First State Trust Company — Women & Wealth

WHAT IS DISTRIBUTABLE NET INCOME, AND WHY IS IT IMPORTANT?

The IRS views most trusts as a separate and distinct tax entity, and accordingly, the IRS taxes them as such. Trusts will often have a separate Tax Identification Number (TIN) and file their own separate tax return, IRS Form 1041, also called a fiduciary income tax return. Typically, a trustee has a duty to file an annual fiduciary income tax return in order to determine the amount of income tax owed, similar to how individuals file a personal tax return, IRS Form 1040 every year.

Trusts are pass through entities which means that the tax on qualifying income generated from the trust can be passed to the beneficiaries of that trust. The maximum taxable amount that can be distributed from a trust to a beneficiary is called distributable net income (DNI). When DNI is passed out to a beneficiary, it becomes a deduction on Form 1041. DNI caps the trust's distribution deduction because it is limited by the amount of money the beneficiary can include in his or her gross income. For every dollar which a beneficiary includes in his/ her gross income, the trust takes a deduction.

The amount of DNI that is passed out to a beneficiary is detailed on a Schedule K-1, which is what the beneficiary uses to report the DNI's tax liability on his/ her personal 1040 tax return. DNI keeps the same character of how it was generated. Therefore, if the trust earns a qualified dividend and passes this dividend out to the beneficiary, it will retain the qualified dividend status. The same goes for tax-exempt interest, rental income, mineral earnings, etc.

DNI is defined in Subchapter J, Sec. 643 (a) of the IRS code. The DNI definition is in essence a detailed computation. The code details the following calculation:

(1) Deduction for distributions
No deduction shall be taken under sections 651 and 661 (relating to additional deductions).

(2) Deduction for personal exemption
No deduction shall be taken under section 642(b) (relating to deduction for personal exemptions).

(3) Capital gains and losses
Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The exclusion under section 1202 shall not be taken into account.

(4) Extraordinary dividends and taxable stock dividends
For purposes only of subpart B (relating to trusts which distribute current income only), there shall be excluded those items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of the governing instrument and applicable local law.

(5) Tax-exempt interest
There shall be included any tax-exempt interest to which section 103 applies, reduced by any amounts which would be deductible in respect of disbursements allocable to such interest but for the provisions of section 265 (relating to disallowance of certain deductions).

(6) Income of foreign trust in the case of a foreign trust—
(A) There shall be included the amounts of gross income from sources without the United States, reduced by any amounts which would be deductible in respect of disbursements allocable to such income but for the provisions of section 265(a)(1) (relating to disallowance of certain deductions).
(B) Gross income from sources within the United States shall be determined without regard to section 894 (relating to income exempt under treaty).
(C) Paragraph (3) shall not apply to a foreign trust. In the case of such a trust, there shall be included gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges.

For simplicity, you can view DNI as earned trust accounting net income (interest, dividends, rent, but not capital gains) minus all deductible expenses (which would include all trustee fees, state taxes, etc.). This simple calculation will not be accurate 100% of the time, but it will be most of the time. Some example shortfalls of this simple calculation are if a trust owns an Inherited IRA, all withdrawals will be part of DNI, while only a small portion of the IRA's RMD will be deemed to income to be included in the trust accounting net income calculation Another example is when income is reported as taxable income in one tax year, but the income is not received until the following tax year. Since DNI is a tax concept, it will follow how the income is viewed from an income tax perspective, and not when it is received, which is how trust accounting is viewed.

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Below you will find an example of how a DNI calculation is made.

DNI Example

Below is a list of all earnings and expenses found within a trust within a tax year:

- Qualified Dividends of $400
- Interest Income of $100
- Tax-exempt Interest of $300
- State Tax Paid of $75
- Trustee Fee of $125

	Dividends	Interest	Tax-Exempt Interest	Total
Income	$400	$100	$300	= $800
Fee & tax deduction	($100)	($25)	($75)	= ($200)
Character of DNI	$300	$75	$225	**$600 DNI**

In the above chart, you can see that the total trustee fee and state tax is fully deductible from the calculation. Since we have different types of taxable interest (such as tax-exempt interest vs. standard interest), we have to combine the total of the two deductible expenses and prorate them among all of the income earned.

As you can see, distributable net income is an important concept because it ultimately impacts the tax exposure of each beneficiary and the distribution tax deductions a trust can take. Therefore, this is an important concept to understand from a planning perspective. Depending on a grantor's goals, this concept can impact the way a trust is drafted, the investments selected within an account, or when a beneficiary may choose to request for distributions from a trust.

If you have any questions, please contact your Trust Officer, or reach out to Jordan Wolff, manager of the Personal Trust team at 302.573.5821.