OVERVIEW OF FIDUCIARY INCOME TAXATION

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Overview

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

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

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

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

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

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

- Grantor trusts — inter vivos trusts created for grantor’s use and benefit (for income tax purposes!)

- Examples:
  - Revocable or living trust
  - Defective grantor trust (IDGT)

- Consequence: all trust income (ordinary and capital gain) is reported on grantor’s income tax return (whether or not distributed to grantor).
Election to Treat a Qualified Revocable Trust as Part of the Decedent's Estate

- Qualified Revocable Trust – generally an inter vivos revocable trust
- Making the Election – “645 election” made on Form 8855
- Tax Return Filing Obligations – only one return required
Election to Treat a Qualified Revocable Trust as Part of the Decedent’s Estate

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

- Disadvantage:
  - Combining could push into higher bracket
Fiduciary Tax and Accounting Issues — Fundamental Concepts:

- Fiduciary (or Trust) Accounting Income - FAI
- Distributable Net Income (DNI)
- Taxable Income
Fiduciary Tax and Accounting Issues
— Fundamental Concepts:

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

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

- Taxable Income - generally calculated in the same manner as an individual

- Differences –
  - Distribution deduction permitted for income distributed to beneficiaries
  - No percentage limitations for charitable contributions
  - Exemptions permitted without phase-outs or proration
Fiduciary Tax and Accounting Issues
—Fundamental Concepts:

- Distribution Deduction – deduction for amount of income distributed to beneficiaries

- Simple Trust – generally FAI required to be distributed, with two limitations:
  - Limited to DNI
  - No deduction for tax-exempt income
Fiduciary Tax and Accounting Issues
—Fundamental Concepts:

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

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

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

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

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

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

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

- Distribution of capital gains (See John Goldsbury, US Trust, “Dealing with the 23.8% Tax on Capital Gains”: http://tiny.cc/FiduciaryIncomeTax)
- Distributions in kind
- Distribution to beneficiaries in excess of DNI: the Tier System
- Distributions in Year of Termination
Dealing with the 23.8% tax on trust capital gains: 21 ways (and counting) to have a trust’s capital gain taxed to the beneficiary

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

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

I. Intro

A. What is subject to the 3.8% surtax? ................................................................. 1
B. What is not subject to the 3.8% surtax? ........................................................... 2
C. How is a trust surtaxed? .................................................................................. 3
D. How does a beneficiary treat trust distributions ............................................ 7
E. How much NII is surtaxed? .............................................................................. 8
The Net Investment Income Tax and Its Applications to Trusts and Estates

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

- Planning Considerations and Strategies for Trusts and Estates
  - Distribute income
  - Make 645 election
  - Use 65 day rule
  - Consider investment strategy
IRS Forms Associated with Fiduciary Income Tax Reporting

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