Chapter 7: Estate and Trust Taxation

Corrections were made to this workbook through January of 2011. No subsequent modifications were made.

The evidence is overwhelming. Tax professionals must prepare for an increasingly older client base. Exactly what kind of demographics can tax practitioners expect over the next 25 years? A recent report by the U.S. Census Bureau projects that the number of people in the U.S. that are 65 and over — about 13% of the population, or 39 million in 2009 — will grow to about 89 million by 2050. While the 65 and over group is growing more than 130%, the U.S. population as a whole will increase only 49%. By 2050, the young in the United States — defined as under age 15 — will no longer outnumber the old. The U.S. population will be considered old!

While there has been a great deal of discussion about the graying of America and the aging boomer generation, it is finally here. Baby boomers (defined as those born between 1946 and 1964) start turning 65 in record numbers in 2011. What does it all mean? One aspect is clear. The demand for estate and trust work will increase. The aging population means more estate income tax returns, more trust income tax returns, more estate and gift tax returns, more inheritance tax returns, more estate planning, and more opportunity for those knowledgeable in these areas.

ESTATES AND TRUSTS IN GENERAL

ESTATES

When an individual dies owning property in the individual's name, a new entity, the estate, is created by operation of law. The estate is a separate legal entity and is treated as a separate taxable entity, distinct from the decedent. Under state law, the estate automatically takes legal title to all of the decedent's assets that do not otherwise pass outside of the estate by contract or other means. The estate only contains the property that goes through estate administration referred to as probate — the legal process of settling a decedent's affairs. Assets that are **not** part of the probate estate are not part of the estate's assets that could produce estate taxable income.

Note. The federal estate tax covers more than just the assets in the probate estate. IRC §§2036–2042 require inclusion of many nonprobate assets in the deceased taxpayer's taxable estate. Assets held in a revocable trust are includable in the grantor's taxable estate.

Probate and Nonprobate Assets

Assets owned in a deceased individual's name are subject to estate administration. The function of the estate or, perhaps more precisely, the executor (i.e., administrator or personal representative of the estate), is to oversee, manage, and ultimately settle the affairs of the decedent. The executor collects the assets, identifies and pays the decedent's liabilities, and then distributes the property to the beneficiaries. The executor's job is to shepherd the decedent's assets through the probate process and preserve them for the beneficiaries of the estate. In effect, the estate is a transitional entity bridging the time between the decedent's death and the settlement of the estate. As noted above, the estate is a separate taxable entity. Consequently, one of the concerns of all parties is that the taxable income of the estate is properly reported.

- One item that passes outside of probate is property held in joint tenancy with right of survivorship (e.g., a joint bank account and a brokerage account held in joint tenancy). Such property passes directly to the surviving co-tenant and is not part of the probate process or subject to the purview of the probate court. In contrast, the decedent's interest in property held in tenancy-in-common goes through probate. One of the characteristics of a tenancy-in-common is that the owner has the right to will his interest to anyone he wishes, including those other than co-tenants of the property. Income produced by such an interest is potentially taxable to the estate. A decedent's share of community property also goes through probate.

Note. A joint tenancy is only created by specific language in a granting document that states that title ownership is taken with rights of survivorship (WROS). Title ownership is presumed to be taken as tenants in common in the absence of survivorship language.

- Property held in trusts (e.g., cash or stocks in an irrevocable trust or a revocable trust that becomes irrevocable upon the grantor's death) is the property of the trust; it does not pass through probate but passes under the terms of the trust instrument. Income of a revocable trust, as discussed below, is taxable to the grantor of the trust. In contrast, generally income of an irrevocable trust (including a revocable trust that becomes irrevocable upon the decedent's death) is taxed to the trust unless distributed to the beneficiaries.

Example 1. This year Tom and Libby Smith implemented one of the first steps of their estate plan by creating a revocable living trust and naming themselves as co-trustees. They transferred virtually all of their assets to the trust, including their personal residence in Illinois, a condominium in Florida, and a number of income-producing investments. Their investments included some dividend-paying stocks, state of Illinois bonds, and a duplex that they rent out. This required changing the title of the assets from their names to the name of the trust.

- A third property interest that escapes probate is property that passes by contract to named beneficiaries. These include such items as retirement plans (e.g., 401(k) plans and IRAs), survivor-type annuities, and life insurance.

Example 2. A closer look at Tom and Libby's investment assets from **Example 1** revealed that one of their investments was an annuity from Tom's retirement plan. Under the terms of the annuity contract, Tom received monthly payments of $4,000 until his death. Upon his death, the annuity contract called for a reduced payment of $3,000 to Libby until she died. Every month, Tom received $4,000 of annuity payments that he dutifully reported on the couple's Form 1040, paying the appropriate income tax. Tom died on March 7 of this year. Before he died, he received three payments of $4,000 each, for a total of $12,000. Upon his death, monthly payments of $3,000 were paid to his wife Libby, a total of $27,000 for the remainder of the year. Are any of these amounts taxed to the estate?

The annuity amounts received before death are reported on Tom's final income tax return, which is probably a joint return as long as Libby remains unmarried at the close of the year. The $27,000 of annuity payments after his death pass outside of probate and are not taxable to the estate. Instead, they are taxable to Libby, who reports them on a joint return with Tom or, if she remarries, a joint return with her new husband.

Basis of Property Acquired from a Decedent

For income tax purposes, property held by the estate usually has a basis equal to its fair market value (FMV) at the date of death.[1] Items that are considered income in respect of a decedent do not receive a step up in basis.[2] These items include accrued items of income at the decedent's death such as unpaid wages, crop-share grain on hand to a nonmaterially-participating crop-share landlord, the balances in retirement plans, and the value of annuity contracts.

> **Note.** See Issue 5 in Chapter 10, Agricultural Issues and Rural Investments, for information regarding income tax basis for 2010 deaths.

TRUSTS

Definition and Creation

Trusts are separate legal entities. In this regard, they are similar to other legally-created entities such as corporations and partnerships. A trust arises from a contractual arrangement. Under the contract, an individual, usually known as the **grantor**, transfers legal ownership of property to another party, the **trustee**, whose duty is to hold and administer the trust 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**, although in some legal documents the Latin word **res** is used. The terms of the trust instrument set forth the duties of the trustee and the rights of the beneficiaries with respect to the trust's assets and the income they produce.

The creation of a trust often results in a division of property interests and two types of beneficiaries. The first type, an **income beneficiary**, is entitled to the trust's **income**. The second type, a **remainderman**, receives the remainder of the trust normally 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.

Trusts are created pursuant to the laws of the state in which the trust is domiciled. Therefore, state law governs the validity of any provision of a trust instrument. State law also governs the relationships between the parties to the trust agreement — the trustee and the beneficiaries — as well as the construction, and effect of the agreement and its enforcement. Similarly, if the trust is silent about some aspect of its operation, state law governs. The importance of the trust instrument cannot be overstated. State law gives grantors great latitude in the creation of trusts and with it the ability to control the rights to the property — both income and corpus. However, if the trust instrument says nothing regarding a particular issue, state law controls. For example, if the trust instrument simply says that a beneficiary is to receive the income of the trust annually, income is defined by state law and not necessarily by generally accepted accounting principles (GAAP) or tax accounting principles.

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 are also used to protect assets from risk of a donee's creditors because of a grantor's troubled business. In addition, trusts are created to protect assets in the case of an unworkable 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. Recently, however, tax legislation has virtually eliminated the income tax motivation for the creation of trusts. On the other hand, the use of trusts continues to be an important part of planning for estate and gift tax.

Rule against Perpetuities. Most states have adopted a law concerning future interests, including interests in trusts, that is referred to as the rule against perpetuities. As applied to trusts, this rule establishes a time limit on the duration of a trust. In most states, a trust must terminate and distribute its assets no later than a specified time, usually 21 years after the death of the last beneficiary who was living at the time the trust was created.

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1. IRC §1014.
2. IRC §691.

Example 3. When Tom (See **Example 1** and **Example 2**) turned 60, he created a separate trust for the benefit of his children and grandchildren and great grandchildren. Under the terms of the trust, the children receive the income for life. When the children die, the income is paid to the grandchildren. Upon the death of the grandchildren, the assets must be distributed within 21 years, otherwise the trust agreement would violate the rule against perpetuities and the trust would be invalid.

The rule against perpetuities was created to prevent people from controlling wealth through instructions in their will long after they have died. Absent the rule, an individual could create a trust that provided a series of income interests in perpetuity. For example, the trust could provide for an income interest to the children, the grandchildren, the great grandchildren, the great-great grandkids, and so on.

As the above example suggests, the rule effectively limits the amount of time that a person can control the property after death. In recent years, many states have modified their rule against perpetuities. Practitioners should check the laws in their states.

An individual can domicile a trust in any of the 50 states without regard to his own domicile. For example, an Indiana resident may establish a trust in Illinois. See the discussion of trust situs in the section "Fiduciary Accounting Income."

Tax Consequences of Creating a Trust

When a grantor establishes a trust, several tax concerns arise.

Gift Tax. The transfer of the property to an irrevocable trust (explained below) is considered a gift to the beneficiaries and not to the trust.[3] Normally, a transfer to an irrevocable trust does not qualify for the annual exclusion (currently $13,000) per year per donee because the transfer to the trust is not a present interest. The two most common exceptions qualifying the transfer to an irrevocable trust as a present interest require the following:

- A withdrawal right by the beneficiary[4]
- The unrestricted right to possess or enjoy the property immediately[5]

A transfer to a revocable trust is not considered a completed gift for gift tax purposes.

Basis of Trust Property. The basis of property transferred to the trust depends on whether the trust acquired the property directly from a decedent or by gift. If the trust is created under the decedent's will (a testamentary trust), the rules for determining the basis of inherited property typically result in a basis equal to the property's value at the date of the decedent's death.[6] If the property was acquired by gift, the basis rules for gifts contained in IRC §1015 apply. The trust's basis is the same as the donor's basis unless the property's value was less than its basis at the time of transfer (i.e., it has a built-in loss at the date of the transfer). In this latter case, the basis of the property depends on the sales price of the property. The basis for gain is the donor's basis while the basis for loss is the FMV at the time of the gift. The basis for depreciation is always the donor's basis. In addition, the basis of the gifted property is increased by any suspended passive losses.[7]

Income Tax Considerations in Forming a Trust. The creation of a trust does not trigger income tax. Similarly, the transfer of property does not trigger recapture (IRC §§1245(b)(1) and 1250(d)(1)) nor does it cause recapture of unused credits. However, the potential recapture carries over to the trust.[8]

3. Treas. Reg. §25.2503-2(a).
4. *Crummey v. Comm'r,* 397 F.2d 82 (9th Cir. 1968).
5. Treas. Reg. §25.2503-3(b).
6. IRC §1014.
7. IRC §469(j)(6)(A).
8. S. Rept. No. 1881, P.L. 87-834, p. 802.

Types of Trusts

Inter Vivos and Testamentary Trusts. Trusts can be created during the grantor's lifetime (e.g., by gift) or upon the grantor's death through the will (e.g., by bequest). Trusts created during one's lifetime are called **inter vivos trusts,** meaning among the living. Trusts created at death are referred to as **testamentary trusts** (i.e., established by operation of the decedent's last will and testament).

Irrevocable and Revocable Trusts.[9] A trust may be classified according to whether the trust arrangement can be altered. If the grantor cannot alter or amend the trust arrangement (e.g., terminate the trust arrangement 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 and the gift tax may apply. 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. An irrevocable trust can be created during the grantor's life or through a will when the grantor dies. An irrevocable trust is a separate taxable entity and is generally taxed on any taxable income received. However, the burden of taxation falls on 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). The taxation of a revocable living trust is governed by the grantor trust rules discussed below.

Individuals often use revocable trusts to avoid probate. Problems which may be associated with probate include costs of probate (once at the decedent's death and again at the spouse's death), publicity (probate is a public process while trusts are generally not open to the public), and delays of transferring property to the intended beneficiaries due to problems of probate. If an individual owns property located in different states, there are multiple probate proceedings so the potential problems are multiplied.

Revocable living trusts, as the name suggests, are created before death. During life, an individual transfers assets to a revocable trust. Because the trust is revocable, the grantor of the trust can obtain the assets whenever he wishes. Thus, the grantor never loses control of the property. In most cases, the grantor of the trust also names himself as trustee in order to simplify the process. As trustee, the grantor can buy, sell, transfer, borrow, or do whatever he could have done had the assets never been transferred to the trust.

In most revocable trusts, the grantor retains the right to change or amend the trust. The grantor thus retains effective control of the assets held in the revocable trust. For state law purposes, assets transferred to a revocable trust are titled in the name of the trust. The transfer of assets to the trust is important when the grantor dies. When the grantor dies, the assets held in the trust are not subject to probate because the trust holds the legal title. Generally, when the grantor dies, the revocable trust becomes irrevocable. The trust then serves as a will substitute. The successor trustee (assuming the deceased grantor was the initial trustee) either retains or distributes the trust assets in accordance with the trust agreement. Therefore, the assets held in the trust pass outside of any probate proceedings.

> **Note.** The revocable trust is ineffective to avoid probate unless the deceased grantor's assets are titled in the name of the trust. This requires actually transferring assets to the trust. For assets with titles — such as real estate, vehicles, and stocks and bonds — the title needs to be registered to the name of the trust. For assets without titles — such as jewelry or farm machinery — a bill of sale or assignment should be signed by the grantor evidencing the transfer to the trust.

The living trust is normally coupled with a simple **pour-over will** that provides that any assets not titled in the name of the trust are poured over to the trust to be managed and distributed in accordance with the provisions of the trust. This is a safety feature in case some of the decedent's assets have not been transferred to the trust. Note that such assets — **those whose disposition is governed by the pour-over will — will go through probate.**

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9. In this chapter, any reference to a trust is to an irrevocable trust unless otherwise stated.

Example 4. When Tom and Libby (see **Examples 1–3**) created their trust, the major purpose was to avoid probate. One of the major advantages in their situation is that multiple probates are avoided. By having their Illinois residence and Florida condominium in a single trust, probate in both states is avoided with respect to the two properties.

While revocable trusts are usually touted as a vehicle to avoid probate, they can also be used for the lifetime management of property. In this regard, they serve as a substitute for a durable power of attorney to manage property. If the grantor should become incompetent, the trustee can continue to manage the trust property. However, revocable trusts are not a substitute for a durable power of attorney concerning healthcare or other healthcare directives.

A transfer of assets to a revocable trust does not put the property out of reach from the grantor's creditors or make the grantor eligible for Medicaid benefits. To potentially protect assets from creditors, the trust must not only be irrevocable but must also meet other strict legal requirements.

Grantor Trusts. This designation is reserved for trusts that are not treated as separate taxable entities for tax purposes but are disregarded.[10] If a grantor retains beneficial enjoyment of the trust property or retains the right to control who will enjoy the property, the trust entity is ignored for income tax purposes. The grantor is then treated as the owner of the property and is taxed on all or a portion of the trust income. The classic example of a grantor trust is a revocable trust. A revocable trust is not treated as a taxable entity because the grantor has never given up control of the assets and, as a practical matter, still owns the assets. From a gift tax perspective, no gift results when assets are transferred to a revocable trust since there is no completed transfer. For income tax purposes, **the income of a revocable trust is taxed to the grantor.**

Example 5. During the year, Tom (see **Examples 1–4**) directs the couple's living trust to sell some of the Microsoft stock held by the trust for $100,000. The stock is in his brokerage account with Merrill Lynch that holds the stock in the name of the revocable trust of Tom and Libby Smith. The stock was one of the original assets that Tom and Libby had transferred to the trust by simply changing the name on the account. The couple's basis in the stock was $20,000. Because the trust is a grantor trust, the trust's basis of the stock is the same as it was in the hands of Tom and Libby, or $20,000. Consequently, the trust realizes and recognizes a gain of $80,000. A review of the Form 1099 provided by Merrill Lynch at the end of the year also indicated that the trust received $5,000 of dividends on various stock that it held. What are the reporting requirements in this situation? Must a trust return be filed?

Income Tax Reporting. The items of income, deduction, and credit of a grantor trust such as a revocable trust ultimately are reported on the grantor's own Form 1040, *U.S. Individual Income Tax Return*. The regulations provide several options for the method of reporting.

The general rule of the regulations contained in Treas. Reg. §1.671-4(a), which was finalized in 1995, provides that all items of income, deduction, and credit of a grantor trust are **not** reported on Form 1041, *U.S. Income Tax Return for Estates and Trusts*, but are detailed on a separate statement to be attached to that form. This statement should include information about the grantor such as name, address, and social security number (SSN). However, Treas. Reg. §1.671-4(b) provides additional choices that are much easier for all. If there is any question regarding reporting, the trust should secure its own taxpayer identification number and file a return using this number. That said, most revocable living trusts take advantage of a simpler option described below.

Treas. Reg. §1.671-4(b)(2) provides the easiest option for reporting. This option can be used **only** when the trust is owned or treated as owned by one grantor or one other person. For this purpose, a trust, all of which is owned by a husband and wife, is treated as owned by one grantor as long as they file a joint return.[11] In this case, the trustee, who in most cases is the grantor, simply furnishes the name and taxpayer identification number of the grantor and the address of the trust to all payors during the taxable year. As a practical matter, the grantor has already done this when he gives the payor his own SSN and address.

10. See IRC §§671–678.

11. Treas. Reg. §1.671-8.

Example 6. Use the same facts as **Example 5.** Recall that Tom and Libby are co-trustees. Under the grantor trust rules, they are treated as co-owners of the trust property since the trust is revocable and all of the income is taxed to them. For reporting purposes, Tom and Libby simply report the capital gain and dividend income on their own joint return. Nothing more is required since they comply with Treas. Reg. §1.671-4(b)(2). They have met both requirements:

1. The trust is treated as being owned by one grantor or one owner.
2. The trustee, in this case Tom or Libby, furnished the payor, Merrill Lynch, with Tom's SSN and home address, which is also the address of the trust.

If the **grantor is not the trustee** of the trust, the trustee has additional reporting obligations as set forth in Treas. Reg. §1.671-4(b)(2)(ii). If these requirements are met, the trust is not required to file a return. First, the grantor of the trust is required to give the trustee a completed Form W-9, *Request for Taxpayer Identification Number and Certification.*[12] In addition, the trustee must furnish the grantor (or other person treated as the owner of the trust) with a statement that:

1. Shows all the trust's items of income, deduction, and credit for the taxable year;
2. Identifies the payer of each item;
3. Provides the information necessary to take the items into account in computing the grantor's taxable income; and
4. Informs the grantor that the items of income, deduction, and credit, and other information shown on the statement must be included in computing the taxable income and credits of the grantor (or other person) on the income tax return of the grantor (or other person).

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As noted above, when these requirements are met, the trustee is not required to file any type of return with the IRS.[13]

Simple and Complex Trusts. For tax purposes, a **simple trust** is a trust that:

- Distributes all trust income currently,
- Does not take a deduction for charitable contributions for the current year, and
- Does not make any current distributions 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 but complex in any year in which principal is distributed. This can be an important distinction since the exemptions for simple and complex trusts differ.

Qualified Disability Trust (Special Needs Trust or Supplemental Needs Trusts). Trusts are frequently used to help provide benefits for individuals with special needs due to a disability or mental illness. The beneficiaries of these trusts often are incapable of caring for themselves, and planning for their care can be difficult once the caregiver is gone. To meet these needs, assets can be transferred to a trust where they can be properly managed and used for the benefit of the individual. For example, parents may create such a trust in order to ensure that a child is provided for after the parents die.

A type of trust that is used increasingly to meet these demands is the so-called **special needs trust** (SNT). The SNT is often referred to as a **supplemental needs trust.** It is designed primarily to provide benefits to special needs individuals in such a way that the beneficiary will not lose any governmental benefits that otherwise are available. SNTs have been in use for many years but the federal government officially sanctioned them in the Omnibus Budget Reconciliation Act of 1993. This act set up the rules for SNTs.

12. See Treas. Reg. §1.671-4(b)(1).

13. Treas. Reg. §1.671-4(b)(2)(ii).

Special needs individuals are entitled to a variety of benefits provided by federal, state, and local governments. For example, a major benefit 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. A child under age 18 can qualify if he meets the Social Security Administration's definition of disability for children, and if his 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 federal SSI payment.

Effective January 1, 2010, the monthly federal benefit rate is $674 for an individual and $1,011 for a couple (if both are eligible). Many states offer a similar benefit, although a smaller amount. Other benefits that may be 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 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 a SNT 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. Moreover, they could be funded with life insurance. Without the use of an SNT, the maximum amount of assets that an individual could inherit would be $2,000. In addition, SNT assets can be used to pay for items that cannot be purchased with SSI such as additional care, a motorized wheelchair, 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 these. Typically, SNTs are designed so that none of the assets can be used for food, clothing, and shelter, or services provided by government programs. If trust funds are available for such purposes, the governmental benefits received by the disabled person could be lost.

SNTs normally are established in one of two ways. The trust could be created by a third party (e.g., the parent of a disabled child). Alternatively, the SNT could be established 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 normally treated as a separate taxable entity. In contrast, an SNT created by the disabled individual with his own funds is usually a grantor trust.

Tax Treatment. For income tax purposes, the SNT is generally treated like any other irrevocable trust. It is a separate taxable entity with its own federal identification number. Its taxpayer identification number is neither the grantor's nor the beneficiary's SSN.

An SNT may qualify as a **qualified disability trust** for tax purposes if:

1. It is created for those under 65 years of age who are disabled,[14] and
2. All beneficiaries of the trust are certified as disabled for some part of the tax year within the meaning of 42 USC 1382c(a)(3) by the commissioner of Social Security.

Qualified disability trusts generally are taxed like other irrevocable trusts. However, such trusts are entitled to an exemption equal to that for an individual ($3,650 in 2010 if the MAGI is less than or equal to $166,800).[15] Normally, the exemption is $100 for complex trusts and $300 for simple trusts. Distributions are not subject to the kiddie tax.

14. See 42 USC 1396c(2)(B)(iv) for definition of disabled.

15. IRC §642(b)(2)(C).

FIDUCIARY ACCOUNTING INCOME

In order to understand the income taxation of estates and trusts, a tax professional also must have a basic understanding of the accounting for estates and trusts (fiduciary accounting). Indeed, as the population ages and the use of trusts grows, many accountants will be called upon not only to prepare a trust's income tax return but just as importantly to determine a trust's income. Of course, as the population ages, the number of estates will also increase.

Example 7. Several years have passed since Tom and Libby (see **Examples 1–6**) created their revocable trust. Since that time, Tom passed away and the trust became irrevocable. Although Libby is the current trustee, the couple's long-time accountant, Al, has provided professional management since Tom died. Under the terms of the trust, Libby is to receive the trust's income for life and the remainder is to be shared by the couple's children upon her death. Most of the couple's assets are now invested in mutual funds.

In gathering the information for the 2010 tax return, Libby came across a Form 1099 from the brokerage firm that held the trust assets, including Forms 1099 from some of the mutual funds that the trust owns. She noted that the brokerage account reported that several capital gains and some capital losses from the sale of stocks were realized. When she reviewed the Forms 1099 from the mutual fund, she found that most reported ordinary dividends as well as capital gains. At that point, she wondered whether she was entitled to the capital gains and the capital gain distributions since she was the income beneficiary. Similarly, she saw that the trust had paid the property taxes on their rental property. Again, she wondered whether the taxes would affect the rental income she would receive since the taxes were imposed on the property that was part of trust corpus.

How is fiduciary accounting income determined? What rules are followed — tax, GAAP, or something else? What do the beneficiaries of trust income receive? What do the remaindermen receive?

First and foremost, fiduciary accounting income (FAI) is a unique concept. It is neither **taxable income nor GAAP income.** All too often uninformed practitioners incorrectly assume taxable income and FAI are the same. For example, interest on municipal bonds is excluded in determining taxable income and is included in FAI. It is even more likely that accountants would incorrectly assume that FAI is the same as income determined using GAAP. Both of these assumptions miss the mark. They are as misguided as believing that taxable income and GAAP income are equivalent. For trusts and estates, FAI is the quantity to be distributed or accumulated for income beneficiaries as defined by the trust agreement or will. If the trust agreement or will is silent, the amount is determined under state law.

As a practical matter, all trusts contain a provision concerning the distribution of income but these say little about what constitutes income, leaving it to state law. Wills rarely define income. For an accountant, this means that a rudimentary knowledge of a state's statute defining principal and income is imperative. For particular situations, accountants would be well advised to have a good reference handy. They also should be forewarned that consultation with an expert on the computation of FAI might be necessary. Consider the following examples.

Example 8. In January of this year, Tom's (see **Examples 1–7**) father died. He left $100,000 to a trust for Tom and the remainder of his estate to a second trust for his granddaughter, Rachel. During the probate period, it was determined that the $100,000 pecuniary bequest produced income of $5,000. Interest income of $15,000 also was received during the period. Is the trust for Tom entitled to any of the income accrued on the principal or is it part of the residuary estate (i.e, the part of the estate that remains after all specific gifts and bequests are satisfied)? Section 202(b)(1) of the Revised Uniform Principal and Income Act indicates the trust would be entitled to receive a portion of the net income equal to the beneficiary's fractional interest in the undistributed principal assets immediately before the distribution.

Example 9. During the year, a trust acquired a home and allowed the trust's beneficiary rent-free use of it. The rent-free use of property owned by a trust by its beneficiary does not result in imputed income to either the trust or the beneficiary.[16]

Many of the rules and practices of fiduciary accounting derive from the fact that a trustee or executor has the fiduciary responsibility to protect the rights of each beneficiary. In this regard, the laws of most states require an annual report to the beneficiaries. The law views the accounting as a report 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 see changes in principal and income. In addition, beneficiaries want to know whether they are being treated fairly and if the trustee has properly discharged his duties. It follows that the primary concern of fiduciary accounting is the proper allocation of the receipts and disbursements of the trust and estate between the various competing interests. Historically, rules and laws have existed that neatly categorize certain receipts (e.g., interest, dividends, and rents) as income. More recently, trust instruments give the trustee the power to allocate receipts and disbursements between income and corpus as he believes is appropriate.

For the most part, trust agreements are drafted to distinguish between income beneficiaries and remainder beneficiaries. 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, whereby the tree represents the assets and the fruit represents the income produced. The fruit goes to the income beneficiary and the remainderman ultimately gets the tree. To illustrate these principles, 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 free of all trust, whereupon this trust shall terminate and be of no further force or effect.

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 "fiduciary accounting income" while the other group of beneficiaries is entitled to the remainder. Thus, the major job of trust accounting and the trustee is to ensure that the amount accruing to each of the two classes of beneficiaries is correctly determined. In short, the trustee must allocate receipts and disbursements properly.

So what is FAI? Unfortunately, the trust agreement often provides little or no guidance in what can be a high-stakes game for all parties. The trustee's major task 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 interests? The remainderman would get all of the "income" and the income beneficiary would get nothing. 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 FAI, 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 are allocated between income and principal in order to compute fiduciary accounting income. FAI for estates is controlled solely by state law unless altered by the will.

16. See generally Alan S. Acker, 852-3d T.M., Income Taxation of Trusts and Estates.

UNIFORM PRINCIPAL AND INCOME ACT

The Uniform Principal and Income Act (UPIA) formally addressed the concept of fiduciary accounting income upon its creation in 1931.[17] One of the primary purposes of the act was to deal with the problems of adjustment of principal and income between tenants and remaindermen in trusts and estates. It was prepared in response to demand for legislation primarily from trustees who were concerned about discharging their fiduciary duties in light of an ever increasing number of difficult and technical problems which arose in determining principal and income issues and dealing with the conflicting opinions of the courts on these issues.

Under the UPIA, fiduciary accounting income (or trust accounting income) is the amount of income as **determined under the terms of the trust agreement**. However, where the trust agreement is silent regarding the treatment of a particular receipt or disbursement, state law governs. 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 FAI when the trust instrument says nothing. All states have a principal and income statute. Most laws are modeled after the UPIA.

> **Observation.** To see a particular state's Income and Principal Act, see the uniform laws maintained by Uniform Laws Commission of The National Conference of Commissioners on Uniform State Laws at **www.nccusl.org.** The bulk of the 74 pages of the UPIA (as amended in 2000) concerns allocation of receipts and disbursements.

The Uniform Commission made major revisions in 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. The Investor Act recognized that the historic view of income and principal (i.e., the fruit of the tree doctrine) had become obsolete and, consequently, revamped the rules. The old 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 FAI purposes as income or principal. 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 (e.g., capital gains). Not only was the old view of income out of step with current practices, the old view of income had become inequitable.

Over the prior 25 years, income yields from stocks and bonds had dropped precipitously as the investment strategy shifted toward capital appreciation. According to reports, the drop may have been as much as 70%, a cruel blow to income beneficiaries. The authors of the Investor Act understood the difficulty and revised the law to reflect current investment strategies. The Investor Act now gives trustees the protection they need to implement modern investment techniques and at the same time comply with prudent investment standards.

The 1997 revisions in the UPIA reflect the new approach to investing. The 1997 act revised the definition of income and principal. **Income** now is more broadly defined as money or property that a fiduciary receives as current return from a principal asset. **Principal** is defined as property held in trust for distribution to a remainder beneficiary when the trust terminates. These changes allow trustees to implement modern investment methods or use so-called total return trusts — sometimes referred to as total return unitrusts (TRU) — with immunity. In addition, 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.[18] Trustees have great latitude in determining how amounts are allocated and ultimately what is included in FAI. 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 FAI. The rules imply that the trustee needs to make adjustments to be **fair,** and what that means is not always clear. In this regard, the standards instruct a trustee who has doubts about any allocation to resolve it in favor of principal.

17. As of June 2010, 42 states and the District of Columbia had adopted the act in total or with modifications. Delaware, Georgia, Illinois, Louisiana, Minnesota, Mississippi, Rhode Island, and Vermont have not adopted the laws but have their own principal and income statutes.

18. Sec. 104 of the 1997 Revised UPIA.

Although the revised UPIA was adopted by most states, some states expanded or redefined various parts. Others did not. 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 the AICPA, among other groups. The national fiduciary accounting standards include six broad principles, with detailed explanations 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 approach taken by any particular state.

FAI Not a Tax Concept

As emphasized earlier, FAI is not a tax concept and is not computed using any rules prescribed by the Code. In fact, 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 FAI.[19]

Example 10. Use the same facts as **Example 8.** Under the will of Tom's father, Frank Smith, $100,000 was left in a trust with income to Tom annually and upon Tom's death, the remainder went to his granddaughter, Rachel. The residuary of the estate was placed in a separate trust for Rachel. Under the agreement, Tom receives the income from his trust annually. One of the assets left in trust was a vacant lot worth $25,000. If the lot is sold for its $25,000 book value, there is no effect; one asset has simply been exchanged for another. On the other hand, if the lot were sold for $30,000, a gain is recognized and the proceeds must be allocated to either income or principal. Note that Tom benefits if the proceeds are allocated to income while Rachel benefits if the proceeds are allocated to corpus. To determine how to allocate the proceeds, reference is made to the trust instrument. If the trust instrument is silent, state law governs.

Another caveat when computing FAI is warranted. GAAP does not necessarily govern the determination of FAI. Similarly, there is no agreement on whether the national fiduciary accounting standards should be considered generally accepted. What is clear is that the trust instrument and state law ultimately control. Note, however, that the revised UPIA relies 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. In UPIA Section 8, it states:

*. . . 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.*

CALCULATING FIDUCIARY ACCOUNTING INCOME

Normally, the provisions of the trust agreement or the will control the calculation of income 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.

19. See the many references to income in IRC §§651, 652, 661, and 662.

Trust Situs

If state law governs the accounting treatment when a trust is silent, it is obviously important to know which state law (or country) governs. But this is not as easy as it might seem. Trust situs controls. Situs is usually defined as the place where the trust is administered. It is typically the legal jurisdiction where the trustee is located. Laws tend "to minimize other traditional connecting facts, such as the domicile of the settlor at the time of creating the trust, the domicile or place of incorporation of the trustee and the physical location . . . of the trust assets."[20] In any particular situation, situs may not be obvious. For example, if the grantor creates a trust in the state in which he lives, 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. As might be expected, in those situations in which the laws of one jurisdiction differ from those of another, situs can be critical.

Caution. State law should be consulted to determine situs. The situs of a trust does not necessarily control whether state income tax returns should be filed in a particular state. Individual state laws should be consulted.

Situs has no effect on federal income taxes. However, situs may be important for a number of purposes, and a grantor is free to locate the trust wherever it is deemed best. The situs can also be changed if desirable or necessary. Reasons for considering a change in situs include the following:

- **State Income Taxes.** Some locations do not tax trusts. For example, Delaware historically has not taxed the trust's income if all the beneficiaries reside outside of Delaware. South Dakota does not tax trusts at all.
- **Duration.** See the earlier discussion on the rules of perpetuity that determine how long a trust can last.
- **Asset Protection.** Grantors can establish spendthrift trusts that generally give the trustee the power to withhold distributions to the beneficiaries for any reason. Therefore, if the creditors of the beneficiary "come calling," the trustee need not answer. However, Delaware also protects all trusts from the claims of creditors as long as the trust was not set up for the grantor's benefit or to defraud the creditors. Alaska allows the grantor to transfer assets to his own trust where they are immunized from creditor claims, provided the grantor was not trying to defraud known creditors.
- **Privacy.** All trusts created by will are open to public scrutiny during probate. Revocable trusts created while the grantor is alive normally are closed for viewing. However, a number of states require trusts to be registered in the state. In those states, the names of the grantor and beneficiaries, but not dollar amounts, normally must be disclosed.
- **Convenience.** While selecting a locale that will avoid taxes may be attractive, it may be cumbersome having property administered in a faraway place.

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20. See Robert A. Hendrickson, *Changing Situs of a Trust*, Law Journal Press, 2003.

Items of Income and Expense

FAI 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 (e.g., net receipts). Nothing is accrued unless provided in the trust instrument, will, or local law. Even depreciation is a cash concept as explained below.

Although FAI for a trust or estate is whatever the trust instrument or will says it is, under most state laws (and trust agreements) certain items are allocated to income while others are usually allocated to corpus. Typical items of income and expense allocated to income are identified as follows:[21]

- 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 or executor commissions
- Depreciation

Depreciation (as well as depletion and amortization) can be a bit confusing for trusts. The first issue concerns the basic concept of depreciation. Normally, depreciation is considered by most accountants to be a noncash expenditure. However, in the trust arena, depreciation involves the movement of cash.

> **Example 11.** A trust is created requiring all income to be distributed to the income beneficiary, Iona, during her life. Upon Iona's death, the principal is distributed to the remainderman, Randolph. If the principal of the trust consists of corporate bonds, the payments of interest to Iona generally do not reduce the value of the remainder that Randolph is to receive upon Iona's death. Observe that the production of income by the bonds does not diminish the bonds' remaining value.
>
> On the other hand, if the corpus of the trust consists of a mine that produces coal, the situation is quite different. In this case, Iona receives royalty income as the coal is mined and sold. If all the coal is extracted during Iona's lifetime, the remainder — the mine — is worth little or nothing when Randolph ultimately becomes the owner. It is a "wasting" asset. To summarize, the distributions of interest income from the bonds do not reduce corpus like the income attributable to coal being mined.
>
> When a trust is created, the grantor (or state law) generally provides for this phenomenon in the trust instrument by requiring the trustee to withhold from the income beneficiary part of the royalty income and to add that part to the trust's corpus.[22] Depreciation works in the same way. When this occurs, the trustee is said to have established a reserve for depreciation.

Once the amount of depreciation is determined, the reserve for depreciation is created. An amount of income is withheld and added to the depreciation reserve. The effect is to reduce the amount of cash to be paid to the income beneficiary and set aside such amount in principal so that resources are available to the remainderman to be used later to replace the property.

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. In this regard, the 1997 UPIA lets the trustee decide, giving full discretion as to whether depreciation is charged.

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21. See Revised UPIA (1997) as amended, Sec. 401–415, and Sec. 501–506.

22. Adapted from Sherman, Jeffrey G. (1998). All You Really Need to Know about Subchapter J You Learned from This Article. *Missouri Law Review, 63*, p. 21. See also Revised UPIA Sec. 503.

Finally, if a reserve for depreciation is required, what is the amount of depreciation? Depreciation methods for FAI purposes may differ substantially from those used for financial or tax accounting. To illustrate, assume a trust holds rental property. The trust instrument may define depreciation as an amount equal to 10% of gross rents or 15% of net rents, whichever is larger. Alternatively, the trust instrument may call for depreciation equal to the amount normally computed using GAAP. Or the trust instrument might provide that trust depreciation is exactly equal to tax depreciation. Regardless of the amount of depreciation computed for FAI purposes, the trust computes and deducts tax depreciation in the normal fashion.

Income Taxes. Taxes imposed on receipts allocated to income are usually charged against income. Under this view, state income taxes normally are allocated to income. On the other hand, if a tax is imposed on a gain from the sale of property and the proceeds realized from the transaction are 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 usually paid out of trust income and allocated to income.

Ordinary Expenses. Expenses incurred in the administration, management, or preservation of the trust property are charged against income, but the trust agreement should be consulted.

Because FAI is not a tax concept, the restrictions on such items as passive losses, the 2% floor on miscellaneous itemized deductions, and similar limitations are not taken into account in computing FAI (although they do apply in computing taxable income).

Premiums and Discounts. These items are not taken into account in computing FAI. There is no amortization as there normally is for financial and tax accounting. This treatment can produce some extremely inequitable situations. For example, assume a zero coupon bond is purchased at a sizable discount in order to produce a market rate of interest of 10%. Without adjustment, the income beneficiary would receive nothing, notwithstanding the real rate of return on the bond is 10%.

Observation. There is no particular correlation between fiduciary accounting income and taxable income.

For example, in arriving at taxable income of the trust, a trustee commission allocable to corpus is just as deductible as one allocated to income. The account from which an expense is paid, income or corpus, is irrelevant in the computation of taxable income.

Deductible expenses that are charged to corpus could result in FAI being greater than trust taxable income. For example, if deductible trustee commissions are paid out of corpus, FAI is not affected but taxable income is affected.

If a fiduciary receives tax-exempt income (which is included in FAI notwithstanding that it is exempt), FAI could be greater than trust taxable income. On the other hand, if a trust realizes capital gains that are allocable to corpus, the trust's taxable income may exceed its FAI.

Distributions from Entities (Corporations, Partnerships, S Corporations). The revised UPIA specifically addresses the allocation of distributions received from entities. It provides that distributions of money from an entity generally are allocated to trust income. This rule applies to distributions from corporations (with no distinction between a C corporation and an S corporation), partnerships, limited liability companies, regulated investment companies (RICs or mutual funds), and real estate investment trusts (REITs). Note that under the act, the amount of trust income derived from partnerships and S corporations is not the amount of taxable income that flows through or that is allocated to the owners, but is solely the amount of the distributions actually received. The receipt of 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.

Example 12. The trust for Tom Smith (from **Example 10**) and his daughter Rachel owns a 10% interest in a partnership. This year, the partnership had interest income of $20,000 and net income from its rental operations of $60,000. The partnership opted to retain $70,000 of its $80,000 of income and distribute $10,000, including $1,000 to the trust.

For tax purposes, the partnership issues a Schedule K-1 showing that the trust's share of partnership taxable income is $8,000 ($2,000 of interest income + $6,000 of rental income). However, for FAI purposes, the amount of FAI with respect to the trust is $1,000, the amount of the distribution. This is true even though the trust's distributable net income (DNI) (discussed later) includes the $8,000 ($2,000 + $6,000) of taxable income.

While the amount of income from an entity is normally the amount of cash received from the entity, there are several exceptions.[23] These include the following:

- 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 is allocated to principal (redemptions).
- Cash received in total or partial liquidation of the entity is allocated to principal.
- Cash received from a mutual fund or REIT that is a capital gain dividend for federal income tax purposes is allocated to principal. Nontaxable distributions from these entities are allocable to income.
- Distributions of property by an entity are allocated to principal (e.g., a C corporation distributes land to a trust). Note that dividends reinvested are allocated to principal.

Items Allocated to Corpus

Cash receipts and disbursements that are usually allocated to corpus include the following:

1. Consideration received on the sale or exchange of trust property (Note that it is the proceeds derived on the sale that are allocated to corpus, not merely the net gain or loss.)[24]
2. Taxes on gains and profits allocated to principal[25]
3. Casualty losses
4. Stock dividends
5. Insurance proceeds on property forming a part of principal
6. Extraordinary dividends (e.g., a dividend paid by a corporation from the sale of one of its operations)
7. Expenses incurred to prepare property for rent or sale (extraordinary repairs)
8. Repayments of loans
9. All or a portion of trustee commissions

Note. If income is accumulated in the trust, it follows that a portion of the trust's tax liability would be attributed to the accumulated income and such tax would be allocated to income.

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23. Revised UPIA Sec. 401(c).

24. See revised UPIA Sec. 404(2).

25. See revised UPIA Sec. 502(1)–(7).

Example 13. The irrevocable trust of Tom and Libby Smith (see **Example 1**) sold some stock that constituted part of trust corpus. It received $20,000 net of commissions for the stock and realized a $6,000 gain on the sale. It paid $900 in federal income tax. The $20,000 receipt is allocated to corpus. Similarly, the income tax is charged to corpus since it arose due to the sale of assets that are part of corpus. Thus, the net increase to corpus is $19,100 ($20,000 – $900). Observe that it is not the net gain that is allocated to corpus but the gross sales proceeds. However, it is the net gain that is taxable to the trust.

Example 14. Assume an irrevocable trust is a simple trust. As a result, all the FAI is distributed. In a simple trust, all of the federal, state, and local taxes paid by the trust are charged to corpus because the income tax liability of a simple trust normally is due solely to capital gains or other items that are allocated to corpus.

If the trust was a complex trust and some of the FAI was accumulated, then, as might be expected, the tax attributable to the accumulated income is charged against that account unless the trust instrument provided that the income tax liability should be charged elsewhere (e.g., corpus or distributed income).

Example 15. This year Dalia died and left her entire estate in trust for her son, Sonny. The trust's situs is New York. The trust is expected to last for Sonny's life, with the remainder passing to Dalia's granddaughter, Greta, upon Sonny's death. The estate is large enough to be subject to the estate tax. Under IRC §642, the executors of the estate have the choice of deducting $50,000 of administration expenses on Form 1041 or on the estate tax return, Form 706, *U.S. Estate (and Generation-Skipping Transfer) Tax Return*.

If the expenses are deducted on the estate's income tax return, Form 1041, the estate tax reported on Form 706 will be increased and the income beneficiary will benefit to the long-term detriment of the remainderman, Greta. Under New York law, there must be an adjustment to decrease the benefit that the income beneficiary now receives and increase the ultimate principal that the remainderman will eventually inherit. The adjustment is the difference between the estate tax with and without the deductions. The difference is then taken from the income account to reimburse the principal account. This is often referred to as the *Warms* adjustment after a New York case.[26]

7

Effect of Total Return Trust on Calculation

As noted above, 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 in accordance with 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 adopted a unitrust 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 trust's assets' value each year as income. If the unitrust 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).

26. See *Matter of Warms' Estate*, 140 NYS 2d 169 (Sur.Ct. N.Y. county 1955).

For income tax purposes, final regulations effective January 2, 2004, revised the definition of FAI to make it consistent with the total return concept.[27] 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 would include not only ordinary 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. The regulations warn, however, "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 as requiring that all its income be currently distributed for purposes of IRC §642(b) (the personal exemption amount) or IRC §651 (the amount of the distribution deduction). The effect of the new rule is to give trustees great discretion in the allocation of receipts and disbursements.

Note. The facts of the following example are used in subsequent examples to demonstrate the computation of the various quantities, including fiduciary accounting income (**Example 16**), trust taxable income (**Example 37**), DNI (**Example 41**), and the character of the income to the beneficiaries (**Example 41**).

Example 16. On March 7, 1995, Grant Tor established a trust for his son Benny Tor (the Benny Tor Trust). 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 fiduciary 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 per trust instrument	5,000
Trustee commission	8,000

FAI is computed as follows:

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

Note. In computing FAI, the capital gain is not included because such gain is allocated to corpus. Similarly, only half of the trustee commission is charged to trust income while the other half is charged to corpus.

27. Treas. Reg. §1.643(b)-1.

INCOME TAXATION OF TRUSTS

When property is transferred to a trust as part of its creation, the issue of taxation arises. Is the trust or its beneficiaries liable for taxes upon its receipt? To this point, 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 and, furthermore, the same treatment holds when the property is ultimately distributed to the beneficiaries. A second and more controversial issue is whether the income from the gifted or devised property should also be protected from income taxation. This issue was considered in *Irwin v. Gavit*,[28] when the Supreme Court refuted the taxpayer's ingenious argument that the income simply represented part of the initial gift that kept on giving. Shortly thereafter, §102(b) was enacted codifying that view and making it clear that the income from the gifted or devised property should be taxed. Thus, when property is transferred to a trust to be held for a beneficiary, the gift or devise received by the trust is not taxable income to either the trust or the beneficiary and when it is later distributed, it is also protected. However, the income from the property is taxable.

The problem in applying these rules is determining whether a distribution to a beneficiary represents the gifted or devised property or the income from either. As a general rule, Subchapter J adopts the approach reflected in IRC §663 that distributions from a trust are nontaxable if the amount of money or the identity of specific property is **ascertainable** under the terms of the trust instrument as of the date of the trust's inception. Otherwise, the distribution represents income. This distinction is critical since the receipt of the gifted or devised property is nontaxable while receipt of income normally is taxable.

The decision in *Irwin v. Gavit* and its later codification made it clear that the income from property transferred to a trust is taxable. The only remaining question was how to tax it.

CONCEPTUAL OVERVIEW

Subchapter J of the Code contains the rules governing the income taxation of estates and trusts. The computation of taxable income of an estate or trust is computed in the same manner as that for an individual with only a few modifications. The primary concern of Subchapter J is who reports the taxable income — the trust or the beneficiary. In all cases, it should be remembered that total taxable income is taxed once, either to the fiduciary or the beneficiary, but not both.

Perhaps the best way to understand the tax treatment of estates and trusts (collectively known as **fiduciaries**) is to compare their treatment to that of partnerships and corporations. A regular C corporation and its shareholders are separate taxable entities. As a result, income received by the corporation can be taxed twice: once at the corporate level and again when the after-tax income is distributed to the shareholders as dividends. In contrast, a partnership is not a taxable entity but rather acts as a conduit. Income flows through the partnership to the individual partners who report their share of partnership income whether or not the income is actually distributed. Distributions from the partnership generally represent nontaxable distributions of income that has flowed through to the partners and was previously taxed.

The tax treatment of estates and trusts does not adopt either of these approaches in their entirety. Presumably, the authors of the fiduciary rules rejected the corporate approach, believing that the income of a trust or an estate should be taxed only once. Conceptually, this seems appropriate given that the fiduciary is merely an agent acting to protect and conserve the assets for the beneficiary. On the other hand, treating fiduciaries like partnerships was deemed unacceptable. If this method were used, a beneficiary would be charged with income without any power to obtain the cash necessary to pay the tax. Moreover, in the context of an estate, the income tax would be imposed on the estate's beneficiaries perhaps long before they actually received the property. In fact, if a beneficiary died before he actually received a distribution of the income from the estate, he would have paid tax on income he never even received. Consequently, a compromise plan was adopted. This approach borrows from both the corporate and partnership schemes.

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28. *Irwin v. Gavit*, 268 US 161 (1925).

The basic principle underlying the design of fiduciary income taxation is that the taxable income of the trust or estate should be taxed once. This is accomplished by treating the trust or estate as a separate taxable entity, like a corporation. Amounts of **taxable** income received by the fiduciary generally are taxed to the entity. This ensures that any taxable income received is taxed currently. However, the tax burden is shifted to the beneficiaries to the extent the fiduciary distributes its income. This shifting is accomplished mechanically by granting a deduction to the trust or estate for any distributions of 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 fiduciary and the beneficiary. The treatment is very similar to that of a corporation that pays a salary to its owners and deducts the salary 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 and estates also borrows from partnership taxation. Like a partnership, the income distributed to the beneficiaries retains its character.

Example 17. Among the assets contained in Libby's (see **Example 1**) now irrevocable trust is a $100,000 bond, paying taxable interest annually at a rate of 10%. This year the trust receives $10,000 of interest income. The trust distributes $4,000 to Libby. In this case, there is $10,000 of interest income that must be taxed. The only issue is to whom it will be taxed. In effect, the law allocates $4,000 of income to Libby, the beneficiary, because it distributed $4,000.

Libby, as beneficiary of the distribution of taxable income, includes the $4,000 in her taxable income while the trust reports the remaining taxable income of $6,000 ($10,000 – $4,000). The $10,000 of taxable 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 showing $6,000 of trust taxable income and reports the $4,000 on a Schedule K-1 given to Libby.

Before moving on, it should be mentioned that grantor trusts, as discussed earlier, are not taxed in this manner. Recall that a grantor trust generally is one in which the grantor retains so much control over the trust property (e.g., the grantor can revoke the trust) that the trust is ignored for income tax purposes altogether. As a result, the income of a grantor trust is taxed to the grantor and the trust normally is never taxed.[29]

OPERATIVE PRESUMPTION FOR DISTRIBUTIONS

A critical presumption in fiduciary taxation is that all distributions — other than specific bequests — represent current trust income (FAI) 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 as distributions of the trust property (corpus). Normally, these excess distributions are nontaxable to the beneficiary. Distributions of the trust corpus itself are tax-free since the beneficiary is simply receiving the gifted or inherited property that 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 fiduciary level. Observe the similarity of this approach to that for distributions of C corporations where all distributions are deemed to be out of earnings and profits to the extent thereof.

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 §§651 and 661, remember there are three basic principles at work:

1. Total taxable income of the fiduciary must be identified, and it is taxed only once.
2. The total taxable income is taxed to either the fiduciary or beneficiary, but not to both.
3. The sum of the taxable income of the trust and the taxable income of the beneficiary must equal the total taxable income (before consideration of exemptions for each taxpayer). In short, 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).

29. See IRC §§671–678.

TAXABLE INCOME BEFORE DISTRIBUTIONS

Under the taxing regime of Subchapter J, the computation of taxable income of the fiduciary and beneficiary involves two basic steps:

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

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

FILING REQUIREMENTS

Estates and trusts must file tax returns if they meet the following conditions:[30]

- The estate or trust has **gross income** for the taxable year of at least $600, regardless of its taxable income. Note that many estates and trusts do not have any taxable income because they distribute all their income. This provision ensures that trusts and estates must file if they have at least $600 in gross income.
- The trust has taxable income for the year.
- The estate or trust has a nonresident beneficiary.

Employer Identification Number

Every estate or trust that is required to file Form 1041 must have an employer identification number (EIN). The EIN can be obtained online at **www.irs.gov/businesses/small.** Alternatively, it can be obtained by phone or mail using Form SS-4, *Application for Employer Identification Number*. If the estate or trust has not received its EIN by the time the return is due, the fiduciary should write "Applied For" in the space provided for the EIN.[31]

Due Dates

Due Date of the Return. The return for either a trust or an estate is due by the 15th day of the fourth month after the close of the taxable year.[32] If the estate or trust is terminated (e.g., all assets are distributed), the tax year ends and the return is due by the 15th day of the fourth month following the close of the short taxable year.

Extended Due Date of the Return. Automatic extensions are granted.[33] The due date is extended to the 15th day of the **fifth** month following the normal due date. For calendar year fiduciaries with a regular due date of April 15, the extended due date is September 15.[34] Form 7004, *Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns,* is filed to obtain an extension.

30. IRC §6012.
31. See the instructions for filing Form 1041.
32. IRC §6072(a).
33. IRC §6081.
34. Temp. Treas. Reg. §1.6081-6T(a).

Opening and Closing an Estate. Estates normally continue in existence as a separate taxable entity for as long as the estate stays "open." An estate typically remains open for as long as undistributed probate assets remain. Estates may stay open for an extended period if legal disputes arise such as arguments among beneficiaries over the ownership of the estate's assets or tax controversies. Prior to the change in tax rates for estates and trusts, executors might keep estates open if the estate tax rate was lower than that of the beneficiaries. Although this motivation no longer exists, the regulations still warn that if the administration of an estate is unduly prolonged, the estate is considered terminated for federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration.[35]

Upon termination of an estate (all assets were distributed to the beneficiaries), the estate is required to notify the IRS in writing that the estate was terminated and all assets were distributed to the beneficiaries. Form 56, *Notice Concerning Fiduciary Relationship,* is used for this purpose.

Taxable Years

Permitted Taxable Year. The tax years that are available to fiduciaries differ depending on whether the taxpayer is a trust or an estate:

- **Trusts.** The taxable year of a trust must generally be the calendar year.[36] However, an election under IRC §645 is available to treat a decedent's revocable trust as an estate for the purpose of adopting a fiscal year. The election is made by filing Form 8855, *Election To Treat a Qualified Revocable Trust as Part of an Estate.*

- **Estates.** Unlike trusts, an estate is not limited in the tax year that it can select. It may adopt a calendar year or any fiscal year.[37] The estate's first tax year begins on the date following the decedent's death and ends on the last day of the selected month.[38] One drawback of a fiscal year for an estate concerns amounts reported to the IRS on Forms 1099. If a fiscal year is selected, the amounts shown on Forms 1099 that reflect a calendar year must be reconciled to the amounts reported on a fiscal year.

Example 18. Tom (see **Example 1**) died on March 7, 2009. If Tom did not file a joint return with his wife Libby, Tom's executor files Tom's final income tax return (Form 1040) for the short taxable year running from January 1, 2009, through his date of death, March 7, 2009. The due date for the short period return is the same as if Tom had lived, which was April 15, 2010. Tom's estate would have a taxable year beginning the day after Tom died, March 8. The year could be as short as March 8, 2009, through March 31, 2009, or as long as March 8, 2009, through February 28, 2010.

TAX RATES

The Code provides a special tax rate schedule contained in IRC §1(e) for estates and trusts. Like the tax rate schedules for individual taxpayers, these are adjusted annually for inflation. Prior to 1987, fiduciary tax rates were the same as those for married persons filing separately. The Tax Reform Act of 1986 ended this approach and provided a separate rate structure for estates and trusts presumably to reduce the opportunities for tax savings through income shifting and splitting. The tax rate schedule for tax years beginning in 2010 follows.

35. Treas. Reg. §1.641(b)-3.

36. IRC §644.

37. IRC §441.

38. Treas. Reg. §1.443-1(a)(2) provides that, "the return of a decedent is a return for the short period beginning with the first day of his last taxable year and ending with the date of his death." Thus, the estate's tax year begins on the day after the date of death.

Tax Rate Schedule
Trusts and Estates
For Tax Years Beginning in 2010

If Taxable Income Is			
Over	**But Not Over**	**The Tax Is**	**Of the Amount Over**
$ 0	$2,300	15.0%	$ 0
2,300	5,350	345.00 + 25.0%	2,300
5,350	8,200	1,107.50 + 28.0%	5,350
8,200	11,200	1,905.50 + 33.0%	8,200
11,200		2,895.50 + 35.0%	11,200

As is evident from the schedule, the tax brackets for trust and estates are highly compressed. First, observe that there is no 10% tax bracket. More importantly, note that the fiduciary tax rates hit the top rate of **35% at $11,201** as compared to **$373,651** for single or joint filers. This compression has severely limited the potential for shifting income to trusts or estates to minimize taxes.[39] In fact, the progression of the 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.

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Interestingly, the effect of the rate structure may defeat the whole purpose for which the trust was created (i.e., preservation of the income and assets). However, the favorable tax rates for dividends and long-term capital gains that apply to individual taxpayers also apply to trusts and estates. While investment in stocks that produce dividends is generally superior to investments that produce interest from a tax perspective, this is particularly true for trusts and estates in light of the tax bracket compression.

Caution. Practitioners should be aware of the income tax rate change beginning in 2011 that increases the maximum rate to 39.6% and eliminates the 15% tax rate on qualified dividends. This potentially could result in a large increase in the federal income tax liability for trusts that regularly have significant taxable income. Trustees may want to adjust the amount of distributions to beneficiaries, if possible, to take advantage of the potentially lower tax rates of beneficiaries. Trustees need to be aware of the 65-day rule in planning for distributions to the beneficiaries.

Although trusts and estates no longer offer the tax benefits of income splitting, trusts still are a popular vehicle for holding and transferring property.

Multiple Trusts and Income Shifting

With or without the highly compressed brackets, grantors may be inclined to use multiple trusts to keep income in the lowest possible brackets. For example, if parents have one adult child, they might want to create ten trusts for the one child with each trust having $2,300 of income — the width of the 15% bracket. However, IRC §643(f) and the regulations provide that two or more trusts are treated as one trust if such trusts have the same grantor and the same beneficiaries and are created for tax avoidance purposes.[40]

39. Income would be shifted to estates by simply leaving the income-producing property in the estate rather than distributing it.

40. Treas. Reg. §1.641(a)-0(c).

Estates and Compressed Brackets

The compressed brackets can present severe problems for estates as illustrated in the following example.

> **Example 19.** Tyrone worked extremely hard this year and was in line to get a bonus of $30,000. Unfortunately, he worked himself to death and never received the fruits of his labors. Had he received the bonus while alive, Tyrone would have been taxed at a 28% rate and would have paid taxes of $8,400 on the bonus. However, because his estate collects the bonus, it may be required to pay taxes on it. In such case, the estate pays taxes on everything over **$11,200** at 35%. This equals $10,500 if the entire bonus is taxed at that rate (35% × $30,000 = $10,500). While the estate could avoid this result by distributing the cash before yearend, state laws controlling distributions may delay such distributions, making it too late.

Early Distributions

Executors should understand the problems created by the estate tax rates and attempt to make early distributions of the estate's income to avoid having it taxed at the high estate rate. Unfortunately, state laws may limit the power of the executor to make distributions prior to the time that notice to creditors has expired or at least until some time has lapsed. Under some state laws, distributions cannot be made without a court order, which cannot be obtained until a certain amount of time has passed or notice to creditors has expired. That said, early distributions without a court order may be effective for tax purposes.[41]

ALTERNATIVE MINIMUM TAX

The alternative minimum tax applies to fiduciaries but is not discussed in this chapter.

ESTIMATED TAXES

Like all taxable entities, trusts and estates normally must pay estimated taxes. However, the rules for trusts and estates are different.

Estates

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.[42] This rule enables an estate to postpone the start date for paying estimated taxes. The required payment is determined in the same manner as for an individual.

Trusts

Trusts are responsible for paying estimated taxes using the same rules that apply to individuals, with some exceptions.[43] Under the normal approach, a trust can avoid penalties if it pays in four timely installments the lesser of 90% of the current year's tax or 100% of last year's tax (110% if prior year's adjusted gross income exceeded $150,000). Trusts created at death can pay estimated taxes using estate tax rules or trust rules.

Special §643(g) Estimated Tax Election for Trusts Only. A unique rule enables a trust that has made estimated tax payments unnecessarily during the year (e.g., the trust has no liability because it distributed all of its income) to treat such payments as being made by its beneficiaries. The trustee may elect to treat any portion of a payment of estimated tax made by the trust as being paid by the beneficiary. This election is not available to estates.

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41. See *Murphy v. U.S.*, 91-1 USTC 50,167, 71A AFTR 2d 93-4213, (W. Dist. OK, Mar. 18, 1991) for a summary of the cases.

42. IRC §6654.

43. IRC §6654(l)(2)(B) .

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. This deemed distribution is taxable under the general rules that follow. 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. The trustee makes the election using Form 1041-T, *Transmittal of Estimated Taxes Credited to Beneficiaries,* which must be filed on or before the 65th day after the close of the trust's taxable year (i.e., March 6 for most trusts).

Making the election can be quite beneficial in that it can:

1. Reduce the amount of income taxed to the trust at high rates, and
2. Help the beneficiary avoid underpayment penalties.

Example 20. 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. 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.

	Payment Allocated All to Trust	Overpayment Allocated to Beneficiary
Dividend income	$1,000	$1,000
Distribution deduction		
Distributions during the year	(400)	(400)
Section 643(g) election amount	(0)	(225)
Exemption	(100)	(100)
Taxable income	$ 500	$ 275
Estimated tax payments	$ 300	$ 75
Actual tax at 15%	(75)	(41)
Overpayment	$ 225	$ 34

DETERMINING TAXABLE INCOME

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

Income broadly conceived
– Exclusions

Gross income
– Deductions for adjusted gross income (charitable contributions, distributions, certain other expenses (§67(b)))

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

Taxable income

While this formula suggests otherwise, trusts and estates generally are not required to distinguish between deductions for and from AGI.[44] Fiduciaries are not granted a standard deduction, and any deductible items are itemized and subtracted from gross income to arrive at taxable income. Indeed, AGI, a familiar quantity on individual returns, cannot be found on Form 1041.[45] Nevertheless, the limitations based on AGI that apply to miscellaneous itemized deductions and personal casualty and theft losses (i.e., the 2% and 10% floors, respectively) do apply to fiduciaries. For this reason, IRC §67(e) indicates what deductions are considered in determining AGI for these purposes. These rules effectively produce the formula previously given, although it never appears in such form on the return. A completed copy of Form 1041 and a sample tax return can be found near the end of this chapter.

Standard Deduction and Itemized Deductions

The standard deduction available to individual taxpayers is not available to trusts and estates. Trusts and estates must itemize all deductions. The phaseout in total itemized deductions — which expired for taxable years after 2009 — does not apply to estates and trusts.[46]

Exemption Deduction

Both trusts and estates are allowed a personal exemption in computing taxable income.[47] The phaseout rules that applied to individuals through 2009 did not apply to trusts or estates:

1. Estates are allowed an exemption of $600.
2. The exemption for trusts is dependent upon whether the trust is **required** to distribute all of its income for the year. A trust that is required to distribute all of its income currently is allowed an exemption of $300 per year. As mentioned earlier, a simple trust as defined in Treas. Reg. §1.651(a)-1 is a trust that is required to distribute all its income currently and is prevented by the trust instrument from making charitable contributions. All simple trusts are entitled to a $300 exemption since they must distribute all their income. If a trust that is required to distribute all its income annually is allowed to make charitable contributions, it is not a simple trust but it would be entitled to a $300 exemption. As a result, a trust that technically is not a simple trust could still be entitled to a $300 exemption.
3. All other trusts — those that are not required to distribute their income — are allowed an exemption of $100 per year. All complex trusts are entitled to a $100 exemption.
4. A special needs trust created as a qualified disability trust for tax purposes is entitled to an exemption equal to that for an individual ($3,650 in 2010).

Gross Income in General

Gross income 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 the sale or exchange of property (capital gains); and
- Income of a trade or business.

44. See Form 1041.

45. Form 1041, line 17, refers to "adjusted total income," a term that is not defined in the law. Adjusted total income is taxable income of the trust before the distribution deduction and the exemption deduction. Determination of AGI for trusts and estates is governed by IRC §67(e).

46. IRC §68(e).

47. IRC §642(b).

In determining whether a receipt is gross income to the trust or estate, reference should be made to what happens if an individual received the same item. If the item is taxable to an individual, then it is taxable to the trust and the estate. If it is exempt to an individual, then it is exempt to the trust and estate.

Sale of Residence

IRC §121 Exclusion. It is not uncommon for a trust to become the owner of a residence. A grantor may transfer their personal residence into a revocable trust. If during the grantor's life the trust sells the residence, §121 may be used to exclude the gain from taxable income.[48] If during the grantor's life, the grantor transfers the residence into an irrevocable trust and the trust later sells the residence, then §121 would not apply to the sale of the residence. If the grantor of a revocable trust holding the grantor's residence dies, the revocable trust becomes irrevocable and §121 would not apply to the sale of the residence.

When an individual dies, the estate may become the owner of the decedent's residence. A subsequent sale of the residence usually does not produce a gain since the basis becomes the value of the property at the decedent's death.[49]

However, if the estate sells the home for a gain, it is fully taxable because the estate cannot have a personal residence. The gain is considered a capital gain because the house in the hands of the estate is a capital asset.[50]

In addition, the holding period for any property acquired from a decedent is considered long-term.[51] It is more likely that a sale would produce a loss due to the associated selling expenses (e.g., realtor commissions and transfer taxes). For more information, see the discussion of selling expenses later in this section.

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.[52] Examples include earned but unpaid salary, interest, rent, dividends (if the record date has passed at death), crop-share grain sales proceeds from a nonmaterially-participating crop-share landlord, retirement plans, annuity distributions, and payments on installment sales contracts. None of this accrued income is reported on the decedent's final return (Form 1040) since the decedent is a cash-basis taxpayer and did not receive it. Under IRC §691, this accrued income retains the same basis and character as it had in the hands of the decedent and 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) would normally be entitled to a deduction for such taxes.[53]

Capital Gains and Losses

The rules governing property transactions for individuals also apply to estates and trusts. In the case of sales of capital assets, the fiduciary computes its net capital gain or loss in the normal fashion. Net short-term capital gains are taxed as ordinary income while net long-term capital gains are taxed at the 15% rate (or in 2010, the 0% rate if the trust or estate 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 normally are not passed through to a beneficiary. They are deductible only on the trust or estate return except upon termination when they are passed to the beneficiaries, as discussed next.[54]

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48. Treas. Reg. §1.121-1(c)(3).
49. IRC §1014(a).
50. IRC §1221.
51. IRC §1223(9).
52. IRC §691.
53. IRC §691(c).
54. IRC §642(h).

Gain on Distributions of Property

Normally, transfers of appreciated property to a beneficiary do not result in the recognition of taxable gain to the trust or estate. Nevertheless, a trust or estate may elect to recognize gain on certain discretionary or mandatory distributions of property to so-called second-tier beneficiaries.[55] If the election is made, the trust or estate is deemed to have sold the property to the beneficiary for its value.

Transactions between Related Parties

IRC §267 imposes a limitation on losses resulting from sales between **related parties**. These rules extend to trusts and estates. First, 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 loss is lost.

The loss limitation is triggered only if there is a transaction between related parties. Related parties for trusts include:[56]

1. A grantor and the 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.

For estates, the executor and the beneficiaries are considered related parties.

IRC §267 has its own set of constructive ownership rules to be used to determine if a person is a related party.

> **Note.** For more information about related parties, see Chapter 8 in the 2009 *University of Illinois Federal Tax Workbook*. This can be found on the accompanying CD.

Deductions of a Fiduciary in General

Fiduciaries may deduct the same expenses that individuals may deduct. These generally include the following:

- Ordinary and necessary expenses paid or incurred in a trade or business[57]
- Expenses incurred in connection with production or collection of income, as well as the management, conservation, or maintenance of property[58] (According to the regulations, amounts paid for administration expenses, including fiduciary fees, are deductible even though the fiduciary is not in a trade or business. See the discussion later in this chapter.)
- Expenses in connection with the determination, collection, or refund of any tax[59]

Like the deductions for individuals, these deductions may be limited (e.g., reduced to the extent they are allocable to tax-exempt income), as discussed later in this chapter.

55. IRC §643(e).
56. IRC §267(b)(4)-(8).
57. IRC §162.
58. IRC §212.
59. Ibid.

Deductions in Respect of a Decedent

An estate can deduct all expenses that would be deductions in respect of a decedent (DRD) under §691. DRDs generally are deductible expenses that accrued as of the date of death but are not on the decedent's final income tax return due to the decedent's method of accounting (e.g., the accrued deductions of a cash-basis taxpayer such as state income taxes or real property taxes that have not been paid). IRC §691(b) specifically indicates that the deductions allowed are those under the following provisions:

- §162 (business expenses)
- §212 (investment expenses, tax preparation expenses)
- §163 (interest expense)
- §164 (taxes)
- §611 (depletion)

As a practical matter, these broad categories include virtually all the expenses that are commonly deductible. Since virtually all decedents are on the cash basis, deductions in respect of a decedent are essentially the accrued deductions of a cash-basis taxpayer. These expenses may be deducted on the estate tax return (Form 706) **and** on the estate's income tax return (Form 1041) or on the return of whoever pays the expenses.

Example 21. Jed died on March 30, 2010. Jed's CPA prepared Jed's 2009 federal income tax return, and Jed died before paying the accountant. On May 3, 2010, the executor of Jed's estate, Emma, paid the accountant $400 for preparation of the return. The estate is entitled to deduct the payment for income tax purposes since it met both requirements of §691(b): tax preparation is deductible under §212 and the fee had accrued prior to the decedent's death.

Note. The expense would also be deductible as a liability of the decedent on Form 706 in arriving at the decedent's taxable estate. DRDs can be deducted on both Forms 706 and 1041.

Administration Expenses of an Estate

In settling the affairs of a decedent during the probate period, the estate may incur a variety of costs that fall under the heading of administration expenses. Such costs normally are deductible on either the Form 706 or Form 1041 but not on both. Since many estates are not subject to estate taxes due to the exemption ($3.5 million before the estate tax repeal in 2010), these rules are of particular significance in computing the taxable income of the estate during the probate period.

Specifically, IRC §2053(a)(2) authorizes an estate to claim a deduction for administration expenses. Treas. Reg. §20.2053-3(a) elaborates, providing the criteria that must be met before an expense qualifies as a deductible administration expense. Administration expenses include:

> *. . . such expenses as are actually and necessarily incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it. The expenses contemplated in the law are such only as attend the settlement of an estate and the transfer of the property of the estate to individual beneficiaries or to a trustee, whether the trustee is the executor or some other person. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions. Administration expenses include (1) executor's commissions, (2) attorney's fees and (3) miscellaneous expenses.*

Treas. Reg. §20.2053-3(d) extends the scope of what might be deductible, indicating that:

> *. . . miscellaneous administration expenses include such expenses as court costs, surrogates' fees, accountants' fees, appraisers' fees, clerk hire, etc. Expenses necessarily incurred in preserving and distributing the estate, including the cost of storing or maintaining property of the estate if it is impossible to effect immediate distribution to the beneficiaries . . .*

IRC §212 also plays a role for the estate since it authorizes the deduction for the expenses incurred for the production of income or expenses incurred for the management, conservation, or maintenance of property held for the production of income. At first glance, it seems that §212 would not apply to an estate's administration expenses since §212 allows the deduction only if the property was held for the production of income. Nevertheless, Treas. Reg. §1.212-1(i) provides otherwise:

> *Reasonable amounts paid or incurred by the fiduciary of an **estate** or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under §212 **notwithstanding that the estate or trust is not engaged in a trade or business,** except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see §642(g) and the regulations thereunder for disallowance of such deductions to an estate where such items are allowed as a deduction under §§2053 or 2054 in computing the net estate subject to the estate tax* (emphasis added).

As an example, an estate holds a decedent's personal property such as a car, home, jewelry, and the like that are not held for the production of income. Still, administration costs related to these would be allowed as an income tax deduction for an estate or trust. Suffice it to say that an estate or trust can deduct some expenses that an individual would not be able to deduct.

The thrust of §§2053 and 212 is that an estate can deduct, either for income tax purposes or estate tax purposes, expenses of administration in which such costs are in fact necessary and essential to settle the affairs of the decedent. In situations in which the administration expenses could be deducted on either the Form 706 or Form 1041, a formal waiver of the election to claim the deduction on Form 706 should be filed with Form 1041.[60] A deduction can be claimed on the estate tax return without the waiver. However, it is not clear whether the waiver is necessary to claim the deduction on Form 1041 in those situations in which an estate tax return, Form 706, is not required and not filed. The prudent course would be to file the waiver in any event.

Most expenses incurred by the estate during the probate process are "administrative" in nature and are deductible. The primary expenses in this category are executor's fees, attorney fees (e.g., routine costs of probate and legal costs incurred to decide ownership of property or to argue will contests), fees for special guardians, and accounting services. However, other costs may be deductible as discussed in detail below. It should be emphasized, however, that the deduction of administration expenses incurred during probate is allowed only for such costs "as are allowable by the laws of the jurisdiction . . . under which the estate is being administered."[61] Most expenses incurred during the probate period must be approved by the probate court before (or after) they are paid and §2053 essentially says that it is allowing a deduction only for expenses authorized by the probate court. The regulations echo that sentiment, saying in part that:

> *. . . the decision of a local court as to the amount and allowability under local law of a claim or administration expense will ordinarily be accepted if the court passes upon the facts upon which deductibility depends.*[62]

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60. See Treas. Reg. §1.642(g)-1 for information required to be contained in the waiver.

61. IRC §2053(a).

62. Treas. Reg. §20.2053-1(b)(2).

Normally, the court's approval controls the deductibility of administration expenses,[63] but not always. As can be seen from the quoted regulation, administration expenses that are incurred and paid for the benefit of estate beneficiaries — rather than the estate — are not deductible.[64] The regulations emphasize that expenses are limited to those incurred in the administration of the **estate**. Those that are not "essential" to the proper settlement of the estate, but incurred for the benefit of the heirs or others, may not be claimed as deductions.

Interest Expense in General. Interest expense paid by an estate could be accrued before or after death. Interest accrued before death is a liability of the estate and is deducted on Form 706. Interest expense accrued and paid after the date of death is deductible as an **administration** expense. Normally, interest accrued during probate is deductible only if the executor keeps the debt in force or incurs new debt in order to prevent a **forced sale of assets** (at unreasonably low sales prices) and if payment of the interest is allowed under local law.[65]

A deduction for **interest** paid to the government for late payment of federal or state death taxes is also deductible on the theory that computational disputes, errors, and delays in the payment of taxes are ordinary by-products of the administration of estates.[66]

In *Estate of Lewis S. Thompson III*,[67] the estate was allowed a deduction for interest on funds borrowed from the decedent's life insurance trust to pay the estate taxes. The estate's assets were insufficient to make tax payments and at the same time provide for the maintenance of the decedent's farm and timber property.

In *Hibernia Bank*,[68] Celia Clark died testate in May 1965, leaving an estate worth several million dollars. The majority of the value was attributable to a mansion on 240 acres in Hillsborough, California, and 10,000 shares of Hibernia Bank stock. Under the will, four trusts were created and, according to the will, they were to be funded by the residue of her estate. The will also named Hibernia Bank as the trustee for each of the trusts. The income of each trust was paid to one of Mrs. Clark's children and the remainder ultimately divided by her four grandchildren. The will nominated two individuals to act as co-executors but both declined. The court appointed Hibernia Bank to act as the executor.

By December of 1967, all the specific bequests and virtually all claims against the estate were paid. At this time, the bank could have distributed the remaining property, including the mansion and bank stock, to the trusts. However, the bank elected to sell the mansion.

Hibernia indicated that the "major reason" for not distributing the estate assets to the testamentary trusts and beneficiaries was that a piece of real property owned by three trusts, seven adult individuals and four guardianships is "difficult to dispose of." In addition, Hibernia characterized one of the heirs as not as "cooperative" as other heirs. In any event, certain difficulties delayed the sale until five years later (1972). During this time, costs of maintaining the mansion ran about $60,000 annually. In order to pay these fees, Hibernia Bank, acting in its role as executor of the estate, opted not to sell the Hibernia bank shares but rather to **borrow money** from itself in two of the years. Hibernia argued that the mansion was a white elephant and finding a buyer was difficult, if not impossible. For this reason, Hibernia asserted that the estate had to keep its stock because it was the estate's only remaining income-producing asset — it was a "life preserver" that saved the estate from financial ruin.

In addition, Hibernia argued that it could not sell the shares because the decedent specifically intended that her shares be distributed to the trusts. The market for the shares was also "thin." Not lost on the circuit court, the bank may have been reluctant to sell the shares to unknown and perhaps undesirable third parties who would become shareholders in the bank.

63. While this rule appears to apply only to expenses incurred related to property going through probate, §2053(b) allows a deduction for administration expenses that would be deductible under §2053(a) if the property was subject to claims and the expenses are paid in a timely manner.

64. Treas. Reg. §20.2053-3(a).

65. Ibid.

66. Rev. Rul. 81-154, 1981-1 CB 470.

67. *Estate of Lewis S. Thompson III v. Comm'r,* TC Memo 1998-325 (Sep. 16, 1998).

68. *Hibernia Bank v. U.S.,* 581 F.2d 741 (9th Cir. 1978).

As a result, the estate incurred interest expense of $196,210 during the period. The probate court approved payment of the expense and, consistent with §2053, the estate claimed a deduction of the interest as an administration expense. However, the circuit court held that the interest expense was not deductible because it was not an expense essential to the administration of the estate. The court indicated that Hibernia had failed to demonstrate an "existing necessity" to keep the estate open during the period of the loans. It could have sold the Hibernia shares. Thus, the loans were unnecessary and not essential for administration of the estate. Instead, it appeared that the expense was for the benefit of the heirs who apparently preferred to have cash distributed to the trusts rather than an undivided interest in the mansion.

Qualified Residence Interest. If an individual owns a home with a mortgage and dies between payment dates, there is an accrued interest expense. Interest expense on a decedent's home mortgage that represented "qualified residence interest" that had **accrued** at death would be a DRD and fully deductible on Form 1041 when paid by the estate. On the other hand, how are payments of mortgage interest on the decedent's home that accrue after his death treated? Since the decedent is no longer living in the home, would it be considered qualified residence interest? IRC §163(h)(4)(D) answers these question**.** Interest paid by a trust or estate on a residence held by the trust or estate is deductible as qualified residence interest but only if the residence is a qualified residence (i.e., the principal or a second residence as defined in §163(h)(2)) of a beneficiary who has a present or residuary interest in the trust or estate. In other words, if the house passes to one of the heirs of the estate who uses it as a residence, the interest would be deductible. On the other hand, if the house ultimately is sold by the estate, how is the interest treated? The interest expense paid by the estate while holding the home is not qualified residence interest. However, it arguably should be deductible as investment interest, subject to the investment interest limitations. It may also be deductible as an **administration** expense as discussed below.[69]

Example 22. Jack and Diane were married for many years before Jack died several years ago. Upon his death, Diane inherited their residence, which was subject to a mortgage of $600,000. Diane died on June 20 of this year. The next mortgage payment was due July 1. At the time of Diane's death, interest of $4,000 had accrued. Probate lasted about 18 months before all the assets, including the home, had been distributed and the estate terminated. During this time, the estate paid $4,000 of interest on the mortgage that had accrued at death and another $72,000 of interest during probate. Diane's estate was subject to estate tax. How much of the interest expense on the home mortgage can the estate deduct?

The $4,000 of interest that had accrued at death is a deduction in respect of a decedent under §691(b) and can be deducted on both the estate's income tax return, Form 1041, and the estate tax return, Form 706. The treatment of the remaining interest of $72,000 appears to depend on whether the home would pass to a beneficiary that would use it as a principal or second residence. If the home passes directly to Diane's daughter, Linda, who moves into the home to use it as her principal residence, the interest of $72,000 would be qualified residence interest deductible on the estate's income tax return, Form 1041, or the estate tax return, Form 706, as an administration expense. The same treatment applies if Linda received the home as part of the residuary estate and she began to use it as her residence. However, what if the estate sold the home or the home did not qualify as a principal or second residence for Linda? In either situation, it seems reasonable to take the position that the home became an investment and the $72,000 of interest qualifies as investment interest on Form 1041 or administration expense on Form 706.

69. *Estate of Wheless v. Comm'r*, 72 TC 470 (June 11, 1979).

Selling Expenses. A familiar problem for estates is the treatment of the estate's selling expenses. To illustrate, consider the expenses incurred during probate in selling the decedent's residence (e.g., real estate commission, attorney fees, real estate transfer taxes, and related items). Selling expenses are also commonly incurred when the estate sells other estate assets, such as artwork and collectibles (e.g., gallery commissions, auction expenses). Whether these costs are deductible under either §2053 or §212 depends on a 2-part test:

1. Was the expense allowed under state and local law?
2. Was the sale of the property necessary based on the criteria set forth in the regulations?

The regulations allow the deduction when the sale is required to pay debts, administration expenses or taxes, to preserve the estate, or to effect distribution. A sale for the convenience of the beneficiaries may not meet these criteria.

One approach to the treatment of selling expenses is to treat the costs as a reduction of the amount realized on the sale (netted against the sales price) as reported on the estate income tax return (Form 1041). This treatment reduces any gain on the sale of the property. However, as a practical matter, this may result in a loss on the sale since the basis of the property to the estate is the FMV of the property at the date of death.

In the case of a residence, this treatment poses another question as to whether the sale of the decedent's personal residence at a loss is deductible. According to one source,[70] the IRS office in Brookhaven, New York, "confronted a number of fiduciary income tax returns on which the fiduciary had reported losses from the sale of [a] decedent's personal residence." In an IRS service center advice memorandum,[71] the IRS concluded the losses were not deductible. The memorandum indicated that an estate might not deduct a loss incurred on the sale of a decedent's personal residence unless it was converted to an income-producing asset. Consequently, it appears that if the estate, trust, or beneficiary made immediate attempts on receipt of the residence to rent or sell it, the deduction could be allowed. If the estate or trust sold it at a loss, the result would be a capital loss. At first, it might appear the loss has little utility since it is unlikely that the estate would have few, if any, capital gains because the property's basis is its FMV at the date of death. However, as discussed later in this chapter, any unused capital losses of a trust or estate are passed to the beneficiaries upon the termination of the trust or estate.

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Prior to 1976, some estates claimed a deduction for selling expenses as an administration expense on the Form 706 **and** an offset against the sales price of the item in computing taxable income on the Form 1041. IRC §642(g) was altered specifically to prohibit this possibility. As a result, if the selling expenses qualify for a deduction under §2053 for estate tax purposes, the estate must elect to claim selling expenses as either an estate tax deduction under §2053 or as an offset against the sales price for purposes of determining the gain or loss reported on the estate's income tax return.

In TAM 9342002, the IRS considered whether expenses incurred to sell the decedent's residence — a condominium — were deductible as administration expenses on Form 706. The decedent's probate estate included the condominium, stocks, and mutual funds. Under the decedent's will, his probate estate, including the condominium, passed to his adult child, Eugene, who also served as the executor of the estate. In addition, the child and the decedent jointly owned bank accounts that were worth $174,000. The child, acting as executor of the estate, sold the condominium for approximately $190,000 and incurred sales costs of $10,839 that the estate deducted. The IRS agent who sought advice asserted that the deduction should not be allowed since there was cash in the joint bank accounts sufficient to pay the expenses and such cash was available to Eugene. The government concluded that the agent was wrong. The TAM explained that there was no cash in the probate estate, so a sale of some of the assets was necessary to pay the decedent's debts, administration expenses, and taxes. The cash held jointly was not part of the probate estate and was outside the jurisdiction and reach of the court. Therefore, Eugene, in his capacity as executor, had no authority to access the bank accounts. This was true even though the decedent had made all of the contributions to the jointly-held accounts. As a result, the selling expenses incurred by the estate were deductible.

Note. Presumably, the estate had the choice of deducting the selling expenses on Form 706 or reducing the amount realized on the sale that would be reported on Form 1041. Eugene chose to report it on Form 706.

70. Fastman, Lainie R., "Selling a Decedent's Real Estate: Some Tax Considerations," *The CPA Journal* (June 2000).

71. SCA 98 TNT 104-82 (June 1, 1998).

As described in *Ferguson,*[72] Agnes Peppard died in September 1976, just one month after her husband's death. Agnes' daughter Joanne, acting as the personal representative of the estate, sold her mother's residence and incurred selling expenses of $3,542. The IRS denied the deduction for the expenses. At trial, however, Joanne contended "that the sale of the house was necessary to help preserve the estate; the house was vacant and the imposition of mortgage payments, utility bills, and other maintenance costs was a cash burden on the estate." On the other hand, the government asserted that the house was sold for the benefit of the daughter as beneficiary of the estate. The court held that the expenses were deductible. The court reached the decision "because the house was vacant and hence a drain on the cash of the estate . . . [thus] the sale of the residence was necessary to preserve the estate."

Observation. The issue of whether selling expenses are deductible can be resolved by having the will direct that the property be sold upon the decedent's death.[73]

Other cases related to selling expenses include the following:

- *Estate of Park v. Comm'r* (475 F.2d 673, 6th Cir. Mar. 21. 1973), which allowed brokerage fees on the sale of a residence and a cottage
- *Estate of Streeter v. Comm'r* (491 F.2d 375, 3rd Cir. Jan. 11, 1974), which disallowed $500,000 of gallery commissions for the sale of a collection of historical artifacts
- *Estate of Smith v. Comm'r* (510 F.2d 479, Feb. 4, 1975), which disallowed auction commissions
- *Estate of Vatter v. Comm'r* (65 TC 633, Dec. 31, 1975), which allowed expenses for selling rental dwellings when trustee did not want to manage the properties as part of the trust

Miscellaneous Administration Expenses. The estate can also deduct other expenses incurred in administering the estate such as the costs for appraisals, copying and faxing documents, bank charges, death certificates, required rent payments on unexpired leases, and costs associated with maintaining and preserving a personal residence prior to its sale or distribution. One case suggests such preservation costs may be deductible.[74] If so, expenses such as utilities, insurance, repairs, and maintenance related to the decedent's residence should be deductible. That said, there are a number of cases in which expenses that were incurred over a long period of time were disallowed because holding the property was not necessary to the preservation of the estate.

Funeral Expenses

The decedent's estate is normally obligated to pay for the decedent's funeral. When the estate pays funeral expenses, they are not deductible on Form 1041. However, such expenses can be deducted on the Form 706. Similarly, it is common for a will to authorize reimbursement of travel expenses of certain individuals (e.g., immediate family member such as an adult child) traveling to the funeral. The costs (or reimbursements of such costs) of family members to attend the funeral are not deductible. Arguably, if the will provides for reimbursement of the traveling expenses for certain individuals, the reimbursements might be considered distributions.

72. *Ferguson v. U.S.,* 48 AFTR 2d 81-6252, 81-1 USTC ¶13409 (DC-AZ Apr. 17, 1981).

73. See *Estate of William W. Wheless, Sr. v. Comm'r,* 72 TC 470 (1979) 633; PLR 8119002; and Rev. Rul. 90-8, 1990-1 CB 173.

74. *Fuller's Estate v. Comm'r,* 171 F.2d 704 (3rd Cir. Dec. 13, 1948) *aff'g Estate of Mortimer Fuller v. Comm'r,* 9 TC 1069 (Dec. 16, 1947).

Medical Expenses

Costs related to healthcare paid by a trust or an estate are not deductible on Form 1041. Such expenses are deductible on Form 706. If medical expenses are paid within a year of the decedent's death, the expenses may be deducted on the decedent's final income tax return (Form 1040) or Form 706 but not on both. Medical expenses paid by a trust or an estate for the beneficiaries are treated as distributions to the beneficiaries who would then account for them on their own personal tax returns.

Deductions Related to Tax-Exempt Income

The deduction limitation for expenses related to tax-exempt income that applies to individual taxpayers also applies to trusts and estates.[75] If a trust or estate has tax-exempt income, all expenses that are not directly related to taxable income are limited and potentially disallowed. For example, if 10% of a trust's income were tax exempt, 10% of any trustee commissions or 10% of any charitable contributions would be disallowed.

Expenses that are directly related to taxable trust or estate income are fully deductible. For example, rent expenses are directly related to rental income and would not be subject to the limitation. Similarly, tax preparation expenses are arguably treated as allocable solely to taxable income presumably on the theory that such expenses would not be incurred if all of the income was tax-exempt. Likewise, personal property taxes on property that produces taxable income are arguably allocated solely to taxable income.

Expenses that are not directly related to a particular type of income — sometimes referred to as **indirect** expenses — must be allocated proportionately between taxable and tax-exempt income. A portion of **any** deductible expense of a fiduciary that is not **directly** attributable to a specific class of income must be allocated to tax-exempt income, thus making it nondeductible.[76] For example, trustee commissions relate to both taxable and tax-exempt income and, consequently, an allocation is required.[77]

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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 (wire transfer fees).

The following formula is used in determining the nondeductible portion of expenses:

$$\text{Nondeductible expense} = \frac{\text{Tax-exempt income}}{\text{Total trust income}} \times \text{Expenses not directly related to income}$$

The numerator normally is interest income on a state or local bond exempt under IRC §103. The expenses affected normally would be those deductible under IRC §212 such as trustee fees. Expenses that are not deductible under §212 should avoid limitation. For example, if the trust must pay a state income tax on tax-exempt income earned from another state, the deduction would be allowed since it is granted under IRC §164 relating to taxes and not §212. Whether an expense is allocated to income or corpus in computing FAI is irrelevant in determining its deductibility for taxable income.

The computation of the denominator of the formula has been the subject of scrutiny on a number of occasions. As might be expected, taxpayers want the denominator as large as possible to minimize the amount of nondeductible expense. Of course, the government thinks otherwise.

> **Example 23.** In one year, a trust has $500,000 of trustee fees. Its only item of income was $1 million of tax-exempt interest. One hundred percent of the trustee fee would be nondeductible ($1 million tax-exempt income ÷ $1 million total trust income × $500,000).

75. IRC §265.

76. Treas. Reg. §1.652(b)-3(b).

77. Treas. Regs. §§1.652(b) and 1.653(b).

One of the more contentious items concerning the denominator is capital gains. Generally, the denominator does not include capital gains unless capital gains are actually included in FAI.[78] In Rev. Rul. 80-165,[79] 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 DNI (discussed in the "Deduction for Distributions" section).

In calculating the denominator, only the **gross** amounts of other income are included in the denominator.

Example 24. This year, the Angst trust paid trustee commissions of $7,000, of which $5,000 is allocable to income and $2,000 is 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 allocated to corpus	$25,000
Long-term capital losses allocated to corpus	(5,000)
Net capital gain	$20,000
Sales	$20,000
Costs of goods sold	(15,000)
Gross income	$ 5,000
Interest on New York state bonds	$10,000

To determine the amount of commissions that are not deductible, the denominator includes the **gross** amounts of income received and is not reduced by expenses. Thus, the denominator includes the rent of $70,000, sales of $20,000, and tax-exempt interest of $10,000 for a total of $100,000. The denominator does not include the net capital gain allocable to corpus of $20,000. Therefore, 10% ($10,000 ÷ $100,000) of the $7,000 of trustee's commissions, or $700, is not deductible, and the remaining $6,300 is deductible.

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

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,[80] the IRS indicated that a proportionate allocation is not mandatory.[81] The IRS noted 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."

78. See Rev. Rul. 77-355; *Manufacturers Hanover Trust Co. v. U.S.*, 312 F.2d 785 (Ct. of Claims, Feb 6, 1963); and *Tucker v. Comm'r*, 322 F.2d 86 (2nd Cir. Aug. 2, 1963) *aff'g* 38 TC 955.

79. Rev. Rul. 80-165, 1980-1 CB 134.

80. Rev. Rul. 63-27, 1963-1 CB 57.

81. Citing *Edward Mallinckrodt, Jr.*, 2 TC 1128 (Dec. 16, 1943).

Terminating Commissions. When a trust or estate is terminated, fiduciaries usually charge a termination commission. Typically, these commissions are based on a percentage of the total value of the principal and can be quite substantial. In these situations, the formula for determining the portion of the fees allocable to tax-exempt income has been the subject of debate. In *Whittemore Jr.*,[82] the 8th 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. The 1st Circuit took an even more aggressive approach in *Fabens,*[83] holding that both unrealized **and** realized capital gains should be included in the denominator. The IRS accepted the *Fabens* position in Rev. Rul. 77-466.

Deductions for Taxes

The deduction of taxes for individuals also extends to trusts and estates. Deductible taxes include real and personal property taxes on assets owned by the fiduciary. A fiduciary can deduct state, local, and foreign income taxes on income produced by the fiduciary. Fiduciaries are entitled to deduct state and local sales taxes in lieu of state and local income taxes. However, a fiduciary cannot use the Optional Sales Tax Table for individuals. Sales tax paid on items used in a trade or business is deducted on the appropriate business schedules instead of on line 11 of Form 1041. Importantly, because the deduction for taxes is granted specifically under §164 rather than §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 §163 subject to several important restrictions. As noted above, trusts and estates are also entitled to this deduction. Investment interest is deductible but limited to net investment income. Personal interest is not deductible. However, an exception exists for qualified residence interest as previously discussed.

Charitable Contributions

Trusts and estates generally are allowed an unlimited deduction for contributions of trust income to qualified charitable organizations.[84] In contrast to the treatment of contributions for individuals or corporations, no percentage limitations exist on the amount of the deduction for contributions made by trusts or estates.

> **Observation.** Contributions are not to be confused with distributions to charitable beneficiaries. Although it seems that they are the same, distributions to a charitable beneficiary are not considered part of the distribution deduction. They are instead accounted for as charitable contributions. Form 1041, Schedule A, line 1, is where charitable contributions are reported.

For a contribution to qualify for deduction, it must be made pursuant to the trust instrument or will. **Deductions are not allowed for discretionary contributions made by the trustee.**

Qualified Donee. The recipient must be a qualified charitable organization. Qualified organizations are essentially the same group of eligible recipients that exists for individual and corporate contributions except organizations that otherwise qualify need not be created or organized in the United States.

82. *Whittemore Jr. v. U.S.*, 383 F.2d 824 (8th Cir. Oct. 4, 1967).

83. *Fabens v. Comm'r*, 519 F.2d 1310 (1st Cir. June 30, 1975).

84. IRC §642(c).

Source of Contribution. A deduction is allowed only for contributions of gross taxable income. Charitable contributions from tax-exempt income are not deductible. This rule is quite logical since allowing a deduction would provide an unjustified double benefit (i.e., the income received is not included in taxable income but when it is given to the charity a deduction would be allowed). For this purpose, a contribution is deemed to consist of its proportion of each type of income that the trust receives, including tax-exempt income.[85] Thus, if a trust's income is 60% tax exempt, then 60% of any charitable contribution is not deductible. Individual and corporate taxpayers are not subject to such a harsh rule.

> **Observation.** It may be possible to circumvent the limitation. For example, if the will or trust instrument is drafted in such a way that contributions would only be made from taxable income (if any), the contribution arguably would not consist of any tax-exempt income and would be fully deductible. Moreover, there is economic substance to this approach since the charity would not receive a distribution unless the trust had taxable income.
>
> Similarly, the trust or will could contain a provision that specifies that tax-exempt income is distributed to taxable beneficiaries and all payments to charities are made from fully-taxable gross income. Alternatively, the instrument might provide that any distributions to a charity is first paid out of available taxable income and any distributions to private beneficiaries are first paid out of available tax-exempt income. The question is whether the regulations require the contribution to have substantial economic effect much like the rules imposed on partnership allocations in IRC §704(b) (i.e., the allocation would only be recognized if the provision has significant nontax consequences).[86]

Set Asides for Future Contributions. There is no deduction for contributions of trust corpus, only for contributions of income (see below for contributions of remainder interests). For many years, trusts were able to claim a deduction for income that was permanently **set aside** for **future** payment to charitable organizations (even though it was not currently paid). To curb potential abuses associated with this practice, such set-aside deductions are no longer permitted for trusts created after October 9, 1969. However, there are two exceptions: estates and pooled income funds are still entitled to such set-aside deductions.[87]

Throwback Election. 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.[88] This rule enables a trust to determine the amount of income for the year that may be 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 by the due date of a timely-filed tax return for the second year as extended. Information contained in the election can be found in Treas. Reg. §1.642(c)-1(b).

Contributions of Remainder Interests. Contributions of remainder interests or income interests to a charitable organization must meet special rules in order to qualify for deduction.[89]

Special problems exist (beyond the scope of this material) if a trust or estate realizes income that would be considered **unrelated business taxable income** to the charity if the charity had received it directly and such income is distributed to the charity. Generally, such income is taxable to the charity and the trust is required to reduce its charitable contribution accordingly. In such cases, a Schedule K-1 is given to the charity.

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85. Treas. Reg. §1.643(c)-3(b).

86. See Treas. Reg. §1.652((b)–1.

87. IRC §§642(c)(2) and (3).

88. IRC §642(c)(1); Treas. Regs. §§1.642(c)-1(b)(2) and (3).

89. See IRC §664. See Schmolka (1984). Income Taxation of Charitable Remainder Trusts and Decedents' Estates: 66 Years of Astigmatism. *Tax Law Review, 40,* 116–327.

Miscellaneous Itemized Deductions

General Rule. Fiduciaries, like individuals, are subject to limitations on the deduction of miscellaneous itemized deductions (MIDs). These deductions are allowed only to the extent they exceed 2% of the fiduciary's AGI.[90] Special rules are used for trusts and estates to determine whether a deduction is classified as a MID. Under IRC §67(e), deductions escape MID status if they are:

- Incurred in the administration of the trust or estate, and
- Would not be incurred had the property not been held in the trust or by the estate.[91]

The expense must be unique to the trust. For example, trustee fees are not considered MIDs and are not subject to the 2% limitation since both of the above tests are met. Other deductions not subject to the 2% limitation and deductible in arriving at AGI include:

1. Trustee fees,
2. Tax preparation fees,
3. Charitable contributions,
4. Deductions for distributions, and
5. Certain other exceptions under §67(b).

Perhaps the most difficult problem in applying the 2% rule concerns the treatment of investment advisory expenses. Trustees often seek advice regarding investments and pay handsomely for it. Should these expenses be exempt from the limitation? Since creation of the 2% rule in 1986, the issue has generated substantial controversy resulting in differing opinions among the appellate courts.

Ultimately, the issue was put to rest by the Supreme Court in *Knight*, ruling that investment advisory fees generally are subject to the 2% rule.[92] In this case, the court noted that it is possible that some types of advisory fees may exclusively relate to trusts and estates, in which case the 2% floor would not apply. However, the court's opinion does not require the "unbundling" of unitary fiduciary fees, as the IRS proposed regulations require. The IRS proposed regulations were patterned on the lower court's narrower test — essentially allowing deductions to avoid the 2% floor only if they were unique to trusts or estates. The regulations would require taxpayers to somehow unbundle the fee to be able to allocate the fees to those that are subject to the 2% floor and to those that are not. Since the Supreme Court adopted a broader test for the exception to the 2% floor for trusts and estates, revised regulations are likely to be created.

On February 27, 2008, the IRS issued Notice 2008-32.[93] This provides interim guidance on the treatment of investment advisory fees and other costs subject to the 2% floor of IRC §67(a) that are bundled as part of one commission or fee paid to the trustee or executor (a bundled fiduciary fee) and are incurred by a nongrantor trust or an estate. For tax years beginning before January 1, 2008, taxpayers are not required to determine the part of a bundled fiduciary fee that is subject to the 2% floor under §67. Thus, taxpayers may deduct the full amount of the bundled fiduciary fee (even if it includes investment advisory fees) on their 2007 Forms 1041 without regard to the 2% floor. However, any payments made by the fiduciary to third parties for expenses subject to the 2% floor are readily identifiable and must be treated separately from the otherwise bundled fiduciary fee. The IRS issued another similar notice for years beginning before January 1, 2010.[94]

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90. IRC §67(e).
91. Section 67(e) extends the exemption from the limitation by making the expenses deductible for AGI.
92. *Knight v. Comm'r*, 552 US 181 (2008).
93. Notice 2008-32, 2008-1 CB 593.
94. Notice 2010-32, 2010-16 IRB 594.

Determination of the Amount of the Limitation. The computation of the limitation on miscellaneous itemized deductions can be quite cumbersome. Since AGI of the trust or estate 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 miscellaneous itemized deductions (taxable DNI), the calculation of allowable miscellaneous itemized deductions may require the use of simultaneous algebraic equations. The instructions for making the computation can be found in the instructions to Form 1041.

Cost Recovery: Depreciation and §179 Expensing

General Rule. The amount of the deduction for depreciation, depletion, and amortization for tax purposes is computed in the usual manner without regard to the fact that the trust or estate is the taxpayer and owner of the property. However, tax depreciation and depreciation for FAI purposes may differ.

Allocation. An earlier discussion of FAI discussed the problems of wasting assets (e.g., natural resources such as coal, oil and gas, and building and intangibles). Recall that without action, the income beneficiary would extract all the benefits of such assets and leave the remainderman with nothing. To protect the remainderman and preserve the value of corpus, trustees often set aside income in a separate account. These set asides are commonly known as reserves for depreciation, depletion, and amortization, depending on the type of wasting asset. Trustees create these reserves by withholding an amount of income that might otherwise be distributed to a beneficiary. How does this accounting treatment work in tandem with the tax rules? Consistent with the reserve concept, tax depreciation as computed in the normal fashion is allocated to the trust to the extent of the reserve. Any tax depreciation in excess of this reserve is allocated pro rata based on where the FAI flows. For example, if 60% of the FAI is distributed and 40% is retained by the trusts, then the balance of depreciation in excess of the reserve is allocated 60% to the beneficiaries and 40% to the trusts.

Technically, the Code provides that an estate or trust is entitled to a depreciation deduction or a depletion allowance (and amortization) "only to the extent not allowable to the beneficiaries under §§167(d) and 611(b)." As indicated previously, the allowable depreciation deduction is allocated between the trust and the beneficiaries **including charitable beneficiaries** in a special manner.[95] If under the trust instrument or state law the trustee is required to maintain a depreciation reserve (i.e., the trustee sets aside income for such purpose), any allowable tax depreciation is deductible **by the trust** to the extent of such reserve. If the allowable depreciation **exceeds** the reserve, the depreciation is allocated between the trust and the beneficiary according to the FAI 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.

Limited Expensing for Trusts and Estates. IRC §179, which generally allows taxpayers to expense a certain amount of assets annually (up to $250,000 in 2010), is **not** available to trusts or estates. Any §179 amount that is passed through to a trust or estate from a partnership or S corporation is not deductible by the trust or the estate. This amount must be capitalized and depreciated in the normal manner. In those situations in which a trust or estate is a partner or a shareholder in an S corporation, the entity is not permitted to expense the amount allocable to the trust or estate but the partnership or S corporation may capitalize such amount and depreciate it. The depreciation passes through to all shareholders or partners.[96]

95. Treas. Regs. §§1.167(h)-1 and 1.611-1(c)(4).

96. Treas. Reg. §1.179-1(f)(3).

Example 25. A trust's records reveal the **following** facts:

Net rental income before depreciation	$104,000
Depreciation reserve required	(4,000)
Fiduciary accounting income	$100,000
Tax depreciation	10,000
Income distribution to beneficiaries	60,000

The allocation of depreciation is computed as follows:

	Total	Trust	Beneficiaries
Tax depreciation	$10,000		
Reserve	(4,000)	$4,000	
Balance	$6,000		
Allocation			
Depreciation distributed (60% × $6,000)	(3,600)		$3,600
Depreciation retained (40% × $6,000)	(2,400)	2,400	
Total		$6,400	$3,600

Example 26. The John Doe Trust was established for John's daughter, Daisy. For the year, the trust had net rental income of $20,000 and MACRS depreciation of $27,000. There is no reserve for depreciation. FAI is $20,000. If all $20,000 of the FAI is distributed to Daisy, all the depreciation is allocated to Daisy.

As a result, Daisy reports $20,000 of rental income and $27,000 of depreciation for a net loss of $7,000. The loss would be a passive loss subject to the limitations of IRC §469.

Example 27. The Manning Trust was established for Mr. Manning's son, Q.B. For the year, the trust had net rental income of $10,000 before taking into account any depreciation. The trust required a reserve for depreciation of $7,000. The trustee set aside $7,000 for depreciation so FAI was $3,000, all of which was distributed. MACRS depreciation was $4,000.

The taxable income of the trust was $6,000 ($10,000 – $4,000) and the beneficiaries receive a distribution of $3,000 with no depreciation deduction.

Depreciation for Estates. Estates do not maintain reserve accounts for depreciation, amortization, or depletion. Consequently, any tax depreciation that an estate may have is allocated between the estate and its beneficiaries according to the amount of FAI allocable to each.

Depreciation Allocations to Charitable Beneficiaries. In allocating depreciation, a portion of the tax depreciation must be allocated to charitable beneficiaries as well as noncharitable beneficiaries. Thus, when the trust has a charitable beneficiary, the depreciation deduction allocated to the charity may be wasted because the charity may not pay taxes.

Deduction of Estate Taxes Attributable to IRD

A deduction for estate taxes attributable to IRD can be taken when the item of IRD is received in cash.[97] The deduction is calculated following the formula described in IRC §691(c). A federal estate tax must have been incurred for the deduction to be applicable.

97. IRC §691(c).

Net Operating Losses

A trust or estate that is operating a trade or business or that has an interest in a partnership or S corporation that suffers losses may have a net operating loss (NOL). Fiduciaries are entitled to an NOL deduction.[98] The computation of the NOL 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 as provided in §172.

A trust or estate 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 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 or estate 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.[99] Under the rules, the beneficiary must file an amended return and recompute taxable income based upon the DNI of the trust or estate 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 the estate or trust is terminated and the trust or estate has an NOL carryover, such loss may be passed on to the beneficiaries as discussed below.[100]

Excess Deductions

When a fiduciary 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 generally lost. However, if in the last taxable year of the trust or estate (the year of termination), the entity has deductions that exceed gross income, the excess flows through to the beneficiaries.[101] In determining the amount of excess deductions, the exemption deduction and the charitable contribution deduction are ignored.

The effect of the excess deductions provision is to allow those deductions that are not taken into account in computing the NOL deduction to pass through. It should be emphasized, however, that this rule only applies to deductions incurred in the year of termination.[102]

> **Observation**. It is worth noting that a charitable contribution deduction is not taken into account in determining an NOL or excess deductions. As a result, the contribution deduction easily could be wasted when there is insufficient income to absorb it.

98. IRC §§642(d) and 172.

99. Rev. Rul. 61-20, 1961-1 CB 248.

100. IRC §642(h)(1).

101. IRC §642(h)(2).

102. For the importance of properly timing deductions, see *Westphal v. Comm'r*, 37 TC 340 (Nov. 28, 1961).

Excess Deductions, NOL, and Capital Loss Carryovers in the Year of Termination. Upon termination of a trust or estate, IRC §642(h) allows beneficiaries to inherit some or all of the entity's capital loss and NOL carryovers as well as any excess final-year deductions over final-year gross income.

The capital loss and NOL carryovers that were not used as of the year of the termination do not expire. Instead, they pass through to the beneficiaries even if they did not arise in the year of termination.[103] Any capital loss carryovers that flow through to the individual beneficiaries may be used by such individuals until the carryovers are exhausted. Corporate beneficiaries may only use the capital loss carryovers for five years. NOL deductions passing out of the trust or estate in the year of termination to the beneficiary can be carried forward for 20 years. For this purpose, the final year of the trust or estate and the first year of the beneficiary are counted as separate taxable years. If the beneficiary should die before using the NOL or capital loss carryovers, the carryovers are lost.

Beneficiaries may report their share of excess deductions as an itemized deduction even though some of the excess deductions were taken into account in determining AGI by the trust or estate.[104] Consequently, a beneficiary must itemize in order to obtain a benefit from the pass through. In addition, the beneficiary can only claim the deductions in the year in which the trust or estate 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 28. In 2010, the Gain Trust terminated. For its 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 an itemized deduction. Had this not been the year of termination, the $10,000 of excess deductions would be 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 29. The Hie Trust operates a sole proprietorship. This year the trust terminated and all the trust assets were distributed to the beneficiary, Jerry. 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 estate's NOL and excess deductions are computed as follows:

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

103. Treas. Reg. §1.642(h)-1(a).

104. Treas. Reg. §1.642(h)-(2)(a). The beneficiary treats the excess deductions as miscellaneous itemized deductions subject to the 2% floor (IRC §67(a) and Schedule K-1 of Form 1041).

In the year of termination, the NOL and the excess deductions in such year pass to the beneficiaries of the property. If this is the year of termination, Jerry is entitled to an NOL deduction of $2,000 for AGI. He is also entitled to a deduction for the excess deductions of $7,300, which are treated as a miscellaneous itemized deduction.

If this is not the year of termination, the trust carries the NOL forward to be used in future years. The excess deductions are lost.

Allocating the Deductions to the Beneficiaries. IRC §642(h) provides that the excess deductions and carryovers pass through to the beneficiaries **succeeding** to the decedent's property. Generally, those beneficiaries whose share of the trust or estate assets actually suffered the burden of the expenses creating the excess deductions or carryovers are entitled to the deductions. For trusts or estates, the remainderman, who receives all or a portion of the property of a trust on final termination, is considered a beneficiary succeeding to the property of the trust or estate and is entitled to the deductions.[105]

Example 30. Terrell established a trust for the benefit of his three daughters, Xenus, Yvonne, and Zoe. According to the terms of the trust, Xenus receives the income for life. Upon her death, Yvonne receives $30,000 and Zoe gets the remainder. In this case, Zoe is entitled to all the excess deductions and carryovers. Zoe could deduct the excess deductions in the year of the entity's termination as miscellaneous itemized deductions subject to the 2% floor.

Casualty and Theft Losses

The rules for deducting casualty and theft losses (IRC §165) 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 fiduciaries. However, the 10% floor does not apply if the property is held for business or investment. It would appear that most assets are held for this purpose; therefore, the limitation may not be a problem.

Passive Activity Losses (PALs)

General Rule. All basic rules for PALs are applicable to trusts and estates. PALs are suspended at the fiduciary level and are triggered when the fiduciary has passive income or disposes of the investment.

Material Participation. The difficulty is determining whether a loss is passive. At this time, there are no regulations that address this issue, although Temp. Treas. Reg. §1.469-5T(g) is reserved for this purpose. The issue was considered in *Mattie K. Carter Trust*.[106] In this case, the trust managed — among other assets — a cattle ranch, which produced losses during 1994 and 1995 of $856,518 and $796,687, respectively. The government 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 trust, 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 by its fiduciaries, employees, and agents met the material participation test.

105. Treas. Reg. §1.642(h)-3(d).

106. *Mattie K. Carter Trust v. U.S.*, 256 F.Supp.2d 536, (DC TX 2003).

The court emphasized that the IRS's position was "arbitrary, [it] subverts common sense, and attempts to create ambiguity where there is none." In addition, the court's opinion is consistent with the way the passive loss rules are applied to closely-held C corporations in which material participation is tied to the exemption under IRC §465 for active businesses contained in IRC §465(c)(7). Those rules attribute the activity of employees to the **entity.**[107] Similarly, under the statute,[108] a trust is an entity and, like a corporation, looks to the activities of employees and agents to conduct its business. However, in a 2007 technical advice memorandum,[109] the IRS indicated that it does not agree with the court's opinion. In a 2010 private letter ruling,[110] the IRS cited a sentence in a 1986 Senate Report to bolster its conclusion that only the trustee's actions matter for purposes of applying the passive loss rules — "the activities of [employees] . . . are not attributed to the taxpayer." Unfortunately, the IRS did not cite its own regulation on the matter that **does** attribute the activities of employees to an entity.[111] Consequently, the ruling is contrary to the IRS's own regulatory position on the issue. Apart from the statutory rationale, to require a fiduciary to be the sole means of satisfying the material participation test would make material participation by corporate fiduciaries (e.g., a bank trust department or a private trust company) impossible.

Example 31. Several years ago, Herman and Wanda, husband and wife, formed an LLC to own and operate a trailer court. This year, Herman died and left his interest in the LLC to a trust for the benefit of his son, Sean. Under the terms of the trust instrument, Sean is to receive all the income from the trust. In 2009, the trust reports interest income of $30,000 and its share of a loss from the LLC of $10,000. Assuming the loss is passive — although *Carter* may suggest otherwise — it is suspended at the trust level and does not offset the $30,000 of interest income that passes through to Sean.

In 2010, the trust reports $35,000 of interest income and $40,000 of income from the LLC. The trust distributes all the income, $75,000 ($35,000 + $40,000), to Sean. For tax purposes, the LLC income of $40,000 is treated as passive income and the trust may offset the suspended loss of $10,000 against it. Consequently, the trust has taxable income before distributions of $65,000 ($35,000 + $40,000 – $10,000).

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

Suspended Losses (§469(g)(2)) and Distribution of a Passive Activity. During the term of the trust or upon its termination, there may be a distribution of an interest with suspended passive losses. In such case, the losses are not triggered and the trust receives no benefit from the suspended losses. Moreover, the losses do not pass through to the beneficiaries. Rather, any suspended losses attributable to the property increase the beneficiary's basis in the passive activity interest.[112] The basis rules for gifted property apply for purposes of a later sale or disposition as well as depreciation. Under IRC §1015, if at the time of distribution the property's value exceeds its basis (as increased by the suspended losses), the basis for gain and loss is the increased basis. In contrast, if the property's value is less than the increased basis at the time of distribution, the basis for gain is the increased basis and the basis for loss is FMV. 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 33** below.)

107. Temp. Treas. Reg. §1.469-1T(g) adopted the IRC §465(c)(7)(C) route for corporate material participation.

108. IRC §469(a)(2)(A).

109. TAM 200733023 (Aug. 17, 2007).

110. PLR 201020104 (Apr. 7, 2010).

111. Temp. Treas. Reg. §1.469-1T(g). Under IRC §469(a)(2)(A), a trust is an entity.

112. IRC §469(j)(12).

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Basis for Depreciation. The basis for depreciation of gifted property with passive losses is the same as it was in the hands of the donor, that is, the increased basis.[113] The donee would step into the shoes of the donor (i.e., the trust) and continue to depreciate the trust's basis in the same manner. The increased basis is treated as newly-acquired property and depreciated using the appropriate life and method specified by MACRS.

Example 32. Travis is the beneficiary of a trust created by his father. Upon Travis' death, the trust instrument provided for the transfer of a small apartment building to his daughter, Debbie. At that time, the trust's basis for the apartment building was $100,000 and its FMV was $60,000. (IRC §1014 does not provide for an increase or decrease to the basis of the trust property at the time of the grantor's death.) In addition, there was $30,000 of suspended losses 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.[114] If Debbie sells the property for $150,000, she recognizes a gain of $20,000 ($150,000 – $100,000 – $30,000). In this instance, Debbie can recover and use the losses due to the basis increase in the property.

On the other hand, if Debbie sold the property for $50,000, she recognizes a loss of $10,000 ($60,000 FMV – $50,000) and no benefit is obtained from the suspended losses.

If Debbie chooses not to sell the property upon receipt, she may depreciate the property. She continues to depreciate the original basis of the property in the same manner as the trust. In addition, she treats the basis increase as new property and depreciates it using the appropriate life and method specified by 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.[115] This prevents taxpayers from circumventing the $25,000 limitation by transferring multiple properties to multiple trusts allowing each to claim a $25,000 allowance. However, estates can utilize the $25,000 allowance for losses occurring for tax years ending less than two years after the decedent's date of death.

Example 33. The facts of **Example 16** are repeated here for convenience.

On March 7, 1995, Grant Tor established a trust for his son Benny Tor. According to the terms of 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 distribution to the Red Cross of $20,000. No distributions were made to the other beneficiaries. Trust taxable income is computed as follows.

113. IRC §167(c)(1); Prop. Treas. Reg. §1.168-5(f)(3).

114. IRC §469(j)(12).

115. IRC §469(i).

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 — [($10,000 tax-exempt income ÷ $125,000 total trust income) × $8,000]
[b] $18,400 = $20,000 — [($10,000 ÷ $125,000) × $20,000]

The charitable beneficiary, the Red Cross, is not treated as a beneficiary. Rather, the distribution to the charity is accounted for as a charitable contribution. Taxable income of $124,140 differs substantially from FAI of $106,000.[116] This is attributable in part to the treatment of the $50,000 gain on the sale of the stock that produces long-term capital gain, which was allocable to corpus. Although capital gains are included in taxable income, they are not included in FAI. In addition, FAI is computed before charitable contributions (and distributions to beneficiaries). However, the charitable contribution reduces taxable income (as does distributions to beneficiaries). Another difference is the treatment of the trustee commission. Only 50% of the commission, or $4,000, is charged against FAI. In contrast, the commission reduces taxable income to the extent it is attributable to taxable income ($8,000 – $640 = $7,360).

DEDUCTION FOR DISTRIBUTIONS

After determining the amount of income that must be taxed, this income must be allocated between the fiduciary and the beneficiaries. This is the whole purpose of Subchapter J — allocation of taxable income. The grand plan of Subchapter J is that the **income recognized by the fiduciary is taxed to the fiduciary itself or 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 fiduciary.

The rules governing calculation of the distribution deduction — IRC §§651 and 661 — presume that all distributions made by the fiduciary first represent both current taxable and nontaxable net income that can be distributed. 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 current taxable and nontaxable income that the trust can distribute is referred to as **distributable net income (DNI).** It is also 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.

116. See Example 16.

Example 34. This year, the Abby trust reported $80,000 of dividend income and $20,000 of tax-exempt interest. It distributed $40,000. How much is deductible by the trust and how much is taxable to the beneficiaries?

Amounts distributed are considered DNI. The trust receives a deduction for taxable DNI distributed and the beneficiaries are taxed on the taxable DNI they receive. The trust's DNI is the net taxable and nontaxable income that is distributable for a total DNI of $100,000 — 80% taxable and 20% nontaxable.

The $40,000 distributed is assumed to be DNI (not corpus) and 80% represents **taxable** DNI. Of the $40,000 distributed, the trust can deduct the taxable portion of $32,000 (80% × $40,000) and the balance of $8,000 (20% × $40,000) is nontaxable.

The beneficiary has $32,000 of taxable income and $8,000 of nontaxable income. Note that the trust's deduction of $32,000 (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.

DEDUCTION FOR SIMPLE AND COMPLEX TRUSTS

Technically, a trust is generally allowed a deduction for distributions to beneficiaries.[117] Distributions include both direct distributions and indirect payments on behalf of a beneficiary.[118] However, this deduction **cannot exceed DNI as reduced by net tax-exempt income.** In other words, the trust can deduct the amount of **taxable DNI** distributed. Taxable DNI serves as the upper limit on the deduction for distributions to beneficiaries. It also serves as the upper limit on the taxable income included by the beneficiaries for distributions from the trust.

Subchapter J actually has two schemes for the taxation of trusts. For simple trusts, 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, the operative Code sections are §§661 and 662. For the most part, the provisions operate in an identical fashion, allowing a deduction for taxable DNI distributed and taxing the same amount to the beneficiaries.

DISTRIBUTABLE NET INCOME (DNI)[119]

When a fiduciary makes a distribution, the critical question concerns the amount of taxable income it contains. DNI measures the amount of current taxable income distributed by the trust **and** the amount of income taxable to the beneficiaries. Recall that, conceptually, DNI represents the taxable and nontaxable income that is distributable. However, the Code takes what might be called an add-back approach. The starting point for computing DNI under §643 is taxable income. To determine the taxable and nontaxable income that is distributable, several adjustments must be made. There are two approaches to compute DNI with both approaches arriving at the same result. The first approach is to compute DNI under §643 as follows:

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

Note. 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.

117. IRC §§651 and 661.

118. A person whose legal obligations are paid by a trust distribution is considered a beneficiary of that trust distributions for tax purposes; Treas. Reg. §1.662(a)-4.

119. IRC §643(a).

3. Add back the personal exemption.

> **Note.** Taxable income of the trust includes the personal exemption deduction. This deduction has no bearing on the amount of income that is actually distributable, so it is added back.

Line 17 of Form 1041 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.

4. Add back net tax-exempt income.

> **Note.** Tax-exempt income is added to taxable income because it is not included in taxable income but 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 tax-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 are treated as paid out of tax-exempt income and are, therefore, nondeductible. These amounts still reduce the amount that is distributable, so they are subtracted in computing DNI (i.e., 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).

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 document direct that corpus (or proceeds from its sale) be distributed.

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 it.[120]

6. 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.

> **Note.** Special treatment is required for income received from sources outside the U.S. by a foreign trust.

The second approach for computing DNI found on page 2 of Form 1041, Schedule B is as follows.

	Adjusted total income (taxable income before distribution deduction and 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

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

7	**Charitable deduction.** Subtract line 6 from line 5. Enter here and on page 1, line 13	7	
Schedule B	**Income Distribution Deduction**		
1	Adjusted total income (see page 26 of the instructions)	1	
2	Adjusted tax-exempt interest	2	
3	Total net gain from Schedule D (Form 1041), line 15, column (1) (see page 26 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 26 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	
7	**Distributable net income.** Combine lines 1 through 6. If zero or less, enter -0-	7	
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law . . . 8		
9	Income required to be distributed currently	9	
10	Other amounts paid, credited, or otherwise required to be distributed	10	
11	Total distributions. Add lines 9 and 10. If greater than line 8, see page 27 of the instructions	11	
12	Enter the amount of tax-exempt income included on line 11	12	
13	Tentative income distribution deduction. Subtract line 12 from line 11	13	
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-	14	
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18	15	
Schedule G	**Tax Computation** (see page 27 of the instructions)		
	...on taxable income (see page 27 of the ins...) . . . 1a		

In computing DNI, it is generally irrelevant whether expenses (deductions) are allocated to income or corpus. As explained earlier, expenses allocable to corpus do not reduce the amount of FAI that is distributable. However, the authors of Subchapter J took a different approach in computing DNI. This approach ensures that deductions are not wasted.

Example 35. This year, the Tate Trust had $5,000 of interest income and $1,000 of trustee fees, all of which are allocable to corpus. The trust distributes all its FAI to Bernie. FAI is $5,000, so Bernie receives $5,000. How much is taxable to Bernie?

One possibility is to treat Bernie as having received $5,000 of interest income and giving the trust a deduction of $1,000 that it could not use. However, a different approach is used. This procedure works to ensure that the $1,000 deduction is not wasted.

Under §§651 and 661, the amount of taxable income that Bernie receives is limited to the taxable DNI he receives. DNI is taxable income with certain modifications.

The taxable income is $4,000 ($5,000 – $1,000 trustee fee regardless of whether it is allocable to income or corpus). DNI is equal to taxable income, $4,000, plus or minus any adjustments. There are no adjustments in this case, so DNI is $4,000. The amount that is taxable to a beneficiary is the amount received but limited to taxable DNI.

Bernie receives $5,000, but is only taxed on $4,000 because taxable DNI is $4,000. The effect is to give the beneficiary the deduction even though the expense is allocable to corpus. This procedure operates to prevent deductions from being wasted.

If this approach were not used, then the $1,000 deduction would be wasted because the trust has no income to absorb the deduction. And, the $1,000 deductible expense does not create an NOL since it is a nonbusiness expense.

This approach seems particularly counterintuitive (i.e., expenses allocated to corpus should not reduce distributable income) since capital gains that are allocable to corpus are not included in DNI. Nevertheless, this is the approach to deductions in computing DNI.

Example 36. The facts of **Examples 16 and 34** are repeated here for convenience.

On March 7, 1995, Grant Tor established a trust for his son Benny Tor. According to the terms of the trust instrument, a reserve for depreciation of $5,000 must be maintained, and both capital gains and 50% of the trustee's commissions 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 Benny. Given the following facts, what is the trust's DNI?

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] $8,000 − (($10,000 ÷ $125,000) × $8,000)
[b] $20,000 − (($10,000 ÷ $125,000) × $20,000)

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

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

Both approaches arrive at the same result as shown. DNI is computed in Schedule B of Form 1041.

Regulations Approach:

Rental income		$100,000
Dividends		15,000
Plus: net tax-exempt income		
Tax-exempt interest	$10,000	
Allocable trustee's commissions	(640)	
Allocable charitable contributions	(1,600)	
	$ 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	
	$40,760	(40,760)
DNI		$ 82,000

Note that this result — the amount of DNI — does not change regardless of whether the commission is allocated to income or corpus. This derives from the fact that the starting point for computing DNI is taxable income.

Add-Back Approach Used on Form 1041:

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

7	**Charitable deduction.** Subtract line 6 from line 5. Enter here and on page 1, line 13	7	

Schedule B Income Distribution Deduction

1	Adjusted total income (see page 26 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 26 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 26 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: 106,000		
9	Income required to be distributed currently	9	85,000
10	Other amounts paid, credited, or otherwise required to be distributed	10	0
11	Total distributions. Add lines 9 and 10. If greater than line 8, see page 27 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)

...on taxable income (see page 27 of the instructions) 1a

Under §661(a), the trust is allowed a deduction for the amount of fiduciary accounting income distributed to the beneficiary, or $85,000. However, §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 interest		
Tax-exempt interest	$10,000	
Allocable trustee's commissions	(640)	
Allocable charitable contributions	(1,600)	
	$ 7,760	(7,760)
Deduction for distributions		$74,240

The trust is treated as having distributed all 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 because it was not included in taxable income. As a result, the trust's 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 (long-term capital gain)	$ 49,900

7

Observation. Although a charity is a beneficiary of the trust in the sense that it receives distributions, it is not treated as a beneficiary for purposes of computing the deduction for distributions. The amounts distributed to the charity are accounted for as part of the charitable contribution deduction. (See pages 1 and 2 of Form 1041 on the following pages.)

For Example 36

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts **2009** OMB No. 1545-0092

A Type of entity (see instr.):
- ☐ Decedent's estate
- ☐ Simple trust
- ☑ Complex trust
- ☐ Qualified disability trust
- ☐ ESBT (S portion only)
- ☐ Grantor type trust
- ☐ Bankruptcy estate-Ch. 7
- ☐ Bankruptcy estate-Ch. 11
- ☐ Pooled income fund

For calendar year 2009 or fiscal year beginning , 2009, and ending , 20

Name of estate or trust (If a grantor type trust, see page 14 of the instructions.)
Benny Tor

Name and title of fiduciary
Charles E. Ton

Number, street, and room or suite no. (If a P.O. box, see page 15 of the instructions.)
1234 Nowhere St.

City or town, state, and ZIP code
Indianapolis

C Employer identification number
35-1234567

D Date entity created

E Nonexempt charitable and split-interest trusts, check applicable boxes (see page 16 of the instr.):
- ☐ Described in section 4947(a)(1)
- ☐ Not a private foundation
- ☐ Described in section 4947(a)(2)

B Number of Schedules K-1 attached (see instructions) ▶

F Check applicable boxes: ☐ Initial return ☐ Final return ☐ Amended return ☐ Change in trust's name ☐ Change in fiduciary ☐ Change in fiduciary's name ☐ Change in fiduciary's address

G Check here if the estate or filing trust made a section 645 election . . . . ▶☐

Income	1	Interest income	1	
	2a	Total ordinary dividends	2a	15,000
	b	Qualified dividends allocable to: **(1)** Beneficiaries ______ **(2)** Estate or trust ______		
	3	Business income or (loss). Attach Schedule C or C-EZ (Form 1040)	3	
	4	Capital gain or (loss). Attach Schedule D (Form 1041)	4	50,000
	5	Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040)	5	85,000
	6	Farm income or (loss). Attach Schedule F (Form 1040)	6	
	7	Ordinary gain or (loss). Attach Form 4797	7	
	8	Other income. List type and amount	8	
	9	**Total income.** Combine lines 1, 2a, and 3 through 8 ▶	9	150,000
Deductions	10	Interest. Check if Form 4952 is attached ▶ ☐	10	
	11	Taxes	11	
	12	Fiduciary fees	12	7,360
	13	Charitable deduction (from Schedule A, line 7)	13	18,400
	14	Attorney, accountant, and return preparer fees	14	
	15a	Other deductions **not** subject to the 2% floor (attach schedule)	15a	
	b	Allowable miscellaneous itemized deductions subject to the 2% floor	15b	
	16	Add lines 10 through 15b ▶	16	25,760
	17	Adjusted total income or (loss). Subtract line 16 from line 9 . . . 17 124,240		
	18	Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)	18	74,240
	19	Estate tax deduction including certain generation-skipping taxes (attach computation)	19	
	20	Exemption	20	100
	21	Add lines 18 through 20 ▶	21	74,340
Tax and Payments	22	Taxable income. Subtract line 21 from line 17. If a loss, see page 23 of the instructions	22	49,900
	23	**Total tax** (from Schedule G, line 7)	23	7,140
	24	**Payments: a** 2009 estimated tax payments and amount applied from 2008 return	24a	
	b	Estimated tax payments allocated to beneficiaries (from Form 1041-T)	24b	
	c	Subtract line 24b from line 24a	24c	
	d	Tax paid with Form 7004 (see page 24 of the instructions)	24d	
	e	Federal income tax withheld. If any is from Form(s) 1099, check ▶ ☐	24e	
		Other payments: **f** Form 2439 ______ ; **g** Form 4136 ______ ; Total ▶	24h	
	25	**Total payments.** Add lines 24c through 24e, and 24h ▶	25	
	26	Estimated tax penalty (see page 24 of the instructions)	26	
	27	**Tax due.** If line 25 is smaller than the total of lines 23 and 26, enter amount owed	27	7,140
	28	**Overpayment.** If line 25 is larger than the total of lines 23 and 26, enter amount overpaid	28	
	29	Amount of line 28 to be: **a Credited to 2010 estimated tax** ▶ ; **b Refunded** ▶	29	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of fiduciary or officer representing fiduciary | Date | ▶ EIN of fiduciary if a financial institution

May the IRS discuss this return with the preparer shown below (see instr.)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no.

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11370H Form **1041** (2009)

For Example 36

Form 1041 (2009) Page **2**

Schedule A **Charitable Deduction.** Do not complete for a simple trust or a pooled income fund.

1	Amounts paid or permanently set aside for charitable purposes from gross income (see page 25)	1	20,000
2	Tax-exempt income allocable to charitable contributions (see page 25 of the instructions)	2	1,600
3	Subtract line 2 from line 1	3	18,400
4	Capital gains for the tax year allocated to corpus and paid or permanently set aside for charitable purposes	4	
5	Add lines 3 and 4	5	18,400
6	Section 1202 exclusion allocable to capital gains paid or permanently set aside for charitable purposes (see page 25 of the instructions)	6	
7	**Charitable deduction.** Subtract line 6 from line 5. Enter here and on page 1, line 13	7	18,400

Schedule B **Income Distribution Deduction**

1	Adjusted total income (see page 26 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 26 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 26 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	106,000		
9	Income required to be distributed currently			9	85,000
10	Other amounts paid, credited, or otherwise required to be distributed			10	0
11	Total distributions. Add lines 9 and 10. If greater than line 8, see page 27 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)

1	**Tax: a** Tax on taxable income (see page 27 of the instructions)	1a	7,140		
	b Tax on lump-sum distributions. Attach Form 4972	1b			
	c Alternative minimum tax (from Schedule I (Form 1041), line 56)	1c	0		
	d **Total.** Add lines 1a through 1c ▶			1d	7,140
2a	Foreign tax credit. Attach Form 1116	2a			
b	Other nonbusiness credits (attach schedule)	2b			
c	General business credit. Attach Form 3800	2c			
d	Credit for prior year minimum tax. Attach Form 8801	2d			
3	**Total credits.** Add lines 2a through 2d ▶			3	
4	Subtract line 3 from line 1d. If zero or less, enter -0-			4	7,140
5	Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611			5	
6	Household employment taxes. Attach Schedule H (Form 1040)			6	
7	**Total tax.** Add lines 4 through 6. Enter here and on page 1, line 23 ▶			7	7,140

	Other Information	Yes	No
1	Did the estate or trust receive tax-exempt income? If "Yes," attach a computation of the allocation of expenses. Enter the amount of tax-exempt interest income and exempt-interest dividends ▶ $ 10,000	✓	
2	Did the estate or trust receive all or any part of the earnings (salary, wages, and other compensation) of any individual by reason of a contract assignment or similar arrangement?		✓
3	At any time during calendar year 2009, did the estate or trust have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country?		✓
	See page 30 of the instructions for exceptions and filing requirements for Form TD F 90-22.1. If "Yes," enter the name of the foreign country ▶		
4	During the tax year, did the estate or trust receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the estate or trust may have to file Form 3520. See page 30 of the instructions		✓
5	Did the estate or trust receive, or pay, any qualified residence interest on seller-provided financing? If "Yes," see page 30 for required attachment		✓
6	If this is an estate or a complex trust making the section 663(b) election, check here (see page 30) ▶ ☐		
7	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here (see page 30) ▶ ☐		
8	If the decedent's estate has been open for more than 2 years, attach an explanation for the delay in closing the estate, and check here ▶ ☐		
9	Are any present or future trust beneficiaries skip persons? See page 30 of the instructions		

Form **1041** (2009)

7

CALCULATING THE DISTRIBUTION DEDUCTION

A trust generally is entitled to deduct the amount distributed. However, §§651 and 661 limit the deduction to the taxable portion of DNI distributed. For this purpose, all distributions first consist of DNI to the extent thereof. 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 the lesser of:

- Amount distributed, or
- Taxable DNI distributed [DNI × (DNI – net tax-exempt income) ÷ Total DNI].

Example 37. This year, the Taylor 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. During the year, the trust distributed $16,000 to its only beneficiary, Bart.

The distribution deduction is ordinarily the amount distributed, $16,000. However, this amount is limited to the portion that represents taxable DNI. **The deduction is limited to the taxable DNI distributed.** DNI is $80,000 ($60,000 taxable dividends + $20,000 tax-exempt interest). The $16,000 distribution is deemed to consist of a pro-rata portion of taxable and nontaxable DNI.

The distribution consists of nontaxable DNI of $4,000 ($20,000 ÷ $80,000 × $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 of $12,000.

Bernie is taxed on the $12,000 of taxable DNI received.

Note. The amount of the distribution deduction to the trust and the amount taxable to the beneficiary is the same. This is always true because the rules simply allocate the taxable income between the trust and the beneficiary so that the income is taxed only once.

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 ÷ $80,000)	× 0.75		
Taxable DNI distributed	$12,000	$12,000	(12,000)
Trust taxable income			$48,000
DNI			
Dividends	$60,000		
Tax-exempt	20,000		
Total DNI	$80,000		
Taxable DNI			
DNI	$80,000		
Less: net tax-exempt income	(20,000)		
Taxable DNI	$60,000		

TAXATION OF BENEFICIARIES

The amount of a trust's taxable income that is included in the gross income of the beneficiary is governed by §652 for simple trusts and §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 previously, 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. 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.[121]

Notwithstanding the general approach, trustees may be permitted 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 so requires or allows such allocation, then the allocation is effective for determining the character of the income to the beneficiaries.[122] 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 has 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 might occur when the trust distributes income that was previously 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 FAI that each receives.

Example 38. A trust has dividend income of $50,000 and $10,000 of trustee commissions allocable to corpus. Fiduciary 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.

During the year, the trust made distributions of $30,000 to Adam and $20,000 to Bettie. Because the DNI of $40,000 is insufficient to cover all the distributions, it must be allocated among the beneficiaries based on the amounts of trust income received by each. As a result, Adam is deemed to receive DNI of $24,000 ($30,000 ÷ $50,000 × $40,000 DNI) and Bettie receives the remaining $16,000. Note that the amounts received in excess of DNI would represent either corpus or accumulated income. These amounts are normally nontaxable.

TIER SYSTEM FOR ALLOCATING DNI

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, therefore, the amount of taxable income and nontaxable income that is allocable to each.

The Code establishes a "tier system" to allocate DNI. DNI **(increased for charitable contributions)** is first allocated to the beneficiaries who are required to receive distributions currently — the **first-tier beneficiaries**.

DNI is then allocated based on each beneficiary's pro-rata share of first-tier distributions of FAI. After allocating DNI to first-tier beneficiaries, any DNI remaining is allocated to charitable contributions.

---

121. IRC §§661 and 662.

122. Treas. Reg. §1.652(c)-2.

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 FAI.

Example 39. A trust has FAI of $50,000 and DNI of $60,000. During the year, the trust makes required distributions of $30,000 to beneficiary A and $10,000 to beneficiary B. Also, the trustee distributed an additional $ 30,000 to A and $30,000 to B. Who gets the DNI? DNI is allocated as follows:

		A	B	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	(40,000)	$30,000	$10,000	
DNI available for charity	$20,000			
Charitable distributions	0			
DNI for second tier	$20,000	10,000	10,000	
DNI received		$40,000	$20,000	

Charitable Contributions. The treatment of a contribution/distribution to a charitable organization is confusing. On the one hand, a contribution is treated as an expense (i.e., it is reported on line 13 of Form 1041). On the other hand, the charity itself is sometimes treated like a beneficiary in that it absorbs taxable and nontaxable DNI just like any beneficiary**. It should be emphasized that the charity is not considered a beneficiary when computing the deduction for distributions to beneficiaries.** Normally a special rule involving a modified DNI, which does not allow a charitable deduction, is a limitation for first-tier beneficiaries.[123] The limitation does not apply to second-tier beneficiaries.[124]

Note. Recall that a trustee can make distributions to charities only if such power is granted in the trust instrument.

CHARACTER OF INCOME

Distributions from the trust carry out the various classes of income (such as dividends, tax-exempt interest, and rents) received by the trust. The amounts flow through to the beneficiaries and have the same character in their hands as they did in 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 ($100,000 gross income – $10,000 trustee fees), 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 a great deal of flexibility for allocating the expenses.[125]

123. IRC §661(a)(1).

124. IRC §661(a)(2).

125. Treas. Reg. §1.652(b)-3(a).

The type and amount of income that a beneficiary receives is determined as follows:

1. **Gross Income.** 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 (e.g., 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 against whatever other class of income the trustee selects.

Note. 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 Schedule K-1 of Form 1041 explain the position of the IRS regarding excess deductions relating to passive losses. Here the IRS explains 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 to 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 tax-exempt income. As noted above, the manner in which indirect expenses are to be allocated to tax-exempt income is filled with uncertainty.[126]

4. **Charitable Contributions.** Charitable contributions normally are treated as coming from a proportionate share of each type of income.[127]

To summarize, expenses that are directly related to a particular type of income reduce such income. With respect to 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.

7

126. See Treas. Reg. §1.652(b)-3(b).

127. Treas. Reg. §1.661(b)-2.

Example 40. The facts from **Examples 16, 34, and 37** are repeated here for convenience.

On March 7, 1995, Grant Tor established a trust for his son Benny Tor. According to the terms of 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 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 and tax depreciation	5,000
Trustee commission	8,000

This year, the trust made a charitable contribution of $20,000. The trustee also distributed $85,000 to Benny. Trust DNI and the character of the distributions to the beneficiaries are computed below.

Rental income		$100,000
Dividends		15,000
Plus: net tax-exempt income		
Tax-exempt income	$10,000	
Allocable trustee's commissions	(640)	
Allocable charitable contributions	(1,600)	
	$ 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)	
	$40,760	(40,760)
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. 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	LTCG	Total
Income	$100,000	$15,000	$0	$10,000	$0	$125,000
Expenses						
Rental expense	(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 $100,000 ÷ Total income $125,000) × $20,000 = $16,000
[b] (Dividends $15,000 ÷ Total income $125,000) × $20,000 = $2,400
[c] (Tax-exempt interest $10,000 ÷ Total income $125,000) × $20,000 = $1,600

Determining Trust or Estate Qualified Dividends for Computing Tax

Qualified dividends are taxed at a maximum rate of 15% (0% if in the 15% tax bracket for 2008–2010) 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.

Example 41. In 2010, 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
DNI distributed to beneficiary ($10,000 ÷ Total DNI $50,000)	× 0.20	
Allocation to beneficiary	$ 6,000	(6,000)
Allocation to trust		$24,000

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 beneficiaries must report is computed in the manner shown in **Example 41.**

YEAR OF REPORTING BY BENEFICIARIES

Beneficiaries receive a summary of the tax consequences of distributions they received through 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 fiduciary's year ends.[128] In situations where 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. Required distributions are deemed to be made on the last day of the trust's taxable year. This rule normally applies to simple trusts.

Example 42. The Game Trust requires that all FAI is distributed to its beneficiary, Fritz, annually. After the close of the trust's year, December 31, 2010, the trustee collects all the information needed to determine the amount of the distribution and pays Fritz this amount on February 2, 2011. Because the trust is required to distribute the income (or principal), it is deemed to have been paid on December 31. Consequently, the trust deducts the distribution in 2010 and Fritz reports the taxable income in 2010.

DISCRETIONARY DISTRIBUTION: 65-DAY RULE

In contrast to required distributions, discretionary distributions are considered distributed when the trustee makes the payment. Therefore, in **Example 43,** if the distribution was discretionary, the trust deducts the payment and the beneficiary reports it in 2011, the actual year of payment. However, under §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.

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

Although the Code imposes no restriction on the use of these so-called throwback distributions, the amounts are limited.[129] The limitation prohibits a trust from making distributions after yearend that would 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 43. Darla receives distributions from a trust at the discretion of the trustee, Leonard. At the close of 2010, Leonard had not yet determined the trust's final income for the year. Shortly after the beginning of 2011, Leonard made the calculations and determined that for 2010 the trust had income of $10,000 and DNI of $8,000. A review of distributions paid during 2010 revealed that $5,500 was distributed on January 14, 2010, which Leonard elected to treat as distributed in 2009, and $6,000 was distributed on August 12, 2010. The maximum amount of 2011 distributions that Leonard may treat as having been distributed in 2010 is $4,000 ($10,000 income – $6,000 distribution).

Throwback year 2010: larger of trust income ($10,000) or DNI ($8,000)	$10,000
Amounts paid in throwback year 2010 (except that which was thrown back to 2009)	(6,000)
Maximum amount that can be thrown back from 2011 to 2010 and deducted in 2010	$ 4,000

As a result, the trust may distribute an additional $4,000 within the first 65 days of 2011 and deduct that amount for 2010. If the trust distributes $4,000 during 2011 and makes the election, the beneficiary must appropriately account for the $4,000 in her 2010 return. The distribution treated as having been paid in 2009 is ignored in determining the maximum amount qualifying for §663(b).

The delayed distribution rule does not apply to simple trusts since all income of simple trusts is deemed to be 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. It need not be made for all distributions made during the 65-day period but for whatever 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 in which a beneficiary dies. In the year a beneficiary dies, any distributions received prior to death are 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, which is in fact distributed to the beneficiary's estate, is income in respect of a decedent.

Example 44. Stephanie, a cash-basis taxpayer, is a beneficiary of a simple trust. Both Stephanie and the trust report using the calendar year. Stephanie dies on July 1, 2009 having received $1,000 from the trust in March 2009. The trust agreement specifies that Stephanie's estate is to receive all accrued unpaid income earned by the trust prior to her death. Trust income and DNI through July 1, 2009, is $9,000.

The trust distributed the remaining $8,000 on December 31, 2010, to Stephanie's estate. Stephanie's final return includes the $1,000 distribution received prior to death. The balance of the income required to be distributed, $8,000, is IRD and is reported on Stephanie's estate income tax return.

129. Treas. Reg. §1.663(b)-1(a).

COMPREHENSIVE TRUST TAX RETURN

This year Samson and Delilah Strong established an irrevocable trust for their son, Simon. The couple transferred several properties to the trust including stocks, bonds, and a rental property. The trust instrument provides that the trustee will distribute income to Simon at the trustee's discretion. An inspection of the trust's records for the year revealed the following information.

Interest from Bank Two certificates of deposit	$20,000
Interest from New York city bonds (tax-exempt)	10,000
Nonqualified dividends	5,000
Rental income	15,000
Long-term capital gain on sale of stock	8,000
Rental expenses	6,000
Trustee commissions allocated between income and corpus	2,000

The terms of the trust instrument provide that the trustee commissions are split equally between income and corpus. The document also allocates all gains and losses on sales of property to corpus. In addition, the trustee is required to set aside $3,000 annually for depreciation. Tax depreciation for the year is $5,000. This year the trust distributed 70% of the income to Simon. The taxable income of the trust and the beneficiary is determined below.

1. **Fiduciary accounting income** is $40,000, computed as follows:

Dividends	$ 5,000
Interest from Bank Two certificates of deposit	20,000
Interest from municipal bonds (tax-exempt)	10,000
Rental income	15,000
Rental expenses	(6,000)
Depreciation	(3,000)
Trustee commissions (50% × $2,000)	(1,000)
Fiduciary accounting income	$40,000

Note.

- The interest income from the municipal bonds, although tax exempt, is included.
- The long-term capital gain is not included since all gains from the sales of trust property are allocated to corpus.
- The trustee commission must be split between income and corpus, resulting in only half of the commissions reducing income.
- Depreciation for trust accounting purposes must be distinguished from depreciation for tax purposes. Tax depreciation and trust accounting depreciation are two separate concepts. The amount set aside for depreciation reduces trust income and actually reduces the amount of cash that the beneficiary receives.

2. **Taxable income** before the distribution deduction is $36,700, determined as follows:

Dividends	$ 5,000
Interest from Bank Two certificates of deposit	20,000
Rental income	15,000
Long-term capital gain on sale of stock	8,000
Rental expenses	(6,000)
Trustee commissions ($2,000 − ($10,000 tax-exempt income ÷ $50,000 total trust income × $2,000))	(1,600)
Depreciation reserve	(3,000)
Depreciation excess (30% of income retained by trust × $2,000)	(600)
Taxable income before distribution deduction and exemption (adjusted total income)	$36,800
Exemption	(100)
Taxable income before the distribution deduction	$36,700

3. DNI can be computed two ways:

a. Using the **regulations approach,** which simply identifies the taxable and nontaxable net income that is distributed; or

b. Using the **add-back approach** of §643(a) (i.e., starting with taxable income before the distribution deduction and exemption as is done on Schedule B of the 1041).

Both approaches produce DNI of $38,400.

Regulations Approach:

Dividends	$ 5,000
Interest from Bank Two certificates of deposit	20,000
Interest from municipal bonds (tax-exempt)	10,000
Rental income	15,000
Rental expenses	(6,000)
Depreciation reserve	(3,000)
Depreciation excess	(600)
Trustee commissions	(2,000)
DNI	$38,400

Add-Back Approach (§643(a)):

Taxable income before the distribution deduction		$36,700
Exemption		100
Long-term capital gain		(8,000)
Net tax-exempt income		
Tax-exempt income	$10,000	
Related expenses (20% × $2,000)	(400)	
Total net tax-exempt income	$ 9,600	9,600
DNI		$38,400

4. Taxable income after distribution is determined as follows.

DNI	$38,400	
Net tax-exempt income	(9,600)	
Total taxable DNI	$28,800	
Taxable income before the distribution and exemption		$36,800
Distribution deduction		
Lesser of:		
Amount distributed (70% × $40,000)	$28,000	
Or		
Taxable DNI distributed [($28,800 ÷ $38,400) × $28,000]	21,000	(21,000)
Exemption		(100)
Taxable income		$15,700

Character of Income to Beneficiary: Schedule K-1.

Using the facts of the comprehensive example and assuming that the trustee elects to allocate expenses pro rata among all the income items, the character of the income to the beneficiary is determined as follows.

Elements of DNI	Dividends	Interest	Tax-Exempt Interest	Rents	Total
Income	$5,000	$20,000	$10,000	$15,000	$50,000
Expenses					
Rental expenses				(6,000)	(6,000)
Depreciation				(3,600)	(3,600)
Trustee fees	(200)	(800)	(400)	(600)	(2,000)
Total DNI	$4,800	$19,200	$ 9,600	$ 4,800	$38,400
Beneficiary's share [a]	× 72.92%	× 72.92%	× 72.92%	× 72.92%	× 72.92%
Beneficiary's income	$3,500	$14,000	$7,000	$3,500	$28,000

[a] DNI received $28,000 ÷ Total DNI $38,400 = 72.92%

In addition, the beneficiary is entitled to deduct his share of the depreciation of $1,400 on line 9a on Form 1041, Schedule K-1.

For Comprehensive Example

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts **2009** OMB No. 1545-0092

A Type of entity (see instr.):
- [ ] Decedent's estate
- [ ] Simple trust
- [x] Complex trust
- [ ] Qualified disability trust
- [ ] ESBT (S portion only)
- [ ] Grantor type trust
- [ ] Bankruptcy estate-Ch. 7
- [ ] Bankruptcy estate-Ch. 11
- [ ] Pooled income fund

For calendar year 2009 or fiscal year beginning , 2009, and ending , 20

Name of estate or trust (If a grantor type trust, see page 14 of the instructions.)
Simon Strong Trust

C Employer identification number
35-1234567

Name and title of fiduciary
Samson Strong

D Date entity created
01/01/00

Number, street, and room or suite no. (If a P.O. box, see page 15 of the instructions.)
1234 Wherever Ave.

City or town, state, and ZIP code
Indianapolis IN 46202

E Nonexempt charitable and split-interest trusts, check applicable boxes (see page 16 of the instr.):
- [ ] Described in section 4947(a)(1)
- [ ] Not a private foundation
- [ ] Described in section 4947(a)(2)

B Number of Schedules K-1 attached (see instructions) ▶ **1**

F Check applicable boxes: [ ] Initial return [ ] Final return [ ] Amended return [ ] Change in trust's name [ ] Change in fiduciary [ ] Change in fiduciary's name [ ] Change in fiduciary's address

G Check here if the estate or filing trust made a section 645 election . . . . ▶ [ ]

Income	1	Interest income	1	20,000
	2a	Total ordinary dividends	2a	5,000
	b	Qualified dividends allocable to: **(1)** Beneficiaries ____ **(2)** Estate or trust ____		
	3	Business income or (loss). Attach Schedule C or C-EZ (Form 1040)	3	
	4	Capital gain or (loss). Attach Schedule D (Form 1041)	4	8,000
	5	Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040)	5	5,400
	6	Farm income or (loss). Attach Schedule F (Form 1040)	6	
	7	Ordinary gain or (loss). Attach Form 4797	7	
	8	Other income. List type and amount	8	
	9	**Total income.** Combine lines 1, 2a, and 3 through 8 ▶	9	38,400
Deductions	10	Interest. Check if Form 4952 is attached ▶ [ ]	10	
	11	Taxes	11	
	12	Fiduciary fees	12	1,600
	13	Charitable deduction (from Schedule A, line 7)	13	
	14	Attorney, accountant, and return preparer fees	14	
	15a	Other deductions **not** subject to the 2% floor (attach schedule)	15a	
	b	Allowable miscellaneous itemized deductions subject to the 2% floor	15b	
	16	Add lines 10 through 15b ▶	16	1,600
	17	Adjusted total income or (loss). Subtract line 16 from line 9 — 17: 36,800		
	18	Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)	18	21,000
	19	Estate tax deduction including certain generation-skipping taxes (attach computation)	19	
	20	Exemption	20	100
	21	Add lines 18 through 20 ▶	21	21,100
Tax and Payments	22	Taxable income. Subtract line 21 from line 17. If a loss, see page 23 of the instructions	22	15,700
	23	**Total tax** (from Schedule G, line 7)	23	2,966
	24	**Payments: a** 2009 estimated tax payments and amount applied from 2008 return	24a	
	b	Estimated tax payments allocated to beneficiaries (from Form 1041-T)	24b	
	c	Subtract line 24b from line 24a	24c	
	d	Tax paid with Form 7004 (see page 24 of the instructions)	24d	
	e	Federal income tax withheld. If any is from Form(s) 1099, check ▶ [ ]	24e	
		Other payments: **f** Form 2439 ____ ; **g** Form 4136 ____ ; Total ▶	24h	
	25	**Total payments.** Add lines 24c through 24e, and 24h ▶	25	
	26	Estimated tax penalty (see page 24 of the instructions)	26	
	27	**Tax due.** If line 25 is smaller than the total of lines 23 and 26, enter amount owed	27	2,966
	28	**Overpayment.** If line 25 is larger than the total of lines 23 and 26, enter amount overpaid	28	
	29	Amount of line 28 to be: **a Credited to 2010 estimated tax** ▶ ; **b Refunded** ▶	29	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of fiduciary or officer representing fiduciary | Date | ▶ EIN of fiduciary if a financial institution

May the IRS discuss this return with the preparer shown below (see instr.)? [ ] **Yes** [ ] **No**

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed [ ] | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no.

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11370H Form **1041** (2009)

For Comprehensive Example

Form 1041 (2009) Simon Strong Trust 35-1234567 Page 2

Schedule A — Charitable Deduction. Do not complete for a simple trust or a pooled income fund.

1	Amounts paid or permanently set aside for charitable purposes from gross income (see page 25)	1	
2	Tax-exempt income allocable to charitable contributions (see page 25 of the instructions)	2	
3	Subtract line 2 from line 1	3	
4	Capital gains for the tax year allocated to corpus and paid or permanently set aside for charitable purposes	4	
5	Add lines 3 and 4	5	
6	Section 1202 exclusion allocable to capital gains paid or permanently set aside for charitable purposes (see page 25 of the instructions)	6	
7	**Charitable deduction.** Subtract line 6 from line 5. Enter here and on page 1, line 13	7	

Schedule B — Income Distribution Deduction

1	Adjusted total income (see page 26 of the instructions)	1	36,800
2	Adjusted tax-exempt interest	2	9,600
3	Total net gain from Schedule D (Form 1041), line 15, column (1) (see page 26 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 26 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	-8,000
7	**Distributable net income.** Combine lines 1 through 6. If zero or less, enter -0-	7	38,400
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law — 8: 40,000		
9	Income required to be distributed currently	9	28,000
10	Other amounts paid, credited, or otherwise required to be distributed	10	0
11	Total distributions. Add lines 9 and 10. If greater than line 8, see page 27 of the instructions	11	28,000
12	Enter the amount of tax-exempt income included on line 11	12	7,000
13	Tentative income distribution deduction. Subtract line 12 from line 11	13	21,000
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-	14	28,800
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18	15	21,000

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

1	**Tax:** a Tax on taxable income (see page 27 of the instructions)	1a	2,966		
	b Tax on lump-sum distributions. Attach Form 4972	1b			
	c Alternative minimum tax (from Schedule I (Form 1041), line 56)	1c	0		
	d **Total.** Add lines 1a through 1c ▶			1d	2,966
2a	Foreign tax credit. Attach Form 1116	2a			
b	Other nonbusiness credits (attach schedule)	2b			
c	General business credit. Attach Form 3800	2c			
d	Credit for prior year minimum tax. Attach Form 8801	2d			
3	**Total credits.** Add lines 2a through 2d ▶			3	
4	Subtract line 3 from line 1d. If zero or less, enter -0-			4	2,966
5	Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611			5	
6	Household employment taxes. Attach Schedule H (Form 1040)			6	
7	**Total tax.** Add lines 4 through 6. Enter here and on page 1, line 23 ▶			7	2,966

Other Information

		Yes	No
1	Did the estate or trust receive tax-exempt income? If "Yes," attach a computation of the allocation of expenses. Enter the amount of tax-exempt interest income and exempt-interest dividends ▶ $ 10,000	✓	
2	Did the estate or trust receive all or any part of the earnings (salary, wages, and other compensation) of any individual by reason of a contract assignment or similar arrangement?		✓
3	At any time during calendar year 2009, did the estate or trust have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country?		✓
	See page 30 of the instructions for exceptions and filing requirements for Form TD F 90-22.1. If "Yes," enter the name of the foreign country ▶		
4	During the tax year, did the estate or trust receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the estate or trust may have to file Form 3520. See page 30 of the instructions		✓
5	Did the estate or trust receive, or pay, any qualified residence interest on seller-provided financing? If "Yes," see page 30 for required attachment		✓
6	If this is an estate or a complex trust making the section 663(b) election, check here (see page 30) ▶ ☐		
7	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here (see page 30) ▶ ☐		
8	If the decedent's estate has been open for more than 2 years, attach an explanation for the delay in closing the estate, and check here ▶ ☐		
9	Are any present or future trust beneficiaries skip persons? See page 30 of the instructions		✓

Form 1041 (2009)

7

For Comprehensive Example

661109

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0092

Schedule K-1 (Form 1041) **2009**
Department of the Treasury
Internal Revenue Service

For calendar year 2009, or tax year beginning, ________, 2009, and ending ________, 20 ____

Beneficiary's Share of Income, Deductions, Credits, etc.

► See back of form and instructions.

Part I Information About the Estate or Trust

A Estate's or trust's employer identification number
35-1234567

B Estate's or trust's name
Simon Strong Trust

C Fiduciary's name, address, city, state, and ZIP code
Samson Strong
1234 Wherever Ave.
Indianapolis, IN 46202

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

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

Part II Information About the Beneficiary

F Beneficiary's identifying number
444-44-4444

G Beneficiary's name, address, city, state, and ZIP code
Simon Strong
1234 Wherever Ave.
Indianapolis, IN 46202

H ☑ Domestic beneficiary ☐ Foreign beneficiary

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

1	Interest income		14,000
2a	Ordinary dividends		3,500
2b	Qualified dividends		
3	Net short-term capital gain		
4a	Net long-term capital gain		
4b	28% rate gain		
4c	Unrecaptured section 1250 gain		
5	Other portfolio and nonbusiness income		
6	Ordinary business income		
7	Net rental real estate income		3,500
8	Other rental income		
9	Directly apportioned deductions	A*	1,400
10	Estate tax deduction		
11	Final year deductions		
12	Alternative minimum tax adjustment	A	199
		G*	437
13	Credits and credit recapture		
14	Other information	A	7,000
		E	17,500

*See attached statement for additional information.

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

For IRS Use Only

For Paperwork Reduction Act Notice, see the Instructions for Form 1041. Cat. No. 11380D **Schedule K-1 (Form 1041) 2009**

For Comprehensive Example

Schedule K-1 (Form 1041) 2009 Page **2**

This list identifies the codes used on Schedule K-1 for beneficiaries and provides summarized reporting information for beneficiaries who file Form 1040. For detailed reporting and filing information, see the Instructions for Beneficiary Filing Form 1040 and the instructions for your income tax return.

	Report on
1. Interest income	Form 1040, line 8a
2a. Ordinary dividends	Form 1040, line 9a
2b. Qualified dividends	Form 1040, line 9b
3. Net short-term capital gain	Schedule D, line 5
4a. Net long-term capital gain	Schedule D, line 12
4b. 28% rate gain	Line 4 of the worksheet for Schedule D, line 18
4c. Unrecaptured section 1250 gain	Line 11 of the worksheet for Schedule D, line 19
5. Other portfolio and nonbusiness income	Schedule E, line 33, column (f)
6. Ordinary business income	Schedule E, line 33, column (d) or (f)
7. Net rental real estate income	Schedule E, line 33, column (d) or (f)
8. Other rental income	Schedule E, line 33, column (d) or (f)
9. Directly apportioned deductions	
Code	
A Depreciation	Form 8582 or Schedule E, line 33, column (c) or (e)
B Depletion	Form 8582 or Schedule E, line 33, column (c) or (e)
C Amortization	Form 8582 or Schedule E, line 33, column (c) or (e)
10. Estate tax deduction	Schedule A, line 28
11. Final year deductions	
A Excess deductions	Schedule A, line 23
B Short-term capital loss carryover	Schedule D, line 5
C Long-term capital loss carryover	Schedule D, line 12; line 5 of the wksht. for Sch. D, line 18; and line 16 of the wksht. for Sch. D, line 19
D Net operating loss carryover — regular tax	Form 1040, line 21
E Net operating loss carryover — minimum tax	Form 6251, line 12

12. Alternative minimum tax (AMT) items	
Code	*Report on*
A Adjustment for minimum tax purposes	Form 6251, line 16
B AMT adjustment attributable to qualified dividends	See the beneficiary's instructions and the Instructions for Form 6251
C AMT adjustment attributable to net short-term capital gain	
D AMT adjustment attributable to net long-term capital gain	
E AMT adjustment attributable to unrecaptured section 1250 gain	
F AMT adjustment attributable to 28% rate gain	
G Accelerated depreciation	
H Depletion	
I Amortization	
J Exclusion items	2010 Form 8801
13. Credits and credit recapture	
A Credit for estimated taxes	Form 1040, line 62
B Credit for backup withholding	Form 1040, line 61
C Low-income housing credit	Form 8586 (also see the beneficiary's instructions)
D Rehabilitation credit and energy credit	See the beneficiary's instructions
E Other qualifying investment credit	See the beneficiary's instructions
F Work opportunity credit	Form 5884, line 3
G Welfare-to-work credit	Form 3800, line 1b
H Alcohol and cellulosic biofuel fuels credit	Form 6478, line 7 (also see the beneficiary's instructions)
I Credit for increasing research activities	Form 3800, line 1c
J Renewable electricity, refined coal, and Indian coal production credit	See the beneficiary's instructions
K Empowerment zone and renewal community employment credit	Form 8844, line 3
L Indian employment credit	Form 3800, line 1g
M Orphan drug credit	Form 3800, line 1h
N Credit for employer-provided child care and facilities	Form 3800, line 1k
O Biodiesel and renewable diesel fuels credit	Form 8864, line 9 (also see the beneficiary's instructions)
P Nonconventional source fuel credit	Form 3800, line 1o
Q Credit to holders of tax credit bonds	Form 8912, line 8
R Agricultural chemicals security credit	Form 3800, line 1v
S Energy efficient appliance credit	Form 3800, line 1q
T Credit for employer differential wage payments	Form 3800, line 1w
U Recapture of credits	See the beneficiary's instructions
14. Other information	
A Tax-exempt interest	Form 1040, line 8b
B Foreign taxes	Form 1040, line 47 or Sch. A, line 8
C Qualified production activities income	Form 8903, line 7
D Form W-2 wages	Form 8903, line 15
E Net investment income	Form 4952, line 4a
F Gross farm and fishing income	Schedule E, line 42
G Foreign trading gross receipts (IRC 942(a))	See the Instructions for Form 8873
H Other information	See the beneficiary's instructions

Note. If you are a beneficiary who does not file a Form 1040, see instructions for the type of income tax return you are filing.

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