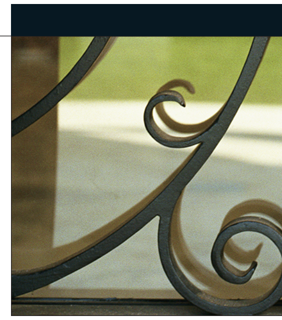

Useful Income Tax Planning Tips for Estates and Trusts

While estates and trusts are taxed much like individuals, certain elections and choices provide special opportunities for these entities.

SCOTT M. NELSON

With the dramatic increases in the estate tax exemption[1] since 2001 (now $5.45 million per person, with portability between spouses[2]) and the highest federal income tax marginal rate at 43.4% (39.6%[3] plus net investment income tax of 3.8%[4]), the focus for many clients is on the income tax ramifications of estate planning, rather than the estate tax implications. For clients who continue to be domiciled in states with a state-level estate or inheritance tax, the dynamics may be somewhat different.[5]

The Statistics of Income Bulletin from the IRS released in 2015[6] shows that the number of estate tax returns filed with the IRS declined nearly 74%, from 45,070 in 2005 to 11,931 in 2014. Over that time, the federal exemption increased from $1.5 million in 2005 to $5.34 million in 2014 (indexed for inflation, and $5.45 million in 2016). Contrast that with the income taxation of trust and estate activity, which is taxed at the highest marginal 39.6% rate once annual taxable income exceeds $12,400[7] in 2016.

Estates and trusts ("trusts" in this article will also include "estates," unless otherwise indicated) may have some advantages for income tax planning, but practitioners need to understand the fiduciary accounting and tax concepts that are covered in Subchapter J of the Code (Sections 641 through 692). This article will not be able to explore all of the issues covered in Subchapter J, but will provide an overview of common issues, an analysis of recent developments, an overview of elections and choices available to the fiduciary, and common planning strategies to consider.

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General rules

The premise of fiduciary income taxation starts out simply enough: If the trust accumulates net taxable income, it pays the income tax[8] (at its compressed rate brackets), or if the net income is distributed to the beneficiaries, the beneficiaries pay the tax.[9] An estate is allowed a personal exemption[10] of $600, and an income tax return is filed[11] if its total gross income (before deductions and credits) is greater. For trusts, there are two different personal exemptions, $300 and $100, depending on whether the trust is a "simple trust" or "complex trust" (discussed below).

Fiduciaries file IRS Form 1041, U.S. Income Tax Return for Estates and Trusts, by the 15th day of the fourth month following the close of the tax year.[12] If any distributions have been made to the beneficiaries during the tax year, a Form 1041, Schedule K-1 is included with the return, and a copy is issued to each beneficiary to reflect his or her share of the income, deductions, and credits generated. For trusts, estates, or beneficiaries subject to state income tax, a similar state tax return will need to be filed in each state with proper nexus.

An extension can be obtained by timely filing a Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return, which will extend the due date of the return for up to 5½ months.[13] Form 7004 does not extend, however, the payment due date[14] (interest will accumulate on any tax that is later determined to be owing, starting with the original due date of the return.)

Excess deductions for the final year can be transferred out to the beneficiaries, which can be accomplished by deferring some of the tax-deductible expenses until the final year.

Tax year. Section 644(a) requires that most trusts use a calendar year for their tax year.[15] An estate, however, can elect a fiscal year that ends on the last day of any month, but can extend no longer than 12 months.[16] For example, if a decedent died on February 1, the fiduciary could elect a tax year that starts on February 2 and ends on the following January 31.

The use of a fiscal year can be advantageous for income tax planning purposes, because the beneficiary is not taxed on the income received until the calendar year in which the estate fiscal year ends. In the example above, if the estate makes distributions to a beneficiary between February 2 and January 31, the beneficiary's income is reported on his or her calendar-year income tax return for the year in which the January 31 fiscal year-end occurred. If the beneficiary received $20,000 of taxable income from the trust on 2/2/2016, the fiduciary would file a fiscal year income tax return for the year ending 1/31/2017, and would then issue a Schedule K-1 to the beneficiary which would be reportable on the beneficiary's 2017 federal income tax return (due on or before 4/15/2018).

Choosing a calendar year allows the tax preparer to use the typical third-party reporting information based on a calendar year. With a fiscal year, the fiscal-year activity may not correspond to the typical statements issued by third parties. For small estates that will start and end within a 12-month period, it may make accounting sense to pick a fiscal year that allows all of the activity to be reported on one, initial and final, income tax return. There also may be planning available if there is a surviving spouse who will file a joint return for the year in which the decedent died. Usually this occurs if the decedent had "loss carryovers" that may be lost after death, but can be offset against income reported on the final joint return.

Finally, another planning opportunity is that excess deductions for the final year can be transferred out to the beneficiaries, which can be accomplished by deferring some of the tax-deductible expenses until the final year. Such excess deductions cannot be passed out to the beneficiaries during the earlier years of administration. The excess deductions in the final year are reported as miscellaneous itemized deductions by the beneficiaries on their Form 1040.

The first year of a trust can extend for less than 12 months, as well as the last year which technically ends when the administration is completed.[17] Termination occurs when all assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses.[18]

Accounting method. The fiduciary selects the accounting method (i.e., cash, accrual, or other) on the first fiduciary income tax return to report income and expenses. Once

1 The exemption is referred to as the "applicable exclusion amount" in Section 2010(c)(2) and represents the maximum amount that is protected by the "applicable credit" applied against the estate tax (Section 2001) under Section 2010(c)(1). The exemption is indexed annually for inflation. Section 2010(c)(3)(B).

2 Portability was introduced as part of the American Taxpayer Relief Act of 2012 (P.L.1/2-240) as new Section 2010(c)(4), and allows unused exemption at death to be transferred for use by the surviving spouse.

3 Section 1.

4 Section 1411(a)(2).

5 For an up-to-date chart of state death taxes, see the table published by McGuire Woods, LLP at www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf (last visited on 5/31/2016).

6 www.irs.gov/uac/SOI-Tax-Stats-Estate-Tax-Statistics (last visited on 5/31/2016).

7 Section 1(e).

8 Section 641(a).

9 Sections 652 and 662.

10 Section 642(b).

11 Different filing requirements apply for nonresident alien estates, or estates with nonresident alien beneficiaries.

12 Section 6072(a).

13 For tax years beginning before 2016, the extension was five months. Reg. 1.6081-6(a)(1). The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 extends that to 5½ months (i.e., September 30 for calendar-year taxpayers).

14 Section 6151(a).

15 Section 644(b) allows fiscal years for trusts exempt from tax under Section 501(a) (generally, charitable or religious organizations, or qualified retirement plans), or Section 4947(a)(1) (generally a trust where charities hold all of the unexpired interests).

16 Sections 441(a) and (e).

17 Section 443(a)(2).

18 Reg. 1.641(b)-3(b). Does not include a claim by a beneficiary in the capacity of beneficiary.

19 Section 661(a)(1).

20 Section 645(a).

21 Section 645(b)(1).

22 Section 645(b)(2).

chosen, the method ordinarily cannot be changed without IRS approval.

65-day rule. This election available under Section 663(b)(2) allows the fiduciary to make distributions within the first 65 days after the end of the tax year, and still consider those to have been made on the last day of the preceding tax year for tax purposes. The 65-day election provides a planning opportunity to the fiduciary, allowing them to gather the tax year financial results and then determine the optimal marginal tax brackets for the trust/estate and beneficiaries. If the governing instrument required a distribution to be made during the year but it is distributed later, it is still considered made in the tax year for trust income tax purposes,[19] and the 65-day election is not needed.

Section 645 election. For a typical estate plan which includes a pour-over will and a revocable trust, the fiduciary can elect to combine the revocable trust with the estate for income tax purposes.[20] The election is available for "qualified revocable trusts," which generally mean any trust (or portion thereof) that was treated as owned by the decedent by reason of a power in the grantor.[21] The election remains in effect until the "applicable date," which generally is defined as two years from the date of death if no estate tax return is filed, or the date that is six months after the final determination of the liability for tax if an estate tax return is required to be filed.[22]

The trustee or the executor make the election by filing Form 8855. This election allows the fiduciary to combine the fiduciary income tax reporting on one Form 1041 each year, allows the trust to select a fiscal year which may defer income into a future tax year, allows the "charitable set-aside deduction," and waives the material participation requirement for passive losses (i.e., participation is treated as active). Note however that for purposes of calculating the distributable net income (DNI) deduction, the trust and estate are treated as separate shares, and distributions made from each entity can result in different allocations of taxable income and deductions to different beneficiaries (discussed later).

Multiple trusts. For many years, taxpayers used multiple trusts for avoidance of progressive tax rates, having each trust taxed at its own brackets. To eliminate much of this planning, Section 643(f) provides that if trusts have "substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries," then the trusts will be treated as one trust if "a principal purpose of such trusts is the avoidance of the tax." For this purpose, spouses are treated as one person—be it one grantor or one beneficiary.

The grantor's motives and principal purpose in establishing multiple trusts are relevant in determining whether the trust will be aggregated into one trust for federal income tax purposes or treated as separate taxable entities. This statutory multiple trust rule applies to trusts created after 3/1/1984. The rule also applies to irrevocable trusts created on or before 3/1/1984, but only to that portion attributable to contributions to principal after 3/1/1984. Finally, the "separate share" concept can apply to multiple trusts, but usually only if the trust aggregation involves trusts with the same separate shares.

Accounting/tax concepts. The rest of the article follows a sequence for a fiduciary's determination of ultimate tax liability by the entity or the beneficiaries. Essentially, the sequence will include a determination of:

1. Accounting income.
2. Determination of income and principal distributions.
3. Entity-level taxable income and deductions.
4. Separate share accounting if applicable.
5. Distributable net income (DNI).
6. Distributions deduction.
7. Deductions/credits attributable to the entity (estate tax and personal exemption) or beneficiaries.

Accounting income

"Accounting income" must be determined first so that the fiduciary can determine the income distributions required or allowed by the estate or trust instrument. Then the tax consequences of those distributions can be determined. The concept of accounting income is different from the definition of "taxable income" for fiduciary tax purposes. Section 643(b) defines fiduciary accounting income (FAI) as:

> The amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocated to principal under the terms of the governing instrument and applicable local law shall not be considered income.

Typically, when an estate or trust instrument refers to distributions of "income" and "principal" to its beneficiaries, it is referring to fiduciary accounting income and not taxable income. To determine accounting income, applicable state law and the governing instrument must be examined. Under traditional fiduciary accounting principles, "income" has been defined as periodic receipts generated from the investment of trust principal, including interest (both taxable and tax-exempt), dividends, and rents. Under state law, capital gain usually is considered accretion to principal and therefore allocated to corpus, while certain expenses and payments such as trustee's fees have been allocated one-half to income and the balance to principal, regardless of the income tax deductibility of such fees.

For a unitrust to be respected for tax purposes, the unitrust payment regime must be authorized by state statute.

The majority of jurisdictions have adopted provisions from the Uniform Principal and Income Act (UPIA) drafted by the Uniform Law Commissioners.[23] As an example of how state law can differ, however, North Dakota recently revised its version of UPIA to define oil, gas, and related revenue as 85% income (contrasted with 10% in UPIA § 411) and 15% principal, to match the 15% depletion allowance for tax purposes.[24]

The governing instrument may specify how to define income and principal, and this likely will be recognized under the applicable state law. The statutory rules may be overridden by the terms of the governing instrument, but the practitioner needs to look at the particular state law to determine if any provisions cannot be modified. Also, regulations under Section 643 provide that, for tax purposes, trust provisions will not be recognized if they depart fundamentally from the local law governing principal and income.

The Uniform Principal and Income Act[25]

The following comments are excerpted from the ULC commentary:

The Act's purpose is to provide procedures for trustees administering trusts and personal representatives administering estates when allocating assets to principal and income, and to govern their proper distribution to beneficiaries, heirs and devisees.

Some of the latest issues covered in UPIA include:

1. *The application of the probate administration rules to revocable living trusts after the settlor's death and to other terminating trusts. Articles 2 and 3.*
2. *The payment of interest or some other amount on the delayed payment of an outright pecuniary gift that is made pursuant to a trust agreement, instead of a will, when the agreement or state law does not provide for such a payment. Section 201(3).*
3. *The allocation of net income from partnership interests acquired by the trustee other than from a decedent. Section 401.*
4. *An "unincorporated entity" concept to deal with businesses operated by a trustee, including farming and livestock operations, and investment activities in rental real estate, natural resources, timber, and derivatives. Section 403.*

23 UPIA § 104-Trustee's Power to Adjust.
24 ND Stat. § 59-04 2-19(411).

5. *The allocation of receipts from discount obligations such as zero-coupon bonds. Section 406(b).*
6. *The allocation between principal and income of net income from harvesting and selling timber. Section 412.*
7. *The allocation between principal and income of receipts from derivatives, options, and asset-backed securities. Sections 414 and 415.*
8. *Disbursements made because of environmental laws. Section 502(a)(7).*
9. *Income tax obligations resulting from the ownership of S corporation stock and interests in partnerships. Section 505.*
10. *The power to make adjustments between principal and income to correct inequities caused by tax elections or peculiarities in the way the fiduciary income tax rules apply. Section 506.*
11. *An income beneficiary's estate will be entitled to receive only net income actually received by a trust before the beneficiary's death, and not items of accrued income. Section 303.*
12. *Income from a partnership is based on actual distributions from the partnership, in the same manner as corporate distributions. Section 401.*
13. *Distributions from corporations and partnerships that exceed 20% of the entity's gross assets will be principal whether or not intended by the entity to be a partial liquidation. Section 401(d)(2).*
14. *Deferred compensation is dealt with in Section 409.*
15. *For "liquidating assets," which includes "property subject to depletion" (patents, copyrights, royalties, and the like), a trustee may allocate up to 10% of the asset's inventory value to income and the balance to principal. Section 410.*
16. *90% of receipts from oil and gas are allocated to principal and the balance to income. Section 411.*
17. *The unproductive property rule is eliminated for trusts other than marital deduction trusts. Section 413.*
18. *Charging depreciation against income is no longer mandatory, and is left to the discretion of the trustee. Section 503.*

Power to adjust. Recent updates to UPIA § 104 recognize a key innovation, the power to adjust between principal and income. The trustee is given the discretionary power to "adjust between principal and income to the extent the trustee considers necessary, if (1) the trustee invests and manages the trust assets as a prudent investor, (2) the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and (3) the trustee determines, after applying the rules in Section 103(a), that the trustee is unable to comply with Section 103(b)." That section sets forth general rules for applying the UPIA, while § 103(b) requires the trustee to administer the trust impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the trustee may favor one or more of the beneficiaries.

The UPIA contains several restrictions that prevent the exercise of the power where certain tax benefits may be lost (i.e., the marital deduction, the gift tax annual exclusion, the charitable deduction in a split-interest charitable trust, etc), and certain beneficiaries are prohibited from exercising the power, such as a trustee who is also a beneficiary, or a trustee who may, by reason of the power, be treated as possessing a general power of appointment or being taxable on trust income.

Conversion to unitrust. Some states (approximately 17) have included a unitrust definition of income as an alternative to the power to adjust. This is a trust that pays a fixed percentage of the changing value of the trust (typically valued at the beginning of each year, or the end of the prior year). For a unitrust to be respected for tax purposes, the unitrust payment regime must be authorized by state statute. (There is some indication that clearly and firmly established common law might be sufficient—but no guidance is provided as to how that determination will be made).

A simple trust, as well as any complex trust where all income is required to be distributed currently, is entitled to a $300 personal exemption deduction.

For either the power to adjust or make unitrust payments, there should be specific trust language authorizing the trustee to allocate to income all or a part of the gains from the sale or exchange of trust

25 www.uniformlaws.org (Insert "principal and income" under "Find an Act" and then push "Go") (last visited on 5/31/2016). The original act was written in 1931, and subsequently amended in 1962, 1997, and 2000. "The current link shows the Principal and Income Act as amended or revised in 2000."

assets, and such provisions should follow the required provisions in the state law.

Taxable income

Generally the taxable income of a trust is the same as the taxable income reported by an individual,[26] but may be, and frequently is, different than "accounting income." Gross income includes income accumulated or held for future distribution under the terms of the trust, income that is currently distributable, and income that, in the fiduciary's discretion, may be either accumulated or distributed. Examples of taxable income are listed in Section 61(a), and for trusts typically include interest, dividends, rents, royalties, business income, distributions of partnership gross income, and income in respect of a decedent. Separate tax rules apply to "simple trusts" and "complex trusts."

Simple trust. Whether a trust is a simple trust is determined by a "governing instrument" test and an "operational" test summarized as follows:

1. *Governing instrument test.* Section 651(a) refers to a trust that is required to distribute all of its income currently and cannot require or provide for distributions to charity. Income typically includes interest, rents, and cash dividends, but under Section 643(b), "income" includes all fiduciary accounting income (FAI) under the governing instrument or applicable local law. A simple trust is allowed a distribution deduction equal to the lesser of income required to be distributed currently (which will be the calculated amount of FAI) or DNI, with the lesser amount reduced by the portion of DNI consisting of tax-exempt income.
2. *Operational test.* Although a simple trust can permit distributions of principal, it will not be a simple trust in any year in which actual distributions of principal are made.

A simple trust, as well as any complex trust where all income is required to be distributed currently, is entitled to a $300 personal exemption deduction.

Example.[27] The decedent's will provides that the estate must distribute currently all of its income to a beneficiary. For administrative convenience, the personal representative did not make a distribution of part of the income for the tax year until the first month of the next tax year. The amount must be deducted by the estate in the first tax year, and must be included in the income of the beneficiary in that year. This amount cannot be deducted again by the estate in the following year when it is paid to the beneficiary, nor must the beneficiary again include the amount in income in that year.

Complex trusts and estates. A complex trust is allowed to accumulate income, or although required to distribute all of its income currently, the trustee is authorized to (and does) make principal distributions during the tax year. They and their beneficiaries are taxed under Sections 661 and 662. If discretionary principal distributions are permitted but not made, the trust will be a simple trust if it is still required to distribute all income currently. In the year of termination, a simple trust is taxed as a complex trust because the trust then makes principal distributions.

DNI. The taxation of income at the entity or beneficiary level is based on the concept of DNI. When a trust distributes its DNI to beneficiaries, it serves as a conduit because the income retains its character and is then taxed at the beneficiary level in the same manner. Section 643(a) provides that DNI means, with respect to any tax year, the taxable income of the trust computed with several modifications. If the income is not in DNI, it is not taxed to the trust or the beneficiary. Once DNI is computed, it serves as a limit on the entity's distribution deduction, and on the amount and the character of current income that is allocable to the income beneficiaries.

Generally any gross income, other than capital gains (which will be discussed further below), is considered taxable income for income tax purposes. This determination is independent of the determination of fiduciary accounting income for distribution purposes. As examples, capital gains allocated to principal are subject to capital gains taxation at the trust level, and expenses that may be partially allocated to principal under fiduciary accounting principles may still be fully deductible for income tax purposes. Again, the determination of taxable income is generally the same analysis as for individuals, with the modifications for deductions and credits as described in further detail below.

Capital gains. Section 643(a)(3) provides that capital gain is excluded from DNI if not allocated to fiduciary accounting income and if not distributed to the beneficiary. However, capital gains are included in DNI if they are either paid,

[26] Section 641(b).

[27] From IRS Publication 559 (2015), *Survivors, Executors, and Administrators*, page 19.

credited, or required to be distributed to a beneficiary during the year, or paid, permanently set aside, or to be used for a charitable purpose. The most recent tax regulations expand the circumstances as to when capital gain can form part of DNI.

Sometimes it will be preferable for capital gain to be in DNI and distributed to the beneficiary, such as when the income generated is quite low (as has occurred in recent years), or the beneficiary has a capital loss that can be used to offset the trust's gain. Other times, it will be preferable for the gain not to be part of DNI and, therefore, not taxed to the beneficiary, such as where the overall federal, state, and local taxes the trust would pay on the gain is lower than what the beneficiary would pay.

To form part of DNI, Reg. 1.643(a)-3 requires capital gains first to be allocated to fiduciary accounting income by either:

1. A mandatory allocation pursuant to state law and the governing instrument.
2. A discretionary allocation pursuant to the reasonable and impartial exercise of a power granted either under state law or by the governing instrument.

For the gains to then form part of DNI when so allocated to FAI, they must either:

1. Be allocated to income.
2. Be treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary.
3. Be actually distributed to the beneficiary or used by the fiduciary in determining the amount that is distributed or required to be distributed to the beneficiary.

Unitrusts. Some state statutes allow total return unitrusts that specifically allocate capital gains to income. They provide that a distribution of a unitrust amount including capital gains is considered a distribution of trust income. The regulations also state that the allocation of capital gains to the unitrust payment must be consistent.

Special tax character. If DNI includes items with special tax status, such as tax-exempt interest, it is necessary to determine the amount of those items included in the beneficiary's distribution. Those items retain their special status in the hands of the beneficiary. Thus, the tax-exempt interest distributed to a beneficiary is also tax-free to the beneficiary on his or her return. In general, the net amount of each special item is apportioned among the beneficiaries according to each beneficiary's share of DNI, unless the trust instrument or local law requires a different allocation.

Example.[28] An estate has distributable net income of $2,000, consisting of $1,000 of dividends and $1,000 of tax-exempt interest. Distributions to the beneficiary total $1,500. Except for this rule, the income distribution deduction would be $1,500 ($750 of dividends and $750 of tax-exempt interest). However, as the result of this rule, the trust's income distribution deduction is limited to $750, because no deduction is allowed for the tax-exempt interest distributed.

An allocation in the trust instrument is recognized only to the extent it has an economic effect independent of the income tax consequences of the allocation. As an example, if an estate or complex trust makes a deductible charitable contribution, the charitable deduction must be allocated

[28] *Id.*

among the classes of income before allocating the other deductions. Unless the governing instrument provides otherwise, the charitable deduction is allocated proportionately among the various classes of income.

The net amount of a special income item is reduced by deductions allocable to the special item. Unless the trust instrument specifies otherwise, deductions are allocated as follows:

1. Any deduction directly allocable to a particular class of gross income should be allocated to that class. For example, the cost of repairs, taxes, and other expenses directly related to the maintenance of rental property are attributable to the rental income.
2. If deductions attributable to a particular class of gross income exceed the income, the trustee can apply the excess deductions against any other class of income, provided the income was included in computing DNI, a proportionate share of any nonbusiness deductions is allocated to nontaxable income, and excess deductions related to tax-exempt income are not offset against any other class of income.
3. Deductions not directly allocable to any particular class of income (e.g. trustee's commissions, safe deposit rentals, or state income tax) are treated the same as excess deductions.

The tier system. If the governing instrument requires income distributions, those are treated as first-tier distributions where DNI is first allocated, with any residual allocated to second-tier distributions.

Example.[29] The terms of Michael Scott's will require the distribution of $2,500 of income annually to his wife, Susan. If any income remains, it may be accumulated or distributed to his two children, Joe and Alice, in amounts at the discretion of the personal representative. The personal representative also may invade the corpus (principal) for the benefit of Michael's wife and children.

By limiting the beneficiary's gross income to DNI, any distribution received by the beneficiary in excess of DNI will be received income tax free.

Last year, the estate had income of $6,000 after deduction of all expenses. Its distributable net income is also $6,000. The personal representative distributed the required $2,500 of income to Susan. In addition, the personal representative distributed $1,500 each to Joe and Alice and an additional $2,000 to Susan.

Susan includes in her gross income the $2,500 of currently distributable income. The other amounts distributed totaled $5,000 ($1,500 + $1,500 + $2,000) and are includable in the income of Susan, Joe, and Alice to the extent of $3,500 (distributable net income of $6,000 minus currently distributable income to Susan of $2,500). Susan will include an additional $1,400 [($2,000 ÷ $5,000) × $3,500] in her gross income. Joe and Alice each will include $1,050 [($1,500 ÷ $5,000) × $3,500] in their gross incomes.

In-kind distribution. Gain or loss is recognized by the trust for distribution of property in-kind, if the distribution is in satisfaction of a right to receive a distribution of:

1. A specific dollar amount.
2. Specific property other than that distributed.
3. Income under certain circumstances.[30]

Gain or loss is also recognized if in-kind distributions fund a pecuniary amount formula clause, or the right to a percentage of trust assets.[31] Finally, gain or loss is recognized if the trustee chooses to make a Section 643(a) election to recognize gain or loss. If a trust does not make the Section 643(a) election and is not required to recognize gain or loss on distributions in kind, then for purposes of determining the trust's distributions deduction under Section 661(a)(2) and the amount includable in the beneficiary's gross income under Section 662(a)(2), the property distributed is taken into account only to the extent of the lesser of (1) the basis of the property in the hands of the beneficiary, or (2) the fair market value of the property.

Deductions

Trusts can deduct a variety of expenditures.

Charitable deduction. Section 642(c)(1) states that a trust is allowed a deduction in computing its taxable income for any amount of gross income, without limitation, that under the terms

29 *Id.* at pages 21-22.
30 Reg. 1.661(a)-2(f).
31 Kenan, 114 F.2d 217, 25 AFTR 607 (CA-2, 1940).
32 In Green, 116 AFTR2d 2015-6668 (DC Okla., 2015), the Tax Court determined that the trust is entitled to a Section 642(c) deduction at fair market value for donated appreciated property purchased with gross income.
33 Section 642(g).
34 Section 163.
35 Section 164.
36 Section 171.
37 Section 691(c).
38 552 U.S. 181, 101 AFTR2d 2008-544 (2008).

of the governing instrument is, during the tax year, paid for a charitable purpose. Because a charitable deduction is available only if the source of the contribution is gross income, tracing the contribution is required to determine its source.[32] No income tax deduction is allowed for charitable contributions made from principal. If an estate or complex trust makes qualified charitable contributions from income, the charitable deduction must be allocated among the classes of income before allocating the other deductions, and unless the governing instrument provides otherwise, the deduction is allocated proportionately Reg. 1642(c)-1(b) allows the fiduciary to deduct the contribution if made before the last day of the next succeeding tax year.

Administrative expenses. Reasonable amounts paid or incurred by the fiduciary of a trust for administration expenses are deductible. Deductible items include legal and accounting fees, court fees, fiduciary's commissions, expenses incurred in selling assets, litigation expenses that are ordinary and necessary, and casualty and theft losses. Because these can also be deducted on an estate tax return, the fiduciary needs to make an election (and attach a statement to the Form 1041) waiving the right to deduct on the other return.[33]

Other deductions. The trust may deduct interest to the same extent as an individual. A trust is subject to the disallowance for "personal" interest deductions, but is entitled to deductions for investment interest and business interest expense. There also may be deductions for depreciation, depletion, net operating losses, and capital losses. No deduction may be taken for any expenses allocable to tax-exempt income.

Miscellaneous itemized deductions. As with individuals, there is a 2% floor on miscellaneous itemized deductions. The 2% floor does not apply to:

1. Interest expense.[34]
2. Taxes.[35]
3. The amortization of bond premiums.[36]
4. Estate taxes attributable to IRD.[37]
5. Expenses paid or incurred in connection with the administration of the trust that would not have been incurred if the property were not held in the trust.

If the trust distributions are less than DNI, the adjusted gross income for the entity is the income reduced by:

1. The administration costs.
2. The income distribution deduction.
3. The amount of the exemption.
4. The domestic production activities deduction.
5. The net operating loss deduction.

If the trust distributes more than the DNI, the DNI must then be recalculated taking into account the allowable miscellaneous itemized deductions (AMID) subject to the 2% floor. The instructions to IRS Form 1041, at page 24-25, provide a lengthy example for how to use algebraic equations to determine the unknown AMID and the DNI.

Bundled fees. Historically, many professional trustees bundled all of their fees into one total, which included some expenses that were subject to the 2% floor, and others that were not. As discussed above, the portion deductible above the line should include only those expenses that are not normally incurred by other taxpayers. In *Knight*[38] the courts were asked to decide whether a trust could fully deduct its investment management fees, or if the trust was required to reduce those fees by 2% of its AGI. The court denied a full deduction, but also noted that "the plain meaning of the statute excludes from full deduction those costs of a type that could be incurred if the property were held individually rather than in a trust."

In 2007, Prop. Reg. 1.67-4 was issued to address the extent to which deductible expenses are subject to the 2% floor. Implementation was delayed until tax years beginning after 2014, and now require the trust to segregate (i.e., "unbundle") costs that are subject to the floor (e.g., ownership costs), and those that are not (e.g., certain tax preparation costs). There also is a specific provision that amounts that would not be allowable as miscellaneous itemized deductions if paid directly by an individual, cannot be indirectly deducted through a grantor trust.

For a non-grantor trust, the determination of whether business income is passive is made at the trust level.

Excess deductions. Under Section 642(h), deductions in excess of income, and unused loss carryovers, are not distributable to beneficiaries except in the final year of the trust. And, while loss carryovers from operations of a trade or business can be accumulated and carried over from year to year, the administration expenses in excess of trust income cannot be carried over from year to year during the trust's existence.

Distribution deduction. The trust is allowed a distribution deduction when calculating its taxable income. A distribution deduction will be allowed, absent tax-exempt income, to the extent of DNI without regard to the source of distribution. By limiting the beneficiary's gross income to DNI (and possibly less if tax-exempt income is involved), any distribution received by the beneficiary in excess of DNI will be received income tax free.

Separate shares. There is a concept in Section 663(c) called "separate shares status," which exists for the sole purposes of determining the entity's distribution deduction and the amount of DNI allocable to the respective beneficiaries. Separate share treatment is mandatory, not elective, and must be used even if separate and independent accounts are not maintained for each share, or if assets are not physically segregated. It cannot be applied to obtain more than one personal exemption, or to split the entity income into shares taxed at lower rate brackets.

The rule does not apply to (1) beneficial interests in simple trusts, (2) discretionary "sprinkling" or "spray" trusts, or (3) separate trusts that may have been created under the same trust instrument. For trusts not subject to the separate share rule, the distribution deduction rules allocate DNI to the beneficiaries pro rata based on all distributions made during the year.

Separate share accounting takes overall DNI and allocates it among the various shares. It is used to calculate the distributions deduction available to each share and the extent to which each beneficiary is subject to tax. For example, in a trust consisting of two equal, substantially separate and independent shares, allocation of DNI is easy: one half is allocated to each separate share. A possible consequence of separate share treatment is that a trust as a whole may distribute amounts equal to or exceeding its total DNI, without deducting the entire distribution. Correspondingly, beneficiaries may not be required to include the total distribution they receive in gross income.

Here are three examples from IRS Publication 559 (2015), *Survivors, Executors, and Administrators:*

> *Example 1.* Patrick's will directs you, the executor, to distribute ABC Corporation stock and all dividends from that stock to his son Edward, and the residue of the estate to his son Michael. The estate has two separate shares consisting of the dividends on the stock left to Edward and the residue of the estate left to Michael. The distribution of the ABC Corporation stock qualifies as a bequest, so it is not a separate share.
>
> If any distributions, other than the ABC Corporation stock, are made during the year to either Edward or Michael, you must determine the distributable net income for each separate share. The distributable net income for Edward's separate share includes only the dividends attributable to the ABC Corporation stock. The distributable net income for Michael's separate share includes all other income.
>
> *Example 2.* Frank's will directs you, the executor, to divide the residue of his estate (valued at $900,000) equally between his two children, Judy and Ann. Under the will, you must fund Judy's share first with the proceeds of Frank's traditional IRA. The $90,000 balance in the IRA was distributed to the estate during the year. This amount is included in the estate's gross income as income in respect of a decedent and is allocated to the corpus of the estate. The estate has two separate shares, one for the benefit of Judy and one for the benefit of Ann. If any distributions are made to either Judy or Ann during the year, then, for purposes of determining the distributable net income for each separate share, the $90,000 of income in respect of a decedent must be allocated only to Judy's share.
>
> *Example 3.* Assume the same facts as in Example 2, except that you must fund Judy's share first with DEF Corporation stock valued at $300,000, instead of the IRA proceeds. To determine the distributable net income for each separate share, the $90,000 of income in respect of a decedent must be allocated between the two shares to the extent they could potentially be funded with that income. The maximum amount of Judy's share that could be funded with that income is $150,000 ($450,000 value of share less $300,000 funded with stock). The maximum amount of Ann's share that could be funded is $450,000. Based on the relative values, Judy's distributable net income includes $22,500 ($150,000/$600,000 × $90,000) of the income in respect of a

decedent and Ann's distributable net income includes $67,500 ($450,000/$600,000 × $90,000).

Alternative minimum tax (AMT). Trusts are subject to the AMT, similar to the structure applied to individuals (i.e., it is imposed to the extent it exceeds the regular tax). The trust is entitled to a $23,900 exemption, and this exemption begins to phase out after alternative minimum taxable income (AMTI) of $79,850. It is completely phased out once AMTI exceeds $175,450.

AMT adjustments include miscellaneous itemized deductions, deductions for state and local taxes, and the personal exemption. There also are recomputations for depreciation and depletion, net operating losses, interest deductions, and deductions relating to oil, gas, or geothermal property. In many but not all cases, the adjustments will increase DNI but also increase the distributions deduction, and be offset by the adjustments. In some cases, the increased distribution deduction will result in some or all of the beneficiaries being treated as having more income for purposes of computing their own alternative minimum tax.

Charitable remainder trusts (CRTs). Section 664 has special rules for CRTs. The rules vary depending on whether the trust is structured as a charitable remainder annuity trust or a charitable remainder unitrust. The regulations have long required that all proceeds of sale of an asset contributed to the trust must be allocated to corpus (and none to income) to the extent of the asset's fair market value at the time of the contribution. The new regulations expand this mandatory allocation rule by also including any assets purchased by the trustee to the extent of its purchase price.

Although exempt from income tax, CRTs pay a 100% excise tax on unrelated business income,[39] and may be liable for taxes on:

1. Self-dealing (Section 4941).
2. Excess business holdings (Section 4943).
3. Jeopardizing investments (Section 4944).
4. Taxable expenditures (Section 4945).

Throwback rules. There is a special set of throwback rules, applicable to trusts treated at any time as foreign, and U.S. trusts created before 3/1/1984, which assume that trust income actually retained by, and taxed to, the trust for an earlier year may later be treated as though it had been originally distributed rather than accumulated. The throwback rules are found at Sections 665 through 667 and were adopted at a time when income tax brackets were not as compressed as they are today. There was an incentive to create trusts for the purpose of accumulating income at lower marginal rates and then paying it out later as a nontaxable principal distribution to beneficiaries.

The throwback computations are made on Schedule J, Accumulation Distribution for Certain Complex Trusts. The throwback rules do not apply to distributions of accumulated income by estates.

Net investment income (NII) tax

For tax years beginning after 2012, certain passive investment (unearned) income of individuals, estates, and trusts is subject to a surtax. It is payable in addition to any other income tax. For a trust, the surtax is 3.8% of the lesser of (1) undistributed NII or (2) the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins ($12,400 in 2016). The tax does not apply to:

1. Trusts all of the unexpired interests of which are devoted to charitable purposes.
2. Trusts exempt from tax under Section 501.
3. Charitable remainder trusts exempt from tax under Section 664.

The 3.8% tax is computed on Form 8960, reflected on Form 1041, and paid with the return. The taxable NII is reduced by distributions made of such income to the beneficiaries, and by deductions for amounts of NII paid or perma-

[39] Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code.

nently set aside for a charitable purpose. The tax also does not apply to grantor trusts (taxable income is taxed to the grantor) and trusts that are not classified as "trusts" for federal income tax purposes under Section 1411(a)(2).

Material participation. The net investment income tax is assessed against the trust's investment income, which is defined as:

1. The gross income from interests, dividends, annuities, royalties, and rents derived from a trade or business that is a passive activity with respect to the taxpayer or that is a trade or business of trading in financial instruments or commodities.
2. Other gross income derived from a trade or business that is a passive activity with respect to the taxpayer or that is a trade or business of trading in financial instruments or commodities.
3. The net gain attributable to the disposition of property (other than the disposition of property in an active business that is not trading in financial instruments or commodities).[40]

For a non-grantor trust, the determination of whether business income is passive is made at the trust level. Material participation is determined generally under Section 469(h). The current Treasury regulations do not address material participation by a non-grantor trust, although legislative history provides that "an estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in its capacity as such, is so participating.

In *Mattie K. Carter Trust*,[41] the court determined that material participation should be tested by whoever participates on behalf of the trust, which in that case included two people to whom the trustee delegated functions:

1. A full-time ranch manager whose actions were subject to the trustee's approval.
2. The beneficiary who supervised the manager and general ranch operations.

In Ltr. Rul. 201029014, a trust that owned a partnership interest was found to have materially participated in the subsidiary's activities if the trustee was involved in the operations of the subsidiary's activities on a regular, continuous, and substantial basis. Most recently, the Tax Court held in *Frank Aragona Trust*,[42] that when a non-grantor trust created its own LLC to manage a business and the trustees themselves were paid by the LLC for managing the business, the trustees' work as managers of the LLC was material participation. The court focused on the trustee's duties to the beneficiaries of the trust when working for the LLC. At the time of this writing, it is anticipated that the IRS will issue further guidance on the issue of material participation for fiduciary income tax purposes.

Special rules

Fiduciary taxation also involves a variety of special rules.

Grantor trusts. Grantor trust rules can be found in Sections 671 through 678. The statute defines when the grantor, or another person,[43] may be treated as the owner of all or any portion of a trust, and as a consequence, will be taxed on the income of the trust, even if the trust income is accumulated or paid to a beneficiary. The grantor (or other person) then must include in computing the grantor's income tax obligation "all items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual."[44] No income tax is assessed against the trust or its beneficiaries.

Intentionally defective grantor trusts. Wealthy clients in some cases welcome the opportunity to pay the trust income tax, allowing the trust to grow income tax free. In the literature, these are referred to as trusts that are grantor trusts ("defective") for income tax purposes, but non-grantor trusts ("effective") for estate tax purposes (i.e., the assets are not included in the grantor's estate for estate tax purposes).[45]

Example.[46] The John Doe Trust is a grantor-type trust. During the year, the trust sold 100 shares of ABC stock for $1,010 in which it

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40 Section 1411(c)(1)(a).

41 91 AFTR2d 2003-1946, 56 F. Supp.2d 536 (DC Tex., 2003).

42 142 TC 165 (2014).

43 When a beneficiary has the right to withdraw principal, the beneficiary may be treated as the grantor as to the portion subject to the withdrawal right under Section 678.

44 Section 671.

45 In Rev. Rul. 2004-64, 2004-2 CB 7, the IRS ruled that payment of the income tax is not an additional indirect gift to the trust beneficiaries, since the grantor is already legally obligated to pay the tax under the grantor trust rules.

46 From IRS Instructions for Form 1041, page 13.

47 E.g., the "Section 179 election" to expense rather than depreciate the cost of Section 174 property is not available for trusts and estates. Reg. 1.179-1(a).

48 Section 1361(c)(2)(A)(i).

49 Section 1361(c)(2)(A)(iii).

50 Section 1361(d).

51 Section 1361(e).

52 Section 1361; Regs. 1.1361-1(e)(1) and 1.641(b)-3(a).

had a basis of $10 and 200 shares of XYZ stock for $10 in which it had a $1,020 basis.

The trust does not report these transactions on Form 1041. Instead, a schedule is attached to the Form 1041 showing each stock transaction separately and in the same detail as John Doe (grantor and owner) will need to report these transactions on his Form 8949, Sales and Other Dispositions of Capital Assets and Schedule D (Form 1040). The trust does not net the capital gains and losses, nor does it issue John Doe a Schedule K-1 (Form 1041) showing a $10 long-term capital loss.

S corporations. Specific rules apply to the taxation of S corporations, covered in Sections 1361 through 1375. If the entity holds S corporation stock, the requirements for preserving S corporation status should be reviewed, as well as reviewing the taxation of distributions to the entity.[47] In most cases, a revocable trust qualifies as an S corporation owner.[48] If an irrevocable trust receives S corporation stock, it must usually elect within two years[49] to be either treated as a qualified Subchapter S trust (QSST)[50] or an electing small business trust (ESBT).[51] The major exceptions include (1) voting trusts, (2) wholly owned grantor or beneficiary controlled trusts, and (3) the estate of a deceased shareholder.

The estate qualifies as an eligible S corporation shareholder and is treated as a single shareholder throughout the administration of the estate. However, if the administration is unreasonably prolonged, the estate terminates and becomes a trust for tax purposes.[52] If a grantor's revocable trust continues to own S corporation stock after the grantor's death, a Section 645 election can be made, and the trust as well as the S corporation stock will be treated as part of the estate for the duration of the election.

Income in respect of a decedent (IRD). IRD is governed by Section 691, with additional special rules under Section 692 available for members of the armed forces, astronauts and victims of terrorist attacks. IRD is income attributable to the decedent that was not properly includable on the final individual income tax return because of the accounting method. In most cases, this means that because the decedent was on the cash method for annual income tax reporting purposes, and the decedent did not receive the income prior to death, the income was not taxable on the final individual income tax return. The IRD is reported as taxable income in the year of receipt by the estate or other recipient.

Examples of IRD include:

1. Unpaid salary.
2. Accrued interest.
3. Qualified planned benefits and IRAs.
4. Nonqualified deferred compensation benefits.
5. Undistributed partnership income.
6. Installment payments.

Qualified funeral trusts. Clients will occasionally pre-fund a burial or funeral trust arrangement which traditionally had been treated as a grantor trust for income tax purposes. To simplify the process, in 1997 Section 685 was enacted to allow the sponsors of these arrangements to file an entity-level tax return for the aggregate income that each sponsor earns from all of the pre-need trusts that they administer. This eliminated the need for each grantor to file separate trust tax returns for their pre-funded arrangements.

Other trust structures. The instructions for IRS Form 1041 also include special compliance steps for (1) Alaska Native Settlement Trusts; (2) bankruptcy estates; (3) common trust funds maintained by a bank; (4) pooled income funds; (5) qualified settlement funds; and (6) widely held fixed investment trusts. These are not mentioned in this article.

Conclusion

Present law provides a high estate tax exemption amount and a compressed income tax rate schedule for estates and trusts. As a result, the income taxation of trusts and estates is a more costly consideration for many families than is the estate tax. This highlights the need for estate planners to stay abreast of the income tax rules for estates and trusts, and to provide clients with favorable planning ideas. ■