Federal Income Taxation of Simple and Complex Trusts
MCLE Basics

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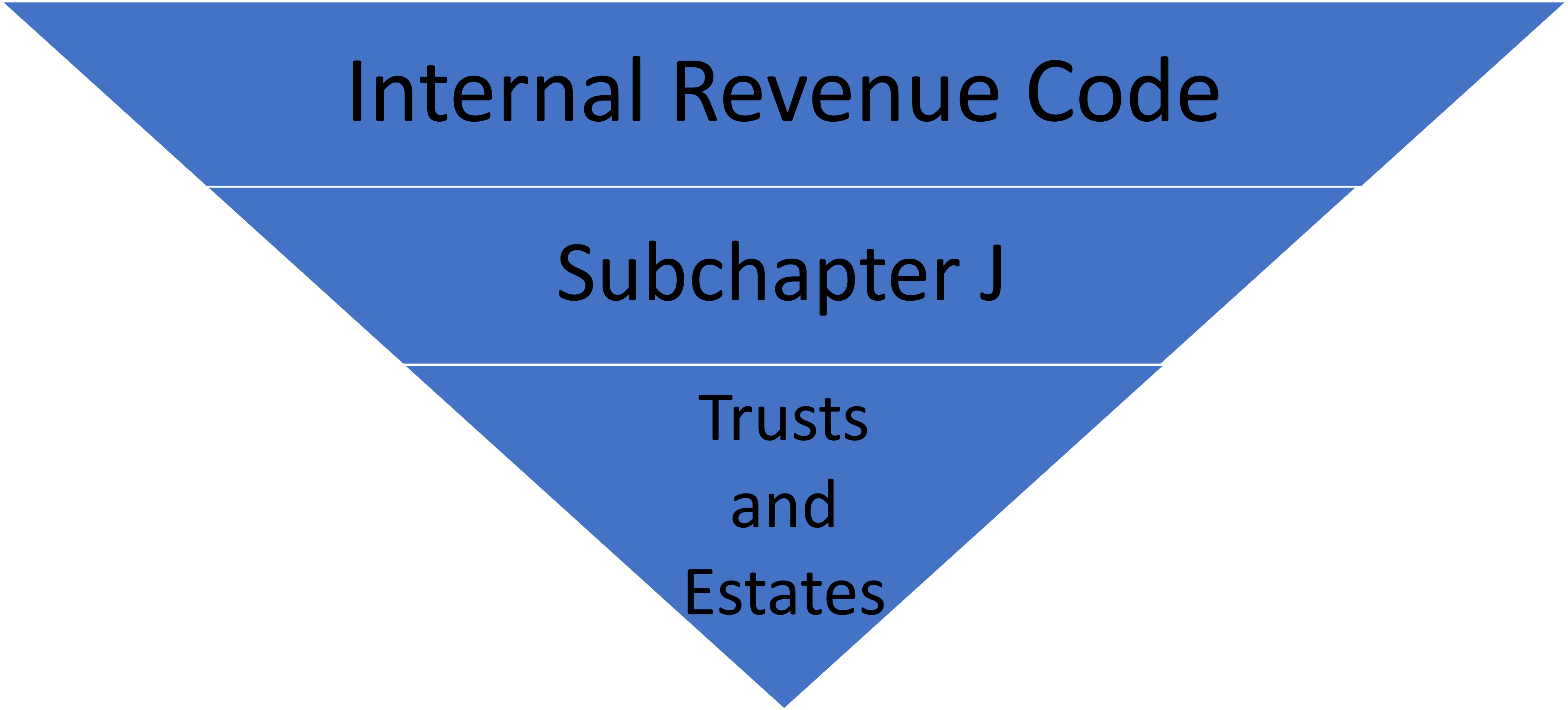
Trust and Estates in the Internal Revenue Code



Overview of Subchapter J of the Code

- §641- §646 General Rules for Taxation of Estates and Trusts
- §651- §652 Trusts Which Distribute Current Income Only
- §661 - §664 Estates and Trusts Which May Accumulate Income or Which Distribute Corpus
- §665 - §669 Treatment of Excess Distributions by Trusts
- §671 - §679 Grantors and Others treated as Substantial Owners
- §681 - §685 Miscellaneous

General Theory

- The general theory behind Subchapter J is that the individual or entity who receives or benefits from the income should bear the tax.
- If a distribution is made to a beneficiary out of the trust's income, the beneficiary should bear the burden of paying the tax on it.
- The tax on income that is accumulated (generally including capital gains) will be borne by the trust, and indirectly by the remainder beneficiaries, who ultimately benefit from the gains or accumulated income.

Compressed Rates for Fiduciary Returns

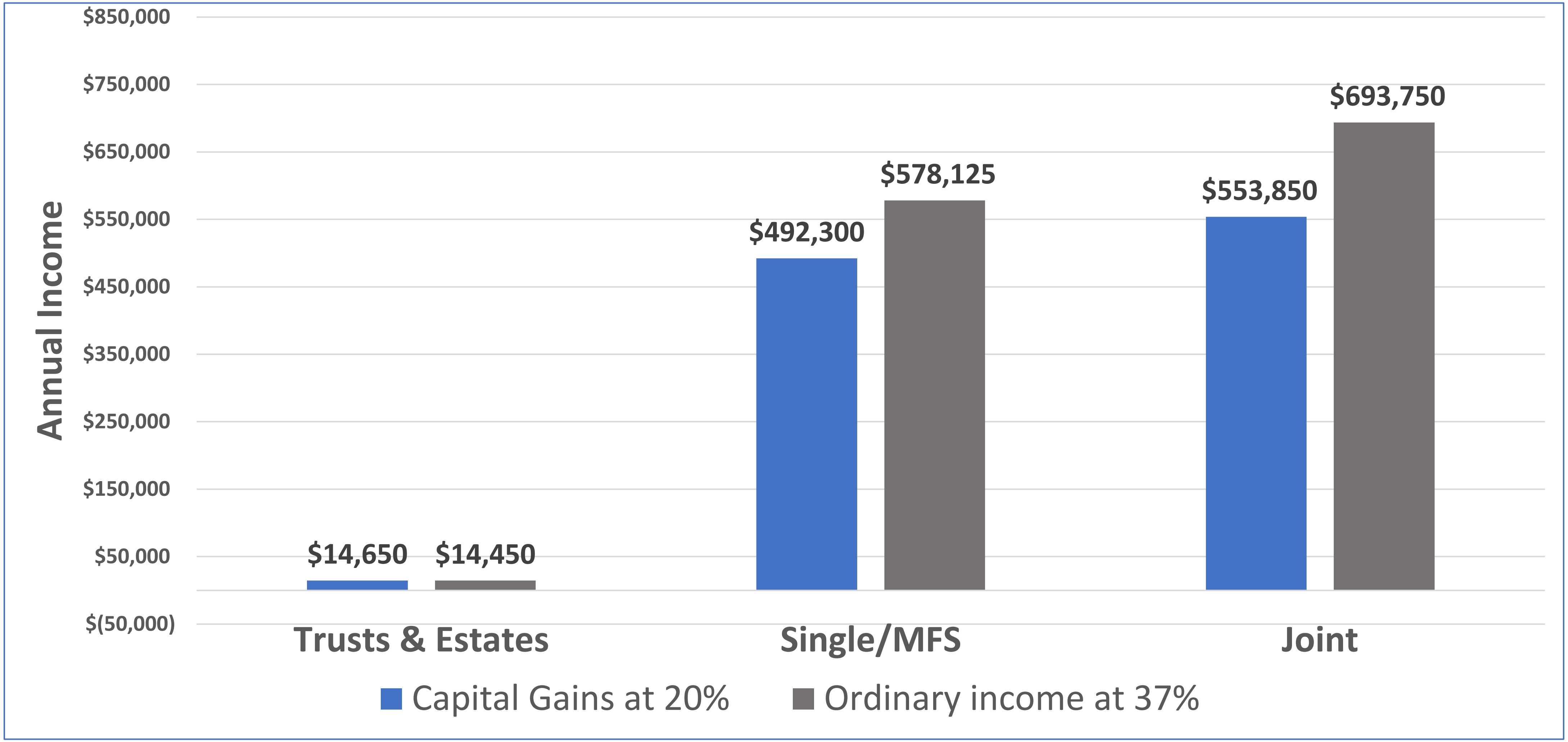
The tax brackets for trusts are very compressed. Rather than 6 brackets for individuals, there are only 4 brackets for trusts and estates, with the highest marginal rate (37% in 2023) for a trust or estate significantly lower than that for individuals.

Highest Marginal Rate (37%)	**Highest Marginal Rate (37%)**	**Highest Marginal Rate (37%)**
Trust or Estate	Single/MFS	Joint
Over $14,450	Over $578,125	Over $693,750

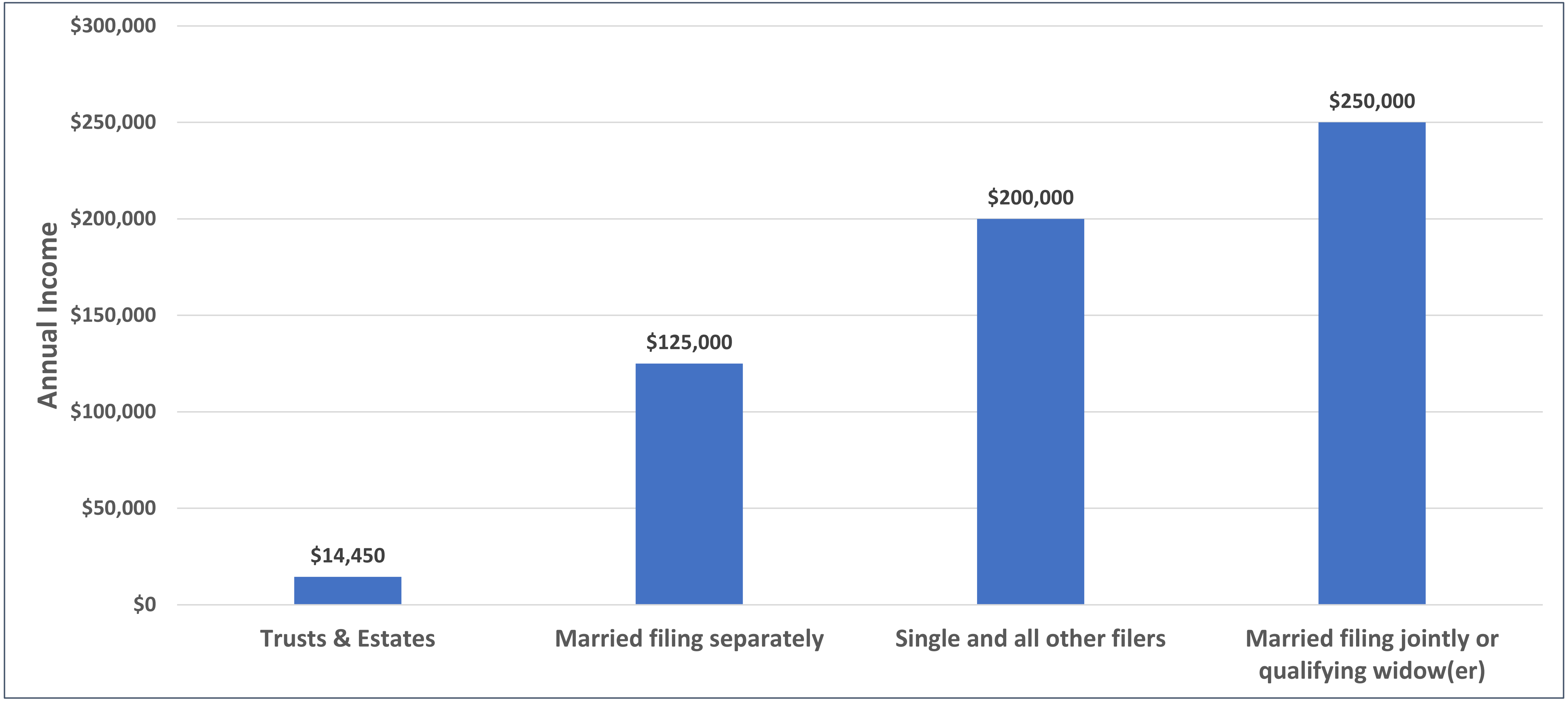
Capital Gains Tax for Trusts & Estates

- The 0% Capital Gains Tax Bracket applies for the first $3,000 of trust/estate income
- The 15% Capital Gains Tax Bracket applies for trust/estate income between $3,001 and $14,650
- The 20% Capital Gains Tax Bracket applies when trust/estate income in excess of $14,650
- Compare to individuals, where the 20% rate does not apply until income exceeds $276,900 for single and $553,850 for joint filers

Top Capital Gain (20%) and Ordinary Income Brackets (37%)



Net Investment Income Tax of 3.8% Thresholds



Separate EIN

- An irrevocable trust needs a separate employer identification number (EIN)
- Obtain the EIN for a previously revocable trust on the grantor's death (as the trust is now irrevocable)
    - Note that the "beginning date" is not the date of the revocable trust – it is the date of the decedent's death
    - For a trust that was irrevocable from creation, the beginning date is the date the trust was funded
- A decedent's estate also needs a separate EIN
- EIN can be obtained almost instantly online through IRS website

Determine Fiscal or Calendar Year

Trusts will always have calendar year

- Exception if § 645 election made to treat decedent's revocable trust as part of estate
- In that case, can file trust and estate on single Form 1041 on the estate's fiscal year

Estates may have calendar or fiscal year

- May be beneficial to pick a fiscal year for distributions to beneficiaries
- However, can be administratively complicated to determine income on fiscal year – cannot rely on 1099s

Return Due Dates for Trusts and Estates

Trust Extension Returns
NOTE: Always due on September 30th!

September 30th

Extension
Due 5 ½ months after the original due date

Due Date + 5 ½ months

Estate Returns
Due on the 15th day of the 4th month following the close of the chosen fiscal year

Fiscal Year + 4 months and 15 days

Trust Returns
*Unless a §645 election is made

April 15th

Individual versus Fiduciary Income Taxation

- In general, trusts and estates are taxed similarly to individuals.
- Trusts and estates are separate taxable entities with their own exemption:
  - Simple Trust $300
  - Complex Trust $100
  - Estate $600
- Trusts must always file on a calendar year basis.
- An estate may file on a fiscal year basis, choosing a fiscal year-end no later than the last day of the month prior to the month of death
  - E.g. – the estate of a decedent who died June 10, 2023 can choose a fiscal year ending on May 31, meaning that the first taxable year of the estate would run from June 11, 2023 through May 31, 2024.
  - Returns for fiscal years are due the 15th day of the 4th month after the fiscal year end (September 15, 2024 for the above example).

Individual versus Fiduciary Income Taxation

- Like an individual, the fiduciary adds up the income received by the trust and takes certain deductions against that income to determine taxable income.
- However, trusts can estates can reduce the fiduciary income taxable at the trust or estate level by means of certain rules that apply to trusts and estates.

Special Fiduciary Income Rules

- Income Distribution Deduction - Allows the fiduciary to eliminate taxable income at the trust level by distributing income to beneficiaries
- Distributable Net Income - Defines the maximum amount of income that qualifies for the income distribution deduction
- Tier System - Defines the largest amount that qualifies for the distribution deduction

Form 1041 can be used for various entities:

IRS Form 1041

- Decedent's Estate
- Simple Trust
- Complex Trust
- Electing Small Business Trust holding S Corp stock
- Qualified Disability Trust
- Bankruptcy Estate (Ch. 7 or Ch. 11)
- Pooled Income Fund

Simple or Complex Trust?

Simple Trust

<u>Requires</u> that all income must be paid currently

No income is required to be paid or set aside for charity

No distributions of principal are made in the current year, *<u>even if the trust allows them</u>*

Complex Trust

All other irrevocable trusts

Could be mandatory income with discretionary principal and principal is distributed (e.g., QTIP trust)

Could also be fully discretionary trust that distributes **some, none, or all income**, and/or principal.

Determine if Return is Required

- Gross income for trusts and estates is similar to that for individuals. To determine whether a return is required, calculate income on page 1, lines 1 – 9 of Form 1041:
  - Interest
  - Dividends (allocate between ordinary and qualified)
  - Capital gains/losses
  - Rents, royalties, partnerships, estates and trusts – Schedule E income is calculated in same way as for individuals
  - Ordinary gain or loss (4797)
  - Other income, which includes distributions from IRAs

Form 1041 for must be filed if:

Note that a return must be filed for first year of an estate if you wish to elect a non-calendar tax year even if no return would otherwise be required

ESTATE → Gross income (line 9 of Form 1041) is greater than $600 → <u>OR</u> → The estate has a nonresident alien beneficiary

TRUST → Gross income (line 9 of Form 1041) is greater than $600 → <u>OR</u> → The trust has taxable income → <u>OR</u> → The trust has nonresident alien beneficiary

Fiduciary versus Tax Accounting Income

- Fiduciary accounting income (“FAI”)
  - Governed by state law (often Uniform Principal and Income Act) and the trust instrument
  - Determines the amount that may or must pass to the trust’s income beneficiaries versus what is accumulated in the trust for the remainder beneficiaries
  - “Net income” means FAI minus expenses and fees chargeable to income under probate accounting principles, and will often be different from taxable income.
- Tax accounting income (“TAI”)
  - Governed by the federal income tax law
  - Determines who is taxed on the income

FAI – Receipts

- Dividends (cash or other property)
- Interest (taxable and tax exempt)
- Rents
- Royalties
- Some or part of IRA distributions (depending on trust instrument and/or local law)
- Ordinary income from business owned by trust
- Some distributions from entities (may be limited)

FAI – Typical Principal Allocations

- Realized long-term and short-term capital gains (unless allocated to income under the trust instrument or local law
- Extraordinary dividends or stock dividends
- IRA distributions (some or all depending on trust instrument and local law)
- Increases in asset value (i.e. appreciation)

FAI - Expenses

- Some expenses, such as fiduciary fees, will be allocated between income and principal
- Depreciation and casualty losses generally allocated to principal
- Taxes, tax preparation fees generally allocated to income
- Legal fees may be allocated depending on purpose

FAI versus TAI - Example

Assume that a complex trust had the following sources of income and deductions during the current tax year	
Income	
Interest	$2,000
Tax-exempt Interest	$1,000
Dividends	$6,000
Rental Income	$15,000
Long-term capital gains	$10,000
Expenses	
Taxes	$2,000
Trustee Fees	$2,000
Tax Prep Fees	$1,000

FAI versus TAI - Example

	FAI	TAI
Interest	$2,000	$2,000
Tax-exempt interest	$1,000	-
Dividends	$6,000	$6,000
Rental Income	$15,000	$15,000
Long-term capital gains	-	$10,000
Gross Income	**$24,000**	**$33,000**
Less: Taxes	($2,000)	($2,000)
Less: Trustee Fees	($1,000)	($1,917)
Less: Tax Prep Fees	($1,000)	($1,000)
Less: Exemption	-	($100)
Net Income	**$20,000**	**$27,983**

Note 1: Trustee fees are divided equally between income and principal
Note 2: Trustee fees reduced by amount allocated to tax-exempt income

1041 Deductions

- Deductions are reported on lines 10 – 22 of the Form 1041
- Cannot take the same deductions on Form 706 and Form 1041, so need to decide where they are best allocated
- Interest – generally the same as for individuals. Does not apply to personal loans, but can deduct mortgage interest on real property owned by the trust.
- Taxes – same as for individuals, with the $10,000 limit
  - State, local, and foreign real property taxes, personal property taxes, and income taxes
- Fiduciary fees – a reasonable fee paid to a personal representative or trustee (must be strictly fiduciary fee and cannot be bundled with investment management fees)

1041 Deductions

- Attorney, accountant, and return preparer fees
  - Reasonable amounts paid to those professionals for services ordinary and necessary in connection with the administration of the trust or estate
- Other deductions not subject to 2% floor
  - Casualty and theft losses
  - Certain depreciation, depletion, and amortization expenses
  - Net operating losses
  - Qualified Business Income deduction (for 2020 – 2025)
- Charitable Deduction – done on Schedule A of 1041 – must be required to be paid or set aside for charitable purposes in trust instrument
  - Not limited by AGI like individuals, but harder to take

1041 Deductions

- Allowable miscellaneous itemized deductions subject to the 2% floor (AMID)
  - Will be allowable again after 2025
  - See §67 Regs. for items subject to 2% floor
  - Deductible only to the extent they exceed trust's adjusted gross income (AGI)
  - AGI for trust = gross income – administration expenses – income distribution deduction – personal exemption of trust
  - Administration expenses are generally fiduciary, attorney, accountant and return preparer fees plus any miscellaneous deductions not subject to 2% floor
  - Note – because the AMID calculation is necessary to calculate the IDD, and the IDD is necessary to calculate the AMID, there can be a circular calculation

Allocation for Tax Exempt Income

- Before completing lines 10 – 16, you must allocate the expenses between taxable and tax-exempt income
- Determine amount of tax-exempt income, such as municipal bond interest
- Determine which expenses are directly attributable to taxable income and those that are directly attributable to tax-exempt income
  - If there are expenses that are directly attributable to tax-exempt income, directly reduce the expenses by that amount
- Calculate the tax-exempt allocation ratio for indirect expenses, such as fiduciary fees by dividing tax-exempt income by total income (including TEI)
- Multiply each indirect expense by that ratio and subtract that amount from the overall expense to determine deductible expense

Distributable Net Income ("DNI")

- DNI determines the amount of the trust's or estate's income distribution deduction.
- Determines how much the beneficiaries must report as income on their tax returns.
- Determines the character (e.g. interest, dividends, etc.) of the taxable income in beneficiaries' hands.
- DNI acts as a ceiling for purposes of the allowable deduction to the trust/estate and for the total amount of income the beneficiary must report on their individual tax return.

Income Distribution Deduction ("IDD")

- This deduction allows the trust to pass through much of its income to the beneficiaries, who are often in a lower tax bracket than the trust
- The Income Distribution Deduction is the smaller of:
  1. DNI – adjusted tax-exempt income; and
  2. Amounts required to be distributed or actually distributed to beneficiaries during the tax year minus tax-exempt income allocated to distributions
- The income distribution deduction calculation is done on Schedule B on page 2 of the Form 1041

DNI

- Intent is to approximate FAI and place a cap on how much tax liability the current beneficiaries must bear, based on the fact the tax on taxable receipts allocated to principal, such as capital gains, should be borne by the trust – and indirectly the remainder beneficiaries who will ultimately benefit from the gains – rather than the current beneficiaries.
- Not necessarily equal to FAI because DNI includes some taxable income that may not be treated as principal receipts for a certain period, and allows full deductions for some expenses that are allocated between income and principal, such as fiduciary fees.

Calculating DNI

	Adjusted total income	(Form 1041, Line 17)
+	Adjusted tax-exempt income	(TEI – TEI allocated to charity – deductible exp allocated to TEI)
+	Net capital gain allocated beneficiaries	(Schedule D, line 19, column 1)
+	Capital gain allocated to charity	(Schedule A, lines 1 and 4)
+	Capital losses*	(Net capital losses entered as positive number)
(-)	Capital gains*	(Net capital gains entered as negative number)
	Distributable Net Income (DNI)	
		*** Except in the year of termination**

Calculating DNI

- In general, capital gains and losses are trapped at the trust or estate level
- In year of termination, gains and losses pass out to the beneficiaries
- Also see rules regarding distributing capital gains in DNI based on a regular pattern of the trustee or other circumstances - See Treas. Reg. § 1.643(a)-3
- Note also that specific bequests in a will (estate) or trust do not carry out DNI to the beneficiaries - §663(a)(1)

DNI Example

Interest	$2,000
Dividends	$6,000
Rental Income	$15,000
Long-term capital gains	$10,000
Total Income	**$33,000**
Less: Taxes	($2,000)
Less: Trustee Fees (reduced by TE allocation)	($1,917)
Less: Tax Prep Fees	($1,000)
Adjusted Total Income	**$28,083**
Adjusted tax-exempt interest	$917
Net Capital Gain	($10,000)
Distributable Net Income (DNI)	$19,000

Tier System

- The tier system applies to estates and to complex trusts
- The tier system forces distributions of income to the beneficiaries before distributions can be considered principal
- Ensures that beneficiaries share in the tax burden for distributions

Tier System – First Tier

- First Tier (Schedule B, line 9): The amount of FAI required by the trust instrument to be distributed during the tax year - even if such income is not actually distributed
- Example: "The Trustee shall distribute the net income of the trust in equal shares to A and B at least annually."
- Simple trusts will have First Tier distributions but no Second Tier distributions
- For simple trusts, the maximum income distribution deduction will be equal to the amount of First Tier distributions less the tax-exempt income included in the distributions

Tier System – Second Tier Distributions

- **Second Tier** distributions (Schedule B, line 10) includes "other amounts paid, credited, or otherwise required to be distributed."
    - "Credited" means that the distributions were made available to the beneficiary or paid for the beneficiary's benefit
    - May include distributions made under "65-day rule" in following year (§663(b))
- A trust will always be a **complex trust** if there are Second Tier distributions
- Includes discretionary distributions of income and/or principal
- Includes mandatory distributions of principal (i.e., age 25 partial distribution)
- **Does not** include specific amounts or property that are required to be paid from principal in three or fewer installments
    - For example, specific pecuniary gifts or devises where amount is ascertainable at date of death (e.g., devise of real property)
- Note if trust is **pre-1985** or **foreign and accumulated income**, and First + Second Tiers > FAI, then may be subject to "throwback rules"

Income Distribution Deduction

- Tentative IDD from DNI (Schedule B, line 13):

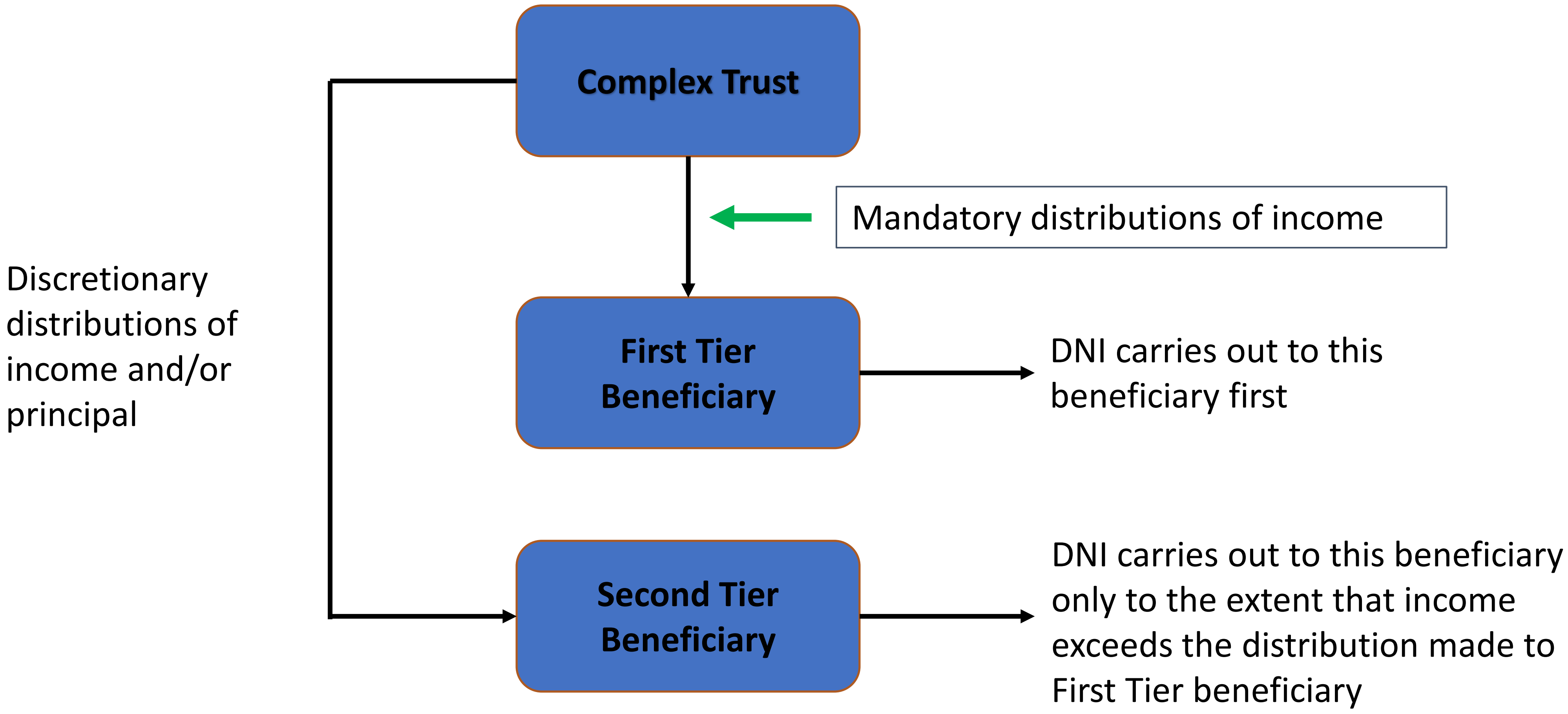
  DNI – adjusted tax-exempt income

- Tentative IDD from the Tier System (Schedule B, line 14):

  1st Tier + 2nd Tier – tax-exempt income allocated to distributions

- Income Distribution Deduction (Sch B, line 15) = smaller of two tentative IDD amounts

Tier System


Complex Trust
Mandatory distributions of income
Discretionary distributions of income and/or principal
First Tier Beneficiary
DNI carries out to this beneficiary first
Second Tier Beneficiary
DNI carries out to this beneficiary only to the extent that income exceeds the distribution made to First Tier beneficiary

Final Tax Calculation

	Adjusted total income
minus	Income distribution deduction
minus	Estate tax deduction
minus	Qualified business income deduction
minus	Exemption ($600/$300/$100)
equals	Taxable Income

* For a simple trust, all that will be left to tax is capital gains
* Trusts and estates allowed some credits, such as foreign tax credit
* See Schedule G of Form 1041

Tax Effect on Beneficiaries

- Income will carry out to beneficiaries on Schedule K-1 in proportion to their receipt of distributions (quantitative allocation)
- Character of income will be retained in hands of beneficiary (qualitative allocation)
- Total amount of income reported by beneficiaries will be equal to the income distribution deduction taken plus the tax-exempt income included in DNI

Qualitative Allocation

- Allocate income categories pro rata among beneficiaries who received distributions among First Tier and then any remainder among Second Tier
- Deductions that reduced DNI will also be allocated pro rata among the various income categories
  - Charitable deductions allocated pro rata among all categories except tax-exempt income. Allocate to tax-exempt income the amount of charitable deduction determined when allocated to calculate charitable deduction.
  - Deductible expenses directly attributable to an income category directly allocated to that income (to the extent remaining)
  - Directly attributable expenses in excess of those allocated above are all pro rata among all income categories (except tax-exempt)
  - All other expenses allocated pro rata among all income, including tax-exempt income
  - No category may show a loss, except in final year of trust or estate

Quantitative Allocation

- First, allocate each category of income pro rata among First Tier beneficiaries.
  - For a simple trust, this will be all the income
- Any remaining income (i.e., in a complex trust) will be allocated pro rata among the Second Tier beneficiaries
- Total amounts allocated to First and Second Tier beneficiaries cannot exceed the income distribution deduction
- Note: When a charitable deduction is claimed, the First Tier allocation is made without including the charitable deduction. The charitable deduction is allocated to Second Tier beneficiaries.

Timing of Beneficiary Reporting

- If beneficiary and trust have same tax year (general rule), income is includible in the beneficiary's income for that tax year.
- If beneficiary and estate or trust (§645 election) have different tax years, the beneficiary will report the income for the taxable year that includes the last day of the estate's or trust's taxable year (§662(c)).
- 65-day rule distributions are reported by the beneficiary for the tax year of the trust or estate, even though they're made in following year.

Separate Share Rule

- Applies to both estates and complex trusts
- Treats multiple beneficiaries of an estate or single trust as if each were the sole beneficiary
- Determines how DNI carries out to each beneficiary
  - DNI is computed separately for each share

Separate Share Rule

Because income is carried out to beneficiaries in proportion to deductible distributions, a disproportionate principal distribution from a complex trust to one beneficiary may result in that beneficiary paying income taxes on income that was, in fact, retained in the trust or estate for later distribution to a different beneficiary.

There are three ways to avoid this problem.

Three ways to avoid beneficiary taxation on undistributed income from a Complex Trust

- Separate trust shares/accounts if permitted
  - Must be set up prior to making disproportionate payment
  - Must be legally Separate
- Treat substantially separate shares separately for DNI allocation only
  - Trustee can determine sequence and timing of distributions
  - Shares are considered ""substantially separate"
- Trust calls for mandatory income amongst beneficiaries, discretionary principal to same
  - Avoid disproportionate principal distribution by making an equal First Tier distribution (mandatory income)
  - Subsequently make principal distribution disproportionately as a non-taxable Second Tier distribution

Separate Share Rule

<u>Example 1: Substantially separate shares</u>:

If the trust provides that the trustee must pay ½ of the residue to son and ½ to charity, the trustee can make a large distribution to son immediately but hold off on the distribution to charity. Because the shares are "substantially separate," the trustee may allocate ½ of the DNI to charity to avoid having it all carried out to son.

<u>Example 2: Income to First Tier Beneficiaries Equally</u>

Trust calls for all income to be distributed among A, B, and C at least annually, with discretion to distribution principal among them. Trustee can distribute income equally among A, B, and C, and can make a larger principal distribution to C only. The principal distribution to C will be tax-free (assuming all IDD was used on First Tier distribution).

Separate Share Rule: Example

<u>Assumptions</u>

- Complex trust
- Two beneficiaries (Son & Daughter)
- Distributable Net Income (DNI) in 2022 = $30,000
- Distributable Net Income (DNI) in 2023 = $10,000
- Trust distributes $20,000 to <u>***S***</u> and $5,000 to <u>***D***</u> in 2022
- Trust distributes $15,000 to <u>***D***</u> in 2023

Separate Share Rule Example

Complex Trust					
2022 Tax Year ($30,000 DNI)			2023 Tax Year ($10,000 DNI)		
Son	Daughter	Trust	Son	Daughter	Trust
$15,000	$5,000	$10,000	$0	$5,000	$5,000

Questions or Follow Up?

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