# Back to Basics: Analyzing the Differences Between Fiduciary Accounting Income ("FAI") and Distributable Net Income ("DNI")

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## Income Taxation of Non-Grantor Trusts

- The income taxation non-grantor trusts, estates, and beneficiaries is governed by I.R.C. sections 641-668, which are part of Subchapter J of the Code.
- These provisions implement a "hybrid" taxation scheme wherein trust income may be taxed <u>either</u> to the trust or estate (at the entity level) <u>or</u> to the beneficiaries (flow-through taxation), but not taxed to both



## Three Concepts of Income

To accomplish this hybrid taxation, Sections 641-668 use three distinct, but interrelated concepts of income:

1) Taxable Income ("TI")
2) Fiduciary Accounting Income ("FAI"), and
3) Distributable Net Income ("DNI")



## Taxable Income ("TI")

(1) Taxable Income ("**<u>TI</u>**") is a concept found throughout the Code, including Subchap. J

- § 641(a) imposes income tax on the taxable income of estates and trusts
- § 641(b) provides that "The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part." [*i.e.*, in Part I of Subchapter J (§§ 641-685)].

# Taxable Income ("TI")

- For purposes of this presentation, TI means
  - All taxable income items (§641(a)), reduced by
  - All allowable tax deductions
- Some common types of deductions that are disallowed for trusts and estates are:
  - Expenses related to the production of tax exempt income (§ 265)
  - Miscellaneous itemized deductions subject to the 2% of AGI floor (§ 67)



# Fiduciary Accounting Income ("FAI")

(2) **FAI** categorizes receipts and distributions as either "Income" or "Principal"

- Income is…
  - Increased by interest, dividends, rents, etc. generated by the assets of a trust or estate
  - Reduced by certain recurring expenses allocated to income
- Principal is…
  - Increased by capital gains and gifts/bequests
  - Decreased by capital losses and expenses allocated to principal



# Distributable Net Income ("DNI")

(3) Distributable Net Income ("**DNI**") is a measure of the income of the trust for the current year that is available for distribution.

DNI usually includes:

- Dividends
- Interest (both taxable and tax-exempt)

DNI usually does not include:

- Capital Gains



# How Do We Calculate DNI?

DNI is defined in § 643(a). Conceptually, it works as follows:

- Start with Taxable Income ("TI")
- Adjust TI so that the result is more like Fiduciary Accounting Income ("FAI") by:
  - (1) Adding back the Personal Exemption ("PE") & Income Distribution Deduction ("IDD")
  - (2) Adding in items of income that are in FAI but not in TI (typically tax-exempt interest)
  - (3) Subtracting out items of income that are in TI but are not in FAI (typically capital gains)

## When will FAI and DNI Diverge?

DNI and FAI will differ in (at least) two cases:

1) An item of income is included in TI (and therefore in DNI) but is not included in FAI.
   - *E.g.*, (a) phantom income from pass-throughs such as partnerships and S corps and (b) original issue discount ("OID")
2) An item is deductible for purposes of TI (and therefore DNI), but it does not reduce FAI.
   - *E.g.*, Tax-deductible expenses charged against principal (such as 1/2 of Trustee fees under the UPIA)



## When will FAI and DNI Diverge?

1) DNI and FAI will differ when an item of income is included in TI (and therefore in DNI) but is not included in FAI. For example:
   - Phantom income from pass-throughs such as partnerships and S corps is included in TI but not in TI
   - Original issue discount ("OID") on fixed income securities is included in TI as interest, but is not included in FAI

**Note**: No cash (and therefore no FAI) is received by the trust in either of the above examples



## (1) Includable in TI/DNI but not FAI

Amounts Taxable to Trust:

- Dividends of $4,000 reported on Form 1099-DIV
- Dividends of $3,000 reported on Schedule K-1
- OID of $2,000 reported on Form 1099-OID

| | FAI | | TI | DNI |
|---|---|---|---|---|
| | Income | Principal | | |
| Dividends (1099) | 4,000 | 0 | 4,000 | 4,000 |
| Dividends (K-1) | 0 | 0 | 3,000 | 3,000 |
| OID (1099) | 0 | 0 | 2,000 | 2,000 |
| | **4,000** | 0 | 9,000 | **9,000** |



## When will FAI and DNI Diverge?

2) DNI and FAI will differ when an item is deductible for purposes of TI (and therefore DNI), but it does not reduce FAI.

For example, when a tax-deductible expense is charged ½ to income and ½ to principal for FAI purposes (as provided in the UPIA),

- TI is reduced by the full amount of the expense, but
- FAI is reduced by only ½ of the amount of the expense

## (2) Deductible from TI/DNI but not FAI

Receipts:

- Taxable interest of $10,000.

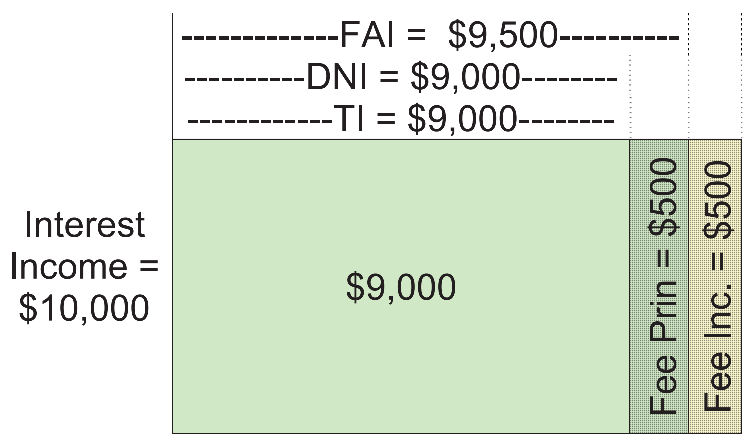
Expenses:

- Deductible trustees' commissions of $1,000 (allocable 1/2 to income, 1/2 to principal)

| | FAI | | TI | DNI |
|---|---|---|---|---|
| | Income | Principal | | |
| Interest | 10,000 | | 10,000 | 10,000 |
| Fee - Income | (500) | | (500) | (500) |
| Fee - Principal | | (500) | (500) | (500) |
| | **9,500** | (500) | 9,000 | **9,000** |



## (2) Deductible from TI/DNI but not FAI






## What is Distributable Net Income?

(Switching topics back to DNI)

- DNI is a measure of the current year income of the trust that is available for distribution.
- DNI is a tax concept that (a) limits the amount of income and (b) determines the character of the income from a non-grantor trust or estate that will be taxed to the beneficiaries (rather than tax to the trust) if it is distributed (or required to be distributed).



## Distributable Net Income—DNI

- General Rule—(a) distributions carry out DNI to the beneficiaries and (b) the trust or estate receives a corresponding deduction.
- However, the most that the trust can deduct, and the most that can be includable in the beneficiary's income, is the lesser of:
  - (1) DNI or
  - (2) the amount actually distributed
- Note: The deduction limitation amounts in (1) and (2) must both be reduced by any Net Tax-Exempt Income ("TEI") that is distributed

## How Do We Calculate DNI?

(This is a repeat of Slide 8)

DNI is defined in § 643(a). Conceptually, it works as follows:

- Start with Taxable Income ("TI")
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  - (1) Adding back the Personal Exemption ("PE") & Income Distribution Deduction ("IDD")
  - (2) Adding in items of income that are in FAI but not in TI (typically tax-exempt interest)
  - (3) Subtracting out items of income that are in TI but are not in FAI (typically capital gains)



## Calculation of DNI-§ 643(a)-v. 1.0

**TI** Taxable income is the starting point—§ 643(a)
**+ IDD** (a)(1) Add back inc. distrib. ded. (IDD, §651/§661)
**+ PE** (a)(2) Add back deduction for personal exemption
**– CG** (a)(3) Subtract out capital gains included in TI
**– ED/TSD** (a)(4) For simple trusts only--Subtract out
(1) extraordinary stock dividends and
(2) taxable stock dividends that are not paid out and are allocated to corpus
**+ Net TEI** (a)(5) Add back TEI (Tax-Exempt Income)
**If FT…** (a)(6) If a Foreign Trust, add back CG and certain non-US Source Income
**= DNI**



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**TI** Taxable income is the starting point—§ 643(a)
**+ IDD** (a)(1) Add back inc. distrib. ded. (IDD, §651/§661)
**+ PE** (a)(2) Add back Deduction for personal exemption
**ATI** **"Adjusted Total Income"**
**– CG** (a)(3) Subtract out capital gains included in TI
**– ED/TSD** (a)(4) For simple trusts only--Subtract out
(1) extraordinary stock dividends and
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**If FT…** (a)(6) If Foreign Trust, add back CG and certain non-US Source Income
**= DNI**



## Calculation of DNI-§ 643(a)-v. 2.0

**Quick-and-Dirty DNI Calculation**

**ATI** Adjusted Total Income
**– CG** § 643(a)(3) Subtract out CG
**+ Net TEI** § 643(a)(5) Add back TEI
**= DNI** § 643(a)

## Adjusting ATI to Get to DNI

**§ 643(a)(2) Deduction for personal exemption (+PE)**

- The Personal Exemption ("PE") deduction, authorized by § 642(b), is not taken into account in calculating the trust's or estate's DNI, so we add it back.
- Rationale: The PE reduces TI, but it doesn't reduce the amount distributable.
- The PE is personal to trust, to be used by the trust against its taxable income; the beneficiary should not get the benefit of the PE (which would happen if DNI were reduced by the PE)



## Adjusting ATI to Get to DNI

**§ 643(a)(3) Capital gains and losses (- CG)**

- Capital Gain (CG) is taxable, but is generally allocated to P under fiduciary accounting principles, and it is not distributable.
- We therefore reduce TI by CG to get at the amount that is actually distributable (*i.e.* DNI).
- Going back to our initial policy rationale:
  - If CGs are not allocated to income, they generally will be retained and not distributed
  - If the trust or estate is retaining CG, the trust or estate should pay the tax on that CG



## Adjusting ATI to Get to DNI

**§ 643(a)(4) Extraordinary divs & taxable stock divs (- ED/TSD) *(for <u>simple</u> trusts only)***

- In the case of simple trusts whose governing instrument requires that all FAI be distributed currently, DNI excludes
  (1) extraordinary dividends (which are taxable) and
  (2) taxable stock dividends,

but only if the dividends have been allocated to principal by the fiduciary *in good faith* and pursuant to the governing instrument or local law



## Adjusting ATI to Get to DNI

**§ 643(a)(5) Net Tax-exempt interest (+Net TEI)**

- TEI is included in FAI but not in TI, so we add it back to TI in calculating DNI
- However, if expenses related to the production of TEI were disallowed for income tax purposes under § 265, then these expenses reduce FAI, but do not reduce TI, so they should not be added back to TI in calculating DNI.
- For this reason, we add back only "Net TEI", *i.e.*, TEI net of the expenses allocated to TEI and disallowed for income tax purposes under § 265.

# Adjusting ATI to Get to DNI

**§ 643(a)(6) Foreign Trusts (but not Foreign Estates)**

Several adjustments are made for foreign trusts:

- Capital gains are not subtracted from taxable income to calculate DNI (§ 643(a)(3) does not apply)
- Non-U.S. Source Income (Non-USSI) is added to TI when calculating DNI (if not already included in TI)
- Income that is exempt from U.S. tax because of a tax treaty is added to TI when calculating DNI



# Reconciling TI, FAI and DNI

| | Effect on TI §641(a) | Effect on FAI §643(b) | Adjustment to get to DNI §643(a) | Relevant Code Section |
|---|---|---|---|---|
| 0. Dividends, taxable int., rent, business income | ↑ TI | ↑ FAI | None | n/a |
| 1. Deduction for distributions ("IDD") | ↓ TI | No effect | + IDD (↑) | §643(a)(1) |
| 2. Deduction for personal exemption ("PE") | ↓ TI | No effect | + PE (↑) | §643(a)(2) |
| 3. Capital gains/(losses) [sub. to eq. adj./unitrust] | CG ↑ TI, (CL↓ TI) | No effect | – CG (↓) (– CL (↑)) | §643(a)(3) |
| 4. Extraord./taxable stock div. allocated to principal | ↑ TI | No effect | – ED/TSD (↓) | §643(a)(4) |
| 5. Net tax-exempt income ("Net TEI") | No effect | ↑ FAI | + Net TEI (↑) | §643(a)(5) |
| 6. Tax-exempt foreign trust income | No effect | ↑ FAI | + Ex. FTI (↑) | §643(a)(6) |



# FAI: Income vs. Principal

(Shifting Topics back to FAI)

- Historically, principal and income accounting tried to balance the interests of current (income) beneficiaries with the interests of future (remainder) beneficiaries.
- When cash is received by a trust, fiduciary accounting asks whether that cash should be credited to income (current beneficiaries) or to principal (future (remainder) beneficiaries).
- Note: When a trust instrument instructs the Trustee to distribute "net income," it means FAI.



# FAI: Income vs. Principal

Principal and Income are determined by the following, listed in order of priority:

1. the terms of the trust instrument or, if the trust instrument is silent (as it often is), by
2. **state principal and income law** or, if state law treatment is unclear, then
3. in accordance with what is "reasonable and equitable" in terms of those entitled to income or principal or to both

# FAI: State Principal and Income Acts

Most states follow one of the Uniform Principal and Income Acts, of which there are 3:

- Uniform Principal and Income Act ("UPIA") (1931) [No longer used by any state]
- Revised UPIA (1962) [Adopted by 3 states: GA, IL and LA]
- Revised UPIA (1997, revised 2008) [46 states & DC]
- Rhode Island has not adopted any version of UPIA.

**Note**: Many states that have "adopted" the UPIA have modified certain sections of it, so it is important to check state law



# FAI: State PIAs—Receipts

| Income | Principal |
|---|---|
| + Dividends | + Capital Gains (Usually) |
| + Taxable Interest | + Receipt of Assets |
| + Tax-Exempt Interest | + Sale of Building |
| + Rent | + Liquidation Proceeds |
| + Business Income (Schedule C) | + Proceeds of Insurance on Capital Asset |
| + Some Extraord. Dividends | + Other Extraord. Dividends |



# FIA: State PIAs—Disbursements

| Income | Principal |
|---|---|
| – Recurring taxes (e.g., Income, real property tax) | – Transfer Taxes (Estate, Gift, Generation-Skipping) |
| – Interest paid | – Capital Losses (Usually) |
| – Ordinary Repairs | – Extraordinary Repairs |
| – ½ of Annual Fees for Trustee, Attorney, Acct. | – ½ of Annual Fees for Trustee, Attorney, Acct. |
| – Depreciation Reserve | + Depreciation Reserve |



# FAI: "Reasonable and Equitable"?

Principal and Income are determined by the following, listed in order of priority:

1. the terms of the trust instrument or, if the trust instrument is silent (as it often is), by
2. state principal and income law or,
   if state law treatment is unclear, then
3. in accordance with what is "**reasonable and equitable**" in terms of those entitled to income or principal or to both