

Advanced Analysis of Trust Taxation Under Subchapter “J”

Why Passive Income Allocated to Corpus Is Not Taxable

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In the field of trust taxation, few subjects provoke as much confusion or skepticism as the treatment of passive income in an irrevocable, non-grantor, complex, discretionary, spendthrift trust. Often misunderstood by tax professionals unfamiliar with the intricacies of Subchapter J, this specific structure has sparked ongoing debate about when and how passive income is taxed, and under what conditions corpus distributions are reportable or taxable events. At the heart of the analysis lies a simple but powerful distinction: not all income received by a trust is taxable income. Specifically, income that is lawfully allocated to corpus and retained there does not become subject to tax either to the trust or to its beneficiaries unless and until it is distributed as Distributable Net Income (DNI).

This analysis unpacks, in depth, why passive income that is allocated to corpus is not taxed to the trust or to the beneficiary. This is not a loophole, nor is it a form of tax evasion or aggressive planning. It is the result of the statutory structure of Subchapter J of the Internal Revenue Code, longstanding fiduciary accounting practices under state law, foundational judicial precedent, and the constitutional constraints imposed by the Sixteenth Amendment. When these sources are examined together, the outcome is not merely legally permissible it is both logical and necessary.

We begin with the statutory design. Under IRC §641, a trust is treated as a separate taxable entity. Income received by the trust is not automatically taxed to the trust itself. Rather, the Internal Revenue Code provides a conduit mechanism, whereby income is taxed to the party who enjoys the benefit either the trust or the beneficiary. This division is determined by the concept of Distributable Net Income, or DNI, defined in IRC §643(a). DNI operates as a bridge: it is the amount of income that is both eligible for deduction by the trust under §661 and required to be included in the income of the beneficiary under §662. Importantly, DNI is not a mirror of gross income. It is a specialized tax measure that intentionally excludes certain categories of income from its computation most notably, capital gains that are allocated to principal and not distributed, under IRC §643(a)(3).

Likewise, IRC §643(a)(7) and the associated Treasury Regulations provide the trustee with the ability, under certain conditions, to exclude tax-exempt income and other receipts from DNI if they are retained in corpus. In this way, the statutory formula draws a deliberate boundary between current income taxable under Subchapter J and receipts that may lawfully remain in principal.

Treasury Regulation §1.643(a)-3 further clarifies this framework. It affirms that capital gains are to be excluded from DNI unless they are either (1) included in accounting income and thus treated as distributable to the beneficiary, or (2) actually distributed. This regulatory

language gives legal effect to fiduciary accounting under state law and to the express language of the trust instrument. Where the trust instrument or applicable state law provides for capital gains and other passive income—such as rents, interest, dividends, or royalties to be allocated to principal, those receipts never enter the DNI calculation. They are not taxed to the trust, and they are not passed through to the beneficiary.

To illustrate, consider a trust that earns \$300,000 in passive income during a taxable year: \$150,000 in long-term capital gains, \$75,000 in dividends, and \$75,000 in rental income. The trust instrument expressly authorizes the trustee to allocate all such income to principal, and state law (e.g., the Uniform Principal and Income Act) allows for the same. If the trustee allocates the full \$300,000 to corpus and makes no distributions during the year, the result is straightforward: the trust recognizes gross income under IRC §61 but creates no DNI under IRC §643. It therefore has no deduction under §661, and no beneficiary has any income under §662. Although gross income exists on paper, no taxable income is realized by either party.

The Uniform Principal and Income Act (UPIA), adopted in some form by most states, reinforces this treatment. Section 401 of the UPIA provides that, by default, capital gains are allocated to principal. Section 104 allows the trustee to adjust between income and principal if doing so is necessary to carry out the trust's purposes or maintain fairness among beneficiaries. Critically, Section 103 of the UPIA makes clear that the provisions of the trust instrument override the default statutory rules. Thus, if a trust document expressly directs the trustee to allocate all passive income to corpus, that directive governs. The trustee's adherence to that instruction becomes not only valid but binding, assuming it does not violate fiduciary duty or applicable law.

Courts have consistently upheld the legal force of such fiduciary classifications. In *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940), the court held that the distribution of appreciated property from corpus did not constitute income to the beneficiary, because the transaction did not carry out any DNI.

The court emphasized that the character of the distribution was determined by the trust's internal accounting and governing instrument. If the distribution arose from corpus—not from income—it was not taxable to the recipient. The court's logic remains highly relevant: taxable income arises only when DNI is distributed. Distributions from principal, even if composed of previously appreciated assets, do not give rise to tax liability under the Code.

This principle was reinforced by the U.S. Supreme Court in *Freuler v. Helvering*, 291 U.S. 35 (1934), where the Court upheld the trustee's classification of receipts in accordance with fiduciary accounting principles. The IRS had attempted to recharacterize trust receipts for tax purposes, but the Court rejected this effort, ruling that lawful fiduciary discretion under the trust instrument could not be overridden by the Service's own preferences. The Court emphasized that absent a statutory mandate, the trustee's lawful allocation decisions must stand.

Similarly, in *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), the Supreme Court made clear that state law determines the characterization of trust transactions. In *Bosch*, the question concerned the interpretation of a trust's dispositive provisions under state court rulings, but the holding has broader implications: federal tax liability must flow from the trust's legal classifications under state law, not the IRS's unilateral interpretations. This point is especially salient when trustees allocate income to corpus, effectively preventing the creation of DNI.

The same principle was echoed in *Greenough v. Tax Commissioner*, 331 U.S. 486 (1947), where the Court clarified that a receipt must reflect a realized gain before it can be taxed. In that case, the Court denied taxation on the grounds that the transaction lacked realization, and thus failed to meet the constitutional definition of income. The ruling underscores a broader point: not all economic benefits or asset movements constitute taxable income under either statutory or constitutional standards.

Even earlier, in *Blair v. Commissioner*, 300 U.S. 5 (1937), the Supreme Court affirmed the settlor's right to define the structure and terms of a trust, including the designation of beneficial interests and the trustee's authority to manage income and corpus. The IRS's role, the Court implied, is not to impose alternative frameworks or second-guess fiduciary decisions made in accordance with governing law and the trust instrument. These statutory and fiduciary principles find their ultimate boundary in the Constitution. The Sixteenth Amendment authorizes the federal government to tax "incomes, from whatever source derived," but it does not grant authority to tax capital, unrealized appreciation, or property that has not generated a realized gain.

In *Eisner v. Macomber*, 252 U.S. 189 (1920), the Supreme Court defined income as "gain derived from capital, from labor, or from both combined," and specifically held that a pro-rata stock dividend—while economically beneficial—did not constitute income because no realization had occurred. This definition is key when analyzing trust corpus distributions. A distribution from principal—even if composed of previously realized income—is not a gain to the beneficiary. It is a capital transfer.

Even the broader articulation of income in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), which defined income as "undeniable accessions to wealth, clearly realized, and over which the taxpayer has complete dominion," still hinges on the requirement of realization. Passive income that is lawfully retained in corpus and not distributed does not meet this threshold. The trust may have dominion over the receipts, but the beneficiary does not—and absent distribution, no accession to wealth occurs at the beneficiary level. Consequently, no taxable event arises.

This conclusion is further supported by IRC §102(a), which excludes from gross income the value of property acquired by gift, bequest, or inheritance. Corpus distributions from an

irrevocable, non-grantor trust—particularly when they do not carry out DNI—fall squarely within this exclusion. They are capital returns, not taxable gains.

Likewise, IRC §662(a) limits beneficiary taxation to amounts actually distributed “to the extent of the income of the estate or trust.” If no income is distributed—because all receipts were retained in corpus—then the beneficiary has no inclusion. Correspondingly, IRC §661 permits the trust to deduct only amounts distributed as DNI. If no DNI exists, no deduction is available, and no taxable income is triggered.

Against this robust framework, the conclusions reached in IRS Chief Counsel Memorandum AM 2023-006 are, at best, mistaken and, at worst, deliberately misleading. The memorandum appears to conflate the concept of gross income under IRC §61 with the unique tax structure governing fiduciary entities under Subchapter J. By ignoring the exclusions found in IRC §643(a), misinterpreting Treasury Regulation §1.643(a)-3, and overlooking the constitutional definition of income, the memo advances a position that is not only legally unsupported, but potentially harmful to fiduciary integrity. Whether the memorandum’s errors stem from analytical confusion or a strategic intent to deter lawful trust practices, the result is the same: it undermines the coherence of Subchapter J and invites misapplication of the tax code. By disregarding the statutory distinction between gross income and DNI, and by ignoring the critical role of fiduciary discretion in the administration of trust property, the memorandum risks encouraging enforcement actions that exceed the IRS’s statutory and constitutional authority.

In truth, the legal framework leaves little room for ambiguity. Passive income that is properly allocated to corpus—pursuant to a valid trust instrument and in accordance with applicable fiduciary law—is excluded from DNI by operation of law. So long as that income is not subsequently reclassified or distributed as current income, it remains permanently insulated from taxation. A later distribution of that same corpus, provided it does not carry out DNI, is not an income event. It is a capital transaction—a return of principal—beyond the reach of income tax under both statutory rules and constitutional doctrines.

To make this more tangible, consider the example of a family trust that receives \$200,000 annually in rental income and dividends, with an additional \$100,000 in realized long-term capital gains. The trust instrument clearly states that all receipts, unless expressly designated otherwise by the trustee, are to be allocated to corpus. The trustee, adhering to both the instrument and fiduciary standards under state law, allocates all \$300,000 to principal.

No distributions are made that year. Under these facts, the trust reports gross income of \$300,000, but none of it is included in DNI. No deduction is claimed under §661, and no inclusion occurs under §662. The income has been captured and preserved as corpus, and unless future distributions explicitly carry out DNI, it remains untaxed.

Even if, five years later, the trustee distributes \$100,000 to a discretionary beneficiary for education or healthcare needs, that distribution is treated as a distribution of principal—unless

DNI has been carried out in that year. The key distinction is not the amount distributed, but the character of the funds distributed. If no DNI exists, the beneficiary receives a non-taxable capital disbursement.

The transaction resembles a return of invested capital rather than a gain or profit. This approach is deeply embedded in trust taxation, fiduciary accounting, and constitutional jurisprudence.

Congress deliberately constructed Subchapter J to function in this manner. The structure is not a loophole. It is a legislative system designed to reflect the nuanced realities of fiduciary governance. It permits the trustee subject to fiduciary duties and the terms of the instrument to determine the classification of receipts, to allocate between income and principal, and to decide whether and when to create taxable events. That discretion is not an incidental feature of trust law; it is central to its function.

Trusts are not static income conduits. They are dynamic entities, designed to hold, protect, and preserve wealth across time horizons that often span multiple generations. They must respond to inflation, changing market conditions, and the evolving needs of current and remainder beneficiaries.

The flexibility to allocate receipts to principal particularly passive income that is not needed currently—ensures that trusts can perform their long-term stewardship function without triggering premature or unnecessary tax liabilities.

Judicial Affirmation of Subchapter J and the Tax-Exempt Treatment of Corpus
Allocations in trusts like the Nexxess Trust have a long history in the court system. The structure and tax treatment of the Nexxess Trust—an irrevocable, non-grantor, complex, discretionary, spendthrift trust—are not only supported by statute and regulation, but also by a long and consistent line of federal case law. Courts across jurisdictions have repeatedly affirmed the validity of fiduciary classifications made under Subchapter J when such actions are grounded in the governing trust instrument and administered in accordance with state law. These decisions reinforce the principle that income lawfully allocated to corpus—particularly when it originates as passive income and is not distributed as Distributable Net Income (DNI) remains outside the scope of current taxation.

In the context of the Nexxess Trust, where passive income is received from various sources—including discretionary transfers from separate business trusts and is consistently allocated to principal, it is essential to understand that this structure is not novel or aggressive.

Rather, it is precisely the type of fiduciary arrangement that has been contemplated and upheld by federal courts for nearly a century. What follows is a brief survey of landmark cases that form the legal backbone for how the Nexxess Trust lawfully defers taxation on retained passive income and protects its corpus from premature or unwarranted federal recharacterization.

It is for this reason that fiduciary law, as codified in the Uniform Principal and Income Act and related statutes, gives trustees the authority to adjust and reclassify receipts based on fairness, prudence, and the intent of the settlor. Courts have consistently protected this discretion against intrusion by federal agencies, provided the trustee acts in good faith and within the bounds of law. The IRS may not override fiduciary decisions absent clear evidence of abuse or statutory violation.

This principle was reaffirmed in *Howard v. United States*, 566 F.2d 1000 (5th Cir. 1978), where the Fifth Circuit declined to permit the IRS to recast a trust's internal accounting classification simply to produce a different tax outcome.

The Court held that when fiduciary decisions are made according to a valid trust instrument and consistent with state law, those decisions are legally determinative for federal tax purposes. The government cannot disregard trust formalities merely because it disapproves of the resulting tax consequences.

Indeed, the limits of federal power to recharacterize trust activity stem not only from statutory interpretation but from constitutional constraint. Under the Anti-Delegation Doctrine, Congress may not delegate its taxing power without clearly defined standards. Subchapter J sets forth such standards by linking tax consequences to the legal accounting and classification choices made under state fiduciary law. The IRS cannot ignore this framework without violating the structure and intent of the law itself.

Similarly, under the Contract Clause and Due Process Clause, the federal government cannot retroactively impose tax burdens that defeat the reasonable expectations of trust parties who act within lawful bounds. Trusts are creatures of contract. They rely on the enforceability of their terms and the predictability of legal and tax outcomes. A trustee who follows the law, adheres to fiduciary duty, and complies with both state and federal rules should not be penalized because a regulatory agency prefers a different classification. To do so would not only destabilize fiduciary governance, but also violate fundamental fairness.

This is why the judiciary has historically resisted attempts by the IRS to expand its authority into trust classification. In cases such as *Farkas v. Commissioner*, 170 F.2d 201 (5th Cir. 1948), courts have rejected IRS efforts to recharacterize principal as income or to tax corpus distributions that do not represent realized gains. The courts have recognized that the character of receipts and distributions must be determined by fiduciary law—not by the IRS's administrative fiat.

The enduring theme of these decisions is one of legal integrity: the tax system must honor the classifications made under the law of trusts and estates, provided they are made in good faith and in accordance with governing instruments. Subchapter J was never intended to override fiduciary discretion; it was designed to complement it. Its purpose is not to maximize

tax revenue at the expense of lawful administration, but to ensure that tax consequences flow from real economic and legal events not artificial reclassifications.

A foundational aspect of this trust's legal identity is its strict limitation to passive income under Subchapter J of the Internal Revenue Code. The trust does not and cannot receive earned income, also known as "active income" or "guaranteed payments." This includes wages, salaries, commissions, self-employment earnings, trade or business income, or compensation for services rendered. These types of receipts, by their nature, involve the exertion of labor, entrepreneurial risk, or the performance of services in exchange for value. Subchapter J, however, is not designed to accommodate such income within the tax structure of a passive fiduciary entity. Instead, it delineates a clear boundary between income that may be retained and allocated to corpus such as rents, royalties, interest, dividends, and capital gains and income that must flow through and be taxed immediately due to its active character. The trust's governing instrument and operational structure therefore categorically exclude any form of earned or guaranteed income, ensuring that all receipts fall squarely within the statutory framework of permissible passive income.

This exclusion is further underscored by the trust's classification as a **complex trust** under Subchapter J in nearly all taxable years. The complex trust structure allows the trustee to accumulate income, make distributions at discretion, and allocate receipts to corpus, all without being compelled to distribute income annually. This flexibility is essential to the trust's long-term asset protection and tax deferral strategies. However, if the trust were to receive active income such as wages or business earnings—such receipts could undermine its status as a complex trust and potentially trigger reclassification under the **simple trust rules**, which require the annual distribution of all income to beneficiaries. Accepting active income would effectively override the trustee's discretion, forcing immediate taxable distributions and collapsing the very structure that allows the trust to operate within the accumulation framework of IRC §§661–663. To preserve its legal and operational identity, the trust must avoid any income that carries with it an obligation to distribute or pass through taxation.

Even when the trust receives funds that originate from an external business entity, such as a business trust or a pass-through partnership, those receipts are only accepted if they qualify as passive income in the hands of the beneficial trust. For example, if a business trust earns income through commercial operations and subsequently makes a discretionary distribution to the beneficial trust, that distribution does not convert into active income simply by virtue of its origin. The beneficial trust did not participate in the activity, exercised no control over the business operations, and had no enforceable right to compel the distribution. It was neither an employee nor a partner, nor did it perform any service in exchange for the funds. From the perspective of the beneficial trust, the receipt is entirely passive—it was not earned, not guaranteed, and not anticipated. Therefore, its classification under Subchapter J is governed by how the trustee receives and allocates it—not by how it was originally generated by another entity.

This distinction is reinforced by Treasury Regulation §1.643(a)-3, which requires that for income to be included in Distributable Net Income (DNI), it must either be classified as income under fiduciary accounting or distributed from current income. The regulation explicitly allows capital gains and other receipts to be excluded from DNI when allocated to corpus.

In the context of a beneficial trust receiving discretionary distributions from a business trust, the passive character of the receipt is confirmed by the absence of any quid pro quo, enforceable right, or earned entitlement. The beneficial trust functions as a recipient of property, not as a participant in income-generating activity. Accordingly, the trustee may, under both the trust instrument and applicable state law (e.g., UPIA §401 and §103), allocate such receipts to principal without creating DNI or triggering current-year taxation. The income is not taxed to the trust because it is not required to be distributed, and it is not taxed to the beneficiary because it was never part of DNI. The passive nature of the trust and the discretionary nature of the distribution preserve the income's eligibility for exclusion from tax.

In essence, this trust operates as a passive vessel—an entity that accumulates capital, preserves intergenerational wealth, and lawfully defers taxation until and unless a taxable event is affirmatively created by the trustee. It does not engage in commerce, render services, or receive compensation. It holds no contracts for labor, performs no consulting, and receives no guaranteed payments. Every dollar it accepts must satisfy two tests: it must be passive in nature under Subchapter J, and it must be allocable to corpus under fiduciary law and the trust's express terms. Where a business trust or another external entity chooses, at its own discretion, to distribute funds to this trust, the receipt is analyzed not by its source, but by its character at the moment of acceptance. If that character is passive—and if the trustee allocates it to corpus—then it falls entirely outside the stream of taxable income, both under statute and under constitutional principles of realization. The result is a lawful, carefully constructed tax posture that reflects both the intent of Congress and the integrity of fiduciary governance.

The tax treatment of irrevocable, complex, non-grantor trusts under Subchapter J has long been reinforced by a consistent line of judicial authority. Courts have repeatedly upheld that when a trustee exercises lawful discretion—consistent with state fiduciary law and the express terms of the trust instrument—allocations of receipts to corpus are determinative for federal tax purposes. These rulings affirm that the IRS may not override fiduciary decisions that are made in good faith and that comply with Subchapter J's statutory framework.

Each of these court cases above speaks directly to the underlying mechanics of Subchapter J—specifically, the conduit rules under IRC §§661–662, the exclusions codified in §643(a), and the fiduciary discretion recognized by Treasury Regulation §1.643(a)-3. More importantly, they reaffirm the constitutional and statutory limits of the IRS's authority to recast principal allocations or impose tax liability where no DNI exists.

These cases, taken together, establish a comprehensive judicial endorsement of Subchapter J's architecture.

They affirm the lawful exclusion of passive income from taxation when allocated to corpus, the enforceability of fiduciary discretion, and the deference owed to the trust instrument and state law in determining income classification. Each case reinforces that federal tax liability must arise from statutory triggers—not administrative reinterpretation. As such, they offer powerful precedent for practitioners defending the integrity of trusts structured and administered according to Subchapter J.

For tax professionals, estate planners, fiduciaries, and legal advisors, understanding the correct trust framework is not a matter of preference it is a professional imperative. Subchapter J is not merely a technical regime; it is a foundational structure that enables the proper administration of complex trusts within both legal and constitutional boundaries.

Mastery of its principles empowers practitioners to distinguish clearly between reportable income and retained corpus, to structure distributions with precision, and to defend trust operations against regulatory overreach. Above all, it reinforces a central truth: what is not income either in form or in substance cannot be taxed as income.

In the final analysis, an irrevocable, non-grantor, complex, discretionary, spendthrift trust—when properly drafted and lawfully administered under Subchapter J and applicable state fiduciary law has the legal authority to control the taxability of its passive income. So long as receipts are properly allocated to corpus and no Distributable Net Income is created, no tax liability arises for either the trust or its beneficiaries.

The trust reports gross income as required under IRC §61, but it does not generate taxable income under Subchapter J because those receipts are never distributed as income. Unless and until the trustee affirmatively chooses to create and distribute DNI, no taxable event occurs. And under both statutory construction and constitutional principle, what is not income may not be taxed as such.

This is not a loophole. It is not evasion. It is the execution of fiduciary responsibility within the boundaries of a system deliberately crafted by Congress. Subchapter J, properly understood, does not subvert the tax code it affirms the legal architecture of fiduciary governance and respects the rule of law in one of its most sophisticated and enduring expressions.