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Overview of Fiduciary Income Taxation

Presented by:

AICPA

Estate Gift & Trust Tax
Technical Resource Panel





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Trusts – General Types

- Inter vivos
 - Revocable
 - Irrevocable
- Testamentary
 - By-pass
 - Marital/Qualified Property Interest (QTIP) Trust
 - Residuary





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Simple vs. Complex

- Simple
 - All trust accounting income required to be distributed annually
 - No charitable contributions
 - No distributions of corpus
- Complex





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Trust Taxation

- IRC §641(b)
- Generally, taxable income of an estate or trust computed in the same manner as in the case of an individual
- Exceptions applicable to general rule are contained in part 1 of subchapter J of Internal Revenue Code (IRC §§ 641 – 685)





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Personal Exemption

- Major differences from personal exemption for individuals
- Personal exemption (IRC §642(b)(3))
 - Estate \$600
 - Simple trust \$300
 - Complex trust \$300 or \$100





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"Income" for Distribution Purposes

- Amount of income of the estate or trust for the taxable year determined under the terms of the *governing instrument* and *applicable local law* (IRC §643(b))
- Commonly referred to as trust accounting income
- IRC does not determine trust accounting income





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"Income" for Distribution Purposes

- First, READ THE GOVERNING INSTRUMENT
- Second, be familiar with your state's Principal and Income Act
- Income computed in accordance with the above will be the "income required to be distributed" of a simple trust





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Distributable Net Income

- Taxable income before
 - Exemption
 - Distribution deduction
 - Special deductions
- Add back
 - Capital losses
 - Municipal bond income (net of allocable expenses)
- Subtract capital gains (generally)





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Distribution Deduction

- Simple trusts – IRC §651
 - Amount of income required to be distributed
- Complex trusts and estates – IRC §661
 - Amounts required to be paid currently (Tier I)
 - Other amounts paid, credited or permanently set aside (Tier II)





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Distribution Deduction

- The distribution deduction is limited to the *lesser* of trust income (IRC §651) or DNI for simple trusts, or the lesser of distributions or DNI for complex trusts (IRC §661)
- DNI is the maximum amount of taxable income of the trust that is taxed to a beneficiary of a trust as the result of a distribution to the beneficiary as determined under IRC §643(a)





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Tiers of Distributions

- Tier I
 - Income required to be distributed
 - Receives DNI first
- Tier II
 - Other amounts paid credited or otherwise set aside
 - Taxed on distributions only to the extent there is remaining DNI

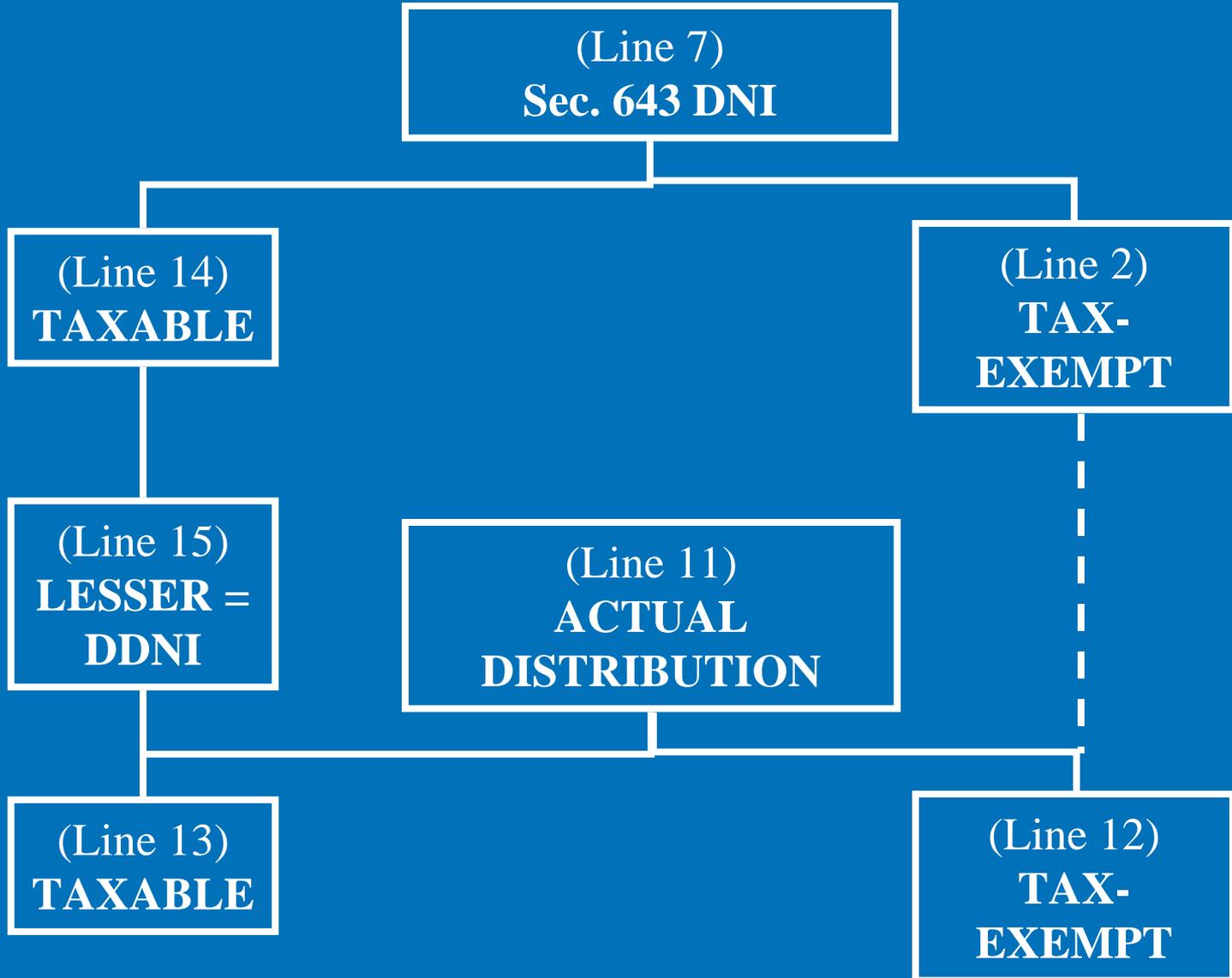




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DNI Relationships





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Deductions

- All ordinary and necessary expenses allowed
 - Administration
 - Trustee Fees
 - Litigation Costs
- Charitable deduction
 - Must be from trust's gross income
 - Must be allowed by trust instrument





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Deductions

- No double deduction if expense was allowed on Form 706
- Exception – deductions "in respect of a decedent" are allowed on both Form 706 and Form 1041
 - Property taxes
 - Accrued interest paid





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Deductions – 2% Limitation

- Expenses which would be subject to the 2% AGI floor for individuals are also subject to the 2% AGI floor for trusts and estates
- Exception
 - Expenses incurred during administration *and*
 - Which would not have been incurred if the property were not held in the trust





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Deductions – 2% Limitation

- *Knight v. Commissioner*, 128 S.Ct. 782 (1/16/08) required expense to be "uncommon (or unusual or unlikely) for a hypothetical individual to incur"
- Proposed regulations (Prop. Reg. 1.67-4) would require the trustee to unbundle its fees to separate the 2% limitation services
- See Notice 2011-37 extending the IRS position to not require unbundling until final regulations are published





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Allocation of DNI

- Direct expenses are allocated to the class of DNI to which they relate
- Indirect expenses are allocated:
 - A portion to non-taxable income
 - Remainder to any class of income included in DNI





CLASS PROBLEM – SIMPLE TRUST

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Description	Actual	Adj.	TAI	Adj.	Taxable	Adj.	Sec. 643 DNI
Receipts:							
Interest	25,000	-0-	25,000	-0-	25,000		25,000
Dividends	50,000	-0-	50,000	-0-	50,000		50,000
Capital Gain	20,000	(20,000)	-0-	20,000	20,000	(20,000)	-0-
Return of Capital	20,000	(20,000)	-0-	-0-	-0-		-0-
Business Inc.	10,000	-0-	10,000	-0-	10,000		10,000
Subtotal:	125,000	(40,000)	85,000	20,000	105,000		85,000
<u>Disbursements:</u>							
Mortgage Int.	(20,000)	-0-	(20,000)	-0-	(20,000)		(20,000)
Mortgage Prin.	(5,000)	5,000	-0-	-0-	-0-		
Trustee Fees							
Income	(2,000)	-0-	(2,000)	-0-	(2,000)		(2,000)
Principal	(2,000)	2,000	-0-	(2,000)	(2,000)		(2,000)
Depreciation	(10,000)	10,000	-0-	-0-	-0-		
Subtotal:	(39,000)	17,000	(22,000)	(2,000)	(24,000)		(24,000)
Total:	86,000	23,000	63,000	18,000	81,000		61,000





Beneficiary's Schedule K-1

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Description	Actual	TAI	Taxable	Sec. 643 DNI	Schedule K-1
Receipts:					
Interest	25,000	25,000	25,000	25,000	1,000
Dividends	50,000	50,000	50,000	50,000	50,000
Capital Gain	20,000	-0-	20,000	-0-	-0-
Return of Capital	20,000	-0-	-0-	-0-	-0-
Business Inc.	10,000	10,000	10,000	10,000	10,000
Subtotal:	125,000	85,000	105,000	85,000	61,000
Disbursements:					
Mortgage Int.	(20,000)	(20,000)	(20,000)	(20,000)	-0-
Mortgage Prin.	(5,000)	-0-	-0-	-0-	-0-
Trustee Fees					
Income	(2,000)	(2,000)	(2,000)	(2,000)	
Principal	(2,000)	-0-	(2,000)	(2,000)	
Depreciation	(10,000)	-0-	-0-	-0-	(10,000)
Subtotal:	(39,000)	(22,000)	(24,000)	(24,000)	
Total:	86,000	63,000	81,000	61,000	





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Net Investment Income Tax

- NII Tax imposed on trusts and estates
 - applicable to taxable years beginning after 12/31/2012
- 3.8% of the lesser of --
 - the undistributed net investment income for the year, or
 - the excess of AGI over bracket amount for highest income tax rate (\$11,950 for 2013)





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Undistributed NII (UNII)

- UNII is determined by reducing the total NII by:
 - Distributed NII, and
 - 642(c) charitable deductions
- Distributed NII is the lesser of:
 - The distribution deduction (allocated between NII and excluded income), or
 - The NII of the estate or trust





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Passive Activities

- Section 469 Active Participation
 - Look to trustees, employees and third-party agents – *Mattie K. Carter Trust v. United States*
 - Look only to trustees who are considered fiduciaries – TAM 2007-33-023, PLR 2010-29-014, TAM 201317010
 - *Carter Trust* is still valid law despite IRS's position