Capital Gains, Distributable Net Income and the 65-Day Rule

Quick-Take: Lots of thought must go into whether to leave income in a trust and subject it to confiscatory federal income tax rates, or to distribute that income to trust beneficiaries, exposing the taxable income to a beneficiary's lower marginal federal income tax rate.

Background: We know that trust income is taxed at an extremely high federal rate due to the compressed federal income tax brackets faced by estates and trusts. In 2025 a trust is subject to the 37% marginal federal income tax rate when its taxable income exceeds $15,560. While an individual trust beneficiary may be in a much lower marginal federal income tax bracket, simply distributing trust income to the beneficiary to avoid the higher marginal income tax bracket of the trust may not make sense. For example, if the trust beneficiary has a substance abuse addiction, a distribution to the addicted beneficiary would be folly. A distribution to a drug rehabilitation center for the beneficiary would make better sense, but not a direct distribution of trust income to a potentially irresponsible trust beneficiary just to expose the taxable income to a lower marginal income tax bracket. Easily said, a trustee will not make a distribution to a trust beneficiary who will not use the funds wisely.

Trustee Distributing Income: When a trustee is considering the question of distributing trust income to a trust beneficiary, it must first consider several factors, starting with the trust's potential state and federal income tax brackets. Other factors that the trustee will look at include: (i) is the trust a resident trust or a non-resident trust?; (ii) what is the trust beneficiary's tax bracket?; (iii) does the trust beneficiary live in a low-tax state or a high-tax state?; (iv) what is the trust beneficiary's tax bracket?; and (v) does the trust beneficiary have any losses or deductions that he/she can use to offset the taxable income distributed from the trust?

DNI: This concept has been covered in the past, so it won't be repeated. Distributable net income (or DNI) is basically the trust's taxable income before certain adjustments are made, i.e., before the trustee considers how much income is to be split between the trust and the trust beneficiaries. To the extent that the trustee makes a distribution to a trust beneficiary, the trust receives a deduction for the amount on its own income tax return, and the trust beneficiary receives a K-1, which basically says that the trust beneficiary must report the DNI as part of the beneficiary's taxable income. In effect, DNI is a zero-sum game in that there is a finite amount of taxable income that is allocated between the trust and its beneficiaries.

Capital Gains and DNI: One common assumption that individuals often make is that capital gains must stay inside of the trust, that such gains are not part of DNI. In fact, capital gains can be allocated to DNI.

Power to Adjust: This is done when the trustee exercises its power to adjust under the Uniform Fiduciary Principal and Income Act when the trust investments are held for their total return, so that some of the investment gains are treated as income to support the current trust beneficiary. In this situation, capital gains can be treated as DNI and thus distributed to the trust beneficiary who is in a lower marginal income tax bracket.

Refer to the Capital Gain Portion: Another way for a trustee to move capital gains to the trust beneficiary is for the trustee to refer to the capital gain when it makes a distribution. As an example, when the trustee makes a distribution, it would report to the beneficiary: "*As part of this distribution from the trust to you, $12,000 is capital gain.*"

65-Day Rule: The Tax Code also permits some planning during the first 65 day of the calendar year, where the trustee can make distributions via an election that will count toward the prior year's distribution to the trust beneficiary from the trust. [IRC 663(b).] This rule applies to a *complex trust;* a simple trust where net income is required to be distributed to trust beneficiary yearly will not qualify for this special rule. Nor will a *grantor* trust qualify for this 65-day rule. For 2025, any distributions from January 1, 2025, to March 6, 2025, will count as a 2024 distribution if this election is made by the trustee. The election is made by the trustee on the trust's tax return deadline of April 15, 2025, or September 30, 2025, for returns on extension.

Tax Arbitrage: The income tax advantage of the 65-day distribution election comes into play when the trust is expected to be in a higher income tax bracket than its beneficiaries. The trust's income tax bracket if far more compressed than the brackets for the individual trust beneficiary. Going back to the trust's marginal 37% federal income tax bracket, it is at $16,560 ($15,200 in 2024), where in contrast the trust beneficiary only reaches this 37% tax bracket when his/her income is well above $575,000. In addition, a trust must pay net investment income tax (NIIT)) at a rate of 3.8% on its investment income of more than $16.560 while the NIIT for a single individual beneficiary does not apply until his/her adjusted gross income exceeds $200,000.

Conclusion: A 65-day distribution election by a trustee, while fairly simple, may result in significant tax savings for the trust, and possibly also for the trust beneficiary. The real benefit of the 65-day election is

that it provides options to the trustee, and with options, better decisions can be made for all trust beneficiaries.

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