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When Capital Gains Become Distributable Net Income (DNI): Key Exceptions for Trusts and Estates

Understanding When Capital Gains Can Shift from Entity-Level Taxation to Beneficiary Taxation

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Executive Summary

Although capital gains are generally excluded from Distributable Net Income (DNI) and taxed at the trust or estate level because they are allocated to principal, Treasury regulations provide several exceptions that permit capital gains to be included in DNI and passed through to beneficiaries. These exceptions apply when capital gains are allocated to fiduciary accounting income under the governing instrument or state law, consistently treated as distributed through an established fiduciary practice, or actually distributed or used in determining beneficiary distributions, including certain termination-year and charitable distribution situations. Because these rules are governed by trust provisions, state law, and documented fiduciary actions, capital gains cannot be included in DNI solely to achieve a more favorable tax outcome.

Key Takeaway: Capital gains are excluded from DNI by default, but they may be passed through to beneficiaries when trust provisions, state law, or consistent fiduciary administration require the gains to be treated as part of distributable income.



Inclusion of Capital Gains in Distributable Net Income (DNI)

Under general fiduciary income tax rules, capital gains are ordinarily **excluded** from Distributable Net Income (DNI). Because capital gains are typically credited to trust principal (corpus) rather than fiduciary accounting income, they remain trapped at the entity level and are taxed directly to the trust or estate on Form 1041.

However, under **Treasury Regulation** § 1.643(a)-3(b), capital gains must or may be included in DNI—thereby shifting the tax burden to the beneficiaries via Schedule K-1—if they meet specific statutory criteria.

When Capital Gains Enter DNI

Pursuant to the terms of the governing instrument and local law, or through a reasonable and impartial exercise of discretionary fiduciary authority, capital gains are included in DNI under three primary scenarios:

1. **Gains Allocated to Fiduciary Income**

    - If the governing trust agreement or local state law explicitly allocates capital gains to fiduciary accounting income (FAI), those gains become part of DNI.

    - **State Law Mechanics:** This often occurs when a trustee exercises a statutory "power to adjust" between principal and income or elects a **unitrust state standard** (where gains are drawn upon to fulfill a fixed percentage distribution mandate).

2. **Gains Consistently Treated as Distributed**

    - Capital gains allocated to principal are included in DNI if the trustee maintains a **regular and consistent practice** of treating realized capital gains as distributed to beneficiaries.

    - **Consistency Requirement:** The fiduciary must establish this practice on the trust's books, records, and tax returns during the *first taxable year* in which capital gains are realized and discretionary principal distributions are made. Once established, this practice binds future tax filings.

3. **Gains Actually Distributed or Used to Determine Distributions**

    - Capital gains are included in DNI if they are actually distributed to a beneficiary or utilized by the fiduciary to calculate the required distribution amount. Key examples include:
    - **Specific Asset Sales:** The trustee sells a specific asset (e.g., real estate) and is directed by the trust instrument to distribute the exact net sales proceeds to a beneficiary.

- **Year of Termination:** In the final year of an estate or trust, all remaining corpus—including all realized capital gains—is distributed to the residual beneficiaries.

- **Charitable Contributions:** Capital gains paid, permanently set aside, or used for charitable purposes under IRC § 642(c) are included in DNI and offset by the charitable deduction.

Capital Gain Allocation in DNI

Standard Rule	DNI Exceptions
Retained in principal	Allocated to Income/Unitrust
Taxed as Entity Level	Consistent Distribution
Excluded from DNI	Final Termination Year

Practice Tip: Capital gains are not included in DNI based on a tax preparer's realization will reduce the combined tax liabilities of the beneficiary and its trust.

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