CHAPTER 27

INCOME TAXATION OF TRUSTS AND ESTATES

SOLUTIONS TO PROBLEM MATERIALS

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
1	Issue ID	Unchanged	1
2	Parties to a fiduciary entity	Unchanged	2
3	Trusts and income shifting	Unchanged	3
4	Fiduciaries and the AMT	Unchanged	4
5	Simple versus complex trust; personal exemptions	Unchanged	12
6	Determining taxable income: five-step approach	Unchanged	5
7	Distributions of appreciated property	Unchanged	6
8	Disallowance of § 212 deductions	Unchanged	11
9	Cost recovery deductions of a fiduciary	Unchanged	7
10	Charitable contributions of a fiduciary	Unchanged	8
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20	Constitution of DNI	Unchanged	20
21	Computing DNI, taxable income	Unchanged	21
22	Income in respect of a decedent	Unchanged	22
23	Termination year losses	Unchanged	23

CHECK FIGURES

13.	$18,850.
15.	$0; $7,500; $15,000.
16.a.	$25,000.
16.b.	$66,000.
16.c.	$14,700.
16.d.	$22,000.
17.a.	$30,000.
17.b.	$81,000.
17.c.	($300).
17.d.	$27,000.
18.a.	$25,000.
18.b.	$15,000.
19.a.	$50,000 first-tier, $70,000 total gross income.
20.	$12,000 (div.), $8,000 (taxable int.), $4,000 (exempt int.), $6,000 (passive); same for both.
21.a.	$100,000.
21.b.	$90,000.
21.c.	$37,900.
21.d.	Lydia $16,000; Kent $12,000 taxable part of distribution.

DISCUSSION QUESTIONS

1. Taxpayers create trusts for a variety of reasons. Some trusts are established primarily for tax purposes, while others are designed to accomplish a specific financial goal or to provide for the orderly management of assets in case of an emergency. The most commonly encountered reasons for creating a fiduciary entity include the following.

   - To hold life insurance policies on the decedent, as part of an estate plan to remove such policies from the gross estate.

   - To manage assets, reduce probate costs, and assure the privacy of the distribution of assets near the end of the grantor's life.

   - To provide funds for an advanced education, accumulating income at a lower tax rate than that to which the grantor is subject.

   - To hold or manage the assets of the grantor while he or she is in the military, governmental service, overseas, or in some other way divorced from the daily management of the assets.

   - To manage the assets of a tax-sheltered retirement fund, corporate liquidation, or divorcing couple in an objective manner.

   Table 27-1

2. The parties to a trust include a grantor, trustee, and one or more beneficiaries. The parties to an estate include the decedent, the executor or administrator, and one or more beneficiaries. In each case, at least two different parties should be involved. Figure 27-1

3. Fiduciary taxation has fallen prey to the "soak the rich" approach to tax reform. Congress wants to prevent taxpayers from using fiduciary entities to shelter taxable income at low tax rates. The compressed rates apply, though, regardless of the motivation for creating the trust. On $30,000 of taxable income, a married couple and a C corporation pay $4,500 of Federal income tax, while a single individual pays about $5,000 and a trust pays about $11,000. p. 27-7

4. A fiduciary entity *is* subject to the alternative minimum tax. The entity then restates its income and passes through AMT income, preferences, and adjustments to its beneficiaries. Given the nature of most fiduciary operations, though, it is unlikely to encounter this tax. No ACE adjustment need be computed by a fiduciary entity.

   The entity must make estimated tax payments with respect to any AMT. The small-corporation exception does not apply to a trust or estate.

   A fiduciary claims a $22,500 AMT exemption, which phases out at a rate of one-fourth of the amount by which AMTI exceeds $75,000. The AMTI of the entity is subject to a 26% tax rate, which reaches 28% when AMTI exceeds $175,000.

   pp. 27-8 and 27-9

5. a. All income is required to be distributed currently to the granddaughter of the grantor. No corpus distributions are made.

b. All income is required to be distributed currently to State University, a qualifying charity. No corpus distributions are made.

c. Income can be sprinkled at the discretion of the trustee; or, same as a. or b., except that a corpus distribution is made during the year.

pp. 27-7, 27-8 and Example 3

6. ***Step One*** Determine entity accounting income.

Step Two Compute entity taxable income before the distribution deduction.

Step Three Determine distributable net income (DNI) and the distribution deduction.

Step Four Compute entity taxable income [Step 2] – [Step 3].

Step Five Allocate DNI and its character to the beneficiaries, applying the tier system if needed.

Figure 27-2

7. With respect to a distribution of appreciated property by a fiduciary, no taxable income generally is recognized. Basis of the asset carries over to the recipient. DNI and the distribution deduction reflect an amount for the distribution equal to the lesser of the asset's basis or its fair market value.

DNI and distribution deduction	$65.000
Gross income to Lopez	$0
Basis to Judith	$65,000

Upon election, though, the distribution can become a taxable event. The gain would be recognized by the fiduciary, and the beneficiary would take a basis in the asset equal to its fair market value. DNI and the distribution deduction both would reflect the asset's fair market value.

DNI and distribution deduction	$100,000
Gross income to Lopez	$35,000
Basis to Judith	$100,000

Examples 7 to 10

8. a. The default application of the deduction for fiduciary fees is to the estate tax return. Section 212 expenses of this sort are deductible on an income tax return only if a waiver of the estate tax deduction is filed.

Here, the deductions are more valuable on the estate tax return, because of the great disparity of marginal rates. Moreover, if the payments were claimed on the estate's income tax return, only five-sevenths would be deductible, due to the presence of the exempt income. Nonetheless, the executor could split the deduction between the estate tax return and the estate's income tax return, but probably within the following bounds.

Case	Deduction Assigned to Estate Tax Return	Deduction Assigned to Estate's Income Tax Return
Most favorable to estate's income tax return	$857	$2,143
Least favorable to estate's income tax return	$3,000	$0

b. The 2% floor applies to a few § 212 items, such as annual mutual fund membership and processing fees, but it does not apply to items that would not have been incurred by an individual, such as the entity's personal exemption, trustee commissions, and other fiduciary fees.

pp. 27-14 and 27-15

9. Cost recovery deductions related to the assets of a fiduciary are assigned proportionately among the recipients of entity accounting income. Examples 14, 15, and §§ 167(h) and 611(b)(3) and (4)

10. If the gift is determinable in both existence and amount to the controlling will or trust agreement, the entity is allowed a deduction for the gift that is paid from gross income. See § 265 for disallowance possibilities.

    The deduction is allowed even if the payment is made during the following tax year. Qualifying charitable organizations for gifts by fiduciaries include all of those so recognized for gifts by individuals, and certain non-U.S. charities.

    Examples 17 and 18

11. • How much of the loss carryforwards will remain upon termination of the trust, for pass-through to Amy?

    • How many years will remain for the carryforwards?

    • Will Amy's other income sources be of the proper nature and amount so that the carryforwards can be used immediately?

    • Should the trust sell the investment assets, or should the trustee distribute the portfolio to Amy in-kind and let her sell them off?

    Examples 31 and 35

12. TAX FILE MEMORANDUM

    Date: November 3, 2003

    From: Deron Johnson

    Subject: Grantor trust rules

Carol's ideas are contrary to the tax law. Life insurance premiums, since they generate exempt income, are nondeductible. § 265

By using a trust as a fiduciary entity in this plan, Carol also brings into play the grantor trust rules of §§ 671 – 679. Where the grantor retains the right to make investment and distribution decisions, the trust is ignored for tax purposes. Thus, trust income and deductions are attributed directly to Carol, the owner of the trust assets.

The donor can retain the following powers without making the entity a grantor trust.

- Invade corpus for the benefit of a beneficiary.
- Withhold income from a beneficiary, during the beneficiary's disability or minority.
- Allocate items between entity accounting income and corpus.
- Choose charitable beneficiaries.

But if the grantor retains the income of the trust (or the right to designate who is to receive such income), the grantor trust rules apply.

PROBLEMS

13.

AMT income ($35,000 + $60,000)	$95,000
AMT exemption	(22,500)
AMT tax base	$72,500
AMT rate for fiduciaries	X 26%
Tentative minimum tax	$18,850

Estimated tax payments must include AMT liability. pp. 27-8 and 27-9

14.

Attribute	Estate	Trust
Separate income tax entity	Yes	Yes
Controlling document	Will; *not* insurance contracts, joint ownership statutes, installment notes, or other items concerning nonprobate assets	Trust instrument
Termination date is determinable from controlling document	No; termination occurs when the estate's activities are completed. This might be a substantial period of time (e.g., where a § 6166 election is made).	Yes, although such date might be contingent upon other events, such as the grantor's death, the beneficiary's graduation from school, or the completion of some contractual duty.
Legal owner of assets under fiduciary's control	Beneficiaries immediately, although the executor has a fiduciary and management duty during the administration period. Indeed, the identity of some of the heirs may not be apparent immediately upon the decedent's death, but legal title passes immediately.	Trustee during trust term, beneficiaries thereafter
Document identifies both income and remainder beneficiaries	Yes	Yes
Separate share rules apply	Yes	Yes
Generally must use calendar tax year	No	Yes

pp. 27-4 to 27-6 and Figure 27-1

15.

Assumption	2003 Deduction for Contribution
Brown is a cash-basis individual	$0 No deduction until 2004, when payment is made
Brown is an accrual-basis corporation	$7,500 Limited to 10% of TI, with 2 1/2 month grace period; no loss of deduction due to exempt income
Brown is a trust	$15,000 Limited to 75/100 of gift, due to exempt income; one-year grace period allowed

pp. 16-13, 16-14, and 27-16

16. a. $25,000 (1/3 of $75,000 accounting income).

b. $66,000.

c. $14,700.

d. $22,000 (1/3 of $66,000).

Item	*Totals*	*Accounting Income*	*Taxable Income*	*Distributable Net Income/ Distribution Deduction*
Ordinary income	$75,000	$75,000	$75,000	
Net long-term capital gain	15,000		15,000	
Fiduciary fees	9,000		(9,000)	
Personal exemption			(300)	
Accounting Income/Taxable Income Before the Distributions Deduction		$75,000 ***STEP 1***	$80,700 ***STEP 2***	$80,700
Exemption				300
Corpus Capital Gain/Loss				(15,000)
Net Exempt Income				
Distributable Net Income				$66,000
Distribution Deduction			(66,000) ***STEP 3***	
Entity Taxable Income			$14,700 ***STEP 4***	

PROOF: The trust should be taxed on "its" $15,000 long-term capital gain less the $300 personal exemption.

Figure 27-3 and Examples 20 and 21

17. a. $30,000 (1/3 of $90,000 accounting income).

    b. $81,000.

    c. ($300).

    d. $27,000 (1/3 of $81,000 DNI).

Item	***Totals***	***Accounting Income***	***Taxable Income***	***Distributable Net Income/ Distribution Deduction***
Ordinary income	$75,000	$75,000	$75,000	
Net long-term capital gain	15,000	15,000	15,000	
Fiduciary fees	9,000		(9,000)	
Personal exemption			(300)	
Accounting Income/Taxable Income Before the Distributions Deduction		$90,000 ***STEP 1***	$80,700 ***STEP 2***	$80,700
Exemption				300
Corpus Capital Gain/Loss				
Net Exempt Income				
Distributable Net Income				$81,000
Distribution Deduction			(81,000) ***STEP 3***	
Entity Taxable Income			($300) ***STEP 4***	

OBSERVATION: A simple trust with no corpus capital gains recognized for the year wastes the personal exemption of the fiduciary.

Figure 27-3 and Examples 20 and 21

18. a. $25,000. Under the separate share rule of § 663(c), a single trust that has more than one beneficiary and that operates using substantially separate and independent shares for each beneficiary of the trust is treated as multiple separate trusts. Therefore, Willie is taxed only on his share of the trust's distributable net income. The second-tier distribution of $10,000 from corpus to Willie is not subject to current income tax.

b. $15,000. The separate share rule of § 663(c) applies. Sylvia's distributable net income is limited to $10,000—the portion of the distribution that is not accumulated.

c. Zero. Doris' distributable net income has been accumulated; as a result of the separate share rule, Doris recognizes no current year gross income.

d. $35,000. The trust is taxed on the total distributable income that is accumulated (i.e., Sylvia's $10,000 and Doris $25,000 respective income shares). Proof: $75,000 DNI – $25,000 taxed to Willie – $15,000 taxed to Sylvia.

Example 28

19. a. After the first tier distributions are accounted for, $2,000 DNI remains to be assigned to the beneficiaries on the second tier ($102,000 DNI – $100,000 DNI used for first tier distributions. Results for Clare are as follows.

	Amount Received	*DNI Received = Gross Income, Portfolio Income*
First Tier	$50,000	$50,000
Second Tier	$25,000	$20,000 DNI remaining
Totals	$75,000	$70,000

b. Results for David are as follows.

	Amount Received	*DNI Received = Gross Income, Portfolio Income*
First Tier	$50,000	$50,000
Second Tier	$0	$0
Totals	$50,000	$50,000

c. First-tier distributions are the "first" $100,000 in required payments. First-tier distributions are those distributions which are composed of trust accounting income that is required to be distributed currently. Claire receives all of the "tax free" payments in excess of DNI.

Examples 25 and 26

20.

Beneficiary	*Amount Received*	*Income Type*			
		Dividends	*Taxable Interest*	*Exempt Interest*	*Passive*
Brenda	$30,000	$12,000◆	$8,000	$4,000	$6,000
Del	$30,000	$12,000	$8,000	$4,000	$6,000
Totals in DNI		$30,000	$20,000	$10,000	$15,000

◆($30,000 distribution/$75,000 total DNI) X $30,000 dividends in DNI. All other calculations by income type are similarly computed.

Example 29

21. a. $100,000.

b. $90,000.

c. $37,900.

d. Allocated as indicated below.

Item	*Totals*	*Accounting Income*	*Taxable Income*	*Distributable Net Income/ Distribution Deduction*
Taxable interest income	$40,000	$40,000	$40,000	
Exempt interest income	60,000	60,000		
Net long-term capital gain	30,000		30,000	
Fiduciary fees	10,000		(4,000) *	
Personal exemption			(100)	
Accounting Income/Taxable Income Before the Distributions Deduction		$100,000 ***STEP 1***	$65,900 ***STEP 2***	$65,900
Exemption				100
Corpus Capital Gain/Loss				(30,000)
Net Exempt Income				54,000 **
Distributable Net Income				$90,000
Distribution Deduction			(28,000) ◆ ***STEP 3***	
Entity Taxable Income			$37,900 ***STEP 4***	

◆$36,000 Deductible portion of DNI (taxable interest of $40,000 – $4,000 allocable fees) X 7/9 ($70,000 distribution/$90,000 DNI) portion of DNI distributed.

Fiduciary fees allocation:

*Taxable income ($40,000 ÷ $100,000) X $10,000

**$60,000 – nondeductible exempt income ($60,000 ÷ $100,000) X $10,000

PROOF: The trust is taxed on:

Retained portion, deductible DNI (2/9 X $36,000)	$ 8,000
Corpus capital gain	30,000
Exemption	(100)
Fiduciary taxable income	$37,900

Beneficiary	Amount Received	*Income Type [Step 5]*	
		Taxable Interest	*Exempt Interest*
Lydia	$40,000	$16,000◆	$24,000
Kent	$30,000	$12,000	$18,000

◆($40,000 distribution/$90,000 total DNI) X $36,000 taxable interest in DNI (assigning the fiduciary fees proportionately to the two types of accounting income).

Figure 27-3 and Example 29

22.

Dora's Item Incurred	**Reported on (X)**		
	Form 1040 Income Tax	**José's Estate: First Form 1041 Income Tax**	**José's Estate: Form 706 Estate Tax**
a. Last paycheck		X	X
b. State income tax withheld on last paycheck		X	X
c. Capital gain portion of installment payment received	X		X
d. Ordinary income portion of installment payment received	X		X
e. Dividend income, record date was two days prior to José's death		X	X
f. Unrealized appreciation, securities	No gross income. Basis step-up.		X
g. Depreciation recapture accrued as of date of death	Not reported on any return. Recapture potential disappears at death.		
h. Medical expenses of last illness			X◆
i. Apartment building, rents accrued but not collected as of death	X		X
j. Apartment building, property tax accrued and assessed but not paid as of death	X		X

◆Executor could elect to claim this on José's last Form 1040.

pp. 27-14 and 27-15

23. **2003** No flow-through of either the negative taxable income or the capital loss incurred. The $300 negative taxable income, due solely to the entity's personal exemption, is lost forever, while the unused capital loss carries forward.

2004 Flow-through of $20,000 negative taxable income, deductible by Yellow Jr. as a miscellaneous itemized deduction, subject to the 2% of AGI floor.

Flow-through to Yellow Jr. of $8,000 net capital loss of 2003, to be netted against his or her own capital gain income. Loss is carried forward only, without any expiration date.

Example 31

NOTES