The Income Taxation of the Capital Gains of a Trust

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The Internal Revenue Code of 1954 does not purport to answer directly the question of who pays the tax on capital gains realized by a trust. Under the scheme of the Code, the critical question is whether a given capital gain is included in the distributable net income of the trust, since it is the trust’s distributable net income which measures the maximum amount includable in the gross income of the beneficiaries (and deductible by the trust) by virtue of distributions to the beneficiaries. Thus to the extent that capital gains are excludable from distributable net income they are taxed to the trust and not to the beneficiary.

Section 643 of the Code defines "distributable net income" as the "taxable income" of the trust with certain "modifications." The modification which concerns us is contained in section 643(a)(3) which provides, pertinently:

Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not... paid, credited, or required to be distributed to any beneficiary during the taxable year....

The proper interpretation of this provision has been the subject of considerable disagreement. For example, in a proposed draft revision of the Code published by the American Law Institute in 1956, it was suggested that section 643(a)(3) was susceptible of four different interpretations which could lead to four different results on the same set of facts. In large part the

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1 ALI, Fed. Income, Estate and Gift Tax Stat. 103–04 (Tent. Draft No. 11, 1956). The cited example involved a corpus distribution in a year in which the trust had a capital gain. The four alternatives stated were:

"(1) The capital gain, though allocable to corpus, could be deemed to have been distributed to the beneficiary in the form of the corpus distribution...."

"(2) The capital gain could be treated as having been allocated to corpus and not distributed to the beneficiary...."
difficulty seems attributable to a lack of clear understanding of the manner in which capital gains were treated under prior revenue acts and to a consequent failure to view the present Code provisions in their historical perspective. We shall begin, therefore, with the past.

Although a trust was first made a separate taxable entity under the Revenue Act of 1916, it was the 1924 act which established the present pattern of making the income taxable to the trust in the first instance and allowing deductions to the trust with respect to income distributable, or distributed, to the beneficiaries. The provisions of the 1924 act were embodied in the 1939 Code and remained substantially unchanged until 1942. The 1939 Code, as amended in 1942, in turn remained substantially unchanged until the 1954 Code. Accordingly, we will divide our consideration of the taxation of the capital gains of trusts into the three periods, i.e., (a) prior to 1942, governed by the original 1939 Code, (b) 1942 to 1954, governed by the 1939 Code, as amended in 1942, and (c) 1954 to the present, governed by the 1954 Code.

Taxation of Capital Gains Prior to 1942

Section 161 of the 1939 Code divided the taxable income of trusts (and estates) into four classes:

(1) income required to be accumulated;
(2) income required to be distributed currently;
(3) income received by estates of deceased persons during administration or settlement of the estate;
(4) income which could be accumulated or distributed in the discretion of the fiduciary.

Section 161 subjected all four classes of income to the same income taxes imposed on individuals, including, therefore, the income tax imposed on the realization of capital gains.

Section 162 determined whether the trust or the beneficiary was

"(3) The corpus distribution could be deemed to consist of capital gain in the same proportion as the capital gain bears to the corpus . . . ."

"(4) The last and probably least desirable alternative would be to construe the statutory language as requiring a tracing of the distribution so as to include the gain in distributable net income only if the corpus distribution could be traced to it."

4 This class also included income collected by a guardian of an infant subject to court order.
5 See I.R.C. § 22(a) (1959); Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921).
to pay the tax, in the following way: Subdivision (b) of section 162 allowed the trustee to deduct, in determining the net income of the trust, income of the second class, i.e., "the amount of the income of the... trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries."

Subdivision (c) of section 162 allowed the trustee to deduct so much of the third and fourth classes of income as was "properly paid or credited" to a legatee, heir, or beneficiary.6

Under both subdivision (b) and subdivision (c) of section 162, the amount which the trust was allowed to deduct (whether deducted or not) was includable by the beneficiaries in computing their net income. Under subdivision (b), the currently distributable amount was includable by the beneficiaries "whether distributed to them or not," but under subdivision (c) the amount was includable by the beneficiaries only if it was "properly paid or credited" to them.

Although the scheme of these provisions seems fairly clear, difficulty arose in their application due to their failure to recognize and provide for the fact that the word "income" can refer to two different concepts: (1) "tax income" denoting those items considered to be within the meaning of "gross income" as used in the federal tax sense, and (2) "trust income," denoting those items interpreted under local law to be comprehended by the word "income" when used in a trust instrument to determine the amount available for distribution to one class of beneficiaries (income beneficiaries) as opposed to another class (remaindermen or corpus beneficiaries).

No problem was presented in this respect where a particular item was both tax income and trust income.7 If, for example, a trust received ordinary dividends during its taxable year, the amount would be tax income and also, absent a contrary provision in the trust, trust income. If the trust provided for its income to be distributed currently, section 162(b) would render the dividends

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6 Subdivision (c) provided, in full:

In the case of income received by estates of deceased persons during the period of administration or settlement of the estate, and in the case of income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated, there shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year, which is properly paid or credited during such year to any legatee, heir, or beneficiary, but the amount so allowed as a deduction shall be included in computing the net income of the legatee, heir, or beneficiary.

7 However, the trust's net tax income, aside from the section 162 deductions, might still be different from its net trust income available for distribution because tax deductions and trust deductions might not be the same.
deductible by the trust and includable by the beneficiaries. The same result would follow under section 162(c) if the trust provided that the income was to be distributed or accumulated in the trustee’s discretion, and the trustee paid or credited the dividends to the beneficiaries.

Difficulty arose, however, when an item which was tax income was not trust income. Such difficulty would be presented in two situations: First, where the word “income” in the trust was construed to exclude the item, and second, where, although the word “income” was normally construed to include the item, the trust either specifically provided for the item’s exclusion from income or gave the trustee discretion to include or exclude the item from income and the trustee decided to exclude it from income and add it to corpus.

Thus the problem arose with respect to capital gains which, although within the tax income of the trust, were, as they are now, ordinarily considered to be trust corpus—i.e., an accretion to corpus—rather than trust income. How, then, were such gains treated under sections 162(b) and 162(c)?

Recall that the amount deductible by the trust and taxable to the beneficiaries was, under section 162(b), “the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the legatees, heirs, or beneficiaries . . .”, and under section 162(c), “the amount of the income of the estate or trust for its taxable year, which is properly paid or credited during such year to any legatee, heir, or beneficiary . . .” (emphasis added).

Were capital gains within the meaning of the word “income” which is italicized in these clauses of sections 162(b) and 162(c)? Or to ask the question another way, did that word “income” comprehend all tax income regardless of whether it was also trust income, or only tax income that was also trust income?

Under section 162(b) the question was avoidable, and thus avoided, for the following reason: To be deductible under section 162(b), the amount had to be not only an “amount of income” but also an amount “which is to be distributed currently.” Whether an amount was currently distributable, in turn, depended upon

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8 The converse situation was also presented, i.e., where an item was not tax income but was considered trust income. See McCullough v. Comm’r, 153 F.2d 345 (2d Cir. 1946); Johnston v. Helvering, 141 F.2d 208 (2d Cir.), cert. denied, 323 U.S. 715 (1944). Such a situation is not, however, pertinent to this inquiry.

whether the beneficiary, under the instrument as interpreted by local law, had the right to compel its distribution. Because capital gains were not ordinarily considered trust income under local law, the beneficiary could not compel their distribution where the trust provided for current distribution of its income, and consequently they were neither deductible by the trust nor taxable to the beneficiaries under section 162(b). Therefore, since the deduction under section 162(b) was not allowable for capital gains for the reason that they were not currently distributable, it was unnecessary to determine whether the deduction was not allowable on the additional ground that the word "income" in section 162(b) meant only items which were both tax income and trust income. Such was the result, if not the precise rationale, of the cases which considered the question.

On the other hand, in a few cases the grantor of the trust was held to have used the word "income," (or similar language such as "income, proceeds, and profits"), as comprehending capital gains, thus entitling the income beneficiary to a distribution of the capital gains. In these cases, the capital gains were held currently distributable and thus deductible by the trust and taxable to the beneficiaries under section 162(b). Again, however, these holdings did not involve a decision that the word "income" in section 162(b) referred only to those items of tax income which were also items of trust income, since the capital gains in question were both tax income and trust income.

The question of the meaning of the word "income" could not, however, be avoided under section 162(c). Assume the following: A trust provides that its income is to be paid to A for life and the corpus transferred to B on A's death. It is expressly stated in the trust instrument that the word "income" does not include

10 Comm'r v. Lewis, 141 F.2d 221 (3d Cir. 1944); Letts v. Comm'r, 84 F.2d 760 (9th Cir. 1936); Freuler v. Helvering, 291 U.S. 35 (1934); LT. 3830, 1946-2 C U R. B U L L. 47.

11 Mary Hadley Case, 8 T.C. 343 (1947); Judson v. United States, 15 F.Suppl. 62 (Ct. Cl. 1936); Anna M. Chambers, 29 B.T.A. 971 (1934), aff'd, 77 F.2d 95 (3d Cir. 1935); see Randolph v. Comm'r, 76 F.2d 472 (8th Cir.), cert. denied, 296 U.S. 599 (1935).

12 See Letts v. Commissioner, 84 F.2d 760 (9th Cir. 1936); Amy H. DuPuy, 32 B.T.A. 969 (1935).

13 In Letts v. Commissioner, 84 F.2d 760 (9th Cir. 1936), the court, although not speaking directly to the problem, used language which would imply that the court assumed that "income" in section 162(b) meant all tax income whether or not also trust income:

Whatever terminology is used, the fact remains that in 1927 the trust received from the corporation $6,998,888.24, of which $1,432,939.28 was taxable income [capital gains], and that $1,185,088.24 thereof was currently distributable .... 84 F.2d at 762.

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capital gains, but that capital gains in any given year may be paid to A or added to corpus in the trustee’s discretion. During the taxable year, the trust has a capital gain of $1,000 and the trustee decides to pay it to A. Is the distribution to A deductible by the trust and taxable to A under section 162(c)?

For convenience that section is again quoted:

In the case of income received by estates of deceased persons during the period of administration or settlement of the estate, and in the case of income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated, there shall be allowed as an additional deduction in computing the net income of the estate or trust, the amount of the income of the estate or trust for its taxable year, which is properly paid or credited during such year to any legatee, heir, or beneficiary, but the amount so allowed as a deduction shall be included in computing the net income of the legatee, heir, or beneficiary. (Emphasis added.)

Note at the outset that the phrase “properly paid or credited” does not obviate a decision on the meaning of “income” in the phrase “amount of income” in section 162(c), as did the phrase “which is to be distributed currently” in section 162(b). To be sure, if the capital gain is not paid or credited, “income” need not be interpreted since no question of a section 162(c) deduction will arise. If, however, as supposed, the capital gain is paid to A, the fact that it is determined to have been properly paid does not mean that it is “trust income,” making it therefore both “tax income” and “trust income,” and thus making irrelevant the interpretation of “income” in section 162(c). This is because, first, the capital gain could have been properly paid, under the instrument, even though it was not trust income, and second, the instrument specifically provided that it was not to be considered trust income. Thus, to allow a section 162(c) deduction in the above circumstances, would require a holding that the word “income,” in the italicized phrase “amount of income” in the section, referred to amounts which were tax income whether or not they were also trust income. Conversely, to disallow the deduction would seem to involve a holding that “income” referred only to those amounts which were both trust income and tax income.

The first case to confront the issue directly was Anna M. Chambers. There a testamentary trust had total tax income for 1930 of $16,967.28, which included $9,913.85 of capital gains. Total distributions to the beneficiaries in 1930 amounted to $21,000. The

14 33 B.T.A. 1125 (1936).
Board determined that under the law of Pennsylvania the will which created the trust required that the trust income be distributed currently, allowed the trustees to distribute corpus in their discretion, and excluded the capital gains from trust income. The conclusion of the Board was that the capital gains were taxable to the trust and not deductible under section 162(e). The reasoning of the Board began as follows:

"We think the word "income" as used in section 162(e) includes gain from the sale of corpus which is distributed as income but does not apply when under the laws of the state it is a part of the corpus of the estate and is not distributable as income."\(^{15}\)

This statement, of course, is merely another way of saying that "income" in section 162(e) refers only to amounts which are both trust income and tax income. What was the basis for such a conclusion? The Board continued:

"This construction is, we think, further justified when we examine the whole section, which must be considered in its relation to other sections of the act in arriving at the content of the word "income." It is provided in (e) that "the amount so allowed as a deduction shall be included in computing the net income of the legatee, heir, or beneficiary" but under section 22(b)(3) of the Revenue Act of 1928 a legatee, heir, or beneficiary is not taxable on the corpus of an estate which is distributed to him under the provisions of the will. Cf. Burnet v. Whitehouse, 283 U.S. 148. He is, however, taxable upon amounts paid to him as an ordinary beneficiary of income. Cf. Irvin v. Gavit, 268 U.S. 161; Helvering v. Butterworth, 290 U.S. 365. The fact that under the revenue laws capital net gain is taxable income does not prevent such gain from becoming a part of the corpus of the estate immediately upon its realization nor change its character to income when distributed by the trustees under a power given them by the will to distribute corpus. If, as here, such gain is in fact distributed by the trustees under their discretionary power to distribute corpus, it is a distribution of corpus to the heirs, legateses, or beneficiaries under the will, and is not deductible by the fiduciary, cf. Helvering v. Pardee, 290 U.S. 365.\(^{16}\)

The Board's reasoning seems faulty on several grounds. In the first place, although properly suggesting that a consideration of the whole of section 162 and its relation to other sections of the act might aid in interpreting "income" in section 162(e), the Board did not follow its own admonition, which, it is submitted, points to a conclusion opposite that of the Board. Note that in

\(^{15}\) Id. at 1128.

\(^{16}\) Id. at 1128–29 (emphasis added).
section 162(c) the word "income" is used five times—three times standing alone, and twice preceded by the word "net." In the first two places where it is used alone, it is contained in phrases descriptive of two of the four classes of income taxable to a trust or estate under section 161, i.e., "income received by estates of deceased persons during the period of administration or settlement of the estate" and "in the case of income which in the discretion of the fiduciary may be either distributed to the beneficiary or accumulated." These phrases of section 162(c) are identical with those of section 161(a)(1) and section 161(a)(2) respectively. Beyond question the word "income" in both instances refers to all items of tax income and thus includes capital gains. In the two places where "income" is used in the phrase "net income" the reference is to the computation of the amount taxable to the trust and the beneficiaries, and again obviously means tax income comprehending capital gains. There would thus seem to be no reason for believing that when the word "income" is used for the third time standing alone, in the phrase "amount of income of the estate or trust for its taxable year" it refers to any other concept than that referred to by the same word four other times in the same subsection.

Moreover, the purpose of section 162 and its role in the statutory pattern for taxation of tax income argue strongly for an interpretation of "income" as tax income. Congress intended to tax all of the tax income of trusts, and to tax the "tax income" to those benefited by it. If tax income is distributable to A or distributed to A in the exercise of the trustee’s discretion, A benefits by it. If tax income is not distributable to A nor distributed to A, but rather kept by the trust for later distribution to B, B benefits by it and B, i.e., the trust which holds the tax income for B, should pay the tax.

The Board, however, viewed section 22(b)(3) of the Code, exempting gifts, bequests and devises, as dictating a different result. The reasoning of the Board in this respect would seem to amount to this: Section 22(b) exempts gifts and bequests of corpus from the income tax. Capital gains, although tax income to the trust, became part of the corpus immediately upon their receipt by the trustee. Therefore, when capital gains were distributed by the trustee under his discretionary power to distribute corpus, they

17 See I.R.C. § 22(a) (1939); Merchants’ Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921).
were distributed as corpus and thus within the exemption of section 22(b). The difficulty with this analysis, however, lies in its failure to distinguish "trust income" from "tax income." Section 22(b) (3) provided:

The following items shall not be included in gross income and shall be exempt from taxation under this chapter: ... the value of property acquired by gift, bequest, or devise, or inheritance (but the income from such property shall be included in gross income) . . . .

Thus, as the parenthetical phrase of section 22(b)(3) indicates, the exemption, in a trust situation, does not apply to the tax income of the trust, whether or not such tax income is considered trust income as well. The exemption applies only to tax corpus, i.e., the value of the original property placed in trust. This original corpus is subject, in a testamentary situation, to the federal estate tax (to the gift tax in an inter vivos situation), and as the Supreme Court stated in Lyeth v. Hoey: 18 "Congress has not indicated any intention to tax again the value of the property which legatees, devisees or heirs receive from the decedent's estate." 10 But accruals to the original corpus—by way of ordinary tax income or capital gains—do not constitute the "value of property acquired by gift, bequest or devise" but are "income from such property," i.e., tax income.

Thus, in the Chambers case, the capital gain was trust corpus as opposed to trust income. It, nevertheless, was also tax income. When distributed to the beneficiary it was still trust corpus and tax income. The distribution by the trust as a conduit certainly could not make the capital gain part of the original corpus, that is, it could not change tax income into tax corpus. Indeed, if the capital gain was within section 22(b)(3) there would seem to be no reason why it was not exempt in the hands of the trustee, who was a legatee, as well as the beneficiary. 20 If such were the case, however, capital gains of a trust would escape taxation altogether—contrary to section 161. The truth is, of course, that the gift and bequest exemption of section 22(b)(3) was irrelevant to the section 162(e) question in Chambers. Nevertheless, the Chambers rationale was not only followed consistently by the Board itself 21 but was, in

18 305 U.S. 188 (1938).
19 Id. at 195.
20 The fact that the trustee is not a beneficial legatee is not relevant. He pays no income tax on amounts of principal received as gifts or bequests.
21 See, e.g., Old Colony Trust Co., 38 B.T.A. 828 (1938), involving capital gains distributed pro rata by the executors of an estate among various pecuniary legatees.
essence, adopted by every court of appeals which thereafter considered the question.\textsuperscript{22} In summary, under the 1939 Code, prior to the 1942 amendments, (1) under section 162(b) capital gains were deductible by the trust

\textsuperscript{22}Simon v. Hoey, 180 F.2d 354 (2d Cir.), cert. denied, 339 U.S. 966 (1950); Burechenal v. Comm'rs, 150 F.2d 489 (6th Cir. 1945); Estate of Rogers, 143 F.2d 606 (2d Cir.), cert. denied, 323 U.S. 780 (1944); Weigel v. Comm'r, 96 F.2d 387 (7th Cir. 1938). Contra, Weber v. Comm'r, 111 F.2d 766 (2d Cir. 1940) (dictum). This case was rejected by Estate of Rogers, supra. Cf. Comm'r v. Stearns, 65 F.2d 371 (2d Cir. 1933).

The approach of the courts took a slightly different form from that of the Board in Chambers. The courts emphasized the section 162(e) phrase "properly paid or credited," holding that those terms:

\begin{itemize}
  \item must be taken to mean properly paid or credited as income. For if it is properly paid or credited as a legacy or inheritance under a will it is exempt from income tax as against the legatee or heir under section 22(b)(2) and cannot be included in the computation of the net income of the legatee or heir under section 162(e); and the result would be to transform the deduction authorized by section 162(e) into an exemption. This would defeat the obvious purpose of section 162(e), which is merely to permit the shifting of the liability to account for estate income from executors or administrators to legatees or heirs to whom it has been properly paid or credited.
  \end{itemize}

Weigel v. Comm'r, 96 F.2d 387, 391 (7th Cir. 1938).

The essence of this approach is the same as that of Chambers, both being based on the erroneous view that section 22(b)(2) exempted gifts of tax income if it was trust or estate corpus.

In Weigel, Rogers and Burechenal, the capital gains were distributed by the executors to the trustees of a testamentary trust. In Simon v. Hoey, on the other hand, the gains were distributed by the executors to legatees, i.e., beneficial legatees. In the Weigel case, the Seventh Circuit had said, in dictum:

When no testamentary trust is involved it is consistent with the reality of the situation to hold, for purposes of section 162(c) supra, that residuary legatees who receive payments of funds composed both of original assets of the estate and of estate income, receive that portion represented by estate income as income derived from their own property. This follows from the generally recognized rule that the right of a residuary legatee to his distributive share of the personal property of an estate vests at the death of the decedent. But in the case of the creation of a testamentary trust out of the residue of an estate, the residue consisting of estate corpus and estate income, the reality, both factually and legally, is that estate income has ceased to have any identity. And it would seem to follow that fiduciaries who take the residue as the res of a testamentary trust receive it as trust corpus and not as a payment, in whole or in part, of estate income.

Weigel v. Comm'r, 96 F.2d 387, 389 (7th Cir. 1938).

This distinction drawn in Weigel between distributions to beneficial legatees as opposed to nonbeneficial legatees would lead to the allowance of the section 162(e) deduction in a case like Simon v. Hoey. As indicated, however, Simon did not allow the deduction and neither the district court nor the Second Circuit ever adverted to the Weigel dictum. In any event, it would seem that this dictum contradicts the rationale of Weigel itself. For if, as the Weigel case held, the phrase "properly paid or credited" in section 102(e) "must be taken to mean properly paid or credited as income" and if, as the court further held, the capital gains became part of the corpus of the estate immediately upon receipt, the gains could no more have been paid to beneficial legatees as income than they were to the trustees of the testamentary trust. If the distribution of the gain to the trustees was a distribution of corpus and within the section 22(b)(3) exemption, it could not be consistently held that an identical payment became a payment of income because the recipients were beneficial legatees as opposed to trustees.
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or estate only if they were required by the will or trust "to be distributed currently"; (2) under section 162(c) capital gains were not deductible by the fiduciary even where they were distributed, unless they were distributed "as income," i.e., unless they were distributed pursuant to the provisions of an instrument allowing their distribution as distributions of income as that term was used within the instrument, trust or will.

The 1942 Amendments

In 1942 Congress enacted several amendments to section 162 of the 1939 Code. Although none of these amendments spoke specifically to the capital gains problem, certain of them were thought, and in at least one case were held, to have affected the question. We will first consider the amendment to section 162(b).

The Amendment to Section 162(b)

As amended in 1942, section 162(b) read, in pertinent part, as follows (the italicized words indicate the new provisions):

There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the legatees, heirs, or beneficiaries, but the amount so allowed as a deduction shall be included in computing the net income of the legatees, heirs, or beneficiaries whether distributed to them or not. As used in this subsection, "income which is to be distributed currently" includes income for the taxable year of the estate or trust which, within the taxable year, becomes payable to the legatee, heir, or beneficiary.

The quoted amendatory provisions, in the words of the Senate Finance Committee Report, were:

designed to include in the income of a legatee or beneficiary the income of the estate or trust for its taxable year which, within such taxable year, becomes payable to the legatee or beneficiary, even though it then becomes payable as part of an accumulation of income held until the happening of some event which occurs within the taxable year. Such cases are usually cases where accumulated income of an estate is paid to a residuary legatee upon termination of the estate or where income of a trust is accumulated for distribution upon the beneficiary’s reaching a specified age.

The question of whether the income of an estate or trust for the taxable year in which it becomes payable as part of an accumulation is taxable on the one hand to the estate or trust or on the other hand to
the legatee or beneficiary has been a source of litigation in certain cases under existing law. This amendment is designed to clarify the law.\textsuperscript{23}

Although the report speaks in terms of clarifying the law, it is probably more accurate to view the amendment to section 162(b) as changing the law. Prior to that amendment it had been uniformly held by several courts of appeals that where, for example, a trustee, on a calendar year basis, was directed to accumulate income until a beneficiary became 21 years old, and then pay the accumulated income to the beneficiary, and the beneficiary became 21 on December 31, the current income of the trust for the year of distribution was not, under section 162(b), deductible by the trust and includable by the beneficiary.\textsuperscript{24} The reasoning of these decisions was that the current income was not "currently" distributable within the meaning of section 162(b) because it was not "periodically" distributable. Strong reliance was placed on the four categories enumerated in section 161(a) which were held to be mutually exclusive so that one of the categories—income accumulated for future distribution—could not fall into the "currently distributable" category in the year payment was required.\textsuperscript{25}


\textsuperscript{24} Comm'r v. Sheldon, 134 F.2d 615 (6th Cir. 1943); Comm'r v. Clark, 134 F.2d 159 (2d Cir. 1943); Spreckels v. Comm'r, 101 F.2d 721 (9th Cir. 1939); Roebling v. Comm'r, 78 F.2d 444 (3d Cir. 1935). Cf. Cowles v. United States, 50 F.Supp. 242 (Ct. Cl. 1943), where the government evinced a total misunderstanding of the above decisions, stating in its brief:

In view of these decisions [Roebling, Spreckles and Clark] we do not contend that where income, which under the terms of the trust instrument is to be distributed in the discretion of the fiduciaries, is accumulated and paid to the beneficiary as a part of the corpus, it is taxable to the beneficiary. (Emphasis added.) 50 F.Supp. at 245.

The Court of Claims refused to accept this concession, properly pointing out that the cases mentioned concerned section 162(b) and not section 162(c):

In each of the cases cited the income was required by the trust instrument to be distributed on a date certain. In none of them was the income distributed under a discretionary power lodged in the trustee by the trust instrument. The income in the case at bar was distributed under a discretionary power and comes squarely within the terms of section 162(c) . . . . 50 F.Supp. at 245.

(The report of the case, incidentally, does not indicate whether any capital gains were involved in the distribution in issue.)

\textsuperscript{25} As was stated by the Second Circuit in Commissioner v. Clark, 134 F.2d 169, 161 (2d Cir. 1943):

The categories of trust income established by section 161(a) are based upon the fiduciary's duties as prescribed by the terms of the trust. Income accumulated for "future distribution" speaks with reference to the trustee's duty to retain the income after its receipt and without regard to the taxable year. In contrast to accumulated income subdivision (2) [of section 161(a)] speaks of income to be "distributed currently," that is, presently or periodically as distinguished from future. The two categories are mutually exclusive. Section 162(b) deals only with the second category. The fact that accumulated income must in some taxable
Whatever be the merits of these decisions, they implied nothing with respect to the capital gains problem. The only question involved was whether the phrase "to be distributed currently" included the case where an amount became payable upon the beneficiary's reaching a certain age. If, as the courts held, this question was to be answered in the negative because the current income was not periodically distributable, it was immaterial whether capital gains or ordinary tax income were involved since in either case the amount was not within the section 162(b) deduction. Nor would an affirmative answer have added anything to the capital gains question under section 162(b). To be sure, if capital gains were involved in the amount in question, as was the case in at least one of the decisions, the court would have had to determine whether the amount was "an amount of income" within section 162(b), but, as was stated previously, this would not involve the court in deter-

The reference in Clark to section 162(e) is of questionable significance. The court's statement that if section 162(b) allowed the deduction in the case before it, section 162(e) became superfluous, was inaccurate. The case before the court involved an amount which the beneficiary, during the trust's taxable year, acquired the right to have distributed to him. Section 162(e) did not apply to such a situation, but rather to one where the amount may be distributed or accumulated in the trustee's discretion. What the court should have stressed was the fact that whereas section 161 divided income of estates and trust into four categories ((a) income to be accumulated; (b) income to be distributed currently; (c) income of estates during settlement or administration; and (d) income which could be accumulated or distributed), section 162 allows deductions only for three categories, omitting any reference to income to be accumulated. See Comm'r v. Stearns, 65 F.2d 371, 373 (2d Cir. 1933).

On the other hand, it would be anomalous to hold that Congress meant that a beneficiary was taxable if he could compel payment when he reached a certain age, but was not taxable if he could not compel payment when he reached a certain age, but was nevertheless paid in the trustee's discretion.

It was earlier stated that the federal courts had held that state law, i.e., the state law's interpretation of the instrument in question, determined whether an amount was currently distributable. Although this is the phraseology of the federal cases, it would be more accurate to describe them as holding that state law determined whether and when a particular amount was to be distributed, that is, how much a beneficiary could compel a trustee to pay him and at what time. The cases under discussion did not involve these questions. They were concerned with the meaning of "currently" or the meaning of the category described as "to be distributed currently." There was nothing in section 161 or section 162 which "by express language or necessary implication" (Burnet v. Harmel, 287 U.S. 103, 110 (1932)) made this question dependent on state law and the question was properly so treated by the courts.

Roebling v. Comm'r, 78 F.2d 444 (3d Cir. 1935).
mining whether "income" included capital gains even if they were not trust income under the instrument. For if the amount was to be distributed it was because it came within the meaning of income as used in the trust instrument which directed that income be accumulated and then paid to the beneficiary on his reaching a certain age. This, again, would make the amount both trust income and tax income and obviate deciding whether "income" in section 162(b) referred only to items which were both tax income and trust income.28

By a parity of reasoning, the quoted amendment to section 162 (b) would not seem to have changed the situation as far as capital gains were concerned; for all that the amendment did was to include within "income which is to be distributed currently" an amount of "income for the taxable year of the estate or trust which, within the taxable year, becomes payable to the legatee, heir, or beneficiary." To illustrate this point, suppose a trust created in 1943 provided for income to be accumulated and paid to A on his 21st birthday, thereafter the income to be paid annually to A, with the corpus to be transferred to B on A's death. Suppose further that the trust was on a calendar year basis, that A became 21 on December 31, 1944 and that the trust received during 1944 ordinary dividends of $1,000 and capital gains of $1,000. Ordinarily, under state law, the capital gains would not be considered within the phrase "income to be accumulated" as used in the trust, although the ordinary dividends would. Thus the gains would not become "payable" within the 1942 amendment to section 162(b) and the deduction would not be allowed, rendering unnecessary, as before, a determination of whether the deduction was also not allowable because "income" in the 1942 amendment meant only items which were both tax income and trust income. Conversely, if the gains were "payable" it would be because the phrase "income to be accumulated" included them, again rendering unnecessary a construction of "income" within the 1942 amendment since the gains would be both tax income and trust income.

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28 Another purpose of the 1942 amendments to section 162(b) was to reverse the result of a number of decisions which had held that where income (ordinary or capital gains) was distributed by an estate as part of a final distribution of an estate, the income distributed was not taxable to the legatee, but was within the exemption of section 22(b)(3). See, e.g., Anderson's Estate v. Comm'r, 126 F.2d 46 (9th Cir. 1942); Dunlop v. Comm'r, 165 F.2d 284 (8th Cir. 1948); Durkheimer v. Comm'r, 41 B.T.A. 585 (1940). For the reasons stated in the text with respect to the cases involving trusts wherein amounts became distributable to beneficiaries on a certain date, these decisions likewise implied nothing one way or the other with respect to the capital gains problem.
Nor did the amendment to section 162(b) appear to affect the decisions, discussed under the prior heading, which held that, under section 162(c), discretionary distributions of capital gains were not deductible to the trust and not taxable to the beneficiary since they were received as tax-exempt gifts or legacies. Just such an effect, however, was given to the amendment to section 162(b) in *Carlisle v. Commissioner*\(^{20}\) where the estate made a discretionary distribution of capital gains in the year prior to the final distribution of the estate. The beneficiary contended the amount was not taxable to her, relying on the square authority of *Burcheizal v. Commissioner*,\(^{30}\) which had held on similar facts, under the unamended 1939 Code, that the distribution was received as a tax-exempt legacy because it was not distributed as "income." Faced with the opportunity to reject the improper rationale of *Burcheizal* and hold that the distribution was taxable to the beneficiary under section 162(c) as a discretionary distribution of income (and thereby to interpret "income" as used in section 162(c) to mean all items of tax income whether or not they also were items of trust or estate income), the court instead held the capital gain distribution deductible to the trust and taxable to the beneficiary under the 1942 amendment to section 162(b). The word "payable," held the court, must be interpreted to include "paid," so that any amount of income actually paid is therefore payable and hence currently distributable. Not to so hold, suggested the court, would create the anomaly that a beneficiary would be taxable upon an amount payable, whether or not received, but would not be taxable upon an amount actually paid, but which was not payable because it was within the fiduciary's discretion to pay or not to pay.\(^{31}\)

Of course, the anomaly which the court wished to avoid in *Carlisle* had been created prior to the 1942 amendment by *Burcheizal* and its brethren cases. As previously noted, capital gains which were required to be distributed currently were taxable to the beneficiary, but those distributed pursuant to a discretionary power were not so taxable. In order properly to remove the anomaly, the *Carlisle* court should have rejected the rationale of *Burcheizal* as to discretionary distributions of capital gains and held them taxable to the beneficiary under section 162(c). Instead this result was reached, in effect, by holding that an exercise of discretion by the

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\(^{20}\)165 F.2d 645 (6th Cir. 1948), affirming 8 T.C. 563 (1947).

\(^{20}\)160 F.2d 482 (6th Cir. 1945).

\(^{31}\)Carlisle v. Comm'r, 165 F.2d 645, 648 (6th Cir. 1948).
fiduciary to pay the capital gains made the gains "payable" within section 162(b). The probable source of this interpretation was a Treasury regulation, which in turn most likely was drawn from the Senate Finance Committee report accompanying the 1942 amendment to section 162(b).

The problem, however, with this judicial interpretation, the administrative regulation, and the legislative report was that they rendered section 162(c) completely superfluous since they wiped out any distinction between a discretionary distribution and a mandatory distribution. If the fiduciary's exercise of discretion to pay income rendered that income "payable" and thus currently distributable, to what could section 162(c) apply? What would be the purpose of retaining section 162(c) in the Code? What would be the purpose of retaining the section 161 distinction between income which could be paid or accumulated and income which is to be distributed currently? As one commentator has said:

Neither statements in Committee Reports nor regulations issued by the Commissioner can deliberately ignore a specific provision in the Code by creating definitions which, in effect, utterly destroy the meaning of the provision.

The same commentator criticized Carlisle on another ground. The basis of the additional criticism was the contention that the word "income" in the pre-1942 section 162(b) phrase "amount of income" meant income as defined by local law, or what I have

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32 Ibid.
33 Reg. 111, Sec. 29.162-2(b) (1943), which provided:

As used in section 162, the term "income which becomes payable" means income to which the legatee, heir, or beneficiary has a present right, whether or not such income is actually paid. Such right may be derived from the directions in the trust instrument or will to make distributions of income at a certain date, or from the exercise of the fiduciary's discretion to distribute income, or from a recognized present right under the local law to obtain or compel a distribution of income. (Emphasis added.)


In the case of a similar trust [that is, a trust which directs the trustee to accumulate the income until the beneficiary becomes 21 years old], where the twenty-first birthday of B, the beneficiary, was on July 1, 1942, and the income of the trust was to be accumulated until that date and then to be distributed to B at such time as the trustee in his discretion decides, if the trustee on December 31, 1942, decides to distribute the accumulated income to B, the income becomes payable to B on December 31, 1942, whether distributed to him or not.

36 Kennedy, Recent Developments in the Taxation of Estates and Trusts, 27 Taxes 1118, 1120 (1949).
been calling, with respect to trusts, trust income. I have attempted
to show previously, however, not only that there was never a square
holding to this effect, because the issue did not have to be faced, but
also that such an interpretation would be contrary to the congress-
ional design to tax the tax income to the person whom the income
benefited.

In the Carlisle case, the meaning of "income" in section 162(b)
had to be faced, but only because the court, through what has been
suggested was an erroneous interpretation of the 1942 amendment,
held that a discretionary payment of capital gains made such gains
"payable" and thus "currently distributable." The court did
not discuss whether "income" included capital gains or whether
it referred only to income under local law (the will was silent
as to disposition of any additions to the estate during administra-
tion, but by its holding it effectuated an authoritative precedent
that "income" meant tax income even though such was not income
under local law.

Carlisle, it is suggested, came up with the right results but for
all the wrong reasons. It applied an inapplicable provision and
interpreted it incorrectly except in one instance, and there without
discussion. It correctly held, however, that capital gains distributed
under a discretionary power to distribute or retain were deductible
to the estate and includable by the legatee.37

The Addition of Section 162(d)

In addition to the section 162(b) amendment, consideration must
be given to another of the 1942 changes in section 162, namely
the addition of section 162(d).

That new subsection read, in pertinent part:

For the purposes of subsection (b) and (c)—

(1) .... In cases where the amount paid, credited, or to be distributed
can be paid, credited, or distributed out of other than income, the
amount paid, credited, or to be distributed (except under a gift, be-
quest, devise or inheritance not to be paid, credited, or distributed at
intervals) during the taxable year of the estate or trust shall be con-
sidered as income of the estate or trust which is paid, credited, or to
be distributed if the aggregate of such amounts so paid, credited, or to
be distributed does not exceed the distributable income of the estate
or trust for its taxable year.

The phrase "distributable income" was defined, in effect, as the
greater of (a) the net tax income or (b) the net trust income.

37 As it should have been held before the 1942 amendment since the amendment to
section 162(b) added nothing.
It is very difficult to determine the effect of this amendment on the capital gains question. On the one hand, it speaks to cases "where the amount paid" not where "the amount of income paid" (emphasis added). It thus avoids the difficulty of section 162(c) and seemingly comprehends any payment, capital gains or not. Moreover, "distributable income," the measuring rod of the maximum deductibility to the trust and taxability to the beneficiary includes, in its computation, capital gains, since these are part of tax income.

On the other hand, the section applies where "the amount paid ... can be paid" and it could be argued that the section refers only to amounts paid out of the original corpus which thus would not include capital gains which are considered accretions to the original corpus. It would seem, however, that "out of other than income" was intended to be broader than just the equivalent of original corpus and to include all sources other than what was local law or trust (or estate) income for the year in question. It would appear, for example, definitely to include payments out of amounts of trust income of prior years which had been accumulated and added to corpus. There is thus no reason why it would not also apply to payments out of accumulated or current nontrust income, i.e., capital gains.

Finally, however, the section, by its express terms, did not apply where the payment was made "under a gift, bequest, devise or inheritance not to be paid ... at intervals." (Emphasis added.) In Carlisle, section 162(d) was interpreted as not applicable to the distribution of capital gains there made by the estate to the legatee because the distribution was not one "to be paid at intervals." This exception would also, as the Carlisle court indicated, prevent the inclusion, within section 162(d), of discretionary distributions of capital gains by a trustee to a beneficiary and would thus not affect the holdings in Burchenal and like cases.

Suppose, however, as in the case of an annuity, that the amount was to be paid at intervals. Assume the following: A trust provides that A and B are to be paid $5,000 a year, that these payments are

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38 As Kennedy noted, section 162(d) is "about as distressing to the understanding as any [provision] ever sponsored by such a presumably august body as the Congress of the United States." KENNEDY, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS § 2.12, p. 160 (1948).

39 The phrase "can be paid" would seem to include "must be paid." See Reg. 111, Sec. 29.162-2(a) (1943).

40 Actually, the Carlisle court spoke of the 1942 amendment to section 22(b)(3). This, however, was merely the counterpart of section 162(d)—or vice-versa.
to be made from trust income to the extent such is sufficient, that if trust income is not sufficient, the annuities are to be paid out of corpus, and that capital gains are to be considered trust income and not corpus. In the year in question, the trust has ordinary income of $5,000 and a capital gain of $10,000. The trustee keeps separate accounts and pays $5,000 from the ordinary income to A and $5,000 from the capital gain to B. Would B be taxable on the $5,000 paid to him under section 162(d)(1)? It would seem so. The amounts paid to A and B would not exceed distributable income which includes, in its computation, the capital gain of $10,000; they are amounts paid "out of other than income," i.e., trust income; and they are amounts which are to be paid at intervals.41

In light of the above, the case of Estate of Wadewitz42 is somewhat of a mystery. There certain stock was placed in trust and the trustees were directed to pay to taxpayer $1,000 per month from the principal and income. In addition, the trustees were given complete discretion to determine how all receipts and disbursements of the trust were to be credited, charged, or apportioned between principal and income. During 1949, 1950 and 1951 the trustees received ordinary dividends and also realized capital gains. During these years the total sum of the ordinary dividends and capital gains was insufficient to provide for the monthly distributions to taxpayer and other beneficiaries of the trust. In fact no distributions were actually made. The trustees reported both the ordinary dividends and the capital gains; the beneficiaries reported neither.

Before the Tax Court, taxpayer conceded that the ordinary dividends were taxable to herself and the other beneficiaries, but contended that the capital gains were taxable to the trust.

The situation seems squarely within the language and purpose of section 162(d). The amount to be distributed to taxpayer ($12,000 a year) included some amount which could (had to) be paid out of other than trust income, i.e., an amount which had to be paid out of original trust corpus or the accretions to trust corpus

41 See Note, Taxation of Capital Gains Realized by Trusts, 12 Tax L. Rev. 99, 101 (1956) (speaking of "the type of annuity trust where the beneficiary is to receive a fixed amount each year out of corpus to the extent that income is insufficient");

Under the 1939 Code, as amended by the Revenue Act of 1942, the result was generally that the beneficiary was taxed on capital gains to the extent of the corpus invasion, because he was taxed on the statutory net income, or the trust income, whichever was greater, to the extent actually distributed to him.

The author, however, cites no cases or rulings. Cf. Estate of Wadewitz, 32 T.C. 538 (1959), discussed in the text accompanying note 42, infra.

42 32 T.C. 538 (1959).
including capital gains. Such included amount was payable at intervals.

The Tax Court, however, did not even mention section 162(d) but held, in agreement with the government’s contention, that the capital gains were taxable to taxpayer since they were currently distributable within section 162(b). The taxpayer had argued that section 162(b) was inapplicable since the trustees, as authorized, had allocated the capital gains to corpus and therefore, they were not "income which is to be distributed currently." The court noted the lack of evidence that such allocation had in fact been made, but went on to say that even assuming such allocation:

[Taxpayer’s] proportionate shares would, in the circumstances of the instant case, be currently, distributable to her. This is so, because she was entitled to $1,000 per month for life, to be paid out of principal and income of the trust. . . . [T]he trust’s ordinary income for each of the taxable years fell far short of an amount sufficient to make distributions to the beneficiaries of the amounts provided in the trust indenture. As a result, each of such beneficiaries . . . could have demanded that the trustees distribute sufficient principal (which, under the hypothesis here assumed, included the capital gains here involved) to make up the difference . . . .

Thus the Tax Court was saying that capital gains were "income" within section 162(b) which could have been demanded by taxpayer, and hence were currently distributable income.

The weakness in the above analysis, it is submitted, is found in the parenthetical material of the last sentence of the quoted excerpt from the court’s opinion. Section 162(b) taxes currently distributable income to the beneficiaries whether distributed or not because they can demand such income be distributed to them. In a conventional trust, e.g., "income to A for life," A can demand the income from the trust be distributed to him. Usually, however, as noted, capital gains would not be considered trust income and thus not subject to A’s demand, i.e., not distributable.

An annuity is somewhat different. Where a trustee is to pay A $1,000, out of income first, and out of principal only if income is insufficient, it could be said that A can demand $1,000 of income thus making $1,000 currently distributable within section 162(b).

But when, as in Wadewitz, the trust directs that the annuity be paid out of income and principal, there is no apparent reason why the beneficiary’s right must first be applied to tax income, i.e., ordinary dividends and capital gain. Since the trust instrument

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43 Id. at 544 (emphasis by the court).
does not speak to the point, the annuity may well be considered a charge on the whole fund and the beneficiary may have only the right to demand payment ratably from all trust assets, including original corpus. He would not have the right, as the Tax Court assumed in Wadewitz, to demand that the specific profits from the capital gains be given to him in payment of that part of the annuity which had to come out of principal. Indeed, the annuitant would have no concern with the source of the payment, and the assumption that a demand for capital gains would have been made is unrealistic. The court’s response to taxpayer’s argument should have been that under section 162(d) he could not avoid being taxed on the payment. For it was just this problem for which section 162(d) was enacted, i.e., to tax to an annuitant payments which under the trust could, or had to, be made from trust corpus as opposed to trust income, to the extent that the trust in the year in question, had tax income available for distribution to the beneficiary.

In summary, it should have been clear that the 1942 amendments effected little change in the capital gains area. The Carlisle case to the contrary notwithstanding, the amendment to section 162(b) was irrelevant to any strictly capital gain question, and the addition of section 162(d) was comparatively insignificant since it applied only where the distributions of the trust were to be made “at intervals.” The solution to the more important question, involving discretionary distributions in taxable years during which capital gains were realized, still depended on a proper interpretation of section 162(e) which had not been amended in 1942.

There is no doubt, however, that the Carlisle case and the early decisions under section 162(e) had created practical confusion. In an article written in 1949, it was pointed out that:

As a matter of actual practice, corporate fiduciaries in Chicago have adopted conflicting positions, some treating capital gains... as taxable to the trust and some treating them as taxable to the beneficiary; and neither position has as yet been challenged upon audit of the returns.44

Proposals of the American Law Institute

Before examining the 1954 Code sections, it would be beneficial to consider the approach taken by the American Law Institute in its proposed federal income tax statute.45

Stated simply, but accurately for our purposes, the draft made

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44 Kennedy, Recent Developments in the Taxation of Estates and Trusts, 27 Taxes 1118, 1191 (1949).
45 ALI, FED. INCOME TAX STAT. (Feb. 1954 Draft) (hereinafter cited as ALI Draft).
deductible by the trust and taxable to the beneficiary any amount distributable or distributed to the beneficiary up to the “distributable net income” of the trust. It further provided, in pertinent part, as follows:

SECTION X806. DEFINITIONS.

(a) DISTRIBUTABLE NET INCOME.—
“Distributable net income” means the net income of a trust for its taxable year, computed with the following modifications:

(1) Capital Gains and Losses.—
(A) Capital Gains.—The amount of any capital gain shall not be included unless the amount is utilized in the determination of the amount available to an income beneficiary.46

The draft comments to this provision stated:

Subsection (a). Distributable Net Income.

A. Existing Provisions
The comparable provisions are the last portion of section 162(d)(1) . . .

B. Suggested Provisions
1. The total distributable net income determines the uppermost limit on amounts taxable to beneficiaries and deductible by the trust . . .
2. . . .
3. Paragraph (1)(A) in general excludes from distributable net income items which are not “income” under state law. The effect of the provision varies. Suppose that there are distributions of $1,000 and that there is ordinary income of $500 and capital gain of $500. Assume that the capital gain is not income under local law. If paragraph (1)(A) were omitted, the beneficiaries would have to pay tax on the $500 of capital gain as well as on the $500 of ordinary income. If this provision applies, the beneficiaries will pay only on the ordinary income while the trust will pay on the capital gain. But suppose the distributions remain at $1,000 and that there is ordinary income of $1,000 and capital gain of $1,000. Then the beneficiaries will have to bear a tax on $1,000 of ordinary income, while the capital gain is taxed to the trust. If this paragraph were omitted, the beneficiaries’ tax would have been on $500 of ordinary income and $500 of capital gain.

For a capital gain item to be excluded from distributable net income under paragraph (1)(A) it must not be treated as income in the particular trust. Thus if the trust instrument provides or the trustee in the

46 ALI DRAFT 124. For the purposes of section X806(a) the draft defined income “when not preceded by the words ‘net’ or ‘gross’ [as having reference to] . . . income under the local law applicable to the determination of the amount available for distribution to an income beneficiary, rather than to gross income or net income under this Code.”

“Income Beneficiary” was defined as “a beneficiary the distribution to whom depends upon the amount which is treated as income under the local law applicable to determining distributions.” Id. at 125.
exercise of his discretion determines that capital gains or taxable stock dividends are to be treated as income, they enter distributable net income even if not ordinarily deemed income under governing law.\textsuperscript{47}

The difficulty with the draft provision was that it made the inclusion of capital gains in distributable net income turn on whether such gains were treated as income under local law, \textit{i.e.}, under the trust instrument as interpreted under local law. Thus capital gains would be included where, \textit{e.g.}, the trust directed that they be considered income or the trustee in the exercise of a discretion granted by the trust allocated them to trust income, and

1. a beneficiary had the right to income under the trust, or
2. the trustee had discretion to, and did, distribute income.

Suppose, however, that a trust was established under which the income was to be paid to A for life, remainder to B; the trust provided that capital gains were to be considered corpus, and not income, but also provided that the proceeds of capital gains might (or had to) be distributed to A. Since the capital gains were not treated as income under the trust, they would, under the draft provision, not be included in distributable net income and thus would be taxed to the trust, \textit{i.e.}, in effect, to the remainderman, even though distributed to A. Yet there is no difference in substance between this trust and a trust which specifically calls capital gains income. The purpose of the draft provision was, presumably, to tax capital gains to a beneficiary who was benefited by such gains. The provision would not fully accomplish its purpose, since a beneficiary could benefit from capital gains even though the trust did not consider them income.

\textbf{The 1954 Code Provisions}

The 1954 Code followed the ALI draft in rendering deductible by the trust and taxable to the beneficiaries amounts distributed or

\textsuperscript{47} ALI \textit{Draft} 424-25. Note that with respect to the first example cited in comment B.3., it is stated that absent the suggested paragraph (1)(A) of section 800(a) “the beneficiaries would have to pay tax on the $500 of capital gain as well as on the $500 of ordinary income.” It is unclear whether this is intended as a statement of what the result would be under prior law, or what it would be if draft section 800(a) were accepted without the inclusion of paragraph (1)(A). If the latter is meant, the statement is correct. If the former is intended, however, the statement implies a misconception of prior law, since, as was stated previously, and as was recognized by the Sixth Circuit in \textit{Carlisle}, (see text accompanying note 40, \textit{supra}), section 102(d)(1) did not apply to corpus distributions, \textit{i.e.}, distributions “out of other than income” unless the distributions were payable “at intervals.” In the situation described in the comment, therefore, the $500 capital gain would not be taxable to beneficiaries merely because there were distributions of $1,000.
distributable to the beneficiaries up to the "distributable net income" of the trust. The definition of distributable net income is found in section 643(a) which provides, in pertinent part, as follows:

For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications—

(1) . . . .
(2) . . . .
(3) . . . . Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year . . . .

Insofar as this section includes in distributable net income capital gains which are allocated to income under the trust, it is in agreement with the ALI draft. Thus, capital gains would be included if the trust directs that they be included in "income" or if the trustee has discretion under the trust to allocate capital gains to income or corpus and allocates the gains in question to income. The Code rejects, however, the draft approach of excluding capital gains merely because they are allocated to corpus. Under section 643(a)(3), capital gains, even if allocated to corpus, are included in distributable net income if they are "paid, credited, or required to be distributed" to a beneficiary.

The applicability of this latter portion of section 643(a)(3) will in some situations be fairly clear. If, for example, the trust states that capital gains, although allocable to corpus and thus not distributable to the beneficiary entitled to the income, are to be distributed to another beneficiary, they would be included in distributable net income.

Or suppose the following (hereafter referred to as hypothetical A): A trust provides that the income is to be paid to A for life, remainder to B; that income does not include capital gains; that the trustee is to keep separate accounts for (1) original corpus plus prior undistributed capital gains, (2) current ordinary income, and (3) current capital gains; and that the trustee may in his discretion make a distribution to A or B out of the current capital gains account, but not out of the account kept for original corpus and prior capital gains.

In the taxable year, the trust has a capital gain of $1,000, and the trustee distributes $1,000 to A out of the current capital gains account. In such a case it would seem clear that the $1,000 capital
gain has been "paid" to A within section 643(a)(3) and thus would be included in distributable net income.

But suppose we vary hypothetical A by assuming that the trustee was prohibited from making any distribution out of the current capital gains account, but was given discretion to make distributions from the account kept for original corpus and prior undistributed capital gains. In the taxable year, the trust has a capital gain of $1,000. The trustee distributes $1,000 to A from the account kept for original corpus and prior undistributed capital gains. Does the gain enter into distributable net income? One would suppose not, since the gain was not paid. Indeed, the instrument prohibited the gain from being paid. But is there a real difference between this situation and the previous one? Consider some additional variations on the above theme:

(a) The trust provides that its income is to be distributed; that capital gains are not income but corpus, and that corpus may be invaded and paid to A. The trust is silent as to the maintenance of separate accounts and as to the source of any corpus invasion and payment. In the taxable year, the trust has a capital gain of $1,000.

(1) The trustee does not keep separate accounts and invades corpus to the extent of $1,000 which is paid to A. The invasion of corpus and payment is before the capital gain is realized.

(2) Same as (1) but the gain is realized before the invasion and payment of corpus to A.

(b) Same as (a)(2), but the trust provides that corpus may be invaded only in a taxable year when a capital gain is realized.

(c) Same as (b), but the trust requires that separate accounts be kept for original and accumulated corpus, ordinary income, and capital gains and that the corpus invasion and payment be only out of original or accumulated corpus.

In all of these situations the trust has had a capital gain in the amount of $1,000 and has made a corpus distribution of $1,000. In this respect, they are the same as hypothetical A. However, they all differ from hypothetical A in that in none of them can the corpus invasion and payment be specifically traced to the current capital gains. Does the difference suffice to exclude the gains from distributable net income? Or, stated otherwise, are capital gains which are allocated to corpus under the trust included in distributable net income only if a given corpus distribution can be traced in this manner?

48 Note that even in hypothetical A, it may not be possible to say that the identical proceeds of the capital gain have been distributed, unless the cash or other kinds of proceeds are segregated and specifically paid. Presumably, however, payment from a current capital gains account would render the gains paid within section 643(a)(3).

49 Note that when we speak of a corpus distribution here, we refer only to partial
traced to a current capital gains account? This was the position taken by Kamin, Surrey and Warren: 50

Whether ... a [capital] gain is included in distributable net income depends on whether or not it has been "paid." This test seems to be analogous to the "tracing" tests which were embodied in the 1939 Code. For example, the pre-sixty-day rule applied only to distributions of income of the preceding years; if there was also income of the current year, the distribution had to be traced to determine which income had been distributed. Similarly whether the current income, as opposed to corpus or accumulated income, had been paid within the meaning of Section 162(c) also involved tracing. While these particular tracing rules have ceased to be applicable, tracing will be necessary to determine whether or not a capital gain has been distributed.61

On the other hand, it has been argued by Theodore Berger that reading a tracing requirement into section 643(a)(3) would be:

clearly contrary to the expressed general intent of the draftsmen of the 1954 Code. It was certainly their desire to get away from the tracing rules which had so complicated prior law. . . .

.... In so far as taxable income becomes the starting point for determining the taxability of distributions, the 1954 Code more nearly resembles prior law on the subject. [Berger's reference here is to section 162(d)(1) of the 1939 Code, as amended in 1942.] Therefore it is at least arguable that prior law should apply and that the first distributions out of corpus in any year should be considered to be capital gains of that year.52

Berger, however, would seem to be inaccurate in implying that section 162(d)(1) rendered taxable to the beneficiary distributions of capital gains in the typical discretionary distribution case where the distributions are not to be paid at intervals. Moreover, even in the at intervals, i.e., annuity, type of trust, although, as indicated earlier, Berger's implicit interpretation of section 162(d)(1) would seem proper, the Wadewitz case casts doubt on whether that interpretation was the accepted one.

distributions. If there has been a total corpus distribution, as in the year of termination or a partial distribution in an amount equal to more than the corpus less the capital gains for the current years, there will, of necessity, have been a distribution of all or part of the capital gains of the current year.


51 As the authors note, tracing involves a grant to the trustee to dictate tax consequences (unless the trust itself specifies the source of the corpus distribution). Something more than a mental note is required of the trustee. See Wilma Aaron, 22 T.C. 1370 (1954); Elizabeth T. Jones, 1 T.C. 491 (1943).

In any event, Berger finally concludes that:

the policy against tracing distributions was strong enough in the minds of the draftsmen to cause the rejection by them of any of these artifices for determining whether an otherwise unidentified payment out of corpus includes a portion of realized capital gains. It is submitted that the intent of the draftsmen of section 643(a) was to tax a beneficiary on capital gains allocated to corpus only in the relatively rare cases where the governing instrument specifically requires distribution of the proceeds or the facts clearly reveal an intent to make available to the beneficiary the proceeds of a sale or exchange as such.53

The legislative history, however, does not really support Berger’s position. The author’s reference presumably is to the following statements in the committee reports:

This approach represents a basic departure from the general rule of the existing law that taxable distributions must be traced to the income of the estate or trust for the current year.

. . . .

The approach adopted by the bill eliminates the necessity, in determining the taxability of distributions, of tracing such distributions to the income of the estate or trust for the current taxable year. The simplicity of this general principle makes it possible to eliminate the so-called 65-day and the 12-month rules of existing law. Under the bill, except to the limited extent provided under the throwback rule (discussed later) which is designed to eliminate a loophole of existing law, amounts distributed in 1 year will not be considered to have been distributed in a preceding year, and the source of a distribution, whether made from the income of the current year or of a preceding year, is immaterial in determining the taxability of the distribution in the hands of the beneficiary. Furthermore, amounts not included in the gross income of the estate or trust will generally not be taxable to the beneficiaries.54

Note, that the tracing problem sought to be avoided here was with respect to determining whether a distribution was out of current income as opposed to accumulated income, not with respect to determining whether the distribution was out of current ordinary

53 Id. at 102. Berger also suggests that a “more equitable solution would be to consider as capital gains distributions in the case of invasions of corpus that proportion which the capital gains added to the corpus that year bear to the corpus available for distribution.” As Berger recognizes, this approach would present many “administrative difficulties” and “subsidiary problems.” In addition, it would seem beyond serious argument that this approach has no sanction in the statute. But cf. ALL, Fed. Incom, ESTATE AND GIFT TAX STAT. 103 (Tent. Draft No. 11, 1950).

income as opposed to current capital gains. As the reports later stated, in detailed discussion of the bill:

Instead of determining whether a particular distribution represents amounts of current or accumulated trust income, this revision, broadly speaking, provides that any distribution is considered a distribution of the trust or estate's current income to the extent of its taxable income for the year.55

Indeed, as will be seen from what follows, the 1954 Code appears to have created, with respect to the tier system, a requirement (not present under prior law) of tracing a distribution to current ordinary income as opposed to current capital gains. First, as has already been suggested elsewhere, the last sentence of section 662(a)(1) requires tracing to determine whether a distribution which could be paid out of income or corpus was paid out of “income for such taxable year” as opposed to corpus. If, for example, an annuity is paid out of original corpus, or out of accumulated income, it is not a first tier distribution within that section. To the extent that such a distribution has to be traced to its chronological source, section 662(a)(1) constitutes a retention of a similar tracing requirement under prior law.

Additionally, and more important to our present discussion, section 662(a)(1) contains an additional nonchronological tracing requirement not present under prior law. This is because the word “income” in section 662(a)(1) is defined by section 643(b) as local law income which does not ordinarily include capital gains. It is thus not sufficient to trace the distribution to current tax income. There is a further requirement that the distribution be traced to current trust income, that is, for example, to ordinary income and not capital gains.

Summarizing, then, Berger’s argument would seem unsound because:

(1) the tracing Congress sought to avoid was different from the tracing argued by Kamin, Surrey and Warren to be involved in section 643(a)(3) respecting capital gains;

(2) Congress not only did not totally eliminate the tracing generally inveighed against; but


also created in another section, section 662(a)(1), the same kind of tracing requirement arguably involved in section 643(a).


The approach of the Treasury is set forth in section 1.643(a)-3 of the regulations, pertinent parts of which state:

(a) Gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income, and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary unless they are:

(1) Allocated to income under the terms of the governing instrument or local law . . . ,
(2) Allocated to corpus and actually distributed to beneficiaries during the taxable year, or
(3) Utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed.

Note, at the outset, that this regulation does not adopt a general approach that where there is capital gain for the taxable year any corpus distribution includes, or is presumed to include, part or all of the capital gains.

Paragraph (a)(2) is really no more than a restatement of the statute with the apparently insignificant substitution of the phrase "actually distributed" for the words "paid" or "credited." Presumably this paragraph would cover situations where the distribution (1) necessarily included the gain either by force of the governing instrument or because all of the corpus was distributed, or (2) could be traced to the current capital gain account of the trustee.

The significant part of the regulation is paragraph (a)(3). The importance of this paragraph lies in its necessary implication that even where the distribution does not necessarily include the gain, the gain is included in distributable net income if it was utilized in determining the amount distributed. Indeed, under this part of the regulation even if the instrument required a noncapital-gain source for the distribution or the trustee, although not required to do so, used a noncapital-gain source, the distribution would be deemed to include the capital gain to the extent that it was utilized to determine the amount distributed.

This approach, of course, directly rejects the suggestion earlier discussed that where the distribution does not necessarily include the gain, it must be traced. To that extent the regulation supports the position of Berger. It goes further than his approach, however,
since it does not restrict the interpretation of the word "paid" (aside from where the gains are necessarily paid as part of a total corpus distribution), to "the relatively rare cases where the governing instrument specifically requires distribution of the proceeds or the facts clearly reveal an intent to make available to the beneficiary the proceeds of a sale or exchange as such." 57

The source of paragraph (a) (3) of the regulation would seem to be the following statement from the committee reports:

The bill adopts the general principle that to the extent of the trust's current income all distributions are deductible by the estate or trust and taxable to the beneficiaries. . . .

This approach, however, requires the use of a measure to impose an outside limit on the total distributions deductible by the estate or trust and taxable to the beneficiary. In general, the measure adopted by the bill for this purpose is taxable income, computed without regard to capital gains and losses unless these gains and losses are utilized in determining the income available for distribution.58

The scope of paragraph (a) (3) of the regulation is somewhat uncertain. First, when would a gain be "utilized . . . pursuant to the terms of the instrument . . . in determining the amount" of the distribution? Although the regulation contains no examples specifically referable to this provision, the language would certainly seem to cover a situation where the trust provided that corpus could be distributed only during a year when there was a capital gain, or where the trust directed the trustee to pay no more than the amount of the gain, or similar situations where the trust requires the trustee to consider the gain in determining whether or how much to distribute. But suppose the instrument merely pro-

57 Note, Taxation of Capital Gains Realized by Trusts, 12 Tax L. Rev. 90, 102 (1956).
58 H.R. Rep. No. 1337, 83d Cong., 2d Sess. 60–61 (1954), reprinted at 3 U.S. Code Cong. & Ad. News 4086–87 (1954) (emphasis added); see also S. Rep. No. 1032, 83d Cong., 2d Sess. 52 (1954), reprinted at 3 U.S. Code Cong. & Ad. News 4714–15 (1954). Note that the language of the regulation and the committee reports is almost identical with the ALI draft provision except that the regulation and the reports apply the utilization principle to all distributions and not merely to "income beneficiaries." It is interesting to note that in its 1956 tentative draft the ALI suggested that section 643 be revised as follows:

(3) CAPITAL GAINS AND LOSSES—Gains from the sale or exchange of capital assets shall, except in the year of termination of the estate or trust, be excluded to the extent that such gains are allocated to corpus and are not (A) utilized in the determination of the amount of income paid, credited, or required, to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in § 642(e) . . . . ALI Fed. Income, Estate and Gift Tax Stat. (Tent. Draft No. 11, 1956).

Nothing in the ALI report, however, makes mention of the language of the regulation or the committee reports.
vides that the trustee may consider the gain in making his determination? Will the issue then turn on the mental processes of the trustee? If so, what will constitute "utilizing"? Will the trustee be heard to say that the gain was not the sole motive for the amount of distribution or that the gain was of very little importance?

This same kind of problem is presented by the rest of this paragraph, i.e., the phrase "utilized . . . pursuant to . . . the practice of the fiduciary . . . ." Presumably, the word "practice" connotes some continuity so that if the instrument were silent as to the consideration of the gains, the consideration of the gain by the trustee in any given year would not of itself require the inclusion of the gain in distributable net income for that year. But even assuming, for example, that if the trustee considered the gains, say three years consecutively, consideration in the fourth year would amount to consideration as a practice, there would still be the problem of what kind of consideration amounts to "utilizing."

The problem is compounded by an implication contained in one of the examples in the regulation. The example states:

A trust is created to pay the income to A for life, with a discretionary power in the trustee to invade principal for A's benefit. In the taxable year, $10,000 is realized from the sale of securities at a profit, and $10,000 in excess of income is distributed to A. The capital gain is not allocated to A by the trustee. During the taxable year the trustee received and paid out $5,000 of dividends. No other cash was received or on hand during the taxable year. The capital gain will not ordinarily be included in the distributable net income. However, if the trustee follows a regular practice of distributing the exact net proceeds of the sale of trust property, capital gains will be included in distributable net income.

It is difficult indeed to determine the basis for the statement in the above example that "The capital gain will not ordinarily be included in distributable net income." Given that no other cash was received or on hand during the taxable year, so that the $10,000 in excess of income distributed to A constituted the proceeds of the capital gain transaction, on what theory could it be said that the gain has not been paid to A within section 643(a)(3)? On what theory could it be said that the gain was not in the words of paragraph (a)(2) of the regulation "Allocated to corpus and actually distributed to beneficiaries during the taxable year"?

Secondly, if in the cited example the gains have not been paid within section 643(a)(3), how could a regular practice render them

59 Reg. Sec. 1.643(a)-3(d) Ex. (1) (1956).
paid? If the trustee does the same thing the next year, are they still not paid? Furthermore, what is meant by "exact net proceeds"? Does it include an amount equal to the net proceeds of the gain, but not taken from the same fund or account? Suppose, for example, the trust as a regular practice distributes, from an account kept for original corpus and accretions thereto of prior years, an amount equal to the "exact net proceeds" of current capital gains. Will such gains be considered paid? If so, how could this comport with the statement in the example that the gain therein was not paid?

Furthermore, whatever be the answer to the last query, must the regular practice be with respect to the precise amount of the net proceeds? Suppose that all the facts of the example were repeated in years 2, 3, 4 and 5, but that in year 2, $9,000 was distributed from corpus, $5,000 in year 3, $1,000 in year 4, and $15,000 in year 5 (assuming here there was $5,000 additional cash on hand). Why should the question whether any gain was paid in any of the five years turn on whether the "exact net proceeds" of each year ($10,000), no more, no less, were distributed each year?

In light of the above discussion, it would seem that the example of the regulation is, in the main, too ambiguous to be useful and where unambiguous, that is, in its statement regarding the outcome of the given facts, probably incorrect. The most that could be said for it is that it is at least an attempt to illustrate the principles of paragraph (a) (3) of the regulation, but even this is not certain.

Coming back then to paragraph (a) (3), the question in order is whether it, and the statement and the committee report on which it is based, are justified by the statute, specifically by the word "paid" in section 643(a) (3). This devolves to two inquiries: (1) will the word "paid" linguistically support the concept of utilization (assuming, as would seem proper, that there are situations which would clearly be seen as utilization)?—and (2) would the purpose of section 643(a) (3) be served by the concept of utilization?

The first question should probably be answered affirmatively. Linguistic arguments supporting this result could certainly be made although they probably would not be devastatingly persuasive. Moreover, in the nature of things, the answer to the second question largely determines the answer to the first, and the answer to the second, and realistically more important, question would seem to be definitely yes. From our prior discussion, despite the difficulties encountered or created by the courts, it would seem reasonably clear that the design of the 1939 Code, and the 1942 amendments
thereto, was to tax the tax income of the trust to those who benefited by it. There is no reason to think that the design of the 1954 Code is any different. A beneficiary who is paid, in the discretion of the trustee, or who has the right to be paid, ordinary income is benefited by such income and is taxed on it. Similarly, a beneficiary who is paid, in the discretion of the trustee, or who has the right to be paid, the proceeds of capital gains is benefited by the gains and is taxed on them. The utilization concept is just a logical extension of this benefit principle. A person may not receive or have the right to receive part or all of the net proceeds of the gain. But, if he receives or has the right to receive some distribution only because there was a capital gain, or if his receipt or right of receipt is in small or large part caused by the existence of such gains, then he has in a realistic sense benefited to some extent by the gains.

To illustrate (and this is not to gainsay the problems inherent in the utilization concept as delineated in paragraph (a)(3) of the regulation) assume a trust provides: Income to A for life, principal to B on A’s death, capital gains to be considered principal; principal may be invaded by the trustee if and only to the extent of capital gains. If A is paid, from original corpus or original corpus with accretions of prior years, an amount equal to the capital gain of the current year, is it not clear that he, not B (i.e., the trust) has benefited from the capital gain and is it not equally clear that A, and not B (i.e., the trust), should pay the tax?

Summary and Some Comments on the Significance of the “Taxable Year”

The income taxation of capital gains of a trust depends ultimately on whether such gains are included in distributable net income under section 643(a)(3). In the relatively rare case of mandatory distribution of such gains, they are clearly so included. In the case of discretionary distributions the question is one of the proper interpretation of the phrase “properly paid [or] credited . . . to any beneficiary during the taxable year.” The conclusion of this article is that this phrase should be interpreted to include capital gains in distributable net income if a discretionary distribution is traceable to the proceeds of a capital gain transaction, or if, and to the extent that, such proceeds have been “utilized” by the fiduciary in exercising his discretion to distribute. Neither of these criteria, of course, can be applied with the ease or precision for which one would hope. Their virtue lies rather in their being true to the general principle of trust taxation under the prior law as well as the
present Code, namely that a trust is treated as a conduit and the beneficiaries are taxed on the tax income of a trust to the extent that their distributions represent the passing of the benefit of such income to them.

Finally, there should be noted an apparently permissible method of insuring that the trust always bears the tax with respect to capital gains. In the prior discussion I have assumed that the capital gains paid to the beneficiary (under either the tracing or utilization tests) were paid during the same trust taxable year in which they were realized. The situation would seem quite different, however, if that assumption were varied.

Recall that under section 643(a)(3) capital gains realized by a trust during its taxable year are excluded from distributable net income "to the extent that such gains are allocated to corpus and are not . . . paid, credited, or required to be distributed to any beneficiary during the taxable year." (Emphasis added.)

Suppose that a capital gain is realized by a trust in its first taxable year, but is paid to a beneficiary on the first day of the trust's second taxable year. Under section 643(a)(3) it would seem that the gain would not be included in distributable net income for either year. It would not be included in distributable net income for the first taxable year since it was not paid during that year. It would not be included in distributable net income for the second taxable year since it was not realized during that year.

This result is similar to that which prevailed in the case of the so-called "Dean trust" under the unamended 1939 Code where accumulated income of the trust's taxable year was paid a day after that taxable year ended. Since at that time the beneficiary was taxed only on amounts which were paid to him (or as to which he had the right to be paid) during the trust's taxable year out of the trust's income for that same taxable year, any income of a trust's taxable year distributed to the beneficiary in the succeeding taxable year of the trust was taxable to the trust in that prior

60 These results are not affected by section 662(c) which provides that:

If the taxable year of a beneficiary is different from that of the estate or trust, the amount to be included in the gross income of the beneficiary shall be 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 during any taxable year or years of the estate or trust ending within or with his taxable year.

This section depends on distributable net income, and capital gains are in distributable net income only if realized and paid during the same taxable year of the trust. Thus, the fact that the trust and the beneficiaries may have different taxable years will not render capital gains includable in distributable net income for any year as long as they are not paid to the beneficiary during the same taxable year of the trust in which they were realized.
taxable year and distributed tax-free to the beneficiary. With respect to ordinary tax income this device was no longer available after the 1942 amendment and cannot be used under the 1954 Code. Under the analysis set forth above, however, it would still appear to be available with respect to capital gains.\footnote{Note that the throwback rules of sections 605-68 would not affect this device, since they apply only to the distribution of prior "undistributed net income" which is defined generally as the excess of distributable net income over distributions. Thus where distributable net income does not include capital gains, the presence of capital gains cannot contribute to undistributed net income.}
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