How Tax Law Divides Income between a Trust or Estate and Their Beneficiaries

With April 15 and tax filings fresh in everyone's minds, here is a brief description of how trusts and estates must compute their income and how that income gets divided between the trust or estate and its beneficiaries. Tax law provides that trusts and estates are to determine their taxable income in the same way that individuals do, but with certain exceptions spelled out in the Internal Revenue Code. In other words, for the most part, tax laws and rules that apply to individuals also apply to trusts and estates.

Once the taxable income of a trust or estate has been determined, it must then be determined how much of that income is properly reportable by the beneficiaries. This is accomplished through two provisions of tax law that apply only to trusts and estates – one provision is known as "distributable net income" and another provision is known as the distribution deduction.

Computing "Distributable Net Income"

How to compute "distributable net income" (often abbreviated as DNI) is spelled out in the Internal Revenue Code and its regulations. To picture DNI, picture a table where across the top row is set forth the different types of income earned by the trust or estate – for example, interest, dividends, rents, etc. Pursuant to tax law, capital gains may or may not be included in this row, but tax-exempt income will be included. Each item of income is then reduced by the tax deductions allowed to the trust or estate in accordance with special allocation rules set forth in tax regulations. The net amount for each item of income in DNI represents the amount of such income that potentially can be taxed to the beneficiaries.

While DNI determines the maximum amount of income potentially taxable to the beneficiaries, the distribution deduction is used to determine the actual amount of income that is taxable to the beneficiaries. Generally, a trust or estate is allowed a tax deduction for (a) all accounting income that it is required to be distributed to beneficiaries, plus (b) all other amounts properly paid, credited or required to be paid, but not more than its DNI. Whatever amount is properly deductible by a trust or estate must be reported as income by the beneficiaries. In other words, the taxable income of the trust or estate never escapes taxation; it is only a question of who must report such income – the trust or estate or the beneficiaries.

If you are involved with trusts or estates, whether as a fiduciary or beneficiary and have questions regarding the proper preparation of their tax returns, don't hesitate to contact us. We have experts in this area ready to help.