By David L. Silverman, Esq.*
Lake Success, New York

Income Taxation of Nongrantor Trusts: An Overview

I. Introduction

Nongrantor trusts are taxable entities which must file income tax returns and issue Schedule K-1 to beneficiaries. For the taxable year 2023, a tax rate of 37 percent is imposed on undistributed trust income over $14,450. Nongrantor trusts arise where the grantor has parted with sufficient dominion and control such that the federal income tax no longer applies to the grantor, but rather to the trust. Taxable income of a trust is computed much like that for individuals, with several modifications. The Medicare or Net Investment Income Tax (NIIT), a 3.8 percent surtax on unearned income, applies to nongrantor trusts subject to Subchapter J. 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 $14,450, and since trusts may not operate as a business, most undistributed trust income could be subject to the tax at 40.8 percent. This makes accumulation of trust income undesirable. As is true with individuals, nongrantor trusts are entitled to deduct expenses and are allowed a personal exemption. They may also deduct amounts distributed to beneficiaries, subject to an important proviso: The ceiling on the deduction is limited to the distributable net income (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. For tax years beginning in 2022, trusts and estates are entitled to a $26,500 exemption in determining the amount of income to which the AMT applies. IRC § 55(d)(1)(D); Rev. Proc. 2021-45. For individuals, estates and trusts, a graduated two-tier AMT rate schedule applies. The fiduciary income tax rules apply only to entities classified as trusts for federal income tax purposes. A trust is an arrangement to protect or conserve property for the benefit of beneficiaries. An entity nominally ascribed trust status may be recharacterized as a corporation or partnership for federal income tax purposes if the entity carries on a business for profit. IRC § 7701(a)(3).

<u>Simple Versus Complex Trusts</u>

Under Subchapter J, all nongrantor trusts are either "simple" or "complex" trusts. A simple trust is one which (i) requires all income to be distributed at least annually (whether or not income is actually distributed); (ii) makes no distributions of

* David L. Silverman graduated from Columbia Law School and received an LL.M. in Taxation from NYU School of Law. He was formerly associated with Pryor Cashman, LLP, and is a former editor of the ABA Taxation Section Newsletter. Mr. Silverman's practice encompasses all areas of federal and New York State taxation, including tax and estate planning, federal and NYS tax litigation and appellate advocacy, criminal tax, probate and estate administration, wills and trusts, will contests, trust accounting, like kind exchanges, asset protection, real estate transactions, and family business succession. David is the author of *Like Kind Exchanges of Real Estate Under IRC §1031* (2008), now in its third edition, and many other tax publications. He writes and lectures frequently to tax professionals in his areas of practice. His office also publishes *Tax News & Comment*, a federal tax quarterly. He has been licensed by the State of New York Department of Education, State Board for Public Accountancy to provide Continuing Education Credits to Certified Public Accountants, since 2007. In that capacity, David has lectured extensively in many areas of involving income and fiduciary taxation, tax litigation, and trusts and estates. His articles, treatises and publications may be viewed at www.nytaxattorney.com. David may be contacted at (516) 466-5900 or by email at dsilverman@nytaxattorney.com.

principal (whether or not the trust instrument permits); and (iii) must not provide that any amounts are to be paid, permanently set aside, or used for charitable purposes. IRC § 651(a)(2). 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. Simple trusts are allowed a $300 personal deduction. IRC § 642(b). Although defined by the trust instrument, a trust will not be considered a simpletrust if the trust definition of income conflicts with that under local law. Thus, if the trust instrument provides that income includes all capital gains, it is doubtful that such trust would qualify as a simple trust for federal income tax purposes even if the trust required all income to be distributed annually. Also, despite the fact that a trust may require income to be distributed, a trustee, for whatever reason, may not make a distribution of income. This would also cause the trust not to be a simple trust in that tax year.

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. A simple trust might become a taxable trust if the trust in a given taxable year provides for discretionary distributions of principal, and a principal distribution is made in a particular year. Similarly, a trust may in fact distribute all income yet not be a simple trust because the instrument does not require it. Complex trusts are allowed a personal exemption of $100. IRC § 642(b).

II. Distributable Net Income (DNI)

For income tax purposes, trusts 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 (i) they derive from tax exempt income, (ii) they constitute distributions of principal, or (iii) 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 or beneficiary will pay tax. If the beneficiary is required to pay tax on a distribution, the trust will receive a corresponding distribution deduction. If the distribution is tax free to the beneficiary, the trust will be not receive a deduction. The tax concept utilized to determine that portion of a distribution which is taxable to the beneficiary and deductible to the trust is the distributable net income (DNI) of the trust. Neither the distribution deduction to the trust, nor the income reportable by the beneficiary receiving a distribution, may exceed DNI.

Gross income of a trust is generally calculated as it would be for an individual. The following items are therefore excluded from gross income of a trust: (i) property acquired by gift; (ii) life insurance proceeds; and (iii) tax-exempt interest. DNI is determined by making several adjustments to "tentative" taxable income. To arrive at tentative taxable income, deductions from gross income are taken. Those deductions track (with some minor variations) deductions available to individuals).DNI equals tentative taxable income increased by (i) the personal exemption and (ii) tax-exempt interest; and decreased by (iii) capital gains and (iv) extraordinary dividends. 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.

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.

Example: Trust has income of $40,000, $10,000 of which is interest income, and $30,000 of which is dividends. Fees are $3,000. Trust has capital gains of $15,000. An exemption of $300 is available.

Calculation of Gross Income:

Interest Income	$10,000
Dividends	$30,000
Capital Gains	$15,000
Gross Income	$55,000

Calculation of Taxable Income:

Gross Income	$55,000
Exemption	($300)
Fees	($3,000)
Taxable Income	$51,700

Calculation of DNI:

Taxable Income	$51,700
Exemption	$300
Capital Gains	
($15,000)	
DNI	$37,000

Trust beneficiaries must report all income distributed (or required to be distributed) to them to the extent of DNI. 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. 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 trust is consequently crucial. It is entirely conceivable that a trust could be a nongrantor trust in one taxable year and a grantor trust in a subsequent taxable year. This could occur if the trustee were granted the power to "toggle" the trust by activating a provision in the trust which would cause the nongrantor trust to be a grantor trust. One such provision often used to accomplish this would be to allow the trustee the power to substitute property of equal value. IRC § 675.

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.

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. Notwithstanding the above, the actual source of payment is not traced.

The distribution deduction is the lesser of (i) "modified" DNI and (ii) the amount actually distributed or required to be distributed. Modified DNI is DNI reduced by the tax-exempt portion of DNI. Some distributions do not "carry out" DNI. Such distributions are tax free to beneficiaries and nondeductible to the trust. For example, a specific bequest not carrying out DNI will be nontaxable to the beneficiary and nondeductible to the trust or estate.

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 exceed those imposed on individuals. However, throwback still applies to foreign trusts. Accumulated income (on which tax has been paid by the trust) 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.

III. Specific Bequests

A will may make a specific bequest to a beneficiary. Technical rules apply to determine whether the bequest is taxable to the beneficiary. To avoid carrying out DNI to a beneficiary, 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 qualifying bequest. 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. IRC § 663; Treas. Regs. §1.663(a)-1.

Note 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 nevertheless report income from post-death appreciation under normal income tax rules. 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. It is the view of the IRS that formula bequests generally will not be ascertainable because they cannot be determined at the time of the decedent's death.

IV. Fiduciary Accounting Income

Fiduciary accounting income (FAI) is income available for payment only to trust income beneficiaries. It includes dividends, interest, and ordinary income. Principal and capital gains are generally reserved for distribution to remainder beneficiaries. The trust may define trust accounting income to include capital gains. Distributions of fiduciary accounting income from both simple and complex trusts will be taxable to the

beneficiary to the extent of the lesser of the amount distributed or DNI, and deductible to the trust in the identical amount. Amounts distributed in excess of DNI will not be taxable to the beneficiary, but neither will the trust receive a deduction. IRC § § 651(a); 661(a)(1). Distributions made to multiple beneficiaries will be reported by beneficiaries according to the proportion of the total DNI that each beneficiary receives. IRC § § 652(b)(c); 662(b)(c).

Provided that no more than the total amount of "fiduciary accounting income" 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 distribution of corpus.

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. If income is accumulated and used to purchase other assets, those assets remain income assets. For example, trustee accumulates $50,000 of income in 2023 and purchases a CD. Interest from the CD is income, but so is the CD itself. Although the trust may contain other CDs that constitute corpus, this $50,000 CD would retain its character as an income asset, rather than a principal asset. Thus, a trustee under a HEMS standard with respect to income distributions could properly distribute the $50,000 to income beneficiaries when the CD matures.

The term "income," when not modified by the words "taxable," "distributable net," "undistributed net," or "gross" in Subchapter J means the amount of income determined under the trust instrument or local law. Thus, as used in Subchapter J, fiduciary accounting income is not a tax term. 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. 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.

In general, principal includes 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.

V. Tier Rules for DNI

The tier rules affect the allocation of distributions among beneficiaries where distributions from a complex trust exceed DNI. IRC § 662(a)(2). Some beneficiaries may be nondiscretionary distributes entitled to trust accounting income, while other beneficiaries may be discretionary distributes. The tier rules are intended to ensure that

nondiscretionary distributees entitled to accounting income are taxed, while discretionary distributees are not taxed. Nondiscretionary distributees are characterized as "first tier" distributees, while discretionary distributees are "second tier" distributees. If allocations are not contained in the trust instrument, the Uniform Principal and Income Act (UPIA) adopted by New York and 38 other states will govern the allocation.

The tier system of allocating DNI is applicable if (i) distributions exceed DNI; (ii) there are multiple beneficiaries; (iii) some beneficiaries are required to receive trust accounting income (first tier beneficiaries); and (iv) other beneficiaries may receive discretionary distributions. Under the general rule which requires proration, the result would not be in accord with the tier rules.

Under the tiering rules, first tier beneficiaries will be allocated DNI first. Any remaining DNI will then be allocated to second tier beneficiaries. Where DNI exceeds first tier distributions, each beneficiary is taxed on a 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 ½ x 8 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.

DNI is allocated among tier one beneficiaries in proportion to their respective fiduciary accounting income. Residual DNI is then allocated 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. If 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 ½ x 10 of income. Since DNI is the ceiling on tax, A and B would receive 1 each tax-free.

Illustration. Trust 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.

VI. Allocation of Trust 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.

In arriving at fiduciary accounting income, expenses attributable to that 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. The standard against which the determination of whether all income has been distributed refers to fiduciary accounting income. Whether or not the trustee has distributed all taxable income or all distributable net income of the trust is immaterial.

An allocation to principal will benefit remainder beneficiaries, while an allocation to income will benefit current income beneficiaries. Historically, most trusts have not permitted the allocation of capital gain to income since doing was thought to be unfair to remainder beneficiaries. However, it is now thought to be prudent to permit allocating some capital gain to income beneficiaries to permit the trust to have a higher total return. A higher total return benefits 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 and must not conflict with local law.

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. For taxable years after 1986, trusts are required to report on a calendar year basis. Trusts are also required to make estimated tax payments. 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. As noted, trusts are subject to the AMT.

IRC §67(a) provides that miscellaneous itemized deductions are allowed only to the extent that those deductions exceed two 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.

The Supreme Court in *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, 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.

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. If a trustee or executor distributes 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.

The trustee of a "qualified" revocable (grantor) trust may elect to treat the trust as part of the grantor''s estate for federal income tax purposes. The election will among other things give the executor more flexibility in choosing the fiscal year of the trust, and will provide some relief for trusts which holds S corporation stock. The election once made is irrevocable, and must be made on the first timely filed income tax return of the estate.

Since the beneficiary will be taxed on distributions required to be made, distributions made after the taxable year, but reported in the earlier taxable year, do 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 previous taxable year. The election is made on the fiduciary tax return. By utilizing the 65-day rule, the trust has some flexibility in determining it taxable income. Since trust tax rates are compressed, it may be possible to distribute enough to fall into a lower tax bracket.

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.

Under the separate share rule, a trust may be divided for tax purposes into separate trusts where the trust provides for separate shares, or where the trust or local law require separate shares by reason of trust distributions or 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.