Chapter 3: Trust Accounting and Taxation

Please note. Corrections were made to this workbook through January of 2016. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as shortURLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

TRUST BASICS

Trusts are separate legal entities. A **trust** arises from a contractual arrangement under which an individual, usually known as the **grantor,** transfers legal ownership of property to another party. That party, the **trustee,** has the duty of holding and administering 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 the **trust principal** or **corpus,** although some legal documents use the Latin word **res.** The terms of the **trust instrument** set forth the duties of the trustee and the rights of the beneficiary with respect to trust assets and any income generated.

Individuals may transfer assets to trusts to protect and conserve those assets for the beneficiaries, who can include anyone. Some people create trusts to protect the financial interests of minor children and other family members who are incapable of competently managing the assets. Trusts are also used to protect assets for a variety of reasons.

TRUST INSTRUMENT

The **trust instrument** is the written document that sets forth the authority, duties, and rights of the parties involved. The instrument may also be known as an **agreement, indenture, declaration,** or **deed.**[1] The instrument generally states the following.[2]

1. Parties who will serve as the trustee and the beneficiaries
2. The purpose of the trust and the conditions that will terminate the trust
3. The assets placed in the trust
4. The powers and limitations of the trustee, as well as reporting requirements and other provisions
5. The trustee's compensation, if any

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1. *Questions and Answers About Trusts.* May 2014. U.S. Department of the Treasury, Bureau of the Fiscal Service. [www.treasurydirect.gov/forms/savpdp0049.pdf] Accessed on Feb. 11, 2015.
2. *BusinessDictionary.com.* 2015. Web Finance, Inc. [www.businessdictionary.com/definition/trust-agreement.html] Accessed on Jan. 15, 2015.

A trust is created under the laws of the state in which it 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 instrument — the trustee and the beneficiaries — as well as the construction and effect of the instrument and its enforcement.

The importance of the trust instrument cannot be overstated. State law gives grantors great latitude in creating trusts and with it the ability to control the rights to the property — both income and corpus. However, if the trust instrument says nothing about a particular issue, then state law controls the matter. 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.

Income and Remainder Beneficiaries

Trust instruments are generally drafted to distinguish between income beneficiaries and remainder beneficiaries. **Income beneficiaries** receive the income produced by the trust assets. **Remainder beneficiaries** (also known as **remaindermen**) receive the assets upon expiration of the income beneficiaries' interests.

This approach reflects the well-known "fruit and tree analogy," in which the tree represents the assets and the fruit represents the income produced. The fruit goes to the income beneficiaries, and the remaindermen ultimately get the tree. To illustrate these principles, consider the following clauses often found in trust instruments.

A clause about mandatory distributions of income may be expressed as follows.

> *The Trustee shall invest and reinvest the trust corpus, shall collect and receive the income therefrom and, after paying all expenses and costs 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.*

A clause about discretionary distributions of income may be set forth as follows.

> *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 (FAI), whereas the other group of beneficiaries is entitled to the remainder of the corpus. (FAI is explained later in this chapter.)

FEDERAL EMPLOYER IDENTIFICATION NUMBER

One of the first questions a practitioner should ask a client who has a trust is whether the trust has applied for or received a federal employer identification number (FEIN). If the trust does not have an FEIN, the client and their tax professional should determine if one is necessary. All trusts except certain grantor-owned revocable trusts require an FEIN. If needed, one can be obtained using any of the following methods.[3]

- Apply online at **uofi.tax/15b3x1** [https://sa.www4.irs.gov/modiein/individual/index.jsp]. The online application is free and provides an immediate FEIN for the taxpayer.
- Complete a Form SS-4, *Application for Employer Identification Number,* and mail it to one of the following addresses. The IRS processes a paper copy of Form SS-4 and issues an FEIN within four weeks.
  - If the taxpayer's principal business, office, or agency is located in one of the 50 states or the District of Columbia, the Form SS-4 should be mailed to:

    Internal Revenue Service
    Attn: EIN Operation
    Cincinnati, OH 45999

  - If the taxpayer has no principal place of business or principal office or agency in any state, the form should be mailed to:

    Internal Revenue Service
    Attn: EIN International Operation
    Cincinnati, OH 45999

- Fax the completed Form SS-4 to one of the following numbers. If the taxpayer's fax number is provided, a fax with the FEIN will be sent back within four business days.
  - If the taxpayer's principal business, office, or agency is located in one of the 50 states or the District of Columbia, the fax should be sent to 859-669-5760.
  - If the taxpayer has no principal place of business or principal office or agency in any state, the fax should be sent to 859-669-5987.

A taxpayer is limited to one FEIN application per responsible person per day.[4] For a trust, the **responsible person** is the grantor, owner, or trustor.[5] This limitation is applicable to all requests for FEINs, whether made online or by fax or mail.

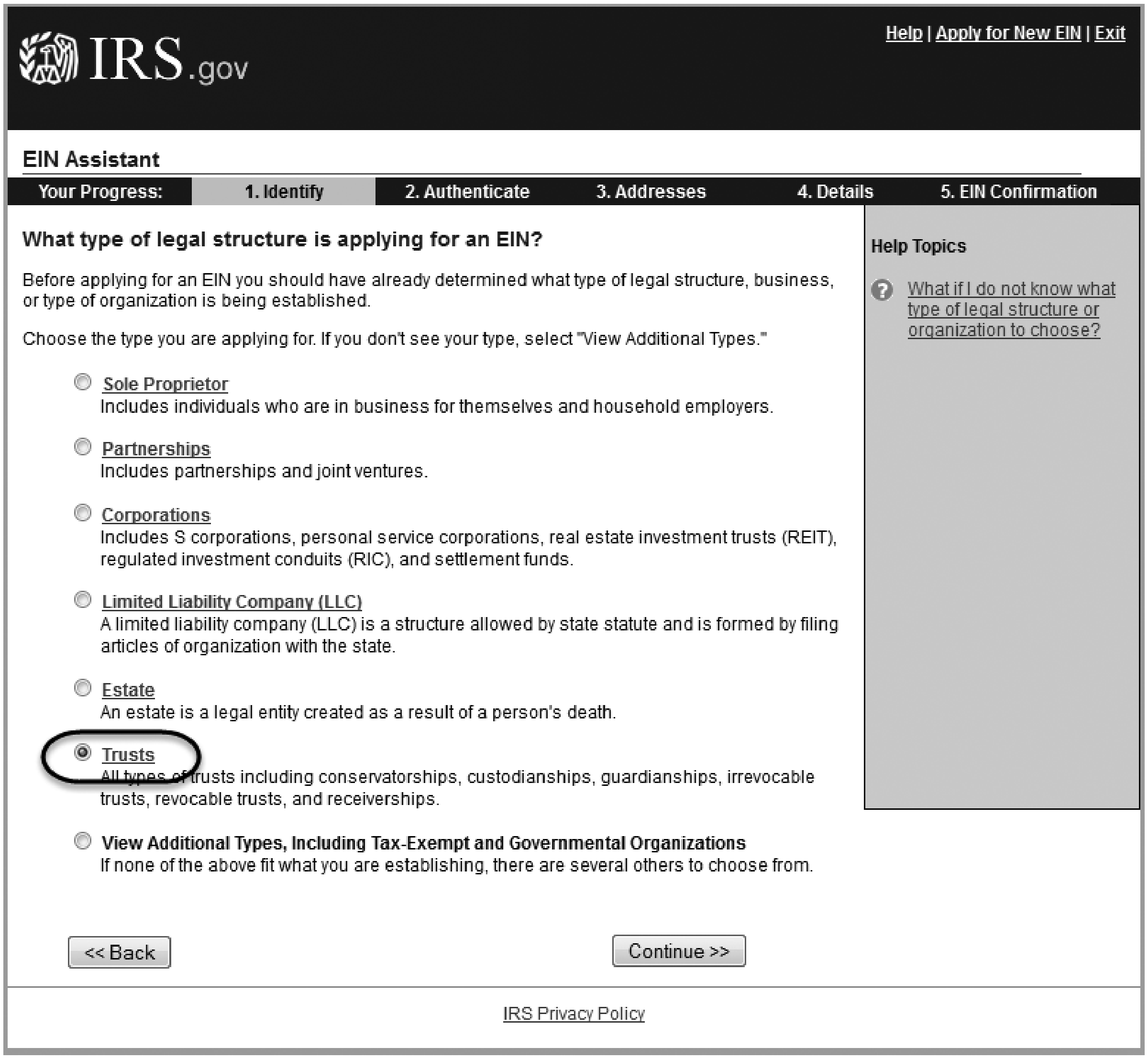
3. *How to Apply for an EIN.* Jan. 13, 2015. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/How-to-Apply-for-an-EIN] Accessed on Feb. 19, 2015.

4. Ibid.

5. *Responsible Parties and Nominees.* Oct. 14, 2014. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Responsible-Parties-and-Nominees] Accessed on Feb. 19, 2015.

Example 1. Charles is a grantor of an irrevocable trust (defined later) created in January 2015. He applies for an FEIN online.

The first step is to select the type of entity.



IRS.gov

Help | Apply for New EIN | Exit

EIN Assistant

Your Progress: 1. Identify 2. Authenticate 3. Addresses 4. Details 5. EIN Confirmation

What type of legal structure is applying for an EIN?

Before applying for an EIN you should have already determined what type of legal structure, business, or type of organization is being established.

Choose the type you are applying for. If you don't see your type, select "View Additional Types."

Sole Proprietor
Includes individuals who are in business for themselves and household employers.

Partnerships
Includes partnerships and joint ventures.

Corporations
Includes S corporations, personal service corporations, real estate investment trusts (REIT), regulated investment conduits (RIC), and settlement funds.

Limited Liability Company (LLC)
A limited liability company (LLC) is a structure allowed by state statute and is formed by filing articles of organization with the state.

Estate
An estate is a legal entity created as a result of a person's death.

Trusts
All types of trusts including conservatorships, custodianships, guardianships, irrevocable trusts, revocable trusts, and receiverships.

View Additional Types, Including Tax-Exempt and Governmental Organizations
If none of the above fit what you are establishing, there are several others to choose from.

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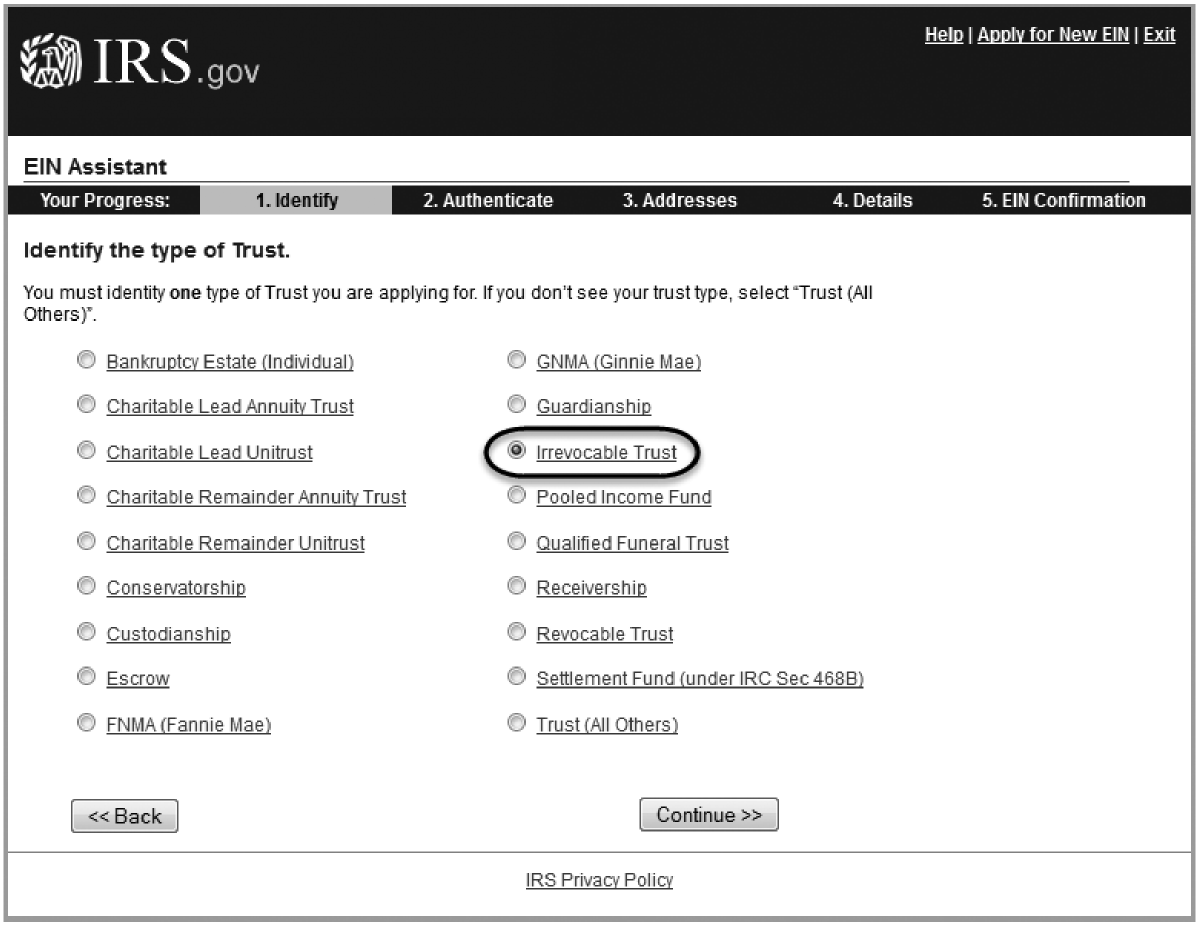
Help Topics

What if I do not know what type of legal structure or organization to choose?

IRS Privacy Policy

The next step is to select the type of trust.



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Help | Apply for New EIN | Exit

EIN Assistant

Your Progress: 1. Identify 2. Authenticate 3. Addresses 4. Details 5. EIN Confirmation

Identify the type of Trust.

You must identity **one** type of Trust you are applying for. If you don't see your trust type, select "Trust (All Others)".

- Bankruptcy Estate (Individual)
- Charitable Lead Annuity Trust
- Charitable Lead Unitrust
- Charitable Remainder Annuity Trust
- Charitable Remainder Unitrust
- Conservatorship
- Custodianship
- Escrow
- FNMA (Fannie Mae)
- GNMA (Ginnie Mae)
- Guardianship
- Irrevocable Trust
- Pooled Income Fund
- Qualified Funeral Trust
- Receivership
- Revocable Trust
- Settlement Fund (under IRC Sec 468B)
- Trust (All Others)

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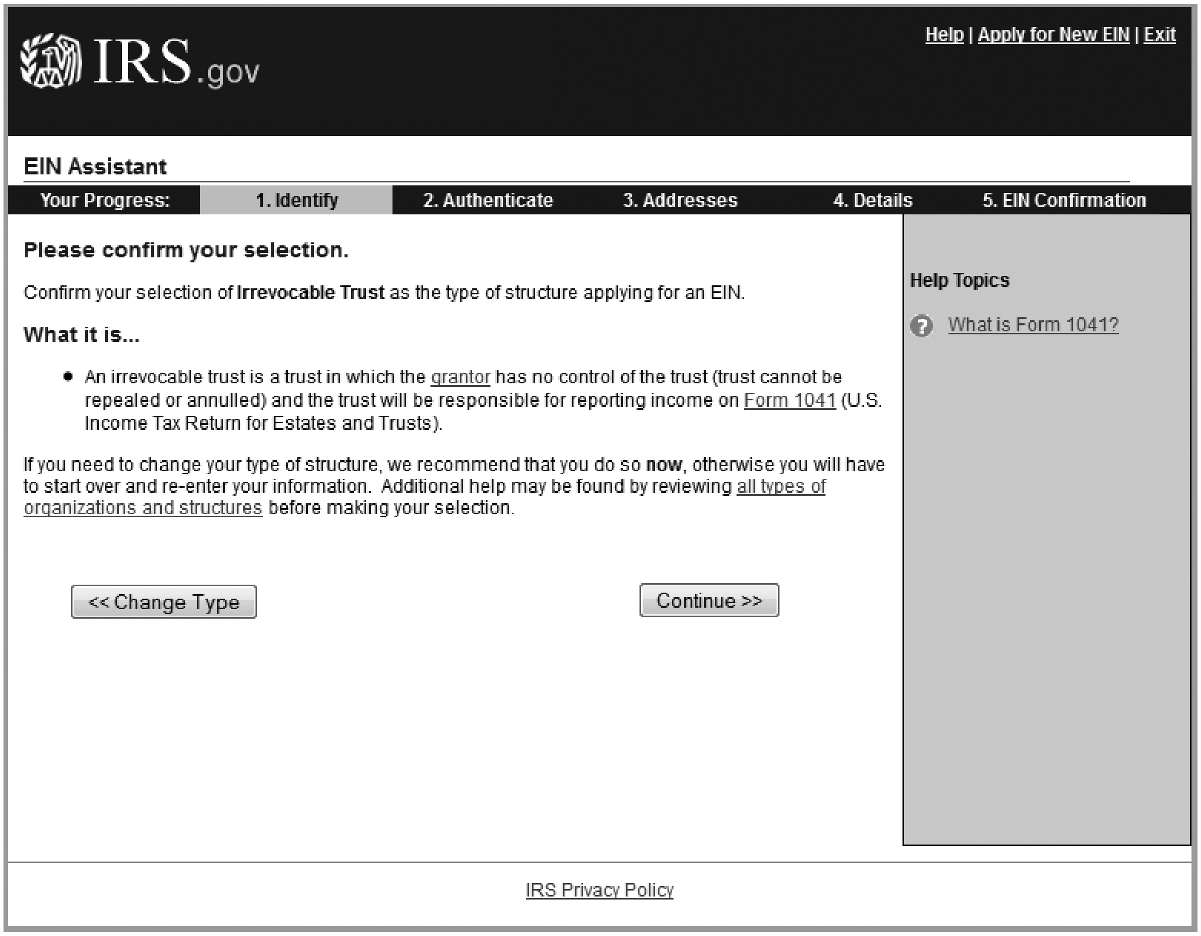
IRS Privacy Policy

3

Charles confirms that the trust is an irrevocable trust and indicates whether the responsible party is an individual or existing business.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EIN Assistant

Your Progress: 1. Identify 2. Authenticate 3. Addresses 4. Details 5. EIN Confirmation

Please confirm your selection.

Confirm your selection of **Irrevocable Trust** as the type of structure applying for an EIN.

What it is...

- An irrevocable trust is a trust in which the grantor has no control of the trust (trust cannot be repealed or annulled) and the trust will be responsible for reporting income on Form 1041 (U.S. Income Tax Return for Estates and Trusts).

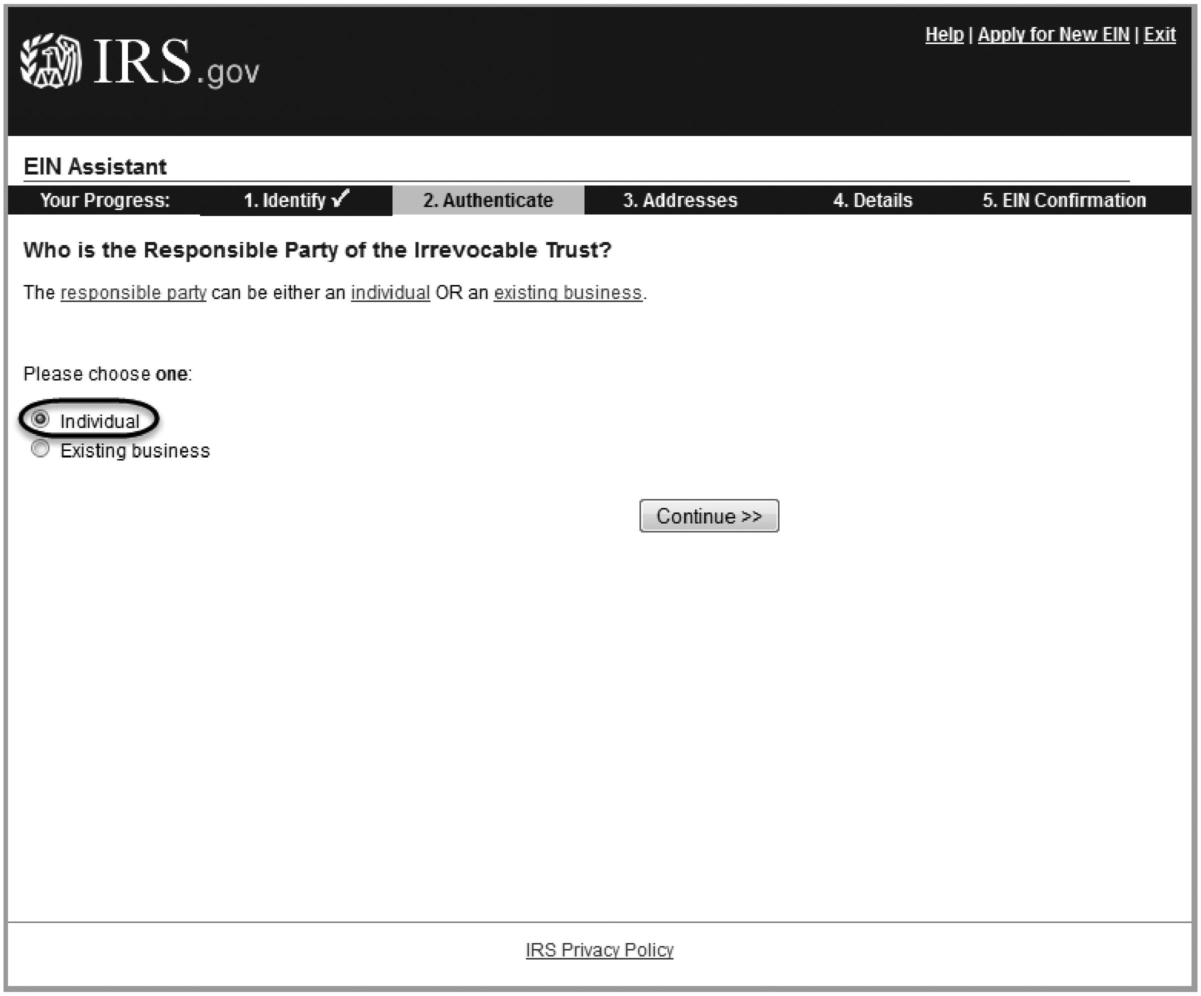
If you need to change your type of structure, we recommend that you do so **now**, otherwise you will have to start over and re-enter your information. Additional help may be found by reviewing all types of organizations and structures before making your selection.

<< Change Type   Continue >>

Help Topics

What is Form 1041?

IRS Privacy Policy


Help | Apply for New EIN | Exit

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EIN Assistant

Your Progress: 1. Identify ✓ 2. Authenticate 3. Addresses 4. Details 5. EIN Confirmation

Who is the Responsible Party of the Irrevocable Trust?

The responsible party can be either an individual OR an existing business.

Please choose **one**:

- (•) Individual
- ( ) Existing business

Continue >>

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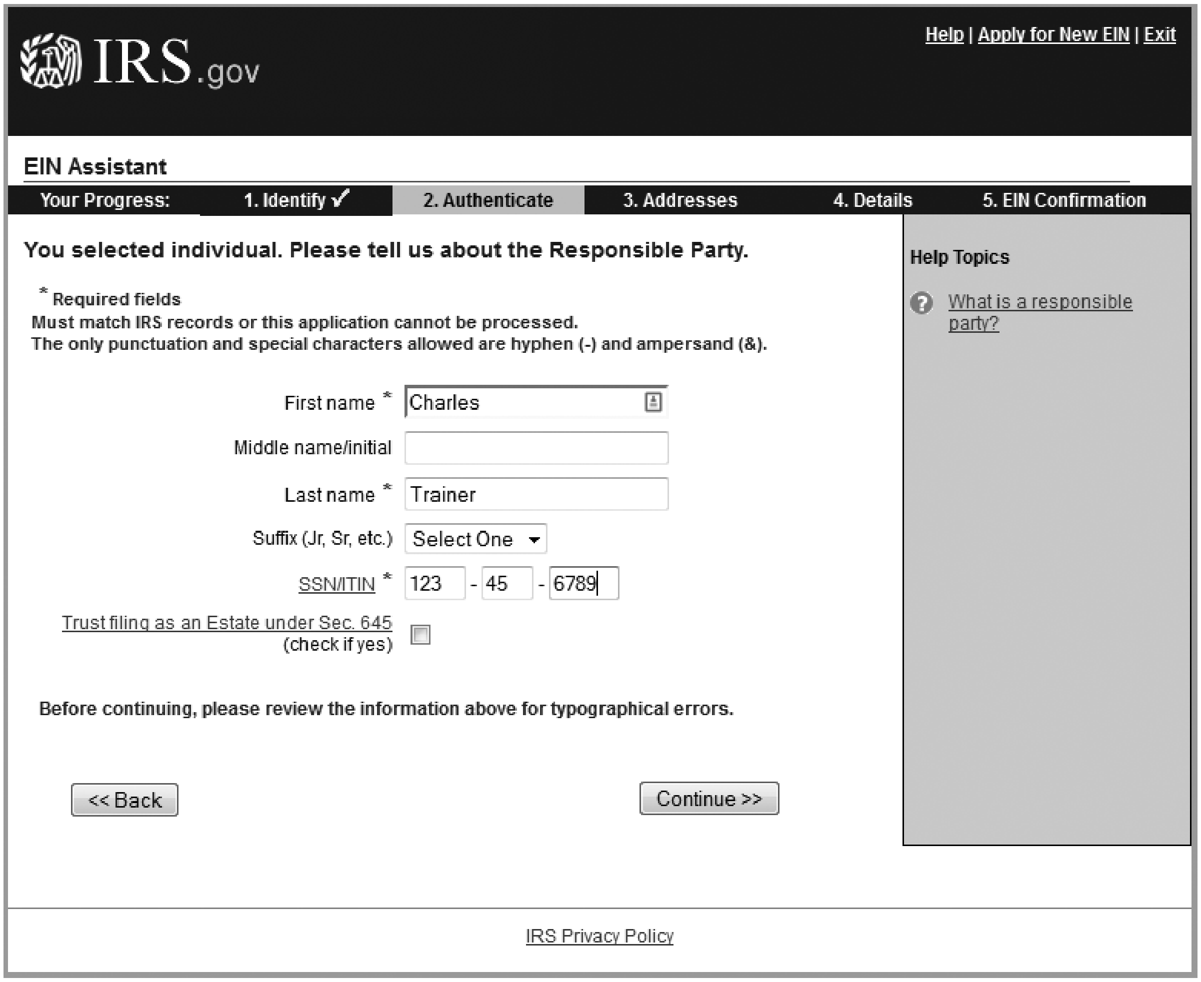
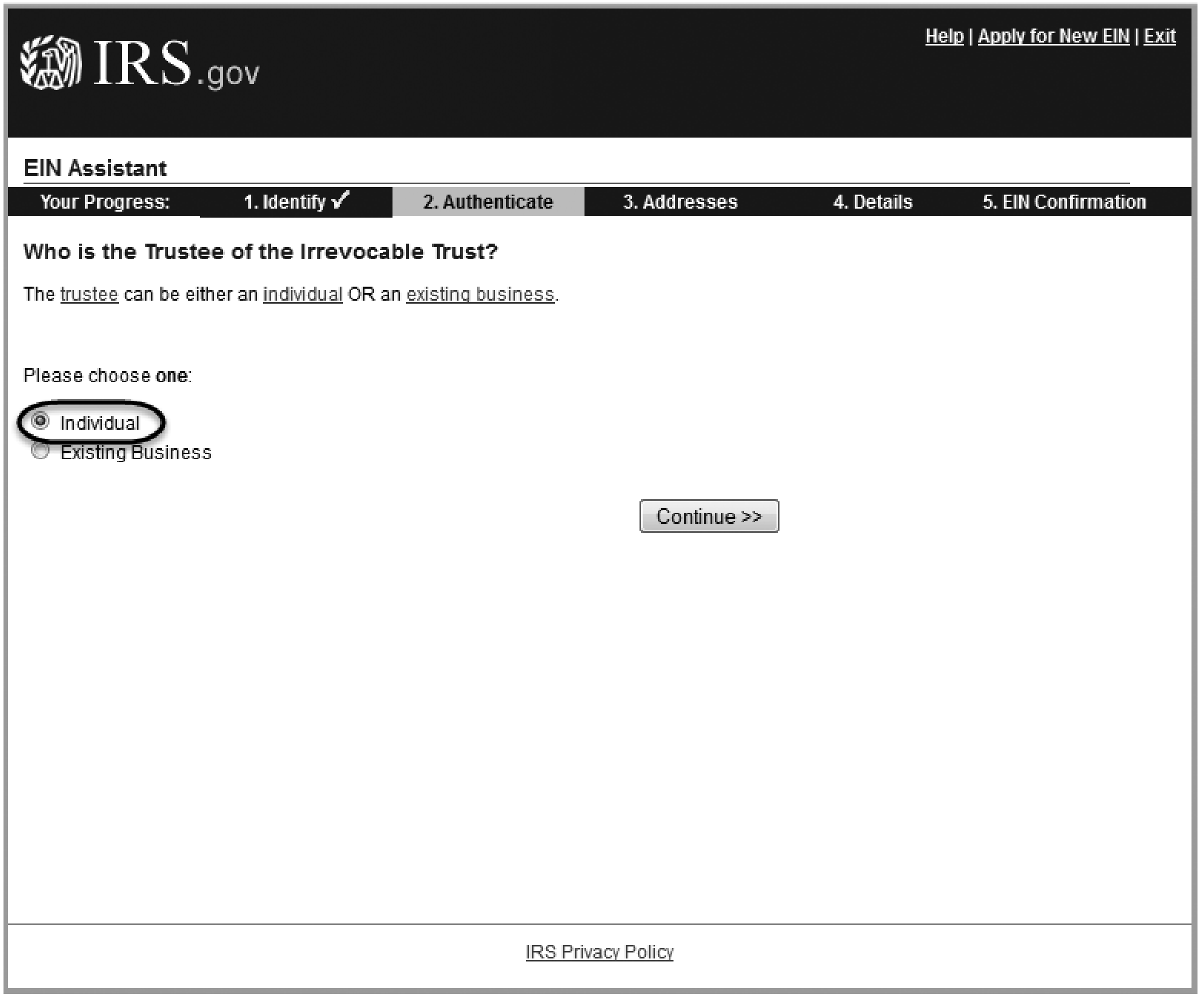
Next, Charles enters his personal information and confirms that the trustee is an individual.





Help | Apply for New EIN | Exit

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EIN Assistant

Your Progress:	1. Identify ✓	2. Authenticate	3. Addresses	4. Details	5. EIN Confirmation

Who is the Trustee of the Irrevocable Trust?

The trustee can be either an individual OR an existing business.

Please choose **one**:

- (•) Individual
- ( ) Existing Business

Continue >>

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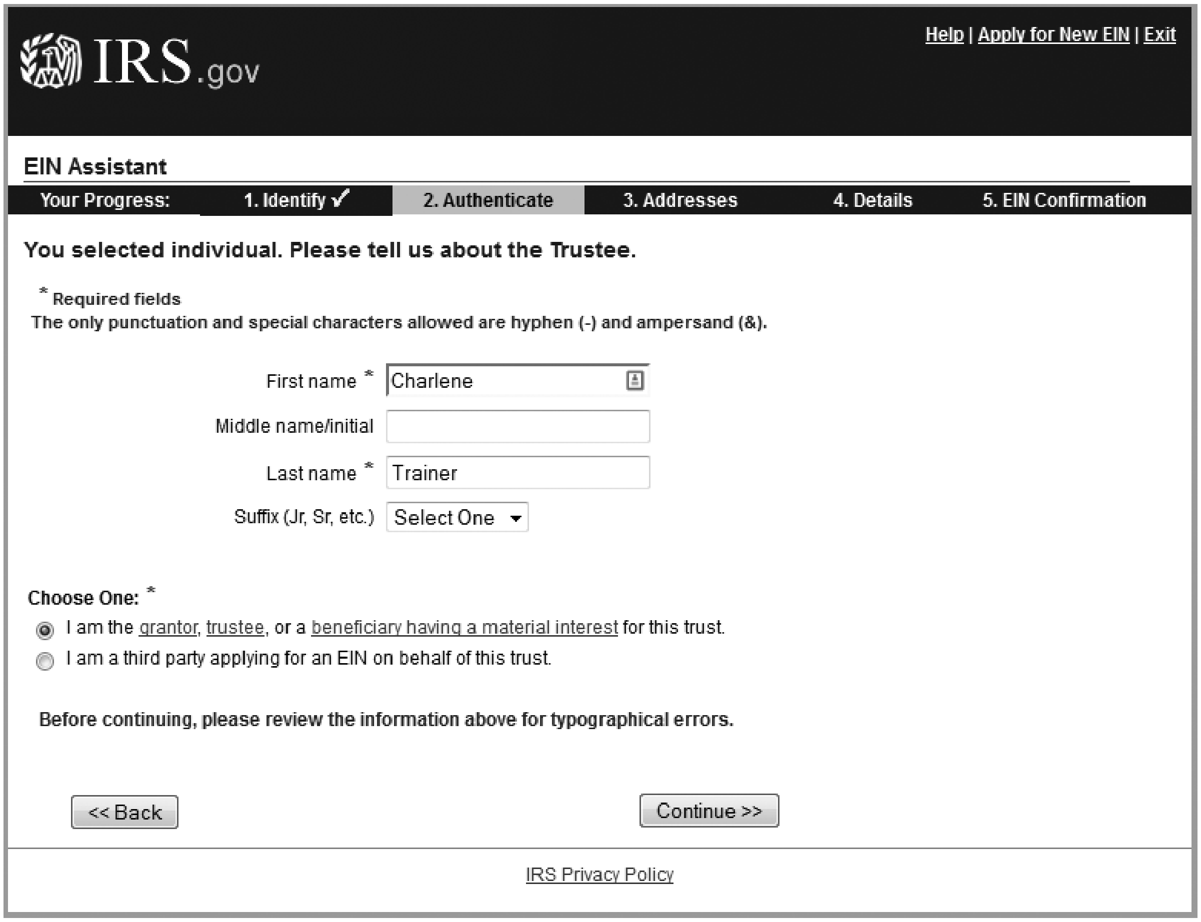
Charles lists his wife, Charlene, as the trustee of the irrevocable trust and enters her address.


IRS.gov

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EIN Assistant

Your Progress: 1. Identify ✓ 2. Authenticate 3. Addresses 4. Details 5. EIN Confirmation

You selected individual. Please tell us about the Trustee.

* Required fields

The only punctuation and special characters allowed are hyphen (-) and ampersand (&).

First name * Charlene

Middle name/initial

Last name * Trainer

Suffix (Jr, Sr, etc.) Select One

Choose One: *

I am the grantor, trustee, or a beneficiary having a material interest for this trust.

I am a third party applying for an EIN on behalf of this trust.

Before continuing, please review the information above for typographical errors.

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EIN Assistant

Your Progress: 1. Identify ✓ 2. Authenticate ✓ 3. Addresses 4. Details 5. EIN Confirmation

What is the Mailing Address for the Irrevocable Trust?

* Required fields

The only special characters allowed for street and city are - and /.

Note: You must enter a complete address. P.O. boxes and international mailing addresses are allowed. For military addresses click here.

Street * 123 Main Street

City * Anywhere

State/Province/Territory IL — For U.S. addresses, enter the state/territory abbreviation or full name. For foreign addresses, enter the full name of the province/territory.

ZIP/Postal Code 61801

Country * UNITED STATES

Phone Number * 2175555555 — Must contain only digits; do not enter extensions.

Do you have a U.S. address that is **different** from above? * ○ Yes ◉ No

Before continuing, please review the information above for typographical errors.

Continue >>

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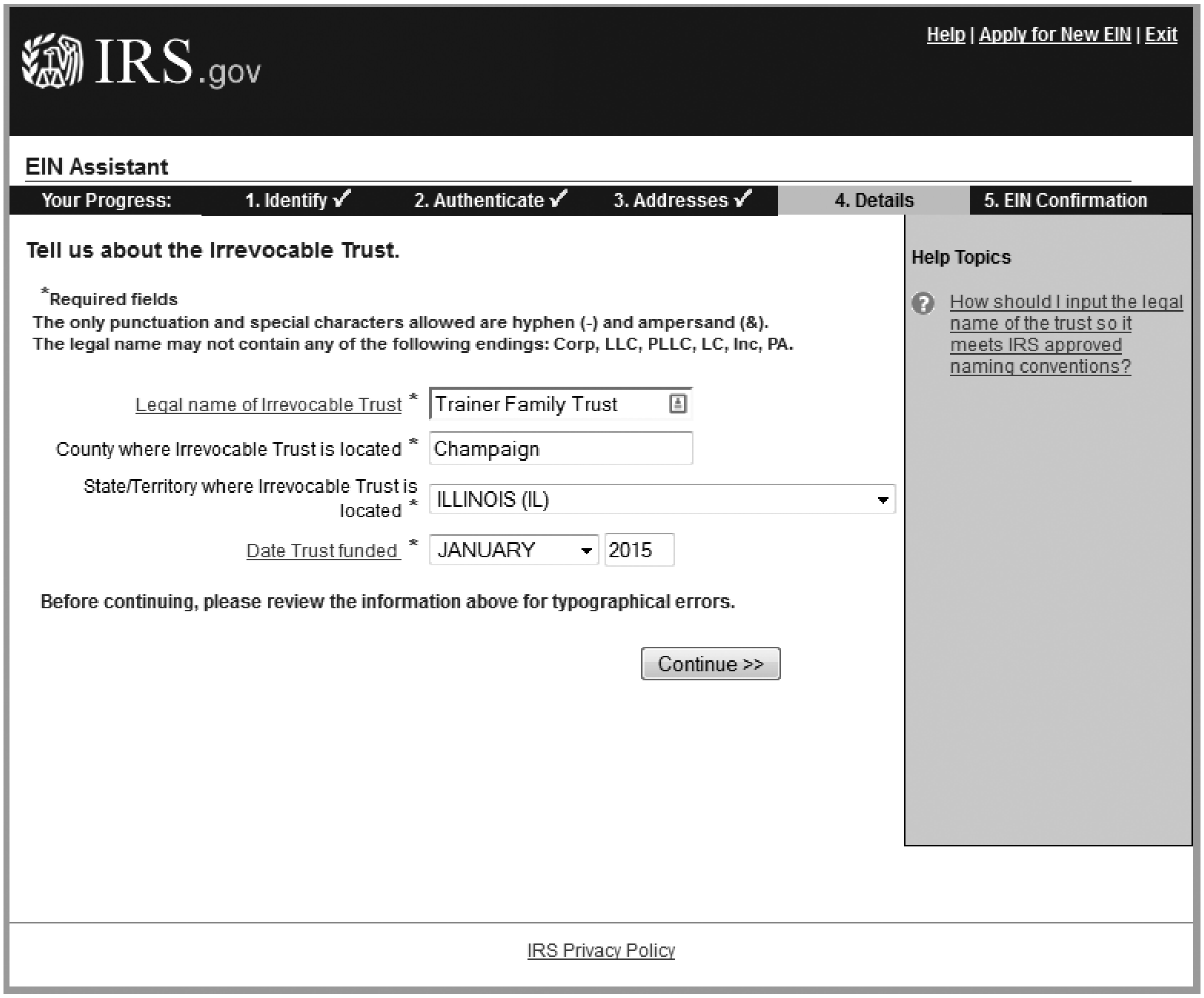
Next, Charles enters the name of the trust (verified in the trust document), the county and state that will regulate the trust, and when the trust was created.


IRS.gov

Help | Apply for New EIN | Exit

EIN Assistant

Your Progress: 1. Identify ✓ 2. Authenticate ✓ 3. Addresses ✓ 4. Details 5. EIN Confirmation

Tell us about the Irrevocable Trust.

*Required fields
The only punctuation and special characters allowed are hyphen (-) and ampersand (&).
The legal name may not contain any of the following endings: Corp, LLC, PLLC, LC, Inc, PA.

Legal name of Irrevocable Trust * Trainer Family Trust
County where Irrevocable Trust is located * Champaign
State/Territory where Irrevocable Trust is located * ILLINOIS (IL)
Date Trust funded * JANUARY 2015

Before continuing, please review the information above for typographical errors.

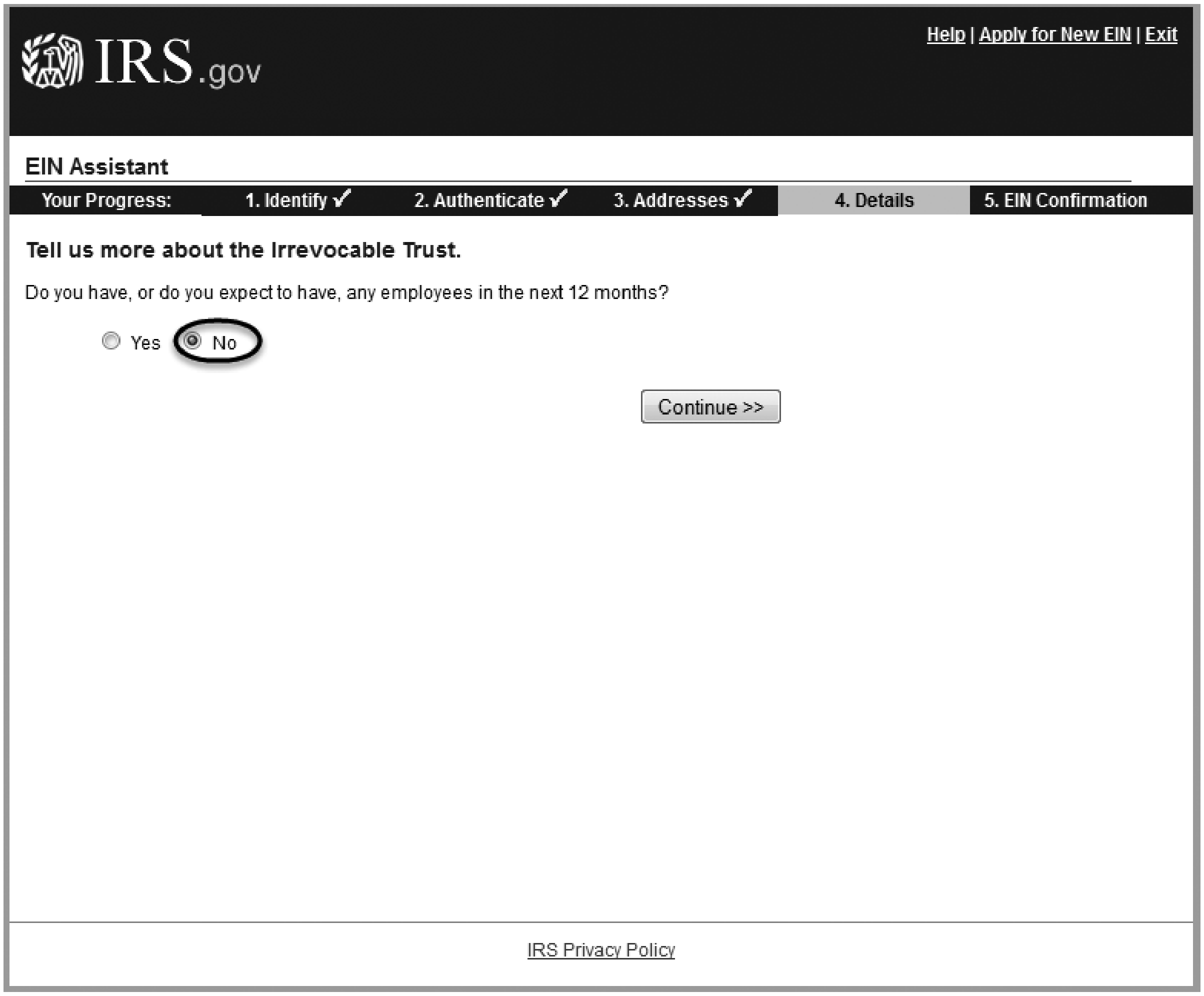
Continue >>

Help Topics

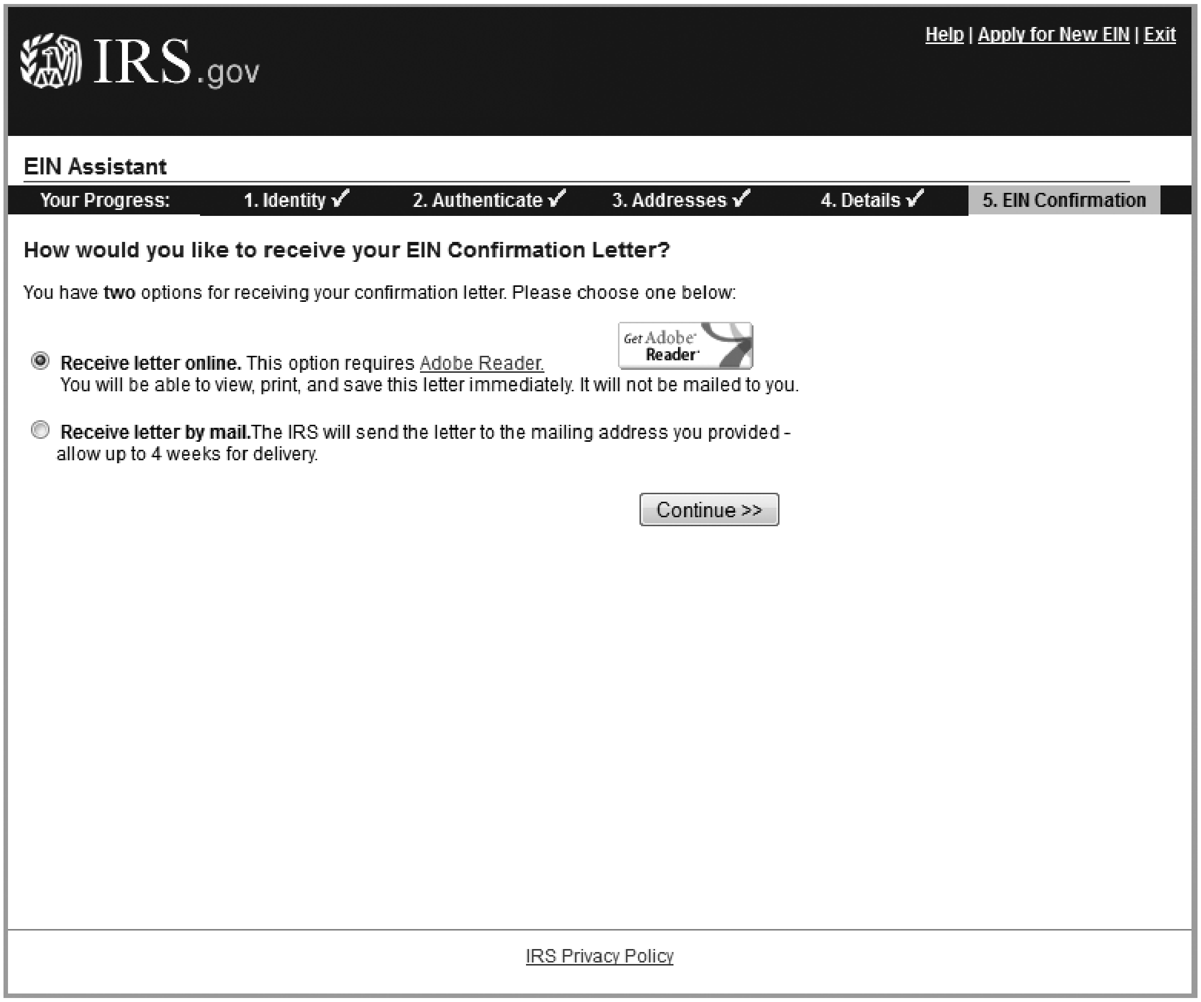
How should I input the legal name of the trust so it meets IRS approved naming conventions?

IRS Privacy Policy

The Trainer Family Trust will not have any employees, so Charles answers “No” to the next question. He does not have to answer any payroll questions.



Lastly, Charles elects to receive the FEIN immediately, rather than wait four weeks for it to arrive via mail. Once Charles receives the FEIN, he can file all required tax returns.



Note. If a taxpayer loses their FEIN, they can request a duplicate certificate by calling 800-829-4933, 7:00 a.m.–7:00 p.m. local time, Monday through Friday. An operator will ask for identifying information and provide the number over the telephone to an authorized person. Examples of authorized persons include a sole proprietor, a partner in a partnership, a corporate officer, a trustee of a trust, and an executor of an estate.[6]

Example 2. Use the same facts as **Example 1,** except Charles meets with his tax return preparer for yearend planning on December 29, 2015. During their meeting, Charles mentions that he started a trust during the year but has not applied for an FEIN. Charles is not in a hurry to get the FEIN because he will not need it until he files a return in March. He asks his preparer to complete a Form SS-4 on his behalf as an authorized person. His Form SS-4 follows.

6. *Lost or Misplaced Your EIN?* Oct. 10, 2014. Internal Revenue Service. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Lost-or-Misplaced-Your-EIN] Accessed on Feb. 19, 2015.

For Example 2

3

Form SS-4 (Rev. January 2010) Department of the Treasury Internal Revenue Service

Application for Employer Identification Number

(For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.)

▶ See separate instructions for each line. ▶ Keep a copy for your records.

OMB No. 1545-0003

EIN

Type or print clearly.

1 Legal name of entity (or individual) for whom the EIN is being requested
Trainer Family Trust

2 Trade name of business (if different from name on line 1)

3 Executor, administrator, trustee, "care of" name
Charlene Trainer

4a Mailing address (room, apt., suite no. and street, or P.O. box)
123 Main Street

5a Street address (if different) (Do not enter a P.O. box.)

4b City, state, and ZIP code (if foreign, see instructions)
Anywhere, IL 61801

5b City, state, and ZIP code (if foreign, see instructions)

6 County and state where principal business is located
Champaign, IL

7a Name of responsible party
Charles Trainer

7b SSN, ITIN, or EIN
123-45-6789

8a Is this application for a limited liability company (LLC) (or a foreign equivalent)? . . . . ☐ Yes ☒ No

8b If 8a is "Yes," enter the number of LLC members . . . . ▶

8c If 8a is "Yes," was the LLC organized in the United States? . . . . ☐ Yes ☐ No

9a **Type of entity** (check only one box). **Caution.** If 8a is "Yes," see the instructions for the correct box to check.

☐ Sole proprietor (SSN)
☐ Partnership
☐ Corporation (enter form number to be filed) ▶
☐ Personal service corporation
☐ Church or church-controlled organization
☐ Other nonprofit organization (specify) ▶
☐ Other (specify) ▶
☐ Estate (SSN of decedent)
☐ Plan administrator (TIN)
☒ Trust (TIN of grantor) **123-45-6789**
☐ National Guard ☐ State/local government
☐ Farmers' cooperative ☐ Federal government/military
☐ REMIC ☐ Indian tribal governments/enterprises
Group Exemption Number (GEN) if any ▶

9b If a corporation, name the state or foreign country (if applicable) where incorporated | State | Foreign country

10 **Reason for applying** (check only one box)
☐ Started new business (specify type) ▶
☐ Hired employees (Check the box and see line 13.)
☐ Compliance with IRS withholding regulations
☐ Other (specify) ▶
☐ Banking purpose (specify purpose) ▶
☐ Changed type of organization (specify new type) ▶
☐ Purchased going business
☒ Created a trust (specify type) ▶ **Irrevocable Trust**
☐ Created a pension plan (specify type) ▶

11 Date business started or acquired (month, day, year). See instructions.
January 1, 2015

12 Closing month of accounting year **December**

13 Highest number of employees expected in the next 12 months (enter -0- if none).
If no employees expected, skip line 14.

Agricultural	Household	Other
0	**0**	**0**

14 If you expect your employment tax liability to be $1,000 or less in a full calendar year **and** want to file Form 944 annually instead of Forms 941 quarterly, check here. (Your employment tax liability generally will be $1,000 or less if you expect to pay $4,000 or less in total wages.) If you do not check this box, you must file Form 941 for every quarter. ☐

15 First date wages or annuities were paid (month, day, year). **Note.** If applicant is a withholding agent, enter date income will first be paid to nonresident alien (month, day, year) . . . . ▶ **N/A**

16 Check **one** box that best describes the principal activity of your business.
☐ Health care & social assistance ☐ Wholesale-agent/broker
☐ Construction ☐ Rental & leasing ☐ Transportation & warehousing ☐ Accommodation & food service ☐ Wholesale-other ☐ Retail
☐ Real estate ☐ Manufacturing ☐ Finance & insurance ☒ Other (specify) **Trust**

17 Indicate principal line of merchandise sold, specific construction work done, products produced, or services provided.

18 Has the applicant entity shown on line 1 ever applied for and received an EIN? ☐ Yes ☒ No
If "Yes," write previous EIN here ▶

Third Party Designee

Complete this section **only** if you want to authorize the named individual to receive the entity's EIN and answer questions about the completion of this form.

Designee's name
Andy Capable, CPA

Designee's telephone number (include area code)
(**217**) **555-5556**

Address and ZIP code
456 Main Street, Anywhere, IL 61801

Designee's fax number (include area code)
( )

Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete.

Name and title (type or print clearly) ▶

Applicant's telephone number (include area code)
( )

Applicant's fax number (include area code)
( )

Signature ▶ Date ▶

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 16055N Form **SS-4** (Rev. 1-2010)

TYPES OF TRUSTS

A tax practitioner must determine what type of trust the client has in order to establish the proper filing procedures. This may require consultation with the drafting attorney to fully understand the terms of the trust and how those impact the tax filing requirements.

Oversight of the trust instrument is strongly suggested to make sure it meets the taxpayer's needs and objectives. Periodic review of the trust instrument is also encouraged in order to make certain the taxpayer's potentially changing goals and objectives continue to be met.

GRANTOR TRUSTS

A **grantor trust** is a trust in which the grantor retains control over the assets and/or benefits from the assets. 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 disregarded for income tax purposes.[7] The grantor is treated as the owner of the property and is taxed on some or all of the trust income.

All revocable trusts are by definition grantor trusts. An irrevocable trust can be treated as a grantor trust if any of the grantor trust definitions contained in the following Code sections are met.[8]

- IRC §671 — Under the general rule for grantor trusts, when the grantor or another person is regarded as the owner of any portion of a trust, the income, deductions, and credits attributable to that portion of the trust are included in calculating the taxable income and credits of the grantor or other person.
- IRC §673 — The grantor has retained a reversionary interest in the trust within a specified time.
- IRC §674 — The grantor or a nonadverse party has certain powers over the beneficial interests under the trust.
- IRC §675 — Certain administrative powers over the trust exist under which the grantor can or does benefit.
- IRC §676 — The grantor or a nonadverse party has the power to revoke the trust or return the corpus to the grantor.
- IRC §677 — The grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse.

Note. Revocable and irrevocable trusts are explained in more detail later.

7. See IRC §§671–678.

8. *Abusive Trust Tax Evasion Schemes — Questions and Answers.* Mar. 12, 2015. Internal Revenue Service. [www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Abusive-Trust-Tax-Evasion-Schemes-Questions-and-Answers] Accessed on Mar. 20, 2015.

There are four filing methods that may be available to report a grantor trust's income and expenses. **Methods 1 and 2 are only available to a grantor trust owned by one grantor** or one person treated as the owner of the trust.[9] For this purpose, a trust owned entirely by a husband and wife is treated as owned by one grantor as long as they file a joint return.[10]

- **Method 1.** The trustee, who may be the grantor, gives the **grantor's** name and identification number to all the payers of income. As a practical matter, the grantor does this by giving the payer their own social security number (SSN) and address. This income is then reported on the grantor's individual tax return.

  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). The trustee must furnish the grantor (or other person treated as the owner of the trust) with a statement detailing the following information.

  - The trust's items of income, deduction, and credit for the tax year
  - The identification of the payer of each item
  - The information necessary to take each item into account in computing the grantor's taxable income
  - Notice to the grantor that the items of income, deduction, and credit and other information shown on the statement must be included in calculating the taxable income and credits of the grantor (or other person) on the income tax return of the grantor (or other person)

Example 3. Carson and Vanessa are married taxpayers who file a joint return. They are co-trustees of the CV Trust. Under the grantor trust rules, they are treated as co-owners of the trust property because the trust is revocable and all the income is taxed to them. The trust received capital gain and dividend income during the tax year, and Carson and Vanessa furnished the payers with Vanessa's social security number and home address. For reporting purposes, Carson and Vanessa simply report the trust's capital gain and dividend income on their joint return.

- **Method 2.** The trustee gives the **trust's** name, address, and FEIN to all payers of income during the tax year. After the tax year ends, the trustee issues Forms 1099 to the grantors to report the income or gross proceeds paid to the trust during the tax year. These forms show the trust as the payer and the grantor (or other person) as the payee. The trustee must report each type of income in the aggregate and each item of gross proceeds separately.

  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)(iii). The trustee must furnish the grantor (or other person treated as the owner of the trust) with a statement detailing the following information.

  - The trust's items of income, deduction, and credit for the tax year
  - The information necessary to take the items into account in calculating the grantor's taxable income
  - A notice to the grantor that the items of income, deduction, and credit and other information shown on the statement must be included in calculating the taxable income and credits of the grantor (or other person) on the income tax return of the grantor (or other person)

9. Ibid.

10. Treas. Reg. §1.671-4(b)(8).

Method 3 is available for a trust treated as owned by two or more grantors or other persons.[11]

- **Method 3.** The trustee gives all payers of income during the tax year the name, address, and FEIN of the trust. After the tax year ends, the trust files Forms 1099 with the IRS for the trust income that is treated as owned by the grantors. Each Form 1099 should show the trust as the payer and an individual grantor (or other person treated as owner of the trust) as the payee. The trustee must report each type of income in the aggregate and each item of gross proceeds separately. Each grantor must be given a copy of the Form 1099 along with a statement containing income and expense information necessary to properly complete their own tax return.

Method 4 is available for trusts that have an FEIN.

- **Method 4.** Use Form 1041, *U.S. Income Tax Return for Estate and Trusts.* If the entire trust is a grantor trust, only the entity information should be entered on the form. No dollar amounts are entered on Form 1041; instead, dollar amounts are shown on an attachment to the form.[12]

  In some circumstances, part of a trust can be considered a grantor trust and the other part considered a nongrantor trust.

> **Note.** For further details on the characterization of a trust as a grantor or nongrantor trust, see the instructions for Form 1041.

  If only part of the trust is a grantor-type trust, the portion of the income, deductions, etc. that is allocable to the nongrantor part of the trust is reported on Form 1041. The amounts allocable to the grantor are shown only on an attachment to the form. The attachment should show the following information.[13]

  - The name, identifying number, and address of the person or persons to whom the income is taxable
  - The trust income that is taxable to the grantor or another person under IRC §§671 through 678 (This income, as well as the deductions and credits that apply to the income, must be reported by the grantor or other person on their own income tax return.)
  - Any deductions or credits that apply to this income

If the grantor trust has been filing Form 1041 and the trustee wants to change to method 1, 2, or 3, the trustee can file a final return for the tax year that immediately precedes the first year for which the trustee reports under an alternative method. On the top of the final return, the trustee must write "Pursuant to §1.671-4(g), this is the final Form 1041 for this grantor trust."[14] The "final return" box must also be checked. In subsequent years, the information that had been reported on the Form 1041 is reported on the grantor's Form 1040, *U.S. Individual Income Tax Return.*

11. Instructions for Form 1041 and Treas. Reg. §1.671-4(b).
12. Ibid.
13. Ibid.
14. Treas. Reg. §1.671-4(g).

REVOCABLE AND IRREVOCABLE TRUSTS

The distinction between revocable and irrevocable trusts is determined by the ability to change the terms of the trust.

Revocable Trusts

A trust is **revocable** if the grantor can alter or cancel trust provisions in whole or in part (e.g., terminate the trust and reacquire the property in the trust). The taxation of a revocable living trust is governed by the grantor trust rules mentioned earlier.

A revocable living trust, as the name suggests, is created before death. An individual transfers assets to a revocable trust during their lifetime. Because the trust is revocable, the grantor can generally reacquire the assets in the trust at any time. The grantor never loses control of the property. In most cases, the grantor of the trust is named as the trustee to simplify the process. As the trustee, the grantor may retain the ability to buy, sell, transfer, borrow, or take other actions with trust assets.

> **Example 4.** Karl wanted to make it easier for his heirs to settle his estate after he passed away. He also wanted to retain control of his assets during his lifetime. To achieve these goals, he transferred his assets into a revocable living trust. His trust document contained the following provision.
>
> > *I reserve the right from time to time to amend or revoke this instrument in whole or part by instrument (other than my Will) signed by me, referring to this instrument, and delivered to the trustee during my life.*

Individuals often use revocable trusts to avoid going through the probate process. Problems that may be associated with probate include the costs, delays in transferring property to the intended beneficiaries, and publicity. (Probate is a public process, whereas a trust is generally not open to the public.) If an individual owns property located in different states, multiple probate proceedings may be held, which can further complicate the probate process.

Typically, with a revocable trust, the grantor retains the right to change or amend the 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. The assets held in the trust are not subject to probate when the grantor dies because the trust holds legal title to the trust assets.

Generally, a revocable trust becomes irrevocable upon the death of the grantor. The trust then serves as a **will substitute.** The successor trustee (assuming the deceased grantor was the initial trustee) retains or distributes the trust assets in accordance with the trust instrument. Therefore, the assets held in the trust bypass the probate process.

> **Observation.** Using a revocable trust to bypass probate generally means that the person appointed as the executor in the grantor's will does not have control over the distribution of assets in the trust (unless both the will and the trust document appoint the same person).

A living trust is normally coupled with a simple pour-over will. This type of will 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. It provides a safety feature in case some of the decedent's assets were not transferred to the trust. The pour-over assets distributed to the trust by the will **are subject to the probate process.**

> **Note.** The probate process and the distribution of assets by a will are generally governed by state probate laws. Each state generally has a probate code that outlines these rules. For an example, see the Uniform Probate Code at **uofi.tax/15b3x2** [www.uniformlaws.org/Act.aspx?title=Probate%20Code].

Note. Creating a revocable trust to avoid probate **is only effective** when the deceased grantor's assets are titled in the name of the trust. This requires actually transferring assets to the trust. For an asset with a title (e.g., real estate, vehicle, stock, or bond), the title must be registered in the name of the trust. For an asset without a title (e.g., jewelry or farm machinery), a bill of sale, assignment, or other appropriate transfer document should clearly indicate that the trust holds legal title to the asset.

Irrevocable Trusts

A trust may be classified according to whether the grantor can revoke or terminate the trust arrangement. **Generally, if the grantor cannot terminate the trust arrangement, 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 gift tax may apply. An irrevocable trust can be created during the grantor's life or through a will when the grantor dies.

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. As such, it 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.

Example 5. As part of a charitable project, PJ purchased a dilapidated home from a disabled woman who could no longer afford the expenses of owning a home. PJ enlisted the help of her church and numerous others to rehabilitate the house. To ensure that the profit from the eventual sale of the home could only be used for the benefit of the former homeowner, she placed the real estate in an irrevocable trust. The trust document included the following provision.

This trust is irrevocable, and Grantor may not alter, amend, revoke, or terminate it in any way.

Irrevocable Trust That Is A Grantor Trust

A trust can be drafted to be both irrevocable for gift and estate tax purposes and a grantor trust for income tax purposes. This requires an advanced level of understanding of the gift tax rules and grantor trust rules.

Example 6. Mitch wishes to create an irrevocable trust for the benefit of his children. His goal is for the children, as trust beneficiaries, to receive the benefit of future appreciation on assets transferred to the trust. Additionally, Mitch wants to individually pay the tax on income earned on the trust assets during his life. In order to achieve this goal, Mitch wants to ensure that the transfers to the trust are considered gifts for gift and estate tax purposes. He also wants to ensure that the trust is taxed as a grantor trust for income tax purposes.

The following excerpts appear in the trust documents:

This trust is irrevocable. I retain no right to alter, amend, or revoke the trust.

The trustee has no right to distribute any income or principal of the trust to me.

I retain the power in a nonfiduciary capacity to acquire property in the trust by substituting property of equivalent value.[15]

Note. Trusts with provisions like those found in **Example 6** are sometimes called "intentionally defective" trusts. This example demonstrates why it is important that tax practitioners read the entire trust document with care or alternatively contact the attorney who drafted the trust document.

15. This retained right makes the trust a grantor trust for income tax purposes under IRC §675(4)(c), and Rev. Rul. 2008-22 even though the transfer of assets to the irrevocable trust is a completed gift for gift and estate tax purposes.

SIMPLE AND COMPLEX TRUSTS

The distinction between simple and complex trusts is determined by the distributions made by the trust.

A **simple trust** meets **all three** of the following requirements.[16]

1. The trust instrument requires that all income be distributed currently for the tax year (regardless of whether the current income distributions are actually made).[17]
2. The trust instrument must not provide that any amounts are to be paid, permanently set aside, or used for charitable purposes.
3. The trust does not make distributions of principal (corpus) during the year.

A trust that qualifies as a **simple trust** for the tax year is allowed to deduct from gross income any income amounts distributed to beneficiaries.[18] Simple trust status is retained even if the trustee does not actually make the income distributions until after the end of the tax year.[19]

Note. To qualify as a simple trust under federal tax rules, the amount that must be currently distributed is **income** as defined under the laws of the state in which the trust was established and under the trust instrument.[20] State trust law typically differentiates between **income** and **capital gains** (with capital gains considered part of the corpus of the trust).

Example 7. During her lifetime, Mildred placed all of her assets into the "Mildred Living Trust," which qualified as a revocable trust until her death. When she passed away, the trust became irrevocable. The trust document does **not** require that any amounts are paid, permanently set aside, or used for charitable purposes. It **does** require that the income is distributed annually.

> *The Trustee shall pay to my husband the net income from the trust at least annually. In addition, the Trustee may distribute to my husband so much or all of the principal of the trust as the Trustee in the Trustee's sole discretion determines is needed for his health, support, maintenance, and education.*

In 2014, the trust earned $3,000 in interest income. It did not pay any deductible expenses in 2014 and did not make any distributions. **The trust is treated as a simple trust for tax purposes in 2014.** Even though no distributions were made, the trust receives a distribution deduction on its income tax return, and Mildred's husband includes the $3,000 as income on his 2014 personal return.

Note. The distribution deduction and taxation of beneficiaries are discussed later in this chapter.

A **complex trust** is any trust that does not qualify as a simple trust.[21]

The classification of a trust may vary from year to year. For example, 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 is simple in any year in which principal is not distributed but complex in any year in which principal is distributed.

Example 8. Use the same facts as **Example 7.** In 2015, Mildred's trust earned $3,500 in interest income. In addition to this income, the trustee distributed $10,000 of the trust's corpus to Mildred's husband in 2015. Because of the principal distribution, the trust is treated as a complex trust for 2015.

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16. Instructions for Form 1041.
17. Treas. Reg. §1.651(a)-1.
18. IRC §651(a).
19. Treas. Reg. §§1.651(a)-2 and 1.651(b)-1.
20. Treas. Reg. §1.643(b)-1.
21. Ibid.

FIDUCIARY ACCOUNTING INCOME

To understand the income taxation of trusts, a tax professional must have a basic understanding of the accounting for trusts (fiduciary accounting). Trust accounting is used to determine the trust's income, which is a necessary step that must be taken before preparing the tax return for any trust or beneficiary.

Fiduciary accounting income (FAI) is a unique concept. It is neither **taxable income nor GAAP income.** Some practitioners incorrectly assume that taxable income and FAI are the same. For example, interest on municipal bonds is excluded in determining taxable income but included in determining FAI. Practitioners are even more likely to incorrectly assume that FAI is the same as income determined using GAAP. Both of these assumptions are as inaccurate as believing that taxable income and GAAP income are equivalent.

For a trust, FAI is the amount to be distributed or accumulated for income beneficiaries as defined by the trust instrument or will. If the trust instrument or will is silent, the amount is determined under state law.

As a practical matter, every trust contains a provision concerning the distribution of income. However, this provision tends to say little about what constitutes income, leaving it to state law. A will rarely defines income. For an accountant, this means that knowledge of a state's statute defining principal and income is imperative. Accountants are advised to have a good reference handy to consult in specific situations. In addition, consultation with an expert on the computation of FAI might be necessary.

Many of the rules and practices of fiduciary accounting derive from the fact that the 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 whether the trustee has properly discharged their duties.

It follows that the primary concern of fiduciary accounting is the proper allocation of the receipts and disbursements of the trust among the various competing interests. Historically, rules and laws have existed that neatly categorize certain receipts as income (e.g., interest, dividends, and rents). More recently, trust instruments have given the trustee the power to allocate receipts and disbursements between income and corpus as the trustee believes is appropriate.

As mentioned earlier, trust instruments are drafted to distinguish between income beneficiaries and remainder beneficiaries. **Income beneficiaries** are entitled to all or a portion of FAI, whereas **remainder beneficiaries** are entitled to the remainder of the trust's assets. Thus, the main duty of trust accounting and the trustee is to ensure that the amount accruing to each class of beneficiaries is correctly determined. In short, the trustee must allocate receipts and disbursements properly.

So, what is FAI? Unfortunately, the trust instrument 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 remainder beneficiary. 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 remainder beneficiary 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 on 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. To calculate FAI, the practitioner must review the trust instrument to identify how receipts and disbursements are allocated between income and principal.

UNIFORM PRINCIPAL AND INCOME ACT

The Uniform Principal and Income Act (UPIA) formally addressed the concept of FAI when it was created in 1931. One of the primary purposes of the act was to deal with the problems of adjusting principal and income between beneficiaries, remaindermen, and other parties with a current or future interest in trust assets. The UPIA 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 technical problems. These problems included determining principal and income and dealing with the conflicting opinions of the courts on these issues.

Under the UPIA, FAI (or trust accounting income) is the income as **determined under the terms of the trust instrument.** However, when the trust instrument 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 for calculating FAI when the trust instrument is silent on that issue. Every state has a principal and income statute. Most of these laws are modeled after the UPIA.

The Uniform Law Commission made major revisions to the original 1931 UPIA in 1962 and again in 1997. One of the critical changes made in 1997 stemmed from the Uniform Prudent Investor Act of 1994. This 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 portfolio 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, but it also had become inequitable.

Over the previous 25 years, income yields from stocks and bonds had dropped precipitously as the investment strategy shifted toward capital appreciation. The authors of the Uniform Prudent Investor Act understood the difficulty and revised the law to reflect current investment strategies. The act gives trustees the protection they need to implement modern investment techniques while complying with prudent investment standards.

The 1997 revisions to the UPIA changed the definitions of income and principal. **Income** is more broadly defined as money or property that a fiduciary receives as current return from a principal asset.[22] **Principal** is defined as property held in trust for distribution to a remainder beneficiary when the trust terminates.[23] 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 treat all beneficiaries fairly, most states now give trustees a unilateral administrative **power to adjust.**[24] If certain conditions are met, the trustee has the power to pay an item of principal to an income beneficiary or to withhold an item of income and add it to trust principal.[25]

Trustees have great latitude in determining how amounts are allocated and what is ultimately included in FAI. This is a mixed blessing for most trustees, particularly when the return on trust assets does not fit neatly 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.

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22. RUPIA (1997) §102(4).
23. RUPIA (1997) §102(10).
24. RUPIA (1997) §104.
25. Ibid.

The revised UPIA (RUPIA) was adopted by most states. However, some states expanded or redefined various parts of the act, while others did not. As of January 2015, 46 states and the District of Columbia had adopted the RUPIA in total or with modifications. **Georgia, Illinois, Louisiana, and Rhode Island have not** adopted the act but have their own principal and income statutes.[26] Consequently, it is critical for practitioners to review the trust instrument to determine the trust's home state (situs) and therefore the state laws that apply.

> **Note.** For further details on the uniform legislation, including the amendments made in 2008 to reflect the IRS tax-withholding policy, see **uofi.tax/15b3x3** [www.uniformlaws.org/Act.aspx?title=Principal%20 and%20Income%20Act%20%282000%29].

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 a term such as **taxable, gross, distributable net,** or **undistributed net,** the reference is to FAI.[27]

Example 9. Connor's father, Bradley, died in 2014. Under the terms of Bradley's will, $100,000 was left in a trust that provides income to Connor annually. Upon Connor's death, the remainder is to go to Bradley's granddaughter, Emma. The residuary of the estate was placed in a separate trust for Emma. Under the agreement, Connor receives the income from the trust annually.

One of the assets left in trust is 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. However, if the lot is sold for $30,000, a gain is recognized and the proceeds must be allocated to income or principal. Under these circumstances, Connor benefits if the proceeds are allocated to income, but Emma benefits if the proceeds are allocated to corpus.

To determine how to allocate the proceeds, the practitioner should refer to the trust instrument. If the trust instrument is silent, state law governs.

CALCULATING FAI

Normally, the provisions of the trust instrument 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.

Trust Situs

If a state's law governs the accounting treatment when a trust is silent, it is obviously important to know which state law (or country) governs. However, determining this is not as easy as it might seem.

Trust situs controls. **Situs** is usually defined as the place in which the trust is administered. It is typically the legal jurisdiction where the trustee is located. In any particular situation, situs may not be obvious. For example, if the grantor creates a trust in the state in which they live, names a trustee who lives in another state, and identifies beneficiaries living 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 may determine situs. As might be expected, in situations in which the laws of one jurisdiction differ from those of another, situs can be critical.

> **Caution.** The situs of a trust does not necessarily control whether a state income tax return should be filed in a particular state. Individual state laws should be consulted to determine situs and tax return filing requirements.

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26. *Legislative Enactment Status: Principal and Income Act (2000).* Apr. 8, 2015. Uniform Law Commission, The National Conference of Commissioners on Uniform State Laws. [www.uniformlaws.org/Act.aspx?title=Principal%20 and%20Income%20Act%20%282000%29] Accessed on Apr. 8, 2015.

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

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

- **State Income Taxes.** Some states do not tax trusts. For example, Delaware historically has not taxed a trust's income if all the beneficiaries reside outside the state. South Dakota has no trust tax.
- **Duration.** Most states have adopted a law concerning future interests 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 period. Typically, that time period is 21 years after the death of the last beneficiary who was living at the time the trust was created. Many states have modified the rule against perpetuities by statute; some states have eliminated it. It is essential for the practitioner to know the applicable state rule because of the possible tax consequences.
- **Asset Protection.** Grantors can establish spendthrift trusts that generally give the trustee the power to withhold distributions to beneficiaries for any reason. Therefore, the trustee does not have to respond to demands from a beneficiary's creditors. However, Delaware also protects all trusts from creditor claims 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 their own trust, where the assets are immunized from creditor claims, provided the grantor is not trying to defraud known creditors.
- **Privacy.** All trusts created by will are open to public scrutiny during probate. A revocable trust created while the grantor is alive normally is closed for viewing. However, a number of states require trusts to be registered in the state. In these states, the names of the grantor and the beneficiaries (but not dollar amounts) normally must be disclosed.
- **Convenience.** Although selecting a locale that does not tax trusts may seem attractive, it may be cumbersome to administer property in a faraway place.

Items of Income and Expense

FAI is the amount available for 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, the will, or state law.

FAI for a trust is whatever the trust instrument or the will says it is. Nonetheless, under most state laws (and trust instruments), certain items are allocated to income while others are usually allocated to corpus. Typical items allocated to income include the following.[28]

- 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

28. See RUPIA (1997) as amended, §§401–415 and 501–506.

Depreciation. Depreciation (as well as depletion and amortization) can be a bit confusing for trusts. The first issue concerns the basic concept of depreciation. Most accountants normally consider depreciation to be a noncash expenditure. However, in the trust arena, depreciation involves the movement of cash to offset the decreased value of a wasting asset to the remaindermen.

Example 10. A trust is created requiring all income to be distributed to the income beneficiary, Isabel, during her life. Upon Isabel's death, the principal is to be distributed to the remainderman, Reid.

If the trust principal consists of corporate bonds, the payments of interest to Isabel generally do not reduce the value of the remainder that Reid is to receive after Isabel's death. This is because the production of income by the bonds does not diminish the bonds' remaining value.

However, if the trust corpus consists of a mine that produces coal, the situation is quite different. In this case, Isabel receives royalty income as the coal is mined and sold. If all the coal is extracted during Isabel's lifetime, the remainder — the mine — is worth little or nothing when Reid ultimately becomes the owner. It is a "wasting" asset.

The distributions of interest income from the bonds do not reduce corpus like the income attributable to the mining of coal.

Typically, when a trust with a wasting asset is established, some of the income from the wasting asset is retained by the trustee and added to the trust corpus. The remaining income is distributed to beneficiaries. This is done in an attempt to maintain an "even hand" between the beneficiaries and the remaindermen and is frequently required by state statute and/or state case law.[29]

Depreciation is handled in a similar way. Once the amount of depreciation is determined, the trustee establishes a reserve for depreciation. Income is withheld and added to the depreciation reserve. The effect is to reduce the amount paid to the income beneficiary and to set aside this amount in principal. Doing so means that resources will be available to the remainderman for use later in replacing the property.

Another 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 situation, the 1997 RUPIA gives the trustee full discretion as to whether depreciation is charged.

Finally, if a reserve for depreciation is required, the **amount** of depreciation must be calculated. Depreciation methods for FAI purposes may differ substantially from those used for financial or tax accounting purposes. 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 calculated using GAAP or for trust depreciation to be exactly equal to tax depreciation. Regardless of the amount of depreciation calculated for FAI purposes, the trust calculates 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. However, 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.

Property Taxes. Although property taxes are levied on trust assets, they are usually paid out of trust income and allocated to income.

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29. See *All You Really Need to Know about Subchapter J You Learned from This Article.* Sherman, Jeffrey G. Winter 1998. Missouri Law Review. [http://scholarship.law.missouri.edu/cgi/viewcontent.cgi?article=3348&context=mlr] Accessed on Feb. 24, 2015. See also RUPIA §503.

Ordinary Expenses. Expenses incurred in the administration, management, or preservation of the trust property are usually charged against income. However, the trust instrument 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. (They do apply, however, in calculating taxable income.)

Premiums and Discounts. Premiums and discounts are not taken into account in calculating FAI. There is no provision for amortization, as there normally is for financial and tax accounting. This treatment can produce some extremely inequitable situations.

For example, assume that a zero coupon bond is purchased at a sizable discount in order to produce a market interest rate of 10%. Without adjustment, the income beneficiary will receive nothing, even though the real rate of return on the bond is 10%.

> **Observation.** There is no particular correlation between FAI and taxable income.
>
> For example, in arriving at a trust's taxable income, 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 calculation 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 even though 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 RUPIA specifically addresses the allocation of distributions received from entities. It provides that distributions 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 (mutual funds), and real estate investment trusts (REIT).

Under the RUPIA, the amount of FAI derived from partnerships and S corporations is not the amount of taxable income that flows through or that is allocated to the owners; it is solely the amount of 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 11. The Ruben Trust 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 distribute income of $10,000, including $1,000 to the Ruben Trust.

For tax purposes, the partnership issues a Schedule K-1 showing that the trust's share of partnership taxable income is $8,000 (($20,000 interest income + $60,000 rental income) × 10%). However, the FAI for the trust is $1,000, which is the amount of the distribution. This is true even though the trust's distributable net income (discussed later) includes the $8,000 of taxable income.

Although the amount of income from an entity is normally equal to the amount of cash received from it, there are several exceptions.[30]

- 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 allocated to income.
- Distributions of property by an entity are allocated to principal (e.g., a C corporation distributes land to a trust). 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 (It is the proceeds derived from the sale that are allocated to corpus, not merely the net gain or loss.)[31]
2. Taxes on gains and profits allocated to principal[32]
3. Casualty losses
4. Reinvested 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. Loan repayments
9. All or a portion of trustee commissions

Note. If income is accumulated in a trust, it follows that a portion of the trust's tax liability is attributable to the accumulated income. This tax is allocated to income.

Example 12. The Jones Irrevocable Trust sold some stock that was part of the 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 because it is attributed to the sale of assets that are part of corpus. Thus, the net increase to corpus is $19,100 ($20,000 – $900).

Although the gross sales proceeds are allocated to corpus, it is the net gain that is taxable to the trust.

Example 13. The Blair Irrevocable Trust is a simple trust. As a result, all the FAI is distributed. In a simple trust, all the federal, state, and local taxes paid by the trust are charged to corpus. This is because the income tax liability of a simple trust normally is due solely to capital gains or other items allocated to corpus.

If the Blair Trust were a complex trust and some of the FAI was accumulated, then the tax attributable to the accumulated income would normally be charged against that account. However, a trust instrument sometimes provides that the income tax liability should be charged elsewhere (e.g., corpus or distributed income).

30. RUPIA §401(c).

31. See RUPIA §404(2).

32. See RUPIA §502(1)–(7).

Effect of Total Return Trust on Calculation

As noted previously, if the trust adopts the total return investment strategy, the trustee has the power to adjust the normal allocation of receipts and disbursements. Once the allocations have been made in accordance with the trust instrument and state law, the trustee can shift income to corpus and corpus to income. Obviously, doing so may lead to disputes between the beneficiaries and the trustee.

To prevent such controversies, some states have 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. This way, regardless of how the assets are invested, the income beneficiaries receive the same percentage of the trust assets' value each year as income.

If the unitrust approach is used, the trust instrument 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).

For income tax purposes, final regulations effective January 2, 2004, revised the definition of FAI to make it consistent with the total return concept.[33] According to the regulations, an allocation between income and corpus under state law is respected if state law provides for a reasonable apportionment between income and remainder beneficiaries of the trust's total return for the year. For this purpose, the total return includes 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 their duty of impartiality to the income and the remainder beneficiaries.

The regulations warn, however, that "trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized."[34] 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 exemption amount available to the trust, discussed later) or IRC §651 (the distribution deduction). The effect of the rule is to give trustees great discretion in the allocation of receipts and disbursements.

Example 14. On March 7, 2014, Grant established a trust for his son, Benny. Grant is the trustee. According to the terms of the trust instrument, an annual reserve for depreciation of $5,000 must be maintained. In addition, both capital gains and 50% of the trustee's commission must be allocated to the principal account. The trust had the following income and expenses for 2014.

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

33. Treas. Reg. §1.643(b)-1.

34. Ibid.

FAI is calculated 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**

The capital gain is not included in FAI because it is allocated to corpus. Similarly, only half the trustee's commission is charged to trust income because the trust instrument specifies that the other half is charged to corpus.

INCOME TAX ISSUES

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 the income taxes?

The law adopts the long-standing rule of IRC §102 concerning gifts and bequests and provides that a gift or devise should not be subject to income tax. 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. However, the income from the property is taxable.

CONCEPTUAL OVERVIEW

Subchapter J of the Code contains the rules governing the income taxation of trusts and other fiduciary entities. The taxable income of a trust is calculated 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, practitioners should remember that total taxable income is taxed once: to the fiduciary or the beneficiary but not both.

Perhaps the best way to understand the tax treatment of trusts is to compare their treatment to that of partnerships and corporations. A 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 regardless of whether it is actually distributed. Distributions from the partnership generally represent nontaxable distributions of income that flowed through to the partners and was previously taxed.

The tax treatment of trusts does not adopt either of these approaches in its entirety. It appears that the authors of the fiduciary rules rejected the corporate approach, believing that the income of a trust should only be taxed 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 trusts like partnerships was deemed unacceptable. If this method were used, a beneficiary would be charged with income but not have any power to obtain the cash necessary to pay the tax. Consequently, a compromise plan was adopted. This approach borrows from both the corporate and the partnership schemes.

The basic principle underlying the design of fiduciary income taxation is that the taxable income of the trust should be taxed once. This is accomplished by treating the trust as a separate taxable entity, like a corporation. **Taxable** income received by the fiduciary generally is 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 that the trust distributes its income. This shifting is accomplished mechanically by granting a deduction to the trust 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 trust and the beneficiaries.

This treatment is very similar to how a corporation pays salaries to its owners and deducts those salaries in calculating its taxable income. In such a case, the income is taxed only once. Although trust taxation resembles corporate taxation, it also borrows from partnership taxation. Like a partnership, the income distributed to the beneficiaries **retains its character.**

Example 15. Among the assets contained in Kitty's complex trust is a $100,000 bond, which pays taxable interest annually at a rate of 10%. In 2015, the trust receives $10,000 of interest income and distributes $4,000 to Kitty. Because of this distribution, $4,000 of the taxable interest income is allocated to Kitty, the beneficiary.

Kitty includes the $4,000 in her taxable interest income, and 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 Kitty.

For reporting purposes, the trust files a Form 1041 showing $6,000 of trust taxable income. It reports the $4,000 on a Schedule K-1 issued to Kitty.

Grantor trusts, as discussed earlier, are not taxed in this manner. 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 altogether for income tax purposes. As a result, the income of a grantor trust is taxed to the grantor and the trust normally is not taxed.[35]

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.[36]

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, whereas the basis for loss is the fair market value (FMV) at the time of the gift. In addition, the basis of the gifted property is increased by any suspended passive losses.[37]

If the trust is a revocable trust, the gift is not complete until the trust loses its revocable status. If the change in status is due to the grantor's death, the assets normally receive a step up in basis for qualifying assets.

35. See IRC §§671–678.

36. IRC §1014.

37. IRC §469(j)(6)(A).

FILING REQUIREMENTS

The fiduciary (or one of the joint fiduciaries) must file Form 1041 for a domestic trust taxable under IRC §641 that has:[38]

1. Any taxable income for the tax year,
2. Gross income of $600 or more (regardless of taxable income), or
3. A beneficiary who is a nonresident alien.

A trust is a **domestic trust** if both of the following apply.[39]

1. A U.S. court is able to exercise primary supervision over the administration of the trust (court test).
2. One or more U.S. persons have the authority to control all substantial decisions of the trust (control test).

Note. See Treas. Reg. §301.7701-7 for more information on the court and control tests.

A trust (other than a trust treated as wholly owned by the grantor) with all the following attributes is also treated as a domestic trust.[40]

1. Existed on August 20, 1996
2. Treated as a domestic trust on August 19, 1996
3. Elected to continue to be treated as a domestic trust

If a domestic trust becomes a foreign trust, it is treated under IRC §684 as transferring all its assets to a foreign trust. This rule applies except to the extent that a grantor or another person is treated as the owner of the trust when it becomes a foreign trust.[41]

A trust that is not a domestic trust is treated as a **foreign trust.**[42] The trustee of a foreign trust must file Form 1040NR, *U.S. Nonresident Alien Income Tax Return,* instead of Form 1041. In addition, a foreign trust with a U.S. owner generally must file Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner.*

TAX YEAR

A trust is generally required to file its Form 1041 using a calendar yearend.[43] However, an election under IRC §645 is available to treat a decedent's revocable trust as part of an estate. If the election is made, the trust adopts the estate's fiscal yearend. The election is made by filing Form 8855, *Election To Treat a Qualified Revocable Trust as Part of an Estate.*

Note. IRC §645 elections are explained in more detail later in this chapter.

Note. Foreign trusts or trusts with beneficiaries that are non-U.S. persons may have other filing requirements and international tax compliance obligations in addition to the annual income tax-filing obligations mentioned in this chapter. For further details, see the 2015 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Foreign Asset Disclosure.

38. Instructions for Form 1041.
39. Ibid.
40. Ibid.
41. Ibid.
42. Ibid.
43. IRC §644.

Due Dates

A trust return is due by the 15th day of the fourth month after the close of the tax year (usually, April 15). For calendar-year trusts with tax years beginning after December 31, 2015, an automatic **5½-month** extension can be obtained by completing Form 7004, *Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns.*[44] If the 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 tax year.

Interest charges apply to any balance due if the tax is not paid on time. There are also two penalties for failing to file a trust return on time. One is a **failure-to-file** penalty of 5% per month or part of a month, up to a maximum of 25%. The other is a **failure-to-pay** penalty of 0.5% per month, up to a maximum of 25%.[45] Both of these penalties are based on a percentage of the balance owed on the trust tax return. If no balance is due, no penalties are assessed.

INCOME TAX RATES

The Code provides a special tax rate schedule in IRC §1(e) for trusts. Like the tax rate schedules for individual taxpayers, the trust tax brackets are adjusted annually for inflation. For 2015, trusts are taxed at the following rates.[46]

Tax Rate Schedule
Trusts and Estates
For Tax Years Beginning in 2015

If Taxable Income Is					
Over	But Not Over	The Tax Is	Of the Amount Over	Capital Gain	NIIT
$ 0	$2,500	15.0%	$ 0	0%	0%
2,500	5,900	375.00 + 25.0%	2,500	15%	0%
5,900	9,050	1,225.00 + 28.0%	5,900	15%	0%
9,050	12,300	2,107.00 + 33.0%	9,050	15%	0%
12,300		3,179.50 + 39.6%	12,300	20%	3.8%

As is evident from the schedule, the tax brackets for trusts are highly compressed. The top rate of **39.6% starts at $12,301** of taxable income, as compared with **$413,201** for single taxpayers and **$464,851** for joint filers.[47] This compression has severely limited the potential for shifting income to trusts to minimize taxes.

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. From a tax perspective, investment in stocks that produce dividends is generally superior to investments that produce interest. This is particularly true for trusts in light of the tax-bracket compression.

44. Instructions for Form 1041.

45. Ibid.

46. Rev. Proc. 2014-61, 2014-47 IRB 860.

47. Ibid.

CAPITAL GAIN RATES

The rules governing property transactions for individuals also apply to 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, whereas net long-term capital gains are taxed at 0%, 15%, or 20%. For the 2015 tax year, the 0% rate applies to amounts up to $2,500.[48] The 15% rate applies to amounts over $2,500 and up to $12,300. The 20% capital gains rate applies to amounts above $12,300.

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 return except upon termination when they are passed to the beneficiaries.[49]

> **Note.** Capital losses and net operating losses deductible upon termination are discussed in more detail later.

NET INVESTMENT INCOME TAX

The net investment income tax (NIIT) may affect the tax liability of a trust. If a trust is subject to income tax under the Code, then that trust is also subject to the NIIT rules.

As mentioned earlier, trusts are allowed to deduct **income distributions** to beneficiaries.[50] Therefore, in most cases, distributed income is not subject to income tax or the NIIT.

Each year, trusts are liable for the 3.8% NIIT on the **lesser of:**[51]

- The trust's **undistributed** net investment income (NII) for the year, **or**
- The **excess** (if any) of the trust's adjusted gross income (AGI) over the dollar amount at which the highest tax bracket for trusts begins **($12,300 for 2015).**

Undistributed NII for the trust is calculated by first determining the trust's NII. NII includes some forms of **income** and **capital gains** the taxpayer receives during the year. However, not all income or capital gains become part of NII for the taxpayer. Both the **income** and the **capital gain** components have some exceptions that are not subject to the 3.8% NIIT.

Generally, **NII includes** the following types of income.[52]

1. **Taxable interest, dividends, nonqualified annuity distributions, royalties, rents, and substitute interest or dividends,** other than such income that is derived in the ordinary course of a trade or business
2. **Income from a passive activity[53] or from a covered trade or business** (i.e., a trade or business that trades in financial instruments or commodities)
3. **Net capital gains attributable to the disposition of property other than property held in a trade or business** (Only net gains included in taxable income are subject to the NIIT.)[54]

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48. Instructions for Form 1041-ES (2015).
49. IRC §642(h).
50. IRC §§651 and 661.
51. IRC §1411(a)(2).
52. IRC §§1411(c)(1) and (2).
53. As defined in IRC §475(e)(2).
54. IRC §1411(c)(1)(A)(iii).

The NII for a trust is based on all the NII amounts **received** by the trust during the year.[55] After the amount of the trust's NII that was received is determined, the undistributed NII is calculated using the following general formula.

Trust NII
– Amount allowed as a deduction under trust tax law for distributions of net income made to beneficiaries[56]
– Amount allowed as a deduction under trust tax law for any amounts permanently paid or set aside for charitable contributions[57]

Undistributed NII subject to NIIT

The NII that the trust distributes to beneficiaries retains its character as NII and forms part of the NII of each beneficiary for the tax year.

Note. The concept of **material participation** is used extensively in the NIIT rules. It may be difficult to determine whether a trust materially participates in an activity. The IRS has not yet provided any direct guidance on this issue, but the Tax Court recently ruled on some relevant cases. For further details on the material participation concept and how trusts are affected by the material participation rules, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities.

Exempt Trusts

Treas. Reg. §1.1411-3(b)(1) specifically exempts certain trusts from the NIIT.

- Trusts (or portions of trusts) that are treated as **grantor trusts**
- Trusts established exclusively for religious, charitable, scientific, literary, or educational purposes or to prevent cruelty to children or animals
- Tax-exempt trusts under IRC §501 (includes trusts organized as civic leagues, social welfare organizations, chambers of commerce, and social or recreation clubs)
- Charitable remainder trusts (However, the beneficiaries of such trusts are subject to the NIIT rules.)
- Any other trusts, funds, or accounts that are statutorily tax exempt, such as Archer medical savings accounts, health savings accounts, §529 qualified tuition programs, and Coverdell education savings accounts
- Foreign trusts (However, the U.S. beneficiaries of such trusts are subject to the NIIT rules.)

Note. The NIIT rules for estates are generally the same as those for trusts. For more information about the NIIT, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update.

55. Treas. Reg. §1.1411-3(e).
56. Treas. Reg. §1.1411-3(e)(3)(i).
57. Treas. Reg. §1.1411-3(e)(4).

ESTIMATED TAXES

Trusts are responsible for paying estimated taxes using the same rules that apply to individuals, with some exceptions.[58] 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 the prior year's tax. (The trust must pay 110% if the prior year's AGI exceeded $150,000 and less than two-thirds of gross income for the current or prior year is from farming or fishing.)[59] A trust created at death can pay estimated taxes using either the estate tax rules or the trust rules.

For a tax year ending less than two years after the decedent's death, no estimated tax payments are due for a trust that is treated as owned by the decedent if the trust receives the residue of the decedent's estate under the will.[60]

> **Note.** For a thorough explanation of the estimated tax rules for individuals, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 4: Estimated Taxes. This is available at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive/].

Special §643(g) Estimated Tax Election. A unique rule enables a trust that makes unnecessary estimated tax payments during the year (e.g., the trust has no liability because it distributed all its income) to treat such payments as being made by its beneficiaries. The trustee may elect to treat **any portion** of an estimated tax payment made by the trust as paid by a beneficiary.

If the trustee makes this election, **a beneficiary is treated as having received a distribution on the last day of their tax year equal to the taxes deemed paid.** The distribution is treated as an estimated tax payment made by the beneficiary on January 15 of the following year.

This provision applies only if a timely election is filed. The trustee makes the election using Form 1041-T, *Allocation of Estimated Tax Payments to Beneficiaries.* This form must be filed on or before the 65th day after the close of the trust's tax year (i.e., March 6 for most trusts).

Some benefits of making the election are as follows.

1. The amount of income taxed to the trust at high rates can be reduced.
2. The beneficiary may be able to avoid underpayment penalties.

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58. IRC §6654(l)(2)(B).
59. Instructions for Form 1041.
60. IRC §6654(l)(2)(B).

Example 16. A complex trust made estimated tax payments of $300. After the close of the 2014 tax year, the trustee determined that the trust received only $1,000 of dividend income and distributed $400. The trust's tax liability is only $75, calculated as follows.

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

The trust elects to treat the $225 overpayment in taxes as a distribution to the beneficiary by filing Form 1041-T within 65 days after the close of the tax year. The trust's estimated tax payments are reduced to $75 ($300 estimated payments − $225 deemed distribution), and its tax liability is reduced to $41, as shown in the following table. The beneficiary treats the $225 deemed distribution as an estimated tax payment made on January 15, 2015.

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

Caution. This election cannot be used to allocate tax **withholding** to beneficiaries.

DISTRIBUTIONS

A critical presumption in fiduciary taxation is that all distributions (other than specific bequests) represent current trust income, or FAI, to the extent that the distribution does not exceed FAI. 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 are tax free because the beneficiary is simply receiving the gifted or inherited property that would have been nontaxable if the property had been received directly. Distributions of the previously taxed income are tax free because the income has already been subject to tax at the trust level.

Three basic principles underlie the statutory framework of IRC §§651 and 661.

1. Total taxable income of the trust must be identified, and it is taxed only once.
2. The total taxable income is taxed to either the trust 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. (That is, the amount of the deduction should be the same as the total taxable income reported to the beneficiary on the Schedule K-1.)

Requirements to Distribute Income

The determination of whether trust income must be distributed currently depends on the terms of the trust instrument and the applicable state law.[61] As discussed previously, a simple trust must distribute current income. If the trust instrument provides that, when determining distributable income, a reasonable amount of the current income must be retained for depreciation or other purposes, this does not disqualify a trust from being considered a simple trust.[62]

A complex trust may also be required to distribute income if that requirement is part of the trust instrument. However, the amount to be distributed is not required to be specified in the trust instrument.[63] The exact amount can be left up to the fiduciary's discretion to allocate among classes of beneficiaries or named beneficiaries.

> **Note.** Distributions are discussed in more detail later.

DETERMINING TAXABLE INCOME

IRC §641(b) provides that a trust's taxable income is calculated in the same manner as that of an individual, modified by §§641–644. The **tax formula** follows.

	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

61. Treas. Reg. §1.651(a)-2.
62. Ibid.
63. Ibid.

Although this formula suggests otherwise, trusts generally are not required to distinguish between deductions for and from AGI.[64] A trust is not allowed a standard deduction, and any deductible items are itemized and subtracted from gross income to arrive at taxable income. Indeed, AGI, a familiar term on individual returns, cannot be found on Form 1041.[65]

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 trusts. For this reason, IRC §67(e) indicates what deductions are considered in determining AGI for these purposes. These rules effectively produce the formula given previously, although it never appears in such form on the return.

Gross Income in General

Gross income is determined in the same manner as gross income of an individual. It typically includes the following components.

- Dividends
- Interest
- Rents
- Royalties
- Income from partnerships, S corporations, and other trusts or estates
- Gains from the sale or exchange of property (capital gains)
- Income of a trade or business

Related-Party Transactions

Losses are not **recognized** by a trust because a loss deduction is disallowed for related parties.[66] Fiduciaries and beneficiaries are considered related parties in a trust.[67] If a trust sustains a loss and the property is later sold by the beneficiary for a gain, the beneficiary recognizes a gain only to the extent that it exceeds the amount of the loss previously disallowed.[68]

Example 17. The Kelly Trust has a basis in Green Acre of $100,000 when it distributes the property to the beneficiary, Jade. At the time Green Acre is distributed, it has a FMV of $80,000. The trust's tentative distribution deduction is $100,000.

The trust is not allowed to claim a loss on the distribution because of the related-party rules. The disallowed loss is $20,000 ($100,000 − $80,000).

Two years after the trust distributes the property to Jade, she sells Green Acre for $105,000. Jade has a gain of $5,000, calculated as follows.

Sales price	$105,000
Less: basis ($80,000 FMV at time of distribution + $20,000 disallowed loss)	(100,000)
Recognized gain	$ 5,000

64. See Form 1041.

65. 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 is governed by IRC §67(e).

66. IRC §267.

67. IRC §267(b) .

68. IRC §§267(b) and (d) .

Deductions in General

Trusts 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[69]
- Expenses incurred in connection with the production or collection of income, as well as the management, conservation, or maintenance of property[70]
- Expenses in connection with the determination, collection, or refund of any tax[71]

Like the deductions for individuals, these deductions for trusts may be limited (e.g., reduced to the extent they are allocable to tax-exempt income).

Charitable Contributions

A charitable contribution deduction is available to a trust only if the underlying trust instrument requires the fiduciary to give part of the trust's gross **income** to a charity.[72] A clause in a will bequeathing an amount to a charity does not create a charitable contribution deduction.

> **Observation.** Distributions to a charitable beneficiary are not considered part of the distribution deduction. Instead, distributions to a charitable beneficiary are accounted for as charitable contributions. Charitable contributions are reported on Form 1041, Schedule A, line 1.

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

Qualified Donee. The recipient of a contribution 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.[73]

Source of Contribution. A deduction is allowed only for contributions of gross taxable income. Charitable contributions from tax-exempt income are not deductible. For this purpose, a contribution is deemed to consist of a proportion of each type of income the trust receives, including tax-exempt income.[74] Thus, if a trust's income is 60% tax exempt, then 60% of any charitable contribution is not deductible.

> **Observation.** It may be possible to circumvent the limitation. For example, if the trust instrument is drafted in such a way that contributions can only be made from taxable income (if any), the contribution arguably will not consist of any tax-exempt income and will be fully deductible. Moreover, there is economic substance to this approach because the charity will not receive a distribution unless the trust has taxable income.
>
> Similarly, the trust instrument may contain a provision that specifies that tax-exempt income is distributed to taxable beneficiaries and that all payments to charities be made from taxable gross income. Alternatively, the instrument might provide that any distributions to a charity are 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). (That is, the allocation will only be recognized if the provision has significant nontax consequences.)

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69. IRC §162.
70. IRC §212.
71. Ibid.
72. IRC §642(c)(1).
73. IRC §642(c)(1), referencing IRC §170(c)(2)(A).
74. Treas. Reg. §1.643(a)-5(b).

Set Asides for Future Contributions. No deduction is allowed for contributions of trust corpus — only for contributions of income. 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 not permitted for trusts created after October 9, 1969.[75]

Throwback Election. If a contribution is paid after the close of the tax year but before the close of the next tax year, the trustee may elect to deduct the payment in the preceding year.[76] This rule enables a trust to determine the amount of income for the year that may be available for contributions, to make the contribution in the following year, and to get a deduction for the previous year. The election is irrevocable and must be made by the extended due date of the tax return for the succeeding year. Information that should be included in the election is specified in Treas. Reg. §1.642(c)-1(b)(3).

Contributions of Remainder Interests. Contributions of remainder interests or income interests to a charitable organization must meet special rules to qualify for deduction.[77] Special problems exist (beyond the scope of this material) if a trust 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.

Itemized Deductions

The standard deduction available to individual taxpayers is not available to trusts. Trusts must itemize all deductions. Moreover, the phaseout in total itemized deductions does not apply to trusts.[78]

Miscellaneous Itemized Deductions. Trusts, like individuals, are subject to limitations on the deduction of miscellaneous itemized deductions (MID). These deductions are allowed only to the extent that they exceed 2% of the trust's AGI.[79] Special rules are used for trusts and estates to determine whether a deduction is classified as an MID. Under IRC §67(e), deductions **avoid** MID status if they are:

- Incurred in the administration of the trust, and
- Would not have been incurred if the property were not held in the trust.[80]

The expense must be unique to the trust. For example, trustee fees are not considered MIDs and are not subject to the 2% limitation because they meet both of the previous tests. Expenses that are **not** subject to the 2% limitation and deductible in arriving at AGI include the following.

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

75. IRC §§642(c)(2) and (3).
76. IRC §642(c)(1); Treas. Reg. §1.642(c)-1(b)(2) and (3).
77. See IRC §664.
78. IRC §68(e).
79. IRC §67(e).
80. IRC §67(e) extends the exemption from the limitation by making the expenses deductible for AGI.

Determination of Limitation Amount. Calculating the limitation on MIDs can be quite complicated. Because the AGI of the trust depends on the amount of the distribution deduction and the distribution deduction in turn depends on taxable income after taking MIDs into account, calculating allowable MIDs may require using simultaneous algebraic equations. The instructions for Form 1041 explain how to make this calculation.

Exemptions

As mentioned earlier, trusts are allowed an exemption in calculating taxable income.[81] The phaseout rules that apply to individuals do not apply to trusts. The exemption for a trust depends on whether the trust is required to distribute all its income for the year.

- The exemption for a simple trust is $300. As mentioned earlier, a simple trust is one that is required to distribute all its income currently and is prevented by the trust instrument from making charitable contributions.
- If a trust that is required to distribute all its income annually is allowed to make charitable contributions, it is not a simple trust. Even so, it is still entitled to a $300 exemption.[82]
- A qualified disability trust is entitled to an exemption equal to that for an individual ($4,000 for 2015).[83]

> **Note.** Qualified disability trusts are not covered in this chapter. More information about these trusts can be found in the instructions for Form 1041 and the 2010 *University of Illinois Federal Tax Workbook,* Chapter 7: Estate and Trust Taxation. The chapter is available at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

- All other trusts are allowed an exemption of $100 per year. Most complex trusts are entitled to a $100 exemption.

> **Note.** The exemption amounts for simple trusts and complex trusts are not subject to an annual inflation adjustment. The exemption for a qualified disability trust (QDT) is the same amount as the personal exemption for the tax year (which is subject to an annual inflation adjustment). The QDT exemption amount is phased out when the QDT's modified AGI exceeds a certain level. For the definition of a QDT and details of the exemption phaseout, see the Form 1041 instructions.

Tax-Exempt Income and Expenses

Trusts cannot deduct expenses related to tax-exempt income.[84] If a trust has both taxable and tax-exempt income, expenses that are directly related to the production of tax-exempt income are not deductible. Indirect expenses that are related to both taxable and tax-exempt income must be allocated.[85] Common examples of indirect expenses include the following.[86]

- Trustee commissions
- Rental of safe deposit boxes
- State income and personal property taxes

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81. IRC §642(b).
82. Treas. Reg. §1.642(b)-1(b).
83. Rev. Proc. 2014-61, 2014-47 IRB 860 and IRC §642(b)(2)(C).
84. IRC §265(a)(1).
85. Treas. Reg. §1.652(b)-3.
86. Treas. Reg. §1.652(b)-3(b).

The allocation of expenses should be calculated using a reasonable method based on the facts and circumstances of each case. One permissible method allocates expenses using the ratio of tax-exempt income to total income.[87]

$$\textbf{\% Expenses not deductible against taxable income} = \frac{\textbf{Tax-exempt income}}{\textbf{Total income}}$$

Example 18. In 2015, the Swanson Family Trust earns $25,000 of interest on municipal bonds, $10,000 of interest on CDs, and $15,000 of rental income. Thus, the trust's total income is $50,000 ($25,000 + $10,000 + $15,000). The interest earned on the municipal bonds is tax exempt.

The trust incurs accounting fees of $6,000. Using the preceding formula, 50% of the expenses are not deductible against taxable income ($25,000 tax-exempt income ÷ $50,000 total income). Therefore, $3,000 ($6,000 × 50%) of the accounting fees are allocated to tax-exempt income and are nondeductible.

Excess Deductions

A trust that operates a trade or business or that has an interest in a partnership or S corporation that experiences losses may have a net operating loss (NOL). Trusts are entitled to an NOL deduction.[88] 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 IRC §172.

When calculating a trust 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** — is generally lost. However, if the trust has deductions that exceed gross income in the last tax year of the trust (the year of termination), the excess flows through to the beneficiaries.[89] 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 considered in calculating the NOL to pass through to the beneficiaries. However, it is important to note that **this rule only applies to deductions incurred in the year of termination.**[90]

Year of Termination. Upon termination of a trust, IRC §642(h) allows beneficiaries to receive some or all of the entity's capital loss and NOL carryovers, as well as any excess deductions.

The capital loss and NOL carryovers that were not used as of the termination year do not expire. Instead, they pass through to the beneficiaries even if they did not arise in the year of termination.[91] Any capital loss carryovers that flow through to individual beneficiaries may be used by those individuals until the carryovers are exhausted. Corporate beneficiaries may only use capital loss carryovers for five years.

NOL deductions may be carried forward for 20 years. For NOLs passing out of the trust to beneficiaries, the final year of the trust and the first year of the beneficiary are counted as separate tax years. If the beneficiary dies before using the NOL or capital loss carryovers, the carryovers are lost.

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

88. IRC §§642(d) and 172.

89. IRC §642(h)(2).

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

91. Treas. Reg. §1.642(h)-1(a).

A beneficiary may report their share of excess deductions as a miscellaneous itemized deduction. Consequently, the 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 year ends. If the sum of the excess deductions and the beneficiary's other deductions exceeds the beneficiary's income, **the excess deductions do not create an NOL** and therefore cannot be carried backward or forward.[92]

Example 19. In 2015, the Grand Trust terminated. For its final year, the trust had nonbusiness income of $50,000 and legal fees of $100,000. The excess deductions of $50,000 ($50,000 – $100,000) pass through to the beneficiary, Matt, who can claim the $50,000 as a miscellaneous itemized deduction. The $50,000 of excess deductions would be wasted if this were not the year of termination. In addition, if the $50,000 itemized deduction exceeds Matt's income, the excess cannot be carried forward or backward.

Nonbusiness expenses, such as the legal fees in **Example 19,** 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 trust could postpone paying legal fees until the final year.

Observation. Careful timing of income and expenses may allow deductions to offset trust income and may avoid excess deductions on termination.

Example 20. The Haven 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 trust's NOL and excess deductions are calculated 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)

Because this is the year of termination, the NOL and the excess deductions pass to Jerry as the beneficiary of the property. Jerry is entitled to an NOL deduction of $2,000. He is also entitled to a miscellaneous itemized deduction for the excess deductions of $7,300.

If this were not the year of termination, the trust would carry the NOL forward to be used in future years. The excess deductions would be lost.

92. Treas. Reg. §1.642(h)-2(a).

DEDUCTION FOR DISTRIBUTIONS

After the amount of taxable income has been determined, it must be allocated between the trust and the beneficiaries. The purpose of Subchapter J is that the **income recognized by the fiduciary entity is taxed to the fiduciary itself or its beneficiaries but not to both.** Determining the amount of income taxable to each depends on the amount of annual distributions from the fiduciary.

DISTRIBUTABLE NET INCOME

The rules that govern calculation of the distribution deduction contained in IRC §§651 and 661 presume that all distributions made by the fiduciary entity 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. The amount of current taxable and nontaxable income that the trust can distribute is the **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.

> **Example 21.** This year, the Abby Trust reported $80,000 of dividend income and $20,000 of tax-exempt interest. It distributed $40,000. How much of the distribution is deductible by the trust, and how much is taxable to the beneficiary?
>
> Amounts distributed are considered DNI. The trust receives a deduction for the taxable DNI it distributes, 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. The total DNI is $100,000, 80% of which is taxable ($80,000 ÷ $100,000) and 20% of which is nontaxable ($20,000 ÷ $100,000).
>
> 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). The balance of $8,000 (20% × $40,000) is nontaxable.
>
> The beneficiary has $32,000 of taxable income and $8,000 of nontaxable income. Therefore, the trust's deduction of $32,000 (the amount of its taxable income it is allocating to the beneficiary) is equal to the amount of taxable income received by the beneficiary and reported on Schedule K-1.

In computing DNI, it is generally irrelevant whether expenses are allocated to income or corpus.

DNI is calculated on page 2 of Form 1041, Schedule B. The calculation is represented by the following formula.

	Adjusted total income (taxable income before distribution deduction and exemption) (line 17 of Form 1041)
+	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

Example 22. Use the same facts as **Example 14,** which are repeated here for convenience. On March 7, 2014, Grant established a trust for his son, Benny. According to the terms of the trust instrument, a reserve for depreciation of $5,000 must be maintained. In addition, 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 2014, the trust made a charitable contribution of $20,000 from income, and the trustee distributed $85,000 to Benny. Given the following information, 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

Taxable income **before** the distribution deduction is calculated 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 tax-exempt income ÷ $125,000 total income excluding capital gains) × $8,000)

[b] $20,000 − (($10,000 tax exempt income ÷ $125,000 total income excluding capital gains) × $20,000)

DNI is calculated as follows.

Taxable income before distribution deduction		$124,140
Exemption		100
Adjusted total income		$124,240
Less: long-term capital gain		(50,000)
Plus: net tax-exempt interest:		
Tax-exempt interest	$10,000	
Allocable trustee commissions	(640) [a]	
Allocable charitable contribution	(1,600) [b]	
Net tax-exempt income	$ 7,760	7,760
DNI		$ 82,000

[a] (($10,000 tax-exempt income ÷ $125,000 total income excluding capital gains) × $8,000)

[b] (($10,000 tax-exempt income ÷ $125,000 total income excluding capital gains) × $20,000)

Under §661(a), the trust is allowed a deduction for the FAI 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, which is calculated as follows.

DNI		$82,000
Less: net tax-exempt interest		
Tax-exempt interest	$10,000	
Allocable trustee 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 net 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 for distributions is calculated by subtracting the net tax-exempt income from total DNI.

The taxable income for the trust is $49,900, calculated as follows.

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

Observation. A charity is a beneficiary of a trust in the sense that it receives distributions. However, 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 the following Form 1041.)

For Example 22

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts **2014** OMB No. 1545-0092
▶ Information about Form 1041 and its separate instructions is at *www.irs.gov/form1041.*

A Check all that apply:
- ☐ Decedent's estate
- ☐ Simple trust
- ☒ Complex trust
- ☐ Qualified disability trust
- ☐ ESBT (S portion only)
- ☐ Grantor type trust
- ☐ Bankruptcy estate-Ch. 7
- ☐ Bankruptcy estate-Ch. 11
- ☐ Pooled income fund

For calendar year 2014 or fiscal year beginning , 2014, and ending , 20

Name of estate or trust (If a grantor type trust, see the instructions.)
Benny Diego Trust

Name and title of fiduciary
Amanda DePanda

Number, street, and room or suite no. (If a P.O. box, see the instructions.)
955 Compton St.

City or town, state or province, country, and ZIP or foreign postal code
Indianapolis, IN 46201

C Employer identification number
35-0123456

D Date entity created
03/07/2014

E Nonexempt charitable and split-interest trusts, check applicable box(es), see instructions.
☐ Described in sec. 4947(a)(1). Check here if not a private foundation . . . ▶ ☐
☐ Described in sec. 4947(a)(2)

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

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

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

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	Net operating loss deduction (see instructions)	15b	
	c	Allowable miscellaneous itemized deductions subject to the 2% floor	15c	
	16	Add lines 10 through 15c ▶	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 instructions	22	49,900
	23	**Total tax** (from Schedule G, line 7)	23	10,898
	24	**Payments: a** 2014 estimated tax payments and amount applied from 2013 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 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 instructions)	26	
	27	**Tax due.** If line 25 is smaller than the total of lines 23 and 26, enter amount owed	27	10,898
	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 2015 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 Use Only
Print/Type preparer's name | Preparer's signature | Date | Check ☐ if self-employed | PTIN
Firm's name ▶ | Firm's EIN ▶
Firm's address ▶ | Phone no.

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11370H Form **1041** (2014)

For Example 22

Form 1041 (2014) 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 instructions)	1	20,000
2	Tax-exempt income allocable to charitable contributions (see 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 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 instructions)	1	124,240
2	Adjusted tax-exempt interest	2	7,760
3	Total net gain from Schedule D (Form 1041), line 19, column (1) (see 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 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	
11	Total distributions. Add lines 9 and 10. If greater than line 8, see 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 instructions)

1	**Tax:** a Tax on taxable income (see instructions)	1a	8,998		
	b Tax on lump-sum distributions. Attach Form 4972	1b			
	c Alternative minimum tax (from Schedule I (Form 1041), line 56)	1c			
	d **Total.** Add lines 1a through 1c ▶			1d	8,998
2a	Foreign tax credit. Attach Form 1116	2a			
b	General business credit. Attach Form 3800	2b			
c	Credit for prior year minimum tax. Attach Form 8801	2c			
d	Bond credits. Attach Form 8912	2d			
e	**Total credits.** Add lines 2a through 2d ▶			2e	
3	Subtract line 2e from line 1d. If zero or less, enter -0-			3	8,998
4	Net investment income tax from Form 8960, line 21			4	1,900
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 3 through 6. Enter here and on page 1, line 23 ▶			7	10,898

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	X	
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?		X
3	At any time during calendar year 2014, 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?		X
	See the instructions for exceptions and filing requirements for FinCEN Form 114. 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 instructions		X
5	Did the estate or trust receive, or pay, any qualified residence interest on seller-provided financing? If "Yes," see the instructions for required attachment		X
6	If this is an estate or a complex trust making the section 663(b) election, check here (see instructions) ▶ ☐		
7	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here (see instructions) ▶ ☐		
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 instructions		X

Form **1041** (2014)

Observations for Example 22

1. Because the trust's taxable income of $49,900 is less than its net capital gain of $50,000, all the income is taxed at favorable capital gains rates.[93]

2. The $50,000 capital gain is subject to the 3.8% NIIT (discussed earlier). The NIIT is shown on line 4 of Schedule G.

Capital Gains

Capital gains are ordinarily excluded from DNI and are not considered paid, credited, or required to be distributed to any beneficiary.[94] However, capital gains are included in DNI to the extent they are allocated to one of the following.[95]

1. Income (However, if income under the applicable state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate capital gains to income must be exercised **consistently.** The amount so allocated may not be greater than the excess of the unitrust amount over the amount of DNI.)

2. Corpus, but **consistently** treated by the fiduciary on the trust's books, records, and tax returns as part of the distribution to a beneficiary

3. Corpus, but actually distributed to a beneficiary or used by the fiduciary in determining the amount distributed or required to be distributed to a beneficiary

Under option 3, capital gains can be included in DNI when the fiduciary uses the capital gains to determine the amount of the distribution. A trustee who intends to include capital gains in the distribution to beneficiaries should document the decision prior to making the distribution.

Example 23. The Rally Trust's assets include Blackacre and other property. The trust instrument states that Bessie, the trustee, must hold Blackacre for 10 years. She must then sell it and distribute all the sales proceeds to Wilbur, the beneficiary. Because Bessie uses the sales proceeds (including any realized capital gains) to determine how much is distributed to Wilbur, any capital gain realized from the sale of Blackacre is included in Rally Trust's DNI for the tax year.

Note. Treas. Reg. §1.643(a)-3 contains several examples that illustrate the rules pertaining to the inclusion of capital gains in DNI.

Including capital gains in DNI under any of the three alternatives must be done either:

1. In accordance with the terms of the trust instrument and applicable local law, or

2. In accordance with a reasonable and impartial exercise of discretion by the fiduciary.[96]

Capital gains that are paid, permanently set aside, or used for charitable contributions must also be included in the calculation of DNI.[97]

Planning Tip. A trust may want to treat a distribution to a beneficiary as including capital gains if the beneficiary is in a lower tax bracket than the trust or if the beneficiary has capital losses that offset capital gains. There is an added incentive to distribute the capital gains to beneficiaries because the 20% capital gains rate applies to 2015 income exceeding $413,200 for single taxpayers and $464,850 for MFJ taxpayers, whereas the limit is $12,300 for trusts.

93. See IRC §1(h)(1).

94. Treas. Reg. §1.643(a)-3(a).

95. Treas. Reg. §1.643(a)-3(b).

96. Ibid.

97. Treas. Reg. §1.643(a)-3(c).

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. Both provisions require the beneficiary to include only the taxable amount received in income. (As mentioned earlier, DNI also includes nontaxable income and nondeductible expenses.)

ALLOCATION OF DNI AMONG BENEFICIARIES

In certain situations, a trust distributes 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 DNI is allocated to the beneficiaries based on the relative amounts of distributions that each receives.

Example 24. A trust has dividend income of $50,000 and $10,000 of trustee commissions allocable to corpus. FAI is $50,000, and DNI is $40,000 ($50,000 – $10,000).

During the year, the trust made distributions of $30,000 to Adam and $20,000 to Bettie. Because the DNI of $40,000 does not cover all the distributions, it must be allocated between the beneficiaries based on the amount of FAI received by each. As a result, Adam is deemed to receive DNI of $24,000 (($30,000 Adam's distribution ÷ $50,000 total distributions) × $40,000 DNI), and Bettie is deemed to receive DNI of $16,000 (($20,000 Bettie's distribution ÷ $50,000 total distributions) × $40,000 DNI).

The amounts that Adam and Bettie received in excess of DNI represent either corpus or accumulated income. These amounts are normally nontaxable.

Tier System for DNI Allocation

The rights of some beneficiaries to income may take precedence over the rights of others. (Some are required to receive distributions, while others receive only discretionary distributions.) To accommodate this, the distribution rules provide priorities for allocating DNI and therefore the amounts of taxable and nontaxable income allocable to the beneficiaries.

The Code establishes a **tier system** to allocate DNI. DNI (calculated without regard to the charitable contribution deduction) is first allocated to the beneficiaries who are **required** to receive distributions currently — the **first-tier beneficiaries.**[98] DNI is allocated based on each beneficiary's pro-rata share of the first-tier distributions.[99]

After DNI is allocated to the first-tier beneficiaries, any remaining DNI is allocated to charitable contributions.

After reducing DNI by the first-tier distributions and charitable contributions, any remaining DNI is allocated to the **second-tier beneficiaries** (those who receive discretionary distributions). The allocation is based on each beneficiary's pro-rata share of the second-tier distributions.

98. IRC §662(a)(1).

99. IRC §662(a)(2).

Example 25. A trust has DNI of $60,000. It did not make any charitable contributions. During the year, the trust made required distributions of $30,000 to Alex and $10,000 to Brittany. In addition, the trustee made discretionary distributions of $40,000 to Alex and $20,000 to Brittany.

DNI is allocated as follows.

			Alex		Brittany	Total
Required distributions			$30,000		$10,000	$ 40,000
Discretionary distributions			40,000		20,000	60,000
Total distributions			$70,000		$30,000	$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	13,333 [a]		6,667 [b]		
DNI received (taxable income)		$43,333	(43,333)	$16,667	(16,667)	
Nontaxable distribution of corpus			$26,667		$13,333	

[a] $\$20{,}000 \text{ second-tier DNI} \times \frac{\$40{,}000 \text{ Alex's second-tier distribution}}{\$60{,}000 \text{ total second-tier distributions}} = \$13{,}333$

[b] $\$20{,}000 \text{ second-tier DNI} \times \frac{\$20{,}000 \text{ Brittany's second-tier distribution}}{\$60{,}000 \text{ total second-tier distributions}} = \$6{,}667$

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. On the other hand, the charity 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.[100] The limitation does not apply to second-tier beneficiaries.[101]

DISCRETIONARY DISTRIBUTIONS: 65-DAY RULE

A complex trust can elect under IRC §663(b) to treat any distribution to a beneficiary made during the first 65 days of a tax year as an amount paid or credited on the last day of the previous tax year. The election is irrevocable for the tax year and is effective only for the year of the election.[102]

The maximum amount of these so-called "throwback distributions" is limited to the prior year's trust income (or DNI if larger) reduced by distributions. This amount is determined using the following formula.

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

100. IRC §661(a)(1).

101. IRC §661(a)(2).

102. Treas. Reg. §§1.663(b)-1 and 1.663(b)-2.

Example 26. Karly receives distributions from a trust at the discretion of the trustee, Caleb. Shortly after the beginning of 2015, Caleb determined that the trust had income of $10,000 and DNI of $8,000 for 2014. A review of the distributions made in 2014 revealed that $5,500 was distributed on January 15, 2014. Caleb elected to treat this $5,500 as distributed in 2013, and $6,000 was distributed on August 12, 2014. The maximum amount of 2015 distributions that Caleb can treat as having been distributed in 2014 is calculated as follows.

3

Throwback year 2014: larger of trust income ($10,000) or DNI ($8,000)	$10,000
Amounts paid in throwback year 2014 (except that which was thrown back to 2013)	(6,000)
Maximum amount that can be thrown back from 2015 to 2014 and deducted in 2014	$ 4,000

The trust can distribute an additional $4,000 within the first 65 days of 2015 and deduct that amount for 2014. If the trust distributes $4,000 during 2015 and makes the election, Karly must appropriately account for the $4,000 on her 2014 tax return.

The 65-day rule only applies to complex trusts. The rule does not apply to simple trusts because all income of simple trusts is **deemed to be distributed, regardless of whether it actually is.**

The §663(b) election must be made by the extended due date of the trust return. The election is made by checking the box on line 6 of Form 1041.

7 Total tax. A... through ... page 1, line 23 . . . . . . ▶ 7

	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 ▶ $		
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 2014, did the estate or trust have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country? . . . . See the instructions for exceptions and filing requirements for FinCEN Form 114. If "Yes," enter the name of the foreign country ▶		
4	During the tax year, did the estate or trust receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the estate or trust may have to file Form 3520. See instructions		
5	Did the estate or trust receive, or pay, any qualified residence interest on seller-provided financing? If "Yes," see the instructions for required attachment		
6	If this is an estate or a complex trust making the section 663(b) election, check here (see instructions) . . ▶ ☒		
7	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here (see instructions) . . ▶ ☐		
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 instructions		

Form **1041** (2014)

The §663(b) election need not be made for all distributions made during the 65-day period — only for whatever amount the trust specifies (subject to the preceding limitations). Once made, the election is irrevocable.

SPECIFIC GIFTS AND BEQUESTS

A trustee may list specific gifts and bequests within a trust instrument. The trust instrument may list an organization or person as a beneficiary of a specific piece of property, dollar amount, or percentage of the trust balance.

GAIN AND LOSS

A trust does not recognize gain or loss when specific property is distributed via gift or bequest. A property distribution is treated as a gift or bequest of specific property if it is distributed all at once or in **no** more than three installments.[103]

However, gain or loss is realized by the trust when there is a distribution of property **in kind** if the distribution satisfies a right to receive:[104]

- A specific dollar amount distribution,
- Specific property other than that distributed, or
- Income if the income is required to be distributed currently.

The beneficiary acquires a basis equal to the trust's adjusted basis immediately before the transfer, adjusted for any gain or loss recognized by the trust.[105] The amount of the trust's distribution deduction and the amount includable in the beneficiary's gross income **is the lesser of the beneficiary's basis in the property or the FMV of the property.**[106] The amount of gain or loss is calculated as the difference between the amount of the bequest satisfied and the trust's basis in the distributed property.[107]

Election to Realize Gain or Loss

A gain or loss is realized by the trust on an in-kind distribution if the trustee elects under §643(e)(3) to recognize a gain or loss. The gain or loss is calculated as if the property were sold to the beneficiary at FMV.[108] The election applies to all distributions made by the trust during the tax year and may be revoked only with the consent of the IRS.[109]

103. IRC §663(a)(1).

104. Treas. Reg. §1.661(a)-2(f).

105. IRC §643(e)(1).

106. IRC §643(e)(2).

107. *W. R. Kenan, Jr. v. Comm'r,* 114 F.2d 217 (2nd Cir.1940); Rev. Rul. 66-207, 1966-2 CB 243.

108. IRC §643(e)(3)(A)(ii).

109. IRC §643(e)(3)(B).

IRC §645 ELECTION

Under IRC §645, a qualified revocable trust can be treated and taxed for income tax purposes as part of an estate (not as a separate trust) if both the executor of the estate and the trustee elect this treatment. If the election is made, only one tax return has to be filed, and the trust income is reported using the estate's fiscal yearend.

The election must be made by the due date (including extensions) of Form 1041 for the first tax year of the estate (or the filing trust) and is irrevocable. This due date is generally the 15th day of the 4th month after the close of the first tax year of the estate.[110] The due date applies even if the combined related estate and electing trust do not have sufficient income to require filing a Form 1041.

The election is made by filing Form 8855. Line G of Form 1041 should be checked to indicate that the trust made a §645 election.

Example 27. In 2000, Marcus Wellstone was concerned about his health and wanted to make sure his assets would be properly managed if he became incompetent. On the advice of his attorney, accountant, and family, he set up a revocable living trust that named his son and accountant as co-trustees. The trust instrument specifies that upon Marcus's death, the trust is to distribute half the trust assets to his son, Thomas, and the other half to his daughter, Sara.

Marcus passed away on January 4, 2014. After consulting with Marcus's attorney and accountant, Thomas, who is the executor, decided to elect under IRC §645 to merge the estate and the grantor trust.

Following is a summary of the Forms 1099 received for 2014.

	Total	Trust Income	Estate Income
Trust dividends	$35,000	$35,000	
Interest	14,500	10,000	$4,500

The §645 election is made by filing Form 8855. The combined 2014 trust and estate income is reported on one Form 1041. These forms follow.

110. Instructions for Form 8855.

For Example 27

Form **8855**
(Rev. January 2009)
Department of the Treasury
Internal Revenue Service

Election To Treat a Qualified Revocable Trust as Part of an Estate

OMB No. 1545-1881

Part I **Estate (or Filing Trust) Information**

Name of estate (or the filing trust, if applicable (see instructions)) **Estate of Marcus Wellstone**	**Employer identification number** (see instructions) **37 - 1234567**
Name of executor (or the filing trustee, if applicable) **Thomas Wellstone**	Type of entity prior to the election: ☒ Domestic estate ☐ Foreign estate ☐ Domestic trust ☐ Foreign trust
Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address) **123 N. Silver Street**	
City or town, state, and ZIP code (if a foreign address, see instructions) **Tampa, FL 33601**	Date of executor's appointment

Under penalties of perjury, I, as executor (or filing trustee):

- Confirm that under applicable local law or the governing document, I have the authority to make this election for the estate (if executor) or trust (if filing trustee) and to agree to the conditions of the election;
- Elect the treatment provided under section 645 for the above-named estate (or filing trust, if applicable);
- Confirm that an agreement has been reached with the trustees of each qualified revocable trust (QRT) joining in the election to allocate the tax burden of the combined electing trusts and related estate, if any, for each tax year during the election period in a manner that reasonably reflects each entity's tax obligation;
- Agree to ensure that the related estate's (or filing trust's, if applicable) share of the tax obligations of the combined electing trust(s) and related estate, if any, is timely paid to the United States Treasury;
- Agree to accept responsibility for filing a complete, accurate, and timely income tax return, when required by law, for the combined electing trust(s) and related estate, if any, for each tax year during the election period;
- (If I am the filing trustee) confirm that if there is more than one QRT making this election, that I have been appointed by the trustees of each QRT making this election to be the filing trustee and I agree to accept the responsibility of filing the appropriate income tax return for the combined electing trust(s) for each tax year during the election period and all other responsibilities of the filing trustee;
- (If I am the filing trustee) represent that no executor has been appointed for a related estate and to the best of my knowledge and belief, one will not be appointed;
- (If I am the filing trustee) agree that, if an executor is appointed for the related estate after this Form 8855 is filed, that I will complete and file an amended Form 8855 if the late appointed executor agrees to the election, and I agree to cooperate with the executor in filing any amended returns required to be filed as a result of the executor's appointment; and
- Confirm to the best of my knowledge and belief, that all information contained in this election and any accompanying statements or schedules is true, correct, and complete.

Signature of executor (or filing trustee)	Date

Part II **Decedent Information**

Name of decedent	SSN of the decedent	Date of death
Marcus Wellstone	**555 - 44 - 3333**	**01/04/2014**

For Paperwork Reduction Act Notice, see page 4. Cat. No. 24542R Form **8855** (1-2009)

For Example 27

Form 8855 (1-2009) Page **2**

Part III **Qualified Revocable Trust Information**

Name of trust	Employer identification number (see instructions)
Wellstone Revocable Trust	**37 7654321**
Name of trustee	
Thomas Wellstone	
Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)	
123 N. Silver Street	
City or town, state, and ZIP code (if a foreign address, see instructions)	
Tampa, FL 33601	

Under penalties of perjury, I, as trustee of the above-named trust:

- Confirm that under applicable local law or the governing instrument, I have the authority to make this election for the trust and to agree to the conditions of the election;
- Elect the treatment provided under section 645 for this trust;
- Agree to timely provide the executor (or filing trustee if there is no executor) with all the trust information necessary to permit the executor (or filing trustee, if applicable) to file a complete, accurate, and timely Form 1041 (or Form 1040-NR for a foreign estate) for the combined electing trust(s) and the related estate, if any, for each tax year during the election period;
- Confirm that an agreement has been reached with the trustees of each QRT joining in the election, and the executor of the related estate, if any, to allocate the tax burden of the combined electing trust(s) and related estate, if any, for each tax year during the election period in a manner that reasonably reflects each entity's tax obligation;
- Agree to ensure that this trust's share of the tax obligations of the combined electing trust(s) and related estate, if any, is timely paid to the United States Treasury;
- Confirm that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855, the trustee that completed Part I has been appointed the filing trustee, and to the best of my knowledge and belief, an executor has not been appointed to administer a related estate and one will not be appointed;
- Agree that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855 and an executor is appointed for the related estate after this Form 8855 is filed, that I will complete and file an amended Form 8855 if the later appointed executor agrees to the election, and I agree to cooperate with the executor in filing any amended returns required to be filed as a result of the executor's appointment; and
- Confirm to the best of my knowledge and belief, that all information of the electing trust contained in this election and any accompanying statements or schedules is true, correct, and complete.

Signature of trustee	Date

Name of trust	Employer identification number (see instructions)
Name of trustee	
Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)	
City or town, state, and ZIP code (if a foreign address, see instructions)	

Under penalties of perjury, I, as trustee of the above-named trust:

- Confirm that under applicable local law or the governing instrument, I have the authority to make this election for the trust and to agree to the conditions of the election;
- Elect the treatment provided under section 645 for this trust;
- Agree to timely provide the executor (or filing trustee if there is no executor) with all the trust information necessary to permit the executor (or filing trustee, if applicable) to file a complete, accurate, and timely Form 1041 (or Form 1040-NR for a foreign estate) for the combined electing trust(s) and the related estate, if any, for each tax year during the election period;
- Confirm that an agreement has been reached with the trustees of each QRT joining in the election, and the executor of the related estate, if any, to allocate the tax burden of the combined electing trust(s) and related estate, if any, for each tax year during the election period in a manner that reasonably reflects each entity's tax obligation;
- Agree to ensure that this trust's share of the tax obligations of the combined electing trust(s) and related estate, if any, is timely paid to the United States Treasury;
- Confirm that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855, the trustee that completed Part I has been appointed the filing trustee, and to the best of my knowledge and belief, an executor has not been appointed to administer a related estate and one will not be appointed;
- Agree that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855 and an executor is appointed for the related estate after this Form 8855 is filed, that I will complete and file an amended Form 8855 if the later appointed executor agrees to the election, and I agree to cooperate with the executor in filing any amended returns required to be filed as a result of the executor's appointment; and
- Confirm to the best of my knowledge and belief, that all information of the electing trust contained in this election and any accompanying statements or schedules is true, correct, and complete.

Signature of trustee	Date

Form **8855** (1-2009)

For Example 27

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts 2014 OMB No. 1545-0092
▶ Information about Form 1041 and its separate instructions is at *www.irs.gov/form1041.*

For calendar year 2014 or fiscal year beginning , 2014, and ending , 20

A Check all that apply:
- [x] 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

Name of estate or trust (If a grantor type trust, see the instructions.): **Estate of Marcus Wellstone**
Name and title of fiduciary: **Thomas Wellstone**
Number, street, and room or suite no. (If a P.O. box, see the instructions.): **123 N. Silver Street**
City or town, state or province, country, and ZIP or foreign postal code: **Tampa, FL 33601**

C Employer identification number: **37-1234567**
D Date entity created: **01/04/14**
E Nonexempt charitable and split-interest trusts, check applicable box(es), see instructions.
- [ ] Described in sec. 4947(a)(1). Check here if not a private foundation . . ▶ [ ]
- [ ] Described in sec. 4947(a)(2)

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

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

G Check here if the estate or filing trust made a section 645 election . . . . . . ▶ [x] Trust TIN ▶ **37-7654321**

Income	1	Interest income	1	14,500
	2a	Total ordinary dividends	2a	35,000
	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	
	5	Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040)	5	
	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	49,500
Deductions	10	Interest. Check if Form 4952 is attached ▶ [ ]	10	
	11	Taxes	11	
	12	Fiduciary fees	12	
	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	Net operating loss deduction (see instructions)	15b	
	c	Allowable miscellaneous itemized deductions subject to the 2% floor	15c	
	16	Add lines 10 through 15c ▶	16	
	17	Adjusted total income or (loss). Subtract line 16 from line 9 — 17: 49,500		
	18	Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)	18	49,500
	19	Estate tax deduction including certain generation-skipping taxes (attach computation)	19	
	20	Exemption	20	600
	21	Add lines 18 through 20 ▶	21	50,100
Tax and Payments	22	Taxable income. Subtract line 21 from line 17. If a loss, see instructions	22	(600)
	23	**Total tax** (from Schedule G, line 7)	23	0
	24	**Payments: a** 2014 estimated tax payments and amount applied from 2013 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 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 instructions)	26	
	27	**Tax due.** If line 25 is smaller than the total of lines 23 and 26, enter amount owed	27	
	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 2015 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 Use Only
Print/Type preparer's name | Preparer's signature | Date | Check [ ] if self-employed | PTIN
Firm's name ▶ | Firm's EIN ▶
Firm's address ▶ | Phone no.

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11370H Form **1041** (2014)