

Fundamentals of Income Taxation of Trusts and Estates

AICPA Sophisticated Tax Planning for Your Wealthy Clients

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What We'll Cover

- Basic Rules
- Distributable Net Income (DNI)
- Types of Trusts
- An Actual Example of a Tax Return for a Complex Trust
 - Trust Accounting Income (TAI)
 - Taxable Income
 - Charitable Deduction/Depreciation Deduction
 - Allocating Administration Expenses to Tax Exempt Income
 - Calculation of DNI
 - Distribution System/Tier System
 - How DNI Gets Allocated to Beneficiaries

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Income Taxation of Trusts and Estates

- Separate Taxable Entities
- Taxable Income Computed in Same Manner as Individuals (Sec. 641(b))
- Own Tax Year and Method of Accounting
 - Trust on calendar year
 - Estate may chose a fiscal year
- Receive Income/Pay Expenses
- Income Taxed to Entity or Beneficiary

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2008 Fiduciary Income Tax Rates

<u>Over</u>	<u>Not Over</u>	
0	2,200	15%
2,200	5,150	25%
5,150	7,850	28%
7,850	10,700	33%
10,700		35%

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Income Taxation of Trusts and Estates

Income Taxed to Either Entity or Beneficiary

- If income is *accumulated* and not deemed distributed, it is taxed to the trust or estate
- If income *distributed*:
 - Trust gets deduction for amount of distribution
 - Beneficiary accounts for income distributed on his own tax return

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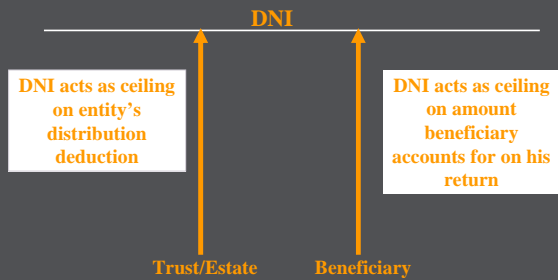
Income Taxation of Trusts and Estates DNI

Distributable Net Income (DNI) governs:

- Amount of trust or estate's distribution deduction
- Amount beneficiary accounts for on his own return
- Character of income in beneficiary's hands

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Income Taxation of Trusts and Estates



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DNI - Sec. 643(a)

Start With Taxable Income and . . .

- Add back the distribution deduction
- Add back the personal exemption
- Subtract out capital gains/add back capital losses allocable to principal (except in the year of termination)
- Subtract out extraordinary dividends and taxable stock dividends
- Add back net tax-exempt income

Think of DNI as being trust accounting income

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DNI - Sec. 643(a)

Note: capital gains generally taxed to trust or estate

- Exception: year of termination

Note: The rules regarding DNI and the distribution deduction are applied differently to simple trusts versus complex trusts and estates

Note: Distributions of principal as well as income will "carry out" DNI

- Exception: Specific bequests under Sec. 663(a)(1)

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Specific Bequests - Sec. 663(a)(1)

- Bequest of specific sum of money or specific property *do not carry out DNI*
 - Trust or estate gets no distribution deduction
 - Beneficiary not required to report any income
- Requirements:
 - Paid all at once, or
 - Paid in not more than 3 installments

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Types of Trusts

- Simple
- Complex
- Grantor

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Simple Trust

- Required to distribute accounting income annually
- Makes no principal distributions, and
- Makes no distributions to charity

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Complex Trust

- Accumulates income
- Makes discretionary distributions of income or mandatory or discretionary distributions of principal, or
- Makes distributions to charity

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Grantor Trust

- Grantor or beneficiary has one or more "powers" described in Sec. 673-678
- Result: All income, expenses and credits "flow through" and are taxed to the Grantor or beneficiary regardless of whether distributions are made
- Subpart A-D, Subchapter J (rules for taxation of trusts and estates) do not apply to Grantor trusts

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Taxable Income of Trust or Estate

- Computed same as individual
- Exemptions: \$600/\$300/\$100
- Different rules for charitable deductions
- Depreciation deduction allocated between entity and beneficiary
- Distribution deduction
- Administration expenses - some not subject to 2% floor
- AGI - same as individual except (a) personal exemption, (2) distribution deduction, (3) charitable deduction and (4) some administration expenses are subtracted "off the top," i.e. subtracted from taxable income to arrive at AGI

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Distributions - Simple Trust

Beneficiary Taxed on Lower of TAI or DNI

Gains Taxed to Trust

Trust Gets Distribution Deduction Equal to DNI

Simple Trust ← Gains

DNI ↓

Beneficiary Accounts for DNI Beneficiary

Trust income retains its character in Beneficiary's hands

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Distributions - Complex Trusts and Estates

Trust/Estate Accumulates Income

Gains and DNI Taxed to Trust

Complex Trust ← Gains
← DNI

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Distributions - Complex Trusts and Estates

Beneficiary Taxed on Distributions Up to DNI

Gains Taxed to Trust

Trust Gets Distribution Deduction Equal to Distributions up to DNI

Complex Trust ← Gains

DNI ↓

Beneficiary Accounts for Distributions Up to DNI Beneficiary

Trust income retains its character in Beneficiary's hands

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Charitable Deduction - Sec. 642(c)

- Requirements:
 - Paid from gross income
 - Paid pursuant to the governing document
- Unlimited in amount
- No distribution deduction
- Taken as deduction in computing AGI
- Generally, must be actually paid in current year or preceding year
 - Estates and pre- 1969 trusts get charitable deduction if “permanently set aside”

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Misc. Itemized Deduction – 2% Floor

ARE INVESTMENT ADVISORY FEES SUBJECT TO THE 2% FLOOR?

- O’Neill – Sixth Circuit – NO
- Mellon – Federal Circuit – YES
- Scott – Fourth Circuit – YES
- Rudkin – Second Circuit – YES
 - Appealed to United States Supreme Court as Knight

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Misc. Itemized Deduction – 2% Floor

ARE INVESTMENT ADVISORY FEES SUBJECT TO THE 2% FLOOR?

- July 27, 2007 – IRS issues proposed regulations under §67 providing guidance on which costs by estates and nongrantor trusts are subject to the 2% floor
- Cost “unique” to estate or trust are not subject to 2% floor
 - “Unique” means individual could not have incurred the expense
 - Would an individual incur the expense in the absence of a trust?
 - USSC in Knight specifically disavowed the “could not” language
- Costs subject to 2% floor determined by type of services provided rather than on taxpayer’s characterization or labels of services
- Prop. Regs would not allow taxpayers to circumvent 2% floor by bundling investment advisory fees and trustee fees together
 - If bundled, taxpayer must use a reasonable method to allocate a single fee between the two types of costs
- Prop. Regs provides a nonexclusive list of services that are exempt or nonexempt from the 2% floor

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Misc. Itemized Deduction – 2% Floor

ARE INVESTMENT ADVISORY FEES SUBJECT TO THE 2% FLOOR?

- Services unique to estate or trust i.e. not subject to 2% floor under Prop. Regs.:
 - Fiduciary accountings
 - Judicial or quasi-judicial filings as part of estate or trust administration
 - Fiduciary income tax and estate tax returns
 - Division or distribution of income or corpus to or among beneficiaries
 - Trust or will contest or construction
 - Fiduciary bond premiums
 - Communications with beneficiaries regarding estate or trust matters

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Misc. Itemized Deduction – 2% Floor

ARE INVESTMENT ADVISORY FEES SUBJECT TO THE 2% FLOOR?

- Services NOT unique to estate or trust i.e. subject to 2% floor under Prop. Regs.:
 - Custody or management of property
 - Advice on investing for total return
 - Gift tax returns
 - Defense of claims by creditors of the decedent or grantor
 - Purchase, sale, maintenance, repair, insurance or management of nontrade or business property

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Misc. Itemized Deduction – 2% Floor

KNIGHT v. COMMISSIONER 127 S. CT. 782 (2008)

- §67(e) excepts from the 2% floor only those costs that it would be uncommon (or unusual or unlikely) for an individual to incur.
- Specifically disavows the "could not have been incurred by an individual" language of the Second Circuit in Rudkin

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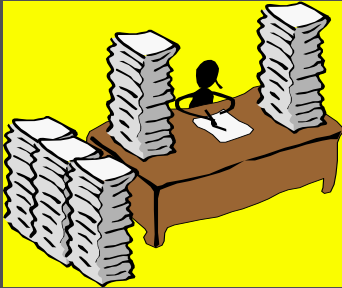
Resources

- Federal Income Taxation of Estates, Trusts and Beneficiaries, 3rd Edition by Ferguson, Freeland and Ascher (Aspen/CCH)
- 1041 Deskbook (Practitioners Publishing Co)
- Income Taxation of Trusts and Estates, 852-3rd (BNA portfolio – Estate, Gift and Trust series)
- Federal Income Taxation of Decedents, Estates and Trusts, 23rd Edition (Nov. 2007) (CCH)
- Federal Income Taxation of Trusts and Estates, by Zaritsky and Lane, 3rd Edition (RIA/Thompson/West)
- Income Taxation of Fiduciaries and Beneficiaries by Abbin, 2 volumes, 2008 Edition (CCH)

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Example of a 2007 Fiduciary Income Tax Return for a Complex Trust



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Facts

- Trust provides that 50% of the income *must* be paid currently to Will
- During 2006 the trustee makes the following *discretionary* distributions:
 - 25% of the income to Cam
 - 25% of the income to charity
- No reserve for depreciation is required

Question: What type of trust is this and why?

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INCOME	
Rents	40,000
Tax Int.	30,000
T/E Int	15,000
LTCG	8,000
EXPENSES	
Depr/Rental	6,000
R/E Rent Ex	14,000
Tr Fee-Prin	1,000
Tr Fee-Inc	2,000
Char Ded	
Exemption	
Total	

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Distribution of Income

Required: 50% to Will

Discretionary: 25% to Cam
25% to Charity

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Trust Accounting Income (TAI)

- Governs amount of distributions
- Trustee allocates receipts/disbursements between accounting income and principal
- Accounting income and principal is determined by governing instrument or, if instrument silent, by state law
 - May be governed by UPIA or unitrust statute

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Trust Accounting Income (TAI)

	TAI	Taxable Income
Corp Bond Int	√	√
Capital Gains		√
Muni Bond Int	√	
Expenses	?	?

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<u>INCOME</u>		<u>TAI</u>
Rents	40,000	40,000
Tax Int.	30,000	30,000
T/E Int	15,000	15,000
LTCG	8,000	-
<u>EXPENSES</u>		
Depr/Rental	6,000	-
R/E Rent Ex	14,000	(14,000)
Tr Fee-Prin	1,000	-
Tr Fee-Inc	2,000	(2,000)
Char Ded		
Exemption		
Total		69,000

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<u>INCOME</u>		<u>TAI</u>
Rents	40,000	40,000
Tax Int.	30,000	30,000
T/E Int	15,000	15,000
LTCG	8,000	-
<u>EXPENSES</u>		
Depr/Rental	6,000	-
R/E Rent Ex	14,000	(14,000)
Tr Fee-Prin	1,000	-
Tr Fee-Inc	2,000	(2,000)
Char Ded		
Exemption		
Total		69,000

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<u>INCOME</u>		<u>TAI</u>
Rents	40,000	40,000
Tax Int.	30,000	30,000
T/E Int	15,000	15,000
LTCG	8,000	-
<u>EXPENSES</u>		
Depr/Rental	6,000	-
R/E Rent Ex	14,000	(14,000)
Tr Fee-Prin	1,000	-
Tr Fee-Inc	2,000	(2,000)
Char Ded Exemption		
Total		69,000

Enter on Form 1041, Sch. B, Line 8

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Amount of TAI Received by Each Beneficiary

Will:	50% x 69,000 TAI = 34,500
Cam:	25% x 69,000 TAI = 17,250
Charity:	25% x 69,000 TAI = 17,250
Total	69,000

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<u>INCOME</u>	<u>TAI</u>	<u>TI</u>
Rents	40,000	40,000
Tax Int.	30,000	30,000
T/E Int	15,000	-
LTCG	8,000	8,000
		78,000
<u>EXPENSES</u>		
Depr/Rental	6,000	-
R/E Rent Ex	14,000	(14,000)
Tr Fee-Prin	1,000	(2,471)
Tr Fee-Inc	2,000	-
Char Ded		(14,206)
Exemption		(100)
Total	69,000	47,223

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<u>INCOME</u>		<u>TAI</u>	<u>TI</u>
Rents	40,000	40,000	40,000
Tax Int.	30,000	30,000	30,000
T/E Int	15,000	15,000	-
LTCG	8,000	-	8,000
			78,000
<u>EXPENSES</u>			
Depr/Rental	6,000	-	-
R/E Rent Ex	14,000	(14,000)	(14,000)
Tr Fee-Prin	1,000	-	(2,471)
Tr Fee-Inc	2,000	(2,000)	-
Char Ded			(14,206)
Exemption			(100)
Total		69,000	47,223

Enter on Form 1041, Page 1, Line 17

<u>INCOME</u>		<u>TAI</u>	<u>TI</u>
Rents	40,000	40,000	40,000
Tax Int.	30,000	30,000	30,000
T/E Int	15,000	15,000	-
LTCG	8,000	-	8,000
			78,000
<u>EXPENSES</u>			
Depr/Rental	6,000	-	-
R/E Rent Ex	14,000	(14,000)	(14,000)
Tr Fee-Prin	1,000	-	(2,471)
Tr Fee-Inc	2,000	(2,000)	-
Char Ded			(14,206)
Exemption			(100)
Total		69,000	47,223

Depreciation Deduction

- No reserve for depreciation
- Depreciation follows accounting income
- All accounting income is distributed to Will, Cam and the charity
- Therefore, the trust is not entitled to deduct any depreciation
- Beneficiaries are entitled to depreciation deduction

<u>INCOME</u>		<u>TAI</u>	<u>TI</u>
Rents	40,000	40,000	40,000
Tax Int.	30,000	30,000	30,000
T/E Int	15,000	15,000	-
LTCG	8,000	-	8,000
			78,000
<u>EXPENSES</u>			
Depr/Rental	6,000	-	-
R/E Rent Ex	14,000	(14,000)	(14,000)
Tr Fee-Prin	1,000	-	(2,471)
Tr Fee-Inc	2,000	(2,000)	-
Char Ded			(14,206)
Exemption			(100)
Total		69,000	47,223

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Non-Deductible Expenses - Sec. 265

- Sec. 265 disallows any deduction attributable to T/E income
- Generally applies to deductions for production of income, usually trustee's fees and executor's fees
- If trust/estate has T/E income, portion of trustee's and executor's fees are nondeductible
- No specific allocation formula
 - Fiduciary can use any reasonable method

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Trustee Fee Allocable to T/E Income

$$\frac{15,000 \text{ T/E Income}}{85,000 \text{ Gross TAI}} \times 3,000 \text{ Total Tr Fees} = 529$$

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Trustee Fee Allocable to T/E Income

$\frac{15,000 \text{ T/E Income}}{85,000 \text{ Gross TAI}} \times 3,000 \text{ Total Tr Fees} = 529$
 Non-Deductible (529)
 Deductible Tr Fees 2,471

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<u>INCOME</u>		<u>TAI</u>	<u>TI</u>
Rents	40,000	40,000	40,000
Tax Int.	30,000	30,000	30,000
T/E Int	15,000	15,000	-
LTCG	8,000	-	8,000
			78,000
<u>EXPENSES</u>			
Depr/Rental	6,000	-	-
R/E Rent Ex	14,000	(14,000)	(14,000)
Tr Fee-Prin	1,000	-	(2,471)
Tr Fee-Inc	2,000	(2,000)	(14,206)
Char Ded			(100)
Exemption			
Total		69,000	47,223

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Trustee Fee Allocable to T/E Income

$\frac{15,000 \text{ T/E Income}}{85,000 \text{ Gross TAI}} \times 17,250 \text{ TAI Charity} = 3,044$
 Non-Deductible 3,044
 Charitable Deduction 14,206

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Calculation of DNI

		<u>DNI</u>
TI before Dist Ded		47,223
Add: Exemption		100
Add: Net T/E Income	15,000	
Less: ND Tr Fee	(529)	
Less: ND Char Ded	(3,044)	11,427
Less: LTCG		<u>(8,000)</u>
DNI		50,750

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Calculation of DNI

		<u>DNI</u>
TI before Dist Ded		47,223
Add: Exemption		100
Add: Net T/E Income	15,000	
Less: ND Tr Fee	(529)	
Less: ND Char Ded	(3,044)	11,427
Less: LTCG		<u>(8,000)</u>
DNI		50,750

Enter on Form 1041,
Sch. B, Line 7



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Components of DNI

	47.06%	35.29%	17.65%	100%
	<u>Rental</u>	<u>Taxable</u>	<u>T/E</u>	<u>Total</u>
	<u>Income</u>	<u>Interest</u>	<u>Interest</u>	<u>Total</u>
Gross TAI	40,000	30,000	15,000	85,000
LESS:				
Rental Exp	(14,000)			(14,000)
Tr. Fees	(1,412)	(1,059)	(529)	(3,000)
Char Ded	<u>(8,118)</u>	<u>(6,088)</u>	<u>(3,044)</u>	<u>(17,250)</u>
Totals	16,470	22,853	11,427	50,750

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Now We've Got a Problem!!!



FTB Will gets distribution of \$34,500
STB Cam gets distribution of \$17,250
Total Distributions \$51,750

But DNI is only \$50,750!!!

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Complex Trust and Estates Tier System

Two tiers:

- First Tier - Distribution of income *required* to be distributed currently
- Second Tier - Distribution of *all other amounts* paid, credited or required to be distributed

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Complex Trust and Estates Tier System



First Tier Beneficiary

Second Tier Beneficiary

DNI is taxed first to FTB and any
balance of DNI is taxed to STB

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Application of the Tier System

Will is a FTB - entitled to 50% of the income or \$34,500

Cam is a STB - *discretionary* distribution of \$17,250

How do we allocate DNI between FTB and STB???

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The Tier System Solves Our Problem

Share of DNI

FTB Will - Receives \$34,500; limited to DNI of \$50,750	\$34,500
STB Cam - Receives \$17,250; limited to remaining DNI: 50,750 less 34,500 or \$16,250	<u>\$16,250</u>
Total (Equal to DNI)	\$50,750

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The Tier System Solves Our Problem

Share of DNI % of DNI

FTB Will - Receives \$34,500; limited to DNI of \$50,750	\$34,500	67.98
STB Cam - Receives \$17,250; limited to remaining DNI: 50,750 less 34,500 or \$16,250	<u>\$16,250</u>	<u>32.02</u>
Total (Equal to DNI)	\$50,750	100

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Remember This??? - Components of DNI

	47.06%	35.29%	17.65%	100%
	Rental	Taxable	T/E	Total
	Income	Interest	Interest	Total
Gross TAI	40,000	30,000	15,000	85,000
LESS:				
Rental Exp	(14,000)			(14,000)
Tr. Fees	(1,412)	(1,059)	(529)	(3,000)
Char Ded	(8,118)	(6,088)	(3,044)	(17,250)
Totals	16,470	22,853	11,427	50,750

Will and Cam get 67.98% and 32.02%, respectively, of each of these items

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Trustee reports these amounts to Will and Cam on separate K-1s

	67.98%	32.02%	Total
	Will	Cam	Total
Rental Income	11,196	5,274	16,470
Taxable Interest	15,536	7,317	22,853
T/E Interest	7,768	3,659	11,427
Total	34,500	16,250	50,750

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Will Reports \$26,732 of TI

	67.98%	32.02%	Total
	Will	Cam	Total
Rental Income	11,196	5,274	16,470
Taxable Interest	15,536	7,317	22,853
T/E Interest	7,768	3,659	11,427
Total	34,500	16,250	50,750

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	67.98% Will	32.02% Cam	Total
Rental Income	11,196	5,274	16,470
Taxable Interest T/E	15,536	7,317	22,853
Interest	7,768	3,659	11,427
Total	34,500	16,250	50,750

**Cam Reports
\$12,592 of TI**

\$12,591

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But . . . Aren't We Missing Something???

	Will Reports	Cam Reports
Taxable Income	\$26,732	\$12,591

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YES! - Depreciation

	Will Reports	Cam Reports
Taxable Income	\$26,732	\$12,591
Depreciation	<u>(3,000)</u>	<u>(1,500)</u>
Net Taxable Income	\$23,732	\$11,091

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Where's the Other \$1,500 of Depreciation?

	Will Reports	Cam Reports
Taxable Income	\$26,732	\$12,591
Depreciation	<u>(3,000)</u>	<u>(1,500)</u>
Net Taxable Income	\$23,732	\$11,091

It is Allocated to Charity and is Wasted!!!

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The Distribution Deduction is \$39,323

	67.98% Will	32.02% Cam	Total
Rental Income	11,196	5,274	16,470
Taxable Interest	15,536	7,317	22,853
T/E Interest	7,768	3,659	11,427
Total	34,500	16,250	50,750

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Trust's Taxable Income

TI Before Dist Deduction	\$47,223
Distribution Deduction	<u>\$39,323</u>
Taxable Income	\$7,900

The taxable income is the LTCG less the \$100 exemption

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Trust's Taxable Income

TI Before Dist Deduction \$47,223
Distribution Deduction \$39,323
Taxable Income \$7,900

Report on
Form
1041,
Page1,
Line22

The taxable income is the LTCG less the \$100 exemption

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Summary

- Compute TAI
- Figure Distribution Beneficiaries Get
- Calculate Taxable Income
 - Allocate Depreciation
 - Allocate Expenses to T/E Income
- Calculate DNI
- Apply Tier System
 - Allocate DNI
- Send K-1s to Beneficiaries
- Complete 1041

Thank God for Tax Software!!!

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