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Income Realization Rules For Simple Trust Beneficiaries Who Change Residence or Citizenship

Estate of Ernst N. Petschek v. Commissioner of Internal Revenue, 81 T.C. 260 (1983).

Ernst N. Petschek resided in France from January 1, 1975, to November 23, 1975. Petschek was a United States citizen during that period.¹ On November 24, 1975, Petschek became a French citizen. Petschek, thereby, became a nonresident alien² for the rest of the year. Throughout 1975, Petschek was the sole beneficiary of a simple trust³ known as the Ernst N. Petschek Trust 5A (Trust 5A).⁴ The income earned by Trust 5A was derived entirely from foreign sources. The trust did not engage in any trade or business within the United States. During the portion of 1975 that Petschek was still a United States citizen, Trust 5A realized net income of \$136,657 and distributed \$132,841 to Petschek.⁵ Petschek reported his 1975 income on the cash basis. He did not report any income from Trust 5A on his 1975 nonresident alien income tax return.

Subsequently, the Commissioner of Internal Revenue (the Commissioner) issued a statutory notice of deficiency pursuant to I.R.C. § 652(a)⁶ and I.R.C. § 871(b)(2)⁷ requiring Petschek to re-

1. Petschek was therefore a nonresident citizen for that period.

2. A nonresident alien is a person who neither resides in nor is a citizen of the United States.

3. Treas. Reg. § 1.651(a)-1 T.D. 6500. Under this section a trust qualifies as simple for any taxable year in which the trust is required to distribute all income currently (whether or not income is actually distributed) and makes no other distributions. Whether a trust requires current distribution of income depends on its terms and applicable local law. Petschek's trust was a simple trust in 1975 since the trustee was required to distribute the trust's income annually to Petschek and no other distributions were made.

4. The Ernst N. Petschek Trust 5A was established in 1955.

5. Trust 5A was a cash basis taxpayer and therefore realized income upon receipt of earnings.

6. I.R.C. § 652 (1976) provides:

SEC. 652. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF TRUSTS DISTRIBUTING CURRENT INCOME ONLY.

(a) INCLUSION - Subject to subsection (b), the amount of income for the taxable year required to be distributed currently by a trust described in section 651 shall be included in the gross income of the beneficiaries to whom the income is required to be distributed, whether distributed or not. If such amount exceeds

port \$136,547 as taxable income from Trust 5A in 1975.⁸ Petschek's executors challenged the deficiency notice by petitioning the Tax Court. The petitioners contended that beneficiaries of trusts could not receive trust income until the end of the trust's taxable year since distributable net income could not be determined until that time⁹ and that I.R.C. § 652(c) implies an end-of-year inclusion rule for trust income. The Tax Court *held*: (1) A beneficiary of a simple trust realizes income simultaneously as the trust realizes income regardless of when distributable net income is calculated. (2) Income received in 1975 by Trust 5A while Petschek was a nonresident American citizen was taxable to petitioner's decedent pursuant to Treas. Reg. 1.871-13(c) (1980). *Estate of Ernst N. Petschek v. Commissioner of Internal Revenue*, 81 T.C. 260 (1983).

This note will compare the conduit theory of trust taxation ¹⁰

the distributable net income, there shall be included in the gross income of each beneficiary an amount which bears the ratio to distributable net income as the amount of income required to be distributed to such beneficiary bears to the amount of income required to be distributed to all beneficiaries.

(b) CHARACTER OF AMOUNTS - The amounts specified in subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary or his delegate.

(c) DIFFERENT TAXABLE YEARS - If the taxable year of a beneficiary is different from that of the trust, the amount which the beneficiary is required to include in the gross income in accordance with the provisions of this section shall be based upon the amount of income of the trust of any taxable year or years of the trust ending within or with his taxable year.

7. I.R.C. § 871(b)(2)(1976) states:

(2) Determination of taxable income. - In determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of the trade or business within the United States.

8. This figure represented the distributable net income of Trust 5A prorated over the number of days in 1975, multiplied by the number of days in 1975 that Petschek was a citizen.

9. Both Trust 5A and Petschek used the calendar year as their tax year.

10. The conduit theory of trust taxation permits income and specified characteristics of the income to pass through certain entities to beneficiaries. The mechanism for passing income through simple trusts is incorporated in I.R.C. § 651 (1976) and I.R.C. § 652 (1976). § 651 allows simple trusts to take a deduction for all income that is required to be currently

with several alternative approaches and discuss the manner in which the Tax Court employed the theory in *Petschek*. The note concludes with an analysis of the potential ramifications of the decision.¹¹

Cases involving taxpayers who change their United States citizenship or residency during the tax year are not uncommon. Several code provisions and treasury regulations directly address this issue. Treas. Reg. § 1.871-13(a)¹² requires individuals who change their status from nonresident United States citizens to nonresident aliens during the taxable year to divide the tax year into two separate periods. During the first period, the nonresident citizen is generally taxable on all income received.¹³ As a nonresident alien, the tax liability for the second period is based entirely upon the amount of gross income received which is either derived from sources within the United States or effectively connected with the conduct of a trade or business within the United States.¹⁴ A nonresident alien, therefore, does not incur any tax liability for income received by a simple trust that is not engaged in a trade or busi-

distributed. This section states:

SEC. 651 DEDUCTION FOR TRUSTS DISTRIBUTING CURRENT INCOME ONLY

(a) DEDUCTION - In the case of any trust the terms of which -

(1) provide that all of its income is required to be distributed currently, and
(2) do not provide that any amounts are to be paid, permanently set aside, or used for the purposes specified in section 642(c) (relating to deduction for charitable, etc., purposes), there shall be allowed as a deduction in computing the taxable income of the trust the amount of the income for the taxable year which is required to be distributed currently. This section shall not apply in any taxable year in which the trust distributes amounts other than amounts of income described in paragraph (1).

(b) LIMITATION ON DEDUCTION - If the amount of income required to be distributed currently exceeds the distributable net income of the trust for the taxable year, the deduction shall be limited to the amount of the distributable net income. For this purpose, the computation of distributable net income shall not include items of income which are not included in the gross income of the trust and the deductions allocable hereto.

§ 652 mandates inclusion of the income described in § 651 in the gross income of the designated beneficiaries whether distributed or not. § 652(b) preserves the character as determined at the entity level to the beneficiaries.

11. See, e.g., *Marsman v. Commissioner*, 18 T.C. 1 (1952), *acq.*, *aff'd in part and reversed in part*, 205 F.2d 335 (4th Cir.), *rehearing denied*, 205 F.2d 335 (4th Cir. 1953) (nonresident alien became resident during the tax year); *Simenon v. Commissioner*, 44 T.C. 820 (1965) (resident alien left U.S. during tax year); *More v. Commissioner*, 66 T.C. 27 (1976) (husband was nonresident alien for part of tax year).

12. Treas. Reg. § 1.871-13(a) T.D. 7670.

13. Treas. Reg. § 1.1-1(b) T.D. 7332.

14. I.R.C. § 872(a) (1976).

ness within the United States,¹⁵ or has not received income from sources within the United States.

If the beneficiary of such a trust abandons his U.S. citizenship during the year, his tax liability will depend on whether he "received" the income before expatriation. Treas. Reg. § 1.871-13(c) embodies this rule. This section states:

(c) *Abandonment of U.S. citizenship or residence.* Income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is not taxable if received [emphasis added] by an alien individual while he is not a resident of the United States, even though he earns [emphasis added] the income earlier in the taxable year while he is a citizen or resident of the United States. However, income from sources without the United States which is not effectively connected with the conduct by the taxpayer of a trade or business in the United States is taxable if received [emphasis added] by an individual while he is a citizen or resident of the United States, even though he abandons his U.S. citizenship or residence after its receipt and before the close of the taxable year.¹⁶

Two approaches have been proffered to determine the moment at which the beneficiary of a simple trust is deemed to be in receipt of income. One approach treats the receipt of income as a process that occurs throughout the year. The other considers income as being received by the beneficial owner on the last day of the taxable year.

Each approach may lead to different tax consequences. In addition, the first method is subject to two possible interpretations which may also lead to divergent results. Under one of these alternatives, the entire year's income is ascertained and then prorated over the days of the year. Under the other variation, tax liability depends upon the beneficiary's daily status as income is received by the trust. Under the year-end approach, the tax consequences would turn on the owner's status on the last day of the taxable year.

15. I.R.C. § 875(2) (1976). This section provides:

(2) a nonresident alien individual or foreign corporation which is a beneficiary of an estate or trust which is engaged in any trade or business within the United States shall be treated as being engaged in such trade or business within the United States.

16. Treas. Reg. § 1.871-13(c) T.D. 7670.

To establish the appropriate rule, relevant case law and general principles of taxation must be examined. In *Freuler v. Helvering*,¹⁷ the fiduciary of a trust neglected to make proper deductions for the depreciation of trust assets before distributing income to the beneficiary. The Supreme Court, holding that the excess amount received by the beneficiary need not be included in income, stated "[t]he test of taxability to the beneficiary is not receipt of income, but the *present right* [emphasis added] to receive it."¹⁸ Therefore, the beneficiary realizes income upon realization by the trust, not upon constructive or actual receipt of the earnings.

In *Debrabrant v. Commissioner*,¹⁹ the trustee erroneously withheld a portion of income from distribution because it was believed that the funds constituted principle. Several years later, a state court directed the trustee to distribute the funds as income. The Second Circuit upheld the determination by the Board of Tax Appeals that the distribution should be included as income to the beneficiary in the year in which the trust received the earnings. While the beneficiary did not constructively receive the income until after the state court's determination, he did have a present right to the funds when they were received by the trust.²⁰

The time at which the right to receive income attaches may also affect tax liability. In *Grant v. Commissioner*²¹ the taxpayer was the beneficiary of a discretionary trust. The taxpayer never elected to receive any income and eventually renounced her interest in the trust. The Commissioner issued a deficiency notice to the beneficiary for all of the income received by the trust prior to the renunciation. The Tax Court sustained the Commissioner's determination holding that the present right to receive income occurred *daily* [emphasis added] as the trust realized income.²²

It seems logical to apply the rule of *Grant* to beneficial owners of simple trusts.²³ Nevertheless, the feasibility of both the pro rata

17. 291 U.S. 35 (1934).

18. *Id.* at 42.

19. 34 B.T.A. 951 (1936), *aff'd*, 90 F.2d 433 (2nd Cir. 1937).

20. See also, *Estate of Dula v. Commissioner*, 23 T.C. 646 (1955), *aff'd*, sub nom. *Polt v. Commissioner*, 233 F.2d 893 (2nd Cir. 1956) (beneficiary taxable on income withheld until approval of accounting in year received by trust); *United States v. Higginson*, 238 F.2d 439 (1st Cir. 1956) (income received by trust but voluntarily withheld by trustees pending resolution of claim was taxable to beneficiaries in year received by trust).

21. 11 T.C. 178 (1948), *aff'd*, 174 F.2d 891 (5th Cir. 1949).

22. *Id.* at 181.

23. Recent legislation applicable to Subchapter S Corporations adopts this approach.

and year-end approaches must also be examined. While no case has adopted the pro rata approach for beneficiaries of simple trusts, this method has been used to determine tax liability for income recipients from other types of pass-through entities. *Marsman v. Commissioner*²⁴ involved a nonresident alien who was the sole owner of a foreign corporation. During the tax year, when the alien became a resident, the corporation qualified as a foreign personal holding company,²⁵ thereby subjecting the owner to tax liability.²⁶ In determining the amount of income subject to taxation, the Fourth Circuit rejected a literal interpretation of the applicable statute and ratably distributed income between the periods of nonresidency and residency.

Marsman is not directly applicable to a scenario involving a change-of-status beneficiary of a simple trust. Professor Dale of New York University argues that this is because the *Marsman* decision rests on policies aimed at eradicating the tax avoidance aspects of foreign personal holding companies which are not relevant to simple trusts.²⁷ Therefore, the opinion does not support the adoption of the pro rata approach for simple trusts.

While the court in *Marsman* rejected a legislatively prescribed year-end inclusion rule for foreign personal holding companies, an argument can be made in favor of such a rule for simple trusts. I.R.C. § 652(a) provides that if the amount required to be currently distributed exceeds distributable net income,²⁸ the later amount should be included in the income of each of the beneficiaries based on their respective pro rata share of the larger amount. A year-end inclusion rule is implicit in § 652 since distributable net income cannot be determined until the end of the trust's taxable year.

Unpersuaded by arguments supporting year-end inclusion or pro rata apportionment, the Tax Court in *Petschek*, relied on

I.R.C. § 1366(a) (West Supp. 1983). However, the Subchapter S provisions do not address pass through problems involving abandonment of citizenship and residency since the Subchapter S electing corporation status is retroactively terminated to the beginning of the year if a shareholder becomes a nonresident alien. I.R.C. § 1371(a) (West Supp. 1983); I.R.C. § 1372(e)(3)(B) (West Supp. 1983); Treas. Reg. § 1.1371-1(f), T.D. 7920; Treas. Reg. § 1.1372-4(b)(B), T.D. 7564.

24. 18 T.C. 1 (1952), *acq.*, *aff'd in part and reversed in part*, 205 F.2d 335 (4th Cir.), *rehearing denied*, 205 F.2d 335 (4th Cir. 1953).

25. I.R.C. § 331 (1939) (current version at I.R.C. § 552 (1976)).

26. I.R.C. § 337 (1939) (current version at I.R.C. § 551 (1976)).

27. Dale, *Tax Accounting for Foreign Persons*, 37 TAX. L. REV. 275, 314, 315 (1982).

28. I.R.C. § 643(a) (1976). This section delineates the appropriate calculations for deriving distributable net income (DNI). DNI is typically calculated at the end of the tax year.

Grant, and held that beneficiaries of simple trusts realize taxable income simultaneously as the trust realizes income.²⁹ In adopting this rule, the court rejected the petitioner's attempts to distinguish *Grant*.³⁰

The court also dismissed the petitioner's contention that a year-end inclusion rule was proper.³¹ The executors claimed that year-end inclusion was necessary since distributable net income calculations were normally made at the end of the year. The court stated that the practice of making calculations at the end of the year did not preclude a determination of taxable income pursuant to *Grant* since interim calculations of distributable net income were feasible and were in fact made in *Grant*.³²

The Tax Court used the *Grant* rule to determine income realization for the purposes of Treas. Reg. § 1.871-13(c) (1980).³³ Petschek's tax liability was based on all of the income received by Trust 5A prior to abandonment of citizenship. Although the simultaneous realization rule was used to justify the decision, the actual deficiency entered against the estate was based on Trust 5A's income prorated over the number of days in 1975 when Petschek was a citizen.³⁴ This figure was used instead of the actual income received before expatriation because the respondents failed to formally plead for an increased deficiency.

Petschek is significant because it resolves the conflict over the proper rule for income realization for beneficiaries of simple trusts. The decision has several notable ramifications.

First, the pro rata method did not survive *Petschek*. The Tax Court clearly based its decision upon the *Grant* rationale.³⁵ The pro rata figure was adopted merely as a matter of procedure.³⁶

Second, nonresidents, citizens abroad and change-of-status taxpayers will now be able to formulate expectations of their tax

29. 81 T.C. at 269.

30. *Id.* at 269. The Tax Court rejected petitioner's reliance on *Hay v. United States*, 263 F.Supp. 813 (N.D. Tex. 1967) since that decision involved a complex trust. The court also noted that *Letts v. Commissioner*, 80 F.2d 760 (9th Cir. 1936) *aff'g.* 30 B.T.A. 800 (1934) merely stands for the proposition that distribution of money by a trust before the trust earns the income is not relevant in determining tax liability of beneficiaries.

31. *Id.* at 269.

32. *Id.* at 270.

33. *Id.* at 271.

34. *Id.* at 262.

35. *Id.* at 271.

36. *Id.* at 271.

liabilities pursuant to *Petschek*. The liability of such taxpayers, however, is not only contingent upon the Internal Revenue Code, but may also depend on the laws of the country of residence, the country that is the source of foreign income, and relevant tax treaties. In the absence of a treaty, the foreign income tax credit of the Internal Revenue Code will apply.³⁷

Foreign income tax credits and income tax treaties attempt to avoid double taxation of citizens residing abroad by providing credits for income taxes paid to foreign countries. The rules for determining these credits are very intricate and vary between countries. Often, neither treaties nor the foreign income tax credit will adequately account for differences in tax laws between countries.³⁸ Variations in split-year and realization rules between countries may burden taxpayers with double taxation, exchange rate losses, and interest expenses. Future tax treaties and foreign tax credit legislation should account for divergent rules so that the negative effects on taxpayers can be minimized.

Third, the decision of the Tax Court may negatively impact revenue. Allocating income on a pro rata basis may be better suited to consistent generation of tax revenue than either the year-end or the *Grant* approaches.³⁹ This is because under a ratable method, tax liability will not turn on the taxpayers status either when income is received, or at the end of the year. Under the *Grant* rule, for instance, if Trust 5A had received all of its income after expatriation, no tax liability would have accrued, whereas the pro rata approach would generate taxes.

Fourth, if providing beneficial owners with fair notice of their tax liabilities is desirable, a simultaneous realization rule may not be appropriate.⁴⁰ This is because a beneficiary's share of income from a trust may not be determinable with certainty until the end of the entity's tax year. Therefore, year-end inclusion would be more conducive to fair notice considerations than the other methods.

Although *Petschek* has settled the law regarding the taxability of change-of-status beneficiaries of simple trusts, legislation in this

37. I.R.C. § 901-908 (1976).

38. See, generally, W. NEWTON, INTERNATIONAL ESTATE PLANNING (1983). For example, inadequate source provisions from tax treaties may lead to inconsistent determinations of source of income, thereby resulting in double taxation. (§ 5-29).

39. Dale, *supra*, at 312.

40. Dale, *supra*, at 313.

area may still be desirable. The legislature is better equipped than the judiciary to weigh relevant national and international policies and to formulate suitable rules. Until such rules are promulgated, *Petschek* will provide viable guidance.

JOEL L. TABAS