

Income Taxation of Trusts & Estates

Christopher M. Harvey, JD, CPA,
LL.M (Taxation)

1

Complex Trusts

2

Complex Trusts & Estates

- Amount of Deduction: Section 661(a)(1)-(2)
 - Section 661(a)(1)-(2): "... there shall be allowed a deduction in computing TI of an estate or trust [other than a simple trust], the sum of
 - (1) any amount of income ... required to be distributed currently (TIER 1); and
 - (2) any other amounts properly paid or credited or required to be distributed ... (TIER 2);
 - but such deduction shall not exceed the DNI of the estate or trust.

3

Complex Trusts & Estates continued

- Section 661(c): Limitation on Deduction: No deduction shall be allowed ... in respect of any portion of the amount allowed as a deduction ... consisting of any item of DNI which is not included in gross income of the trust or estate.
 - In other words, no deduction for tax-exempt income.
 - Same rule for simple trusts.

4

Character of Income

- 662(a): Inclusion
 - (1) Tier 1: The amount of income required to be distributed, whether distributed or not.
 - (2) Tier 2: All other amounts properly paid, credited or required to be distributed.
 - Treas. Reg. Section 1.662(a)(3).
 - If the sum of amount required to be distributed plus all other amounts properly paid, credited or required to be distributed exceeds the DNI, then include in gross income a pro rata portion.

5

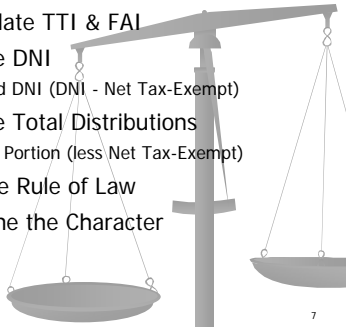
Character of Income (continued)

- 662(b): Character of Amounts
 - Character to the beneficiary is the same as the character to the estate or trust.
 - Unless the will or trust specifically allocates classes of income to specific beneficiaries, then amounts from 661(a) shall consist of the same proportion of each class of item entering into DNI as the total bears to total DNI.
 - Each Beneficiary receives the same proportion of each class. Treas. Reg. Section 1.662(b)(1).

6

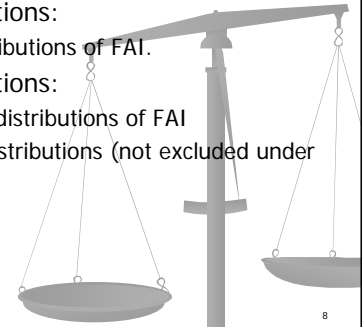
Steps in the Process

- Steps 1,2: Calculate TTI & FAI
- Step 3: Calculate DNI
 - Calculate Adjusted DNI (DNI - Net Tax-Exempt)
- Step 4: Calculate Total Distributions
 - Calculate Taxable Portion (less Net Tax-Exempt)
- Step 5: Apply the Rule of Law
- Step 6: Determine the Character



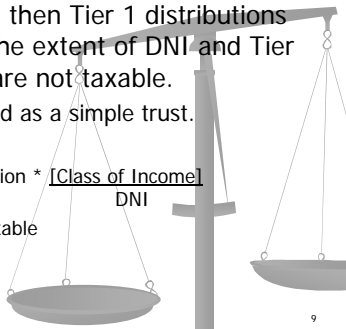
Tier 1 & Tier 2 Distributions

- Tier 1 Distributions:
 - Required distributions of FAI.
- Tier 2 Distributions:
 - Discretionary distributions of FAI
 - All principal distributions (not excluded under Section 663).



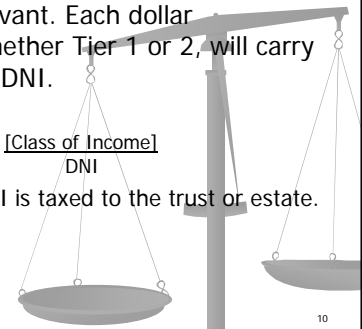
I. Character: Tier 1 \geq DNI

- If Tier 1 \geq DNI, then Tier 1 distributions are taxable to the extent of DNI and Tier 2 distributions are not taxable.
 - Essentially taxed as a simple trust.
 - Formula:
 - Tier 1 Distribution * $\frac{[\text{Class of Income}]}{\text{DNI}}$
 - Tier 2: Not Taxable



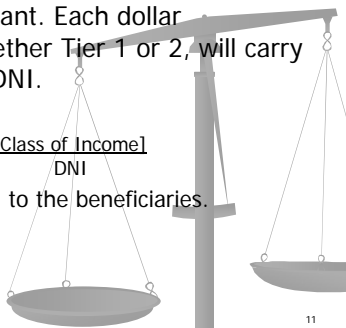
II. Character: Tier 1 < DNI & Tier 1 + Tier 2 < DNI

- Tiers are irrelevant. Each dollar distributed, whether Tier 1 or 2, will carry out a dollar of DNI.
 - Formula:
 - Distribution * $\frac{[\text{Class of Income}]}{\text{DNI}}$
 - Balance of DNI is taxed to the trust or estate.



III. Character: Tier 1 < DNI & Tier 1 + Tier 2 = DNI

- Tiers are irrelevant. Each dollar distributed, whether Tier 1 or 2, will carry out a dollar of DNI.
 - Formula:
 - Distribution * $\frac{[\text{Class of Income}]}{\text{DNI}}$
 - All DNI is taxed to the beneficiaries.



IV. Character: Tier 1 < DNI & Tier 1 + Tier 2 > DNI

- Tier 1 distributions are taxable completely and Tier 2 distributions are taxable to extent of remaining DNI with balance nontaxable.
 - Allocate DNI to Tier 1, then Tier 2.
 - Formula:
 - Tier 1 Distribution * $\frac{[\text{Class of Income}]}{\text{DNI}}$
 - Tier 2: Remaining DNI * $\frac{[\text{Class of Income}]}{\text{DNI}}$

