

***Southern Arizona  
Estate Planning  
Council***

***FIDUCIARY  
INCOME TAX  
BOOT CAMP***

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***FIDUCIARY INCOME TAX BOOT CAMP***

**INCOME TAXATION OF TRUSTS AND  
ESTATES**

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## OVERVIEW

- **Non-Grantor Trusts and Estates**
- **Grantor Trusts**
- **Beneficiary Owned Trusts**

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## Non-Grantor Trusts and Estates

- Overview of Simple Trusts
- Overview of Complex Trusts and Estates
- Conduit Taxation

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## Income Taxation of Non-Grantor Trusts and Estates

- General Rule – § 641(a) imposes an income tax on the income of estates and trusts.
- § 641(b) – income is computed in the same manner as that of an individual with certain exceptions, and the tax is paid by the fiduciary.
- Tax rates are found in §1(e).

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## Net Investment Income Tax (“NIIT”)

- §1411 imposes a 3.8% tax on net investment income above a statutory threshold amount.
- For trusts and estates the tax is imposed on undistributed net investment income above \$12,300 [\$12,500 in 2017].
- For trusts and estates the combined income tax, and net investment income tax on ordinary investment income may be 43.4%.
- The overall tax due on long term capital gain income may be 23.8%.

## Simple Trusts & Complex Trusts

- What is a trust?
- Simple trusts – §§ 651 and 652
  - Income (fiduciary accounting income) is required to be distributed currently
  - No distributions of corpus
- Complex trusts and estates – §§ 661 and 662
  - All fiduciary entities that do not qualify as simple trusts

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## Conduit Taxation

- Taxable income of a trust or an estate is taxable either to the trust or to the beneficiaries.
- If the trust or estate makes distributions, then the trust is allowed a deduction for the distributions made to the beneficiary, and the beneficiary reports the item as income on his own tax return to the extent of the lower of the amount of the distribution, or the trust's distributable net income.

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## Distributable Net Income (“DNI”)

- Function and Role
- Computation
  - Taxable Income
  - Adjustments to Determine DNI
  - Capital Gains Allocable to Income

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## Role of DNI

- Limits Beneficiaries’ Taxable Income
  - Separate share rule
- Character Rule
  - Character flows through to beneficiary
- Limits Trust/Estate’s Distribution Deduction

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## Distribution Deduction

- Distribution deduction is limited to the lesser of **trust accounting income** (§651) or **DNI** for simple trusts, and the lesser of the distribution or DNI for complex trusts (§661)
- DNI is the maximum amount of taxable income of the trust that is taxed to a beneficiary of the trust as the result of a distribution to the beneficiary as determined under §643(a)

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## Trust Accounting Income

- Income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law (§ 643(b)).
- Local law – Arizona Principal and Income Act (A.R.S. § 7401 et. seq.) determines whether a receipt is income or principal for trust accounting purposes.

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## Distributable Net Income

- Computation of Distributable Net Income
  - Add Back
    - Personal exemption
    - Distribution deduction
  - Add Back
    - Capital Losses
    - Net Tax Exemption Income
  - Subtract capital gains from taxable income?

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## Section 643(a)(3)

- **Distributable net income.** For purposes of this part, the term “distributable net income” means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications—
- **(3) Capital gains and losses.** Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

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## Capital Gains – Treas. Reg. §§ 1.643(a) and (b)

- Circumstances where capital gains are allocated to **trust accounting income** and therefore included in DNI.
- Circumstances where capital gains are allocated to **trust principal**, but are paid, credited, or required to be distributed to a beneficiary, and therefore included in DNI.

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## Analysis – Step One

- Has a distribution been made (or is one required to be made)?
  - Fiduciary duties apply.
- Are Capital Gains in fact allocated to income or to principal?

If Capital Gains are allocated to income under the terms of the governing instrument or applicable local law, then such gains are automatically part of DNI.

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## Analysis – Step Two

If Capital Gains are in fact allocated to principal, can such gains be included in DNI?

- Such gains still may be included in DNI.
- Treas. Reg. §1.643(a)-3 lists circumstances in which an allocation to DNI is allowed.
- Authority under state law or the governing instrument is required.

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## §1.643(a)-3(b) and §1.643(b)-1

- An allocation of capital gains to **income** will generally be respected if:
  - the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or
  - pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

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## Sample Language: Discretion Granted under Terms of Governing Instrument to Allocate Capital Gains to Income

- The Trustee (other than a Trustee who is also a qualified beneficiary, and other than the Grantor) may allocate realized short term capital gains and/or realized long term capital gains to either trust income or trust principal.

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## Capital Gains Allocated to Principal

- Methods of including Capital Gains in DNI when Capital Gains are allocated to Principal
- Consistency Requirement
- State Statutes

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## Methods of Including Capital Gains in DNI when Capital Gains are allocated to Principal

- Capital Gains are 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.
- Capital Gains are allocated to principal but actually distributed to the beneficiary.
- Capital Gains are allocated to principal but utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

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## Example I

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.**

**The Example is equating the term deem with the distribution being "treated by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary."**

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## Example 2

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.

The Trust has \$5,000 of dividend income and \$10,000 of capital gain. 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.

The 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.***

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## Example 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.

The Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year ***from the sale of certain specified assets or a particular class of investments.*** This treatment of capital gains is a reasonable exercise of Trustee's discretion.

**The consistency requirement only applies to certain specified assets or a particular class of assets.**

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## Example 4

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.

**Pursuant to the terms of the governing instrument (in a provision not prohibited by applicable local law), capital gains realized by Trust are allocated to income.** Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the \$10,000 capital gain is included in Trust's distributable net income for the taxable year.

**Capital gains are allocated to income under the trust agreement. Thus there is no discretion and no consistency requirement.**

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## Illustration

- The following example illustrates the adjustments to taxable income in computing DNI
- Simple Trust with:
  - \$8,000 of taxable income allocable to FAI
  - \$2,000 of tax exempt income allocable to FAI
  - \$3,000 of deductible expenses paid from corpus (none subject to §67)
  - Trustee distributes \$5,000 each to beneficiaries A and B

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## Illustration (continued)

- **The trust's distributions deduction:**

<b>Gross Income</b>	\$8,000	
<b>Deductible Expenses</b>	<u>(2,400)</u>	80% of \$3,000
<b>Taxable Income</b>	5,600	
<b>§643(a)(5)</b>		\$2,000 tax exempt income less 20% of the \$3,000 of deductions
	<u>1,400</u>	
<b>DNI</b>	<b>\$7,000</b>	
<i>Carries Out</i>	\$3,500	<i>To both A and B</i>

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## Illustration (continued)

- Distribution deduction = the 80% taxable portion of DNI = \$5,600
- Inclusion to each of A and B = \$3,500 = \$2,800 taxable and \$700 tax exempt
- \$2,800 taxable = \$4,000 less \$1,200 (half of \$8,000 and half of \$2,400 each)
- \$700 tax exempt = \$1,000 less \$300 (half of \$2,000 and half of \$600 each)

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## Allocation of Trust Income

- Tier Rules
- Exclusion of Special Bequests
- Distributions in Kind
- Separate Share Rule
- Charitable Deduction
- Trust Termination – Deductions & Carryovers

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## Tier Rules

- The “tier” rules distinguish between
  - (1) required current distributions of income, and
  - (2) discretionary distributions of income, and required or discretionary distributions of accumulated income or principal.
- The tier rules only apply to complex trusts.

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## Tier Rules (continued)

- DNI is initially allocated to all first tier required distributions of current income.
- Any excess DNI is allocated pro rata among any second tier beneficiaries on the basis of their respective second tier distributions.
- Second tier distributions in excess of any remaining DNI are a tax-free distribution of trust corpus.
- Distributions to charity are treated like an “intermediate tier.”
  - The distributions reduce DNI allocated to the second tier beneficiaries.

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## Separate Share Rule

- Substantially independent and separately administered shares of a single trust or of an estate will be treated as separate trusts or estates for DNI allocation purposes (§663(c)).
- The calculation of DNI and the effect of distributions for one share will not affect the calculation of DNI for any other separate share.
- Example: Pot trust for children until oldest is age 21.

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## Illustration: Separate Share Rule & Tier Rule

- Complex trust with:
  - \$50,000 of taxable income allocable to FAI
  - \$10,000 of deductible expenses paid from corpus (none subject to § 67).
- \$40,000 of DNI
- Trustee required to distribute all income in equal shares to A and B and Trustee has discretion to distributed principal
- Trustee distributes \$25,000 to A and \$75,000 to B

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## Illustration (continued)

- Tier one distributions:

◦ A's $\frac{1}{2}$ of income	\$25,000
◦ A's $\frac{1}{2}$ of DNI	\$20,000
◦ B's $\frac{1}{2}$ of income	\$25,000
◦ B's $\frac{1}{2}$ of DNI	\$20,000
- Tier two distribution:
  - B's discretionary distribution of principal = \$50,000

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## Specific Bequests

- Specific Bequests—distributions of assets in satisfaction of specific bequests do not carry out DNI (§ 663(a)(1)).
- Rule is consistent with §102.

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## Distributions in Kind

- Income carried out by a distribution of property in kind is limited by §643(e)(2) to lesser of property's FMV or basis.
- Recipient's basis is a carryover basis.
- §643(e) Election
  - Allows basis in hands of recipient to equal the FMV of the property.
  - Trust must recognize gain on the distribution if it makes a 643(e) election

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## Charitable Deduction

- §642(c) allows a deduction for distributions to qualified charities.
- §642(c) has no percentage limitations.
- Governing instrument requirement.
- § 642(c) requires tracing of amounts distributed and limits the deduction to amounts actually paid from gross income of the estate or trust.

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## Charitable Deduction: Sample Language

- The Trustee is authorized to distribute current gross income to fund bequests or distributions to charitable organizations.

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## Set Aside Deduction

- § 642(c)(2) permits a deduction for amounts of gross income permanently set aside for a qualified charitable purpose pursuant to the terms of a governing instrument for an estate.
- Deduction does not apply to trusts unless a § 645 election is in effect.

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## Trust Termination: Deductions & Carryovers

- Deductions reduce taxable income and, correspondingly, DNI.
- Deductions that exceed taxable income, do not pass out to the beneficiaries and are wasted unless they constitute a net operating loss or capital loss and carryover to the entity's next tax year.
- § 642(h) provides that excess deductions in the year of termination of a trust or estate pass through to the beneficiaries.

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## Compensatory (Equitable) Adjustments

- Trustee Duty of Impartiality.
- Example. An estate that is subject to payment of FET may make a §642(g) election to use estate expenses as an FET deduction under §§2053 and 2054, or to use those expenses (to the extent possible) to reduce estate income taxes. The unavoidable choice is between reducing taxable income that will reduce DNI that should reduce the income tax that income beneficiaries would incur, or reducing FET that would leave more corpus for the remainder beneficiaries.

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## Compensatory (Equitable) Adjustments (continued)

- Trustee Duty of Impartiality.
- Example. Trustee makes a distribution of cash to the income beneficiary. Trustee raised the cash by the sale of stock. Trustee has discretion to treat the capital gain as part of DNI. The unavoidable choice is between increasing DNI that will increase the income tax that the income beneficiary would incur, or excluding the capital gain from DNI that would cause the income tax burden to be borne by the remainder beneficiaries.

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## Illustration involving distributions

The following distributions occur in a year in which DNI is \$200x:

Each of A and B receive Fair Market Value of \$150x

How much DNI will each of A and B receive?

What if the fiduciary makes the §643(e)(3) election?

Asset	FMV	Basis	Recipient	DNI carryout	Built in Gain
Blackacre	\$75x	\$50x	A		
A Corp stock	\$60x	\$10x	A		
Cash	\$15x		A		
Greenacre	\$50x	\$50x	B		
B Corp stock	\$45x	\$30x	B		
C Corp stock	\$15x	\$5x	B		
Cash	\$40x		B		

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## Grantor Trust Rules

- Definitions
- Reversionary Interests
- Power to Revoke
- Power to Direct Beneficial Enjoyment
- Powers Over Beneficial Enjoyment
- Administrative Powers
- 678 Trusts
- Portion Rules

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## Grantor Trust Rules

- §§ 671 – 679 [subpart E] provide an exception to the general rule of § 641 that income of a trust or estate is taxed to the trust or estate, or its beneficiaries.

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## Grantor Trust Rules (continued)

- The grantor trust rules provide that when a trust is treated as a “grantor” trust, that the income, deductions, and credits are reportable on the grantor’s individual income tax return. (§ 671)
- The grantor trust rules (§§ 672 – 677 and 679) identify certain trusts, generally on the basis of the interests or powers retained by or on behalf of the grantor as subject to Subpart E.

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## Definitions – § 672

- “Income” means “taxable income” for purposes of subpart E [the grantor trust rules].
- The term “income” means “fiduciary accounting income” for the balance of Subchapter J.

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## Definitions (continued)

- “adverse party”
- “nonadverse”
- “related or subordinate”

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## Spousal Unity Rule

- § 672 provides that for purposes of subpart E, a grantor shall be treated as holding any power or interest held by—
  - (A) any individual who was the spouse of the grantor at the time of the creation of such power or interest, or
  - (B) any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor.

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## Grantor Trust Ignored for Income Tax Purposes

- The IRS “ignores” a grantor trust for income tax purposes by treating the grantor as the “owner” of the trust assets.
- Rothstein v. United States, involved a grantor’s installment purchase (for a note) of closely-held stock from a irrevocable trust established by the grantor.
- Rev. Rul. 85-13 involved the same facts as Rothstein – a grantor’s installment purchase (for a note) of closely-held stock from a trust.

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## § 673 – Right of Reversion

- § 673 provides that the grantor is treated as the “owner” of any portion of a trust if trust income or principal ultimately reverts to the grantor after a “safe period.”
- “Safe period” is if the actuarial value of the reversion at trust’s creation is less than 5% of the value of the portion.

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## § 676 – Power to Revoke

- § 676(a) provides the general rule that a grantor of a trust is treated as the “owner” of any portion of a trust if the grantor or a nonadverse party, or both, have the power to revest title to that portion in the grantor.
- If the power is held by the the grantor’s spouse, it is attributed to the grantor under the spousal unity rule.

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## § 677 – Income for Benefit of Grantor

- § 677(a) provides the grantor is treated as the “owner” of any portion of a trust whose income, without the approval or consent of any adverse party, **is**, or in the discretion of the grantor or a nonadverse party, or both, **may be** either–
  - (1) distributed to the grantor or the grantor’s spouse, or
  - (2) held or accumulated for future distribution to the grantor or the grantor’s spouse.

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## § 677 – Income for Benefit of Grantor (continued)

- § 677(a)(3) provides that the grantor is treated as the “owner” of any portion of a trust from which income, without the approval or consent of any adverse party, **is**, or in the discretion of the grantor or a nonadverse party, or both, **may be** applied to the payment of premiums upon policies of insurance on the life of the grantor or his spouse.

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## § 674 – Power to Control Beneficial Enjoyment

- § 674(a) provides broadly that the grantor is treated as the “owner” of any portion of a trust if the beneficial enjoyment of the corpus or income is subject to a power of disposition exercisable by the grantor, a nonadverse party, or both, without the approval or consent of any adverse party.
- §§ 674(b), (c), and (d) provide numerous exceptions to the overly broad general rule.

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## § 674(b) – Powers Permitted to Be Held by Anyone

- § 674(b) provides that certain powers may be held by anyone as trustee without creating a grantor trust.
- § 674(b) includes:
  - Power to distribute corpus if limited by standard or charged to share
  - Power to withhold income temporarily
  - Power to withhold income during disability of a beneficiary
  - Power to allocate between corpus and income

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## § 674(c) – Powers of Independent Trustees

- § 674(c) provides an exception to grantor trust status for a power to distribute income or principal without being limited by a standard for invasion—
  - if neither the grantor nor the grantor’s spouse is a trustee, **and**
  - if not more than half of the trustees are related or subordinate parties who are “subservient to the wishes of the grantor.”

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## § 674(d) – Power to Allocate Income Limited by a Standard

- § 674(d) provides an exception to grantor trust status for the power to make or withhold distributions of income held by a trustee, other than the grantor or grantor’s spouse, if the power is limited by a reasonably definite external standard.

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## § 675 – Administrative Powers

- § 675 provides that the grantor is treated as the owner of any portion of a trust over which the grantor has certain administrative powers or controls.
  - (1) Power to deal with trust assets for less than full and adequate consideration
  - (2) Specific power of grantor to borrow trust assets without adequate security or adequate interest
  - (3) Actual borrowing of the trust assets by the grantor
  - (4) Administrative powers

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## Beneficiary Owned Trust § 678

- § 678(a) – a person other than the grantor is treated as the “owner” of any portion of a trust over which the person has the sole power to vest the corpus or the income in the powerholder
  - Crummey Trust
  - Section 2503(c) Trust
  - Creeping 678 Trust
  - Grantor trust rules trump § 678(a) – § 678(b)

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## Portion Rules

- A grantor (or other person) is taxed as the owner of “any portion of a trust” in which he holds a covered power or interest. A grantor who owns only a portion of the trust includes in his tax computation the income, deductions, and credits allocable to the portion of the trust the grantor is deemed to own.
- Any portion of the trust on which the grantor is not taxed as the owner under §§ 671–679 will be taxable under the normal rules of subchapter J (§ 641 et seq.)

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## Portion Rules – Different Portions

- A grantor can own a portion of a trust in any one of six ways:
  - (1) ordinary income portion;
  - (2) principal portion;
  - (3) both the ordinary income portion and principal portion;
  - (4) fractional share of all items of trust income and principal;
  - (5) pecuniary share of all items of trust income and principal; or
  - (6) all items attributable to specific trust assets.

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## Portions

- Entire Trust
- Fraction or Pecuniary Amount

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## Planning with the Grantor Trust Rules

- Uses of Grantor Trusts in Estate Planning
- Toggling Grantor Trust Status
- Grantor's Death—Recognition of Gain
- Basis in assets held in Grantor Trust at Grantor's Death

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## Revenue Rulings

- Rev. Rul. 2004-64 – Gift Tax Consequences of Grantor Paying Income Tax on Trust Income
- Rev. Rul. 2007-13 and Rev. Rul. 2011-28 – Grantor Trusts and Life Insurance
- Rev. Rul. 2008-22 – Estate Tax Inclusion of Grantor Trust in Grantor's Estate

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## Installment Sale to Grantor Trust

- A grantor trust is “disregarded” for income tax purposes.
- If the grantor sells assets to his grantor trust he is treated as selling the assets to himself, and the sale is ignored.
- Result: No gain or loss is recognized and the basis of the asset remains unchanged.

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## Other Uses of Grantor Trusts

- Avoiding 3-year rule for gift of life insurance policy.
- Selling trust assets back to grantor in order to obtain basis step-up at grantor's death.
- Paying rent to a post-QPRT grantor trust.
- Possible avoidance of Net Investment Income Tax if trust owns S corporation stock and grantor materially participates in the business.

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## Other Benefits of Grantor Trusts

- Preserves high basis in loss assets.
- Grantor continues to pay income tax on trust earnings.
- Leverages estate and gift tax exemption.
- Leverages GST tax exemption.

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## toggling Grantor Trust Status

- Is it possible for grantor trust status to be turned off and on?
- § 675(3) borrowing makes a trust a grantor trust.
- Relinquishment of § 675(4)(C) power will turn off grantor trust status. A Trust Protector can be given the authority to reinstate the power to substitute assets.

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## Grantor's Death – Recognition of Gain

- Will the grantor's death give rise to gain recognition?
  - Death is not a recognition event.
  - Chief Counsel Advice 200923024.

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## Grantor's Death – Basis

- Basis of assets held in a grantor trust after grantor's death? Three alternatives:
  - (1) if a bequest or devise, then §1014;
  - (2) if a sale, then § 1012; or
  - (3) if a gift, then § 1015.
- Rev. Proc. 2015-37

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## Divorce Trusts

- § 672(e) [spousal unity rule] provides a grantor is treated as holding any power or interest held by an individual who was the spouse of the grantor at the time of the creation of such power or interest.
- § 682 pre-empts grantor trust income taxation to the grantor.

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