In the above example, assume that there was $10,000 in trustee's fees, $5,000 of which was charged against FAI. As a result, FAI would be $35,000, while DNI would now be $40,000. The distribution deduction ought to be the lower of the FAI or DNI ($35,000), reduced by the net tax-exempt interest included in DNI ($8,000) so that the distribution deduction is $27,000. This results in taxable income of $5,000, representing the $10,000 of gross income retained by the trust, reduced by that portion of the trustee fees charged against the principal, $5,000.

Although Reg. § 1.651(b)-1 does not specify a method to reduce FAI by the tax-exempt income included in FAI, it seems that FAI should be reduced by the same amount as DNI would be reduced if DNI were the applicable amount for computing the distribution deduction.

Therefore, in order to determine the trust's distribution deduction, one needs to first compute FAI and DNI under § 643(a), and the distribution deduction will then be the lesser of FAI or DNI, reduced by net tax-exempt interest.

2. *Taxation of Beneficiary in Simple Trust*

a. *Summary*

In a simple trust, there is only one class or tier of beneficiaries — those entitled to receive currently the trust's FAI for the year. In summary, § 652 provides that:

(1) the income beneficiary will include in income the lesser of FAI or DNI (reduced by net tax-exempt income), which is equal to the distribution deduction allowed the trust under § 651;

(2) the income will be included in income whether or not it is distributed by the trust;

(3) if there is more than one income beneficiary, the included income is apportioned between or among them in proportion to the FAI each is required to receive;

(4) the items of income keep their character from the trust to the beneficiaries; and

(5) the income is included in the beneficiary's tax year that ends with or that includes the end of the trust's year for that distribution.

b. *Discussion*

Beneficiaries of a simple trust will have gross income solely because of their right to receive FAI under the trust, whether or not they actually receive it.[846] This has been interpreted to mean that an income beneficiary must report receipts of gross income in the year recognized, even though there was a good faith dispute that such receipt was FAI.[847] This may lead to harsh, and perhaps unnecessary results.

Example: During 2012, the trustee sold an asset and allocates the net proceeds to principal. The income beneficiary alleges that $10,000 of the net proceeds should be allocated to income and distributed to him. The dispute is resolved finally in 2017 in favor of the income beneficiary. Under the tax law, the income beneficiary is required to report the income for 2012 even though the outcome of the dispute was not yet known and could not have been known.[848]

This example demonstrates the practical problem with the rule — the income beneficiary is expected to be omniscient because she must know the ultimate outcome of the dispute long before it is resolved. Further, there appears to be no harm to the federal fisc if the trust, instead of the income beneficiary, pays the tax on income that is not allocated in good faith to FAI and, as a result, is not distributed in good faith.[849]

Query: An income beneficiary seeks your advice. The beneficiary believes that certain trust receipts should have been allocated to income and distributed to her, but the trustee believes that such receipts were properly allocated to principal. There are arguments in favor of both positions. Do you advise the income beneficiary to report the amount she believes is the correct FAI, even though her arguments may not prevail?

Regardless of your answer, § 652 and the rules currently in existence require the beneficiary to report this income currently, even if there is a dispute as to (1) the validity of the trust;[850] (2) the amount of income under state law;[851] (3) what items are allocated to income or to principal;[852] or (4) who qualifies as an income beneficiary;[853] and even if the beneficiary refuses to accept distribution.[854] In *Polt v. Commissioner*,[855] in discussing this illogical rule, the court stated, "[T]ax consequences to the beneficiaries cannot be determined by the timing of payment over by the trustee, even though he may be guided by an honest . . . interpretation of state law. . . . Income of a trust distributable to a beneficiary is taxable to the beneficiary, even though the trustee refuses to distribute it pending court approval of his action."

A better response, which has yet to be adopted by the IRS or the courts, would be when an uncertainty concerning the FAI arises like those above, notwithstanding the governing instrument, the trustee is no longer obligated to distribute all of the income and the trust is not a simple trust for that year.

The amount included in income by a beneficiary cannot exceed the taxable items comprising DNI (or FAI if FAI is less

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[846] § 652(a); Reg. § 1.652(a)-1.

[847] *Debrabant v. Commissioner*, 90 F.2d 433 (2d Cir. 1937); Rev. Rul. 85-116.

[848] Not everyone believes that this rule must apply. See, for example, Judge Simpson's dissent in *Estate of Bruchman v. Commissioner*, 53 T.C. 404 (1969), where he wrote, "For us to apply such rule once more would merely breathe additional life into a rule that lacks justification and would compound the difficulty of bringing about its demise."

[849] Because the income tax rates for trusts are more onerous than the tax rates for individuals, the IRS could expect to collect more tax by allowing the FAI that is withheld in good faith to be taxed to the trust.

[850] *United States v. Higginson*, 238 F.2d 439 (1st Cir. 1956).

[851] *Debrabant v. Commissioner*, 90 F.2d 433 (2d Cir. 1937); Rev. Rul. 85-116.

[852] Rev. Rul. 62-147.

[853] *Estate of Bruchman v. Commissioner*, 53 T.C. 404 (1969).

[854] *Seligson v. Commissioner*, T.C. Memo 1992-320 (income from simple trust taxable to estranged son of testator, even though son did not want and did not receive any income distributions, although he had not disclaimed income interest; court also applied doctrine of constructive receipt as alternative theory for its holding, which appears unnecessary and incorrect in view of Subchapter J).

[855] 233 F.2d 893 (2d Cir. 1956).

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than DNI), net of deductions directly or indirectly charged against those taxable items.

The amount of income to be reported by an income beneficiary is subject to two limitations, one regarding DNI and the other regarding the characterization of distributable amounts.[856]

The first limitation applies if the trust's FAI exceeds DNI. If there is one income beneficiary, the beneficiary includes only the amount of DNI in gross income, subject to the characterization limitation. If there is more than one beneficiary, the total amount of gross income included by all the income beneficiaries is limited to DNI, prorated among the beneficiaries. The amount of DNI prorated to a beneficiary is a fraction of the trust's DNI. That fraction is the amount of FAI distributable to the particular beneficiary, divided by the total amount of FAI required to be distributed currently.[857] Thus, if there are two equal beneficiaries, each is limited to one-half of the trust's DNI. If there are two income beneficiaries, one required to receive one-third of the trust's income and the other, two-thirds, then the first is limited to one-third of the trust's DNI and the other to two-thirds.

The second limitation is that the amount included in the beneficiary's gross income has "the same character in the hands of the beneficiary as in the hands of the trust."[858] This means that the items of income included in DNI, such as rental income, dividends, and tax-exempt interest, retain their special character. A beneficiary is treated as receiving his or her pro rata share of these net items in DNI. For example, assume DNI consists of net rental income (60%) and net tax-exempt interest (40%) and there is only one beneficiary. If FAI is less than DNI, the beneficiary will be treated as receiving 60% of the FAI as net rental income and 40% as net tax-exempt interest. If FAI exceeds DNI, the beneficiary will be treated as receiving 60% of DNI as net rental income and 40% of DNI as net tax-exempt interest. The FAI in excess of DNI will be treated as a gift or bequest of property not taxable pursuant to § 102.

These items, however, are net of the deductions taken into account in computing DNI. These deductions need to "be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary."[859] In general, a distribution retains its character in the hands of the beneficiary, based on the character of the items (both income and deductions) in DNI. Reg. § 1.652(b)-3 controls the allocation of deductions and in general requires that deductions be allocated to corresponding items of income in DNI. The method of allocating expenses to items of income is discussed below in the next section.

Section 652(c) and Reg. § 1.652(c)-1 provide that if the tax year of a beneficiary is different from that of the trust, the amount that the beneficiary must include in gross income under § 652 is based on the amount of trust income for any tax year or years of the trust ending within or with his tax year. In other words, the beneficiary is deemed to receive the income on the last day of the trust's tax year regardless of when actually distributions are made. However, because all simple trusts must be calendar-year taxpayers, this rule has no practical consequence.

If the beneficiary dies before the end of the trust's year, the trust may not end within or with the last tax year of the deceased beneficiary. In this case, gross income for the last tax year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. This is an exception to the general aspect of Subchapter J that does not require tracing of income. How to determine income actually distributed to the beneficiary before death is uncertain, although four possibilities present themselves:

(1) Trace the income actually distributed to the beneficiary requiring the fiduciary to trace the income received and distributed. Exactly how a fiduciary traces actual income distributed must be determined by each fiduciary on a case-by-case basis.

(2) Determine the net income earned to the date of each distribution made to the deceased beneficiary and assume that each distribution consists first of the income earned to the date of distribution that was not deemed distributed in a prior distribution.

(3) Determine the net income earned up to the date of the beneficiary's death and assume that the aggregate distributions to the beneficiary consist first of this income.

(4) Determine the net income for the entire year and assume that the aggregate distributions made while the beneficiary was living consist first of this amount.[860]

Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under § 691.[861]

3. *Allocation of Income*

If an allocation "has an economic effect independent of the tax consequences of the allocation,"[862] or if local law or the terms of the trust requires that different classes of trust income be allocated to different beneficiaries, then the allocation will be effective for determining the character of the income in the hands of the beneficiary.[863] If the trustee has discretion to allocate different classes of income to different beneficiaries, but the trustee is not required to make the allocation, then the allocation does not determine the character of distributions in the hands of a beneficiary.[864] But, if the trustee is required to distribute all or a specified percentage of a class of income to a beneficiary, then the allocation is required by the terms of the trust and will have an independent economic effect, because the

[856] § 652(a).

[857] § 652(a) (second sentence).

[858] § 652(b) (first sentence).

[859] § 652(b) (last sentence). For a more detailed discussion, see V.E.4., below.

[860] *See* Acker, *Estate Planners' Guide to IRD*, § 10.04[A] (2006).

[861] Reg. § 1.652(c)-2; *Schimberg v. United States*, 365 F.2d 70 (7th Cir. 1966).

[862] Reg. § 1.652(b)-2(b).

[863] Reg. § 1.652(b)-2(a), (b).

[864] Reg. § 1.652(b)-2(b)(1); *Baker v. Commissioner*, T.C. Memo 1990-107.

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