment or accumulation of income, or relating to distribution of corpus, to or for one or more beneficiaries within a group or class, the separate share rule is not thereby applicable, unless the distributions or accumulations in respect to one share cannot affect other shares, or unless compensating adjustments must be made, so that substantially separate and independent shares exist. Thus A and B may otherwise appear to have separate shares in a trust, but if the trustee is empowered to invade the entire corpus of the whole trust for A, the separate share rule is not applicable.

A separate share may have more than one beneficiary, and the same person may be a beneficiary of more than one share, without eliminating the applicability of the separate share rule.

The Proposed Regulations provide that "The separate share rule may also be applicable to successive interests in point of time, as for instance in the case of a trust providing for a life estate to A and a second life estate or remainder to B." It has been assumed that this sentence will have an important bearing on the taxation of trust income to the beneficiaries in the year when a life tenant of a trust dies and corpus expenses are paid later in the same year. It is assumed that the income for the deceased life tenant is computed as a separate share up to the date of his death, and that the corpus deductions are applicable only to a separate share computed for the period after

his death. One difficulty in accepting this assumption without further clarification lies in the restriction of the separate share rule to complex trusts. See § 1.663 (c)-1-(a)(1) of the Proposed Regulations: ". . . treated as separate trusts for the sole purpose of determining the amount of distributable net income applicable to the respective beneficiaries under *sections 661 and 662.*" (Emphasis supplied). If the trust terminates upon death of the life tenant and is distributed in the same taxable year, it becomes a complex trust and the separate shares rule is applicable. If distribution is not completed in the taxable year of the trust in which the life tenant dies, see comment in Part 4 above.

The Proposed Regulations give an example of a trust that qualifies for the separate shares treatment for the separate and equal shares of three beneficiaries A, B and C. In the taxable year of 1955 the trust receives taxable royalty income of $20,000 and has deductible expenses of $5,000. Distributions are within the discretion of the trustee, who distributes $12,000 that year to A, and makes no other distributions. The separate share of A is computed as follows:

One-third of the trust's income	$6,666.67
Less—one-third of the trust's expenses	1,666.67
Distributable net income of A's share	$5,000.00

The trust would be entitled to a distribution deduction of $5,000 and A would report trust income of $5,000. The $7,000 balance of A's $12,000 distribution would be deemed to be a distribution from other than 1955 income, and might be subject to the throwback provisions of Sections 665-668. The taxable income of the trust would be as follows:

Royalties		$20,000.00
Deduct—expenses	$5,000.00	
—distribution to A	5,000.00	
—trust exemption	100.00	10,100.00
Taxable income		$9,900.00

PART 42

As is evident from a study of the rules set forth in the Parts above, the 1954 Code made a number of drastic changes in the income taxation of estates and trusts. It is only natural for various inequities and difficulties to come to light when the new provisions are applied to specific situations. Legislative remedies have been suggested and may be seriously considered in drafting

amendments to the Code in 1957. The proposed Technical Amendments Bill of 1957, released late in October, 1956 by the Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means does not contain any sections dealing with the taxation of estates and trusts, but it is expected that many additional Code changes will be reflected in a later Bill in 1957 or 1958.

Among the suggestions that have been made, for future amendments to the Code, are the following:

1. Charges against corpus should be allowed to reduce income taxable to the fiduciary, such as capital gains, and only the excess would be allowable to reduce income taxable to beneficiaries.
2. The separate share rule should be made applicable to estates.
3. The conduit principle should be implemented to prevent loss to beneficiaries as to credits for partially tax-exempt interest or foreign taxes.
4. Payments to charity should be treated as distributions rather than as deductions.
5. The "tier" system should be revised or eliminated, to eliminate inequities.