

# Fiduciary Income Taxation



**Southern Arizona Estate Planning Council**

**&**

**Community Foundation for Southern Arizona**

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## I. Overview

### A. Decedents and Estates.

#### 1. Separate Entities.

- (a) The decedent and his or her estate are separate entities, and each is identified with tax authorities by separate taxpayer identification numbers.
- (b) The decedent's social security number is used to identify the decedent, and the decedent's estate is identified by a separate employer identification number (EIN).

#### 2. General Definition of Estate. An estate is a separate legal entity that comes into existence upon the death of an individual that includes all of the property and rights to property owned by such person before death.

- (a) Estate for State Law Purposes. A decedent's estate for state law purposes, which is subject to probate, includes the property owned individually by the decedent, but excludes property which is disposed of by beneficiary designations (e.g., IRAs, insurance, etc.) and survivorship (e.g., joint accounts, joint tenants with right of survivorship, etc.). It also excludes property which was held in trust for the benefit of the decedent. State law focuses on the legal title of the property.
- (b) Estate for Estate Tax Purposes. As a general rule, a decedent's estate for estate tax purposes includes all property the decedent had a right to control, enjoy or possess, regardless of how the property was titled and whether or not it is subject to probate under state law.

### B. Trusts.

#### 1. Overview of Trusts.

- (a) Settlor. The Settlor is the person who creates the trust. A trust may have more than one Settlor. A Settlor is also referred to as a "Grantor," "Trustor," "Donor," or "Trustmaker."
- (b) Trustee. A Trustee holds legal title to property for the benefit of one or more beneficiaries.
- (c) Property. Every trust must hold property. Without property, there is no trust.
- (d) Beneficiary. Every trust must have one or more beneficiaries. These are the people, organizations or pets (some states allow trusts for pets) for which the Trustee holds the property. As a general matter, there are two types of beneficiaries: current beneficiaries (those who are entitled to trust property now) and remainder beneficiaries (those who are entitled to trust property after the occurrence of one or more events – typically the death of the current beneficiary).

2. Global Classification of Trusts. Trusts are classified as either grantor trusts or non-grantor trusts, and the income taxation of a trust and its beneficiaries depends on the trust's classification.
- (a) Grantor Trusts.
- (i) To the extent a trust is categorized as a grantor trust, the assets of the trust are treated as owned by another person and not the trust for income tax purposes.
  - (ii) Typically, the person treated as owning the grantor trust's assets also transferred the assets to the trust and then retained certain powers or controls over the trust (such as the right to control the trust income or principal, to reacquire trust property with equivalently valued property, to receive loans from the trust, to change trust beneficiaries, to revoke the trust, or to enjoy distributions of trust income (directly, to his or her spouse, or as payment on life insurance premiums)).
  - (iii) However, a person who did not make any gifts to the trust may be treated as the owner of trust property (assuming no one else is the owner under the rules just described) if he or she can exercise certain rights to withdraw the property or income from the trust (or could do so but released the power to do so).
  - (iv) While a trust is normally categorized entirely as a grantor or non-grantor trust, a trust can be partially a grantor trust and partially a non-grantor trust if a person is treated as owning some but not all of the trust property.
  - (v) The person who is treated as owning trust assets is required to take into account for income tax purposes any items of trust income, deduction, and credits against tax that are attributable to the portion of the trust assets the person (or entity) is deemed to own.
- (b) Non-Grantor Trusts.
- (i) A non-grantor trust is a separate entity for income tax purposes and must determine its taxable income each year.
  - (ii) However, a non-grantor trust is allowed certain deductions in determining its income tax liability, including a distribution deduction equal to the amount of distributable net income ("DNI") the trust distributes to its beneficiaries during the year.
  - (iii) The distribution deduction is a deduction against gross income that applies only to non-grantor trusts, and the distribution deduction and the DNI of a trust function together to cause a portion of the income of a trust to be includible in the gross income of its beneficiaries.

C. Relevant Sections of Internal Revenue Code.

1. Part I, Subchapter J – §§ 641 - 685
  - (a) Subpart A, General Rules – §§ 641 - 464
  - (b) Subpart B, Simple Trusts – §§ 651 - 652
  - (c) Subpart C, Complex Trusts – §§ 661 - 663
  - (d) Subpart C, Charitable Remainder Trusts – § 664
  - (e) Subpart D, Excess Distributions – §§ 665 - 668
  - (f) Subpart E, Grantor Trusts – §§ 671 - 679
  - (g) Subpart F, Miscellaneous – §§ 681 - 685
2. Part II, Subchapter J – §§ 691 - 692
  - (a) Income in Respect of Decedents

D. Relevant Arizona Statutes.

1. Probate and Will Statutes, §§ 14-1101 - 14-3974 and §§ 14-6101 - 14-6311
2. Revised Uniform Principal and Income Act – §§ 14-7401 - 14-7431  
(adopted in 2001 and updated in 2009)
3. Arizona Trust Code – §§ 14-10101 - 14-11102  
(adopted effective January 1, 2009, as amended)

## II. Accounting Periods and Methods

- A. Estates. The first tax year of an estate begins on the day after the decedent's death. An estate may choose a calendar year (i.e., tax year ending December 31) or a fiscal year (i.e., tax year ending on a date other than December 31). If a fiscal year is chosen, then it may be for any period of 12 months or less that ends on the last day of a month. For example, if a decedent dies on March 21, 2023, the longest fiscal year that can be chosen for the estate's taxable year would be a fiscal year end February 28, 2024.
- B. Trusts. All trusts, except the following, are required to use a calendar year (IRC § 644):
1. Trusts that are exempt from tax under IRC § 501(a).
  2. Wholly charitable trusts described in IRC § 4947(a)(1).
  3. Qualified Revocable Trusts that have elected to be treated as part of an estate under IRC § 645. **Note:** When the Section 645 election ends, the tax year of the new trust must be a calendar year.
  4. Grantor trusts treated as wholly owned by the grantor (see Rev. Rul. 90-55).
- C. IRC § 645 Election. The Trustee of a "qualified revocable trust" and the executor of a decedent's estate may elect to treat the qualified revocable trust as part of the estate for income tax purposes.

1. Qualified Revocable Trust. A trust (or portion thereof) that was treated as a grantor trust under IRC § 676 (power to revoke).
  2. Election.
    - (a) The election is made on IRS Form 8855, which may be filed with the initial income tax return or filed independently.
    - (b) File the election by the due date (including extensions, if any) of the Form 1041 for the first tax year of the related estate (or the filing trust). This applies even if the combined related estate and electing trust(s) do not have sufficient income to be required to file Form 1041.
    - (c) Once made, the election is irrevocable.
  3. Benefits.
    - (a) Only one income tax return is required to be filed for both the trust and estate.
    - (b) The trust is treated as being on the same tax year of the estate. Since an estate may elect a fiscal year (i.e., a year not ending on December 31st), the trust is permitted to also be on a fiscal year (which it would not otherwise be allowed to do).
    - (c) An electing trust is an eligible holder of S-corporation stock during the election period.
    - (d) No estimated tax payments are required for filing periods ending up to two years after death of decedent.
    - (e) Electing trust can claim the \$25,000 deduction for active participation in a rental real estate activity allowed to estates.
    - (f) Can claim a loss for funding a pecuniary bequest with deflated assets under § 267(b)(13).
  4. Burdens.
    - (a) May require computation of separate shares, if interests are not the same as the estate.
    - (b) Trustee and personal representative responsible for insuring tax obligations are timely paid.
  5. Duration. If a Form 706 (estate tax return) is not required then the qualified revocable trust will be treated as part of the estate for two years. If an estate tax return is required then the qualified revocable trust will be treated as part of the estate until six months after the date of the final determination of estate tax liability.
- D. Cash vs. Accrual. Although most fiduciaries use the cash-basis method of accounting, the accrual method may be required when the production, purchase, or sale of merchandise is a material income-producing factor, regardless of whether inventory is physically on hand at year-end. This method would be required, for example, when an

estate continues to operate an accrual-basis manufacturing proprietorship previously owned by the decedent.

### III. Fiduciary Accounting Income and Distributable Net Income

#### A. Fiduciary Accounting Income.

1. Concept. Income of the estate or trust for the taxable year determined under the terms of the governing instrument, if any, and applicable law. Think of this as the “economic” or “book” income as compared to the “tax” income.
2. Principal and Income Act.
  - (a) Unless the terms of the will or trust agreement provide otherwise, the default rules under the principal and income act of applicable state law determine whether a receipt or disbursement is income and/or principal for trust accounting purposes.
  - (b) Very important to read the will or trust agreement
3. Beneficial Interests. The allocation of receipts and disbursements between income and principal has a direct impact on determining the amount distributable to the income beneficiary(ies) and the amount of principal available for present or future distributions.
4. Tax Consequences. The allocation of receipts and disbursements between income and principal has a direct impact on determining the amount of taxable income to the trust and its beneficiary(ies).

#### B. General Rules for Allocations under Arizona Principal and Income Act.

1. Receipts and Disbursements from Income.
  - (a) Interest Income
  - (b) Ordinary Dividends / Entity (partnership and S Corp.) Distributions of Cash
  - (c) One-half of Legal, Accounting, and Trustee Fees
  - (d) Net Rental Income
  - (e) Ordinary and reoccurring expenses (e.g., interest, ordinary repairs, insurance premiums, taxes assessed against principal)
  - (f) Expenses related to receipts allocated to income
  - (g) Income taxes on receipts allocated to income
  - (h) 10% of Royalty Income
  - (i) 10% of Deferred Compensation, Annuities, IRAs, etc.
2. Receipts and Disbursements from Principal.
  - (a) Extraordinary Dividends / Entity (partnership and S Corp.) Distributions of Property
  - (b) Distributions in Partial or Full Liquidation
  - (c) Sale Proceeds from Sale of Principal Asset

- (d) One-half of Legal, Accounting, and Trustee Fees
- (e) Expenses related to receipts allocated to principal
- (f) Income taxes on receipts allocated to principal
- (g) 90% of Royalty Income
- (h) 90% of Deferred Compensation, Annuities, IRAs, etc.

C. Trustee Discretion to Allocate Income and Principal.

1. Adjustments under State Law. ARS § 14-7402 provides general guidelines for allocating receipts and disbursements to or between principal and income, and ARS § 14-7403 grants a trustee discretion to make adjustments between income and principal.
  - (a) Overall, the general purpose of granting a trustee discretion is to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest, dividends, and rents.
  - (b) State law does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio's total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule.
  - (c) A trustee must act impartially and in good faith.
2. Adjustments for Tax Purposes.
  - (a) The method of determining trust or estate income will apply for federal income tax purposes if it is consistent with the terms of the governing instrument and state law. 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.
  - (b) However, 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.
  - (c) Treas. Reg. § 1-643(a)-3 provides the rules for allocating capital gains to income and/or including capital gains in DNI. In particular, gains from the sale or exchange of capital assets are included in DNI to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law):

- (i) allocated to income;
  - (ii) 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
  - (iii) 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.
- (d) Example 1 – from Treas. Reg. § 1-643(a)-3. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has \$5,000 of dividend income and \$10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the \$10,000 capital gain to principal. During the year, Trustee distributes to A \$5,000, representing A's right to trust income. In addition, Trustee distributes to A \$12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the \$10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.
- (e) Example 2 – from Treas. Reg. § 1-643(a)-3. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the \$10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.
- (f) See IRC § 643 and corresponding Treasury Regulations for more details about allocations of income and receipts for income tax purposes.

**D. Function and Role of DNI.**

1. Distributable net income (DNI) is a federal income tax concept only that is calculated each tax year of a trust or estate and has no application outside of that context. The purpose of DNI is (i) to limit the distribution deduction that the trust can take, and (ii) to determine how much of a distribution to a beneficiary is income includible in the beneficiary's gross income. In a nutshell, DNI is



concerned with determining the appropriate amount of tax to be borne by the trust or estate and its beneficiaries, and it serves as a yardstick.

2. DNI limits a trust's or estate's distribution deduction under IRC § 651 and IRC § 661.
  - (a) Simple Trusts (IRC § 651). A simple trust is a trust that requires all trust accounting income to be distributed annually, does *not* distribute any other amount during the year, *and* does not provide that any amount may be paid or set aside for charitable purposes.
    - (i) The distribution deduction is limited to the lesser of trust accounting income or DNI (IRC § 651).
    - (ii) A beneficiary of a Simple Trust must include the income of the trust in the beneficiary's gross income regardless of whether the income is actually distributed to the beneficiary. If the trust income exceeds DNI, then the amount in excess of DNI is tax-free. The character of the income is the same character in the beneficiary's hands as it was in the hands of the trust as DNI.
  - (b) Complex Trusts (IRC § 661). A Complex Trust is any trust that is not a Simple Trust (i.e., trust makes discretionary distributions of income, discretionary distributions of principal, *or* distributions to charity).
    - (i) Distribution deduction is limited to the lesser of distributions or DNI (IRC § 661).
    - (ii) A beneficiary of a Complex Trust must include the income of the trust in the beneficiary's gross income that equals the sum of the income required to be distributed to the beneficiary currently (regardless of whether it is actually distributed) plus any other amounts distributed to the beneficiary. The beneficiary includes distributions in gross income to the extent of DNI and based on the character of the DNI. If there are both mandatory income distributions and other distributions, then DNI is allocated first to the mandatory income distributions, then to any other amounts required to be distributed that are payable out of income (such as an annuity), then to the other non-mandatory distributions. DNI is not carried out to a beneficiary in certain circumstances, including gifts or bequests of specific sums of money or specific property payable in three or fewer installments and amounts paid or set aside for charitable purposes. As with a Simple Trust, the character of the DNI allocated to the beneficiary is the same character as it was in the hands of the trust as DNI.
  - (c) Toggle between Classification. A trust can be a simple trust in one year and a complex trust in another year, and can switch back and forth depending on its distributions and the terms of the trust.

3. A non-grantor trust may pass its tax burden on to its beneficiaries in one of two ways: (i) if the trust must distribute all income to the beneficiaries each year, then the beneficiaries will be taxed on the trust income to the extent of DNI (and the trust will take a corresponding distribution deduction) regardless of whether the trust actually distributed the income, and (ii) if the trust may distribute any other amount to the beneficiaries, then the beneficiaries will take the amount actually distributed into their income each year to the extent of DNI (and the trust will take a corresponding distribution deduction). Thus, to the extent the distribution deduction does not equal or exceed DNI, the non-grantor trust is subject to tax on its taxable income.
4. DNI limits a beneficiary's taxable income
  - (a) DNI is the maximum amount of taxable income of a trust or estate that is taxable to a beneficiary as the result of a distribution to the beneficiary.  
     Example: DNI = \$5,000 and distribution of \$25,000
  - (b) As DNI increases, it decreases the potential income taxable to the trust or estate and increases the potential income taxable to the beneficiary.
5. DNI preserves the character of items distributed to beneficiaries (e.g., ordinary income, capital gain, tax exempt interest).

E. Determining DNI.

The following is a general summary of how an estate's or trust's DNI is calculated (see IRC § 643(a)):

(1) Start With	Taxable Income
(2) Add Back	Distribution Deduction
(3) Add Back	Personal Exemption
(4) Add Back	Capital Losses Allocated to Principal (except in year of termination)
(5) Add Back	Net Tax-Exempt Interest (not allocated to administrative expenses or charitable deduction)
(6) Add Back	Income Tax Deduction for Estate Taxes Paid on Income in Respect of Decedent
(7) Add Back	Excluded Gains from Sale of Qualified Small Business Stock
(8) Subtract Out	Capital Gains Allocated to Principal (except in year of termination)
(9) Subtract Out	Extraordinary Dividends Allocated to Principal [Simple Trust Only]
(10) Subtract Out	Taxable Stock Dividends Allocated to Principal [Simple Trust Only]
(11)	Distributable Net Income

1. Distributions. No deduction for distributions to beneficiaries.
2. Personal Exemptions. Deduction for personal exemption (Estate = \$600, Simple Trust = \$300, Complex Trust = \$100, Qualified Disability Trusts = \$4,400 in 2022).
3. Capital Gains and Losses.
  - (a) Capital Gains are excluded to the extent they are allocated to principal and are not (i) paid, credited or required to be distributed to any beneficiary during the taxable year, or (ii) paid, permanently set aside, or to be used for charitable purposes specified in IRC § 642(c). Stated differently, Capital gains will be included in DNI if (i) they are allocated to income, (ii) they are allocated to principal and paid, credited or required to be distributed to any beneficiary during the taxable year, or (iii) they are allocated to principal and paid, permanently set aside, or to be used for charitable purposes specified in IRC § 642(c).

**Note:** Short-term capital gains from mutual funds = income.
  - (b) Capital Losses are excluded except to the extent they are taken into account in determining the amount of capital gains which are paid, credited or required to be distributed to any beneficiary during the taxable year. In other words, if capital losses are netted against capital gains that are included in DNI then such losses are included in DNI. You can never have a net capital loss included in DNI.
4. Extraordinary and Stock Dividends. For simple trusts, extraordinary dividends and stock dividends are not included unless they are allocated to income.
5. Tax Exempt Interest. DNI includes tax-exempt income reduced by the expenses allocated to tax-exempt interest that would be deductible but for IRC § 265.
  - (a) IRC § 265 disallows any deduction attributable to tax-exempt income.
  - (b) Example.
    - (i) Trust has \$30,000 of taxable interest and \$10,000 of tax-exempt interest, and incurs \$10,000 trustee fee
    - (ii) One-fourth of trustee fee (\$2,500) is non-deductible

#### **IV. Allocation of Trust Income between Trust/Estate and Beneficiaries**

##### **A. Simple Trusts.**

1. IRC § 651. A simple trust is allowed to deduct the amount of income for the taxable year which is required to be distributed currently. If the amount of income required to be distributed currently exceeds the distributable net income of the trust for the taxable year, then the deduction is limited to the amount of the distributable net income.
2. IRC § 652. The amount of income for the taxable year that is required to be distributed currently must be included in the gross income of the beneficiaries to

whom the income is required to be distributed, *whether distributed or not*. If such amount exceeds the distributable net income, then each beneficiary must include an amount of gross income that bears the same ratio to distributable net income as the amount of income required to be distributed to such beneficiary bears to the amount of income required to be distributed to all beneficiaries.

B. Estates / Complex Trusts.

1. IRC § 661 – Distribution Deduction. In any taxable year an estate or complex 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 (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year); and (2) any other amounts properly paid or credited or required to be distributed for such taxable year. Such deduction is limited to the amount of the distributable net income.

2. IRC § 662 – Amounts For Which Beneficiary Must Account.

(a) A beneficiary of an estate or complex trust must include the following amounts in gross income:

(i) Tier 1 Distributions. The amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not.

If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income, then DNI is allocated proportionately among the Tier 1 beneficiaries.

(ii) Tier 2 Distributions. All other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year.

If the sum of the amount of income for the taxable year required to be distributed currently to all beneficiaries, and all other amounts properly paid, credited, or required to be distributed to all beneficiaries exceeds the DNI of the estate or trust, then DNI (after being reduced by the Tier 1 amounts and any charitable contributions) is allocated proportionately among the Tier 2 beneficiaries.

(b) Allocation of DNI Between Tier 1 and Tier 2.

(i) DNI is first allocated to Tier 1 distributions. Then, to the extent there is DNI remaining after Tier 1 distributions and any charitable contributions deduction, DNI is allocated to Tier 2 distributions.

(ii) If more than one beneficiary receives Tier 2 distributions of the remaining DNI, then DNI is allocated among the Tier 2 beneficiaries on the basis of the relative amount of Tier 2 distributions made to each.

- (iii) A single beneficiary can be both a Tier 1 and a Tier 2 beneficiary if they receive both mandatory and discretionary distributions of income in a single tax year.
  - (c) Purpose of IRC § 662. The purpose of the tier system is to adjust the tax effects of a distribution between a first tier beneficiary and a second tier beneficiary. Accordingly, when all beneficiaries are in the same tier, the tier system has no application.
3. Character of Income.
- (a) The 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.
  - (b) The 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.

C. Separate Share Rule (IRC § 663).

- 1. Overview. If a single trust (or estate) has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts (or estates) for the sole purpose of determining the amount of distributable net income allocable to the respective beneficiaries.
- 2. Mandatory. Separate share treatment is not elective.
- 3. Existence of Separate Share. Ordinarily, a separate share exists if the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries.
- 4. For DNI Purposes Only. The separate share rule does not permit the treatment of separate shares as separate trusts (or estates) for any purpose other than the application of distributable net income. It does not, for instance, permit the treatment of separate shares as separate trusts (or estates) for purposes of filing income tax returns and payment of tax.
- 5. DNI Calculated for Each Separate Share. The amount of distributable net income for any share is computed as if each share constituted a separate trust or estate. Accordingly, each separate share shall calculate its distributable net income based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses.
- 6. Example.
  - (a) Testator is survived by a spouse and two children. Testator's will contains a fractional formula bequest dividing the residuary estate between the

surviving spouse and a trust for the benefit of the children. Under the fractional formula, the marital bequest constitutes 60% of the estate and the children's trust constitutes 40% of the estate. During the year, the executor makes a partial proportionate distribution of \$1,000,000 (\$600,000 to the surviving spouse and \$400,000 to the children's trust), and makes no other distributions. The estate receives dividend income of \$20,000, and pays expenses of \$8,000 that are deductible on the estate's federal income tax return.

- (b) The fractional formula bequests to the surviving spouse and to the children's trust are separate shares. Because Testator's will provides for fractional formula residuary bequests, the income and any appreciation in the value of the estate assets are proportionately allocated between the marital share and the trust's share. Therefore, in determining the distributable net income of each share, the income and expenses must be allocated 60% to the marital share and 40% to the trust's share. The distributable net income is \$7,200 (60% of income less 60% of expenses) for the marital share and \$4,800 (40% of income less 40% of expenses) for the children's trust share.
- (c) Because the amount distributed in partial satisfaction of each bequest exceeds the distributable net income of each share, the estate's distribution deduction is limited to the sum of the distributable net income for both shares. The estate is allowed a distribution deduction of \$12,000 (\$7,200 for the marital share and \$4,800 for the trust's share).
- (d) As a result, the estate has zero taxable income (\$20,000 income less \$8,000 expenses and \$12,000 distribution deduction).
- (e) The surviving spouse and the children's trust must include in gross income \$7,200 and \$4,800, respectively.

D. 65-Day Rule (IRC § 663(b)).

- 1. Overview. If the fiduciary makes the proper election and if within the first 65 days of any taxable year of an estate or a trust an amount is properly paid or credited, then such amount shall be considered paid or credited on the last day of the preceding taxable year. Any amount treated as having been distributed in the immediately prior tax year shall be so treated for all purposes.
- 2. Amount.
  - (a) The fiduciary may designate some or all of the distributions made in the first 65 days of the tax year as covered by the election. However, the maximum amount covered by the election is limited to the greater of (1) fiduciary accounting income for the tax year for which the election is made or (2) DNI for that year.

- (b) Both (1) and (2) are reduced by any amounts paid, credited, or required to be distributed in such tax year, other than any amounts considered paid or credited to the tax year preceding the tax year in question by reason of a prior § 663(b) election.
- 3. Election. Election applies to the year for which the election is made (i.e., good for one year only). Once made, the election is irrevocable.
- 4. Example.
  - (a) For 2022, a calendar-year complex trust that has \$150,000 of FAI and \$135,000 of DNI. The trustee paid \$70,000 to the beneficiary on January 31, 2022, and \$55,000 on July 31, 2022. The 2023 trust records indicate a distribution of \$100,000 on January 31, 2023. The 2021 Form 1041 indicates a valid § 663(b) election treating the \$70,000 distribution as paid on December 31, 2021.
  - (b) The maximum amount available for the § 663(b) election on the 2022 Form 1041 is \$95,000 (\$150,000 FAI less the \$55,000 distribution on July 31, 2022). The \$70,000 distribution on January 31, 2022, does not reduce the maximum amount to which the 2022 election may apply because that amount was properly treated on the 2021 Form 1041 as distributed on December 31, 2021.
  - (c) The question is how much, if any, of the \$95,000 maximum should be designated as a § 663(b) election for 2022. This decision may be made as late as the due date (including extensions) of the Form 1041 for 2022.
- E. 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 is paid or credited all at once or in not more than 3 installments do not carryout DNI to the beneficiary. An amount that can be paid or credited only from the income of the estate or trust is not considered to be a gift or bequest of a specific sum of money.
- F. Distributions In Kind.
  - 1. Types. Three types of in kind distributions: (1) specific bequest, (2) satisfaction of required distribution (income, money or property), and (3) discretionary.
  - 2. Applicability. Unless an in kind distribution from a trust or estate qualifies for the IRC § 663(a)(1) exclusion as a specific bequest, IRC § 643(e) will apply and income will be carried out regardless of whether the distribution constitutes income or principal and regardless of whether the fiduciary distributes cash or other property in kind.
  - 3. Mandatory Recognition of Gain or Loss.
    - (a) Is the fiduciary using appreciated or depreciated property to satisfy an obligation to distribute money or income (e.g., securities for \$10,000

bequest)? If so, then the trust or estate is deemed to have sold the property being distributed and recognizing any gain or loss on such “sale”.

- (b) Is the fiduciary using appreciated or depreciated property to satisfy an obligation to distribute specific property (e.g., using securities in lieu of real estate)? If so, then the trust or estate is deemed to have sold the property being distributed and recognizing any gain or loss on such “sale”.
- (c) Pecuniary amount formula clauses vs. fractional

4. Election to Recognize Gain or Loss.

- (a) 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.
- (b) An IRC § 643(e) election applies to all distributions made by the estate or trust during a taxable year.
- (c) An election to recognize gain or loss will adjust the tax consequences to the trust or estate, the income beneficiary and the remainderman (i.e., amount of income, character, basis).
- (d) Benefits of the Election. The election to recognize a gain on property distributions may be beneficial in the following situations:
  - (i) When the basis of property is insufficient to carry out all of the estate’s or trust’s DNI.
  - (ii) To increase the beneficiary’s basis in the property.
  - (iii) To generate gains to use up current or carryforward capital losses or otherwise unusable deductions.
  - (iv) When the income beneficiary has a net operating loss to offset any increase in ordinary income resulting from the election.
  - (v) To provide tax and economic parity among beneficiaries.
- (e) Potential Disadvantages of the Election. The election to recognize gain for property distributions should be avoided in the following circumstances:
  - (i) The beneficiary has capital losses available to offset the gain on a later sale of the distributed property.
  - (ii) The beneficiary is in a lower capital gain tax bracket.
  - (iii) The estate or trust is subject to the 3.8% net investment income tax and the beneficiary is not.
  - (iv) The beneficiary has no current intention of selling the property or is seriously ill or elderly, which will likely result in deferral or elimination of the gain upon the beneficiary’s death.



- (v) The distribution is a final distribution on termination of the estate or trust, in which case the gain flows through to the beneficiary regardless of the election.
5. 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.
  6. Gain or Loss Included in DNI.
    - (a) If the gain or loss recognized is ordinary income, it should be included in DNI.
    - (b) 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.
    - (c) If the gain or loss is included in DNI, 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.
  7. Value of Asset for Computing Distribution Deduction and Distribution Amount.
    - (a) Specific Bequest. Lesser of FMV or basis
    - (b) Satisfaction of Required Distribution. FMV due to gain recognition
    - (c) Discretionary Distributions.
      - (i) Election. FMV due to gain recognition
      - (ii) No Election. Lesser of FMV or basis
  8. Basis of Property and Holding Period in Hands of Beneficiary.
    - (a) The 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.
    - (b) If beneficiary is going to hold property until death, then you most likely will not want to elect to recognize gain by the trust or estate so that the asset gets a basis adjustment at the death of the beneficiary.
    - (c) Holding period for the beneficiary is the same as the estate or trust (IRC § 1223(2)).
  9. Example No. 1.
    - (a) 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. The trustee does *not* make a § 643(e) election.
    - (b) The distribution of stock carries out \$20,000 of DNI (the lower of the cost basis or fair market value of the stock). Since the trustee did not make a § 643(e) election, the trust does not recognize any gain.

- (c) The beneficiary takes a \$20,000 basis in the distributed stock (the trust's \$20,000 basis plus zero gain recognized by the trust), and the beneficiary's holding period is the same as the trust's.

10. Example No. 2.

- (a) 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. The trustee makes a § 643(e) election.
- (b) The distribution of stock carries out \$50,000 of DNI (FMV of the stock). Since the trustee did make a § 643(e) election, the trust recognizes \$30,000 of gain.
- (c) The beneficiary takes a \$50,000 basis in the distributed stock (the trust's \$20,000 basis plus \$30,000 gain recognized by the trust), and the beneficiary's holding period is the same as the trust's.

11. Planning with Discretionary Distributions.

- (a) Two pieces of property with same FMV but different basis lower than their respective FMVs will carry out different amounts of DNI. If properties are distributed to different beneficiaries, then each beneficiary will be allocated different amounts of DNI.
- (b) Blackacre \$100 and \$90 / Greenacre \$100 and \$10

G. Charitable Income Tax Deduction.

1. Payment from Gross Income. In order for a trust or estate to take a charitable income tax deduction, the charitable contributions must be paid out of the trust's or estate's gross income and not the underlying principal.
2. Pursuant to Terms of Governing Instrument. Furthermore, any charitable contribution must be made pursuant to the terms of the governing instrument (i.e., trust agreement or will).
3. Payment Allocated to Previous Tax Year. If a charitable contribution is paid after the close of the taxable year and on or before the last day of the following year, then the estate or trust may elect to treat such contribution as paid during the previous year (e.g., charitable contribution made in 2023 can be claimed in 2022).
4. May require filing Form 1041-A in addition to Form 1041.

H. Estate / Trust Termination – Deductions and Carryovers.

1. Deductions in General.
  - (a) Deductions reduce taxable income and DNI
  - (b) Deductions in excess of income are lost (i.e., they do not pass through to beneficiaries)

2. Exceptions.
  - (a) Net operating losses from a trade or business may be carried forward pursuant to IRC § 172.
  - (b) Capital Losses may be carried forward.
3. Termination. In the year of termination, and only in the year of termination, certain carryovers and excess deductions do pass through to the beneficiaries.
  - (a) To the extent reasonably possible, deductions should be timed so that they are incurred in the final tax year if they are going to exceed income.
  - (b) It's important to determine when the trust or estate terminates. It's not always clear.
4. Net Operating Loss.
  - (a) Character. The NOLs carried out to the beneficiaries have the same character.
  - (b) Carryforward. NOLs generated before January 1, 2018 (pre TCJA law), are carried forward 20 years and may offset 100% of taxable income. NOLs generated after December 31, 2017 may be carried forward indefinitely. If carried to years beginning before January 1, 2021, then the NOL may offset 100% of taxable income. If carried to years beginning after December 31, 2020, then the NOL may offset only 80% of taxable income.
    - (i) For purposes of determining the number of years to which a NOL or capital loss may be carried forward by a beneficiary, the last tax year of the trust or estate and the first tax year of the beneficiary each constitute a separate year. This seems reasonable because the trust or estate used the NOL in its final year and the beneficiary was able to use the NOL in its first year, both occurring in the same year.
    - (ii) **Note:** 2nd Circuit has treated this as one year when the tax years of the trust or estate and beneficiary are the same.
  - (c) Conversion of NOL to Excess Deduction. If the last taxable year of the estate or trust is the last year in which a deduction on account of a net operating loss may be taken, the deduction, to the extent not absorbed in that taxable year by the estate or trust, is considered an "excess deduction".
5. Capital Losses.
  - (a) Character. The capital loss carryover retains its character in the hands of the beneficiary, except that a capital loss carryover for a corporate beneficiary is always treated as a short-term capital loss. The first tax year to which the loss can be carried over to the beneficiary is the beneficiary's tax year in which the estate or trust terminates.
  - (b) Carryforward. There is no time limit for using the capital loss carryovers that pass out to the beneficiaries.

6. Excess Deductions.
  - (a) In determining the amount of the excess distributions, the personal exemption of the estate or trust, any charitable contributions, and any NOL are not taken into account.
  - (b) Any charitable contributions not deductible by the trust or estate are wasted.
  - (c) Excess deductions retain their separate character as an amount allowed in arriving at adjusted gross income, a non-miscellaneous itemized deduction, or a miscellaneous itemized deduction.
7. Beneficiaries Entitled to Excess Deductions, NOLs & Capital Losses.
  - (a) General. For determining the proper beneficiaries to succeed to the loss carryover, the carryover will pass through to those beneficiaries who, upon termination of the estate or trust, bear the burden of any economic loss for which a carryover is allowed. The NOLs and capital loss carryovers are 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.
  - (b) Intestate Estate. Heirs at law
  - (c) Testate Estate.
    - (i) Residuary beneficiaries
    - (ii) Beneficiaries entitled to specific property or amounts if they receive less than what they were entitled
  - (d) Trust. Similar to testate estate
    - (i) Remainder beneficiaries
    - (ii) Beneficiaries entitled to specific property or amounts if they receive less than what they were entitled
    - (iii) If a residuary interest is purchased or assigned, then the buyer or assignee is not entitled to excess deductions, NOLs or capital losses. Such items still go to the remainder beneficiaries.
8. Passive Activity Losses.
  - (a) Decedent.
    - (i) The 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.
    - (ii) Essentially, this means that to the extent of the basis step-up, suspended passive losses will be permanently disallowed. Those unused passive losses do not pass to the decedent's estate, trust or its beneficiaries.

(iii) Losses in excess of the basis step-up will be allowed on the decedent's final tax return.

(b) Estates and Trusts.

(i) Passive activity losses function in much the same way as for individual taxpayers. Passive losses can only offset passive income and any passive losses not used in a particular year are suspended.

(ii) In the year of disposition of the passive activity, the suspended losses may be used to offset any gain from the disposition and then are converted into nonpassive losses to be used by the fiduciary against other income and gains.

(iii) Any passive losses not used are trapped in the trust or estate.

(iv) Distribution of Passive Investment.

a. If the passive investment is distributed in a non-taxable transaction, then any suspended losses are added to the basis of the distributed asset. The additional basis will offset any gain realized in the future.

b. 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.

i. If an estate or trust has multiple passive activities and disposes of its entire interest in an activity that has suspended losses greater than the gain on disposition of that activity, then the current year income and loss from the remaining passive activities are netted. Any net passive income from the remaining activities is then reduced by the suspended losses. Any suspended losses remaining are treated as nonpassive losses and deducted from the fiduciary's nonpassive income.

(v) Material Participation.

a. Frank Aragona Trust. The trust owned real estate rental properties and also owned interests in wholly owned entities and owned majority interests in other entities that conducted rental real estate activities. The trust was the sole owner of an LLC that managed the real estate properties. Three of the six co-trustees were full-time employees of the LLC that managed the rental properties owned by the trust. The court concluded that the trustees were regularly and continuously active in the business and, thus, the trust was active as well.

b. Holdings.

i. A trust can qualify for the "real estate professional" exception under §469(c)(7) so that rental losses are not disallowed as

passive activities for purposes of the passive activity loss rules of §469. If the trustees are individuals, their work can be considered “work performed by an individual” (as required by a regulation), so a trust is capable of performing personal services and therefore can satisfy the §469(c)(7) exception.

- ii. The activities of three of the co-trustees as employees were considered in determining whether the trust materially participated in the business.
- c. IRS has yet to issue regulations under IRC § 469 as to what facts constitute material participation for a trust and an estate.

## V. Estate Administration and Income In Respect of a Decedent

### A. Miscellaneous Itemized Deductions.

1. For taxable years beginning after December 31, 2017 and before January 1, 2026, an estate or trust must compute its adjusted gross income in the same manner as an individual, except that costs that are paid or incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in such estate or trust are allowed in arriving at adjusted gross income (Treas. Reg. § 1.67-4(a)(1)(i)).
2. Costs that would be commonly or customarily incurred by a hypothetical individual holding the same property are not deductible. The following is guidance provided by Treas. Reg. § 1.67-4 as to what are and are not costs commonly or customarily incurred by a hypothetical individual:
  - (a) General. It is the type of product or service rendered to the estate or non-grantor trust in exchange for the cost, rather than the description of the cost of that product or service, that is determinative. In addition to the types of costs described as commonly or customarily incurred by individuals below, costs that are incurred commonly or customarily by individuals also include, for example, costs incurred in defense of a claim against the estate, the decedent, or the non-grantor trust that are unrelated to the existence, validity, or administration of the estate or trust.
  - (b) Ownership Costs. Ownership costs that are chargeable to or incurred by an owner of property simply by reason of being the owner of the property are subject to the 2% floor. Such ownership costs include, but are not limited to, partnership costs deemed to be passed through to and reportable by a partner if these costs are defined as miscellaneous itemized deductions pursuant to IRC § 67(b), condominium fees, insurance premiums, maintenance and lawn services, and automobile registration and insurance costs. However, other expenses incurred merely by reason of the ownership of property may be fully deductible under other provisions of the IRC.

- (c) Tax Preparation Fees. Costs relating to all estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax returns are not subject to the 2% floor. The costs of preparing all other tax returns (for example, gift tax returns) are costs commonly and customarily incurred by individuals and thus are subject to the 2% floor.
- (d) Investment Advisory Fees. Fees for investment advice are incurred commonly or customarily by a hypothetical individual investor and therefore are subject to the 2% floor. However, certain incremental costs of investment advice beyond the amount that normally would be charged to an individual investor are not subject to the 2% floor. For this purpose, such an incremental cost is a special, additional charge that is added solely because the investment advice is rendered to a trust or estate rather than to an individual or attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen) such that a reasonable comparison with individual investors would be improper.
- (e) Appraisal Fees. Appraisal fees incurred by an estate or a non-grantor trust to determine the fair market value of assets as of the decedent's date of death (or the alternate valuation date), to determine value for purposes of making distributions, or as otherwise required to properly prepare the estate's or trust's tax returns, or a generation-skipping transfer tax return, are not incurred commonly or customarily by an individual and thus are not subject to the 2% floor. The cost of appraisals for other purposes (for example, insurance) is commonly or customarily incurred by individuals and is subject to the 2% floor.
- (f) Other Fiduciary Expenses. Certain other fiduciary expenses are not commonly or customarily incurred by individuals, and thus are not subject to the 2% floor. Such expenses include without limitation the following: Probate court fees and costs; fiduciary bond premiums; legal publication costs of notices to creditors or heirs; the cost of certified copies of the decedent's death certificate; and costs related to fiduciary accounts.
- (g) Bundled Fees. When a non-grantor trust pays a "bundled fee" (a single fee, commission, or other expense which includes costs subject to the 2% floor and costs amounts not subject to the 2% floor), the bundled fee must be allocated between the costs subject to the 2% floor and the costs that are not subject to the 2% floor. Any reasonable method may be used to allocate a bundled fee between those costs that are subject to the 2% floor and those costs that are not, including without limitation the allocation of a portion of a fiduciary commission that is a bundled fee to investment advice.

B. Income In Respect of a Decedent.

1. General Definition. In general, 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:
  - (a) all accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;
  - (b) 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
  - (c) income to which the decedent had a contingent claim at the time of his death.
2. Existence. IRD exists whenever no further acts are required and a decedent is entitled to receive an amount, that had the decedent lived to actually receive it, would have been income to the decedent.
  - (a) Peterson Test (Estate of Peterson v. Comm – Sale of Cattle). Decedent had negotiated the sale of cattle but had not completed the sale. The sale was completed after his death.
    - (i) Decedent entered into legal significant transaction;
    - (ii) Decedent performed the substantive tasks required;
    - (iii) No economically significant contingencies remained at death; and
    - (iv) Decedent would have received property but for his death.
  - (b) Rev. Rul. 78-32. A key issue is whether the decedent’s successor in interest is entitled to receive the proceeds of the transaction without investing more effort than mere ministerial or nonsubstantive acts.
  - (c) O’Daniel Case. Decedent did not have an enforceable right to a bonus at his death but his employer paid one anyway and the court determined that such payment was IRD.
3. Significance. Characterization as IRD is significant for three reasons:
  - (a) determines who is responsible for reporting and paying the tax on the income;
  - (b) the property is not eligible for basis adjustment under IRC § 1014; and
  - (c) 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. It is treated as a miscellaneous itemized deduction, not subject to the 2% limitation.



4. Common Sources and Types of IRD.

(a) Compensation.

- (i) Includes accrued but unpaid salary and vacation pay, deferred compensation, and bonuses.
- (ii) Commissions earned but not received prior to death are usually IRD. However, if the successors in interest do not have an enforceable right to the decedent's commissions, then the payments would not be IRD.
- (iii) Income is recognized as payments are received.

(b) Qualified Retirement Plans. If the distribution would have been taxable to the decedent, then the distribution is IRD to the recipient.

(c) Annuities. If the distribution would have been taxable to the decedent, then the distribution is IRD to the recipient.

(d) Installment Notes.

- (i) Payments under installment notes with respect to sales completed prior to the decedent's death constitute IRD to the extent the postmortem payments include capital gain or other forms of income realized prior to the decedent's death. There is no basis adjustment with respect to the remaining amounts due under the installment note.
- (ii) A contract can be drafted to eliminate the IRD problem by nullifying the contract if the decedent-seller dies before the transaction closes. The benefit of not treating the sale as IRD is that the property should be eligible for a new basis equal to the fair market value at death under IRC § 1014.
- (iii) Sales consummated after the decedent's death, even if the agreement was created prior to death, do not constitute IRD and the property will receive a basis adjustment under IRC § 1014 (see Treas. Reg. § 1.961(a)-2(b), Example 4).

(e) Exercise, Sale or Disposition of Stock Options. An individual may die owning stock options received as compensation that were not exercised as of their date of death. The options may be exercised by the successors in interest. The income realized when the options are exercised or the stock is disposed of may be treated as income in respect of a decedent.

5. Transfers and Distributions of IRD.

(a) General Rule. If a right to IRD is transferred by (1) the estate of the decedent, or (2) a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, then the estate or such person, for the taxable period in which the transfer occurs, must include in gross income an amount equal to the fair market value of such IRD at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value.

- (b) Exception. If the estate of a decedent or any person transmits the right to IRD to another who would be required by IRC § 691(a)(1) to include such income when received in his gross income, only the transferee will include such income when received in his gross income.
- (c) For these purposes, the term “transfer” includes sale, exchange, or other disposition, but does *not* include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.
- (d) Examples.
  - (i) Sale. Upon a sale of a right to IRD by the estate or person entitled to receive it, the fair market value of the right or the amount received upon the sale, whichever is greater, is included in the gross income of the seller.
  - (ii) Gift. If a right to IRD is disposed of by gift, then the fair market value of the right at the time of the gift must be included in the gross income of the donor.
  - (iii) Satisfaction of Pecuniary Bequest. If a right to IRD is transferred by an estate or trust in satisfaction of a pecuniary bequest, then the fair market value of the right at the time of the gift must be included in the gross income of the estate or trust.
  - (iv) Specific Distribution. If a right to IRD is transferred by an estate or trust to a specific beneficiary, then only the specific beneficiary must include such income in gross income when received.
  - (v) Residuary Distribution. If a right to IRD is transferred by an estate or trust to a residuary beneficiary, then only the residuary beneficiary must include such income in gross income when received.
- (e) Distributions of IRD that Carry Out DNI.
  - (i) Unless IRC § 663(a)(1) applies, a distribution of the right to receive IRD should carry out DNI under the same rules that apply to any other asset distributed in kind under IRC § 643(e). However, IRC § 643(e) limits the amount of DNI carried out by a distribution of any property in kind from an estate or trust (presumably including a right to receive IRD) to the lesser of basis or FMV of the distributed asset. Because the basis of most items of IRD is zero, the amount of DNI carried out normally would be zero as well.
  - (ii) If the distribution is an acceleration event under IRC § 691(a)(2) (i.e., a transfer constituting a sale, exchange, or other disposition), then a basis increase in the amount of the income realized by the acceleration should allow application of IRC § 643(e)(2)(A), which would regard

the amount of DNI carried out to equal the basis of the distributed item.

- (iii) If the distribution is an acceleration event (e.g., satisfaction of a pecuniary amount), then the result ought to be an income tax wash to the fiduciary. The DNI carryout should produce (1) a distribution deduction that offsets the income caused by acceleration, and (2) income to the recipient who ultimately will receive the IRD tax free due to a new basis in the right to receive the IRD generated by the acceleration. The result of such an income carry out would be simply to accelerate the tax year in which the IRD is taxed but not alter the taxpayer who would be incur the tax liability, which would be appropriate for tax policy reasons.

C. Deduction In Respect of a Decedent.

1. 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 are referred to as deductions in respect of the decedent (DRD). To be deductible as DRD, the expense must be a deduction for which the decedent was liable. Expenses that have not matured to the point of accrual at the decedent's date of death should be considered DRD when later paid.
2. DRD expenses are deductible on Form 706 as a debt of the decedent.
3. In addition, DRD expenses are also generally deductible for income tax purposes *when paid*, either by the decedent's estate on Form 1041 or by the person who acquires property subject to liability from the decedent.
4. IRC § 691(b) expressly refers to five classes of deductions and one credit that can be treated as DRD:
  - (a) IRC § 162 business expenses
  - (b) IRC § 163 deductions for interest
  - (c) IRC § 164 deductions for taxes
  - (d) IRC § 212 expenses for production of income
  - (e) IRC § 611 deductions for depletion
  - (f) IRC § 27 foreign tax credits

**VI. State Income Taxation of Estates and Trusts**

- A. Estates. Generally, estates are 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 (e.g., rental property in another state).

## B. Trusts.

1. Overview. 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.
2. Arizona. In Arizona, for example, a trust is an Arizona resident trust and all of its income is subject to Arizona income tax if the trustee is a resident of Arizona regardless of where its beneficiaries are located. If the trustee of the trust is not an Arizona resident then only the trust's Arizona sourced income is subject to Arizona income tax (e.g., rental property in Arizona).
3. Other States. Other states may look at where the settlor of the trust was domiciled at the time of creating the trust and may consider whether and how many beneficiaries live in the state. So if a trust has a settlor, trustee or beneficiary in more than one state then the rules of each state where one of those parties is located or was located at the creation of the trust should be reviewed to determine if the trust is subject to income taxes in that particular state.
4. Kaestner v. North Carolina Dept. of Revenue.
  - (a) North Carolina sought to tax the income of a trust that was settled in New York, managed by a trustee in New York under New York law, and had no assets or direct investments in North Carolina.
  - (b) The court held that both (i) a minimum connection between the state and the person, property, or transaction it seeks to tax and (ii) a rational relationship between the tax and activities occurring within the state are required.
  - (c) In previous decisions, the Court ruled states may tax trust distributions to an in-state beneficiary and a trust's income if the trustee administers the trust in that state.

## VII. Grantor Trusts

### A. General.

1. 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.
2. The deemed owner of a trust can be the creator of the trust or another person (typically, beneficiary)
3. 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)

- ### B. Tax Return Reporting for Grantor Trusts. Grantor trusts have three reporting options under Treas. Reg. § 1.671-4. The alternative methods in paragraphs 2 and 3 below are not available in certain circumstances, including: (i) if the trust's situs, or any assets, are located outside the U.S.; (ii) Qualified Subchapter S Trusts; or (iii) if the trust owner has a fiscal year or is not a U.S. person.

1. File Form 1041 with Statement (Treas. Reg. § 1.671-4(a)). The trustee provides all payors with the trust's name, address and TIN, and then files Form 1041 with the IRS and attaches a statement to the Form 1041 which shows the items of income, deduction and credit attributable to the deemed grantor of the trust. The trustee then provides a copy of the Form 1041 and the attached statement to the deemed grantor so that the grantor may report such items on his or her personal income tax return.
  2. 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. If the trustee uses this method then all items of income are reported by the payor using the deemed grantor's name and TIN but using the trust's address. In addition, unless the deemed grantor is also the trustee, the trustee must also furnish the person who is the deemed grantor a statement showing all items of income, deduction and credit. If the trustee selects this method then the trustee is not required to file any type of income tax return for the trust with the IRS (Treas. Reg. § 1.671-4(b)(2)(ii)(B)).
  3. Provide Name, TIN, and Address of Trust to Payors (Treas. Reg. § 1.671-4(b)(2)(i)(B)). The trustee may provide the name, TIN and address of the trust to all payors of income. If the trustee does this, then the trustee must file with the IRS the appropriate Forms 1099, reporting the income and gross proceeds paid to the trust during the taxable year, and showing the trust as the payor and the deemed grantor as the payee. In addition, unless the deemed grantor is also the trustee, the trustee must also furnish the person who is the deemed grantor a statement showing all items of income, deduction and credit.
- C. Basis Adjustment of Assets of Grantor Trust upon Death of Deemed Owner (Rev. Rul. 2023-2). IRS has ruled that if a since-deceased taxpayer creates irrevocable trust, retaining a power which causes taxpayer to be owner of entire trust for income tax purposes but doesn't cause trust assets to be included in taxpayer's gross estate for estate tax purposes, and funds the trust with an asset in a transfer that was a completed gift for gift tax purposes, then the basis of the asset is not adjusted to its FMV on date of taxpayer's death under IRC § 1014 because the asset wasn't acquired or passed from decedent as defined in IRC § 1014(b).



## Overview of Types and Purposes of Various Trusts

Type of Trust	Primary Purpose(s)	Description
Asset Protection Trust “DAPT” if domestic “FAPT” if offshore	Asset protection	A trust that protects trust assets from creditors by: <ol style="list-style-type: none"> <li>1. preventing the assignment or transfer of a beneficiary’s interest,</li> <li>2. rendering a beneficiary’s interest unascertainable,</li> <li>3. limiting the trustee’s distributions to ascertainable standards,</li> <li>4. allowing the trustee discretionary distributions to multiple beneficiaries, or</li> <li>5. changing or terminating a beneficiary’s interest upon the occurrence of certain events (for example, insolvency of beneficiary).</li> </ol>
Beneficiary Defective Income Trust “BDIT”	Estate tax planning	Terms of trust lead to all trust income includible on beneficiary tax return.
Charitable Lead Trust “CLAT” or “CLUT”	Estate tax planning; charitable planning	Similar to a GRAT or GRUT (see below), except the term interest is given to charity. Remainder usually passes to family members. Can be either an <i>inter vivos</i> trust or a testamentary trust. Charitable lead interest must be a qualified annuity or unitrust interest.
Charitable Remainder Trust “CRAT” or “CRUT”  “NI-CRUT” or “NIM-CRUT”	Estate tax planning; charitable planning	Similar to GRAT or GRUT (see below), except the remainder passes to charity. Can be either an <i>inter vivos</i> trust or a testamentary trust. Can be structured to limit payout to net income, instead of unitrust or fixed annuity, or net income plus make-up provisions.
Conduit or See-Through Trust	Income tax planning	Trust with provisions to hold retirement plan assets and pass through the income to beneficiary.

## Overview of Types and Purposes of Various Trusts

Type of Trust	Primary Purpose(s)	Description
Crummey Trust	Gift tax planning	Beneficiary is given a “Crummey” withdrawal power (that is, a limited, noncumulative power to withdraw principal or income). This power enables the transfer to the trust to be eligible for the gift tax annual exclusion.
Dynasty Trust	Estate tax planning	An irrevocable trust with a term that generally extends as long as legally possible to preserve the wealth for future generations (children, grandchildren, and great grandchildren).
Electing Small Business Trust “ESBT”	Income tax planning	Trust with certain provisions allowing it to own S-Corporation stock. Can have multiple beneficiaries.
Estate Trust	Estate tax planning.	A marital trust (that is, qualifies for the marital deduction) that gives the trustee discretion of either currently distributing to or accumulating income for the surviving spouse.
General Power of Appointment Trust	Estate tax planning	A marital trust (that is, qualifies for the marital deduction) that grants a surviving spouse a general power of appointment over the trust assets.
Generation-Skipping Trust “GST Trust”	Estate tax planning	Trust provisions designed to “skip” an intermediate generation and minimize estate tax.
Grantor Retained Annuity Trust “GRAT”	Gift and estate tax planning	<i>Inter vivos</i> trust in which grantor transfers property while retaining a fixed dollar annuity payable for a term of year. Remainder normally passes to family members.
Grantor Retained Interest in Tangible Property Trust	Gift and estate tax planning	<i>Inter vivos</i> trust in which grantor transfers property while retaining a right to use and enjoy certain tangible property for a term of year. Remainder normally passes to family members.



## Overview of Types and Purposes of Various Trusts

Type of Trust	Primary Purpose(s)	Description
Grantor Retained Unitrust "GRUT"	Gift and estate tax planning	<p><i>Inter vivos</i> trust in which grantor transfers property while retaining a right to receive distributions equal to a fixed percentage of the annual FMV of the trust's assets for a fixed term of years.</p> <p>Remainder normally passes to family members.</p>
Income Trust [also called a Section 2503(b) Trust]	Gift and estate tax planning	All trust income must be distributed to the beneficiary at least annually.
Intentionally Defective Grantor Trust "IDGT"	Estate tax planning	Trust terms designed to make trust taxable to grantor (or other person) for income tax purposes, but avoid being taxable to grantor for estate tax purposes.
Irrevocable Life Insurance Trust	Estate tax planning	<p><i>Inter vivos</i> trust corpus consists of life insurance policy(ies).</p> <p>Generally, the grantor is the insured but retains no interest as beneficiary or trustee.</p> <p>On grantor's death, income and corpus benefits pass to family members as provided in the trust instrument.</p>
Irrevocable Trust	Estate tax planning	Assets are transferred to a trust with no retained power to alter, amend or revoke.
Minor's or Discretionary Trust [also called a Section 2503(c) Trust]	Gift and estate tax planning; education planning	<p><i>Inter vivos</i> trust for the benefit of a minor before attaining the age of 21.</p> <p>Accumulated income and corpus passes to minor upon reaching age 21.</p> <p>The trust becomes a grantor trust to the beneficiary at age 21 if the trust instrument extends the term of the trust beyond age 21.</p>
Optimal Basis Increase and Income Tax Efficiency Trust "OBIT"	Estate tax planning	Uses powers of appointment to optimize step-up in basis and limit step-down.

## Overview of Types and Purposes of Various Trusts

Type of Trust	Primary Purpose(s)	Description
Personal Residence Grantor Retained Interest Trust [also called a Qualified Personal Residence Trust] "QPRT"	Gift and estate tax planning	<p><i>Inter vivos</i> trust in which grantor retains right to occupy trust property as a personal residence for a term of years.</p> <p>Remainder to family members.</p> <p>The grantor cannot be the holder of an interest in more than two such trusts at the same time.</p>
Pourover Trust	Estate planning	<p>Useful as a receptacle for insurance proceeds, IRA benefits, and qualified retirement plan benefits.</p> <p>May also receive a portion of probate estate under the will.</p>
Qualified Disability Trust	Estate planning	Non-grantor trust established for individual under age 65 who is disabled.
Qualified Domestic Trust "QDOT"	Estate tax planning	Optimizes marital deduction for surviving spouses that are not U.S. citizens.
Qualified Subchapter-S Trust "QSST"	Income tax planning	Trust with certain provisions allowing it to own S-Corporation stock. Can have only one lifetime beneficiary. All income must be distributed.
Qualified Terminable Interest Property Trust	Estate planning	<p>Provides a surviving spouse with an income interest for life.</p> <p>Enables a decedent to control the disposition of the remainder interest in the trust after the surviving spouse's death, but the transfer can still qualify for the marital deduction and is included in the gross estate of the surviving spouse.</p>
Reciprocal Trusts	Estate planning	Two or more trusts with identical provisions.
Revocable Living Trust	Estate planning	Assets are transferred to a trust subject to grantor's power to alter, amend or revoke (becoming an irrevocable trust at death and avoiding probate).

## Overview of Types and Purposes of Various Trusts

Type of Trust	Primary Purpose(s)	Description
Spendthrift Trust	Estate planning	A trust established to protect a beneficiary from spending the entire inheritance by making periodic distributions instead of a one-time settlement. Depending on state law, may offer creditor protection.
Spousal Lifetime Access Trust "SLAT"	Estate planning	Irrevocable trust created for benefit of spouse or other family members.
Standby Trust	Financial planning	Unfunded trust stands ready to receive and manage trust assets when the grantor is no longer able to manage the assets. Usually revocable when established, becoming irrevocable when grantor becomes disabled.
Supplemental or Special Needs Trust	Financial/elder care planning	Distributions from the trust provide a disabled or elderly person with financial assistance without affecting the government benefits available to that person.
Testamentary Trust	Estate planning	Term that is set up to commence upon death of the grantor; terms of trust provided in Will.



## Elections Commonly Used by Estates and Trusts

<b>Description</b>	<b>Code Sec.</b>	<b>Purpose</b>	<b>Notes</b>	<b>Due Date</b>
Deduct charitable contributions in preceding year	642(c)(1)	One year carryback of qualifying charitable contributions	May create additional filing requirement of Form 1041-A for trusts.	With Form 1041 or amended 1041
Election to claim administrative expenses of estate	642(g)	Coordinate whether the expenses will be deducted on Form 1041 OR Form 706 estate tax return.	Review Form 706 before claiming; consider relevant benefits.	With Form 1041
Recognize gain on distributions In-Kind	643(e)(3)	Recognize gain or loss on property distributions as if sold at FMV. Basis for recipient is fiduciary basis, plus gain, minus loss recognized. Holding period begins anew.	Annually as desired. Applies to all property distributions for the year.	With Form 1041
Treat Qualified Revocable Trust as Part of Estate	645	Combine trust and estate in single tax return; allow trust to have certain tax benefits of estates	Expires after 2 years when no 706 required.	Form 8855 due by extended due date of Estate
Treat distributions within 65 days of year as paid in prior year	663(b)	Increase distribution deduction retroactively for complex trusts and estates	Allows post-year end planning.	Distributions must be completed within 65 days. Election made with 1041
Report decedent's U.S. Savings Bonds by fiduciary	454(a)	Accrued income on Series EE/E bonds can be reported on decedent's final 1040, OR reported on first fiduciary income tax return, OR continue to defer until bonds cashed or mature.	Allows post-mortem planning opportunity	With final Form 1040 or initial Form 1041
Election to adopt fiscal year	441(e)	Estates can report on a fiscal year basis using any month end, so long as not more than 12 months.	Certain trusts eligible when Sec 645 election also made.	Made by filing the first return; once selected, requires IRS approval to change



# 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		





# 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?



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.
B Number of Schedules K-1 attached (see instructions)
C Employer identification number
D Date entity created
E Nonexempt charitable and split-interest trusts, check applicable box(es).
F Check applicable boxes: Initial return, Final return, Amended return, Net operating loss carryback, Change in trust's 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 TIN

Table with 30 rows and 3 columns. Rows 1-9: Income (Interest income, Total ordinary dividends, Business income or (loss), Capital gain or (loss), Rents, royalties, partnerships, other estates and trusts, etc., Farm income or (loss), Ordinary gain or (loss), Other income, Total income). Rows 10-22: Deductions (Interest, Taxes, Fiduciary fees, Charitable deduction, Attorney, accountant, and return preparer fees, Other deductions, Net operating loss deduction, Adjusted total income or (loss), Income distribution deduction, Estate tax deduction, Qualified business income deduction, Exemption). Rows 23-30: Tax and Payments (Taxable income, Total tax, Current year net 965 tax liability paid, Total payments, Estimated tax penalty, Tax due, Overpayment, Amount of line 29 to be).

Sign Here: Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.
Signature of fiduciary or officer representing fiduciary, Date, EIN of fiduciary if a financial institution.
May the IRS discuss this return with the preparer shown below? See instructions. Yes No

Paid Preparer Use Only: Print/Type preparer's name, Preparer's signature, Date, Check if self-employed, PTIN, Firm's name, Firm's EIN, Firm's address, Phone no.

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

<b>Schedule B Income Distribution Deduction</b>		
<b>1</b>	Adjusted total income. See instructions	<b>1</b>
<b>2</b>	Adjusted tax-exempt interest	<b>2</b>
<b>3</b>	Total net gain from Schedule D (Form 1041), line 19, column (1). See instructions	<b>3</b>
<b>4</b>	Enter amount from Schedule A, line 4 (minus any allocable section 1202 exclusion)	<b>4</b>
<b>5</b>	Capital gains for the tax year included on Schedule A, line 1. See instructions	<b>5</b>
<b>6</b>	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	<b>6</b>
<b>7</b>	<b>Distributable net income.</b> Combine lines 1 through 6. If zero or less, enter -0-	<b>7</b>
<b>8</b>	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law	<b>8</b>
<b>9</b>	Income required to be distributed currently	<b>9</b>
<b>10</b>	Other amounts paid, credited, or otherwise required to be distributed	<b>10</b>
<b>11</b>	Total distributions. Add lines 9 and 10. If greater than line 8, see instructions	<b>11</b>
<b>12</b>	Enter the amount of tax-exempt income included on line 11	<b>12</b>
<b>13</b>	Tentative income distribution deduction. Subtract line 12 from line 11	<b>13</b>
<b>14</b>	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-	<b>14</b>
<b>15</b>	<b>Income distribution deduction.</b> Enter the smaller of line 13 or line 14 here and on page 1, line 18	<b>15</b>

**Schedule G Tax Computation and Payments** (see instructions)

<b>Part I – Tax Computation</b>		
<b>1 Tax:</b>		
<b>a</b>	Tax on taxable income. See instructions	<b>1a</b>
<b>b</b>	Tax on lump-sum distributions. Attach Form 4972	<b>1b</b>
<b>c</b>	Alternative minimum tax (from Schedule I (Form 1041), line 54)	<b>1c</b>
<b>d</b>	<b>Total.</b> Add lines 1a through 1c	<b>1d</b>
<b>2a</b>	Foreign tax credit. Attach Form 1116	<b>2a</b>
<b>b</b>	General business credit. Attach Form 3800	<b>2b</b>
<b>c</b>	Credit for prior year minimum tax. Attach Form 8801	<b>2c</b>
<b>d</b>	Bond credits. Attach Form 8912	<b>2d</b>
<b>e</b>	<b>Total credits.</b> Add lines 2a through 2d	<b>2e</b>
<b>3</b>	Subtract line 2e from line 1d. If zero or less, enter -0-	<b>3</b>
<b>4</b>	Tax on the ESBT portion of the trust (from ESBT Tax Worksheet, line 17). See instructions	<b>4</b>
<b>5</b>	Net investment income tax from Form 8960, line 21	<b>5</b>
<b>6</b>	Recapture taxes. Check if from: <input type="checkbox"/> Form 4255 <input type="checkbox"/> Form 8611	<b>6</b>
<b>7</b>	Household employment taxes. Attach Schedule H (Form 1040)	<b>7</b>
<b>8</b>	Other taxes and amounts due	<b>8</b>
<b>9</b>	<b>Total tax.</b> Add lines 3 through 8. Enter here and on page 1, line 24	<b>9</b>

<b>Part II – Payments</b>		
<b>10</b>	2022 estimated tax payments and amount applied from 2021 return	<b>10</b>
<b>11</b>	Estimated tax payments allocated to beneficiaries (from Form 1041-T)	<b>11</b>
<b>12</b>	Subtract line 11 from line 10	<b>12</b>
<b>13</b>	Tax paid with Form 7004. See instructions	<b>13</b>
<b>14</b>	Federal income tax withheld. If any is from Form(s) 1099, check here <input type="checkbox"/>	<b>14</b>
<b>15</b>	Current year net 965 tax liability from Form 965-A, Part I, column (f) (see instructions)	<b>15</b>
<b>16</b>	Other payments: <b>a</b> Form 2439 _____; <b>b</b> Form 4136 _____; <b>Total</b>	<b>16c</b>
<b>17</b>	Credit for qualified sick and family leave wages for leave taken before April 1, 2021	<b>17</b>
<b>18</b>	Credit for qualified sick and family leave wages for leave taken after March 31, 2021, and before October 1, 2021	<b>18</b>
<b>19</b>	<b>Total payments.</b> Add lines 12 through 15 and 16c through 18. Enter here and on page 1, line 26	<b>19</b>

<b>Other Information</b>		<b>Yes</b>	<b>No</b>
<b>1</b>	Did the estate or trust receive tax-exempt income? If "Yes," attach a computation of the allocation of expenses. Enter the amount of tax-exempt interest income and exempt-interest dividends . . . . . \$ _____		
<b>2</b>	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? . . . . .		
<b>3</b>	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 _____		
<b>4</b>	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 . . . . .		
<b>5</b>	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 . . . . .		
<b>6</b>	If this is an estate or a complex trust making the section 663(b) election, check here. See instructions . . . . . <input type="checkbox"/>		
<b>7</b>	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here. See instructions . . . . . <input type="checkbox"/>		
<b>8</b>	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"/>		
<b>9</b>	Are any present or future trust beneficiaries skip persons? See instructions . . . . .		
<b>10</b>	Was the trust a specified domestic entity required to file Form 8938 for the tax year? See the Instructions for Form 8938 . . . . .		
<b>11a</b>	Did the estate or trust distribute S corporation stock for which it made a section 965(i) election? . . . . .		
<b>b</b>	If "Yes," did each beneficiary enter into an agreement to be liable for the net tax liability? See instructions . . . . .		
<b>12</b>	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 . . . . .		
<b>13</b>	<b>ESBTs only.</b> Does the ESBT have a nonresident alien grantor? If "Yes," see instructions . . . . .		
<b>14</b>	<b>ESBTs only.</b> Did the S portion of the trust claim a qualified business income deduction? If "Yes," see instructions . . . . .		

Schedule K-1 (Form 1041)

2022

Department of the Treasury Internal Revenue Service

For calendar year 2022, or tax year

beginning / / 2022 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
C Fiduciary's name, address, city, state, and ZIP code
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

H Domestic beneficiary Foreign beneficiary

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

Table with 4 columns: Item number, Description, Item number, Description. Rows include Interest income, Ordinary dividends, Qualified dividends, Net short-term capital gain, Net long-term capital gain, 28% rate gain, Alternative minimum tax adjustment, Unrecaptured section 1250 gain, Other portfolio and nonbusiness income, Ordinary business income, Net rental real estate income, Credits and credit recapture, Other rental income, Directly apportioned deductions, Other information, Estate tax deduction.

\*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





# Bases of State Income Taxation of Nongrantor Trusts 2022

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Note: For comprehensive coverage of this subject, see Richard W. Nenno and Vincent C. Thomas, State Income Taxation of Trusts: 2022 (Young Conaway Stargatt & Taylor, LLP 2022). A free copy of the book may be ordered at <https://lnkd.in/e2i-siAf>.









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State	Tax Dep't Website	Citations	Top 2022 Rate	Trust Created by Will of Domiciliary/ Resident	Inter Vivos Trust Created by Domiciliary/ Resident	Trust Administered in State	Trust with Domiciliary/ Resident Trustee/ Fiduciary	Trust With Domiciliary/ Resident Beneficiary
Alabama	revenue.alabama.gov	Ala. Code §§ 40-18-1(33), 40-18-5(l)(c); Ala. Admin. Code r. 810-3-29-.07(2)(b)-(c); Instructions to 2022 Ala. Form 41 at 2.	5.00% on taxable income over \$3,000	 <sup>1</sup>	 <sup>1</sup>			
Alaska	dor.alaska.gov	No income tax imposed.						
Arizona	azdor.gov	Ariz. Rev. Stat. Ann. §§ 43-1011(A), (B), 43-1301(5), 43-1311(B)(2), (C); Instructions to 2022 Ariz. Form 141AZ at 1, 14; Tax Year 2022, Tax Table-Estates and Trusts.	2.98% on taxable income over \$28,652					
Arkansas	dfa.arkansas.gov	Ark. Code Ann. § 26-51-201(b), 26-51-203(a); 2022 Ark. Indexed Tax Brackets.	4.90% on net income over \$91,800	 <sup>2</sup>	 <sup>2</sup>			
California	ftb.ca.gov	Cal. Rev. & Tax. Code §§ 17041(a)(1), 17043(a), 17742(a); Cal. Const. art. XIII, § 36(f)(2); Instructions to 2022 Cal. Form 541 at 9, 12.	13.30% on taxable income over \$1 million					 <sup>3</sup>

<sup>1</sup> Provided that trust has domiciliary or resident fiduciary or current beneficiary for more than seven months during taxable year.











<sup>2</sup> Provided that trust has resident fiduciary.

<sup>3</sup> Other than beneficiary whose interest is contingent.

State	Tax Dep't Website	Citations	Top 2022 Rate	Trust Created by Will of Domiciliary/ Resident	Inter Vivos Trust Created by Domiciliary/ Resident	Trust Administered in State	Trust with Domiciliary/ Resident Trustee/ Fiduciary	Trust With Domiciliary/ Resident Beneficiary
Colorado	tax.colorado.gov	Colo. Rev. Stat. §§ 39-22-103(10), 39-22-104(1.7)(c); Instructions to 2022 Colo. Form 105 at 3, 4; 2022 Colo. Form 105 at 1.	4.40% on taxable income					
Connecticut	portal.ct.gov/drs	Conn. Gen. Stat. §§ 12-700(a)(9)(E), 12-701(a)(4)(C)–(D); Conn. Agencies Regs. § 12-701(a)(4)-1(a)(3)–(4); Instructions to 2022 Form CT-1041; 2022 Form CT-1041 at 1.	6.99% on taxable income		 <sup>4</sup>			
Delaware	revenue.delaware.gov	Del. Code Ann. tit. 30, §§ 1102(a)(14), 1601(8); Instructions to 2022 Del. Form 400 at 1–2; 2022 Del. Form 400 at 2.	6.60% on taxable income over \$60,000	 <sup>5</sup>	 <sup>5</sup>		 <sup>5</sup>	
District of Columbia	otr.cfo.dc.gov	D.C. Code §§ 47-1806.03(a)(11), 47-1809.01, 47-1809.02; Instructions to 2022 D.C. Form D-41 at 7.	10.75% on taxable income over \$1,000,000					
Florida	floridarevenue.com	No income tax imposed.						

<sup>4</sup> Provided that trust has resident noncontingent beneficiary.









<sup>5</sup> Provided that trust has resident beneficiary.

State	Tax Dep't Website	Citations	Top 2022 Rate	Trust Created by Will of Domiciliary/ Resident	Inter Vivos Trust Created by Domiciliary/ Resident	Trust Administered in State	Trust with Domiciliary/ Resident Trustee/ Fiduciary	Trust With Domiciliary/ Resident Beneficiary
Georgia	dor.georgia.gov	Ga. Code Ann. §§ 48-7-20(b)(1), (d), 48-7-22; Instructions to 2022 Ga. Form 501 at 9.	5.75% on taxable net income over \$7,000					 <sup>2</sup>
Hawaii	tax.hawaii.gov	Haw. Rev. Stat. §§ 235-1, 235-51(d); Haw. Code R. § 18-235-1.17; Instructions to 2022 Haw. Form N-40 at 1, 10.	8.25% on taxable income over \$40,000			 <sup>5</sup>	 <sup>5</sup>	
Idaho	tax.idaho.gov	Idaho Code §§ 63-3015(2), 63-3024(a); Idaho Admin. Code Regs. 35.01.01.035(01), 35.01.01.075; Instructions to 2022 Idaho Form 66 at 8.	6.5% on taxable income over \$7,939	 <sup>6</sup>	 <sup>6</sup>	 <sup>6</sup>	 <sup>6</sup>	
Illinois	revenue.illinois.gov	35 Ill. Comp. Stat. 5/201(a), (b)(5.4), (c), (d), 5/1501(a)(20)(C)-(D); Ill. Admin. Code tit. 86, § 100.3020(a)(3)-(4); Instructions to 2022 Form IL-1041 at 5, 12; 2022 Form IL-1041 at 2.	6.45% on net income					
Indiana	in.gov/dor	Ind. Code §§ 6-3-1-12(d), 6-3-2-1(b)(3); 45 Ind. Admin. Code 3.1-1-21(d); Instructions to 2022 Ind. Form IT-41 at 1, 3; 2022 Ind. Form IT-41 at 1.	3.23% on taxable income					

<sup>2</sup> Provided that trust has resident fiduciary.

<sup>5</sup> Provided that trust has resident beneficiary.

<sup>6</sup> Provided that other requirements are met.











State	Tax Dep't Website	Citations	Top 2022 Rate	Trust Created by Will of Domiciliary/ Resident	Inter Vivos Trust Created by Domiciliary/ Resident	Trust Administered in State	Trust with Domiciliary/ Resident Trustee/ Fiduciary	Trust With Domiciliary/ Resident Beneficiary
Iowa	tax.iowa.gov	Iowa Code §§ 422.5(1), 422.5A(9); Iowa Admin. Code r. 701-700.3; Instructions to 2022 Iowa Form IA 1041 at 3.	8.53% on taxable income over \$78,435			 <sup>6</sup>	 <sup>6</sup>	
Kansas	ksrevenue.org	Kan. Stat. Ann. §§ 79-32,109(d), 79-32,110(a)(2)(F), (d); Instructions to 2022 Kan. Form K-41 at 2; 2022 Kan. Form K-41 at 4.	5.70% on taxable income over \$30,000					
Kentucky	revenue.ky.gov	Ky. Rev. Stat. Ann. §§ 141.020(2)(d), 141.030(1); 103 Ky. Admin. Regs. 19:010; Instructions to 2022 Ky. Form 741 at 2; 2022 Ky. Form 741 at 2.	5.00% on taxable income				 <sup>5</sup>	
Louisiana	revenue.louisiana.gov	La. Stat. Ann. §§ 47:300.1(3), 47:300.10(3); Instructions to 2022 La. Form IT-541 at 1, 2, 4, 5.	4.25% on taxable income over \$50,000			 <sup>7,8</sup>		
Maine	maine.gov/revenue	Me. Rev. Stat. Ann. tit. 36, §§ 5102(4)(B)–(C), 5111(1-F), 5403(1)(A); Instructions to 2022 Form 1041ME at 1, 3.	7.15% on taxable income over \$54,450					

<sup>5</sup> Provided that trust has resident beneficiary.

<sup>6</sup> Provided that other requirements are met.

<sup>7</sup> Unless trust designates governing law other than Louisiana.

<sup>8</sup> Testamentary trust created by non resident; inter vivos trust created by resident or nonresident.

State	Tax Dep't Website	Citations	Top 2022 Rate	Trust Created by Will of Domiciliary/ Resident	Inter Vivos Trust Created by Domiciliary/ Resident	Trust Administered in State	Trust with Domiciliary/ Resident Trustee/ Fiduciary	Trust With Domiciliary/ Resident Beneficiary
Maryland	marylandtaxes.gov	Md. Code Ann., Tax-Gen. §§ 10-101(g), (n), 10-102, 10-105(a)(1)(viii), 10-106; Instructions to 2022 Md. Form 504 at i, 1, 5, 6.	5.75% (plus county tax between 2.25% and 3.20%) on taxable net income over \$250,000	 <sup>5</sup>	 <sup>5</sup>	 <sup>5</sup>		
Massachusetts	mass.gov/orgs/massachusetts-department-of-revenue	Mass. Gen. Laws ch. 62, §§ 4, 10(a), (c); Mass Regs. Code tit. 830, § 62.10.1(1)(a); Instructions to 2022 Mass. Form 2 at 2, 5, 10; 2022 Mass. Form 2 at 2.	5.00% on taxable income (12.00% for short-term gains and gains on sales of collectibles)	 <sup>5</sup>	 <sup>2, 5</sup>			
Michigan	michigan.gov/taxes	Mich. Comp. Laws §§ 206.16, 206.18(1)(c), 206.51(1)(b); Instructions to 2022 MI-1041 at 3; 2022 MI-1041 at 1.	4.25% on taxable income	 <sup>5</sup>	 <sup>9</sup>			
Minnesota	revenue.state.mn.us	Minn. Stat. §§ 290.01 Subd. 7b, 290.06 Subd. 2c, Subd. 2d; Instructions to 2022 Minn. Form M2 at 1-2, 19.	9.85% on taxable net income over \$142,405	 <sup>10</sup>	 <sup>10</sup>	 <sup>11</sup>		

<sup>2</sup> Provided that trust has resident fiduciary.

<sup>5</sup> Provided that trust has resident beneficiary.

<sup>9</sup> Unless trustee, assets, administration, and beneficiaries are outside Michigan.










<sup>10</sup> Post-1995 trust only.

<sup>11</sup> Pre-1996 trust only.

State	Tax Dep't Website	Citations	Top 2022 Rate	Trust Created by Will of Domiciliary/ Resident	Inter Vivos Trust Created by Domiciliary/ Resident	Trust Administered in State	Trust with Domiciliary/ Resident Trustee/ Fiduciary	Trust With Domiciliary/ Resident Beneficiary
Mississippi	dor.ms.gov	Miss. Code Ann. § 27-7-5(1)(a)(iii); Instructions to 2022 Miss. Form 81-110 at 3, 11.	5.00% on taxable income over \$10,000					
Missouri	dor.mo.gov	Mo. Rev. Stat. §§ 143.011, 143.061, 143.331(2)-(3); Instructions to 2022 Form MO-1041 at 4, 11.	5.30% on taxable income over \$8,968)	<sup>12</sup>	<sup>12</sup>			
Montana	mtrevenue.gov	Mont. Code Ann. § 15-30-2103(1)(g), (2); Mont. Admin. R. 42.30.101(16); Instructions to 2022 Mont. Form FID-3 at 3, 17-18; 2022 Mont. Form FID-3 at 2.	6.75% on taxable income over \$19,800	<sup>6</sup>	<sup>6</sup>	<sup>6</sup>	<sup>6</sup>	<sup>6</sup>
Nebraska	revenue.nebraska.gov	Neb. Rev. Stat. §§ 77-2714.01(6)(b)-(c), 77-2715.03(2)-(3), 77-2717(1)(a)(ii); Instructions to 2022 Neb. Form 1041N at 7, 8.	6.84% on taxable income over \$17,330					
Nevada	tax.nv.gov	No income tax imposed.						
New Hampshire	revenue.nh.gov	No income tax imposed on nongrantor trusts.						

<sup>6</sup> Provided that other requirements are met.












<sup>12</sup> Provided that trust has resident income beneficiary on last day of taxable year.

State	Tax Dep't Website	Citations	Top 2022 Rate	Trust Created by Will of Domiciliary/ Resident	Inter Vivos Trust Created by Domiciliary/ Resident	Trust Administered in State	Trust with Domiciliary/ Resident Trustee/ Fiduciary	Trust With Domiciliary/ Resident Beneficiary
New Jersey	state.nj.us/treasury/taxation	N.J. Stat. Ann. §§ 54A:1-2(o)(2)–(3), 54A:2-1(b)(7); Instructions to 2022 Form NJ-1041 at 2, 28.	10.75% on taxable income over \$1,000,000	 <sup>13</sup>	 <sup>13</sup>			
New Mexico	tax.newmexico.gov	N.M. Stat. Ann. § 7-2-7(C); Instructions to 2022 N.M. Form F1D-1 at 3, 9.	5.90% on taxable income over \$210,000					
New York State	tax.ny.gov	N.Y. Tax Law §§ 601(c)(1)(B)(iv)–(ix), 605(b)(3)(B)–(C); 20 N.Y. Comp. Codes R. & Regs. tit. 20, § 105.23(a)-(b); Instructions to 2022 N.Y. Form IT-205 at 2, 9.	10.90% on taxable income over \$25,000,000	 <sup>13</sup>	 <sup>13</sup>			
New York City	tax.ny.gov	N.Y. Tax Law §§ 1304(a)(3)(A), 1304-B(a)(1)(ii), 1305(c); N.Y.C. Admin. Code §§ 11-1701(b)(3), 11-1704.1, 11-1705(b)(3); Instructions to 2022 N.Y. Form IT-205 at 2, 18.	3.876% on taxable income over \$50,000	 <sup>13</sup>	 <sup>13</sup>			
North Carolina	ncdor.gov	N.C. Gen. Stat. §§ 105-153.7(a), 105-160.2; Instructions to 2022 N.C. Form D-407A at 1, 2; 2022 N.C. Form D-407 at 1.	4.99% on taxable income					 <sup>14</sup>

<sup>13</sup> Unless trust has no trustee, asset, or source income in state and trustee files informational return.

<sup>14</sup> Unless trust does not have resident trustee and resident beneficiaries have not received income, have no right to demand it, and are uncertain ever to receive it (Kaestner, 139 S. Ct. 2213 (2019)). Tax might be eliminated in other situations.









State	Tax Dep't Website	Citations	Top 2022 Rate	Trust Created by Will of Domiciliary/ Resident	Inter Vivos Trust Created by Domiciliary/ Resident	Trust Administered in State	Trust with Domiciliary/ Resident Trustee/ Fiduciary	Trust With Domiciliary/ Resident Beneficiary
North Dakota	nd.gov/tax	N.D. Cent. Code § 57-38-30.3(1)(e), (g); N.D. Admin. Code § 81-03-02.1-04(2); Instructions to 2022 N.D. Form 38 at 2; 2022 N.D. Form 38 at 2.	2.90% on taxable income over \$13,700			 <sup>6</sup>	 <sup>6</sup>	 <sup>6</sup>
Ohio	tax.ohio.gov	Ohio Rev. Code Ann. §§ 5747.01(I)(3), 5747.02(A)(3), (E); Instructions to 2022 Ohio Form IT 1041 at 8, 9.	3.990% on taxable income over \$115,300		 <sup>5</sup>			
Oklahoma	ok.gov/tax	Okla. Stat. tit. 68, §§ 2353(6), 2355(G),(C)(1)(f), 2355.1A; Okla. Admin. Code § 710:50-23-1(c); Instructions to 2022 Okla. Form 513 at 4, 17.	4.75% on taxable income over \$7,200					
Oregon	oregon.gov/dor	Or. Rev. Stat. §§ 316.037, 316.282(1)(d); Or. Admin. R. 150-316.0400(3)-(5); Instructions to 2022 Or. Form 41 at 3; 2022 Or. Form 41 at 3.	9.90% on taxable income over \$125,000					
Pennsylvania	revenue.pa.gov	72 P.S. §§ 7301(s), 7302; 61 Pa. Code § 101.1; Instructions to 2022 Form PA-41 at 5; 2022 Form PA-41 at 1.	3.07% on taxable income	 <sup>15</sup>	 <sup>15</sup>			

<sup>5</sup> Provided that trust has resident beneficiary.

<sup>6</sup> Provided that other requirements are met.











<sup>15</sup> Unless settlor is no longer resident or is deceased and trust lacks sufficient contact with Pennsylvania to establish nexus.

State	Tax Dep't Website	Citations	Top 2022 Rate	Trust Created by Will of Domiciliary/ Resident	Inter Vivos Trust Created by Domiciliary/ Resident	Trust Administered in State	Trust with Domiciliary/ Resident Trustee/ Fiduciary	Trust With Domiciliary/ Resident Beneficiary
Rhode Island	tax.ri.gov	R.I. Gen. Laws §§ 44-30-2.6(c)(3)(A)(II), (E), 44-30-5(c)(2)–(5); 280-RICR-20-55-7.7; Instructions to 2022 Form RI-1041 at 1-1; 2022 RI-1041 Tax Rate Schedules at 1.	5.99% on taxable income over \$8,700	 <sup>5</sup>	 <sup>5</sup>			
South Carolina	dor.sc.gov	S.C. Code Ann. §§ 12-6-30(5), 12-6-510(B), 12-6-520; Instructions to 2022 Form SC1041 at 1, 3.	6.5% on taxable income over \$16,040					
South Dakota	dor.sd.gov	No income tax imposed.						
Tennessee	tn.gov/revenue	Tenn. Code Ann. §§ 67-2-102(5), 67-2-110.	0.00% on income (interest and dividends only)					
Texas	comptroller.texas.gov/taxes	No income tax imposed.						
Utah	tax.utah.gov	Utah Code Ann. §§ 59-10-104(2)(b), 59-10-202(2)(b), 75-7-103(1)(i)(ii)–(iii); Instructions to 2022 UT Form TC-41 at 3, 12; 2022 UT Form TC-41 at 1.	4.85% on taxable income	 <sup>16</sup>		 <sup>8, 16</sup>		

<sup>5</sup> Provided that trust has resident beneficiary.

<sup>8</sup> Testamentary trust created by nonresident; inter vivos trust created by resident or nonresident.

<sup>16</sup> Post-2003 trust having Utah corporate trustee may deduct all nonsource income but must file Utah return if must file federal return.

State	Tax Dep't Website	Citations	Top 2022 Rate	Trust Created by Will of Domiciliary/ Resident	Inter Vivos Trust Created by Domiciliary/ Resident	Trust Administered in State	Trust with Domiciliary/ Resident Trustee/ Fiduciary	Trust With Domiciliary/ Resident Beneficiary
Vermont	tax.vt.gov	Vt. Stat. Ann. tit 32, §§ 5811(11)(B), 5822(a)(5), (6), (b)(2); Instructions to 2022 Vt. Form FIT-161 at 2; 2022 Vt. Form FIT-161 at 2.	8.75% on taxable income over \$10,150					
Virginia	tax.virginia.gov	Va. Code Ann. §§ 58.1-302, 58.1-320, 58.1-360; 23 Va. Admin. Code § 10-115-10; Instructions to 2022 Va. Form 770 at 1, 10.	5.75% on taxable income over \$17,000			 <sup>17</sup>		
Washington	dor.wa.gov	No income tax imposed.						
West Virginia	tax.wv.gov	W. Va. Code §§ 11-21-4e(a), 11-21-7(c)(2)–(3); W. Va. Code R. §§ 110-21-4(4.1), 110-21-7(7.3); Instructions to 2022 W. Va. Form IT-141 at 2, 8.	6.5% on taxable income over \$60,000					
Wisconsin	revenue.wi.gov	Wis. Stat. §§ 71.06(1q), (2e) (b), 71.125(1), 71.14(2), (3), (3m); Instructions to 2022 Wis. Form 2 at 1, 22.	7.65% on taxable income over \$280,950		 <sup>18</sup>	 <sup>19</sup>		
Wyoming	revenue.wyo.gov	No income tax imposed.						

<sup>17</sup> Until July 1, 2019

<sup>18</sup> Trust created or first administered in Wisconsin after October 28, 1999, only.

<sup>19</sup> Irrevocable inter vivos trust administered in Wisconsin before October 29, 1999, only.

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