Distributable Net Income: Mastering Difficult DNI Calculations for Estates and Complex Trusts

TUESDAY, DECEMBER 5, 2017, 1:00-2:50 pm Eastern

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Distributable Net Income

Dec. 5, 2017

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Distributable Net Income: Mastering Difficult DNI Calculations for Estates and Complex Trusts

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What We'll Cover

- Structure of Subchapter J
- Basic Rules and Tax Rates
- Types of Trusts
- Trust Accounting Income (TAI)
- Taxable Income
- Distributable Net Income (DNI)
  - Including Capital Gains in DNI
- Distribution System - Simple Trusts
-
- Distribution System – Complex Trusts - How DNI Gets Allocated
  - Tier System
  - Separate Share Rule
  - 65 Day Rule
  - Specific Bequests
  - Distributions in Kind

Income Taxation of Trusts and Estates
Code Outline

- PART I, SUBCHAPTER J
  - Subpart A - Sec. 641-646 - General Rules
  - Subpart B - Sec. 651-652 - Simple Trusts
  - Subpart C - Sec. 661-664 - Complex Trusts and CRTs
  - Subpart D - Sec. 665-668 - Accumulation Distributions
  - Subpart E - Sec. 671-679 - Grantor Trusts
  - Subpart F - Sec. 681-685 - Misc. Rules

- PART II, SUBCHAPTER J
  - Sec. 691-692 - Income in Respect of a Decedent

Income Taxation of Trusts and Estates

- Separate Taxable Entities
- Taxable Income Computed in Same Manner as Individuals (Sec. 641(b))
- Own Tax Year and Method of Accounting
- Receive Income/Pay Expenses
- Income Taxed to Entity or Beneficiary

2017 Fiduciary Income Tax Rates

Over	Not Over	
0	2,600	15%
2,600	6,100	25%
6,100	9,300	28%
9,300	12,700	33%
12,700		39.6%

Non-Deductible Expenses - Sec. 265

- Sec. 265 disallows any deduction attributable to T/E income
- Generally applies to deductions for production of income, usually trustee's fees and executor's fees
- If trust/estate has T/E income, portion of trustee's and executor's fees are nondeductible
- No specific allocation formula
  - Fiduciary can use any reasonable method

Non-Deductible Expenses - Sec. 265
Example

- FACTS:
  - Trust has $30,000 taxable interest and $10,000 T/E interest
  - Incurs $20,000 trustee fee
  - Portion of trustee fee attributable to T/E income is non-deductible

$$\frac{\textbf{\$10,000 T/E income}}{\textbf{\$40,000 Total income}} \times \textbf{\$20,000 fees} = \textbf{\$5,000 non-deductible}$$

Types of Trusts

- Simple
- Complex
- Grantor

Simple Trust

- Required to distribute accounting income annually
- Makes no principal distributions, and
- Makes no distributions to charity

Complex Trust

- Accumulates income
- Makes discretionary distributions of income or mandatory or discretionary distributions of principal, or
- Makes distributions to charity

Grantor Trust

- Grantor or beneficiary has one or more “powers” described in Sec. 673-678
- Result: All income, expenses and credits “flow through” and are taxed to the Grantor or beneficiary regardless of whether distributions are made
- Subpart A-D, Subchapter J (rules for taxation of trusts and estates) do not apply to Grantor trusts

Trust Accounting Income (TAI)

- Governs amount of distributions
- Trustee allocates receipts/disbursements between accounting income and principal
- Accounting income and principal is determined by governing instrument or, if instrument silent, by state law
  - May be governed by UPIA or unitrust statute

Trust Accounting Income (TAI)

	TAI	Taxable Income
Corp Bond Int	√	√
Capital Gains		√
Muni Bond Int	√	
Expenses	?	?

Trust Accounting Income - TAI

- BACKGROUND
  - Prudent Investor Act
    - – Modern portfolio theory – invest for total return
      - Replaces the traditional notions of income and principal
    - – Enactment of the Uniform Principal and Income Act
    - – Enactment of Unitrust statutes

Trust Accounting Income - TAI

- TRUST ACCOUNTING INCOME
  - Could be TAI defined under:
    - Traditional definition of income and principal
    - Unitrust statute
      - Must be no less than 3%, no more than 5% of FMV of trust assets
    - Uniform Principal and Income Act
      - Requirements:
        - » Trust is managed under the Uniform Prudent Investor Act
        - » The beneficiary must be eligible for income distributions
        - » The distribution is not favorable to one beneficiary over another

Taxable Income of Trust or Estate

- Computed same as individual
- Exemptions: $600/$300/$100
- Different rules for charitable deductions
- Depreciation deduction allocated between entity and beneficiary
- Distribution deduction
- Administration expenses - some not subject to 2% floor
- AGI - same as individual reduced by (1) personal exemption, (2) distribution deduction and (3) some administration expenses are subtracted “off the top,” i.e. subtracted from taxable income to arrive at AGI

Income Taxation of Trusts and Estates

- Income Taxed to Either Entity or Beneficiary
  - If income is *accumulated* and not deemed distributed, it is taxed to the trust or estate
  - If income *distributed*:
    - Trust gets deduction for amount of distribution, limited to DNI
    - Beneficiary accounts for income distributed on his own tax return, limited to DNI

Income Taxation of Trusts and Estates - Distributable Net Income (DNI)

- Distributable Net Income (DNI) governs:
  - Amount of trust or estate's distribution deduction
  - Amount beneficiary accounts for on his own return
  - Character of income in beneficiary's hands

Income Taxation of Trusts and Estates

DNI

DNI acts as ceiling on entity's distribution deduction

DNI acts as ceiling on amount beneficiary accounts for on his return

Trust/Estate

Beneficiary

DNI - Sec. 643(a)

- Start With Taxable Income and . . .
  - *Add back* the distribution deduction
  - *Add back* the personal exemption
  - *Subtract out* capital gains/*add back* capital losses allocable to principal (except in the year of termination)
  - *Subtract out* extraordinary dividends and taxable stock dividends allocated to corpus for simple trust
  - *Add back* net tax-exempt income

DNI – Easy Example

Facts – Trust income:

- Interest $10,000
- Dividends $15,000
- Trustee's fees 5,000

DNI:

Taxable income	$19,900
Add: Exemption	$100
DNI	$20,000

Taxable income:

Interest	$10,000
Dividends	$15,000
Less: Tr fees	($5,000)
Net	$20,000
Less: exemption	($100)
Taxable income	$19,900

DNI – Example with LTCG

- Facts – Trust income:
  - Interest $10,000
  - Dividends $15,000
  - LTCG $30,000
  - Trustee's fees 5,000

Taxable income:

Interest	$10,000
Dividends	$15,000
LTCG	$30,000
Less: Tr fees	($5,000)
Net	$50,000
Less: exemption	($100)
Taxable income	$49,900

DNI:

Taxable income	$49,900
Less: LTCG	($30,000)
Add: Exemption	$100
DNI	$20,000

DNI – Example with LTCG and T/E Interest

- Facts – Trust income:
  - Interest $10,000
  - Dividends $15,000
  - LTCG $30,000
  - T/E Interest $5,000
  - Trustee's fees $5,000

Taxable income:

Interest	$10,000
Dividends	$15,000
LTCG	$30,000
Less: Tr fees	($4,167)
Net	$50,833
Less: exemption	($100)
Taxable income	$50,733

DNI:

Taxable income	$50,733
Less: LTCG	($30,000)
Add: Net T/E interest	$4,167
Add: Exemption	$100
DNI	$25,000

Allocation of expenses to T/E interest:

T/E Interest	$5,000
$\frac{\$5{,}000 \text{ T/E Interest}}{\$30{,}000 \text{ TAI}}$ x $5,000 =	(833)
Deductible trustee's fees	$4,167

DNI - Sec. 643(a)

- Note: capital gains generally taxed to trust or estate
  - Exceptions:
    - 3 situations under Reg. 1.643(a)-3
    - Paid to or set permanently set aside for charity. Reg. 1.643(c)
    - year of termination
- Note: The rules regarding DNI and the distribution deduction are applied differently to simple trusts versus complex trusts and estates
- Distributions of principal as well as income will “carry out” DNI
  - Exception: Specific bequests under Sec. 663(a)(1)

Include Capital Gains in DNI – The Problem

- Generally, capital gains are allocated to principal and taxed to the estate or trust

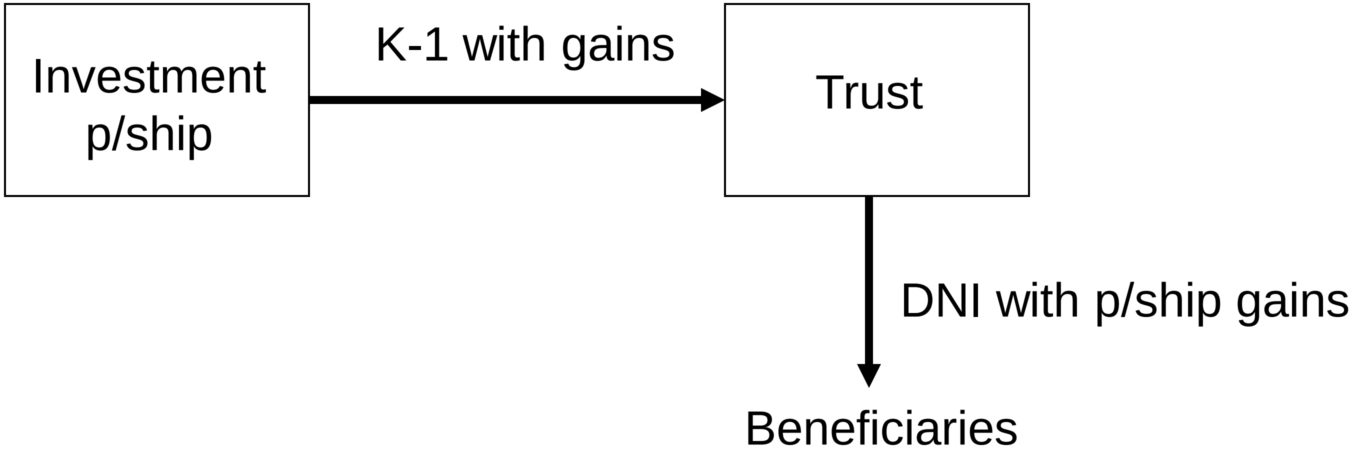
- Compressed tax rate schedule for estates and trusts
  - Short-term capital gains taxed at 39.6% + 3.8% surtax if taxable income exceeds $12,400 (2016)
  - Long-term capital gains taxed at 20% + 3.8% surtax if taxable income exceeds $12,400 (2016)

- Planning point – have gains taxed to beneficiary where gains would most likely be taxed at a lower tax rate

- For capital gains to be taxed to a beneficiary, the capital gain must be included in DNI

Include Capital Gains in DNI

- In addition to those circumstances mentioned in the regulations, capital gains flowing from a partnership or S corporation K-1 are included in DNI. Crisp v. United States, 34 Fed. Cl. 112 (1995).
  - Planning point: the trustee may want to consider investing through a partnership so that capital gains can be distributed and escape the income tax and the surtax at the trust level



In-Kind Distributions Under §643(e)

- An estate or trust does not recognize gain or loss on the in-kind distribution of property to a beneficiary. §643(e).
- The distribution carries out DNI at the lesser of the property's basis or it fair market value.
- The beneficiary takes a carryover basis in the property. §643(e)(1).
- The fiduciary may elect to recognize gain as if the property was sold at its fair market value. §643(e)
  - If so, DNI is carried out to the extent of the fair market value of the property distributed and the beneficiary takes a basis in the distributed property equal to the estate or trust's basis plus any gain or minus any loss recognized on the distribution.
- The election is made year by year and applies to all property distributed during the year.
- §643(e) allows the fiduciary to determine where the gain will be recognized: at the entity level or at the beneficiary level.
- This may allow the beneficiary to time the recognition of gain to a time when he will not be subject to the 3.8% surtax.
  - A beneficiary who holds the property until death will get a step-up in basis and avoid the tax on the gain altogether.

Grantor Trust

- Gains taxed to grantor or beneficiary to extent trust is a grantor trust due to powers held under §§673-677 or to the extent the trust is a “deemed” grantor trust under §678.

- Irrevocable trust may be structured as a grantor trust so capital gains are taxed to the grantor
  - Structure trust for benefit of non-grantor beneficiaries as a grantor trust

- Beneficiary of irrevocable trust may have withdrawal power so that beneficiary is taxed on some or all of the gains.
  - Crummey withdrawal power
  - 5 x 5 power

Include Capital Gains in DNI

- The regulations describe 3 circumstances under which capital gains can be included in DNI. Reg. 1.643(a)-3(b).
- Gains are included in DNI where they are, pursuant to the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law:
  1. Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of DNI determined without regard to this subparagraph 1.643(a)-3(b));
  2. Allocated to corpus but treated consistently by the fiduciary on the trust's books, records and tax returns as part of a distribution to a beneficiary; or
  3. Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Analyzing Regulation 1.643(a)-3(b)

- Reg. 1.643(a)-3(b) has specific requirements must be met in order to have capital gains taxed to the beneficiary

- No pressing the “easy button”

- Regulations have:
  - Two prerequisites and
  - Three methods

Analyzing Regulation 1.643(a)-3(b)

- Two prerequisites – capital gains included n DNI only if inclusion is pursuant to:
  - Trust agreement and local law; or
  - A reasonable and impartial exercise of discretion by the trustee in accordance with a power granted to the trustee by local law or the trust agreement if not prohibited by local law.

- Three methods
  - Allocated to **income**
  - Allocated to **corpus**, but treated consistently by the fiduciary on the trust's books, records and tax returns as part of distribution to the beneficiary
  - Allocated to **corpus**, but **actually distributed** to the beneficiary or **utilized by the fiduciary in determining the amount that is distributed** or required to be distributed to the beneficiary

Method 1 - 1.643(a)-3(b)(1)

- Allocated to **income**

- Trust agreement must specifically provide that capital gains are allocated to income
  - A mere general boilerplate statement that the trustee has discretion to allocate receipts and disbursements between income and principal may not be enough

- Solution if trust instrument is silent as to whether capital gains are allocated to income
  - Decant
    - Most states require trustee have significant discretion to distribute principal.
  - Power adjust under UPIA
    - However, §643 regulations don’t have an example if or how capital gains enter into DNI if trustee exercises the power to adjust

Trust Accounting Income - TAI

- TRUST ACCOUNTING INCOME
  - Could be TAI defined under:
    - Traditional definition of income and principal
    - Unitrust statute
      - Must be no less than 3%, no more than 5% of FMV of trust assets
    - Uniform Principal and Income Act
      - Requirements:
        - » Trust is managed under the Uniform Prudent Investor Act
        - » The beneficiary must be eligible for income distributions
        - » The distribution is not favorable to one beneficiary over another

Method 2 - 1.643(a)-3(b)(**2**)

- Allocated to **corpus**, but treated consistently by the fiduciary on the trust's books, records and tax returns as part of distribution to the beneficiary

- Trustee could be given discretion to treat principal distributions consisting of capital gains
  - Trustee must document that capital gains are included in DNI
  - Consistency requirement
    - Term "consistency" not clearly defined in regulations
    - Once employed, future principal distributions deemed included in DNI
    - May prohibit existing trusts from using this method
      - Examples in regulations make it relatively clear that the establishment of a practice of distributing gains must commence in the first year in which a distribution of principal occurs
      - Solution: decant into a new trust and use Method 2 in first year

Method 3 - 1.643(a)-3(b)(**3**)

- Allocated to **corpus**, but **actually distributed** to the beneficiary or **utilized by the fiduciary in determining the amount that is distributed** or required to be distributed to the beneficiary

- Regulations do not address whether this method may be used if the principal distribution is greater than or less than the actual capital gains for the year

- Principal distribution required at stated ages (1/3 at 25, 1/3 at 30 and balance at 35), and asset must be sold to make the distribution

- Method 3 is useful for older or existing trusts which are silent on whether capital gains can be allocated to income

Including Capital Gains in DNI

- Bottom line
  - Best when appropriate discretion is expressly granted in the trust agreement
  - If not, consider:
    - Power to adjust
    - Decanting (if available)

Distributions - Simple Trust

Beneficiary Taxed on Lower of TAI or DNI

<u>Gains Taxed to Trust</u>

Trust Gets Distribution Deduction Equal to DNI

Simple Trust

Gains

DNI

Beneficiary Accounts for DNI

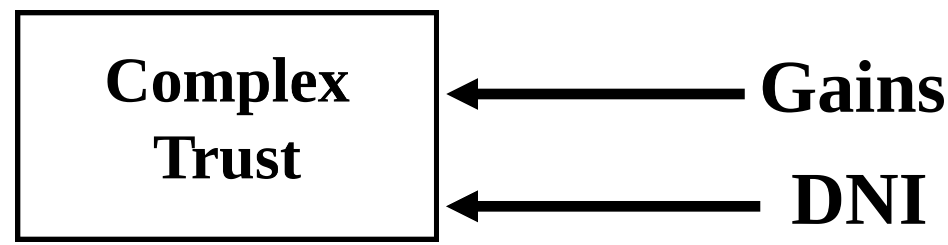
Beneficiary

Trust income retains its character in Beneficiary's hands

Distributions - Complex Trusts and Estates

<u>Trust/Estate *Accumulates* Income</u>

Gains and DNI Taxed to Trust

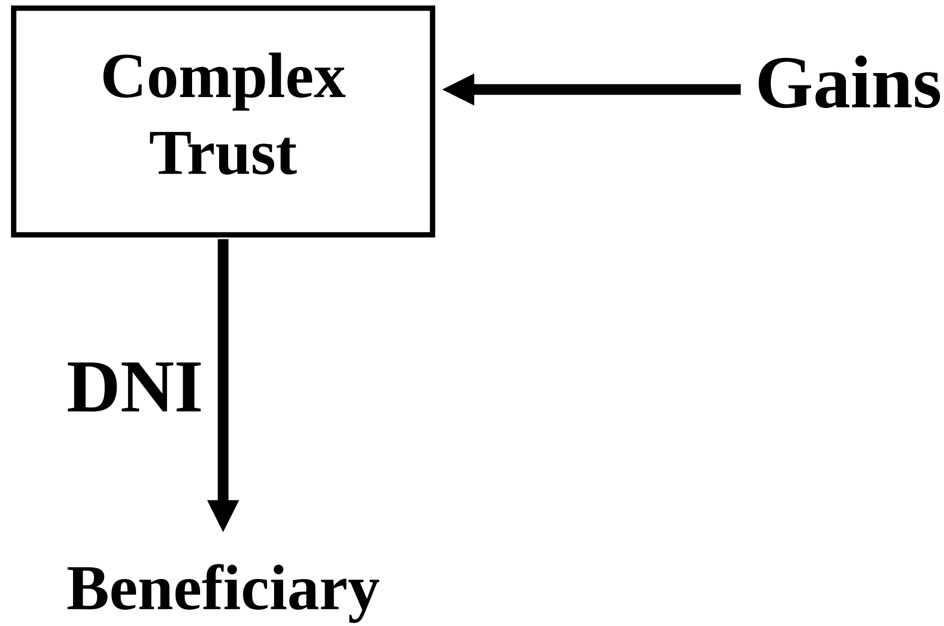


Distributions - Complex Trusts and Estates

Beneficiary Taxed on Distributions Up to DNI

<u>Gains Taxed to Trust</u>

Trust Gets Distribution Deduction Equal to Distributions up to DNI



Beneficiary Accounts for Distributions Up to DNI

Trust income retains its character in Beneficiary's hands

Distribution System – Simple Trusts

- Distribution deduction - trust is entitled to deduct all of its TAI (but not in excess of its DNI)
  - Items of income not included in gross income (e.g. tax-exempt income) are not deductible by the trust

- Inclusion by beneficiary – the TAI (but not in excess of its DNI) is includible in the beneficiary's gross income
  - Items of income not included in gross income (e.g. tax-exempt income) are not includible in the beneficiary's income

- Example: Simple trust has TAI and DNI for the year is $9,000. The TAI must be distributed to A. The trust gets a distribution deduction of $9,000 and the beneficiary must include $9,000 in his income.

Distribution System – Simple Trusts

- Multiple beneficiaries - If there is more than one beneficiary, the DNI is apportioned among them in proportion to the TAI received by each beneficiary.

- Example: Trust requires one-third of TAI be distributed to A and two-thirds of TAI be distributed to B. TAI and DNI for the year is $9,000. The trust gets a distribution deduction of $9,000.

  – A must report $3,000 (1/3 of $9,000) and B must report $6,000 (2/3 of $9,000).

Distribution System – Simple Trusts

- Character of income – items of income retain the same character in the hands of the beneficiary as they had in the hands of the trust

- Example: Trust requires one-third of TAI be distributed to A and two-thirds of TAI be distributed to B. TAI and DNI for the year is $9,000. The TAI and DNI consists of $6,000 of dividends and $3,000 of interest. The trust gets a distribution deduction of $9,000.

  – A must report $3,000 (1/3 of $9,000) and B must report $6,000 (2/3 of $9,000).

  – A’s $3,000 distribution consists of $2,000 of dividends and $1,000 is interest.

  – B’s $6,000 distribution consists of $4,000 of dividends and $2,000 of interest

Complex Trusts - Allocation of DNI

- Generally, DNI is allocated among beneficiaries proportionately, based on distributions to each beneficiary

- As with simple trusts, distributions from an estate or complex trust are generally considered to carry out a pro rata part of each item of DNI.

  – In other words, distributions from a complex trust or estate is deemed to consist of the same proportion of each class of items entering into the computation of DNI as the total of each class bears to the total DNI

Complex Trusts - Allocation of DNI

- Example:
  - Trust has $20,000 of DNI
  - Trustee distributes $30,000 to A and $10,000 to B
  - Under normal pro-rata rules, A would include $15,000 of DNI ($30,000 distribution/$40,000 total distribution x $20,000 DNI)
  - Under normal pro-rata rules, B would include $5,000 of DNI ($10,000 distribution/$40,000 total distribution x. $20,000 DNI)

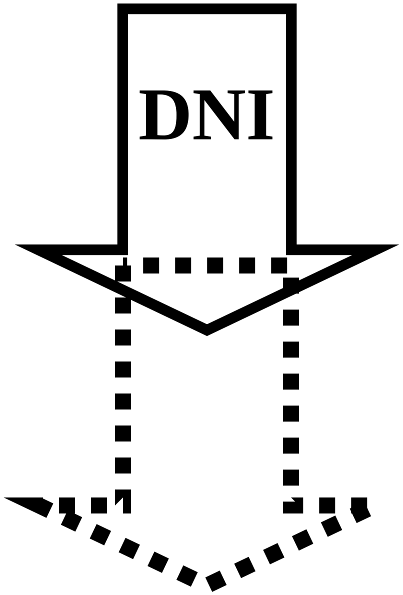
Complex Trusts – Special Rules in the Allocation of DNI

- FIVE IMPORTANT CONCEPTS:
  - Tier System
  - Separate Share Rule
  - 65 Day Rule (§663(b) election)
  - Specific Bequests - §663(a)(1)
  - Distributions in Kind - §643(e)

Complex Trust and Estates
Tier System

- Two tiers:
  - First Tier - Distribution of income *required* to be distributed currently
  - Second Tier - Distribution of *all other amounts* paid, credited or required to be distributed

Complex Trust and Estates
Tier System



First Tier Beneficiary

Second Tier Beneficiary

DNI is taxed first to FTB and any balance of DNI is taxed to STB

Complex Trust and Estates
Tier System - Example

Facts: $40,000 DNI and TAI
Trust requires A receive 50% of income
Trustee makes discretionary distributions of $20,000 to each B and C

A is FTB (Gets 50% of $40,000 TAI)

B and C are STB (Discretionary Benes)

Complex Trust and Estates
Tier System - Example

$40,000   DNI

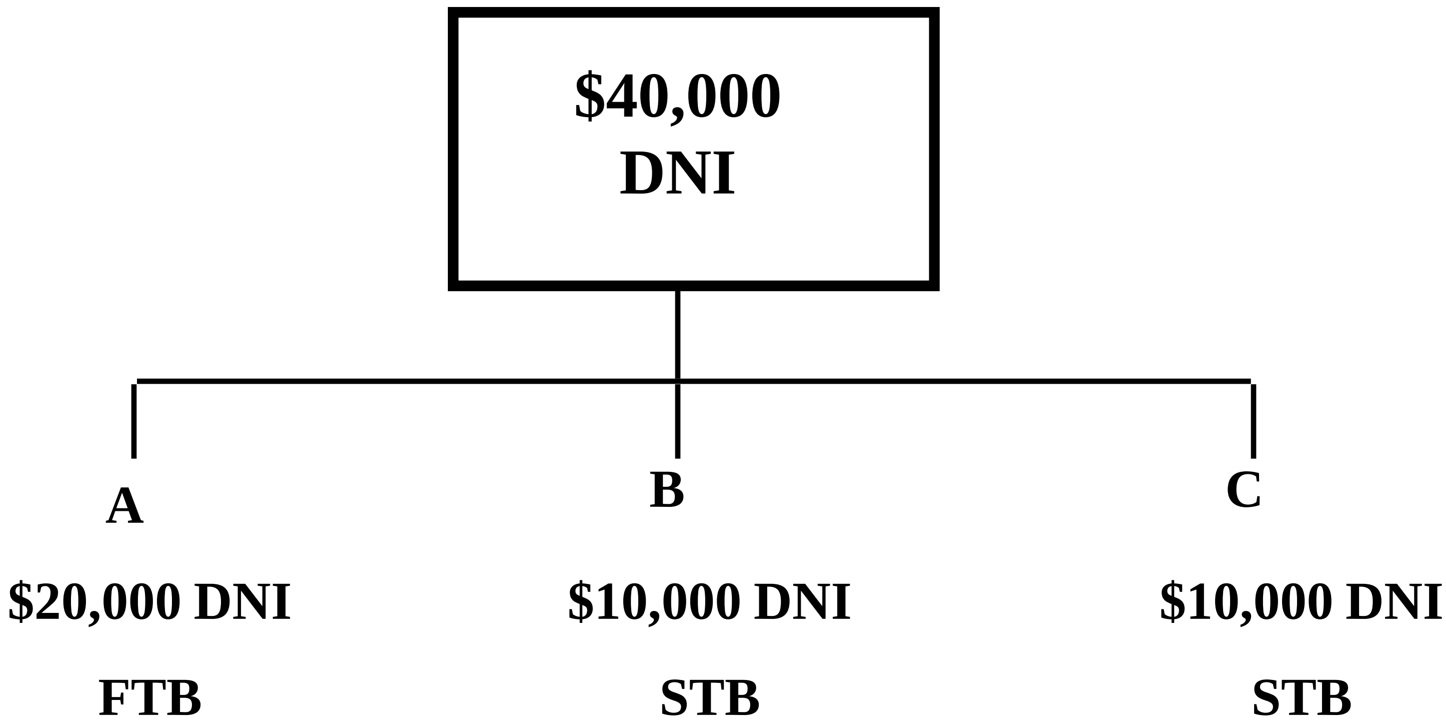
($20,000) DNI for FTB

$20,000 DNI for STB

Divided by 2 STB

$10,000 DNI for Each STB

Complex Trust and Estates
Tier System - Example



Complex Trusts – Separate Share Rule

- General rule: DNI is allocated proportionately to beneficiaries based on distributions made to each
- However, disproportionate distributions to beneficiaries from a trust or estate can lead to different tax treatment for different beneficiaries
- The separate share rule is designed to cure this inequity
- The separate share rule allocates DNI among the beneficiaries based on distributions of their “share” of DNI
- Distributions to beneficiaries who don’t have separate shares are allocated DNI based on distributions made to them over the total distributions made to all the beneficiaries in a particular year i.e. a proportionate share of DNI

Complex Trusts - Separate Share Rule

Solely for purposes of computing DNI, substantially separate and independent shares of different beneficiaries of a trust are treated as separate trusts.

Effect: Treat multiple beneficiaries of single trust or estate as if each were the sole beneficiary of a single trust solely for determining how much DNI each distribution carries out.

Result: beneficiary is not taxed on more than his share of DNI.

Complex Trusts – Separate Share Rule

- Example:
  - Trust has $20,000 of DNI
  - Trustee distributes $30,000 to A and $10,000 to B
  - Under normal pro-rata rules, A would include $15,000 of DNI ($30,000 distribution/$40,000 total distribution x $20,000 DNI)
  - Under normal pro-rata rules, B would include $5,000 of DNI ($10,000 distribution/$40,000 total distribution x $20,000 DNI)
  - Added fact: separate share rule applies. A's separate share earns $10,000 of DNI and B's separate share earns $10,000 of DNI

Complex Trusts – Separate Share Rule

A's Separate Share

DNI: $10,000

Distribution: $30,000

Amount included in A's income: $10,000, limited to his share of DNI

B's Separate Share

DNI: $10,000

Distribution: $10,000

Amount included in B's income: $10,000, limited to his share of DNI

Trust files one income tax return, takes a $20,000 distribution deduction, A includes $10,000 in income (even though he received $30,000 in distributions) and B includes $10,000 in income.

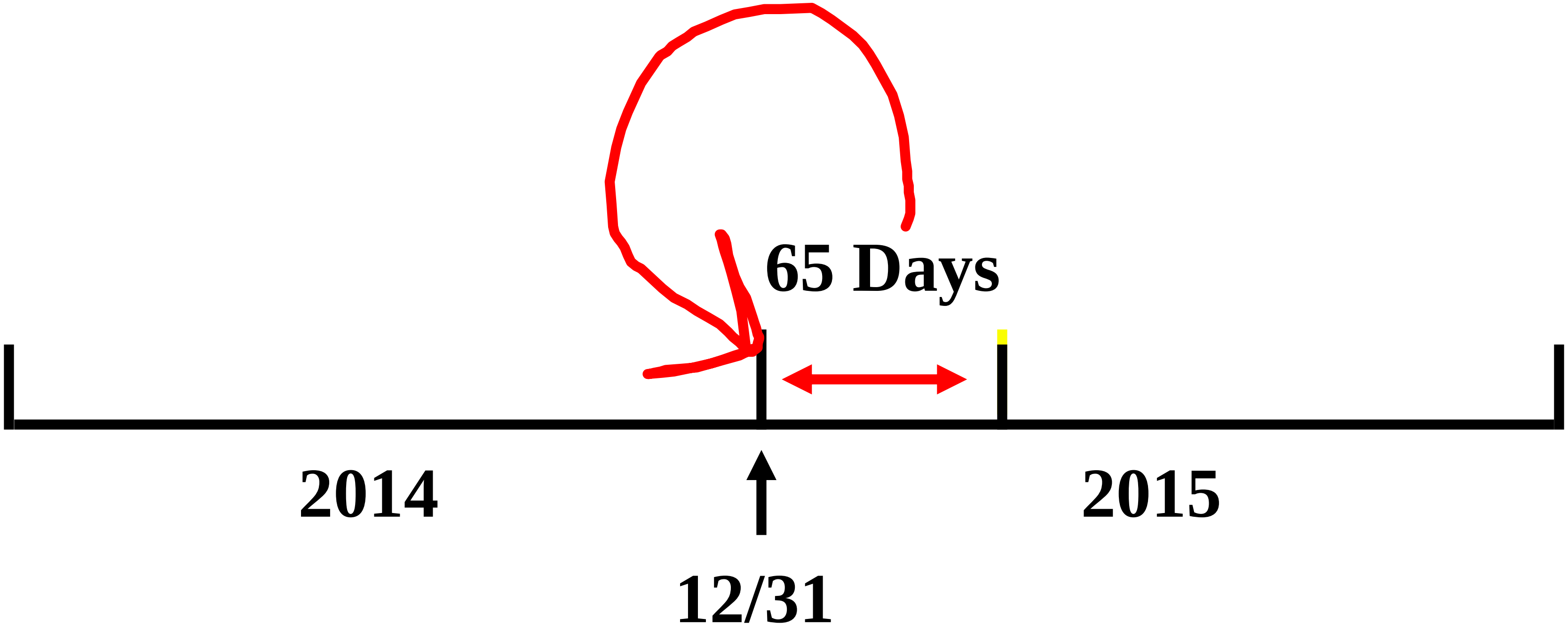
Complex Trusts - Separate Share Rule

- Applies to estates and trusts
- DNI computed separately for each share
- Mandatory, not elective
- Only affects share of DNI
  - Doesn’t allow filing multiple returns
  - Doesn’t allow separate calculation of tax
- Want to avoid separate share rule?
  - Draft as a “spray” trust
  - Provide in trust document that the shares subdivide into separate trusts

65 Day Rule aka Sec. 663(b) Election

- Applies to complex trusts and estates
- Allows fiduciary to treat distribution made within 65 days of Y/E as being made on 12/31 of preceding year
- Election must be made by due date of return
- Election is irrevocable
- Year by year election (e.g. good for 1 year only)
- Limited to > DNI less current year distributions or TAI not distributed

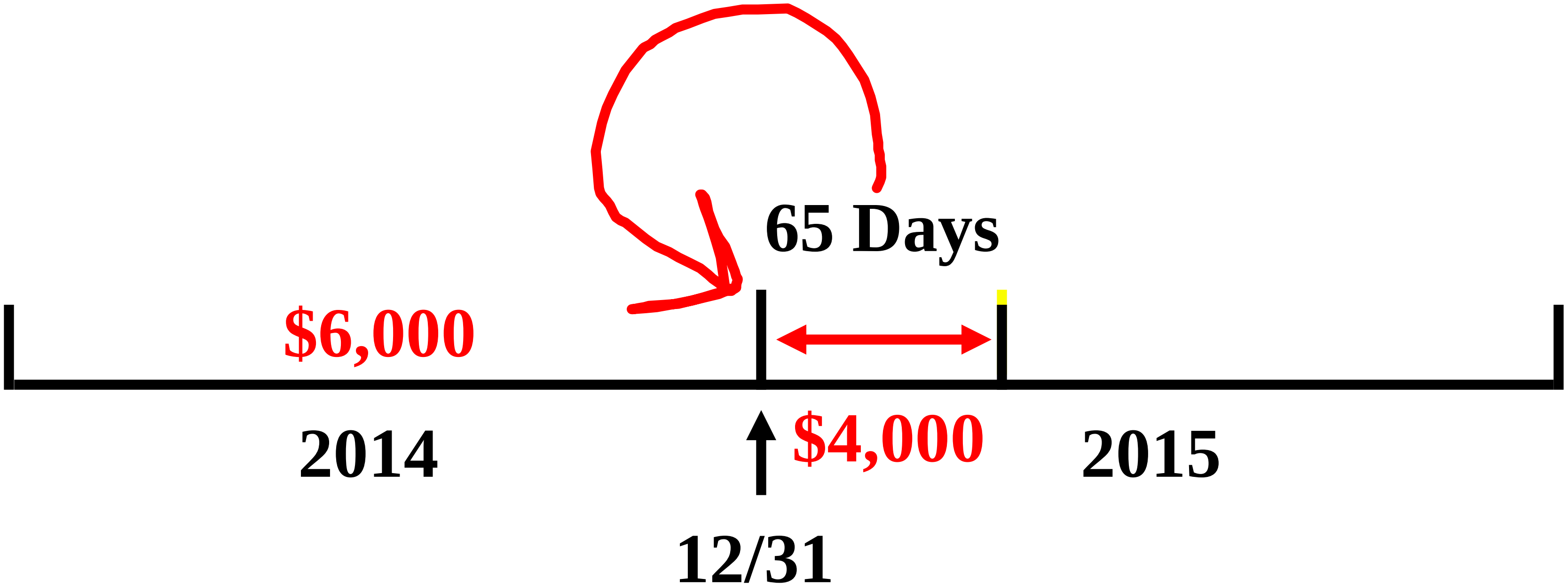
65 Day Rule aka Sec. 663(b) Election



65 Day Rule aka Sec. 663(b) Election

Facts: $10,000 DNI for 2014

Distributes $6,000 in 2014, $4,000 in 2015



Specific Bequests - Sec. 663(a)(1)

- Bequest of specific sum of money or specific property *do not carry out DNI*

- Requirements:
  - Paid all at once, or
  - Paid in not more than 3 installments
  - Not paid from income

- Amount of bequest must be ascertainable at focal date e.g. date of death

- Not deductible by trust/estate or taxable to beneficiary

Summary

- Trust or estate is a separate taxable entity
- Income is taxed to either estate/trust or beneficiary
- Concept of “distributable net income” (DNI) determines
  – Amount of distribution deduction
  – Amount included in beneficiary’s income
  – Character of income
- DNI affected by
  – Tier system of allocating DNI
  – Separate share rule
  – 65 day rule
  – Section 663(a)(1) for specific bequests
  – Section 643(e) rules for distributions in kind
- This stuff is really complicated

Resources

- Federal Income Taxation of Estates, Trusts and Beneficiaries, 3rd Edition by Ferguson, Freeland and Ascher (Aspen/CCH)

- 1041 Deskbook (Practitioners Publishing Co)

- Income Taxation of Trusts and Estates, 852-3rd (BNA portfolio – Estate, Gift and Trust series)

- Federal Income Taxation of Decedents, Estates and Trusts, David A. Berek (2013 Edition) (CCH)

- Federal Income Taxation of Trusts and Estates, by Zaritsky and Lane, 3rd Edition (RIA/Thompson/West)

- Income Taxation of Fiduciaries and Beneficiaries by Byrle M. Abbin, 2 volumes, 2013 Edition (CCH)

Thank You!