

FIDUCIARY INCOME TAXATION

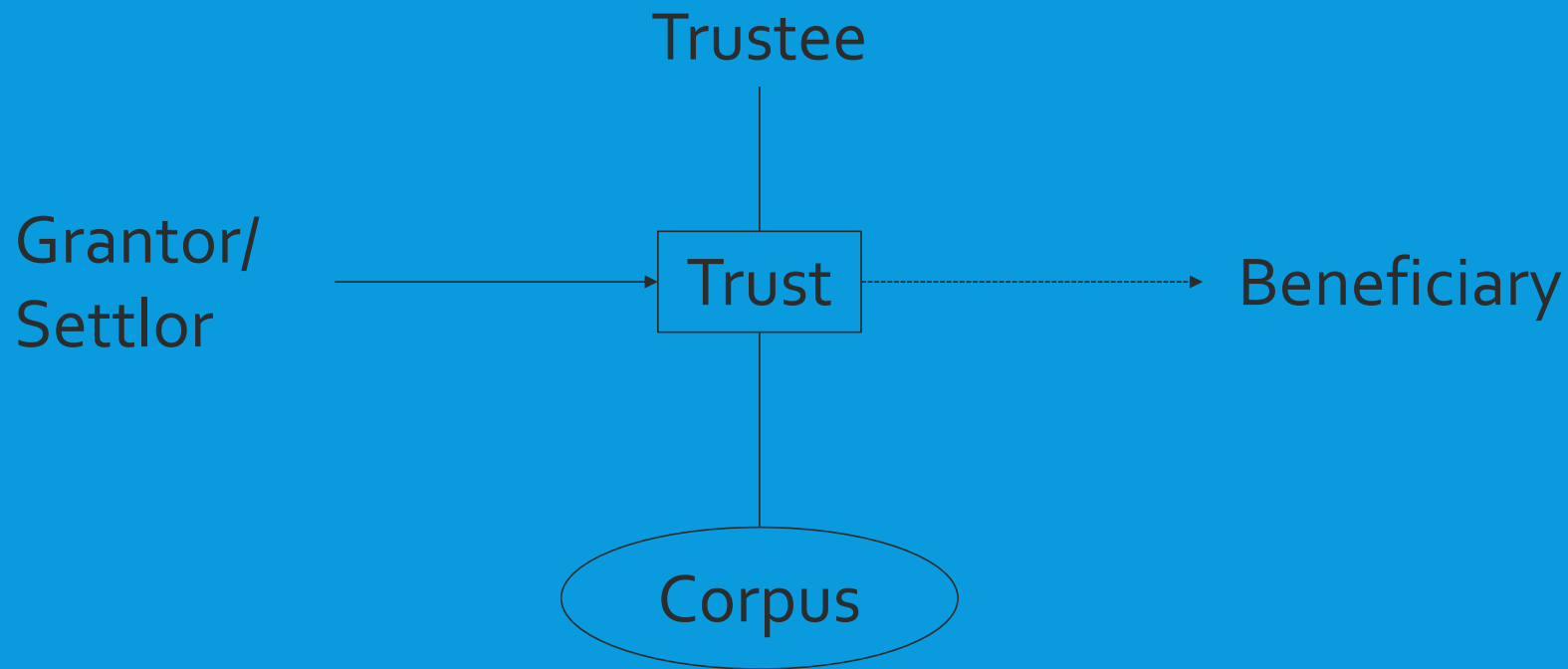


Southern Arizona Estate Planning Council
&
Community Foundation for Southern Arizona
June 9, 2023

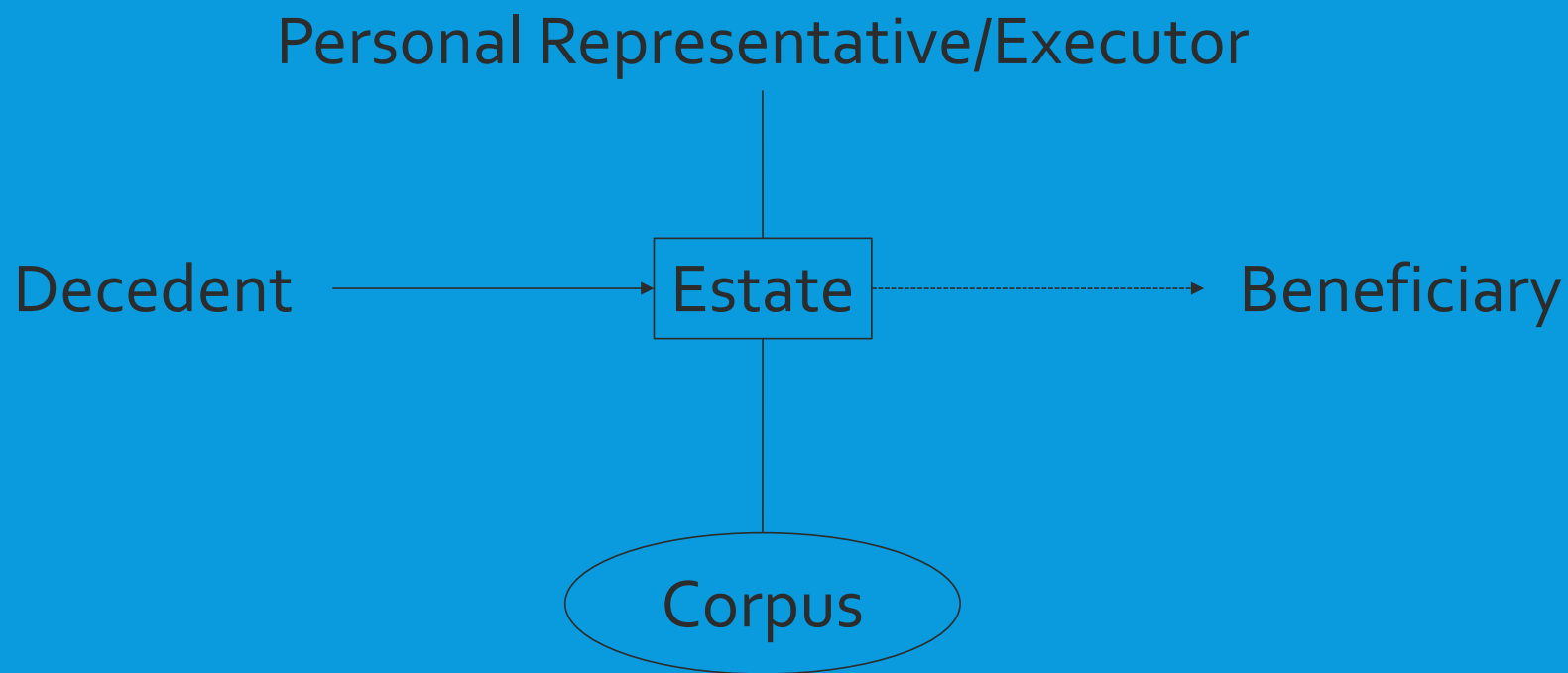
Anne Roediger, CPA
Daren J. Layton, Esq., CPA



STRUCTURE OF A TRUST



STRUCTURE OF AN ESTATE



FIDUCIARY ACCOUNTING INCOME

- The income of the estate or trust for state law purposes
- Think of this as the “economic” or “book” income as compared to the “tax” income

FIDUCIARY ACCOUNTING INCOME

- Deals with the allocation of receipts and disbursements between income and principal
- Has a direct impact on the beneficial interests of the beneficiaries
- Has a direct impact on determining the amount of taxable income for the estate / trust and its beneficiary(ies)

FIDUCIARY ACCOUNTING INCOME

- Each state has a set of default rules that provide for the allocation of receipts and disbursements between income and principal
- Most states have adopted a version of the Uniform Principal and Income Act (ARS §§ 14-7401 - 14-7431)
- The governing instrument (e.g., will or trust agreement) may override the state default rules

FIDUCIARY ACCOUNTING INCOME

- Default rules listed in Section III.B. of materials

FIDUCIARY ACCOUNTING INCOME

- Example
 - Taxable Interest = \$1,000
 - Tax-Exempt Interest = \$5,000
 - Dividends = \$2,500
 - IRA Distribution = \$4,000
 - Net Rental Income = \$3,500
 - Partnership Distribution = \$2,000
 - Liquidating Distribution from S Corp. = \$15,000
 - Capital Gains from Sale of Stocks = \$5,000
 - Net Proceeds from Sale of Vacant Land = \$10,000
 - Trustee Fees = \$3,000
 - Accounting Fees = \$2,000
 - Legal Fees (general) = \$1,000
 - Legal Fees (to collect past due rents) = \$500

FIDUCIARY ACCOUNTING INCOME

Item	Income	Principal
Taxable Interest		
Tax-Exempt Interest		
Dividends		
IRA Distribution		
Net Rental Income		
Partnership Distribution		
Liquidating Distribution from S Corp.		
Proceeds from Sale of Stock		
Net Proceeds from Sale of Vacant Land		
Trustee Fees		
Accounting Fees		
Legal Fees (general)		
Legal Fees (to collect past due rents)		
Net Total		

FIDUCIARY ACCOUNTING INCOME

Item	Income	Principal
Taxable Interest	\$1,000	\$0
Tax-Exempt Interest	\$5,000	\$0
Dividends	\$2,500	\$0
IRA Distribution	\$400	\$3,600
Net Rental Income	\$3,500	\$0
Partnership Distribution	\$2,000	\$0
Liquidating Distribution from S Corp.	\$0	\$15,000
Proceeds from Sale of Stock	\$0	\$5,000
Net Proceeds from Sale of Vacant Land	\$0	\$10,000
Trustee Fees	(\$1,500)	(\$1,500)
Accounting Fees	(\$1,000)	(\$1,000)
Legal Fees (general)	(\$500)	(\$500)
Legal Fees (to collect past due rents)	(\$500)	\$0
Net Total	\$10,900	\$30,600

SIMPLE TRUST EXAMPLE

Item		FAI	DNI	Adjusted Inc
Dividends	\$ 5,000			
LTCG	\$ 11,000			
T/E Interest	\$ 3,500			
Expenses	\$ (4,000)			
Total	\$ 15,500			
		Sch B Ln 8 or 9	Sch B Ln 7	Pg. 1, Ln 17

How much does the income beneficiary receive?

How much do they pay tax on?

How much does the Trust pay tax on?

SIMPLE TRUST EXAMPLE

Item		FAI	DNI	Adjusted Inc
Dividends	\$ 5,000	\$ 5,000	\$ 5,000	\$ 5,000
LTCG	\$ 11,000			\$ 11,000
T/E Interest	\$ 3,500	\$ 3,500	\$ 3,500	
Expenses	\$ (4,000)	\$ (2,000)	\$ (4,000)	\$ (4,000)
Total	\$ 15,500	\$ 6,500	\$ 4,500	\$ 12,000
		Sch B Ln 8 or 9	Sch B Ln 7	Pg. 1, Ln 17

How much does the income beneficiary receive?

How much do they pay tax on?

How much does the Trust pay tax on?

Department of the Treasury—Internal Revenue Service

1041 U.S. Income Tax Return for Estates and Trusts

2022

OMB No. 1545-0047

A Check all that apply:

- Decedent's estate
Simple trust
Complex trust
Qualified disability trust
ESBT (S portion only)
Grantor type trust
Bankruptcy estate-Ch. 7
Bankruptcy estate-Ch. 11
Pooled income fund

For calendar year 2022 or fiscal year beginning and ending

Name of estate or trust (if a grantor type trust, see the instructions)
JOE SAMPLE TRUST
Name and title of fiduciary
JERRY MCGUIRE, TRUSTEE
Number, street, and room or suite no. (if a P.O. box, see the instructions)
1234 MAIN ST
City or town, state or province, county, and ZIP or foreign postal code
TUCSON AZ 85712

C Employer identification number
D Date entity created
E None exempt charitable and split-interest trusts, check applicable boxes. See instructions.
Described in sec. 4947(a)(1). Check here if not a private foundation
Described in sec. 4947(a)(2)

B Number of schedules K-1 attached (see instructions) 1

F Check applicable boxes: Initial return, Final return, Amended return, Net operating loss carryback Change in fiduciary name, Change in fiduciary, Change in fiduciary's name, Change in fiduciary's address

G Check here if the estate or filing trust made a section 645 election Trust TN

Table with 30 rows for Income, Deductions, and Tax and Payments. Includes items like Interest income, Total ordinary dividends, Business income, Capital gain, Rents, royalties, Farm income, Ordinary gain, Other income, Interest, Taxes, Fiduciary fees, Charitable deduction, Attorney fees, Other deductions, Net operating loss deduction, Adjusted total income, Income distribution deduction, Estate tax deduction, Qualified business income deduction, Exemption, Taxable income, Total tax, Current year net 965 tax liability, Total payments, Estimated tax penalty, Tax due, Overpayment, and Amount of line 29 to be credited to 2023.

Sign Here: Signature of fiduciary or officer representing fiduciary, Date, EIN of fiduciary if a financial institution, Preparer's name, Preparer's signature, Date, EIN of preparer, Check self-employed, PTN, Firm's name, Firm's address, Firm's EIN, Phone no.

For Paperwork Reduction Act Notice, see the separate instructions. Form 1041 (2022)

Schedule A Charitable Deduction. Don't complete for a simple trust or a pooled income fund.			
1	Amounts paid or permanently set aside for charitable purposes from gross income. See instructions	1	
2	Tax-exempt income allocable to charitable contributions. See instructions	2	
3	Subtract line 2 from line 1	3	
4	Capital gains for the tax year allocated to corpus and paid or permanently set aside for charitable purposes	4	
5	Add lines 3 and 4	5	
6	Section 1202 exclusion allocable to capital gains paid or permanently set aside for charitable purposes. See instructions	6	
7	Charitable deduction. Subtract line 6 from line 5. Enter here and on page 1, line 13	7	

Schedule B Income Distribution Deduction			
1	Adjusted total income. See instructions	1	12,000
2	Adjusted tax-exempt interest	2	3,500
3	Total net gain from Schedule D (Form 1041), line 10, column (1). See instructions	3	0
4	Enter amount from Schedule A, line 4 (minus any allocable section 1202 exclusion)	4	
5	Capital gains for the tax year included on Schedule A, line 1. See instructions	5	0
6	Enter any gain from page 1, line 4, as a negative number. If page 1, line 4, is a loss, enter the loss as a positive number	6	-11,000
7	Deductible net income. Combine lines 1-6. If zero or less, enter -0-	7	4,500
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law	8	
9	Income required to be distributed currently	9	6,500
10	Other amounts paid, credited, or otherwise required to be distributed	10	0
11	Total distributions. Add lines 9 and 10. If greater than line 8, see instructions	11	6,500
12	Enter the amount of tax-exempt income included on line 11	12	3,500
13	Tentative income distribution deduction. Subtract line 12 from line 11	13	3,000
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-	14	1,000
15	Income distribution deduction. Enter the smaller of line 13 or line 14 here and on page 1, line 18	15	1,000

Schedule G Tax Computation and Payments (see instructions)

Part I — Tax Computation			
1	Tax:		
a	Tax on taxable income. See instructions	1a	1,185
b	Tax on lump-sum distributions. Attach Form 4972	1b	
c	Alternative minimum tax (from Schedule I (Form 1041), line 54)	1c	0
d	Total. Add lines 1a through 1c	1d	1,185
2a	Foreign tax credit. Attach Form 1118	2a	
b	General business credit. Attach Form 3800	2b	
c	Credit for prior year minimum tax. Attach Form 8801	2c	
d	Bond credits. Attach Form 8912	2d	
e	Total credits. Add lines 2a through 2d	2e	0
3	Subtract line 2e from line 1d. If zero or less, enter -0-	3	1,185
4	Tax on the ESBT portion of the trust (from ESBT Tax Worksheet, line 17). See instructions	4	
5	Net investment income tax from Form 990, line 21	5	
6	Recapture taxes. Check if from: <input type="checkbox"/> Form 4255 <input type="checkbox"/> Form 8611	6	
7	Household employment taxes. Attach Schedule H (Form 1040)	7	
8	Other taxes and amounts due	8	
9	Total tax. Add lines 3 through 8. Enter here and on page 1, line 24	9	1,185

Part II — Payments			
10	2022 estimated tax payments and amount applied from 2021 return	10	
11	Estimated tax payments allocated to beneficiaries (from Form 1041-T)	11	
12	Subtract line 11 from line 10	12	
13	Tax paid with Form 7004. See instructions	13	0
14	Federal income tax withheld. If any is from Form(s) 1099, check here <input type="checkbox"/>	14	
15	Current year net 965 tax liability from Form 965-A, Part I, column (f) (see instructions)	15	
16	Other payments: a Form 2439 ; b Form 4136 ; Total	16a	
17	Credit for qualified sick and family leave wages for leave taken before April 1, 2021	17	
18	Credit for qualified sick and family leave wages for leave taken after March 31, 2021, and before October 1, 2021	18	
19	Total payments. Add lines 12 through 15 and 16a through 18. Enter here and on page 1, line 28	19	

Other Information		Yes	No
1	Did the estate or trust receive tax-exempt income? If "Yes," attach a computation of the allocation of expenses. SEE EXEMPT INC WK	<input checked="" type="checkbox"/>	
	Enter the amount of tax-exempt interest income and exempt-interest dividends \$ 3,500 SEE STMT 1		
2	Did the estate or trust receive all or any part of the earnings (salary, wages, and other compensation) of any individual by reason of a contract assignment or similar arrangement?		<input checked="" type="checkbox"/>
3	At any time during calendar year 2022, did the estate or trust have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country? See the instructions for exceptions and filing requirements for FinCEN Form 114. If "Yes," enter the name of the foreign country		<input checked="" type="checkbox"/>
4	During the tax year, did the estate or trust receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the estate or trust may have to file Form 3520. See instructions		<input checked="" type="checkbox"/>
5	Did the estate or trust receive, or pay, any qualified residence interest on seller-provided financing? If "Yes," see the instructions for the required attachment		<input checked="" type="checkbox"/>
6	If this is an estate or a complex trust making the section 663(b) election, check here. See instructions	<input type="checkbox"/>	
7	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here. See instructions	<input type="checkbox"/>	
8	If the decedent's estate has been open for more than 2 years, attach an explanation for the delay in closing the estate, and check here	<input type="checkbox"/>	
9	Are any present or future trust beneficiaries skip persons? See instructions		<input checked="" type="checkbox"/>
10	Was the trust a specified domestic entity required to file Form 8938 for the tax year? See the instructions for Form 8938		<input checked="" type="checkbox"/>
11a	Did the estate or trust distribute S corporation stock for which it made a section 965(i) election?		<input checked="" type="checkbox"/>
	b If "Yes," did each beneficiary enter into an agreement to be liable for the net tax liability? See instructions		
12	Did the estate or trust either make a section 965(i) election or enter into a transfer agreement as an eligible 965(i) transferee for S corporation stock held on the last day of the tax year? See instructions		<input checked="" type="checkbox"/>
13	ESBTs only. Does the ESBT have a nonresident alien grantor? If "Yes," see instructions		
14	ESBTs only. Did the S portion of the trust claim a qualified business income deduction? If "Yes," see instructions		

BENEFICIARY 1
Schedule K-1
(Form 1041)

Department of the Treasury
Internal Revenue Service

2022

For calendar year 2022, or tax year

Final K-1 Amended K-1

b61117

OMB No. 1545-0002

beginning ending
**Beneficiary's Share of Income, Deductions,
Credits, etc.**

See back of form and instructions

Part I Information About the Estate or Trust

A Estate's or trust's employer identification number

B Estate's or trust's name
JOE SAMPLE TRUST

C Fiduciary's name, address, city, state, and ZIP code
JERRY MCGUIRE
TRUSTEE
1234 MAIN ST
TUCSON AZ 85712

D Check if Form 1041-T was filed and enter the date it was filed _____

E Check if this is the final Form 1041 for the estate or trust

Part II Information About the Beneficiary

F Beneficiary's identifying number

G Beneficiary's name, address, city, state, and ZIP code
BBA LUCKY

H Domestic beneficiary Foreign beneficiary

**Part III Beneficiary's Share of Current Year Income,
Deductions, Credits, and Other Items**

1 Interest income	11 Final year deductions
2a Ordinary dividends	
2b Qualified dividends 1,000	
3 Net short-term capital gain	
4a Net long-term capital gain	
4b 28% rate gain	12 Alternative minimum tax adjustment
4c Unrecaptured section 1250 gain	
5 Other portfolio and nonbusiness income	
6 Ordinary business income	
7 Net rental real estate income	
8 Other rental income	13 Credits and credit recapture
9 Directly apportioned deductions	
	14 Other information
	A 3,500
10 Estate tax deduction	E * 1,000 STMT

*See attached statement for additional information.
Note: A statement must be attached showing the beneficiary's share of income and directly apportioned deductions from each business, rental real estate, and other rental activity.

For IRS Use Only

SAMPLE FORM 1041



Adobe Acrobat
Document

FIDUCIARY ACCOUNTING INCOME & DISTRIBUTABLE NET INCOME

- Adjustments between income and principal are permissible under the Arizona Principal and Income Act unless governing instrument provides otherwise
 - Purpose of discretion is to permit prudent investing
 - Cannot be used to modify beneficial interests

FIDUCIARY ACCOUNTING INCOME & DISTRIBUTABLE NET INCOME

- Allocations of Income and Principal for Tax Purposes
 - If a fiduciary's allocation is consistent with maximizing the trust's total return and maintaining the balance between the income and remainder beneficiaries' interests, then the fiduciary entity's definition of income will apply for tax purposes.
 - If an allocation departs fundamentally from traditional principles of income and principal or if the fiduciary's allocation is primarily tax motivated, then the fiduciary's definition of income will not apply

FIDUCIARY ACCOUNTING INCOME & DISTRIBUTABLE NET INCOME

- Allocation of Capital Gains for Tax Purposes
 - Primarily governed by Treas. Reg. § 1-643(a)-3
- Often desirable to allocate capital gains to DNI so that the capital gains (especially short-term capital gains) are taxable to the beneficiary rather than the estate or trust
- Capital gains are included in DNI to the extent they are:
 - allocated to income;
 - allocated to principal but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
 - allocated to principal but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary

FIDUCIARY ACCOUNTING INCOME & DISTRIBUTABLE NET INCOME

- Examples from Treas. Reg. § 1-643(a)-3

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Simple Trust

- Trust allowed a distribution deduction for amount required to be distributed; trust's deduction limited to the amount of DNI
- Beneficiary must include in gross income the amount that must be distributed; beneficiary's gross income limited to the amount of DNI
- If multiple beneficiaries, then the income is allocated among the beneficiaries based on the proportionate amount required to be distributed to each beneficiary

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Simple Trust - Example
 - FAI = \$25,000
 - DNI = \$20,000
 - Single Beneficiary
- Trust's Deduction is \$20,000, and beneficiary has \$20,000 of taxable income; remaining \$5,000 is tax-free to the beneficiary

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Simple Trust - Example
 - FAI = \$20,000
 - DNI = \$25,000
 - Single Beneficiary
- Trust's Deduction is \$20,000, and beneficiary has \$20,000 of taxable income; remaining \$5,000 is taxed to the trust

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Simple Trust - Example
 - FAI = \$25,000
 - DNI = \$20,000
 - Trust income is required to be distributed equally among 4 beneficiaries
- Trust's Deduction is \$20,000, and each beneficiary has \$5,000 of taxable income; remaining \$1,250 is tax-free to each beneficiary

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Simple Trust - Example
 - FAI = \$20,000
 - DNI = \$25,000
 - Trust income is required to be distributed equally among 4 beneficiaries
- Trust's Deduction is \$20,000, and each beneficiary has \$5,000 of taxable income; remaining \$5,000 is taxed to the trust

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Simple Trust - Example
 - FAI = \$20,000
 - DNI = \$25,000
 - Trust income is required to be distributed among 4 beneficiaries as follows: (1) 25%, (2) 25%, (3) 40%, and (4) 10%
- Trust's Deduction is \$20,000; and trust's taxable income is \$5,000
- Beneficiaries have the following taxable income: (1) \$5,000, (2) \$5,000, (3) \$8,000, and (4) \$2,000

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Estate / Complex Trust
 - Estate or trust is allowed as a deduction in computing the taxable income, the sum of (1) any amount of income for such taxable year required to be distributed currently; and (2) any other amounts properly paid or credited or required to be distributed for such taxable year. Deduction limited to the amount of DNI.
 - Beneficiary must include in gross income the amount that must be distributed (Tier 1 Distributions) **plus** any other amounts properly paid or credited or required to be distributed for such taxable year (Tier 2 Distributions). Beneficiary's gross income limited to the amount of DNI.

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Allocation of DNI Between Tier 1 and Tier 2 Distributions
 - DNI is allocated first to Tier 1 beneficiaries
 - Then, to the extent there is DNI remaining after Tier 1 distributions and any charitable contributions deduction (sometimes referred to as Tier 1 ½), DNI is allocated to Tier 2 beneficiaries
 - If multiple beneficiaries, then the income is allocated among the beneficiaries of each Tier based on the proportionate amount required to be distributed and/or distributed to each beneficiary

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Complex Trust - Example
 - Mandatory Income and discretionary principal for HEMS
 - FAI = \$25,000
 - DNI = \$20,000
 - Distributions = \$30,000
 - Single Beneficiary
- Trust's Deduction is \$20,000, and beneficiary has \$20,000 of taxable income; remaining \$10,000 is tax-free to the beneficiary

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Complex Trust - Example
 - Mandatory Income and discretionary principal for HEMS
 - FAI = \$20,000
 - DNI = \$25,000
 - Distributions = \$30,000
 - Single Beneficiary
- Trust's Deduction is \$25,000, and beneficiary has \$25,000 of taxable income; remaining \$5,000 is tax-free to the beneficiary

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Complex Trust - Example
 - Discretionary Income and principal for HEMS
 - FAI = \$25,000
 - DNI = \$20,000
 - Distributions = \$30,000
 - Single Beneficiary
- Trust's Deduction is \$20,000, and beneficiary has \$20,000 of taxable income; remaining \$10,000 is tax-free to the beneficiary

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Complex Trust - Example
 - Discretionary Income and principal for HEMS
 - FAI = \$20,000
 - DNI = \$25,000
 - Distributions = \$30,000
 - Single Beneficiary
- Trust's Deduction is \$25,000, and beneficiary has \$25,000 of taxable income; remaining \$5,000 is tax-free to the beneficiary

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Complex Trust - Example
 - Mandatory Income to A
 - Discretionary principal to A and A's descendants for HEMS
 - FAI = \$25,000
 - DNI = \$20,000
 - Distributions to A = \$30,000
 - Distributions to B, C, and D (A's descendants) = \$10,000 each
- Trust's Deduction is \$20,000
- A has \$20,000 of taxable income; remaining \$10,000 is tax-free to A
- Distributions to B, C, and D are tax-free

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Complex Trust - Example
 - Mandatory Income to A
 - Discretionary principal to A and A's descendants for HEMS
 - FAI = \$20,000
 - DNI = \$25,000
 - Distributions to A = \$30,000
 - Distributions to B, C, and D (A's descendants) = \$10,000 each
- Trust's Deduction is \$25,000
- A has \$25,000 of taxable income; remaining \$5,000 is tax-free to A
- Distributions to B, C, and D are tax-free

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Complex Trust - Example
 - Mandatory Income to A
 - Discretionary principal to A and A's descendants for HEMS
 - FAI = \$20,000
 - DNI = \$50,000
 - Distributions to A = \$30,000
 - Distributions to B, C, and D (A's descendants) = \$10,000 each
- Trust's Deduction is \$50,000
- A has taxable income as follows: \$20,000 (tier 1) and \$7,500 (tier 2)
- Distributions to B, C, and D are taxable for the first \$7,500 and tax-free for the remaining \$2,500

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Complex Trust - Example
 - Mandatory Income to A
 - Discretionary principal to A and A's descendants for HEMS
 - FAI = \$20,000
 - DNI = \$50,000
 - Distributions to A = \$30,000
 - Distributions to Descendants = B (\$20,000), C (\$5,000), and D (\$15,000)
- Trust's Deduction is \$50,000
- A has taxable income as follows: \$20,000 (tier 1) and \$6,000 (tier 2)
- Distributions to B, C, and D are taxable as follows:
 - B \$12,000 taxable and \$8,000 non-taxable
 - C \$3,000 taxable and \$2,000 non-taxable
 - D \$9,000 taxable and \$6,000 non-taxable

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Complex Trust - Example
 - Mandatory Income to A
 - Discretionary principal to A and A's descendants for HEMS
 - FAI = \$20,000
 - DNI = \$50,000
 - Distributions to A = \$15,000
 - Distributions to Descendants = B (\$10,000), C (\$5,000), and D (\$5,000)
- Trust's Deduction is \$40,000; taxable income to trust is \$10,000
- A has taxable income as follows: \$20,000 (tier 1)
- Distributions to B, C, and D are taxable as follows:
 - B \$10,000 taxable
 - C \$5,000 taxable
 - D \$5,000 taxable

ALLOCATION OF INCOME AMONG ESTATE/TRUST AND BENEFICIARIES

- Character of Income
 - Gross income distributed by an estate or trust to its beneficiaries retains the same character in the hands of the beneficiary as it had to the estate or trust.
 - Amounts distributed are treated as consisting of the same proportion of each class of items entering into the computation of DNI as the total of each class bears to the total DNI of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries.

SEPARATE SHARE RULE

- If a single trust (or estate) has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, then their shares are treated as separate trusts (or estates) **for the sole purpose of** determining the amount of DNI allocable to the respective beneficiaries.

SPECIFIC BEQUESTS

- Distributions of any amount which, under the terms of the governing instrument, are properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which are paid or credited all at once or in not more than 3 installments do not carryout DNI to the beneficiary
- Examples
 - Personal property to children
 - Jewelry to grandchildren
 - \$10,000 to friend

DISTRIBUTIONS IN KIND

- Distributions of Property (other than cash)
- Three types of in kind distributions:
 - specific bequest
 - (e.g., jewelry to beneficiary per terms of governing instrument)
 - satisfaction of required distribution
 - (e.g., securities worth \$5,000 in lieu of \$5,000 cash)
 - discretionary
 - (e.g., securities as a discretionary distribution of principal)

DISTRIBUTIONS IN KIND

- Specific Bequests
 - Distributions of specific property per the terms of the governing instrument do not cause gain or loss recognition and do not carry out DNI

DISTRIBUTIONS IN KIND

- Satisfaction of Required Distribution
 - Property distributed deemed to have been sold and requires gain or loss to be recognized
- Examples
 - securities for \$10,000 bequest
 - securities in lieu of real estate
 - real estate in satisfaction of required income distribution

DISTRIBUTIONS IN KIND

- Discretionary Distribution
 - When a fiduciary makes a discretionary distribution of property to a Tier 2 beneficiary, the estate or trust *may* elect to treat the distribution as if the property had been sold to the beneficiary and recognize gain or loss on the distribution
 - Election to recognize gain will adjust the tax consequences to the trust or estate, the income beneficiary and the remainderman

DISTRIBUTIONS IN KIND

- Related Party Rules

- Estates and trusts are subject to the related party rules that disallow loss recognition on transactions between related parties.
- A trust and its beneficiaries are always related parties under IRC § 267(b)(6).
- An estate and its beneficiaries are related parties except for a sale or exchange in satisfaction of a pecuniary bequest.

DISTRIBUTIONS IN KIND

- Including Gain or Loss in DNI
 - If the gain or loss recognized is ordinary income, it should be included in DNI.
 - If the capital gain had been included in DNI had the fiduciary sold it to a third party, then it should be included in DNI.
 - If the gain or loss is included in DNI, then it will increase or decrease the amount of the distribution deduction for the estate or trust and increase or decrease the amount taxable to the beneficiary.

DISTRIBUTIONS IN KIND

- Value for Determining Distribution Amount
 - Specific Bequest – Lesser of FMV or basis
 - Satisfaction of Required Distribution – FMV due to gain recognition
- Discretionary Distributions
 - Election – FMV due to gain recognition
 - No Election – Lesser of FMV or basis

DISTRIBUTIONS IN KIND

- Basis and Holding Period
 - Adjusted basis of the property in the hands of the estate or trust immediately before distribution, adjusted for any gain or loss recognized to the estate or trust on distribution
 - Holding period for the beneficiary is the same as the estate or trust

DISTRIBUTIONS IN KIND

- Example

- A trust has \$50,000 of DNI. The trustee funds a residuary bequest by transferring stock with a FMV of \$50,000 and a basis of \$20,000, and the trustee does *not* make a § 643(e) election.
- No gain or loss recognized
- Distribution of stock carries out \$20,000 of DNI
- Beneficiary takes a \$20,000 basis in the distributed stock, and the beneficiary's holding period is the same as the trust's

DISTRIBUTIONS IN KIND

- Example
 - A trust has \$50,000 of DNI. The trustee funds a residuary bequest by transferring stock with a FMV of \$50,000 and a basis of \$20,000, and the trustee does make a § 643(e) election.
 - \$30,000 gain recognized by trust
 - Gain will be included or excluded from DNI depending on terms of trust, history of including capital gains in DNI, etc.
 - Distribution of stock carries out \$50,000 of DNI
 - Beneficiary takes a \$50,000 basis in the distributed stock, and the beneficiary's holding period is the same as the trust's

DISTRIBUTIONS IN KIND

- Example
 - Blackacre FMV \$100 and basis of \$90
 - Greenacre FMV \$100 and basis of \$10

INCOME IN RESPECT OF A DECEDENT

- The term “income in respect of a decedent” refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent.
- IRD includes:
 - all accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;
 - income accrued solely by reason of the decedent’s death in case of a decedent who reports his income by use of an accrual method of accounting; and
 - income to which the decedent had a contingent claim at the time of his death.

INCOME IN RESPECT OF A DECEDENT

- Characterization as IRD is significant for three reasons:
 - Determines who is responsible for reporting and paying the tax on the income;
 - The property is not eligible for basis adjustment under IRC § 1014; and
 - To the extent estate tax is attributable to the inclusion of the IRD claim in the gross estate, an income tax deduction is allowed for the estate tax in the year the IRD is included in taxable income.

INCOME IN RESPECT OF A DECEDENT

- Transfers and Distributions of IRD
 - Sales, gifts, and exchanges of IRD are typically recognition events for the transferor, and the transferee does not recognize income as payments are received
 - Distributions to specific beneficiaries or residual beneficiaries are not recognition events for the transferor, and the transferee must recognize income as payments are received

INCOME IN RESPECT OF A DECEDENT

- Distributions of IRD that Carry Out DNI
 - Unless IRC § 663(a)(1) applies, a distribution of the right to receive IRD should carry out DNI
 - IRC § 643(e) limits the amount of DNI carried out by a distribution of any property in kind from an estate or trust to the lesser of basis or FMV of the distributed asset
 - Basis of most items of IRD is zero unless taxable disposition

DEDUCTION IN RESPECT OF A DECEDENT

- Deductible payments that would have reduced the decedent's taxable income had the decedent incurred them during life and would have reduced the decedent's net worth for federal estate tax purposes
- IRC § 691(b) expressly refers to five classes of deductions and one credit that can be treated as DRD:
 - IRC § 162 business expenses
 - IRC § 163 deductions for interest
 - IRC § 164 deductions for taxes
 - IRC § 212 expenses for production of income
 - IRC § 611 deductions for depletion
 - IRC § 27 foreign tax credits

DEDUCTIONS AND CARRYOVERS

- General Rule
 - Deduction reduce taxable income and DNI
 - Deductions in excess of income for each taxable year are lost (i.e., they do not pass through to beneficiaries and are not carried forward to subsequent tax years)

DEDUCTIONS AND CARRYOVERS

- Exceptions
 - Net operating losses from a trade or business may be carried forward pursuant to IRC § 172 Deduction reduce taxable income and DNI
 - Capital Losses may be carried forward
 - In the year of termination, and only in the year of termination, certain carryovers and excess deductions do pass through to the beneficiaries

DEDUCTIONS AND CARRYOVERS

- Beneficiaries Entitled to Excess Deductions, NOLs & Capital Losses
 - Pass to those beneficiaries who, upon termination of the estate or trust, bear the burden of any economic loss for which such deductions are allowed
 - Allocated to the beneficiaries succeeding to the property of the trust or estate in proportion to the share of the burden of the loss each beneficiary sustains

DEDUCTIONS AND CARRYOVERS

- Beneficiaries Entitled to Excess Deductions, NOLs & Capital Losses
 - Intestate Estate – Heirs
 - Testate Estate
 - Residual beneficiaries
 - Beneficiaries entitled to specific property or amounts if they receive less than what they were entitled
 - Trust
 - Residual beneficiaries
 - Beneficiaries entitled to specific property or amounts if they receive less than what they were entitled

DEDUCTIONS AND CARRYOVERS

- Passive Activity Losses – Decedents
 - Unused losses are allowed as a deduction on the decedent's final personal income tax return but only to the extent these losses are in excess of the difference between the basis of the interest in the transferee's hands over the adjusted basis of the interest immediately before the death of the taxpayer.
 - This limitation prevents a double deduction
 - Example
 - D died and had an interest in a passive activity that had a suspended passive activity loss of \$80,000. D's basis in the activity prior to death was \$90,000. The activity's FMV at D's death was \$140,000.
 - As a result, \$50,000 ($\$140,000 - \$90,000$), which is the amount of the basis adjustment, is permanently disallowed.
 - The amount that can be deducted on D's final return is \$30,000 ($\$80,000 - (\$140,000 - \$90,000)$).

DEDUCTIONS AND CARRYOVERS

- Passive Activity Losses – Estates and Trusts
 - Passive activity losses function in much the same way as for individual taxpayers
 - Unused losses and credits from passive activities become suspended and carryforward indefinitely to offset future passive activity income or to be recognized upon a taxable disposition of 100% of the passive activity.

DEDUCTIONS AND CARRYOVERS

- Passive Activity Losses – Estates and Trusts
 - Generally, a passive activity involves the conduct of a trade or business in which the taxpayer does **not** materially participate
 - Material participation is important because it determines whether losses are currently deductible and whether the net investment income tax applies
 - *Frank Aragona Trust v. Commissioner* – Tax Court allowed the taxpayers to treat the trust as “materially participating” in business activities through participation in the activities by trustees.

DEDUCTIONS AND CARRYOVERS

- Passive Activity Losses – Estates and Trusts
Unused Losses upon Termination
 - Passive activity losses are not passed through to the beneficiary upon the termination of the trust or estate.
 - If the passive investment is distributed in a non-taxable transaction, then any suspended losses are added to the basis of the distributed asset.
 - If the passive investment is distributed in a taxable transaction, then the current and suspended passive activity losses are treated as nonpassive and are deductible by the trust or estate.

DEDUCTIONS AND CARRYOVERS

- Passive Activity Losses – Estates and Trusts
Unused Losses upon Termination

- Example

- Trust makes a non-taxable distribution of its assets to the remaining beneficiary, which includes a rental property with a tax basis of \$225,000, suspended passive activity losses of \$25,000, and a FMV of \$275,000.
 - The property will have a tax basis of \$250,000 ($\$225,000 + \$25,000$), and the trust does not recognize any gain or loss.

- Example – Same as above except a taxable distribution

- \$50,000 gain
 - \$25,000 suspended loss is freed up and offsets gain

DEDUCTIONS AND CARRYOVERS

- Passive Activity Losses – Estates and Trusts
\$25,000 Rental Real Estate Exemption
 - The rental real estate exemption is allowed to estates (and trusts making a Sec. 645 election) for tax years ending less than two years after the decedent's death for rental real estate activities in which the decedent actively participated.

STATE INCOME TAXATION

- Estates
 - Subject to income taxation in the state where the decedent was domiciled at the time of the decedent's death and in states where they have income
- Trusts
 - Every state has different rules and factors that they use to determine if and to what extent a trust is subject to its state income tax
 - See Bases of State Income Taxation of Nongrantor Trusts by Richard W. Nenno

GRANTOR TRUSTS - GENERALLY

- Grantor trusts are trusts that are treated as disregarded entities for income tax purposes, and all items of income, deduction, and credit are reported by the deemed owner of the trust
- The deemed owner of a trust can be the creator of the trust or another person (typically, beneficiary)
- Rules for determining whether a trust is a grantor trust and who is the deemed owner of the trust are under Subpart E of Subchapter J (IRC §§ 671-679)

GRANTOR TRUSTS – REPORTING OPTIONS

- Reporting options for grantor trusts are found in Treas. Reg. § 1.671-4
 - File Form 1041 with Statement (Treas. Reg. § 1.671-4(a))
 - Provide Name and TIN of Deemed Grantor to Payors (Treas. Reg. § 1.671-4(b)(2)(i)(A)). The trustee may provide the name and taxpayer identification number (TIN) of the deemed grantor, and the address of the trust, to all payors of income.
 - Provide Name, TIN, and Address of Trust to Payors (Treas. Reg. § 1.671-4(b)(2)(i)(B))

GRANTOR TRUSTS – BASIS ADJUSTMENT

- Revenue Ruling 2023-2
 - If asset is not includable in the decedent's estate for estate tax purposes, then no basis adjustment under IRC § 1014



FINAL THOUGHTS & QUESTIONS

Thank You!

Anne Roediger, CPA

Daren J. Layton, Esq., CPA