

Explanation of Problems 3 & 4

These problems point out the problem caused when DNI exceeds FAI and the trust has tax-exempt interest. In calculating the income distribution deduction, Section 651 requires a reduction for tax-exempt income. Treas. Reg. Section 1.651(b)-1 requires FAI to be reduced by tax-exempt income also, but it does not provide the mechanism for doing the reduction. If FAI is greater than DNI, the reduction will always be the net-tax-exempt income. If, however, DNI is greater than FAI, a different situation applies. In order to represent the appropriate amount of tax-exempt income in FAI as there is in DNI, a special computation is required. The Code treats FAI as consisting of equal components of DNI, therefore the formula for the reduction is the same as it is for characterization purposes:

$$\text{FAI} * [\text{Net Tax Exempt Income} / \text{DNI}]$$

In Problem 3, DNI and FAI both equal \$50,000, so the reduction is the same for both or the entire net-tax-exempt income of \$20,000. DNI and FAI are the same because the Section 1245 gain was allocated to FAI and therefore was a component of both DNI and FAI.

In Problem 4, DNI (\$50,000) is greater than FAI (\$20,000), and therefore the reduction applies. Under Section 651(b), DNI will be reduced by the entire amount of net-tax-exempt income of \$20,000. Whereas, FAI will be reduced by using the reduction formula above $\$20,000 \times [\$20,000 / \$50,000] = \$8,000$.

The point to remember is that if DNI is greater than FAI and you have tax-exempt income, be watchful of how much tax-exempt income you reduce FAI by using the above reduction formula.