Overview of Fiduciary Income Taxation

Presented by:
AICPA
Estate Gift & Trust Tax
Technical Resource Panel
Trusts – General Types

• Inter vivos
  – Revocable
  – Irrevocable
• Testamentary
  – By-pass
  – Marital/Qualified Property Interest (QTIP) Trust
  – Residuary
Simple vs. Complex

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

- **Complex**
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)
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
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)
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)
"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
"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
Distributable Net Income

• Taxable income before
  – Exemption
  – Distribution deduction
  – Special deductions

• Add back
  – Capital losses
  – Municipal income (net of allocable expenses)

• Subtract capital gains (generally)
DNI Relationships

(Line 7)
Sec. 643 DNI

(Line 14)
TAXABLE

(Line 15)
LESSER = DDNI

(Line 11)
ACTUAL DISTRIBUTION

(Line 2)
TAX-EXEMPT

(Line 13)
TAXABLE

(Line 12)
TAX-EXEMPT
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
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
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
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
Deductions – 2% Limitation

• *Knight v. Commissioner*, 128 S.Ct. 782 (1/16/08) requires 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 fee once the regulations are finalized

• See Notice 2010-32 extending for 2009 IRS position not to require unbundling
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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<tr>
<th>Description</th>
<th>Actual</th>
<th>Adj.</th>
<th>TAI</th>
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## Beneficiary’s Schedule K-1

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