§6.1 ALL INCOME TO SURVIVING SPOUSE

The surviving spouse is entitled to all income for life under a general power of appointment (IRC section 2056(b)(5)) or QTIP (IRC section 2056(b)(7)) marital deduction trust. Marital trust income limited by an ascertainable standard, such as "trustee shall distribute all of the net income of the marital trust as trustee in its reasonable discretion shall determine to be proper for my spouse’s health, education, support and maintenance in accordance with my spouse’s accustomed manner of living” will result in the disallowance of the marital deduction. Estate of Davis, 394 F.3d 1294 (9th Cir. 2005), affirming T.C. Memo 2003-55.

§6.1(a) Meaning Of Income

"Income,” means income as determined under the governing instrument and applicable state law. IRC section 643(b). If a governing instrument’s definition of income departs from the traditional principles of what constitutes income and principal, it will not be recognized by the IRS. Treas. Reg. §1.643(b)-1.

§6.1(b) Same Principles Apply To QTIP And GPOA Marital Deduction Trusts

Treas. Reg. §20.2056(b)-7(d)(2) (concerning QTIP trusts) provides for the application of the principles of Treas. Reg. §20.2056(b)-5(f) (concerning general power of appointment trusts) regarding the surviving spouse’s right to all income for life. Treas. Reg. §20.2056(b)-5(f)(1) provides:

[T]he surviving spouse is 'entitled for life to all the income from the entire interest or a specific portion of the entire interest’…if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Such degree of enjoyment is given only if it was the decedent's intention, as manifested by the terms of the trust...that the trust should produce for the surviving spouse during her life such an income, or that the spouse should have such use of the trust property as is consistent with the value of the trust corpus and its preservation. The designation of the spouse as sole income beneficiary for life of the entire interest or a specific portion of the entire interest will be sufficient to qualify the trust unless the terms of the trust and the surrounding circumstances considered as a whole evidence an intention to deprive the spouse of the requisite degree of enjoyment.

§6.1(c) Power To Terminate Trust May Suffice

If a marital deduction trust may be terminated during the life of the surviving spouse, through the exercise of a power of appointment by the surviving spouse or by distribution of the corpus to the surviving spouse, the interest passing in trust satisfies the condition that the surviving spouse must be entitled to all the income from the property if the surviving spouse (i) is entitled to the income until the trust terminates; or (ii) has the right exercisable in all events to have the corpus distributed to him or her at any time during life. Treas. Reg. §20.2056(b)-5(f)(6).

§6.1(d) Compelled Right To Income Suffices

The requirement that the surviving spouse must be entitled for life to all income, payable at least annually, will be satisfied if under the terms of the trust instrument, the surviving spouse has the right exercisable annually (or more frequently) to require distribution to him or herself of the trust income, and if not distributed, the trust income is to be accumulated and added to corpus. Treas. Reg. §20.2056(b)-5(f)(8).
§6.1(e) Delayed Receipt Of Income

Treas. Reg. §20.2056(b)-5(f)(9) provides that “[a]n interest is not to be regarded as failing to satisfy the condition…[that the surviving spouse be entitled to all income for life, payable at least annually] merely because the spouse is not entitled to income from estate assets for the period before distribution of those assets by the executor, unless the executor is, by the decedent’s…[governing instrument] authorized or directed to delay distribution beyond the period reasonable required for administration of the decedent’s estate.”

§6.2 NEW IRS REGULATIONS CONCERNING INCOME

On December 30, 2003, the IRS issued new final regulations that change (and update) the definition of “income” under IRC section 643(b).¹ The new regulations are aimed at dealing with the changing landscape of trustee powers under state law concerning the prudent investor rule,² and the 1997 version of the Uniform Principal and Income Act (“UPIA (1997)”).³ The new regulations apply to trusts and estates for taxable years ending after January 2, 2004.

§6.2(a) Prudent Investor Rule

The prudent investor rule encourages trustees to adopt a total return investment strategy designed to maximize the total return on trust assets. This tends to result in shifting trust investments toward equities and away from bonds, thereby having a potential adverse impact on the income beneficiary. Based on the traditional concepts of income and principal, the income beneficiary is entitled only to the rents, dividends, interest, and royalties earned by the trust, while capital gains are allocable to trust principal. The dividend return on equities as a percentage of their value traditionally has been substantially less than the interest return on bonds.

§6.2(b) Uniform Principal and Income Act

To ensure that the income beneficiary is not penalized if a trustee adopts a total return investment strategy under the prudent investor rule, several states have revised the definitions of income and principal, by adopting UPIA (1997). In a nutshell, UPIA (1997) provides a means to blend the Uniform Prudent Investor Act and the total return approach. This is accomplished in part by providing the fiduciary with discretionary power to reallocate principal (such as capital gains) and income (such as interest, dividends, rents, and royalties) to implement the total return approach. Section 104 of UPIA (1997) permits the trustee, under certain conditions, to make an adjustment between income and principal if necessary to ensure that both the income beneficiary and the remainder beneficiaries are treated impartially based on what is fair and reasonable to all of the beneficiaries.⁴ Thus, a receipt of capital gains that previously would have been allocated to trust principal may be allocated by the trustee to income (and thus be included in the trust’s DNI under Treas. Reg. §1.643(a)-3(b)) if necessary to treat the income beneficiary and remainder beneficiaries impartially, provided the trustee exercises its discretion of allocation in a manner that meets the requirements of Treas. Reg. §1.643(b)-1 and the discretion is authorized by state law. Treas. Reg. §1.643(b)-1. Conversely, a receipt of rent, dividends,

³ See, E. James Gamble, “If It’s The 1990s, It Must Be Time For Another Principal and Income Act,” in 32 Institute on Estate Planning ch. 8 (Matthew Bender, New York, 1998), for further discussion of UPIA (1997).
or interest that previously would have been allocated to trust income may be allocated by the trustee to principal if necessary to treat the income beneficiary and remainder beneficiaries impartially. Such allocation will be recognized for marital deduction income purposes, including QDOTs, if authorized by state law. Treas. Reg. §20.2056A-5(c)(2).

§6.2(c) Unitrust Payments

Some states allow the trustee to pay a unitrust amount to the income beneficiary in satisfaction of that beneficiary’s right to the income from the trust. This unitrust amount is a fixed percentage, sometimes required to be within a range set by state statute (such as three to five percent), of the fair market value of the trust assets determined annually or on the basis of a multiple-year rolling average.\(^5\)

Practice Point: When a unitrust contains a substantial amount of income in respect of a decedent under IRC section 691 (for which income taxes will have to be paid by either the trust or the beneficiary), consider whether income taxes should be taken into consideration when valuing trust assets for determining the unitrust amount.

§6.2(d) Requirements Of The Regulations

The new regulations pertaining to the definition of income for marital deduction purposes provide that a surviving spouse’s income interest in a marital deduction trust satisfies the income standard set forth in the marital deduction regulations if the spouse is entitled to income as defined under a state statute, such as UPIA (1997), that provides for a reasonable apportionment between the income beneficiary and the remainder beneficiaries of the total return of the trust and the statute meets the requirements of Treas. Reg. §1.643(b)-1. As Treas. Reg. §1.643(b)-1 makes clear, reasonable apportionment can be accomplished either through a unitrust definition of income that is authorized by state law, or by giving the trustee the power to make adjustments between income and principal, provided such power is authorized by state law. Treas. Reg. §§1.643(a)-3, 1.643(b)-1, 1.651(a)-2(d), 1.661(a)-2(f), 20.2056(b)-5(f)(1), 20.2056(b)-7(d)(1), 20.2056(b)-10, 20.2056A-5(c)(2), 20.2056A-13, 25.2523(e)-1(f)(1), and 25.2523(h)-2. In addition, a conforming amendment is made to Treas. Reg. §20.2056A-5(c)(2) providing rules regarding distributions of income from a QDOT.

Caution: Treas. Reg. §1.643(b)-1 provides that trust provisions that depart from the traditional principles of what constitutes income and principal are not recognized. For example, if a trust instrument directs that all the income shall be paid to the income beneficiary, but defines ordinary dividends and interest as principal, the trust will not be considered as a trust that “is required to distribute all its income currently” for purposes of IRC section 642(b) (relating to the personal exemption) and IRC section 651 (relating to simple trusts). Traditional principles of what constitutes trust income and principal are that dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, as stated above, an allocation of amounts between income and principal will be respected by the IRS if state law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation, or state law permits the trustee to make adjustments between income and principal to fulfill the trustee’s duty of impartiality between the income and remainder beneficiaries.

§6.2(e) Income Tax Consequence of Switching Between Income Definitions

\(^5\) See, Section 3A.07 of Horn, Flexible Trusts and Estates for Uncertain Times (ALI-ABA, Philadelphia, 2003) www.ali-aba.org/aliaba/BK26.asp, for a discussion of unitrusts and sample trust drafting language. See also, Paragraph 3.1(H) of Appendix 2 for a sample unitrust definition of income based on a percentage of the trust’s value determined on the basis of a three-year rolling average.