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There are numerous elections that fiduciaries can make on estate and trust federal income tax returns to help maximize tax efficiency for the entity and its beneficiaries. One such election is the Section 643(e)(3) election, which permits a fiduciary to treat the distribution of in-kind property as having been sold by the entity to the beneficiaries at fair market value (FMV), thereby triggering potential gain,[1] among other consequences.

Practitioners must be well-versed in the consequences of this election to advise fiduciaries properly on whether it should be made. An understanding of the statutory framework for income taxation[2] of estates, trusts, and beneficiaries is necessary to provide context for the Section 643(e)(3) election. Further, it is important to know the types of distributions subject to the election, what the election achieves, when it might make sense, and how it is made or revoked, as appropriate.

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Statutory framework

The income taxation of trusts or estates (hereafter collectively "entity") and beneficiaries is governed by Subchapter J of the Code, which reflects a hybrid theory of taxation. This theory is embodied in the income distribution deduction (IDD), which an entity is allowed to claim for distributions made (or treated as made) to beneficiaries during the year. The taxable portion of any distribution that a beneficiary receives from an entity will be subject to income tax on the beneficiary's personal income tax return. Correspondingly, the distributing entity is permitted to deduct the taxable portion of the distribution. Any of the entity's taxable income remaining after claiming the IDD is subject to income tax on the entity's return. The result is that the taxable income for the year is generally taxed at either the entity level or the beneficiary level, but usually not both.

Practitioners should understand the types of distributions subject to the election, what the election achieves, when it might make sense, and how it is made or revoked.

Income distribution deduction

The IDD may be computed differently for a simple trust than for a complex trust or estate. A simple trust must distribute all of its income currently, has no charitable beneficiaries in the current year, and does not distribute corpus during the current year.[3] "Income" means fiduciary accounting income (FAI), which is defined generally as "the

amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law . . ."[4] For this purpose, income is a net amount - the excess of gross accounting income over expenses allocable to such income. The "governing instrument" will be the trust for a simple or complex trust, or a will for an estate. "Local law" normally means the applicable state law governing the allocation of income and expenses between the FAI and the corpus, or principal[5], of the entity.[6]

A complex trust is defined by default as any trust that is not a simple trust.[7] Thus, any trust that is not required to distribute FAI currently, has charitable beneficiaries in the current year, or makes current-year distributions from corpus is a complex trust.

For a simple trust, the IDD computed under the general rule is equal to the entity's FAI for the year.[8] However, if the FAI that must be distributed exceeds the trust's distributable net income (DNI), the IDD is limited to the taxable portion of the DNI (i.e., DNI less the trust's tax-exempt income net of any related deductions).[9]

For a complex trust or estate, the IDD computed under the general rule is equal to the taxable portion of the sum of the income required to be distributed in the current year and any other amounts (i.e., discretionary payments) properly paid, credited, or required to be distributed for the year.[10] As with a simple trust, the IDD is limited to the taxable portion of the DNI.[11]

Distributable net income

An important step in determining an entity's IDD is computing its DNI. Unlike FAI, which is computed based on the governing instrument or state law, DNI is a tax concept. Thus, FAI and DNI may not be equal. The most frequent difference between these two concepts relates to fiduciary fees. Under most state laws, fiduciary fees are chargeable one-half each to FAI and corpus.[12] In contrast, such fees are fully deductible for income tax purposes, except to the extent they are related to tax-exempt income. Thus, to the extent that fiduciary fees are deducted on the entity's income tax return, but are charged to corpus, DNI will be less than FAI.

DNI is important because it establishes: (1) the maximum amount the entity can deduct as an IDD for the year[13]; (2) the maximum amount of the distribution on which the beneficiaries can be taxed for the year[14]; and (3) the character of the income or expense in DNI that flows through to the beneficiaries.[15] On this last point, items flow through to the beneficiaries in proportion to their part of the DNI.[16]

Unlike the IDD, DNI is computed the same way for simple trusts, complex trusts, and estates. As a practical matter, it is computed by determining the entity's taxable income before the IDD (TI before IDD), then adjusted as follows:

- Add back the entity's personal exemption.

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[1] While potential gain may be triggered, loss generally is not. See note 32, *infra*.

[2] This article focuses strictly on federal income taxation. State income taxation issues are outside the scope of the article.

[3] Section 651(a) and Reg. 1.651(a)-1.

[4] Section 643(b).

[5] The Code uses "corpus" while state statutes defining income and principal often use "principal." Although practitioners commonly use the terms interchangeably, this article uses "corpus."

[6] In most states, the statutes governing such allocation are based in whole or in part on the Uniform Principal and Income Act. Normally, the governing instrument specifies how income and expenses are to be allocated and such allocation is typically respected for both state law and income tax purposes. If the governing instrument is silent regarding allocations, the state statute usually governs. Occasionally, even if the governing instrument is not silent, its allocation provisions may be precluded or overridden by the state statute.

[7] Reg. 1.651(a)-1(b).

[8] Section 651(a).

[9] Section 651(b).

[10] Sections 661(a) and (b).

[11] Section 661(c).

[12] See, e.g., 760 ILCS 14(a)(6), (c)(1) for such an allocation under Illinois law.

[13] Sections 651(b) and 661(c).

[14] Sections 652(a) and 662(a).

[15] Sections 652(b) and 662(b).

[16] *Id.* Although distributions are generally treated as consisting of the same proportion as the items that enter into the computation of DNI, such allocation does not apply if the governing instrument or local law specifically allocates the items differently. Section 663(c); Reg. 1.663(c)-1(a). Also, in limited circumstances, the normal DNI proportionality rule may be modified due to special allocations in the governing instrument. Regs. 1.642(h)-1 and -2.

[17] Capital gains have historically not been included in DNI and, thus, do not get "carried out" to beneficiaries by distributions. However, the final Regulations under Section 643 issued in 2004 identify when and how capital gains may be included in DNI such that they can be "carried out" to beneficiaries by distributions. Blattmachr and Gans, "The Final Income Regulations: Their Meaning and Importance," 103 Tax Notes 891 (5/17/04).

[18] Section 643(a).

[19] Sections 661(b) and 661(c).

[20] Section 652(a).

[21] Sections 662(a)(1) and (a)(2).

[22] However, the following distributions are ignored when allocating DNI to beneficiaries and in computing the entity's IDD: (1) charitable distributions; (2) current year distributions that were considered when computing the entity's IDD in a previous year; and (3) distributions under Section 663(a) (i.e., "specific" bequests and devises under the terms of the governing instrument). Such distributions do not carry out DNI to the beneficiary.

EXHIBIT 1
Computing the entity's IDD

	Simple Trust	Complex Trust/Estate
General Rule	FAI	Total taxable distributions
Limit	TI before IDD +/- adjustments = DNI - net tax-exempt interest = IDD limit ("taxable DNI")	Same as for simple trust

- Add back net tax-exempt interest (gross tax-exempt interest less expenses allocable thereto).
- Add back the entity's capital losses allocable to corpus.
- Subtract the entity's capital gains allocable to corpus.[17]
- Subtract extraordinary dividends and taxable stock dividends allocable to corpus (for simple trusts only).[18]

Once DNI is computed, it is reduced by the net tax-exempt interest to arrive at the taxable portion of the DNI ("taxable DNI"), which also represents the IDD limit for simple trusts, complex trusts, and estates.[19] See Exhibit 1 for a summary of the rules for computing IDD and DNI.

Logically, the rules for determining the IDD parallel the rules for determining how much gross income the beneficiaries must report on their personal income tax returns. Thus, the beneficiaries of a simple trust must report gross income equal to their share of the entity's FAI, but limited to their share of taxable DNI.[20] The beneficiaries of a complex trust or an estate must report gross income equal to their share of total taxable distributions, but limited to their share of taxable DNI.[21]

See Exhibit 2 for a summary of the rules for determining a beneficiary's gross income from an entity.

Determining a beneficiary's share of taxable DNI

DNI is generally allocated to beneficiaries who receive a distribution from the entity regardless of whether the distribution comes from income or corpus.[22] Required FAI distributions are considered made whether or not the distribution is in fact made.

In a simple trust with only one beneficiary, all of the taxable DNI would be allocated to that beneficiary. However, if a simple trust has more

EXHIBIT 2
Determining the beneficiary's gross income from the entity

	Simple Trust	Complex Trust/Estate
General Rule	Share of FAI	Share of total taxable distributions
Limit	Share of taxable DNI	Same as for simple trust

than one beneficiary, the elements of DNI are apportioned ratably based on the amount required to be distributed currently to each.[23]

Example: The Robert Crane Trust, a simple trust, has FAI of $40,000 and DNI (all taxable) of $36,000[24] in the current year. Its income and expenses comprise taxable interest of $40,000 (allocable to FAI); long-term capital gains (LTCG) of $15,000 (allocable to corpus); and trustee's fees of $4,000 (payable from corpus). The two income beneficiaries, Jane and David, are entitled to the trust's FAI, based on shares of 60% and 40%, respectively.

Jane receives $24,000 (60% x $40,000 FAI) as her share of FAI, but reports gross income of only $21,600 (60% x $36,000 DNI), which is her share of taxable DNI. David receives $16,000 (40% x $40,000 FAI) as his share of FAI, but reports gross income of $14,400 (40% x $36,000 DNI), which is his share of taxable DNI. The trust reports the $15,000 of LTCG on its tax return. After subtracting the trust's personal exemption of $100[25], the trust reports taxable income of $14,900.

The trust's IDD of $36,000, which is the same under both the general rule and the limit since all of the DNI is taxable, equals the total amount of gross income reported by both Jane and David ($21,600 + $14,400).

As with a simple trust, if an estate or complex trust has only one beneficiary, all of the taxable DNI will be allocated to that beneficiary. However, if there is more than one beneficiary, various computational problems may arise because, unlike a simple trust, an estate or complex trust may not require the distribution of FAI currently or may permit or require distributions of corpus currently.

Due to the various distribution options, DNI for an estate or complex trust is allocated to beneficiaries based on a tier system.[26] FAI that is required to be distributed currently, even if not actually distributed, is classified as a "tier-one" distribution. All other distributions, meaning

[23] Section 652(b).

[24] DNI is reduced by all tax deductible expenses, even if a portion of expenses is payable from corpus for FAI purposes. This treatment effectively means that income beneficiaries receive a tax benefit by virtue of reporting gross income less than the FAI received during the year. In this case, the DNI comprises the $40,000 of interest income, allocable to FAI, less the $4,000 trustee's fees, even though allocable to corpus, not FAI.

[25] Trusts that are required to distribute FAI currently are entitled to an exemption of $100, while all other trusts are entitled to an exemption of $300. Estates are entitled to an exemption of $600. Sections 642(b)(1) and (2)(A) - (B). There is no exemption for an estate or trust in the year of termination.

[26] Sections 662(a)(1) and (2).

[27] Regs. 1.662(a)-2 and -3. The terms "tier-one" and "tier-two" do not appear in the Code or Regulations but are used commonly by commentators in secondary sources of tax law and by practitioners.

[28] There are exceptions to nonrealization treatment. For example, an estate or trust will realize gain or loss if in-kind property is distributed in satisfaction of a right to receive a distribution of a specific dollar amount; of specific property other than the in-kind property distributed; or of income as defined under Section 643(b) and related Regulations, if the income is required to be distributed currently. Reg. 1.661(a)-2(f).

[29] Sections 643(e)(1) and (e)(2).

[30] Section 643(e)(1).

discretionary ones, are classified as "tier-two" distributions.[27]

Pursuant to the tier system, DNI is allocated first to tier-one beneficiaries. When only tier-one distributions are made and the total of these amounts exceeds DNI (or both tier-one and tier-two distributions are made but the tier-one distributions exceed DNI), the following formula is used to allocate DNI among the beneficiaries:

Tier-one distributions to the beneficiary
Tier-one distributions to all beneficiaries
x DNI =
Beneficiary's share of DNI

If both tier-one and tier-two distributions are made and the tier-one distributions do not exceed DNI, but the total of both types of distribution exceeds DNI, the following formula is used to allocate the remaining DNI among the tier-two beneficiaries:

Tier-two distributions to the beneficiary
Tier-two distributions to all beneficiaries
x Remaining DNI =
Beneficiary's share of remaining DNI

Example: The trustee of the Laura Wright Trust is required to distribute $10,000 annually to each of the trust's beneficiaries, Tina and Don. In addition, the trustee is empowered to distribute other amounts of trust FAI or corpus at her discretion. For the current year, the trust reports FAI of $60,000 and DNI (all taxable) of $50,000. The trustee distributes $40,000 ($10,000 of tier-one distributions and $30,000 of tier-two distributions) to Tina and $30,000 ($10,000 of tier-one distributions and $20,000 of tier-two distributions) to Don.

In this case, both tier-one and tier-two distributions have been made. Because the total of tier-one distributions does not exceed DNI, the DNI is allocated to the full amount of such distributions and no formula allocation is necessary. However, because the total of tier-one and tier-two distributions exceeds DNI, the remaining DNI must be allocated per the tier-two formula allocation. The DNI is allocated between Tina and Don as follows:

Tier-one distributions:
To Tina $10,000 DNI
To Don $10,000 DNI

Tier-two distributions:
To Tina $18,000 DNI [($30,000/$50,000) x $30,000 remaining DNI]
To Don $12,000 DNI [($20,000/$50,000) x $30,000 remaining DNI]

Thus, Tina's share of the entity's taxable distributions is $40,000, but her current year reportable gross income is limited to $28,000 ($10,000 + $18,000), which is her allocable share of the entity's taxable DNI. Don's share of the entity's taxable distributions is $30,000, but his current year reportable gross income is limited to $22,000 ($10,000 + $12,000), which is his allocable share of the entity's taxable DNI.

Types of distributions subject to the Section 643(e)(3) election

Section 643(e) applies to discretionary, or tier-two, distributions. Simple trusts do not permit discretionary distributions, so this section and the corresponding election available under Section 643(e)(3) do not apply. However, an estate or complex trust may permit discretionary, or tier-two, distributions, so Section 643(e) and the Section 643(e)(3) election may be available to such an entity. The prudence of making the election will depend on the underlying facts.

The previous examples assumed that the distributions were made in currency or by check. In these situations, the amount of the distribution is equal to the currency or check amount. But what if a distribution is not made in currency or by check, but rather is made "in-kind?"

When tier-two, in-kind distributions are made, Section 643(e) determines the amount of the distribution for purposes of both the entity's IDD and the gross income reportable by the entity's beneficiaries. In addition, it determines the beneficiary's basis in the distributed property for income tax purposes.

Section 643(e) usually does not treat the distribution of in-kind property as a realization event to the entity.[28] As a result, the amount of the distribution for the entity's IDD and the gross income inclusion by the beneficiary is the lesser of the entity's basis in, or the FMV of, the distributed property.[29] The beneficiary takes a basis in the property equal to its basis in the hands of the entity.[30]

Example: The James Quill Estate has DNI of $60,000 (all ordinary taxable income arising from IRAs and qualified retirement plan distributions). The executor makes only one distribution during the year to Amy, a residuary beneficiary, consisting of a parcel of investment

land (a capital asset). The estate had a basis of $10,000 in the land and the FMV was $30,000.

Pursuant to the general rules of Section 643(e), the estate realizes no gain on the distribution. The amount of the estate's IDD and Amy's gross income inclusion is $10,000, and Amy takes a basis in the land, which she holds as an investment (i.e., capital) asset, of $10,000. Also, the estate has taxable ordinary income (ignoring its personal exemption of $600) of $50,000 ($60,000 ordinary income - $10,000 IDD).

What does a Section 643(e)(3) election achieve?

Under Section 643(e)(3), a fiduciary can elect to treat a discretionary in-kind distribution as a deemed realization event (i.e., as if the distributed property was sold to the beneficiary at its FMV).[31] In this case, the election triggers a gain[32] to the entity and the amount of the distribution for purposes of the entity's IDD and the gross income inclusion by the beneficiary is the FMV of the distributed property.[33]

Example: The facts are the same as in the previous example but, the executor makes a Section 643(e)(3) election. Now, the estate realizes gain of $20,000 ($30,000 deemed amount realized less $10,000 basis). The amount of the estate's IDD and Amy's gross income inclusion is $30,000 and Amy takes a basis in the land of $30,000. Also, the estate has taxable income (ignoring its personal exemption of $600) of $50,000 [($60,000 ordinary income + $20,000 capital gain) - $30,000 IDD]. The taxable income comprises $30,000 of ordinary income ($60,000 ordinary income - $30,000 IDD) and $20,000 of LTCG.

In comparing the two prior examples, two advantages of making the election are apparent. First, the character of the estate's current taxable income is changed. By not making the election, the $50,000 is entirely ordinary in character. By making the election, $30,000 is ordinary and $20,000 is LTCG in character. This is beneficial because, while an estate's ordinary income is subject to normal marginal tax rates, LTCG is subject to a maximum preferential rate of only 20%. Second, Amy's basis in the land is $30,000 with the election as opposed to only $10,000 without the election. A higher basis may be important to Amy if she intends to sell the land because the additional $20,000 of basis will correspondingly reduce her realized and recognized gain on the sale.

On the other hand, the election has two disadvantages. First, it increases the gross income that Amy must report currently by $20,000, from $10,000 to $30,000. Second, the $20,000 of gain inherent in the land is accelerated to the current year. If the election was not made, the gain would be first realized in the year that Amy sold the land. This negative would be eliminated, however, if Amy chose to hold the land throughout her life, or if she died before having the opportunity to sell it. Either way, the $20,000 of gain would escape taxation because the beneficiaries of Amy's estate would take a step-up basis under Section 1014 equal to the land's FMV at the date of Amy's death (or six months thereafter in the event of an alternative valuation date election under Section 2032(a)(1)).

Due to the competing (and sometimes uncertain nature) of these advantages and disadvantages, it is often difficult to assess the efficacy of a Section 643(e)(3) election. However, all other things being equal and because of the time value of money, it is usually better if the election is not made due to the overall tax result for the entity and beneficiaries. As one commentator said, "elections under Section 643(e)(3) will generally be the exception rather than the rule."[34] The reason for this can be quantified with a specific fact pattern.

Example: The facts are the same as in the previous two examples. Amy sells the land shortly after receiving it for $30,000, its FMV on the date of distribution. In the initial example, where no Section 643(e)(3) election is

[31] Section 643(e)(3)(A)(ii). The election does not apply to required, or tier-one, distributions described in Section 663(a). See Randall, Gardner, and Stewart, "Distributions of Property From Estates and Trusts: Avoiding Income Tax Traps," 27 Estate Planning 312, at pp. 313 – 314.

[32] The election generally will not trigger a loss because Section 267 disallows the trust or estate from claiming a deduction for any realized loss on the disposition of in-kind property to a related party. For these purposes, a related party includes the fiduciary and beneficiary of a trust, and the executor and beneficiary of an estate (except for distributions in satisfaction of a pecuniary bequest). Sections 267(b)(6) and (11).

[33] Sections 643(e)(3)(A)(i) and (iii).

[34] Danforth, "Planning for the Section 643(e)(3) Election," 29 Tax Mgmt. Estates, Gifts and Trusts Journal, p. 166.

[35] Section 1(e).

[36] Because this income consists entirely of IRA and qualified plan distributions, none of it would be subject to the NII tax.

[37] Although estates and trusts are potentially subject to the 3.8% NII tax, the tax does not apply to the extent that the entity distributes the NII. In this case, since the property triggering the LTCG was distributed to the beneficiary, the NII tax would not apply.

[38] Section 1211(b).

[39] Regs. 1.642(h)-1 and (h)-2.

made, Amy realizes gain of $20,000 when the land is sold ($30,000 amount realized - $10,000 adjusted basis), which is LTCG. If Amy's marginal tax rate is 28%, the LTCG would be subject to a maximum preferential rate of 15%, resulting in income tax of $3,000 ($20,000 x .15). In addition, since LTCG is a form of unearned income, the $20,000 potentially would be subject to a net investment income (NII) tax of 3.8%, or $760, resulting in a total federal tax for Amy of $3,760 ($3,000 + $760).

After deducting the estate's personal exemption of $600, the estate is taxed on ordinary taxable income of $49,400 ($60,000 ordinary income - $10,000 IDD - $600 exemption). Using 2014 rates[35], the tax on this amount is $17,891.50.[36] The combined federal tax liability for Amy and the estate is $21,651.50 ($3,760 + $17,891.50).

In contrast, in the second example, when the Section 643(e)(3) election is made, the estate realizes gain of $20,000 ($30,000 amount realized - $10,000 adjusted basis), which is LTCG. After deducting the estate's personal exemption of $600, the estate has taxable income of $49,400 ($60,000 ordinary income + $20,000 LTCG - $30,000 IDD - $600 exemption), of which $29,400 is ordinary ($60,000 ordinary income - $30,000 IDD - $600 exemption) and $20,000 is LTCG. Based on 2014 rates, the income tax on the $29,400 is $9,971.50. The $20,000 LTCG is subject to a preferential rate of 20%, resulting in an income tax of $4,000.[37] The total federal tax for the estate is $13,971.50 ($9,971.50 + $4,000).

Amy reports current ordinary gross income of $30,000, resulting in a federal income tax of $8,400. When she sells the land, she realizes no gain or loss because the $30,000 amount realized equals her basis in the land.

The combined tax liability for the estate and Amy is $22,371.50 ($13,971.50 + $8,400), or $720 ($22,371.50 - $21,651.50) higher than if no election is made. Based on these facts, the election should not be made.

Situations in which a Section 643(e)(3) election may be beneficial

The discussion up until to this point has focused on why the Section 643(e)(3) election is often not beneficial. However, there are at least three situations in which a Section 643(e)(3) election is beneficial: (1) the entity has capital losses in excess of capital gains for the current year; (2) the entity has capital loss carryovers; or (3) the distributed property is cost recoverable in the hands of the beneficiary.

Excess capital losses

If an entity has current-year capital losses in excess of capital gains ("net capital loss") (NCL), a maximum of $3,000 of the NCL is currently deductible by the entity.[38] The remaining NCL can be carried forward and offset against the entity's capital gains in future years. However, any NCL that is not absorbed by capital gains prior to, and including, the year of termination, is carried out in the termination year to the beneficiaries of the trust's property.[39] The beneficiaries can then deduct their share of the NCL on their personal income tax return. If the trust is in existence for a long period, the deduction attributable to the NCL and the resulting tax savings is delayed, thereby reducing the net present value of the tax savings. Because a Section 643(e)(3) election accelerates gain recognition, to the extent that such gain is capital, capital losses can be offset against them.

Example: In the current year, the Sam White Trust, a complex trust, has DNI (all ordinary taxable income) of $40,000, capital losses of $50,000, and no capital gains. The trust owns a noncash capital asset with a FMV of $200,000 and a basis of $150,000. The trustee will use this asset to make a discretionary in-kind distribution of $100,000 to each of the trust's beneficiaries, Abby and Ben. The asset is not cost recoverable over time to either beneficiary.

Without the Section 643(e)(3) election, the trust has a NCL of $50,000, only $3,000 of which would be deductible currently, resulting in a NCL carryover of $47,000. Abby and Ben report current gross income of $20,000 ($40,000 DNI x 50%) each.

With the election, the trust reports a capital gain of $50,000 from the in-kind distribution ($200,000 deemed amount realized - $150,000 basis), which would completely offset the capital loss of $50,000, resulting in no NCL carryover. Abby and Ben still report current gross income of $20,000 ($40,000 DNI x 50%) each.

The election is desirable in this situation because it accelerates the tax savings attributable

to what would otherwise be excess capital losses, unusable until sufficient capital gain was generated except for the $3,000 maximum NCL per tax year.

Capital loss carryovers

Similar to the situation in which the entity has capital losses in excess of capital gains in the current year, a Section 643(e)(3) election may make economic sense if the entity has capital loss carryovers. In these situations, the gain produced by the election can absorb the capital loss carryovers currently instead of deferring their deductibility until they are carried out to the beneficiaries in the year that the entity is terminated.

Example: The facts are the same as in the previous example, except that the trust has no current year capital gains or losses, but does have a capital loss carryover of $50,000. Without the Section 643(e)(3) election, the trust has a NCL of $50,000, only $3,000 of which would be deductible currently, resulting in a NCL carryover of $47,000. Abby and Ben report current gross income of $20,000 ($40,000 DNI x 50%) each.

With the election, the trust reports a capital gain of $50,000 ($200,000 deemed amount realized - $150,000 basis) from the in-kind distribution, which would offset completely the capital loss carryover of $50,000, resulting in no NCL carryover. Abby and Ben still report current gross income of $20,000 ($40,000 DNI x 50%) each.

The election is beneficial in this situation because it accelerates the tax savings attributable to the capital loss carryover.

Distributed property is cost recoverable by the beneficiary

In the two prior examples, it was assumed that the asset distributed to the beneficiaries was not cost recoverable over time. If the asset were cost-recoverable, it is possible that a Section 643(e)(3) election could be beneficial if the beneficiary's future marginal tax rate(s) exceed their current marginal tax rate(s).

Example: In the current year, the Jenelle Jones Trust, a complex trust that is not required to distribute FAI currently, has DNI of $120,000 (all taxable ordinary income). The trust owns a piece of equipment (Section 1231 property with a seven-year class life) that has a FMV of $100,000 and a basis of $60,000. The trustee will use this equipment to make a discretionary in-kind distribution of $100,000 to the residuary beneficiary, Jason. Jason will use the asset in his business and it is cost recoverable using a 200% declining balance method over an eight-year period (due to the half-year convention, even though the equipment has a seven-year cost recovery life, full cost recovery will take eight years).[40]

Without the Section 643(e)(3) election, the trust has taxable income of $59,700 ($120,000 ordinary income - $60,000 IDD - $300 exemption) and Jason reports gross income and takes a basis in the building of $60,000. He would then be able to cost recover $60,000 over an eight-year period.

With the election, the trust reports an ordinary gain of $40,000 ($100,000 deemed amount realized - $60,000 basis) from the in-kind distribution, resulting in taxable income of $59,700 ($120,000 ordinary income + $40,000 ordinary gain - $100,000 IDD - $300 exemption), which is the same as without the election. The gain is not LTCG because, under Section 1239, gain realized on a transaction between related parties (here the trustee of the trust and Jason) is treated as ordinary, not capital, gain. As a result, the trust's tax liability would be the same as without the election.

Jason reports gross income of and takes a basis in the building of $100,000. While the election increases his current gross income by $40,000, he is able to cost recover an additional $40,000 over an eight-year period. If Jason's marginal tax rate over the next eight-years is substantially higher than in the current year, the tax savings associated with the additional $40,000 of cost recovery, even after discounting, will exceed the tax cost associated with the additional $40,000 of current gross income.

Based on these facts, the election is beneficial because the overall tax liability of the estate and beneficiary decreases. Due to the election, the tax savings attributable to the increased $40,000 basis overwhelms the tax cost associated with the increased current gross income of $40,000.

[40] Under the modified accelerated cost recovery system (MACRS), the cost of an asset is recovered over a period specified in the law. Section 168(e).

[41] Section 643(e)(3)(B).

[42] Section 643(e)(4).

[43] Section 643(e)(3)(B).

Making or revoking the election

The fiduciary must make the election on the entity's income tax return for the tax year in which the in-kind distribution is made.[41] The election applies to all in-kind distributions by the fiduciary during the tax year other than those described in Section 663(a).[42] Once made, the election may be revoked only with IRS consent.[43]

Conclusion

Many factors affect the decision whether to make a Section 643(e)(3) election, including the current and expected marginal tax rates of the entity and the beneficiary; the likelihood of the beneficiary holding the asset until death versus selling it; when the beneficiary plans to sell the asset; the existence of capital losses or capital loss carryovers by the entity; and whether the distributed property may be depreciable in the hands of the beneficiary. Practitioners advising fiduciaries of an estate or complex trust that makes discretionary distributions of in-kind property must be aware of and give appropriate weight to these factors. As a matter of full disclosure and as a basis for avoiding or minimizing client dissatisfaction or malpractice claims, the practitioner must explain clearly the potential pros and cons of making the election to the fiduciary. In the end, however, the decision whether to make the election should be left to the fiduciary, the one ultimately responsible for the entity and its income tax return.