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Estate Planning Considerations for the North Carolina Principal and Income Act of 1973

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ESSENTIAL ESTATE PLANNING CONSIDERATIONS FOR THE NORTH CAROLINA PRINCIPAL AND INCOME ACT OF 1973

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I. Introduction

North Carolina, along with twenty-eight other states,¹ has adopted a version of the Revised "1962" Uniform Principal and Income Act,² codified in Chapter 37 of the North Carolina General Statutes³ (referred to hereinafter as the "Act"). While this version is a substantial adoption of the major provisions of the Revised

Uniform Principal and Income Act, there are numerous variations, omissions and additional matter, too extensive to be catalogued by the commissioners in their annotations to the Uniform Law. No attempt will be made here to list and discuss each difference between the Act and the Revised Uniform Principal and Income Act. Neither the Act nor its predecessor, the North Carolina Uniform Principal and Income Act adopted in 1937, has been a frequent subject of litigation in the appellate courts. Indeed, the questions the Act is designed to answer, regarding how a fiduciary allocates income, expenses and other accruals or depletions when dealing with the interests of successive beneficiaries, appear rarely to have troubled North Carolina practitioners.

The purpose of the Act is to clarify the duties of a fiduciary in situations involving the interests of successive beneficiaries. In many instances, the testator’s or settlor’s intent will not be clear from the instrument; in others, he will not have foreseen the problems his fiduciary will face. Even where the fiduciary has dis-

6. The 1937 Act, supra note 5, was mentioned in only three cases: Greer v. United States, 448 F.2d 937 (4th Cir. 1971)(see infra text at note 30); Citizen’s Nat’l Bank v. Grandfather Home for Children, Inc., 280 N.C. 354, 185 S.E.2d 836 (1972)(concerning allocation of expenses of proceeding to construe a will); Wells v. Planters Nat’l Bank & Tr. Co., 265 N.C. 98, 143 S.E.2d 217 (1965)(apportionment of administration expenses and rents received). The 1973 Act has been cited only once, Northwestern Bank v. Robertson, 39 N.C. App. 403, 250 S.E.2d 727 (1979)(judgment directing application of assets which include principal and income must designate the interest to be used in meeting each claim).
7. North Carolina texts discuss the Act only in passing, e.g., 1 N. WIGGINS, WILLS AND ADMINISTRATION OF ESTATES IN NORTH CAROLINA § 145 (2d ed. 1983), and do not explain how it might apply, e.g., R. LEE, NORTH CAROLINA LAW OF TRUSTS §§ 26, 27 (5th ed. 1976), or that an allocation of income or expenses to principal or income is required or how to make the allocation, e.g. M. EDWARDS, NORTH CAROLINA PROBATE HANDBOOK §§ 19-5 (3d ed. 1982); E. QUICK & M. GOLDSMITH, NORTH CAROLINA ESTATE ADMINISTRATION MANUAL (N.C. Bar Ass’n 1984); J. HUGGARD, THE ADMINISTRATION OF DECEDENTS’ ESTATES IN NORTH CAROLINA (1985). The practical aspects of making allocations during the administration of estates and trusts are beyond the scope of this article.

Neither the Act nor its 1937 predecessor has been mentioned in most of the relatively few appellate cases in which these statutes could have applied, e.g., In re Bulis, 240 N.C. 529, 82 S.E.2d 750 (1954); Wachovia Bank & Trust Co. v. Grubb, 233 N.C. 22, 62 S.E.2d 719 (1950); Cannon v. Cannon, 225 N.C. 611, 36 S.E.2d 17 (1945); Ingle v. Allen, 71 N.C. App. 20, 321 S.E.2d 588 (1984), rev. denied, 313 N.C. 508, 329 S.E.2d 391 (1985).
cretion to allocate between principal and income, he may need guidance. At the common law, a trustee’s duty where there are two or more beneficiaries is to deal impartially with them and where a trust is created for successive beneficiaries to act toward each of them with due regard for his respective interests. The tension is between the trustee’s duty to make the trust property productive and his duty to use reasonable care to conserve the corpus; it is the economic tension between the income beneficiary and the remainderman, the ultimate taker at some uncertain future time; it is the tension between having one’s cake and eating it, too. The “due regard” principle furnishes scant guidance for fiduciaries. The Act is designed to furnish the necessary guidance in a uniform way to promote as simple and convenient an administration of an estate or trust as is consistent with fairness to all beneficiaries. The Commissioners on Uniform Laws perceived that the practical rules of


9. Restatement (Second) of Trusts § 232, Comment b (1959), clearly delineates the tension the Act is designed to settle:

b. Duty to each of successive beneficiaries. If by the terms of a trust the trustee is directed to pay the income to a beneficiary during a designated period and on the expiration of the period to pay the principal to another beneficiary, the trustee is under a duty to the former beneficiary to take care not merely to preserve the trust property but to make it productive so that a reasonable income will be available for him, and he is under a duty to the latter beneficiary to take care to preserve the trust property for him.

Although the trustee is not under a duty to the beneficiary entitled to the income to endanger the safety of the principal in order to produce a large income, he is under a duty to him not to sacrifice income for the purpose of increasing the value of the principal. Thus, the trustee is under a duty to a life beneficiary not to purchase or retain unproductive property or property which yields an income substantially lower than that which is normally earned by trust investments, although it is probable that the property will appreciate in value. See [Restatement (Second) of Trusts] § 240.

On the other hand, the trustee is under a duty to the beneficiary who is ultimately entitled to the principal not to purchase or retain property which is certain or likely to depreciate in value, although the property yields a large income, unless he makes adequate provisions for amortizing the depreciation. See [Restatement (Second) of Trusts] § 239.

See Kuykendall v. Proctor, 270 N.C. 510, 155 S.E.2d 293 (1967)(action by personal representative against trustee for decedent for failure to exercise properly her discretion to provide for decedent’s comfort and support where trustee individually had a remainder interest in the trust corpus).
the Revised Uniform Principal and Income Act were nearer a settlor’s probable intent than the impractical guidance of common law principles, for few settlors would contemplate the extensive and detailed bookkeeping adjustments required for fairness to successive interests. No doubt the draftsmen of the North Carolina Act were similarly motivated.¹⁰

Unless the governing instrument makes another provision, the Act applies to regulate the allocation of income and expense between the income and principal interests of a trust or estate.¹¹ Accordingly, draftsmen who do not expressly exempt the fiduciary from the provisions of the Act¹² or simply give the fiduciary standard North Carolina powers by incorporating by reference the provisions of N.C. Gen. Stat. § 32-27¹³ are directing by default that

11. N.C. GEN. STAT. § 37-18(a) (1984) provides:
   (a) A trust or a decedent’s estate shall be administered with due regard to the respective interests of income beneficiaries and remaindermen. A trust or a decedent’s estate is so administered with respect to the allocation of receipts and expenditures if a receipt is credited or an expenditure is charged to income or principal or partly to each:
      (1) In accordance with the terms of the trust instrument or will, notwithstanding contrary provisions of this Article; or
      (2) In the absence of any contrary terms of the trust instrument or will, in accordance with the provisions of this Article, or
      (3) If neither of the preceding rules of administration is applicable, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as of those entitled to principal, and in view of the manner in which men of ordinary judgment would act in the management of their own affairs.
the provisions of the Act apply to govern the allocation made by
the fiduciary. This article will explore some of the consequences
of each choice and will provide a framework for a decision whether
to have selected sections of the Act apply or to draft specific in-
structions or to allow for fiduciary discretion. But first, a discus-
sion of basic predrafting considerations is necessary.

II. BASIC PREDRAFTING CONSIDERATIONS CONCERNING
ALLOCATIONS BETWEEN PRINCIPAL AND INCOME

A. Scope of Fiduciary’s Discretion

A typical will or trust provision designed to avoid application
of the Act and grant the fiduciary discretion might provide:

[The fiduciary shall have power to] determine, irrespective of
statute or rule of law, what shall fairly and equitably be charged
or credited to income and what to principal notwithstanding any
determination by the courts or by any custom or statute, and
whether or not to establish depreciation reserves.

Such discretion may be desirable in order to avoid having one’s
silence invoke the automatic effect of the Act in resolution of
conflicting claims between successive interests or to avoid the com-
plexities of drafting directions for the fiduciary designed to cover
all aspects of allocations between principal and income which
might arise. It has been suggested that a discretionary clause may
be used to achieve certain purposes: “to avoid litigation when the
law is not settled; to avoid complexity or injustice when the law is
settled; and to allow the favoring of either the life tenant or the
remainderman.” The use of such a provision raises two questions:

permitted or provided by law.” The law makes such provisions in Chapter 37 of
14. N.C. GEN. STAT. § 32-27(29) as originally enacted granted the fiduciary
power “[t]o determine . . . what is principal and what is income of any estate or
trust and to allocate or apportion receipts and expenses as between principal and
income in the exercise of the fiduciary’s discretion . . . .” 1965 N.C. Sess. Laws
ch. 628, § 1. The 1967 amendment took away that discretion (effective October 1,
1967) by inserting the language, “where not otherwise provided by the Uniform
amendment changed the reference to the Uniform Act to read, “Principal and
15. R. WILKINS, supra note 12, at ¶ 13.60W(19).
17. Note, Discretionary Income and Principal Clauses in Trust Instru-
ments, 50 YALE L.J. 1467 (1941). From the trustee’s perspective, there is another

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first, whether the language is really effective to authorize the trustee to exercise his discretion notwithstanding the Act or other statutes or the common law of the state and, second, if it is effective, whether that discretion is absolute or does it have boundaries. In addition, it may be asked whether the fiduciary by exercising such discretion can by allocation change the tax character of, for example, an item that would otherwise be income under the tax laws.

The Act specifically provides for fiduciary discretion:

If the trust instrument or will gives the trustee or personal representative discretion in crediting a receipt or charging an expenditure to income or principal or partly to each, no inference of imprudence, partiality or abuse of discretion arises from the fact that the trustee or personal representative has made an allocation contrary to a provision of this Article. 18

Where a discretionary allocation clause has been used, however, two contrary views of its construction have arisen, aptly designated the "narrow view" and the "broad view." 19 Courts following the so-called narrow view hold that the fiduciary's discretion extends only to situations where there is a genuine question or some honest doubt under local law as to whether a receipt is principal or income. 20 The broader view is that a simple grant of discretion with-


On the other hand, some institutional trustees may prefer discretion only in circumstances not covered by the Act to avoid pressures from beneficiaries who may importune the trustee to exercise the powers in a manner contrary to the provisions of the Act. Perhaps this was the impetus for the 1967 amendment to the Act, supra note 14.

Yet another purpose served by discretionary powers of a fiduciary, which underlies those suggested in the text, is to permit the fiduciary to adjust accounts to reach expected trust results when other discretionary powers have produced results inconsistent with the general law of trusts. Sherman v. Sherman, 32 Ohio Op. 2d 334, 202 N.E.2d 443 (P. Ct. 1962), cited and discussed infra at note 34.


20. E.g., Am. Sec. & Tr. Co. v. Frost, 117 F.2d 283 (D.C. Cir. 1940), cert.
out guidelines is sufficient to allow the fiduciary to allocate contrary to established law, provided his exercise of discretion is made in good faith and with reasonable judgment. In assessing such good faith and reasonable judgment, courts which have used the broader view in deciding such cases have looked to the settlor’s or testator’s intent as revealed in the instrument concerning the need of the life tenant vis-a-vis the projected benefit to the remaindermen.\textsuperscript{21} Under the \textit{Restatement} view, the requirement of reasonableness can be waived by language granting the fiduciary discretion that is “absolute” or “unlimited” or “uncontrolled.”\textsuperscript{22} But an abuse of discretion will always be found if the fiduciary acts in bad faith. Public policy will not allow a testator or settlor to deprive the court of all power of control.\textsuperscript{23}


\textsuperscript{22} \textit{RESTATEMENT (SECOND) OF TRUSTS} §\textsuperscript{187}, Comment d (1959):
\begin{itemize}
  \item [d.] Factors in determining whether there is an abuse of discretion. In determining the question whether the trustee is guilty of an abuse of discretion in exercising or failing to exercise a power, the following circumstances may be relevant: (1) terms of the trust; (2) the purposes of the trust; (3) the nature of the power; (4) the existence or non-existence, the definiteness or indefiniteness, of an external standard by which the reasonableness of the trustee’s conduct can be judged; (5) the motives of the trustee in exercising or refraining from exercising the power; (6) the existence or nonexistence of an interest in the trustee conflicting with that of the beneficiaries.
\end{itemize}


23. Heyer v. Bullock, 210 N.C. 321, 186 S.E. 356 (1936)(Stacy, C.J.: “[A trustee’s discretion] is subject to the control of the court at all times. [citing cases back to Jordan v. Jordan, 4 N.C. 292 (1816)""); Stix v. Comm’r, 152 F.2d 562, 563 (2d Cir. 1945) per L. Hand, J.: Nevertheless, we agree that no language, however strong, will entirely remove any power held in trust from the reach of a court of equity. After allowance has been made for every possible factor which could rationally enter into the trustee’s decision, if it appears that he has utterly disregarded the interests of the beneficiary, the court will intervene. Indeed,
There is no North Carolina appellate case which directly deals with the scope of a will or trust provision giving a fiduciary discretion to allocate between principal and income. North Carolina law is clear, however, that the intent of a testator or settlor, unless unlawful, is controlling in construing a will or trust agreement. It is also clear that a trustee must deal impartially with the beneficiaries of a trust. The courts have not hesitated to review the discretion of trustees in appropriate cases and to condemn abuses of discretion amounting to fraud, bad faith, improper motive, or arbitrariness. The courts will safeguard and preserve the interests of beneficiaries.

Dicta in two North Carolina Supreme Court cases suggest that North Carolina would follow the so-called broad view: a fiduciary who is given discretion to allocate between principal and income may exercise such discretion unless his exercise is arbitrary or fraudulent, but his discretion is circumscribed by the settlor’s intent as indicated by the instrument as a whole. The Fourth Circuit, in a well-reasoned opinion, has held that North Carolina

were that not true, the power would not be held in trust at all; the language would be no more than a precatory admonition. See 3 A. Scott, supra note 2, § 187.4; G. Bogert & G. Bogert, supra note 2, § 560.

29. Citizens Nat’l Bank v. Grandfather Home for Children, Inc. 280 N.C. 354, 185 S.E.2d 836 (1972)(trial court erred in allocating expenses to principal where instrument gave fiduciary discretion and there was no finding of an abuse of discretion); Little v. Wachovia Bank & Trust Co., 252 N.C. 229, 113 S.E.2d 689 (1960)(quoting RESTATEMENT (SECOND) OF TRUSTS § 187 and adding, ‘of course the trustee will not be given ‘unlimited power to make allocations as between income and principal in contravention of the intent of the settlor as indicated by the terms of the trust instrument as a whole.’ ’).
30. Greer v. United States, 448 F.2d 937 (4th Cir. 1971)
would follow the broader view in such cases, the boundary of discretion being marked by the intent of the settlor as expressed in the governing instrument in the absence of fraud, bad faith, or improper motive. Fiduciary discretion in other contexts has been respected.

The discretion to allocate between principal and income should be broadly construed unless the fiduciary's actions are a perversion of the purposes contemplated by the settlor as drawn from the instrument and the relevant circumstances. The fiduciary's exercise of discretion will more likely promote the intent of the settlor or testator and the welfare of the beneficiaries as a whole than the rules set down by the Legislature or by specific instructions set down by a draftsman at a remote time. Even "absolute" discretion, however, does not set the fiduciary adrift from

31. "The extent of the discretion lodged in trustees by settlors may be enlarged by the use of adjectives or phrases such as 'absolute' or 'unconditional.'" Davidson v. Duke University, 282 N.C. 676, 708, 194 S.E.2d 761, 781 (1973).

32. Courts also look to the financial situation of the present beneficiaries. For example, if there would be no apparent reason for the fiduciary to invade principal to support the income beneficiary whose income greatly exceeded her needs, the fiduciary's good faith and the intent of the settlor may well preclude a discretionary payment of principal. Greer v. United States, 448 F.2d 937 (4th Cir. 1971). Compare, e.g., Estate of Mose Sumner v. Comm'r, 59 T.C. 837 (1973), non-acq., with Atwell v. United States, 339 F. Supp. 425 (S.D. Tex. 1972).


34. See, e.g., Sherman v. Sherman, 202 N.E.2d 443, 453 (Ohio P. Ct.), aff'd, 5 Ohio St. 2d 27, 213 N.E.2d 360 (1962):

This Court believes a fourth purpose could be added to the above list [referring to the three reasons enumerated for trustee discretion, Note, supra note 17 and accompanying text]. When a settlor has granted the trustee broad powers which in effect permit the trustee to depart from many established trust duties, he may insert such a discretionary allocation clause to permit the trustee to cause ordinary trust results when the use of their broad powers has created results inconsistent with ordinary trust results.

In this case the trustee had been allowed to keep a substantial portion of the trust corpus invested in the stock of one corporation. The growth of that corporation was undoubtedly due in large part to its retention of earnings, at a cost to the income beneficiaries. The trustee's discretion could be exercised to remedy this imbalance, for example, by allocating stock dividends to income, contrary to the local law.
all legal and equitable notions; his discretion is still to be exercised in a manner contemplated by the settlor or testator as expressed in the instrument and as appears from the relevant facts and circumstances. The statute requires that "[a] trust or a decedent's estate shall be administered with due regard to the respective interests of income beneficiaries and remaindermen." The sense of the statute which should govern a fiduciary's discretion is found in the rule respecting allocations where neither the governing instrument nor the Act is applicable: in such cases, the allocation shall be made in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as of those entitled to principal, and in view of the manner in which men of ordinary prudence, discretion and judgment would act in the management of their own affairs.

B. Tax Consequences of Fiduciary Discretion

1. Effect of Allocation on Income Taxation

"Income" is defined for purposes of the estate and trust income tax provisions of the Internal Revenue Code as fiduciary accounting income. The Code expressly refers to local law. This does not mean, however, that state law controls whether receipts by an estate or trust are subject to federal income taxation—this

35. The very fact that the settlor or testator created the trust, divided the estate between life tenant and remainderman, and embodied the discretionary power in the principal and income clause instead of in the direct disposition provisions shows that he did not intend the principal-income clause to confer an unlimited power to deviate from local law, however broad the language employed.
Subcommittee Report, supra note 17, at 191.
39. I.R.C. § 643(b) (1985) provides:
(b) Income.—For purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means 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. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local laws shall not be considered income.
provision relates to fiduciary accounting for principal and income which is utilized by the taxing statute to effect a tier structure of taxable priorities.\textsuperscript{40} How the fiduciary accounts for and allocates to principal and income determines how taxes are allocated between the income interest and the remainder interest. An illustration is provided in the text, \textit{infra} at footnote 121.

The Regulations anticipate abuses of fiduciary discretion and give the Commissioner authority to ignore allocations which “depart fundamentally from concepts of local law.”\textsuperscript{41} The purpose of the Regulations is to prevent attempts by fiduciaries to shift tax liabilities by making allocations inconsistent with “fundamental” concepts of state law; the provision would permit the Service to question such an allocation under the rules of state law governing allocations. If the governing instrument directs an allocation to be made, it is doubtful even under the Regulations the Commissioner could prevail,\textsuperscript{42} but where the fiduciary acts under a grant of broad discretion, it is a closer question.\textsuperscript{43} Two items, extraordinary divi-


\textsuperscript{41} Treas. Reg. § 1.643(b)-1 (1986) provides, in part:

Trust provisions which depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized for this purpose. For example, if a trust instrument directs that all the trust income shall be paid to A, but defines ordinary dividends and interest as corpus, the trust will not be considered one which under its governing instruments is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to “simple” trusts).

Treas. Reg. § 1.643(b)-2 provides, in part:

\textit{Dividends allocated to corpus}.—Extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law are not considered “income” for purposes of subpart A, B, C, or D, part I, subchapter J, chapter 1 of the Code.

These regulations have been criticized as an unwarranted attempt to impose a “federal concept of ‘income’” on a fiduciary acting under specific directions in computing fiduciary accounting income when that question is, under the statute, left to local law. Ferguson, \textit{supra} note 40, at 400-01.

\textsuperscript{42} See Bisbee v. Fahs, 80 F. Supp. 929 (D. Fla. 1948)(allowing capital losses to be charged to income under will provision).

\textsuperscript{43} Compare Doty v. Comm'r, 148 F.2d 503 (1st Cir. 1945)(beneficiary taxed
dends and taxable stock dividends, are inexplicably a proper subject for the exercise of a fiduciary's good faith discretionary allocation to principal unless the governing instrument or local law clearly requires allocation to income. Certainly these are not the only items subject to a fiduciary's discretion. For tax purposes, any good faith exercise of discretion by the fiduciary, if allowable by state law, will be accepted by the Service, but an allocation clearly contrary to concepts discussed in the previous section of this article will not be allowed.

2. Estate Tax Implications of Discretion in Irrevocable Trusts

Powers of management and administration reserved to the settlor of an irrevocable inter vivos trust may attract the estate tax through I.R.C. § 2036 and § 2038 if those powers are tantamount to the power to designate the persons who will possess or enjoy the property or the income therefrom. The State Street Trust Company case caused considerable consternation in this on ordinary dividends allocated to principal by fiduciary under discretionary allocation power), with Thornton v. Comm'r, 5 T.C. 1177 (1945) (fiduciary exercised "sound discretion" allocating part of long term capital loss to income, thereby reducing income tax of income beneficiary) and Comm'r v. Wade, 155 F.2d 918 (2d Cir. 1946).

44. FERGUSON, supra note 40, at 405; See J. PERSCHEL & E. SPURGEON, FEDERAL TAXATION OF TRUSTS, GRANTORS AND BENEFICIARIES §§ 3.02[A], [B] (1978).
45. See text accompanying notes 29-37, supra.
49. State Street Trust Co. v. United States, 263 F.2d 635 (1st Cir. 1959). The grantor as co-trustee had retained powers to exchange trust property for other property, to invest in assets ordinarily not considered suitable for a trust investment and to make discretionary allocations between principal and income. Even though "perhaps no single power . . . would be enough to warrant inclusion of the corpus of the trust in his estate . . . the powers conferred on the trustees, considered as a whole, are so broad and all inclusive that within any limits a Massachusetts court of equity could rationally impose, the trustees, within the scope of their discretionary powers, could very substantially shift the economic benefits of the trust between the life tenants and the remaindermen." Id. at 639. Citing and quoting from Dumaine v. Dumaine, 301 Mass. 214, 16 N.E.2d 625 (1938)(supra note 21—a "broad view" case) the court noted that "short of utter
area, holding that certain discretionary administrative powers retained by the grantor as co-trustee caused property transferred to be included in his estate. State Street was, however, effectively overruled by Old Colony Trust Co. v. United States and there now seems to be little question that "no aggregation of purely administrative powers can meet the government's amorphous test of 'sufficient dominion and control' so as to be equated with ownership." It is essential to note that the holdings in the cases following the Old Colony rationale are founded on state law which would require the settlor or trustee to treat all interests fairly, reasonably and in good faith.

Particularly until that rule is finally settled by North Carolina appellate courts and the holding of Old Colony is adopted in the Fourth Circuit, a conservative approach is to provide that fiduciary discretion respecting allocations between principal and income be exercised only by a co-trustee other than the settlor. At least it should be made clear in the trust instrument, if the settlor-trustee is to have such power, that his discretion is not absolute but is subject to standards of reasonableness and good faith.

3. Gift Tax Implications of Discretion in Trusts

The federal gift tax law provides for a $10,000 annual exclu-

disregard of the rights of a life tenant or a remainderman springing from 'arbi-
trary or dishonest conduct or bad faith, or fraud' . . . a Massachusetts court would have no external standard with which to measure the trustee's conduct." The sword of discretion can cut two ways.

51. 423 F.2d 601 (1st Cir. 1970).
54. Cf. Greer, 448 F.2d 937 (indicating approval of Old Colony holding).
55. See Hauser, supra note 37, ¶ 69.602. For an argument against the pre-
sion in I.R.C. § 2503(b), provided two requirements are satisfied. First, the gift must not be a gift of a future interest and second, the gift must have an ascertainable value. It could be argued that broad trustee powers, including discretion or certain directions with regard to allocations between principal and income, render an income interest incapable of valuation. This is the IRS position. In Revenue Ruling 77-358, the trustee was required to allocate between principal and income in accordance with state law, provided that gains and losses on the sale of trust assets were to be charged to income and in selecting assets for reinvestment, only assets yielding a current return would be acquired. Because the income of the trust would be diverted to offset any losses incurred in the sale of trust assets, the income required to be distributed could not be accurately determined and so the value of that interest was held to be unascertainable. This view has received some judicial support.

57. The statute provides that gifts of future interests do not qualify for the annual exclusion. Treas. Reg. § 25.2503-3(a) (1986) defines the term: "'Future interest' is a legal term and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession or enjoyment at some future date or time." An income interest, of course, qualifies as a present interest. Rev. Rul. 58-242, 1958-1 C.B. 251.
60. Id.
61. E.g., Van Den Wymelenberg v. United States, 397 F.2d 443 (7th Cir.), cert. denied, 393 U.S. 953 (1968); Fischer v. Comm'r, 288 F.2d 574 (3d Cir. 1961). But see, e.g., Mercantile-Safe Deposit & Trust Co. v. United States, 311 F. Supp. 670 (D. Md. 1970). In the first two cases cited, the trustee had broad powers of sale and exchange and investment. In addition, the trustees in the Fischer case had the power to make improvements on the substantial rental property held by them, and the cost of the improvements could, the court thought, leave nothing for the beneficiaries when added to mortgage payments required to be made. There was no discussion in Van Den Wymelenberg or Fischer of the equitable restraints state law would impose on the trustees. Those equitable restraints and that the instrument "specifically dictated that 'the welfare of such beneficiary shall be the primary concern of the trustee'" dictated a different result in Mercantile-Safe Deposit & Trust Co. The result in Greer v. United States, 448 F.2d 937 (4th Cir. 1971)(ascertainable value of a charitable remainder prior to 1969 amendment of I.R.C. § 2055(e)) is based on a similar analysis of North Carolina
Other courts, however, have been more receptive to taxpayers' arguments. In each of these cases, the court has noted that, while the allocation power might be a legal right to effect an indirect diversion of income to the remaindermen, state law would circumscribe the conduct of the trustee to keep his actions within the bounds of reasonableness, particularly where the settlor's intent to benefit the income interest was apparent from the four corners of the instrument. Greer v. United States indicates this view would probably prevail were the question raised by a North Carolina taxpayer. The same rationale should usually apply to defeat an argument by the IRS that a gift is incomplete because of broad powers to allocate between principal and income retained by the settlor-trustee.

4. Grantor Trust Rules—Implications of Discretionary Allocations

The grantor trust rules provide that "[a] power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language" does not cause the grantor to be treated as owner, regardless of who holds such power. The words "broad language" and the absence of a requirement that this power be exercised by one in a fiduciary capacity suggests the conclusion that an absolute discretion in the grantor is permitted. The Senate Finance Committee Report indicates, however, that the law and the instrument involved. Cases concerning the ascertainable value of charitable remainders prior to the 1969 amendment of I.R.C. § 2055(e) are collected in Annot., 46 A.L.R. FED. 246, § 2 (1980) and may be helpful in an analysis of I.R.C. § 2503(b) questions.

63. 448 F.2d 937 (4th Cir. 1971).
64. See Treas. Reg. §§ 25.2511-2(c), (d) (1986).
68. Senate Report No. 1622, 83rd Cong., 2nd Sess. at 369 (1954) says, in part: This exception is designed to insure that a power which is normally vested in the trustee for purposes of conforming appropriate trust accounting principles may not, if vested in the grantor as trustee, be con-
same sort of standards discussed earlier in this article apply here as well. Accordingly, when the grantor is to be trustee, or if he is not to be trustee but more than half of the trustees are “related or subordinate parties who are subservient to [his] wishes,” the grant of discretion to allocate between principal and income should be limited by a standard of fiduciary good faith and reasonableness so that the power is clearly not within the grantor trust rules.

C. Beneficiary as Trustee

If a trustee is also a beneficiary of the trust, his powers may be of such significance as to require the corpus of the trust to be included in his estate under I.R.C. § 2041. The Regulations provide, however, with respect to administrative powers:

[the mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercised in a fiduciary capacity, where the holder has no power to enlarge or shift any of the beneficial interest therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.]

Under North Carolina law, a trustee-beneficiary will not be allowed to exercise administrative powers relating to discretionary allocations of principal and income. N.C. Gen. Stat. § 32-34(a) provides:

... [A] power conferred upon a person in his capacity as fiduciary to make discretionary distributions of principal or income to himself or to make discretionary allocations in his own favor of receipts or expenses as between income and principal cannot be exercised by him. If the power is conferred on two or more fiduci-
aries, it may be exercised by the fiduciaries who are not so disqualified.

Consequently, if a beneficiary is to be trustee, even if another trustee or co-trustee has discretion as to distributions, the beneficiary-trustee should not be given discretion to make allocations between principal and income. Appropriate limiting language might provide:

... If my wife is a beneficiary and also serves as co-trustee of any trust under the provisions of this will or any codicil thereto, she shall have no such discretionary power as co-trustee regarding discretionary allocations as between principal and income as provided in the preceding paragraphs, and all such powers shall be exercised by the other co-trustee.

D. Marital Deduction

To qualify for the marital deduction, trusts must provide that the spouse is entitled to all of the income for life. Administrative powers which would allow the trustee to shift income away from the donee or surviving spouse might jeopardize the trust's qualification for the marital deduction. But if the power to allocate be-

75. See generally, Moore, Caution: Boilerplate May Be Hazardous to Your Client's Health, 1980 INST. ON EST. PLAN. ¶ 501.4c.


77. Treas. Reg. § 20.2056(b)-5(f)(1) (1986): [T]he effect of the trust [must be] to give [the surviving spouse] substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Such degree of enjoyment is given only if it was the decedent's intention, as manifested by the terms of the trust instrument and the surrounding circumstances, that the trust should produce for the surviving spouse during her life such an income ... as is consistent with the value of the trust corpus and with its preservation.

Treas. Reg. § 25.2523(e)-1(f)(1) (1986) has identical language. See Prop. Treas. Reg. §§ 20.2056(b)-7(c) and 25-2523(f)-1(c) (1986). The regulations specifically provide that state law (i.e., law discussed in text accompanying notes 29-37, supra) "shall be taken into account in determining whether or not [the above}
tween income and principal, construed in light of state law, the
provisions of the instrument as a whole and the surrounding cir-
cumstances, is subject to a standard of reasonableness, the interest
is not disqualified.78

Revenue Ruling 69-5679 promulgates rules that govern the ex-
tent to which fiduciaries may have the power to allocate income
and expenses between principal and income and to provide or not
to provide for depreciation reserves without causing the loss or
diminution of the marital deduction where the surviving or donee

conditions] are satisfied.” Treas. Reg. §§ 20.2056(b)-5(e), 25.2523(e)-1(3) (1986); Prop. Treas. Reg. §§ 20.2056(b)-7(d), 25.2523(f)-1(e) (1986).


In the case of a trust, the rules to be applied by the trustee in alloca-
tion of receipts and expenses between income and corpus must be con-
sidered in relation to the nature and expected productivity of the assets
passing in trust, the nature and frequency of occurrence of the expected
receipts, and any provisions as to change in the form of investments. If it
is evident from the nature of the trust assets and the rules provided for
management of the trust that the allocation to income of such receipts as
rents, ordinary cash dividends, and interest will give to the spouse the
substantial enjoyment during life required by the statute, provisions that
such receipts as stock dividends and proceeds from the conversion of the
trust assets shall be treated as corpus will not disqualify the interest as
passing in trust. Similarly, provision for a depletion charge against in-
come in the case of trust assets which are subject to depletion will not
disqualify the interest passing in trust, unless the effect is to deprive the
spouse of the requisite beneficial enjoyment. The same principle is appli-
cable in cases of depreciation, trustees commissions, and other charges.

Treas. Reg. § 20.2056(b)-5(f)(4) (1986) provides, in part:

(4) Provisions granting administrative powers to the trustee will not have
the effect of disqualifying an interest passing in trust unless the grant of
powers evidences the intention to deprive the surviving spouse of the
beneficial enjoyment required by the statute. Such an intention will not
be considered to exist if the entire terms of the instrument are such that
the local courts will impose reasonable limitations upon the exercise of
the powers. Among the powers which if subject to reasonable limitations
will not disqualify the interest passing in trust are the power to deter-
mine the allocation or apportionment of receipts and disbursements be-
tween income and corpus . . . .

The same provisions are found in the gift tax regulations, Treas. Reg. §§
Stewart v. Comm’r, 52 T.C. 830 (1969), rev’d, 436 F.2d 1281 (3d Cir.) cert. denied,
1969), rev’d, 458 F.2d 1265 (9th Cir. 1972); Greer v. United States, 448 F.2d 937
(4th Cir. 1971).

spouse has a life estate or an income interest with a power of appointment. The provisions of this Revenue Ruling should extend to testamentary and _inter vivos_ qualified terminable interest property trusts. The rules generally provide that if state law or the governing instrument (1) prevents the fiduciary from favoring other beneficiaries over the spouse, (2) gives the spouse enforceable rights in the trust, and (3) limits the fiduciary from making allocations that, based on the composition of the assets, would deprive the spouse of enjoyment, these powers are permissible. In Example Two of the Ruling the fiduciary has discretion to allocate between principal and income; in Example Three state law regarding allocations controls. Both examples are held to qualify under the marital deduction regulations, but the holding with respect to Example Two is based on the assumption that state law would require adherence to principles such as those outlined in Section 187 of the _Restatement (Second) of Trusts_. There is no North Carolina case which directly involves the scope of a fiduciary's discretion to allocation between principal and income, but it seems clear that this state's law is sufficient to satisfy the requirements of Revenue Ruling 69-56.

The question of allocating income accrued but unpaid at the death of the beneficiary of a qualified terminable interest property trust bears brief mention. Must this income be allocated to the spouse's estate (allocated to income) or can it be allocated to the remaindermen (allocated to principal)? The statute provides that the spouse must be "entitled to all the income from the property" for life. The Committee Reports indicate such income must be allocated to the spouse's estate.

82. See text accompanying notes 29-37, supra. There are apparently no cases wherein the qualification of the marital deduction is challenged because of a trustee's discretion to allocate between principal and income.
85. "A qualifying income interest for life in any property must provide the spouse with a degree of beneficial enjoyment sufficient to satisfy the rules applicable to marital deduction trusts under Treas. Reg. § 20.2056(b)-5(f)." _Joint Committee Explanation of the Unlimited Marital Deduction—Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, 97th Cong., 1st Sess. 235 (1981)._ Treas. Reg. § 20.2056(b)-5(f)(8) (1986) provides, "as regards the income from the period between the last distribution date
The Act allocates such income to the estate of the spouse but if the instrument gives the trustee discretion, he could allocate these receipts to corpus, thereby passing that amount to the remaindermen rather than to the spouse's estate. Accordingly, the following language should be included in instruments in which the trustee has discretion to allocate between principal and income:

[A]ny accrued and undistributed income at the death of settlor's wife shall be paid to her executors and administrators.

Failure to do so, however, should not be fatal. The IRS has indicated that even a direction in the instrument that such income be distributed to the remainder beneficiary is not violative of the qualified terminable interest property provisions.

III. How the Act Applies and When Discretionary Allocations Are Recommended

A. When the Right to Income Arises for an Income Beneficiary

The Act provides:

An income beneficiary is entitled to income for the period beginning on the date specified in the trust instrument or will, or, if no date is specified, on the date an asset becomes subject to the trust or on the date [day] after the date of the decedent's death and ending on the date the income interest of the beneficiary terminates. In the case of an asset becoming subject to a trust by reason of a will, it becomes subject to the trust as of the date of the death of the testator even though there is an intervening period of administration of the testator's estate.

and the date of the spouse's death, it is sufficient if that income is subject to the spouse's power to appoint."


87. R. Wilkins, supra note 12, at ¶¶ 19.10, 19.10W (1985). But see Wachovia Will and Trust Manual 14 n.2 (1985): "An income interest will constitute qualified terminable interest property even if income between the last distribution date and the date of the spouse's death is not required to be distributed to the spouse or the spouse's estate."

88. L.T.R. 3403102, October 21, 1983. Prop. Treas. Reg. §§ 20.2056(b)-7(c) and 25-2523(f)-1(c) (1986) provide that it is not a requirement for qualification that the income between the last distribution date and the death date be distributed to the spouse's estate. See L.T.R. 8429057, April 18, 1984.

This provision is in accord with the common law of North Carolina. If an item—a receipt—is allocated by the fiduciary to income, the income beneficiary under a will is entitled to such income from the day following the date of decedent's death; the same rule holds if the asset producing the income is subject to a trust, unless the instrument specifies otherwise. This provision is not subject to fiduciary discretion unless the fiduciary has express discretion to distribute income to one beneficiary rather than to another. The only device for circumventing this section, other than a specific provision in the will or trust instrument, is for the fiduciary in the exercise of his discretion to allocate the receipt to principal so that it would not accrue to the income beneficiary at all. Accordingly, a fiduciary must give close consideration not only to who is entitled to income but also to who bears the burden of tax on that income.

For an income beneficiary under a will, the income accrues from the date following the date of the testator's death, unless the will makes a different provision. A similar rule applies for the income beneficiary of a testamentary trust: if the will leaves Blackacre to T in trust for A to receive the income, A's income interest accrues as of the date of the testator's death. It might be asked whether the estate or the beneficiary (including the trust if the devise were in trust) is taxed on such income. Either the executor or the Service might assert that such income is really income taxable to the beneficiary (or to the testamentary trust).

Consider first the income beneficiary under a will. The scheme of Subchapter J of the Internal Revenue Code is to tax with income the one entitled to it or the one who receives it. In


91. The discretion contemplated in N.C. Gen. Stat. § 37-18(b) (1984) is only the discretion to “[credit] a receipt or [charge] an expenditure to income or principal or partly to each . . . .” If, to use the case covered in the second sentence of § 37-20(a), an asset becomes subject to a trust by reason of a will, a fiduciary with plenary powers to allocate between principal and income would have no authority once he had allocated an item to income to hold it for the corpus of the trust if the income beneficiary were entitled to distribution of the income under the instrument.

92. This discussion assumes a general direction in the will to distribute income currently.

93. See generally Ferguson, supra note 40, at 407-20. Generally speaking, an estate or trust is taxed on its income in much the same manner as an individual, but is allowed to deduct amounts of income required to be distributed or actually
this regard, § 662(a)(1)\textsuperscript{94} provides that a beneficiary shall include in gross income "[t]he amount of income for the taxable year required to be distributed currently . . . , whether distributed or not . . . . The test of taxability to the beneficiary is not receipt of income, but the present right to receive it."\textsuperscript{95} Whether income is currently distributable depends on the provisions of the instrument and state law.\textsuperscript{96} The ultimate right to receive income is not a present right to compel its distribution.\textsuperscript{97} Income on assets devised and bequeathed to the executor, currently payable to a beneficiary, can be reallocated from the estate to the beneficiary if not actually paid, but this result may be unlikely because state law constraints on the executor probably deny the beneficiary’s right to current distribution.\textsuperscript{98}

If the testator makes a general or specific devise\textsuperscript{99} to a trust, a similar question\textsuperscript{100} arises with respect to the income earned by the distributed to beneficiaries in a tax year. I.R.C. §§ 661, 651 (1985). The beneficiaries entitled to receive or actually receiving such income distributions are taxed thereon. I.R.C. §§ 662, 652 (1985).

\textsuperscript{94} I.R.C. § 662(a)(1) (1985).

\textsuperscript{95} Freuler v. Helvering, 291 U.S. 35 (1934).

\textsuperscript{96} Treas. Reg. §§ 1.651(a)-2(a), 1.661(a)-2(c) (1986).

\textsuperscript{97} Estate of Smith v. Comm'r, 168 F.2d 431 (6th Cir. 1948), aff'g First Nat'l Bank of Memphis v. Comm'r, 7 T.C. 1428 (1946); and In re Smith's Estate v. Henshi, 64 F. Supp. 196 (D.C. Tenn. 1946).


\textsuperscript{100} The concern here is not with income from property which was left to the executor as to which he has title under N.C. GEN. STAT. § 28A-15-2(a) (1984). Rather, the issue here is whether the executor might be taxed on income from realty devised to a simple trust.
asset during administration and before formal funding of the trust, assuming the trust is a simple trust required to distribute its income currently. The question in this instance is whether income which is "subject to a trust" can be taxed to the trust (or passed through to the beneficiary) if the trust has not been established and funded. The general rule is that a testamentary trust is treated as a separate taxable entity when it comes into existence under state law and is funded. Under North Carolina law, a trustee derives his title from the instrument which names him and his legal existence is derived from that instrument, not from the administrative proceedings relating to qualification, posting bond, etc., as is now required by N.C. Gen. Stat. § 36A-107. A devisee of realty is entitled to receive the rents to the exclusion of the executor and a tenant cannot pay the executor. Accordingly, if the devise is to a simple trust, the beneficiary of the trust, not the estate, is taxable on the income.

101. Cf. Estate of Bryan v. Comm'r, 22 T.C.M. 864 (1963), aff'd, 364 F.2d 751 (4th Cir. 1966)(I.R.S. argued that assets were distributed to trustee under residuary provision of will and consequently the income beneficiary of the trust was taxable).


108. See Hibernia Nat'l Bank in New Orleans v. Donnelly, 121 F. Supp. 179 (E.D. La.), aff'd per curiam, 214 F.2d 487 (5th Cir. 1954)(under Louisiana law, legatees of stock were entitled to possession from date of death and so were taxed on dividends thereon, rather than the estate); Weber v. Comm'r, 111 F.2d 766 (2d Cir. 1940)(capital gain on sale of land taxable to beneficiaries); Rev. Rul. 59-375, 1959-2 C.B. 161 (where real property under state law passes directly to heirs, gain realized on sale of real property to pay estate debts is apportioned between the estate and heirs in proportion to proceeds received by each). See generally Ferguson, supra note 40, at 407-26; A. Michaelson & J. Blattmachr, supra note 40, at 10. But cf., Cohen v. Comm'r, 8 T.C. 784 (1947); Rev. Rul. 62-116, 1962-2 C.B. 207; Rev. Rul. 57-133, 1957-1 C.B. 200. Where the estate is amply solvent, the
B. Apportionment of Rent and Interest Accruals and Recurring Charges

N.C. Gen. Stat. § 37-20(b)\(^{109}\) provides that receipts due but not paid at death are principal and that periodic payments are apportioned, the part accruing prior to death to principal and the balance to income. N.C. Gen. Stat. § 37-20(c)\(^{110}\) makes a similar allocation upon termination of an income interest.\(^{111}\) N.C. Gen. Stat. § 37-39\(^{112}\) apportions recurring charges in the same fashion.


The example posed should be distinguished from a devise to a residuary trust. Because a residuary trust is generally considered to come into existence when the estate is terminated, Bruner v. Comm'r, 3 T.C. 1051 (1944); Neuman v. Comm'r, 28 T.C.M. (CCH) 724 (1969), or when it is deemed to have been terminated under Treas. Reg. § 1.641(b)-3(a) (1986), Chick v. Comm'r, 7 T.C. 1414 (1946), aff'd, 166 F.2d 337 (1st Cir.), cert. denied, 334 U.S. 845 (1948), attempts to reallocate income to a residuary beneficiary have been unsuccessful. United States v. Britten, 161 F.2d 921 (3d Cir. 1947); Titusville Trust Co. v. Comm'r, 3 B.T.A. 868 (1926). See generally, 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 36.44 (1983).

111. The statutes provide:

(b) In the administration of a decedent's estate or when an asset becomes subject to a trust by reason of a will:

(1) Receipts due but not paid at the date of death are principal; and
(2) Receipts in the form of periodic payments (other than corporate distributions to stockholders and receipts incident to the operation of a trade or business), including rent, interest or annuities, not due at the date of death shall be treated as accruing day to day. That portion of any receipt accruing on or before the date of death is principal, and the balance is income.

(c) On termination of an income interest, the income beneficiary whose interest is terminated, or his estate, is entitled to:

(1) Income undistributed on the date of termination;
(2) Income due but not paid to the trustee or personal representative on the date of termination; and
(3) Income in the form of periodic payments (other than corporate distributions to stockholders and receipts incident to the operation of a trade or business), including rent, interest, or annuities, not due on the date of termination, accrued, on a day-to-day basis, on or before the date of termination.

112. N.C. GEN. STAT. § 37-39 (1984). This section provides:

Recurring charges; apportionment: Regularly recurring charges payable...
Accordingly, for example, if the Act applies and the decedent dies between annual rental payments on a commercial building, the rent and expense attributable to the asset through the date of death are allocable to principal; rent and expense attributable to the asset after the date of death are allocable to income.

At the common law when the landlord dies between rent days there is no apportionment—the rents follow the reversion. The rule as to interest is otherwise, and interest is apportioned.113 The common law has been changed in North Carolina, not only by N.C. Gen. Stat. § 37-20,114 but also by § 42-6,115 which requires apportionment of "rents, rent charges, annuities, pensions, dividends, or any other payment of any description, . . . made payable at fixed periods to successive owners under any instrument or by will . . . ." and by N.C. Gen. Stat. § 42-7,116 which provides for apportionment of farm rents upon the death of the lessor and allows the tenant to continue in possession to the end of the current year. But whether the Act applies to allocate post-death receipts, part of which accrued before death, between the personal representative (principal) and the devisee (income) or whether under a discretionary power from income shall be apportioned to the same extent and in the same manner that income is apportioned under G.S. 37-20.


114. N.C. GEN. STAT. § 37-20(b) (1984). This statute changes the common law of this state as enunciated in, e.g., First-Citizens Bank & Trust Co. v. Frazelle, 226 N.C. 724, 40 S.E.2d 367 (1946). The common law rule is that rents follow the reversion: where A devises his personalty to B and Blackacre, rented to T and in T's possession as lessee, to C, and the rent on Blackacre falls due after A's death, C, not B, is entitled to all the rent, none of it being apportioned to B as personalty owned by A on the day of his death. Wells v. Planters Nat'l Bank & Trust Co., 265 N.C. 98, 143 S.E.2d 217 (1965). The applicable provisions of the North Carolina Uniform Principal and Income Act, formerly codified as N.C. GEN. STAT. § 37-4 (construed with former N.C. GEN. STAT. § 37-2)(repealed 1973)) did not change this rule; that statute applied only to successive ownership under a trust. Wells, 265 N.C. 98, 143 S.E.2d 217 (1965). But N.C. GEN. STAT. § 37-20(b) (1984) expressly applies to interests passing through a decedent's estate.


In this connection, it should be noted that in 25 counties, agricultural leases and cropshare contracts run from December 1 to December 1, rather than for the calendar year. N.C. GEN. STAT. § 42-23 (1984). Cropshare arrangements are "periodic payments" and must be apportioned. Wells v. Planters Nat'l Bank & Trust Co., 265 N.C. 98, 143 S.E.2d 217 (1965).
such receipts are allocated to principal or to income, the income character of such items for tax purposes is not changed.

Rents received after death are income in respect of a decedent to the extent allocable to the period prior to death and the balance is ordinary income to the recipient. Interest rules are the same. An allocation by the fiduciary of pre-death rents or interest to income, contrary to the Act, does not change the taxable status of the item for the estate or trust, but that allocation and the operation of the distributable net income (DNI) rules do directly determine who receives the item and who pays the income tax on such receipt. An example is helpful:

**Situation One:** Decedent dies August 1 entitled to an interest payment of $12,000 falling due December 31. Under the Act, the executor allocates the pre-death portion to principal. Assume there is no other income for the period and only a $400 administration expense. Assume further that all income must be distributed currently to the surviving spouse.

**Situation Two:** Same facts as Situation One, except that the executor, exercising his discretion, allocates the entire interest receipt and the administration expense to income.

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Note that the cited ruling deals with cropshares, the amount of which may not be determinable until well after death. Even though no amount could be accrued at death for income tax purposes by an accrual basis taxpayer, yet a proportionate part of the rent ultimately received is income in respect of a decedent. Estate of Davison v. United States, 292 F.2d 937 (Ct. Cl.), cert. denied, 368 U.S. 939 (1961). See generally Ferguson, supra note 40, at 194-202; Miller, Income in Respect of A Decedent—General, TAX MGMT. (BNA) No. 32-2d, at A-28-29 (1981).


120. Cf. Seawell v. Cheshire, 241 N.C. 629, 638, 86 S.E.2d 256, 262 (1955), refusing to surcharge the trustee after the death of the income beneficiary for allocating all administration expenses to income.

121. This allocation would, of course, have to be within the bounds of the fiduciary's discretion, discussed in text accompanying notes 29-37, supra.
FIDUCIARY ACCOUNTING INCOME (FAI)
[I.R.C. § 643(b); N.C. Gen. Stat. § 32-20(b)]
- Interest $5,000 $12,000
- Legal fee [N.C. Gen. Stat. § 37-21(a)(1)] 0 (400)
Total FAI $5,000 $11,600

TAX COMPUTATION

**Estate**

Gross Income [I.R.C. §§ 61, 641]
- Interest (portion IRD) $12,000 $12,000

Tentative Taxable Income (TTI)
- I.R.C. § 642(b) exemption (600) (600)
- I.R.C. § 212 expense (400) (400)
TTI $11,000 $11,000

Distributable Net Income (DNI)
- I.R.C. § 643(a)(2) [add back exemption] 600 600
DNI $11,600 $11,600

I.R.C. § 661 Distribution Deduction
- FAI [I.R.C. § 661(a)] 5,000 11,600
  or or or
- DNI [I.R.C. § 661(c)] 11,600 11,600

I.R.C. § 661 Deduction [lesser of above 2 amounts] $5,000 $11,600

**Beneficiary**

Tentative Taxable Income 11,000 11,000
I.R.C. § 661 Deduction 5,000 11,600
Taxable Income of Estate $6,000 $0

Beneficiary [I.R.C. § 662(c)]
- FAI $5,000 $11,600
  or or or
- DNI 11,600 11,600

Beneficiary’s income [lesser of above 2 amounts] 5,000 11,600

Beneficiary receives all FAI, net of expense allocable to income 5,000 11,600

The income beneficiary has clearly been preferred in Situation Two—the surviving spouse has received $6,600 more than he
would have received under the Act. Indeed, had the executor not exercised his discretion in Situation Two to allocate the administration expense contrary to the Act, the spouse could have received $7,000 which would otherwise have belonged to the principal beneficiaries of the estate. Note in both situations that the entire receipt is taxed, a portion as income in respect of a decedent, but that the discretionary allocation has allowed the fiduciary to prefer the income beneficiary. Without such discretion, the fiduciary could not prefer the income beneficiary, even to the extent of the administration expense. Granting such discretion is clearly recommended unless there are good reasons against it, especially where all beneficiaries of the estate are members of the same immediate family.

C. Income Earned and Expenses Incurred During Administration of a Decedent’s Estate

Section 37-21(a) of the General Statutes seems misplaced in Chapter 37 in that it does not deal with income, but rather specifies that certain expenses incurred in connection with “the administration and settlement of a decedent’s estate” are to be charged to principal unless otherwise directed in the will. This provision applies to an estate even though no trust is involved. Unless the will or a court otherwise directs, N.C. Gen. Stat. § 37-21(b) provides for net income on property passing to specific legatees and devisees to be paid to them and the balance of the estate income to other takers (except legatees of pecuniary bequests not in trust) in proportion to their interests computed at the times of distribution on the basis of “inventory value.” In determining what is income the “rules applicable to a trustee under this chapter” are to be followed. After having ascertained what is income for administrative purposes, the personal representative must then determine the appropriate taker of that income, a substantive law question in that its answer affects the amount of property received by beneficiaries.

124. “Inventory value” is defined in N.C. GEN. STAT. § 37-17(a)(2) (1984): The cost of property purchased by the trustee and the market value of other property at the time it becomes subject to the trust, but in the case of a testamentary trust, the trustee may use any value finally determined for the purposes of an estate or inheritance tax.

or heirs. Where the surviving spouse is not entitled to all estate income, this statute has implications which can affect the qualification of a bequest or devise for the marital deduction.

In considering the qualification for the marital deduction, these rules of state law, regarding income and interest on bequests and devises and allocation of expenses, are the focus of concern:

**RULE 1:** Administration expenses, including death taxes are charged to the principal of the estate unless the will directs otherwise.\(^{125}\)

**RULE 2:** Income on specific devises and bequests is payable to the devisee or legatee (less expenses attributable to the property, excluding taxes charged to principal).\(^{126}\) If the devise or bequest is in trust, the income beneficiary of the trust is entitled to such net income.\(^{127}\)

**RULE 3:** Residuary devisees and legatees are entitled to the balance of the net income earned during the administration in proportion to their interests in the undistributed assets of the estate computed at inventory value at the time of distribution.\(^{128}\)

**RULE 4:** No interest is payable on a pecuniary bequest not in trust until one year after decedent's death.\(^{129}\) No interest is payable when the bequest is directed to be satisfied at a future time.\(^{130}\)

**RULE 5:** A pecuniary bequest in trust, however, which directs that income be paid to a beneficiary for a designated period enti-

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tles that beneficiary to the income from the date of death.\(^{131}\).

**RULE 6:** Income from property used to discharge pecuniary legacies and to satisfy debts and administration expenses is payable to residuary legatees.\(^{132}\) If the residuary is in trust, such income is treated as income of the trust.\(^{133}\)

If the Act applies and there is no contrary testamentary provision (except that no death taxes are to be paid from the marital share\(^{134}\)—to get around Rule 1) the effects of N.C. Gen. Stat. § 37-21\(^{135}\) and the rules discussed are:

(a) *Outright pecuniary marital deduction bequests:* Not entitled to any income and entitled to interest only from one year after decedent's death. Accordingly, the value of the marital deduction might be diminished pursuant to Treas. Reg. 20.2056(b)-4(a).\(^{136}\) To circumvent this problem, Covey suggests the following language:


\(^{133}\) Other rules of state law which may have an impact in this area include the following:

In the absence of a testamentary provision to the contrary, the federal estate tax falls on the residuary. Rule 1, supra at text accompanying note 125; Craig v. Craig, 232 N.C. 729, 62 S.E.2d 336 (1950) (except in the case of a dissent by a surviving spouse where the decedent was not survived by a parent or by descendants, N.C. Gen. Stat. § 30-3(a) (1984)). North Carolina inheritance tax is charged against the one who inherits the property. N.C. Gen. Stat. § 105-15 (1985).


\(^{134}\) See Treas. Reg. §§ 20.2056(b)-4(c) (1986).


\(^{136}\) Treas. Reg. § 20.2056(b)-4(a) (1986).
So long as any part of said sum shall remain unpaid, my said wife shall be entitled to receive from my executor such part of the income of my estate as will equal six percent (6%) per annum from the date of my death upon such unpaid part; provided, however, that if my executor shall determine that my said wife, but for the foregoing provision, be entitled to receive as income or interest a greater amount, my executor shall pay such greater amount to my said wife. I direct that any income taxes paid by my executor in respect of the income attributable to said sum shall be charged to and deducted from the amount payable under this paragraph in such equitable manner as my executor shall determine.137

(b) **Pecuniary marital deduction trust which entitles the surviving spouse to income:** There should be no reduction in the value of the marital deduction; the surviving spouse is entitled to the income attributable to the trust from the date of decedent's death under Rule 5.

(c) **Outright residuary marital deduction:** The residuary is responsible for debts and claims under N.C. Gen. Stat. § 28A-15-5138 so the marital share will be net of these deductible expenses.139 The residuary is entitled to estate income not attributable to pre-residuary bequests (Rules 3 and 6) so there should be no reduction in the valuation of the marital deduction on account of nonentitlement to income.

(d) **Residuary marital deduction in trust:** Same as (c), above. The spouse is entitled, as income beneficiary of the trust, to all of the estate's income attributable to the residuary, so the qualification for the marital deduction should not be affected.

(e) **Pecuniary formula bequest:** Should be governed by the same rules as other pecuniary bequests as set out in paragraphs (a) and (b), above.

(f) **Fractional share bequests:** These bequests are generally a part of the residuary estate and so should attract a proportionate part of the estate's income attributable to the residuary and the qualification for the marital deduction would not be jeopardized.

From the preceding discussion, it appears that the income allocation rules would affect the qualification for the marital deduc-

137. R. COVEY, MARITAL DEDUCTION AND CREDIT SHELTER DISPOSITIONS AND THE USE OF FORMULA PROVISIONS 74 (1985). If the surviving spouse is to receive income only on the marital share, the draftsman should include a provision to insure that income will be paid on outright pecuniary marital deduction bequests.
139. H. WEINSTOCK, supra note 48, at § 15.21(d).
tion only if an outright pecuniary bequest, including a formula bequest, is used. In those cases, language providing for estate income to the surviving spouse is necessary to avoid the possibility of a reduction in the value of the marital deduction. As discussed earlier in this article, fiduciary discretion regarding allocations between principal and income should not affect qualification for the marital deduction.

D. Allocation of Income Among Beneficiaries

If the surviving spouse is not required to receive all of the estate’s net income and the will makes no other provision respecting payment of the estate’s net income, N.C. Gen. Stat. § 37-21(b) determines ownership of that income and directs distribution, generally according to the rules discussed in the previous section of this article. The provision also covers income allocation in intestate estates. Net income on specific devises and bequests is allocated to those takers and the balance of the estate’s net income is allocated to other legatees and devisees (except to legatees of pecuniary bequests in trust, who are allocated income under Rule 5). How that balance of the estate’s net income is to be divided among the beneficiaries can present perplexing problems for the fiduciary.

If the allocation is to be made pro rata to a pre-residuary pecuniary bequest, the proportionate relationship of that bequest to the balance of the estate will change as taxes and debts and administration expenses are paid from the residuary and as values of assets fluctuate. The time at which the fiduciary is to determine

140. These problems are discussed at length in Report of the Committee on Probate and Estate Administration, 102 Tr. & Est. 916 (1963), and R. Covey, supra note 137, at 60-85.
141. See text accompanying notes 76-82, supra.
143. See text accompanying notes 125-133, supra.
144. See Rule 2, supra note 126.
145. See Rule 5, supra note 131.
146. The same problem arises with fractional share residuary bequests and also in intestate estates where there are non-pro rata distributions to beneficiaries in anticipation of the final distribution. For a suggested solution during administration, see Dole, A Technique for Making Distributions From Principal and Income to Residuary Beneficiaries During Administration of Estates—With Application to Trusts, 79 Harv. L. Rev. 765 (1966).
the proportions which will control the allocation is therefore of first importance. Is he to make further determinations as values of assets change and how does he account for income received before payment of large claims but disbursed after such payment, when the residuary share has been diminished? Consider this example:

Assume an estate, after administration of expenses and debts, of $1,000,000, bequeathed one-half outright to the widow and one-half outright to the other individuals. Assume further that estate taxes aggregating $250,000 are paid, charged solely against the half of the estate bequeathed to the other individuals. Of $750,000 remaining in the possession of the executor, the widow is still entitled to $500,000, which is now \( \frac{2}{3} \) of the undistributed assets.

Assume further that the estate earns income at a steady 4% rate throughout the administration. Before the estate taxes are paid, the estate will yield $40,000 annually, which will be distributable $20,000 to the widow and $20,000 to the other beneficiaries. After the taxes are paid, however, the $750,000 remaining will earn only $30,000 annually, \( \frac{1}{3} \) of which will be produced by the widow's $500,000 interest. At this point the executor is faced with a dilemma: should he continue to distribute half of the income to the widow and half to the other residuary legatees, or should he give the widow \( \frac{2}{3} \) and the other residuary legatees only \( \frac{1}{3} \)? However he decides to allocate income, there is a strong chance that his decision will result in controversy.147

The Act, at N.C. Gen. Stat. § 37-21(b)(2),148 is designed to resolve this controversy, but it does not solve all problems of allocation. The legatees in the example posed would receive the estate's net income "in proportion to their respective interests in the undistributed assets of the estate computed at times of distribution on the basis of inventory value."149 Suppose in the example the executor did not distribute any income until immediately after the estate's death tax liability were satisfied, say nine months from the date of death. In that nine-month period, the $1,000,000 estate has earned $30,000. After the check is written for the tax liability, the "time of distribution," the interests are \( \frac{2}{3} - \frac{1}{3} \). Is the widow now

149. Id.
entitled to $20,000 when, if distribution had occurred the previous day, she would have been entitled to only $15,000? The Statute may appear to give her the larger amount if the word "distribution" means distribution of income. That construction is not warranted, however, in light of the statute's design to require a change in income shares as changes in estate asset shares occur. "Distribution" as used in the Statute should refer to times of distribution of assets which result in a change in shares.¹⁵⁰

"Inventory value" is defined in N.C. Gen. Stat. § 37-17(a)(2).¹⁵¹ The definition is designed for trustees, not executors. What "inventory value" as defined means in connection with N.C. Gen. Stat. § 37-21(b)(2)¹⁵² is not entirely clear. It has been suggested that "inventory value" for purposes of the latter section should be interpreted as federal estate tax values rather than date of death values where different results would be produced.¹⁵³ The North Carolina Statute is not, however, subject to that interpretation because the Act contains a provision not found in the Revised

¹⁵⁰ See Estate of Palitz, 331 N.Y.S.2d 929 (1972)(fractional share marital deduction will); Estate of Greenfield, 484 Pa. 141, 398 A.2d 983 (1979)(fractional share interests created by widow's dissent). The same problem arises in intestate estates where advance payments or distributions are made in unequal portions to some heirs but not to others. See generally Polasky, Marital Deduction Formula Clauses in Estate Planning—Estate and Income Tax Considerations, 63 Mich. L. Rev. 809, 844-52 (1965); Shaiman, The Widow's Election—Tax and Fiduciary Considerations, 40 Temp. L.Q. 1, 9-12 (1966).


¹⁵³ R. Covey, supra note 137, at 63. His suggestion is apparently based at least in part on the provision of the New York analogue of N.C. GEN. STAT. § 37-21(b)(2) (1984) which, unlike its North Carolina counterpart, provides that after payment of estate and inheritance taxes the proportions of the beneficiaries are computed based on the fair market value of assets immediately after such payment.
Uniform Principal and Income Act. N.C. Gen. Stat. § 37-17(a)(6) provides that: "[t]rusts include, where applicable, a decedent’s estate whether testate or intestate." Substituting the word "estate" for "trusts" in the definition of "inventory value"154 would define that term as "the market value of other property at the time it became subject to the estate."

A second problem suggested by Covey is the lack of clarity of the words "in proportion to their respective interests in the undistributed assets of the estate. Are funds held for the payment of administration expenses and death taxes considered a part of the 'undistributed assets' in making the income allocation and, if so, does the income beneficiary of the funds from which these payments are made have an 'interest' in such assets?"155 He suggests that the most equitable and practical approach "would be to consider administration expenses and death taxes chargeable to the residuary estate as being part of the estate until paid, since the estate will be receiving income on funds used for such payments."156 There is no North Carolina authority directly on point but this position has merit and should be adopted.157


155. R. COVEY, supra note 137, at 63-64. Mr. Covey poses the following hypothetical:

Assume that a decedent's will creates a trust of $100,000 for A and leaves his residuary estate outright to B, that the residuary estate is $400,000 before the payment of administration expenses and estate taxes and $250,000 after payment of these obligations, and that the value of the estate remains constant during the period of administration. Is A's share of the income (i) $100,000/$500,000, or (ii) $100,000/$350,000, or (iii) $100,000/$500,000 before the payment is made and subject to reduction as other payments are made until it eventually becomes $100,000/$350,000?

156. R. COVEY, supra note 137, at 64. He points out that, "[i]f the rule were otherwise, the administration expenses and estate taxes would have to be fixed before the allocation could be finalized." But the interpretation suggested is open to question. See, Covey, Allocation of Income Earned During Estate Administration—A Study in Statutory Interpretation, 2 REAL PROP., PROB. & TRUST J. 1, 8 (1967).

157. Cf. Wachovia Bank & Trust Co. v. Jones, 210 N.C. 339, 186 S.E.2d 335 (1936), adopting the Massachusetts rule that all income earned during the administration of the estate not payable to others or otherwise disposed of by will is distributable among the residuary legatees. Even though the residue is considered formed at the time of death, "'where the gift of the residue is after the payment
Finally, as also pointed out by Covey, the interaction of N.C. Gen. Stat. § 37-21(b)(2) and § 37-30(a) can cause an inequitable allocation of income tax on undistributed estate income where non-pro rata distributions of income are made. The following clause, Covey suggests, would avoid these results:

I direct that any income taxes imposed upon or chargeable to the income of my estate shall be apportioned to and deducted from the shares of all beneficiaries (exclusive of any charitable beneficiary) having an interest in such income in such equitable manner as my executors shall determine. Any such determination shall be conclusive as to all persons interested in the income of my estate.

In most estates, the surviving spouse will receive all net in-
come of the estate under the will. Where that is not the case and in larger estates and in estates in which fractional share bequests are used, draftsmen should be aware of these provisions of the Act and consider providing other directions for the fiduciary in appropriate cases.

E. Apportionment of Tax on Trapping Distributions

There are significant tax planning opportunities where trusts are created under a will because the estate's DNI\textsuperscript{162} can be divided among a greater number of taxable entities.\textsuperscript{163} Under the DNI rules, any distribution, whether principal or income, carries out a proportionate share of the estate's DNI to the distributee,\textsuperscript{164} which

\textsuperscript{162} I.R.C. § 643(a) (1985).


With respect to such distributions in kind, made after June 1, 1984, and in taxable years ending after that date, I.R.C. § 643(d)[e] (1985) requires that the amount taken into account under I.R.C. § 661(a)(2) (1985) and § 662(a)(2) (1985) shall be the lesser of the basis of the property before the distribution or the fair market value of the distribution, and the recipient's basis for the property shall be its basis immediately prior to distribution. An exception to this general rule is that the executor or trustee may elect to recognize gain or loss as if the property were sold to the recipient in which case the amount taken into account under the cited sections is the fair market value of the property and the recipient acquires a basis equal to the property's date of distribution value. The effect of this new statute is to dampen the effectiveness of trapping distributions in that the fiduciary now has to use basis instead of fair market value to determine the amount of the distribution, but planning opportunities do exist. Aucutt, \textit{Tax Planning for In-kind Distributions Increased by New Special Election}, 62 J. TAX'N 48 (1985); Kelly, \textit{Treatment of Property Distributed In-kind Under the Tax Reform Act of 1984}, 63 TAXES 423 (1985); Freeland, Maxfield & Sawyer, \textit{Estate & Trust Distribution of Property In Kind After the Tax Reform Act of 1984}, 40 TAX L. REV. 449 (1985); Lassila, \textit{The Trust Taxation Provisions of the Tax Reform Act of 1984: Analysis, Implications and Planning Considerations}, 63 TAXES 364 (1985). It is likely that equitable adjustment claims will become more frequent in response to the actions of fiduciaries under this statute. A provision exonerating the fiduciary from any liability with respect to such elections and the failure or refusal to make equitable adjustments may be advisable. See Lassila, \textit{supra}.

\textsuperscript{164} I.R.C. § 662(a)(2) (1985).
includes a trust. Accordingly, for example, annual principal distributions to testamentary trusts become part of each trust's corpus, although such distributions are income for tax purposes under the DNI rules and each trust is taxable on that income. The income is "trapped" in the trusts, to be taxed on the trusts' returns. The question, of course, is whether the income beneficiary or remainderman of the trust is to bear the tax on this trapped distribution of income.

If the trustee is required to operate under the Act, he is required to allocate the tax to principal by N.C. Gen. Stat. § 37-30(b). More than likely, the distribution was accomplished to reduce the overall income tax burden of the income beneficiary who, at least in New York, is usually required to bear the tax burden. North Carolina fiduciaries, on the other hand, are reported customarily to charge corpus with this expense. It may be (and probably would be in the footnote example) that a testator gen-

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166. N.C. GEN. STAT. § 37-30(b) (1984):
Any tax levied upon profits, gains or receipts allocated to principal shall be charged against principal notwithstanding denomination of the tax as an income tax by the taxing authority.
167. Using the example suggested by Brackney, supra note 163, assume a typical estate plan with a power of appointment marital deduction trust, and a unified credit trust the income from which is payable to the spouse with remainder to the children. The executors distribute estate income (which is significant) to the spouse during administration. If the spouse enjoys substantial separate income and a commensurate tax burden, it might be beneficial to make a substantial principal distribution to the two trusts in the same year as the distribution is made to spouse. For example, if the estate had $60,000 in income, distributable to the spouse, and made a principal distribution of $150,000 to each trust, only $16,666.67 ($60,000 to spouse divided by $360,000 total distribution) of the distribution to the spouse is imbued with income characteristics. The trusts, each taxed on $21,666.67, pay significantly less income tax than the spouse would have in his marginal bracket. The distributions significantly benefit the income beneficiary—the spouse—at a tax cost to the remaindermen. Under different circumstances, for example, children by a former marriage, the remaindermen might be inclined to complain. Indeed, an astute guardian might complain on behalf of natural children under appropriate circumstances.
170. Note 167, supra.
erally prefers for the income beneficiaries, who may be his wife and children, not to be taxed on such distribution, preferring instead that the tax fall on the corpus which will ultimately be received by more remote takers. But that is not always the case. If it be more equitable for the one who receives the tax benefit to bear the tax burden, the trustee needs discretion or else direction from the instrument. Without it, the mechanics of the DNI rules will allocate the tax to the remainderman unless he can convince the court that, for equitable reasons, "receipts allocable to principal" do not include trapping distributions.

In substance, that was the question before the court in the now famous Holloway case. In Holloway, the executor had made trapping distributions to four trusts, thereby transferring income tax liability from the estate income account to the trust principal account. A guardian ad litem for the remainder beneficiaries proposed an adjustment. Although the New York version of the Revised Uniform Principal and Income Act did not apply because the distributions were made prior to its adoption, the court at the first hearing found that the statute codified earlier New York case law holding that trapping distributions were "receipts allocable to principal" and that the trustees were therefore not unreasonable in refusing to make the adjustment. The New York State Bankers Association then joined forces with the guardian ad litem, the trustees agreed to take no position, having been absolved from any impropriety in the first decision, and the court agreed to a rehearing. On rehearing, the surrogate reversed himself, basing his decision squarely "upon the purely equitable principle that the burden of income taxes should be charged to the account into

171. There are uncertain tax consequences arising from equitable adjustments. See R. Covey, supra note 137, at 55-56.

In a marital deduction trust, it would, of course, be inadvisable to have the will contain a direction that income from the trust bear this tax. Such a requirement would run afoul of the rule that the surviving spouse receive all of the trust income.


which the taxed item goes."176

The precedential value of this decision lies not only in its landmark requirement of an equitable adjustment for trapping distributions but also in its recognition that the applicable provisions of the Revised Uniform Principal and Income Act do not preempt the court's equity powers. As has been recognized, this is important because the Revised Uniform Principal and Income Act does not provide for equitable apportionments.177 But neither the Revised Uniform Principal and Income Act nor N.C. Gen. Stat. § 37-30(b)178 can be viewed as if in a vacuum. A personal representative has discretionary power to make principal distributions179 which, because of the federal taxing statutes, are taxed as income to the recipient trust. That discretion, it could be argued, is the precipitating tax event.180 That the Act, in responding to that discretionary decision, takes the tax from the pockets of those not receiving the income should be no barrier to equitable relief to correct an irrational and unfair result.181

The obvious point is the necessity for consideration of the problem in the planning stage. The drafting solutions would seem to be to (1) require the adjustment, (2) require the adjustment in accordance with a formula, (3) give the fiduciary discretion to make an adjustment, or (4) prohibit an adjustment.182 The com-

176. In re Holloway, 327 N.Y.S.2d at 869. It was made to appear to the court that New York fiduciaries regularly made such adjustments when using trapping distributions. See Parr, Distributions by Estates, A Review of the Tax Consequences, 107 Tr. & Est. 97 (1968).


179. Strictly speaking, a personal representative makes distributions before settlement of all claims, debts and administration expenses at his own risk, e.g., Mallard v. Patterson, 108 N.C. 255, 13 S.E.2d 93 (1891); N.C. Gen. Stat. § 28A-22-1 (1984). Earlier distributions, are, however, commonly made where an estate is amply solvent.

180. See A. Michaelson & J. Blattmachr, supra note 40, at 56 n.111.


plexities and uncertainties of an exact adjustment (if that is possible) and the inflexibility of the formula approach recommend against their use. Prohibiting adjustments, perhaps appropriate in smaller estates, may discourage the exercise of fiduciary powers in other areas and can create unexpected disparities. A simple discretionary power to make adjustments is the most sensible solution. It allows the fiduciary to weigh the tax consequences and the added accounting costs resulting from a complex adjustment in the balance with his duties to the trust in general. Appropriate lan-


184. See generally, Dobris, supra note 183. Professor Dobris concludes “that when the inequality is clear and apportionment is easy, courts should require an equitable adjustment. When the inequality is unclear, or the apportionment hard to make, courts should not require an adjustment.” Id. at 280. A similar standard for making equitable adjustments may be appropriate for fiduciaries having discretion.

Some draftsmen (and certainly fiduciaries) will decide against any such adjustments and will use language substantially as follows:

I authorize my fiduciaries, in their absolute discretion, to exercise all tax elections contained in the tax laws affecting my estate and the trust created hereunder regardless of the effect such exercise may have on any interest created hereunder or on any beneficiary. And I direct that no equitable adjustment shall be made on account of such exercise.

Furthermore, I authorize my fiduciaries, in their absolute discretion, to exercise all other management powers, express or implied, regardless of the tax effects such exercise may have on any interest created hereunder or on any beneficiary. And, I direct that no equitable adjustment shall be made on account of any disproportionate tax effect of such exercise.

By the use of the foregoing language, I intend to excuse my fiduciaries from the duty of impartiality with respect to the tax effect of the exercise of all their management powers insofar as that duty requires the making of equitable adjustments when fiduciary action has an unfair impact on beneficiaries.

Dobris, supra note 183, at 341.

185. Carrico & Bondurant, supra note 169, at 566-67; Cornfeld, supra note 163, at ¶ 1405. For a discussion of problems and solutions regarding beneficiaries serving as fiduciaries, see Moore, Conflicts in Post-mortem Estate Planning after the Tax Reform Act, 12 Inst. Est. Plan. ¶ 1920 (1975) and see Ascher, The Fiduciary Duty to Minimize Taxes, 20 Real Prop., Prob. & Tr. J. 663, 700 (1985) wherein Professor Ascher persuasively argues the fiduciary duty as developed in Restatement (Second) of Trusts §§ 169-81 (1959), as a "duty owed to the bene-
language might provide:

I authorize my executor to exercise or to refrain from exercising any election, option, discretion, or choice available under any provision [of this will, of state law and] of any tax law applicable to my estate or me if my executor in good faith believes such exercise or nonexercise to be in the best interest of one or more of my estate or any of my beneficiaries, regardless of the fact that either a particular tax or the total of all taxes applicable to my estate or me is thereby increased or that there is a change in the proportions in which various beneficiaries (including my executor) share in my estate. My executor [may, but] shall not be required of to[,] adjust any beneficiary's interest on account of any action authorized by the foregoing sentence.186


The North Carolina Statute 187 is quite similar to the language of the 1962 Revised Uniform Principal and Income Act.188 No useful purpose would be served by an exegesis of this part of the Act, for the problems and solutions of allocations of corporate distributions have been the subject of volumes by courts189 and commentators.190 In general, the Act191 adopts the Massachusetts Rule hold-

186. Asher, supra note 185, at 715.
ing that stock dividends are principal and cash dividends are income.\textsuperscript{192} The Act allocates all corporate distributions to income (including distributions, notwithstanding that they are in shares of the corporation, falling within the exceptions stated in I.R.C. § 305(b)(1)-(4)\textsuperscript{193}), with the following exceptions: stock dividends and stock splits are principal,\textsuperscript{194} as are distributions pursuant to a call of shares, a merger, consolidation, or reorganization, or a total or partial liquidation.\textsuperscript{195} Distributions from ordinary income or realized capital gains by a regulated investment company or real estate investment trust are income,\textsuperscript{196} but other distributions by such entities are principal.\textsuperscript{197} There is no provision for apportionment of corporate distributions between income and principal where death occurs before payment.\textsuperscript{198}

Whether the Act or some other method of allocation more nearly approximates the intent of any testator or settlor is certainly open to question.\textsuperscript{199} One may not have wanted all stock divi-

\textsuperscript{192} This was the prior law in North Carolina. Humphrey v. Lang, 169 N.C. 601, 86 S.E. 526 (1915).
\textsuperscript{193} I.R.C. §§ 305(b)(1)-(4) (1985).
\textsuperscript{198} 3 A. Scott, supra note 2, at § 236.1. See In re Bulis, 240 N.C. 529, 82 S.E.2d 750 (1954).
\textsuperscript{199} E.g., Note, Principal and Income Allocation of Stock Distribution—The Six Percent Rule, 64 Mich. L. Rev. 856 (1966).

[I]t has frequently been asserted that in doubtful questions as between life beneficiaries and remainders the creator of the trust would prefer to decide in favor of the life beneficiary, since the life beneficiary is ordinarily the nearest and dearest in relation to him. Such a generalization may be well founded, as where the testator leaves his property in trust for his widow for life with remainder to distant relatives or to charity. It is not so clear where the remaindersmen are his children. A court can hardly take judicial notice that a man loves his wife more than he loves his children.
dends allocated to principal, for example, but the Act does so, to the detriment of the income beneficiary who may have been the preferred beneficiary in the settlor’s or testator’s mind, had he been alerted to the question. Clear in most instances fiduciary discretion is preferable to the Act which admittedly favors simplicity over fairness. For example, discretion would allow the fiduciary to compensate in favor of the income beneficiary by allocating stock dividends to income where he had exercised his investment discretion in a manner not favorable to that beneficiary.

These are matters that should be covered at the drafting stage. If the testator or settlor desires to protect the principal and to prevent dilution of control of the corporation, appropriate language might provide the following direction:

Unless inconsistent with other provisions of this instrument, to consider and treat as principal all dividends payable in stock of the issuing corporation, all dividends in liquidation and all “rights” to subscribe to securities of the issuing corporation, and to consider and treat as income all other dividends and rights received (except those declared and payable as of a “record date” preceding my death, which shall be considered and treated as principal).

This language must not be used for a marital deduction trust because of the likelihood that the spouse-beneficiary might be deprived of the substantial enjoyment of “all the income” of the trust and the marital deduction would be lost.

Where trustee discretion is preferred, the following discretionary power might be appropriate:

To apportion extraordinary and stock dividends and other property received and charges incurred between income and principal and to allocate to principal and to income such part or all of such receipts and expenses as in its discretion are properly chargeable or credited thereto.

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3 A. SCOTT, supra note 2, at § 236.3 at 1985.
200. See generally, G. BOGERT & G. BOGERT supra note 2, at § 859.
203. See supra note 76.
204. WACHOVIA WILLS AND TRUST MANUAL XI-5, n.3 (1958 ed., 1978 repl. pg.).

The general trust law rule is that where a trustee receives at the creation of the trust bonds which are selling at premium, he has no duty either to sell or to set aside from the income an amortization fund. All of the interest on the bonds is income. 205 On the other hand, if a trustee purchases bonds at a premium, the weight of authority is that he must or may properly set aside from the interest a sufficient amount to amortize the premium over the life of the bond. 206 Because of the practical difficulties involved in amortization of premiums (including the uncertainty as to the exact amount of the premium attributable to the higher interest rate obtained207) and the usual small amounts at stake, the Act, 208 like the Revised Uniform Principal and Income Act, 209 provides that bonds are principal at inventory value 210 and that bond premiums shall not be amortized. Sale proceeds are principal.

Where a trust estate includes at its creation bonds selling at a discount, the income beneficiary is entitled, under general trust rules, only to the interest received on the bonds. Likewise, where a trustee purchases bonds at a discount, the weight of judicial authority is "that not only has the trustee no duty or power to pay the life beneficiary out of the principal the amount of the probable increase in value of the bonds as they approach maturity, but even though the bonds are paid at maturity and the increase in value of the principal is thus realized, no part of the proceeds is allocable to income." 211 Practical considerations are the primary recommenda-

205. 3 A. SCOTT, supra note 2, at § 239.2.
207. Comm'r v. Korell, 176 F.2d 152, 156 (2d Cir. 1949).
210. This affirms the rule stated in the first sentence of this paragraph that a trustee receiving bonds purchased by the settlor or testator at a premium is not to amortize the premium—the value of the bond at receipt (inventory value) is principal. See Note, An Aspect of the Uniform Principal and Income Act as Relative to Premiums and Discounts on Bonds, 20 TEMP. L.Q 472 (1947). For tax treatment of amortizable bond premiums, see I.R.C. § 171 (1985).
211. 3 A. SCOTT, supra note 2, at § 240.2; G. BOGERT & G. BOGERT, supra note 2, § 826.
tion for this rule.\textsuperscript{212} This is the rule adopted by the Act.\textsuperscript{213}

Where, however, the obligation is bought at a discount and is payable at maturity in a fixed amount and redeemable before maturity at prices set in advance, the income beneficiary ("who was the income beneficiary at the time of increment")\textsuperscript{214} is entitled under the Act to have the increment in value distributed to him from the first principal cash available.\textsuperscript{215} So, for example, where a trust holds callable bonds, the income beneficiary at the time the bonds became subject to the trust or at the time of the purchase of such bonds is entitled to be paid cash equivalent to the increment as cash is available from principal during the time the bonds are maturing. If there is no principal cash available, he is entitled to be paid when cash is realized from the bonds "by sale, redemption, or other disposition."\textsuperscript{216} This provision of the Act does not apply to

\textsuperscript{212} There are, however, practical considerations that we think lead to the conclusion that such accumulation ought not to be made. There is, in truth, no fund out of which such accumulation from discount may be made. It is in the main duty of the trustee to keep the corpus of the trust fund invested. The discount is not in fact realized until the bond is paid either at maturity or on call. If the payment of the proportional increment of the discount is to be made to the life tenant with each installment of income, the money must be procured from some source. There is no obvious source from which it may rightly be obtained in the ordinary estate. This theory rests upon the assumption that every bond purchased by a trustee is safe and will be paid at par on call or at maturity. That presumption is not in every instance true. Losses occur. A trust investment may be justified although it turns out to be unsafe. If the income has been disbursed on the footing that the discount will be paid and that expectation should be disappointed, the corpus of the trust must suffer the loss to the extent it has been drawn upon in anticipation of full payment. If the discount should not be realized, the trustee would be in an unfortunate position if he had attempted to forestall an event which did not come to pass. If payment is delayed until the bond is paid and the discount realized, the life tenant at that time may not be the only person chiefly intended to be benefitted by the founder of the trust. The amount of discount at which a bond may be purchased is not dependent on any single feature. . . . "[T]he amount of the discount at which a bond is bought is the blend of a number of possible contributing causes, among which the nominal rate of interest in relation to the market rate is one. It cannot be said to be the only one."


\textsuperscript{213} N.C. GEN. STAT. § 37-23(a) (1984).
\textsuperscript{214} N.C. GEN. STAT. § 37-23(b) (1984).
\textsuperscript{215} Id.; See 3 A. Scott, supra note 2, at § 233.1.
\textsuperscript{216} Practicalities have here again outweighed the income beneficiary's inter-
Treasury Bills and may therefore be a trap for the unwary. Treasury Bills have "no fixed schedule of appreciation" and so if the Act applies, the increment in value when realized must be allocated to principal, not to income as many fiduciaries might assume.  

The Act prefers the income beneficiary where bonds are purchased at a premium, the remainder beneficiary where bonds are purchased at a discount and the remainder beneficiary where the trustee invests in Treasury Bills. Most settlors and testators would wish for both interests to be treated fairly and equitably. The Act does not attempt to accomplish such impartiality and its amendment has been urged. Clearly discretion in the trustee is a preferable solution to these problems. Appropriate language might provide:

My trustee shall in his sole discretion have the authority to charge or credit to principal any premiums and discounts on securities, including treasury bills, purchased at more or less than par.

217. This trap is suggested by Hauser, supra note 37, at § 69.606. See Eck, Drafting Considerations in Appointing the Surviving Spouse as Trustee of the Non-marital Trust, 45 MONT. L. REV. 215, 236 (1984). N.C. GEN. STAT. § 37-23 (1984) is identical to § 8 of the REVISED UNIFORM PRINCIPAL AND INCOME ACT, 7B U.L.A. 165-66 (1985). This provision for New York is different, with the apparent design to cover Treasury Bills:

The increment in value of a bond or other obligation for the payment of money bearing no stated interest but payable or redeemable at maturity or at a future time at an amount in consideration of which it was issued is income.


1. N.C. Gen. Stat. § 37-25: Disposition of Natural Resources

This section applies to receipts from the taking of depletable natural resources and tracks the provisions of the Revised Uniform Principal and Income Act except that the percentage of receipts required to be allocated to principal is higher. The purpose of the Statute is to see that a part of the proceeds from wasting assets is allocated to principal, to the remainderman. It applies to receipts under an agreement in existence at death or at the creation of a trust as well as to receipts under agreements made by the fiduciary.

Focusing on planning, rather than on administration of an estate or trust under this section, there are at least two problems which strongly suggest that the fiduciary should have discretion in this area. First, N.C. Gen. Stat. § 37-25(a)(3) requires a trustee receiving royalties from a gravel pit to set aside fifty (50%) percent of the gross receipts as a reserve for depletion although for federal income tax purposes the depletion deduction would only be

220. "Depletable natural resources" include coal, oil, gas and all other natural metallic and non-metallic deposits, as distinguished from non-depletable natural resources which include for purposes of this section "timber, water, soil, sod, dirt, turf or mosses." N.C. Gen. Stat. § 37-25(c) (1984). See I.R.C. § 613 (1985).

221. The Revised Uniform Principal and Income Act requires where the receipts are not properly characterized as rent or otherwise allocated under a production payment agreement, . . . 27 and one-half percent of the gross receipts (but not to exceed 50% of the net receipts remaining after payment of all expenses, direct and indirect, computed without allowance for depletion) . . . be added to principal as an allowance for depletion. The Act provides:

Fifty percent (50%) of the gross receipts attributable to the permanent severance of the natural resources (but not to exceed sixty-six and two-thirds percent (66 2/3%) of the net receipts attributable to the permanent severance of the natural resources remaining after payment of all expenses, direct and indirect, computed without allowance for depletion) shall be added to principal as an allowance for depletion.

222. See generally 3 A. Scott, supra note 2, at § 239.3; G. Bogert & G. Bogert, supra note 2, at § 827; Annot., 18 A.L.R.2d 98 (1951); Wyler, The Apportionment of Proceeds from Depletable Natural Resources Held in Trust, 18 Hastings L.J. 391 (1967).


224. Hauser, supra note 37, at § 69.605.

five (5%) percent. 226

Second, because oil and mineral interests held in trust may be widely diversified geographically, the fiduciary should not be called upon to determine which forum's law applies in determining the propriety and extent of a reserve for depreciation. Where the trust makes no provision as to the allocation of receipts or expenses to income or principal and no provision as to what state's law is to govern, a question of the conflict of laws may arise. 227 The general rule is that the administration of a trust of real property, including the allocation of principal and income, is governed by the law of the forum where the land lies. 228 But there is a conflict of authority. Where depletable properties are likely to be held by an estate or trust, the appropriate instrument at least should specify what state's law is to govern administration, if no direction is made re-

226. I.R.C. § 613(b)(6)(a) (1985). This is not to suggest that a five percent allocation would be more appropriate than a fifty percent allocation in any situation. The suggestion is that the allocation does appear high and that as a practical matter such a requirement might in certain circumstances thwart a trustee's opportunity to liquidate a depletable natural resource because of the unfairness of the allocation in that situation. Compare, e.g., Arizona: Ariz. Rev. Stat. Ann. § 14-7409 (1967) (receipts are income unless some part apportioned to principal in the sole discretion of the trustee, but the apportionment may not exceed lesser of twenty-seven and one-half percent of gross receipts or fifty percent of net receipts); California: Cal. Civil Code § 730.09 (West, 1982)(same); Kansas: Kan. Stat. Ann § 58-910 (1983)(22%); Maryland: Md. Est. & Trusts Code Ann. § 14-209 (1974)(22%). For federal tax purposes, in an estate the depletion deduction is "apportioned between the estate and the heirs, legatees and devisees on the basis of the income of the estate from such property which is allocable to each." Treas. Reg. § 1.611-1(c)(5) (1986). For depletable property held in trust, the deduction is apportioned between the income beneficiaries and the trustee on the basis of the trust income from such property allocable to each unless the governing instrument or state law requires or permits the trustee to maintain a depletion reserve. In the latter case, the deduction is allocated to the trustee to the extent income is set aside for the reserve and any part of the deduction in excess of the reserve is apportioned between the income beneficiaries and the trustee on the basis of trust income (in excess of the reserve) allocable to each. Treas. Reg. § 1.611-1(c)(4) (1986). The Regulations also provide that an allocation which gives any beneficiary or the trustee a depletion deduction in excess of his pro rata share of trust income will not be respected. Id. This position has been criticized as contrary to I.R.C. § 611(b)(3) (1985). Gilbert, Allocation of Depletion Among Trusts and Beneficiaries, 39 Taxes 508, 511 (1961). See, Hay v. United States, 263 F. Supp. 813 (N.D. Tex. 1967)(upholding validity of Treas. Reg. § 1.611-1(c)(4) (1986)).

227. 3 A. Scott, supra note 2, at § 586.

specifying allocations between principal and income. At best, the trustee should be given discretion to make such allocations. 229


N.C. Gen. Stat. § 37-26 230 provides that proceeds from timber sales "shall be allocated in accordance with G.S. 37-18(a)(3)." The latter section 231 provides that (if neither the instrument nor the Act applies) allocations are to be made:

. . . in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as of those entitled to principal, and in view of the manner in which men of ordinary prudence, discretion and judgment would act in the management of their own affairs.

Presumably the fiduciary would take into account, besides the settlor's intent appearing from the four corners of the instrument and the other relevant circumstances of the parties, the provisions of the mortality tables 232 and the present value rules. 233 This statu-
tory standard for allocating proceeds from timber sales between principal and income under a "prudent man rule" leaves the fiduciary open to criticism by second guessers. Absent explicit allocation instructions, either the fiduciary's judgment should be made conclusive by a special provision in the instrument or he should be given broad discretion in this area.

3. N.C. Gen. Stat. § 37-27: Other Property Subject to Depletion

N.C. Gen. Stat. § 37-27\(^{234}\) provides that wasting assets,\(^{235}\) other than those covered by the preceding two sections, such as leaseholds, patents and copyrights, receipts not in excess of five (5\%) percent per year of the greater of inventory value or market value at the end of the fiscal or calendar year are income and the balance is principal. The North Carolina provision is different from that of the Revised Uniform Principal and Income Act in that the Revised Uniform Act provides for allocation of receipts to income "not in excess of five percent per year of [the properties'] inventory value." The difference in the North Carolina Act represents a substantial improvement over the Revised Uniform Act because it eliminates disparities which can result from use of static inventory proceeds apportioned, life tenant receiving equivalent to annual growth); First Nat'l Bank of Mobile v. Wefel, 252 Ala. 212, 40 So. 2d 434 (1949). Compare, e.g., Ballentine v. Poyner, 3 N.C. 110 (1800)(where juniper swamp land is suitable only for growing wood for staves, shingles, etc., income beneficiary is entitled to proceeds and cutting is not waste) with Thomas v. Thomas, 166 N.C. 627, 82 S.E. 1032 (1914)(standing timber is considered corpus—life tenant is liable for waste if he cuts it); Ward v. Sheppard, 3 N.C. 283 (1803)(same).

234. N.C. GEN. STAT. § 37-27 (1984) provides:
Other property subject to depletion. Except as provided in G.S. 37-25 and 37-26, if the principal consists of tangible or intangible property subject to depreciation, including leaseholds, patents, copyrights, royalty rights, and rights to receive payments on a contract for deferred compensation, or other intangible assets of a wasting nature, receipts from the property, not in excess of five percent (5\%) per year of its inventory value or of its fair market value at the end of the particular fiscal or calendar year, whichever is greater, are income and the balance is principal.

235. See RESTATEMENT (SECOND) OF TRUSTS § 239 (1959); G. BOGERT & G. BOGERT, supra note 2, at § 827; 3 A. SCOTT, supra note 2, at § 239: "Wasting property includes such property as leasehold interests; royalties; patent rights; interests in things the substance of which is consumed such as mines, oil and gas wells, quarries and timberlands; interests in things which are consumed in the using or worn out by using, such as machinery and farm implements."
value\textsuperscript{236} to measure income.\textsuperscript{237} But the improvement is one-sided only: it helps the income beneficiary in cases where the value of the asset appreciates, but forsakes\textsuperscript{238} the remainder beneficiary when the value of the asset declines.

A settlor or testator may wish for the income beneficiary to have all receipts or none at all or some other portion than five percent of the greater of inventory value or current fair market value of the asset. Planning with any certainty for testators is impossible because the situation at death cannot be known: leaseholds may have nearly expired or a new invention soon may threaten the value of a patent. A rate of return greater or less than five percent may sometimes be reasonable. Here, again, fiduciary discretion may in proper cases be the appropriate approach.\textsuperscript{239} Certainly if wasting assets are a significant part of an estate, at least the settlor or testator should have a role in the decision and be informed of this provision.


A trustee has a duty to an income beneficiary to make trust property productive.\textsuperscript{240} When unproductive property is ultimately

\textsuperscript{236} N.C. GEN. STAT. § 37-17(a)(2) (1984) defines inventory value and is quoted \textit{supra} note 124.

\textsuperscript{237} \textit{See} Abravanel, Apportioning Receipts From Wasting Assets Under the Uniform Laws: A Proposal for Legislative Reform, 58 N.C.L. Rev. 255 (1980). The author cites the case of George Bernard Shaw's will. At the time of Mr. Shaw's death, the copyright value of \textit{Pygmalion} was insignificant. The value rose considerably the next year, when \textit{My Fair Lady} was produced. A "five percent of inventory value" under the REVISED UNIFORM ACT thus would have seriously prejudiced the income beneficiary. Under the North Carolina Act, the greater fair market value at the end of the second year could have been used as the base for this calculation.

\textsuperscript{238} The fiduciary would seem, however, to have authority to reduce the allocation to income in these situations. The language of the statute provides for an allocation to receipts "not in excess of five percent per year" (emphasis supplied). N.C. GEN. STAT. § 37-27 (1984).

\textsuperscript{239} \textit{See} Younger, Apportioning Receipts From Wasting and Unproductive Assets: A Comment on the New Principal and Income Act, 40 N.Y.U. L. Rev. 1118, 1124 (1965), criticizing the New York Legislature for rejecting the five percent solution ("part of the Uniform Act for over thirty years, and no complaints that it is unfair have been heard of") in favor of "the vague standard of what is reasonable, equitable and ordinarily prudent."

\textsuperscript{240} \textit{Restatement (Second) of Trusts} § 181; 3 A. Scott, \textit{supra} note 2, at §§ 181, 240. \textit{Cf.} Bank of Wadesboro v. Hendley, 229 N.C. 432, 50 S.E.2d 302 (1948)(approval of family settlement agreement to allow trust to sell unproductive
sold so that the proceeds can be invested in income producing property, a portion of the proceeds should be allocated to income. Where a property subject to a trust produces substantially less income than the ordinary rate of return on trust assets, the same rule applies. 241 N.C. Gen. Stat. § 37-28 242 accomplishes this allocation and establishes a standard for how underproductive property must be before it falls into the category of unproductive property.

Under the Act, if there is a sale of property, any portion of the principal of which has not produced an average net income of at least one percent per year of its inventory value for more than a year, a part of the net proceeds of the sale is allocated to the income beneficiary. The part of the proceeds so allocated is equivalent to the difference between the net sale proceeds and an amount which, had it been invested at four percent simple annual interest while the property was underproductive, would have produced the net proceeds. The Act provides adjustments for past receipts of some income, the value of beneficial use by the income beneficiary and carrying charges and expenses charged to income while the property was underproductive. Unlike the Revised Uniform Principal and Income Act, 243 N.C. Gen. Stat. § 37-28(c) 244 provides that no allocation shall be made if the trust corpus as a

farm); Wachovia Bank & Trust Co. v. Johnston, 269 N.C. 701, 153 S.E.2d 449 (1967)(equity will order sale of lands where necessary to preserve and protect the estate); First-Citizens Bank & Trust Co. v. Rasberry, 226 N.C. 586, 39 S.E.2d 601 (1946)(same); American Trust Co. v. Nicholson, 162 N.C. 257, 78 S.E. 152 (1913)(power of court to order sale upon application of trustee where property is unproductive and beneficiary is in need); N.C. GEN. STAT. § 41-11 (1984) (power of life tenant to force a sale of unproductive lands), applied in Stepp v. Stepp, 200 N.C. 237, 156 S.E. 804 (1931).

241. 3 A. SCOTT, supra note 2, at § 240; G. BOGERT & G. BOGERT, supra note 2, at § 824; and see Note, Unproductive Trust Property In Florida: Sacrificing Yearly Return For Administrative Convenience, 32 U. FLA. L. REV. 247 (1980); Comment, Apportionment Between Principal and Income of Proceeds Derived From the Sale of Unproductive Realty Held in Trust, 40 YALE L.J. 275 (1930); Note, Unproductive Trust Assets In New York, 36 ST. JOHN'S L. REV. 259 (1962); Comment, Trust Administration—Apportionment and Other Remedies of an Income Beneficiary When the Trustee's Retention of Unproductive Property Causes a Loss or Termination of Income, 58 MICH. L. REV. 1049 (1960); Shattuck, Unproductive Trust Property in Massachusetts, 20 B.U.L. REV. 447 (1940); Brandis, Trust Administration: Apportionment of Proceeds of Sale of Unproductive Land and Of Expenses, 9 N.C.L. REV. 127 (1930).


244. N.C. GEN. STAT. § 37-28(c) (1984).
whole has generated an average of four percent of its inventory value for each year that the trust principal included the underproductive asset, even though the underproductive property sold has produced none. The Act also provides a ceiling rule tied to the difference between actual trust income and a computed income of the trust at four percent per year.

For example, if the only trust asset were vacant land with an inventory value of $100 which had been held for three years and which had produced no income, upon a sale for $100 the "delayed income" portion is computed as follows:

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<table>
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<tbody>
<tr>
<td>100.00</td>
<td>Gross proceeds</td>
</tr>
<tr>
<td>(8.00)</td>
<td>Sale expense</td>
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<tr>
<td>(0.00)</td>
<td>Capital gains tax</td>
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<tr>
<td>(2.00)</td>
<td>Carrying charges (ad valorem taxes)</td>
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<tr>
<td>$ 90.00</td>
<td>Net proceeds</td>
</tr>
<tr>
<td>– 80.36</td>
<td>&quot;Amount, which had it been invested at simple interest at 4% per year while the property was unproductive would have produced the net proceeds.&quot; ($90.00 ÷ 1.12)</td>
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<tr>
<td>9.64</td>
<td>Tentative delayed income</td>
</tr>
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_Ceiling Rule Computation—N.C. Gen. Stat. § 37-28(c)(2):_

**Situation One:** Same facts as above—only one trust asset.

**Situation Two:** In addition to the vacant land, the trust had $100.00 cash invested at five (5%) percent, yielding $5.00 per year.

**Situation One**  **Situation Two**

12  24  "Income principal would produce at 4% for 3 years." The statute does not specify whether this amount should be compounded.

0  15  Actual average net income for 3 years.
Ceiling amount: in Situation One, the ceiling amount is greater than tentative delayed income, so the tentative figure is delayed income to which the income beneficiary is entitled.

In Situation Two, the ceiling amount is less than the tentative figure, so the lesser ceiling amount is the amount of delayed income which can be paid to the income beneficiary as delayed income.

There is delayed income under the Act even if the property is sold at a loss.\textsuperscript{245}

In cases except those involving a marital deduction trust,\textsuperscript{246} it is probably prudent to authorize or even to direct the trustees to hold or acquire unproductive or underproductive property. There may be good reasons for doing so, such as maintaining control over a family business or holding real estate during a depressed time when there is the certain hope of future appreciation. And consider this reason:

Thought should also be given, and guidance provided to the trustees, with respect to the question of whether any part of the ultimate proceeds of sale of the property is to be allocated to the income beneficiaries of the trust.

Take, for example, a situation where the trust principal is $100,000.00 of tax-exempt bonds producing a 5\% return and $100,000.00 of growth common stock paying no dividends, and the sole income beneficiary is in the 70\% income tax bracket. The income beneficiary is receiving annually a 2 \( \frac{1}{2} \) \% return on the principal, which is equal to a return of 8 \( \frac{1}{3} \) \% before taxes. Assume five years pass, the growth stocks have not grown, and they

\textsuperscript{245} For example, if the property in Situation 1 with an inventory value of $100 were sold for $90 and there were $7 of sale expense and $2 carrying charges, leaving a net proceed of $81, the income beneficiary would be entitled to $8.68 ($81 - $81 / 1.12). But if the property is sold for a gain, and the statute applies to entitle the income beneficiary to the "delayed income" it is taxed to him even though it might not be distributed to him through mistake or other delay. Rev. Rul. 85-116, 1985-31 I.R.B. 19.

\textsuperscript{246} To qualify for the marital deduction, the surviving spouse must have the power to require the trustee to make non-income producing property income producing. Treas. Reg. § 20.2056(b)-5(f)(4) (1986).
are sold for $100,000.00. Under the 1962 Uniform Act, the income beneficiary would be entitled to $16,666.00 of the $100,000.00 of proceeds.

Should he have it? Not only has he already had a substantial return from the trust, under the facts he would not even have to pay any tax on the $16,666.00 allocated to him as income; since the sale of the growth stocks produced no capital gains, the distribution of the portion of the proceeds of the sale to him will not increase the distributable net income of the trust under § 643(a)(3) of the Code, and he will pay no tax on the distribution, since the trust has no other taxable income. The net result at the end of five years is that the income beneficiary will have received an average annual return on the trust principal of 5.833% tax-free, which is the equivalent of a before-tax return of 19.444%.

Whether the settlor or testator would have desired this result is the question—but he may very well have wished to prefer the remainderman in such a situation, to pass as much property as possible free of estate or gift tax to the ultimate taker. It is his decision to make and it should not be made by default by simply including in the boilerplate of the instrument a reference to the standard North Carolina fiduciary powers.

When it is unlikely that a significant portion of the trust corpus will be comprised of such property and the trust is not a marital deduction trust, it is probably advisable to provide for no allocation to income of the proceeds of the sale of such property simply to avoid the administrative inconvenience of the computation and of including such amounts in the distributable net income of the trust.


The Act requires fiduciaries to establish depreciation

247. Hauser, supra note 37, at ¶ 69.609.
248. N.C. GEN. STAT. § 37-37 (1984) provides:

Depreciation. A reasonable allowance for depreciation of property subject to depreciation under generally accepted accounting principles shall be charged against income, but no allowance for depreciation shall be made for that portion of any real property used by a beneficiary as a residence and no allowance for depreciation need be made for any property held by the trustee on January 1, 1974, for which the trustee was not then required to make and was not then making an allowance for depreciation.

This provision is identical to § 13(a)(2) of the REVISED UNIFORM PRINCIPAL AND INCOME ACT, 7B U.L.A. 176 (1985).
reserves for property subject to depreciation.\textsuperscript{249} Part of the income must be set aside for the remainder beneficiary to replace the principal value lost over time due to physical deterioration or obsolescence. This rule applies alike to improvements or other depreciable assets owned by the settlor or testator at the time of the creation of the trust or estate and those acquired or constructed by the fiduciary.\textsuperscript{250} There are significant tax and economic consequences springing from the establishment of reserves for depreciation or, if the fiduciary has discretion to forego such reserves, from the failure to establish them.

1. Some Tax Considerations

An estate or trust is allowed a deduction for depreciation only to the extent the deduction is not allowable to beneficiaries under Section 167(h) of the Internal Revenue Code.\textsuperscript{251} Estates and trusts are treated differently under this section of the Code. For trusts, the deduction is apportioned between the income beneficiaries and

\begin{footnotesize}
\textsuperscript{249} Since Howe v. Earl of Dartmouth, 7 Ves. Jr. 137, 32 Eng. Rep. 56, 25 Eng. Rul. Cases 29 (1802), the general rule (and the rule of RESTATEMENT (SECOND) OF TRUSTS § 239) has been that a fiduciary is under a duty to the remaindermen to sell a wasting asset and invest the proceeds to produce income or, under the RESTATEMENT view, to allow for amortization to protect the remaindermen. But historically fiduciaries have not, and have not been required to, set aside a reserve for depreciation of buildings owned by the settlor which became part of the original trust estate. Scott suggests the reason may have been "a feeling that the value of the land on which the building rests is likely to increase at least as fast as the value of the building depreciates." 3 A. SCOTT, supra note 2, at § 239.4 at 204A. See, Note, Allowance for Depreciation of Buildings Held in Trust for Successive Beneficiaries, 60 HARV. L. REV. 952 (1947); Note, Trusts—Improved Real Estate—Validity of Depreciation Reserves, 55 MICH. L. REV. 857 (1957). There are apparently no North Carolina cases.

\textsuperscript{250} Where the fiduciary makes improvements which are not permanent, he is required to deduct from the income each year enough to amortize the cost of the improvement. 3 A. SCOTT, supra note 2, at § 233.3; RESTATEMENT (SECOND) OF TRUSTS §§ 233, 239, comment h (1959); Note, Allocation of the Cost of Improvements to Real Property Held in Trust, 19 HASTINGS L.J. 932 (1968); Cf. Middleton v. Rigsbee, 179 N.C. 437, 102 S.E. 780 (1920)("costs of permanent improvements . . . which tend to enhance the value of the remainderman's estate as well as [the life tenant's] . . . should be properly apportioned between them"). Permanent improvements, on the other hand, are paid from principal. Woody v. Christian, 205 N.C. 610, 172 S.E. 210 (1933)(extensive repairs in order to make property productive); see Capron, Reserves Against the Depreciation of Real Property Held By a Trustee, 12 OHIO ST. L.J. 565 (1951); Annot., 10 A.L.R.3d 1309 (1966).

\end{footnotesize}
the trustee in accordance with the provisions of the trust instrument, or if there are no provisions, on the basis of trust income allocable to each. If the trust instrument requires or permits the trustee to establish a reserve and he does so, or if state law requires a reserve, the deduction is first apportioned to the trust to the extent of income set aside to the reserve and the balance in excess of the amount set aside for the reserve is apportioned between the beneficiaries and the trustee in accordance with the provisions of the trust instrument or on the basis of income allocable to each.\textsuperscript{252} If no depreciation reserve is established and the trust is a simple trust, the beneficiary gets the deduction.\textsuperscript{253} 

An estate, on the other hand, has no alternative method of allocation, but must apportion the depreciation deduction between the estate and “the heirs, legatees, and devisees” on the basis of income allocable to each, rather than in accordance with the will.\textsuperscript{254} 

Examples are helpful:

\textit{Example One:} Assume an estate in which the will incorporates by reference the standard North Carolina fiduciary powers under N.C. Gen. Stat. § 32-27, thereby requiring establishment of depreciation reserves.\textsuperscript{255} Assume also, $5,000 of rental income and that the executor has discretion to distribute that income to B. If the depreciation deduction is $1,000 and that amount is held as a depreciation reserve, B receives $4,000. Section 167(h) of the Internal Revenue Code allocates the deduction $800 \([\frac{4,000}{5,000} \times 1,000]\) to B and $200 \([\frac{1,000}{5,000} \times 1,000]\) to the estate. Thus, B is taxed on $3,200 and the estate on $800.\textsuperscript{256} 

\textit{Example Two:} Same facts as \textit{Example One} except that the executor exercises his discretion not to establish a depreciation reserve. $5,000 is distributed to B and the entire $1,000 depreciation deduction is his because no income is allocable to the estate. B’s taxable income is thus $4,000 and the estate has no taxable income.

\textit{Example Three:} The same facts as \textit{Example One} except that the entity is a simple trust and the trustee has standard North Carolina fiduciary powers under N.C. Gen. Stat. § 32-27 and is

\begin{thebibliography}{99}
\bibitem{252} Rev. Rul. 74-530, 1974-2 C.B. 188.
\bibitem{253} I.R.C. § 167(h) (1985); Treas. Reg. § 1.167(h)-1(b) (1986). \textit{See generally, Ferguson, supra} note 40, at 312.
\bibitem{254} I.R.C. § 167(h) (1985); Treas. Reg. 1.167(h)-1(c) (1986).
\bibitem{255} \textit{See} text accompanying note 13, \textit{supra}.
\bibitem{256} This example ignores personal exemptions. \textit{Ferguson, supra} note 40, at 314-15.
\end{thebibliography}
therefore required to maintain a depreciation reserve. He does so, withholding $1,000. Unlike *Example One*, above, for an estate, the entire deduction for depreciation is apportioned to the trust so that the trust has no taxable income and the beneficiary's taxable income is $4,000.\textsuperscript{257}

*Example Four:* The same facts as *Example Three* except that the trustee is not required to maintain a depreciation reserve and elects not to do so. If the trust is a simple trust, the beneficiary gets the entire depreciation deduction. If the trust is a complex trust and the trustee accumulates $1,000 of income, the same apportionment method used in *Example One*, above, applies to give the trust one-fifth [$1,000/$5,000] of the deduction and the beneficiary four-fifths [$4,000/$5,000] of the deduction.

The Code refers to "pertinent provisions of the instrument" which may control depreciation apportionment in the case of trusts.\textsuperscript{258} Can the terms of the instrument or can the trustee by the exercise of his discretion allocate the depreciation deduction other than between the trust and beneficiaries commensurate with their pro rata share of income? The Regulations say not.\textsuperscript{259} Although the subject of criticism,\textsuperscript{260} this provision of the Regulations has been

\textsuperscript{257} Treas. Reg. § 1.167(h)-1(b) (1986); *See* Treas. Reg. § 1.661(c)-2 (1986), *e.g.,* McIntosh v. United States, 64-2 T.C. ¶ 9716 (D. Vt. 1964); FERGUSON, *supra* note 40, at 315 n.78.

\textsuperscript{258} I.R.C. § 167(h) (1985) provides, in part:

In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust.

\textsuperscript{259} Treas. Reg. § 1.167(h)-1(b) (1986) provides, in part:

(2) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depreciation in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depreciation reserve pursuant to discretionary authority to do so in the governing instrument.

No effect shall be given to any allocation of the depreciation deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument, except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depreciation.

\textsuperscript{260} Hauser, *supra* note 37, at ¶ 69.604.
The statutory provision regarding apportionment of the depreciation deduction between estates and "heirs, legatees, and devisees" is more clear. It might seem that in a typical estate plan in which the surviving spouse is the income beneficiary of the marital deduction trust and is entitled to estate income on that portion of the estate and in which the will directs the executor to distribute the unified credit amount to children who are also designated discretionary income beneficiaries of income on that amount during estate administration, the surviving spouse would be entitled to a depreciation deduction commensurate with the portion of the estate's income distributed to her. Under the Fourth Circuit Nissen decision, however, the surviving spouse does not have the requisite status as an "heir, legatee and devisee." In Nissen, the will left the residue, including the Nissen Building in Winston-Salem, North Carolina, to Wachovia Bank and Trust Company as executor and trustee. Trusts were to be established for two beneficiaries. One beneficiary was entitled to all income for life from the trust for him; the other beneficiary was a discretionary income beneficiary of the trust for her. The executor had discretionary authority regarding allocations of principal and income and discretionary authority to pay estate income to the two ultimate beneficiaries of the trusts to be established. The executor exercised its discretion and made distributions to the two beneficiaries but deducted all depreciation on the estate income tax return. The Commissioner objected on the grounds that part of the deduction should have been apportioned to the beneficiaries. The Tax

261. Dusek v. Comm'r, 45 T.C. 355 (1966), affirmed, 376 F.2d 410 (10th Cir. 1967). In Dusek, the trustee was required to maintain a depreciation reserve but was "authorize to apportion and allocate between the trust and the primary beneficiary all appropriate tax deductions for . . . depreciation . . . ." The trustee bought rental property, accumulated all but $100 of the income and attempted to allocate the entire depreciation deduction to the beneficiary, wife of the grantor-trustee. The plan was to have none of the rental income, but all of the depreciation deduction on the joint return of the grantor and beneficiary. The "pertinent provisions of the instrument" language of I.R.C. § 167(h) was held to mean only a provision allowing or requiring creation of depreciation reserves.

262. I.R.C. § 167(h) (1985) provides, in part:
In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

Court agreed, but the Fourth Circuit reversed the Tax Court. The depreciation deduction is not lost, however, to the beneficiary of an estate who is not an "heir, devisee [or] legatee" because the mechanics of the distributable net income rules would operate to reduce the estate's DNI, thereby reducing the taxable amount of the distribution to such a beneficiary. If the surviving spouse were entitled to all of an estate's income pending establishment of testamentary trusts of which the spouse was the beneficiary, the distributable net income on which she is taxed is reduced by the deduction. This also holds true if, in the example posed in the previous paragraph, the unified credit amount were left in trust for remote takers with children as income beneficiaries (so that neither the spouse nor the children would be "heirs, devisees, [or] legatees"). In situations like the example in the previous paragraph where the unified credit amount beneficiaries are "devisees" or "legatees" the result is the same, although disparities can arise if distributions to beneficiaries are made in different tax years of the estate. The income distributed to the spouse is treated in the calculation of the depreciation deduction apportionment as income apportioned to the estate. Application of Nissen can, however, make a substantial difference to beneficiaries in estates with facts similar to those presented in that case, especially where administration is prolonged. For example, in the distribution arrangement of Nissen, if an estate has $10,000 income, is entitled to $5,000 depreciation deduction and distributes $5,000, the beneficiaries are taxed on the whole $5,000; if $10,000 is distributed, the deduction flows through by the DNI computation and the beneficiaries are still taxed only on $5,000 and the estate has no taxable income.

Finally, apportionment of depreciation deductions cannot be made in relation to ultimate disposition of the asset to which the deduction is attributable. The depreciation apportionment rules

264. 41 T.C. 522.
267. Rev. Rul. 74-530, 1974-2 C.B. 188, holding that amounts allocated to beneficiaries of trusts and to heirs, legatees, and devisees of estates are not limited to the income allocated and may exceed such income, does not indicate a different result.
268. Neither I.R.C. § 167(h) (1985) nor Treas. Reg. § 1.167(h)-1 (1986) provides that the depreciation deduction is allocable in relation to the ultimate disposition of the asset to which the deduction is attributable.

http://scholarship.law.campbell.edu/clr/vol8/iss2/2
applicable to trusts have the same effect. The draftsman cannot anticipate that rental income allocable to and paid to the ultimate distributee of a depreciable asset will be offset by all of the depreciation deduction attributable to such property, even if a depreciation reserve is not established. For example, assume an estate not required to establish depreciation reserves had net rental income of $1,000, net interest income of $3,000, no expenses and $2,000 of depreciation. The depreciable asset is distributable to A, the cash to B. The executor elects to distribute rental income to A and interest income to B. A will be entitled only to $250 of the depreciable deduction; B will get $750.

2. Economic Considerations

If the draftsman simply incorporates by reference the standard North Carolina fiduciary powers,269 the Act applies and depreciation reserves are required. A comparison of that result with a discretionary decision not to establish a depreciation reserve is best illustrated by the following example:

Example: Assume a simple trust with $15,000 rental income, depreciation deduction available of $8,000, legal fees of $1,000, commissions of $600. Column (a) represents no depreciation reserve; column (b) represents depreciation reserve of $8,000.

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<table>
<thead>
<tr>
<th>Description</th>
<th>Column (a)</th>
<th>Column (b)</th>
</tr>
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<tbody>
<tr>
<td>FAI: I.R.C. § 643(b); N.C. Gen. Stat. § 37-19</td>
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<td></td>
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<tr>
<td>Rents</td>
<td>15,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Legal fee N.C. Gen. Stat. § 37-32(a)</td>
<td>(500)</td>
<td>(500)</td>
</tr>
<tr>
<td>Commission N.C. Gen. Stat. § 37-31(a)</td>
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<td>(300)</td>
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<td><strong>FEDERAL GROSS INCOME I.R.C. §§ 641.61</strong></td>
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<tr>
<td>Rents</td>
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<tr>
<td><strong>GROSS INCOME</strong></td>
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<td>I.R.C. § 642(b)</td>
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<td>(300)</td>
</tr>
<tr>
<td>I.R.C. § 212</td>
<td>(1,000)</td>
<td>(1,000)</td>
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<tr>
<td>I.R.C. § 212</td>
<td>(600)</td>
<td>(600)</td>
</tr>
<tr>
<td>I.R.C. § 642(e), 167(h)</td>
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<td>(8,000)</td>
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<td><strong>TTI</strong></td>
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<td><strong>DISTRIBUTABLE NET INCOME (DNI)</strong></td>
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<tr>
<td>FAI (I.R.C. § 651(a))</td>
<td>14,200</td>
<td>6,200</td>
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<tr>
<td>or</td>
<td>or</td>
<td>or</td>
</tr>
<tr>
<td>DNI (I.R.C. § 651(b)) (lesser amount)</td>
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<tr>
<td>I.R.C. § 651 Deduction</td>
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<tr>
<td><strong>TAXABLE INCOME</strong></td>
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<td>TTI</td>
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<tr>
<td>I.R.C. § 651</td>
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<td>-0-</td>
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<td>I.R.C. § 651(a)</td>
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<td></td>
</tr>
<tr>
<td>FAI</td>
<td>14,200</td>
<td>6,200</td>
</tr>
<tr>
<td>or</td>
<td>or</td>
<td>or</td>
</tr>
<tr>
<td>DNI (lesser amount)</td>
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<td><strong>BENEFICIARY'S INCOME</strong></td>
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<td>Depreciation deduction</td>
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<td><strong>BENEFICIARY TAXED ON</strong></td>
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<td>5,400</td>
</tr>
<tr>
<td><strong>SUMMARY</strong></td>
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</tr>
<tr>
<td>Amount taxed</td>
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</tr>
<tr>
<td><strong>AMOUNT RECEIVED TAX-FREE</strong></td>
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<td>1,200</td>
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</table>

If there are such things as haunts, the specter of the dead husband would certainly follow the lawyer who failed to provide for
$8,000 of tax-free income to the surviving wife in this example. On a more practical level, the wrath of the surviving wife herself may be more fearful. More than likely, the husband would not have wanted a depreciation reserve as required by the statute. And, in many situations, there is a good chance inflation would make up for a good portion of the depreciation reserve if none were established.270

3. Planning

Where depreciable assets are to comprise a significant part of an estate or trust, careful advance consideration of depreciation consequences is essential.271 These decisions are largely for the settlor or trustee and should not be left by default to the Act, or simply to the discretion of the fiduciary, for that matter. The provisions of the instrument should be as definitive as practicable. Specifically with regard to the Act, an exception must be made for N.C. Gen. Stat. § 32-27(29)272 if depreciation reserves are not to be required. If the fiduciary is to have discretion, he should be given some guidance concerning the extent to which the income beneficiary is to be preferred. If the primary purpose of a trust is to preserve corpus, it is best specifically to provide for depreciation reserves and to include guidance for the fiduciary regarding what allowance is considered reasonable.273 In many estates, as the text example illustrates, fiduciary discretion will be appropriate.274

IV. Conclusion

If the Intestate Succession Act is a poor man’s will, the North Carolina Principal and Income Act of 1973 is a poor man’s instruc-

271. See generally, Englebreth & Cantrell, Depreciation and Depletion Deductions for Trusts and Estates, 120 Tr. & Est. 37 (1981).
273. A simple provision for a “reasonable allowance for depreciation” is inadvisable. For example, if a settlor transfers an asset with a value of $100,000, a depreciated basis of $10,000, and a remaining useful life of ten years, a “reasonable allowance for depreciation” under generally accepted accounting principles might be $10,000 per year, ten times the tax depreciation allowed. The settlor may not have intended such a large amount to be withheld each year from the income beneficiary. Hauser, supra note 37, at ¶ 69.604.
274. Appropriate language is quoted in the text, supra at note 15.
tion to his fiduciary regarding allocations between principal and income. The Act generally follows the common law and has almost no provision for flexibility to accomplish equity between successive interests. In most cases simplicity and certainty are preferred over fairness. That is a workable solution which may yield appropriate results in many cases. But it is probably not what a settlor or testator would choose if his wishes were considered.

It is the draftsman's job to consider those wishes and provide for their accomplishment. If he makes no provision or incorporates by reference the North Carolina standard fiduciary powers, the Act applies. Or he may draft specific instructions to the fiduciary regarding certain allocations. Both alternatives lack the flexibility necessary for fairness and the second presumes a foresightedness the settlor or testator likely does not and cannot possess. In most cases the best alternative is broad fiduciary discretion.

In drafting for fiduciary discretion, careful attention to the expression of the settlor's or testator's intentions, especially preference for income or remainder beneficiaries, is important. Corporate fiduciaries will prefer and perhaps request specific expressions of such intent or other forms of guidance. Until North Carolina law in this area develops further, the discretion should be made absolute, not subject to review or question by anyone, and the operative language should be clear and unequivocal. The fiduciary's authority should cover specifically and separately allocation of receipts and expenses attributable to property which is subject to special treatment by the Act, particularly those sections discussed in this Article; a simple broad grant of discretion might be subject to question. The draftsman should include broad exculpatory language absolving the fiduciary from any liability. And the fiduciary should probably be given discretion to make equitable adjustments. Broad fiduciary discretion to allocate between principal and income will allow for accommodation of changing economic conditions and changing circumstances of beneficiaries and the nature of trust in-


276. No beneficiary may have such discretionary power. See text accompanying note 74, supra. There may be other problems, e.g., valuation for gift tax purposes. See text accompanying note 59, supra. And see text accompanying note 66, supra, regarding grantor trust rules. There are a number of areas which could be cause for concern which are not discussed in this article, such as estates and trusts with charitable beneficiaries.
vestments. Fiduciary discretion will not solve all problems of estate and trust administration in this area but it should at least avoid the potential unfairness in the application of those sections of the Act discussed in this article.