

Calculating Fiduciary Accounting Income for Trusts: Interpreting Operating Documents, Applying UPIA and State Law

Reconciling FAI to DNI and Trust Taxable Income, Avoiding Tax and Beneficiary Challenges

TUESDAY, JUNE 21, 2016, 1:00-2:50 pm Eastern

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FOR LIVE PROGRAM ONLY

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June 21, 2016

Jeffrey M. Bergman

Schiff Hardin, Chicago

jbergman@schiffhardin.com

Howard L. Sanger, Attorney

Sanger & Manes, Palm Springs, Calif.

hsanger@sangerlaw.com

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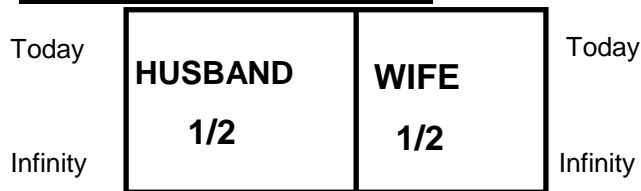
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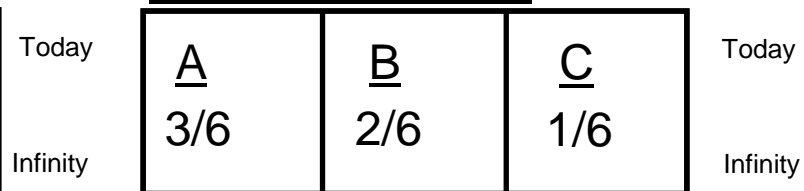
SLICING/DICING PROPERTY

VERTICAL SLICING

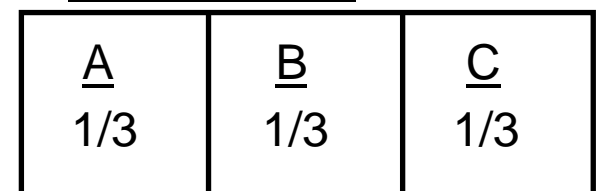
COMMUNITY PROPERTY



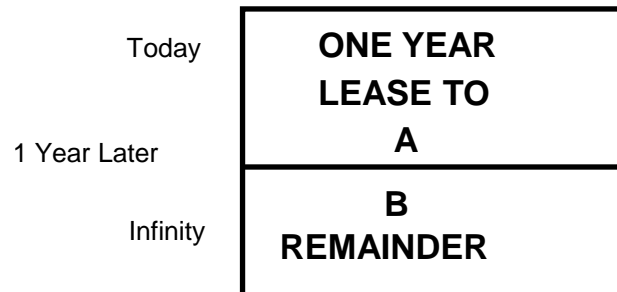
TENANCY IN COMMON



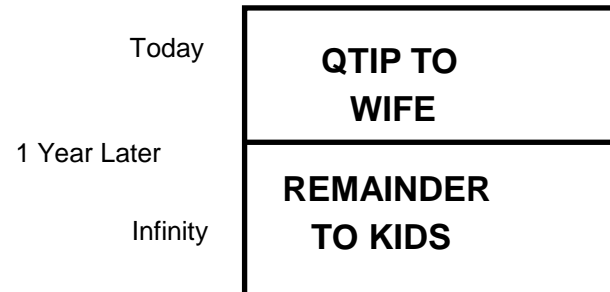
JOINT TENANCY

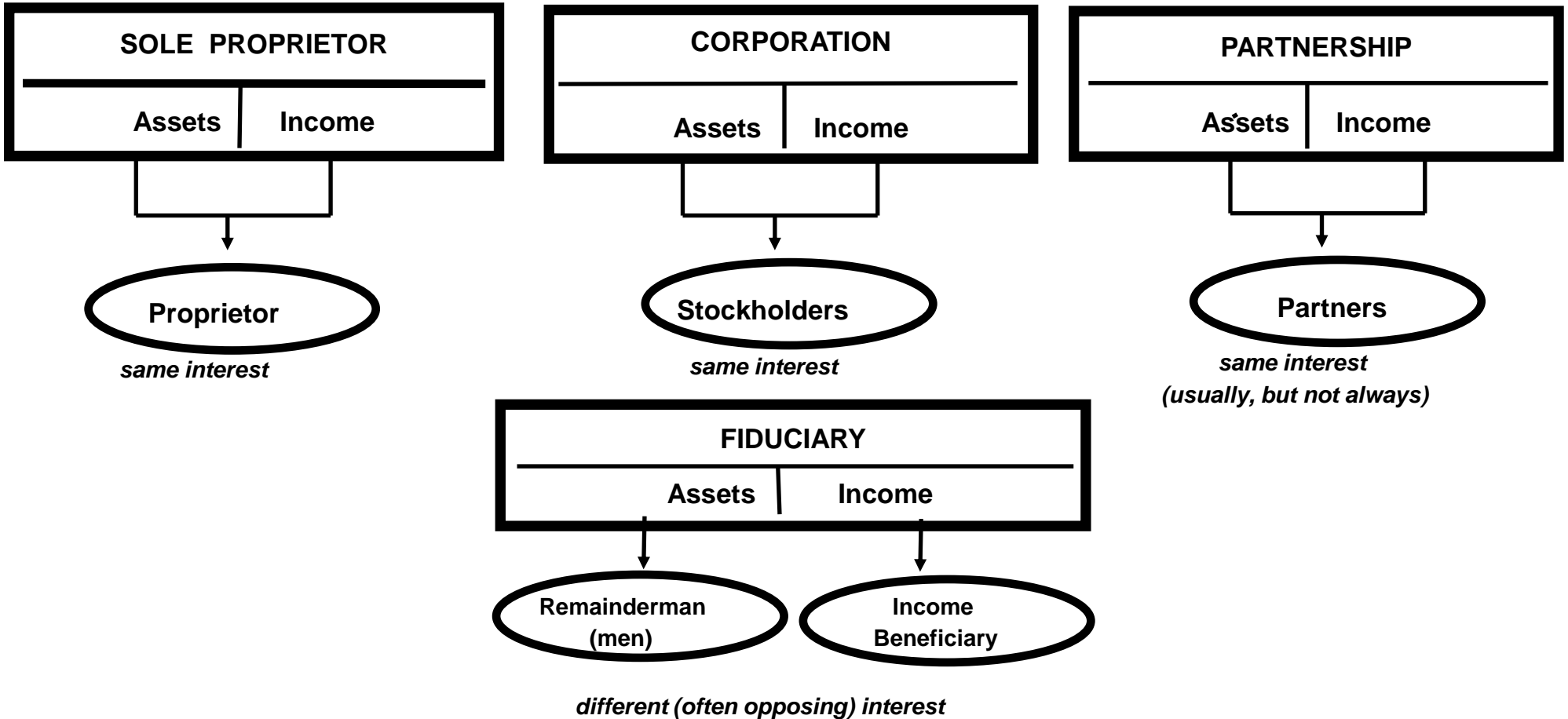


HORIZONTAL SLICING

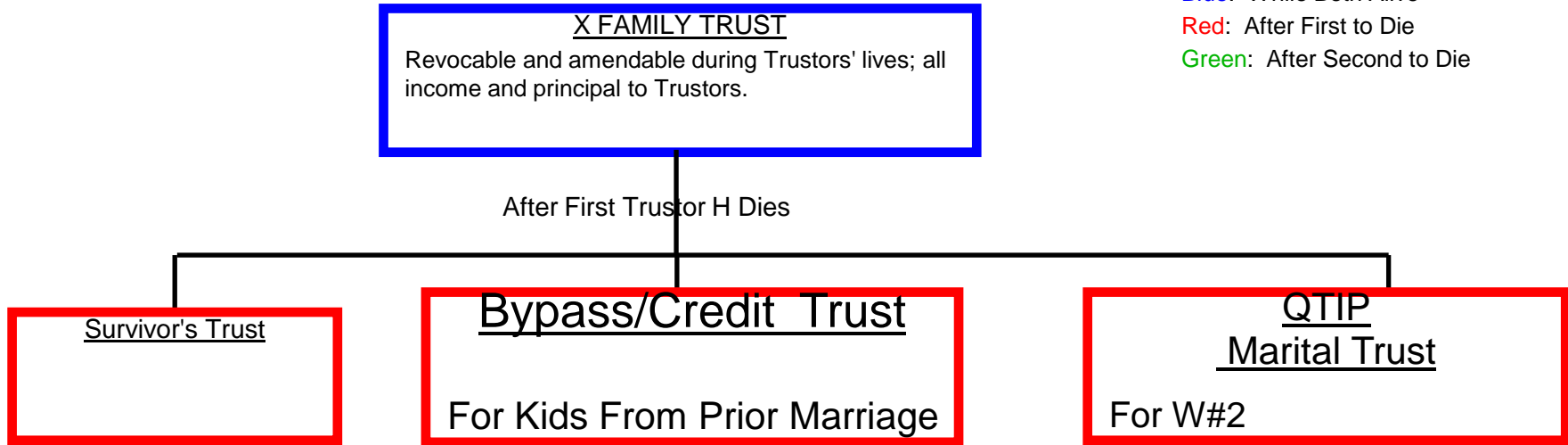


TRUST

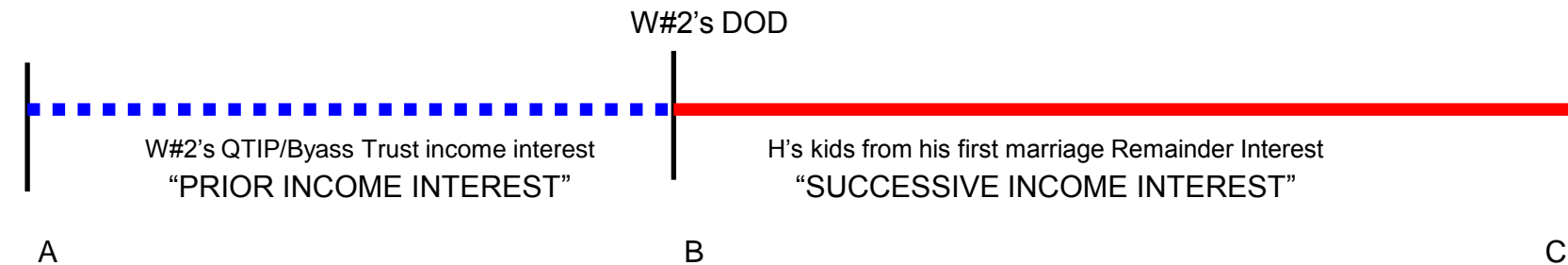
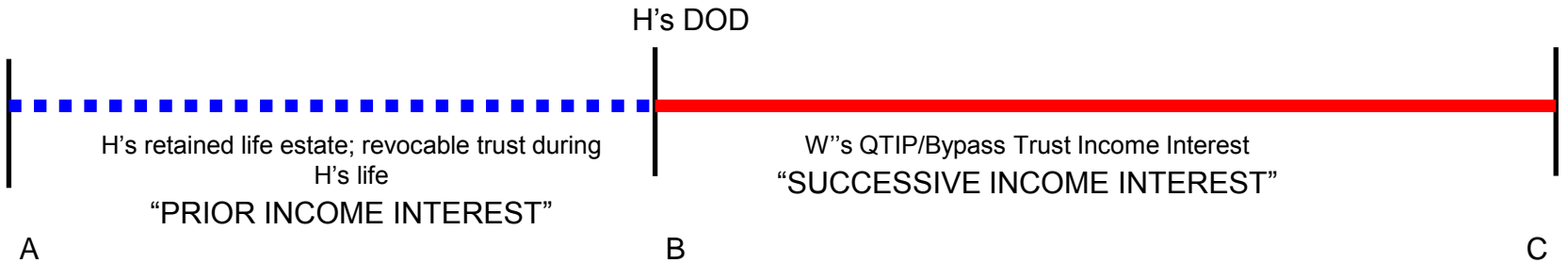




Legend:
 Blue: While Both Alive
 Red: After First to Die
 Green: After Second to Die



SUCCESSIVE TRUST INTERESTS



Schedule A Charitable Deduction. Do not complete for a simple trust or a pooled income fund.			
1	Amounts paid or permanently set aside for charitable purposes from gross income (see instructions)	1	
2	Tax-exempt income allocable to charitable contributions (see instructions)	2	
3	Subtract line 2 from line 1	3	
4	Capital gains for the tax year allocated to corpus and paid or permanently set aside for charitable purposes	4	
5	Add lines 3 and 4	5	
6	Section 1202 exclusion allocable to capital gains paid or permanently set aside for charitable purposes (see instructions)	6	
7	Charitable deduction. Subtract line 6 from line 5. Enter here and on page 1, line 13	7	

Schedule B Income Distribution Deduction			
1	Adjusted total income (see instructions)	1	
2	Adjusted tax-exempt interest	2	
3	Total net gain from Schedule D (Form 1041), line 15, column (1) (see instructions)	3	
4	Enter amount from Schedule A, line 4 (minus any allocable section 1202 exclusion)	4	
5	Capital gains for the tax year included on Schedule A, line 1 (see instructions)	5	
6	Enter any gain from page 1, line 4, as a negative number. If page 1, line 4, is a loss, enter the loss as a positive number	6	
7	Distributable net income. Combine lines 1 through 6. If zero or less, enter -0-	7	
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law	8	
9	Income required to be distributed currently	9	
10	Other amounts paid, credited, or otherwise required to be distributed	10	
11	Total distributions. Add lines 9 and 10. If greater than line 8, see instructions	11	
12	Enter the amount of tax-exempt income included on line 11	12	
13	Tentative income distribution deduction. Subtract line 12 from line 11	13	
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-	14	
15	Income distribution deduction. Enter the smaller of line 13 or line 14 here and on page 1, line 18	15	

Schedule G Tax Computation (see instructions)			
1	Tax: a Tax on taxable income (see instructions)	1a	
	b Tax on lump-sum distributions. Attach Form 4972	1b	
	c Alternative minimum tax (from Schedule I (Form 1041), line 56)	1c	
	d Total. Add lines 1a through 1c	1d	
2a	Foreign tax credit. Attach Form 1116	2a	
b	General business credit. Attach Form 3800	2b	
c	Credit for prior year minimum tax. Attach Form 8801	2c	
d	Bond credits. Attach Form 8912	2d	
3	Total credits. Add lines 2a through 2d	3	
4	Subtract line 3 from line 1d. If zero or less, enter -0-	4	
5	Recapture taxes. Check if from: <input type="checkbox"/> Form 4255 <input type="checkbox"/> Form 8611	5	
6	Household employment taxes. Attach Schedule H (Form 1040)	6	
7	Total tax. Add lines 4 through 6. Enter here and on page 1, line 23	7	

Other Information		Yes	No
1	Did the estate or trust receive tax-exempt income? If "Yes," attach a computation of the allocation of expenses Enter the amount of tax-exempt interest income and exempt-interest dividends \$ _____		
2	Did the estate or trust receive all or any part of the earnings (salary, wages, and other compensation) of any individual by reason of a contract assignment or similar arrangement?		
3	At any time during calendar year 2012, did the estate or trust have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country? See the instructions for exceptions and filing requirements for Form TD F 90-22.1. If "Yes," enter the name of the foreign country _____		
4	During the tax year, did the estate or trust receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the estate or trust may have to file Form 3520. See instructions		
5	Did the estate or trust receive, or pay, any qualified residence interest on seller-provided financing? If "Yes," see the instructions for required attachment		
6	If this is an estate or a complex trust making the section 663(b) election, check here (see instructions) <input type="checkbox"/>		
7	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here (see instructions) <input type="checkbox"/>		
8	If the decedent's estate has been open for more than 2 years, attach an explanation for the delay in closing the estate, and check here <input type="checkbox"/>		
9	Are any present or future trust beneficiaries skip persons? See instructions <input type="checkbox"/>		

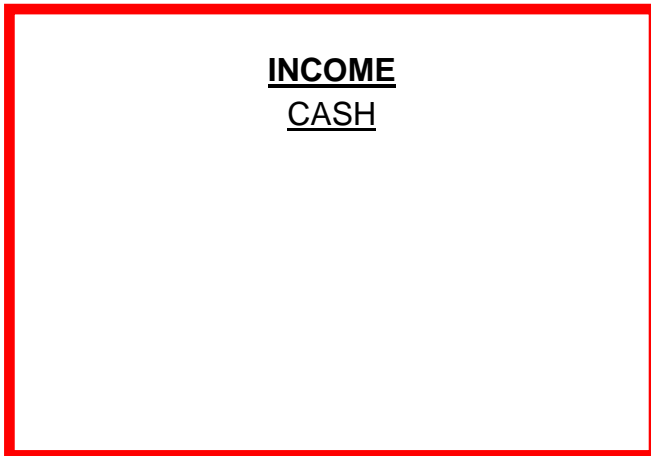


CHART #5

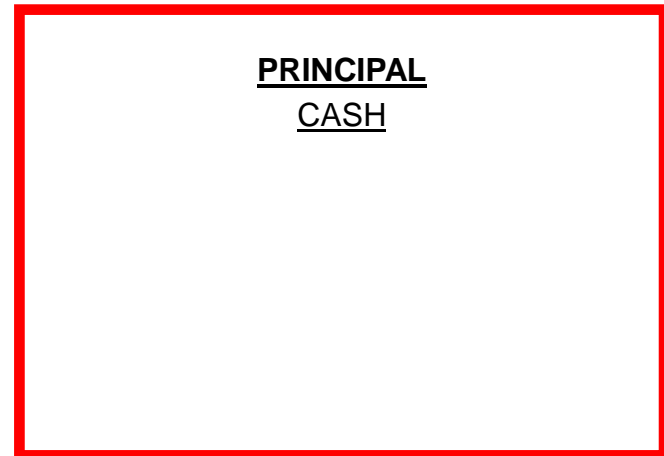
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Sanger & Manes, LLP

Box A



Box B



Apportionment Of Receipts Between Successive Interests

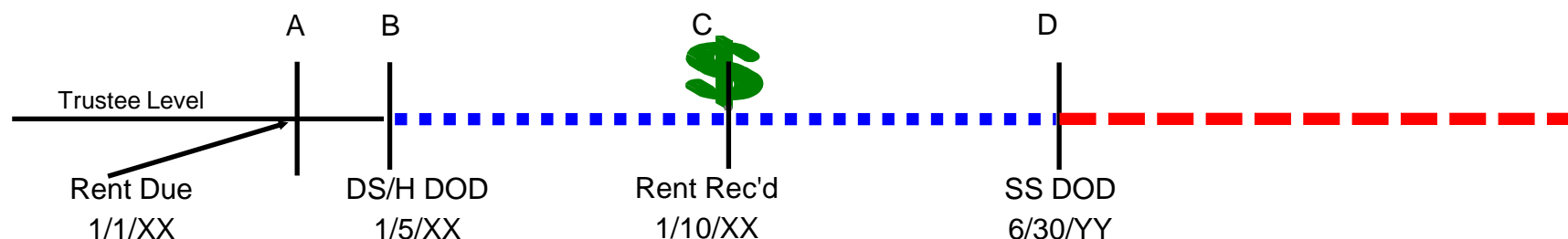
PC 16346 & 16347; UPAIA 302

FACTS

1. DS/H died 1/5/XX.
2. SS/W#2 dies several yrs later, on 6/30/YY.
3. DS/H left a typical BP/QTIP trust giving all income to SS/W#2; remainder to kids from his first marriage.
4. Trust owns a large warehouse leased to IBM for \$100,000 per month.
5. Rent is due on the first of each month.
6. IBM in fact delivers the rent on the 5th of each month.

Query #1

1. Rent received is fiduciary "income". PC §16356; UPAIA §405
2. Should the trustee allocate the \$100,000 January rent rec'd on January 10 at "C", five days after DS/H DOD at "B", to (a) "income" & distribute the \$100,000 to SS/W#2 stepmother, or (b) "principal" to be ultimately distributed to H's children from his first marriage? §16346; UPAIA 302.

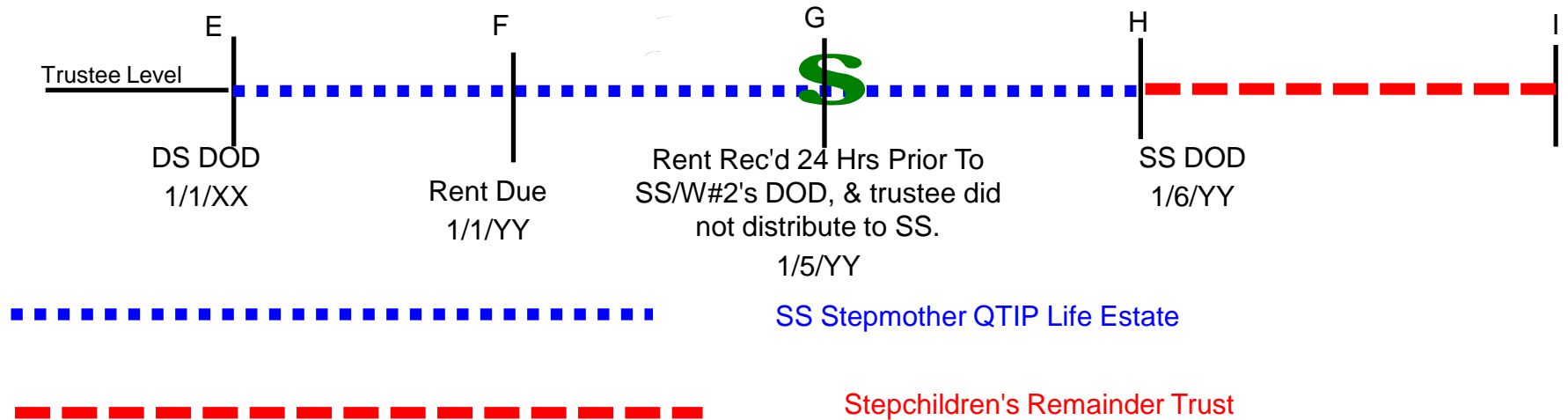


Apportionment Of Receipts Between Successive Interests

PC 16346 & 16347

Query #2

1. Rent received is fiduciary "income". PC §16356; UPAIA §405.
2. Is the \$100,000 January rent rec'd on 1/5/YY at "F", one day before SS/W#2's DOD at "G", (a) "income" to be distributed to SS stepmother's estate & her children from her first marriage, or (b) "principal" to be ultimately distributed to the remainder stepchildren from DS/H's first marriage? PC 16347; UPAIA



Calculating Fiduciary Accounting Income for Trusts:

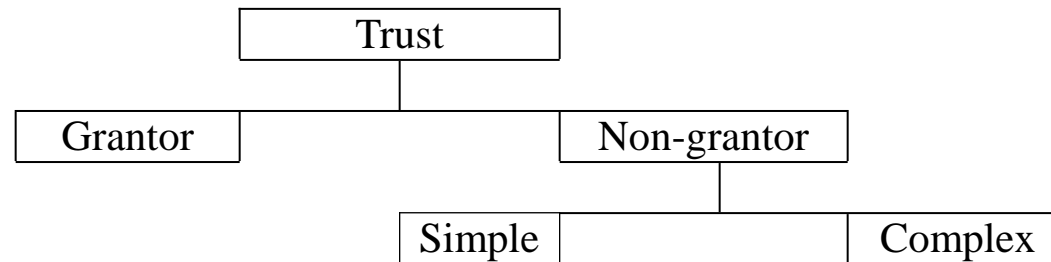
**Interpreting Operating Documents, Applying UPIA and State Law;
Reconciling FAI to DNI and Trust Taxable Income, Avoiding Tax and
Beneficiary Challenges**

**Tuesday, June 21, 2016
1:00 p.m. to 2:50 p.m. E.T.**

**Jeffrey M. Bergman
Schiff Hardin LLP
233 S. Wacker Drive, Suite 6600
Chicago, Illinois 60606 (312)
258-5571
jbergman@schiffhardin.com**

I. Introduction.

- A. Planning for the fiduciary income tax has become more challenging, for two reasons: first, the increased income tax rates initially introduced by the American Taxpayer Relief Act of 2012, which increased the highest rate for ordinary income tax to 39.6 percent and the highest capital gains tax rate for most transactions to 20 percent; second, the 3.8 percent supplemental Medicare surtax under Section 1411 which, although it was part of the Affordable Care Act passed in 2010, only became effective in 2013.
- B. In examining any trust from an income tax perspective, several determinations must be made. The first is whether the trust is a grantor trust or a non-grantor trust. If the trust is a non-grantor trust, a determination must be made if the non-grantor trust is a simple trust or a complex trust. These determinations will affect how the trust is treated for income tax purposes. Note that grantor trusts, a fascinating subject of their own, are outside the scope of today's discussion.



II. Basic Principles of Taxation of Non-grantor Trusts

A. A non-grantor trust is treated as a separate taxpayer for income tax purposes. Code Section 641(b) provides that the gross income of a non-grantor trust generally is computed in the same manner as that of an individual. Thus, interest, dividends, capital gains, royalties, rents, annuities, and similar items are included in the trust's gross income. Likewise, the trust is entitled to many of the deductions that individuals may claim. With respect to taxable income retained by the trust, the trust computes and pays a separate income tax. At the same time, however, the non-grantor trust ordinarily is treated as a conduit of the income that it distributes or is required to distribute to its beneficiaries. Such distributed income generally is taxable to the beneficiaries rather than to the trust.

- B. To understand fiduciary income taxation, one must understand several categories of income.
1. Taxable and nontaxable income. Taxable income for federal income tax purposes includes dividends from corporate stock, interest on corporate and United States bonds, rents, and capital gain. Nontaxable income includes municipal bond interest. While items like municipal bond interest are not taxable on the U.S. fiduciary income tax return, the amount of such income must be reported, and it factors into the allocation of income between the trust or estate and the beneficiary.
 2. Trust accounting income and principal. State Principal and Income Acts categorize receipts as either trust accounting income, available to an income beneficiary of the trust, or principal, available to current discretionary principal beneficiary or a remainder person. Dividends and interest (taxable and nontaxable) are usually accounting income. Capital gains are usually principal, but it is possible to override that presumption. Cash returns from depletable assets, such as timber or oil and gas, are allocated part to income, part to principal. Trust accounting income sometimes is referred to as ordinary income.

- C. Estates and non-grantor trusts compute their income tax liability for a given taxable year using the following formula:

Taxable income = gross income - deductions - personal exemption

1. Deductions generally include certain interest payments, state and local taxes, charitable contributions, fiduciary, attorney, and accountant fees, miscellaneous itemized deductions (subject to the two-percent floor), and the income distribution deduction.
2. The personal exemption is defined by the following table:

Type of entity	Exemption
<i>Estate</i>	\$600
<i>Simple trust</i>	\$300
<i>Complex trust</i>	\$100

- D. The proper federal income tax form for a domestic estate or non-grantor trust is Form 1041 – U.S. Fiduciary Income Tax Return.
1. An estate must file a return if it has (i) \$600 or more of gross income for the taxable year, or (ii) a beneficiary who is a nonresident alien. The due date for the return is the 15th day of the fourth month after the close of the taxable year.
 2. A non-grantor trust must file a return if it has (i) any taxable income for the taxable year, (ii) \$600 or more of gross income for the taxable year, or (iii) a beneficiary who is a nonresident alien. The due date for the return is April 15.

- E. All amounts distributed from a trust to a beneficiary, whether those amounts represent income or principal of the trust in a fiduciary accounting sense, are treated as income to the beneficiary for federal income tax purposes to the extent that the trust has distributable net income for the taxable year. Thus, distributions by a trust of trust accounting principal may cause the beneficiaries to receive taxable income.
1. Under Code Section 643(a), distributable net income (or “DNI”) basically consists of the trust’s taxable income, computed with certain modifications, the most notable of which is the subtraction, in most cases, of capital gains earned by the trust.
 2. If a trust distribution “carries out” DNI to the beneficiaries, the trust receives an income distribution deduction against its gross income. At the same time, the recipient beneficiary includes her share of DNI in her gross income.
 3. Under Code Sections 652(b) and 662(b), income retains the same character in the hands of a beneficiary as it had when earned by the trust. Thus, any tax-exempt income included in DNI remains tax-exempt in a beneficiary’s hands, any dividend income remains dividend income, and so forth.

4. Code Section 663(a) provides that certain distributions by a trust (such as those in satisfaction of a gift or bequest of specific property or a specific sum of money) do not carry out DNI. Such distributions do not cause the recipients to receive taxable income, nor does the trust receive an income distribution deduction for the amount distributed. In addition, distributions in excess of a trust's DNI for the taxable year do not constitute taxable income to the beneficiaries.
5. Capital gains generally are excluded from DNI under Code Section 643(a)(3). A trust ordinarily is subject to taxation on the entire amount of its capital gain income, regardless of how much property is distributed during the taxable year. An exception to this rule applies for the year when the trust is terminated. All of the income of the trust, including capital gains, generally is included in DNI for the year of termination. See Treas. Reg. § 1.643(a)-3(d) example (3). There are also certain other exceptions, described in Treas. Reg. § 1.643 (a)-3, that can cause capital gains to be included in DNI.

III. Simple and Complex Trusts

- A. Once a trust has been characterized as a non-grantor trust, one then must determine whether the trust is a simple trust or a complex trust. Different rules apply to computing the income distribution deduction available to each, which will in turn affect the income taxation of the trust and its beneficiaries.

- B. A *simple trust* is one whose governing instrument (i) requires that the trust distribute all of its trust accounting income currently, and (ii) does not provide for certain charitable payments or set asides. Moreover, a trust will not be treated as a simple trust during any taxable year when it actually distributes principal. Treas. Reg. § 1.651(a)-1.
1. Code Section 651 provides that in computing its net taxable income, a simple trust receives an income distribution deduction for the amount of income that it is required to distribute currently, but only to the extent that the trust has DNI. This is true whether or not the trust actually distributes any income.
 2. In turn, under Code Section 652, the beneficiaries of a simple trust must include in their gross incomes an amount in the aggregate equal to the trust's income distribution deduction, whether or not a distribution actually was made. This amount is allocated among the beneficiaries either ratably to the extent that no distribution was made or according to the amounts that they actually received from the trust, and the beneficiaries normally are treated as receiving a proportionate share of each type of income (i.e., dividends, interest, etc.) included in DNI.
 3. Thus, in most cases, a simple trust will be taxed only on its capital gains, if any, as all other taxable income will be carried out to its beneficiaries.

EXAMPLE: A trust has dividend income of \$5,000 for the taxable year and no other income. By its terms, the trust is required to distribute all of its income currently to its beneficiary. The trustee makes no distributions during the taxable year other than \$5,000 of trust accounting income to the beneficiary. The trust is a simple trust for the taxable year. It will have adjusted total income of \$5,000 and will receive an offsetting income distribution deduction in the same amount. The beneficiary will have \$5,000 of dividend income for the year.

EXAMPLE: A trust has interest income of \$3,000 and royalty income of \$5,000 for the taxable year, and realizes \$5,000 of capital gain during the year from the sale of an asset. The trustee distributes \$4,000 of trust accounting income to each of the trust's two beneficiaries during the taxable year and makes no other distributions. The trust is a simple trust for the taxable year. It will have adjusted total income of \$13,000 and will receive an income distribution deduction of \$8,000, resulting in the trust having \$5,000 of taxable income (the amount of the capital gain), ignoring other deductions. Each beneficiary in turn will have \$1,500 of interest income and \$2,500 of royalty income for the year.

EXAMPLE: A trust is required to distribute all income to W currently. Trust has \$20,000 taxable interest income; \$10,000 of capital gain attributable to corpus; and trustee's fees of \$2,000, chargeable \$1,000 to income and \$1,000 to corpus.

- (1) Trustee distributes \$19,000 to W.
- (2) DNI is \$18,000; the trust's gross ordinary income (\$20,000) less deductible expenses (\$2,000). W picks up \$18,000 of taxable interest on her income tax return.
- (3) Trust's taxable income:

Gross Income	\$30,000
Less:	
DNI Distribution	(18,000)
Trustee's fees	(2,000)
Exemption	<u>(300)</u>
Taxable Income	<u>\$ 9,700</u>

EXAMPLE: Same facts above, except the trustee had discretion to allocate income between W and S, and distributed $\frac{3}{4}$ to W and $\frac{1}{4}$ to S. W would report \$13,500 of interest income ($\frac{3}{4} \times \$18,000$), and S would report \$4,500 ($\frac{1}{4} \times \$18,000$).

EXAMPLE: Assume a simple trust has rental income of \$20,000 and expense attributable to the rent of \$5,000. It has dividend income of \$20,000 and tax-exempt municipal bond interest of \$10,000. It has trustee fees of \$5,000 (\$2,500 chargeable to income and \$2,500 to corpus).

(1) The trustee distributes all of its net income to W, consisting of \$14,000 of net rental income (\$20,000 rental income, less \$5,000 expenses attributable to rent, less \$1,000 of fees allocable to income (\$20,000/\$50,000 of \$2,500 (total fees allocable to income))) and \$28,500 of net investment income (\$20,000 dividend income, plus \$10,000 tax-exempt interest, less \$1,500 fees allocable to income). The total amount W receives is \$42,500.

(2) DNI calculation:

Rents	\$20,000
Dividends	20,000
Tax-Exempt Interest	10,000
Less:	
Expense allocable to tax-exempt interest 1/5 of \$5,000)	<u>(1,000)</u>
	\$49,000
Deductions:	
Expense directly attributable To rental income	(5,000)

Fees (\$5,000 less the \$1,000 allocable to tax-exempt interest)	<u>(4,000)</u>
	<u>\$40,000</u>

(3) W received \$42,500. Assuming the trustee allocated the \$4,000 of fees equally to rental income and dividend income for tax purposes, W is treated as having received rental income of \$13,000, dividends of \$18,000, and tax-exempt interest of \$9,000 (excludable on her federal return). She, in effect, picks up \$31,000 of taxable income.

(4) Trust's taxable income.

Dividends	\$20,000
Rental income:	<u>20,000</u>
Less:	
Rental Expense	(5,000)
Trustee Fees (\$5,000 less \$1,000 attributable to tax-	(4,000)
exempt income)	
DNI Distribution to W	(31,000)
Exemption	<u>(300)</u>
Taxable Income	<u>\$ (300)</u>

C. All trusts that are not simple trusts are *complex trusts*, which basically are trusts that permit the accumulation of trust accounting income or that distribute principal during the taxable year. A trust that was characterized as a simple trust during one taxable year may become a complex trust during another taxable year, and vice versa. All trusts are treated as complex trusts during the year of termination because principal distributions are made to the beneficiaries at that time. The rules that apply to complex trusts also apply generally to estates.

1. Under Code Section 662, distributions from a complex trust to beneficiaries carry out DNI, and are treated as proportionate distributions of each type of income included in DNI. Thus, if the trust has both taxable and tax-exempt income, each distribution that is deemed to carry out DNI will be part taxable and part tax-exempt to each beneficiary.
2. The trust determines its income distribution deduction for a given taxable year as follows:
 - a. First, under Code Section 661(a), income that it is required to be distributed currently is added to all amounts that are properly paid or credited, or required to be distributed, for that year. (The trustee can elect under Code Section 663(b) to treat an amount properly paid or credited within the first 65 days of any taxable year as if it were paid or credited on the last day of the preceding taxable year. The Taxpayer Relief Act of 1997 extends this 65-day rule to estates.)
 - b. Next, (i) that sum, reduced by the amount of tax-exempt income that was distributed (or deemed to have been distributed) by the trust, is compared to (ii) the trust's DNI, reduced by the amount of tax-exempt interest earned by the trust. The lesser of those two amounts is the trust's income distribution deduction for the year.

3. Under Code Section 662(c), the beneficiaries of the trust are treated as receiving DNI distributed by the trust as if it were received on the last day of the trust's taxable year and must include the taxable portions of DNI in their gross incomes for that year.

EXAMPLE: A complex trust earned \$5,000 of dividend income and \$5,000 of taxable interest from a corporate bond for the current taxable year, during which the trustee, pursuant to discretion granted in the trust instrument, made an \$8,000 distribution to a beneficiary. No other distributions were made or required to be made during the year. The trust has DNI of \$10,000 and is entitled to an income distribution deduction of \$8,000, leaving the trust with taxable income (ignoring other deductions) of \$2,000. At the same time, the beneficiary has received taxable income of \$8,000 (\$4,000 of which is dividend income and \$4,000 of which is bond interest), which she must include in gross income for her taxable year.

EXAMPLE: Assume the same facts as the previous example, except that the trust earned only \$5,000 of dividend income and no bond interest. The trust therefore has DNI of \$5,000. As a result of the \$8,000 distribution to the beneficiary, the trust receives a \$5,000 income distribution deduction and has no taxable income for the year. The individual receives \$5,000 of dividend income as a result of the distribution.

EXAMPLE: A complex trust earned \$5,000 of taxable dividend and interest income for the taxable year, and \$2,500 of tax-exempt interest. The trustee made a discretionary distribution to the beneficiary during the year of \$3,000. No other amount was distributed or required to be distributed during the taxable year. As a result of the distribution, the beneficiary is deemed to have received \$1,000 of tax-exempt income and \$2,000 of taxable income from the trust, and will accordingly include \$2,000 of the distribution in his gross income. The trust, in turn, will have gross income of \$5,000 and an income distribution deduction of \$2,000.

- D. A complex trust with multiple beneficiaries may both (i) require that some or all of the income be distributed to one or more beneficiaries currently, and (ii) permit distributions of other amounts to one or more beneficiaries. In this situation, income distributed to the beneficiaries may need to be classified according to a “tier system.”
1. The purpose of the tier system is to expose mandatory income beneficiaries to the maximum amount of DNI based on the income that they receive, with the remaining DNI, if any, allocated among the beneficiaries of the other distributions.
 2. Under the tier system, if the amount of income required to be distributed currently is greater than the DNI of the trust, the entire amount of the DNI is allocated to the beneficiaries of the mandatory income distributions, in proportions based upon the amount of income that each receives.
 3. The beneficiaries of other distributions are taxed only if the DNI exceeds the first tier distributions. If there is more than one beneficiary of these other distributions, each is taxed on his or her proportionate share of the excess DNI based upon the amount of trust property distributed to each.

EXAMPLE: A trust has DNI of \$14,000, and the trustee is required to distribute \$10,000 of income annually to A. The trustee also makes discretionary distributions of \$2,000 to A and \$8,000 to B. Under the tier system, \$10,000 of DNI first is allocated to A for his mandatory income distribution. The remaining \$4,000 of DNI is allocated between A and B based on the proportionate amount of the other distributions received. A received 20% of the discretionary distributions, and B received 80%. Therefore, an additional \$800 of DNI (20% of \$4,000) will be allocated to A, and \$3,200 of DNI (80% of \$4,000) will be allocated to B.

E. Separate Share Treatment.

1. Under Section 663(c), a separate and independent share of a trust or estate for a beneficiary is treated as a separate entity for the purpose of determining distributable net income. The net effect is that a distribution to that beneficiary will carry out only income attributable to that separate share, not a greater amount of income attributable generally to the trust or the estate.

EXAMPLE: A trust provides that the trustee may distribute or accumulate $\frac{1}{2}$ of the trust income for each of two children and may pay out \$5,000 of corpus to each child from his $\frac{1}{2}$ of corpus. In one year, the trustee distributed \$2,500 of income and \$5,000 of corpus to Child A and accumulates the rest of the income. DNI is \$5,000. Under the tier system, A would be taxed on all of the income of \$5,000 although \$2,500 of income was being accumulated for Child B. If, however, A and B's shares are treated as separate shares for determining DNI, only \$2,500 is taxable to A, and the trust pays tax on the \$2,500 accumulated for B.

2. Under the final regulations, adopted December 28, 1999, if the will or state law creates separate economic interests in a beneficiary or a class of beneficiaries, and the interests neither affect nor are affected by interests accruing to another beneficiary or class of beneficiaries, then each beneficiary's or class's interest must be treated as a separate estate for the purpose of computing distributable net income. A separate share comes into existence at the earliest time that a fiduciary reasonably determines that a separate economic interest exists.
3. The regulations specify that a spouse's elective share must be treated as a separate estate for purpose of calculating DNI. Treas. Reg. § 1.663(c)-4(b). Income allocable to the surviving spouse's elective share and distributed to the spouse pursuant to a right to share in the estate's income under state law will be treated as distributed to the spouse pursuant to a right to share in the estate's income under state law will be treated as distributed to the spouse under Code Sections 661(a) and 662(a). The following examples illustrate application of the regulations.

EXAMPLE: Testator dies with a \$6,000,000 estate. Spouse elects to take against the Will and is entitled to a proportionate share of the estate net income. The elective share is one-third. During 2015, the entire estate has \$300,000 of net income. The estate distributes \$1,000,000 to the spouse in 2015 in partial satisfaction of her elective share. No other distributions are made. The net income allocable to the spouse is \$100,000 (one-third of the total net income) because her elective share is treated as a separate share.

EXAMPLE: Same facts as the previous example, except that, under state law, the spouse is entitled to only one-third of the date of death value of the estate and no income. The estate is not allowed a deduction under Section 661 for any amounts distributed to the spouse.

The effect of the regulations is to limit the amount of income considered distributed as part of an elective share. State law still determines whether the elective share is entitled to share in the income.

4. The regulations indicate that the separate share rule also will apply for the purposes of allocating income in an estate that provides for creation of a marital trust and credit shelter trust.

EXAMPLE: Testator dies in 2015 with an estate of \$15,000,000 and a fractional optimum marital formula plan having used \$430,000 of exemption during life. Under the plan \$5,000,000 (33.33%) will be allocated to a family trust and \$10,000,000 (66.67%) will be allocated to a marital trust. The estate has \$60,000 of net income for 2015. At the end of the year, the executor allocates \$600,000 to the family trust to partially fund it. The distribution should not carry out all \$60,000 of the estate income, because the family trust is a separate share. The regulations state that the fiduciary has discretion to use a “reasonable and equitable” method for allocating the income for each separate share. Treas. Reg. §§ 663(c)-2(c); 1.663(c)-5, Ex. 3. This may result in an allocation of \$20,000 (33.33%) of the income to the family trust, or another percentage allocation that takes into account the changes in the separate percentages after the partial distribution.

IV. Deductions and Losses

- A. The estate planning professional should be cognizant of the impact that income tax deductions may have on the trust's DNI. Some expenses of the trust, such as trustee fees, are deductible for income tax purposes even though applicable state law requires that they be paid wholly or partially from trust principal. As a result, the DNI of the trust may be less than the amount of current trust accounting income that is distributed.

EXAMPLE: A trust has dividend income of \$20,000 for the taxable year and no other income. The trustee is paid a \$1,000 fee, which state law requires to be paid one-half from trust income and one-half from trust principal. The trust is a simple trust and distributes its entire trust accounting income of \$19,500 (\$20,000 less \$500 paid to the trustee out of income) to the beneficiary during the taxable year. For income tax purposes, the trust has DNI of \$19,000 (\$20,000 less the \$1,000 deduction for trustee fees). The trust will receive an offsetting income distribution deduction in the same amount. The beneficiary reports \$19,000 of taxable dividend income from the trust, even though she received \$19,500.

B. When a substantial, tax-deductible expenditure is paid from principal (such as an extraordinary fee), the trustee may be obligated under state law to reimburse the trust principal from trust income because of the tax benefit received by the income beneficiaries at the expense of trust principal. Many trust instruments supersede state law and provide that such adjustments shall not be made.

- C. Trusts are subject to Code Section 67(a), which provides that miscellaneous itemized deductions are allowed only to the extent that they exceed two percent of the trust's adjusted gross income.
 - 1. Code Section 67(e) states that the income distribution deduction under Sections 651 and 661, and the Code Section 642(b) personal exemption, are taken into account in arriving at the adjusted gross income of a trust and therefore are not subject to the two-percent floor.

2. Deductions for expenses that are related to the administration of the trust, and that would not have been incurred if the property were not held in the trust, also are not considered miscellaneous itemized deductions under Code Section 67(e).
 - a. On July 16, 2014, the Internal Revenue Service issued final regulations to address the treatment of expenses of estates and non-grantor trusts under the “2% floor” applicable to “miscellaneous itemized deductions” under section 67 of the Internal Revenue Code.
 - b. Section 67 was enacted 25 years ago to limit an individual’s miscellaneous itemized deductions to 2% of the individual’s adjusted gross income. Section 67(e) provides that for this purpose “the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual” and that the 2% floor does not apply to “costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.” This exception has been the subject of several litigated cases, including Michael J. Knight, Trustee v. Commissioner, 552 U.S. 181 (2008), in which a unanimous Supreme Court held that trust investment advisory fees are generally subject to the 2% floor.

- c. While the Knight case was pending in the Supreme Court, the IRS published tough proposed regulations, providing, among other things, that when a trust pays a single or unitary fee that includes both services that are subject to the 2% floor and services that are not, the trustee must “unbundle” that fee to determine the portion that is subject to the 2% floor and the portion that is fully deductible. From year to year, the IRS published notices relieving trustees of the unbundling requirement, culminating in Notice 2011-37, which extended the no-unbundling pronouncements to fiduciary income tax returns for all taxable years beginning before the date on which final regulations on the subject were published.
- d. The new regulations, in Treas. Reg. § 1.67-4(a), provide that a miscellaneous itemized deduction of an estate or non-grantor trust is subject to the 2% floor if it “commonly or customarily would be incurred by a hypothetical individual holding the same property.” Examples include “costs incurred in defense of a claim against the estate, the decedent, or the non-grantor trust that are unrelated to the existence, validity, or administration of the estate or trust,” as well as “ownership costs” that attach to a particular asset, such as “partnership costs deemed to be passed through to and reportable by a partner ... , condominium fees, insurance premiums, maintenance and lawn services, and automobile registration and insurance costs.”

- e. Under Treas. Reg. § 1.67-4(b)(3), the costs of preparing tax returns are characterized with reference to the type of return. The costs of individual income tax and gift tax returns, are generally viewed as “costs commonly and customarily incurred by individuals and thus ... subject to the 2-percent floor.” But the costs of returns that by their nature are filed only by executors or trustees are not subject to the 2% floor, including estate and GST tax returns and fiduciary income tax returns, of course, but also including, sensibly, a decedent’s final income tax return.

- f. The regulations, in Treas. Reg. § 1.67-4(c)(1), include a requirement for single fees to be “unbundled” into components that are subject to the 2% floor and components that are not. That is the bad news. The good news is that, under Treas. Reg. § 1.67-4(c)(2), if the fee “is not computed on an hourly basis,” *only* the investment advice component would have to be unbundled, by “[a]ny reasonable method.” Payments made out of the bundled fee to third parties, or fees assessed on top of the bundled fee, for services subject to the 2% floor would also have to be accounted for separately, but presumably such amounts would be determined by the bright-line tests described above and would not have to be subjectively apportioned.

- g. There is an exception, in Treas. Reg. § 1.67-4(b)(4), for “special” investment advice “attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen).” This represents an enterprising adaptation of a similar acknowledgment in the last paragraph of the Supreme Court’s Knight opinion, in which the formulation was “the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer.” The fact that the “ordinary taxpayer” has no need for “balancing of the interests of various parties” will not be lost on fiduciaries and commentators, who will notice that the bar has been subtly raised. Nevertheless, fiduciaries will be well advised to review both the ordinary and extraordinary contexts they encounter for balancing the interests of their beneficiaries and to develop protocols for distinguishing between trusts with “usual” successive interests and those with more sophisticated balancing needs.

- h. In sum, fiduciaries should anticipate the following:
- Except for investment advisory costs, the costs incurred by an estate or trust that are subject to the 2% floor should be objectively determined in a largely common-sense manner. There is no apparent search for new types of subjective costs comparable to investment advisory costs.
 - If not already in use, conversion to unitary fees and flat fees may increase the income-tax efficiency of some trusts. This may be true of individual fiduciaries, not just institutional fiduciaries, and of other professionals who advise fiduciaries.
 - While absorption of some costs in-house might support larger income tax deductions than payments to subcontractors and other third-party vendors, overall fairness to clients and customers might suggest a greater bundled fiduciary fee in such a case, and the increment is likely to be treated as a special assessment subject to the 2% floor anyway. Thus, decisions about obtaining services outside or providing those services in-house are likely to continue to be based largely on business judgments rather than tax considerations.
 - In a trust where the competing interests of beneficiaries are uncommonly complex, but the bundled fee is the same, a smaller portion of that fee may be allocated to the costs of investment advice subject to the 2% floor. If the fee increases for that reason, the increment should not be subject to the 2% floor.

3. A trust that has miscellaneous itemized deductions and an income distribution deduction for the year will face an interrelated tax computation. This occurs because one of the items that must be subtracted from total income to determine adjusted gross income is the income distribution deduction for the year. The income distribution deduction depends upon DNI, which in turn is calculated by taking into account deductions, including allowable miscellaneous itemized deductions.

- D. For purposes of determining the character of income constituting DNI, all deductible items directly attributable to one class of income are allocated to that class.
1. For example, repair expenses, taxes, and other expenses directly attributable to the maintenance of rental property or to the collection of rental income must be allocated to rental income. See Treas. Reg. § 1.652(b)-3(a).
 2. Expenses not directly attributable to a specific class of income may be allocated to any item of income included in computing DNI, provided that if the trust has tax-exempt income, a pro rata share of the deductions not allocable to a specific class of income must be allocated to tax-exempt income. The portion of the deductions allocable to tax-exempt income is determined by a fraction, the numerator of which equals the tax-exempt income of the trust and the denominator of which equals the total income of the trust. See Treas. Reg. § 1.652(b)-3(b).
 3. The ability of a fiduciary to allocate nonattributable expenses to any class of income gives the fiduciary some flexibility in determining which items of income will carry out to the beneficiaries.

V. Special Considerations for Estates (or Trusts Making the Section 645 Election)

A. Timing of Distributions.

1. Selection of a taxable year for an estate other than a calendar year can lead to significant deferral of tax to the beneficiaries. This is possible because the beneficiaries of an estate are treated as receiving DNI distributed by the estate on the last day of the estate's taxable year. They include the taxable portions of DNI in their gross incomes in the year in which the estate's taxable year ends. IRC § 662(c).

EXAMPLE: Assume an estate has a tax year ending January 31. On February 1, 2015, the estate distributes income to a beneficiary. The beneficiary will be deemed to receive that income on January 31, 2016. Thus, the beneficiary does not have to take the income into account until he starts making estimated tax payments in 2016 and, depending on the his tax situation, may not pay any additional tax because of the distribution until April 15, 2017.

2. When distributions of DNI are made from an estate, the executor's timing of those distributions will affect which beneficiaries must include the income attributable to DNI in their gross income.

EXAMPLE: The residuary estate is to be held in trust to pay income to A for life, remainder to B. Before distribution to the trustees, the executor may distribute income to A. On the last day of the estate's taxable year, the executor distributes \$4,000 of income to A, and distributes \$96,000 in principal to the trustees. DNI is \$4,000. The residuary bequest carries out DNI, and the beneficiaries include a pro rata share of the DNI in their gross incomes. Therefore, A is taxed on only 4 percent of DNI, and the trust is taxed on the remaining 96 percent. However, if the distribution of the trust principal had been delayed until the beginning of the next tax year, all \$4,000 of DNI would have been taxed to A.

Note that distributions in satisfaction of bequests of a specific sum of money or specific property payable in three or fewer installments will not carry out DNI.

3. The executor may elect to treat distributions made within 65 days after the close of its tax year as if they were made on the last day of the tax year. IRC § 663(b).

4. Trapping Distributions.

- a. A “trapping distribution” is a distribution from an estate to a trust or trusts that carries out the distributable net income (DNI) of the estate to the trust. The trust can then distribute some or all of the DNI to the trust beneficiaries. Trapping distributions thus allow the estate to split its income among several taxpayers (the estate, trusts, and trust beneficiaries).
- b. Although a distribution is considered a distribution of income for federal tax purposes, it may represent principal for trust accounting purposes (e.g., a distribution of a right to income in respect of a decedent, or “IRD”). A trapping distribution will be made to a simple trust only if the distribution is treated as principal for trust accounting purposes. Otherwise, the estate’s DNI will pass through the trust and be taxable to the beneficiary to whom the trust income must be distributed.
- c. DNI is not carried out to the beneficiaries of a complex trust in the year the trapping distribution is made, except to the extent the trust makes a distribution. It does not matter whether the trapping distribution is treated as principal or income for trust accounting purposes.

5. Excess Deductions and Loss Carryovers.

- a. Upon termination of an estate or trust, the estate or trust's excess deductions and unused net operating loss and capital loss carryovers may be used by the residuary beneficiaries of the estate or trust.
- b. Net operating loss and capital loss deductions may be carried forward by the beneficiaries, but may not be carried back.
- c. Excess deductions (deductions over income in the estate or trust's final tax year) are deductible only in the beneficiary's taxable year during or at the end of which the estate or trust terminates.
 - (1) Excess deductions are not used to calculate a beneficiary's adjusted gross income. They are miscellaneous itemized deductions and deductible only to the extent that the beneficiary's total miscellaneous itemized deductions exceed 2 percent of the beneficiary's adjusted gross income.
 - (2) An estate or trust's excess deductions do not include its charitable deduction.

B. Election to Treat Trust as Part of Estate.

1. Section 645, added in 1997, permits the executor of an estate and the trustee of a “qualified revocable trust” to elect together to treat the revocable trust as part of the estate for federal income tax purposes (IRC § 645). This election must be made no later than the time required to file the estate’s first income tax return (including extensions), and will last until two years after the date of death if no estate tax return is required, or until six months after the final determination of estate tax liability if an estate tax return is required. A “qualified revocable trust” is defined as one owned by the decedent under Section 676 at the time of his death by reason of a power of the decedent (and not solely by reason of a power in a non-adverse party).
2. Such an election will permit a testamentary trust to enjoy certain income tax advantages previously reserved to estates. For example, like an estate, an electing trust would receive an immediate income tax deduction for any amounts permanently set aside for charity. (IRC § 642(c)). Other advantages include an exemption from the passive activity loss rules.

3. It will not always be to the advantage of the trust to make such an election. Because an electing trust must take the same taxable year as the estate, an election under Section 645 may forego the opportunity to defer payment of income tax as a result of the differing taxable years of the estate and revocable trust.
4. Final regulations under Section 645 were issued on December 23, 2002, and address, among other things, the definition of qualifying trusts, and the rules concerning the procurement and use of taxpayer identification numbers.

VI. Fiduciary Income Tax Treatment of Unitrusts and Trustee Equitable Adjustments

- A. The IRS has amended the definition of income under Treas. Reg. § 1.643(b)-1, and amended numerous related regulations, to take into account changing investment practices and revisions to state principal and income acts that allow for a more equitable division of the return from trust investments. In response, states have accelerated the adoption of provisions that allow a trustee to allocate some portion of principal returns to income. The two most common ways this is done is to allow a trustee to convert an income interest to a unitrust interest, or to permit the trustee to exercise discretion in allocating realized capital gains to income.
- B. Treas. Reg. § 1.643(b)-1 provides that these kinds of adjustments will be recognized and respected by the IRS, if local law provides for reasonable apportionment of the total return of the trust, or if permitted under the terms of the instrument and not inconsistent with local law. In the latter case, the trustee's discretionary exercise of any such power must be reasonable and consistent. If the trustee allocates capital gains to income, then they will be treated as part of DNI for the year, and therefore may be taxed to the beneficiary rather than to the trust. See Treas. Reg. § 1.643(a)-3.

- C. Special rules apply to NIMCRUTs and pooled income funds:
1. The regulations state that, if state law allows trust income to be defined as a fixed percentage of the trust assets, and that percentage may be less than 5%, then a NIMCRUT created in that state must contain its own definition of income to ensure that the 5% minimum fixed percentage requirement is satisfied. Treas. Reg. § 1.664-3(a)(1)(i).
 2. The terms of instruments governing pooled income funds may need to be modified to provide that, notwithstanding state law, capital gains cannot be allocated to income. If the fund does not contain this provision, the IRS will not allow the fund to claim a charitable deduction for its long-term capital gain.
- D. The IRS has also modified Treas. Reg. § 26.2601(b)(4)(i)(D) and added two examples under (E) to make clear that administration of a pre-1986 trust under new state law provisions regarding income will not un-grandfather the trust for GST tax purposes.

VII. Allocations of Capital Gains to DNI (a/k/a Pushing Capital Gains Out to Beneficiaries)

- A. There are several options available for pushing capital gains into DNI. The state statute for exercising a power to adjust, or to convert to unitrust, may require that capital gains be included in amounts distributed in excess of ordinary income. Treasury regulations provide that “an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between income and remainder beneficiaries of the total return of the trust for the year...” Treas. Reg. § 1.643(b)-1.

B. Capital gains may be allocated to income under either an equitable adjustment or unitrust approach if permitted by the terms of the governing instrument and applicable local law or if it is pursuant to a reasonable and impartial exercise in discretion by the fiduciary and is not prohibited by applicable local law. Treas. Reg. § 1.643(a)-3. If the unitrust approach is taken, a discretionary power to allocate gains to income for tax reporting purposes must be exercised consistently and the amount cannot exceed the excess of the unitrust amount over the amount of distributable net income that would otherwise have been determined.

- C. Treas. Reg. § 1.643(a)-3 defines several circumstances where capital gains may be allocated to DNI. Two of the alternatives under the regulation impose a requirement that the fiduciary consistently treat capital gains as either included or excluded in DNI. However, Treas. Reg. §1.643(a)(3)(b)(3) does not contain this requirement. It states that gains can be included in DNI if “[a]llocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.”
- D. The trustee must make sure that the distribution is consistent with the terms of the trust instrument. For new trusts, language should be included to specifically authorize the trustee to allocate gains to income. The trustee also must make sure that the distribution is consistent with the trustee’s duties to the beneficiaries of the trust.

VIII. State Income Tax Planning Issues

- A. In recent years, a number of developments have increased the need for fiduciaries to understand the laws of different states and how they affect the administration and taxation of trusts.
 - 1. One development has been the increased use of change of situs provisions to move trusts from the original jurisdiction to a new jurisdiction with more favorable laws.
 - 2. Another development has been the increasing number of states that permit decanting. Trusts are being moved more and more frequently to jurisdictions that permit decanting so that the trusts can be decanted into new trusts with more favorable provisions than the current trusts. However, as will be discussed below, a change in the situs of a trust may result in a trust being subject to income taxation in two states rather than simply one.

- B. Most states, and the District of Columbia, tax the income of non-grantor trusts and estates. The rules governing the income taxation of trusts or estates vary significantly from state to state, and fiduciaries must understand and adhere to the income tax rules that govern each trust. Challenges particularly arise when a trust is moved to a new jurisdiction.
- C. In dealing with the income taxation of a trust or estate, fiduciaries face two important responsibilities. One responsibility is to ensure that a trust or estate pays the state income tax that it owes. A second responsibility is to minimize the exposure of a trust or estate to state income tax. In order to meet these responsibilities, a fiduciary must have a clear understanding of the income tax laws of each state that might seek to tax the income of a trust or estate.

IX. The Different Ways in Which States Tax Trust Income

- A. Seven states, Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming, do not tax the income of trusts. The other states and the District of Columbia do tax the income of trusts to a greater or lesser extent.
- B. Every state follows the general approach of the Internal Revenue Code, that to the extent income is distributed from an irrevocable non-grantor trust to a beneficiary, the beneficiary pays the tax. Consequently, in examining the income taxation of a trust or estate from a state law perspective, one is primarily looking at the taxation of income accumulated in a trust, as well as capital gains.

- C. Non-grantor irrevocable trusts are generally taxed for state income tax purposes on one or more of the bases listed below. A trust that meets one or more of the bases for taxation in a state is generally referred to as a “Resident Trust.”
1. The trust was created pursuant to the will of a testator who lived in the state at the time of his or her death.
 2. The creator of an inter vivos trust lived in the state at the time the trust became irrevocable.
 3. The trust is administered in the state.
 4. One or more trustees live or do business in the state.
 5. One or more beneficiaries live in the state.

D. There are many variations to the rules above in the laws of particular states. Some states apply more than one basis in determining whether a trust is subject to income taxation of that trust. For example:

1. New York defines a Resident Trust as a trust created by a New York resident or grantor. New York does not tax a trust if a trust has no New York trustees, assets, or source income.
2. Connecticut taxes irrevocable trusts that are created by a Connecticut testator or a person who is a resident of Connecticut at the time the trust became irrevocable.
3. Delaware generally does not impose any income tax upon Resident Trusts except in cases where one or more trust beneficiaries live in Delaware, and even then only upon the portion of the trust income attributable to the beneficiaries who reside in Delaware.
4. Maryland taxes an irrevocable trust created by a Maryland testator or grantor if the trust was created under the will of a decedent domiciled in Maryland on the date of decedent's death, the creator or grantor of the trust is a current resident of Maryland, or the trust is principally administered in Maryland.
5. A trust will be subject to Missouri income tax if it was created by the will of a Missouri decedent or it is an inter vivos trust created by a Missouri resident. In addition, the trust must have a resident income beneficiary on the last day of the taxable year if the trust is to be subject to tax in Missouri.
6. A trust is a California resident for income tax purposes if a trustee or non-contingent beneficiary is a resident of California, regardless of the residence of the settlor. With respect to corporate fiduciaries, the residence of the corporate fiduciary is the place in which the corporation conducts the major portion of the administration of the trust.

X. Examples of Challenges Faced by Fiduciaries

A. Two large challenges facing corporate trustees are:

1. Paying state income tax when no state income tax is owed.

EXAMPLE: A trust is a Delaware Resident Trust. No beneficiary of the trust is a Delaware resident. Delaware does not tax non-Delaware source ordinary income or capital gains that will benefit individuals who reside outside Delaware. Trustee, however, believing that Delaware income tax should be paid, pays the taxes for many years.

2. Trustee does not pay state income tax although state income tax is owed.

EXAMPLE: Individual establishes an irrevocable trust in Illinois for benefit of his descendants. Under Illinois law, the trust is always subject to Illinois income tax because it was established by an Illinois resident. Trustee is located in Texas and there are no beneficiaries in Illinois. Texas does not tax the income of trusts and estates. Trustee does not pay any income tax on the assumption that it is now a Texas trust and not subject to Illinois income tax.

- B. Changing the residency of a trust as a solution to state income taxation
1. Changing the residency for income tax purposes requires that the trustee and counsel analyze the rules regarding the residency of a trust in the current state and any state to which the trustee is considering moving the trust. Depending upon the laws of this current state of residency and the possible future states of residency, one must look at the terms of the trust instrument as well as the location of the trustee, the trust assets and the beneficiaries. An analysis should also be made of the potential state income tax savings that will arise from moving the trust.
 2. It is also helpful to have in the document provisions that will provide flexibility in possibly changing the situs of the trust or the ability to add such provisions.