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**ESTATE PLANNING MEMORANDUM**

**TO:** CPAs, Clients & Associates

**FROM:** David L. Silverman, Esq.  
Shirlee Aminoff, Esq.

**DATE:** April 2, 2010

**RE:** Distributable Net Income and Income in Respect of a Decedent

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In general, any distribution of income or principal by an estate will cause the beneficiary to be taxed to the extent of the lesser of (i) the estate's "distributable net income" (DNI) or (ii) the amount of the distribution. Estate income is said to be "carried out" to the beneficiary. Capital gains are an exception. Since they are allocated to corpus and are not distributed to beneficiaries currently, they are generally excluded from DNI. Two other important exceptions to the general rule for carrying out DNI exist. First, payment of specific bequests, i.e., a specific sum of money or specific property, provided they are ascertainable under the terms of the will, will not carry out fiduciary income to beneficiaries. Thus, property distributed in cash or in kind to a beneficiary will not trigger a distribution deduction at the estate level or generate gross income at the beneficiary level.

The second exception is termed the "separate share rule." To qualify, the governing instruments must require that distributions to beneficiaries be made in "substantially the same manner as if separate trusts had been created." Treas. Reg. §1.663(c)-3(a). The rule is intended to

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prevent one beneficiary from being taxed on income which was accumulated for another beneficiary, but was distributed to the first beneficiary. To illustrate, assume that DNI equals 10, and the estate makes a distribution of 6 to one of two equal beneficiaries during the year, but makes no distribution to the other beneficiary. Without the separate share rule, the beneficiary receiving 6 would be taxable on 6, since 6 is the lesser of DNI (10) and the amount distributed (6). However, under the separate share rule, the beneficiaries would be treated as having separate equal shares of the trust. Thus, each separate “trust” would have DNI of 5. Thus, the beneficiary receiving a distribution of 6 would be taxed on 5 and would receive a principal distribution of 1. The separate share rule does not create a “flow through” system of taxation. The beneficiary receiving no distribution would not be taxed. Rather, the remaining 5 of income would be taxed to the estate.

[Note: When considering the concept of DNI, one should distinguish IRC §102, which provides that gross income does not include the value of property acquired by gift or inheritance. Therefore, if a decedent died seized only of raw land in Nebraska generating no income, and that land were deeded to his daughters, there would be no DNI and no income tax would be imposed on the daughters by reason of the bequest. On the other hand, if the land were leased, income therefrom would generate DNI, which would be taxed either to the estate, or to the daughters, if distributed to them.]

Since most decedents utilized the cash method, IRC §691 provides that income earned by the decedent before death, but collected after death, must be reported by the decedent’s estate. Such income is termed “income in respect of a decedent” or IRD. IRD items typically include (i) interest; (ii) salary or commissions earned; (iii) dividends whose record date preceded death; or (iv) gain portions of collections on a pre-death installment sale. IRC §2033 provides that a decedent's gross estate equals the value of all property to the extent of the decedent’s interest at the time of death. Since IRD is an “interest” of the decedent at his time of death, IRD is taxed under the transfer tax system and the income tax system. To mitigate the harshness of this result, IRC §691(c) provides a federal income tax deduction equal to the difference between the actual estate tax payable and the estate tax that would have been payable had the IRD been excluded from the gross estate.

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IRC §691(b) permits deductions in respect of a decedent (DRD). Such deductions include trade or business expenses, interest, taxes, depletion, etc., which accrued before death but were not paid before death, and thus were not deductible on the decedent's final income tax return. Since these items constitute debts, they may be deductible on the the decedent's estate tax return, thus producing a double benefit. Note that IRD items, in contrast to most other items included in the gross estate, do not receive a basis step up at the decedent's death. IRC §1014(c). This can be particularly disadvantageous if the decedent sold highly appreciated property immediately before death using the installment method to report gain. In this case, the gross profit ratio would remain high. Had the contract been entered into after death, there would be no gain because the property would have received a stepped up basis.

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