

# Overview of Fiduciary Income Taxation

Presented by:

AICPA

Estate Gift & Trust Tax  
Technical Resource Panel



# Trusts – General Types

- Inter vivos
  - Revocable
  - Irrevocable
- Testamentary
  - By-pass
  - Marital/Qualified Property Interest (QTIP) Trust
  - Residuary

# Simple vs. Complex

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

# Trust Taxation

- IRC §641(b)
- Generally, taxable income of an estate or trust computed in the same manner as in the case of an individual
- Exceptions applicable to general rule are contained in part 1 of subchapter J of Internal Revenue Code (IRC §§ 641 – 685)

# Personal Exemption

- Major differences from personal exemption for individuals
- Personal exemption (IRC §642(b)(3))
  - Estate \$600
  - Simple trust \$300
  - Complex trust \$300 or \$100

# Distribution Deduction

- Simple trusts – IRC §651
  - Amount of income required to be distributed
- Complex trusts and estates – IRC §661
  - Amounts required to be paid currently (Tier I)
  - Other amounts paid, credited or permanently set aside (Tier II)

# Distribution Deduction

- The distribution deduction is limited to the *lesser* of trust income (IRC §651) or DNI for simple trusts, or the lesser of distributions or DNI for complex trusts (IRC §661)
- DNI is the maximum amount of taxable income of the trust that is taxed to a beneficiary of a trust as the result of a distribution to the beneficiary as determined under IRC §643(a)

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IRS Nationwide  
**TAX FORUM**

# "Income" for Distribution Purposes

- Amount of income of the estate or trust for the taxable year determined under the terms of the *governing instrument* and *applicable local law* (IRC §643(b))
- Commonly referred to as trust accounting income
- IRC does not determine trust accounting income

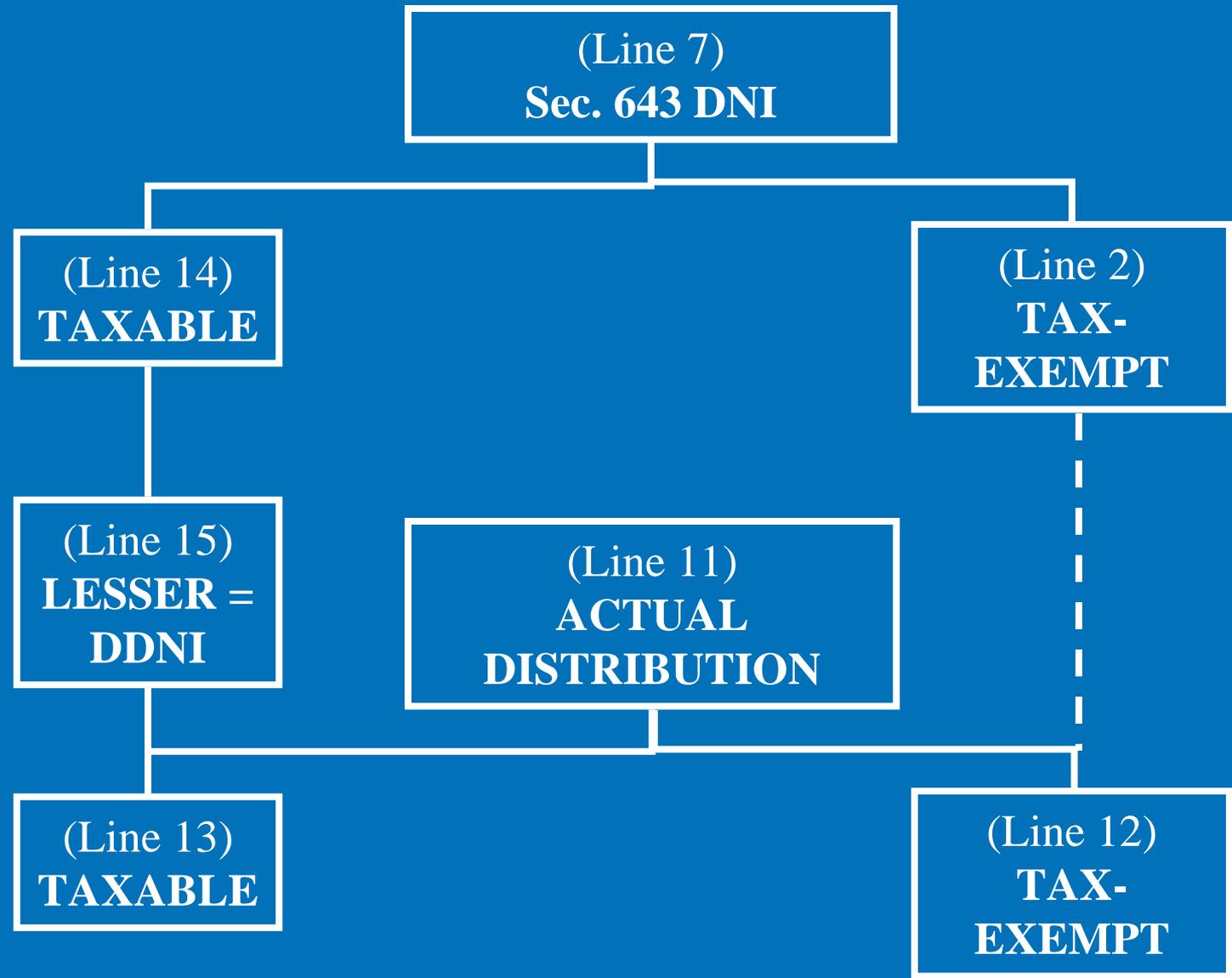
# "Income" for Distribution Purposes

- First, READ THE GOVERNING INSTRUMENT
- Second, be familiar with your state's Principal and Income Act
- Income computed in accordance with the above will be the "income required to be distributed" of a simple trust

# Distributable Net Income

- Taxable income before
  - Exemption
  - Distribution deduction
  - Special deductions
- Add back
  - Capital losses
  - Municipal income (net of allocable expenses)
- Subtract capital gains (generally)

# DNI Relationships



# Tiers of Distributions

- Tier I
  - Income required to be distributed
  - Receives DNI first
- Tier II
  - Other amounts paid credited or otherwise set aside
  - Taxed on distributions only to the extent there is remaining DNI

# Deductions

- All ordinary and necessary expenses allowed
  - Administration
  - Trustee Fees
  - Litigation Costs
- Charitable deduction
  - Must be from trust's gross income
  - Must be allowed by trust instrument

# Deductions

- No double deduction if expense was allowed on Form 706
- Exception – deductions "in respect of a decedent" are allowed on both Form 706 and Form 1041
  - Property taxes
  - Accrued interest paid

## Deductions – 2% Limitation

- Expenses which would be subject to the 2% AGI floor for individuals are also subject to the 2% AGI floor for trusts and estates
- Exception
  - Expenses incurred during administration *and*
  - Which would not have been incurred if the property were not held in the trust

## Deductions – 2% Limitation

- *Knight v. Commissioner*, 128 S.Ct. 782 (1/16/08) requires expense to be "uncommon (or unusual or unlikely) for a hypothetical individual to incur"
- Proposed regulations (Prop. Reg. 1.67-4) would require the trustee to unbundle its fee once the regulations are finalized
- See Notice 2010-32 extending for 2009 IRS position not to require unbundling

## Allocation of DNI

- Direct expenses are allocated to the class of DNI to which they relate
- Indirect expenses are allocated:
  - A portion to non-taxable income
  - Remainder to any class of income included in DNI

# CLASS PROBLEM – SIMPLE TRUST

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**TAX FORUM**  
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Description	Actual	Adj.	TAI	Adj.	Taxable	Adj.	Sec. 643 DNI
<b>Receipts:</b>							
Interest	25,000	-0-	25,000	-0-	25,000		25,000
Dividends	50,000	-0-	50,000	-0-	50,000		50,000
Capital Gain	20,000	(20,000)	-0-	20,000	20,000	(20,000)	-0-
Return of Capital	20,000	(20,000)	-0-	-0-	-0-		-0-
Business Inc.	10,000	-0-	10,000	-0-	10,000		10,000
<b>Subtotal:</b>	<b>125,000</b>	<b>(40,000)</b>	<b>85,000</b>	<b>20,000</b>	<b>105,000</b>		<b>85,000</b>
<b><u>Disbursements:</u></b>							
Mortgage Int.	(20,000)	-0-	(20,000)	-0-	(20,000)		(20,000)
Mortgage Prin.	(5,000)	5,000	-0-	-0-	-0-		
Trustee Fees							
Income	(2,000)	-0-	(2,000)	-0-	(2,000)		(2,000)
Principal	(2,000)	2,000	-0-	(2,000)	(2,000)		(2,000)
Depreciation	(10,000)	10,000	-0-	-0-	-0-		
<b>Subtotal:</b>	<b>(39,000)</b>	<b>17,000</b>	<b>(22,000)</b>	<b>(2,000)</b>	<b>(24,000)</b>		<b>(24,000)</b>
<b>Total:</b>	<b>86,000</b>	<b>23,000</b>	<b>63,000</b>	<b>18,000</b>	<b>81,000</b>		<b>61,000</b>

# Beneficiary's Schedule K-1



Description	Actual	TAI	Taxable	Sec. 643 DNI	Schedule K-1
<b>Receipts:</b>					
Interest	25,000	25,000	25,000	25,000	1,000
Dividends	50,000	50,000	50,000	50,000	50,000
Capital Gain	20,000	-0-	20,000	-0-	-0-
Return of Capital	20,000	-0-	-0-	-0-	-0-
Business Inc.	10,000	10,000	10,000	10,000	10,000
<b>Subtotal:</b>	<b>125,000</b>	<b>85,000</b>	<b>105,000</b>	<b>85,000</b>	<b>61,000</b>
<b>Disbursements:</b>					
Mortgage Int.	(20,000)	(20,000)	(20,000)	(20,000)	-0-
Mortgage Prin.	(5,000)	-0-	-0-	-0-	-0-
Trustee Fees					
Income	(2,000)	(2,000)	(2,000)	(2,000)	
Principal	(2,000)	-0-	(2,000)	(2,000)	
Depreciation	(10,000)	-0-	-0-	-0-	(10,000)
<b>Subtotal:</b>	<b>(39,000)</b>	<b>(22,000)</b>	<b>(24,000)</b>	<b>(24,000)</b>	
<b>Total:</b>	<b>86,000</b>	<b>63,000</b>	<b>81,000</b>	<b>61,000</b>	