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May, 2021

# Demystifying Distributable Net Income - Income Taxation of Estates and Trusts

## 55<sup>th</sup> Annual Heckerling Institute on Estate Planning

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# What We'll Cover

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- Background
- Definition of Distributable Net Income (DNI)
- Calculating DNI
- Types of Trusts – Simple and Complex
- Simple Trusts
- Complex Trusts
  - Tier System
  - Separate Share Rule
  - 65 Day Rule - § 663(b) election
  - Specific Bequests - § 663(a)(1)
  - Distributions in Kind - § 643(e)
- Including Capital Gains in DNI
- Conclusion

# Income Taxation of Trusts and Estates

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

# Income Taxation of Trusts and Estates

## Code Outline

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- **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

# Background - Income Taxation of Trusts and Estates

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- 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

# 2021 Tax Rates – Ordinary Income

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<b>If Taxable Income is:</b>	<b>The Tax is</b>
Not over \$2,650	10%
Over \$2,650 but not over \$9,550	\$265 plus 24% of amount over \$2,650
Over \$9,550 but not over \$13,050	\$1,921 plus 35% of amount over \$9,550
Over \$13,050	\$3,146 plus 37% of amount over \$13,050

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# 2021 Tax Rates – Capital Gains

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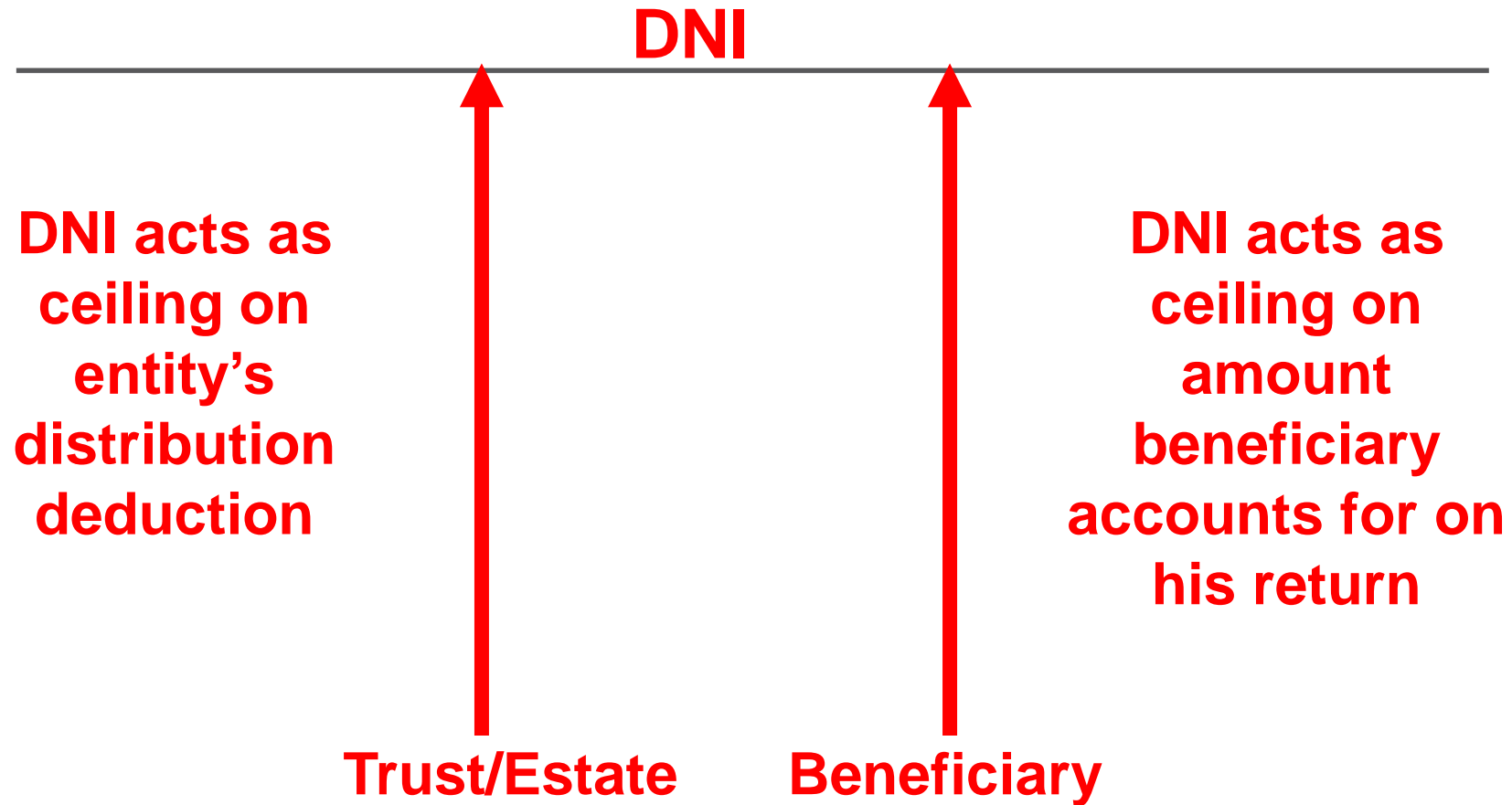
<b>If Taxable Income is:</b>	<b>Maximum Capital Gain Rate</b>
Not over \$2,700	0%
Over \$2,700 but not over \$13,250	15%
Over \$13,250	20%

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

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- 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

# Background - Income Taxation of Trusts and Estates



# Background - DNI - Sec. 643(a)

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- 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

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## Facts – Trust income:

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

## Taxable income:

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

## DNI:

Taxable income	\$19,900
Add: Exemption	<u>\$100</u>
DNI	\$20,000

## Line on 1041

17 - Front
-
7 - Sch B

# DNI – Example with LTCG

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## 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	<u>(\$5,000)</u>
Net	\$50,000
Less: exemption	<u>(\$100)</u>
Taxable income	\$49,900

## DNI:

Taxable income	\$49,900
Less: LTCG	(\$30,000)
Add: Exemption	<u>\$100</u>
DNI	\$20,000

## Line on 1041

17 - Front
6 – Sch B
-
7 – Sch B

# Non-Deductible Expenses - Sec. 265

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- Sec. 265 disallows any deduction attributable to tax-exempt income
- Generally applies to deductions for production of income, usually trustee's fees and executor's fees
- If trust/estate has tax-exempt 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

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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

$$\begin{array}{r} \text{\$10,000 T/E income} \\ \hline \text{\$40,000 Total income} \end{array} \times \begin{array}{r} \text{\$20,000 fees} \\ \text{(\$5,000)} \\ \text{\$15,000 deductible} \end{array} = \begin{array}{r} \text{\$5,000 non-deductible} \\ \text{\$15,000 deductible} \end{array}$$


# 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	<u>(\$4,167)</u>
Net	\$50,833
Less: exemption	<u>(\$100)</u>
Taxable income	\$50,733

## DNI:

Taxable income	\$50,733	Line on 1041	17 - Front
Less: LTCG	(\$30,000)		6 - Sch B
Add: Net T/E interest	\$4,167		2 - Sch B
Add: Exemption	<u>\$100</u>		-
DNI	\$25,000		7 - Sch B

## Allocation of expenses to T/E interest:

T/E Interest	\$5,000
<u>\$5,000 T/E Interest</u> x \$5,000 =	<u>(833)</u>
\$30,000 TAI	
Deductible trustee’s fees	\$4,167

# DNI - Sec. 643(a)

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- Note: capital gains generally not included in DNI but taxed to the 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 the allocation of DNI between the trust and its beneficiaries are applied differently to simple trusts versus complex trusts and estates
- Distributions of principal as well as trust accounting income (TAI) will “carry out” DNI
  - Exception: Specific bequests under Sec. 663(a)(1)

# Types of Trusts

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- Simple
- Complex
- Grantor – not important for our discussion today

# Simple Trust

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

# Complex Trust

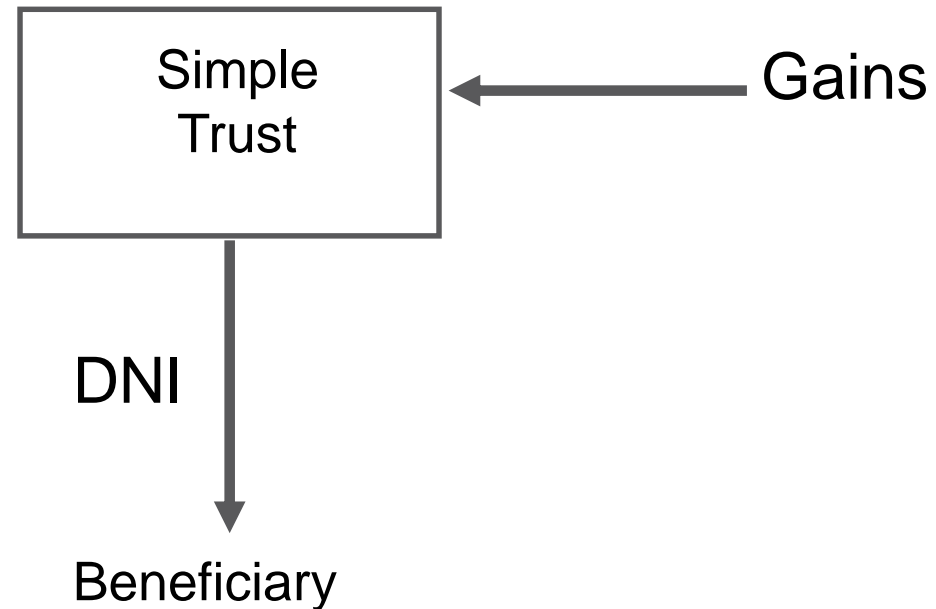
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- Makes discretionary distributions of trust accounting income
- Makes mandatory or discretionary distributions of principal, or
- Makes distributions to charity

# Distributions - Simple Trust

Beneficiary Taxed on Lower of TAI or DNI  
Gains Taxed to Trust

Trust Gets Distribution  
Deduction Equal to DNI



Beneficiary Accounts for DNI

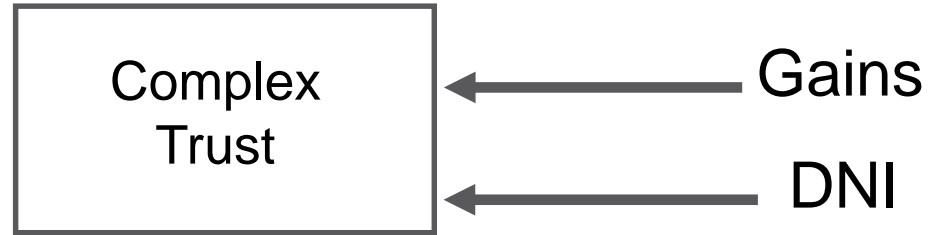
Trust income retains its character in  
Beneficiary's hands

# Distributions - Complex Trusts and Estates

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Trust/Estate Accumulates Income

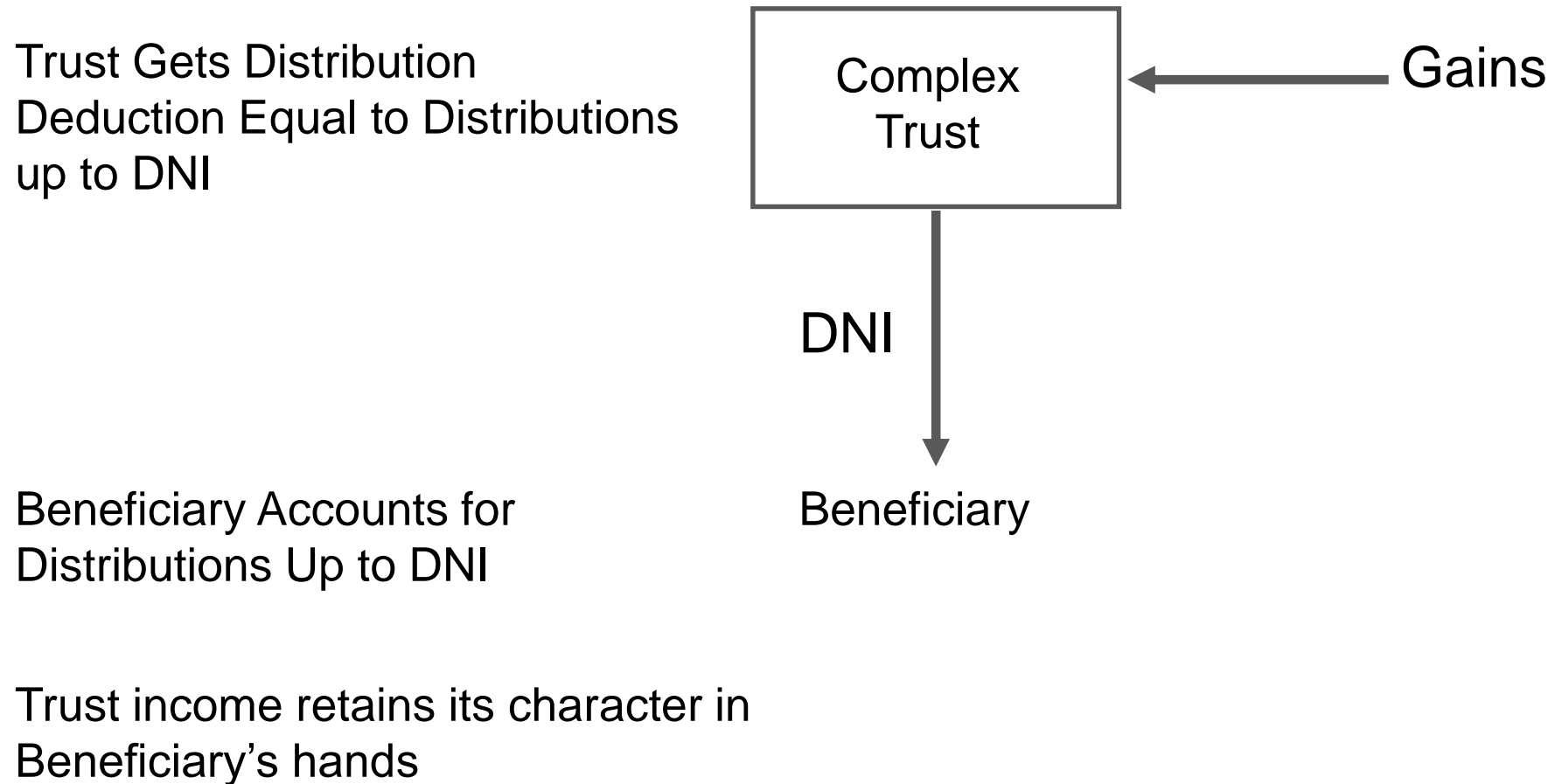
Gains and DNI Taxed to Trust



# Distributions - Complex Trusts and Estates

Beneficiary Taxed on Distributions Up to DNI

Gains Taxed to Trust



# Distributions - Applicable Code Sections

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Simple Trusts	Complex Trusts/ Estates
651	661
652	662

# Distributions - Applicable Code Sections

	Simple Trusts	Complex Trusts/ Estates
Distribution Deduction	651	661
	652	662

# Distributions - Applicable Code Sections

	Simple Trusts	Complex Trusts/ Estates
Distribution Deduction	651	661
Amt Bene Accounts For	652	662

# Distribution System – Simple Trusts

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- 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

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- 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

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- 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

# Inclusion of Amounts in Gross Income of Beneficiaries of Complex Trusts - §662

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The key to understanding the distribution rules for complex trusts and estates and the allocation of DNI among multiple beneficiaries consists of understanding six important concepts. They are:

- (1) General Rule: DNI is allocated to the beneficiaries on a pro-rata basis i.e. amount of the distribution to the beneficiary/total distributions to all the beneficiaries x DNI = beneficiaries share of DNI
- (2) the “tier system” of distributions,
- (3) the separate share rule,
- (4) the 65 day rule under §663(b)
- (5) specific bequests under §663(a)(1)
- (6) Distributions in Kind - §643(e)

# Complex Trusts - Allocation of DNI

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- 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

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- Example – General Rule
  - 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 ( $\$30,000 \text{ distribution} / \$40,000 \text{ total distribution} \times \$20,000 \text{ DNI}$ )
  - Under normal pro-rata rules, B would include \$5,000 of DNI ( $\$10,000 \text{ distribution} / \$40,000 \text{ total distribution} \times \$20,000 \text{ DNI}$ )

# Complex Trusts – Special Rules in the Allocation of DNI

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## SIX IMPORTANT CONCEPTS:

- General rule: DNI allocated pro-rata based on distribution
- 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

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- The allocation of the distribution among various beneficiaries of a complex trust or estate is considerably more difficult than for the beneficiaries of simple trusts.
- How is DNI allocated when there are multiple beneficiaries, some of whom are entitled to net income and others are who are discretionary beneficiaries or receive distributions of corpus?
- This allocation is controlled by the “tier system”. The “tier system” of taxation is contained in § 662(a)(2).

# Complex Trust and Estates - Tier System

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- If total distributions do not exceed DNI, the tiers are irrelevant.
- Amounts paid, credited or required to be distributed carry out DNI dollar for dollar, each reflecting its proportionate share of the items of income and deductions in DNI.
- Any remaining DNI not distributed is taxed to the trust.

# Complex Trust and Estates - Tier System

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- If **distributions exceed DNI** and there are **multiple beneficiaries**, some who are **required to get trust accounting income (first tier beneficiaries)** and others who **receive distributions in the trustee's discretion (second tier beneficiaries)**, the tier of a distribution is important in determining the tax consequences to the beneficiary.

# Complex Trust and Estates - Tier System

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- The tier system of allocating DNI is applicable if:
  - (1) **Distributions exceed DNI;**
  - (2) There are **multiple beneficiaries;**
  - (3) Some beneficiaries are **required to get trust accounting income (first tier beneficiaries);**
  - (4) and others who **receive distributions in the trustee's discretion (second tier beneficiaries)**

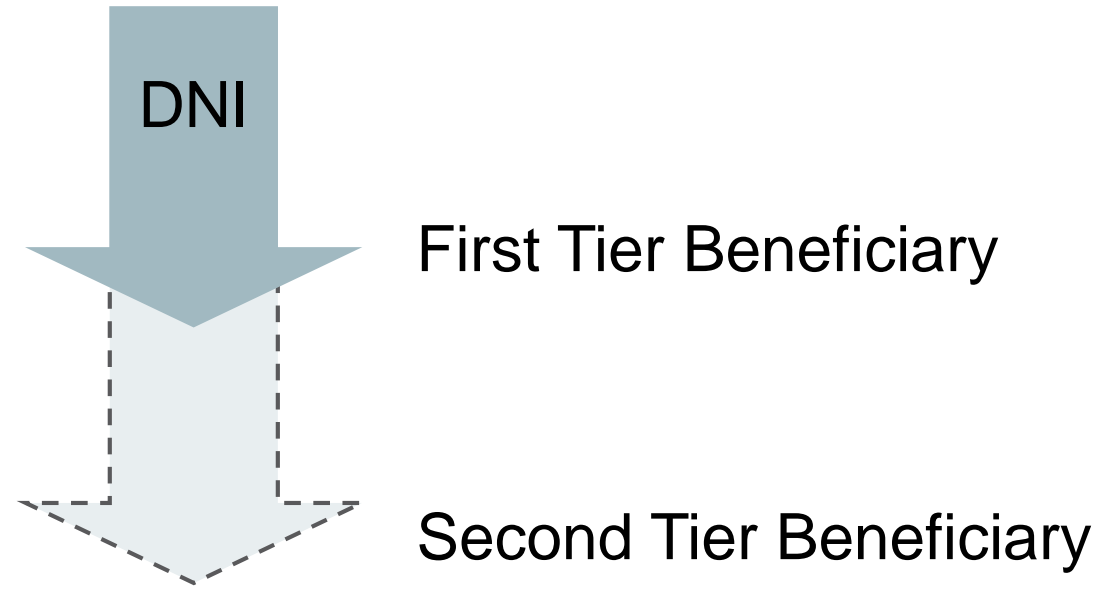
# Complex Trust and Estates - Tier System

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- Two tiers:
  - First Tier - Distribution of trust accounting 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

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

# Complex Trusts – Tier System

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**Example:** A trust instrument requires the trustee to distribute \$30,000 of income to A and gives the trustee to discretion to distribute income and principal to B.

The trust has \$40,000 of DNI.

The trustee distributes \$30,000 to A and \$20,000 to B.

If the normal pro rata rules were applied to the distributions, A would report \$24,000 of DNI ( $\$30,000/\$50,000 \times \$40,000$  DNI) and B would report \$16,000 of DNI ( $\$20,000/\$50,000 \times \$40,000$  DNI). The DNI would be allocated pro rata to each beneficiary based on distributions to each.

# Complex Trusts – Tier System

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**Example (Cont.):** Under the tier system, DNI would be allocated first to A (the first tier beneficiary) to the extent of the income required to be distributed to A (\$30,000) and the balance of the DNI after taking into consideration the distribution to A (\$40,000 DNI less \$30,000 DNI allocated to A or \$10,000) would be allocated to B (the second tier beneficiary).

Although B received a distribution of \$20,000, there is only \$10,000 of DNI remaining to be allocated to his distribution after allocating \$30,000 of DNI to the first tier beneficiary's (A) distribution. The \$10,000 balance of the \$20,000 distributed to B is treated as a tax-free distribution of principal to B.

# Complex Trust – General Rule v. Tier System

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Beneficiary	General Rule	Tier System
A	\$24,000	\$30,000
B	\$16,000	\$10,000

# Complex Trust and Estates

## Tier System - Example

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**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

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**\$40,000 DNI**

**(\$20,000) DNI for FTB**

**\$20,000 DNI for STB**

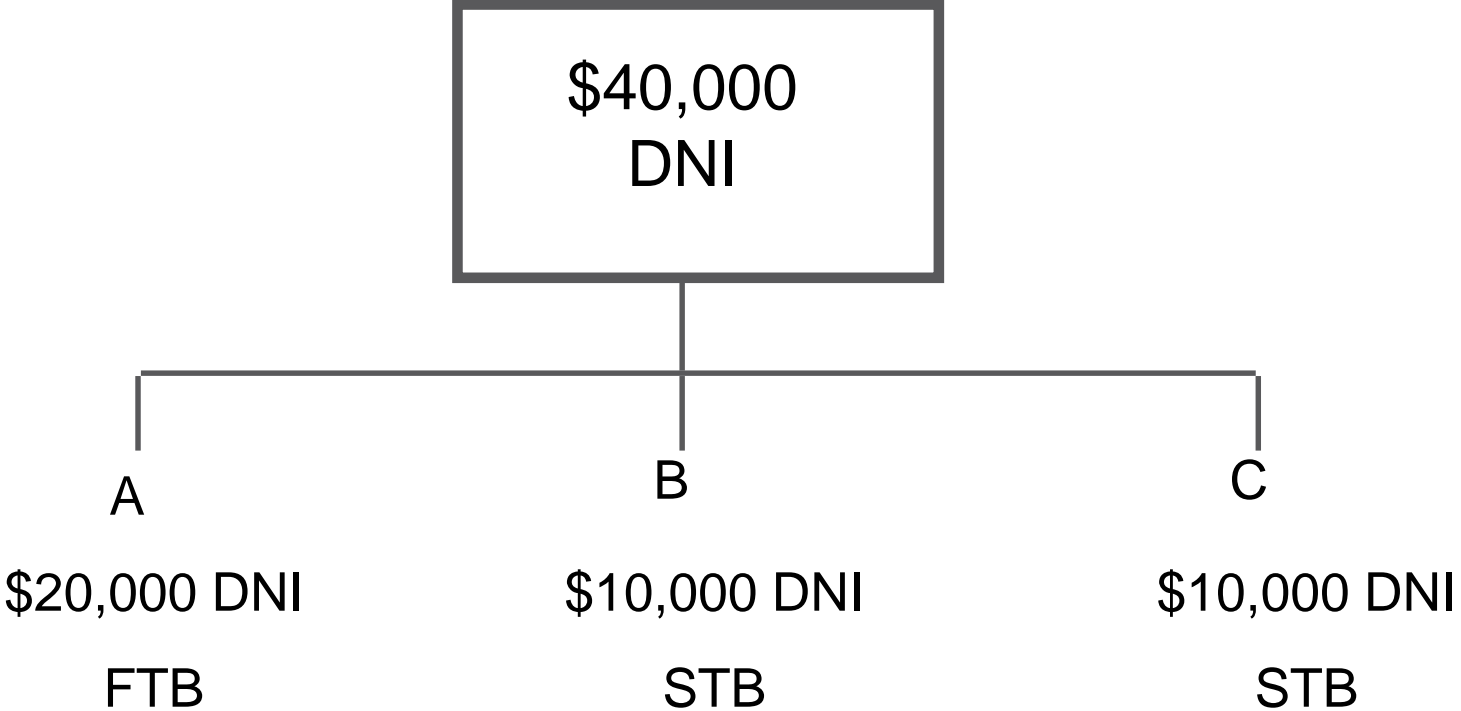
**Divided by 2 STB**

**\$10,000 DNI for Each STB**

# Complex Trust and Estates

## Tier System - Example

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# Complex Trusts – Tier System

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- A beneficiary may be both a first and second tier beneficiary.

# Complex Trusts – Tier System

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- **Example:** Under the terms of Trust X, A and B are each required to be paid 25 percent of net trust accounting income quarterly.
- The trustee has discretion to pay other amounts of income and principal to A, B and C.
- For the trust's taxable year, trust accounting income (TAI) is \$100,000, DNI is \$90,000, and, in addition to TAI required to be distributed to A and B, the trustee made discretionary payments of \$10,000 to A and \$90,000 to C.
- What income from Trust X should the beneficiaries include in gross income for the taxable year?
- The table below illustrates the allocation of DNI under the tier system.

# Complex Trusts – Tier System

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- Fifty percent of the TAI is required to be distributed currently to A and B. These are first-tier amounts, and A and B are first-tier beneficiaries. Thus, A and B are each allocated \$25,000 of DNI.
- Next, any remaining DNI—\$40,000 in the example (\$90,000 DNI less \$50,000 DNI allocated to the first tier beneficiaries)—is allocated to second-tier beneficiaries A, B and C. A received 10 percent of second-tier distributions (\$10,000/\$100,000) and is allocated \$4,000 of the remaining DNI (10% of \$40,000 remaining DNI). C received 90 percent of second-tier distributions (\$36,000/\$100,000), and \$36,000 of the remaining DNI (90% of \$40,000 remaining DNI) is allocated to him. B, also a potential second tier beneficiary, did not receive any discretionary distribution so none of the remaining \$40,000 of DNI is allocated to him.
- Note that A is both a first and second tier beneficiary.

# Complex Trusts – Tier System

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	<b>A</b>	<b>B</b>	<b>C</b>	<b>DNI</b>
<b>First Tier</b>	\$25,000	\$25,000	0	\$50,000
<b>Second Tier</b>	<u>\$4,000</u>	<u>0</u>	<u>\$36,000</u>	<u>\$40,000</u>
<b>Total</b>	\$29,000	\$25,000	\$36,000	\$90,000

# Complex Trusts – Tier System

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- Effect of the charitable deduction.
- If an estate or trust is entitled to a **charitable deduction**, special rules apply for determining the amount taxable to first tier beneficiaries and the character of such amounts.

# Complex Trusts – Tier System

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- The second sentence of § 662(a)(1) and the last two sentences of § 662(b) provide that if the amount of income required to be distributed exceeds DNI computed without the charitable deduction, then the first tier beneficiaries take into income a higher, modified, DNI.
- The DNI for first tier beneficiaries is modified by not taking the charitable deduction into consideration in computing DNI.
- Such modified DNI sets the ceiling for taxing first tier beneficiaries.
- As a result, first tier beneficiaries never receive any advantage from the charitable deduction.
- The language of § 662(a) requires that the income required to be distributed be considered as distributed first to the individual beneficiaries and then to charities.

# Complex Trusts – Tier System

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- **Example:** Trust has DNI and trust accounting income of \$50,000 and distributes the entire amount to A, who is required under the trust instrument to receive all income annually (i.e. A is a first tier beneficiary).
- Trust makes a \$40,000 charitable contribution.
- Although under the general rule charitable contributions reduce DNI, so that in this case the available DNI appears to be only \$10,000, under the second sentence of § 662(a)(1) the beneficiary is required to report the full \$50,000 in his gross income.
- What appears to be \$10,000 of DNI (\$50,000 less \$40,000 charitable deduction) is modified for purposes of first tier beneficiaries by adding the \$40,000 amount paid to charity to the DNI allocable to first tier beneficiaries. Note the result: first tier beneficiaries do not get the benefit of any charitable deduction.

# Complex Trusts – Tier System

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- **Example:** Facts are the same as above except that the mandatory income distribution to A is only \$20,000 and the trustee makes \$25,000 of discretionary distributions to other beneficiaries (second tier beneficiaries).
- All of the first tier distribution to A is taxable – the DNI allocated to the first tier beneficiary is not reduced by the charitable deduction.
- The DNI available for the second tier beneficiaries is zero - \$50,000 less (\$20,000 first tier distribution + \$40,000 charitable distribution).
- Thus, there is no DNI available for the second tier beneficiaries.
- The charitable deduction comes “off the top” for second tier beneficiaries but comes “off the bottom” for the first tier beneficiary. Thus, the charitable deduction reduces the amount available for second tier beneficiaries but not for first tier beneficiaries. The charitable deduction can be thought of as a tier 1 1/2.

# Ten Points to Keep in Mind Regarding the Operation of the Tier System

1. The tier system is applied in determining the tax effect of distributions on the beneficiaries of estates and trusts. It has no effect on the trust or estate itself.
2. The tier system affects only beneficiaries of estates and complex trusts. It has no application to beneficiaries of simple trusts. The entire tier system is found in I.R.C. § 662 which governs the amount included in the income of the beneficiaries of a complex trust or estate.
3. The purpose of the tier system is to adjust the tax effects of a distribution between a first tier beneficiary and a second tier beneficiary.
4. It follows that when all beneficiaries are in the same tier because payments of income are entirely mandatory or entirely discretionary, the tier system has no application.
5. A first tier beneficiary is one to whom an amount of income is required to be distributed currently.
6. A second tier beneficiary is one who (a) receives a distribution of income which is not required to be distributed currently i.e., a discretionary distribution of income, or, (b) receives either a mandatory or discretionary distribution of corpus. Most distributions by estates will almost always be second tier distributions, as it is rare for a will to require the distribution of income currently.

# Ten Points to Keep in Mind Regarding the Operation of the Tier System

7. A second tier beneficiary is the favored tier for tax purposes.
8. A first tier beneficiary receives equitable treatment with respect to a second tier beneficiary only where the separate share rule (discussed below) applies. The separate share rule insulates the first tier beneficiary from the income belonging to the second tier beneficiary.
9. Even where all the beneficiaries are in the second tier, one beneficiary may be favored taxwise over another beneficiary unless the separate share rule applies. This is due to the fact that unless the separate share rule applies, the general rule is that DNI is allocated pro rata based on distributions received by each beneficiary.
10. After 1997, the separate share rule also applies to estates.

# Complex Trusts – Separate Share Rule

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- What if one beneficiary has a portion or share of a trust in which no other beneficiary has right to receive a distribution from that share i.e., the beneficiary has a share that is separate from the interests of the other beneficiaries?
- This is where the separate share comes into play.
- The beneficiary is only taxed up to the DNI from his separate share.
- Thus, the DNI must be calculated separately for each share that constitutes a “separate share” and the beneficiary can only be taxed up to the amount of DNI earned in his separate share.
- The distribution deduction for each separate share are added together to determine the distribution deduction for the entire trust.

# Complex Trusts – Separate Share Rule

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- 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 the DNI of their “share” of the trust.
- 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

## Harkness v. United States, 469 F.2d 310 (Ct. Cl. 1972)

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- Decedent left half of the residue of his estate to his spouse.
- During 1955 tax year the executor distributed \$36 million to all the beneficiaries, the spouse receiving \$27 million (75%) of the total \$36 million in distributions.
- DNI for the tax year was \$1 million.
- Spouse said she should be taxed on only one-half of the total \$1 million of DNI (\$500,000) since she was only entitled to one-half of the residue.
- Court says spouse is taxed on her proportionate share of DNI (\$750,000).

# Complex Trusts – Separate Share Rule

## Harkness v. United States, 469 F.2d 310 (Ct. Cl. 1972)

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- Prior to 1997, the separate share rule did not apply to estates.
- If the separate share rule did apply, the spouse would be taxed only on the amount of DNI allocated to her share, not a proportionate amount of DNI based on distributions.
- This case illustrates the reason for the separate share rule.

# Complex Trusts – Separate Share Rule

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- The separate share rule will apply when (1) there are multiple beneficiaries of a trust, (2) distributions are made during the year and (3) the language of the trust indicates that each beneficiary has a **separate share** of the trust.

# Complex Trusts – Separate Share Rule

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- The separate share rule is set forth in § 663(c).
- It states as follows: “For the sole purpose of determining the amount of distributable net income in the application of sections 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts.”

# Complex Trusts – Separate Share Rule

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- The separate share rule allocates DNI among multiple beneficiaries based on DNI allocable to their “share” of the trust. § 663(c).
- Note that, like the tier system, the separate share rule only applies if there are more than one beneficiary.
- Assuming the tier system doesn’t apply, distributions to beneficiaries who don’t have separate shares are allocated DNI based on the distributions made to them over the total distributions made to all the beneficiaries in a particular year i.e. a proportionate share of DNI.
- The effect of the separate share rule is to limit the trust beneficiary’s potential tax liability to the amount of DNI attributable to his trust share.

# Complex Trusts – Separate Share Rule

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- In order for the separate share rule of § 663(c) to apply, it must appear that there are identifiable shares. For example, if the trustee can invade corpus for the benefit of A and no accounting is required to even things up, there really aren't separate shares.
- Example: A trust requires the trustee to distribute one-half of the income to A and one-half of the income to B. The trust also gives the trustee the authority to invade corpus for the benefit of either A or B as the trustee determines. There are no substantially separate and independent shares if the trustee has the power to invade corpus for the benefit of one beneficiary to the detriment of the other beneficiary. Thus, the separate share rule is not applicable and DNI would be allocated based on distributions i.e. a proportionate share of DNI.

# Complex Trusts – Separate Share Rule

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- Solely for purposes of computing DNI, substantially separate and independent shares of different beneficiaries of a trust (or estate) 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.
- The trust is taxed as one trust but each share is treated as a separate trust for purposes of computing the distribution deduction for each share and the inclusion of income for each share.
- Result: beneficiary is not taxed on more than his share of DNI.

# Complex Trusts – Separate Share Rule

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- Example – General Rule:
  - 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 ( $\$30,000 \text{ distribution} / \$40,000 \text{ total distribution} \times \$20,000 \text{ DNI}$ )
  - Under normal pro-rata rules, B would include \$5,000 of DNI ( $\$10,000 \text{ distribution} / \$40,000 \text{ total distribution} \times \$20,000 \text{ DNI}$ )
  - 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

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- How do you determine if separate shares exist?
- Separate shares are determined by the language of the governing instrument.
- If the trust states that the corpus is to be divided into separate shares for each beneficiary, separate shares will be deemed to exist and each share must calculate its share of DNI based on the income and expenses of each share.
- If the trust is a discretionary trust where the income and principal can be distributed to the beneficiaries in the trustee's discretion, separate shares do not exist and the DNI is allocated based on the distributions made to each beneficiary..

# Complex Trusts - Separate Share Rule

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- The separate share rule is designed to insure that the beneficiary of each identifiable, separate share of a single trust does not receive more than its pro-rata share of the trust's DNI.
- Each share computes its DNI as though it were a separate trust.
- Each share calculates DNI based on its portion of gross income that is includible in DNI and its portion of any applicable deductions and losses.
- The allocation of gross income is made according to the amount of income to which the separate share is entitled under the governing instrument and local law.
- The amount of gross income resulting from distributions to a beneficiary of a share is determined by the DNI allocated to that share.

# Complex Trusts - Separate Share Rule

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- The trust's distribution deduction is allocated per share, based on the respective distributions and DNI per share.
- Once the distribution deduction is computed per share, the distribution deductions are combined to determine the total distribution deduction for the trust.
- The trust then computes the taxable income for the entire trust for all the combined shares.
- The result is that each beneficiary is not taxed on more than the DNI earned by his share.

# Complex Trusts - Separate Share Rule

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- **Example:** A discretionary trust has \$20,000 of DNI.
- Trustee distributes \$30,000 to A and \$10,000 to B.
- Under the normal pro-rata distribution rules,
- A would include \$15,000 of DNI ( $\$30,000 \text{ distribution} / \$40,000 \text{ total distribution} \times \$20,000 \text{ DNI}$ ). Under normal pro-rata rules, B would include \$5,000 of DNI ( $\$10,000 \text{ distribution} / \$40,000 \text{ total distribution} \times \$20,000 \text{ DNI}$ ).

# Complex Trusts - Separate Share Rule

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- **Example (Cont.):** Now suppose the trust, instead of being a discretionary trust, says A and B have separate shares.
- Suppose the distributions are the same but that A's share of the trust earned \$2,000 of interest and \$6,000 of dividends for a total of \$8,000 of DNI.
- Although A received a \$30,000 distribution, he would be taxed on only \$8,000, the DNI earned by his share of the trust.

# Complex Trusts - Separate Share Rule

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- **Example (Cont.):** Suppose B's share of the trust earned \$4,000 of interest and \$8,000 of dividends for a total of \$12,000 of DNI.
- B received a distribution of \$10,000 and would be taxed on the entire \$10,000 distribution as that is less than the \$12,000 of DNI earned by his share of the trust.
- The remaining \$2,000 of B's DNI, since it was not distributed to B, would be taxed to the trust.

# Complex Trusts - Separate Share Rule

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- **Example (Cont.):** The trust is one trust consisting of two separate shares.
- The total DNI of the trust is \$20,000 - \$8,000 from A's share and \$12,000 from B's share.
- The trust receives a distribution deduction \$18,000 based on the \$8,000 of DNI allocable to A and the \$10,000 of DNI allocable to B.
- The income taxed to the trust is \$2,000 which is the amount of DNI from B's share that was not distributed to him.
- The income tax on the \$2,000 taxed to the trust should be allocated to B's share.

# Complex Trusts - Separate Share Rule

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- **Example (Cont.):** Note that trust is treated as having separate shares *solely* for purposes of allocating DNI between A and B. It does not mean that the trust must file two tax returns or that the trust is allowed two \$100 exemptions.

# Complex Trusts - Separate Share Rule

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- The separate share rule will not apply where a single trust is split into several separate trusts, as opposed to separate shares of the same trust. Reg. § 1.663(c)-1(a).
- Traditionally, the separate share rule applied only to trusts. Effective for decedents dying after August 5, 1997, the separate share rule now applies to estates as well.

# Complex Trusts - Separate Share Rule

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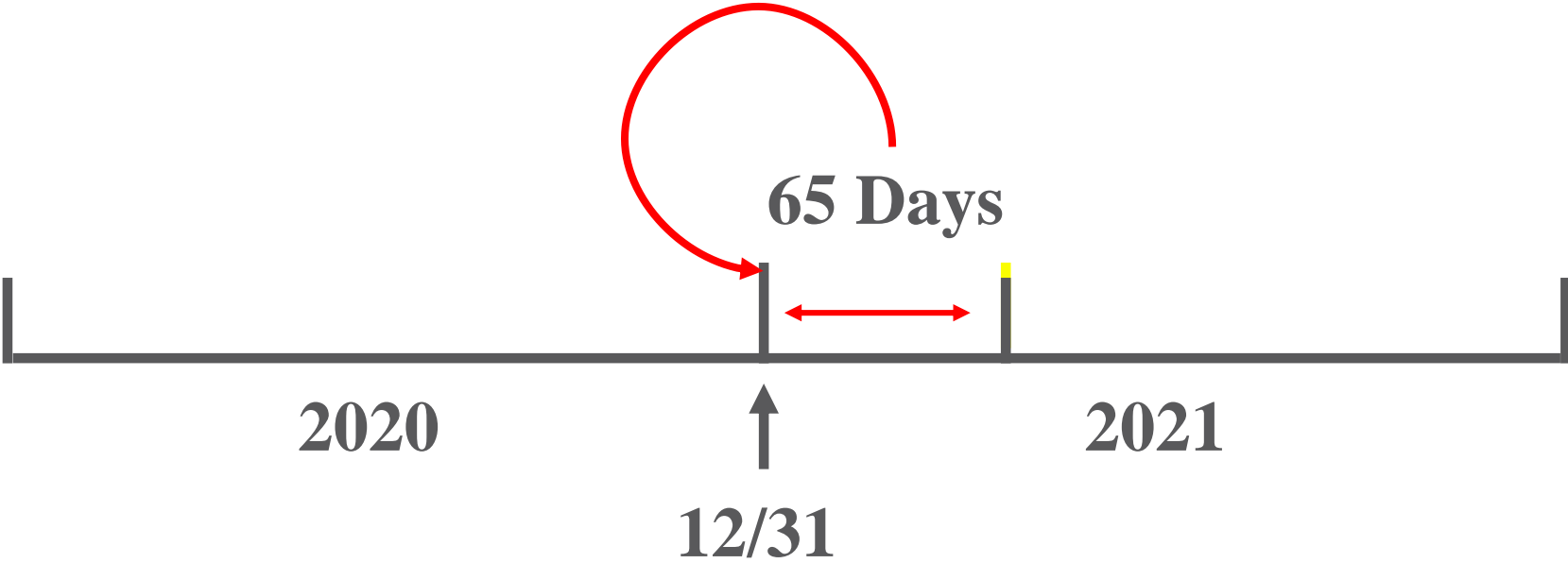
- Applies to estates (for decedents dying after August 5, 1997) and trusts
- DNI computed separately for each share
- Mandatory, not elective. Reg. 1.663(c)-1(d).
- Only affects share of DNI
  - Doesn't allow filing multiple returns
  - Doesn't allow separate calculation of tax
  - Doesn't allow multiple exemptions
  - Doesn't required separate accounts for each share. Reg. 1.663(c)-1(c).
- 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

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- Applies to complex trusts and estates
- Allows a fiduciary to treat distribution made within 65 days of the year-end as being made on December 31 of preceding year
- Election must be made by due date of return
- Election is irrevocable – check box on Form 1041, Page 3, “Other Information,” Line 6
- Year by year election (e.g. good for 1 year only)
- Limited to  $>$  DNI less current year distributions or TAI not distributed
- A late election (or revocation) is possible under Reg. 1.9100-1 if the trustee can demonstrate that it acted reasonably and acted promptly to request an extension once it discovered the error.

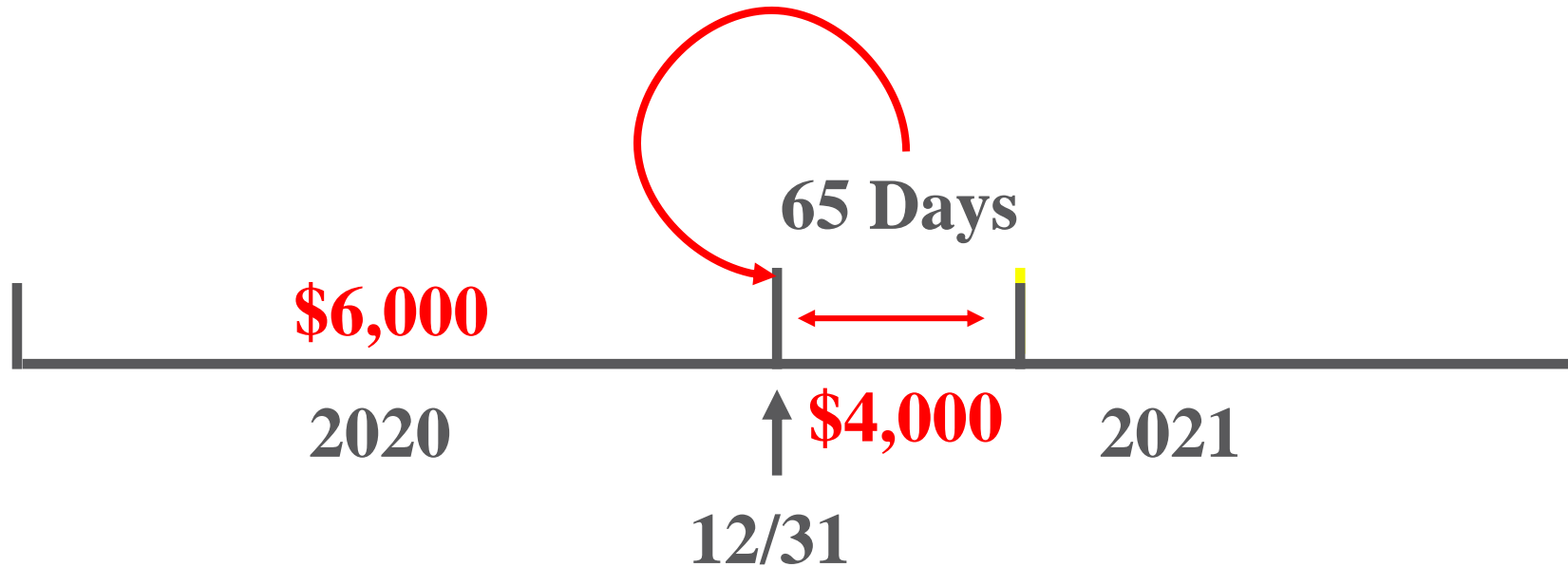
# 65 Day Rule aka Sec. 663(b) Election



# 65 Day Rule aka Sec. 663(b) Election

Facts: \$10,000 DNI for 2020

Distributes \$6,000 in 2020, \$4,000 in 2021



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

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- 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

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

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- §663(a)(1) is an exception to the §661 and §662 rules governing distributions from estates and complex trusts.
- If a distribution meets the requirements of §663(a)(1), the estate or trust is not entitled to a distribution deduction under §661 and the beneficiary is not required to include the distribution in income under §662.

# Section 643(e) Election – Distributions in Kind – Residuary Bequests

- Estate/Trust may elect, but is not required, to recognize G/L. §643(e)(3).
- Distribution carries out DNI, but amount of DNI depends on whether the Section 643(e) election was made
  - No Election: DNI carried out is lesser of basis or FMV of distributed property. §643(e)(2).
  - Election: DNI carried out is FMV of distributed property. §643(e)(3).
- Basis of property to beneficiary is basis of property to estate/trust plus or minus any gain or loss the estate/trust elects to recognize on the distribution. §643(e)(1).
- Holding period tacks if basis is same “in whole or in part” as transferor’s basis, otherwise, holding period starts anew. §1223(2).

# Section 643(e) Election – Distributions in Kind – Residuary Bequests

	No § 643(e)	§ 643(e)
Gain Recognized	No	Yes § 643(e)(3)(ii)
DNI Carried Out	<FMV or basis § 643(e)(2)	FMV § 643(e)(3)(iii)
Basis to Beneficiary	Basis +/- G or L § 643(e)(1) (carryover basis)	Basis +/- G or L § 643(e)(1) (FMV)
Beneficiary's Holding Period	HP Tacks § 1223(2)	HP Tacks § 1223(2)

# Section 643(e) Election – Distributions in Kind

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- **Example:** A trust has DNI of \$50,000.
- The trustee funds a residuary bequest by transferring stock with a fair market value of \$50,000 and a basis of \$20,000.
- The trustee **does not make a §643(e) election.**
- The distribution of stock carries out \$20,000 of DNI (the lower of the cost basis or fair market value of the stock). Since the trustee did not make a §643(e) election, the trust doesn't recognize any gain.
- The beneficiary takes a \$20,000 basis in the distributed stock (the trust's \$20,000 basis plus zero gain recognized by the trust).
- Since the beneficiary's basis is determined in whole or in part by reference to the trust's basis in the stock, the trust's holding period of the stock is tacked onto the beneficiary's holding period for purposes of determining if the gain is long-term or short-term.

# Section 643(e) Election – Distributions in Kind

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- **Example:** A trust has DNI of \$50,000.
- The trustee funds a residuary bequest by transferring stock with a fair market value of \$50,000 and a basis of \$20,000.
- The trustee **makes a §643(e) election.**
- The distribution of stock carries out \$50,000 of DNI (the fair market value of the stock). The §643(e) election causes the trust to recognize gain of \$30,000 (\$50,000 FMV less \$20,000 basis).
- The beneficiary takes a \$50,000 basis in the distributed stock (the trust's \$20,000 basis plus the \$30,000 of gain recognized by the trust).
- Since the beneficiary's basis is determined in whole or in part by reference to the trust's basis in the stock, the trust's holding period of the stock is tacked onto the beneficiary's holding period for purposes of determining if the gain is long-term or short-term.

# Section 643(e) Election – Distributions in Kind

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- Making the Election. A § 643(e) election is made by the estate or trust on its return for the taxable year for which the distribution was made. Check box on Form 1041, Page 3, “Other Information.” Line 7.
- The election is made by checking a box on the bottom of page 2 of the Form 1041.
- The election applies to all property distributions made during the year with the exception of § 663(a) property distributions. § 643(e)(3)(B), (e)(4). Thus, the estate or trust may not make a § 643(e) election in a particular year for some property distributions but not for others.
- Once made, the election may only be revoked with the consent of the Secretary of the Treasury. § 643(e)(3)(B), last sentence.
- The election is made on a year-by-year basis i.e. it can be made for property distributions in one year but not the next.
- The revocation of the § 643(e) election may be approved through a Reg. 301.9100 relief request. PLR 9641018.

# Including Capital Gains in DNI – The Problem

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- 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 37% + 3.8% surtax if taxable income exceeds \$13,050 (2021)
  - Long-term capital gains taxed at 20% + 3.8% surtax if taxable income exceeds \$13,250 (2021)
- Planning point – have gains taxed to beneficiary where gains would most likely be taxed at a lower tax rate

# Including Capital Gains in DNI – The Problem

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- Where a beneficiary is entitled to distributions of principal, the beneficiary is not taxed in the capital gain unless one of the specific exceptions under Reg. 1.643(a)-3 is satisfied
- For capital gains to be taxed to a beneficiary, the capital gain must be included in DNI
- Analysis:
  - May the fiduciary include capital gains in DNI and have them taxed to the beneficiary?
  - Should the fiduciary allocate capital gains to DNI?
- Overriding factor – trustee must consider his fiduciary duty to both the income beneficiary and the remainderman in making principal distributions
  - Uniform Trust Code imposed a “duty of impartiality” on the trustee

# Including Capital Gains in DNI

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- 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
    1. 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)

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- Reg. 1.643(a)-3(b) has specific requirements that must be met in order to have capital gains taxed to the beneficiary
- Regulations also has 14 examples – but they don't answer all our questions
- No pressing the “easy button”
- Regulations have:
  - Two prerequisites and
  - Three methods

# Analyzing Regulation 1.643(a)-3(b)

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- Two prerequisites – capital gains included in 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

# Analyzing Regulation 1.643(a)-3(b)

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- Method 1, requiring an allocation to income, is limited unless the trust instrument or state law allocates gains to income (unlikely), the state has a unitrust statute or the fiduciary has broad discretion to allocate capital gains to income.
- Method 2 requires the a consistent practice of allocating capital gains to DNI. This method may not be available if the trust is not in its first year of existence or if the fiduciary does want to be obligated to allocate capital gains to DNI in the future.
- Method 3 appears to be the most flexible

# Including Capital Gains in DNI

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- Bottom line
  - Best when appropriate discretion is expressly granted in the trust agreement
    - Attorneys should consider including such discretionary language in trust instruments going forward
  - Alternatively, local law may provide the discretionary powers
  - If not, consider:
    - Power to adjust
    - Decanting (if available)

# Conclusion

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- Background
- Definition of Distributable Net Income (DNI)
- Calculating DNI
- Types of Trusts – Simple and Complex
- Simple Trusts
- Complex Trusts
  - Tier System
  - Separate Share Rule
  - 65 Day Rule - §663(b) election
  - Specific Bequests - §663(a)(1)
  - Distributions in Kind - §643(e)
- Including Capital Gains in DNI

# Resources

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- Income Taxation of Estates and Trusts, Soled, Aker, Doyle, Siegel and Weisblatt, Carolina Academic Press (December, 2019)
- Federal Income Taxation of Estates, Trusts and Beneficiaries, 3<sup>rd</sup> 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 (2020 Edition) (Wolters Kluwer)
- Federal Income Taxation of Trusts and Estates, by Zaritsky and Lane, 3<sup>rd</sup> Edition (RIA/Thompson/West)
- Income Taxation of Fiduciaries and Beneficiaries by Byrle M. Abbin, 2 volumes, 2019 Edition (Wolters Kluwer)

Thank You!