

# Income Taxation of Trusts & Estates

John P. DeSantis



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## I. Introduction

- A. Non-Grantor Trusts: Subchapter J of the Internal Revenue Code ("IRC") (Sections 641-663).
- B. Grantor Trusts vs. Non-Grantor Trusts.
  - 1. Grantor Trusts: Grantor taxed on the trust's income (IRC Sections 671-678)
  - 2. Non-Grantor Trusts: Trust and/or the Beneficiaries of the Trust are taxed on the trust's income.



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## I. Introduction

- C. Types of Non-Grantor Trusts.
  - 1. Simple Trusts (IRC Sections 651 and 652). The requirements of a Simple Trust are: (1) the terms of the trust provide all of its income (Fiduciary Accounting Income ("FAI")) be distributed currently; (2) the terms of the trust do not provide for any amounts to be paid to charity; and (3) no distributions in excess of FAI are in fact made to the beneficiaries of the trust.
  - 2. Complex Trusts and Estates (IRC Sections 661-663). Complex trusts fail one or more of the three requirements of a Simple trust.



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## II. Concepts Applicable to all Non-Grantor Trusts

- A. Fiduciary Accounting Income ("FAI").
  - 1. IRC Section 643(b) and Regulations thereunder.
  - 2. See Section III. of this Outline.
- B. Calculating the Taxable Income of an Estate and Non-Grantor Trust -The Starting Point.
  - 1. IRC Section 641 (b).
  - 2. See Section IV. of this Outline.



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## II. Concepts Applicable to all Non-Grantor Trusts

- C. Distributable Net Income ("DNI").
  - 1. IRC Section 643(a) and Regulations thereunder.
  - 2. See Section V. of this Outline.
- D. Estates vs. Non-Grantor Trusts.
  - 1. Summary of the Major Income Tax Differences between them.
  - 2. See Section VI. of this Outline.



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## III. Fiduciary Accounting Income ("FAI")

**IRC Section 643(b)-** For purposes of subparts A, B, C and D of part J of the IRC, the term "**income**", when not preceded by the words "taxable", "distributable net", "undistributed net" or "gross" means the amount of income of the estate or trust for the taxable year **determined under the terms of the governing instrument and applicable local law.**

**Governing Instrument:** Most governing instruments do not define what is income and corpus.



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### III. Fiduciary Accounting Income ("FAI")

**Applicable Local Law:** Applicable State Law of (1) Estate- the decedent's domicile or (2) Trust (stated in Trust Agreement).

Example : NYS- EPTL 11-2.1  
NJ- 3B :19B-1 etc.



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### III. Fiduciary Accounting Income ("FAI")

#### Key Concepts:

- **Income** = FAI and **Corpus** = Principal

General Rules of what is Income and Corpus:

- **Fiduciary Accounting Income** = Interest, Tax Exempt Interest, Dividends, Rental Income, Cash received from Entities and generally a portion (10% in NJ) of Minimum Required Distributions from Qualified Plans (All such income items are reduced by any expenses related to such income).
- **Corpus** = Capital Gains, IRC Sections 1245 and 1250 Recapture, 1231 Gain, etc.



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### IV. Computation of TI of an Estate or Trust

**General Rule and Starting Point:** IRC Section 641(b)- *The TI of an estate or trust shall be computed in the same manner as an individual, except as provided in this part (Part J).*

**Summary of the major tax differences between computing TI of (1) an individual and (2) a Trust or an Estate.** *Most of these differences are set forth in IRC Section 642.*



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## V. Distributable Net Income ("DNI"). IRC Section 643(a)

### A. Role of DNI.

- a. The **DNI** of an Estate/Trust **LIMITS** (I) *the amount such entity can DEDUCT under IRC Sections 651 (Simple Trusts) and 652 (Complex Trusts/Estates)* and (II) *the amount on which beneficiaries can be taxed under IRC Sections 652(Simple Trusts) and 662(Complex Trusts and Estates).*



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## V. Distributable Net Income ("DNI"). IRC Section 643(a)

### B. Computation of DNI:

- a. **Start with the entity's "Tentative Taxable Income"**- Namely, the TI of the entity before the entity's distribution deduction under IRC Section 651 or 661)
- b. ADD:
- i. Exemption Amount (IRC Sec. 643(a)(1)).
  - ii. Net Capital Loss (IRC Sec. 643(a)(3)).
  - iii. Net Tax-Exempt Income – Gross tax-exempt income less deductions (A) directly attributable to tax exempt income and (B) indirectly attributable to tax exempt income. (IRC Sec. 643(a)(5)).
- c. LESS: Net Capital Gain (IRC Sec. 643(a)(3)).
- d. EQUALS: DNI



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## VI. Basic Concepts- Estate vs. Trust: A Summary of the Major Income Tax Differences

| Issue                                     | Estate                              | Trust                                      |
|-------------------------------------------|-------------------------------------|--------------------------------------------|
| Year-End                                  | Fiscal                              | Calendar                                   |
| EIN                                       | Yes                                 | Irrevocable – Yes<br>Revocable – Mostly no |
| Tax Filing                                | GI: >=\$600<br>B-Non-Resident Alien | Same & any TI<br>Same                      |
| Est. Tax Payments                         | None for first 2 tax years          | Yes if will owe \$1,000 or more            |
| Allocate Est. Tax Payments to Beneficiary | Final Tax Year                      | Any Tax Year                               |



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## VI. Basic Concepts- Estate vs. Trust: A Summary of the Major Income Tax Differences

| Issue                   | Estate                                                                                                     | Trust                                                  |
|-------------------------|------------------------------------------------------------------------------------------------------------|--------------------------------------------------------|
| Holding Period          | Long-Term                                                                                                  | Tacking                                                |
| Basis of Asset Received | Step-up (Not IRD)                                                                                          | Carry-over                                             |
| OI Tax Rates            | Compressed                                                                                                 | Same                                                   |
| Exemption               | \$600                                                                                                      | Complex: \$100<br>Simple: \$300<br>QDT (2025): \$5,100 |
| PALS                    | If Decedent actively participated, estate will be deemed to Actively Participate for first 2 taxable years | Only if Trustee actively participates                  |

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## VI. Basic Concepts- Estate vs. Trust: A Summary of the Major Income Tax Differences

| Issue             | Estate                                                             | Trust                                    |
|-------------------|--------------------------------------------------------------------|------------------------------------------|
| Commencement Date | Day following date of Decedent's death                             | First date property transferred to trust |
| Return Due Date   | 15 <sup>th</sup> day of 4 <sup>th</sup> month, 5.5 month extension | Same                                     |

Note: If have a "qualified revocable trust" and both the Executor of the estate and the Trustee of the Revocable Trust make an IRS SECTION 645 ELECTION (Form 8855), the estate will be treated as a trust for income tax purposes.

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