APPLICATION OF THE EQUITABLE ADJUSTMENT DOCTRINE TO THE SECTION 643(e)(3) ELECTION

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I. INTRODUCTION**

Prior to enactment of the Deficit Reduction Act of 1984, the Internal Revenue Code (the Code) provided that distributions of property in kind to ben-

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** Unless otherwise provided, all code references herein are to the Internal Revenue Code of 1954, as amended. [Ed. note. On October 22, 1986, Congress enacted the Tax Reform Act of eficiaries of a trust or estate were deemed to carry out distributable net income (DNI) to the extent of the property's fair market value at the time of distribution.[1] In such transactions, the trust or estate realized no gain or loss on the distribution unless the distribution was in satisfaction of a right to receive a specific dollar amount or specific property other than that distributed.[2]

The general effect of an in kind distribution of appreciated or depreciated property was a deduction to the estate or trust equal to the property's fair market value (provided there was sufficient DNI) and gross income of like amount to the beneficiary. In addition, the beneficiary received a fair market value basis in the property while the unrealized gain or loss in the distributed property went unrecognized to the trust or estate.[3] This treatment was inconsistent with the consequences resulting from a sale of the property by the trust or estate and subsequent distribution of the proceeds to the beneficiary. If income from such a sale were allocated to corpus, the entity would pay tax on the gain. The transaction would otherwise have the same economic results as the first mentioned distribution. Thus, two transactions that were in substance the same had different consequences as a result of application of Treasury Regulation section 1.661(a)-2(f)(1)-(3).

The Deficit Reduction Act of 1984 significantly changed the treatment of like-kind distributions from estates or trusts.[4] New section 643(e) provides the general rule that distributions of property from a trust or estate are treated as carrying out DNI only to the extent of the lesser of the property's basis, adjusted for gain or loss recognized by the trust or estate on the distribution, or fair market value at the time of distribution.[5] However, section 643(e)(3) allows the fiduciary to elect to recognize gain or loss on the distribution as if there had been a sale to the beneficiary at fair market value.[6] Thus, under the general rule a trust or estate may no longer distribute appreciated or depreciated property to a beneficiary at a fair market basis and recognize no gain or loss on the transaction. Unless an election to recognize gain or loss is made, the beneficiary takes a basis equal to the trust or estate's basis in the property.

The fiduciary's election, therefore, can have negative or positive consequences to beneficiaries, depending on their relative interests in the corpus or income and applicable fiduciary accounting rules. Under certain fiduciary accounting rules, an election under section 643(e) may result in one beneficiary's receiving tax benefits while another bears the economic burden. Arguably, such a result justifies some equitable adjustment through the application of the

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1986, Pub. L. No. 99-514, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 12. Provision was made to rename the Internal Revenue Code of 1954 as the Internal Revenue Code of 1986. *Id.* § 2 (hereinafter referred to as Int. Rev. Code of 1986)].

1. Treas. Reg. § 1.661(a)-2(f)(2) (West 1986).
2. *Id.* § 1.661(a)-2(f)(1).
3. *Id.* § 1.661(a)-2(f)(3).
4. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 81, 1984 U.S. CODE CONG. & ADMIN. NEWS (98 Stat.) 597.
5. I.R.C. § 643(e)(2) (West 1986).
6. *Id.* § 643(e)(3)(A)*(ii)*.

"equitable adjustment doctrine."[7] Courts have applied the doctrine in similar situations.[8] This paper presents an overview of the purposes and present application of both the equitable adjustment doctrine and section 643(e).[9] The paper then discusses the possibility of such an adjustment and its consequences under section 643(e).

II. The Equitable Adjustment Doctrine

Courts have applied the equitable adjustment doctrine when a fiduciary's elections or decisions financially benefitted some beneficiaries to the detriment of others. Inequitable consequences can arise because the beneficiaries may have differing property interests under local law. An equitable adjustment is a method to compensate for disproportionate sharing of tax burdens through a reallocation of assets from one beneficiary's account to that of another. Considering actual tax consequences, a reallocation or adjustment achieves the goal of impartial treatment of beneficiaries as required under local law.

Much debate and controversy has arisen concerning the applicability of the equitable adjustment doctrine and adjustments that should be made when it does apply.[10] The tax consequences of such adjustments are also at issue.[11] The basis of equitable adjustments lies in at least two aspects of the fiduciary duty: (1) the duty of impartiality, and (2) the duty to minimize taxes.[12] The duty

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7. *See infra* notes 10-16 and accompanying text.

8. *See* Freeland, Maxfield & Sawyer, *Estate and Trust Distributions of Property in Kind After the Tax Reform Act of 1984*, 40 Tax L. Rev. 449, 457 n.29 (1985); Raattama & Sawyer, *Interaction of the New I.R.C. § 643(e) Election and Florida's Equitable Adjustment Doctrine*, Fla. B.J., Oct. 1985, at 97 (suggesting such an adjustment may be necessary).

9. *See infra* § III.

10. For a comprehensive discussion of the equitable adjustment doctrine, see Blattmachr, *The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey*, 18 Inst. on Est. Plan. ¶¶ 1400-1415 (1984); Carrico & Bondurant, *Equitable Adjustments: A Survey and Analysis of Precedents and Practice*, 36 Tax Law. 545 (1983); Dobris, *Equitable Adjustments in Postmortem Income Tax Planning: An Unremitting Diet of* Warms, 65 Iowa L. Rev. 103 (1979).

11. *See* sources cited *supra* note 10.

12. Generally the duties of a trustee and personal representative are comparable, with the exception of a few minor variations. The primary duties found applicable to the fiduciary are as follows:

> (1) The duty to use ordinary skill and prudence in the management of the trust or estate. (2) The duty of loyalty, requiring the executor to administer the estate for the benefit of creditors first and beneficiaries second. The trustee is required to administer trust property for the benefit of the beneficiary. (3) The duty to not delegate. The fiduciary is under a duty to personally perform duties of his office and cannot transfer administration of the trust to another person. However, the trustee can delegate performance of certain acts which it is unreasonable to expect him or her to perform. (4) The duty to keep accounts. (5) The duty to furnish information regarding the nature and amount of trust property at the request of the beneficiary. (6) The duty to take and keep control of trust property. (7) The duty to make trust property productive. (8) The duty to pay income to the beneficiary as provided by the trust. (9) The duty of impartiality when dealing with beneficiaries. (10) The duty of co-fiduciaries to participate in the administration of the trust or estate and use reasonable care to prevent a co-fiduciary from committing a breach of trust. (11) The duty to resist revocation of a trust where the trust instrument provides for

of impartiality requires the fiduciary to act impartially toward beneficiaries and prohibits sacrificing the interest of one beneficiary by making a tax election that benefits another.[13] The duty to minimize taxes is derived from the fiduciary's duty to conserve trust or estate assets and to make the property reasonably productive.[14]

Courts and legislatures have not given extensive attention to the equitable adjustments doctrine. Therefore, there is a lack of uniformity in its application.[15] This article will not address all situations in which the doctrine might arise but will focus on those adjustments especially relevant to the analysis of an adjustment in the context of a section 643(e) election.[16]

A. *The* Warms *Adjustment*

The earliest reported case applying the equitable adjustment doctrine was *In re Warms' Estate.*[17] In *Warms*, the executor elected, pursuant to section 642(g), to deduct administration expenses on the estate's income tax return rather than as an estate tax deduction. Under fiduciary accounting rules, administration expenses were paid out of principal of the residuary estate. Thus, the income tax deduction benefitted the income beneficiary while the remainderman bore the economic burden of expenses. In addition, estate taxes increased as a result of not deducting administration expenses on the estate tax return. The additional tax was paid from principal. The court determined an adjustment was warranted and chose to have the income account reimburse the principal account for increased estate taxes resulting from use of the expenses as income tax deductions rather than estate tax deductions.[18]

> revocation only with the consent of the trustee. (12) The duty to preserve trust property. (13) The duty to take all reasonable steps to enforce claims. (14) The duty to act reasonably in defending claims against the trust or estate. (15) The duty to keep trust property separate from the trustee's own property and property of other trusts, and to earmark the trust property as property of the trust.

See Est. & Trust Prac. & Fid. Resp. (IBP) ¶¶ 35,501 - 35,515.17 (1979); G. Bogert & G. Bogert, Handbook of the Law of Trusts §§ 93-124 (5th ed. 1973).

13. *See, e.g.*, Howe v. Earl of Dartmouth, 32 Eng. Rep. 56 (1802); *see also* G. Bogert & G. Bogert, *supra*, note 12, at § 106; A. Scott, The Law of Trusts § 183 (3d ed. 1967); Dobris, *supra* note 10, 107-08.

14. *See* G. Bogert & G. Bogert, *supra* note 12, at § 101; A. Scott, *supra* note 12, at § 181; Dobris, *supra* note 10, at 107-08.

15. *See* Carrico & Bondurant, *supra* note 10 (analyzing existing case and statutory law).

16. *See* Blattmachr, *supra* note 10, at ¶ 1402 (identifying ten situations where courts have made equitable adjustments).

17. 140 N.Y.S.2d 169 (Sur. Ct. 1955).

18. *Id.* at 171. The special guardian for the instant remainderman argued that administration expenses should be charged to the income account. The court rejected the argument, reasoning that the source of payment of expenses does not change because expenses were charged to income rather than principal. *Id.* at 170.

The following example illustrates how a *Warms* adjustment might arise. Assume an estate with taxable income of $100,000 and taxable estate, without regard to administration expenses, of $500,000. Additionally, tax rates for both income and estate taxes are 50% and administration expenses are

Courts in other states have also invoked the *Warms* "adjustment."[19] Additionally, it is local practice in some states to make such adjustments.[20] Although there has been little legislative activity in the equitable adjustments area, at least three states have statutes allowing *Warms* adjustments.[21] New York and Maryland have similar statutes requiring adjustment without a need to incorporate the statutory power by reference, provided the will expresses no provision to the contrary.[22] Connecticut takes a different approach, permitting specified fiduciary powers to be incorporated by reference in wills and trusts.[23] One such power directs the fiduciary to claim certain administration expenses, casualty losses, and other expenses to achieve the lowest overall tax liability for the estate and beneficiaries.[24] An adjustment is required when the fiduciary's election results in a greater portion of estate tax being paid from and charged to principal than if a contrary election had been made.[25]

Following *Warms*, courts faced questions of whether adjustments should be made when the section 642(g) election affects marital and nonmarital beneficiaries. The election affects the marital share when the bequest is dependent on the size of the estate after deductions for administration expenses or when

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$25,000. If the administration expenses are deducted on the estate return, the estate tax will be $237,500 (as shown below). However, if expenses are deducted on the income tax return, estate taxes will be $250,000 with income taxes reduced by $12,500 (as shown below).

	No Section 642(g) Election	Section 642(g) Election Made
Taxable Estate (Before Adm. Exp)	$500,000	$500,000
Adm. Expense Deduction	(25,000)	—
Taxable Estate	475,000	500,000
Tax Rate	× 50%	× 50%
Tax	$237,500	$250,000

The principal account bears the burden of paying administration expenses even when deductions benefit the income beneficiary pursuant to a § 642(g) election. The income account would be required to reimburse principal for the $12,500 increase in estate taxes resulting from the § 642(g) election.

19. *See In re* Bixby's Estate, 140 Cal. App. 2d 326, 295 P.2d 68 (1956) (adoption of "*Warms* adjustment" in California); *In re* Veith's Estate, 26 Fla. Supp. 145 (Dade County Ct. 1965) (same in Florida); *In re* Kent's Estate, 23 Fla. Supp. 133 (Palm Beach County Ct. 1964) (same); *In re* Bell's Estate, 8 Ches. Co. Rep. 21 (Orphan's Ct. 1956) (same in Pennsylvania), *aff'd*, 393 Pa. 623, 144 A.2d 843 (1958); Rhode Island Hosp. Trust Co. v. Sanders, 84 R.I. 347, 125 A.2d 100 (1956) (same in Rhode Island).

20. *See* Carrico & Bondurant, *supra* note 10 (discussing local practices in Colorado, Georgia, Illinois, Kentucky, Massachusetts, Nevada, North Carolina, Oregon and Wyoming).

21. Connecticut, Maryland and New York. *See infra* notes 22-23.

22. MD. ESTATE & TRUST CODE ANN. § 11-106(a) (1974); N.Y. EST. POWERS & TRUSTS LAW § 11-1.2(A) (McKinney Supp. 1986).

23. CONN. GEN. STAT. ANN. § 45-100(e)(35)(B) (West 1981).

24. *Id.*

25. *Id.*

there is a maximum marital deduction clause. With the exception of one case, the courts have refused to require adjustment in these circumstances.[26]

B. *The* Rice *Adjustment*

Under Subchapter J, the taxable income of an estate or trust will be affected by the computation of DNI.[27] Section 643(a) defines DNI as taxable income of the estate or trust computed with certain modifications.[28] One of the modifications is an exclusion for capital gains allocated to corpus and not actually distributed, required to be distributed, or permanently set aside for charity.[29]

When a fiduciary sells an asset, the expenses attributable to the sale, such as commissions and state capital gain taxes, are allocated to principal under fiduciary accounting rules.[30] These expenditures, however, reduce DNI even when payable from principal.[31] These deductions reduce income allocable to principal only when they exceed DNI.[32] Congress expressly provided for this result so that deductions paid from corpus would not go to waste.[33] However, the effect of the allocation deprives principal, the source giving rise to the deductible expenditure, of the tax benefit of the deduction in years when it has taxable gain.

For example, assume a trust has taxable ordinary income of $25,000 and a capital gain of $5,000, along with $3,000 of deductions attributable to a capital gain. The deduction will reduce ordinary income but not capital gain. When a fiduciary makes a sale, recognizing gain and generating deductible expenses allocable to corpus, an unfair allocation is automatically made through interaction of the DNI system and fiduciary accounting rules. Contrary to the diversion remedied by the *Warms* adjustment, this diversion is not the result of a fiduciary's election; arguably, then, no adjustment is needed.[34] No state has adopted a statute allowing for adjustment in this situation. Moreover, the Uniform Principal and Income Act requires no adjustment.[35] Presently, there is a split of authority concerning whether an equitable adjustment is required

26. *See In re* Veith's Estate, 26 Fla. Supp. 145 (Dade County Ct. 1954) (adjustment not required); *In re* McTarnahan's Estate, 27 Misc. 2d 13, 202 N.Y.S.2d 618 (Sur. Ct. 1960) (same); *In re* Inman's Estate, 22 Misc. 2d 573, 196 N.Y.S.2d 369 (Sur. Ct. 1959) (same). *But see In re* Levy's Estate, 9 Misc. 2d 561, 167 N.Y.S.2d 16 (Sur. Ct. 1957) (adjustment required).

27. *See* I.R.C. § 643 (West 1986).

28. *Id.* § 643(a).

29. *Id.* § 643(a)(3); Treas. Reg. § 1.643(a)-3 (West 1986).

30. *See, e.g.*, FLA. STAT. § 738.13(3) (1985); N.Y. EST. POWERS & TRUST LAW § 11-2.1(d)(1) (McKinney 1967).

31. *See* Treas. Reg. § 1.643(d)-2 (West 1986) (illustration of the § 643 provisions).

32. *See* Moore, *Conflicts in Post-Mortem Planning After the Tax Reform Act*, 12 INST. ON EST. PLAN. §§ 600-609 (1978).

33. *See* Dobris, *supra* note 10, at 120.

34. *See infra* notes 42-44 and accompanying text.

35. REV. UNIF. PRINCIPAL AND INCOME ACT, §§ 5, 13, 7B U.L.A. 145 (1962).

from the income account to reimburse principal for an increase in income taxes borne by the principal account by reason of the Code.[36]

Rice Estate[37] involved a sale by the trustee in which gain of $400,000 was realized, resulting in a capital gain tax of approximately $100,000. Deductible attorney's fees of $202,000 were charged to principal, while the tax benefit of these fees inured to the income beneficiary.[38] Since there was a fifty percent capital gain deduction in effect at the time of the sale,[39] that deduction, combined with the attorney's fees, would have reduced taxable gain to zero. The court ordered the income account to reimburse the principal account for the increase in capital gains taxes borne by the corpus as a result of expense allocations to the benefit of the income account as required under Subchapter J.[40] In making its decision, the court cited *Warms* as precedent, disregarding the absence of any fiduciary election as to whether principal expenditures would reduce DNI.[41]

However, in *In re Estate of Dick*,[42] the New York Surrogate Court refused to make the adjustment required by the *Rice* court, reasoning that *Warms* did not justify an adjustment. The court emphasized that *Warms* involved a fiduciary's exercise of a statutory election while in the case before it the trustee was not granted an option.[43] *Dick* was followed by a Florida court in *In re Kent's Estate*.[44]

C. *Trapping Distributions*

A common technique employed to tax estate income at lower marginal brackets is the "trapping distribution."[45] The trustee often accomplishes income split-

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36. *See infra* notes 37-44 and accompanying text. *See also* notes 60-69 and accompanying text.

37. 8 Pa. D. & C.2d 379 (1956).

38. *Id.* at 412.

39. The Tax Reform Act of 1986 repealed the 60% capital gain deduction formerly provided under § 1202. Repeal is effective for taxable years beginning after December 31, 1986. However, the Tax Bill did not change characterization of gain as capital or ordinary. Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(a), 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 132. However, the maximum capital gain rate is 28% for taxable years beginning in 1987 and thereafter. Int. Rev. Code of 1986 § 1(j).

40. 8 Pa. D. & C. 2d at 413.

41. *Id.* at 414.

42. 29 Misc. 2d 648, 218 N.Y.S.2d 182 (Sur. Ct. 1961).

43. *Id.* at 650, 218 N.Y.S.2d at 184; *see also* New England Merchants Nat'l Bank v. Converse, 373 Mass. 639, 369 N.E.2d 982 (1977) (adjustments refused under facts similar to *Dick* because adjustment not practical).

44. 23 Fla. Supp. 133, 136 (Palm Beach County. Ct. 1964) (fiduciary not required to cure inequities created by interaction of tax law with principles of estate accounting). *But see* Dobris, *supra* note 10, at 140-41:

> The *Dick* opinion is wrong, principal should be reimbursed for lost use of a deduction. Requiring an adjustment is the proper course of action for a court when a fiduciary's discretionary act has caused an adjustable inequity or when the allocation of the benefits and burdens of mandatory action is unjust under standard allocations rules.

45. For a detailed discussion on "trapping distributions" see Blattmachr, *supra* note 10, at § 1403.3; Carrico & Bondurant, *supra* note 10, at 563-67 (review of statutory and judicial responses

ting by making a partial distribution of estate principal to a trust. Normally, this situation arises when the income beneficiary of a testamentary trust is entitled to all accounting income earned by the estate during administration, even though income may not be paid out to the trustee until estate administration is completed. For tax purposes, the distribution of principal constitutes income to the trust and is deductible by the estate to the extent of DNI,[46] even though the distribution is principal on the books of the estate and is allocated to principal on the books of the trust.[47] The distribution, therefore, even if principal, will have the effect of shifting DNI from the estate to its beneficiary, the trust. However, because the trust may have no accounting income to be distributed, DNI will be trapped in the trust as corpus. This result occurs because the income beneficiary of the trust is only entitled to distributions of income, as opposed to corpus, and the trust is unable to distribute all its DNI for the year. The trust will be required to pay tax on trapped DNI received from the estate.[48] Thus, two entities, the estate and the trust, will share the income tax burden of the estate's DNI, presumably reducing the overall tax liability.

If the trust received income rather than corpus, it would be able to distribute it to the income beneficiary and thus receive a section 661 deduction, to the extent of DNI. As a result of the trapped DNI being taxable to the trust, principal is reduced by taxes to the detriment of the principal beneficiaries. Thus, when income of the estate actually incurring the income tax is later distributed to the income beneficiary, it may be received tax free.[49]

In *In re Estate of Holloway*,[50] the New York Surrogate Court faced the issue of whether an equitable adjustment was warranted in a situation involving a trapping distribution. The court held the income account had to reimburse the principal account for income taxes paid by the trust on the trapped distribution.[51] The Surrogate Court first denied the adjustment, reasoning that section 13(c)(4) of the Revised Uniform Principal and Income Act required principal

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in this area as well as drafting solutions); Cohan & Frimmer, *Trapping Distributions: The Trap that Pays*, 112 TR. & EST. 766 (1973); Dobris, *supra* note 10, at 127-30.

46. *See* I.R.C. §§ 661-662 (West 1986).

47. *See* Blattmachr, *supra* note 10, at 1403.3.

48. *Id.*

49. The following example illustrates how a trapping distribution will result in an equitable adjustment. Assume an estate distributes $20,000 of principal to a previously unfunded testamentary trust created under a will. The estate had income of $50,000 and made no other distributions during the year. Beneficiary *A* is entitled to principal and beneficiary *B* is entitled to all income of the estate. The $20,000 distribution will carry out DNI and reduce the estate's income to $30,000 because of § 661. The trust will be taxed on $20,000 because it may only distribute income to *B*. Assuming a tax rate of 30%, trust principal will be reduced by the $6,000 of taxes. If, in the next year, the estate distributes income to *B*, assuming the estate has no additional income, *B* will receive $20,000 free of tax. Under principles of *Holloway*, the income account would be required to reimburse principal in the amount of $6,000.

50. 67 Misc. 2d 132, 323 N.Y.S.2d 534 (Sur. Ct. 1971), *modified*, 68 Misc. 2d 361, 327 N.Y.S.2d 865 (Sur. Ct. 1972).

51. 68 Misc. 2d at 366, 327 N.Y.S.2d at 869.

to pay all taxes on property allocated to principal.[52] However, on rehearing the court reversed its earlier decision, stating that based on purely equitable principles, the burden of income taxes should be charged to the account into which the item goes.[53] *Holloway* and *Rice* both support the proposition that, even when non-elective tax procedures alter beneficiaries' interests, a state court may override statutory principal and income allocation rules and order an adjustment.

D. *Disproportionate Distributions*

When there is more than one beneficiary of an estate and the fiduciary makes a disproportionate distribution, a disproportionate amount of DNI may be allocated to that beneficiary and a disproportionate amount of income will be reportable by such beneficiary.[54] Unless an adjustment is made, each of the remaining beneficiaries will continue to be entitled to their proportionate share of income unreduced by any income tax (or by less tax than if the disproportionate distributions had not been made). An inequity results when the beneficiary receiving the disproportionate distributions pays income tax on income receipts allocable to another beneficiary. The inequity exists due to the scheme of Subchapter J: distributions are deemed to carry out estate income for the year without regard to character as current income or principal.[55] However, for fiduciary accounting purposes, estate income is distributed on a pro rata basis with reference to the respective interests of the different beneficiaries in estate principal.[56]

Consider an estate with principal of $100,000, income of $10,000, and two residuary beneficiaries, *A* and *B*, each entitled to equal portions of income and principal. *A* and *B* are each entitled to $5,000 of income for the year. Suppose $15,000 of principal is distributed to *A* with no distribution to *B*. *A* is taxed on the full $10,000 of income because *A* is deemed to carry out DNI although *B* is still entitled to *B*'s share of income.[57] Later, when income is distributed to *A* and *B*, *B*'s share will be tax free and *A* will have borne the burden of *B*'s share of taxes on the income.[58]

Unlike trapping distributions, there is little tax purpose for disproportionate distributions. They usually result from thoughtless or ill-advised distributions by the fiduciary or from a distribution to a dependent beneficiary.[59] In *In re Salesky's Estate*,[60] the Pennsylvania Orphans Court held that a widow, electing to take her dower share against the will, was entitled to reimbursement for

52. 67 Misc. 2d at 133-34, 323 N.Y.S.2d at 535.
53. 68 Misc. 2d at 365, 327 N.Y.S.2d at 869.
54. *See* I.R.C. § 662 (West 1986). With respect to a trust, this may not be true as a result of the separate share rules. *Id.* § 663(c).
55. *See id.* §§ 661-662.
56. *See, e.g.*, N.Y. Est. Powers & Trusts Law § 11-2.1(a)(c) (McKinney 1967).
57. *See* I.R.C. §§ 652, 662 (West 1986).
58. *See* Carrico & Bondurant, *supra* note 10, at 571-76; Dobris, *supra* note 10, at 130-36.
59. *See* Dobris, *supra* note 10, at 133 nn.177-78 and accompanying text. However, on certain occasions the lower tax bracket of the beneficiary may result in an overall tax savings.
60. 15 Pa. Fiduc. 213 (Orphan's Ct. 1965).

having to bear a disproportionate income tax burden on account of non-pro rata distributions.[61] Similarly, in *In re Estate of Cooper*,[62] a Florida court held that a widow was entitled to reimbursement for additional taxes borne by her. However, in *Cooper* there was a prior agreement in which the widow reserved the right to reimbursement,[63] thus the decision is questionable precendent.

E. *Depreciation Deductions Inuring to the Benefit of the Income Beneficiary While Increasing the Principal Beneficiary's Tax Burden*

Pursuant to section 167(h), if no reserve for depreciation is maintained, the depreciation deduction is allocated between beneficiaries and the trust or estate on the basis of income allocable to each.[64] Therefore, if the income beneficiaries receive all the income and there is no provision for allocation in the trust instrument, depreciation only reduces the income beneficiary's tax liability. Later, when the asset is sold, a larger gain will be realized because of the reduction in basis for depreciation.[65] Under normal fiduciary accounting, receipts of the sale are allocable to corpus and the principal beneficiary will bear the burden of tax on any gain or recapture, despite the income beneficiaries receiving the benefit of depreciation deductions.

In *Matter of Pross*,[66] the court, relying on *Holloway*,[67] held that the income beneficiary would have to bear the burden of capital gains taxes when the income beneficiary received the benefit of depreciation.[68] While *Pross* has been cited as authority for an equitable adjustment where no fiduciary discretion is

61. *Id.* at 215-16. The estate's income tax savings resulting from the distribution was approximately $15,000 while the widow paid approximately $10,000 in taxes on the distribution.

62. 186 So. 2d 844 (Fla. 1966).

63. *Id.* at 844-45.

64. *See* I.R.C. § 642(e) (West 1986).

65. *Id.* § 1016(a)(2). For example, suppose a trust holds a capital asset with a depreciable basis of $100,000. The trust does not provide for allocation of depreciation. In Year 1, the trust earns income of $20,000 which it distributes to *B*, the income beneficiary, and depreciation of $15,000 is allowable and is allocated entirely to *B*. If, on the first day of Year 2, the asset is sold for $100,000, a taxable capital gain of $15,000 results (amount realized of $100,000 less adjusted basis of $85,000). Gain under normal fiduciary accounting rules is taxable to the principal account. Assuming tax on the gain is $5,000, the principal account will be reduced by $5,000 although the income beneficiary received the benefit of depreciation. Under a *Warms* adjustment, the income account should be required to reimburse principal for the capital gains tax of $5,000.

66. 90 Misc. 2d 895, 396 N.Y.S.2d 309 (Sur. Ct. 1977).

67. *See supra* notes 50-53 and accompanying text.

68. 90 Misc. 2d at 898, 396 N.Y.S.2d at 311. Surrogate Brewster in citing *Holloway* stated:

> If the trustees set aside the amount deducted for depreciation to preserve principal in fulfillment of their duty, the reserve would be wholly applicable to principal and the source of capital gain. However, in this case, there was no reserve. The capital gain is nothing more than a paper entry which has come about by reason of the depreciation deduction having reduced the base of the property below the amount realized upon the foreclosure. There was no addition to appreciation of or replacment for the trust principal . . . . To the extent that the income beneficiary received the benefits of the deduction for depreciation without any concomitant benefit to trust principal, equity requires that the charge for the capital gains tax be placed on the person receiving the capital gain.

Id. at.898, 396 N.Y.S.2d at 311.

involved, the fiduciary under the New York version of the Revised Uniform Principal and Income Act elected not to establish a depreciation reserve.[69] Therefore, *Pross* is of questionable validity.

F. *Sale of Trust or Estate Assets*

As previously discussed, fiduciary discretion in selling trust or estate assets could result in the shifting of benefits in the *Rice/Dick*[70] scenario. In determining whether to sell or distribute an asset in kind, the fiduciary is faced with another more general dilemma. If the fiduciary distributes assets in kind, the beneficiary will receive either a section 1014 basis or a fair market value date of distribution basis. If assets are distributed to satisfy a pecuniary bequest, the basis to the beneficiary will be fair market value. However, the trust or estate will recognize a gain.[71] If assets are distributed in a specific distribution, their income tax basis to the beneficiary will be a section 1014 basis;[72] however, no gain is recognized.[73]

Conversely, if assets are sold at a gain, the corpus of the trust or estate will normally bear the burden of capital gains taxes. Thus, the fiduciary must choose between distributing the asset with the possibility of unrealized appreciation or selling the asset at the expense of principal beneficiaries. Courts have generally held that trustees have the power to sell, absent a contrary provision.[74] At present, no statutory or common law authority exists directly supporting an adjustment for beneficiaries suffering disproportionate income tax burdens because of sales. However, several analogies support such an adjustment. The remainder of this paper will develop these analogies.

III. Section 643(e)

A. *The General Rule*

The Deficit Reduction Act of 1984 added section 643(e) to control tax consequences to estates and trusts and their beneficiaries upon in kind distributions.[75] Under the general rule, when the personal representative or trustee

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69. *Id.*; *see* N.Y. Est. Powers & Trusts Law § 11-2.1(a) (McKinney 1967); Rev. Unif. Principal & Income Act § 2, 7B U.L.A. 151 (1962).

70. *See supra* notes 27-44 and accompanying text.

71. Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Rev. Rul. 60-87, 1960-1 C.B. 286.

72. I.R.C. § 1014 (West 1986); Treas. Reg. § 1.1014-1, 3 (West 1986).

73. I.R.C. § 663(a) (West 1986).

74. *See* G. Bogert & G. Bogert, *supra* note 12, at § 133. A trustee's power to sell trust assets is implied in equity whenever such power is necessary or useful in carrying out the trust, even though the trust instrument is wholly silent on the subject of sale. *See, e.g.*, Preston v. Safe Deposit & Trust Co., 116 Md. 211, 81 A. 523 (1911); Garesche v. Levering Inv. Co., 146 Mo. 436, 48 S.W. 653 (1898); Clark v. Fleischman, 81 Neb. 445, 116 N.W. 290 (1908); Crown Co. v. Cohn, 88 Or. 642, 172 P. 804 (1918); Wisdom v. Wilson, 59 Tex. Civ. App. 593, 127 S.W. 1128 (1910).

75. For a detailed discussion of new § 643(e) and its impact, see Aucutt, *Tax Planning for*

makes no election, gain or loss is not recognized to the trust or estate upon an in kind distribution.[76] When no election is made, the beneficiary's basis in distributed property will equal the property's adjusted basis in the trust or estate, adjusted by any gain or loss recognized by the trust or estate.[77] Thus, the beneficiary normally gets a carryover basis. The amount distributed for purposes of sections 661 and 662 is equal to the lesser of the property's adjusted basis, adjusted for gain or loss recognized by the trust or estate, or fair market value.[78]

B. *The Elective Rule*

Under the elective rule, gain or loss is recognized to a trust or estate upon an in kind distribution as if the property had been sold at fair market value.[79] For purposes of sections 661(a)(2) and 662(a)(2), the amount distributed is the fair market value of the property.[80] The beneficiary's basis is the adjusted basis of the property to the trust or estate adjusted by any gain or loss recognized on the distribution. By requiring the trust or estate to recognize gain or loss under the elective rule, Congress has alleviated the prior law's distortion, which allowed a beneficiary a fair market value basis while the trust or estate recognized no gain or loss.[81]

C. *In Kind Property Distributions Where Section* 643(e) *Is Not Applicable*

Before determining application of the equitable adjustment doctrine to a section 643(e) election, one must first determine if section 643(e) applies to the transaction under consideration. As the subsequent discussion will illustrate, the scope of section 643(e) is quite narrow.

Section 643(e) should not apply to the following in kind distributions:

In-Kind Distributions Increased by New Special Election, 62 J. TAX. 48 (1985); Freeland, Maxfield & Sawyer, *Estate and Trust Distributions of Property In-Kind After the Tax Reform Act of 1984*, 40 TAX L. REV. 449 (1984); Kelly, *Treatment of Property Distributed In-Kind Under the Tax Reform Act of 1984*, 63 TAXES 423 (June 1985).

76. Gain or loss may result when no election is made in two situations: (1) where the asset has a mortgage in excess of basis, and (2) upon distribution of an installment obligation pursuant to § 453B. Freeland, *supra* note 75, at 475. However, no § 1245 or § 1250 gain should be recognized in a distribution in which no gain or loss is otherwise recognized. I.R.C. § 1245(b)(1)-(2) (West 1986); Treas. Reg. § 1.12454(a)-(b) (West 1986); I.R.C. § 1250(d)(1)-(2) (West 1986); Treas. Reg. § 1.1250-3(a)-(b) (West 1986); *see* Freeland, *supra* note 75, at 467-69.

77. I.R.C. § 643(e)(1) (West 1986).

78. *Id.* § 643(e)(2).

79. *Id.* § 643(e)(3). The Tax Reform Act of 1986 amended § 643(e)(3)(B) to provide that election under § 643(e)(3) shall apply to all distributions made by the estate or trust during a taxable year. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1806(b), 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 726. Thus, an election to recognize gain or loss cannot be made on each separate distribution, as the language of the Tax Reform Act of 1984 seems to provide. Section 643(e)(3)(B) continues to provide that election must be made on the tax return for the taxable year of the distribution.

80. I.R.C. § 643(e)(3)(A)*(iii)*.

81. *See* Treas. Reg. § 1.661(a)-(2)(f) (West 1986).

(1) Distributions described in section 663(a).

(2) In kind distributions of property in satisfaction of pecuniary bequests not within section 663.

(3) Distributions of specific property or cash bequests directed by the terms of the instrument and paid in more than three installments.

(4) Distributions described in sections 651(a) and 661(a)(1).

(5) Distributions of property governed by section 691.

(6) Distributions when the grantor is treated under sections 671-78 as the owner of a trust.

1. Distributions Within Section 663(a)

Section 663(a) provides that distributions within that section shall not be included as amounts falling within sections 661(a) or 662(a). Therefore, since sections 661 and 662 are not applicable, the estate or trust receives no deduction and the beneficiary treats amounts received as a section 102(a) gift. Consequently, section 643(e)(4) provides an exception for distributions described in section 663(a). Section 663(a) applies to the following distributions:

(1) Specific bequests or gifts of a specific sum of money or property paid or credited in not more than three installments.[82]

(2) Amounts paid or subsequently set aside that qualify for charitable deduction under section 642(c).[83]

(3) Amounts distributed to which section 651 or 661 applied in a preceding taxable year, because the distribution was made when required in a previous year.[84]

2. Distributions in Satisfaction of Pecuniary Bequests, More than Three Installments, and Under Sections 651(a)(1) and 661(a)(1)

Section 643(e) will not apply to in kind distributions of property used to satisfy pecuniary bequests not within section 663.[85] An example of such a distribution occurs when a decedent leaves his spouse fifty percent of the adjusted

82. I.R.C. § 663(a)(1) (West 1986).
83. *Id.* § 663(a)(2).
84. *Id.* § 663(a)(3).
85. *See* Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); Treas. Reg. § 1.663(a)-1(b)(1) (West 1986); H.R. REP. No. 861, 98th Cong., 2d Sess. 870, *reprinted in* 1984-3 C.B. 124.

gross estate and the executor uses appreciated property to satisfy the bequest.[86] Gain will be recognized and section 643(e) will not apply because there is a deemed cash distribution rather than a property distribution.[87]

Distribution of a specific sum of money or item of property according to an instrument and paid or credited in more than three installments will also fall outside section 663(a)(1). However, section 643(e) should not apply because any gain on appreciated property results because of satisfaction of the obligation with appreciated property.[88]

Additionally, section 643(e) should not apply to distributions under sections 651(a)(1) and 661(a)(1). These are required distributions and if appreciated property is used to satisfy them, gain will be recognized.[89]

3. Property Representing the Right to Receive Income in Respect of Decedent and the Grantor Trust Rules

Under section 691, income in respect of a decedent (IRD) is taxable to the estate or beneficiaries upon receiving a distribution.[90] IRD generally includes amounts to which the decedent was entitled as gross income but that were not properly includible in taxable income for a previous year or the taxable year ending with decedent's death because of the method of accounting used.[91] The general subchapter J rules regarding distributions from trusts and estates, including section 643(e), are not applicable to distributions of rights to IRD.[92] Thus, for example, if an estate distributes the right to a decedent's accrued salary, distribution of that right will not invoke section 643(e). Instead, section 691 will apply and the salary is income to the recipient upon receipt.

Section 643(e) also will not apply to the extent the grantor trust rules of sections 671-678 treat the grantor or another person as owner of the trust property.[93] The grantor trust rules override sections 661 and 662 and render section 643(e) inapplicable.

IV. Application of the Equitable Adjustment Doctrine to a Section 643(e)(3) Election

As previously discussed, section 643(e) will not apply to many in kind distributions because other Code provisions or principles of common law apply.[94]

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86. Treas. Reg. § 1.663(a)-1(b)(1) (West 1986).
87. *See* Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940).
88. *Id.*
89. *See* Rev. Rul. 67-74, 1967-1 C.B. 194; I.R.C. § 643(e)(2) (West 1986). *But see* Treas. Reg. § 1.661(a)-2(c) (West 1986); Rev. Rul. 68-195, 1968-1 C.B. 305 (West 1986).
90. I.R.C. § 691(a) (West 1986).
91. Treas. Reg. § 1.691(a)-(1) (West 1986).
92. *Id.* § 1.691(a)-4(b); Rollert Residuary Trust v. Commissioner, 80 T.C. 619, 644 (1983), *aff'd*, 752 F.2d 1128 (6th Cir. 1985); Freeland, *supra* note 75, at 463.
93. *See* Rev. Rul. 67-241, 1967-2 C.B. 225; Treas. Reg. § 1.671-2(d) (West 1986).
94. *See supra* notes 82-84 and accompanying text.

A. *In Kind Property Distributions from Trusts*

Section 643(e) should apply under the following fact pattern. Assume *A* and *B* are beneficiaries of a written trust. *A* has a right to discretionary distributions of trust income and corpus and *B* is entitled to the remainder of trust corpus at *A*'s death. For calendar year 1986 the trust has DNI of $100,000. The trustee makes a discretionary distribution to *A* of a capital asset with a fair market value (FMV) of $150,000 and a basis of $75,000.

Under the general rule, the trust recognizes no gain or loss on distribution of the capital asset to *A* (see Table I below). *A* has a basis of $75,000 in the distributed property (the asset's adjusted basis to the trust).[95] The "amount distributed" for purposes of sections 661(a)(2) and 662(a)(2) is $75,000 (the lesser of the basis of the property to *A* or FMV).[96] Assuming the trust does not distribute any income to *A* during the year, *A* has taxable income of $75,000 as a result of the distribution.[97] If *A* immediately sells the property for $150,000, *A* will be taxed on $75,000 gain remaining in the property. The trust will receive a distribution deduction of $75,000[98] and consequently will be subject to tax on $25,000 of undistributed DNI.[99]

TABLE I

	No Election Made	Section 643(e)(3) Election Made
TRUST		
DNI	$100,000	$100,000
Capital Gain	—	75,000
Total	$100,000	$175,000
Distribution Deduction	(75,000)	(100,000)
Section 1202 Deduction[100]	—	(22,500)
Taxable Income	25,000	52,500
Tax Rate (approx.)[101]	× .25	× .35
Tax	$ 6,250	$ 18,375

95. I.R.C. § 643(e)(1) (West 1986).
96. *Id.* § 643(e)(2).
97. *Id.* § 662(a)(2).
98. *Id.* § 661(a)(2).
99. DNI of $100,000 less the $75,000 distribution deduction.
100. *See supra* note 39 (discussion of the repeal of § 1202 for taxable years beginning after December 31, 1986).
101. The Tax Reform Act of 1986 changed tax rates applicable to trusts and estates significantly. For taxable years beginning in 1987, the top rate is 38.5% for taxable income in excess of $15,150. For taxable years beginning in 1988, the top rate is 28% for taxable income exceeding $5,000. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 101, 1986 U.S. Code Cong. & Admin. News (100 Stat.) 12 (amending I.R.C. § 1(e) and adding Int. Rev. Code of 1986 § 1(g) & (h)).

TABLE I (continued)

	No Election Made	Section 643(e)(3) Election Made
BENEFICIARY (A)		
Section 662 Income	$ 75,000	$100,000
Capital Gain	75,000	—
Total	$150,000	$100,000
Section 1202 Deduction	(22,500)	—
Total Taxable Income	$127,500	$100,000
Tax Rate (Assumed)[102]	× .50	× .50
Tax	$ 63,750	$ 50,000
OVERALL TAX LIABILITY		
Trust	$ 6,250	$ 18,375
Beneficiary (A)	63,750	50,000
	$ 70,000	$ 68,375

On the other hand, if a section 643(e)(3) election is made, different consequences occur (see Table I). The trust recognizes a $75,000 capital gain on distribution of the property to *A*.[103] The beneficiary would receive a $150,000 basis in the property ($75,000 basis to the trust adjusted for the $75,000 gain recognized)[104] and the "amount distributed" for purposes of sections 661(a)(2) and 662(a)(2), and the beneficiary's basis in distributed property will be $150,000.[105] However, the distribution's deduction to the trust under section 661(a)(2), as well as taxable income to *A* under section 662(a)(2), is limited to DNI.

This brings to focus the question of whether capital gain recognized by the trust increases DNI. The election does not automatically cause DNI to increase. If a section 643(e)(3) election results in capital gain in the year of termination of the trust or estate, capital gain will enter the DNI computation.[106] Section 643(a) ordinarily provides for capital gain exclusion from DNI. However, Treasury Regulation section 1.643(a)-(3) sets out three situations when capital gains are included in DNI:

> (1) Capital gains are allocated by the fiduciary to income under the terms of the trust instrument or local law either on the books or by notice to the beneficiary.

102. This example assumes a taxable year ending December 31, 1986. The Tax Reform Act of 1986 reduced the top income tax rate for individuals significantly. The top marginal rate is 38.5% and 28%, respectively, for taxable year 1987 and years beginning in 1988 and beyond. The maximum rate on capital gains beginning January 1, 1987 is 28%. Int. Rev. Code of 1986 § 1(j).

103. I.R.C. § 643(e)(3)(A)(ii) (West 1986).

104. *Id.* § 643(e)(1).

105. *Id.* §§ 643(e)(1), (e)(3)(A)(iii).

106. *Id.* § 643(a)(3); Treas. Reg. § 1.643(a)-3(a)(2) (West 1986).

(2) Capital gains are allocated to corpus but actually distributed to beneficiaries during the year.

(3) Capital gains are utilized under the terms of the instrument or in practice by the fiduciary in determining the amount to be distributed.

In the hypothetical, the first requisite above is not met, assuming the governing instrument is silent as to allocation of capital gains and local law requires allocation to corpus.[107] The second instance under the regulations requiring capital gains to be included in DNI only applies if there is a distribution required by the governing instrument upon the happening of a specified event.[108] In this hypothetical, no such condition for inclusion is present. The third instance under the regulations occurs when capital gains are utilized in determining the amount distributed or required to be distributed. Under our hypothetical, this requisite is not satisfied. Thus, under the hypothetical, the capital gain of $75,000 is excluded from DNI.[109]

Therefore, taxable income to *A* and the distribution deduction to the trust are limited to $100,000, the amount of DNI. *A* receives property with a $150,000 basis but is only taxed on $100,000. In effect, *A* receives $50,000 in property tax free. The trust, however, recognizes the full $75,000 gain. Thus, *B*, the remainder beneficiary, bears the tax burden because the tax reduces principal in the trust. At the same time, *A* receives the benefit of a $50,000 tax-free step up in basis.

This hypothetical illustrates how a section 643(e)(3) election might benefit one beneficiary at the expense of another and creates an opportunity to apply the equitable adjustment doctrine. The consequences of a section 643(e)(3) election appear to be similar to the result in a *Warms*[110] type situation. Applying the *Warms* rationale, the trustee would be required to adjust the income account by reimbursing principal for increased taxes to the trust resulting from the section 643(e)(3) election. Referring to Table I, the election reduced combined taxes to the trust and beneficiary *A* but resulted in an increase in tax to the trust of $12,125 (while *A*'s tax was reduced by $13,750). *Warms* would require the trustee to transfer $12,125 from the income account to the principal account. Even after adjustment, *A* realizes a net reduction in tax liability as a result of the election and receives a $50,000 step up in basis.

The applicability of an adjustment to a section 643(e)(3) election is further

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107. *See, e.g.*, UNIF. PRINCIPAL & INCOME ACT § 3(2), 7B U.L.A. 192 (1931); REV. UNIF. PRINCIPAL & INCOME ACT § 3(b)(1), 7B U.L.A. 155 (1962); *see also* Rev. Rul. 69-392, 1968-2 C.B. 284.

108. *See* Treas. Reg. § 1.643(a)-3(d), examples (3), (4) & (5) (West 1986); Rev. Rul. 68-392, 1968-2 C.B. 284.

109. *See* Rev. Rul. 68-392, 1968-2 C.B. 284; Priv. Ltr. Rul. 8,506,005 (Nov. 7, 1984), IRS - LTR. RULINGS REP. (CCH) No. 416 (Feb. 20, 1985); Priv. Ltr. Rul. 8,429,005 (Mar. 26, 1984), IRS - LTR. RULINGS REP. (CCH) No. 386 (July 25, 1984); Priv. Ltr. Rul. 8,324,002 (Feb. 16, 1983), IRS - LTR. RULINGS REP. (CCH) No. 329 (June 22, 1983); Priv. Ltr. Rul. 8,105,028 (Oct. 28, 1980), IRS - LTR. RULINGS REP. (CCH) No. 206 (Feb. 11, 1981).

110. *See supra* notes 17-26 and accompanying text.

supported by *Rice*.[111] Although no fiduciary election was involved, the adjustment resulted as a consequence of the exclusion of capital gains from DNI. In addition, the section 643(e)(3) election, similar to a trapping distribution, is normally made to minimize overall taxes of the trust or estate and its beneficiaries. *Holloway*, which required the income account to reimburse principal for tax paid on a trapped distribution, also supports adjustment after a section 643(e)(3) election.[112]

The applicability of an equitable adjustment with respect to a section 643(e) election may be compared with adjustments made when the fiduciary decides to sell an asset and recognize gain, distributing proceeds rather than distributing the asset in kind with unrealized appreciation.[113] As pointed out earlier, no present authority directly authorizes an adjustment though, under *Warms*, it appears to be warranted. The exercise of a fiduciary's discretion to make a sale of a trust asset or a section 643(e)(3) election may benefit one beneficiary at the expense of another and create a situation in need of an equitable adjustment.

In the previous hypothetical, if the facts remained the same but the trust was required to distribute trust income to *A*, different consequences, as shown in Table II, result. By making an election, the combined tax liability of the trust and *A* is reduced by $7,875. However, the tax liability of the trust is increased by $18,375. Thus, under the *Warms* rationale, the trustee would be required to reimburse the principal account for $18,375. The income beneficiary may argue for limiting the reimbursement amount to $16,250, the beneficiary's

TABLE II

	No Election Made	Section 643(e)(3) Election Made
TRUST		
DNI	$100,000	$100,000
Capital Gain	—	75,000
Total	$100,000	$175,000
Section 661(a)(1) Deduction	(100,000)	(100,000)
Section 661(a)(2) Deduction	—	—
Section 1202 Deduction[114]	—	(22,500)
Taxable Income	0,000	$ 52,500
Tax Rate[115]	—	× .35
Tax	$ 0,000	$ 18,375

111. *See* 8 Pa. D. & C. 2d at 413.
112. *See* 68 Misc. 2d at 365, 327 N.Y.S.2d at 869.
113. *See supra* § II.F.
114. *See supra* note 100.
115. *See supra* note 101.

TABLE II (continued)

	No Election Made	Section 643(e)(3) Election Made
BENEFICIARY (A)		
Section 662(a)(1)	$100,000	$100,000
Section 662(a)(2)	—	—
Capital Gain	$ 75,000	—
Total	$175,000	$100,000
Section 1202 Deduction	(22,500)	—
Taxable Income	$152,500	$100,000
Tax Rate[116]	× .50	× .50
Tax	$ 76,250	$ 50,000
OVERALL TAX LIABILITY		
Trust	$ 0,000	$ 18,375
Beneficiary (A)	76,250	50,000
	$ 76,250	$ 68,375

tax reduction related to the election. Such an argument is not supported by *Warms*, which only focused on the increase in estate taxes resulting from a section 642(g) election, not decreases in estate income taxes inuring to the benefit of the party favoring the election.[117]

B. *Effect of Ordinary Income Recognition Provisions*

The above hypotheticals involved distribution of assets resulting in capital gain recognition due to a section 643(e)(3) election. The inequitable consequences occur at least partially because capital gain is generally excluded from DNI.[118] However, when section 1245 or 1250 gain is recognized,[119] DNI is increased and partially eliminates the need for an equitable adjustment. An adjustment would not be necessary because the distributee beneficiary would not be getting a tax free step up in basis, since the amount taxable to the beneficiary would also be increased by the sections 1245 and 1250 income.

In addition, when a trustee makes a section 643(e)(3) election, section 1239 characterizes any gain recognized by related persons as ordinary income, provided the distributed property is subject to depreciation in the distributee's hands.[120] For purposes of section 1239, the trust and a beneficiary with more

116. *See supra* note 102.
117. *See Warms*, 140 N.Y.S.2d at 171.
118. *See supra* notes 39, 100-102.
119. Sections 1245 and 1250 gain lurking in property distributed in kind should not be required to be recognized in a distribution in which no gain or loss is otherwise recognized (i.e., where no § 643(e)(3) election is made). *See* I.R.C. §§ 1245(b)(1),(2), 1250(d)(1),(2) (West 1986).
120. *See id.* § 1239(a)-(b)(2).

than a remote contingent interest are related persons.[121] However; section 1239 does not apply to estates.[122] Therefore, to the extent section 1239 applies, ordinary income will increase DNI and, as discussed with respect to sections 1245 and 1250 recapture, section 1239 will partially or totally eliminate the need for an equitable adjustment. Likewise, a section 643(e)(3) election may result in section 1231 ordinary gain also increasing DNI and having an effect on any possible equitable adjustment similar to sections 1245, 1250 and 1239.

Circumstances might warrant an equitable adjustment when the fiduciary makes an election under section 643(e)(3) and capital loss is recognized. However, this will only occur in an estate if section 267, regarding losses between related parties, disallows the loss when a trustee makes an election.[123]

V. Tax Effect of the Equitable Adjustment

Although beyond the scope of this paper, it should be noted that an equitable adjustment as a result of a section 643(e)(3) election may have further tax ramifications to the entity and beneficiary.[124] For example, making an adjustment could reduce taxable income of the income beneficiary and reduce the distribution deduction to the trust if the trust is required to distribute all income to the beneficiary.[125] Neither the courts nor the Service have explored all the detailed tax ramifications of equitable adjustments and, therefore, the overall effect of an adjustment pursuant to a section 643(e)(3) election is speculative.

VI. Conclusion

In certain situations a fiduciary's section 643(e)(3) election to recognize capital gain or loss upon in kind distributions from a trust or estate may lead to inequitable consequences to beneficiaries. This results from the interaction of the DNI scheme and local law. In such circumstances the policy first established in *Warms* argues for an equitable adjustment, provided no provision in the trust instrument or will directs otherwise. The *Warms* adjustment, although not uniformly applied, has often been adopted where inequitable consequences result from a fiduciary's election. It is applied less frequently when the election or discretion has not been exercised.

The section 643(e)(3) election most often arises when the fiduciary, pursuant to his duty to minimize taxes, seeks to lower overall tax liability of the trust or estate and the beneficiaries. However, as illustrated, one beneficiary may have an increase in tax liability while another beneficiary's tax liability is reduced. Thus, the exercise of the fiduciary's duty to minimize taxes conflicts

121. *Id.* § 1239(b)(2).
122. *See id.* § 1239(b) (not included in the definition of "related persons").
123. *Id.* § 267(a)-(b)(6).
124. *See* Blattmachr, *supra* note 10, at 1400.
125. *Id.* at ¶ 1404.1, 1410. However, by reducing the amount of accounting income, DNI that would otherwise be taxed to the beneficiary is not taxed to the corpus of the trust, which may warrant a further adjustment. *Id.*

with his duty of impartiality. An equitable adjustment among the beneficiaries is often necessary to enable the fiduciary to satisfy both duties.

Draftsmen should ensure that fiduciaries are given the flexibility and necessary powers to make appropriate elections, including the new section 643(e)(3) election. Furthermore, it would be appropriate for the trust or will instrument to specify that no tax election will create the need for equitable adjustments among beneficiaries whose interests might be affected. In other cases it might be appropriate for the governing instrument to specifically require equitable adjustment in the event of a section 643(e)(3) election. Only through an understanding of the new section 643(e)(3) election and the principles of the equitable adjustment doctrine can the proper decision be made.