Income Taxation of Nongrantor Trusts

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TABLE OF CONTENTS

I. Introduction...................................................................................................................... -2-
II. Fiduciary Accounting Income.......................................................................................... -6-
III. Reporting and Compliance. ............................................................................................. -8-
IV. Gross Income. .................................................................................................................. -9-
V. “Tentative” Taxable Income. ........................................................................................... -9-
VI. Concept of Distributable Net Income. ........................................................................... -12-
VII. “Tier” Rules. .................................................................................................................. -16-
VIII. Taxation of Trust Beneficiaries...................................................................................... -18-
IX. Example of Taxation of Simple Trust............................................................................ -19-
X. Hypothetical Complex Trust............................................................................................ -21-
XI. Hypothetical Complex Trust – Taxation of Beneficiaries............................................ -25-
I. Introduction. Nongrantor trusts are taxable entities, and fiduciaries must file income tax returns and issue Schedule K-1 to beneficiaries. Tax increases effective for the 2013 taxable year now impose a tax rate of 39.6 percent on undistributed trust income over $11,950. Taxable income of a trust is computed as for individuals, with several modifications. The Medicare tax of 3.8 percent on unearned income applies to trusts.
subject to Subchapter J of the Code. As is the case with individuals, nongrantor trusts are entitled to deduct expenses and are allowed a personal exemption. Nongrantor trusts may also deduct amounts distributed to beneficiaries, subject to an important proviso: The ceiling on the deduction is limited to “distributable net income” or DNI of the trust. The theme of fiduciary income taxation is to tax the beneficiary receiving the current benefit. To a significant degree, the trust instrument and local law may affect the determination of who is taxed. Trusts are subject to the AMT.

A. **Entity Must Constitute a Trust For Federal Income Tax Purposes.** The fiduciary income tax rules apply only to entities classified for federal income tax purposes as trusts. A trust is an arrangement to protect or conserve property for the benefit of beneficiaries. An entity nominally ascribed a trust may be subject to recharacterization as a corporation or partnership for federal income tax purposes if the entity carries on a business for profit.

B. **“Simple” Trusts.** Under Subchapter J, which governs fiduciary income tax, all nongrantor trusts are either “simple” trusts or “complex” trusts. The hallmarks of a simple trust are those which (i) require that all income be distributed at

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6 IRC §1411. The tax is 3.8 percent of the lesser of (i) undistributed net investment income or (ii) the excess (if any) of (a) AGI over (b) the dollar amount at which the highest tax bracket in IRC §1(e) begins for the tax year. Since the highest tax bracket for trusts (and estates) begins at $11,950, trusts are much more likely to be subject to the Medicare tax. In addition, since trusts may not operate as a business, most of the income of a trust will likely be subject to the Medicare tax. The confluence of these factors would make accumulation of trust income undesirable.

7 IRC §55(d)(1)(C). AMT DNI is calculated on income distributed to beneficiaries. The difference between regular DNI and AMT DNI will be a tax preference on the tax return of the beneficiary.

8 IRC §7701(a)(3)

9 Trusts which are deemed owned by the grantor are, for tax purposes, disregarded entities. Income from such trusts is taxed to the grantor. IRC §§671-679

10 This requirement is met if state law requires all income to be distributed.

11 Although defined by the trust instrument, a trust will not be considered a simple trust if the trust definition of income conflicts with that under local law. Thus, if the trust instrument provided that income included all capital gains, it is doubtful that such trust would be a simple trust for federal income tax purposes even if the trust required all income to be distributed annually.
least annually (whether or not income is actually\textsuperscript{12} distributed); (ii) makes no distributions of principal (whether or not the trust instrument permits it); and (iii) must not provide that any amounts are to be paid, permanently set aside, or used for charitable purposes\textsuperscript{13}. If the trust is a simple trust, all income will be carried out to beneficiaries and the trust will take a distribution deduction for that amount. The character of the amount distributed will be passed through to the beneficiary.\textsuperscript{14} The term “trust” when used in this Note refers to nongrantor, rather than to grantor\textsuperscript{15}, trusts.

C. “Complex” Trusts. All trusts that are not simple trusts are “complex” trusts. A complex trust is one in which either (i) all income is not required to be distributed annually or (ii) distributions of principal are made in the taxable year.\textsuperscript{16} By reason of the fact an otherwise simple trust might become a taxable trust if the trust provides for discretionary distributions of principal, and a principal distribution is in fact made in a particular year, it follows that the determination of whether a trust is complex or may change in a given taxable year, depending upon whether or not principal is distributed during that taxable year\textsuperscript{17}. Similarly, a trust may distribute all income yet not be a simple trust because the instrument does not require that all income be distributed. A trust requiring that all income be distributed may also not be a simple trust if it provides for a charity.

\textsuperscript{12} Despite the fact that a trust may require income to be distributed, this does not accomplish the fact. A trustee, for whatever reason, may not make a distribution of income although required to under the trust instrument.

\textsuperscript{13} IRC § 651(a)(2)

\textsuperscript{14} However, the trust may validly allocate items of income. Under Treas. Reg. §1.643(a)(3), capital gains may at times be distributed from the trust. Except in the final year of the trust, this had not previously been the case.

\textsuperscript{15} Grantor trusts are those trusts in which the grantor retains sufficient control such that for income tax purposes, the grantor is treated as the owner of the assets, and reports income of the trust on his own income tax return. The trust is, for nearly all income tax purposes, a disregarded entity, such as a single-member LLC.

\textsuperscript{16} IRC §651(a)

\textsuperscript{17} Trusts are taxable year taxpayers, with the exception of revocable grantor trusts that elect to be taxed as part of the estate under IRC § 645, in which case the trust would adopt the taxable year of the estate, which may not be a calendar year. If the trust and beneficiary have different taxable years, the beneficiary includes income in the taxable year that includes the last day of the taxable year of the estate or trust.
D. **Trust Distributions.** Distributions from both simple and complex trusts will be deductible to the trust and reduce DNI. Those distributions will be taxable to the beneficiary to the extent of the lesser of the amount distributed or DNI. Amounts distributed in excess of DNI will not be taxable to the beneficiary, but neither will the trust be permitted to take a deduction. Distributions made to multiple beneficiaries will be reported by beneficiaries according to the proportion of the total distribution that each beneficiary receives.

E. **Retention of Income by Trust.** Since simple trusts are required to distribute all income, only complex trusts may accumulate income. Prior to the relative parity between the tax rates imposed on trusts and individuals, accumulations of income were viewed as abusive, since trusts were taxed at lower rates. The “throwback” rules were enacted to stem this perceived abuse. Today, throwback no longer applies to domestic trusts, principally because nongrantor trusts are taxed at rates that actually exceed those imposed on individuals. However, throwback still applies to foreign trusts. Accumulated income becomes part of corpus, unless the trust instrument provides otherwise. Distributions in excess of current income are distributions of principal which are tax-free to the beneficiary.

1. **Illustration 1.** Trust requires all income to be distributed currently, and authorizes trustee to make distributions from corpus based upon the ascertainable “HEMS” standard. In 2014, income but no principal is distributed to beneficiary. The trust is a simple trust in 2014. If the trustee had determined that beneficiary should be paid $100 of corpus in 2014, the trust would be a complex trust in 2014.

2. **Illustration 2.** Trust A has $10,000 of gross income in 2014, and $2,000 of deductions (including the personal exemption). Trust A makes a distribution to beneficiary of $5,000. DNI of Trust A is $4,000. Trust A has taxable income of $4,000. The distribution deduction allowed Trust A

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18 IRC §§ 651(a); 661(a)(1)
19 IRC §§ 652(b),(c); 662(b),(c)
20 IRC § 102
21 HEMS is an acronym for the ascertainable standard referring to the “health, education, maintenance or support” of a beneficiary commonly employed in trust instruments.
is limited by DNI.\(^{22}\) Since $1,000 of the distribution has been made from corpus, that amount is distributed tax-free. The trust is a complex trust for the taxable year.

F. No “Tracing” of Origin of Distributions. Provided that no more than the total amount of “fiduciary accounting income” (defined below) is distributed, the trust may qualify as a simple trust. In reaching this limit, it is immaterial that items constituting trust corpus on the trust ledger are actually distributed. Thus, the distribution of $10,000 by a trust with fiduciary accounting income of $10,000 whose source is from corpus will nevertheless be treated as a distribution of fiduciary accounting income, since the required income distribution may be satisfied by a by a distribution of corpus.\(^{23}\)

G. Income and Principal Distinguished. Trust principal consists of assets of the trust which are being held for eventual distribution to the remainder beneficiaries. Income consists of the return in cash or property from the use of principal. Rental property would thus be considered trust principal, and the income it generates would be considered trust income. If sold, the proceeds would remain trust principal. Trust principal may be considered the “tree” and trust income the “fruit” of the tree.

1. Distinguish Accumulated Income. If income is accumulated and used to purchase other assets, those assets will remain income assets. For example, trustee accumulated $1,000 of income in 2014 and purchases a CD. Interest from the CD is income, but so is the CD itself. Thus, although the trust estate may contain other Certificates of Deposit that constitute corpus, this $1,000 CD would retain its character as an income asset, rather than a principal asset. Thus, a trustee under a HEMS standard to distribute income could properly distribute the $1,000 to income beneficiaries when the CD matures.

II. Fiduciary Accounting Income. The term “income,” when not modified by the words “taxable,” “distributable net,” “undistributed net,” or “gross” in Subchapter J means the

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\(^{22}\) So too, in this case, the amount which the beneficiary must include in income is also limited to $4,000, which is the amount of the deduction which is allowed the trust. The remaining $1,000 is nondeductible to the trust and not includible to the beneficiary. IRC §662(a)(2).

\(^{23}\) Notwithstanding the foregoing, if appreciated property is distributed in kind in satisfaction of the obligation of the trustee to distribute income – unless an exception applies – gain or loss will be realized on the distribution. Treas. Reg. §§ 1.651(a)-2(d) and 1.661(a)-2(f); Rev. Rul. 67-74.
amount of income determined under the trust instrument or local law.\textsuperscript{24} Thus, as used in Subchapter J, \textit{fiduciary accounting income} is not a tax term.\textsuperscript{25} The Code has some bearing on fiduciary accounting income, since unrealistic definitions of fiduciary accounting income will affect federal income tax. When that occurs, the Regulations may intercede.

A. \textbf{Fiduciary Accounting Income Distinguished From Gross Income.} Fiduciary accounting income includes some items that are not included in gross income and excludes other items that are included in gross income. For example, fiduciary accounting income includes tax-exempt interest, an item excluded from gross income, but excludes capital gains, an item included in gross income.

B. \textbf{Fiduciary Accounting Income Distinguished from Trust Principal.} In general, principal comprises capital gains and sales of property, casualty losses, stock dividends, and a portion of trustee commissions and investment fees. Fiduciary accounting income includes dividends, net rental income from real or personal property, interest, dividends, and a portion of trustee commissions and investment fees.

C. \textbf{Allocation of Trust Expenses.} In arriving at fiduciary accounting income, expenses\textsuperscript{26} attributable to income are allowed. Expenses of administration and trustee commissions are apportioned between income and principal in accordance with the trust instrument or if not, in accordance with local law.

D. \textbf{Reasonable Allocations Between Income and Principal Permitted.} In general, both the tax law and fiduciary principles require capital gains to be allocated to corpus, a result which “traps” capital gains in the trust.\textsuperscript{27} The fiduciary is permitted to make allocations between income (in the fiduciary accounting sense) and principal provided they reflect a “reasonable apportionment” of the total return of the trust for the year.\textsuperscript{28} Since the standard against which the

\textsuperscript{24} IRC §643(b)

\textsuperscript{25} Unless preceded by the term “taxable” or “distributable net.” IRC § 643(b)

\textsuperscript{26} Such expenses may include real estate taxes, income taxes, real property maintenance costs, and a portion of trustee commissions.

\textsuperscript{27} IRC §643(a)(3) requires capital gains to be included in DNI unless “paid, credited or required to be distributed to any beneficiary during the taxable year.”

\textsuperscript{28} Treas. Reg. §1.643(b)-1
determination of whether all income has been distributed refers to fiduciary accounting income, whether or not the trustee has distributed all taxable income of the trust or all distributable net income of the trust is immaterial. An allocation to principal will (generally\(^{29}\)) benefit remainder beneficiaries, while an allocation to income will benefit current income beneficiaries. Capital gain is included in DNI to the extent that it is actually allocated (i) to income\(^{30}\); (ii) to corpus, but is treated in a consistent manner by the fiduciary on its tax returns as having been distributed to the beneficiary\(^{31}\); or (iii) to corpus, but in practice serves as a measure of the amount distributed or required to be distributed to the beneficiary\(^{32}\).

1. **Allocation Must be “Reasonable” and “Impartial”**. Historically, most trusts have not permitted the allocation of capital gains to income since doing so would be unfair to remainder beneficiaries. It is thought to be prudent to permit allocating some capital gains to income beneficiaries to permit the trust to have a higher total return. The higher total return would benefit both income and remainder beneficiaries. Therefore, an allocation of capital gain to DNI will be respected provided (i) the allocation to fiduciary accounting income is made pursuant to a dictate under the governing instrument and local law; or (ii) the allocation is made pursuant to trustee discretion under local law or the governing instrument. However, if the allocation is pursuant to trustee discretion, that discretion must be exercised reasonably and impartially\(^{33}\) and must not be in conflict with local law\(^{34}\).

III. **Reporting and Compliance**. In general, and subject to an unlikely election by the trustee to report on the accrual method of accounting, most trusts will report on a cash basis. This will generally be beneficial, as it will result in a deferral of income, and will also permit the trustee to time distributions to make the most effective use of deductions, which could also prevent the loss by the trust of deductions. For taxable years after 1986,

\(^{29}\) However, a principal beneficiary may be a current beneficiary as well.

\(^{30}\) Treas. Reg. § 1.643(a)-3(b)(1)

\(^{31}\) Treas. Reg. § 1.643(a)-3(b)(2)

\(^{32}\) Treas. Reg. § 1.643(a)-3(b)(3)

\(^{33}\) Treas. Reg. § 1.643(a)-3(b)

\(^{34}\) *Id.*
trusts are required to report on a calendar year basis.\textsuperscript{35} Trusts are required to make estimated tax payments.\textsuperscript{36} IRC §643(g)(1)(A) authorizes the trustee to elect to treat any portion of an estimated tax payment as being made by a beneficiary. In general, trusts are subject to the alternative minimum tax (AMT).

IV. **Gross Income.** In calculating taxable income of a trust, gross income must first be determined. Gross income of a trust is calculated as it would be for an individual. The following items are excluded from gross income of a trust: (i) property acquired by the trust by gift; (ii) life insurance proceeds; (iii) tax-exempt interest.\textsuperscript{37}

V. **“Tentative” Taxable Income.** Tentative taxable income is necessary to compute distributable net income, a central concept in trust taxation. Distributable net income is in turn necessary to compute the distribution deduction. To arrive at tentative taxable income, the deductions from gross income may be taken. Those deductions track (with some minor variations\textsuperscript{38}) deductions available to individuals:

A. **Personal Exemption.** A trust that distributes all of its income currently is entitled to a $300 personal exemption. The personal exemption for all other trusts is limited to $100.\textsuperscript{39}

B. **Charitable Contributions.** Some important differences exist in the deductibility of charitable contributions when compared to individuals. First, a trust may take

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\textsuperscript{35} Estates and “qualified revocable trusts” that elect may report on a non-calendar year basis. IRC § 645(b). The rule requiring most trusts to report on a calendar-year basis emanated from a perceived abuse which permitted a taxpayer whose taxable year ended “within” the taxable year of the trust to gain an unseemly deferral. For example, if the taxable year of the trust ended on January 31, 2000, the taxable year of the beneficiary ending “within” the taxable year of the trust would be 2000. Therefore, the beneficiary would not report income until April of 2001. Yet the beneficiary might have received most of the trust income, for example, in February of 1999. This would permit enable the beneficiary to gain a deferral of two year on reporting trust income.

\textsuperscript{36} Estimated tax payments are made on Form 1041-ES

\textsuperscript{37} IRC §641(b)

\textsuperscript{38} For example, a trust does not itemize deductions.

\textsuperscript{39} IRC §§ 63, 642.
a full deduction\textsuperscript{40} for amounts contributed to a charity. However, the contribution must be “pursuant to the terms of the governing instrument.”\textsuperscript{41}

1. **Capital Gains Paid to Charities.** The trust may take a deduction for capital gains allocated to principal if distributed or permanently set aside for a charitable purpose under IRC §170(c).

C. **Section 212 Deductions.** Trusts are not businesses and may not take an IRC §162 business deduction. Rather, trusts (like individuals) may deduct expenses incurred in the production of income. Unlike IRC §162 deductions, IRC §212 losses cannot be carried forward, which means they will be lost if not utilized currently. This may partially explain the “ceiling” rule for DNI. Were this rule not in effect, if the distribution deduction exceeded DNI, the trust would permanently lose the benefit of the deduction, since loss carryover is not allowed.\textsuperscript{42} The “cost” of this rule is that income beneficiaries tend to benefit disproportionately, since any distribution in excess of the ceiling is tax-free.

D. **Depreciation and Depletion.** Depreciation is generally allocated between income beneficiaries and the trust based upon fiduciary accounting income, and is allocated to income beneficiaries on a pro rata basis.\textsuperscript{43}

E. **Expenses of Trust and Estate Administration.** IRC §67(a) provides that miscellaneous itemized deductions are allowed only to the extent that those deductions exceed 2 percent of AGI. IRC §67(e) provides that AGI of an estate or trust is computed like that of an individual, except that costs paid or incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in such estate or trust are allowable in arriving at AGI. Consequently, those costs are not subject to the two percent floor. Although the statutory language appears benign, the Supreme Court in

\textsuperscript{40} Individuals are limited under IRC §170

\textsuperscript{41} IRC §642(c)(1)

\textsuperscript{42} The IRC §172 loss carryover is not available to trusts.

\textsuperscript{43} Treas. Reg. §1.167(h)-1(b). The retention of receipts to fund a depreciation reserve will be considered a reduction in income, and will not cause an otherwise simple trust to become a complex trust. Treas. Regs. §1.643(b)-1.
Knight v. Com’r, 552 U.S. 181 (2008) held that fees customarily or generally incurred by an estate or trust are not uncommonly incurred by individual investors. Therefore such expenses are subject to the two percent floor. The Court acknowledged it was conceivable “that a trust may have an unusual investment objective, or may require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper.” Taking its cue from Knight, Treasury withdrew earlier proposed regulations, and advanced new proposed regulations. Under new proposed regulations, in order to avoid the two-percent floor, the trust or estate must show that (i) the investment advisory fee exceeds that normally charged to individual investors; and (ii) the excess is attributable to an unusual investment objective of the trust or estate. In offering limited relief, the IRS has stated that taxpayers will not be required to determine the portion of a “Bundled Fiduciary Fee” that is subject to the two-percent floor under Section 67 for taxable years beginning before the date that the regulations become final.

F. Expenses Attributable to Tax-Exempt Interest. Expenses attributable to tax-exempt income are disallowed. Therefore, if a trust has tax-exempt interest, a portion of trustee commissions would be disallowed in computing tentative taxable income.

G. Allocation of Expenses. The Regulations stipulate that expenses directly attributable to a specific class of income are allocated to that income. Expenses not capable of being allocated to a specific class of income may be allocated in the discretion of the fiduciary to one or more classes of income. However, indirect expenses must be allocated between taxable and tax-exempt income. Trustee commissions in general would be equally allocated to income and principal, since they appear not to be directly related to a specific class of income. Expenses incurred with respect to real estate activities, on the other hand, would constitute expenses that could be deducted from real estate income, as they appear to be directly related to real estate activity.

1. Typical Expenses Allocable to Principal. The following expenses would typically be allocated to principal:

a. Administrative expenses
b. Estate taxes
c. Capital gains and losses
d. Distributions of principal

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44 IRC §103
45 Treas. Reg. § 1.652(b)-3(a)
e. Principal portion of debts paid
f. Half of trustee fees

2. **Typical Expenses Allocated to Income.** The following expenses would typically be allocated to income:

a. Real estate tax
d. Income taxes
e. Depreciation

b. Expenses relating to rental real estate (ordinary repairs)
f. Salaries
c. Half of trustee fees

e. Principal portion of debts paid

VI. **Concept of Distributable Net Income.** For income tax purposes, trust are considered “modified” tax conduits, since some trust income is reported by beneficiaries, and some by the trust itself. Distributions to beneficiaries are in part taxable, and in part tax-free. Distributions may be tax-free to beneficiaries either because they derive from tax-exempt income, they constitute distributions of principal, or they constitute distributions of accumulated income, with respect to which the trust has already paid tax in a previous tax year. If income is taxable, then either the trust will pay tax or, if the income is distributed, the beneficiary will pay tax. In cases where the beneficiary is required to pay tax on the distribution, the trust will receive a corresponding distribution deduction. Conversely, if the distribution is tax-free to the beneficiary, the trust will be not be entitled to a distribution deduction. The tax concept utilized to determine what portion of a distribution is taxable to the beneficiary, and what portion constitutes a taxable distribution, is the distributable net income of the trust. Neither the distribution deduction to the trust, nor the income reportable by the beneficiaries in receiving a trust distribution, may exceed DNI.

A. **Calculation of Distributable Net Income.** (DNI) is determined by making several adjustments to tentative taxable income. DNI equals tentative taxable income increased by (i) the personal exemption\(^46\); (ii) tax-exempt interest\(^47\) and

\(^46\) Simple trusts are allowed a $300 personal exemption; complex trusts are allowed a $100 personal exemption. The personal exemption is added back to DNI because while it is a deduction, it is not an actual expense, so that it is available for distribution. The inclusion in DNI is also to prevent both the individual and the trust from benefitting from the personal exemption. IRC § 642(b)

\(^47\) The rationale for including tax-exempt interest in DNI is that although it is not includible in taxable income, it is nevertheless available for distribution. The inclusion in DNI of tax-exempt interest to which IRC §103 applies, is reduced by expenses allocable to the tax-exempt interest, and which would be deductible but for IRC §265.
decreased by (ii) net capital gains or losses (to the extent allocable to corpus)\(^48\) and (iii) extraordinary dividends\(^49\). DNI will determine both the amount of income reported by a beneficiary, as well as the character of that income. To the extent the beneficiary receives a distribution in excess of DNI, that amount will be nontaxable to the beneficiary and nondeductible by the trust.

B. Conduit Principle – Character of DNI Items. With respect to both simple and complex trusts, the character of income in the hands of the beneficiary is the same as in the hands of the trust.\(^50\) With respect to simple trusts, unless the trust instrument provides otherwise, all beneficiaries share in income, and in the tax items, on a pro rata basis. If the trust has tax-exempt and taxable income, the beneficiaries will report the taxable and tax-exempt income in proportion to their share of income. The trust instrument may validly alter this result by providing that one beneficiary share disproportionately in tax-exempt or taxable income. However, it is not enough that the trust instrument grants the trustee discretion in this regard\(^51\).

C. Beneficiaries Report Net Amounts of DNI. Thus, expenses allocable to separate items of DNI (with differing character) may produce multiple netted DNI items. Tax-exempt interest must be allocated a pro rata amount of expenses. Some expenses cannot be traced to individual DNI items. In those cases, the trustee may allocate expenses to DNI items taxed at higher rates.\(^52\) Notwithstanding the above, the actual source of payment is not traced. This means that the trustee may not cherry-pick items of income to be distributed to particular beneficiaries.

\(^48\) IRC § 642(c). Capital gains allocated to trust principal are excluded because they are not available for distribution. Capital losses allocated to trust principal are included in DNI because although they decrease taxable income, they do not decrease the amount available for distribution to beneficiaries. Despite the foregoing, capital gains may be included in DNI to the extent permitted by the trust instrument and local law, if the trustee reasonably and in the exercise of impartial discretion so determines. Treas. Reg. § 1.643(a)-3(b). In that case, those capital gains would be includible in DNI.

\(^49\) Which the trustee, acting in good faith, allocates to corpus by reason of the trust instrument and local law.

\(^50\) For simple trusts, this result is reached by IRC §652(b); for complex trusts, IRC §662(b).

\(^51\) Treas. Reg. §1.652(b)-2(b)(2)

\(^52\) IRC § 652(b); Treas. Reg. § 1.652(b)-3(b)
D. **Distribution Deduction.** The distribution deduction available to the trust is the lesser of (i) “Modified” DNI and (ii) the amount actually distributed or required to be distributed.53

1. **Modified DNI.** Modified DNI is DNI reduced by the tax-exempt portion of DNI.

E. **Distributions That Do Not Carry Out DNI.** Some distributions do not carry out DNI. This means that such distributions would be tax-free to beneficiaries and would not result in a deduction for the trust.

1. **Bequests of Sums of Money or Specific Property.** In the case of estates, certain specific bequests do not carry out DNI.54 To qualify for the exclusion from DNI, the specific bequest must (i) be in fewer than four installments; (ii) not be payable from income and (iii) must be “ascertainable” as of the inception of the trust or estate. This rule is significant, since post-death appreciation will not be taxed to a beneficiary receiving a bequest that qualifies under the rule. Rather, residuary beneficiaries – who are considered to take title to estate assets by operation of law at the death of the decedent – will be charged with reporting income attributable to post-death appreciation. Note however that if the specific bequest were of income producing assets, although the beneficiary would not be charged with income under Subchapter J by reason of DNI being carried out, the beneficiary would report income from post-death appreciation under the normal income tax rules.

2. **Tax Treatment.** Bequests falling within the exception will render the bequest nontaxable to the beneficiary and nondeductible to the trust or estate.

3. **“Ascertainable”**. To satisfy the requirement that the specific sum of money or other property be ascertainable, the regulations provide that the legacy of money or the bequest of specific property must be ascertainable under the terms of the Will or governing instrument at the time of the decedent’s death.55 It is the view of the IRS that formula bequest

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53 IRC §§ 651, 661
54 IRC § 663(a)(1)
55 Treas. Regs. § 1.663(a)-1(b)(1)
generally will not be ascertainable because they cannot be determined at the time of the decedent’s death.\(^{56}\)

4. **Distributions of Appreciated Property Under Obligation.** As noted, distributions of appreciated property in kind in satisfaction of the obligation of the trustee to distribute income will result in recognition of gain or loss to the trust or estate. DNI will be carried out to the extent of the fair market value of the property. Basis of the property will be adjusted to reflect gain or loss. Treas. Reg. §§ 1.651(a)-2(d) and 1.661(a)-2(f); Rev. Rul. 67-74.

5. **Distributions of Appreciated Property Where No Obligation.** If a trustee or executor distributed appreciated property but not in satisfaction of an obligation, DNI is carried out to the extent of the lesser of basis or the fair market value of the asset. Alternatively, the trustee or executor may elect to treat the distribution as if the distribution were made in satisfaction of an obligation, as described above, with the executor or trustee recognizing gain or loss, and basis being adjusted accordingly.\(^{57}\)

6. **Election to Treat Revocable Trust as Part of Estate.** The trustee of a “qualified” revocable trust may elect to treat the trust as part of the grantor’s estate for income tax purposes. The election will among other things grant the executor more flexibility in choosing the fiscal year of the trust, and provides some relief for trusts which hold S corporation stock. The election once made is irrevocable, and must be made on the first timely filed income tax return of the estate.\(^{58}\)

7. **65-Day Rule.** Since the beneficiary will be taxed on distributions required to be made, distributions made after the taxable year does not impair the fisc. Consequently, under the 65-day rule, the trustee (or executor) may elect to treat distributions made within the first 65 days of a taxable year as having been made on the last day of the previous year. DNI will be deemed to have been carried out on the last day of the

\(^{56}\) PLR 9218076 (Distributions pursuant to terms of settlement agreement carried out DNI because amounts not ascertainable under terms of trust instrument.)

\(^{57}\) IRC § 643(e)(3)

\(^{58}\) IRC § 645. The election commences on the date of the decedent’s death and ends two years after the decedent’s death if no Form 706 is required. If Form 706 is required, the election ends 6 months after the date of final determination of estate tax liability.
previous taxable year.\textsuperscript{59} The election is made on the tax return. However, the Regulations provide that the election may not be made if doing so would result in a tax-free distribution of corpus by reason of the DNI limitation\textsuperscript{60}.

VII. \textbf{“Tier” Rules}. The tier rules distinguish between amounts of income required to be distributed currently\textsuperscript{61} and other amounts properly paid\textsuperscript{62}, credited, or required to be distributed\textsuperscript{63}. The tiering rules are intended to ensure that mandatory income beneficiaries are taxed on distributions to the extent of DNI, and that beneficiaries who receive discretionary distributions are not taxed. First tier distributions are distributions of income as required by the trust. Second tier distributions are all other distributions. Distributions in excess of DNI are deemed to come from corpus. Under the general rule which requires proration, the result would not be in accord with the tier rules.

A. \textbf{Operation of Tier Rules Where First-Tier Distributions Exceed DNI}. Where first-tier distributions exceed DNI, each beneficiary reports a pro rata share of DNI. After DNI is exhausted, remaining distributions are tax-free. For example, if \(DNI = 10\), and 6 is distributed to each of A and B, then A and B would report \(5/10 \times 10\) of income. Since DNI is the ceiling on tax, A and B would receive 1 each tax-free.

B. \textbf{Operation of Tier Rules Where DNI Exceeds First Tier Distributions}. Where DNI exceeds first tier distributions, each beneficiary is taxed on their proportionate share of distributions. For example, if \(DNI = 10\), and 4 is distributed to each of A and B, then A and B would report \(4/10 \times 10\) of income. DNI is the ceiling, but not the floor, in determining taxation. Since A and B were distributed only 4, they are taxed on only that amount.

C. \textbf{Operation of Tier Rules Where DNI Exceeds all Distributions, but not First Tier Distributions}. DNI is allocated among Tier One beneficiaries in proportion to their respective fiduciary accounting income. Residual DNI is then allocated

\begin{itemize}
 \item \textsuperscript{59} IRC § 663(b)
 \item \textsuperscript{60} Nevertheless, there is no requirement that the beneficiary actually incur a tax. That is, the election may be made with respect to a distribution to the beneficiary of tax-exempt interest.
 \item \textsuperscript{61} “Tier One” distributions. IRC §661(a)(1)
 \item \textsuperscript{62} The term “properly paid” means a distribution to a beneficiary actually made pursuant to the trust instrument.
 \item \textsuperscript{63} “Tier Two” distributions. IRC §661(a)(2)
\end{itemize}
among Tier Two beneficiaries *pro rata*. Once DNI is exhausted, any remaining amounts distributed are deemed distributions of corpus, and are distributed tax-free to beneficiaries.\(^6^4\)

1. **Illustration 1.** Trust A provides that all income is to be distributed to beneficiary 1 and that the trustee may make discretionary distributions to beneficiary 2. In a year in which trust has fiduciary accounting income and DNI of $100,000, trustee distributes $100,000 to beneficiary 1 and $10,000 to beneficiary 2. Under the tier rules, beneficiary 1 is allocated all of the DNI and beneficiary 2 is allocated none. Beneficiary 1 is taxed on $100,000 and beneficiary 2 receives the $10,000 as a tax-free distribution of corpus.

2. **Illustration 2.** Trust A provides that all income is to be distributed equally to A and B. Trustee may makes discretionary distributions of principal to both A and B. In 2014, Trust A has $50,000 of fiduciary accounting income and $25,000 of distributable net income. Trustee makes a discretionary distribution of $25,000 to B. Accordingly, A receives a distribution of $25,000 (half of fiduciary accounting income) and B receives a distribution of $50,000 (half of fiduciary accounting income plus $25,000 discretionary distribution from corpus).

3. **Result In Absence of Tiering Rule.** A has received $25,000, and B has received $50,000. Without tiering, since A has received 1/3 of what B has received, A would be taxed on 1/3 of DNI, or $8,333.33, and B would be taxed on $16,666.67, or 2/3 of DNI.

4. **Result Under Tiering Rules.** Under the tiering rules, since A and B are share entitlement to fiduciary accounting income, they also share in the tax imposed on that income. Each of A and B would therefore pay tax on $12,500 of DNI. B would take the $25,000 discretionary distribution tax-free, since it is a “tier 2” distribution coming from corpus.

5. **Source of Distribution Immaterial.** The result is static whether or not the amount received by B actually derives from corpus or income on the trust ledger. There is no requirement that the discretionary distribution to B actually come from assets designated on the trust ledger as “corpus.” So too, the distribution to A could come from the proceeds of the sale of capital assets. Even a distribution in kind may carry out DNI.

\(^{6^4}\) IRC §102(a)
6. **Result if No Tier One Distributions.** If there are no tier-one distributions, DNI is carried out to second-tier beneficiaries in proportion to the amount properly paid, credited, or required to be distributed to the beneficiary compared to that amount required to be distributed to all beneficiaries.

7. **Charitable Distributions.** Charitable distributions of income follow first tier distributions, but precede second tier distributions. Thus, DNI would be first carried out to first tier beneficiaries, then to charities, and only then to second tier beneficiaries (if any DNI remains).65

8. **DNI Exceeds Fiduciary Accounting Income.** If DNI remains after satisfying all first tier distributions, DNI would be allocated pro rata among second tier beneficiaries. After DNI is fully absorbed (carried out to beneficiaries), the remaining second tier distribution would constitute a tax-free distribution of corpus, or would be accumulated within the trust.66

9. **Undistributed Net Income (“UNI”).** For domestic trusts, until 1998, undistributed net income of a trust could create tax problems when later distributed.67

**VIII. Taxation of Trust Beneficiaries.** Trust beneficiaries must report all income distributed (or required to be distributed) to them.68 As is the case with S corporations and partnerships, the trust is a “conduit” for purposes of determining the character of income. Items of income retain their character when distributed.69 However, unlike single-member LLCs and grantor trusts, nongrantor trusts are not disregarded entities for income tax purposes. The determination of whether a trust is a grantor or nongrantor

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65 IRC § 662(a)(2), parenthetical language.

66 IRC § 662(a)(1); Treas. Regs. § 1.662(a)-2(b)

67 To the extent DNI was not currently distributed to beneficiaries, UNI arose. If this UNI was later distributed in an “accumulation distribution,” special rules (“throwback rules”) applied, and required a complex calculation whose objective was to impose currently that amount of tax (plus interest) on the current distribution, such that the taxpayer received no benefit from the deferral. Recognizing that marginal income tax rates for trusts were actually higher than that of individuals – and that in most cases no benefit would accrue by accumulating trust income – Congress in 1998 eliminated the throwback rules for all trusts except foreign trusts or domestic trusts that were once foreign trusts.

68 IRC §§ 652(a), 662(a)

69 Exception for throwback.
trust is consequently a crucial determination. It is entirely conceivable that a trust could be a grantor trust in one taxable year and a nongrantor trust in another taxable year.

A. Basis Rules. The beneficiary generally takes a substituted basis in distributed property, and tacks the holding period of the trust. However, the trustee may elect to recognize gains or losses on the distribution of appreciated property. This may be prudent if the trust has losses which can offset gains. If this election is made, the beneficiary will take a fair market value basis in the distributed property, and a new holding period will commence.

B. Termination of Trust. Upon termination, a trust must distribute all income and principal to beneficiaries. By definition, all trusts will be complex trusts in the year of trust termination. Any operating losses which the trust has in the year of termination will pass through to the beneficiaries, who may deduct such losses as itemized deductions. Capital loss carryovers may also be utilized by trust beneficiaries in the final year of the trust.

C. Separate Share Rule. Under the separate share rule, a trust may be divided for tax purposes into separate trusts (or estates) where the trust provides for separate shares, or where the trust or local law require separate shares by reason of the distributions or other provisions of the trust appearing to require that result. If the separate share rule applies, the trust will be treated for tax purposes as separate trusts for purposes of carrying out distributable net income. For the separate share rule to apply, the division of the trust into multiple shares must not affect the rights of other beneficiaries. The separate share rule does not increase the number of personal exemptions available to the trust.

IX. Example of Taxation of Simple Trust. Assume that in 2014 Trust has the following income items: (i) dividends of $10,000; (ii) capital gain of $10,000. Trust pays trustee commissions of $5,000, half of which is allocable to income and half to corpus. Trust is required to distribute all income to A and may invade principal for A under a HEMS standard.

1. Determination of Gross Income. The trust has **gross income of $20,000**.
2. Determination of Tentative Taxable Income. The trust **has tentative taxable income of $14,700**. [$20,000 - ($5,000 + 300)]

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70 The regulations provide that separate shares exist if beneficiaries possess identifiable economic interests that are not affected by “economic interests accruing to another beneficiary or class of beneficiaries.” Treas. Reg. §1.663(c)-4(a)

71 Personal exemption pursuant to IRC §642(b)
3. **Determination of Fiduciary Accounting Income.** Fiduciary accounting income is $7,500. [$10,000 of dividends less trustee commission allocable to income of $2,500].

4. **Distribution Deduction.** The distribution deduction is the lesser of (1) DNI or (2) the amount required to be distributed.

5. **Distributable Net Income.** DNI = Tentative Taxable Income ($14,700) augmented by the personal deduction ($300) and reduced by capital gain ($10,000). DNI = $5,000. [($14,700 + $300) - $10,000].

6. **Amount Required to be Distributed.** The trust must distribute $7,500 to A. [$10,000 of dividends less $2,500 of commissions allocable to income].

7. The distribution deduction is $5,000.

8. **Determination of Taxable Income of Trust.** Taxable income of trust is $9,700. [$14,700 - $5,000].

9. **Determination of Taxable Income of Beneficiary.** Taxable Income of Beneficiary A is $5,000. [Lesser of DNI of $5,000 and amount required to be distributed of $7,500].
X. Hypothetical Complex Trust. Trust is governed by the New York Uniform Principal and Income Act. Trust provides that half of trust income is to be distributed equally to A and B. Trustee commissions are allocated half to principal and half to income. There is no reserve for depreciation. Discretionary distributions of principal based on a HEMS standard are allowed to A, B and C. In 2014, excluding income from the trust, A has $300,000 in taxable income and B has no taxable income. In 2014, trustee distributes half of trust income to B, but no trust income to A. On January 10, 2015, trustee makes discretionary distributions of principal of $20,000 each to B and C. Assume for purposes of IRC §67(e) that all expenses of administration, including trustee fees, would not have been incurred if the property were not held in the trust. Trust is a calendar year taxpayer. For the taxable year 2014, the trust has the following receipts and disbursements:

A. Trust Receipts & Disbursements For 2014:

Rental Income $20,000
Dividends $20,000
Interest $20,000
Tax-Exempt Interest $20,000
Capital Gain (LT) $20,000
Trustee Commission ($10,000)
Rental Expense ($10,000)

B. Task: Calculate fiduciary accounting income (FAI), tentative taxable income (TTI), distributable net income (DNI), IRC §661 deduction (“modified” DNI), trust taxable income, taxable income to A, B, and C, and the character of income to those beneficiaries. Trustee wishes to allocate some of the capital gain to income. Determine whether the trustee may do so. Determine also whether A has a cause of action against trustee for breach of fiduciary obligation with respect to the failure to distribute income to A.
C. **Determination of Fiduciary Accounting Income (FAI):**  
   IRC §643(b)

   - **Rental Income**: $20,000
   - **Dividends**: $20,000
   - **Interest**: $20,000
   - **Tax-Exempt Interest**: $20,000
   - **Trustee Commission**: ($5,000)
   - **Rental Expense**: ($10,000)
   
   **FAI**: $65,000

   **Excluded from Fiduciary Accounting Income:**
   - **Capital Gains**: $20,000
   - **Trustee Commissions**: $5,000

D. **Determination of Gross Income:**  
   IRC §61(a)

   - **Rental Income**: $20,000
   - **Dividends**: $20,000
   - **Capital Gain (LT)**: $20,000
   - **Interest**: $20,000
   - **Gross Income**: $80,000

   **Excluded from Gross Income:**
   - **Tax-Exempt Interest**: ($20,000)
   - **Trustee Commissions**: ($10,000)
   - **Rental Expense**: ($10,000)
E. Determination of Tentative Taxable Income:

1. Tentative Taxable Income = Taxable Income - Distribution Deduction
2. Taxable Income = Gross Income - Allowable Deductions

<table>
<thead>
<tr>
<th>Gross Income:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental Income</td>
<td>$20,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>$20,000</td>
</tr>
<tr>
<td>Capital Gain (LT)</td>
<td>$20,000</td>
</tr>
<tr>
<td>Interest</td>
<td>$20,000</td>
</tr>
<tr>
<td>Gross Income</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Allowable Deductions:</th>
<th>Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental Expense</td>
<td>($10,000) IPC §212</td>
</tr>
<tr>
<td>Personal Exemption</td>
<td>($100) IRC §§ 63, 642</td>
</tr>
<tr>
<td>Depreciation</td>
<td>($5,000) IRC §167, Trust, Local Law</td>
</tr>
<tr>
<td>Trustee Commission72</td>
<td>($7,500) IRC §§212, 652, Regs. §1.652(b)-3(b)</td>
</tr>
<tr>
<td>Total Deductions</td>
<td>($22,600) Trust, Local Law</td>
</tr>
<tr>
<td>Gross Income</td>
<td>$80,000</td>
</tr>
<tr>
<td>Allowable Deductions73</td>
<td>($22,600)</td>
</tr>
<tr>
<td>Tentative Taxable Income</td>
<td>$57,400</td>
</tr>
</tbody>
</table>

72 Allocation of Trustee Fees to Tax-Exempt Interest: Trustee Commissions under IRC §212 must be reduced by those fees forfeited under IRC §265. The fraction of fees lost equals the fraction whose numerator is the amount of tax-exempt interest, and whose denominator is the amount of gross fiduciary accounting income.

73 Not including distribution deduction.
F. Determination of Distributable Net Income:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
<th>Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tentative Taxable Income</td>
<td>$57,400</td>
<td>§643(a)(1)</td>
</tr>
<tr>
<td>Personal Exemption</td>
<td>$100</td>
<td>§643(a)(2)</td>
</tr>
<tr>
<td>Capital Gains</td>
<td>($20,000)</td>
<td>§643(a)(3)</td>
</tr>
<tr>
<td>Tax-Exempt Interest</td>
<td>$20,000</td>
<td>§643(a)(5)</td>
</tr>
<tr>
<td>Tax-Exempt Interest (reduction)</td>
<td>($2,500)</td>
<td>§643(a)(5)</td>
</tr>
<tr>
<td>Distributable Net Income</td>
<td>$55,000</td>
<td></td>
</tr>
</tbody>
</table>

G. Determination of Amount Required to be Distributed:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC §661(a)(1) [FAI Required to be Distributed]</td>
<td>$32,500</td>
</tr>
<tr>
<td>IRC §661(a)(2) [other amounts distributed or reqd to be distributed]</td>
<td>$40,000</td>
</tr>
<tr>
<td>Total IRC §§ 661(a)(1) &amp; 661(a)(2) distributions</td>
<td>$72,500</td>
</tr>
<tr>
<td>Amount Required to be Distributed</td>
<td>$72,500</td>
</tr>
</tbody>
</table>

H. Modification of DNI for Amounts Not Considered in Determining Gross Income

Tax-Exempt Interest Not Included in Determining Gross Income:

\[
55,000 \times \frac{17,500}{55,000} = \frac{17,500}{1} \quad \text{Distributable Net Income} \quad \frac{55,000}{1} \quad \text{IRC §661(c): Limitation relating to tax-exempt income} \quad (17,500) \quad \text{IRC §661: Modified Distributable Net Income} \quad 37,500
\]

74 Trust requires only half of current income to be distributed.
75 Discretionary distributions made by trustee in accordance with HEMS standard.
76 IRC §661(b): Items of DNI Not Included in Determining Gross Income of Trust
77 IRC §661(c)
78 Since total IRC §§661(a)(1) & 661(a)(2) distributions exceed DNI, distribution deduction is limited to DNI.
I. IRC §661 Distribution Deduction

Distribution Deduction = Lesser of (i) Modified DNI or (ii) Amount Required to be Distributed

Amount Required to be Distributed = $32,500\textsuperscript{79} (income) + $40,000\textsuperscript{80} (corpus) = $72,500

Distribution Deduction = Lesser of (i) $37,500 or (ii) $72,500

Distribution Deduction = $37,500

J. Taxable Income of Trust

<table>
<thead>
<tr>
<th>Authority</th>
<th>Tentative Taxable Income</th>
<th>Distribution Deduction</th>
<th>Taxable Income of Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRC §§ 61(a), 212</td>
<td>$57,400</td>
<td>($37,500)</td>
<td>$19,900</td>
</tr>
</tbody>
</table>

K. Character of Trust Income. Since capital gain was excluded from DNI, the trust would be taxable on long term capital gain. The 3.8 percent Medicare tax would also apply.

XI. Hypothetical Complex Trust – Taxation of Beneficiaries

A. Required First-Tier Distributions:

| IRC §662(a)(1) Required Distribution to A\textsuperscript{81} | $16,250 |
| IRC §662(a)(1) Required Distribution to B | $16,250 |
| Total IRC §662(a)(1) Distributions | $32,500 |

B. First Tier Distributions to A and B: IRC §662(a)(1)

1. DNI | $55,000
2. DNI Carried out to A | ($16,250)
3. DNI Carried out to B | ($16,250)
4. Total DNI Carried Out to A and B | ($32,500)
5. Residual DNI | $22,500

---

\textsuperscript{79} One-half of fiduciary accounting income

\textsuperscript{80} Principal distributions

\textsuperscript{81} A is taxed on the required distribution even though trustee made no distribution.
C. Character of Distributions to A and B on First-Tier Distributions:

1. Dividends $32,500 x ($20,000/$55,000) $11,818.18
2. Taxable Interest $32,500 x ($12,500/$55,000) $7,386.86
3. Tax-Exempt Interest $32,500 x ($17,500/$55,000) $10,340.91
4. Rental Income 32,500 x ($5,000/$55,000) $2,954.54

Total $32,500

D. Tax Rate Imposed on A and B

1. Dividends: Capital Gains; Medicare Surtax
2. Taxable Interest: Ordinary Income; Medicare Surtax
3. Tax-Exempt Interest: -0-
4. Rental Income: Ordinary Income; Medicare Surtax

E. Second Tier Distributions: IRC §662(a)(2)

1. Residual DNI $22,500
2. Residual DNI to A $11,250
3. Residual DNI to C $11,250
4. Taxable distribution to A $11,250
5. Taxable distribution to C $11,250
6. Tax-free distribution to A $8,750
7. Tax-free distribution to C $8,750

F. Character of Distributions to B and C on Second-Tier Distributions

1. Dividends $22,500 x ($20,000/$55,000) $8,181.82
2. Taxable Interest $22,500 x ($12,500/$55,000) $5,113.64
3. Tax-Exempt Interest $22,500 x ($17,500/$55,000) $7,159.09
4. Rental Income $22,500 x ($5,000/$55,000) $2,045.45
5. Total $ 22,500

G. Tax Rate Imposed on B and C:

1. Dividends: Capital Gains; Medicare Surtax
2. Taxable Interest: Ordinary Income; Medicare Surtax
3. Tax-Exempt Interest: -0-
4. Rental Income: Ordinary Income; Medicare Surtax

H. May Trustee Allocate Capital Gains Income to A? If the trust instrument grants the trustee broad discretion to allocate to income in order to increase the total return of the trust, it appears that an allocation to income is reasonable, it will be respected for federal income tax purposes. However, unless the trust expressly directs the trustee to
allocate capital gain income to B, the trustee will be required to distribute income equally to both A and B.

I. **Legal Exposure of Trustee to Beneficiary A:** Trust requires Trustee to distribute half of income annually to A and to B. The discretion of Trustee is limited to distributions of principal. The failure of trustee to make required distribution will result in Beneficiary A receiving “phantom” income. On these facts, trustee appears to have breached its fiduciary obligation to A. Had the trust been a sprinkling trust, still requiring all income to be distributed, but granting the trustee discretion to determine which beneficiaries should receive that income, then A would have no recourse. Trustee may allocate capital gains to income only if the trust instrument so provides, and will be respected by the IRS if the allocation is reasonable.

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82 Treas. Regs. § 1.651(a)-2(a)
XII. Deprecation Allowances to Trust and to Beneficiaries

A. Total Depreciation $10,000
B. Depreciation Allowed to Trust $5,000
C. Depreciation Allowed to A $2,500
D. Depreciation Allowed to B $2,500