

Audit Technique Guide for Charitable Trusts – IRC Sections 4947(a)(1) and 4947(a)(2)

Introduction

This guide provides technical information and audit guidelines for cases involving charitable trusts. See IRM 7.26.15, IRC Section 4947 Trusts, and the 2001 EO CPE text, Trust Primer for more in-depth technical information on charitable trusts. As charitable trusts don't file for tax exemption, agents may not see one during an audit, with the exception of those trusts filing the Form 990- PF, Return of Private Foundation (or IRC Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation) . "Agent" refers to the EO employee assigned to work the case regardless of the employee's job series.

A trust is a three-party arrangement among:

- the creator of a trust
- the manager of a trust (trustee)
- the trust's beneficiary, which may include more than one person or organization

A trust's creator, also known as a grantor or donor, may form a trust during his or her lifetime or upon death. A trust is a legal entity that can incur federal income tax liability that is separate from that of the grantor. Trusts may be organized in different ways and serve a variety of grantor motives. Funds placed in trust can provide advantages for estate, financial, personal, or business purposes such as decreasing tax burden and controlling disbursements to beneficiaries.

Frequently, the trust amounts are directed completely, or in part, to charitable interests, which serve as the trust's beneficiaries. When trusts receive income and distribute that income to charitable interests, they may take a charitable deduction to reduce trust income tax liability for a given year.

Glossary

Annuity trust: An annuity trust is a trust in which the payments for the duration of the trust, either to a private or charitable beneficiary, are of a fixed amount. The trustee(s) determine the payment amount by multiplying a specified percentage by the fair market value of the assets initially placed in the trust.

Beneficiary: Beneficiary(ies) refers to the person, persons, or organization that receives payments or assets from a trust. Beneficiaries can be either charitable or non-charitable, and can be either an income beneficiary or a remainder beneficiary. The beneficiary holds the beneficial title to the trust property. The trust document must clearly identify the beneficiary or beneficiaries.

Charitable lead trust (CLT): Charitable lead trusts (CLT) are split-interest trusts in which a charity receives an income stream during the life of the trust and non-charitable beneficiaries receive the remaining assets when the trust terminates. Charitable lead trusts can be classified as either grantor, or non-grantor lead trusts, and payments can be made on an annuity basis or a unitrust basis.

Charitable Lead Annuity Trusts (CLAT): In a CLAT, the trust pays a uniform payment to the charity. A grantor establishes the trust to benefit the remainder beneficiary, as it is usually the grantor or the grantor's designee. Any property appreciation remains in the trust to benefit the remainder beneficiary.

Charitable remainder annuity trust (CRAT): A charitable remainder annuity trust (CRAT) is a charitable remainder trust in which the income payments to the non-charitable beneficiary are fixed throughout the life of the trust. The trustee(s) calculate the payment amount by multiplying the designated percentage by the fair market value of the assets initially placed in the trust.

Charitable remainder trust (CRT): Charitable remainder trusts (CRT) are split-interest trusts in which a non-charitable beneficiary receives a stream of income for the duration of the trust, and a designated charity receives the remaining trust assets upon termination. Charitable remainder trusts can be either annuity trusts or unitrusts, depending on the method used to calculate the payment amounts. Further, unitrusts can be of the net income or net income with makeup variety.

Charitable remainder unitrust (CRUT): A charitable remainder unitrust (CRUT), also called a unitrust, is a charitable remainder trust in which the income payments to the non-charitable beneficiary fluctuate with the fair market value of the assets in the trust. The trustee(s) calculate the payment amount by multiplying the designated percentage (called the unitrust percentage) by the fair market value of the assets, as they are valued each year. Unitrusts can have net income or net income with makeup provisions.

Complex trust: A complex trust is any trust that doesn't meet the requirements for a simple trust. Complex trusts may accumulate income, distribute amounts other than current income and, make deductible payments for charitable purposes under IRC Section 642(c).

Corpus (or Principal): The corpus (or principal) of a trust consists of the original assets transferred into the trust. Often referred to as the body of the trust, the corpus may generate income streams.

Fair Market Value (FMV): The market price of the asset (or liability) as of a certain point in time.

Grantor: The grantor is also known as the trustor, settlor, or founder. The grantor is the person who transfers the trust property to the trustee.

Grantor trust: A grantor trust is a trust over which the grantor has retained certain interests or control. The grantor trust rules in IRC Section 671 - IRC Section 678 are anti-abuse rules. They prevent the grantor from taking tax advantages from assets that haven't left his or her control. The anti-abuse rules treat the grantor as owner of all or a portion of the trust. The grantor is subject to tax on trust income so treated even if he or she doesn't actually receive the income.

Income beneficiary: The income beneficiary of a split-interest trust is the recipient of the stream of payments made over the duration of the trust. The income beneficiary of charitable remainder trusts and pooled income funds is the non-charitable beneficiary. In charitable lead trusts, the income beneficiary is the designated charitable organization.

Inter vivos: (during life) An inter vivos trust is a trust that is created and takes effect during the grantor's lifetime.

Irrevocable trust: An irrevocable trust is one that, by its terms, can't be revoked.

Net income charitable remainder unitrust (NICRUT): Net income charitable remainder unitrusts are charitable remainder unitrusts that allow the annual payment to the non-charitable beneficiary to be the lesser of either the unitrust amount or the trust's net income.

Net income with makeup charitable remainder unitrusts (NIMCRUT): A net income with makeup charitable remainder unitrust allows the payment to the non-charitable beneficiary to be the lesser of the unitrust amount or the accounting income, however any deficiencies must be repaid when income allows. Deficiencies in the distributions, which occur when the net income is less than the unitrust payment amount, accrue year-to-year and are made up in subsequent years when the net income of the trust is greater than the unitrust amount.

Pooled income fund (PIF): A trust administered by a charity in which multiple donors pool assets for investment. The trustee(s) distribute the resulting income to donors on a prorated basis until their death, when their assets are transferred to the charity.

Property: A trust must have some assets, even if only one dollar. Trust property includes assets like cash, securities, real property, tangible personal property, and life insurance policies. The assets can be either transferred during life of the grantor (**inter vivos**) or at his or her death (**testamentary**). The trust property is also referred to as the corpus, principal, estate or trust res.

Remainder beneficiary (or Remainderman): The remainder beneficiary of a split-interest trust is the recipient of the trust's assets at the conclusion of the trust. In the case of charitable remainder trusts, the remainder beneficiary is the selected charity; in charitable lead trusts, the remainder beneficiary is the designated private beneficiary.

Revocable trust: If the grantor retains the ability to revoke the trust and revest the trust assets in the grantor, the trust is revocable and the income is taxable to the grantor under the grantor trust rules. Assets in a revocable trust are included in the grantor's gross estate for federal estate tax purposes. Revocable trusts are also called living trusts. They are used primarily as a will substitute.

Simple trust: A simple trust must distribute all its income currently. Generally, it can't accumulate income, distribute out of corpus, or pay money for charitable purposes. If a trust distributes corpus during a year, as in the year it terminates, the trust becomes a complex trust for that year.

Split-interest trust: A split-interest trust is an arrangement, which has both charitable and non-charitable beneficiaries. The amount and timing of the distributions depends on the type of arrangement.

Testamentary: A testamentary trust is one created by a last will and testament.

Trust: A trust is a legal arrangement between its creator (donor or grantor), the manager of the trust (trustee), and the beneficiary or beneficiaries of the trust. Trusts are legal entities in their own right, and can be responsible for any tax liabilities separate from the liabilities of the grantor and beneficiary. The trust document defines the conditions and provisions of a trust.

Trustee: The trustee is the individual or entity responsible for holding and managing the trust property for the benefit of the beneficiary. Trustees can be a corporate fiduciary or any competent individual who isn't a minor. The trustee holds the legal title to the trust property. As such, the trustee has a fiduciary duty to the beneficiaries with respect to the trust property. In the event of a breach of fiduciary duty, a trustee may be held personally liable. Such breaches include failing to pay out distributions or misappropriation. Trustees coordinate the preparation, verification, and submission of all required state and Federal tax forms and legal documents.

Non-Exempt Charitable Trusts (IRC Section 4947(a)(1))

A non-exempt charitable trust (NECT) is a trust that:

- isn't exempt from taxation under section 501(a),
- all of the unexpired interests in which are devoted to one or more of the purposes described in IRC Section 170(c)(2)(B), and
- for which a charitable deduction was allowed.

With few exceptions, a NECT distributes all of its financial outlays for charitable purposes. The NECT makes charitable distributions annually until it expends all of its assets and income.

Note: Treas. Reg. 53.4947-(1)(b)(2)(vii) permits the trust's unexpired interests to be devoted to IRC Section 170(c)(3) and IRC Section 170(c)(5) purposes with IRC Section 170(c)(2)(B) purposes. Treas. Reg. 53.4947-1(a) includes IRC Section 170(c)(1) purposes within the scope of IRC Section 170(c)(2)(B) purposes.

In addition to the charitable beneficiary requirement, the trust holds amounts for which charitable deductions were allowed under:

Charitable deduction provisions:	
IRC Section 170	Charitable, etc., contributions and gifts
IRC Section 545(b)(2)	Charitable contributions (Personal holding companies)
IRC Section 642(c)	Deduction for amounts paid or permanently set aside for a charitable purpose (Estate and trust income taxes)
IRC Section 2055	Transfers for public, charitable, and religious uses (Estate and trust excise taxes)
IRC Section 2106(a)(2)	Transfers for public, charitable, and religious uses (Estate excise taxes)
IRC Section 2522	Charitable and similar gifts (Gift taxes)

IRC 508(d)(2)(B) disallows a charitable deduction to any organization which isn't treated as an IRC Section 501(c)(3) organization for not meeting the notice requirement of IRC Section 508(a). However, IRC Section 508(a) doesn't apply to non-exempt charitable trusts. As recognized by Treas. Reg. 1.508-2(b)(1)(viii), deductions for contributions to a non-exempt charitable trust aren't disallowed.

Because the NECT doesn't necessarily distribute all of the income collected for charitable purposes, the NECT reports certain income each year as taxable. Since a NECT isn't tax-exempt, any income it receives and doesn't subsequently distribute for charitable purposes is taxable under Subtitle A, regardless of the source.

Filing Requirements

A NECT must comply with the requirements of IRC Section 6033 in the same way as an organization described in IRC Section 501(c)(3). A NECT is treated as private foundation unless it receives a determination that it that it is described as a supporting organization under IRC Section 509(a)(3). This impacts the filing requirements:

If the NECT is classified as a supporting organization, the NECT files:	If the NECT is treated as a private foundation, the NECT files:
Form 990, Return of Organization Exempt From Income Tax or Form 990-EZ, Short Form Return of Organization Exempt From Income Tax	Form 990- PF, Return of Private Foundation (or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation)
Form 1041, U.S. Income Tax Return for Estates and Trusts, if the trust has taxable income	Form 1041, if the trust has taxable income

	Form 4720, Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the IRC if there is liability for chapter 42 excise taxes
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To receive an initial determination that the NECT is described in IRC Section 509(a)(3), it needs to file Form 8940, Request for Miscellaneous Determination and pay the [applicable fee](#).

Note: A NECT’s receipt of a foundation classification as a supporting organization described in IRC Section 509(a)(3) isn’t the same as receiving recognition of tax-exempt status under IRC Section 501(c)(3); it just means that the NECT is treated as a public charity and files a Form 990 or Form 990-EZ

When applying for a determination under IRC Section 509(a)(3) on Form 8940, the NECT gives the following information from the date that it first became described in IRC Section 4947(a)(1):

- Form 990, Schedule A, Parts I, IV-VI, with respect to the most recently completed tax year.
- A list of all of the trustees who have served.
- A statement stating whether these trustees were IRC Section 4946 disqualified persons (other than foundation managers).
- A copy of the original trust instrument and all subsequently adopted amendments to that instrument.
- Other information as required under Rev. Proc. 2017-5 or any successor revenue procedure.

Taxation

The determination that a NECT is classified as a supporting organization under section 509(a)(3) impacts the potential tax liabilities of the NECT and disqualified persons:

If classified as a supporting organization under IRC Section 509(a)(3):	If treated as a private foundation:
Employment taxes (if applicable)	Employment taxes (if applicable)
Excise tax: IRC Section 4911 (excess lobbying expenditures)	Excise tax: IRC Section 4940(b) (net investment income)
Excise tax: IRC Section 4912 (disqualifying lobbying expenditures)	Excise tax: IRC Section 4941 (self-dealing)
Excise tax: IRC Section 4943 (excess business holdings)	Excise tax: IRC Section 4942 (failure to distribute)
Excise tax: IRC Section 4955 (political expenditures)	Excise tax: IRC Section 4943 (excess business holdings)
Excise tax: IRC Section 4958 (intermediate sanctions)	Excise tax: IRC Section 4944 (jeopardizing investments)
Excise tax: IRC Section 4965 (being a party to prohibited tax shelter transactions)	Excise tax: IRC Section 4945 (taxable expenditures)

Excise tax: IRC Section 4966 (taxable distributions of sponsoring organizations maintaining donor advised funds)	Excise tax: IRC Section 4955 (political expenditures)
Excise tax: IRC Section 4967 (prohibited benefits distributed from donor advised funds)	Excise tax: IRC Section 4965 (being a party to prohibited tax shelter transactions)
Income tax (Any income not distributed is taxable)	Income tax (Any income not distributed is taxable)

If a NECT is treated as a private foundation, the termination provisions of IRC Section 507 and governing instrument provisions of IRC Section 508(e) apply.

Split Interest Trusts (IRC Section 4947(a)(2))

Split-interest trusts make distributions to both charitable and non-charitable beneficiaries, while providing tax benefits to their donor. All split-interest trusts file Form 5227, Split Interest Trust Information Return, annually to report financial activity, including asset holdings, income, and distributions, and to determine if they should be treated as a private foundation. This return doesn't calculate tax liability. Based on the method and timing of distributions, split-interest trusts divide into three categories:

- Charitable remainder trusts
- Charitable lead trusts
- Pooled income funds

Someone creates a split-interest trust by executing a will or a separate trust instrument. In either case, the instrument specifies the term of the trust, designates the trustee(s) and beneficiaries, and provides parameters for managing assets and distributing income.

The instrument usually specifies the trust's corpus when created. The individual who owns, and then transfers the assets that make up the trust corpus is the grantor. Individuals and entities receiving income and assets from the trust are the beneficiaries.

A trustee holds, invests, and distributes the trust's income and assets. This may be an individual, a group of individuals, or an entity, such as a bank or charity. Each trustee must ensure that all transactions, including distributions, conform to the trust instrument requirements and any applicable laws. Additionally, the trustee coordinates the preparing, verifying, and submitting of all required federal and state tax forms.

Trustees, for all split-interest trusts, report any distributions of trust principal or income for charitable purposes on Form 5227, Split-Interest Trust Information Return. The details of these charitable distributions, and the trusts' income and asset holdings, are available to the public.

Note: The only portion of the Form 5227 not available for public inspection is Schedule A, which includes details of distributions to and donations from individuals and non-charitable entities.

Exception: A CRT created before May 27, 1969, isn't required to file Form 5227 if no amount was transferred to the trust after that date.

Per the Pension Protection Act of 2006 (PPA), split-interest trusts no longer have to file Form 1041-A, as all of the information previously reported on it are now included in the Form 5227. If a charitable remainder trust has any

unrelated business taxable income (UBI), the trust is liable for an excise tax of 100% of the UBI and must file a Form 4720 to pay it. It no longer has to file a Form 1041 in this case. A split-interest trust other than an IRC Section 664 charitable remainder trust must file Form 1041 with Form 5227 if it has \$600 of gross income or any taxable income during the year.

Charities often promote split-interest trusts with the charity serving as the trustee, however this isn't a requirement. For charitable remainder trusts, there is no requirement that the named charity even know of its impending gift. A charity doesn't have to be specifically named as the remainderman at the time the charitable remainder trust is created.

The remainder-man can be described by class (such as any organization exempt under IRC Section 501(c)(3)). The trustee with the specific power to choose the remainder beneficiary may choose the specific remainderman at a later date. A private foundation controlled by the grantor's family can be the remainder beneficiary.

Split interest trusts aren't subject to all of the Chapter 42 restrictions on private foundations. IRC Sections 4941 and IRC Section 4945 apply in all cases, as do IRC Section 507 and IRC Section 508(e). IRC Sections 4943 and IRC 4944 apply except in two situations:

- If all of the income interests (and none of the remainder interests) are entirely charitable and all amounts held in trust for which a charitable deduction was allowed have a value of not more than 60 percent of the aggregate fair market value of all amounts in the trust.
- If a charitable deduction was allowed for amounts payable under the terms of the trust to every remainder beneficiary, but not to any income beneficiary.

The IRS published sample trust instrument provisions that, if followed, would meet IRC Section 508(e) requirements. IRS issued a series of revenue procedures in 2003 with approved sample trust documents covering the various scenarios that a CRAT would typically involve. See Rev. Proc. 2003-53 through Rev. Proc. 2003-60. In 2005, IRS issued a series of revenue procedures that provided sample trust instruments for various scenarios involving CRUTs. See Rev. Proc. 2005-52 through Rev. Proc. 2005-59.

The PPA added IRC Section 6652(c)(2)(C), which imposes a penalty for failure to file and failure to file complete and correct returns. IRS can impose this same penalty on trustees who are required to file a return, but knowingly fail to do so. The penalty is \$20 for each day the failure continues with a maximum of \$10,000 for any one return. However, if the trust has gross income greater than \$250,000, the penalty is \$100 for each day the failure continues with a maximum of \$50,000 for any one return. The IRS may demand, in writing, a trustee file a delinquent return, or furnish an information return, specifying a time to comply with the demand. If the trustee fails to comply with the demand by the specified date, the trustee can be charged a penalty of \$10 for each day the failure continues with a maximum of \$5,000 for any one return.

Charitable Remainder Trusts

A charitable remainder trust consists of two distinct parts:

- A private interest in the form of a right to a stream of payments from the trust for life or a term certain (not in excess of 20 years). A charity may be the recipient of part of the annuity or unitrust amount so long as there is at least part of the amount going to a non-charitable beneficiary each year.
- A charitable interest in the assets remaining in the trust either held in continuing trust for charitable purposes or payable to or for the use of an organization(s) described in IRC Section 170(c) at the expiration of the preceding non-charitable interest. A charitable remainder trust is irrevocable.

Upon a CRT being created, the trust instrument can reserve a power for the non-charitable beneficiary to appoint by will, the charitable remaindermen. Rev. Rul. 76-7, 1976-1 C.B. 179.

Upon an *inter vivos* CRT being created, the grantor may reserve a power to substitute another charity as the remainderman in place of the charity named in the trust document. Rev. Rul. 76-8, 1976-1 C.B. 179.

The CRT doesn't need to be named in the trust document and the trustee may be vested with the power to name the charitable recipient of the remainder interest. However, all CRTs must provide that the trustee will transfer the remainder to a qualified charitable organization if the named organization isn't qualified at the time payments are to be made to it. Treas. Regs. 1.664-2(a)(6)(iv) and 1.664-3(a)(6)(iv)

The donor may be named as trustee or retain the power to substitute himself as trustee. Rev. Rul. 77-285, 1977-2 C.B. 213. **Note:** Only an independent trustee may have the power to allocate the annuity or unitrust amount among the various named recipients. Rev. Rul. 77-73, 1977-1 C.B. 175. The donor may not retain the power to name himself as trustee when the trustee has the power to allocate the annuity or unitrust amount among the various named recipients. Rev. Proc. 77-285.

The non-charitable interest is payable to a "person." The definition of "person" includes a trust, estate, partnership, association, company, or corporation (See IRC Section 7701(a)(1)). If the income recipient isn't an individual (or combination of individual and charity) the term of the trust must be a term of years, up to 20 years.

The annuity or unitrust payment amount may be made to the guardian of a minor. A portion of the annuity or unitrust amount may be paid to an IRC Section 170(c) charitable recipient. Treas. Regs. 1.664-2(a)(3)(i) and 1.664-3(a)(3)(i).

Note: The trust document may also give the trustee discretion to distribute a part of the annuity or unitrust amount to a charitable recipient. In all cases, there must be at least one non-charitable recipient of the annuity or unitrust amount. IRC Sections 664(d)(1) and IRC Section 664(d)(2).

Commonly, the annuity or unitrust payment is payable, in succession, to the grantor and the grantor's spouse for life. The grantor may reserve the right to revoke, by directing in the last will and testament, his or her spouse's income right in the trust. Rev. Rul. 74-149, 1974-1 C.B. 157.

An *inter vivos* charitable remainder unitrust, created during the grantor's life, may receive additions to the trust assets by property transfers made during the grantor's life or at his death by a provision in his will. Rev. Rul. 74-149 indicates that additional property contributions may not be made to a charitable remainder annuity trust. Treas. Reg. 1.664-2(b).

The trust may satisfy the annuity or unitrust amount by distributing property rather than cash. A property distribution to satisfy the annual payout requirement is treated as a sale or exchange by the trust. Treas. Reg. 1.664-1(d)(5).

IRC Section 4947(a)(2) doesn't apply to (A) any amounts payable under the terms of the trust to income beneficiaries unless a deduction was allowed under IRC Sections 170(f)(2)(B), 2055(e)(2)(B), or 2522(c)(2)(B), (B) any amounts in trust other than amounts for which a deduction was allowed under IRC Sections 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such amounts are segregated from amounts for which no deduction was allowable, or (C) any amounts transferred in trust before May 27, 1969.

Charitable Remainder Annuity Trusts

A CRAT pays a specific amount of money to the non-charitable beneficiary every year. The annuity can be either a stated dollar amount or a fixed percentage of the assets' fair market value on the date contributed to the trusts. The annuity may not be less than 5 percent.

For transfers after June 18, 1997, the annuity may not be greater than 50 percent of the fair market value of trust assets as of the date of the transfer of assets to the trust. See IRC Section 664(d)(1).

The payout doesn't vary and it doesn't matter how much income the trust earns during the year. If assets the trust holds are producing substantial gains, the non-charitable beneficiary won't benefit. If income is insufficient to support the payout, the difference is made up from the principal of the trust. Because the annuity is fixed, the non-charitable recipient receives no benefit from any annual trust asset appreciation.

The amount that will actually pass to the charity can't be determined until the non-charitable interest expires. However, the present value of the remainder interest is determined at the time of the contribution using actuarial tables. If the assets have been appreciating, the charity will benefit. If the corpus has been invaded to pay the annuity to the non-charitable beneficiary, there may be little left for the charity.

Charitable Remainder Unitrusts

The CRUT pays a fixed percentage (of at least 5 percent) of the net assets' fair market value valued annually and for transfers after June 18, 1997, up to 50 percent. The unitrust payout is different each year because the payout is based on an annual valuation. IRC Section 664(d)(2).

If the value of the unitrust assets increases, the payout to the non-charitable beneficiary will increase. The advantage of the unitrust over the annuity trust to the non-charitable beneficiary is that the unitrust serves as a hedge against inflation.

As with the annuity trust, the amount the charity will actually receive can't be determined until the non-charitable interest terminates.

Net Income Charitable Remainder Unitrusts (NICRUT)

In lieu of a fixed percentage, the trust document may instead provide that the trustee pays annually the lesser of the unitrust amount or the trust accounting income (IRC Section 664(d)(3)). Any amounts the trust earned in excess of the amount paid to the income beneficiary become part of the corpus, and increases the amount the charity receives at the end of the trust term.

Trust accounting income is the amount of income for the tax year as determined under the governing instrument terms and applicable state law. (IRC Section 643(b))

Depending on the applicable state law, the trustee may charge expenses against trust income when determining the payout amount. These include administrative, management, trustee expenses, and amounts expended to preserve trust property.

When computing trust income, include most passive income, but not capital gains, unless so defined in the trust document or under state law.

Net Income with Makeup Charitable Remainder Unitrusts (NIMCRUT)

The NIMCRUT follows the same rules as the NICRUT, but with a twist. When the trust income is less than the fixed percentage amount for any given year, a shortfall is created because the beneficiary is getting less than the fixed percentage amount. The amount of shortfall may be "made up" in a later year. The make-up must come from extra trust accounting income, not from principal.

Example: Trust A has a unitrust payout of 5%. In year 1 through 4, the trust has no net income and the unitrust payout is \$0.00. In year 5 the trust earns 8%. The extra 3% can be used to make-up the short fall.

A donor uses a NIMCRUT to place property that doesn't produce regular income and isn't readily marketable into a CRUT. A NIMCRUT will frequently hold real estate and stock or other interests in a closely held business. By using a

NIMCRUT, the payment to the income beneficiary is \$0.00, the lesser of the unitrust percentage amount or the trust accounting income.

A grantor who wishes to have small current income payments and larger payments in the future uses a NIMCRUT.

Example: Grantor is 50 years old and is contemplating retiring in 10 years. He owns a parcel of appreciating real estate. He is in a high tax bracket and doesn't currently need any income. He places the property in a NIMCRUT. It doesn't make any current payment to him, as it has no income. This continues for 10 years. In year 10, he retires and the trustee sells the property. The trustee uses the settlement to invest in income producing assets. The trust now pays him the unitrust percentage, which is 7%. The trust is making 11%. The trust can now use its NIMCRUT makeup provision to pay him additional payments to make up the payments that weren't received in the earlier years. He now has additional retirement income at a time when he may be in a lower tax bracket.

"Flip" Unitrust

Another variety of unitrust is called the "flip" trust. This trust starts out as either a NIMCRUT or a NIMCRUT. When a specific event occurs, as spelled out in the trust document, it "flips" or converts automatically to a straight fixed percentage unitrust.

Treas. Reg. 1.664-3(a)(1)(i)(c) provides the authority for the flip provision. Specifically, that regulation permits the net income method for a unitrust for an initial period and then a fixed percentage amount for the trust's remaining period only if the governing instrument provides for certain conditions.

These conditions include the requirement that the change in unitrust payment method is triggered on a specific date or by a single event whose occurrence isn't discretionary with, or in the control of, the trustees or any other persons.

Treas. Reg. 1.664-3(a)(1)(i)(d), while not an all-inclusive list, gives some permissible triggering events: the sale of unmarketable assets and the marriage, divorce, death, or birth of a child, because they aren't considered to be discretionary with any person.

A trust's reformation to add a flip provision could result in a self-dealing transaction under IRC Section 4941 unless there is authority to do so. A flip qualifying under the requirements of the IRC Section 664 regulations won't constitute an act of self-dealing, including trust document reformations occurring under the effective date provisions of Treas. Reg. 1.664-3(a)(1)(i)(f).

Charitable Lead Trusts

The CLT (defined in IRC Section 170(f)(2)(B)) is a split-interest trust that is the reverse of the charitable remainder trust. In the CLT, the charitable payment is a guaranteed annuity or fixed percentage of fair market value of trust property, valued annually, payable to charity for a term of years or for the life or lives of specified individuals.

Charity comes first. The trustee pays the remainder interest in the trust to private interests, often the grantor or the grantor's heirs.

In a non-grantor CLT, the trust pays the tax on income from the trust. The grantor doesn't get an income tax charitable deduction for the transfer to the trust. The trust is entitled to a charitable deduction for any amount of gross income paid to a charity during the year.

In a grantor CLT, the grantor pays the tax on the income from the trust. The grantor gets an income tax charitable deduction for the present value of the annuity or unitrust interest at the time the assets are transferred. These trusts are inter vivos trusts.

All CLTs are irrevocable. In addition, no net income and net income markup variants are permitted.

There are no minimum or maximum payout rate limitations. The 10% test present for CRTs doesn't apply to CLTs. The trust document will either allow or disallow additional contributions.

Charitable Lead Annuity Trusts (CLAT)

In a CLAT, the trust pays a uniform payment to the charity. A grantor establishes the trust to benefit the remainder beneficiary, as it is usually the grantor or the grantor's designee. Any property appreciation remains in the trust to benefit the remainder beneficiary.

At the end of CLAT's term, the corpus and any income in the trust transfer to the remainder beneficiary. This means that the property could revert to the donor or pass to other non-charitable beneficiaries. The trust's term may be limited to a set number of years, the lifetime of either the donor, the donor's spouse, or a lineal ancestor (or spouse of a lineal ancestor) of all of the non-charitable beneficiaries.

The trustee determines the amount paid to the charity based on the initial fair market value of the assets placed into the trust. Income and asset appreciation become part of the corpus. As a result, the payment to the charity becomes a smaller percentage of the trust's value over time.

To determine the present value of the annuity, use the rate listed in the IRC Section 7520 Interest Rates for the month in which the grantor establishes the trust. For guidance on how to compute the present value of the annuity, see [Pub. 1457](#), Actuarial Valuations Version 3A.

In a CLAT, it's uncommon to see a provision permitting additional contributions. Once funded, the donor can't claim additional charitable contributions. See Treas. Regs. 1.170A-6(c)(2)(i), 20.2055-2(e)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vi)(a).

See Rev. Proc. 2007-45, 2007-29 I.R.B. 89 and Rev. Proc. 2007-46, 2007-29 I.R.B. 102 for examples of a CLAT document.

Charitable Lead Unitrusts

In a CLUT, the trust pays a percentage of the trust's assets to the charity:

- The trust document specifies the percentage amount.
- The trust annually revalues the assets to determine the amount.

In a CLUT, the trust assets grow or shrink, depending on the type of asset. The income generated (if any), and the fluctuation in market values affect the computation of the amount paid to the charity. The following table shows the relationship between return on investment (ROI), the fixed percentage amount, and the remaining assets paid to the non-charitable beneficiary:

If ROI is:	Then:
positive but consistently less than the percentage payout amount	The FMV of the assets at the end of the trust term are less than the original FMV.
always negative	The larger the loss on ROI, the less the final FMV of the assets. In all cases, the FMV will be less than the original FMV of assets.

When the return on investment is negative or less than the required percentage amount, the trustee pays the difference out of corpus. If the return on investment exceeds the payment to the charity for the year, the trust pays income tax on the excess.

See Rev. Proc. 2008-45, 2008-30 I.R.B. 224 and Rev. Proc. 2008-46, 2008-30 I.R.B. 238 for examples of a CLUT document.

Pooled Income Funds (PIF)

Public charities establish and maintain PIFs to pay income to the grantor or an individual beneficiary named by the grantor or to pass the remainder interest to charity.

The grantor contributes property to a commingled fund (pooled income). Yearly, the charity pays out income earned by the fund to each donor or other named beneficiary in proportion to the assets contributed. On the donor's or other named income beneficiary's death, a portion of the assets attributable to the income interest severs from the fund and transfers to the charity.

There are a number of differences between a CRT and a PIF. For the PIF, the income beneficiary receives his full proportionate share of all trust accounting income earned by the PIF. There is no predetermined annuity or fixed percentage payment amount. Because the payment is based on income, there is never any invasion of corpus. If the fund doesn't earn income, it doesn't make a payment for the year.

The exempt organization manages the PIF (usually with a professional investment company's help). Virtually anyone, including the grantor can manage or be a trustee for a CRT. From the grantor's perspective, a CRT is much more flexible but a PIF has the advantage of simplicity.

PIFs file Form 5227. However, a PIF created before May 27, 1969, won't file Form 5227 if no amounts were transferred to the PIF after that date. If the PIF has any taxable income, gross income of \$600 or more (regardless of taxable income), or a beneficiary who is a nonresident alien, it files Form 1041.

Preaudit Procedures

Before conducting a trust audit, review the training publications: *Training 10920-102, Fiduciary/ Abusive Domestic Trusts (Participant Guide)* and *Training 33341-102, Income Taxation of Trusts and Decedents' Estates (Participant Guide)*.

For guidance on domestic trusts from the Small Business/Self Employed (SB/SE) perspective, visit the *Trusts (Domestic)* web page. The links on the left side of the page include news, contacts, job aids, and court cases. Issues papers and an audit technique guide are listed under the job aids.

For all cases, follow the guidance in IRM 4.75.10, Pre-Audit Procedures, for general case development. See the exhibits below for a line by line analysis of Form 1041-A or Form 5227.

If the trust has an ownership interest in any entity, pull Integrated Data Retrieval System (IDRS) research on those entities, using command code TRDBV to review any income or employment tax returns, and command code BMFOLU to view any payroll reports.

When writing the initial information document request, consider asking for the following items:

- A complete copy of the trust instrument, including all attachments, schedules, and any amendments made to date. (Treas. Reg. 1.6012-3(a) requires a trustee to furnish these documents to the IRS upon request.)
- A completed and signed Form 56, Notice Concerning Fiduciary Relationship, for the current trustee or trustees. **Note:** Where a trust instrument appoints more than one trustee, the names of all trustees must

appear on Form 56 and all must sign the form. This requirement doesn't apply if the trust instrument provides that fewer than all have authority to sign agreements and bind the trust.

- All trustees' minutes and resolutions from the inception of the trust to the present. These include records on trustees' appointment, resignation, or termination, all assets transferred into the trust, and the ownership of all certificates of beneficial interest.
- The identification of all former and current trustees, from the inception of the trust to the present. (Include the name, address and telephone number, both business and personal for each trustee.)
- A list of all certificate holders (beneficiaries) of the trust, including name, address, and Social Security Number or Employer Identification Number.
- Bank statements, deposit slips, debit/credit memos and cancelled checks for all trust accounts whether U.S. and foreign, including checking and savings for the audit year(s).
- All accounting books and records for the trust for the year(s). Records should include but aren't limited to: check registers, disbursements journals, receipts journals, general ledger, and other workpapers used to prepare the tax return(s) and financial statement(s).
- A list of all entities in which the trust holds an ownership interest.
- Payroll ledger and related records for the audit year(s).
- Copies of any lease agreements entered into or in effect during the audit year(s).
- Loan documents, including promissory notes, deeds of trust, security agreements, financial statements, etc., for all loans entered into or in effect during the audit year(s).
- Records to establish the basis of all assets held by the trust, whether acquired from the grantor or otherwise, from the inception of the trust through the end of the audit year. This includes invoices, purchase agreements, and the names and addresses of the persons who transferred property to the trust. For property acquired from the grantor, this includes information showing the grantor's basis in the property immediately before the transfer.
- Records for sales or other transfers of property from the trust during audit year(s).
- A statement explaining the purpose of any businesses operated within the trust. If someone who isn't a trustee manages the business, the statement should include that person's name, address, Social Security Number and explain the extent of their ability to control the funds and other property of the trust.
- Copies of any contacts for business services to be rendered by the trust during audit year(s).

In drafting the initial interview, consider asking the following questions:

- When was this trust created?
- Why was this trust created (for what purpose)?
- How did you find out about trusts?
- Were any tax benefits explained to you?
- What made you think the information was accurate?
- Did you consult with an attorney or CPA? If so, whom? If not, why?
- What advice did they give you? Was it written? Provide copies.
- Who helped you in forming this trust? (get names of everyone involved in the creation of the trust)
- Did you use a trust "package" used? If so, who was it purchased from?
- What services did they provide?
- How much were you charged for these services?
- Do you have a copy of the invoice for services rendered?
- Who paid for the services?
- How were the services paid for?
- Did you deduct this amount? If so, where?
- Did you receive any promotional materials or instructional manuals? If yes, describe and provide copies.
- What assets were contributed or transferred into this trust, and by whom?
- Was control of these assets given up? If so, who controls them now?

- What, if anything, was received in exchange for these assets?
- Did you file gift tax returns reporting the assets transferred into the trust? If not, why? If so, provide copy of return.
- Describe the business activity of the trust.
- How is it operated?
- Who manages the business?
- Who controls the business assets?
- Who makes the day-to-day decisions?
- Where does the trust do its banking? (Bank, account number)
- Who has signature authority over the trust bank accounts?
- How are bills approved for payment?
- How are the checks actually signed? (i.e. rubber stamped, in advance, by whom, etc.)
- Do you hold any position with respect to this trust? (general manager, agent, employee)
- Are you compensated by this trust in any way?
- Do you have possession or use of any of the trust's assets?
- Does the trust pay rent for any property? If so, what is rented and for what amount?
- Does the trust make payments for services or products to any other trust?
- Were any loans made out of this trust? If so to whom, when, and for what amount?
- Have the loans been repaid?
- Who appointed the trustee?
- Why was he/she selected?
- Is there any relationship?
- Explain the trustee's participation in the operation of the business.
- Please provide the names (and TINs) of any and all trusts associated with this trust; name, TIN, trustee, protector, beneficiaries, domestic or foreign.
- Please provide the names and TINs of all other trusts in which you have any type of involvement. (i.e. grantor, investor, trustee, beneficiary, protector, manager, etc.)

Field/Office Correspondence Audit Procedures

Conduct a careful review of the trust instruments. The trust instrument should identify the purpose of the trust, the property transferred, and the appointment and authority given to the trustees. Some trust instruments may discuss the role of a "protector" or similar device to allow the beneficiaries to retain control over the trustees. This person has the power to remove a trustee at the direction of the beneficiary, who may be the grantor.

Ask the person involved in the operation of the business questions. In particular, determine who has control over the bank accounts, makes the day-to-day decisions, and has use and control over trust assets. Does the trustee exercise control over the business operations?

Question taxpayers about how they were introduced to trusts as a method of doing business. This could indicate whether a knowledgeable professional was advising them or they were sold a trust package from a promoter of trusts that advocates tax avoidance.

Follow procedures in [IRM 4.75.11](#), On Site Audit Guidelines, [IRM 4.75.12](#), Required Filing Checks and Package Audit Procedures and [IRM 4.75.13](#), Issue Development.

If you need to adjust a Form 1041, visit the Estate and Gift Tax Share Point site to obtain a copy of the Form 1041 Workcenter and its user guide. The Excel template generates a Form 4549, Income Tax Examination Changes, for the audit report.

If you encounter an issue that falls under the jurisdiction of Estate and Gift Tax, request assistance via the Specialist Referral System website.

Case Closing Procedures

Revocation procedures don't apply to IRC Sections 4947(a)(1) and 4947(a)(2) trusts.

Even though an IRC Section 4947(a)(1) trust may be treated as an IRC Section 509(a)(3) supporting organization, the trust may lose this recognition and instead be treated as a private foundation. Apply final adverse determination letter procedures in this situation.

Example: An IRC Section 4947(a)(1) trust previously qualified for recognition as an IRC Section 509(a)(3) supporting organization (operated in connection with a supported organization). After the Pension Protection Act of 2006, the trust no longer qualified due to the elimination of the alternative responsiveness sub-test #2. The trust would now be treated as a private foundation.

In audits of IRC Sections 4947(a)(1) and 4947(a)(2) trusts, consider these related issues:

- Employment tax cases such as worker reclassification, fringe benefit treatment, and unreported amounts
- Income tax cases (Forms 1041, discrepancy adjustments)
- Excise tax cases (gaming and/or Chapter 42 taxes)

Discuss with your group manager whether to close the related cases separately at the earliest opportunity, or together.

A Form 990 (IRC Section 4947(a)(1) trusts only) can close as a no change/no change with advisory if there is no modification to the foundation status.

A Form 990- PF can close as a no change/no change with advisory if there is no modification to the IRC Section 4940 tax or foundation status. See [IRM 4.75.16](#), Case Closing Procedures, for case file assembly and other common closing procedures.

For agreed cases involving employment, income, or gaming excise taxes:

- Issue a report of examination.
- Secure the agreement.
- Collect payment or complete a request for an installment agreement. See [IRM 4.75.16](#)
- Prepare the appropriate closing letter. See [IRM 4.75.15](#), Closing Letters and Reports of Examination.
- Close the case to your manager, who closes it to Examination Special Support (ESS).

For agreed cases involving Chapter 42 taxes:

- Request correction.
- Obtain verification of correction.
- Correction made: Issue report of examination.
- Correction not made: Treat as unagreed.
- Secure the agreement on Form 870-E, Waiver of Restriction on Assessments and Collection of Deficiency and Acceptance of Over-assessment.
- Collect payment and/or complete the installment agreement request.
- Prepare the appropriate closing letter.
- Close the case to your manager, who closes it to ESS.

Note: If you plan to impose excise taxes on the trustee(s) (foundation manager(s)), issue a Thorne letter. See the exhibit below for a sample Thorne letter with language for a theoretical IRC Section 4945 scenario. Consult with Area Counsel for their pre-issuance review of the Thorne letter.

For cases requiring correction:

- If correction is acceptable, issue the acceptance letter. See Letter 5305.
- If correction is inadequate or unacceptable, issue the rejection letter. See Letter 5306.
- If uncorrected, determine whether they need additional time for correction.
- Grant an extension of time with managerial approval so they can make correction.
- If uncorrected as of the end of the extension date, close as unagreed, even if the taxpayer previously signed an agreement to the 1st tier tax on Form 870-E.

For agreed cases involving foundation status modification:

- Secure Form 6018, Consent to Proposed Action.
- Obtain a statute extension, if less than 180 days remaining on the statute of limitations.
- Prepare a Form 3198-A, completing the Mandatory Review/Operations, Planning & Review section.
- Close the case to your manager, who closes the case to Mandatory Review.

For agreed cases involving terminations of the trust, see [IRM 4.75.16.5.10](#), Terminations.

For unagreed cases, regardless of the type of tax or action (termination/ foundation status modification):

- Obtain a full copy of the tax form under protest showing the date received, if not already in the file or on the Reporting Compliance and Case Management System (RCCMS). Use Online SEIN if obtaining a Form 990- PF or a filed Form 4720.
- Issue a formal audit report with the appropriate waiver/agreement form(s).
- Issue a Thorne letter if proposing excise taxes on the trustee(s) (foundation manager(s)).
- Ensure that there are 455 days remaining on the statute of limitations when closed from the group.
Note: Effective September 2, 2014, all cases received in Appeals require 365 days remaining on the assessment statute of limitations.
- Prepare a Form 3198-A, completing the Mandatory Review/Operations, Planning & Review section.
- Verify that a formal protest to Appeals is valid. If invalid, secure a valid protest (see below).
- Prepare and issue a full rebuttal to any protests.
- Close the case to your manager as unagreed (with or without protest.)
- If applicable, consider offering to enter into a Fast Track Settlement before you issue the formal report of examination. Fast track negotiations requires both agent and manager approval. See [IRM 4.75.15.14](#) for Fast Track Settlement.

A valid protest contains the following elements:

- The taxpayer's name, address, Employer Identification Number (EIN) and a daytime phone number.
- A statement from the taxpayer that they want to protest the proposed determination.
- A copy of the 30-day letter showing the findings that they disagree with (or the date and IRS office symbols from the letter).
- An explanation of their reasons for disagreeing, including any supporting documents.
- The law or authority, if any, on which they are relying.

The protest must also contain a valid jurat statement: "Under penalties of perjury, I declare that I have examined this protest statement, including accompanying documents, and to the best of my knowledge and belief, the statement contains all relevant facts, and such facts are true, correct and complete." Representatives submitting the protest must also include a substitute declaration stating that the representative prepared the protest and any

accompanying documents, and personally knows (or doesn't know) that the statement of facts in the protest and any accompanying documents are true and correct. Organization officers or representatives may sign the protest ([Pub. 892](#)).

For unagreed cases subject to IRC Section 7428 declaratory judgment procedures, prepare an administrative record. See [IRM 4.75.32](#), Declaratory Judgment Cases and The Administrative Record.

Exhibit – Form 1041 Line By Line Pre-Audit Analysis

Types of Entities

Simple trust:

- Charitable contributions aren't deductible.
- Capital gains shouldn't be included in distributable net income (schedule D, line 16, column 1).
- The trust must distribute all ordinary income currently, and the tax is on the beneficiaries whether or not distributed.
- Returns showing tax merit further consideration, unless the tax is based entirely on capital gain.

Complex trust:

- If the Schedule D indicates that distributable net income includes capital gains, and return isn't final treat this as a large, unusual, or questionable (LUQ) item.
- If the distribution deduction (line 18) exceeds the adjusted total income (line 17), deem the issue of accumulated income distribution as an LUQ item.

Grantor type trust:

- Look for an attachment stating name of grantor and types of income to be reported on Form 1040.
- Check the Form 1040 if the Form 1041 reports large amounts of income to see if these amounts carry over properly to the individuals' returns.

Pooled income fund:

- Check for charitable deduction issues.

Entity Information

For the trust name, titles containing the following terms may be indications of sham entities:

- Asset management
- Business
- Enterprises
- Equipment
- Equity
- Holding
- Incorporated
- Leasing
- Machinery
- Resources
- Services
- Unincorporated
- Vehicle

Consider the following as additional potential sham entity indicators:

- The same trust and/or trustee name appears on various related or unrelated trusts.
- The trust has a name with abbreviations in the title, especially one with no discernible meaning.
- The trust has a name ending in Co. that suggests a company.
- The name includes Heritage Asset, Family Charitable or Family.
- The name includes UBO (Unincorporated Business Organization) or Pure Trust.

For beneficiary(ies), consider the following indicators of sham entities:

- Beneficiaries are trusts or foreign trusts.
- Beneficiary is a trust but lists a SSN instead of an EIN (could be the SSN is actually an EIN.)
- Beneficiary SSN or EIN is missing.
- Beneficiary and trustee EIN's appear to be sequenced (go 10 up and 10 down).
- Beneficiaries are UBI's (Units of Beneficial Interest) rather than names.

For fiduciaries, consider the following unusual items:

- The return lists a trust as the fiduciary
- The fiduciary and the beneficiary are the same.

For preparers, the following items may trigger LUQ classification:

- The same preparer prepares related trust returns.
- The preparer didn't sign the Form 1041 or didn't list a SSN or EIN.
- The preparer is connected to known promoter.
- The preparer is a trust.
- The preparer's address and the address associated with the preparer's EIN are inconsistent.

For returns, consider the following as possibly unusual:

- There are multiple returns for one taxpayer or address.
- For returns with no Schedules K-1, check whether the trust claimed the income distribution deduction.
- The tax returns have a post office box as an address but don't have a bank as trustee.
- The trust didn't file a gift tax return (Form 706) in initial year.
- Personal service returns.

Example: Chiropractors, dentists, insurance agents, real estate agents, day care operators, etc.

For entity information, consider these unusual elements:

- Concealment of the identity of grantor, trustees, and beneficiaries.
- The entry "religious objection" in place of an EIN/SSN.
- Omitted information (date created, name of fiduciary or beneficiary, etc.).
- Current creation dates (1994 forward).
- Initial or final year return is checked.
- The trustee is also a trust.
- Any indication of tax haven country involvement.

Income

Each type of income retains its character in the entity and when it's distributed to any beneficiary. The trust doesn't distribute losses except for the final year. Any time the income is from a trust entity, this may indicate a tier usage situation.

Line #	Title	Issue
1	Interest income	Look for netting of losses against interest, dividend and/or capital gains
2a	Total ordinary dividends	
2b	Qualified dividends	
3	Business income or (loss)	Generally, a trust can't operate a trade or business. If there is a Schedule C, treat the schedule as a LUQ item.
4	Capital gain or (loss)	Issue may be related to basis or related party transaction.
5	Rents, royalties, partnerships, other estates and trusts	Consider whether personal residence "rental" or unallowable passive activity loss. Trusts aren't entitled to the \$25,000 deduction for rental real estate. No losses can be passed through to the beneficiary.
6	Farm income or (loss)	May be active business that should be reported as a sole proprietorship, corporation or partnership.
7	Ordinary gain or (loss)	Issue may be basis or related party transaction.
8	Other income	May be used to report management fees, fiduciary fees or amounts from other trust. Amount but not source may be listed to hide identity of source. Consider negative entries such as net operating losses being deducted by the trust.

Deductions

If the trust has tax exempt income, the trust must allocate expenses for various deductions.

Line #	Title	Issue
10	Interest	Personal interest isn't deductible, i.e. revolving charge accounts; personal notes for money borrowed from a bank, credit union or other persons; installment loans on personal use property; interest attributable to underpayments of federal, state or local income taxes. Interest that is paid or incurred on indebtedness allocable to a trade or business, including rental activity, should be deducted on the appropriate line of Schedule C, E or F.
11	Taxes	Non-deductible taxes include federal income taxes, estate, inheritance, gift, and most state and local taxes except for property taxes.
12	Fiduciary fees	Large fiduciary fees may indicate a potential issue, such as unreasonable fees, and/or payments made to the grantor.

13	Charitable deduction	Significantly large charitable contribution deduction may indicate the trust's attempt to transfer monies to a related entity. Review Trust Agreement for authorization of contributions. Simple trust may not take a charitable deduction. Consider that the wrong box (simple verse complex trust) may have been checked.
14	Attorney, accountant, and return preparer fees	Large fees may indicate a potential issue, such as: unreasonable fees, allocation between the estate tax return (Form 706) and the fiduciary income tax return (Form 1041), and payments made to the grantor. Hidden trust package fees may be buried in other line item expenses.
15a	Other deductions not subject to the 2% floor	Review for the following: NOL's claimed with no explanation provided. NOLD in excess of net income. Losses deducted by trust. Personal expenses deducted. Funeral expenses, not deductible. AMT preference items Note: Investment advisory fees are subject to 2% floor and are preference items for AMT purposes. Additional items not subject to 2% floor include: Non-business casualty and theft losses Net operating losses. Fiduciary's share of depreciation, depletion, and amortization not deducted elsewhere on the return
15b	Net operating loss deduction	Check for AMT preference items. If there is an entry on this line, there should be an entry on the AMT schedule.
15c	Allowable miscellaneous itemized deductions subject to the 2% floor	Expenses subject to the 2% floor include safe deposit box rental, collection fees, investment advisory fees, and appraisal fees.
19	Estate tax deduction	If deduction claimed, review Form 706. Review the computation. If not attached, request it.
20	Exemption	Simple trust is limited to \$300. Complex trust is limited to \$100. Decedent's estate is limited to \$600. No exemptions allowed in the final year for an estate.

Schedule A

A simple trust can't take a charitable deduction. If you determine that the trust isn't a simple trust, reduce the exemption from \$300 to \$100.

For all charitable deductions, was the contribution made to a qualified organization as defined in IRC Section 501(c)? Was it actually made?

If line 13, (charitable deduction), is greater than line 9, (total income), excess may be disallowed. You can't create or increase a net operating loss with a charitable deduction. The charitable deduction is limited to 100% of gross income. Include gross income not previously distributed or deducted in the limitation amount.

If a [Form 1041-A](#) wasn't filed, consider asserting late-filing penalty on the trust.

Is there an allocation for the charitable deduction as related to tax exempt income?

For a PIF, if there's a deduction for a charitable contribution, select the return to verify that the deduction is calculated at net present value rather than fair market present value. See Regulations for net present value tables.

Large charitable contributions deduction may indicate the trust's attempt to transfer monies to a related entity. Review Trust Agreement for authorization of contributions.

Audit Tip: If Schedule A has an entry for an amount permanently set aside for charitable purposes and the trust was created on or after October 2, 1969, no deduction is allowable for that amount. If there's an IRC Section 642(c) election attached to the return, was the election properly filed per Treas. Reg. 1.642(c)-1(b)? If not, disallow the deduction. If the election was properly filed, were the amounts actually paid to qualified charitable organizations in a subsequent year? If not, disallow the deduction.

Audit Tip: If a trust is claiming to be a charitable trust or split-interest trust, was tax exempt status approved by the IRS? If not, disallow the deduction. If tax exempt status was approved but the trust isn't operating as a charitable entity (for example, is paying expenses of the grantor or the grantor's family,) propose revocation.

Schedule B

If Income Distribution Deduction (IDD) exceeds Distributable Net Income (DNI) then Net Tax Exempt Income (NTEI), throwback provisions could apply.

In general, except for the final year, the percentage of fees allocated to tax-exempt income isn't deductible on the 1041. (Classification tip: If yes is checked on line 1 of Other Information (at the bottom of Form 1041, page 2) then there is tax-exempt income and you should compute allocation for lines 10, 12, 14 and 15 of the Deductions area on the front of the Form 1041).

If an income distribution deduction is claimed, ensure K-1's are attached. (Ensure EIN/SSN information is included.) If a large income distribution deduction is claimed, check the beneficiary returns to ensure the income has been properly reported. If beneficiaries aren't listed, the beneficiaries may not have picked up income. (Check K-1s).

Normally an estate isn't required to distribute all income currently. Unless the estate has elected the 65-day rule has been elected, all distributions must be made within the year in order to be deductible. (65-day rule applies to complex trusts as well).

No losses or excess deductions are allowed to be distributed unless in termination year.

In the year of termination, all income and losses are deemed distributed. Each item retains its character upon distribution (in other words, ordinary income, capital gain, passive, active, etc.)

If capital gains are being distributed on Schedule D and Schedule B in a year other than the termination year, perfect the return.

If there is an Income Distribution Deduction and the trust hasn't completed Schedule B, select the return for perfection.

Audit Tip: Review the trust agreement to ensure distributions are made per the terms of the document. If the trustee refuses to cooperate, then the trust is probably an abusive trust.

Schedule C (Form 1040)

An active business shouldn't operate in a trust. Consider any Schedule C reported on a Form 1041 for audit. Exception: Trusts containing a decedent's business and trusts in bankruptcy.

Consider these questions:

- Does the name of the trust contain the same name as the trustee and/or beneficiary? (Refer to the "Entity" section above.)
- Does the name of the trust include names such as "enterprises," "resources" or similar titles?
- Does the same trustee appear on various related or unrelated trusts?
- Is the beneficiary another trust?
- Does the beneficiary have a foreign address?
- Are there any wages or management fees paid?
- Is the PIA Code on Schedule C 8888?
- Was the trust created recently?
- Is the preparer known for setting up abusive trusts?
- Does the Schedule C show a loss, which is providing tax benefit to the trust? If so, there may be a passive loss issue.
- Does the trust pass out the Schedule C loss to the beneficiaries? If yes, are K-1's included with the return?
- Are personal expenses deducted?
Example: Mortgage interest, utilities, personal residence depreciation.
- Is the business address different from the trust address or other return?

Does the return show an assignment of income?

- Does it appear that the trustee and/or beneficiary are doing the work?
- Are the gross receipts generated from personal service? Assignment of income isn't allowed and all income must be reported at the 1040 level.
- Is the Schedule C activity management, consulting or "making loans for profit"? (These may be coming from other Schedule Cs.)
- Are there few expenses?
- Is the PIA code of the activity a personal service such as chiropractor, doctor, insurance agent, real estate agent, etc.?

What types of expenses are incurred? Is there a large rental expense or other type of expense that could be paid to a related party?

Schedule D

The Uniform Principal and Income Act considers capital gain income and losses as corpus in most cases. Most states have adopted the Act. However, the trust document may give the trustee power to change this allocation.

Capital gain income from an installment sale a decedent makes represents income to a decedent.

For that reason, the basis of the asset sold doesn't step up to the date of death value and the capital gain income is the same as that reported by the decedent before his death. Treat income in respect of a decedent as corpus and not as part of distributable net income. If the date acquired for property listed on the Schedule D is the same date as the trust created date, the trust's basis in the assets is generally the grantor's basis plus any gift tax paid by the grantor.

Capital losses can only apply against capital gain income or any other income designated as corpus under the Uniform Principal and Income Act.

Capital gain income can be part of distributable net income only where the terms of the instrument provide for the distribution of corpus.

If the trust distributes capital gain income, the trust lists the amount on Schedule B, line 3 and Schedule D, line 16, column 1.

Select all returns where the capital loss shown on line 4 is greater than \$3,000. Select all returns with an entry on line 4 if Schedule D is missing.

If the trust is in its final year and is passing out a capital loss to the beneficiaries, the beneficiaries must retain the capital classification of these losses. Select the trust return and the beneficiaries return to ensure the losses are being properly limited.

Schedule D: Simple Trusts

The trust must distribute all income to the beneficiaries. Capital gain income isn't distributable to the beneficiary and is taxable to the fiduciary. If the trust claims to have made capital gain distributions, the trust has changed to a complex trust for that taxable year. Check the trust agreement to see if the trustee has the power to distribute corpus. In the year of termination, the trust may distribute capital gain income or any unused capital loss to the beneficiaries.

Schedule D: Complex Trusts

The trustee distributes income at his/her discretion. The trust may be able to distribute capital gain income based upon the governing instrument. If distributing capital gain income, the trust reports it on Schedules B and D. If the return shows large gains, select the return for audit to make sure the trust treats the capital gains properly per the Trust Agreement. In the year of termination, the trust may distribute capital gain income or any unused capital loss to the beneficiaries.

Schedule D: Grantor Trusts

All items of income and deductions are taxable to the grantor directly under IRC Sections 671 - IRC 678. The grantor's personal return should show any capital gains or losses on Schedule D.

Schedule E (Form 1040)

In general, a Schedule E loss is passive. The trust can't distribute or deduct the loss. Trusts may not take the \$25,000 rental real estate loss. If the return is the final year trust return with Schedule E losses and there's no Form 4797 indicating a sale, the beneficiaries can't take the losses. The trusts add the losses to the basis of the Schedule E activities' assets on the trust return. The beneficiary to whom the trust distributes the property accounts for the adjusted basis for determining his/her gain or loss on his/her eventual sale of the property. **Note:** Land rent, interest, dividends, and royalties aren't passive income. (IRC Section 469.)

Rental Real Estate Losses:

- What is the nature of the rental property?
- Is the address of the rental property the grantor's residence's address?
- Is the address of the rental property another trust's address?
- Does it appear that the rental property is personal use property?
- Does it appear that the rental income is coming from a related entity?

- Is land rent used to offset rental real estate losses?
- Are royalties used to offset rental losses?

Other Loss Issues:

- Are interest, dividends, and royalties entered on [Form 8582](#), Passive Activity Loss Limitations, as passive income used to offset passive losses?
- Was the rehabilitation credit or low income housing credit taken without passive income? **Note:** The taxpayer must have passive income to use the credits.
- Is the income/loss from a partnership or S-corporation?
- If the trust owns an interest in an S Corporation, partnership or trust, how did the trust acquire the interest? (Potential gift tax issue.)
- Was the rental property or partnership interest gifted and losses taken upon its disposition?
- Was the rental property or partnership interest sold to a beneficiary?
- Does the back of the Schedule E show other trusts?

For amounts categorized as non-passive the trustee must actively participate.

Passive Losses

Rental losses (almost in their entirety) and business losses in which the fiduciary fails to actively or materially participate generally can't reduce interest, dividends, capital gains or any other investment income. The trust suspends these losses on Form 8582. The participation of the trustee or fiduciary determines whether the activity is passive or non-passive. If the trustee/fiduciary is a bank trust officer, losses are usually passive. The amount of participation by any of the beneficiaries is inconsequential.

The following table discusses Form 1041 in light of the passive loss limitations.

Line #	Title	Issue
3	Business income or (loss)	The trustee/fiduciary must be actively participating in the day-to-day operation of the business. In addition, should the business be operating in the trust?
5	Rents, royalties, partnerships, other estates and trusts	Rental income is passive regardless of whether the trust generates income by the rental of property or equipment. No \$25,000 loss is allowable to a trust. A trust isn't a "natural person."
5	Rents, royalties, partnerships , other estates and trusts	The trustee/fiduciary must actively participate in the day-to-day operation of the business. Look for out of state EIN's and any indication that the partnership (or S- corporation) is real estate based. If necessary, pull a BRTVU (Business Return Transaction File View (IDRS)) for the entity in question and check the PIA code. If the trust is a limited partner or minority shareholder, the losses are probably passive.
6	Farm income or (loss)	The trustee/fiduciary must be actively participating in the day-to-day operation of the farm. In addition, should the farm be operating in the trust?

7	Ordinary gain or (loss)	The trust uses Form 4797 to report gains and losses on dispositions of assets used in a business or rental. This could reflect passive or non-passive income/ losses.
8	Other income	<p>A NOL may be a passive loss carryforward. This applies to any NOL's. NOL's can only be made up of losses created from lines 1 through 8. Administrative expenses can't create or increase an NOL.</p> <p>Passive losses can't be distributed to a beneficiary. Check the K-1's for this distribution. A portion of the suspended passive losses can be used in the Form 1041 tax calculation if the property/entity in question was completely disposed of during the tax year. The gain on the sale of a passive activity creates passive income, assuming that the activity was still passive in the year of disposition. Gains flowing through from other entities, such as partnerships or S-corporations, can be passive income if the involvement is passive. The rental of leased fields, parking lots, campgrounds and trailer parks isn't passive income, and can't be used to offset any passive losses.</p>

Schedule F

As a general rule, a trust isn't allowed to operate an active trade or business. In a decedent's estate, an active business should be wrapped up within a reasonable period of time, generally 2-3 years. Farm land rental isn't a Schedule F activity. It should generally be reported on Schedule E. See IRC Section 469(c)(7)(C). Trusts may not pass losses through to the beneficiaries except in year of termination.

Farm Loss Issues:

- Is the activity an ongoing business?
- What is the nature of the business?
- Does it appear to be a legitimate farming activity?
- Is the PIA Code on Schedule F 8888? PIA 8888 means unable to classify.
- Is the address on Schedule F and K-1's the same? This indicates that personal expenses may be deducted.
- Are there any wages or management fees paid? Could be to another trust or to the grantor or beneficiary.
- What types of expenses are incurred?
- Is there a large rental expense or other type of expense that could be paid to a related party?
- Does the Schedule F show a loss which is providing tax benefit to the trust? If so, a passive loss issue may be present.
- Does the trust pass out the Schedule F loss to the beneficiaries?
- Are Schedules K-1 included with the return?
- Is there interest expense claimed? Could be personal.

Schedule K-1

Items on the Schedule K-1 that may warrant further review:

- No Schedule K-1 attached when line 18 shows a distribution.
- Beneficiary is another trust.

- Trustee is also the beneficiary.
- Beneficiary has a foreign address (especially a known tax haven address).
- Beneficiary is a trust, but lists an SSN instead of an EIN.
- Beneficiary SSN or EIN is missing.
- No beneficiaries listed.
- Items erroneously present on the Schedule K-1.
Example: Losses or credits except in the final year return.
- Charitable contributions listed (not permitted.)
- Review any handwritten entries on a computer generated Schedule K-1.
- Compare the Schedule K-1 entries against the [Form 1041](#). If the trust made a distribution, check the corresponding EIN/SSN to verify the reporting of the distribution.

Exhibit – Form 5227 Line By Line Pre-Audit Analysis

Items in the Heading:

Box E: Note whether it is an initial or final return, if so the trust must complete Part III of Schedule A. Box F: Trust creation date is the date the trust first received assets.

Box G: If trust has substantial unrelated business taxable income, then question the validity of the CRT.

Part I Income and Deductions

Lines	Notes
1-3	CRTs typically only report interest, dividend and/or capital gain income (or losses). The trust generally distributes most or all of this income to the income beneficiary(ies).
4-7	Flow-through income generally retains same character as it had at the initial tier. Rents and royalties are common; other sources listed aren't common. Entity shouldn't be claiming a net operating loss.
9-13	The trust only reports capital gains as income if the trust instrument states that capital gains are to be included in income, otherwise the trust adds them to corpus.
17-23	Trustee, attorney, accountant, and return preparer fees are very common. Charitable deduction isn't common, unless it is a charitable lead trust.
24-26	Allocable deductions: If there is nontaxable income, then it is critical the trust properly allocates deductions to it proportionate to the amount of the nontaxable income divided by the total amount of income.

Part II Schedule of Distributable Income

This schedule tracks the distributable income that the trust eventually must pay to the income beneficiaries of the trust. Ordinarily, this income is mostly distributed in the current year, so that there wouldn't be much carried over from prior years. However, if the trust is a net income with makeup provision charitable remainder unitrust (NIMCRUT), then there typically would be a significant carryover amount on Line 27.

The income categorizes into three tiers of income:

- Tier 1: ordinary
- Tier 2: capital gain
- Tier 3: nontaxable

This is also the order by which the trust must distribute income:

- The trust must first deplete ALL of the income from Tier 1.
- The trust then distributes ALL of the income from Tier 2.
- Then if there is still income left, the trust treats it as Tier 3 (nontaxable). **Note:** There is also a Tier 4 not reflected in this schedule, which is return of capital and nontaxable to the recipient.

The amounts on Line 29 are transferred to Schedule A, Part 1-A.

Part III-A Distributions of Principal for Charitable Purposes

In general, the trust should only complete this section if it is the final year and the CRT is making final distributions to the charitable remainder interest, or the entity is a charitable lead trust, so the trust must make distributions from principal sometimes to fulfill the payout requirement to the charity.

Part III-B Accumulated Income Set Aside and Income Distributions for Charitable Purposes

This section should rarely contain amounts, as Congress eliminated the permanent set-aside deduction for post-1969 trusts. A CRT may claim a charitable deduction for qualified amounts paid to charitable organizations not deemed to be a distribution to one of the beneficiaries. The trust would have to pay this amount from the income of the CRT, and not from corpus. (IRC Section 642(c))

Part IV Balance Sheet

Look for items that you would ordinarily look for when auditing a [Form 990](#) or [Form 990-PF](#). There should generally only be investment-type assets.

If a business appears to operate through the CRT, consider excise taxes.

CRTs are subject also to the private foundation excise taxes, so closely review loans to/from officers.

Watch for large reductions in FMV of assets without cause. The income payout amount for a CRUT is based on the net FMV and can fluctuate year-to-year.

Parts V-A and V-B

If the trust checked the “Yes” box on Line 63, review the trust instrument to assure that it also reflects that the entity is a “NIMCRUT.” Also, verify that Line 67a is correct. The trust eventually pays this amount to the income beneficiaries. Reconcile the amount reported as much as possible to the amounts reported for “Undistributed Income from prior tax years” (line 27) in the preceding years.

Line 66a is a “loophole” for not reporting flow-through income from a flow-through entity, such as a LLC or partnership. If the flow-through entity doesn’t flow-through any income items (such as cash, property), then the fiduciary accounting income of the CRT would be zero. (IRC Section 643(b))

This allows the CRT to defer reporting the income from the flow-through entity for many years, with the understanding that the trust eventually has to pay it to the CRT. There are no checks and balances in-place to assure that the trust eventually pays out the income.