

**A PRIMER ON
FIDUCIARY INCOME TAXES**

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FIVE KEY CONCEPTS

- Mostly, the taxation of trusts and estates follows the rules for individual taxpayers.
- The estate planning documents are the primary authority.
- Taxes are paid at the final destination by the recipient beneficiaries absent an accumulation of income.
- Except for the year of termination, no losses pass out to the beneficiaries.
- The satisfaction of a pecuniary bequest with appreciated property or IRD is treated as a sale or exchange.

FORM 1041 FILING REQUIREMENTS

- A trust or estate is a separate legal entity for federal tax purposes and the fiduciary tax return.
- Form 1041 is used to report the income, deductions, gains, losses, etc. of a domestic decedent's estate, trust or bankruptcy estate.
- A fiduciary must file a tax return on Form 1041 if a domestic estate has gross income of \$600 or more during a tax year.
- A trust income tax return must be filed if the trust has any taxable income for the year or gross income of \$600 or more.
- If one or more of the beneficiaries of a domestic trust or estate is a nonresident alien individual,
 - the personal representative must file Form 1041, even if the gross income of the estate is less than \$600 [Reg. 1.641(a)(2) and 1.61-1(a)].
- For tax years beginning in 1998, the requirement to file a return for a bankrupt estate applies only if the gross income is at least \$6,250.
- The filing requirements for trusts and estates are described in IRC Sec. 6012.

- A Form 1041 is required for a life estate only when the life tenant has fiduciary responsibilities.

FORM 1041

- The fundamental concepts of income taxation revolve around the conduit nature of trusts and estates,
 - which are similar to partnerships in that income passes through on the Form K-1 to the intended beneficiaries.
- They are different from partnerships in that a trust or estate can also be a tax paying entity as well as a flow-through.
- If income passes out to the beneficiaries, the trust or estate (with some limitations) receives a deduction for distributions to beneficiaries.

AUTHORITY FOR TRUST AND ESTATE TAXATION

- The authority for the income taxation of trusts and estates is a combination of
 - civil law,
 - federal tax law,
 - state tax law,
 - the documents,
 - accounting theory, and
 - probate law.
- Because of this combined authority, fiduciary income taxation takes on a complexity that can be overwhelming to a practitioner new to this area.

SUBCHAPTER J - IRC SECS. 641-691

- The portion of the Internal Revenue Code that is devoted to the income taxation of trusts and estates is Subchapter J.
- The rules for taxation operate on the premise that a trust or estate earns or receives income and incurs and pays expenses.
 - The trust or estate then makes distributions to beneficiaries that are either

- required by the instrument, or
 - made through the discretionary powers of the fiduciary.
- The total taxable income is subject to tax and this amount is calculated using the same rules as are used for individuals.
- The taxable income and tax is then allocated between the entity and the beneficiaries using the rules in Subchapter J.
- The income is taxed at its final situs.
 - If the income is accumulated in the trust or estate, that entity pays the tax.
 - If the income is distributed to the beneficiary or beneficiaries, the trust or estate is given a deduction for the amount of the distribution.
 - That amount passes out to the beneficiary on the Schedule K-1, and
 - the recipient, whether it is an individual, another trust, a partnership, etc., incorporates this amount on its tax return.

BASIC CONCEPT OF FIDUCIARY TAXATION

- The taxable income of a trust or estate is determined in the same manner as an individual with some modifications:
 - the trust or estate gets a deduction for taxable income distributed to beneficiaries;
 - what is left represents taxable income retained by the trust or estate;
 - the trust or estate pays a tax on such accumulated taxable income; and
 - the beneficiary or beneficiaries report and pay tax on the distributions of taxable income.
- Conclusion: All taxable income will be taxed at its final situs.

INCOME TAX RATES

- Unless distributed to the beneficiaries, income is taxed to the trust or estate at special rates.
- Several tax acts have compressed the rates for trusts and estates so that the top marginal income tax rate is reached at a much lower taxable income level than for an individual.

CALCULATING THE INCOME TAXATION OF TRUSTS AND ESTATES

- Determine the fiduciary accounting income.
- Determine trust/estate taxable income before the distribution deduction.
- Determine the distribution deduction.
- Determine the trust taxable income.
- Determine the tax.
- Allocate the income distributed to the beneficiaries and to the appropriate categories.

DIFFERENCES BETWEEN TRUST/ESTATE TAXATION AND INDIVIDUALS

- While the rules for individuals apply to the taxation of trusts and estates, there are several differences in calculating the tax that must be taken into consideration.
 - The personal exemption for estates is \$600 and either \$300 or \$100 for trusts.
 - Note that this is significantly less than for individual taxpayers.
 - There are different rules for computing the charitable contribution.
 - There are special allocations that must be considered between the trust or estate and its beneficiaries of
 - NOL's,
 - depreciation,
 - depletion, and

- amortization.
 - There are disallowances of normally deductible expenses if they have been deducted on the Form 706 (estate tax return).
 - Special tax treatment must apply on distributions to beneficiaries of appreciated property if used to satisfy a pecuniary bequest.
- Extensions
- Estates file extensions on Form 2758 (trusts file on Form 8736), which is a
 - 90-day extension, and
 - not automatic.
 - Both trusts and estates use Form 8800 to apply for an additional three-month extension.

THE SIMPLE TRUST

- Characteristics of a simple trust
- all the income is required to be distributed currently;
 - whether or not it is actually distributed.
 - no discretionary distributions are made; and,
 - no charitable contributions are made.
- Basic approach to the taxation of simple trusts
- determine whether trust is simple or complex;
 - determine the fiduciary accounting income;
 - compute the trust taxable income before the distribution deduction;
 - determine the distributable net income (DNI) under IRC Sec. 643;
 - determine the distribution deduction under IRC 651;

- determine the category allocations of income and deductions;
 - determine the beneficiary's share and the character of the allocation; and
 - complete the necessary forms.
- IRC Sec. 651(b) states that if the amount of income required to be distributed currently exceeds the calculation of distributable net income (DNI),
- then the distribution deduction shall be limited to the DNI.
- Calculation of DNI shall only include items of income and deductions that are included in the gross income and deductions of the trust for tax purposes.
- Often the calculation of this amount is not determined until after the tax year ends.
 - A fiduciary may be required to distribute income currently but may, in fact, defer making its distribution until after the close of the trust taxable year.
 - A trust required to distribute its income currently is entitled to deduct the distribution in the year that the *income is earned and required to be distributed*.
 - Furthermore, the beneficiary must include the amount ultimately distributed in the year of deduction,
 - even if the amount was not determined by the close of that year.
- IRC Sec. 652 states that
- "the amount of income required to be distributed by a trust described in Section 651 shall be included in the gross income of the beneficiaries to whom the income is required to be distributed,
 - whether distributed or not."
- A trustee can have "sprinkling powers" among a class of beneficiaries and

- this will still qualify as a simple trust as long as all the income is required to be distributed currently.
- The characterization of a trust as simple or complex can change from year to year.
 - This is because two of the three requirements of a simple trust depend on trust activity during the year.
- IRC Sec. 642(b) states that a trust that requires the trustee to distribute all the FAI currently gets a \$300 personal exemption against other trust taxable income.
 - All other trusts are allowed a \$100 deduction and, estates are allowed a \$600 personal exemption.
- It is imperative to read the trust documents to determine whether the trust has a mandatory income distribution requirement that could make it a simple trust.

THE COMPLEX TRUST

- A complex trust does not require that all income be distributed currently.
- It can provide for and make distributions out of principal and can provide for charitable contributions.
- The rules for complex trusts are found in IRC Secs. 661 and 662.
- The distribution deduction in a complex trust is the sum of
 - the amounts required to be distributed,
 - plus all other amounts distributed,
 - limited to deductible distributable net income [IRC Sec. 661(a)(2)].
- The distributions from a complex trust follow a tier system and are comprised of two tiers.
 - The first tier of distributions under IRC Sec. 662(a)(1) are composed of income that is required to be distributed currently.

- Tier 2 distributions, as directed by IRC Sec. 662(a)(2), contain all other amounts properly
 - paid,
 - credited or
 - required to be distributed.
- The underlying rationale of the two-tier system is that Tier 1 distributions are more likely to be from taxable income and should absorb most of the DNI.
 - Therefore, DNI absorbs the first tier of distributions before the second tier.
 - This means if all the DNI is absorbed by the Tier 1 distribution, any Tier 2 distributions in excess of DNI escape tax.
- If the DNI is greater than the Tier 1 distribution, but less than the combined Tiers 1 and 2 distributions,
 - the excess of the DNI is allocated among the Tier 2 beneficiaries.
- If there is more than one Tier 1 beneficiary,
 - the DNI is allocated to each beneficiary in relation to the amount of fiduciary accounting income (FAI) distributed to each.
- It should be noted that a beneficiary can be both a Tier 1 and Tier 2 beneficiary.
- In the year of termination, a trust is always complex because it makes principal distributions to the beneficiaries.
- Estates are treated as complex trusts because they usually accumulate income during administration.

DISTRIBUTABLE NET INCOME (DNI)

- Distributable Net Income (DNI) creates a tax presumption that any distribution is made from income first.
- It helps determine how much of the income of a trust or estate is taxed to the fiduciary and how much is taxed to the beneficiaries.

- It also determines the character of the income taxed to each.
- Unlike a partnership that also flows income to a partner via a Schedule K-1, a trust or estate is allowed a deduction for the amount of income that is passed out to the beneficiary, also via a Form K-1.
 - The amount of this distribution deduction is equal to the lesser of:
 - the taxable portion of DNI, or
 - the amount actually distributed or required to be distributed.
- The distribution deduction is calculated on Schedule B of the Form 1041.
 - While this calculation determines the distribution deduction, it also determines the amount of taxable income allocated to a particular beneficiary.
 - Therefore, the sum of the Schedule K-1 allocations should equal the total distribution deduction.
- DNI is strictly a tax concept, a fiction that is one of many that we tax practitioners must deal with constantly.
 - It departs from the customary income-principal concept that forms the basic fiduciary accounting rules.
 - Once you calculate fiduciary accounting income, you must put that number aside and concentrate on the different inquiry of trust taxable income.

THE MECHANICAL CALCULATION OF DISTRIBUTABLE NET INCOME (DNI)

- IRC Sec. 643 distributable net income (DNI) is a hybrid of taxable income and fiduciary accounting income.
- The starting place for its calculation is trust taxable income followed by a series of adjustments as described below.
- Begin with trust taxable income, and
 - + add back the personal exemption
 - + add back capital losses (if added to corpus)

- + add back net tax-exempt income that is allocated to income for FAI purposes
- reduce taxable stock dividends and extraordinary cash dividends allocated to corpus
- reduce capital gains allocated to corpus
- = IRC Sec. 643 DNI

DETERMINING DEDUCTIBLE DNI OR THE DISTRIBUTION DEDUCTION

- Once IRC Sec. 643 DNI is calculated, Sec. 651 or Sec. 661 deductible DNI must be calculated.
- IRC Sec. 643 DNI includes tax-exempt interest, and
 - since there is no deduction for distributions of tax-exempt income,
 - Sec. 643 DNI must be modified to determine the deduction.
- Once IRC Sec. 643 is determined, it must be separated into two components;
 - the taxable component, and
 - the tax-exempt component.
 - Sometimes this is as simple as subtracting out all the tax-exempt income.
 - Other times, an allocation is necessary and this depends on the type of trust and how much income is distributed.

COMPUTING THE DEDUCTIBLE DNI (DDNI)

- To compute the distribution deduction (DDNI),
 - Schedule B compares the IRC Sec. 651 or 661 DNI (the taxable portion of Sec. 643 DNI) with the taxable portion of the actual distribution.
 - In a simple trust, the actual distribution is determined once fiduciary accounting income is calculated.

- It becomes more difficult with a complex trust, especially one that accumulates the income.
- Generally, the deduction for distributions to beneficiaries is the lesser of
 - the total amount of distributions made or required to be made to the beneficiaries, or
 - the DNI of the trust or estate.

KEY DIFFERENCES BETWEEN TRUSTS AND ESTATES

- Many times the treatment of trusts and estates is the same for tax purposes.
- However, there are some differences that are noted below:
 - estates receive a larger personal exemption (\$600) than trusts (\$300 or \$100);
 - estates and administrative trusts are not required to make estimated payments until the estate has been in existence two years; and,
 - estates may elect to use a fiscal year while trusts must use a calendar year.

ELECTION TO TREAT REVOCABLE TRUST AS PART OF ESTATE FOR INCOME & GST TAXES

- The Taxpayer Relief Act of 1997 created a new type of entity under IRC Sec. 645.
- By election, a qualified revocable trust (QRT) can be treated as an estate for income tax purposes.
- When this election is made, all of the rules relating to
 - tax elections,
 - fiscal years,
 - methods of accounting, and
 - termination of probate estates

also apply to the new combined reporting entity.

- This election would be made where there is both
 - an estate, and
 - a revocable trust

in an estate plan or

- just a revocable trust that becomes irrevocable upon the grantor's death.
- Form 8855 is available to make the election.
- Advantages of the IRC Sec. 645 election
 - There are some preferential income tax treatments available to estates that are not available to trusts, including:
 - the use of a fiscal year;
 - the \$25,000 PAL deduction for active participation for two years after the date of death under IRC Sec. 469(i)(4);
 - the qualification by the combined or electing entity as an S corporation shareholder;
 - charitable contribution deduction is allowed for income set aside as well as actually paid; and
 - a loss deduction is available for a pecuniary bequest satisfied with depreciated property even though the parties are "related" under IRC Sec. 267.

DISTRIBUTION OF NONCASH PROPERTY TO A BENEFICIARY

- If noncash property is distributed to a beneficiary,
 - the beneficiary is taxed to the extent of DNI.
- The property distribution is taken into account at the lesser of
 - its adjusted basis, or
 - its FMV.

- There is a special election that is available where
 - the trust or estate can choose to treat the property distribution as a sale to the beneficiary at FMV, and
 - the trust or estate pays the tax on any gain.
 - The beneficiary takes the property with an adjusted basis based on the FMV.
 - The adjusted basis to the beneficiary would have been a carryover basis had not this special election been made.

THE 65-DAY RULE

- The trustee may wish to distribute all of the income of a complex trust during the calendar year of the trust,
 - but the trustee may not always know the amount of income to distribute as of the last day of the tax year.
- IRC Sec. 663(b) provides a solution where the income cannot be determined until after the end of the year.
- Distributions made within 65 days of the trust's subsequent tax year end
 - may be deemed to have been made as of the last day of the tax year, and
 - the trust will still be afforded a distribution deduction,
 - thus shifting the tax liability to the beneficiaries.
- This election is made by the trustee on an annual basis and must be made on a timely filed return (including extensions).
- This election is available to both trusts and estates.
- Note that the trustee of a simple trust would not be concerned with this situation
 - since all income is required to be distributed to the beneficiaries,

- and is reported by the beneficiaries whether or not the income is actually distributed to them. [IRC Secs. 651 & 652].
- Distributions eligible for the election, however, cannot exceed the greater of
 - the trust income for the election year, or
 - the DNI for that year.

MULTIPLE TRUSTS TREATED AS SINGLE TRUSTS

- Under IRC Sec. 643(f), multiple trusts are treated as a single trust and taxed accordingly if
 - the multiple trusts have substantially the same grantor or grantors and the same primary beneficiary or beneficiaries,
 - there is substantially no independent purpose, and
 - tax avoidance is their principal purpose.
- For purposes of this rule, a husband and wife are treated as one.
- This rule does not apply to multiple trusts that were created before March 2, 1984.

THE SEPARATE SHARE RULE

- In many instances, a single trust with multiple beneficiaries is treated as though a separate trust or account is maintained for each beneficiary.
- Often the trust document will state that separate accounts or shares are to be maintained for each beneficiary.
- IRC Sec. 663(c) provides that the trust will be treated as though separate trusts were created to determine DNI.
- The separate share rule prevents one beneficiary from being required to report DNI properly reportable by another.
- If the amount paid or payable to the beneficiaries of a complex trust or estate exceeds DNI,

- the DNI must be allocated among the beneficiaries.
- This allocation is generally accomplished through the tier system.
- However, this tier system works an injustice when a trust or estate is administered in substantially separate shares.
- IRC Sec. 663(c) contains a special rule for the allocation of separate shares that achieves the two-trust result but in one trust.
- In order to invoke IRC Sec. 663(c), the single trust must have
 - more than one beneficiary, and
 - the beneficiaries must have substantially separate and independent shares.
- Separate share allocation cannot be used
 - to get more than one deduction for the personal exemption, or
 - to split the undistributed income of the trust into several shares to be taxed at lower bracket rates.
- The separate share rule is not elective.
 - If the rule applies, it must be used.
- Separate share treatment will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created.
- The separate share rule also applies to estates.