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## **Deductions in a Proposed Calculation and Allocation of Distributable Net Income to the Separate Shares of a Trust or Estate**

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# DEDUCTIONS IN A PROPOSED CALCULATION AND ALLOCATION OF DISTRIBUTABLE NET INCOME TO THE SEPARATE SHARES OF A TRUST OR ESTATE

*Michael T. Yu\**

## INTRODUCTION

In a previous article,<sup>1</sup> I criticized the separate share regulations<sup>2</sup> for potentially producing certain inequitable results and, consequently, proposed an allocation of distributable net income (DNI)<sup>3</sup> to the separate shares of a trust or estate.<sup>4</sup> The proposed allocation of DNI focused on the income items that contributed to the DNI of a trust or estate with separate shares and expressly omitted any discussion of deductions.<sup>5</sup> This article addresses certain deductions as they relate to the DNI of a trust or estate with separate shares and proposes a calculation and allocation of DNI applicable to the separate

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1. Michael T. Yu, *A Proposed Allocation of Distributable Net Income to the Separate Shares of a Trust or Estate*, 3 PITT. TAX REV. 121, 121-22 (2006).

2. Treas. Reg. §§ 1.663(c)-1 to -5 (as amended in 1999).

3. "Distributable net income" is the taxable income (with certain modifications) of a trust or estate. I.R.C. § 643(a).

4. The separate share regulations do not address instances in which separate trusts are created but do address instances in which separate shares of one trust (or estate) are created. See Treas. Reg. § 1.663(c)-1(a) (as amended in 1999). A detailed discussion of the differences between creating separate trusts and creating a trust with separate shares is beyond the scope of this article; certain commentators have discussed the nontax considerations, including consolidated management and investment of trust assets, geographical location of beneficiaries, consolidated legal and trustee's fees, and the nature of the trust assets. JOHN L. PESCHEL & EDWARD D. SPURGEON, *FEDERAL TAXATION OF TRUSTS, GRANTORS AND BENEFICIARIES* 2-44 to -45 (3d ed. 1998).

5. Yu, *supra* note 1, at 122 n.8.

shares of a trust or estate. In analyzing the current separate share regulations addressing those deductions, this article discusses how the regulations contravene, in certain circumstances, the Internal Revenue Code's ("Code") calculation of DNI and provide calculations that may produce anomalous results when a separate share has a net loss for at least one type of income.

As stated in the previous article, the general aim of the separate share rule<sup>6</sup> is to prevent one separate share of a trust or estate from being required to pay the income tax attributable to income being accumulated for another separate share.<sup>7</sup> Underlying this general aim are the general principles that each separate share has its own economic interest separate from every other separate share and, accordingly, that each separate share should be responsible for its own items of income and deduction.<sup>8</sup> Under the separate share rule and regulations, separate shares of a trust or estate are treated as separate trusts or separate estates only for the purpose of determining the amount of DNI used in calculating the income tax of such separate trusts or estates and of the beneficiaries of such separate trusts or estates.<sup>9</sup> On December 28, 1999, the Treasury Department issued final separate share regulations<sup>10</sup> addressing, among other issues, when separate shares of a trust or estate come into existence and how DNI is computed and allocated to the separate shares of a trust or estate.

This article examines the treatment of certain deductions<sup>11</sup> in the separate share regulations and discusses how the separate share regulations arguably provide two methods for calculating DNI to be used in coordinating the income taxation of a trust or estate with separate shares and of the beneficiaries of such trust or estate. Specifically, this article analyzes how the two methods

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6. The term "separate share rule" does not appear in I.R.C. § 663(c). The Treasury Regulations, however, refer to the "separate share rule" and "the separate share rule provided by section 663(c)." *E.g.*, Treas. Reg. §§ 1.663(c)-1 to -4 (as amended in 1999). In this article, the term "separate share rule" refers to I.R.C. § 663(c), and the term "separate share regulations" refers to Treas. Reg. §§ 1.663(c)-1 to -5.

7. Treas. Reg. § 1.663(c)-1(a) (as amended in 1999).

8. *See id.* § 1.663(c)-2 (as amended in 1999). These principles are analogous in the partnership tax area to I.R.C. § 704(c), which, generally, seeks to ensure that tax benefits and burdens are applied to the taxpayer who earned them.

9. I.R.C. § 663(c); Treas. Reg. § 1.663(c)-1 (as amended in 1999).

10. T.D. 8849, 2000-1 C.B. 245, 246 (as corrected March 28, 2000).

11. This article focuses on the deductions related to ordinary portfolio income and passive income because certain other deductions (such as deductions for charitable contributions and deductions for capital losses) are beyond the scope of the calculation and allocation of DNI proposed in this article or because certain other deductions (such as depreciation deductions and the income tax deduction for estate tax paid attributable to income in respect of a decedent (IRD) included in gross income) do not necessarily enter into the calculation and allocation of DNI proposed in this article. Additionally, this article does not address deductions in the year of termination of the trust or estate.

address the income taxation of a trust or estate with two separate shares in which one separate share has a net loss as to at least one type of income. Such loss, pursuant to the separate share regulations, is “not available” to any other separate share of the trust or estate,<sup>12</sup> and this article discusses how the methods each address such loss. The first method, which calculates DNI at the level of the trust or estate, obscures the separate share’s loss, which is effectively used by the other separate share. On the other hand, the second method, which calculates DNI separately for each separate share, can produce anomalous results in which the total DNI for all separate shares exceeds the DNI of the trust or estate. To address the weaknesses of the two existing methods, this article proposes a calculation and allocation of DNI to the separate shares of a trust or estate that uses both methods but additionally reconciles them by focusing on the items of income and deduction entering into the computation of the DNI of the trust or estate.

Part I of this article provides an overview of the calculation of DNI.<sup>13</sup> Part II addresses how DNI operates in the application of §§ 661 and 662. Part III analyzes the separate share regulations’ two methods for calculating DNI as to a trust or estate with separate shares and discusses the weaknesses of both methods. Finally, Part IV presents and discusses a proposed calculation and allocation, to the separate shares of a trust or estate, of income and deduction items entering into the computation of the DNI of the trust or estate.

## I. OVERVIEW OF THE CALCULATION OF DNI

Generally, a trust or estate is treated as a conduit for income tax purposes, and, therefore, the income taxation of a trust or estate is coordinated with the income taxation of the beneficiaries of such trust or estate so that an item of income is subject to income tax only once. The concept of DNI enables the coordinated single income taxation of a trust or estate and the beneficiaries of such trust or estate. DNI is, for any taxable year, the taxable income of the estate or trust computed with certain modifications.<sup>14</sup> The taxable income of the estate or trust is computed (with certain exceptions) in the same manner as

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12. Treas. Reg. § 1.663(c)-2(b)(5) (as amended in 1999). The separate share regulations also attempt to ensure that the separate shares of a trust or estate include in gross income each separate share’s properly allocable items of income, which are discussed in my previous article. See Yu, *supra* note 1, at 131–32.

13. For an overview of the income taxation of trusts and estates with separate shares and of the separate share rule and the separate share regulations, see Yu, *supra* note 1, at 123–27.

14. I.R.C. § 643(a).

in the case of an individual.<sup>15</sup> The taxable income of an individual who itemizes deductions is the individual's gross income minus allowed deductions (other than the standard deduction).<sup>16</sup> The taxable income of an individual who does not itemize deductions, however, is the individual's adjusted gross income minus the standard deduction (which may include the additional standard deduction) and the deduction of personal exemptions provided in § 151.<sup>17</sup> In general terms, the taxable income of an individual (and, therefore, of a trust or estate) is the taxpayer's gross income minus allowed deductions.

The Code provides that DNI is the taxable income of the trust or estate with seven modifications. Although the modifications are not the subject of this article, a brief summary of them follows. The first modification is that there is no deduction under §§ 651 and 661 for distributions.<sup>18</sup> The second modification is that there is no deduction under § 642(b) for personal exemptions.<sup>19</sup> The third modification has three subparts. The first subpart is that gains from the sale or exchange of capital assets are excluded<sup>20</sup> to the extent such gains are allocated to principal and are not: (1) paid, credited, or required to be distributed to any beneficiary during the taxable year; or (2) paid, permanently set aside, or to be used for the charitable purposes specified in § 642(c).<sup>21</sup> The second subpart is that losses from the sale or exchange of capital assets are 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 that are paid, credited, or required to be distributed to any beneficiary during the taxable year.<sup>22</sup> The last subpart is that the exclusion under § 1202 relating to qualified small business stock shall not be taken into account.<sup>23</sup>

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15. *Id.* § 641(b).

16. *Id.* § 63(a).

17. *Id.* § 63(b).

18. *Id.* § 643(a)(1).

19. *Id.* § 643(a)(2).

20. *Id.* § 643(a)(3).

21. As a result, the capital gains that are included in the DNI of a trust or estate are those: (1) allocated to income, (2) allocated to principal and paid, credited, or required to be distributed to a beneficiary during the taxable year, or (3) allocated to principal and paid, permanently set aside, or to be used for the charitable purposes specified in § 642(c). The regulations provide further requirements governing when capital gains that are allocated to income are included in the DNI of a trust or estate. Treas. Reg. § 1.643-3(b) (as amended in 2004). This article does not address deductions attributable to capital losses, so a thorough discussion of capital gains and losses entering into the computation of the DNI of a trust or estate is beyond the scope of this article. *See supra* note 11.

22. I.R.C. § 643(a)(3).

23. *Id.*

The fourth modification is that, as to trusts that distribute current income only, there shall be excluded those items of gross income constituting extraordinary dividends or taxable stock dividends that the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of the fiduciary's determination that such dividends are allocable to principal under the terms of the governing instrument and applicable local law.<sup>24</sup> The fifth modification is that any tax-exempt interest excluded from gross income under § 103 is included in DNI, reduced by any amounts that would be deductible in respect of disbursements allocable to such interest but for the provisions of § 265 (relating to the disallowance of deductions allocable to tax-exempt interest).<sup>25</sup> The sixth and seventh modifications deal with foreign trusts and abusive transactions, respectively, and are beyond the scope of this article. In summary, DNI is an amount that is computed after deductions have reduced the taxpayer's gross income and certain modifications have been made.

## II. OPERATION OF DNI IN §§ 661 AND 662

DNI is the Code's mechanism that coordinates the single income taxation between (1) the trust or estate and (2) its beneficiaries. DNI serves the following functions: (1) it limits the deductions allowable to a trust or estate for distributions to beneficiaries, (2) it is used to determine how much of a beneficiary's distribution from a trust or estate is includible in the beneficiary's gross income, and (3) it is used to determine the character of distributions in the hands of the beneficiaries.<sup>26</sup> The basic income taxation provisions governing a trust or estate and its beneficiaries are §§ 661 and 662. Section 661 addresses the income taxation of a trust or estate, and § 662 addresses the income taxation of the beneficiaries of a trust or estate.

The relevant provisions of § 661 are as follows. A trust or estate that makes distributions to its beneficiaries in the same taxable year that it receives items of income may claim an income tax deduction for all such distributions.<sup>27</sup> The deduction for such distributions, however, cannot exceed the DNI of the trust or estate.<sup>28</sup> Additionally, the deduction for such distributions excludes any amount attributable to net tax-exempt income of the

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24. *Id.* § 643(a)(4).

25. *Id.* § 643(a)(5).

26. Treas. Reg. § 1.643(a)-0 (1960).

27. I.R.C. § 661(a).

28. *Id.*

trust or estate because such amount is not subject to income tax and therefore should not be included in the deduction for distributions.<sup>29</sup>

Absent a specific provision in the governing instrument allocating different classes of income to different beneficiaries, the deduction for distributions allowed to the trust or estate is deemed to consist proportionally of each class of items that enters (as a net amount) into the computation of DNI of the trust or estate.<sup>30</sup> For example, if equal amounts of net taxable interest (gross taxable interest less deductions allocated thereto) and net rents (gross rents less deductions allocated thereto) enter into the computation of the DNI of a trust or estate, then, absent a specific provision in the governing instrument allocating different classes of income to different beneficiaries, the deduction for distributions made by a trust or estate is deemed to consist one-half of taxable interest and one-half of rents, which reflects the proportion by which those items (as net amounts) enter into the computation of the DNI of the trust or estate.<sup>31</sup> Because the net amount of each class of items is, of course, its gross amount less deductions allocated thereto, the characterization of the deduction for distributions allowed to a trust or estate depends on both the gross amount of each class of items that enters into the computation of the DNI of the trust or estate and the deductions allocated to each such class of items.

As to the deduction for distributions by a trust or estate, in the determination of the proportion by which classes of income (as net amounts) enter into the computation of the DNI of a trust or estate, the items of deduction entering into such computation of DNI (including the deduction allowed under § 642(c) regarding amounts paid or permanently set aside for a charitable purpose, which is beyond the scope of this article) are allocated, absent an allocation of different classes of income under the specific terms of the governing instrument, among the "items of distributable net income"<sup>32</sup>

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29. *Id.* § 661(c); Treas. Reg. § 1.661(c)-1 (as amended in 1964).

30. I.R.C. § 661(b).

31. Assume there is DNI of \$200, attributable one-half to net taxable interest of \$100 (gross taxable interest of \$300 less \$200 deductions allocated thereto) and one-half to net rents of \$100 (gross rents of \$900 less \$800 deductions allocated thereto). Absent a specific provision in the governing instrument allocating different classes of income to different beneficiaries, if a trust or estate distributes \$80, then the deduction for distributions allowed to the trust or estate is deemed to consist of \$40 of taxable interest (one-half of the distribution of \$80) and \$40 of rents (one-half of the distribution of \$80), which reflects the proportion by which those amounts of taxable interest and rents (as net amounts of \$100 each) enter into the computation of the DNI of the trust or estate of \$200.

32. I.R.C. § 661(b) refers to "items of distributable net income," but Treas. Reg. § 1.661(b)-2 (1960) refers to "items of income." The author believes that the Code is imprecise to refer to "items of distributable net income" when apparently it refers to "items of income that enter into the computation of distributable



entering into such computation of DNI in accordance with Treasury regulations.<sup>33</sup> The relevant Treasury regulations<sup>34</sup> provide the following principles governing the allocation of items of deduction.<sup>35</sup>

The regulations provide rules for two categories of expenses: those that are “directly attributable to one class of income”<sup>36</sup> (“direct expenses”) and those that are “not directly attributable to a specific class of income”<sup>37</sup> (“indirect expenses”). Although there are no definitions of direct expenses and indirect expenses, the regulations provide examples of each. Examples of direct expenses allocated to rental income include “repairs to, taxes on, and other expenses directly attributable to the maintenance of rental property or the collection of rental income.”<sup>38</sup> Examples of indirect expenses include “trustee’s commissions, the rental of safe deposit boxes, and State income and personal property taxes.”<sup>39</sup>

All direct expenses are allocated to the class of income to which they relate.<sup>40</sup> If the total of direct expenses exceeds the class of income to which the direct expenses relate, the excess of direct expenses may be allocated (in part or in whole) to “any other class of income” (including capital gains)<sup>41</sup> included in the DNI of the trust or estate.<sup>42</sup> Excess direct expenses attributable to tax-exempt income, however, may not be allocated to any class of taxable income.<sup>43</sup> Although passive losses are not specifically addressed in the regulations under § 652, several commentators have noted that passive losses should not reduce non-passive income.<sup>44</sup> One commentator suggests that

net income,” or, as the regulations provide, “items of income.” Additionally, the author notes that DNI, as discussed in Part I of this article, is a single amount (calculated from the taxpayer’s taxable income with certain modifications) and therefore cannot properly be apportioned into “items of distributable net income.”

33. I.R.C. § 661(b). Treas. Reg. § 1.661(b)-1 (1960) adds that the allocation occurs as provided “unless local law requires” a specific allocation of different classes of income to different beneficiaries.

34. Treas. Reg. § 1.661(b)-2 (1960) provides that the items of deduction entering into the computation of DNI are allocated among the items of income entering into the computation of DNI in accordance with the rules set forth in Treas. Reg. § 1.652(b)-3 (1960).

35. Treas. Reg. § 1.652(b)-3 (1960).

36. *Id.* § 1.652(b)-3(a).

37. *Id.* § 1.652(b)-3(b).

38. *Id.* § 1.652(b)-3(a).

39. *Id.* § 1.652(b)-3(c).

40. *Id.* § 1.652(b)-3(d).

41. Part I of this article provides a general discussion of the rules governing when capital gains and losses are included in the computation of the DNI of a trust or estate.

42. Treas. Reg. § 1.652(b)-3(a), (d) (1960).

43. *Id.* § 1.652(b)-3(d).

44. Leo L. Schmolka, *Passive Activity Losses, Trusts, and Estates: The Regulations (If I Were King)*, 58 TAX L. REV. 191, 200 (2005) (noting that “Congress specifically intended that portfolio income not be subject to offset by passive losses” and citing I.R.C. § 469(e)(1), which excludes portfolio income in the

excess direct expenses from a passive activity, however, “may offset other items of passive income.”<sup>45</sup>

Indirect expenses may be allocated (in part or in whole) to “any item of income” (including capital gains) included in computing DNI, “but a portion must be allocated to nontaxable income.”<sup>46</sup> The regulations provide two contradictory examples calculating the portion of indirect expenses to allocate to nontaxable income, both based on the relative amounts of nontaxable income and taxable income. The first example allocates indirect expenses based upon the relative amounts of net nontaxable income and net taxable income “after direct expenses” have been taken into account,<sup>47</sup> and the second example allocates indirect expenses based upon the relative amounts of gross nontaxable income and gross taxable income before any direct expenses have been taken into account.<sup>48</sup> Although commentators disagree on the appropriate allocation,<sup>49</sup> an allocation based upon the relative amounts of gross nontaxable income and gross taxable income before any direct expenses have been taken into account is to certain commentators<sup>50</sup> an acceptable method.<sup>51</sup>

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determination of income or loss from a passive activity); Alan S. Acker, *Income Taxation of Trusts and Estates*, 852 TAX MGMT. PORT. (BNA), at A-72 (2003) (noting that the instructions for Form 1041 Schedule K-1 indicate that “in no case can excess deductions from a passive activity be allocated to income from a nonpassive activity, or to portfolio income earned by the estate or trust”).

45. Acker, *supra* note 44, at A-72.

46. Treas. Reg. § 1.652(b)-3(b) (1960).

47. *Id.*

48. Treas. Reg. § 1.652(c)-4 (1960).

49. See HOWARD M. ZARITSKY ET AL., *FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS* 2-88 to -89 (3d ed. 2001) (summarizing the four different formulae, which are beyond the scope of this article, that “have been proposed and considered by the IRS, the courts, and commentators” and noting that “the law is far from clear on the precise formula that should be applied”); see also M. CARR FERGUSON ET AL., *FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES* 7-98 (3d ed. 2008 Supp.) (arguing that an income item exceeded by its direct expenses “does not exist economically and should not be included at all in the allocation base”); Acker, *supra* note 44, at A-74 (responding to Ferguson et al. that the logical result of their position is that “even indirect expenses should first be allocated against the other items of income before determining the amount allocable to the tax-exempt income”).

50. See PESCHEL & SPURGEON, *supra* note 4, at 3-28 (asking “What is an acceptable base for such an allocation [of indirect expenses]?” and answering “In most cases, gross income or receipts is likely to be used”); Acker, *supra* note 44, at A-74 (concluding that the method reflected in the example in Treas. Reg. § 1.652(c)-4 “perhaps only opts for simplicity over equity”).

51. The author finds acceptable an allocation of indirect expenses based upon the relative gross amounts of nontaxable and taxable income before any direct expenses have been taken into account because the Treasury regulations generally allocate deductions to an item or class of “income” or to a specifically-named item or class of income (such as rents, dividends, or interest), which are all terms that suggest gross amounts. See Treas. Reg. § 1.652(b)-3 (1960) (deductions allocated “among the items of income”); *id.* § 1.652(b)-3(a) (deductions allocated “to one class of income,” “to rental income,” “to the income from such business,” and “against other classes of income”); *id.* § 1.652(b)-3(b) (deductions allocable “to any item of

While § 661 addresses the income taxation of the trust or estate making distributions, § 662 addresses the income taxation of a beneficiary receiving a distribution from a trust or estate. Each beneficiary receiving a distribution from a trust or estate must include the distribution in the beneficiary's gross income, but the amount of the distribution to be included<sup>52</sup> in the beneficiary's gross income cannot exceed the beneficiary's share of the DNI of the trust or estate.<sup>53</sup> A beneficiary's share of the DNI of a trust or estate is determined by a two-tier distribution system.<sup>54</sup>

Generally, the first tier consists of amounts that are required to be distributed in the current taxable year to beneficiaries, and the second tier consists of all other amounts properly distributed to beneficiaries during the current taxable year.<sup>55</sup> Initially, amounts in the first tier are allocated DNI proportionally to the extent that DNI is available.<sup>56</sup> If, however, amounts in the first tier are greater than DNI, then the DNI is allocated proportionally among those amounts in the first tier.<sup>57</sup> After the allocation of DNI to first-tier distributions, if any DNI remains, then it is allocated proportionally among second-tier distributions in the same manner as first-tier distributions.<sup>58</sup> If, however, no DNI remains after allocations have been made to first-tier distributions, then the second-tier distributions are allocated no DNI.<sup>59</sup>

The consequences of this two-tier system are as follows. If a beneficiary receives a total distribution from a trust or estate that is less than the beneficiary's allocated share of DNI, then the entire amount of the distribution

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income" and "to the rents or dividends" and allocated "to nontaxable income" and "to tax-exempt interest"); *id.* § 1.652(b)-3(d) (deductions allocable "to any other class of income" and "to the taxable interest or dividends" but deductions attributable to tax-exempt income not allocable "against any other class of income" or to "rents, taxable interest, or dividends"). *But see id.* § 1.652(b)-3(b) (deductions allocated "after direct expenses," but the author notes that the phrase "after direct expenses" appears only as a parenthetical in a sentence describing how indirect expenses are allocated in part to tax-exempt income); *see also supra* note 47 and accompanying text. Accordingly, the proposed calculation and allocation in this article allocate indirect expenses based upon the relative gross amounts of nontaxable and taxable income.

52. The term "amount to be included in the beneficiary's gross income" refers to the maximum amount that, as to a distribution received by the beneficiary from a trust or estate, the beneficiary must include in the beneficiary's gross income. Such "amount to be included in the beneficiary's gross income" may include tax-exempt interest income, which is excluded from the beneficiary's gross income under I.R.C. § 103(a). Section 662 and the regulations thereunder nonetheless indicate that the distribution initially is "to be included in gross income."

53. I.R.C. § 662(a).

54. *Id.* § 662(a)(1)-(2).

55. *Id.* § 662.

56. *Id.* § 662(a)(1).

57. *Id.*

58. *Id.* § 662(a)(2).

59. *Id.*

is the amount to be included in the beneficiary's gross income. If, however, a beneficiary receives a total distribution from a trust or estate that is greater than the beneficiary's allocated share of DNI, then the beneficiary's share of DNI is the amount to be included in the beneficiary's gross income. In this way, the two-tier system implements the rule stated above that each beneficiary receiving a distribution from a trust or estate must include the distribution in the beneficiary's gross income, but the amount to be included in the beneficiary's gross income cannot exceed the beneficiary's share of the DNI of the trust or estate.<sup>60</sup> It is important to note, however, that the two-tier system first uses DNI to determine the taxable *amount* of the total distribution from a trust or estate received by each beneficiary (the "amount to be included in the beneficiary's gross income"). Once the amount to be included in each beneficiary's gross income is calculated, the next step is to use DNI to determine the *character* of such amount in the beneficiary's hands.<sup>61</sup>

Absent a specific allocation in the governing instrument of different classes of income to different beneficiaries, the amount to be included in the beneficiary's gross income will have the same proportional character in the hands of the beneficiary as it had in the hands of the trust or estate.<sup>62</sup> In a similar manner as to the deduction for distributions allowed to a trust or estate, unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, the amount to be included in the gross income of a beneficiary is treated as consisting proportionally of each class of items that enters (as a net amount) into the computation of DNI of the trust or estate.<sup>63</sup> For example, if equal amounts of net taxable interest (gross taxable interest less deductions allocated thereto) and net rents (gross rents less deductions allocated thereto) enter into the computation of the DNI of a trust or estate, then, absent a specific provision in the governing instrument allocating different classes of income to different beneficiaries, the amount to be included in the gross income of a beneficiary is deemed to consist one-half of taxable interest and one-half of rents, which is the proportion by which those items (as net amounts) enter into the computation of the DNI of the trust or estate.<sup>64</sup>

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60. *Id.* § 662(a).

61. *Id.* § 662.

62. I.R.C. § 662(b).

63. *Id.* Treas. Reg. § 1.662(b)-1 (1960) adds that the allocation occurs as provided "unless local law requires" a specific allocation of different classes of income to different beneficiaries.

64. Assume there is DNI of \$200, attributable one-half to net taxable interest of \$100 (gross taxable interest of \$300 less \$200 deductions allocated thereto) and one-half to net rents of \$100 (gross rents of \$900 less \$800 deductions allocated thereto). Absent a specific allocation in the governing instrument of different

As to the amount to be included in the beneficiary's gross income, in the determination of the proportion by which classes of income (as net amounts) enter into the computation of the DNI of a trust or estate, the items of deductions entering into such computation of DNI (including the deduction allowed under § 642(c) regarding amounts paid or permanently set aside for a charitable purpose, which is beyond the scope of this article) are allocated among the "items of distributable net income"<sup>65</sup> entering into such computation of DNI in accordance with Treasury regulations.<sup>66</sup> The relevant Treasury regulation provides that the amount "includible" in the beneficiary's gross income "shall have the same character in the hands of the beneficiary as in the hands of the estate or trust"<sup>67</sup> but does not specify a method of allocating items of income and deduction to the beneficiary. As discussed regarding the deduction for distributions allowed to a trust or estate, the trust or estate determines the final character of each class of income entering into the computation of DNI of the trust or estate based upon the net amounts of each such class of income, after direct and indirect expenses have been taken into account.<sup>68</sup> Accordingly, because the amount "includible" in the beneficiary's gross income has the same character in the hands of the beneficiary as in the hands of the estate or trust, the apparent method for determining the character of such amount as to the beneficiary is the same method used for the trust or estate making the distribution to the beneficiary.

In summary, under §§ 661 and 662, DNI serves to ensure the single income taxation of the trust or estate and its beneficiaries. Once DNI has been calculated under § 643 (and is, therefore, calculated after deductions have been taken by the trust or estate and certain modifications have been made), DNI is allocated to the first-tier and then second-tier distributions to determine the

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classes of income to different beneficiaries, if the amount to be included in a beneficiary's gross income is \$80, then the \$80 is deemed to consist of \$40 of taxable interest (one-half of the distribution of \$80) and \$40 of rents (one-half of the distribution of \$80), which reflects the proportion by which those amounts of taxable interest and rents (as net amounts of \$100 each) enter into the computation of the DNI of the trust or estate of \$200.

65. I.R.C. § 662(b) refers to "items of distributable net income," but Treas. Reg. § 1.662(b)-2 (1960) refers to both "items of distributable net income" and "classes of income." The author believes that I.R.C. § 662 and Treas. Reg. § 1.662(b)-2 (1960) are imprecise to refer to "items of distributable net income" when apparently they refer to "items of income that enter into the computation of distributable net income," or, as the regulations provide, "classes of income." Additionally, the author notes that DNI, as discussed in Part I of this article, is a single amount (calculated from the taxpayer's taxable income with certain modifications) and therefore cannot properly be apportioned into "items of distributable net income."

66. I.R.C. § 662(b).

67. Treas. Reg. § 1.662(b)-1 (1960).

68. *Id.* § 1.652(b)-3 (1960).

extent to which the beneficiary's distribution from the trust or estate is included in the beneficiary's gross income. Once the beneficiary's amount to be included in gross income has been calculated, the character of such amount is determined by following the general rule that the amount has the same character in the hands of the beneficiary as in the hands of the trust or estate. Because a beneficiary's DNI is the maximum amount that is to be included in the beneficiary's gross income, the beneficiary's DNI must be analyzed to determine the character of the amount to be included in the beneficiary's gross income.

Absent a governing instrument that specifically allocates different classes of income to different beneficiaries, the beneficiary's DNI consists of the same proportion of items of income and deduction as those entering into the computation of the DNI of the trust or estate. In this way, then, the character of the amount to be included in the beneficiary's gross income depends on the character of the items of income and deduction entering into the computation of the DNI of the trust or estate. As noted above, however, the DNI of the trust or estate, calculated under § 643, has already been allocated to the beneficiaries under the two-tier system. Accordingly, once DNI has been allocated to the beneficiaries, the items of income and deduction entering into the computation of the DNI of the trust or estate only determine the character of the amount to be included in the beneficiary's gross income.

### III. SECTION 663(C)'S LIMITATION AND THE POTENTIALLY INCONSISTENT SEPARATE SHARE REGULATIONS

This part of the article discusses how the separate share rule and regulations address the calculation and allocation of DNI as used in the income taxation of a trust or estate with separate shares and the beneficiaries of such a trust or estate. My previous article discussed the general operation of the separate share rule, the general purpose of which is to prevent one separate share of a trust or estate from being subjected to income tax attributable to income being accumulated for another separate share.<sup>69</sup> Just as the income items of one separate share should not be allocated to another separate share, the deductions and losses that are applicable solely to one separate share of a trust or estate are "not available to any other share of the same trust or estate."<sup>70</sup> Because the separate shares of a trust or estate are viewed as having

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69. Yu, *supra* note 1, at 127-32.

70. Treas. Reg. § 1.663(c)-2(b)(5) (as amended in 1999).

independent economic interests, the separate share regulations attempt to ensure that the items of income and deduction are properly separated among the separate shares of a trust or estate.

As discussed above, this article focuses on how certain deductions are addressed by the separate share rule and regulations.<sup>71</sup> To implement the separate share rule, the separate share regulations apparently provide two methods for calculating and allocating DNI to the separate shares of a trust or estate. This article criticizes the two methods as providing anomalous results when one separate share has a net loss for at least one type of income and analyzes how one of the methods contravenes the separate share regulation providing that a deduction or loss that is applicable solely to one separate share of a trust or estate is “not available to any other share of the same trust or estate.”<sup>72</sup>

*A. The Separate Share Rule and Regulations Addressing Certain Deductions in the Calculation and Allocation of DNI to the Separate Shares of a Trust or Estate*

The separate share rule provides:

For the sole purpose of determining the amount of distributable net income in the application of sections 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts. Rules similar to the rules of the preceding provisions of this subsection shall apply to treat substantially separate and independent shares of different beneficiaries in an estate having more than 1 beneficiary as separate estates.<sup>73</sup>

In addressing how to determine “the amount of distributable net income in the application of sections 661 and 662,” the separate share regulations arguably appear to have provided two methods to calculate DNI under the separate share rule. The separate share regulations do not expressly provide two methods; rather, the two methods (and the examples implementing the two methods) appear throughout the regulations.

A summary of the first method is as follows: First, calculate the DNI of the trust or estate under § 643; second, allocate such post-deduction DNI to the

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71. See *supra* note 11.

72. Treas. Reg. § 1.663(c)-2(b)(5) (as amended in 1999).

73. I.R.C. § 663(c).

separate shares of the trust or estate.<sup>74</sup> This method presupposes that the DNI of the trust or estate consists of only positive amounts that can be divided and allocated among the separate shares generating such positive amounts. Accordingly, this method is proper only when each separate share has net income for each type of income entering into the computation of DNI but is problematic when one separate share has a net loss for any type of income entering into the computation of DNI of the trust or estate. Such a loss may enter into the computation of DNI for the trust or estate under § 643 and, therefore, may reduce the items of income of another separate share, which contravenes the separate share regulation providing that the deductions and losses of one separate share are “not available to any other share of the same trust or estate.”<sup>75</sup>

The separate share regulations provide the following language apparently applying the first method. First, a single trust or estate with substantially separate and independent shares is treated as separate trusts or estates “for the sole purpose of determining the amount of distributable net income allocable to the respective beneficiaries under sections 661 and 662.”<sup>76</sup> Second, “[t]he division of distributable net income into separate shares will limit the tax liability of B.”<sup>77</sup> Third, “[t]he separate share rule does not permit the treatment of separate shares as separate trusts (or estates) for any purpose other than the application of distributable net income.”<sup>78</sup> Fourth, “[t]he trust qualifies for the separate share treatment under section 663(c) and the distributable net income must be divided into three parts for the purpose of determining the amount deductible by the trust under section 661 and the amount includible in A’s gross income under section 662.”<sup>79</sup> In the foregoing examples, the terms “division,” “divided,” “allocable,” and “application” in relation to DNI appear

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74. The existence of the first method is, apparently, acknowledged by certain commentators. See, e.g., FERGUSON ET AL., *supra* note 49, at 7-84.6.

Separate-share status does not, therefore, have the effect of reducing the trust’s or estate’s overall DNI, but only allocates it among the various shares for purposes of calculating the amount of the distribution deduction available to the entity under § 661 with respect to each share and the amount on which each beneficiary is subject to taxation under § 662.

*Id.*; F. LADSON BOYLE & JONATHAN G. BLATTMACHR, *BLATTMACHR ON INCOME TAXATION OF ESTATES AND TRUSTS* 3-1, 3-104 (15th ed. 2008) (“A trust’s DNI is divided among the separate shares under rules in the regulations.”); *id.* at 3-105 (“The separate share rule only applies to allocate the DNI of the trust among the shares, not to create DNI.”).

75. Treas. Reg. § 1.663(c)-2(b)(5) (as amended in 1999).

76. *Id.* § 1.663(c)-1(a) (as amended in 1999).

77. *Id.*

78. *Id.* § 1.663(c)-1(b).

79. *Id.* § 1.663(c)-5, ex. 1 (as amended in 1999).



to presuppose the initial calculation of DNI for the trust or estate under § 643 and the later allocation of portions of that amount of DNI to the separate shares of the trust or estate for purposes of §§ 661 and 662.

In contrast, a summary of the second method determining DNI under the separate share rule is as follows. First, calculate the DNI of each separate share of the trust or estate individually under § 643, allocating to each such separate share its appropriate items of income and deduction; second, sum the DNI amounts of all separate shares, which should equal the DNI of the trust or estate.<sup>80</sup> This method, like the first method, is proper when each separate share has net income for each type of income entering into the computation of DNI but, unlike the first method, is also proper when one separate share has a net loss for any type of income entering into the computation of DNI. In the calculation of each separate share's DNI, any non-passive loss may reduce non-passive income (but not less than zero), and any passive loss may reduce passive income (but not less than zero); any net passive loss, however, may not reduce any non-passive income.<sup>81</sup>

The separate share regulations provide the following language apparently applying the second method. First, "in determining the distributable net income of each share, the income and expenses must be allocated 60% to the marital share and 40% to the trust's share."<sup>82</sup> Second, "[t]he distributable net income is \$7,200 (60% of income less 60% of expenses) for the marital share and \$4,800 (40% of income less 40% of expenses) for the trust's share."<sup>83</sup> Third, "[t]he fiduciary must use a reasonable and equitable method to allocate income and expenses to the trust's share."<sup>84</sup> Fourth, "depending on when the distribution is made to the trust, it may no longer be reasonable or equitable to determine the distributable net income for the trust's share by allocating to it 40% of the estate's income and expenses for the year."<sup>85</sup> Finally, "[t]he computation of the distributable net income for the trust's share should take into consideration that after the partial distribution the relative size of the

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80. The existence of the second method is, apparently, acknowledged (concurrently with the first method, *see supra* note 74) by certain commentators. *See, e.g.*, FERGUSON ET AL., *supra* note 49, at 7-84.6 ("Separate-share status requires computation of separate DNIs for each of the separate shares."); BOYLE & BLATTMACHR, *supra* note 74, at 3-104 ("First DNI for each share is computed as if each share is a separate trust.").

81. *See supra* note 44.

82. Treas. Reg. § 1.663(c)-5, ex. 2 (as amended in 1999).

83. *Id.*

84. *Id.* § 1.663(c)-5, ex. 3.

85. *Id.*

trust's separate share is reduced and the relative size of the spouse's separate share is reduced."<sup>86</sup>

The language indicating an application of the second method appears most explicitly in the separate share regulations providing the "[r]ules of administration."<sup>87</sup> First, "[t]he amount of distributable net income for any share under section 663(c) is computed for each share as if each share constituted a separate trust or estate."<sup>88</sup> Second, "[a]ccordingly, each separate share shall calculate its distributable net income based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses."<sup>89</sup> Third, there are three rules, one each for § 643(b) income, income in respect of a decedent, and gross income not attributable to cash, governing how such "gross income is allocated among the separate shares" of the trust or estate.<sup>90</sup> Fourth, "[a]ny deduction or any loss which is applicable solely to one separate share of the trust or estate is not available to any other share of the same trust or estate."<sup>91</sup> Finally, "[f]or purposes of calculating distributable net income for each separate share, the fiduciary must use a reasonable and equitable method to make the allocations, calculations, and valuations required by paragraph (b) of this section."<sup>92</sup>

In the foregoing examples, the language providing for an allocation of income as well as deductions and losses to each separate share and for a computation of DNI individually for each such separate share appears to presuppose an independent calculation of DNI for each such separate share, taking into account each such separate share's items of income and deduction. In sum, the separate share regulations' two methods calculate differently the DNI of separate shares of a trust or estate. As will be discussed below, the two methods provide the same results when all separate shares have net income for each type of income entering into the computation of DNI but different results when any separate share has a net loss as to at least one type of income entering into the computation of DNI.

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86. *Id.*

87. *Id.* § 1.663(c)-2 (as amended in 1999).

88. *Id.* § 1.663(c)-2(b)(1).

89. *Id.*

90. *Id.* § 1.663(c)-2(b)(2)-(4). For a more thorough discussion of these rules, see Yu, *supra* note 1, at 131-32.

91. Treas. Reg. § 1.663(c)-2(b)(5) (as amended in 1999).

92. *Id.* § 1.663(c)-2(c).

*B. Calculations Showing Anomalous Results Under the Two Methods of Determining DNI for the Separate Shares of a Trust or Estate*

The first method of determining DNI can, in certain instances, contravene the purpose of the separate share rule, as discussed in the next two examples. In the first example, a trust has two separate shares. The first separate share has net taxable interest income of \$25 (attributable to \$50 of taxable interest income and \$25 of direct expenses), and the second separate share of the trust has a net loss of \$15 (attributable to \$10 of taxable interest income and \$25 of direct expenses). Under the first method of interpreting § 663(c), DNI is calculated under § 643 as follows: First, the trust's taxable income is calculated as \$10 (attributable to \$60 of total taxable interest income less \$50 of total direct expenses allowed as a deduction). For the sake of simplicity, there are no modifications to the trust's taxable income, and the trust's DNI is also calculated as \$10. Consequently, both for purposes of characterizing the distribution deduction for the trust under § 661 and of characterizing the amount to be included in the gross income of each beneficiary under § 662, the ceiling is the \$10 of DNI, as calculated at the trust level under § 643.

Under the first method, allocating the DNI of \$10 between the two separate shares is problematic. The trust's DNI of \$10 is attributable to the first separate share's net income of \$25 and the second separate share's net loss of \$15. Even though the first method apparently presupposes separate shares contributing only positive amounts to the calculation of DNI, it is consistent with the first method to allocate the trust's DNI of \$10 to the first separate share, which contributed net income of \$25 to the final calculation of \$10 of DNI. Because the trust's DNI has been calculated under § 643, effectively, a cross-deduction has occurred in which the net loss of the second separate share has reduced the net income of the first separate share.

Assume that there is only one distribution of \$25 to the first separate share. Although it might have been assumed that the DNI of the first separate share is \$25 (\$50 of taxable interest income less the \$25 of direct expenses allowed as a deduction), the DNI allocated to the first separate share is, as discussed above, only \$10. As to the \$25 distribution, then, the first separate share includes only \$10 in gross income. Accordingly, the second separate share's loss has reduced the first separate share's net income and, therefore, its income tax liability. This cross-deduction between two separate shares contravenes the separate share regulation providing that a deduction or loss

applicable solely to one separate share of a trust or estate is “not available” to another separate share of the same trust or estate.<sup>93</sup>

Eliminating the cross-deduction, however, may be impossible because DNI must always, initially, be calculated under § 643 at the trust or estate level. As to the first separate share’s \$25 distribution in the preceding paragraph, such separate share should not include \$25 in gross income because the trust has only \$10 of DNI. In this way, the cross-deduction cannot be eliminated. Even if the first method cannot preclude a cross-deduction, though, the first method should also not obscure the net loss of a separate share, as it arguably does with the second separate share’s net loss of \$15 above. The proposed calculation and allocation presented later in this article attempt to ensure that any net loss of a separate share is identified and calculated so that the separate share can trace such loss. Although the proposed calculation and allocation of DNI cannot ensure absolutely equal and equitable results, the proposal will help trace the economic interests of each separate share, which may assist separate shares such as the second one above in seeking equitable adjustments from the fiduciary.

The second method of determining DNI also produces anomalous results when applied to the first example. Under the second method, the DNI of each separate share is first independently calculated.<sup>94</sup> The first separate share’s taxable income is calculated as \$25 (attributable to \$50 of taxable interest income less \$25 of direct expenses allowed as a deduction). For the sake of

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93. Treas. Reg. § 1.663(c)-2(b)(5) (as amended in 1999). F. Ladson Boyle and Jonathan G. Blattmachr note that:

Notwithstanding this rule [that any deduction or loss that is applicable solely to one separate share is not available to any other share], when a net loss in one share results in the DNI of an entire trust being less than the potential DNI of a different share (computed as though it was a separate trust), the DNI of the share with net income should not exceed the DNI of the trust. The effect of limiting the DNI of the profitable, second share to the trust’s DNI is to give the second share the benefit of the net loss in the first share.

BOYLE & BLATTMACHR, *supra* note 74, at 3-104 to -105.

94. In addressing Treas. Reg. § 1.663(c)-2(b)(5) (as amended in 1999), which provides that a deduction or loss that is applicable solely to one separate share of a trust or estate “is not available” to any other separate share of the trust or estate, certain commentators have criticized the allocation of items of income and deduction as follows:

Rigid segregation of items of income and deduction may yield implausible results. For example, if most or all of the items of income relate to one share, but most or all of the items of deduction relate to another, the DNI of the latter share may be less than zero. Surely, at least for this purpose, segregation must defer to common sense: the DNI of the first share (artificially high as a result of segregation) must never exceed the entity’s overall DNI.

FERGUSON ET AL., *supra* note 49, at 7-84.8 n.274. This article next addresses a situation very similar to this one, but the separate share with a net loss has DNI of \$0 because DNI (and taxable income, from which DNI is calculated) cannot be less than zero.

simplicity, there are no modifications to the first separate share's taxable income, and the first separate share's DNI is also calculated as \$25. The second separate share's taxable income is calculated as \$0 (attributable to \$10 of taxable interest income less \$25 of direct expenses—which results in a \$15 net loss—but, because taxable income cannot be a negative number, it is treated as \$0). For the sake of simplicity, there are no modifications to the second separate share's taxable income, and the second separate share's DNI is also calculated as \$0.

Assume that there is only one distribution of \$25 to the first separate share. Because the DNI of the first separate share is \$25, it initially appears that the first separate share must include \$25 in gross income. This result is anomalous because, as discussed above, the trust's DNI is \$10. Addressing a similar situation, commentators have indicated that the DNI of such a separate share "must never exceed the entity's overall DNI."<sup>95</sup> The second method presumes that the sum of all DNI amounts of the separate shares (as calculated independently) equals the DNI of the trust or estate (as calculated under § 643 at the entity level) and, therefore, apparently requires no final reconciliation between such sum of all DNI amounts and the DNI of the trust or estate. The proposed calculation and allocation, however, require such a final reconciliation.

A second example shows the problems under the current two methods of properly tracing passive and non-passive income and deductions. Again, a trust has two separate shares. The two separate shares have both (1) non-passive income and deductions and (2) passive income and deductions as follows: One separate share has net interest income of \$25 (attributable to \$50 of taxable interest income and \$25 of direct interest expenses) and net passive rental income of \$25 (attributable to \$50 of passive rents and \$25 of direct passive rental expenses). Another separate share has net interest income of \$25 (attributable to \$50 of taxable interest income and \$25 of direct interest expenses) and net passive rental loss of \$40 (attributable to \$10 of passive rents and \$50 of direct passive rental expenses).

Under the first method of determining DNI for the separate shares of a trust or estate, DNI is calculated under § 643 as follows: First, the trust's taxable income is calculated as \$50, attributable to net interest income only. Gross taxable interest income of \$100 less \$50 direct interest expenses results

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95. See FERGUSON ET AL., *supra* note 49, at 7-84.8 n.274 (noting that the separate share's DNI "must never exceed the entity's overall DNI"); BOYLE & BLATTMACHR, *supra* note 74, at 3-104 to -105 (noting that "the DNI of the share with net income should not exceed the DNI of the trust").

in \$50 net interest income. Gross passive rental income of \$60 less \$75 direct passive rental expenses results in a \$15 passive rental loss, but net passive losses cannot reduce non-passive income.<sup>96</sup> Accordingly, the trust's taxable income, which is attributable to net taxable interest income of \$50, is \$50. For the sake of simplicity, there are no modifications to the trust's taxable income, and the trust's DNI is also calculated as \$50. Both for purposes of characterizing the distribution deduction for the trust under § 661 and of characterizing the amount to be included in the gross income of each beneficiary under § 662, the ceiling is the \$50 of DNI (attributable to \$50 of net taxable interest income), as calculated under § 643 at the trust level.

Under the first method, allocating the DNI of \$50 between the two separate shares obscures the passive income and loss. The trust's DNI of \$50 is attributable to \$50 of net interest income and no net passive rental income. The first method allocates the \$50 of DNI as follows: Twenty-five dollars to each of the first and second separate shares because each contributed \$25 net interest income to the final calculation of \$50 of DNI. None of the trust's DNI is attributable to net passive rental income, so there is no further analysis of passive income or losses. Because the trust's DNI has been calculated under § 643, effectively, there has occurred a cross-deduction whereby the second separate share's \$40 net passive rental loss has reduced the first separate share's \$25 net passive rental income for a \$15 net passive loss of the trust, which is treated as \$0 because net passive losses cannot reduce non-passive income.<sup>97</sup>

Accordingly, the second separate share's net passive rental loss has reduced the first separate share's income tax liability as to its net passive rental income. This cross-deduction between two separate shares contravenes the separate share regulation providing that a deduction or loss applicable solely to one separate share is "not available" to another separate share of the same trust or estate.<sup>98</sup> As discussed in the first example, however, eliminating the cross-deduction may be impossible because DNI must always, initially, be calculated under § 643 at the trust or estate level.

Because DNI is calculated under § 643 at the trust or estate level, the passive rents and passive losses are netted at such entity level, thereby obscuring the first separate share's net passive rents and the second separate share's net passive losses. The proposed calculation and allocation, however,

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96. See *supra* note 44.

97. See *supra* note 44.

98. Treas. Reg. § 1.663(c)-2(b)(5) (as amended in 1999).

provide a clearer tracing of passive and non-passive income and deductions than does the first method to ensure that separate shares can identify and calculate their respective items of income and deduction. Although the proposed calculation and allocation of DNI cannot ensure absolutely equal and equitable results, the proposal will help trace the economic interests of each separate share, which may assist separate shares such as the second one above in seeking equitable adjustments from the fiduciary.

The second method of calculating and allocating DNI to the separate shares of a trust or estate also produces anomalous results when applied to the second example. The first separate share's taxable income is calculated as \$50 (attributable to: (1) \$25 of net taxable interest income (\$50 of taxable interest income less \$25 of direct expenses), and (2) \$25 of net passive rental income (\$50 of passive rents less \$25 of direct expenses)). For the sake of simplicity, there are no modifications to the first separate share's taxable income, and the first separate share's DNI is also calculated as \$50. The second separate share's taxable income is calculated as \$25 (attributable to: (1) \$25 of net taxable interest income (\$50 of taxable interest income less \$25 of direct expenses), and (2) \$0 (attributable to \$40 of net passive rental losses (\$10 of passive rental income less \$50 of direct expenses), which cannot reduce the non-passive net taxable interest income in this example and is, therefore, treated as \$0)). For the sake of simplicity, there are no modifications to the second separate share's taxable income, and the second separate share's DNI is also calculated as \$25.

The sum of the DNI amounts of the two separate shares is \$75 (\$50 for the first separate share and \$25 for the second separate share), but the trust's DNI is only \$50. The second method thus fails to make two reconciliations. First, it fails to reconcile the sum of all DNI amounts of the separate shares (as calculated independently) and the DNI of the trust or estate (as calculated under § 643 at the entity level). Second, it fails to reconcile the types of income entering into the computation of the DNI amounts of the separate shares (as calculated independently) and the types of income entering into the computation of the DNI of the trust or estate (as calculated under § 643 at the entity level). The proposed calculation and allocation, however, require both such reconciliations.

In summary, the two methods of calculating and allocating DNI to the separate shares of a trust or estate have certain weaknesses. The first method can obscure the independent economic interests of the separate shares by allowing the cross-deduction of deductions or losses between separate shares. The second method can produce anomalous results by providing a total DNI amount for all separate shares (after DNI is calculated independently for each

separate share) that exceeds the DNI of the trust or estate. The next part of this article proposes a treatment of deductions that resolves the foregoing problems. The proposal includes a calculation and allocation of DNI to the separate shares of a trust or estate that combine the features of the separate share regulations' two methods to provide transparency so that separate shares can trace their independent economic interests.

#### IV. PROPOSED TREATMENT OF DEDUCTIONS IN INCOME TAXATION OF A TRUST OR ESTATE WITH SEPARATE SHARES

An earlier proposed allocation of DNI to the separate shares of a trust or estate focused on tracing the income items that contributed to the DNI of a trust or estate with separate shares; such earlier proposal expressly omitted any discussion of deductions.<sup>99</sup> To address the problems discussed in Part III above, this article proposes a calculation and allocation of DNI to the separate shares of a trust or estate that resolves the issues raised in this article.

First, the proposal provides baskets of passive and non-passive income and deductions so that each separate share can trace them more clearly than under the current separate share regulations. The proposal also ensures that passive losses cannot reduce non-passive income. Finally, the proposal allocates indirect expenses based upon the relative gross amounts of nontaxable and taxable income of the separate shares.

Next, the proposal uses the two methods for calculating and allocating DNI provided in the separate share regulations but provides a final reconciliation of them. The proposal uses the first method because § 643 requires that DNI be calculated at the entity level. Accordingly, the proposal implements the first method's calculation of the DNI of the trust or estate, and the proposal uses such entity DNI in a subsequent reconciliation with the second method, which is discussed next.

The proposal uses the second method in an attempt to effect the policy that the separate shares of a trust or estate be treated as having independent economic interests. Accordingly, the proposal implements the second method's independent calculation of the DNI of each separate share of the trust or estate, ensuring that each separate share takes into account its own items of income and deduction, including any potential loss as to any type of income. In implementing the second method, the proposal ensures that no cross-deduction of losses occurs among separate shares and, at least initially, gives

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99. Yu, *supra* note 1, at 122 n.8.



effect to the separate share regulation providing that the deductions and losses applicable solely to one separate share are “not available” to another separate share.<sup>100</sup>

As discussed in Part III of this article, however, such a cross-deduction among separate shares is not always avoidable because DNI is calculated under § 643 at the entity level. Consequently, the proposal provides a final reconciliation between the two methods as follows. First, the proposal reconciles the types of income in the DNI amounts of the separate shares and the types of income in the DNI of the trust or estate by first comparing the DNI of the trust or estate and the sum of the DNI amounts of the separate shares and by next, if necessary, adjusting the DNI amounts of the separate shares to consist only of the types of income in the DNI of the trust or estate. Second, the proposal reconciles the sum of the DNI amounts of the separate shares and the DNI of the trust or estate by using the DNI of the trust or estate, as it is calculated under the first method, and then allocating such entity DNI among the separate shares according to their proportional DNI amounts, as they are calculated under the second method. The reconciliations ensure that the DNI of the trust or estate as calculated under § 643 serves as the maximum for the sum of all DNI amounts of all separate shares. By implementing both methods and then finally reconciling them, the proposal ensures that, to the extent possible, the deductions and losses that are applicable solely to one separate share are not available to any other separate share unless a cross-deduction results only because DNI is calculated at the entity level.

#### *A. Proposed Calculation and Allocation of DNI to the Separate Shares of a Trust or Estate*

In this Part IV.A, the article presents the proposed calculation and allocation of DNI to the separate shares of a trust or estate, focusing on the items of income and deduction entering into the computation of DNI of the trust or estate.<sup>101</sup> In Part IV.B, the article applies the proposed calculation and allocation to the two examples discussed in Part III of this article.

An overview of the proposed calculation and allocation is as follows. First, the proposal provides two calculations of DNI, one at the trust or estate level, and a second one for each separate share. Second, the proposal provides

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100. Treas. Reg. § 1.663(c)-2(b)(5) (as amended in 1999).

101. The seven Steps in this proposed calculation and allocation expand upon and replace the first three Steps in the allocation proposed in my first article. See Yu, *supra* note 1, at 155–62.

baskets so that each separate share can trace different types of income and deductions. Third, the proposal provides a final reconciliation between the DNI of the trust or estate and the sum of the DNI amounts calculated for each separate share.

The proposed calculation and allocation consist of the following steps:

**Step 1. Calculation of DNI of a trust or estate with separate shares**

This step ensures that, during the relevant taxable year, the trust or estate has separate shares. Additionally, this step calculates the DNI of the trust or estate; if there is DNI, this step identifies for later use the net income items entering into the computation of such DNI. This step is consistent with the separate share regulations' first method for calculating and allocating DNI; accordingly, this step provides a calculation for Entity DNI that serves as the maximum DNI of the trust or estate.

- a. Ensure that the trust or estate has separate shares, as defined in Treasury Regulation § 1.663(c).
- b. Calculate the DNI of the trust or estate ("Entity DNI" or "EDNI") under § 643 and the regulations thereunder, applying the limitations on deductions for passive losses and expenses related to tax-exempt income.
  - i. If EDNI equals zero, stop because there is no DNI to allocate to the separate shares of the trust or estate.
  - ii. If EDNI is greater than zero, note the net income items entering into the computation of EDNI because the proportions of those items will be retained if EDNI is greater than the sum of the DNI amounts of the separate shares of the trust or estate, as calculated in Step 7.

**Step 2. Allocation to principal and income baskets of the items of income entering into the computation of EDNI**

This step allocates the items of income of the trust or estate to four baskets: principal—IRD, principal—non-IRD, income—passive, and income—non-passive. The allocation to the four baskets identifies and traces the different types of income received by the trust or estate.

- a. Sum all items of income entering into the computation of EDNI of the trust or estate ("Entity (Items of Income)").
- b. Allocate to one basket ("Entity (principal)") the portion of Entity (Items of Income), if any, attributable to items of income that are not income within the meaning of § 643(b).
  - i. Allocate to one sub-basket ("Entity (principal—IRD)") the portion of Entity (principal), if any, attributable to items that are income in respect of a decedent.

- ii. Allocate to a second sub-basket (“Entity (principal—non-IRD)”) the portion of Entity (principal), if any, attributable to items that are not IRD.
- c. Allocate to a second basket (“Entity (income)”) the portion of Entity (Items of Income), if any, attributable to items of income that either (1) are income within the meaning of § 643(b) or (2) are not cash received by the trust or estate (for example, original issue discount, a distributable share of partnership tax items, and the pro rata share of an S corporation’s tax items).
  - i. Allocate to one sub-basket (“Entity (income—passive)”) the portion of Entity (income), if any, attributable to passive income items, and, as necessary, divide Entity (income—passive) into relevant classes of income (such as “Entity (income—passive rents)”).
  - ii. Allocate to a second sub-basket (“Entity (income—non-passive)”) the portion of Entity (income), if any, attributable to non-passive income items.
    - A. Allocate to one sub-sub-basket (“Entity (income—non-passive tax-exempt)”) the portion of Entity (income—non-passive), if any, attributable to tax-exempt income items, and, as necessary, divide such amount into relevant classes of income (such as “Entity (income—non-passive tax-exempt interest)”).
    - B. Allocate to a second sub-sub-basket (“Entity (income—non-passive taxable)”) the portion of Entity (income—non-passive), if any, attributable to taxable income items, and, as necessary, divide such amount into relevant classes of income (such as “Entity (income—non-passive taxable interest)” and “Entity (income—non-passive taxable dividends)”).

**Step 3. Allocation to principal and income baskets of the items of deduction entering into the computation of EDNI**

This step allocates the items of deduction of the trust or estate to four baskets: principal—IRD, principal—non-IRD, income—passive, and income—non-passive. The allocation to the four baskets identifies and traces the deductions relating to the different types of income received by the trust or estate.

- a. Sum all items of deduction entering into the computation of EDNI of the trust or estate (“Entity (Items of Deduction)”).

- b. Divide, under Treas. Reg. § 1.652(b)-3, Entity (Items of Deduction) into direct expenses (“Entity (Direct Items of Deduction)”) and indirect expenses (“Entity (Indirect Items of Deduction)”).
- c. Allocate Entity (Direct Items of Deduction) as follows:
  - i. Allocate to one basket (“Entity (principal deductions)”) the portion of Entity (Direct Items of Deduction), if any, directly related to the items of income that are not income within the meaning of § 643(b).
    - A. Allocate to one sub-basket (“Entity (principal—IRD deductions)”) the portion of Entity (principal deductions), if any, directly related to income in respect of a decedent (IRD).
    - B. Allocate to a second sub-basket (“Entity (principal—non-IRD deductions)”) the portion of Entity (principal deductions), if any, directly related to non-IRD items.
  - ii. Allocate to a second basket (“Entity (income deductions)”) the portion of Entity (Direct Items of Deduction), if any, directly related to items of income that either (1) are income within the meaning of § 643(b) or (2) are not cash received by the estate or trust (for example, original issue discount, a distributable share of partnership tax items, and the pro rata share of an S corporation’s tax items).
    - A. Allocate to one sub-basket (“Entity (income—passive deductions)”) the portion of Entity (income deductions), if any, directly related to passive income items.
    - B. Allocate to a second sub-basket (“Entity (income—non-passive deductions)”) the portion of Entity (income deductions), if any, directly related to non-passive income items.
      - I. Allocate to one sub-sub-basket (“Entity (income—non-passive tax-exempt deductions)”) the portion of Entity (income—non-passive deductions), if any, directly related to tax-exempt income items, and, as necessary, divide such amount into relevant classes of deduction (such as “Entity (income—non-passive tax-exempt interest deductions)”).
      - II. Allocate to a second sub-sub-basket (“Entity (income—non-passive taxable deductions)”) the portion of Entity (income—non-passive deductions), if any, directly related to taxable income items, and, as

necessary, divide such amount into relevant classes of deduction (such as “Entity (income—non-passive taxable interest deductions)” and “Entity (income—non-passive taxable dividends deductions)”).

- d. Hold the Entity (Indirect Items of Deduction) basket, which will be allocated later.

**Step 4. Tentative allocation to the separate shares of a trust or estate of the items of income entering into the computation of EDNI**

This step allocates to the separate shares of a trust or estate the items of income entering into the computation of EDNI based on whether EDNI is attributable to principal items or to income items received by the trust or estate. This allocation identifies and traces the different types of income received by the trust or estate.

- a. Tentatively allocate all items of income in the Entity (principal—IRD) and Entity (principal—non-IRD) baskets, if any, to the separate shares of the trust or estate in accordance with the amount of principal of the trust or estate that each separate share is entitled to under the terms of the governing instrument or applicable local law (each separate share’s tentative allocation respectively called its “Tentative income (principal—IRD)” and “Tentative income (principal—non-IRD)”).
- b. Tentatively allocate all items of income in the Entity (income—passive), Entity (income—non-passive tax-exempt), and Entity (income—non-passive taxable) baskets, if any, to the separate shares of the trust or estate in accordance with the amount of income of the trust or estate that each separate share is entitled to under the terms of the governing instrument or applicable local law (each separate share’s tentative allocation respectively called its “Tentative income (income—passive),” “Tentative income (income—non-passive tax-exempt),” and “Tentative income (income—non-passive taxable)”).

**Step 5. Allocation to the separate shares of a trust or estate of the items of deduction attributable to direct expenses entering into the computation of EDNI and reduction of tentatively allocated income by such deductions**

This step allocates to the separate shares of a trust or estate the items of deduction attributable to direct expenses entering into the computation of EDNI and then reduces the tentative allocation of income by such expenses. This step ensures that no deduction is allowed for excess direct tax-exempt or passive expenses but allows a further deduction, as to the

other three baskets of income, for any excess direct expenses (but disallows a deduction for any net loss).

- a. Allocate the direct expenses (if any) in the following five baskets, Entity (principal—IRD deductions), Entity (principal—non-IRD deductions), Entity (income—passive deductions), Entity (income—non-passive tax-exempt deductions), and Entity (income—non-passive taxable deductions), to the appropriate separate shares in accordance with the terms of the governing instrument or applicable local law.
- b. As to each separate share's five baskets of tentatively allocated income (Tentative income (principal—IRD), Tentative income (principal—non-IRD), Tentative income (income—passive), Tentative income (income—non-passive tax-exempt), and Tentative income (income—non-passive taxable)), calculate each such basket's tentative net income (or tentative net loss), after direct expenses only, by reducing each such basket by any direct expenses allocated to the separate shares under Step 5.a above.
  - i. Any tentative net loss as to the two baskets of income, Tentative income (income—passive) and Tentative income (income—non-passive tax-exempt), gives rise to no further deduction.
  - ii. Any tentative net loss as to the three baskets of income, Tentative income (principal—IRD), Tentative income (principal—non-IRD), and Tentative income (income—non-passive taxable), gives rise to a further deduction for excess direct expenses, which may be allocated under Treas. Reg. § 1.652(b)-3(d) as the fiduciary may elect. Re-calculate each separate share's tentative net income (or tentative net loss) as to the foregoing three baskets, after any direct expenses and excess direct expenses; any tentative net loss gives rise to no further deduction.

**Step 6. Allocation to the separate shares of a trust or estate of the items of deduction attributable to indirect expenses entering into the computation of EDNI and reduction of tentatively allocated income (after any direct expenses and excess direct expenses) by such deductions**

This step allocates to the separate shares of a trust or estate the items of deduction attributable to indirect expenses entering into the computation of EDNI and then reduces the tentative allocation of income (after any direct expenses and excess direct expenses) by indirect expenses and ensures that no deduction is allowed for any excess expenses (both direct

and indirect). The allocation in Step 6.a of indirect expenses is based on the relative gross amounts of nontaxable and taxable income before direct expenses have been taken into account.

- a. If Entity (Indirect Items of Deduction) is greater than zero, as to each separate share with Tentative income (income—non-passive tax-exempt) greater than zero (before being reduced by direct expenses), allocate to each such separate share an amount of Entity (Indirect Items of Deduction) that bears the same ratio to Entity (Indirect Items of Deduction) as each such separate share's Tentative Income (income—non-passive tax-exempt) bears to Entity (Items of Income).
- b. After Step 6.a above (and after Step 5 regarding direct expenses), as to each separate share's Tentative income (income—non-passive tax-exempt) basket, calculate net tax-exempt income (or net tax-exempt loss), and disallow a deduction for net losses attributable to excess direct and indirect expenses over tax-exempt income.
- c. After Step 6.a above, allocate the remaining indirect expenses, if any, to the separate shares of the trust or estate under Treas. Reg. § 1.652(b)-3(b), as the fiduciary may elect.
- d. After Step 6.c above (and after Step 5 regarding direct expenses), as to each separate share's five baskets of income (Tentative income (principal—IRD), Tentative income (principal—non-IRD), Tentative income (income—passive), Tentative income (income—non-passive tax-exempt), and Tentative income (income—non-passive taxable)), calculate each such basket's final net income (or final net loss).
  - i. Any net loss as to the two baskets of income, Tentative income (income—passive) and Tentative income (income—non-passive tax-exempt), gives rise to no further deduction.
  - ii. Any net loss as to the three baskets of income, Tentative income (principal—IRD), Tentative income (principal—non-IRD), and Tentative income (income—non-passive taxable), may give rise to a re-allocation by the fiduciary of the indirect expenses, which may be allocated under Treas. Reg. § 1.652(b)-3(b) as the fiduciary may elect.<sup>102</sup> Any net loss after any such re-allocation gives rise to no further deduction.

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102. Generally, each basket of income should, if possible, be greater than or equal to zero (and not less than zero) because the fiduciary should attempt to maximize the deductibility of indirect expenses by ensuring their allocation to baskets of income that could be reduced by them.

### **Step 7. Calculation of the DNI of each separate share of a trust or estate and reconciliation with Entity DNI**

This step is consistent with the separate share regulations' second method for calculating and allocating DNI; accordingly, this step provides a calculation for the DNI of each separate share of the trust or estate, thus ensuring that each separate share is treated as having an independent economic interest and, consequently, its own items of income and deduction. However, as discussed in Part III of this article, cross-deduction among separate shares may be impossible to prevent because DNI is calculated under § 643 at the level of the trust or estate.

Consequently, this step compares the DNI of the trust or estate (as calculated in Step 1 above) and the sum of the DNI amounts of the separate shares (as calculated in this step). If the DNI of the trust or estate is less than the sum of the individual DNI amounts, this step adjusts the individual DNI amounts to equal the DNI of the trust or estate. Any adjustment to the DNI of a separate share is transparent, which may assist a beneficiary of such separate share in seeking equitable adjustments from the fiduciary.

- a. As to the net income (or net loss) for each such separate share's five baskets of income, calculate the Tentative DNI of each such separate share, applying the limitations on deductions for passive losses and expenses related to tax-exempt income.
- b. Sum the Tentative DNI amounts of all separate shares of the trust or estate.
  - i. If the sum of Tentative DNI amounts equals Entity DNI, each separate share's Tentative DNI amount equals its Final DNI amount.
  - ii. If the sum of Tentative DNI amounts is greater than Entity DNI:
    - A. Confirm the net income items entering into the computation of Entity DNI in Step 1.
    - B. As to each separate share with a Tentative DNI greater than zero, adjust each such separate share's Tentative DNI so that each such Tentative DNI amount includes only the same class of net income items that entered into the computation of Entity DNI in Step 1.
    - C. After Step 7.b.ii.B. above, as to each separate share with net income items that entered into the computation of Entity DNI in Step 1, allocate to each such separate share a portion of Entity DNI that bears the same ratio to Entity DNI as each such separate share's Tentative DNI amount (as



adjusted in Step 7.b.ii.B. above) bears to the total Tentative DNI amounts (as adjusted in Step 7.b.ii.B. above) of all such separate shares. The portion of Entity DNI allocated to each such separate share is the separate share's Final DNI, and the character of the Final DNI in the hands of each such separate share consists of a proportionate share of the net income items entering into the computation of Entity DNI in Step 1.

*B. Application of the Proposed Calculation and Allocation to the Preceding Two Examples and Discussion*

**Example 1:** A trust has two separate shares. One separate share has net taxable interest income of \$25 (attributable to \$50 of taxable interest income and \$25 of direct interest expenses) and the second separate share has a net loss of \$15 (attributable to \$10 of taxable interest income and \$25 of direct interest expenses). As to the foregoing facts, this article first summarizes the application of the proposed calculation and allocation and then provides a detailed analysis of each step of the proposed calculation and allocation.

Step 1 of the proposed calculation and allocation calculates the DNI for the entire trust as \$10 (resulting from \$60 of taxable interest income less \$50 of direct expenses allowed as a deduction). Next, Steps 2 through 6 allocate the trust's items of income and deduction between the two separate shares and calculate each separate share's net income (or net loss) as follows: the first separate share has \$25 of net income, and the second separate share has a \$15 net loss.

Step 7 calculates a Tentative DNI amount individually for each separate share as follows: the first separate share has \$25 of Tentative DNI, and the second separate share has \$0 of Tentative DNI. Additionally, Step 7 provides a final reconciliation of the trust's \$10 of DNI with the amount of \$25 of Tentative DNI, which is the sum of the Tentative DNI amounts calculated individually for the two separate shares. First, Step 7 does not adjust the Tentative DNI amount of either separate share so that it includes only the class of income included in the trust's DNI because, here, the only Tentative DNI amount greater than zero, the first separate share's \$25, consists of net interest income, which is the same class of income comprising the trust's \$10 of DNI. Next, because the trust's \$10 of DNI sets the maximum of DNI for the two separate shares, Step 7 allocates the \$10 of DNI based on the separate shares' proportional Tentative DNI amounts, so that the first separate share has \$10 of Final DNI and the second separate shares has \$0 of Final DNI.

Under the proposed calculation and allocation, Step 5 highlights the independent economic interests of the two separate shares, the first one having \$25 of net income and the second one having a \$15 net loss. The proposed calculation and allocation cannot prevent the first separate share from benefiting from the second separate share's loss. Nevertheless, although the trust's \$10 of DNI is allocated to the first separate share, the tracing of income and deductions nonetheless may assist the second separate share in seeking from the fiduciary equitable adjustments because the first separate share benefited from the excess deductions of such second separate share.

The steps of the proposed calculation and allocation of DNI apply as follows.

- Step 1.a. The trust has separate shares.
- Step 1.b. EDNI is \$10 (\$60 total interest income less \$50 direct interest expenses).
- Step 1.b.i. This step does not apply because EDNI does not equal zero.
- Step 1.b.ii. EDNI is \$10, which is greater than zero. The net income item entering into the computation of EDNI is interest income.
- Step 2.a. Entity (Items of Income) is \$60 (\$50 for the first separate share and \$10 for the second separate share).
- Step 2.b. This step does not apply because there is no portion of Entity (Items of Income) that is Entity (principal).
- Step 2.c. Entity (income) is \$60 (attributable to \$60 of interest income, which is income within the meaning of § 643(b)).
- Step 2.c.i. This step does not apply because there is no portion of Entity (income) that is Entity (income—passive).
- Step 2.c.ii. Entity (income—non-passive) is \$60 (attributable to \$60 of non-passive interest income).
- Step 2.c.ii.A. This step does not apply because there is no portion of Entity (income—non-passive) that is Entity (income—non-passive tax-exempt).
- Step 2.c.ii.B. Entity (income—non-passive taxable) is \$60 (attributable to \$60 of non-passive taxable interest income).
- Step 3.a. Entity (Items of Deduction) is \$50 (\$25 for the first separate share and \$25 for the second separate share).
- Step 3.b. Entity (Direct Items of Deduction) is \$50 (attributable to \$50 of direct interest expenses), and Entity (Indirect Items of Deduction) is \$0.

- Step 3.c.i. This step does not apply because no portion of Entity (Direct Items of Deduction) is Entity (principal deductions).
- Step 3.c.ii. Entity (income deductions) is \$50 (attributable to \$50 of direct taxable interest expenses).
- Step 3.c.ii.A. This step does not apply because no portion of Entity (income deductions) is Entity (income—passive deductions).
- Step 3.c.ii.B. Entity (income—non-passive deductions) is \$50 (attributable to \$50 of direct non-passive interest expenses).
- Step 3.c.ii.B.I. This step does not apply because no portion of Entity (income—non-passive deductions) is Entity (income—non-passive tax-exempt deductions).
- Step 3.c.ii.B.II. Entity (income—non-passive taxable deductions) is \$50 (attributable to \$50 of direct non-passive taxable interest expenses).
- Step 3.d. This step does not apply because there is no Entity (Indirect Items of Deduction).
- Step 4.a. This step does not apply because there is no Entity (principal).
- Step 4.b. There is \$60 of Entity (income—non-passive taxable), and, under the terms of the governing instrument and the facts of this example, the first separate share's Tentative income (income—non-passive taxable) is \$50, and the second separate share's Tentative income (income—non-passive taxable) is \$10.
- Step 5.a. The \$50 of Entity (income—non-passive taxable deductions) are allocated to the appropriate separate shares as follows. The \$25 of expenses directly attributable to the first separate share is allocated to such separate share, and the \$25 of expenses directly attributable to the second separate share are allocated to such separate share.
- Step 5.b. The first separate share's Tentative income (income—non-passive taxable) of \$50 is reduced by \$25 of direct expenses, resulting in net income of \$25 (after direct expenses only). The second separate share's Tentative income (income—non-passive taxable) of \$10 is reduced

- by \$25 of direct expenses, resulting in a net loss of \$15 (after direct expenses only).
- Step 5.b.i. This step does not apply because there is no net loss as to Tentative income (income—passive) or Tentative income (income—non-passive tax-exempt).
- Step 5.b.ii. The second separate share's net loss as to Tentative income (income—non-passive taxable) gives rise to a further deduction for excess direct expenses, but the second separate share has no other income items and, therefore, cannot allocate the excess direct expenses to any such income items.
- Step 6. This step does not apply because there is no Entity (Indirect Items of Deduction).
- Step 7.a. The first separate share's taxable income is \$25 (Tentative income (income—non-passive taxable) of \$25 (after direct expenses only)), reduced by no indirect expenses; for the sake of simplicity, there are no modifications to the \$25 of taxable income, so Tentative DNI is \$25.
- The second separate share's taxable income is \$0 (Tentative income (income—non-passive taxable) of an initial loss amount of \$15 (after direct expenses only), but no less than \$0), reduced by no indirect expenses; for the sake of simplicity, there are no modifications to the \$0 of taxable income, so Tentative DNI is \$0.
- Step 7.b. The sum of the DNI amounts of all separate shares is \$25 (attributable to the first separate share's DNI of \$25 and the second separate share's DNI of \$0).
- Step 7.b.i. This step does not apply because the sum of the separate shares' Tentative DNI amounts of \$25 does not equal Entity DNI of \$10.
- Step 7.b.ii. The sum of the separate shares' Tentative DNI amounts of \$25 is greater than Entity DNI of \$10, so this step applies.
- Step 7.b.ii.A. The net income items entering into the computation of Entity DNI in Step 1 are interest income items.
- Step 7.b.ii.B. The first separate share's Tentative DNI of \$25 consists of net interest income items, which entered into the computation of Entity DNI in Step 1, so there is no

adjustment. The second separate share's Tentative DNI is \$0, so there is no adjustment.

- Step 7.b.ii.C. The first separate share is allocated \$10 of Entity DNI, which is the portion of \$10 of Entity DNI that bears the same ratio (100%) to \$10 of Entity DNI as such separate share's Tentative DNI amount of \$25 (as adjusted in Step 7.B.ii.B. above) bears to \$25, the total Tentative DNI amounts (as adjusted in Step 7.B.ii.B. above) of all separate shares. The \$10 is the first separate share's Final DNI. The character of the Final DNI in the hands of the first separate share consists of all interest income, which is the same proportion (100%) as the net interest income items (\$10) entering into the computation of Entity DNI (\$10). The second separate share's Final DNI is \$0.

**Example 2:** A trust has two separate shares. The two separate shares have both (1) non-passive income and deductions and (2) passive income and deductions as follows: One separate share has net interest income of \$25 (attributable to \$50 of taxable interest income and \$25 of direct interest expenses) and net passive rental income of \$25 (attributable to \$50 of passive rents and \$25 of direct passive rental expenses). Another separate share has net interest income of \$25 (attributable to \$50 of taxable interest income and \$25 of direct interest expenses) and a net passive rental loss of \$40 (attributable to \$10 of passive rents and \$50 of direct passive rental expenses). As to the foregoing facts, this article first summarizes the application of the proposed calculation and allocation and then provides a detailed analysis of each step of the proposed calculation and allocation.

Step 1 of the proposed calculation and allocation calculates the DNI for the entire trust as \$50, resulting from \$50 of net taxable interest income (\$100 gross taxable interest income less \$50 of direct expenses allowed as a deduction) and \$0 of net passive rental income (\$60 passive rents less \$75 direct passive rental expenses, but not less than zero because net passive losses cannot reduce non-passive income). Next, Steps 2 through 6 allocate the trust's items of income and deduction between the two separate shares and calculate each separate share's net income (or net loss) as follows: The first separate share has \$25 of net interest income and \$25 of net passive rental income, and the second separate share has \$25 of net interest income and a \$40 net passive rental loss.

Step 7 calculates a Tentative DNI amount individually for each separate share as follows. The first separate share's Tentative DNI is \$50, and the

second separate share's Tentative DNI is \$25. Additionally, Step 7 provides a final reconciliation of the trust's \$50 of DNI with the amount of \$75 of DNI, which is the sum of the Tentative DNI amounts calculated individually for the two separate shares. First, Step 7 adjusts the Tentative DNI amount of each separate share so that it includes only the class of income included in the trust's DNI, which here is net interest income; accordingly, as adjusted, the first separate share's Tentative DNI is \$25, and the second separate share's Tentative DNI is \$25. Next, because the trust's \$50 of DNI sets the maximum of DNI for the two separate shares, Step 7 allocates the \$50 of DNI based on the separate shares' Tentative DNI amounts (after the adjustment to the Tentative DNI amounts to include only net interest income), so that the first separate share has \$25 of Final DNI and the second separate share has \$25 of Final DNI.

Under the proposed calculation and allocation, each separate share calculates its DNI amount by taking into account its own passive and non-passive items of income and deduction. Step 5 highlights the independent economic interests of the two separate shares, the first one having \$25 of net interest income and \$25 net passive rental income and the second one having \$25 of net interest income and a \$40 net passive rental loss. The proposed calculation and allocation cannot prevent the first separate share from benefiting from the second separate share's loss. Nevertheless, although the trust's \$50 of DNI is allocated equally between the two separate shares based upon their equal amounts of net interest income, the tracing of all items of income and deduction may assist the second separate share in seeking from the fiduciary equitable adjustments because the first separate share benefited from the excess passive rental deductions of such second separate share.

The steps of the proposed calculation and allocation of DNI apply as follows.

- Step 1.a.           The trust has separate shares.
- Step 1.b.           EDNI is \$50 (attributable to: (1) \$50 net interest income, resulting from \$100 interest income less \$50 direct interest expenses, and (2) \$0 net passive rental income, resulting from \$60 passive rents less \$75 direct passive rental expenses, but not less than zero because net passive losses cannot reduce non-passive income).
- Step 1.b.i.         This step does not apply because EDNI does not equal zero.
- Step 1.b.ii.        EDNI is \$50, which is greater than zero. Because there is \$0 of net passive rental income, the only net income

- item entering into the computation of EDNI is interest income.
- Step 2.a. Entity (Items of Income) is \$160 (\$100 total interest income and \$60 total passive rents).
- Step 2.b. This step does not apply because there is no portion of Entity (Items of Income) that is Entity (principal).
- Step 2.c. Entity (income) is \$160 (attributable to \$100 of total interest income and \$60 of total passive rents, which are each income within the meaning of § 643(b)).
- Step 2.c.i. Entity (income—passive) is \$60 (attributable to \$60 of passive rents).
- Step 2.c.ii. Entity (income—non-passive) is \$100 (attributable to \$100 of non-passive interest income).
- Step 2.c.ii.A. This step does not apply because there is no portion of Entity (income—non-passive) that is Entity (income—non-passive tax-exempt).
- Step 2.c.ii.B. Entity (income—non-passive taxable) is \$100 (attributable to \$100 of non-passive taxable interest income).
- Step 3.a. Entity (Items of Deduction) is \$125 (attributable to \$50 of total direct interest expenses and \$75 of total direct passive rental expenses).
- Step 3.b. Entity (Direct Items of Deduction) is \$125 (attributable to \$50 of direct interest expenses and \$75 of direct passive rental expenses), and Entity (Indirect Items of Deduction) is \$0.
- Step 3.c.i. This step does not apply because no portion of Entity (Direct Items of Deduction) is Entity (principal deductions).
- Step 3.c.ii. Entity (income deductions) is \$125 (attributable to \$50 of direct interest expenses and \$75 of direct passive rental expenses).
- Step 3.c.ii.A. Entity (income—passive deductions) is \$75 (attributable to \$75 of direct passive rental expenses).
- Step 3.c.ii.B. Entity (income—non-passive deductions) is \$50 (attributable to \$50 of direct non-passive taxable interest expenses).
- Step 3.c.ii.B.I. This step does not apply because no portion of Entity (income—non-passive deductions) is Entity (income—non-passive tax-exempt deductions).

- Step 3.c.ii.B.II. Entity (income—non-passive taxable deductions) is \$50 (attributable to \$50 of direct non-passive taxable interest expenses).
- Step 3.d. This step does not apply because there is no Entity (Indirect Items of Deduction).
- Step 4.a. This step does not apply because there is no Entity (principal).
- Step 4.b. There are two baskets of income, \$60 of Entity (income—passive) and \$100 of Entity (income—non-passive taxable), each of which must be allocated to the two separate shares. Under the terms of the governing instrument and the facts of this example, the first separate share has Tentative income (income—passive) of \$50 and Tentative income (income—non-passive taxable) of \$50, and the second separate share has Tentative income (income—passive) of \$10 and Tentative income (income—non-passive taxable) of \$50.
- Step 5.a. The \$75 of Entity (income—passive deductions) are allocated to the appropriate separate shares as follows: The \$25 of expenses directly attributable to the first separate share are allocated to such separate share, and the \$50 of expenses directly attributable to the second separate share are allocated to such separate share. The \$50 of Entity (income—non-passive taxable deductions) are allocated to the appropriate separate shares as follows: The \$25 of expenses directly attributable to the first separate share are allocated to such separate share, and the \$25 of expenses directly attributable to the second separate share are allocated to such separate share.
- Step 5.b. Each of the two separate shares has two baskets of income, and each separate share must calculate the net income (or net loss) of each basket of income (after direct expenses only). The first separate share's calculations are as follows: Tentative income (income—passive) of \$50 is reduced by \$25 of direct expenses, resulting in net income of \$25 (after direct expenses only), and Tentative income (income—non-passive taxable) of \$50 is reduced by \$25 of direct expenses,



resulting in net income of \$25 (after direct expenses only).

The second separate share's calculations are as follows: Tentative income (income—passive) of \$10 is reduced by \$50 of direct expenses, resulting in a net loss of \$40 (after direct expenses only), and Tentative income (income—non-passive taxable) of \$50 is reduced by \$25 of direct expenses, resulting in net income of \$25 (after direct expenses only).

- Step 5.b.i. The second separate share's net loss as to Tentative income (income—passive) gives rise to no further deduction.
- Step 5.b.ii. This step does not apply because there is no net loss as to the relevant baskets of income.
- Step 6. This step does not apply because there is no Entity (Indirect Items of Deduction).
- Step 7.a. The Tentative DNI of each of the two separate shares is calculated as follows: The first separate share's taxable income is \$50, the sum of \$25 (Tentative income (income—non-passive taxable) of \$25 (after direct expenses only), reduced by no indirect expenses) and \$25 (Tentative income (income—passive) of \$25 (after direct expenses only), reduced by no indirect expenses); for the sake of simplicity, there are no modifications to the \$50 of taxable income, so the first separate share's Tentative DNI is \$50.
- The second separate share's taxable income is \$25, the sum of \$25 (Tentative income (income—non-passive taxable) of \$25 (after direct expenses only), reduced by no indirect expenses) and \$0 (Tentative income (income—passive) of \$40 of loss (after direct expenses only), which cannot reduce the \$25 of non-passive income and is, therefore, effectively \$0; reduced by no indirect expenses); for the sake of simplicity, there are no modifications to the \$25 of taxable income, so the second separate share's Tentative DNI is \$25.
- Step 7.b. The sum of the Tentative DNI amounts of all separate shares is \$75 (attributable to the first separate share's Tentative DNI of \$50 and the second separate share's Tentative DNI of \$25).

- Step 7.b.i. This step does not apply because the sum of the separate shares' Tentative DNI amounts of \$75 does not equal Entity DNI of \$50.
- Step 7.b.ii. The sum of the separate shares' Tentative DNI amounts of \$75 is greater than Entity DNI of \$50, so this step applies.
- Step 7.b.ii.A. The net income items entering into the computation of Entity DNI in Step 1 are interest income items.
- Step 7.b.ii.B. The first separate share's Tentative DNI of \$50 consists of \$25 of net interest income items and \$25 of net passive rental income, so the first separate share's Tentative DNI is adjusted to be \$25, so that such separate share's Tentative DNI amount (as adjusted) includes only the same class of net income items (interest income) that entered into the computation of Entity DNI in Step 1. The second separate share's Tentative DNI of \$25 consists of \$25 of net interest income items and \$0 of net passive rental income, so there is no adjustment because the second separate share's Tentative DNI includes only the same class of net income items (interest income) that entered into the computation of Entity DNI in Step 1.
- Step 7.b.ii.C. The first and second separate shares each receive \$25 of Final DNI under the same calculation as follows. Each separate share is allocated \$25 of Entity DNI, which is the portion of \$50 of Entity DNI that bears the same ratio (50%) to \$50 of Entity DNI as each such separate share's Tentative DNI amount of \$25 (as adjusted in Step 7.B.ii.B. above) bears to \$50, the total Tentative DNI amounts (as adjusted in Step 7.B.ii.B. above) of all such separate shares. Each of the first and second separate shares has \$25 of Final DNI. The character of the Final DNI in the hands of each separate share consists of all interest income, which is the same proportion (100%) as the net interest income items (\$50) entering into the computation of Entity DNI (\$50).

## V. CONCLUSION

When a distribution from a trust or estate to a beneficiary is to be included in the beneficiary's gross income, the character of the distribution is the same in the hands of the beneficiary as it was in the hands of the trust or estate. In order to determine the character of the distribution in the hands of the trust or estate, and, consequently, in the hands of a beneficiary, the items of income and deduction entering into the computation of the DNI of the trust or estate must be identified and calculated.

Currently, the separate share regulations arguably provide two methods of calculating the items of income and deduction entering into the computation of the DNI of the trust or estate, and each method has its own weaknesses when applied to a trust or estate with separate shares, one of which has a net loss for at least one type of income. The first method allows one separate share to benefit from the net loss of another separate share, thereby not only contravening the separate share regulation providing that a deduction or loss applicable solely to one separate share of a trust or estate is "not available" to another separate share of the trust or estate,<sup>103</sup> but also obscuring the independent economic interests of the separate shares. The second method, conversely, prevents any share from benefiting from the net loss of another share but produces the anomalous result that the sum of all DNI amounts for all separate shares may exceed the DNI of the trust or estate.

The proposed calculation and allocation of DNI to the separate shares of a trust or estate address the foregoing weaknesses by providing two calculations of DNI, one at the entity level and a second one at the level of each separate share, and by tracing the items of income and deduction (passive and non-passive) entering into both such calculations. Although both DNI calculations are used, the proposed calculation and allocation reconcile them, thereby ensuring that each separate share's DNI amount reflects only the classes of income comprising the entity's DNI and that the sum of the DNI amounts of all separate shares equals the DNI of the trust or estate.

Because DNI is calculated under § 643 at the level of the trust or estate, the proposed calculation and allocation cannot ensure that the deductions or losses of one separate share are "not available" to another separate share of the trust or estate. The proposed calculation and allocation, however, more closely trace passive and non-passive income and deductions so that the independent economic interests of each separate share may be identified. Such

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103. Treas. Reg. § 1.663(c)-2(b)(5) (as amended in 1999).

transparency may help a separate share with a net loss to seek equitable adjustments from a fiduciary when another separate share benefits from that loss. Accordingly, the separate share regulations should be amended to provide a calculation and allocation of DNI to the separate shares of a trust or estate such as those proposed in this article.