

Learning Objectives:

- Understand the basic concepts & definitions concerning trusts and estates
 - Distinguish between trust corpus (principal) and income
 - Know how to compute the trust's taxable income
 - Understand the significance of distribution deduction the DNI
 - Understand the significance of first- and second-tier distributions in complex trusts
 - Understand the concept of income in respect of a decedent (IRD)
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I. Trusts & Estates – Overview

A. The function of estates & trusts

1. estate (defined)

- a “transitional” legal entity that comes into existence upon the death of an individual
- it collects and conserves an individual's assets, satisfies all liabilities, and distributes the remaining assets to heirs
- it is used during the period of time in which the decedent's legal affairs are being settled
- it is used by the executor/administrator of the estate to manage the assets owned by the decedent
- once all legal requirements are satisfied, the estate terminates & ownership passes to beneficiaries or heirs

2. trust (defined)

- a legal arrangement (typically involving three parties) in which an individual, the *grantor*, transfers legal ownership of assets to one party, the *trustee*, and the legal right to enjoy & benefit from those assets to a second party, the *beneficiary* (or beneficiaries)
- usually refers to an arrangement created by a will or by inter vivos (lifetime) gift
- trustee takes title to property for purpose of protecting or conserving it for the beneficiary
- it is usually designed for the protection of the beneficiary
- the terms of the trust, the duties of the trustee, and the rights of the various beneficiaries are specified in the legal document – the *trust instrument*
- the grantor has unlimited discretion such that a trust can be a very flexible document

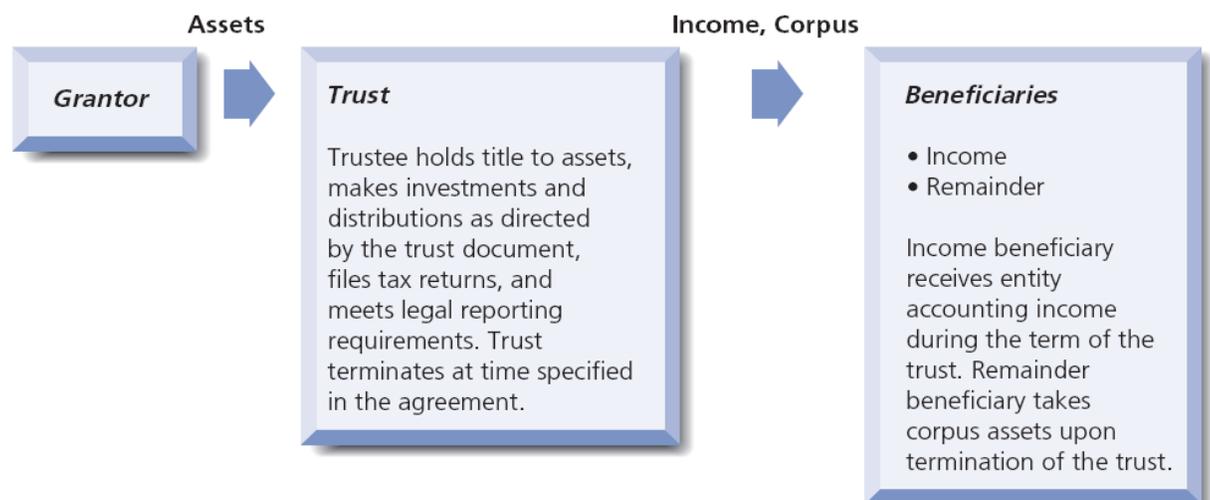
B. Basic concepts and definitions – Estates

1. *Decedent*
2. *Executor* – a decedent's legal representative appointed under the will (or called the *administrator* if appointed by the probate court because there is no will). Has a fiduciary responsibility to operate the estate.
3. *Beneficiary* – one who will receive the assets and/or income from the estate.

C. Basic concepts and definitions – Trusts

1. *Principal or corpus* is the initial assets transferred by the grantor plus certain additions or deductions as required by the provisions of the trust instrument or state law.
2. *Income* is the earnings derived from the principal. Certain gains, losses or deductions may be considered adjustments to principal.
3. *Grantor (donor or settlor)* – the party that transfers assets to the trust
4. *Trustee (fiduciary)* – the party (individual or corporate) that administers the trust.
5. *Income Beneficiary* – the party (or parties) who receives the income when distributed by the trustee under the provisions of the trust instrument.
6. *Remainderman* – the party who eventually receives the principal.
7. *Reversionary interest* – is where the corpus reverts to the grantor when the trust terminates
8. *Grantor trust* – in a grantor trust the grantor retains beneficial enjoyment or control over trust property or income. The Code taxes the grantor on the trust income. The trust is a disregarded entity for tax purposes.

D. Structure of a typical trust:



E. Some common reasons for using trusts

1. Life insurance trust
 - holds life insurance policies on the insured
 - removes proceeds of policies from gross estate (if gift made to an irrevocable trust)
 - safeguards against receipt of proceeds by young or inexperienced beneficiary
2. "Living" (revocable) trust
 - holds (some/all) assets owned by an individual
 - is used to manage assets (and to simplify asset management)
 - reduces probate costs, since beneficiaries are established for trust
 - provides privacy for asset transfers (since a will is a public document)
3. Trust for minors
 - could be used to provide funds for college education, living expenses,
 - shifts income to lower-bracket taxpayers
 - allows parents to retain some control over children's use of assets
4. "Blind" trust
 - holds assets of grantor without his/her input or influence
 - often used while grantor holds political office or some other sensitive position
5. Retirement trust
 - a special tax-exempt trust that manages asset contributions under a qualified retirement plan
6. Divorce (or alimony) trust
 - manages assets of an ex-spouse and ensures they will be transferred on a prescribed schedule to named beneficiaries
7. Liquidation trust
 - manages assets and final dissolution of a corporation undergoing a complete liquidation

F. The nature of trust & estate (fiduciary) taxation

1. trusts and estates are separate taxpayers
 - trustee must file Form 1041
 - for an estate – if gross income > \$600
 - for a trust – if gross income > \$600, or if trust reports any taxable income
 - taxable income is subject to highly progressive rates (see – inside cover of text book)
 - top rate of 35% is applied to taxable income > \$11,200
 - there is no 10% tax rate
 - “qualified” dividends & LTCGs are taxed at the usual 15/0% rates
 - are usually required to make quarterly estimated payments
 - trusts must use calendar year (estates have a choice)
 - are subject to an alternative minimum tax (AMT at 26% or 28%)
2. trust and estates are allowed a personal exemption
 - estate – \$600
 - trust – either \$300, or \$100 (see types of trusts)
3. trust and estates are NOT entitled to a standard deduction
4. there is no double taxation of income earned by a trust or an estate
 - estates and trusts act as conduits for income received (are flow-thru entities)
 - taxable income of trusts or estates is taxed to the entity or to its beneficiaries to the extent that each has received the accounting income
 - the beneficiaries report the distributed trust income on their individual tax returns & the income retains its character
 - if all income is not distributed, some will be taxed to entity
 - a deduction for income distributed to beneficiaries is created within the trust (this is the mechanism that is used to avoid double taxation)
5. distributed income has the same character in the hands of the beneficiary as it has in the trust
6. in general, the income tax consequences for a trust or estate are determined in similar manner as for individuals (same definition of gross income, exclusions & deductions)

G. Type of trusts – simple vs. complex trusts

1. simple trust (defined) – a simple trust:
 - is required to distribute all of its accounting income annually (this amount may bear little relationship to the trust’s taxable income),
 - makes no distributions of corpus during the year, and
 - makes no contributions to charitable organizations
2. complex trust – any trust that is not a simple trust
3. personal exemption – \$300 if the trust is required to distribute all of its accounting income annually; \$100 otherwise (some income may be retained).

II. Computing the Taxable Income of Trusts & Estates

A. The five step process used to compute taxable income

Step 1: Compute the entity's accounting income (per trust document/state law)

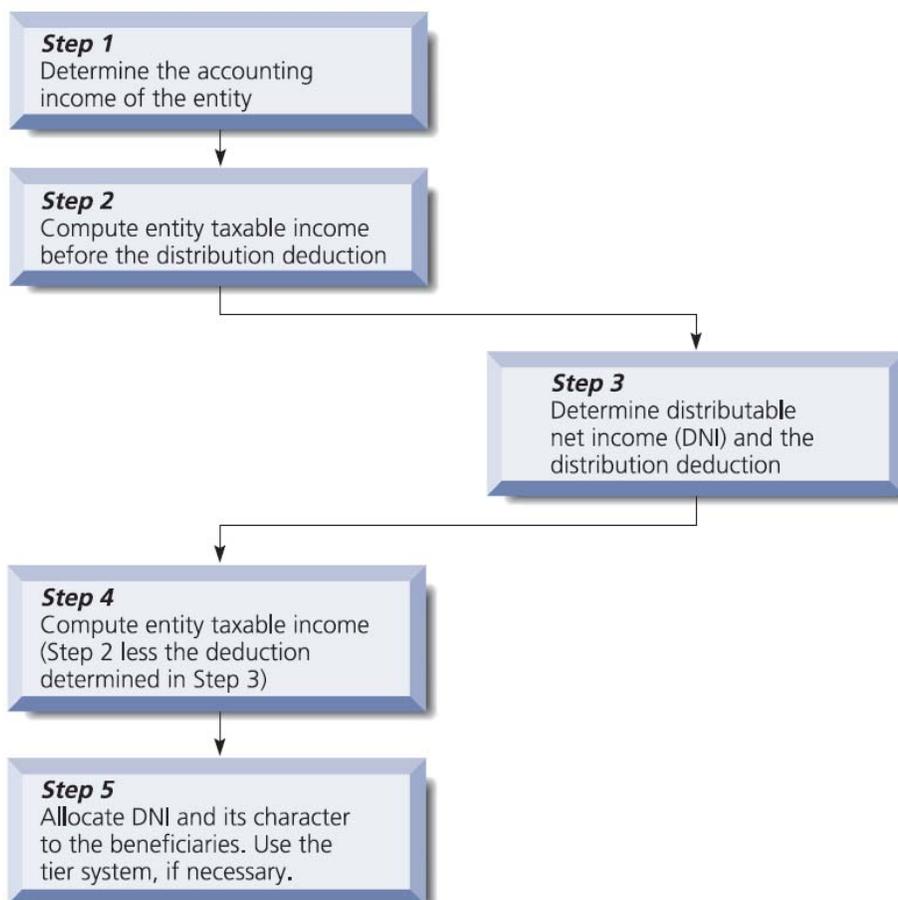
Step 2: Compute entity taxable income before the distribution deduction

Step 3: Compute distributable net income (DNI) and the distribution deduction

Step 4: Compute entity taxable income (step 2 less the deduction determined in step 3)

Step 5: Allocate distributable net income, and its character, to the beneficiaries (if a complex trust – may need to use the tier system)

This diagram shows how it is really not a sequential process.



B. Entity's accounting income

1. accounting income is based on the controlling document
 - either the trust agreement or state law determines whether amounts are allocated to corpus or current income
 - if the entity distributes income currently, that income should generally correspond to accounting income
2. for a simple trust – accounting income is the amount that trustee must distribute to beneficiaries each year
3. generally, accounting income does not include capital gains (instead this is an increase to principal)
4. depreciation may be deducted from income or principal depending on governing law

C. Common allocations to income and to corpus – under the Revised Uniform Principal and Income Act (essentially GAAP for estates/trusts).

1. amounts allocable to the income account
 - income:
 - ordinary and operating net income from trust assets
 - rent, interest, dividends, 72½ % of royalties
 - net profits of a business (losses are usually charged to corpus)
 - expenses:
 - ½ of trustee fees/commissions (management, conservation, or maintenance of property)
 - ordinary & necessary expenses for a trade or business, or production of income
 - taxes levied on accounting income
 - depreciation
2. amounts allocable to the principal (corpus) account
 - receipts:
 - capital gain/loss on investment assets
 - insurance recoveries on income-producing assets
 - casualty gain/loss on income-producing assets
 - stock dividends & stock splits
 - 27½ % of royalties
 - expenditures:
 - ½ of trustee fees/commissions (management, conservation, or maintenance of property)
 - principal payment on debt
 - extraordinary repairs and capital improvements
 - taxes levied on gains and other items of principal
 - depreciation

D. Trust taxable income

1. gross income (computed similarly for individual taxpayers)
 2. less: deductions (defined similarly for individual taxpayers)
 - excluding expenses related to tax-exempt income
 - including a pro rata share of the trustee's fee
 3. less: personal exemption (generally \$300 for simple trust & \$100 for complex trusts)
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4. taxable income before the distribution deduction
 5. distribution deduction (DD)
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- = trust taxable income

pro-rata amount of trustee's fees disallowed =

$$\text{trustee fees} \times \frac{\text{tax-exempt interest}}{\text{all income}^1} = \text{amount disallowed}$$

Note¹: Excludes income allocable to corpus.

E. Deductible expenses

1. must be ordinary and necessary expenses paid
2. includes trustee's administration fees
3. trustees' and executors' fees and tax return preparation fees are NOT considered miscellaneous itemized deductions (are not subject to the 2% floor)
4. there is no limit on complex trust's charitable contribution deduction (this is not an issue for a simple trust since they can't make CC)

F. Allocation of indirect expenses

1. if there is any tax-exempt income, indirect expenses (e.g. trustee's fees) must be allocated pro rata between taxable & tax-exempt income
2. the allocation is made based on portion of "accounting income" that is attributable to tax-exempt income

G. Distribution deduction – simple trusts

1. all "income" (accounting net income) must be distributed annually
2. distribution deduction is the lesser of accounting income or distributable net income (DNI), both are reduced by net tax-exempt income earned by trust
3. amount deductible by trust is taxed to beneficiaries irrespective of amount they actually receive (taxed similar to partnerships & S corporations)

H. Distributable net income (DNI) & the distribution deduction

1. computation of DNI

taxable income before the distribution deduction
 plus: personal exemption previously deducted
 plus: net capital losses
 plus: net tax-exempt interest (net of expenses)
less: capital gains added to principal
 = distributable net income (DNI)

distribution deduction =

lesser of: DNI (distributable net income)
 or
 accounting income (amount actually distributed to
 beneficiaries)

– reduced by net tax-exempt income (in
 other word the lesser of DNI or
 accounting income is reduced by net tax-
 exempt income)

2. notes about the DNI

- it represents
 - the maximum income that may be taxed to the beneficiary, and
 - the maximum deduction available to the entity
- it does NOT include income unavailable for distribution (capital gains added to principle)
- it may include nontaxable income that is available for distribution
- all expenses that are deductible for tax purposes enter into the DNI calculation (even those allocated to corpus)

I. NOL and capital loss carryover

1. NOL is not passed through to beneficiaries unless trust terminates, NOL can be carried back and forward (are unusual in a trust – unless engages in a business)
2. net capital loss – lesser of \$3,000, or excess of capital losses over capital gains. Simple trusts distribute all income however, so have no other income to offset. Capital losses can be carried over by trust.
3. if not used before trust terminates, are passed through to beneficiaries

III. Taxation of Beneficiaries

A. Distributions by Simple Trusts

1. DNI is the maximum taxable amount to the beneficiaries
2. may be less if DNI includes tax-exempt interest
3. if more than one income beneficiary, trustee must apportion elements of DNI ratably
4. each type of DNI must be allocated proportionately to income beneficiaries (to prevent manipulation of tax liabilities by assigning, for example, tax-exempt income to high bracket taxpayers, and taxable income to low bracket taxpayers)

B. Distributions by complex trusts & estates – must use a two-tier system

1. First-tier distributions include income that is required to be distributed.
2. Second tier distributions include all other amounts properly paid, credited or required to be distributed.

C. For complex trusts & estates this leaves three possibilities:

1. If only first-tier distributions are made and those amounts exceed DNI, then DNI is allocated among the beneficiaries:

$$\frac{\text{First-tier dist. to beneficiary}}{\text{First-tier dist. to all beneficiaries}} \times \text{DNI} = \text{Beneficiary's share of DNI}$$

2. If first and second-tier distributions are made and first-tier distributions exceed DNI:

- use the formula above to allocate first-tier distributions
- second-tier distributions are not taxed since all DNI has been allocated

3. If first and second-tier distributions are made and first-tier distributions do not exceed DNI, then DNI is allocated among beneficiaries

$$\frac{\text{2nd-tier dist. to beneficiary}}{\text{2nd-tier dist. to all beneficiaries}} \times \frac{\text{Remaining DNI}}{\text{DNI}} = \text{Beneficiary's share of DNI}$$

D. Character of income – various classes of income retain their character and flow through to beneficiaries. If all DNI is distributed and there are multiple beneficiaries, must allocate various classes of income. Distributions are treated as consisting of the same proportion as the items that enter into the computation of DNI.

IV. Property distributions

A. Generally, entity does not recognize gain or loss

1. beneficiary takes same basis in asset as it had in the estate or trust
2. distribution absorbs distributable net income (DNI) and qualifies for a distribution deduction to extent of the lesser of:
 - basis to beneficiary
 - fair value on date of distribution
3. trustee or executor can elect to recognize gains and losses on assets distributed in kind
 - beneficiary's basis in asset would be fair value
 - distribution absorbs distributable net income (DNI) and qualifies for a distribution deduction equal to fair value on date of distribution

V. Income of a Decedent

A. Income in respect of decedent (IRD)

1. most individuals are on a cash basis
2. at death, the individual may have earned, but not received as income such items as:
 - interest on CD's, bonds or savings
 - salary, commission, bonuses, 401(k)s
 - dividends received after date of death with date of record before death
3. income in respect of a decedent (IRD) must be included in the gross income of the party entitled to receive it (i.e. the estate or beneficiary) and as part of the gross estate for estate tax purposes)
4. likewise, deductions in respect of a decedent (DRD) may be deducted by the party required to pay them (if they are deductible expenses) and they reduce the value of the gross estate.
5. the recipient may claim an income tax deduction (a miscellaneous itemized deduction, not subject to 2% floor) in the amount of the extra estate tax due as result of the net IRD counted as part of the estate
6. properties classified as IRD, do not receive a step-up in basis, retain the same basis they had in hands of decedent