Chapter 5: Trust Taxation

Corrections were made to this workbook through January of 2009. No subsequent modifications were made.

As the population ages and its need for estate planning grows, accountants are increasingly called upon to have a greater knowledge of trusts and their uses. While some accountants may act as fiduciaries, most provide accounting and tax services. The purpose of this chapter is to acquaint practitioners with some of the intricacies of Subchapter J of the Internal Revenue Code that governs the income taxation of trusts and estates.

Note. Although this chapter focuses on the tax law as it applies to trusts, the vast majority of the discussion also applies to estates.

WHAT IS A TRUST?

Trusts are separate legal entities, similar to other legally-created entities such as corporations and partnerships. A trust arises from a contractual agreement created under state laws. Under the typical trust agreement, an individual, usually known as the **grantor,** conveys legal ownership of property to another party, the **trustee.** The trustee has a duty to hold and administer the property for the enjoyment and benefit of a third party known as the **beneficiary.** The property contained within the trust is usually referred to as either the trust **principal** or **corpus.** Because a trust is created under state law, the relationships between the parties to the trust agreement, the validity, construction, and effect of the agreement and its enforcement are determined by the laws of the state in which the trust is domiciled.

The key player in the operation of a trust is the trustee. The terms of the trust instrument set forth the duties of the trustee. The trustee typically manages and administers the trust property (e.g., buys and sells stock, manages rental property), collects the income from the property, and after payment of liabilities, distributes the income and principal of the trust according to the terms of the trust agreement. The trustee serves in a fiduciary capacity, protecting the rights of the beneficiaries and acting in their best interests with respect to the trust's assets and the income they produce. The position of trustee is generally named by the grantor. The trustee may be the grantor, a corporation such as the trust department of a bank, a competent member of the grantor's family, or some party other than the beneficiary. Professional trustees receive an annual fee to compensate them for their services. It is important to understand that the terms of trust agreements often vary regarding a number of critical matters such as the definition of income and when such income as well as corpus is distributed.

Individuals normally transfer assets to a trust in order to protect and conserve the assets for the beneficiary. Trust beneficiaries are often minor children or other family members who are incapable of competently managing the assets. Trusts also have been used to protect assets from risk of a donee's creditors. In addition, trusts are created to protect assets in the case of a failing marriage. Although those who create trusts usually do so for nontax reasons, trusts have also been established — at least in the past — as a means to reduce taxes. However, increases in trust income tax rates have virtually eliminated the income tax motivation for the creation of trusts. Nevertheless, the use of trusts continues to be an important part of planning for estate and gift taxes.

TYPES OF TRUSTS

There are many different types of trusts. Some common trusts are described below.

REVOCABLE VERSUS IRREVOCABLE TRUSTS

A trust may be classified according to whether the trust arrangement can or cannot be altered. If the grantor cannot alter or amend the trust arrangement (e.g., terminate the trust arrangement so as to reacquire the assets, change the beneficiary or any term of the trust), the trust is said to be **irrevocable.** In this case, the grantor has made a permanent transfer that constitutes a completed gift for gift tax purposes. In addition, because there has been an irrevocable transfer, the trust is treated as a separate taxable entity distinct from the grantor and the beneficiaries. The irrevocable trust is generally taxed on any taxable income received. However, the burden of taxation can shift to the beneficiaries to the extent the trust distributes its income.

A trust is **revocable** if the grantor can alter or amend the trust provisions in whole or in part (e.g., terminate the trust and reacquire the property that is in the trust). Revocable trusts are a popular tool used to avoid probate. A transfer of assets to a revocable trust normally does not put the property out of reach of the grantor's creditors. To protect assets from creditors, the trust must not only be irrevocable, it must also meet other requirements.

Transfers to a revocable trust do not result in taxable gifts because there is no completed transfer. Similarly, a revocable trust is not treated as a separate taxable entity because the grantor has never surrendered dominion and control of the assets and effectively still owns the assets. For this reason, the income of a revocable trust is normally taxed to the grantor.

GRANTOR TRUSTS

This designation is reserved for certain trusts that are not treated as separate taxable entities for tax purposes.[1] For example, if a grantor retains beneficial enjoyment of the trust property, can reacquire the trust property, or retains the right to control who will enjoy the property, the trust entity is disregarded for income tax purposes. In this case, the grantor is treated as the owner of the property and is usually taxed on all or a portion of the trust income. Revocable trusts, discussed above, are one type of grantor trust.

SIMPLE AND COMPLEX TRUSTS

These terms have technical meanings for tax purposes. The Code defines a simple trust as one that:

1. Distributes all trust income currently,
2. Does not claim a deduction for charitable contributions for the current year, and
3. Does not make any current distributions out of trust principal.

A complex trust is any trust other than a simple trust. For example, a trust is complex if it can accumulate income or make charitable contributions.

The classification of a trust may vary from year to year. For instance, if a trustee is required to distribute all trust income currently but also has the discretion to make distributions out of trust principal, the trust will be simple in any year in which principal is not distributed. However, it is complex in any year in which principal is distributed. This can be an important distinction since the exemptions for simple and complex trusts differ.

1. IRC §§671–678

SPECIAL NEEDS OR SUPPLEMENTAL NEEDS TRUSTS (QUALIFIED DISABILITY TRUST)

Trusts are frequently used to help provide benefits for individuals with special needs such as a disability or mental illness. The beneficiaries, such as a disabled child, often are incapable of caring for themselves; and planning for their care can be difficult. In these situations, assets can be transferred to a trust where they can be properly managed and used for the benefit of the individual.

A type of trust that is increasingly used is the special needs trust (SNT). The SNT is also referred to as a supplemental needs trust. It is designed to provide benefits to special-needs individuals in such a way that the beneficiary will not lose any governmental benefits that otherwise are available.

Special-needs individuals are entitled to a variety of benefits provided by federal, state, and local governments. One major benefit available is Supplemental Security Income (SSI). SSI makes monthly payments to people with low income and limited resources who are 65 or older, blind, or disabled. Children under age 18 can qualify if they meet Social Security's definition of disability and their income and resources fall within the eligibility limits. The amount of the SSI payment is different from one state to another because some states add to the SSI payment. Effective for 2008, the monthly federal benefit is $637 for individuals and $956 for couples. Many states offer similar benefits, which are usually lower amounts. Other benefits available are Medicare (e.g., long-term and nursing-home care), Medicaid, vocational rehabilitation, and subsidized housing.

Many of the benefits available to special-needs individuals are based upon need and are often subject to restrictions. For example, in order to qualify for SSI, a disabled adult cannot personally hold more than $2,000 in assets, excluding a car and a home. In addition, SSI must be spent on food, clothing, and shelter expenses. This is where SNTs can be extremely beneficial.

In a properly drafted SNT, the assets are not counted for purposes of qualification for certain governmental benefits. For example, an unlimited amount of assets could be held by a SNT. These funds could be provided by life insurance. Additionally, SNT assets can be used to pay for items that cannot be purchased with SSI funds, such as additional care, motorized wheelchairs, vacations, grooming supplies, video games, cable television, Internet access, legal fees, and more. If Medicaid does not pay for certain medical care or treatment, the trust can step in and provide such payments. Typically, SNTs are designed so that none of the assets can be used for food, clothing, shelter, or services provided by government programs. If trust funds are available for such purposes, the benefits could be lost.

Individuals establish SNTs in two ways. The trust can be created by a third party, such as a parent for his disabled child. Alternatively, the SNT can be created by the disabled individual with his own funds. This might occur when there is a recovery from a lawsuit or the disabled individual is a beneficiary of an estate or an insurance policy. The type of SNT affects the tax consequences. An SNT created by a third party is usually treated as a separate taxable entity, but an SNT created by a disabled individual with his own funds is usually a grantor trust.

OTHER TRUSTS

There are many other types of trusts established for special purposes. For example, in the area of estate planning, trusts abound. There are marital deductions trusts such as qualified terminal interest property trusts (QTIPs), general power of appointment trusts, and credit or bypass trusts. There are also irrevocable life insurance trusts (ILITs), grantor-retained annuity trusts (GRATs) and unitrusts (GRUTs), intentionally defective irrevocable trusts (IDITs) and qualified personal residence trusts (QPRTs). For charitable planning, there are charitable remainder annuity trusts (CRATs), charitable remainder unitrusts (CRUTs), and charitable lead trusts. In the divorce area, it is not unusual to find alimony trusts.

TYPES OF BENEFICIARIES

When the grantor creates a trust, she may divide the interests and rights in the property among the beneficiaries in any manner she wishes. Two or more persons may own different interests in the same property. For example, a beneficiary may receive the right to possess or enjoy the property immediately. This is called a **present interest.** Conversely, the beneficiary's rights to the property may be delayed either for a specific period of time or until a certain event occurs. In such case, the beneficiary has a **future interest.**

Ordinarily, the division of the property interests creates two types of beneficiaries. The first type, an **income beneficiary,** is entitled to the trust's income. The second type, a **remainderman,** receives the corpus of the trust. This normally occurs when the interests of all other beneficiaries terminate. However, the remainderman may enjoy the trust property during the existence of the trust if the trust instrument so provides.

CREATION OF TRUSTS AND TAX CONSIDERATIONS

The creation of a trust triggers a number of tax considerations, including income and gift tax.

GIFT TAX

When a grantor establishes a trust, the potential for gift tax exists. The transfer of the property to the trust is considered a gift to the beneficiaries (not to the trust) and a taxable gift may result. Generally, gifts to trusts do not quality for the annual gift tax exclusion ($12,000 in 2008) because gifts to trusts are normally considered a gift of a future interest. An exception exists for a trust with a mandatory income beneficiary. In that situation, using actuarial principles, the income interest can be valued and qualify as a present interest. Any potential gift tax may be offset by the amount of the remaining unified credit. This is currently set to exempt $1 million in taxable gifts during the donor's lifetime. A gift to a trust for the benefit of a grandchild or later generation can result in a generation-skipping transfer tax.

BASIS

The basis of property transferred to a trust during the grantor's lifetime is determined using the basis rules for gifts of property.[2] Normally, the basis of property acquired by gift is the same as the donor's basis — a carryover basis — unless the property's value was less than its basis at the time of transfer (i.e., a built-in loss). In this latter case, the basis of the property depends on the sale price of the property. The basis for gain is the donor's basis while the basis for loss is the property's FMV at the time the gift was made.

The basis for depreciation is usually the donor's basis. In addition, the basis of the gifted property is increased by any suspended passive losses attributable to the property.[3] If the trust is created by the decedent's will, the rules for determining the basis of inherited property apply. Normally the basis of such property is its value at the date of death or alternate valuation date.[4]

The creation of a trust also raises questions concerning recapture of depreciation and certain tax credits. The transfer of property does not trigger recapture.[5] However, the potential recapture carries over to the trust.[6]

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2. IRC §1015
3. IRC §469(j)(6)(A)
4. IRC §1014
5. IRC §§1245(b)(1) and 1250(d)(1)
6. S Rept No. 1881 (PL 87-834), p. 802

TRUST ACCOUNTING

In the future, many accountants will be called upon to not only prepare a trust's income tax return but, just as importantly, to determine a trust's income, including questions such as the following:

- What is trust accounting income?
- How much will the beneficiaries of trust income receive?
- What amount will the remainderman receive?

First and foremost, trust accounting income is **not a tax concept.** All too often, uninformed practitioners assume that taxable income and trust accounting income are the same. Or more likely, they incorrectly assume that trust accounting income is the same as GAAP income. Such assumptions are foolhardy and ill-advised. They are as misguided as believing that taxable income and generally-accepted accounting principles (GAAP) income are equivalent. Trust accounting income is a quantity defined by the trust agreement; if the agreement is silent, the amount is determined under state law. As a practical matter, most trust agreements say little about what constitutes income. For an accountant, this means that a working knowledge of a state's statute defining income is generally necessary.

The principal concern of trust accounting derives from the requirement that a trustee has the fiduciary responsibility to protect the rights of each beneficiary. The laws of most states require the trust to report annually to the beneficiaries. The law views the trustee's accounting as a description of the results of the trustee's decisions and actions relative to the beneficiaries' interests. Beneficiaries and other interested parties review the accounting for the period to examine and evaluate changes in principal and income. Using the annual report, beneficiaries can determine whether they are being fairly treated and if the trustee has properly discharged his duties. It follows that one of the primary concerns of trust accounting is the proper allocation of the receipts and disbursements of the trust among the various competing interests. Historically, rules and laws have existed that neatly categorize certain items as affecting income or principal. More recently, trust instruments give the trustee the power to allocate receipts and disbursements between income and corpus as he believes is appropriate.

Historically, trust agreements have been drafted to distinguish between income and principal. Income beneficiaries receive the income that is produced by the trust assets and the remainder beneficiaries receive the assets upon expiration of the interests of the income beneficiaries. This approach reflects the famous fruit-and-tree analogy where the tree represents the assets and the income they produce is the fruit. The fruit goes to the income beneficiary and the remainderman ultimately gets the tree. Unfortunately, this task is not as easy as it may seem.

To illustrate, consider the following clauses often found in trust instruments:

> *The Trustee shall invest and reinvest the trust corpus, shall collect and receive the income therefrom and, after paying all expenses and cost incident thereto, shall distribute the net income to X, annually or more frequently, for the rest of X's life. Upon X's death, the then corpus of this trust shall be distributed to Y, absolutely and free of all trust, whereupon this trust shall terminate and be of no further force or effect.*

Or the trust instrument may contain the clause:

> *The Trustee shall distribute as much or all of the income to the beneficiary as the Trustee believes appropriate to provide for the beneficiary's support, health, and education and shall periodically add all undistributed income to principal. Upon the beneficiary's death, the Trustee shall distribute all accrued and undistributed income and all principal then comprising the trust to his spouse, if living, otherwise equally among their issue.*

These clauses provide that one group of beneficiaries is entitled to all or a portion of **trust accounting income** while the other group of beneficiaries is entitled to the remainder. Thus, the major job of trust accounting is to ensure that the amount accruing to each of the two classes of beneficiaries is correctly determined. The critical issue is determining what items are allocated to income and what items are allocated to principal. In other words, what is trust accounting income? Trusts often say little or nothing about what constitutes income. Yet, this is a high-stakes question for the trustee. The trustee's major task it is to provide a fair return to the income beneficiary but maintain the principal for the remainderman. Income and remainder beneficiaries may sharply disagree over how an item should be allocated. For instance, if gains on the sale of property are allocated to corpus, what effect does an investment strategy that stresses investment in growth stocks have on an income beneficiary's interest? In any situation, the trustee must be impartial and the accountant may be called upon to help the trustee make the allocation.

Observation. In determining trust accounting income, many trusts do not define income but rather adhere to state law or give the trustee complete discretion to allocate receipts and disbursements. Practitioners must review the trust document to identify how receipts and disbursements should be allocated between income and principal in order to compute trust accounting income.

TRUST ACCOUNTING INCOME

Trust accounting income (TAI) is the amount of income as **determined under the terms of the trust agreement.** In some situations, the trust instrument loosely defines income. In others, the grantor allows the trustee complete discretion in allocating receipts and disbursements between income and principal. More often that not, the trust agreement is silent regarding the treatment of a particular type of receipt or disbursement. In these situations, the treatment is determined in accordance with state law. The default to state law is useful for the trustee because it provides both guidance and protection. For the accountant, it provides a roadmap on the calculation of TAI when the trust instrument is silent. For this purpose, most states (43 at last count) have adopted the **Uniform Principal and Income Act (UPIA).** The bulk of the 74 pages of the Act (as amended in 2000) concerns allocation of receipts and disbursements.

Note. To review a particular state's act, see the website on uniform laws maintained by the Uniform Laws Commission at **www.nccusl.org/update**. Comments are appended to each section of the statute, providing useful explanation and insight as to the intent of the law.

The UPIA was created in 1931 to deal with the difficult problems of adjustment of principal and income between tenants and remaindermen in trust and other estates in property. It was prepared in response to considerable demand for legislation, primarily from trustees who were troubled about discharging their fiduciary duties, faced as they were by an ever-increasing number of difficult and technical problems which arose in deciding principal and income issues and the conflicting opinions of the courts on such issues.

The Uniform Commission made major revisions to the UPIA in 1962 and again in 1997. One of the critical changes made in 1997 stemmed from the creation of the Uniform Prudent Investor Act in 1994. This Act revamped the rules governing the actions of trustees. The Prudent Investor Act recognized that the historic view of income and principal (i.e., the fruit-of-the-tree doctrine) had become obsolete. Such a view was inconsistent with modern portfolio theory. That theory attempts to maximize the total return from trust assets, regardless of whether the gain is classified for trust accounting purposes as income or principal. In other words, modern investment theory views income from a portfolio of trust assets to include not only traditional income from the assets (e.g., dividends, interest, and rents) but also growth of the assets, or more precisely, capital appreciation. Not only was the old view of income out of step with current practices, the old view of income had become inequitable. It was reported that over the last 25 years the income yield from stocks and bonds dropped precipitously as the investment strategy shifted toward capital appreciation. The drop may have been as much as 70%, a cruel blow to income beneficiaries. The authors of the Prudent Investor Act understood the difficulty and revised the law to reflect current investment strategies. The Prudent Investor Act now gives trustees the tools they need to implement modern investment techniques, and at the same time, comply with prudent investment standards.

> **Caution.** There has been an increase in litigation against trustees for breach of fiduciary duty when the value of trust assets underperforms the beneficiary's expectations. These claims are often based on breach of duty to diversify investments or duty of impartiality to beneficiaries in the trust investment mix (fixed income as opposed to equity).

The 1997 revisions in the UPIA reflect the new approach to investing. Now trustees electing to implement modern investment methods or use total return trusts — sometimes referred to as total return **unitrusts,** or TRUs — generally may do so with immunity. To ensure that trustees may treat all beneficiaries fairly, most states now give a trustee a unilateral administrative power to adjust. If certain conditions are met, this power allows the trustee to pay an item of principal to an income beneficiary, or withhold an item of income and add it to trust principal.[7] Trustees now have great latitude in determining how amounts are allocated and what is ultimately included in TAI. Obviously, this is a mixed blessing for most trustees, particularly when the return on trust assets does not fit neatly and fairly into the well-defined categories of TAI. In this regard, the standards instruct a trustee who has doubts about any allocation to resolve it in favor of principal.

Although the UPIA was adopted by most states, some states expanded or redefined various parts. Moreover, depending on the jurisdiction, the rules may or may not apply to estates. Consequently, it is critical to review the trust agreement to determine the situs of the trust and, therefore, the state laws that apply.

Uniform Fiduciary Accounting Principles

The National Fiduciary Accounting Standards were created in a 1984 report by the Committee on National Fiduciary Accounting Standards. The report was a joint effort of the American Bar Association, American Bankers Association, American College of Trust and Estate Counsel, and AICPA, among other groups. The National Fiduciary Accounting Standards includes six broad principles, with a detailed explanation and a sample report. However, users should be forewarned that the sample report was developed years ago, with input from trust officers in many states, and therefore it may be different from the form required by any particular state.

Purpose of TAI

As emphasized earlier, TAI is not a tax concept and is not computed using any rules prescribed by the Code. In this regard, IRC §643(b) makes it clear that whenever Subchapter J refers to income and it is not modified by such terms as taxable, gross, distributable net, or undistributed net, the reference is to trust accounting income.[8] The effect is that tax law definitions of income reflect changes made in state laws.

> **Example 1.** Under the terms of Garfield's will, a trust was created for his 65-year-old son, Sonny, and his 35-year-old grandson, Buddy. According to the agreement, Sonny receives the income from the trust annually. Upon Sonny's death, Buddy receives the remainder. One of the assets held in the trust is a vacant lot. If the lot is sold for its book value, there is no effect. In this case, one asset has simply been exchanged for another. On the other hand, if the lot sells for more than its book value, a gain is recognized and it must be allocated to either income or principal. Sonny benefits if the gain is allocated to income. Buddy benefits if the gain is allocated to corpus. To determine how the gain should be allocated, reference is made to the trust instrument. If the trust instrument is silent, state law governs.

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7. UPIA §104
8. See the many references to income in IRC §§651, 652, 661, and 662.

Another caveat when computing TAI is warranted. Generally accepted accounting principles (GAAP) do not necessarily govern the determination of TAI. Similarly, it is not clear whether the National Fiduciary Standards have gained acceptance. What is clear is that the trust instrument and state law ultimately control. It should be noted, however, that the UPIA does rely on financial accounting principles in those cases in which the trustee holds and operates a business of which the grantor was a sole proprietor or a partner. It provides:

> *...the net profits of the business computed in accordance with generally accepted accounting principles for a comparable business are income. If a loss results in any fiscal or calendar year, the loss falls on principal and shall not be carried into any other fiscal or calendar year for purposes of calculating net income.*[9]

Definition of Trust Accounting Income

TAI is the amount — stated in terms of money or its equivalent — that is available for either current or future distribution to the income beneficiaries. It is an all-cash concept: gross receipts less disbursements (i.e., net receipts). Nothing is accrued. Even depreciation is a cash concept, as explained later.

Calculating TAI

The first step in computing TAI is to read and understand the trust agreement, as there are no GAAP or standard rules for calculating TAI. TAI is defined in the trust instrument and, if the instrument is silent, state law controls. Practitioners must be sure that the computation of accounting income complies with the trust agreement and state statutes as well as court decisions and interpretations that construe these statutes. Normally, the provisions of the trust agreement control even if a state's laws provide for a different treatment. Section 103 of the UPIA provides that the grantor can give the trustee complete discretion in allocating receipts and disbursements between income and principal and such power controls even if it is contrary to state laws.

Trust Situs. Determining which state law applies is critical. Most trust agreements specify the state laws to follow. However, in any particular case, situs may not be obvious. For example, if the grantor creates a trust in one state, names a trustee in another state, and identifies beneficiaries in several states, there may be questions regarding situs. Similarly, if the trust is created in one state but the grantor moves to another state, there may be questions. Moreover, the type of property may have some bearing on trust situs. In some states, real estate owned within that state might determine situs.

> **Note.** Situs of a trust should not be used to determine whether state income tax returns should be filed in a particular state.

TYPICAL INCOME ITEMS

Although TAI is whatever the trust instrument (or trustee) says it is, under most state laws (and trust agreements) certain items are normally allocated to income while others are usually allocated to corpus. Typical items allocated to income include:[10]

- Interest income,
- Dividend income,
- Net rental income from real or personal property,
- Net profits from operation of a trade or business (losses are usually charged to corpus),
- All or a portion of trustee commissions, and
- Depreciation.

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9. UPIA §8

10. See Revised UPIA 1997 as amended IRC §§401–415 and IRC §§501–506.

Depreciation

Depreciation (as well as depletion and amortization) can be a bit confusing for trusts. The first issue concerns the basic concept of depreciation. Ordinarily, depreciation is considered by most accountants as a noncash expenditure. However, in the trust arena, depreciation involves the movement of cash. Once the amount of depreciation is determined, it is charged against income and credited to principal. A **reserve for depreciation** is created. The effect is to reduce the amount of cash paid to the income beneficiary and set aside the amount in principal so that resources are available to the remainderman for later use.

The second issue concerns whether a reserve for depreciation is created. The trust instrument may or may not require a reserve for depreciation. Similarly, state law may or may not require a depreciation reserve. For states adhering to UPIA, the trustee is given full discretion as to whether a depreciation reserve is created.

Finally, if a reserve for depreciation is called for, what is the amount? Depreciation methods for trust accounting purposes may differ substantially from those used for financial or tax accounting. For instance, the trust agreement may require a special computation. It may define depreciation as an amount equal to 10% of gross rents or 15% of net rents, whichever is larger. It may call for depreciation equal to the amount normally computed using GAAP. Or, it might provide that trust depreciation is exactly equal to tax depreciation. Regardless of the amount of depreciation computed for trust accounting purposes, the trust computes and deducts tax depreciation in the usual manner.

Income Taxes

Taxes imposed on receipts allocated to income are usually charged against income. Under this view, state income taxes are allocated to income. Similarly, if a tax is imposed on a gain from the sale of property and such gain is allocated to principal, the related tax should also be allocated to principal (notwithstanding characterization of the tax as an income tax by the taxing authority).

Property Taxes

Although property taxes are levied on trust assets, they are paid from trust income and allocated to income.

Ordinary Expenses

Ordinary expenses incurred in the administration, management, or preservation of the trust property are charged against income.

Passive Losses and Miscellaneous Itemized Deductions

Because TAI is not a tax concept, special rules such as those for passive losses or miscellaneous itemized deductions are not taken into account in computing TAI (although they do apply in computing taxable income).

Premiums and Discounts

Premiums and discounts are not taken into account in computing TAI.

Income from Entities

Under the UPIA, the income derived from an ownership interest in an entity is the amount of cash received. The UPIA provides that distributions of cash from an entity generally are allocated to trust income. The entity's taxable income and GAAP income are irrelevant. This rule applies to distributions from corporations, partnerships, LLCs, regulated investment companies (i.e., RICs or mutual funds), and real estate investment trusts (REITs). For purposes of this rule, there is no distinction made between a C and S corporation.

> **Note.** Under the Act, the amount of trust income derived from partnerships and S corporations is not the amount of income that flows through or that is allocated to the owners. It is solely the amount of the cash distributed. A Schedule K-1 from a partnership or S corporation that reports taxable income to the trust is irrelevant except to the extent that it reports distributions.

While the amount of income from an entity is typically the amount of cash received from the entity, there are several exceptions[11] when cash received is allocated to principal. These include:

- Cash received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity
- Cash received in total or partial liquidation of the entity
- Cash received from a mutual fund or REIT that is a capital gain dividend for federal income tax purposes. Nontaxable distributions from these entities are allocable to income.
- Distributions of property by an entity.

Note. Reinvested dividends are allocated to principal.

CORPUS ITEMS

The following items are normally allocated to corpus:

- Consideration received on the sale or exchange of trust property, not merely net gain or loss
- Taxes on gains and profits allocated to the principal
- Casualty losses
- Stock dividends
- Insurance proceeds on property forming a part of the principal
- Extraordinary dividends (e.g., corporate dividends funded from the sale of a major operation)
- Expenses incurred to prepare property for rent or sale such as extraordinary repairs
- Repayments of loans
- If income is accumulated in the trust, a portion of the trust's tax liability is attributed to the accumulated income, and such tax is allocated to accumulated income
- All or a portion of trustee commissions

TOTAL RETURN TRUSTS AND POWER TO ADJUST

As described previously, if the trust adopts the total return investment strategy, the trustee has the power to adjust the normal allocation of receipts and disbursements. Once the allocations are made under the trust instrument and state law, the trustee can shift income to corpus and corpus to income. Obviously, this could lead to disputes between beneficiaries and the trustee. To prevent such controversies, some states have adopted a TRU approach to defining income. According to this method, the trust instrument specifies a fixed percentage of the value of the trust's assets (revalued annually) as accounting income. In that way, regardless of how the assets are invested, the income beneficiaries receive the same percentage of the value of the trust's assets each year as income. If the TRU approach is used, the trust agreement should identify the composition of the distributions. For example, the document should state that any income distribution is considered to come first from traditional income sources (e.g., dividends, interest) and then from corpus (e.g., capital gains — short-term, then long-term).

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11. UPIA §401(c)

For income tax purposes, final regulations effective January 2, 2004,[12] revised the definition of TAI to make it consistent with the total return concept. According to the regulations, an allocation of amounts between income and corpus pursuant to state law is respected if state law provides for a reasonable apportionment between income and remainder beneficiaries of the total return of the trust for the year. For this purpose, the total return includes not only ordinary taxable and tax-exempt income, but also capital gains and unrealized appreciation. For example, the reasonable-apportionment test is met by a state statute that permits the trustee to make adjustments between income and corpus to fulfill a trustee's duty of impartiality between the income and remainder beneficiaries. However, the regulations warn that "trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized." For example, if a trust provides that all trust income be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered to require that all its income be currently distributed for purposes of the correct personal exemption amount[13] or the amount of the distribution deduction.[14] The effect of the new regulations is to give trustees great discretion in the allocation of receipts and disbursements.

Note. The facts in **Example 2** are part of a comprehensive example to illustrate the computation of trust accounting income, the deduction for distributions, taxable income of the trust, taxable income, and its character to the beneficiaries.[15]

Example 2. On March 7, 1995, Grant Tor established a trust for his son Benny Tor. Grant is the trustee. According to the terms of the trust instrument, an annual reserve for depreciation of $5,000 must be maintained, and both capital gains and 50% of the trustee's commission must be allocated to the principal account. Given the following facts, **what is trust accounting income for the year?**

Rental income	$100,000
Tax-exempt income	10,000
Dividends	15,000
Long-term capital gain	50,000
Rent expense	10,000
Reserve for depreciation and tax depreciation	5,000
Trustee commission	8,000

Trust accounting income is computed as follows:

Rental income	$100,000
Tax-exempt income	10,000
Dividends	15,000
Gross income	$125,000
Rent expense	(10,000)
Reserve for depreciation	(5,000)
Trustee commission (50% × $8,000)	(4,000)
Trust accounting income (TAI)	$106,000

Note. In computing TAI, the capital gain is not included because it is allocated to corpus. Similarly, only 50% of the trustee commission is charged to trust income, with the remaining 50% charged to corpus.

12. Treas. Reg. §1.643(b)-1

13. IRC §642(b)

14. IRC §651

15. See Examples 2 (TAI), 17 (trust taxable income before distributions), 19 (DNI, distribution deduction, final trust taxable income), and 24 (beneficiary taxable income and character) in this chapter.

UNDERSTANDING THE INCOME TAXATION OF TRUSTS

The basic issues in the income taxation of trusts are:

1. What items should be taxed?
2. Who should be taxed on such items?
3. How and when should they be taxed?

Resolution of these questions can be traced to the treatment given to gifts and bequests and the income they produce.

When property is transferred to a trust as part of its creation, the first issue arises. Is the trust or its beneficiaries taxed upon its receipt of the property? The law adopts the longstanding rule of IRC §102 concerning gifts and bequests. IRC §102(a) provides that a gift or devise should not be taxed. Therefore, the transfer of property to the trust produces no income tax upon creation of the trust. The same treatment holds when the property is ultimately distributed to the beneficiaries.

The second and more controversial issue is whether the income from the gifted or devised property should also be protected from income taxation. In *Irwin v. Gavit*,[16] the Supreme Court refuted the taxpayer's ingenious argument that the income simply represented part of the initial gift — in other words, it was part of the gift that keeps on giving. According to the Court, the income from the gifted property was distinct from the property itself and therefore fully taxable. Shortly thereafter, IRC §102(b) was added to the Code, making it clear that the income from the gifted or devised property should be taxed.

Consequently, when property is transferred to a trust held for a beneficiary, the gift or devise received by the trust is not taxable income to either the trust or the beneficiary. When it is later distributed, it is also nontaxable. However, the income from the property is taxable. The problem in applying these principles is determining whether a distribution to a beneficiary represents the gifted or devised property, or the income derived from it. As a general rule, Subchapter J adopts the approach that distributions from a trust are nontaxable if the amount of money or the specific identity of the property is ascertainable under the terms of the trust instrument as of the inception of the trust.[17] Otherwise, the distribution represents income. This distinction is critical since the receipt of the gifted or devised property is nontaxable, whereas the receipt of income is normally taxable.

The remaining issue is how the trust's income is taxed. The methods for taxing individuals, corporations, and partnerships were considered but not adopted. Instead, a modified approach was developed, and the rules became part of Subchapter J. The major objective of Subchapter J is not determining the amount of taxable income. In fact, the computation of a trust's taxable income is computed in the same manner as that of an individual, with a few differences. The primary concern of Subchapter J is the identification of the party who reports the taxable income — the trust or the beneficiary. In short, how is trust-taxable income allocated between the parties?

The basic principle underlying the design of trust income taxation is that the trust's taxable income should be taxed once. This is accomplished by treating the trust as a separate taxable entity. Amounts of taxable income received by the trust are generally taxed to the entity. This ensures that any taxable income received is taxed currently. However, the tax burden is shifted to the beneficiary to the extent that the trust distributes the income. This shifting is accomplished mechanically by granting a deduction to the trust for any distributions of taxable income. Such distributions are then included in the gross income of the beneficiary. In effect, the deduction is simply the mechanism used to allocate the income between the trust and the beneficiary. The treatment is very similar to that of a corporation that pays a salary to its owners and deducts the distribution in computing its taxable income. In such case, there is only one tax on the income. While this approach resembles corporate taxation, the taxation of trusts also borrows from partnership taxation. Like a partnership, the trust serves as a conduit in that the income distributed to the beneficiaries retains its character. Therefore, the treatment of a trust's taxable income can vary from year to year depending on whether the trust makes distributions.

16. *Irwin v. Gavit,* 268 U.S. 161 (1925)

17. IRC §663

Example 3. In 2008, Farley established a trust for his son, Arnold, by transferring a $100,000 bond that paid taxable interest annually at 10%. This year the trust receives $10,000 of interest income, which must be taxed. The trust distributes $4,000 to Arnold. The law allocates $4,000 of income to Arnold because the trust distributed $4,000. Arnold includes $4,000 in his taxable income and the trust reports the remaining taxable income of $6,000 ($10,000 interest income less a deduction for the $4,000 distribution). The $10,000 of income is taxed only once: $6,000 to the trust and $4,000 to the beneficiary. For reporting purposes, the trust files a Form 1041, *U.S. Income Tax Return for Estates and Trusts*, showing $6,000 of trust taxable income. The trust reports $4,000 on Arnold's Schedule K-1.

A critical presumption in trust income taxation is that all distributions normally represent current trust income to the extent thereof. Distributions in excess of current trust income ordinarily are treated first as distributions of previously-taxed income (i.e., accumulated income) and then distributions of the trust property (corpus). Normally these excess distributions are nontaxable to the beneficiary. Distributions of the trust property are tax-free. The beneficiary is simply receiving the gifted or inherited property, which would have been nontaxable had the property been received directly. Distributions of the previously-taxed income are tax-free because the income has already been subject to tax at the trust level.

While the basic pattern used to tax the income of fiduciaries is reasonably straightforward, it is difficult to see these concepts at work in the Code. In trying to decipher the statutory framework of IRC §§651 and 661, there are two basic principles at work:

1. Total taxable income of the trust must be identified and taxed only once.
2. The total taxable income is taxed to either the trust or beneficiary, but not to both.

Observation. The sum of the trust's taxable income and the beneficiary's taxable income must equal the total taxable income (before consideration of exemptions for each taxpayer). Whatever amount is deductible by the trust for distributions is taxable income to the beneficiary (i.e., the amount of the deduction should be the same as total taxable income reported to the beneficiary on the Schedule K-1).

Consistent with the design of Subchapter J, the computation of taxable income of the trust and beneficiary involves two basic steps:

1. Identify total income that is subject to tax.
2. Allocate total taxable income between the trust and the beneficiaries based on the amount of distributions, using the distribution deduction.

The allocation of taxable income is tied to distributions, which in turn depends on the amount of income and other amounts paid to beneficiaries. For this reason, the calculation of trust accounting income and how much is distributed are critical variables in the calculation of the distribution deduction. Unfortunately, the final taxable income left to the trust is not simply taxable income less the amount distributed. The law complicates the calculation by assuming that the distribution consists of a representative share of the various types of income, including tax-exempt income. For this reason, a special concept is used. Distributable net income (DNI) is computed and used to measure the amount of taxable income in the distribution. Each of these steps is discussed below.

GRANTOR TRUSTS

Special rules apply to income taxation of a grantor trust. As explained later, grantors who directly or indirectly control trusts — they retain too many strings on the transferred property — are treated as owning all or a portion of the trust. As deemed owners of the property, the income of that portion of the trust is taxed to the grantor rather than the trust.

COMPUTATION OF TRUST TAXABLE INCOME (BEFORE DISTRIBUTIONS)

The first step in determining the taxable income of both the trust and the beneficiaries is identifying the stream of income that must be taxed. This amount represents the amount of taxable income that is taxed to either the trust or the beneficiaries, but not to both. There is no double taxation as with C corporations. Once total taxable income is determined, it is allocated between the trust and the beneficiaries based on distributions made during the year.

Under IRC §641(b), the taxable income of a trust is computed in the same manner as an individual with only a few modifications identified in IRC §§641–644. As a result, all basic principles applicable in calculating an individual's taxable income are applied in calculating trust taxable income. These principles and modifications are discussed below.

FILING REQUIREMENTS — GENERAL

IRC §6012 requires trusts to file returns under the following circumstances:

1. The trust has **gross income** for the year of at least $600.

> **Note.** Many trusts will not have taxable income because it is all distributed. Nevertheless, if it has at least $600 of gross income it must file a tax return, regardless of its taxable income.

2. The trust has any taxable income for the year.
3. The trust has a beneficiary that is a nonresident.

Taxable Year

The taxable year of a trust must be the **calendar year.**[18]

Due Date of the Return

Like individual taxpayers, the return for a trust is due by the fifteenth day of the fourth month after the close of the taxable year.[19] Extensions are available. Since all trusts must use the calendar year, trust returns are due on April 15, except perhaps in the year of termination. If a trust is terminated (e.g., all the assets are distributed to the beneficiaries), the tax year ends and the return is due by the fifteenth day of the fourth month following the close of the short taxable year.

FILING REQUIREMENTS FOR REVOCABLE GRANTOR TRUSTS

The filing requirements for **revocable grantor trusts** are different from nongrantor trusts. Normally, a grantor trust files a separate statement attached to a blank Form 1041. Treas. Reg. §1.671-4(b) modifies this filing requirement. A grantor trust does not need to file any Form 1041 or obtain a tax identification number if it is:

1. A domestic trust;
2. Owned entirely by the grantor, or the grantor and the grantor's spouse, as with a revocable living trust; and
3. The grantor, the grantor's spouse, or both are trustees or co-trustees.

For such grantor trusts, the grantor reports all the trust income, deductions and credits on the grantor's Form 1040. Consequently, the due date for reporting the trust's items is the same as that of the individual grantor.

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18. IRC §644

19. IRC §§6091(b)(1) and 6072(a)

Even if the grantor or the grantor's spouse is not the trustee or co-trustee of the trust, the individual grantor is able to report all trust income, deductions and credits directly on the individual grantor's income tax return if the requirements of Treas. Reg. §1.671-4(b) are satisfied. There are two alternatives available.

Alternative 1. The trustee gives each payor the **grantor's** name, TIN, and address. In addition, the trustee must:

- Get a Form W-9 from the grantor
- Give Forms 1099 to the grantor
- Give the grantor a statement:
    - Showing all items of income, deductions, and credits of the trust for the taxable year
    - Identifying the payor of each item
    - Providing the grantor with information needed to determine his tax liability
    - Informing the grantor that he is treated as the owner of the items of income, deductions, and credits of the trust and other information and must take the items into account.[20]

Alternative 2. The trustee gives each payor the **trust's** name, TIN, and address. In addition, the trustee:

- After receiving Forms 1099 from the payors, files Forms 1099 with the IRS showing the grantor as the payor and the grantee as the payee.
    - Income must be aggregated by type
    - Each item of gross proceeds is reported separately
- Gives a statement:
    - Showing all trust items of income, deductions and credit
    - Giving the grantor the information needed to determine the grantor's tax liability
    - Informing the grantor that he is treated as the owner of all the items of income, deductions and credits of the trust and must take the items into account.[21]

ESTIMATED TAXES

Like all taxable entities, trusts may be required to make estimated tax payments. Trusts avoid possible penalties and interest for failing to pay estimated taxes by adhering to the same rules as individuals, with certain exceptions.[22] However, trusts created at death can pay estimated taxes using estate tax rules or trust rules. Estates are required to make estimated tax payments for any tax year ending two or more years after the date of the decedent's death. This rule may enable a trust to postpone the start date for paying estimated taxes.

A special rule enables a trust that made estimated tax payments unnecessarily during the year to treat such payments as if they were made by its beneficiaries. Using Form 1041-T, *Allocation of Estimated Tax Payments to Beneficiaries*, the trustee makes the election to treat all or a portion of the estimated payment in excess of its liability as being distributed to the beneficiary who is deemed to have made the payment.[23]

20. Treas. Reg. §1.671-4(b)(2)(i)(A)
21. Treas. Reg. §1.671-4(b)(2)(i)(B)
22. IRC §6654(l)(2)(B)
23. IRC §643(g)

If the election is made, a beneficiary is treated as having received a distribution on the last day of his taxable year equal to the taxes deemed paid by the trust. This deemed distribution is taxable under the general rules. For estimated tax purposes, the beneficiary is considered as having used the distribution to make an estimated tax payment on January 15 of the following year. This provision applies only if a proper election is filed on or before the 65th day after the close of the trust's taxable year. Making the election can be quite beneficial because it can:

- Reduce the amount of income taxed to the trust, and
- Help the beneficiary avoid underpayment penalties.

Example 4. During 20x1, a complex trust made estimated tax payments of $300. After the close of the taxable year, the trust determined that it received only $1,000 of dividend income and distributed $400. In such case, the trust's tax liability is only $75, as determined below. As a result, it could elect to treat the $225 overpayment in taxes as paid by the beneficiary by filing Form 1041-T within 65 days after the close of the taxable year. Alternatively, it could determine the amount of distribution that would result in no trust overpayment.

	Payment Allocated All to Trust	Overpayment Allocated to Beneficiaries
Dividend income	$1,000	$1,000
Distribution deduction		
Distributions during the year	(400)	(400)
IRC §643(g) election amount		(225)
Exemption	(100)	(100)
Taxable income	500	275
Estimated tax payments	300	75
Actual tax at 15%	(75)	(41)
Overpayment	225	34

The trustee makes the election using Form 1041-T, which must be filed on or before the 65th day after the close of the trust's taxable year, or March 7.

TAX RATES

Since 1986, trusts have had their own unique tax rate schedule.[24] The tax rates are adjusted annually for inflation. Trust and estate tax rates for taxable years beginning in 2008 are:[25]

Estates and trusts, if line 6 of the Estimated Tax Worksheet above is:			
Over:	**But Not Over:**	**The Tax Is:**	**Of the Amount Over:**
$ 0	$ 2,200	15%	$ 0
2,200	5,150	$ 330.00 + 25%	2,200
5,150	7,850	1,067.50 + 28%	5,150
7,850	10,700	1,823.50 + 33%	7,850
10,700	—	2,764.00 + 35%	10,700

24. IRC §1(e)

25. 2008 Form 1041-ES, *Estimated Income Tax for Estates and Trusts,* p. 3

As is evident from the schedule, the tax rates for trusts are highly compressed. There is no 10% tax bracket for trusts. More importantly, the trust tax rates reach the top rate of 35% at $10,701 as compared to $357,700 for single or joint filers. This compression has severely limited the potential for shifting income to trusts in order to minimize taxes. In fact, the progression of the trust rates is so steep that trustees must consider distributing the trust's income to lower bracket beneficiaries rather than accumulating it. This is true even if the income is subject to the kiddie tax since the parents' rate may be lower than the trust rate. Interestingly, the effect of the rate structure may defeat the whole purpose for which the trust was created (i.e., preservation of income and assets). However, the favorable tax rates for dividends and long-term capital gains (i.e., 15%) that apply to individual taxpayers also apply to trusts. While investment in stocks that produce dividends is generally preferred from a tax perspective over investments that produce interest, this is particularly true for trusts in light of the tax rate compression.

MULTIPLE TRUSTS AND INCOME SHIFTING

Because of the highly compressed rates, grantors may be inclined to use multiple trusts to keep income in the lowest possible brackets. The regulations defeat this scheme by providing that two or more trusts are treated as one trust if they have the same grantor and the same beneficiaries, and are created for tax avoidance purposes.[26]

TAX FORMULA

IRC §641(b) provides that a trust's taxable income is computed in the same manner as an individual's taxable income but modified by IRC §§641–644. The definition of taxable income for a trust — gross income minus deductions — is similar, but not identical to that for an individual.

Income from all sources
– Exclusions

Gross income
– Deductions for adjusted gross income
  Charitable contributions
  Deductions for distributions
  Certain other expenses (IRC §67(b))

Adjusted gross income (AGI is not shown on the return)
– Miscellaneous deductions
– Casualty losses
– Other deductions (taxes, interest, trustee commissions, attorney fees, etc.)
– Exemption

Taxable income

While the formula suggests otherwise, trusts generally are not required to distinguish between deductions for and from AGI.[27] Trusts are not granted a standard deduction, and any deductible items are simply subtracted from gross income to arrive at taxable income. In fact, AGI — a familiar quantity on individual returns — cannot be found on Form 1041. Nevertheless, the limitations based on AGI that apply to miscellaneous itemized deductions and personal casualty and theft losses (e.g., the 2% and 10% floors) apply to trusts. For this reason, the Code identifies the deductions considered for AGI. The reduction in itemized deductions does not apply to trusts.[28] The interplay of these rules produces the formula above, but it never appears in such form on the tax return.

Various items of trust taxable income are described on the following pages.

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26. Treas. Reg. §1.641(a)-0(c)

27. Form 1041, *U.S. Income Tax Return for Estates and Trusts*

28. IRC §68(e)

EXEMPTION DEDUCTION[29]

Trusts are allowed a personal exemption in computing taxable income.[30] The phaseout rules that apply to individuals do not apply. The exemption amount for trusts is dependent upon the type of trust. A trust that is required to distribute all its income currently (simple trusts) is allowed an exemption of $300 per year. All other trusts (complex trusts) are allowed an exemption of $100 per year. A trust is not allowed an exemption on the final return since all the trust's income is distributed.

> **Observation.** For simple trusts, it is not unusual for tax software to produce a negative taxable income of $300, representing the exemption deduction. This amount does not create a net operating loss deduction. Unless a simple trust has income allocated to corpus, such as gains from the sales of property (i.e., capital gains), the exemption is normally wasted.

GROSS INCOME OF A TRUST

Gross income for a trust is determined in the same manner as gross income of an individual. It typically includes dividends; interest; rents; royalties; income from partnerships, S corporations, and other trusts or estates; gains from sale or exchange of property (capital gains); and income of a trade or business. In determining whether a receipt is gross income to the trust, reference should be made to what would happen if the same item were received by an individual. If the item would be taxable to an individual, then it would be taxable to the trust. If it would be tax-exempt to an individual, it would be tax-exempt to the trust. If the trust participates in a like-kind exchange, amounts received are nontaxable if they would have been nontaxable in the hands of an individual.

INCOME IN RESPECT OF A DECEDENT (IRD)

IRD is generally the income of a cash-basis taxpayer that accrued as of the date of death.[31] Examples include earned but unpaid salary, accrued interest, accrued rent, and dividends if the record date was prior to death. None of this accrued income is reported on the decedent's final Form 1040 since the decedent normally is a cash-basis taxpayer and did not receive the income prior to death. Under IRC §691, this accrued income retains the same basis and character as it had in the hands of the decedent. It is reported by the recipient, normally the estate, a trust, or an heir. If the trust receives the income, it reports it as if the decedent had received it. Just as important, if the IRD was subject to federal estate taxes, the trust (or other recipient) normally is entitled to a deduction for such taxes.[32] Special rules also exist concerning social security and Medicare taxes related to wages paid after an individual's death.

PROPERTY TRANSACTIONS: CAPITAL GAINS AND LOSSES

The rules governing property transactions for individuals also apply to a trust. The trust computes its net capital gain or loss in the normal fashion. Net short-term capital gains are taxed as ordinary income. Net long-term capital gains are taxed at the 15% rate. In 2008, capital gains are taxed at the 0% rate if the trust is in the 15% bracket. A net capital loss can be used to offset up to $3,000 of other income and carried over until it is exhausted. Capital losses are not passed through to a beneficiary. They are deductible only on the trust return. If the trust terminates, the losses are generally passed to the beneficiaries as discussed on the following page.[33]

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29. IRC §642(b)

30. Ibid

31. IRC §691

32. IRC §691(c)

33. IRC §642(h)

DISTRIBUTIONS OF PROPERTY

A trust normally does not recognize gain or loss on the distribution of property. However, §643(e) allows the trust to elect to recognize gain on certain discretionary or mandatory distributions of property to second-tier beneficiaries. The effects of distributions of property by trusts are discussed in conjunction with the distribution deduction below.

TRANSACTIONS BETWEEN RELATED PARTIES

IRC §267 imposes a limitation on losses resulting from sales between related parties. These rules extend to trusts. Losses on sales between related parties are not deductible. Any loss not recognized by the seller may be used by the buyer to offset any gain recognized on a subsequent sale. If the seller sells the property at a loss, the realized loss will never be recognized.

The loss limitation is triggered only if there is a transaction between related parties. Definitions of related parties in the context of trusts include:

1. Grantor and trust,
2. One trust and another trust if the same person is a grantor of both trusts,
3. A trust and a beneficiary of that trust,
4. A trust and a beneficiary of another trust if the same person is a grantor of both trusts, and
5. A trust and any corporation in which the trust or any grantor of the trust owns directly or indirectly more than 50% of the value of the outstanding stock.

IRC §267 has its own set of constructive ownership rules that must be considered when determining whether a person is a related party.

DEDUCTIONS ALLOWED

Trusts generally deduct the same type of expenses that individuals deduct. Similarly, if such deductions are limited for individuals, they are probably limited for trusts as well. To determine whether a particular item is deductible, the various code sections granting the deduction to individuals and those limiting such deductions must be considered. For example, the deduction for investment interest expense is generally allowed by IRC §163(a). However, it is limited to net investment income under IRC §163(d). This rule applies to both individuals and trusts.

As with individuals, the broadest authority for deductions can be found in IRC §§162 and 212:

1. If a trust engages in a trade or business — a somewhat rare occurrence — it may deduct all the ordinary and necessary expenses paid or incurred in carrying on such trade or business.[34] The various limitations apply, such as IRC §274, which relates to meals and entertainment. This assumes that the trust does not so closely resemble a corporation that it might be taxed as a corporation.
2. The more common deductions for trusts are those governed by IRC §212, expenses incurred in connection with production or collection of income, as well as those for management, conservation, or maintenance of property. According to the regulations, amounts paid for administration expenses, including trustee fees, are deductible notwithstanding the fact that the trust is not necessarily a profit-seeking activity.[35]
3. Trusts may also deduct expenses in connection with the determination, collection, or refund of any tax, such as tax preparation expenses.[36]

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34. IRC §162
35. Treas. Reg. §1.212-1(i)
36. IRC §212

The distinction between IRC §162 business expenses and IRC §212 production of income expenses can make a difference even in the trust area. Trusts often take a passive or investor role with respect to an activity. If the primary purpose of the trust is to conserve assets rather than operate a business, the expenses are deductible under IRC §212. In such cases, the expenses could be subject to the limitation imposed on miscellaneous itemized deductions. These expenses do not enter into the calculation of any net operating loss deduction, nor are they deductible for the alternative minimum tax. In the absence of evidence showing that the trust is doing more than merely conserving the assets, the expenses could be governed by IRC §212 rather than IRC §162.

Other deductions for trusts include interest,[37] taxes,[38] losses,[39] bad debts,[40] depreciation,[41] and charitable contributions.[42] If a trust holds real estate or other business assets, the passive loss rules may come into play as discussed below.[43]

Subchapter J makes a few clarifications and modifications related to deductions. Many of these are contained in IRC §642 and others are found throughout the Code.

Note. Whether an expense is allocated to income or corpus in determining TAI is not taken into account. It is completely disregarded in determining its deductibility. Thus a deductible expense, like a trustee commission that is allocated to corpus, is still deducted in computing trust taxable income even though it is not charged against TAI.

Example 5. Tyrell sells his principal residence at a loss. No deduction is permitted for the loss since it was personal rather than business related.[44] This is the case even though the residence sold at a gain would be taxable, subject to the IRC §121 exclusion.

If a trust holds the home for the production of income and sells it for a loss, the loss is deductible under IRC §165 because the home is not a personal asset of the trust but rather investment property. Contrast this result with that of a nongrantor trust selling the beneficiary's principal residence and not being protected by the exclusion of IRC §121. A grantor trust owning a personal residence where the grantor otherwise qualifies under IRC §121 is eligible for exclusion under IRC §121.[45]

LIMITATIONS ON DEDUCTIONS RELATED TO TAX-EXEMPT INCOME

The IRC §265 limitation on deductions related to tax-exempt income that applies to individual taxpayers also applies to trusts. Although this rule is rarely encountered for most individual taxpayers, it is quite common in the trust area. If a trust has tax-exempt income, all trust expenses that are not directly related to taxable income are limited. The most commonly affected trust deductions are expenses of administering the trust, such as trustee commissions and attorney fees, and charitable contributions made by the trust.

37. IRC §163
38. IRC §164
39. IRC §165
40. IRC §166
41. IRC §§167 and 168
42. IRC §§170 and 642(c)
43. IRC §469
44. IRC §165
45. Treas. Reg. 1.121-1(c)(3)

Directly-Related Expenses

Expenses that are directly related to taxable trust income are fully deductible. For example, rent expenses are directly related to rental income and are not subject to the IRC §265 limitation. Similarly, tax-preparation expenses are treated as allocable solely to taxable income, presumably on the theory that such expenses are not incurred if all income is tax exempt. Consequently, tax-preparation expenses should not be limited. Likewise, personal property taxes on property that produces taxable income are arguably allocated solely to taxable income.

Indirect Expenses

For those expenses that are not directly related to a particular type of income — indirect expenses — a portion must be allocated between taxable and tax-exempt income. Specifically, a portion of any deductible expense of a trust that is not directly attributable to a specific class of income must be allocated to tax-exempt income, thus making it nondeductible.[46] For example, trustee commissions relate to both taxable and tax-exempt income. Therefore, an allocation is required.[47] There is little guidance available regarding the treatment of expenses such as legal fees incurred during probate, bank service charges, and costs associated with distributions, such as wire transfer fees. Similarly, the amount of the expense that is allocated to tax-exempt income and which is not deductible is not perfectly clear. If an expense is directly related to tax-exempt income, none of the expense is deductible. For other expenses, it appears that a proportionate amount of the expense is not deductible based on the ratio of gross tax-exempt income to total gross income, using the following formula:

$$\textbf{Nondeductible expense} = \frac{\textbf{Tax-exempt income}}{\textbf{Total trust income}} \times \begin{array}{c}\textbf{Expenses not directly related to}\\ \textbf{a particular type of income}\end{array}$$

The numerator is typically municipal bond interest, which is exempt under IRC §103. The expenses normally affected are those deductible under IRC §212, such as trustee fees. The limitation does not apply to expenses that are not deductible under IRC §212. For example, if a trust must pay a state income tax on tax-exempt income earned from another state, the limitation does not apply. This is the case because the deduction is granted under IRC §164 relating to taxes, and not under IRC §212.

The computation of the denominator of the formula has come under fire more than once and from different directions. As might be expected, taxpayers want the denominator as large as possible to minimize the amount of nondeductible expense. Of course, the government holds the opposite position. To appreciate the problem, assume that in one year, a trust has $100,000 of trustee fees and its only other receipts and disbursements are $200,000 of tax-exempt interest, $800,000 of gross rental income, and $500,000 of rental expenses. If gross rents ($800,000) are used in the denominator, 20% ($200,000 ÷ ($200,000 + $800,000)) of the trustee fees would not be deductible. If net rents ($800,000 – $500,000) are used, 40% ($200,000 ÷ ($200,000 + $800,000 – $500,000)) of the trustee fees will not be deductible. Unfortunately, there is no certainty as to the proper approach.[48] The taxpayer normally opts to use the gross amounts since this approach is more beneficial.

One of the more contentious items concerning the denominator is capital gains. Decisions in this area indicate that the denominator does not include capital gains unless capital gains are actually included in TAI or in distributable net income.[49] In Rev. Rul. 80-165, the government held that distributions by a C corporation received by a trust which represented nontaxable returns of capital under IRC §302(c)(2) must be excluded from the denominator because such distributions do not enter into the calculation of distributable net income (discussed on the following page).

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46. Treas. Reg. §1.652(b)-3(b)

47. Treas. Reg. §§1.652(b) and 1.653(b)

48. Compare Treas. Reg. §§1.652(b)-3(b) and 1.652(c)-4 that differ on the issue.

49. Rev. Rul. 77-355, *Manufacturers Hanover Trust Co.*, 312 F.2d 785 (Court of Claims, 1963); and *Tucker v. Comm'r*, 322 F.2d 86 (CA-2, 193), *aff'g* 38 TC 955

Example 6. In 2008, the Hudson Trust paid trustee commissions of $7,000: $5,000 allocable to income and $2,000 allocable to corpus. Its records reveal the following additional information:

Rental income	$70,000
Rental expenses	(30,000)
Net rental income	$40,000
Long-term capital gains allocable to corpus	$25,000
Long-term capital losses allocable to corpus	(5,000)
Net capital gain	$20,000
Sales	$20,000
Cost of goods sold	(15,000)
Gross income	$ 5,000
Interest on state of New York bonds	$10,000

To determine the amount of commissions that are not deductible, taxpayers would take the position that the denominator includes the gross amounts of income received and is not reduced by expenses. However, this is debatable, as noted above.

Therefore, the denominator includes the $70,000 rental income, $20,000 gross sales, and $10,000 tax-exempt interest. This totals $100,000. The denominator does not include the $20,000 net capital gain allocable to corpus. Therefore, 10% ($10,000 ÷ $100,000) of the $7,000 trustee's commissions, or $700, is not deductible. The remaining $6,300 is deductible.

Note. In computing the amount of the deductible commissions, the fact that commissions are allocable to income or corpus for trust accounting purposes is irrelevant.

Termination Commissions

When a trust is terminated, trustees usually charge a fee. Typically, these termination commissions are based on a percentage of the total value of the principal and can be quite substantial. In situations such as these, the formula for determining the portion of the fees allocable to tax-exempt income has been the subject of debate. Imagine if the only expense during the year was a $1 million terminating commission and the only income was interest from a municipal bond. At first glance, the deduction would be totally nondeductible. However, in *Whittemore Jr. v. U.S.*, the Eighth Circuit held that the fraction used should be the ratio of tax-exempt income over the life of the trust to gross income over the same period, including capital gains.[50] The First Circuit took an even more aggressive approach in *Fabens v. Comm'r*, holding that both unrealized and realized capital gains should be included in the denominator.[51] The IRS accepted the *Fabens* position in Rev. Rul. 77-466.

Observation. An estate or trust might be able to avoid the expense disallowance by distributing the tax-exempt bonds one year and paying the expenses in the subsequent year. In Rev. Rul. 63-27, the IRS indicated that a proportionate allocation is not mandatory. Citing *Edward Mallinckrodt, Jr.,*[52] the IRS explained that although the court required proportionate allocation in that case, "it also recognized that such proration was not mandatory and it would have considered some other method if it had been presented."

50. *Whittemore Jr. v. U.S.*, 20 AFTR 2d 5533, 67-2 USTC ¶9670, 383 F.2d 824 (CA-8, 1967)

51. *Fabens v. Comm'r,* 519 F.2d 1310 (CA-1, 1975)

52. *Mallinckrodt, Jr. v. Comm'r,* 2 TC 1128 (1943)

DEDUCTIONS FOR TAXES

The deduction of taxes for individuals also extends to trusts. Normally, deductible taxes include real and personal property taxes on assets owned by the trust. In addition, a trust can deduct state, local, and foreign income taxes on income produced by a trust. Trusts also can deduct state and local sales taxes in lieu of state and local income taxes. However, a trust cannot use the Optional Sales Tax Table for individuals. In addition, the distribution does not include sales taxes paid on items used in a trade or business.

> **Note.** Because the deduction for taxes is granted specifically under IRC §164 rather than IRC §212, there is no requirement to allocate a portion of taxes paid to tax-exempt income.

DEDUCTIONS FOR INTEREST

Individuals are entitled to a deduction for interest expense under IRC §163 subject to several important restrictions. The same is true for trusts. As mentioned above, investment interest paid is deductible but limited to net investment income. Personal interest paid is not deductible. An exception exists for qualified residence interest. This type of interest is deductible by individuals. For many years, trusts were not allowed to deduct qualified residence interest paid on a personal residence even if the residence was occupied by the trust's beneficiary. However, in 1988, the deduction was extended to trusts. Any residence owned by a trust is treated as a qualified residence for purposes of IRC §163, and the related interest is deductible if it is a qualified residence of the beneficiary.[53]

Interest incurred because of a federal or state income tax deficiency is normally not allowed as a deduction to the trust. This is based on the theory that it is personal interest. However, if the interest was attributable to a trade or business operated by the trust, the interest may be deductible.[54]

CHARITABLE CONTRIBUTIONS[55]

Trusts may claim a deduction for contributions of trust income to qualified charitable organizations if it meets several requirements. In contrast to the charitable deduction for individuals and corporations, there is no limit on the deduction of contributions made by a trust.

Trust Instrument Governs

The contribution must be made pursuant to the trust instrument. Deductions are not allowed for discretionary contributions made by the trustee. Trustees who arbitrarily make contributions to charities violate their fiduciary duties.

In *Estate of O'Conor v. U.S.*, the decedent's will transferred substantial assets to a trust for the benefit of his wife, who had an unlimited power over the assets. Using this power, she directed the executors to pay all amounts over to a charitable foundation. The husband's executors made the distributions directly to the charity but claimed a marital deduction. The court denied the marital deduction presumably because the distributions were not first made to the wife. The court then denied a charitable deduction to the estate because the husband's will did not indicate any charitable intent and, therefore, the contribution was not made pursuant to the will.[56]

Qualified Donee

The donee must be a qualified charitable or government organization. This is essentially the same group of eligible recipients that exists for individual and corporate contributions, except that foreign charitable organizations also qualify.[57]

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53. IRC §163(h)(5)(D)
54. *Miller,* 841 F.Supp 305, 93-2 USTC ¶50,631
55. IRC §§642(c) and 170(c)
56. *Estate of O'Conor v. U.S.*, 69 TC 165 (1977)
57. Treas. Reg. §1.642(c)-1(a)(2)

Contributions from Tax-Exempt Income

A deduction is allowed only for contributions of taxable income. Charitable contributions from tax-exempt income are not deductible.

> **Note.** This is inconsistent with the treatment of individual and corporate taxpayers, in which the source of the contribution is irrelevant. However, the rule is logical. Allowing a deduction would provide an unjustified double benefit, such that the exempt income received is not included in taxable income. However, when it is given to the charity, a deduction is allowed.

When a trust makes a contribution, it is ordinarily deemed to consist of each type of income that the trust receives, including tax-exempt income.[58] Consequently, if a trust's income is 60% exempt, then 60% of its contributions are not deductible. However, some suggest that it may be possible to avoid this rule. For example, if the trust instrument is drafted in such a way that specifies that contributions are only made from taxable income, the contribution arguably does not consist of any exempt income and is fully deductible. There is economic substance to this approach because the charity does not receive a distribution unless the trust has taxable income.[59]

Election to Treat Contributions as Paid in Preceding Taxable Year

If a contribution is paid after the close of the taxable year, but before the close of the next taxable year, the trustee may elect to deduct the payment in the preceding year.[60] This rule enables a trust to determine the amount of income for the year that is available for contributions, make the contribution in the following year, and get a deduction for the previous year. The election is irrevocable and must be made in a timely-filed tax return for the second year as extended.[61]

Contributions of Remainder Interests

Contributions of remainder interests or income interests to a charitable organization must meet special rules in order to qualify for the deduction.[62]

Distributions to Beneficiaries versus Charitable Distributions

It is easy to view a charity as a beneficiary of the trust in the sense that it may receive distributions of trust income. However, a charity is not treated as a beneficiary for purposes of computing the deduction for distributions. Amounts distributed to a charity are accounted for separately as charitable contributions and are not deductible as distributions.

MISCELLANEOUS ITEMIZED DEDUCTIONS

Trusts are subject to the 2% limitation on miscellaneous itemized deductions (MIDs).[63] IRC §67(e) provides a 2-prong test to determine if the 2% limitation applies. Deductions are not MIDs if they are:

1. Incurred in the administration of the trust, and
2. Would not be incurred had the property not been held in the trust.

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58. Treas. Reg. §1.643(c)-3(b)
59. Treas. Reg. §1.642(c)-3(b)(2) and Rev. Rul. 71-285, 1971-2 CB 248
60. IRC §642(c)(1) and Treas. Reg. §§1.642(c)-1(b)(2) and (3)
61. Information to be contained in the election can be found in Treas. Reg. §1.642(c) -1(b).
62. IRC §664 and Schmolka (1984). "Income Taxation of Charitable Remainder Trusts and Decedents' Estates: 66 Years of Astigmatism." *Tax Law Review 40,* pp. 116–327
63. IRC §67(e)

The expense must be unique to the trust. For example, trustee fees are not considered MIDs because they are incurred as part of the administration of the trust and would not be incurred but for the existence of the trust. The following deductions are not MIDs:

- Exemption deduction
- Trustee fees
- Tax preparation fees
- Charitable contributions
- Deductions for distributions
- Certain other exceptions under IRC §67(b)

Perhaps the most difficult problem in applying the 2% rule concerns the treatment of investment advisory expenses. Should they be exempt from the limitation? The Supreme Court recently resolved the conflict among the circuits in *Wm. L. Rudkin Testamentary Trust, et al. v. Comm'r.*[64] This case involved a trust established under the will of Henry A. Rudkin in 1967. Rudkin's family was involved in the founding of Pepperidge Farms, the food products company that was later sold to Campbell's Soup in the 1960s. The trust was initially funded primarily with proceeds from that sale. The income and principal of the trust were applied for the benefit of Rudkin's son, the son's spouse, descendants, and spouses of descendants. The trustees were provided with broad authority in the management of property, including the power "to invest and reinvest the funds of Rudkin's estate or of any trust created hereunder in such manner as they may deem advisable without being restricted to investments of the character authorized by law for the investment of estate or trust funds" and "to employ such agents, experts and counsel as they may deem advisable in connection with the administration and management… of any trust created hereunder, and to delegate discretionary powers to or rely upon information or advice furnished by such agents, experts and counsel." In 2000, the trustee paid investment advisors about $22,000 for their services. For the year, the trust reported total income of $624,816 and deducted the advisory fees in full. Upon review, the IRS imposed the 2% limitation and permitted a deduction of $9,780. A deficiency of about $4,448 was imposed.

As in previous cases, the taxpayer argued that while an individual may make a voluntary and personal choice to seek investment advice, fiduciary duties made such professional advice a necessary and involuntary part of trust administration. In contrast, the IRS asserted that because investment advisory fees are commonly incurred by individual investors outside the context of trust administration, the fees failed to satisfy the requirement that they would not have been incurred if the assets were not held in trust. In addition, the IRS noted that neither state law nor the trust instrument imposed a legal obligation on the trustee to obtain professional investment management services. In January 2008, the Supreme Court finally addressed the situation with its review of the Second Circuit's decision in *Rudkin* (at the Supreme Court level, the plaintiff was the trustee of the Rudkin trust, Michael J. Knight, and, therefore, the Supreme Court decision is cited as *Knight v. Comm'r*).[65] In *Knight*, the Supreme Court held that investment advisory fees are considered miscellaneous itemized deductions. Proposed regulations now exist that are consistent with the Supreme Court's decision. Only time will reveal the implications of *Knight* for investment fees buried in mutual fund returns and similar arrangements. For example, what if the trustee simply includes the cost of investment advice in the trustee fee?

64. *Wm. L. Rudkin Testamentary Trust, et al. v. Comm'r*, 124 TC No. 19 (2005)

65. *Knight v. Comm'r*, 101 AFTR 2d 2008-544 (USSC, Jan. 16, 2008)

Determining the 2% Limitation

The computation of the limitation on MIDs is cumbersome. Since trust AGI depends on the amount of the distribution deduction, and the distribution deduction in turn depends on taxable income after taking into account the deduction for MIDs (taxable DNI), the calculation of allowable MIDs may require the use of simultaneous algebraic equations. The instructions for making the computation, as found in the instructions to Form 1041, reflect this approach.

COST RECOVERY: DEPRECIATION AND IRC §179 EXPENSING

Computation

The amount of the deduction for depreciation, depletion, and amortization for tax purposes is computed in the normal manner (e.g., using MACRS) without regard to the fact that the trust is the taxpayer and owner of the property. However, tax depreciation and depreciation for TAI purposes may differ.

Allocation

The critical question regarding depreciation, depletion, and amortization relates to who is entitled to the deduction for such expenses. The Code provides that a trust is entitled to a depreciation deduction or a depletion allowance "only to the extent not allowable to the beneficiaries under IRC §§167(d) and 611(b)." The amortization rules adopt the same approach.

The allowable depreciation deduction is allocated between the trust and the beneficiaries, including charitable beneficiaries, in a special manner.[66] If under the trust instrument or state law the trustee is required or permitted to maintain a depreciation reserve (i.e., the trustee sets aside income for such purpose) and does so, any allowable tax depreciation is deductible by the trust to the extent of the reserve. If the allowable depreciation exceeds the reserve, the depreciation is allocated between the trust and the beneficiary according to the TAI allocable to each. If the trust instrument or state law is silent regarding a reserve, the deduction is allocated in the same manner as income.

Example 7. Reynold Trust's records for the year reveal the following facts:

Net rental income before depreciation	$104,000
Reserve for depreciation	4,000
Tax depreciation (MACRS)	10,000
Income distribution to beneficiary	60,000

TAI is $100,000 ($104,000 – $4,000). The trust computes the depreciation allocation as follows:

	Total	Trust	Beneficiary
Tax depreciation	$10,000		
Reserve for depreciation	(4,000)	$4,000	
Balance	$ 6,000		
Allocation:			
Income distributed: 60% × $6,000	(3,600)		$3,600
Income retained: 40% × $6,000	(2,400)	2,400	
Total	$ 0	$6,400	$3,600

Note. If the beneficiary is a charity, the depreciation must be allocated to the charity, perhaps resulting in a loss of the depreciation deduction.

66. Treas. Reg. §§1.167(h)-1 and 1.611-1(c)(4)

Example 8. The John Doe Trust was established for his daughter, Daisy. This year, the trust has net rental income of $20,000 and MACRS depreciation of $27,000. There is no reserve for depreciation. TAI is $20,000. If all $20,000 of TAI is distributed to Daisy, all the depreciation is allocated to her. As a result, Daisy reports $20,000 of rental income and $27,000 of depreciation, for a net loss of $7,000. The loss is likely passive subject to the limitations of IRC §469.

Example 9. This year the Turner Trust had net rental income of $10,000 before taking into account any depreciation. The trust document requires a reserve for depreciation of $7,000. The trustee set aside $7,000 for depreciation. Consequently, TAI is $3,000, all of which is distributed. MACRS depreciation is only $4,000. Trust taxable income is $6,000 ($10,000 – $4,000) and the beneficiaries receive a distribution of $3,000 with no depreciation deduction.

Limited Expensing[67]

The limited expensing deduction allowed by IRC §179 is not available to trusts. Any pass through of IRC §179 expense from partnerships or S corporations is not allowed. However, partnerships or S corporations may capitalize the expensed amount and depreciate it, allowing the depreciation to flow through to the trust.[68]

MEDICAL EXPENSES[69]

Medical expenses paid by a trust receive special treatment. If the medical expenses are for the care of a decedent prior to his death and they are paid by an estate within one year after death, the medical expenses can be deducted either on the decedent's final Form 1040 or the estate's Form 706, but not on both. Medical expenses paid after the 1-year period are deductible only as liabilities on the estate tax return (Form 706) if it is filed.

Assets are often transferred to trusts to help pay medical and related expenses of beneficiaries who may not be able to pay for them. The trust is not allowed a deduction for medical expenses. The trust is simply making a distribution to satisfy an obligation of the beneficiary, the treatment of which is discussed below.

SATISFACTION OF LEGAL OBLIGATIONS OF BENEFICIARY

Trustees often pay expenses on behalf of a beneficiary. For example, the trustee could pay for the beneficiary's expenses for medical care, income taxes, property taxes, college tuition, meals, lodging, or vacation. The trustee could use some of the income required to be distributed to pay such expenses or use discretionary income or principal. According to the regulations, "any amount used to discharge or satisfy any [beneficiary's] legal obligation" is treated as a distribution.[70] Therefore, if a trustee pays a beneficiary's debts, the payments are simply treated as normal distributions. The beneficiary is treated as having paid the expense. For example, if a trust pays a beneficiary's $1,000 medical bill, the trust is treated as having made a $1,000 distribution to the beneficiary. Such a distribution is normally deductible by the trust. The beneficiary has $1,000 of taxable income, but can claim an itemized deduction for the medical expenses as if he paid them (subject to the limitations for medical expenses of IRC §213).

Observation. If distributions are made to satisfy a grantor's obligation to support or maintain a beneficiary (a child), the amount used is considered taxable to the grantor under IRC §677(b).

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67. IRC §179

68. Treas. Reg. §1.179-1(f)(3)

69. IRC §213(c)

70. Treas. Reg. §1.1661(a)-2(d)

NET OPERATING LOSSES

A trust that operates an unprofitable trade or business or that has an interest in a partnership or S corporation that suffers a loss may have a net operating loss (NOL). Trusts are entitled to an NOL deduction. The NOL computation is made in the same manner as for an individual. An NOL results when the deductions exceed gross income with certain modifications. Deductions are not allowed for distributions to beneficiaries, charitable contributions, exemptions, and other items.[71]

A trust may carry back an NOL to its two preceding tax years and forward to the next 20 years. The NOL carryback or carryover reduces the distributable net income (DNI) for the year to which the loss is carried. Because DNI (discussed below) sets an upper limit on the amount that is deductible to the trust for distributions as well as the amount taxable to the beneficiaries, the NOL may have the effect of reducing the amount taxable to the beneficiaries.[72] Under procedural rules, the beneficiary must file an amended return and recompute taxable income based upon the DNI of the trust as reduced by the NOL. If the amount distributed in the carryback year exceeds the revised DNI amount, the excess is treated as a distribution of corpus and not accumulated taxable income.

If a trust is terminated and it has an NOL carryover, such loss may be passed on to the beneficiaries as discussed below.[73]

EXCESS DEDUCTIONS[74]

When a trust computes its NOL, certain modifications are made such that nonbusiness expenses (e.g., trustee and attorney fees) are deductible only to the extent of nonbusiness income (e.g., interest and dividends). The excess of nonbusiness expenses over nonbusiness income — referred to as excess deductions — are normally lost. However, if the entity has deductions that exceed gross income in the trust's year of termination, the excess flows through to the beneficiaries.[75] In determining the amount of excess deductions, the exemption deduction and the charitable contribution deduction are ignored. The effect of this rule for excess deductions is to allow those deductions that are not taken into account in computing the NOL deduction to pass through. Importantly, this rule only applies to deductions incurred in the year of termination.[76]

Observation. A charitable contribution deduction is not taken into account in determining an NOL or excess deductions. As a result, the contribution deduction can easily be wasted when there is insufficient income to absorb it.

EXCESS DEDUCTIONS, NOL, AND CAPITAL LOSS CARRYOVERS IN THE YEAR OF TERMINATION

Upon termination of a trust, IRC §642(h) allows beneficiaries who receive the property to inherit the entity's capital loss and NOL carryovers as well as any excess deductions.

Capital Loss and NOL Carryovers in Year of Termination

A trust's unused capital loss and NOL carryovers as of the year of the trust's termination do not expire. Instead, they pass through to the beneficiaries even if they did not arise in the year of termination.[77] Any capital loss carryovers that flow through to the individual beneficiaries may be used until they are exhausted. Corporate beneficiaries may only use them for five years. NOL deductions passing through the trust in the year of termination can be carried forward for 20 years. For this purpose, the final year of the trust and the first year of the beneficiary are counted as separate taxable years. If the beneficiary should die before completely using the NOL or capital loss carryovers, they are lost.

71. IRC §§642(d) and 172
72. Rev. Rul. 61-20, 1961-1 CB 248
73. IRC §642(h)(1)
74. IRC §642(h)
75. IRC §642(h)(2)
76. For the significance of properly timing deductions, see *Westfall* 37 TC 341 (1961).
77. Treas. Reg. §1.642(h)-1(a)

Excess Deductions in Year of Termination

Beneficiaries may deduct their share of excess deductions as an itemized deduction even though some of the excess deductions were deducted from AGI by the trust.[78] The beneficiary treats the excess deductions as MIDs.[79] Consequently, a beneficiary must itemize in order to obtain a benefit from the pass through. In addition, the excess deductions flowing through are subject to the deduction limitation of IRC §68. Finally, the beneficiary can only claim the deductions in the year in which or with which the trust year ends. If the excess deductions exceed the beneficiary's other taxable income, they do not create an NOL and, therefore, cannot be carried back or forward.

Example 10. In 2004, the Garsh Trust terminated. For the final year, the trust had gross income of $5,000 and legal fees of $15,000. The excess deductions of $10,000 ($5,000 – $15,000) pass through to the beneficiary, who can claim the $10,000 as a MID. If this had not been the year of termination, the $10,000 of excess deductions would have been wasted. The legal fees are considered a nonbusiness expense and are not deductible in computing an NOL. As a result, the trustee should ensure that excess deductions occur only in the year of termination. For example, a cash-basis estate could postpone paying the legal fees until the final year.

Example 11. The Hamilton Trust runs a proprietorship. This year the trust terminated and it distributed the assets to the beneficiary, George. For the year of termination, the trust reported the following:

Business income	$ 3,000
Nonbusiness income	2,500
Total income	$ 5,500
Business expenses	($ 5,000)
Trustee and attorney fees	(9,800)
Total expenses	($14,800)

The trust's NOL and excess deductions are computed as follows:

Business income	$3,000
Business expense	(5,000)
NOL	($2,000)
Nonbusiness income	$2,500
Trustee and attorney fees	(9,800)
Excess deductions	($7,300)

In the year of termination, the NOL and the excess deductions pass to the beneficiaries of the property. Therefore, George is entitled to an NOL deduction of $2,000 from AGI. He may also claim a MID for the excess deductions of $7,300 subject to the deduction limitation.

> **Note.** If the trust did not terminate, the NOL is carried forward to be used in future years but the excess deductions are lost.

78. Treas. Reg. §1.642(h)-(2)(a)

79. IRC §67(a) and Form 1041, Schedule K-1

ALLOCATING DEDUCTIONS AND CARRYOVERS TO BENEFICIARIES

IRC §642(h) provides that the excess deductions and carryovers pass through to the beneficiaries of the decedent's property. Generally, those beneficiaries responsible for the expenses creating the excess deductions or carryovers are entitled to the deductions. For trusts, the remainderman, who receives all or a portion of the trust property on termination, is considered a beneficiary succeeding to the trust's property and is entitled to the deductions.[80]

Example 12. Charles created a trust for the benefit of his daughters, Brenda, Carol, and Page. According to the terms of the trust, Brenda receives the income for life. Upon Brenda's death, Carol receives $30,000 and Page gets the remainder. In this case, Page is entitled to all the excess deductions and carryovers. Page can deduct the excess deductions in the year of the entity's termination as a MID subject to the deduction cutback.

CASUALTY LOSSES

The rules for deducting casualty losses[81] are the same as those for individuals. The limitation of the deduction to that amount in excess of 10% of AGI also applies. The limitation applies even though the concept of AGI is normally not associated with trusts. However, the 10% floor does not apply if property is held for business or investment. It would appear that most assets are held for this purpose, so the limitation may not be a hurdle.

PASSIVE ACTIVITY LOSSES (PALS)

The basic rules for PALs are applicable to trusts.[82] PALs are suspended at the trust level and triggered when the trust has passive income or disposes of the activity.

It is difficult to determine whether a loss is passive. Currently, there are no regulations that address this issue, although Temp. Treas. Reg. §1.469-5T(g) is reserved for this purpose. In *Mattie K. Carter Trust v. U.S.*, one of the assets the trust managed was a cattle ranch that produced losses during 1994 and 1995 of $856,518 and $796,687, respectively. The IRS argued that the trust's material participation in a business should be measured only in terms of the trustee's participation as a trustee. The trust countered that the trust was the taxpayer and that as a legal entity it could participate in an activity through its fiduciaries, employees, and agents. The district court agreed with the taxpayer, indicating that material participation should be determined by the activities of the taxpayer; in this case, the trust. The court proceeded to conclude that the collective activities of the trust as carried on its behalf by its fiduciaries, employees, and agents met the material participation test.[83]

Example 13. Several years ago, Hannah formed an LLC to own and operate a trailer court. This year Hannah died and left her LLC interest to a trust for the benefit of her son, Mark. Under the trust instrument, Mark receives all the trust's income. In 2007, the trust reported interest income of $30,000 and its share of a loss from the LLC of $10,000. TAI is $30,000 and all of it is distributed. Assuming the loss is passive — although *Carter* may suggest otherwise — the loss is suspended at the trust level and does not offset the $30,000 of interest income that must be reported by Mark.

In 2008, the trust reported $35,000 of interest income and $40,000 of income from the LLC, all of which was distributed to the trust. TAI is $75,000. The trust distributed all the income to Mark. For tax purposes, the LLC income of $40,000 is treated as passive income and the trust may offset it by the suspended loss of $10,000. Consequently, the trust has taxable income before distributions of $65,000 ($35,000 + ($40,000 – $10,000)).

As explained in the next section, the trust's DNI is also $65,000. Thus, Mark reports $65,000 of income even though he receives $75,000. Of the $65,000 taxable to Mark, $30,000 is passive and can be combined with any passive losses that he may have. The amount distributed in excess of the $65,000 DNI is treated as a distribution of corpus and not accumulated income.

80. Treas. Reg. §1.642(h)-3(d)

81. IRC §165

82. IRC §469

83. The issue was considered recently in *Mattie K. Carter Trust v. U.S.*, 91 AFTR 2d 2003-1946, 2003-1 USTC ¶50,418, 256 F.Supp.2d 536, (DC TX, 2003).

Suspended Losses[84] and Distribution of a Passive Activity

During the term of the trust or upon its termination, the trust may distribute an interest with suspended passive losses. In such a case, the losses are not triggered and the trust receives no benefit from the suspended losses. Moreover, the losses do not pass through directly to the beneficiaries. Rather, any suspended losses attributable to the property increase the beneficiary's basis in the passive activity interest.[85] The basis rules for gifted property apply for purposes of a later sale or disposition as well as depreciation. Under IRC §1015, if the property's value at the time of distribution exceeds its basis **(as increased by the suspended losses),** the basis for gain and loss is the increased basis plus any adjustment for gift tax paid. If the property's value is less than the increased basis at the time of distribution, and the property is sold for a gain, the basis is the increased basis. However, if the property is sold for a loss, the basis is fair market value. In the latter situation, the beneficiary benefits from the passive losses only if property is sold for more than its increased basis or through depreciation. (See example below.)

Basis for Depreciation

The basis for depreciation of gifted property with passive losses is the same as it was in the hands of the trust; that is, the increased basis.[86] The donee will step into the shoes of the donor (i.e., the trust) and continue to depreciate the property's basis in the same manner. The amount of the increase in basis due to the suspended passive losses will be treated as newly acquired property and depreciated using the appropriate life and method specified by MACRS.

Example 14. Mitch is the beneficiary of a trust created by a gift from his father. The primary asset of the trust is an apartment building. At Mitch's death, the trust instrument provides for the transfer of the building to his daughter, Donya. At the time of the gift, the trust's basis for the building was $100,000 and its value was $60,000.

> **Note.** IRC §1014 does not provide for an increase or decrease to the basis of the trust property at the time of the beneficiary's death.

In addition, there is a $30,000 suspended loss attributable to the property. The distribution of the property does not trigger the use of the losses and their potential use by the trust is extinguished. Instead, the losses are added to the basis of the property, increasing the basis to $130,000.[87] Donya sells the property for $150,000, and recognizes a gain of $20,000 ($150,000 – ($100,000 + $30,000)). Donya can recover and use the losses due to the basis increase in the property.

Example 15. Use the same facts as **Example 14,** except Donya sold the property for $50,000. In this case, she recognizes a $10,000 loss and receives no benefit from the suspended losses.

Example 16. Use the same facts as **Example 14,** except Donya chooses not to sell the property upon receipt. She may depreciate the property and continue to depreciate the property's original basis in the same manner as the trust. She will treat the $30,000 basis increase as new property and depreciate it using MACRS.

$25,000 Rental Real Estate Exception

The $25,000 de minimis offset for losses attributable to rental real estate is allowed for "natural persons" and therefore, normally does not apply to trusts.[88] This prevents taxpayers from circumventing the $25,000 limitation by transferring multiple properties to multiple trusts, allowing each to claim a $25,000 allowance.

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84. IRC §469(g)(2)
85. IRC §469(j)(12)
86. IRC §167(c)(1) and Prop. Treas. Reg. §1.168-5(f)(3)
87. IRC §469(j)(12)
88. IRC §469(i)

Example 17. Use the same facts as **Example 2.** On March 7, 1995, Grant Tor established a trust for his son, Ben. Under the trust instrument, a reserve for depreciation of $5,000 must be maintained, and both capital gains and 50% of the trustee's commission must be allocated to the principal account. Tax depreciation for the year is the same as the reserve for depreciation. Given the following facts, **what is the trust's taxable income before accounting for distributions?**

Rental income	$100,000
Tax-exempt income	10,000
Dividends	15,000
Long-term capital gain	50,000
Rent expense	10,000
Reserve for depreciation and tax depreciation	5,000
Trustee commission	8,000

This year the trust made a charitable contribution of $20,000. No distributions were made to the beneficiaries. Trust taxable income is computed as follows:

Rental income		$100,000
Dividends		15,000
Long-term capital gain		50,000
Gross income		$165,000
Less:		
Rent expense	$10,000	
Depreciation	5,000	
Trustee commission	7,360 [a]	
Charitable contribution	18,400 [b]	
Exemption deduction	100	
	$40,860	(40,860)
Taxable income before distributions		$124,140

[a] $7,360 = $8,000 − nondeductible expense = $8,000 − (($10,000 ÷ $125,000) × $8,000)

[b] $18,400 = $20,000 − nondeductible expense = $20,000 − (($10,000 ÷ $125,000) × $20,000)

$$\textbf{Nondeductible expense} = \frac{\textbf{Tax-exempt income}}{\textbf{Total trust income}} \times \begin{array}{c}\textbf{Expenses not directly related to}\\ \textbf{a particular type of income}\end{array}$$

DEDUCTION FOR DISTRIBUTIONS

After determining the amount of trust income that must be taxed, the income must be allocated between the trust and the beneficiaries. This is the whole purpose of Subchapter J, which discusses allocation of taxable income. The grand plan of Subchapter J is that the taxable income recognized by the trust is taxed to the trust itself or to its beneficiaries, but not to both. The determination of the amount of income taxable to each depends upon the amount of annual distributions from the trust and how much taxable income is distributed from the trust.

The provisions governing determination of the distribution deduction — IRC §§651 and 661 — make the critical presumption that all distributions made by the trust first represent both taxable and nontaxable net income that can be distributed. All distributions are deemed to first consist of current taxable and nontaxable income rather than accumulated income, receipts allocated to corpus, or corpus itself. This quantity of taxable and nontaxable income that the trust can distribute is referred to as **distributable net income (DNI).** It is further presumed that every distribution of DNI represents a pro rata share of taxable and nontaxable income that is distributable. The trust deducts the amount of taxable income included in the DNI that is distributed and the beneficiaries report the same amount as taxable income.

Example 18. For 2008, Gilbert Trust has $80,000 of dividend income and $20,000 of tax-exempt interest. Its DNI is the net taxable and nontaxable income that is distributable, for a total of $100,000 DNI. If the trust distributes $40,000, the amount distributed is assumed to be DNI (not corpus). Eighty percent ($80,000 ÷ $100,000) represents taxable DNI. Consequently, 80% of the $40,000 distributed, or $32,000 (80% × $40,000), is deducted. The remaining 20%, or $8,000 (20% × $40,000), is nondeductible.

In this situation, the beneficiary has $32,000 of taxable income and $8,000 of nontaxable income.

Observation. The amount of the trust's deduction, which represents the amount of its taxable income that it is allocating to the beneficiary, is exactly equal to the amount of taxable income received by the beneficiary and reported on Schedule K-1.

AMOUNT OF DEDUCTION

Technically, under IRC §§651 and 661, a trust is generally allowed a deduction for distributions to beneficiaries. However, this deduction **cannot exceed DNI as reduced by net tax-exempt income.** IRC §§651 and 661 allow the trust to deduct the amount of **taxable DNI** distributed. Taxable DNI serves as the upper limit on the amount of the deduction for distributions to beneficiaries. It also serves as the upper limit on the amount of taxable income included by the beneficiaries for distributions from the trust.

SIMPLE VERSUS COMPLEX TRUSTS

Subchapter J creates two separate schemes for the taxation of trusts. One approach is for simple trusts.[89] IRC §651 addresses the treatment of the distribution by the trust and IRC §652 explains the treatment of the distribution to the beneficiary. For complex trusts, IRC §661 and §662 apply. For the most part, the provisions operate in a similar fashion, allowing a deduction for taxable DNI distributed and taxing a like amount to the beneficiaries.

DISTRIBUTABLE NET INCOME[90]

When a trust makes a distribution, the critical question concerns the amount of taxable income it contains. DNI is the measuring rod used to determine the amount of current taxable income distributed by the trust and concomitantly the amount of income taxable to the beneficiaries. As stated previously, DNI represents the taxable and nontaxable income that is distributable. The Code takes an add-back approach to calculate DNI. The starting point for computing DNI under IRC §643 is taxable income. To arrive at both the taxable and nontaxable income that is distributable from this point of departure requires several adjustments. DNI is computed as follows:

1. Start with taxable income.
2. Add back the deduction for distributions to beneficiaries.

Note. If the starting point in the computation of DNI is taxable income, the distribution deduction must be added back in order to obtain the total amount of income that is potentially distributable. In short, the calculation simply starts with taxable income before the distribution deduction.

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89. IRC §§651 and 652

90. IRC §643(a)

3. Add back the personal exemption.

   - The starting point — taxable income of the trust — includes the personal exemption deduction. This deduction has no bearing on the amount of income that is actually distributable; therefore, it is added back. As a practical matter, the starting point is taxable income before the distribution deduction and exemption deduction.

   - Form 1041, line 17, represents taxable income before the distribution deduction and the exemption amount. This is the trust taxable income that can be taxed to either the trust or the beneficiaries or is allocated between them. Form 1041, Schedule B, *Income Distribution Deduction,* which computes DNI, begins its calculation with this number.

4. Add back net tax-exempt income.

   - Tax-exempt income is added to taxable income even though it is not included in taxable income because it is part of the income that is distributable. Recall that DNI includes both the taxable and nontaxable income that is distributable.

   - Net tax-exempt income is computed by subtracting the portion of any expenses that are attributable to exempt income and are nondeductible. Although nondeductible, this portion of the expenses still reduces the amount of income that is distributable. To illustrate, assume 10% of the trustee fees and 10% of the charitable contributions are treated as paid out of tax-exempt income and, therefore, are nondeductible. These amounts still reduce the amount that is distributable so they are subtracted in computing DNI. More precisely, they are subtracted to obtain net tax-exempt income.

5. Subtract any net capital gains that are allocable to corpus. The only net capital gains included in DNI are those distributable to beneficiaries (e.g., in the year of termination).

   - Subtract capital gains because they are not distributable, but allocated to corpus.

   - According to Treas. Reg. §1.643(a), capital gains are included in DNI when the trustee "follows a regular practice of distributing the exact net proceeds of the sale of the trust assets" or when the terms of the trust instrument direct that the corpus (or proceeds from its sale) be distributed.

6. Capital gains also are included in DNI when the trust directs that all or part of the corpus assets (or the proceeds of the sale of corpus) are used to pay a fixed annuity when the income for the year is insufficient and the trustee therefore must sell or distribute corpus assets to fund the annuity.[91] Add back any net capital losses. Capital losses are considered only to the extent that they affect the net capital gain calculation.

7. In the case of a simple trust, subtract any extraordinary dividends and taxable stock dividends that the trust, acting in good faith, allocates to corpus.

8. Special treatment is required for foreign income received by a foreign trust.

The general formula for computing DNI is shown below and can be found in Form 1041, Schedule B, on page 2.

	Taxable income (before distribution deduction and personal exemption (line 17))
+	Net capital losses
–	Capital gains and other income allocable to corpus and not available for distributions
+	Tax-exempt income net of allocated expenses and available for distribution
	Distributable net income

[91] Rev. Rul. 68-392, 1968-2 CB 284

Example 19. Use the same facts as **Example 2.** On March 7, 1995, Grant Tor established a trust for his son, Ben. Under the terms of the trust, a reserve for depreciation of $5,000 must be maintained, and both capital gains and 50% of the trustee's commission must be allocated to the principal account. Tax depreciation for the year is the same as the reserve for depreciation. In addition, the trust made a charitable contribution of $20,000 and the trustee distributed $85,000 to Ben. Given the following facts, **what is the trust's distributable net income, deduction for distributions, and taxable income?**

Rental income	$100,000
Tax-exempt income	10,000
Dividends	15,000
Long-term capital gain	50,000
Rent expense	10,000
Reserve for depreciation and tax depreciation	5,000
Trustee commission	8,000

Trust DNI and taxable income before the distribution deduction are computed as follows.

Rental income		$100,000
Dividends		15,000
Long-term capital gain		50,000
Gross income		$165,000
Less:		
Rent expense	$10,000	
Depreciation	5,000	
Trustee commission	7,360 [a]	
Charitable contribution	18,400 [b]	
Exemption deduction	100	
	$40,860	(40,860)
Taxable income before distributions		$124,140

[a] $7,360 = $8,000 — nondeductible expense = $8,000 — (($10,000 ÷ $125,000) × $8,000)

[b] $18,400 = $20,000 — nondeductible expense = $20,000 — (($10,000 ÷ $125,000) × $20,000)

$$\textbf{Nondeductible expense} = \frac{\textbf{Tax-exempt income}}{\textbf{Total trust income}} \times \textbf{Expenses not directly related to a particular type of income}$$

DNI is $82,000. Two approaches can be taken in determining DNI:

1. The add-back approach used on the Form 1041, or
2. The regulations approach that identifies the taxable and nontaxable income that is distributable.

The add-back approach used on Form 1041, Schedule B is shown on the following page.

Taxable income before the distribution deduction	$124,140
Exemption	100
Adjusted total income	$124,240
Long-term capital gain	(50,000)
Net tax-exempt income (see following page)	7,760
DNI	$ 82,000

For Example 19

Schedule B In... Distribution ... ion

1	Adjusted total income (see page 25 of the instructions)		1	124,240
2	Adjusted tax-exempt interest		2	7,760
3	Total net gain from Schedule D (Form 1041), line 15, column (1) (see page 25 of the instructions)		3	
4	Enter amount from Schedule A, line 4 (minus any allocable section 1202 exclusion)		4	
5	Capital gains for the tax year included on Schedule A, line 1 (see page 25 of the instructions)		5	
6	Enter any gain from page 1, line 4, as a negative number. If page 1, line 4, is a loss, enter the loss as a positive number		6	(50,000)
7	**Distributable net income.** Combine lines 1 through 6. If zero or less, enter -0-		7	82,000
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law	8 86,000		
9	Income required to be distributed currently		9	
10	Other amounts paid, credited, or otherwise required to be distributed		10	85,000
11	Total distributions. Add lines 9 and 10. If greater than line 8, see page 26 of the instructions		11	85,000
12	Enter the amount of tax-exempt income included on line 11		12	7,760
13	Tentative income distribution deduction. Subtract line 12 from line 11		13	77,240
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-		14	74,240
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18		15	74,240

Schedule G **Tax Computation** (see page 27 of the instructions)

Under the basic rule of IRC §661(a), the trust deducts the amount of trust accounting income distributed to the beneficiary, or $85,000. But IRC §661(c) limits the distribution deduction to the portion of taxable DNI deemed distributed, or $74,240, as determined below.

DNI		$82,000
Less: Net tax-exempt income		
Tax-exempt interest	$10,000	
Allocable trustee's commissions ($8,000 – $7,360)	(640)	
Allocable charitable contributions ($20,000 – $18,400)	(1,600)	
	$ 7,760	(7,760)
Deduction for distributions		$74,240

The trust is treated as having distributed all of the DNI ($82,000) because it distributed $85,000. Because 100% of DNI is distributed, 100% of the trust's tax-exempt income ($7,760) is also considered distributed. No deduction is allowed for the portion of the net tax-exempt income deemed distributed since it was not included in taxable income. As a result, the trust's distribution deduction is computed by subtracting the net tax-exempt income from total DNI. The taxable income for the trust is $49,900, computed as follows:

Taxable income before distribution deduction	$124,140
Deduction for distributions	(74,240)
Trust taxable income	$ 49,900

Observation. The taxable income of $49,900 is a logical result because it represents the $50,000 capital gain recognized by the trust, less the exemption of $100. In situations where all the DNI is distributed, this is a good way to verify that the calculation of taxable income is correct.

Calculation of Distribution Deduction

As noted above, a trust generally is entitled to deduct the amount distributed. However, IRC §§651 and 661 limit the deduction to the taxable portion of DNI distributed. For this purpose, every distribution is deemed first to consist of DNI to the extent thereof. In addition, each dollar of DNI distributed consists of a pro rata portion of each type of income entering into the calculation of DNI. If DNI consists of both taxable DNI (e.g., interest, dividends, rents) and nontaxable DNI (tax-exempt interest), a beneficiary is deemed to receive a proportionate share of each. A deduction is allowed only for the taxable DNI distributed.

The distribution deduction is calculated as the lesser of:

1. Amount distributed, or
2. Taxable DNI distributed, in which Taxable DNI = (DNI – net tax-exempt income).

$$\textbf{Taxable DNI distributed} = \textbf{DNI} \times \frac{\textbf{Taxable DNI}}{\textbf{Total DNI}}$$

Note. If only a portion of DNI is distributed (e.g., 40%), then only this percentage of the amount is considered taxable DNI.

Example 20. This year the Acme Trust reported dividends of $60,000 and tax-exempt interest of $20,000. Taxable income before the distribution deduction consists of dividends of $60,000. In May, the trust distributed $16,000 to its only beneficiary, Wiley. The distribution deduction is generally the amount distributed, or $16,000. But, this amount is limited to the portion that represents taxable DNI.

DNI is $80,000 (taxable dividends $60,000 + tax-exempt $20,000). The $16,000 distribution is deemed to consist of a pro rata portion of taxable and nontaxable DNI. Here the distribution consists of nontaxable DNI of $4,000 (($20,000 ÷ $80,000) x $16,000 distribution) and taxable DNI of $12,000 (($60,000 ÷ $80,000) × $16,000 distribution). Although the trust distributed $16,000, it may deduct only the taxable DNI distributed, or $12,000. Wiley is taxed on only the taxable DNI received, or $12,000.

Trust taxable income is $48,000, as computed below.

Taxable income before distributions			
Dividends			$60,000
Distribution deduction			
Amount distributed		$16,000	
Limited to taxable DNI distributed			
DNI distributed	$16,000		
Taxable DNI ÷ Total DNI ($60,000 [a] ÷ $80,000 [b])	× 75%		
Taxable DNI distributed	$12,000		(12,000)
Trust taxable income			$48,000

[a] DNI of $80,000 less net tax-exempt income of $20,000 equals Taxable DNI of $60,000.
[b] Dividends of $60,000 plus tax-exempt income of $20,000 equals Total DNI of $80,000.

Note. The amount of the distribution deduction and the amount taxable to the beneficiary are the same. This is always the case because these rules allocate the taxable income between the trust and the beneficiary and the income is taxed only once.

TAXATION OF BENEFICIARIES

The amount of a trust's taxable income included in the gross income of the beneficiary is governed by IRC §652 for simple trusts and IRC §662 for complex trusts. The thrust of both provisions is to require the beneficiary to include whatever amount is distributed, but not to exceed the amount representing taxable DNI received (recall that DNI also contains nontaxable income and nondeductible expenses). As noted above, for this purpose, every distribution is deemed first to consist of DNI to the extent thereof. In addition, each dollar of DNI distributed consists of a pro rata portion of each type of income entering into the calculation of DNI (e.g., rents, dividends, tax-exempt interest, and taxable interest). The character of the trust's income flows through. If DNI consists of both taxable and nontaxable DNI, a beneficiary is deemed to receive a proportionate share of each.[92]

Notwithstanding the general approach, trustees may be directed by the trust instrument to allocate certain types of income to certain beneficiaries. If an allocation "has an economic effect independent of the tax consequences of the allocation" or if local law or the trust instrument requires or allows the allocation, the allocation is effective for determining the character of the income to the beneficiaries.[93] For example, if a simple trust requires the trustee to distribute all taxable income to beneficiary B and all tax-exempt income to beneficiary C, the allocation will have economic effect because the actual amount received by each beneficiary depends on the character of the income received.

ALLOCATION OF DNI AMONG BENEFICIARIES

In certain situations, the trust might distribute more than the current DNI. This can occur when the trust distributes income that has previously been accumulated. If the amount distributed exceeds DNI for the year, the question arises as to which beneficiary receives the DNI and, therefore, the taxable income. If there is more than one beneficiary, the amount of DNI is allocated to the beneficiaries based on the relative amounts of trust accounting income that each receives.

Example 21. A trust has dividend income of $50,000 and trustee commissions of $10,000 allocable to corpus. Trust accounting income is $50,000 and DNI is $40,000. The difference is attributable to the trustee commissions that were allocable to corpus and not income.

In June, the trust made distributions of $30,000 to Michele and $20,000 to Alexia. Because DNI of $40,000 is insufficient to cover all of the distributions, it is allocated among the beneficiaries based on the amounts of trust income received by each.

Consequently, Michele is deemed to receive DNI of $24,000 (($30,000 ÷ $50,000) × $40,000 DNI) and Alexia is deemed to receive the remaining $16,000 (($20,000 ÷ $50,000) × $40,000 DNI).

Note. Amounts received in excess of DNI represent either corpus or accumulated income. These amounts are normally nontaxable.

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92. IRC §§661 and 662

93. Treas. Reg. §1.652(c)-2

TIER SYSTEM OF DNI ALLOCATION

Because some beneficiaries' rights to income may take precedence over the rights of others (some are required to receive distributions while others get only discretionary distributions), the distribution rules provide for priorities as to the allocation of DNI and, thus, the amount of taxable income and nontaxable income that is allocable to each.

The Code establishes a "tier system" to allocate DNI. Under this system, DNI (increased for charitable contributions) is first allocated to the beneficiaries who are required to receive distributions currently, so-called **first-tier beneficiaries.** DNI is allocated based on each beneficiary's pro rata share of first-tier distributions of trust accounting income. After allocating DNI to first-tier beneficiaries, any DNI remaining is allocated to charitable contributions. The balance of DNI remaining (as reduced by first-tier distributions and charitable contributions) is allocated to **second-tier beneficiaries** (those who receive discretionary distributions) based on each beneficiary's pro rata share of second-tier distributions of trust accounting income.

Example 22. A trust has TAI of $50,000 and DNI of $60,000. In March, the trust makes required distributions of $30,000 to Everett and $10,000 to Inez. The trust instrument requires an annual $2,000 distribution to a qualified charity. In addition to the required distributions, the trustee distributed $30,000 to Everett and $30,000 to Inez. DNI is allocated as follows:

	Everett	Inez	Total
Required distributions	$30,000	$10,000	$ 40,000
Discretionary distributions	30,000	30,000	60,000
Total received	$60,000	$40,000	$100,000
DNI before contributions			$ 60,000
First tier	$30,000	$10,000	(40,000)
DNI available for charity			20,000
Charitable distributions			(2,000)
DNI for second tier	9,000	9,000	18,000
DNI received	$39,000	$19,000	$58,000

The treatment of a contribution/distribution to a charitable organization is a bit confusing. On the one hand, a contribution is treated as an expense and reported on Form 1041, line 13. On the other hand, the charity itself is treated as a beneficiary in that it absorbs taxable and nontaxable DNI just like any distribution to a beneficiary. **It should be emphasized that the charity is not considered a beneficiary when computing the deduction for distributions to beneficiaries.** Instead, the distribution to the charity is accounted for as an expense.

CHARACTER OF INCOME

Distributions from the trust retain the various classes of income (such as dividends, tax-exempt interest, and rents) received by the trust. The gross amounts flow through to the beneficiaries and have the same character in their hands as they did in the hands of the trust. The difficulty here concerns how the various expenses incurred by the trust reduce the different types of income. To illustrate, assume a trust has gross income of $100,000, consisting of $50,000 of dividends, $30,000 of interest and $20,000 of net rents. It also paid trustee fees of $10,000. Thus, its net income and DNI is $90,000, which it distributes to its sole beneficiary. The problem is the allocation of the trustee fees. Do the expenses reduce the interest, the dividends, the rents, or a pro rata portion of each? The regulations provide great flexibility in allocating the expenses.[94] The type and amount of income that a beneficiary receives is determined as follows:

1. **Gross Receipts.** The gross amounts of each type of income are identified.
2. **Direct Expenses.** Each income item is reduced by any deduction directly related to that item. For example, rental expenses such as repairs, maintenance, real property taxes, and depreciation allocable to the trust reduce rental income. If the deductions directly attributable to a particular class of income exceed that income (i.e., excess deductions), the regulations provide that the excess is treated as an indirect expense and can be allocated to whatever other class of income the trustee selects. However, these regulations were issued in 1956, before enactment of the passive loss rules (1986) and the special tax rate applying to dividends (2003). Notwithstanding the silence of the regulations, the instructions to Form 1041, Schedule K-1, explain the IRS's position regarding excess deductions relating to passive losses. Here the IRS indicates that "[I]n no case can excess deductions from a passive activity be allocated to income from a nonpassive activity or to portfolio income…" Presumably, such excess (i.e., the net passive loss) could be allocated to other passive income.
3. **Indirect Expenses.** Indirect expenses are those that are not directly related to a specific class of income. These may be allocated and subtracted from any type of income the trustee selects. However, a pro rata share of all nonbusiness deductions that are not directly related to a particular type of income (e.g., trustee's commissions) must be allocated to exempt income. As noted above, the manner in which indirect expenses are allocated to exempt income is filled with uncertainty.[95]
4. **Charitable Contributions.** Charitable contributions normally are treated as coming from a proportionate share of each type of income.[96]

To summarize, expenses that are directly related to a particular type of income reduce such income. For indirect expenses, a portion of indirect expenses and charitable contributions must be charged against tax-exempt income. The balance of the indirect expenses (e.g., trustee fees) may be allocated as the trustee wishes.

DETERMINATION OF QUALIFIED DIVIDENDS

Qualified dividends are taxed at a maximum rate of 15% (0% if in the 15% tax bracket for 2008) for both the trust and the beneficiaries. A special calculation must be made to determine the amount of qualified dividends retained by the trust to be taxed at the favorable rate. The gross amount of qualified dividends is allocated between the trust and the beneficiaries based on the percentage of DNI distributed to the beneficiaries.

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94. Treas. Reg. §1.652(b)-3(a), Allocation of Deductions

95. Treas. Reg. §1.652(b)-3(b)

96. Treas. Reg. §1.661(b)-2

Example 23. In 2007, a trust had qualified dividends of $30,000. Total DNI was $50,000, and $10,000 was distributed to the sole beneficiary. The amount of qualified dividends allocated to the trust for purposes of calculating the trust's tax is $24,000, determined as follows.

Qualified dividends	$30,000	$30,000
Allocation to beneficiary		
DNI distribution to beneficiaries ÷ total DNI ($10,000 ÷ $50,000)	× 20%	
	$ 6,000	(6,000)
Allocation to trust		$24,000

Observation. This method of allocating the amount of qualified dividends between the beneficiary and the trust is used solely for calculating the tax liability of the **trust**. The actual amount of qualified dividends reported on the Schedule K-1 that the beneficiary must report is computed in the manner shown above.

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Example 24. Use the same facts as **Example 2.** On March 7, 1995, Grant Tor established a trust for his son, Ben. Under the trust instrument, a reserve for depreciation of $5,000 must be maintained, and both capital gains and 50% of the trustee's commission must be allocated to the principal account. Tax depreciation for the year is the same as the reserve for depreciation. In addition, the trust made a charitable contribution of $20,000 and the trustee distributed $85,000 to Ben. Given the following facts, what is the **character of the distributions received by the beneficiary?**

Rental income	$100,000
Tax-exempt income	10,000
Dividends	15,000
Long-term capital gain	50,000
Rent expense	10,000
Reserve for depreciation	5,000
Trustee commission	8,000

Trust DNI and the character of the distributions to the beneficiaries is computed below.

Rental income		$100,000
Dividends		15,000
Net tax-exempt income		
Tax-exempt income	$10,000	
Allocable trustee commission above	(640)	
Allocable charitable contribution above	(1,600)	
Net tax-exempt income	$ 7,760	7,760
Less:		
Rent expense		(10,000)
Depreciation		(5,000)
Trustee commission ($8,000 – $640)		(7,360)
Charitable contribution ($20,000 – $1,600)		(18,400)
DNI		$ 82,000

If the trustee elects to allocate expenses to dividend income (other than those that must be allocated to tax-exempt income and charitable contributions that are deemed to consist of each type of trust income), the character of the income to the beneficiary is determined below.

Note. In light of the preferential rates applying to dividends, it may be more beneficial to allocate the trustee fees to rents and preserve the character of the dividends.

Elements of DNI	Rents	Qualified Dividends	Nonqualified Dividends	Tax-Exempt Interest	Long-Term Capital Gain	Total
Income	$100,000	$15,000	$0	$10,000	$0	$125,000
Expenses						0
Rental expenses	(10,000)					(10,000)
Depreciation	(5,000)					(5,000)
Trustee fees (income and corpus)		(7,360)		(640)		(8,000)
Contributions	(16,000) [a]	(2,400) [b]	—	(1,600) [c]	—	(20,000)
Total DNI	$ 69,000	$ 5,240	$0	$ 7,760	$0	$ 82,000

[a] ((Rents ÷ Total income) × $20,000) = (($100,000 ÷ $125,000) × $20,000) = $16,000
[b] ((Dividends ÷ Total income) × $20,000) = (($15,000 ÷ $125,000) × $20,000) = $2,400
[c] ((Tax-exempt interest ÷ Total income) × $20,000) = (($10,000 ÷ $125,000) × $20,000) = $1,600

DISTRIBUTIONS OF PROPERTY

During the life of a trust, it is not unusual for the trustee to distribute property rather than cash. This presents a number of special problems. The treatment generally depends on whether the distribution represents specifically gifted property. In such case, there is no effect on the trust unless the trust elects to recognize gain or loss as discussed below. The distribution of the specific gifted property does not carry DNI with it and is not taxable to the beneficiary. The basis of the property carries over to the beneficiary unless the election to recognize gain is made by the trustee. In this case, the basis is the property's FMV.

If the property distributed is not the gifted property, the treatment depends on whether the trustee elects to recognize gain or loss. From a planning view, this rule gives the trust the ability to recognize gain or loss (subject to the disallowance rules of §267) or shift it to the beneficiaries.

No Election to Recognize Gain or Loss

If there is no election, the trust recognizes no gain or loss on the property distribution. The amount of the distribution (and the amount of DNI retained, if any) is equal to the lesser of the fiduciary's basis of the property or FMV. The trust's basis of the property simply carries over to the beneficiary.[97]

Note. The built-in gain or loss on the property is not gone forever, but merely deferred. It is preserved in the basis to the beneficiary.

97. IRC §643(e)

Technically, the basis of the property to the beneficiary under §643(e)(1) is:

	Adjusted basis of property to the trust
+	Gain recognized by the estate or trust
−	Loss recognized by the estate or trust
	Property's basis to the beneficiary

As shown in the formula above, if the fiduciary does not recognize gain or loss, the trust's basis of the property carries over to the beneficiary.

Example 25. This year, a trust makes a discretionary distribution of appreciated property to a beneficiary. The property has a value of $10,000, with a basis of $6,000. The trustee does not elect to recognize gain. Because no gain is recognized, the amount of DNI distributed is $6,000 (the lesser of the $10,000 value or the $6,000 basis) and the beneficiary's basis is $6,000. There are no ill effects from the distribution of appreciated property. The trust merely has shifted the potential gain to the beneficiary.

Example 26. This year, a trust makes a discretionary distribution of property sold at a loss to a beneficiary. The property has a value of $10,000, and a basis of $25,000. The trustee does not elect to recognize loss. The amount of income distributed to the beneficiary is $10,000 (the lesser of the $10,000 value or the $25,000 basis). Consistent with nonrecognition, the basis of the property is a carryover basis of $25,000 (adjusted basis $25,000 + $0 gain – $0 loss). As in the previous example, the trustee has shifted the loss to the beneficiary.

Note. It would be unwise for the trustee to elect to recognize the loss in **Example 26** because it would be disallowed under §267. However, when §267 applies, it is not clear whether the beneficiary's basis continues to be the property's $10,000 FMV, or a carryover basis of $25,000.

ELECTIVE RECOGNITION OF GAIN OR LOSS

The trustee may elect to recognize gain or loss on the distribution of property.[98] However, the loss is disallowed under the related party rules of §267. If the election is made, it applies to all property distributions made during the taxable year.[99] Consequently, the trustee cannot pick and choose which gains or losses to recognize.

When the trustee makes the election, the basis of the property to the beneficiary normally becomes its FMV.[100] However, if a loss is disallowed to a trust under §267, it is unclear whether the basis is the FMV of the property, as is normally the case, or whether the beneficiary is entitled to deduct a portion of the loss when the property is subsequently sold. The amount of the distribution (and the amount of DNI distributed, if any) is equal to the FMV of the property.[101]

98. IRC §643(e)(3)

99. IRC §643(e)(3)(B)

100. IRC §643(e)(1)

101. IRC §643(e)(3)(A)(iii)

Example 27. The treatment resulting from nonrecognition and elective recognition of gain or loss in **Examples 25 and 26** is summarized below.

- If no gain or loss is recognized, the amount of the distribution is equal to the lesser of the basis or property's FMV, and the property's basis carries over to the beneficiary.
- In contrast, if the executor elects to recognize gain or loss, the amount of the distribution is equal to the property's FMV and the property's basis to the beneficiary is its FMV.

Value	Adjusted Basis of Trust	IRC §643(b)(3) Election to Recognize Gain or Loss	Trust Gain (or Loss) Recognized	Amount of Distribution	Adjusted Basis of Beneficiary
$10,000	$ 6,000	No	$ 0	$ 6,000	$ 6,000
10,000	6,000	Yes	4,000	10,000	10,000
10,000	25,000	No	0	10,000	25,000
10,000	25,000	Yes	Disallowed	10,000	Unclear

Note. The above illustration indicates that the executor would not want to make the election to recognize the $15,000 loss in the last item in order to avoid the question of the basis of the item to the beneficiary, and to allow the loss to be recognized by some taxpayer.

YEAR OF REPORTING BY BENEFICIARIES

Beneficiaries receive a summary of the tax consequences of distributions received on a Schedule K-1 from the trustee. The Schedule K-1 identifies the amounts and character of the various items of income and deduction that may have an effect on the beneficiary's income.

REQUIRED DISTRIBUTIONS

A beneficiary normally reports distributions from the trust in the tax year in which the trust's year ends.[102] When the trust instrument **requires** distributions of income or principal to be made at the close of the trust's year, it makes no difference for income tax purposes when such distributions are actually made. This is the case even if the distribution is made in the following year. Required distributions are deemed made on the last day of the trust's taxable year. This rule normally applies to simple trusts.

Example 28. The Thomas trust requires that all TAI is distributed to its beneficiary, Bob, annually. After the close of the trust's year, December 31, 2007, the trustee is able to collect all the information needed to determine the amount of the distribution. The trustee pays Bob that amount on February 2, 2008. Because the trust is required to distribute the income (or principal), it is deemed to have been paid on December 31, 2007. Consequently, the trust deducts the distribution in 2007 and Bob reports the taxable income in 2007.

DISCRETIONARY DISTRIBUTIONS: 65-DAY RULE FOR COMPLEX TRUSTS AND ESTATES

In contrast to required distributions, discretionary distributions are normally considered distributed when the trustee makes the payment. For instance, if **Example 28** involved a complex trust where the distribution is discretionary, the trust deducts the payment and the beneficiary reports it in 2008, the actual year of payment. However, under IRC §663(b), if a trust properly elects, it may treat distributions made during the first 65 days of the year as having been made on the last day of the previous year. The special 65-day rule applies to complex trusts and estates.

102. IRC §662(c) and Treas. Reg. §1.662(c)-1

Although the Code imposes no restriction on the use of throwback distributions, Treas. Reg. §1.663(b)-1(a) limits their amount. The limitation prohibits a trust from making distributions after yearend that will be tax-free because they exceed the prior year's DNI. The maximum amount of throwback distribution is limited to the prior year's trust income (or DNI, if larger) reduced by distributions. The following formula may be used:

	Larger of the throwback year's trust income or DNI
−	Amounts paid in the throwback year (except that which will be thrown back)
	Maximum amount that can be thrown back

Example 29. Dora receives distributions from a trust at the discretion of the trustee, Larry. At the close of 2006, Larry had not yet determined the trust's final income for the year. Shortly after the beginning of 2007, he made the calculations and determined that the trust had income of $10,000 and DNI of $8,000 in 2006. A review of distributions paid during 2006 revealed that $5,500 was distributed in January 2006, which Larry elected to treat as distributed in 2005, and $6,000 was distributed in August 2006. The maximum amount of 2007 distributions that Larry may treat as distributing in 2006 is $4,000 ($10,000 income – $6,000 distribution).

	For the throwback year, 2006, larger of trust income ($10,000) or DNI ($8,000)	$10,000
−	Amounts paid in the throwback year 2006 (except that which was thrown back)	(6,000)
	Maximum amount that can be thrown back from 2007 to 2006 and deducted in 2006	$ 4,000

As a result, the trust may distribute an additional $4,000 within the first 65 days of 2007 and deduct the amount in 2006. If the trust distributes $4,000 during 2007 and makes the election, the beneficiary must appropriately account for the $4,000 in her 2006 return.

Note. The distribution treated as having been paid in 2005 is ignored in determining the maximum amount qualifying for IRC §663(b).

The delayed-distribution rule does not apply to simple trusts, because all income of simple trusts is deemed distributed regardless of whether it is actually distributed.

The 65-day election must be made by the due date of the trust return, April 15, as extended. It is made by checking the appropriate box on Form 1041 (Question 6 on the 2007 Form 1041). It need not be made for all distributions made during the 65-day period, only the amount the trust specifies (subject to the limitations above). The election is irrevocable once the last day for making it has passed.

DEATH OF A BENEFICIARY

Treas. Reg. §1.662(c)-2 provides a special reporting rule for the year that a beneficiary dies. In the year a beneficiary dies, any distribution received prior to death is includable on the beneficiary's final return to the extent of his share of available DNI for the full taxable year of the trust within which the beneficiary's death occurred. Income required to be distributed to the beneficiary, but in fact distributed to the beneficiary's estate, is income in respect of a decedent (IRD).

Example 30. Benita is a beneficiary of a simple trust. She died on December 31, 2007, having received $1,000 from the trust in March 2007. Trust income for all of 2007 was $9,000. Under the trust instrument, all $9,000 of income must be distributed to Benita or Benita's estate. The trust distributed the remaining $8,000 on January 15, 2008, to Benita's estate. Her final return includes the $1,000 distribution received prior to death. The balance of the $8,000 income that must be distributed is IRD and is reported on Benita's estate income tax return.