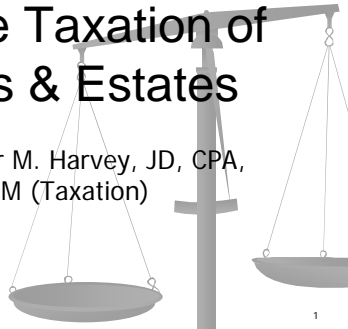


Income Taxation of Trusts & Estates

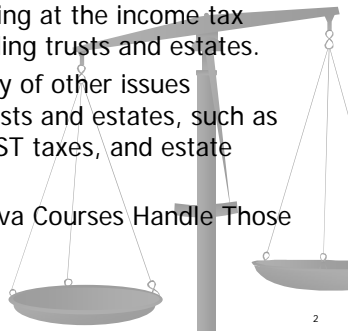
Christopher M. Harvey, JD, CPA,
LL.M (Taxation)



1

Course Coverage

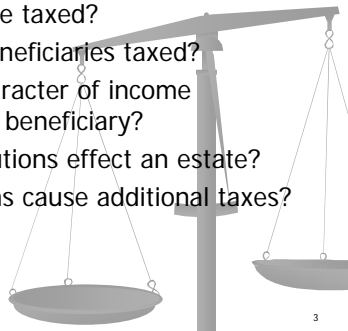
- We will be looking at the income tax issues surrounding trusts and estates.
- There are plenty of other issues surrounding trusts and estates, such as estate taxes, GST taxes, and estate planning.
- Other Great Nova Courses Handle Those Issues



2

Course Roadmap

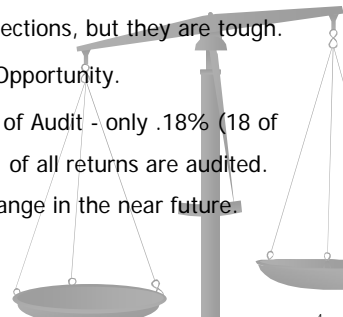
- How is an estate taxed?
- How are the beneficiaries taxed?
- What is the character of income distributed to a beneficiary?
- How do distributions effect an estate?
- Can distributions cause additional taxes?



3

Risks & Rewards

- Only 23 Code Sections, but they are tough.
- Great Practice Opportunity.
- LOW LOW Risk of Audit - only .18% (18 of 10,000 returns) of all returns are audited.
Not likely to change in the near future.



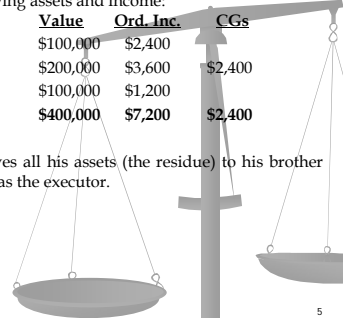
4

Life & Times of Bill Smith

- Bill Smith has the following assets and income:

	Value	Ord. Inc.	CGs
■ Savings Account	\$100,000	\$2,400	
■ Mutual Fund	\$200,000	\$3,600	\$2,400
■ 1,000 shares of Pfizer	\$100,000	\$1,200	
■ Totals	\$400,000	\$7,200	\$2,400

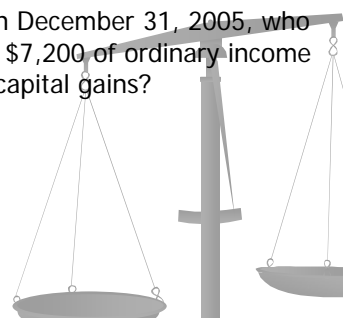
- Under Bill's will, he gives all his assets (the residue) to his brother Tom. Bill appoints Jane as the executor.



5

Question 1

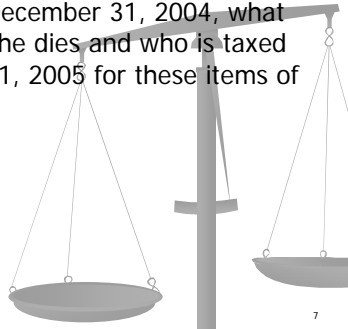
- If Bill is alive on December 31, 2005, who is taxed on the \$7,200 of ordinary income and \$2,400 of capital gains?



6

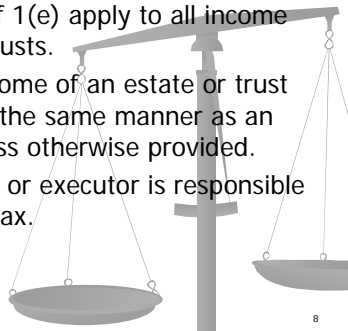
Question 2

- If Bill died on December 31, 2004, what happens when he dies and who is taxed on December 31, 2005 for these items of income?



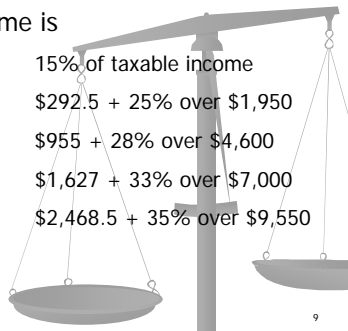
Section 641

- (a): tax rates of 1(e) apply to all income of estate and trusts.
- (b): taxable income of an estate or trust is calculated in the same manner as an individual, unless otherwise provided.
- (b): the trustee or executor is responsible for paying the tax.



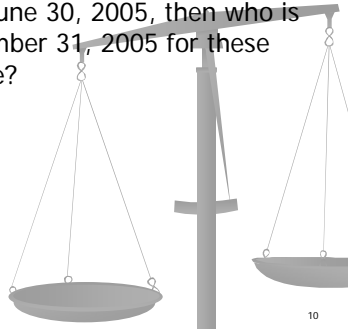
Section 1(e): 2005 Tax Rates

- If Taxable Income is
 - \$0 - \$1,950 15% of taxable income
 - \$1,950 - \$4,600 \$292.5 + 25% over \$1,950
 - \$4,600 - \$7,000 \$955 + 28% over \$4,600
 - \$7,000 - \$9,550 \$1,627 + 33% over \$7,000
 - Over \$9,550 \$2,468.5 + 35% over \$9,550



Question 3

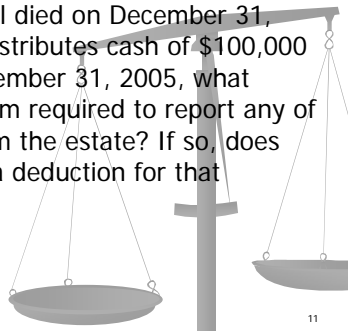
- If Bill died on June 30, 2005, then who is taxed on December 31, 2005 for these items of income?



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Question 4

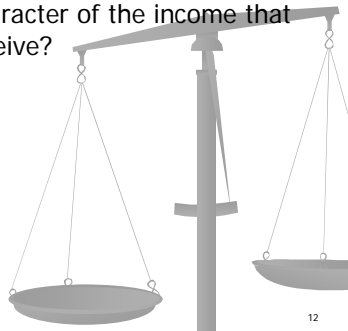
- Assume that Bill died on December 31, 2004, if Jane distributes cash of \$100,000 to Tom on December 31, 2005, what happens? Is Tom required to report any of the income from the estate? If so, does the estate get a deduction for that income?



11

Question 5

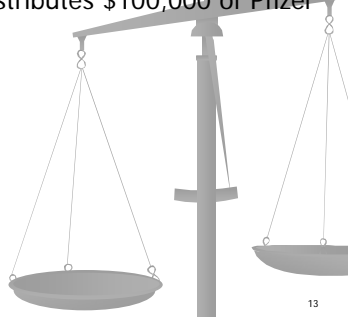
- What is the character of the income that Tom would receive?



12

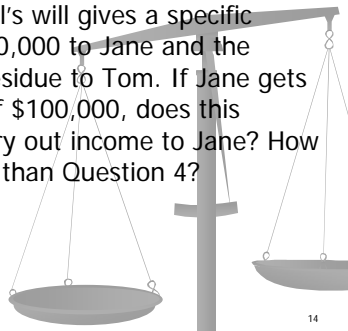
Question 6

- What if Jane distributes \$100,000 of Pfizer stock to Tom?



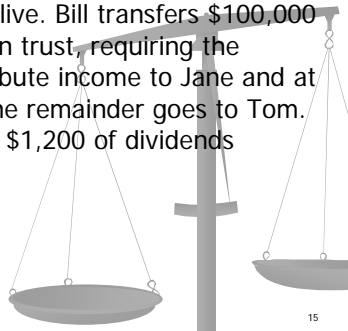
Question 7

- Assume that Bill's will gives a specific bequest of \$100,000 to Jane and the remainder or residue to Tom. If Jane gets a distribution of \$100,000, does this distribution carry out income to Jane? How is this different than Question 4?



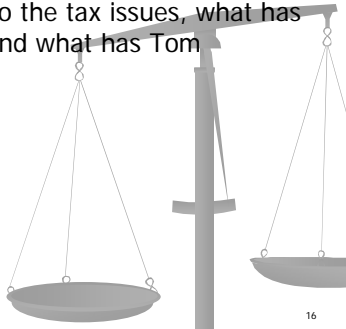
Question 8

- Assume Bill is alive. Bill transfers \$100,000 of Pfizer stock in trust, requiring the trustee to distribute income to Jane and at Jane's death, the remainder goes to Tom. The trust earns \$1,200 of dividends annually.



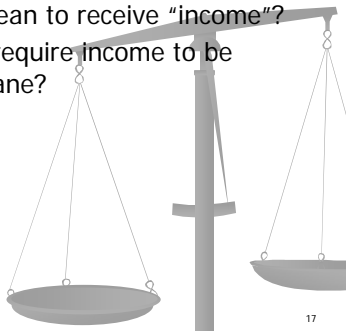
Question 8(a)

- Before we get to the tax issues, what has Jane received and what has Tom received?



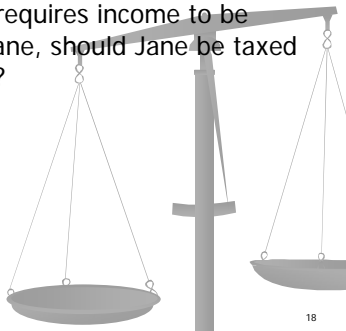
Question 8(b)

- What does it mean to receive "income"?
- Does the trust require income to be distributed to Jane?



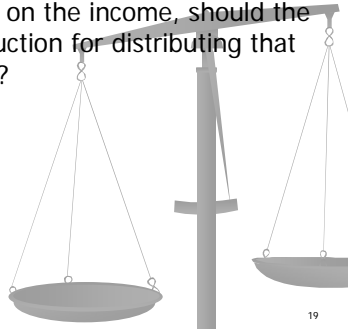
Question 8(c)

- Since the trust requires income to be distributed to Jane, should Jane be taxed on that income?



Question 8(d)

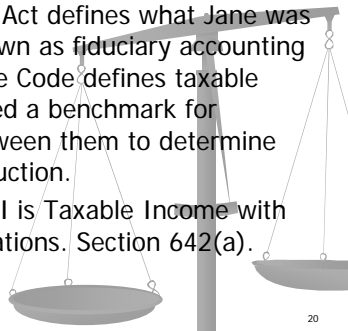
- If Jane is taxed on the income, should the trust get a deduction for distributing that income to Jane?



19

Distributable Net Income (“DNI”)

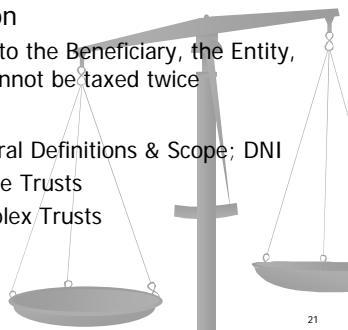
- Since the P & I Act defines what Jane was entitled to, known as fiduciary accounting income, and the Code defines taxable income, we need a benchmark for reconciling between them to determine the proper deduction.
- This is DNI. DNI is Taxable Income with certain modifications. Section 642(a).



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Review

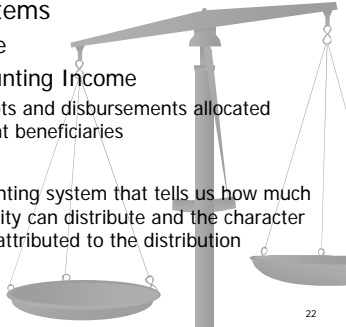
- Conduit Taxation
 - Income Taxed to the Beneficiary, the Entity, or Both, but cannot be taxed twice
- Code Sections
 - 641-643: General Definitions & Scope; DNI
 - 651-652: Simple Trusts
 - 661-663: Complex Trusts



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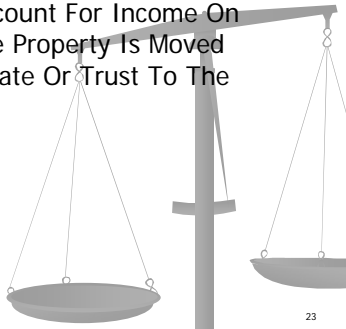
Review cont.

- Accounting Systems
 - Taxable Income
 - Fiduciary Accounting Income
 - How are receipts and disbursements allocated among different beneficiaries
 - DNI
 - Artificial accounting system that tells us how much income the entity can distribute and the character of the income attributed to the distribution



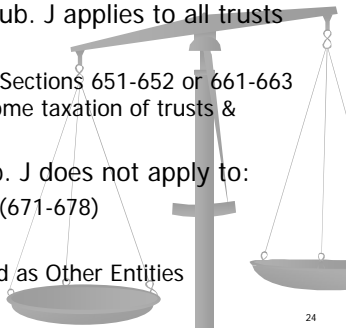
PURPOSE of Sub. J

- How Do We Account For Income On Property As The Property Is Moved Through An Estate Or Trust To The Beneficiary?



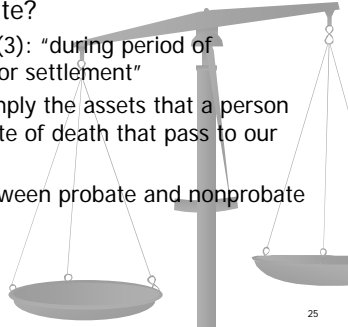
Does Sub J Apply?

- General Rule: Sub. J applies to all trusts and estates.
 - Thus, DNI and Sections 651-652 or 661-663 govern the income taxation of trusts & estates.
- Exceptions: Sub. J does not apply to:
 - Grantor Trusts (671-678)
 - Some Estates
 - Trusts Classified as Other Entities



Estates

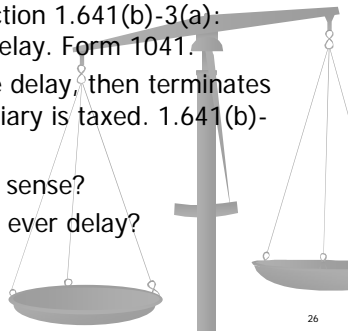
- What is an Estate?
 - Section 641(a)(3): “during period of administration or settlement”
 - An estate is simply the assets that a person owns at the date of death that pass to our heirs
 - Distinguish between probate and nonprobate assets



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Estates: Period of Admin.

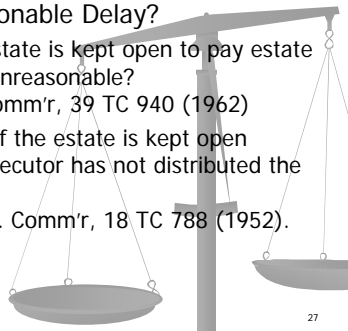
- Treas. Reg. Section 1.641(b)-3(a): unreasonable delay. Form 1041.
- If unreasonable delay, then terminates and the beneficiary is taxed. 1.641(b)-3(d).
- Does this make sense?
- Why would you ever delay?



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Estates: Unreasonable Delay

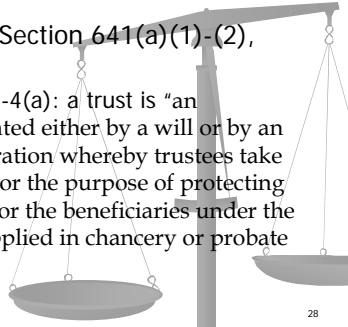
- What is Unreasonable Delay?
 - Hypo 1: The estate is kept open to pay estate taxes? Is this unreasonable? See Miller v. Comm’r, 39 TC 940 (1962)
 - Hypo 2: What if the estate is kept open because the executor has not distributed the assets? See Roebing v. Comm’r, 18 TC 788 (1952).



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Trusts

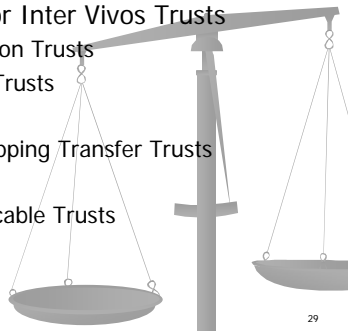
- What is a Trust? Section 641(a)(1)-(2), and (4).
- Section 301.7701-4(a): a trust is "an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."



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Types of Trusts

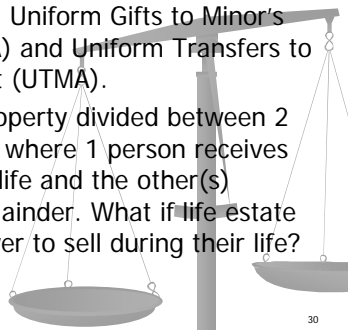
- Testamentary or Inter Vivos Trusts
 - Marital Deduction Trusts
 - Credit Shelter Trusts
 - Family Trusts
 - Generation Skipping Transfer Trusts
 - Minor's Trusts
 - General Irrevocable Trusts



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Types of Trusts cont.

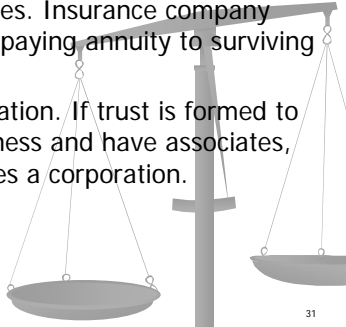
- Custodianships. Uniform Gifts to Minor's Account (UGMA) and Uniform Transfers to Minor's Account (UTMA).
- Life Estates. Property divided between 2 or more people where 1 person receives the income for life and the other(s) receive the remainder. What if life estate holder had power to sell during their life?



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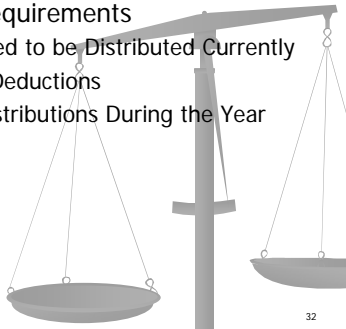
Types of Trusts cont.

- Insurance Policies. Insurance company holds proceeds paying annuity to surviving spouse.
- Trust or Corporation. If trust is formed to carry on a business and have associates, then it resembles a corporation.



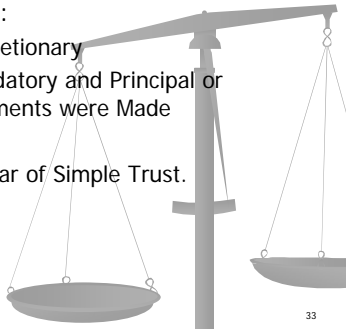
Simple Trusts

- Section 651: Requirements
 - Income Required to be Distributed Currently
 - No Charitable Deductions
 - No Principal Distributions During the Year



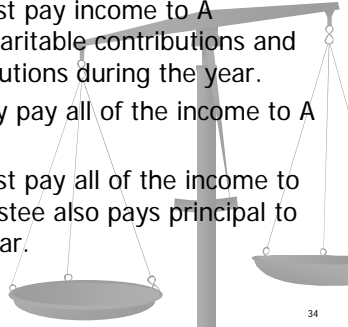
Complex Trusts & Estates

- "Requirements":
 - Income is Discretionary
 - Income is Mandatory and Principal or Charitable Payments were Made
 - Estate
 - Termination Year of Simple Trust.



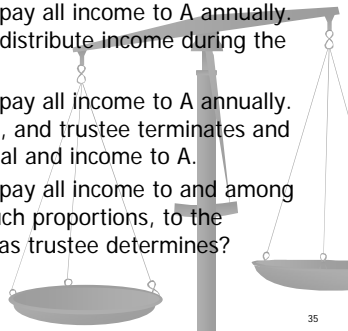
Hypos

- (1) Trustee must pay income to A annually. No charitable contributions and no other distributions during the year.
- (2) Trustee may pay all of the income to A annually.
- (3) Trustee must pay all of the income to A annually. Trustee also pays principal to A during the year.



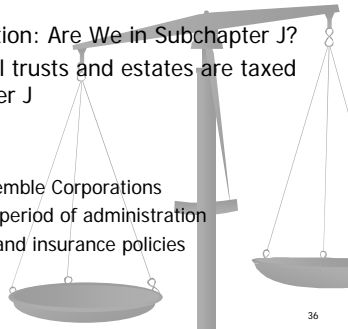
Hypos cont.

- (4) Trustee must pay all income to A annually. Trustee does not distribute income during the year.
- (5) Trustee must pay all income to A annually. Final year of trust, and trustee terminates and distributes principal and income to A.
- (6) Trustee must pay all income to and among beneficiaries in such proportions, to the exclusion of any, as trustee determines?



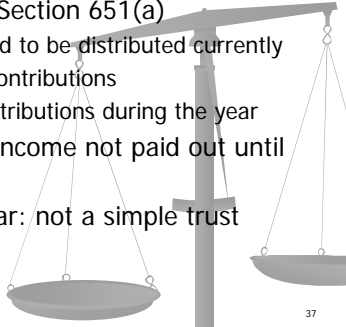
Review

- Threshold Question: Are We in Subchapter J?
- General Rule: All trusts and estates are taxed under Subchapter J
- Exceptions:
 - Grantor Trusts
 - Trusts that Resemble Corporations
 - Estates beyond period of administration
 - custodianships and insurance policies



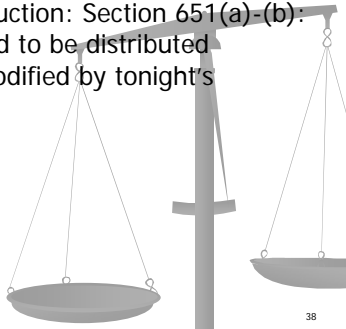
Simple Trusts: Requirements

- Requirements: Section 651(a)
 - Income required to be distributed currently
 - No charitable contributions
 - No principal distributions during the year
- Irrelevant that income not paid out until next year
- Termination Year: not a simple trust



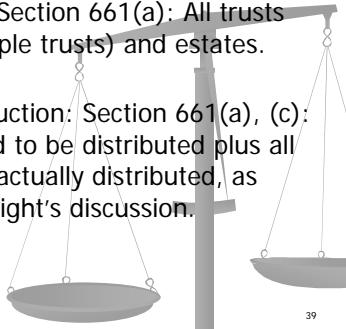
Simple Trusts: Deduction

- Amount of Deduction: Section 651(a)-(b):
Income required to be distributed currently, as modified by tonight's discussion.



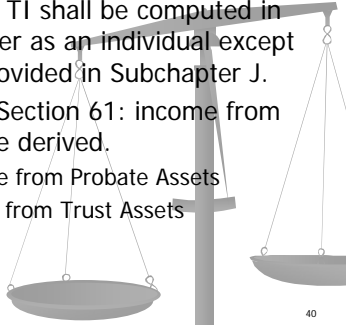
Complex Trusts & Estates

- Requirements: Section 661(a): All trusts (other than simple trusts) and estates.
- Amount of Deduction: Section 661(a), (c):
income required to be distributed plus all other amounts actually distributed, as modified by tonight's discussion.



Taxable Income of Trusts/Estates

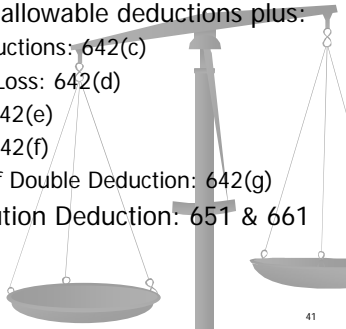
- Section 641(b): TI shall be computed in the same manner as an individual except as otherwise provided in Subchapter J.
- Gross Income: Section 61: income from whatever source derived.
 - Estates: Income from Probate Assets
 - Trusts: Income from Trust Assets



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Deductions

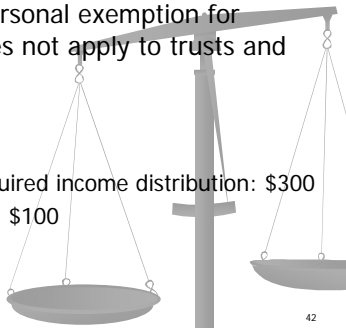
- Deductions: All allowable deductions plus:
 - Charitable Deductions: 642(c)
 - Net Operating Loss: 642(d)
 - Depreciation: 642(e)
 - Amortization: 642(f)
 - Disallowance of Double Deduction: 642(g)
- Income Distribution Deduction: 651 & 661



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Personal Exemption

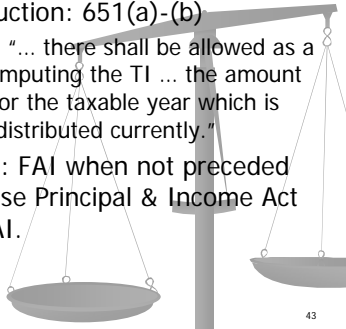
- Section 151: personal exemption for individuals. Does not apply to trusts and estates.
- Section 642(b):
 - Estates: \$600
 - Trusts with required income distribution: \$300
 - All other trusts: \$100



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Simple Trust: Thorough

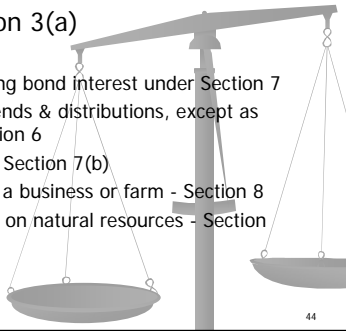
- Amount of Deduction: 651(a)-(b)
 - Section 651(a): "... there shall be allowed as a deduction in computing the TI ... the amount of the income for the taxable year which is required to be distributed currently."
- Income: 643(b): FAI when not preceded by tax words. Use Principal & Income Act to determine FAI.



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Principal & Income Act

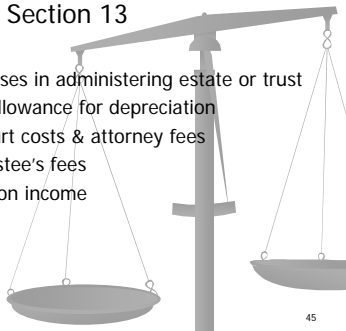
- Income: Section 3(a)
 - Rents
 - Interest, including bond interest under Section 7
 - Corporate dividends & distributions, except as provided in Section 6
 - Bond Discount - Section 7(b)
 - Net profits from a business or farm - Section 8
 - Lease payments on natural resources - Section 9(a)(1)



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Principal & Income Act cont.

- Disbursements: Section 13
 - Income:
 - ordinary expenses in administering estate or trust
 - a reasonable allowance for depreciation
 - one-half of court costs & attorney fees
 - one-half of trustee's fees
 - any tax levied on income



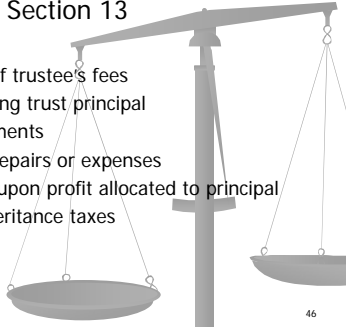
45

Principal & Income Act cont.

■ Disbursements: Section 13

■ Principal:

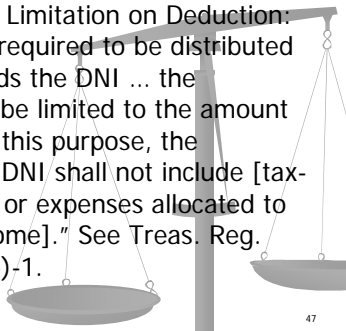
- other portion of trustee's fees
- costs of investing trust principal
- mortgage payments
- extraordinary repairs or expenses
- any tax levied upon profit allocated to principal
- estate and inheritance taxes



Section 651(b): Limitation

■ Section 651(b): Limitation on Deduction:

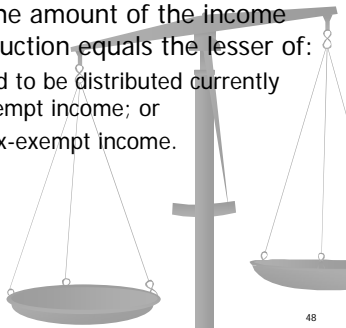
"If the amount required to be distributed currently exceeds the DNI ... the deduction shall be limited to the amount of the DNI. For this purpose, the computation of DNI shall not include [tax-exempt income or expenses allocated to tax-exempt income]." See Treas. Reg. Section 1.651(b)-1.



RULE OF LAW: 651(a)-(b)

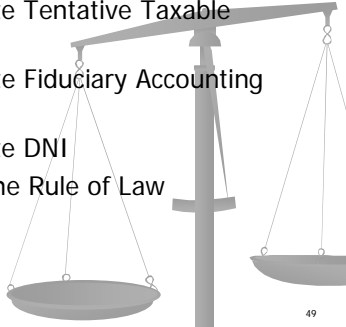
■ General Rule: the amount of the income distribution deduction equals the lesser of:

- income required to be distributed currently less net tax-exempt income; or
- DNI less net tax-exempt income.



Steps in the Process

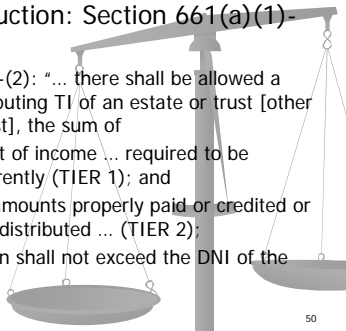
- Step 1: Calculate Tentative Taxable Income
- Step 2: Calculate Fiduciary Accounting Income
- Step 3: Calculate DNI
- Step 4: Apply the Rule of Law



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Complex Trusts & Estates

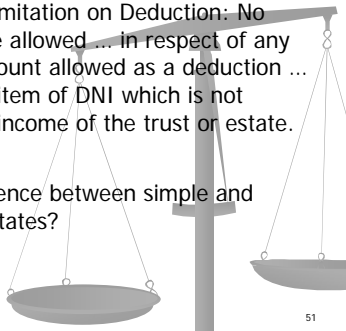
- Amount of Deduction: Section 661(a)(1)-(2)
 - Section 661(a)(1)-(2): "... there shall be allowed a deduction in computing TI of an estate or trust [other than a simple trust], the sum of
 - (1) any amount of income ... required to be distributed currently (TIER 1); and
 - (2) any other amounts properly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



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Complex Trusts: Limitation

- 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.
- What is the difference between simple and complex trusts/estates?



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DNI

- Section 643(a): TI with modifications
 - (1) Deduction for distribution
 - (2) Deduction for personal exemption
- Hypo (1):
Trustee must pay income to A annually. No charitable contributions and no other distributions. Trust has \$10,000 of dividends and \$15,000 of interest. Calculate TTI, FAI, DNI, 651 deduction and TI.

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DNI cont.

- (3) Capital Gains and Losses: Excluded to the extent allocated to principal and not (a) paid, credited or required to be distributed to any beneficiary, or (b) paid, permanently set aside or used for charitable purposes under 642(c).

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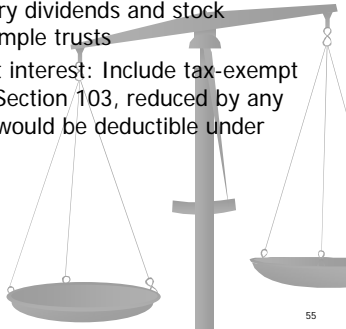
DNI cont.

- Hypo (2):
 - Suppose we have a trust with 1,000 shares of Pfizer stock that pays a dividend of \$1,000 annually. A is entitled to the income annually and remainder to B. If when the trust was formed the stock was worth \$100,000, and today it is worth \$125,000 and the trustee sells the stock, the trust has a \$25,000 capital gain. Calculate TTI, FAI, DNI, 651 deduction and TI.

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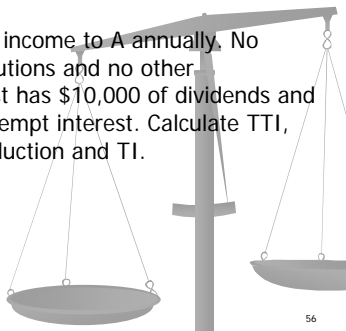
DNI cont.

- (4) Extraordinary dividends and stock dividends for simple trusts
- (5) Tax-exempt interest: Include tax-exempt interest under Section 103, reduced by any amount which would be deductible under Section 265.



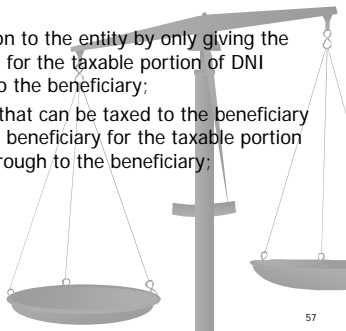
DNI cont.

- Hypo (3):
Trustee must pay income to A annually. No charitable contributions and no other distributions. Trust has \$10,000 of dividends and \$15,000 of tax-exempt interest. Calculate TTI, FAI, DNI, 651 deduction and TI.



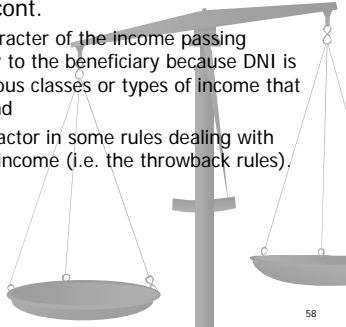
Reasons for DNI

- Reasons for DNI
 - limits the deduction to the entity by only giving the entity a deduction for the taxable portion of DNI passing through to the beneficiary;
 - limits the income that can be taxed to the beneficiary by only taxing the beneficiary for the taxable portion of DNI passing through to the beneficiary;



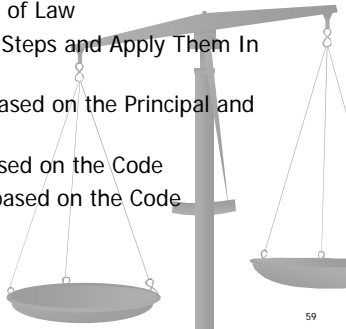
Reasons for DNI cont.

- Reasons for DNI cont.
 - preserves the character of the income passing through the entity to the beneficiary because DNI is comprised of various classes or types of income that we must track; and
 - is a determining factor in some rules dealing with accumulations of income (i.e. the throwback rules).



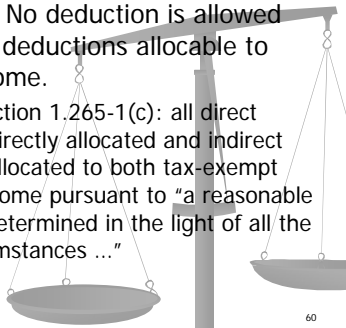
Review

- Follow the Rule of Law
- Remember the Steps and Apply Them In Order
- Calculate FAI based on the Principal and Income Act
- Calculate TI based on the Code
- Calculate DNI based on the Code



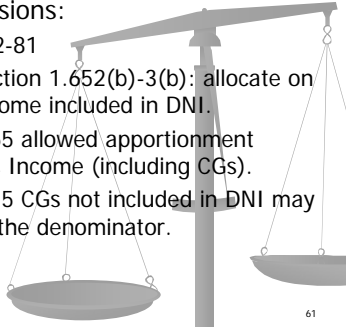
Section 265: Expenses

- Section 265(a): No deduction is allowed for Section 212 deductions allocable to tax-exempt income.
 - Treas. Reg. Section 1.265-1(c): all direct expenses are directly allocated and indirect expenses are allocated to both tax-exempt and taxable income pursuant to "a reasonable proportion ... determined in the light of all the facts and circumstances ..."



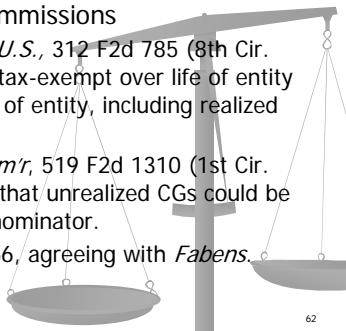
Reasonable Allocation Methods

- Annual Commissions:
 - See Z&L page 2-81
 - Treas. Reg. Section 1.652(b)-3(b): allocate on the basis of income included in DNI.
 - Rev. Rul. 73-565 allowed apportionment based on Gross Income (including CGs).
 - Rev. Rul. 77-355 CGs not included in DNI may not be used in the denominator.



Allocation Methods:

- Terminating Commissions
 - *Whittemore v. U.S.*, 312 F2d 785 (8th Cir. 1963), ratio of tax-exempt over life of entity to total income of entity, including realized CGs.
 - *Fabens v. Comm'r*, 519 F2d 1310 (1st Cir. 1975), holding that unrealized CGs could be used in the denominator.
 - Rev. Rul. 77-466, agreeing with *Fabens*.

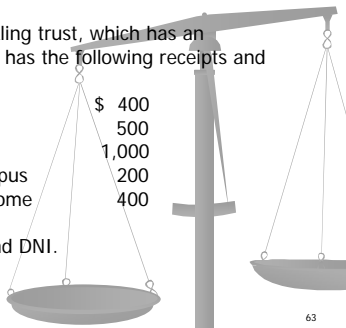


Example: Indirect Expenses

- Hypo (4):
An irrevocable sprinkling trust, which has an independent trustee, has the following receipts and expenses:

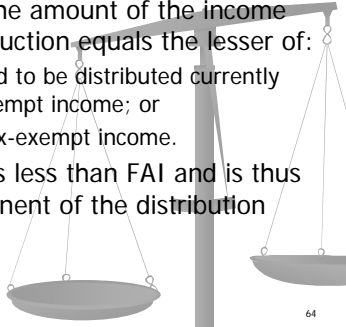
LTCC	\$ 400
Tax-exempt interest	500
Taxable interest	1,000
Trustee fee from corpus	200
Trustee fee from income	400

Compute FAI, TT1 and DNI.



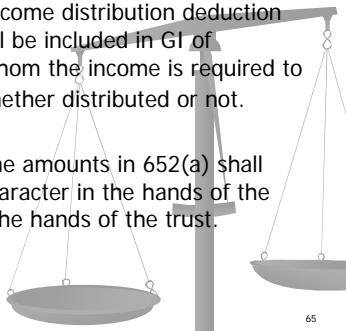
RULE OF LAW: 651(a)-(b)

- General Rule: the amount of the income distribution deduction equals the lesser of:
 - income required to be distributed currently less net tax-exempt income; or
 - DNI less net tax-exempt income.
- Typically, DNI is less than FAI and is thus the core component of the distribution deduction.



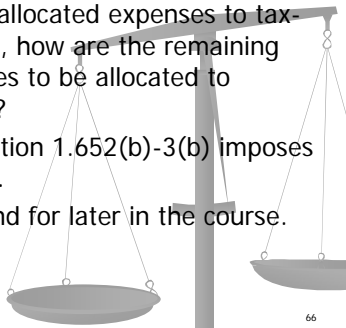
Section 652: Beneficiary Taxation

- Section 652(a): income distribution deduction under 651(a) shall be included in GI of beneficiaries to whom the income is required to be distributed, whether distributed or not.
- Section 652(b): the amounts in 652(a) shall have the same character in the hands of the beneficiary as in the hands of the trust.



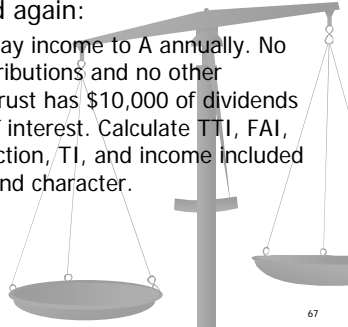
Expenses Allocated to Taxable Income

- After you have allocated expenses to tax-exempt interest, how are the remaining indirect expenses to be allocated to taxable income?
- Treas. Reg. Section 1.652(b)-3(b) imposes no requirement.
- Keep this in mind for later in the course.



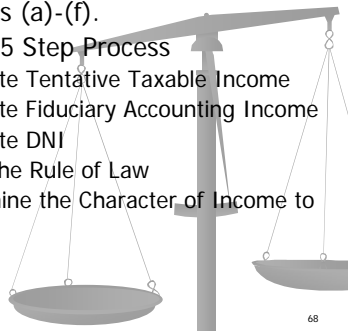
Hypos

- Hypo (1) visited again:
 - Trustee must pay income to A annually. No charitable contributions and no other distributions. Trust has \$10,000 of dividends and \$15,000 of interest. Calculate TTI, FAI, DNI, 651 deduction, TI, and income included under 652(a) and character.



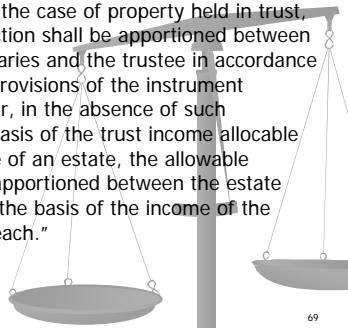
More Problems

- Problem 2. Parts (a)-(f).
- Remember the 5 Step Process
 - Step 1: Calculate Tentative Taxable Income
 - Step 2: Calculate Fiduciary Accounting Income
 - Step 3: Calculate DNI
 - Step 4: Apply the Rule of Law
 - Step 5: Determine the Character of Income to Beneficiaries



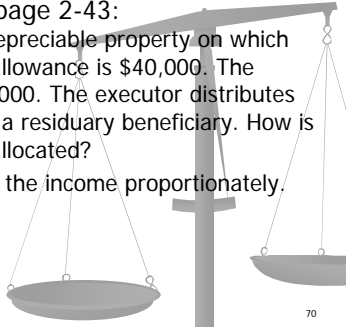
Depreciation: Sections 642(e) & 167(d)

- Section 167(d): "In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs ... on the basis of the income of the estate allocable to each."



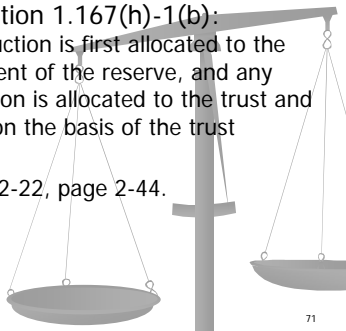
Estates & Depreciation

- Example 2-20, page 2-43:
An estate owns depreciable property on which the depreciation allowance is \$40,000. The estate TTI is \$60,000. The executor distributes \$15,000 to Betty, a residuary beneficiary. How is the depreciation allocated?
- Deduction follows the income proportionately.



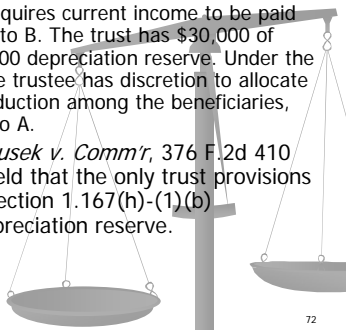
Trusts & Depreciation

- Treas. Reg. Section 1.167(h)-1(b):
Depreciation deduction is first allocated to the trustee to the extent of the reserve, and any remaining deduction is allocated to the trust and the beneficiaries on the basis of the trust income.
- Examples 2-21 & 2-22, page 2-44.



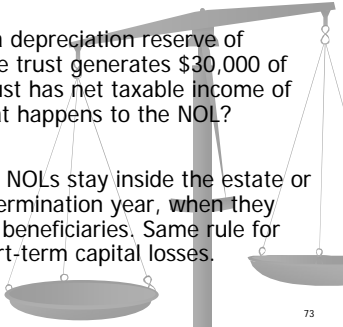
Discretionary Allocations

- Hypo: ABC Trust requires current income to be paid to A and remainder to B. The trust has \$30,000 of income and a \$30,000 depreciation reserve. Under the trust instrument, the trustee has discretion to allocate the depreciation deduction among the beneficiaries, who allocates it all to A.
- Does this work? *Dusek v. Comm'r*, 376 F.2d 410 (10th Cir. 1967) held that the only trust provisions that Treas. Reg. Section 1.167(h)-(1)(b) recognizes is a depreciation reserve.



Net Operating Losses: 642(h)

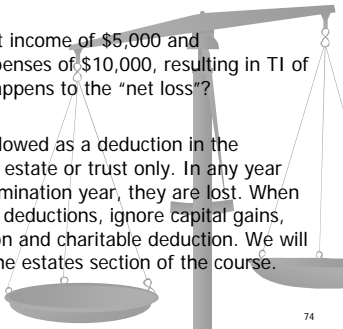
- Hypo (5):
 - Trust requires a depreciation reserve of \$40,000 and the trust generates \$30,000 of income. The trust has net taxable income of (\$10,000). What happens to the NOL?
 - Section 642(h): NOLs stay inside the estate or trust until the termination year, when they pass out to the beneficiaries. Same rule for net long or short-term capital losses.



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Excess Deductions: 642(h)

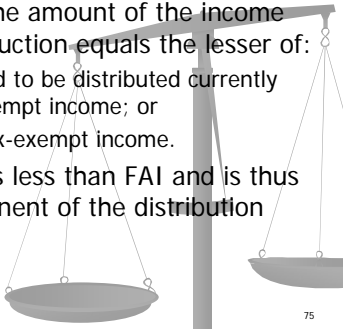
- Hypo (6):
 - Estate has interest income of \$5,000 and administration expenses of \$10,000, resulting in TI of (\$5,000). What happens to the "net loss"?
 - Section 642(h): allowed as a deduction in the termination of the estate or trust only. In any year other than the termination year, they are lost. When calculating excess deductions, ignore capital gains, personal exemption and charitable deduction. We will see this more in the estates section of the course.



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RULE OF LAW: 651(a)-(b)

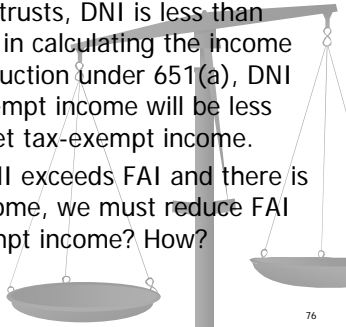
- General Rule: the amount of the income distribution deduction equals the lesser of:
 - income required to be distributed currently less net tax-exempt income; or
 - DNI less net tax-exempt income.
- Typically, DNI is less than FAI and is thus the core component of the distribution deduction.



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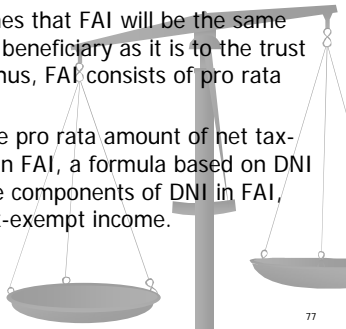
What if DNI Exceeds FAI?

- In most simple trusts, DNI is less than FAI. Therefore, in calculating the income distribution deduction under 651(a), DNI less net tax-exempt income will be less than FAI less net tax-exempt income.
- If, however, DNI exceeds FAI and there is tax-exempt income, we must reduce FAI by net tax-exempt income? How?



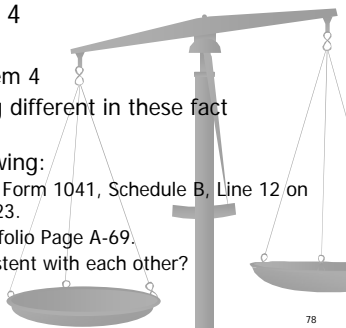
FAI is Made Up of DNI

- The Code assumes that FAI will be the same character to the beneficiary as it is to the trust under 652(b). Thus, FAI consists of pro rata portions of DNI.
- To determine the pro rata amount of net tax-exempt income in FAI, a formula based on DNI can calculate the components of DNI in FAI, including net tax-exempt income.



Problems 3 and 4

- Problems 3 and 4
 - Do Problem 3
 - Then Do Problem 4
 - Notice anything different in these fact patterns?
 - Read the Following:
 - Instructions to Form 1041, Schedule B, Line 12 on Pages 22 and 23.
 - Read BNA Portfolio Page A-69.
 - Are they consistent with each other?



Formula When DNI > FAI

- For purposes of the income distribution deduction under 651(a) when DNI > FAI, FAI less net tax-exempt income would be calculated as follows:

$$\text{FAI} - \left[\text{FAI} * \frac{[\text{Net Tax-Exempt Income}]}{\text{DNI}} \right]$$

