Chapter 27

Income Taxation of Trusts and Estates

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Using Trusts (slide 1 of 5)

- Life Insurance Trust
  - Holds life insurance policies on the insured
  - Removes proceeds of policies from gross estate (if irrevocable trust)
  - Safeguards against receipt of proceeds by young or inexperienced beneficiary

Using Trusts (slide 2 of 5)

- "Living" (revocable) Trust
  - Holds all assets owned by an individual
  - Simplifies probate, since beneficiaries are established for trust
  - Provides privacy for asset transfers
  - Simplifies asset management

Using Trusts (slide 3 of 5)

- Trust for minors
  - Provides funds for college education
  - Shifts income to lower-bracket taxpayers
  - Allows parents to retain some control over children's use of assets

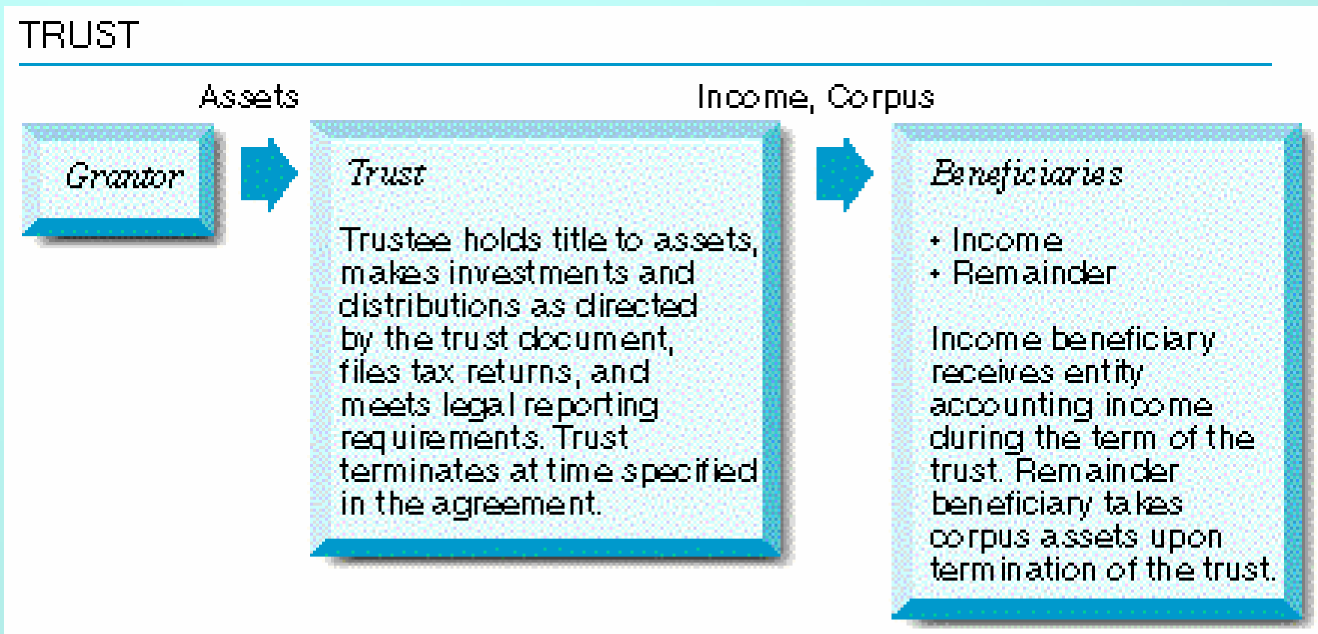
Using Trusts (slide 4 of 5)

- “Blind” trust
  – Holds assets of grantor without his/her input or influence (e.g., while grantor holds political office or some other sensitive position)
- Retirement trust
  – A special tax-exempt trust that manages asset contributions under a qualified retirement plan

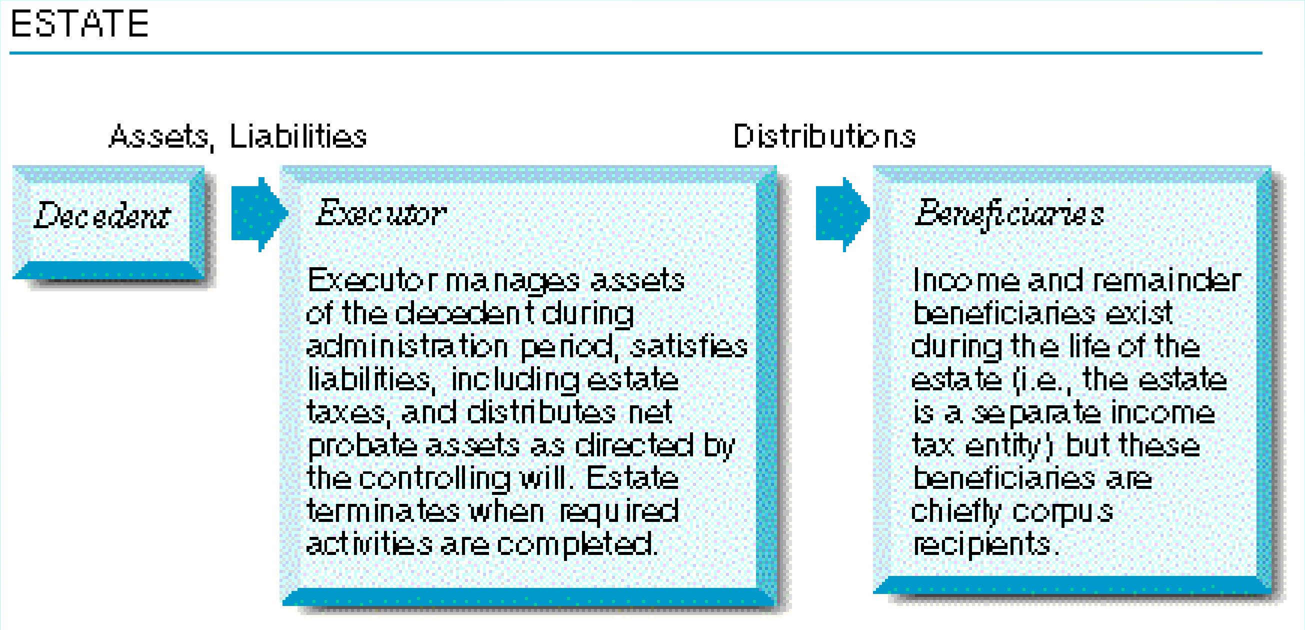
Using Trusts (slide 5 of 5)

- Alimony trust
  - Manages assets of an ex-spouse and ensures they will be transferred on a prescribed schedule to named beneficiaries
- Liquidation trust
  - Manages assets and final dissolution of a corporation undergoing a complete liquidation

Structure of Typical Trust



Structure of Typical Estate



What Is A Trust?

- Not defined in Code
  - Usually refers to an arrangement created by a will or by inter vivos (lifetime) declaration
  - Trustee takes title to property for purpose of protecting or conserving it for beneficiary

What Is An Estate?

- Created upon the death of every individual
  - Collects and conserves an individual's assets, satisfies all liabilities, and distributes the remaining assets to heirs

Filing Requirements

- Fiduciary must file a Form 1041, U.S. Income Tax Return For Estates and Trusts, in the following situations:
  - For an estate with gross income of $600 or more
  - For a trust that either has any taxable income or, if no taxable income, has gross income of $600 or more
- Due date is 15th day of fourth month following year-end

Tax Accounting Periods, Methods, And Payments (slide 1 of 2)

- Tax year
  - Estates can use calendar year or fiscal year
  - Trusts must use a calendar year

Tax Accounting Periods, Methods, And Payments (slide 2 of 2)

- Estimated tax payments
  - Trusts and estates are required to make quarterly estimated tax payments using same schedule as individuals
    - Applies to estates and grantor trusts only for tax years ending two or more years after date of decedent's death
    - Charitable trusts and private foundations are exempt from making estimated tax payments

Tax Rates for Estates and Trusts

Taxable Income		Tax is:	
Over	But Not Over		Of Amount Over
$ -0-	$1,900	15%	$-0-
1,900	4,500	$ 285.00+27%	1,900
4,500	6,850	$ 987.00+30%	4,500
6,850	9,350	$1,692.00+35%	6,850
9,350	....	$2,567.00+38.6%	9,350

Note: tax on net long-term capital gains of fiduciary is limited to 20%

Personal Exemptions

Estates	$600
Simple trusts(generally)	$300
All other trusts (primarily complex trusts)	$100

Alternative Minimum Tax

- May apply to an estate or trust in any year
  - AMTI calculation is generally the same as for individuals
  - Annual exemption = $22,500, with phaseout
  - Rate = 26% on first $175,000 AMTI, 28% thereafter

Taxable Income of Trusts, Estates and Beneficiaries

1. Determine Entity Accounting Income
2. Determine Entity Taxable Income Before the Distribution Deduction
3. Compute Distributable Net Income (DNI) and the Distribution Deduction
4. Compute Entity Taxable Income (Step 2 less the deduction determined in Step 3)
5. Allocate Distributable Net Income, and its character, to the Beneficiaries. Use the Tier system, if necessary.

Entity Accounting Income

- Accounting income is based on the controlling document
  - Either the document or state law determines whether amounts are allocated to corpus or current income
  - If the entity distributes income currently, that income should generally correspond to accounting income

Common Allocations: Income or Corpus

Allocable to Income	Allocable to Corpus
-Ordinary and operating net income from trust assets	-Depreciation on business assets
-Interest, dividend, rent, and royalty income	-Casualty gain/loss on income-producing assets
-Stock dividends	-Insurance recoveries on income-producing assets
-One-half of fiduciary fees/ commissions	-Capital gain/loss on investment assets
	-Stock splits
	-One-half of fiduciary fees/ commissions

Taxation Of Estates And Trusts
(slide 1 of 2)

- Generally, estates and trusts act as conduits for income received, and taxation is at beneficiary level
  - This is codified through allowance of a distribution deduction

Taxation Of Estates And Trusts
(slide 2 of 2)

- Exceptions:
  - Complex trusts accumulate income for specified times (e.g., until beneficiary is age 30)
  - Estates are not always required to make current distributions
- In these cases, or other cases where the entity is not required to distribute current income, the entity itself is taxed

Property Distributions (slide 1 of 2)

- Generally, entity does not recognize gain
  - Beneficiary takes same basis in asset as it had in the estate or trust
  - Distribution absorbs distributable net income (DNI) and qualifies for a distribution deduction to extent of the lesser of:
    - Basis to beneficiary
    - FMV on date of distribution

Property Distributions (slide 2 of 2)

- Property distributions (cont'd)
  - Trustee or executor can elect to recognize gains and losses on assets distributed in kind
    - Beneficiary's basis in asset would be FMV
    - Distribution absorbs distributable net income (DNI) and qualifies for a distribution deduction equal to FMV on date of distribution

Deductions Allowed (slide 1 of 3)

- Deductions are allowed for ordinary and necessary expenses for:
  - A trade or business
  - Production of income
    - 2% of AGI floor applies to many §212 expenses
  - Management, conservation, or maintenance of property
  - Determination, collection, or refund of any tax

Deductions Allowed (slide 2 of 3)

- Other deductions
  - No deduction is allowed for expenses related to the production or collection of tax-exempt income
  - Cost recovery deductions are allocated proportionately to the recipients of accounting income
  - Deductions are allowed for casualty or theft losses and NOLs
  - Wash sale and related party rules apply

Deductions Allowed (slide 3 of 3)

- Other deductions (cont'd)
  - Charitable contribution deduction is allowed to the extent of amounts included in gross income for the year
    - Deemed to be made proportionately from each of the income elements of entity accounting income

Distributable Net Income (slide 1 of 3)

- Entity is allowed a deduction for distributions to beneficiaries
  - Distributable net income (DNI) is used to compute the amount of the deduction
    - Maximum amount beneficiaries pay tax on
      - The character of income in DNI is preserved to the beneficiaries
    - Maximum amount of distribution deduction

Distributable Net Income (slide 2 of 3)

- Calculating DNI
  - Step 1: Determine entity's taxable income before the distribution deduction
    - Includes all of entity's income, deductions, gains, losses and exemption

Distributable Net Income (slide 3 of 3)

- Calculating DNI (cont'd)
  - Step 2: Make the following adjustments to entity's taxable income to determine distributable net income:
    - Add back:
      - Personal exemption
      - Net tax-exempt interest
      - Net capital losses
    - Subtract net capital gains allocable to corpus

Distribution Deduction

– For estates and complex trusts, distribution deduction is the lesser of:
  - Deductible portion of DNI, or
  - The taxable amount actually distributed
– For a simple trust, full distribution is always assumed

Entity Taxable Income

- Entity taxable income is calculated as follows:

Entity taxable income before
the distribution deduction
Less: Distribution deduction
Entity taxable income

Allocation Of DNI (slide 1 of 6)

- Each type of DNI must be allocated proportionately to income beneficiaries
  - This prevents manipulation of tax liabilities by assigning, for example, tax-exempt income to high bracket taxpayers, and taxable income to low bracket taxpayers

Allocation Of DNI (slide 2 of 6)

- Amount taxable to beneficiaries
  - For a simple trust
    - DNI is the maximum taxable amount
    - May be less if DNI includes tax-exempt interest
    - If more than one income beneficiary, apportion elements of DNI ratably

Allocation Of DNI (slide 3 of 6)

- Amount taxable to beneficiaries (cont'd)
  - For estates and complex trusts
    - Use a two-tier system
      - Income required to be distributed is categorized as a first-tier distribution
      - All other amounts properly paid, credited or required to be distributed are second-tier distributions

Allocation Of DNI (slide 4 of 6)

- Amount taxable to beneficiaries (cont'd)
  - If only first-tier distributions are made and those amounts exceed DNI, use the following formula to allocate DNI among beneficiaries

$$\frac{\text{First-tier dist. to beneficiary}}{\text{First-tier dist. to all beneficiaries}} \times \text{DNI} = \text{Beneficiary's Share of DNI}$$

Allocation Of DNI (slide 5 of 6)

- Amount taxable to beneficiaries (cont'd)
  - If first and second-tier distributions are made and first-tier distributions exceed DNI, use the previous formula to allocate first-tier distributions
  - Second-tier distributions are not taxed since all DNI has been allocated

Allocation Of DNI (slide 6 of 6)

- Amount taxable to beneficiaries (cont'd)
  - If first and second-tier distributions are made and first-tier distributions do not exceed DNI, use the following formula to allocate DNI among beneficiaries
  -

$$\frac{\text{2nd-tier dist. to beneficiary}}{\text{2nd-tier dist. to all beneficiaries}} \times \text{Remaining DNI}$$

= Beneficiary's share of DNI

Character of Income

- Various classes of income retain their character and flow through to beneficiaries
  - If all DNI is distributed and there are multiple beneficiaries, must allocate various classes of income
    - Distributions are treated as consisting of the same proportion as the items that enter into the computation of DNI

Trust Taxation Example

(slide 1 of 9)

The Alto Family Trust has the following income and expenses:

Interest income	$8,000
Tax-exempt income	$6,000
Capital gain income	$4,000
Fiduciaries fees	$2,000

The trust agreement allocates fiduciaries fees to trust income. Capital gains are allocated to trust corpus.

Trust Taxation Example
(slide 2 of 9)

1. Accounting income is as follows and is distributed to Sue, the sole beneficiary, at the end of the year:

Interest income	$ 8,000
Tax-exempt income	6,000
Fiduciaries fees	(2000)
Accounting income	$12,000

Trust Taxation Example

(slide 3 of 9)

Fiduciary fees are allocated between interest income and tax-exempt income before calculating trust taxable income:

$$\frac{\text{Interest income}}{\text{Total income}} \times \text{Fees} = \frac{\$\ 8{,}000}{\$14{,}000} \times \$2{,}000 = \$1{,}143$$

$$\frac{\text{Tax-exempt inc.}}{\text{Total income}} \times \text{Fees} = \frac{\$\ 6{,}000}{\$14{,}000} \times \$2{,}000 = \$\ \ 857$$

Trust Taxation Example

(slide 4 of 9)

2. Taxable income of the trust, before the distribution deduction, is as follows:

Capital gain	$ 4,000
Interest income	8,000
Less: fiduciaries fees related to interest income	(1,143)
Less: exemption	(300)
Taxable income before distribution deduction	$10,557

Net tax exempt income is $6,000 less $857, or $5,143.

Trust Taxation Example

(slide 5 of 9)

3. Calculate Distributable Net Income (DNI) and the distribution deduction as follows:

DNI:

Taxable income before DNI	$10,557
Plus: Exemption	300
Plus: Tax-exempt income (total)	6,000
Net of: Expenses allocated to tax-exempt income	(857)
Less: Capital gains allocated to corpus	(4,000)
DNI	$12,000

In this case, since no expenses were allocated to corpus, DNI is the amount actually distributed to the beneficiary.

Trust Taxation Example
(slide 6 of 9)

Distribution Deduction

The distribution deduction is the lesser of the amount actually distributed ($12,000) or DNI net of tax-exempt income (less expenses):

DNI	$12,000
Less: tax-exempt income	(6,000)
Plus: expenses related to tax-exempt income	857
Distribution deduction	$ 6,857

Trust Taxation Example

(slide 7 of 9)

4. Determine trust taxable income after distribution deduction

Taxable income before distribution deduction	$10,557
Distribution deduction	(6,857)
Taxable income	$ 3,700

Note: tax is limited to 20% since income is from capital gains

Trust Taxation Example

(slide 8 of 9)

5. Allocate DNI and its character to the beneficiaries.

DNI to Sue is $12,000, consisting of the following:

	Interest Income	Tax-Exempt Income	Total
Gross income	$8,000	$6,000	$14,000
Allocable fees	1,143	857	2,000
Net income, per category	$6,857	$5,143	$12,000

Trust Taxation Example
(slide 9 of 9)

- Sue received a distribution of $12,000 from the trust. She pays tax on $6,857, which corresponds to tax on trust's $8,000 of interest income, and a deduction for a portion of the trustee's fees. She lost deductions of $857 for fees allocated to tax-exempt income.

If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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