

# Fiduciary Income Tax: Fundamentals for Estate Planners:

ACTEC – Heart of America  
May 9, 2024

Janet Rae Montgomery



*"I need someone well versed in the art of torture—do you know PowerPoint?"*

# Why?

- Estate taxes diminished in importance due to very high exemptions
- Compression of estate tax rates (40%) and income tax rates (37%+) means income taxes are at least as important as transfer taxes
- Basis is King – and Basis is an income tax/capital gains concept

# Agenda

- Pre-Mortem Planning (Appendix A)
- Subchapter J
- Basic Rules and Rates
- 3 Types of Trusts
- Trust Accounting Income (TAI) or Fiduciary Accounting Income (FAI)
- Taxable Income
- Distributable Net Income (DNI)
- Simple Trusts – Distribution System
- Complex Trust – Distribution System (How DNI Is Allocated)
  - Tier System
  - Separate Share Rule
  - 65 Day Rule
  - Specific Bequests
  - In-Kind Distribution

# Agenda (continued)

- Charitable Deductions
- Depreciation
- Section 645 Election (Trust = Estate)
- Terminating Distributions (Capital Losses and Excess Deductions)
- Drafting and Planning Ideas

# Subchapter J

- Handful of rules
- Part I
  - Subpart A – Sections 641-646 – General Rules
  - Subpart B – Sections 651-652 – Simple Trusts
  - Subpart C – Sections 661-664 – Complex Trusts and Charit. Remainder Trusts
  - Subpart D – Sections 665-668 – Accumulation Distributions (limited utility)
  - Subpart E – Sections 671-679 – Grantor Trusts
  - Subpart F – Sections 681-685 – Miscellaneous Rules
- Part II – Sections 691-692 – Income in Respect of a Decedent (IRD)

# Special Aspects of Income Taxation of Trusts and Estates

- Taxable Income is computed the same manner as for individuals (Section 641(b))
- The trust or estate is a separate taxable entity (imperfect conduit)
- Trust/Estate has its own Tax Year and own Method of Accounting
- Trust/Estate receives income and pays expenses
- Income is Taxed EITHER to the Trust/Estate OR to the Beneficiary
  - Distribution deduction
  - DNI

# 2024 Income Tax Rates

• Rate	Married Filing Jointly	Trusts and Estates
• 10%	Up to \$19,050	Up to \$3,100
• 12%	\$19,051 - 77,400	
• 22%	\$77,401 – 165,000	
• 24%	\$165,002 - \$315,000	\$3,101 – 11,150
• 32%	\$315,001 - \$400,000	
• 35%	\$400,001 - \$600,000	\$11,151 – 15,200
• <b>37%</b>	<b>\$600,000 and higher</b>	<b>\$15,201 and higher</b>



# Three types of trusts

- Simple
- Complex
- Grantor

# Simple Trust

- All income is **required** to be distributed to the beneficiary(s) annually
- Makes no principal distribution, and
- Makes no distributions to charity.

# Complex Trust

- Accumulates income
- Makes discretionary distributions of income, or required or discretionary distributions of principal
- Makes a distribution to charity

# Grantor Trust

- Grantor or beneficiary has one or more powers described in Sections 673-678.
- Therefore: All income, expenses, and credits are taxed to the Grantor or beneficiary whether or not distributions are made to them (and even if they are made to other beneficiaries).
- The rest of the Subchapter J rules do not apply to grantor trusts.

# Fiduciary Accounting Income

- When the Code says income without a modifier, it means this
- Terms of the Trust/Will or, if the instrument is silent, state law governs what is income and what is principal
- **Just because something is taxable does not mean it is income for FAI purposes**
- State Law is found in its Principal and Income Act
  - Often this is UPIA, or RUPIA, or a unitrust statute may come into play

# Fiduciary Accounting Income (FAI)

	FAI	Taxable Income
Bank Interest	Yes	Yes
Corporate dividends	Yes	Yes
Tax-exempt Muni bond interest	Yes	No
Insurance	No	No
IRA	No or 10%	Yes
Capital Gains	No	Yes

# Taxable Income of a Trust or Estate

- Computed as for an individual
- Exemptions: \$300 Simple - \$100 Complex - \$600 Estate
- Rules for charitable deductions are different
- Depreciation deduction allocated between Beneficiary and T/E
- Distribution Deduction
- Administrative expenses – most still allowed
- AGI – same as individual less (1) personal exemption, (2) distribution deduction, and (3) some/most administrative expenses are deducted from taxable income before AGI is determined

# Net Investment Income (NII) – 3.8% Surtax

- For estates and trusts, the surtax, which is in addition to all other taxes, including Alternative Minimum Tax, applies to the lesser of:
  - Adjusted Gross Income (AGI) in excess of the highest income tax bracket threshold (\$13,051 in 2021), or
  - Undistributed net investment income. §1411(a)(2)
- Threshold: \$13,051 (MFJ: \$250,000)
- 3.8% surtax imposed on 3 types of income:
  - Gross income from interest, dividends, rents, royalties and annuities;
  - Gross income from (a) passive activity, or (b) business of trading in financial instruments or commodities; and
  - Net gain (CG)



# Income Taxed Either to Trust/Estate or to the Beneficiary

- If income is *accumulated* and not deemed distributed, it is taxed to the trust or estate
- If income is *distributed*
  - Trust/Estate gets a deduction for the amount of the distribution (distribution deduction), limited to DNI
  - Beneficiary pays tax on the income distributed on beneficiary's own return, limited to DNI
  - What is DNI?

# Distributable Net Income (DNI)

## Sec. 643(a)

DNI is the Code's attempt to approximate FAI:

- Start with taxable income
- Add back distribution deduction
- Add back personal exemption
- (Usually) Subtract capital gains (add back capital losses allocated to principal)
- Subtract extraordinary dividends and taxable stock dividends
- Add net tax-exempt income

Rules for DNI differ between simple trusts and complex trusts/estates

# Distributable Net Income (DNI) (cont'd)

DNI establishes:

- Amount of trust or estate's distribution deduction
- Amount beneficiary reports on beneficiary's own return
- Character of income in the hands of the beneficiary

# Capital Gains and DNI

- General rule: Capital Gains are taxed to the trust or the estate
- When would you not want to tax CG to the trust/estate?
  - Beneficiary has offsetting losses
  - Trust/estate is going to have to pay the 3.8% surtax
  - Seems fair
- There are 3 exceptions to the General Rule (which exceptions are consuming the rule) (Richard Dees explanation follows)

# Redline between proposed and final regulations for capital gain inclusion: consistency required?

McDermott  
Will & Emery

**(b) Capital gains included in distributable net income.** Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and consistent and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument, if not ~~inconsistent with~~ prohibited by applicable local law)-

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount which that is distributed or required to be distributed to a beneficiary.

# Distributions

- Simple Trust
  - Section 651 (treatment of income in hands of trust)
  - Section 652 (treatment of income distributed to bene)
- Complex Trust
  - Section 661 (treatment of income in hands of trust)
  - Section 662 (treatment of income distributed to bene)

# Simple Trusts and Distributions

- Trust/Estate can deduct all of its FAI (but not in excess of its DNI).
- Items of income not included in gross income (tax-exempts) are not deducted.
- Beneficiary includes the FAI (but not in excess of DNI) in gross income.
- If more than one beneficiary, FAI is apportioned among them in proportion to the FAI each receives.
- Items of income have the same character in the hands of the beneficiary as in the hands of the trust.

# Complex Trusts and Distributions

- General rule: DNI is allocated proportionately among the beneficiaries based on distributions made to each beneficiary.
- Distributions from complex trust/estate carry out a pro rata portion of each item of DNI.
- Example: Trust has \$40,000 of DNI. Trustee distributes \$60,000 to A and \$20,000 to B (a total of \$80,000 has been distributed).

A includes \$30,000 in income ( $\$60,000/\$80,000 \times \$40,000$ )  $3/4$

B includes \$10,000 in income ( $\$20,000/\$80,000 \times \$40,000$ )  $1/4$



# Special Rules in Allocating DNI

- Tier System
- Separate Share Rule
- 65 Day Rule (663(b) election)
- Specific Bequests (663(a)(1))
- Distributions in Kind (643(e))

# Complex Trusts – Tier System

- First tier - Beneficiary who is **entitled** to income receives all items of income first.
- Second tier – Beneficiary who receives all other amounts may report income to the extent DNI not allocated to First Tier beneficiary.
- DNI is taxed first to First Tier beneficiary(s), and balance of DNI is taxed to second tier beneficiary(s).

# Tier System Example

Trust has \$40,000 in FAI and DNI.

A, B and C are trust beneficiaries.

Terms of trust require A to receive 50% of all income.

Trustee distributes \$20,000 to A (1/2 of income) and decides to make discretionary distributions of \$20,000 each to B and to C.

A is a First Tier beneficiary and gets 50% of the FAI, and 50% of the DNI so 100% of A's \$20,000 distribution is taxable.

B and C received the same amount but each report only ½ of the remaining DNI, so \$10,000 of their distributions are taxable and the balance is a distribution of principal not subject to tax.

# Separate Share Rule

Trust has \$40,000 of DNI. Trustee distributes \$60,000 to A and \$20,000 to B (a total of \$80,000 has been distributed).

IF separate share rule applies, the pro rata rules outlined in slide 24 to NOT apply. Need more facts.

A's separate share has earned \$20,000 of the DNI, and B's separate share has earned \$20,000 of DNI. Trust files one income tax return and takes a \$40,000 distribution deduction.

A includes \$20,000 in income, and B includes \$20,000 in income.

Mandatory rule for estates and complex trusts.

Avoid if possible in the drafting stages either by giving the trustee the authority to “spray” income or by dividing into separate trusts.

# 65 Day Rule (663(b) Election)

- Applies to complex trusts and to estates
- Allows distributions made within 65 days of year end as having been made on 12/31 of the preceding year.
- Election must be made by due date of the return.
- Election is irrevocable (for that year/distribution) but the election can change from year to year.
- Limited to lesser of DNI less current year's distributions, or FAI not previously distributed

# Specific Bequests (663(a)(1))

- Bequests of a specific sum of money or specific property DO NOT carryout DNI
- Must be paid all at once or paid in not more than 3 installments
  - Payment delayed for administrative convenience of trustee is ignored
- Amount of the bequest must be ascertainable at the date of death
- Payment is not deductible by the trust or estate and is not taxable to the beneficiary

# Distributions in Kind (643(e) Election)

- Trust/Estate may *elect*, but is not required, to recognize gain/loss
- Basis of property in hands of beneficiary is the basis of the property in the hands of the trust/estate, *plus or minus* any gain or loss the trust/estate elects to recognize on the distribution. Holding period tacks on if basis is determined in whole or part by basis in hands of trust/estate
- Distribution carries out DNI, but the amount of the DNI depends on whether or not the election was made:
  - No election: DNI carried out is *Lesser* of basis or FMV of distributed property
  - Election: DNI carried out is the FMV of the distributed property

# Charitable Deduction

- Must be paid pursuant to the governing instrument
- Must be paid from gross income
- Unlimited
- No distribution deduction
- Paid in current year or preceding year (have a year to decide which tax year this contribution will apply to)
- Estates and pre-1969 trusts get a charitable deduction if the money is paid or “permanently set aside” (A trust making the 645 election gets this too.)



# Depreciation (642(e))

- For a trust:
  - Depreciation is allocated between income beneficiary and trust as outlined in the trust instrument
  - If trust is silent, allocated on the proportion of income paid out to the beneficiary vs. retained by the trust
- For an estate:
  - Depreciation is allocated between income beneficiary and estate on the basis of the income allocable to each
- Depreciation reserve and be maintained by the trustee, and trust gets the deduction to extent trustee transfer income to reserve
  - Example: FAI is \$20,000 and the depreciation deduction is \$5,000. If trustee puts \$5,000 of income in a depreciation reserve, the entire depreciation deduction is allocated to the trust

# 645 Election

- Treats qualified revocable trust (QRT – typical estate planning trust) as part of the decedent's estate for fiduciary income tax purposes
- Election is made jointly by the executor and trustee
  - Election is for a limited period of time
  - Final regulations (and 1041 instructions should be consulted)
  - Election is made on Form 8855 which must be filed by the due date of the fiduciary income tax returns for the first taxable year of the estate, including extensions
  - Return is filed for the estate (combining trust and estate income)

# Benefits of the 645 Election

- File one return, combining estate and trust income
- Charitable set-aside is available
- Eligible to hold S stock for duration of the election (estate not limited to a 2 year holding period after death of grantor)
- No estimated tax payments required for any taxable year ending within 2 years of grantor's death
- Use fiscal year end (trust otherwise required to use calendar year)
- Passive Activity deduction for rental real estate for the first 2 years of the estate

# Termination of Trust or Estate – 642(h)

- Unused loss carryforwards - NOL, capital losses pass to the beneficiary on the termination of the trust or estate, but only in the year of termination
- Excess deductions (where deductible trust/estate expenses exceed income in the final year) pass out to the beneficiary in year of termination but subject to the 2% floor and, hence, lost (or are they?)
- While the TCJA suspended miscellaneous itemized deductions through 2025 (§67(g)), according to IRS Notice 2018-61, the Treasury intends to issue regulations clarifying the effect of the TCJA on the excess deductions.

# Drafting and Planning Ideas

- Take administrative expenses on 706 or 1041 wherever the tax rate is higher
- Select fiscal year end for estates (and for QRT)
- Draft flexibly to include capital gains in DNI
- Include language to allow non-pro-rata distributions
- Avoid the separate share rule by drafting as a spray trust or dividing into separate subtrusts
- Consider the 645 election to take advantage of estate's more favorable rules

# Drafting and Planning Ideas (cont'd)

- Draft carefully to qualify for the 642(c) fiduciary income tax charitable deduction
- When considering which tax rates are “better” remember the 3.8% surtax (MFJ threshold: \$250,000 for 2024)
- Avoid excess deductions in all but terminating year
- Consider the gain on funding when using pecuniary formulas
  - use fractional instead if you can, or
  - fund fast (to minimize gain/suspended losses)
  - Kenan gain (using appreciated property to pay a bene)

## Drafting: Authority to make charitable contributions

The trustee may, in addition to the authority granted elsewhere in this trust to the trustee to make discretionary distributions of income and principal, make distributions of trust income or principal to any charitable organizations described in Section 170(c) of the Internal Revenue Code, or in corresponding provisions of subsequent federal tax laws; provided, however, that:

(1) no such distribution shall be made (A) from any trust named for my spouse, or (B) which would affect any RMD payments required by any provisions of this trust, or (C) which would disqualify any separate trust holding S Corporation Stock from being able to make an election under Section 1362 of the Internal Revenue Code, or which would have the effect of revoking any such election if already made;

(2) no such distribution shall be made if such distribution would exceed "net taxable income" as defined for tax accounting purposes under the Internal Revenue Code for the year in which such distribution is to be made; and ...

## Drafting: charitable contributions (cont'd)

(3) no such distribution shall be made from a trust share (A) without the consent of the beneficiary for whom such trust share is named, in the case of a beneficiary then living and legally competent for whom a trust share is named, or (B) if the beneficiary for whom such trust share is named is not then living, or if any trust share is not then identified by the name of a then living beneficiary, without the consent of a majority in interest of the beneficiaries to whom trust income may or must then be distributed.



# Drafting: Useful boilerplate

- In-Kind Distributions: To make allocations, divisions, and distributions of trust property in cash or in kind, or partly in each; to allocate different kinds or disproportionate shares of property or undivided interests in property among the beneficiaries or separate trusts, without liability for, or obligation to make compensating adjustments by reason of disproportionate allocations of unrealized gain for federal income tax purposes; and to determine the value of any property so allocated, divided, or distributed;

# Drafting: Useful boilerplate (cont'd)

## Treating Capital Gains as part of income

- To allocate realized capital gains to income in whole or in part on the books of the trust or by notice to any beneficiary of the trust; and
- To distribute capital gains which have been allocated to income to any trust beneficiary otherwise entitled to receive any discretionary distributions of trust income or principal.

# Drafting: Useful boilerplate (cont'd)

## Depreciation reserves

- To determine in an equitable manner with due regard to the respective interests of any beneficiary entitled to receive or have the benefit of the income from the trust and any remainderman the allocation or apportionment of all receipts and disbursements between income and principal, except that reserves for depreciation shall be established out of income only to the extent that the trustee determines that readily marketable assets in the principal of the trust will be insufficient for any renovation, major repair, improvement or replacement of trust property which the trustee deems advisable.



*"You seem to know something about law. I like that in an attorney."*