

OVERVIEW OF FIDUCIARY INCOME TAXATION

Gregory S. Williams, Esq.

Carruthers & Roth, P.A.

Phone: 336-478-1183

E-mail: gsw@crlaw.com

Overview

2

- ❑ **Fiduciary income taxation is the assortment of rules governing the taxation of estates and trusts**
- ❑ **Modified conduit approach**
- ❑ **Relation to Fiduciary Accounting Income (FAI)**
- ❑ **Combining a trust and an estate into one taxpayer**
- ❑ **Grantor trust rules**
- ❑ **Distribution of capital gains**
- ❑ **Net income investment tax**

Estates — Basic Concepts

3

- ❑ **Commencement – date of death**
- ❑ **Duration – just enough time to complete duties**
- ❑ **Income Taxation – tax income once**
- ❑ **Accounting Methods – cash or accrual**
- ❑ **Taxable Years – calendar or fiscal**
- ❑ **Estimated Tax Payments – only if open > 2 yrs**
- ❑ **Tax Return Filing Requirements - gross income > \$600**
- ❑ **Income Tax Rates**

Trusts —Basic Concepts and Issues

4

- ❑ **Commencement – in vivo or testamentary transfer of property to a trust**
- ❑ **Duration – per the trust document**
- ❑ **Income Taxation of Trusts — tax income once**
 - ❑ **Simple Trusts —Code Sections 651-652**
 - ❑ **Complex Trusts —Code Sections 661-663**
 - ❑ **Grantor Trusts —Code Sections 671-678**
- ❑ **Taxable Year – generally calendar**
- ❑ **Estimated Tax Payments - > \$1,000 in tax**
- ❑ **Tax Return Filing Requirements – any taxable income or gross income > \$600**
- ❑ **Income Tax Rates**

Income Tax Rates – Trusts/Estates

5

- **Very compressed**
- **Ordinary Income**
 - **\$2,500 and less – 15% (\$9,075 for individuals)**
 - **Over \$12,150 – 39.6% (\$406,750 for individuals)**
- **Capital gain**
 - **Less than \$12,150 – 15% (\$406,750 for individuals)**
 - **Over \$12,150 – 20% (\$406,750 for individuals)**
- **Net Investment Income Tax**
 - **Less than \$12,150 – 0% (\$200,000 for individuals)**
 - **Over \$12,150 – 3.8% (\$200,000 for indiv.)**

Simple and Complex Trusts

6

- **Simple trust**
 - Trust required to distribute all of its accounting income
 - Makes no charitable contributions
 - No distributions out of corpus
 - \$300 annual exemption

- **Complex trust**
 - Any trust that is not a simple trust (i.e., distribution of income is discretionary, charity is a beneficiary or principal distributions are made)
 - \$100 annual exemption

Grantor Trusts

7

- **Grantor trusts – inter vivos trusts created for grantor’s use and benefit (for income tax purposes!)**
- **Examples:**
 - **Revocable or living trust**
 - **Defective grantor trust (IDGT)**
- **Consequence: all trust income (ordinary and capital gain) is reported on grantor’s income tax return (whether or not distributed to grantor)**

Election to Treat a Qualified Revocable Trust as Part of the Decedent's Estate

8

- ❑ **Qualified Revocable Trust – generally an inter vivos revocable trust**
- ❑ **Making the Election – “645 election” made on Form 8855**
- ❑ **Tax Return Filing Obligations – only one return required**

Election to Treat a Qualified Revocable Trust as Part of the Decedent's Estate

9

- **Advantages:**
 - Fiscal year eligible
 - \$600 annual exemption
 - Trust can deduct up to \$25K in real estate passive losses
 - Deduct amounts permanently set aside for charity
 - Use estate rules for S corp stock ownership
 - No estimated taxes for 2 years
- **Disadvantage:**
 - Combining could push into higher bracket

Fiduciary Tax and Accounting Issues — Fundamental Concepts:

10

- ❑ **Fiduciary (or Trust) Accounting Income - FAI**
- ❑ **Distributable Net Income (DNI)**
- ❑ **Taxable Income**

Fiduciary Tax and Accounting Issues

—Fundamental Concepts:

11

- **Fiduciary (or Trust) Accounting Income - FAI**
 - Accounting concept to determine maximum that could be distributed to income beneficiaries (not a tax concept; not GAAP)
 - Determined according to the trust document and state Principal and Income law

Fiduciary Tax and Accounting Issues

—Fundamental Concepts:

12

- **Distributable Net Income (DNI)**
 - **Tax concept used to make sure to avoid double taxation**
 - **Generally, trust taxable income, with modifications:**
 - **No deduction for distributions to beneficiaries**
 - **No deduction for the personal exemption for the entity**
 - **Capital gains allocated to principal excluded**
 - **Capital losses allocated to principal excluded**
 - **Net tax-exempt interest is included**

Fiduciary Tax and Accounting Issues

—Fundamental Concepts:

13

- ❑ **Taxable Income - generally calculated in the same manner as an individual**
- ❑ **Differences –**
 - ❑ **Distribution deduction permitted for income distributed to beneficiaries**
 - ❑ **No percentage limitations for charitable contributions**
 - ❑ **Exemptions permitted without phase-outs or pro-rata**

Fiduciary Tax and Accounting Issues

—Fundamental Concepts:

14

- **Distribution Deduction – deduction for amount of income distributed to beneficiaries**
- **Simple Trust – generally FAI required to be distributed, with two limitations:**
 - **Limited to DNI**
 - **No deduction for tax-exempt income**

Fiduciary Tax and Accounting Issues

—Fundamental Concepts:

15

- ❑ **Distribution Deduction (cont'd)**
- ❑ **Complex Trust or Estate – generally FAI required to be distributed, if any, plus any other amounts of income properly paid, credited or required to be distributed for the taxable year, with two limitations:**
 - ❑ **Limited to DNI**
 - ❑ **No deduction for tax-exempt income**

Comparing Fiduciary Accounting Income, DNI and Taxable Income

		FAI		DNI		Taxable Income
Dividends		Include		Include		Include
Ordinary Interest		Include		Include		Include
Tax-exempt Interest		Include		Include - less allocable expenses		Exclude
Capital Gains		Exclude		Exclude (generally)		Include
Fiduciary Fees		Allocated between income and principal		Allocate between taxable and tax-exempt income		Allocate between taxable and tax-exempt income
Exemption		None		None		\$300 simple trust; \$100 other trusts; \$600 estate
Income Distribution Deduction		None		None		Lesser of DNI minus tax-exempt interest; or the total distributions to beneficiaries less tax-exempt interest included in the distributions

Income Reportable by Fiduciaries

17

- ❑ **Interest Income —Line 1, Form 1041**
- ❑ **Ordinary Dividend Income —Line 2a, Form 1041**
- ❑ **Qualified Dividend Income —Line 2b, Form 1041**
- ❑ **Business Income —Line 3, Form 1041**
- ❑ **Capital Gains and Losses —Line 4, Form 1041**

Income Reportable by Fiduciaries

18

- ❑ **Rents, Royalties, Partnerships, Income from Other Estates and Trusts —Line 5, Form 1041**
- ❑ **Farm Income —Line 6, Form 1041**
- ❑ **Ordinary Gain or Loss (Form 4797)—Line 7, Form 1041**
- ❑ **Other Income —Line 8, Form 1041**
- ❑ **Total Income —Line 9, Form 1041**

Deductions Available to Fiduciaries

19

□ General Rules

- Entitled to many of those of individuals
- Allocation and reduction when tax-exempt income is present
- No standard deduction
- Exemptions not phased out
- Generally no double deductions
- Limitations on carryover of unused losses of decedent
- Income distribution deduction
- Depreciation, depletion, amortization

Deductions Available to Fiduciaries

20

- ❑ **Specific Items of Deduction on Form 1041**
 - ❑ **Interest expense – Line 10**
 - ❑ **Taxes – Line 11**
 - ❑ **Fiduciary fees – Line 12**
 - ❑ **Charitable deduction – Line 13**
 - ❑ **Attorney and accountant fees – Line 14**

Deductions Available to Fiduciaries

21

- ❑ **Specific Items of Deduction on Form 1041**
 - ❑ **Other deductions (not subject to 2% floor) – Line 15a**
 - ❑ **NOLs – Line 15b**
 - ❑ **Miscellaneous Itemized deductions subject to the 2% floor – Line 15c**
 - ❑ **Income Distribution Deduction – Line 18**
 - ❑ **Estate tax deduction – Line 19**

Trust and Estate Distributions: Special Issues and Situations

22

- **Distribution of capital gains (See John Goldsbury, US Trust, “Dealing with the 23.8% Tax on Capital Gains”:
<http://tiny.cc/FiduciaryIncomeTax>)**
- **Distributions in kind**
- **Distribution to beneficiaries in excess of DNI:
the Tier System**
- **Distributions in Year of Termination**

**Dealing with the 23.8% tax on trust capital gains:
21 ways (and counting) to have a trust's capital gain
taxed to the beneficiary**

John Goldsbury¹

U.S. Trust, Bank of America Private Wealth Management
john.goldsbury@ustrust.com

Summary. Historically, having a trust's capital gains taxed to the beneficiaries has been a challenge. With the recent increase to the long-term capital gain rate (i.e., the addition of a top bracket of 20%) and the advent of the 3.8% surtax, there will be a renewed focus on that area. This article explores several ways this can be achieved.

The regular income tax treatment of capital gains is not a new matter; the surtax treatment of trusts is. So, this paper will first review the new 3.8% surtax and how it applies to trusts and beneficiaries. The rest (and majority) of this paper will then explore how a trust's capital gains can be taxed to the beneficiary.

I. Intro

A. What is subject to the 3.8% surtax?.....	1
B. What is not subject to the 3.8% surtax?.....	2
C. How is a trust surtaxed?.....	3
D. How does a beneficiary treat trust distributions.....	7
E. How much NII is surtaxed?.....	8

The Net Investment Income Tax and Its Applications to Trusts and Estates

24

- ❑ **The 3.8% Tax on Net Investment Income**
- ❑ **Net Investment Income Definition**
- ❑ **Application of the Net Investment Income Tax to Trusts and Estates**
- ❑ **Active vs Passive Activities: Trusts and Estates**

The Net Investment Income Tax and Its Applications to Trusts and Estates

25

- **Planning Considerations and Strategies for Trusts and Estates**
 - **Distribute income**
 - **Make 645 election**
 - **Use 65 day rule**
 - **Consider investment strategy**

IRS Forms Associated with Fiduciary Income Tax Reporting

26

- Notice Concerning Fiduciary Relationship
- 1041-ES—Estimated Income Tax for Estates and Trusts
- Schedule J—Accumulation Distribution for Certain Complex Trusts
- 1116—Foreign Tax Credit
- 1310—Statement of Person Claiming Refund Due a Deceased Taxpayer
- 3520—Annual Return to Report Foreign Transactions
- 4562 —Depreciation and Amortization
- 4684—Casualties and Thefts
- 4797—Sales of Business Property
- 4952—Investment Interest Expense Deduction
- 4970—Tax on Accumulation Distribution of Trusts
- 4972—Tax on Lump-Sum Distribution
- 6198—At-Risk Limitations
- 7004—Application for Automatic Extension of Time to File
- 8283 —Noncash Charitable Contributions
- 8582—Passive Activity Loss Limitations
- 8582-CR—Passive Activity Credit Limitations
- 8855—Election to Treat a Qualified Revocable Trust as Part of an Estate
- 8903—Domestic Production Activities Deduction
- 8960 Net Investment Income Tax — Individuals, Estates and Trusts
- Form 8960 Instructions
- Instructions for Form 1041 & Schedules A, B, 6, J, and K-1
- Instructions for Schedule D
- Instructions for Schedule I

OVERVIEW OF FIDUCIARY INCOME TAXATION

Gregory S. Williams, Esq.

Carruthers & Roth, P.A.

Phone: 336-478-1183

E-mail: gsw@crlaw.com