<u>THE INCOME TAXATION OF</u>

<u>TRUSTS & ESTATES</u>

Jacqueline A. Patterson, Esq.
Haney, Buchanan & Patterson, LLP
707 Wilshire Blvd., 53rd Floor
Los Angeles, CA 90017
(213) 228-6500
(213) 228-6503 (Fax)
email: jpatterson@hbpatty.com

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DESCRIPTION **PAGE**

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INTRODUCTION

This presentation is designed to discuss the fundamentals of the income taxation of trusts and estates. The course materials begin with the basic concepts and provide exercises and examples that reflect the calculation and allocation of taxable income and its presentation on the appropriate forms. The course focuses on the Federal Form 1041 and the accompanying schedules. Because the income tax for trusts and estates is calculated using the rules for individual taxpayers, the tax accountant is required to have an understanding of these rules as well as Subchapter J of the 1986 Internal Revenue Code. This is further complicated by the fact that there is a combination of authority that dictates the tax benefits and burdens in the trust and estate area. The federal and state tax codes, the Civil Code, contract law, state law, accounting principles and the underlying instrument all dictate how the fiduciary must perform. The dynamic nature of tax, as reflected by constant law changes, also increases the complexity. The 1986 Tax Reform Act dramatically changed the tax treatment of many activities and entities as have subsequent tax law changes since 1986. The '86 Act curtailed the use of trusts to reduce or defer tax; revised the tax rates (often called "confiscatory"); limited income shifting to children; required the use of a fiscal year by most trusts; and began requiring estimated tax payments in many circumstances. The '97 tax law change specifically addressed the treatment of separate shares, and the ability to characterize an entity as a trust or estate through an election. The 2001 Act began the phase-in of estate tax repeal with new emphasis on "modified carryover basis" and the 2003 Act reduced tax rates for both qualified dividends and capital gains for both regular and AMT purposes. These changes directly impact the fiduciary entity. Several new sets of regulations have been added to Subchapter J that involve separate shares, Electing Small Business Trusts, a trust's election to be treated as an estate for income tax purposes, and ordering rules for distributions from charitable remainder trusts. Also, new regulations have been proposed to define Sec. 643 DNI in a way that comports with the new changes in the state law concepts of fiduciary accounting income. And, of course, any law change that impacts individuals will also impact trusts and estates. Sometimes translating the rules for individual taxpayers to trusts and estates is easy and sometimes it is more problematic. We will explore some of these issues in later chapters.

The fiduciary relationship can extend to the revocable living trust, the estate or administrative trust or the irrevocable trust. While each relationship has unique characteristics, many of the basic concepts are the same.

5 Basic Rules in the Income Taxation of Trusts and Estates

1. The taxation of trusts and estates follows the rules for individual taxpayers.
2. The estate planning documents are the primary authority.
3. Taxes are paid at the final destination by the recipients.
4. Except for the year of termination, no losses pass out to the beneficiaries.
5. The satisfaction of a pecuniary bequest with appreciated property or IRD is treated as a sale or exchange.

Filing Requirements of Form 1041

A trust or estate is a separate legal entity for federal tax purposes and the fiduciary tax return. Form 1041 is used to report the income, deductions, gains, losses, etc. of a domestic decedent's estate, trust or bankruptcy estate. A fiduciary must file a tax return on Form 1041 if a domestic estate has gross income of $600 or more during a tax year. A trust income tax return must be filed if the trust has any taxable income for the year or gross income of $600 or more. If one or more of the beneficiaries of a domestic trust or estate is a nonresident alien individual, the personal representative must file Form 1041, even if the gross income of the estate is less than $600 [Reg. 1.641(a)(2) and 1.61-1(a)].

For tax years beginning in 1998, the requirement to file a return for a bankruptcy estate applies only if the gross income is at least $6,250. The filing requirements for trusts and estates are described in IRC Sec. 6012. A Form 1041 is required for a life estate only when the life tenant has fiduciary responsibilities.

THE FIDUCIARY FORM 1041

The fundamental concepts of income taxation revolve around the conduit nature of trusts and estates which are similar to partnerships in that income passes through on the Form K-1 to the intended beneficiaries. They are different from partnerships in that a trust or estate can also be a tax paying entity as well as a flow-through. If income passes out to the beneficiaries, the trust or estate, with some limitations, receives a deduction for distributions to beneficiaries.

Authority for Trust and Estate Taxation

The authority for the income taxation of trusts and estates is a combination of civil law, federal tax law, state tax law, the documents, accounting theory and probate law. Because of this combined authority, the area takes on a complexity that can be overwhelming to a practitioner new to this area. It is not a large area of law, but a complex one, and often neglected both by practitioners and the IRS. However, there has been increased attention to the income taxation of trusts and estates area on both fronts. The tax practitioner has been forced to deal with the estate planning area because clients are wealthier today and better educated in the importance of estate planning. Clients are more familiar with living trusts and the increased utilization of the unified credit through marital deduction trusts, by-pass trusts, etc. The IRS has shown an interest in the 1041 area that was previously "never audited" because there is definite revenue potential. There is more IRS training in the area and a matching program has been implemented that matches Schedule K-1's with the beneficiary's individual return entries in a manner that is similar to the Form 1099 matching program.

Subchapter J - IRC Secs. 641-691

The portion of the Internal Revenue Code that is devoted to the income taxation of trusts and estates is Subchapter J. These sections place the responsibility for taxation and work in conjunction with other sections of the code that tax individuals. The rules for taxation operate on the premise that a trust or estate earns or receives income and incurs and pays expenses. The trust or estate then makes distributions to beneficiaries that are either required by the instrument or made through the discretionary powers of the fiduciary. The total taxable income is subject to tax and this amount is calculated using the same rules as are used for individuals. The taxable income and tax is then allocated between the entity and the beneficiaries using the rules in Subchapter J. The income is taxed at its final situs. If the income is accumulated in the trust or estate, that entity pays the tax. If the income is distributed to the beneficiary or beneficiaries, the trust or estate is given a deduction for the amount of the distribution. That amount passes out to the beneficiary on the Schedule K-1 and the recipient, whether it be an individual, another trust, a partnership, etc., incorporates this amount on its tax return.

Basic Concept of Fiduciary Taxation

The taxable income of a trust or estate is determined in the same manner as an individual with some modifications;

The trust or estate gets a deduction for taxable income distributed to beneficiaries;

What is left represents taxable income retained by the trust or estate;

The trust or estate pays a tax on such accumulated taxable income;

The beneficiary or beneficiaries report and pay tax on the distributions of taxable income; and,

Conclusion: All taxable income will be taxed at its final situs.

Income Tax Rates

Unless distributed to the beneficiaries, income is taxed to the trust or estate at special rates. Several tax acts have compressed the rates for trusts and estates so that the top marginal income tax rate is reached at a much lower taxable income level than for an individual.

Fiduciary Tax Rates

2004	2003	2002	Rate
$0 – 1,950	$0 – 1,900	$0 – 1,850	15%
$1951 – 4,600	$1,901 –4,500	$1,851 – 4,400	25/25/27%
$4,601 – 7,000	$4,500 – 6,850	$4,400 – 6,750	28/28/30%
$7,001 – 9,550	$6,850 – 9,350	$6,750 – 9,200	33/33/35%
$9,551 -…	$9,350 - …	$9,200 - …	35/35/38.6 %

Steps to Calculating the Income Taxation of Trusts and Estates

1. Determine the fiduciary accounting income.
2. Determine trust/estate taxable income before the distribution deduction.
3. Determine the distribution deduction.
4. Determine the trust taxable income.
5. Determine the tax.
6. Allocate the income distributed to the beneficiaries and to the appropriate categories.

Differences Between Trust/Estate Taxation and Individuals

While the rules for individuals apply to the taxation of trusts and estates, there are several differences in calculating the tax that must be taken into consideration.

1. The personal exemption for estates is $600 and either $300 or $100 for trusts. This is significantly less than for individual taxpayers.

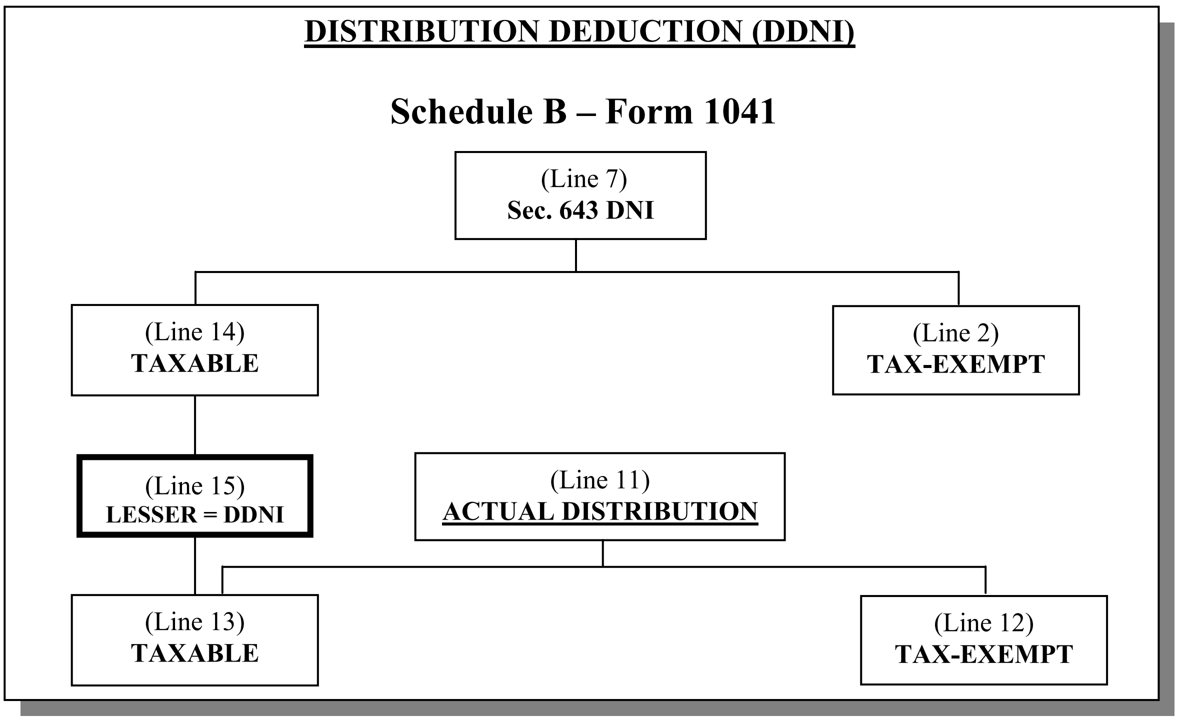
2. There are different rules for computing the charitable contribution.

3. There are special allocations between the trust or estate and its beneficiaries of NOL's, depreciation, depletion and amortization, that must be considered.

4. There are disallowances of normally deductible expenses if they have been deducted on the Form 706.

5. Special tax treatment must apply on distributions to beneficiaries of appreciated property if used to satisfy a pecuniary bequest.

Estates file extensions on Form 2758 which is a 90-day extension and not automatic. Trusts file on Form 8736. Both trusts and estates use Form 8800 for an additional three-month extension.



Distributable Net Income (DNI)

Distributable Net Income (DNI) creates a tax presumption that any distribution is made from income first. It helps determine how much of the income of a trust or estate is taxed to the fiduciary and how much is taxed to the beneficiaries. It also determines the character of the income taxed to each.

Unlike a partnership that also flows income to a partner via a Schedule K-1, a trust or estate is allowed a deduction for the amount of income that is passed out to the beneficiary, also via a Form K-1. The amount of this distribution deduction is equal to the lesser of:

a. The taxable portion of DNI, or

b. The amount actually distributed or required to be distributed.

The distribution deduction is calculated on Schedule B of the Form 1041. While this calculation determines the distribution deduction, it also determines the amount of taxable income allocated to a particular beneficiary. Therefore, the sum of the Schedule K-1 allocations should equal the total distribution deduction.

Distributable Net Income (DNI) is strictly a tax concept, a fiction that is one of many that we tax practitioners must deal with constantly. It departs from the customary income-principal concept that forms the basic fiduciary accounting rules. Once you calculate fiduciary accounting income, which is the first step in the tax spreadsheet, you must put that number aside and concentrate on the different inquiry of trust taxable income.

DNI was introduced into the law to curb an abuse that was prevalent under prior laws. Trustees would accumulate income in the trust at the then low trust tax rates and make distributions out of principal to the beneficiaries tax-free. This was at a time when the individual tax rates were between 50% - 70%. Under this method, high bracket taxpayers could avoid the tax on trust distributions and could make use of the low trust tax brackets. This problem does not exist today because of the compressed tax rate structure for trusts and estates.

The Mechanical Calculation of Distributable Net Income (DNI)

IRC Sec. 643 distributable net income (DNI) is a hybrid of taxable income and fiduciary accounting income. The starting place for its calculation is trust taxable income followed by a series of adjustments as described below.

Begin with Trust Taxable Income and:

+ Add back the Personal Exemption.

+ Add back capital losses if added to corpus.

+ Add back net tax-exempt income that is allocated to income for FAI purposes.

- Reduce taxable stock dividends and extraordinary cash dividends allocated to corpus.

- Reduce capital gains allocated to corpus.

= IRC Sec. 643 DNI

Determining Deductible DNI or the Distribution Deduction:

Once IRC Sec. 643 DNI is calculated, Sec. 651 or Sec. 661 Deductible DNI must be calculated. As the example above reflects, IRC Sec. 643 DNI includes tax-exempt interest and since there is no deduction for distributions of tax-exempt income, Sec. 643 DNI must be modified to determine the deduction. Once IRC Sec. 643 is determined, it must be separated into two components; the taxable component and the tax-exempt component. Sometimes this is as simple as subtracting out all the tax-exempt income. Other times, an allocation is necessary and this depends on the type of trust and how much income is distributed.

Computing the Deductible DNI (DDNI)

To compute the distribution deduction (DDNI), Schedule B compares the IRC Sec. 651 or 661 DNI (the taxable portion of Sec. 643 DNI) with the taxable portion of the actual distribution. In a simple trust, the actual distribution is determined once fiduciary accounting income is calculated. It becomes more difficult with a complex trust, especially one that accumulates the income. Generally, the deduction for distributions to beneficiaries is the lesser of:

a. The total amount of distributions made or required to be made to the beneficiaries; or

b. The DNI of the trust or estate.

Tax Spreadsheet

Included in this chapter is a format for a tax spreadsheet that will be useful to you in preparing any Form 1041. The spreadsheet should become the summary workpaper for the permanent file and should reflect the entire tax and financial situation of the entity for any particular year. The spreadsheet is flexible enough to accommodate the most complicated or simple fiduciary account. We will be using this spreadsheet format to solve the remaining problems presented in these materials. The spreadsheet can be easily formatted using any spreadsheet software.

INCOME TAXATION OF TRUSTS & ESTATES
FORMAT MODEL

PART 1 - INFORMATION QUADRANT

Terms of Instrument	Issues/Assumptions	Distributions

PART 2 - SUBCHAPTER J CALCULATION

(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
					TTI		SEC.		FORM 1041
ITEM	ACTUAL	ADJ	FAI	ADJ	B/F DD	ADJ	643 DNI	ADJ	TTI
Income:									
Subtotal:									
Deductions:									
Subtotal:									
Net:									
Depreciation									

PART 3 - ALLOCATION BY CATEGORY

ALLOCATIONS									
Categories	Interest	Rental	Tax Ex. Int.		Cap. Gains		Total		
Net:									
	I----------------	651/661 DNI							
	I----------------	SEC 643 DNI	-----------------I						

PART 4 - ALLOCATION TO ENTITY / BENEFICIARY

Beneficiaries/									
Trust	Interest	Rental	Tax Ex. Int.		Cap Gains		Total	Deprec.	
Tier 1									
Tier 2									
Charity									
Trust									
Total									

Key Differences Between Trusts and Estates

Many times the treatment of trusts and estates is the same for tax. However, there are some differences that are noted below:

The throwback rules only apply to trusts and not estates; (Repealed effective 8/5/97).

Estates are not subject to the grantor rules;

IRC. Sec. 644, regarding property sold within two years of being transferred to a trust, only applies to trusts and not estates; (Repealed effective 8/5/97).

The separate share rule, prior to the '97 Act only applied to trusts and not estates. Effective 8/5/97, the separate share rule applies to both trusts and estates.

Estates receive a larger personal exemption ($600) than trusts ($300 or $100);

Prior to the '97 Act, the disallowance of loss under IRC. Sec. 267 did not apply to estates;

Estates and administrative trusts are not required to make estimated payments until the estate has been in existence two years; and,

Estates may elect to use a fiscal year while trusts must use a calendar year.

Class Problem – Simple Trust

(1) Calculate Sec. 643 DNI

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

(2) Calculate DDNI

643 DNI

____

Tax-exempt

__________ __________

Lesser = DDNI ________

ACTUAL

____

Tax-exempt

__________ __________

Election to Treat Revocable Trust as Part of Estate for Income & GST Taxes

The Taxpayer Relief Act of 1997 has created a new type of entity under IRC Sec. 645. By election, a qualified revocable trust (QRT) can be treated as an estate for income tax purposes. When this election is made, all of the rules relating to tax elections, fiscal years, methods of accounting, and termination of probate estates also apply to the new combined reporting entity. This election would be made where there is both an estate and a revocable trust in an estate plan or possibly just a revocable trust that becomes irrevocable upon the grantor's death. This election to combine an estate and trust for reporting purposes started out as IRC Sec. 646 but was renumbered under the IRS Restructuring and Reform Act of 1998. Revenue Procedure 98-13 originally set forth the requirements and procedures to make this election, but final regulations have been issued at Reg. Sec. 1.645-1. If both an estate and trust are involved, both the executor and the trustee must make the election. If there is no executor, the trustee makes the election. In either case, the written statement must include:

1. The names, addresses and identification numbers for the trust and estate;
2. A statement that the election is being made;
3. A representation that the trust qualifies for the combination under Sec. 645 as owned by the decedent by virtue of the power to revoke it; and
4. The written signature by the trustee and the executor.

This statement must be attached to the Form 1041 and be filed with the return. The election is deemed made when the Form 1041 is filed. A new form (8855) is available to make the election.

This election does not require the existence of a probate estate. In the situation where there is no estate, the trustee makes the election, obtains an identification number and includes in the statement that there is no executor or administrator. The TIN must be obtained by the trustee to file as an estate.

Furnishing TIN to Payors

If there is a personal representative, all payors of an electing trust shall be furnished a Form W-9, Request for Taxpayer Identification Number and Certification, or an acceptable substitute Form W-9 with the name of the related estate as the primary name on the form, the name of the electing trust as the secondary name on the form, the TIN of the related estate, and the address of the trustee. The form must be signed under penalties of perjury by the personal representative.

If there is no personal representative, the trustee of the electing trust shall furnish a Form W-9 or an acceptable substitute Form W-9 with the name required by, and the TIN obtained under, Section 301.6109-1(a)(4)(ii)(B).

Advantages of the IRC Sec. 645 Election

There are some preferential income tax treatments available to estates that are not available to trusts. They include:

1. The use of a fiscal year;
2. The $25,000 PAL deduction for active participation for two years after the date of death under IRC Sec. 469(i)(4);
3. The qualification by the combined or electing entity as an S corporation shareholder;
4. Charitable contribution deduction is allowed for income set aside as well as actually paid; and
5. A loss deduction is available for a pecuniary bequest satisfied with depreciated property even though the parties are "related" under IRC Sec. 267.

Duration of the Election

The election begins on the date of the decedent's death and terminates on the day before the applicable date. The election does not apply to successor trusts. The applicable date is two years after the decedent's death where no Form 706 is required to be filed. If a Form 706 is required to be filed for the decedent's estate, the applicable date is the day that is 6 months after the date of final determination of liability for estate taxes. This date is the earliest date on which any of the following has occurred:

1. The issuance by the IRS of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within twelve months after the issuance of the letter;

2. The final disposition of a claim for refund when all items have either been allowed or disallowed. If a waiver of notification with respect to disallowance is filed with respect to a claim for refund prior to disallowance of the claim, the claim for refund will be treated as disallowed on the date the waiver is filed.

3. The execution of a settlement agreement with the Internal Revenue Service that determines the liability for the estate tax;

4. The issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or a petition for certiorari is filed within 90 days after the issuance of a decision, judgment, decree, or other order of a court: or

5. The expiration of the period of limitation for assessment of the estate tax provided in IRC Sec. 6501.

FIDUCIARY ACCOUNTING

Fiduciary Accounting is the type of accounting that is required for executors, administrators, guardians, trustees and sometimes, assignees and receivers. It is different from commercial accounting in many ways. Many of the principles and rules of fiduciary accounting vary from state to state and can even vary from county to county. Many of the actions taken by the fiduciary are governed by the wishes of the decedent or grantor, as expressed in the will or trust instrument, and are not a function of state law. However, certain basic principles apply to the accounting methods required of all fiduciaries. Once fiduciary accounting is understood, it is easier in many ways than commercial accounting. Once an accountant understands the basics of fiduciary accounting, it is easy to design and maintain an efficient bookkeeping system for the fiduciary entity. There is not a standard accounting system for a fiduciary to adopt because fiduciary entities vary so much in size and complexity that each fiduciary should have an accounting method designed with his or her particular circumstances in mind. The range can be anywhere from a checkbook to a mainframe bookkeeping system. It is also important to distinguish between "keeping the books" and preparing "fiduciary accounts." The *books and records* are the trustee's internal financial records of the trust or estate's transactions and are used to provide a variety of information to the beneficiaries and other third parties including the Internal Revenue Service and other taxing authorities. An *account* is the bookkeeping system that distinguishes between principal and income and has sufficient detail to keep the beneficiaries and often the court apprised of the transactions and investments of the trust.

Fiduciaries have a common-law duty to keep records and to render accounts to beneficiaries. If the fiduciary fails to keep accurate books of accounts, the burden is on the fiduciary to establish the propriety of the acts in question, and all presumptions with regard to those transactions are against the fiduciary.

At the termination of the administration of a probate estate, or during the period of administration, the fiduciary of an estate is required to file accountings with the court with proper notice to all beneficiaries and heirs at law. The same duty is often required of a trustee at the termination of a trust, or periodically during the life of the trust and the trustee must account to the beneficiaries. All accounts filed in probate proceedings and all trust accountings should follow the basic rules of fiduciary accounting and most states have adopted rules relating to the content and format of all accounts to be filed with the Court. The format and requirements of court accountings are beyond the scope of this course, but the fiduciary tax accountant is often called upon to prepare such accountings during the administration of a trust or estate and should consult the Probate Code for guidance and assistance. Fiduciary accounting is the method by which the fiduciary reports to the beneficiaries and often the court regarding the assets in the fiduciary's care.

Fiduciary Accounting for trusts and estates is incorporated into the determination of taxable income and the allocation of the tax burden among the fiduciary and the beneficiaries. Fiduciary income is required to be disclosed by trusts (not estates) on Schedule B on Form 1041 and is significant in a number of tax and nontax areas.

Basic Objective of Fiduciary Accounting

It must be remembered that a fiduciary is a person(s) or trust company who has agreed to accept the legal ownership and the control and management of an asset or a group of assets that belongs to someone else. The fiduciary also agrees to manage the assets in exact accordance with the wishes of the person who established the fiduciary relationship. The type of fiduciary that is discussed in these materials is the executor or administrator of an estate or the trustee of a trust. The fiduciary must make periodic reports of his stewardship to those equitable owners, and sometimes to the court. Therefore, it is extremely important that the trustee or executor maintains good accounting records that will enable him to prepare these reports. Such accountings will also serve to protect the fiduciary in case any of his actions or decisions is questioned.

Reports are called accounts or accountings and are guided by the Report of the Fiduciary Accounting Standards. The basic objective of fiduciary accounting is to establish and maintain accounting records enabling the fiduciary to prepare a report of administration that will fulfill the following objectives:

a. to establish and maintain accounting records that provide essential and useful information in a meaningful form to interested parties;
b. to provide maximum clarity as to the information presented; and
c. to provide full disclosure.

Ethical Considerations of the Fiduciary and the Fiduciary Accountant

A fiduciary has the absolute duty of good faith, loyalty and prudence in the handling of his fiduciary duties. This prohibits any commingling of his own funds with those of the trust or estate and no burying of items in the reports to the court or the beneficiaries. The fiduciary of an estate remains personally liable for tax and related penalties. The IRS first seeks to collect tax from the estate of the taxpayer or transferee [Reg. 301.6901-1 and 301.6903-1]. Discharge by the state court of the fiduciary does not relieve the fiduciary for tax purposes (Reg. 1.641(b)-2), as a written release from the IRS is required.

The accountant who is engaged by the fiduciary or the fiduciary's attorney to establish and maintain the accounting records for the entity and to prepare its periodic reports occupies a rather unique position. He has a direct responsibility to the fiduciary that hires him, but must also be mindful of the beneficiaries. The end result for the accountant to keep in mind at all times is:

a) to correctly interpret the terms of the governing instrument;
b) to properly handle all transactions in accordance with those terms; and
c) to produce correct and informative fiduciary reports.

The accountant must be alert for any ethical issues or conflicts that arise. This includes, but is not limited to, the possibility that inadequate records are given to him, or the possibility that the fiduciary is dishonest. A continuing question for the accountant involves issues such as confidentiality and conflicts and early in the engagement the accountant must determine the identity of the client and the duty owed to the client. The ethical considerations for fiduciary accounting are dictated by the Uniform Principles of the Accounting Standards Committee, the accountant's conscience and the accountant's ethical training.

Other Types of Fiduciaries

There are fiduciaries other than the legal owner of trust or estate assets. These fiduciaries are also held to a very high standard of care, but are not required to separate income and principal in the same manner as the trust or estate fiduciary.

a. Committee - A fiduciary appointed by the court to care for the property or person of an incompetent. This person is also called a conservator, curator or tutor.

b. Agent - A person who acts for another person by the latter's authority. This person does not possess title to the property and owes a duty of obedience to his principal's orders.

c. Guardian - A court appointee that manages the affairs of a minor.

d. Trustee in Bankruptcy - Receivers and trustees in a bankruptcy proceeding that are governed by the Federal Bankruptcy Act.

Fiduciary Chart of Accounts

The fiduciary chart of accounts contains two proprietorship accounts because in a trust or estate there are two owners. The equitable owners consist of the income and remainder beneficiaries. The principal account is the account that represents the net assets belonging to the remainder beneficiaries. The income account refers to the operating income and expense accounts that will be closed into the income account periodically and represents the income beneficiary's claim to the net income of the trust or estate. The use of two separate ledger accounts, properly segregates cash into principal and income although there may be only one bank account:

a. Income Cash
b. Principal Cash

a. Equity (Income)
b. Equity (Principal)

A fiduciary chart of accounts is very similar to one used in a regular business. The only real difference is that there are two net worth sections, one for "Principal" and one for "Income." This is in addition to the two cash accounts discussed above. The following illustrates a chart of accounts for an estate or trust:

ASSETS 100 - Principal Cash Income) 101 - Income Cash 102 - Stocks 103 - Bonds 104 - Other	**NET WORTH (INCOME)** 500 - Estate Income (Trust 600 - Distributions of Income
NET WORTH (PRINCIPAL) 300 - Estate Principal (Trust Principal) 301 - Assets Not Inventoried 302 - Distributions of Principal	**INCOME** 700 - Interest Income 701 - Dividend Income 702 - Rental Income 703 - Partnership/Business Income 703 - Other Income
EXPENSES AND DISTRIBUTIONS **ALLOCABLE TO PRINCIPAL** 400 - Administrative Expenses 401 - Estate and Inheritance Taxes 402 – Gains and Losses on Realization 403 - Legacies Paid 404 - Distributions of Principal Expense 405 - Principal Portion of Debts Paid 406 - Income Tax on Capital Gains 407 - Extraordinary Repairs (Income) 408 - Fiduciary Fees (Principal)	**CHARGES TO INCOME** 800 - Salaries 801 - Office Expenses 802 - Real Estate Taxes 803 - Depreciation Expense 804 - Miscellaneous 805 - Income Taxes 806 - Interest Expense Paid 807 - Fiduciary Fees 808 - Attorney/Accounting Fees

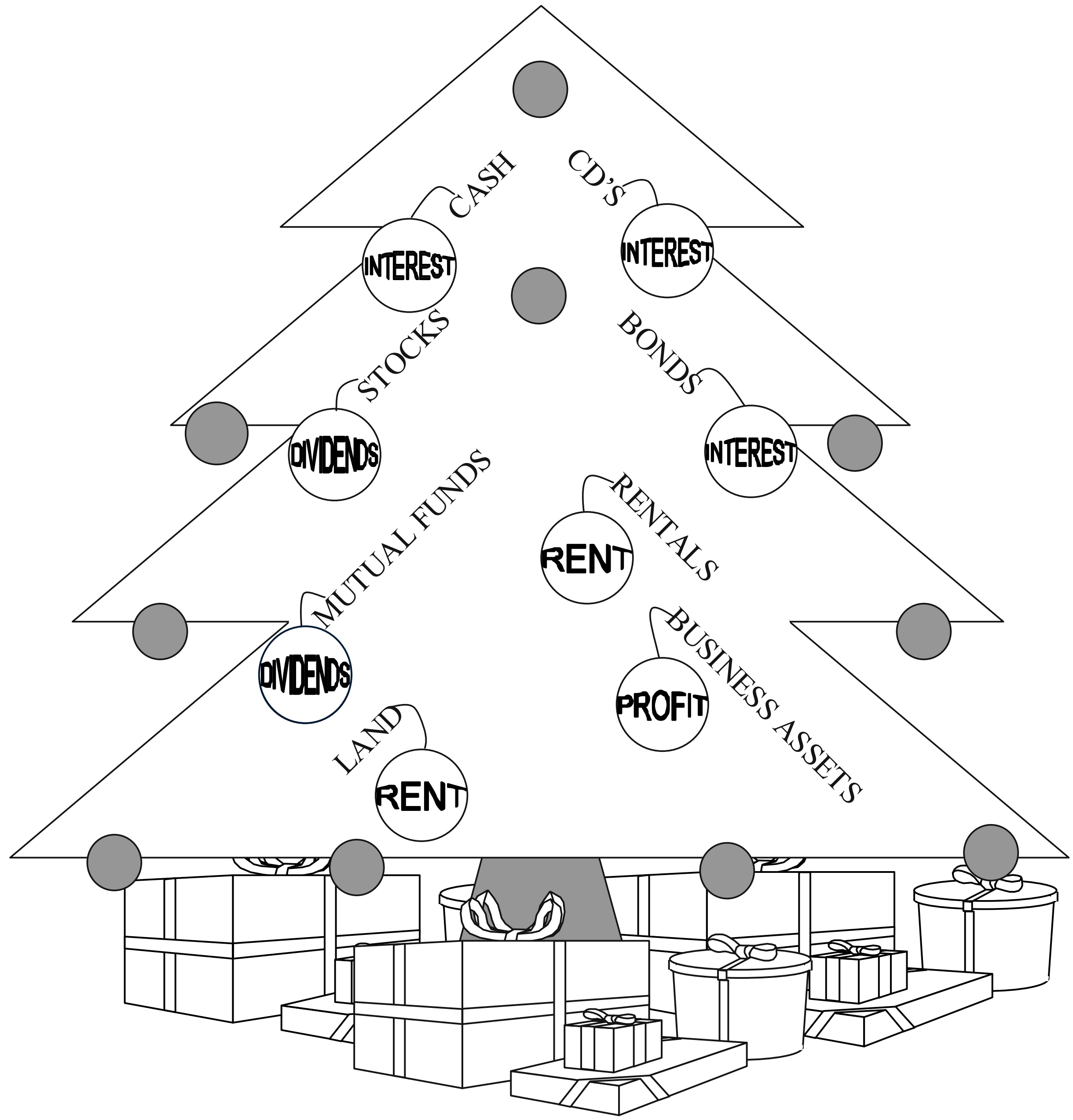
The Opening Bookkeeping Entry

The property turned over to the care and management of the fiduciary is debited to the proper account and a corresponding credit entry is made to estate or trust principal. Valuation for an estate uses the date of death value for fiduciary accounting purposes even if the alternative valuation date was used for purposes of the Form 706. Community property can be recorded at full value with a contra account for the surviving spouse's equity, or only the decedent's share can be recorded. The former tracks the assets more clearly. For property transferred to a trust, the transfer of the property constitutes a gift. For tax purposes, the correct basis may not be known for many years after the gift was made and, then, it is the grantor's adjusted basis where the property is sold at a gain. If the property is later sold by the trust at a loss, the lower of the grantor's adjusted basis or the FMV at the date of the gift is used. For fiduciary accounting purposes, it is a general practice to record the property at its FMV at the date of the transfer. If a later sale occurs, an adjustment can be made to record the correct tax amount. This is different treatment than is used for tax where a carryover basis is used.

For property transferred to a testamentary trust, the value is recorded as of the date of the transfer. Often a probate has occurred and there may be a time lapse from the actual date of death. This is the value that the trustee is charged with and the proper amount for the books.

"Fruit" and Tree Analysis of Principal and Income

It is helpful to use the following diagram to understand the difference between principal and income. Principal can be compared to the branches of the tree. The income that is generated from the use of the principal asset is termed "fruit." If an asset is sold for cash, it is a principal transaction and no income is produced. If a principal asset generates revenue for its use, fiduciary income is created. The diagram is helpful to separate and distinguish between income and principal
(corpus).



The Distinction Between Principal and Income

The main problem encountered in designing and maintaining the accounting system for a fiduciary is the absolute necessity of having the books distinguish clearly between the principal (or corpus) of the trust or estate and its income. This distinction is necessary because often the decedent's will or the trust instrument designates one person to receive the income (perhaps a lifetime beneficiary), and another to receive the principal (the remainderman). The instrument can define what is principal and what is income in an uncommon fashion, and it will still stand as proper authority requiring adherence by the fiduciary. Often the nonprofessional fiduciaries will not understand or appreciate the distinction between fiduciary income and principal under the statutory definitions.

A common provision in a trust or estate is:
"Income only to A (for life), remainder to B."

In this example, A and B have "adverse interests." This does not mean that they are unfriendly toward one another. It means that by the nature of their ownership interests, they have opposing interests. The income beneficiary is very interested that fiduciary income is calculated and tracked carefully and correctly. The remainder beneficiary is correspondingly interested that corpus is preserved properly and also tracked and accounted for correctly. Even if the income beneficiary and the remainder beneficiary are the same person, the requirements of estate, inheritance and income tax laws usually make it desirable, if not mandatory, to keep such records. Also, such accounting is necessary to chart the performance of the accounts.

Example 1

The only assets in an estate are a non-income producing piece of real estate, a vacant lot, and cash in a checking account. If the vacant lot is sold for the value claimed for estate tax purposes, this is a simple exchange of one asset for another; real property for cash. The conclusion is that neither income or principal is affected except for the reclass of principal assets from a hard asset to cash which is also an asset.

Example 2

If the vacant lot is sold for a price in excess of the value on the books, one must first look to the instrument for the treatment of gain on the sale of a capital asset. If the instrument is silent, look to state law. Under the Uniform Principal and Income Act or the Revised Uniform Principal Income and Act, such gain is an addition to principal.

Example 3

A vacant house is rented to a tenant. The rent received on the property is considered income and distributed or accumulated for the benefit of the income beneficiary.

Example 4

The vacant lot is sold and the proceeds are used to buy bonds. The bonds remain in the principal account, but any interest earned on the bonds is income.

Example 5

The income from investments is accumulated in the trust or estate and the fiduciary purchases other securities with this income. The dividends and interest received on these investments are income. However, because these assets were purchased with income, they are also income assets and must be separated from principal assets.

It is absolutely necessary to track income and principal separately. Actual physical separation is not necessary as long as there are separate accounts and adequate tracking.

Example 6

"Income to be accumulated for A and B until age 21, then income only to A and B for life and remainder to C"

If the income is required to be distributed to A and B annually, this is uncomplicated. It becomes more complicated where income is accumulated for A and B for a certain period of time (usually until the beneficiary reaches a certain age) and then a distribution is made. A and B are very much interested in how much income has accumulated over the years and want an adequate and complete accounting. C is also interested that A and B aren't distributed principal money or assets that rightfully belongs to him as the remainder beneficiary. The adverse interests of A, B & C provide fertile ground for lawsuits against the fiduciary.

Therefore, the fiduciary, and those hired by the fiduciary, must protect themselves with careful and accurate recordkeeping.

Fiduciary Accounting Income

Income for fiduciary accounting may be very different from what is considered accounting income. Fiduciary accounting income (FAI) is the income that the grantor intended the income beneficiary to receive and those wishes of the grantor are primary authority guiding the accounting treatment for the trust or estate. The fiduciary is controlled by the terms of the governing instrument and initially setting up an accounting system to provide for these mandates will prove invaluable throughout the administration of the trust or estate. Fiduciary accounting income will often not be the same as trust taxable income as we will see later on in these materials. Tax considerations should be ignored at this point to avoid confusion.

FIDUCIARY ACCOUNTING INCOME (FAI)

a. Fiduciary accounting income (FAI) is the actual cash that the income beneficiary receives;
b. FAI is sometimes completely different from trust/estate taxable income;
c. FAI is the starting point in calculating the income taxation of trusts and estates; and,
d. Gross FAI is often used for several of the prorations used for tax purposes.

At the end of the accounting period, the books of the fiduciary must produce a figure known as "Fiduciary Accounting Income." This is the net income determined in exact accordance with whatever specific directions the governing instrument (or state law) dictates. This is not accounting income as we accountants know and understand it. The instrument must be carefully reviewed to determine its directives.

ORDERING OF AUTHORITY FOR DETERMINING FAI

1. Where the instrument is silent, state law will apply.
2. Where state law is silent, the fiduciary and the accountant should allocate to principal.
3. An allocation that results in a reasonable and consistent application.
4. The attorney who drafted the document can make the call.
5. Where the above-described approaches are not feasible, court intervention is available.

The Uniform Principal and Income Act

Trust principal and income are generally governed by the Uniform Principal and Income Act (UPIA). The UPIA will apply, however, only in the absence of specific contrary instructions in the trust or estate documents. The Uniform Principal and Income Act is a 1997 revision of a model code, called the Uniform Principal and Income Act, that was drafted in 1931 and revised in 1961 (RUIPA). It lists what is characterized as principal and income. These sections can be referred to when there is confusion on the part of the fiduciary or accountant as to what is principal and what is income.

A grantor creating a will or trust can empower the trustee with discretionary authority to make determinations and the paramount rule is the intention of the creator of the interests. If an instrument is silent on the treatment of principal and income, the allocations are to be made in accordance with the Revised Act. Where the instrument provides complete discretion to the fiduciary in allocating receipts and expenditures to income or principal, the fiduciary is required to exercise this discretion reasonably and equitably.

New '97 Uniform Principal and Income Act

The Uniform Principal and Income Act was revised by the drafting committee of the National Conference of Commissioners on Uniform State Laws. A final draft was submitted and approved. The revised model code offers more detailed provisions concerning the treatment of modern investment vehicles and accepts modern portfolio management concepts as well as revising the standards of fiduciary conduct from those promulgated under the “Prudent Man Rule” of the 1961 revision. The model code was adopted into California law in Probate C Sections 16320 – 16375. The full text of the statute can be found at www.leginfo.ca.gov.

The new standards require fair, reasonable, and impartial administration (FRIA) of the interests of both the current income beneficiaries and the remaindermen consistent with the wishes of the settlor. The grantor’s intentions still override the provisions of the model code. If a fiduciary has any doubt in a situation, any uncertainties are to be resolved in favor of an allocation to principal.

Income

"Income" is the return in money or property derived from the use of principal and includes the following:

a. Rent of real or personal property, including sums received for cancellation or renewal of leases;
b. Interest on money lent, including sums received as consideration for the privilege of prepayment of principal except as provided for bond premium and bond discount;
c. Income earned during the administration of a decedent's estate;
d. Corporate distributions;
e. Accrued increments on bonds or other obligations issued at a discount collected in less than one year;
f. Receipts from business and farming operations;
g. Receipts from the disposition of natural resources; and
h. Receipts from other principal subject to depletion.

Charges to Income - Trusts or Estates

a. Ordinary expenses incurred in connection with the administration, management or preservation of the trust property, including regularly recurring taxes assessed against any portion of the principal, water rates, premiums on insurance, interest and ordinary repairs.

b. A reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principals. However, no allowance shall be made for depreciation of that portion of any real property used by a beneficiary as a residence or for depreciation of any property held by the trustee on the effective date of this Act for which the trustee is not then making an allowance for depreciation.

c. One-half of the court costs, attorney's fees and other fees on periodic judicial accounting, unless the court directs otherwise.

d. Court costs, attorney's fees and other fees on other accounts or judicial proceedings if the matter primarily concerns the income interest, unless the court directs otherwise.

e. One-half of the trustee's regular compensation, whether based on a percentage of principal or income, and all expenses reasonably incurred for the current management of principal and the application of income.

e. Any tax levied upon receipts defined as income under this Act or the trust instrument and payable by the trustee.

If charges against income are of an unusual amount, the trustee may by means of a reserve or other reasonable means, charge them over a reasonable period of time and withhold from distribution sufficient sums to regularize distributions.

Principal

"Principal" is the property that has been set aside by the owner or the person legally empowered so that it is held in trust eventually to be delivered to a remainderman. The return or use of the principal (the income) is in the meantime taken or received by or held for accumulation for an income beneficiary. Principal includes:

a. Consideration received by the trustee on the sale or other transfer of principal or on repayment of a loan or as a refund or replacement or change in the form of principal;
b. Proceeds of property taken on eminent domain proceedings;
c. Proceeds of insurance upon property forming part of the principal except proceeds of insurance upon a separate interest of an income beneficiary;
d. Stock dividends, receipts on liquidation, and other corporate distributions;
e. Receipts from the disposition of corporate securities;
f. Royalties and other receipts from the disposition of natural resources;
g. Receipts from other principal subject to depletion;
h. Any profit resulting from any change in the form of principal; and,
I. Any allowances for depreciation established under Sections 16372.

Charges to Principal of an Estate

All expenses incurred in connection with the settlement of the decedent's estate, including debts, funeral expenses, last illness, estate taxes, interest and penalties concerning taxes, family allowances, fees of attorneys and the personal representatives and court costs, are charged against the principal of the estate and are not shown as expenses. The payment of legacies are also charged against principal.

Charges to Principal - Trusts or Estates

The following shall be charged against principal:

a. Trustee's compensation not chargeable to income, expenses reasonably incurred in connection with principal, court costs and attorney's fees primarily concerning principal, and trustee's compensation computed on principal as an acceptance, distribution or termination fee.
b. Payments on the principal of an indebtedness, including mortgages. Expenses of preparing property for rental or sale. Expenses incurred in maintaining or defending title or to construe the trust or to protect the trust or its property.
c. Extraordinary repairs, including additions, capital improvement, payment of special assessments. The trustee, however, can establish an allowance for depreciation out of income in his discretion.

d. Income taxes levied on capital gains.
e. If an estate or inheritance tax is levied in respect of a trust in which both an income beneficiary and a remainderman have an interest, any amount apportioned to the trust, including interest and penalties, even though the income beneficiary also has a right to the principal.

Common Differences Between FAI and Trust Taxable Income

There are some basic differences between fiduciary accounting income and trust taxable income. For instance, capital gains are generally not included in FAI but are included in trust taxable income. For fiduciary accounting purposes, these are not really gains and losses but an adjustment to inventory values and any gains simply increases the estate or trust principal. Nontaxable interest income, perhaps on municipal bonds, are included in FAI but excluded from tax under a specific nonrecognition code section. Attorney, accountant and other administration expenses are often allocated between principal and income for FAI but are deducted in full (with some limitations) for tax purposes. And depreciation is often not charged against FAI but is taken as a tax deduction against income. Therefore, it is common that the calculation of fiduciary accounting income (FAI) and trust taxable income will result in different amounts.

Business Income in a Trust or Estate

It is possible for an active business to be one of the assets that the fiduciary manages and the net income from this business is income to the trust or estate. The accountant has the choice of incorporating the bookkeeping system of the business into the fiduciary's bookkeeping system or of continuing separate books for the business and using a "control" account in the fiduciary's books. Combining the two sets of books can cause numerous complications, so it is generally considered much more efficient to keep them separate.

The business interest will have been given an appraised valuation, along with the other fiduciary assets, and it is this figure that will be debited to an asset account. At the end of each accounting period of the business, the fiduciary will debit this asset account for the amount of the business net profit and will credit an income account for the same amount.

As the fiduciary makes periodic withdrawals of cash from the business, the business interest account will be credited when the income cash account is debited on the fiduciary books. The fiscal year of the business must be changed to that of the fiduciary if the two are not already the same.

Accounting for Liabilities

Since fiduciary accounting is usually on a strict cash basis, there is seldom any need for liability accounts on the books, except possibly for those of a very current nature such as payroll tax deductions. For an estate, liabilities existing at the time of the decedent's death are not recorded on the books, but are handled on a cash basis and are recorded only when paid by a charge against the principal of the estate. This raises the question of how to account for any mortgages, installment notes, or other long-term liabilities existing at the decedent's death. These can be accounted for by memorandum records, with memo entries being made to record each periodic payment (excluding interest, which is a proper charge against current income). The liability can also be recorded on the books with a corresponding debit to "Debts of Decedent" and can be subsequently handled in the ordinary manner.

In a trust, it is possible that mortgaged property has been turned over to the trustee as one of the assets. If so, the mortgage should be shown on the trust books and handled in the future according to general accounting rules. An estate executor or trustee may be authorized to mortgage property or to otherwise borrow money in the name of the fiduciary. In the event of any such liabilities arising after the decedent's death or the creation of the trust, these liabilities will be recorded on the books and their treatment will follow ordinary accounting rules.

Capital Gains Not Generally Included in Fiduciary Accounting Income

When trust or estate assets are sold by the fiduciary, one form of corpus is replaced by another. Cash or other property is usually exchanged for the trust or estate asset. The fiduciary may realize a capital gain or loss on this disposition for tax purposes, but under fiduciary accounting principles, only the composition of the corpus has changed. Therefore, unless the governing instrument declares otherwise, capital gain or loss is not included in fiduciary accounting income. Except for the effect of the income tax associated with such gains and costs related to the disposition, the current value of the assets still remains the same. Any gain associated with the disposition of a capital asset, and added to corpus, is taxed at the trust or estate level.

Depreciation

Depreciation, as a charge against fiduciary accounting income, will only come into play in the trust situation and the instrument will provide direction. If the instrument provides for depreciation and the trust income is to bear the expense of depreciation, the FAI will be reduced by depreciation. If the trust instrument is silent regarding depreciation, state law governs and the trustee has discretion to create a reserve for depreciation. Often depreciation is ignored for fiduciary accounting income purposes. Therefore, FAI will not be reduced by any depreciation. If depreciation is not reserved in the trust's books, this does not mean that it cannot be used as a deduction for income tax purposes. FAI will be adjusted for any allowable depreciation in arriving at taxable income.

> **Example**
>
> The terms of the trust indicate that a reserve for depreciation is to be set up on the trust books. Therefore, FAI will be reduced by this amount. For tax purposes, depreciation will still be deducted. If the trust property earns $50,000 in income before depreciation and the depreciation reserve is $20,000, the FAI will be $30,000 ($50,000 - 20,000). If there were no reserve, the income beneficiary would receive the full $50,000 in trust income.

Reserves are more commonly used where assets are depletable and likely to be used up before distribution to the remainder beneficiary. Other reserves can be created for repairs such as on the termination of long-term leases. The fiduciary has the discretion to set up reserves for depreciation under CA Probate Code Sec. 16372.

Charitable Distributions

A trust's donations to a charity is never treated as an expense for FAI purposes. It would be improper for a trustee to burden income with such a payment and call it an operating expense. Therefore, charitable contributions are treated as distributions for FAI purposes and they are made only as provided for in the trust instrument. A charitable distribution may be made from income or from principal or both, depending on the terms of the trust instrument. These terms will govern the accountant in recording the distribution. The contribution will be charged to the proper distribution account, the same as a distribution to an individual beneficiary.

As we will review in another chapter, a charitable distribution may be treated as a deduction for income tax purposes, whether made from income or principal, and will be one of the items used in adjusting fiduciary accounting income to trust taxable income.

Class Problem

During the current year, a trust has the following receipts and disbursements. Calculate the fiduciary accounting income for the year. There is no reserve for depreciation and RUIPA applies.

ACTUALS		ADJ	FAI
RECEIPTS			
Interest	25,000	________	
Dividends	50,000	________	
Capital Gain	20,000	________	
Return of Capital	20,000	________	
Tax-Exempt Interest	10,000	________	
Total	125,000		
DISBURSEMENTS			
Mortgage Int	(20,000)	________	
Mortgage Principal	(5,000)	________	
Trustee Fees			
Income	(2,000)	________	
Principal	(2,000)	________	
Dep.	(10,000)	________	
Total	(39,000)	________	
FAI			

THE SIMPLE TRUST

IRC Sec. 651(a) defines a simple trust as any trust where the terms provide that all the income is required to be distributed currently, no other amounts are distributed, and no amounts are paid or permanently set aside for charitable purposes. Therefore, a simple trust, by its terms, requires that all income (FAI) be distributed currently to the income beneficiary, whether or not it is actually distributed. IRC Sec. 651(b) states that if the amount of income required to be distributed currently exceeds the calculation of distributable net income (DNI), then the distribution deduction shall be limited to the DNI. Essentially this means that the distribution deduction in a simple trust is the fiduciary accounting limited by the deductible DNI [IRC Sec. 651(b)]. The code section goes on to state that the calculation of DNI shall only include items of income and deductions that are included in the gross income and deductions of the trust for tax purposes. Often the calculation of this amount is not determined until after the tax year ends. A fiduciary may be required to distribute income currently but may, in fact, defer making its distribution until after the close of the trust taxable year. A trust required to distribute its income currently is entitled to deduct the distribution in the year that the *income is earned and required to be distributed*. Furthermore, the beneficiary must include the amount ultimately distributed in the year of deduction, even if the amount was not determined by the close of that year. IRC Sec. 652 states that "the amount of income required to be distributed by a trust described in Section 651 shall be included in the gross income of the beneficiaries to whom the income is required to be distributed, whether distributed or not." A trustee can have "sprinkling powers" among a class of beneficiaries and this will still qualify as a simple trust as long as all the income is required to be distributed currently.

Characteristics of a Simple Trust

1. All the income is required to be distributed currently;
2. No discretionary distributions are made; and,
3. No charitable contributions are made.

The characterization of a trust as simple or complex can change from year to year. This is because two of the three requirements of a simple trust depend on trust activity during the year. IRC Sec. 642(b) states that a trust that requires the trustee to distribute all the FAI currently gets a $300 personal exemption against other trust taxable income. All other trusts are allowed a $100 deduction and, estates are allowed a $600 personal exemption. The amount of the personal exemption does not determine whether a trust is simple or complex. As we will see later on, a complex trust can require that all the income be distributed currently. If the first year of a trust is a short year, there is no pro ration of the personal exemption, and no exemption is available in the final year of the trust.

Example 1

> The trust terms state that all income is to be distributed currently to the income beneficiary and the trustee has discretion to make distributions of principal. In Year 1, the trustee distributes only income to the income beneficiary. In this year, the trust is characterized as simple. In Year 2, the trustee distributes all the income and makes a corpus distribution of $10,000. Because the $10,000 is discretionary, the trust is complex for Year 2. In both years the trust gets a personal exemption of $300 because, by the terms of the trust, the trustee is required to distribute all the income currently.

Example 2

> A trust is required to accumulate income during the minority of the beneficiary and then distribute income only from ages 21-30. The trust is complex during the minority of the beneficiary and simple from ages 21-30.

In the year of termination, a trust is always complex because it makes principal distributions to the beneficiaries. Estates are treated as complex trusts because they usually accumulate income during administration. It is imperative to read the trust documents to determine whether the trust has mandatory income distribution requirements which could make it a simple trust. The fiduciary accounting must be reviewed on an annual basis to verify its continuing status.

Basic Approach to the Taxation of Simple Trusts

a. Determine whether trust is simple or complex;

b. Determine the fiduciary accounting income;

c. Compute the trust taxable income before the distribution deduction;

d. Determine the distributable net income (DNI) under IRC Sec. 643;

e. Determine the distribution deduction under IRC 651;

f. Determine the category allocations of income and deductions;

g. Determine the beneficiary's share and the character of the allocation; and

h. Complete the necessary forms.

Determination of Category of Distributions

The determination of the allocation of the category of income distributed to the beneficiary or beneficiaries will be made as of the last day of the accounting year.

Example

The income generated by a simple trust is composed of interest of $10,000 paid May 1, and dividends of $10,000 paid Sept. 1. A distribution is made to A of $10,000 on June 1 and a distribution to B of $10,000 on Oct.1. From a practical viewpoint, A's distribution of $10,000 had to come from the interest earned as those were the only funds available at that time in the year. However, each beneficiary will be deemed to receive a $5,000 distribution of interest and a $5,000 dividend distribution. This is because the determination as to the allocation by category of income is determined as of the last day of the accounting year or Dec. 31. Neither the fiduciary nor the beneficiary can make a specific allocation of the funds distributed.

An exception to this rule is where a beneficiary dies during the tax year. In this situation, an allocation must be made based on the income actually received by the beneficiary during the accounting period terminating at the death of the beneficiary, not the entire year of the trust. IRC Reg. 1.652(c)-2.

Expenses Allocated to Tax-Exempt Income

Often the trust instrument or state law will allocate the trustee's fees equally between income and principal. For tax purposes, however, the trust gets a full deduction for these expenses. However, if there is tax-exempt income, a portion of the fees must be allocated to the tax-exempt income to avoid a double deduction. Authority for this is found in IRC. Sec. 265. The formula for the disallowance is found in IRC Reg. 1.652(b)-3(b) and 1.652(c)-4. If expenses allocated to tax-exempt income exceed the tax-exempt income itself, they cannot be used to offset other income. [IRC Reg. 1.652(b)-3(d)].

Administration Expenses

Administration expenses are expenses of the trust or estate that are necessary costs that 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 a trust or estate. Therefore, such expenses must be unique to the administration of a fiduciary entity. Such costs as trustee fees, attorney fees, and accounting fees are examples of administration expenses. IRC Sec. 67(e) generally requires that individuals and trusts and estates reduce miscellaneous itemized deductions by 2% of gross income. IRC Sec. 67(e) states that administration fees are not subject to this 2% floor. Therefore, it is important to properly identify administration expenses in order to avoid the 2% floor on itemized deductions.

A controversial issue has been the proper categorization of the cost of outside investment advice. In *William J. O'Neill v. Commissioner,* 994 F2d 302, the Sixth Circuit reversed the Tax Court decision that held that fees paid by trustees to investments advisers were subject to the 2% floor on miscellaneous deductions. The Tax Court held that individual investors routinely incur costs for investment advice and therefore these costs are not "unique to the administration of an estate or trust." In overturning the Tax Court, the Sixth Circuit found that it was the trustees' responsibility to manage the trust assets as a "prudent investor" and that where the trustee lacked sufficient experience in investing and managing large sums of money, seeking outside advice was prudent and proper. The Service issued an Action on Decisions, (*O'Neill v. Comm'r,* 1994-38 IRB 4) stating it would not follow the circuit court's decisions and that investment adviser were indeed subject to the 2% floor. Additionally a new case *Mellon Bank, N.A. v. United States, (Fed. Cl. 2000)* 86 AFTR 2Par. 2000-5081, has rejected *O'Neill* and has supported the Service's position. The court held that for an outside investment fee to be termed an administrative expense, it must fall directly within the definition of IRC Sec. 67(e)(1). The issue was once again "up in the air" and, in light of *Mellon Bank,* it appeared risky to treat outside investment fees as administrative expenses.

On May 3, 2003, the 4th Circuit joined the fray in *Scott v U.S.,* 328 F.3d 132 (4th Cir.). In this case the trust directed the trustee to distribute income to certain beneficiaries, with principal ultimately passing to other beneficiaries. The trustee had discretion to invade corpus for the benefit of the income beneficiaries. The trustees were three attorneys who were not trained as investment advisors and who had stated they would not serve unless the trust could obtain outside investment advice. The trust had assets worth approximately $25 million. The trustees deducted the fees charged by the outside investment firm without regard for the 2% limitation of IRC Sec. 67. The IRS denied the deduction. The trustees paid the additional tax and sued for a refund. The U.S. District Court for the Eastern District of Virginia held for the IRS and concluded that the investment advisor fees were subject to the 2% limitation on itemized deductions. The court based its decision on the fact, that unlike *O'Neil*, the *Scott* trustees were not required to seek investment advice to fulfill their fiduciary duties. The court noted that the fiduciaries were subject to the prudent person standard, but that Virginia affords the trustees total protection if they invest in assets specified in assets specified by statute.

The Fourth Circuit affirmed this decision, but without relying on the unique provisions of Virginia law. Rather, the court focused on the requirement of IRC Sec. 67(e)(1), that the 2% floor should apply to the miscellaneous itemized deductions of a trust or estate unless it could be shown that they are both "paid or incurred in connection with the administration of the trust", and that they "would not have been incurred if the property were not held in such trust." The court found that the trustees had met the burden of the first part of the test but not the second part. They held that investment advisor fees are not unique to a trust or estate, are often incurred outside the context of fiduciary administration, and agreed with the holding in *Mellon Bank.*

This issue may ultimately be decided by the Supreme Court of the United States. The ultimate resolution is important as it affects not only the 2% limitation but also the adjustment for AMT.

Direct and Indirect Expenses

It should be noted that expenses that are directly traceable to a specific type of income must be netted against that income. An example would be rental expenses that must be netted against rental income. Where an expense is not directly traceable, the trustee has discretion to use any reasonable method he chooses. This creates some planning opportunities especially in situations where the trust or estate has passive losses that cannot be utilized or passed through to the beneficiaries. In this situation, it may be more prudent to allocate the indirect expenses to portfolio income rather than rental and minimize the passive loss. Where deductions are in excess of one category, they may be utilized only against income from a category in the same type (active portfolio, etc.).

Depreciation on Rental Property

A real cost of doing business is that over time the assets are used up or become obsolete in the operation of a business and for the production of income. Because assets are usually purchased with initial cash outlays, this expenditure must be costed out against income over a pre-prescribed period of time as stated in the cost recovery rules of IRC Secs. 167 & 168. There are some interesting issues that arise in the depreciation and depletion area of the trust and estate tax law.

IRC Sec. 167(h) provides; "In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each."

For purposes of depreciation, property acquired from the decedent is treated as newly acquired property and is placed in service by the recipient. The depreciation method in effect at the decedent's death is applied to determine the depreciation of the estate, trust and heirs.

If depreciation were not allowed to be allocable to the income beneficiary, its use would be lost except in those years when there was principal income such as capital gain. The allocation of the depreciation deduction to the income beneficiary for tax, but not accounting purposes, raises some interesting conflicts between the income beneficiary and the residuary beneficiary.

Example

	Accounting	Tax	Accounting	Tax
Building			$ 100,000	$100,000
Rents	$ 10,000	$ 10,000		
Depreciation		(5,000)		
Net	10,000	5,000		
12 years	120,000	60,000	-0-	(60,000)
Net Basis			$ 100,000	$ 40,000
Sale of Building:				
Sales Proceeds:	$200,000		200,000	200,000
Gain			$ 100,000	$ 160,00

For tax purposes, all the gain would be allocated to the trust and, thus, the principal pays an increased tax because the basis was reduced for tax purposes. However, the income beneficiary received all the benefit of the depreciation deduction during the operating years because the depreciation was charged against income. Sec. 1245 recapture and its treatment in a trust creates some relief as we will see in later sections of the seminar materials.

It should be noted that a trust or estate cannot make a IRC Sec. 179 election.

Depreciation Reserve

If the instrument allows or requires, a trust can create a reserve for depreciation. Additionally, under CA Probate Code Sec. 16372, the creation of a reserve for depreciation is discretionary with the trustee. This serves to reclassify income to corpus to compensate the remainder beneficiary for the depreciating asset and is accumulated for the remainderman on the termination of the trust or at some point as described in the instrument. The income beneficiary receives that much less cash equal to the reserve amount in the distribution of fiduciary accounting income. Any amount of depreciation in excess of the reserve amount is allocated according to the normal ratios.

Distribution of Noncash Property to a Beneficiary

If noncash property is distributed to a beneficiary, the beneficiary is taxed to the extent of DNI. The property distribution is taken into account at the lessor of: 1) its adjusted basis; or 2) its FMV. There is a special election that is available where the trust or estate can choose to treat the property distribution as a sale to the beneficiary at FMV and the trust or estate pays the tax on any gain. The beneficiary takes the property with an adjusted basis based on the FMV. The adjusted basis to the beneficiary would have been a carryover basis had not this special election been made.

THE COMPLEX TRUST

A complex trust does not require that all income be distributed currently. It can provide for and make distributions out of principal and can provide for charitable contributions. The rules for complex trusts are found in IRC Secs. 661 and 662. The distribution deduction in a complex trust is the sum of the amounts required to be distributed, plus all other amounts distributed, limited to deductible distributable net income [IRC Sec. 661(a)(2)]. The distributions from a complex trust follow a tier system and are comprised of two tiers. The first tier of distributions under IRC Sec. 662(a)(1) are composed of income that is required to be distributed currently. Tier 2 distributions, as directed by IRC Sec. 662(a)(2), contain all other amounts properly paid, credited or required to be distributed. The underlying rationale of the two tier system is that Tier 1 distributions are more likely to be from taxable income and should absorb most of the DNI. Therefore, DNI absorbs the first tier of distributions before the second tier. This means if all the DNI is absorbed by the Tier 1 distribution, any Tier 2 distributions in excess of DNI escape tax. If the DNI is greater than the Tier 1 distribution, but less than the combined Tiers 1 and 2 distributions, the excess of the DNI is allocated among the Tier 2 beneficiaries. If there is more than one Tier 1 beneficiary, the DNI is allocated to each beneficiary in relation to the amount of fiduciary accounting income (FAI) distributed to each. It should be noted that a beneficiary can be both a Tier 1 and Tier 2 beneficiary.

Example 1
The trust provision reads: "Trustee has discretion to distribute income or principal to A."

In actuality, all the income from the trust is distributed to A.

a. The income distribution is a Tier 2 distribution because there was no requirement to distribute it.

b. All the beneficiaries of an estate are Tier 2 beneficiaries because there is generally no requirement to make income distributions.

Example 2
Trust provision reads: "All income to be currently distributed to A and the trustee has the discretion to distribute an additional $5,000 to A and $2,500 to B."

Year 1 - Trustee distributes all the income to A. In this year the trust is a simple trust.

Year 2 - Trustee distributes all the income to A and make a discretionary distribution of $5,000 to A and $2,500 to B. In this year the trust is complex. A is both a Tier 1 and Tier 2 beneficiary and B is a Tier 2 beneficiary.

Example 3
The trust provision reads: "$10,000 per year is to be distributed to A and the trustee may distribute or retain any additional income." In the current year, the trust has income of $17,000 and the trustee distributes all the income to A.

a. In any year the trust is complex.

b. $10,000 is a Tier 1 distribution;

c. $7,000 is a Tier 2 distribution.

d. It is very important to review the trust provisions to determine how the distributions are handled.

LOSSES, PASS THROUGHS & THE SEPARATE SHARE RULE

BUSINESS LOSSES IN THE TRUST OR ESTATE

The general rule in the income taxation of trusts and estates is that losses only pass out to the beneficiary in the year of termination. If a trust or estate has excessive business losses, the losses will appear on Page 1 of the Form 1041 as a loss and can be netted against other income from the trust. If the overall tax position of the trust is a loss, or there is no taxable income retained at the entity level, these losses cannot pass out to the beneficiaries except in the year of termination.

Net Operating Losses

An NOL of a trust must be calculated using the rules for individuals under IRC Sec. 172. The NOL is carried back or forward using the normal NOL rules and the carryback or carryforward is calculated. An NOL of an estate or trust is determined in the same manner as an individual's net operating loss except the following are not taken into account:

a. The deduction for amounts paid or permanently set aside for charitable purposes; and,

b. The deduction for distributions.

A net operating loss can be carried back two years and carried forward 20 years. This new period is a result of the ’97 Act and replaces a former 3 year carryback and 15 year carryforward. A special rule exists for losses occurring in 2001 or 2002 that allow a five-year carryback period. An estate or trust may elect to waive the carryback period of the net operating loss for any taxable year. When an estate or trust carries back a net operating loss, both the taxable income and the distributable net income of the estate or trust are reduced for the prior taxable years.

Any unused carryover at the termination of the estate or trust is distributed to the beneficiaries and deductible over the remainder of the 20-year carryforward period.

CAPITAL GAINS AND LOSSES

In the disposition of capital assets, there must be a capital asset as defined under IRC Sec. 1221 and there must be a sale or exchange. The holding period is one year and one day for long term and one year or less for short term. During the period 1981 - 1984, the long-term holding period was 6 months. The holding period begins on the day the trust or estate acquired the property and includes the day of disposition. However, property acquired by a decedent's estate and sold within one year is considered long term for holding period purposes. In the securities area, the trade dates for acquisition is used.

Generally, the capital gains of an estate or trust are excluded from DNI and FAI except in the following circumstances:

a. Where capital gains are allocated to income pursuant to the underlying instrument or local law;

b. Where capital gains are allocated to corpus but are actually distributed to the beneficiaries;

c. Where capital gains are deductible as a charitable contribution; and,

d. Where capital gains occur in the year of termination.

Unless one of these conditions applies, the exclusion of capital gains from DNI means that beneficiaries have no personal tax liability for such gains as they are taxed at the fiduciary level.

Under IRC Sec. 643(a)(3), DNI is decreased by the amount of capital gains, except to the extent that such gains are actually distributed to the beneficiaries or are required to be distributed under the terms of the trust instrument. In Ltr. Rul 8728001, D created a trust to pay from income and principal amounts required to meet the beneficiaries' support, comfort and education until the youngest of the seven beneficiaries (D's grandchildren) reached 25 years old. In 1983, the trust sold stock. The trust instrument said that the trustee had discretionary authority to allocate receipts between income and principal. The trustee exercised this authority and allocated part of the capital gain to income. The trustee then included the gain in DNI and the IRS agreed. The IRS noted that applicable state law said that, while capital gains were normally allocable to principal, the governing instrument could change this by specific provision. The provisions in the trust instrument had changed this rule, the IRS said, by authorizing the trustees to decide whether gains were income or principal. As this authorization was in conformity with state law, the trustee's decision to apportion the gain to income or principal was, in effect, an apportionment pursuant to the trust instrument and applicable state law. Thus, their apportionment to and distribution as income caused them to be included in DNI under Sec. 643(a)(3).

Capital Gains in the Year of Termination or Partial Termination

Capital gains increase DNI if they are realized in the same taxable year that the entity terminates. All capital gains realized in the year of termination are included because they are distributed to the persons entitled to the assets of the entity on termination. The trust instruments may require partial termination of a trust at a specified time.

> **Example**
> Income to A until age 21 where 50% of the corpus is to be distributed to A and the remainder is to be distributed to A at age 35. If the corpus assets must be sold to make the distribution and there is gain on the sale, the gain is included in DNI and is passed on to the beneficiary to the extent distributed to him.

Also, if the trustee makes a regular practice of distributing the exact net proceeds on the sale of trust property, it may be included in DNI and is taxable to the beneficiary.

Section 1231 Assets

IRC Sec. 1231 provides special treatment on gains and losses recognized on disposition of Sec. 1231 assets. Net Sec. 1231 gains are treated as long term capital gains and net Sec. 1231 losses are treated as ordinary losses. If a trust realizes a Sec. 1231 gain, it will be excluded from DNI if it is treated as capital but will be included if treated as ordinary. Inclusion could occur in the recapture area where Sec. 1231 gains are treated as ordinary if there have been any Sec. 1231 losses treated as ordinary in the preceding five years. For tax purposes, these recapture rules override local law or the provisions of the instrument.

Section 1245 and 1250 Recapture

An interesting situation occurs in the recapture area when the trust disposes of a Sec. 1231 asset. If the recapture provisions recharacterize capital gain into ordinary income, this can affect the DNI calculation (which excludes capital gains). Because Sec. 1231 is solely a tax provision, fiduciary accounting income does not perform such a recharacterization. The result is another difference between fiduciary accounting income and trust taxable income.

If capital gain is recharacterized as ordinary income because of the recapture provisions of IRC Secs. 1245 and 1250, the ordinary income amount is included in DNI. On transfers at death, any unrecognized recapture is forgiven and the beneficiary takes a stepped up or stepped down basis. The beneficiary is only responsible for any recapture potential that is generated from the point of death on.

Capital Losses

Generally, losses from the sale or exchange of capital assets are excluded from DNI. The exception is where capital losses are taken into account in determining net capital gains under one of the exceptions noted above. If the losses from the sale or exchange of capital gains are more than the gains, all of the losses are allocated to the fiduciary and none are allocated to the beneficiaries. If there are capital gains and losses in the year of termination, these would be netted and the excess would be included in DNI.

The rules for capital losses follow the individual rules under IRC Sec. 1211. An individual is allowed to offset other income by $3,000 of excess net capital losses per year. Any excess is carried forward under the carryover provisions of IRC Sec. 1211. This allowable $3,000 loss would appear at page 1 of the Form 1041 and be netted against other income. If the trust or estate cannot utilize the $3,000 loss in the current year, it must be carried over to a subsequent year. To the extent the capital loss subject to the limitation is deducted from ordinary income, consider the net short-term loss as deducted first from ordinary income.

A capital loss carryover may be carried forward indefinitely and maintains its character as either long or short term. Individuals are not allowed the carryback treatment allowed a corporation. Corporations, on the other hand, can only carryforward for five years before the loss expires.

PASSIVE ACTIVITY RULES

IRC Sec. 469, created by 1986 TRA, is a complex set of rules designed to limit the use of losses and credits from passive investments to offset service and portfolio investment income. IRC Sec. 469 disallows the current use of "passive activity losses" and "passive activity credits" otherwise available during the taxable year. Passive losses are the excess of a taxpayer's losses from passive activities over income from passive activities. Passive activity credits, similarly, are the excess of a taxpayer's credits from passive activities over the taxpayer's tax liability allocable to passive activities. A disallowed passive activity loss or credit is carried forward until the taxpayer's next taxable year where it can be used to offset net income and taxes from passive activities. Such disallowed losses and credits are also available to offset compensation, active business income and portfolio income when the taxpayer disposes of his or her passive interest in a fully taxable transaction. The exception allowed a $25,000 loss for rental real estate, where the taxpayer actively participates, is available to estates for the first two years of existence but is not available to trusts unless the trust elects to be treated as an estate.

The regulations do not address the issue of material participation for an estate or trust. There is no special rule that allows the participation of a beneficiary to be taken into account to determine whether an estate or trust is deemed to materially participate in an activity. Until a regulation or ruling provides otherwise, it appears that the participation of the executor or trustee must be taken into account to determine whether there has been material participation.

Effect of Passive Activity on DNI

Passive activity losses that cannot be used to reduce the current taxable income of the trust or estate should not reduce its DNI. The most sensible approach is to treat the loss from a passive activity in the same manner as a business loss. For fiduciary accounting income purposes, the loss is suspended and offsets future passive activity income. For trust taxable income purposes, the loss is also suspended and carried into a subsequent year. Look to the trust instrument to see if PAL's are specifically treated as income for FAI purposes. If this is the case, the amount of the PAL would reduce FAI by the amount of the passive loss.

An interesting situation occurs where depreciation alone creates the loss. In this situation, if FAI is not charged with depreciation, the passive income can be passed out to the beneficiaries and they can be allocated depreciation separately. This is one way to get passive losses out to the beneficiaries and creates some planning opportunities. The beneficiary then uses Forms 8582 to determine the personal amounts deductible.

1993 Legislation

The Revenue Reconciliation Act of 1993 relaxed the passive activity rules somewhat in the real estate area. Rental real estate is no longer considered passive if the taxpayer materially participates under the rules of IRC Sec. 469. Prior to this, rental real estate was presumptively considered passive under the rules.

It should be noted that if the fiduciary accumulates passive income in the trust and does not distribute it, that passive income loses its character as passive. The fiduciary is cautioned to think twice about accumulating passive income and not distributing to beneficiaries who have passive losses.

PAL Passing from a Partnership to a Trust

A partnership Form K-1 usually shows only the loss amount from a passive activity with the corresponding alternative minimum tax adjustment. The tax practitioner may be forced to contact the partnership to request the regular tax depreciation. Once this information is collected, the practitioner can then split out the depreciation deduction from the other deductions. This could change a net passive loss to passive income net of depreciation which could then flow out to the beneficiaries.

Level of Activity at Which the Character of a Passive Activity is Fixed

Any gain, net loss, or net credit of an activity owned by a trust or estate should be determined by the actions of whomever receives the DNI of the entity. If the trust distributes its DNI currently, the active or passive nature of an activity generating a net gain, net loss, or net credit should be determined at the beneficiary's level, without regard to the fiduciary's actual involvement in the enterprise. But if the trust or estate does not distribute all of its DNI currently, the active or passive nature of an activity generating that part of a net gain, net loss or net credit that was not distributed should be determined at the fiduciary's level, without regard to the beneficiaries' actual involvement in the enterprise.

Example

In the year of termination, a complex trust receive $100,000 in dividends and has a $50,000 loss from a business partnership. The trustee does not materially participate but one of the two beneficiaries does. The trust makes a 1/2 distribution to each beneficiary. A, who materially participates in the partnership, is deemed to receive $50,000 in dividends and ($25,000) loss from the partnership. This loss is fully deductible by A as it is not considered passive. B, however, receives $50,000 in dividend income and the ($25,000) can only be used to increase the adjusted basis of the asset. In a non-terminations year, the loss would not be available to the beneficiaries for distribution but would be suspended.

Special Rule for Gifts of Passive Activity Property with Suspended Losses

IRC Sec. 469(j)(6) presents a special rule for gifts of passive activity property with suspended losses. This rule was enacted by '88 TAMRA and retroactive to '86 TRA states that, in the case of a disposition of any interest in a passive activity by gift to a trust or estate, the basis of such interest immediately before the transfer shall be increased by the amount of any passive activity losses allocable to such interest with respect to which a deduction has not been allowed by reason of IRC Sec. 469(a). Such losses shall not be allowable as a deduction for any future taxable year and do not create additional cost basis for purposes of depreciation.

Special Rule for Distributions by Estates and Trusts of Passive Activity Property With Suspended Losses

IRC Sec. 469(i)(12) states a special rule for distributions by trusts and estates of passive activity property with suspended losses. If any interest in a passive activity is distributed by an estate or trust, the basis of such interest immediately before such distribution shall be increased by the amount of any passive activity losses allocable to such interest, and such losses shall not be allowable as a deduction for any taxable year. Again, the cost basis is not increased for purposes of depreciation. The net effect of the two rules stated above is that suspended losses that increase basis are not deductible until there is a fully taxable disposition.

INVESTMENT INTEREST EXPENSE AND TRUSTS AND ESTATES

Line 10 of the Form 1041 reflects the deductible interest and includes:

a. investment interest subject to limitations;

b. any qualified residential interest; and,

c. any interest expense payable under IRC Sec. 6601 on any unpaid portion of the estate tax relating to specific property.

a. Investment Interest expense - Basically, investment interest expense is allowed to the extent of net investment income. Net investment income is investment income less investment expenses. Any disallowed investment interest expense is allowed as a carryover to the next tax year. Interest expense paid by an estate or trust on a loan that is allocable to property held for investment may not be fully deductible in the current year. Form 4952 is used to calculate the amount of investment interest expense deductible for the current year and the amount, if any, to carryforward to future years.

Under Reg. 1.163-8T, if the estate or trust paid or accrued interest on a loan and used the proceeds of the loan for more than one purpose, the interest expense may have to be allocated. This is required because of the different rules applicable to investment interest, personal interest, trade or business interest, home mortgage interest and passive activity interest.

Investment interest expense does not include:

a. Home mortgage interest expense;

b. Interest expense properly allocable to a passive activity;

c. Any interest expense that is capitalized, such as construction interest subject to IRC Sec. 263A;

d. Interest expense related to tax-exempt interest income;

e. Personal interest which includes;

1. revolving charge accounts;
2. personal notes for money borrowed from a bank, credit union or from another person;
3. installment loans on personal property; and,
4. interest on unpaid taxes.
5. interest paid on pecuniary bequests.

f. Trade or business interest which is interest expense paid or accrued on indebtedness incurred in connection with the conduct of a trade or business (including a rental activity) by the estate or trust.

Investment interest expense includes interest expense that is properly allocable to portfolio income. Portfolio income includes income (not derived in the ordinary course of a trade or business) from interest, dividends, annuities, royalties, and net gain from the disposition of property held for investment. Net income from the following passive activities can result in portfolio income:

a. Rental of substantially nondepreciable property;

b. Equity-financed lending activities;

c. The acquisition of certain interest in a pass-through entity licensing intangible property; and

d. Net passive income from a publicly traded partnership.

Portfolio income can also include property held for investment in an activity conducting a trade or business in which the taxpayer does not materially participate and that is not a passive activity. An example would be a working interest in an oil or gas property that is not a passive activity if the taxpayer does not materially participate in the activity.

b. Interest Allocated to Tax-Exempt Income - Interest that is paid on indebtedness incurred or continued to purchase or carry obligations on which the interest is wholly exempt is not deductible and not included on Line 10 of Form 1041. If the interest expense is attributable to both taxable and tax-exempt income, the allocation method used for administration expenses and charitable contributions may be used.

c. Residential Interest Expense - Interest paid or accrued by an estate or trust on indebtedness secured by a qualified residence of a beneficiary of an estate or trust is treated as qualified residential interest if the residence would be a qualified residence (i.e. the principal residence or the second residence selected by the beneficiary.) The beneficiary must have a present interest in the estate or trust or an interest in the residuary of the estate or trust.

Investment Expenses

Investment expenses are the allowed deductions, other than interest expense, that are directly connected with the production of investment income. An example would be depreciation or depletion allowed on assets that produce investment income. If investment expenses are limited by the 2% floor on miscellaneous deductions, investment expenses for purposes of the form 4952 can be reduced by the amount disallowed.

THE 65-DAY RULE

The trustee may wish to distribute all of the income of a complex trust during the calendar year of the trust, but the trustee may not always know the amount of income to distribute as of the last day of the tax year. IRC Sec. 663(b) provides a solution where the income cannot be determined until after the end of the year. Distributions made within 65 days of the trust's subsequent tax year end may be deemed to have been made as of the last day of the tax year and the trust will still be afforded a distribution deduction, thus shifting the tax liability to the beneficiaries. This election is made by the trustee on an annual basis and must be made on a timely filed return (including extensions). This election becomes irrevocable after the due date of the return [Reg. 1.663(b)-2.1]. This election is now available to both trusts and estates as a result of the '97 Act. The trustee of a simple trust would not be concerned with this situation since all income is required to be distributed to the beneficiaries, and is reported by the beneficiaries whether or not the income is actually distributed to them. [IRC Secs. 651 & 652]. Distributions eligible for the election, however, cannot exceed the greater of the trust income for the election year or the DNI for that year.

Example

Trust has $1,000 of accounting income and $800 of DNI for 2004. On Jan. 1, the trustee makes a distribution to the beneficiary of $500 to be treated as a distribution in 2003. The trustee then makes a $600 distribution to the beneficiary in July, 2004 and $500 in January 2005. The trustee wishes to have the January 2005 payment treated as distributed in 2004.

Conclusion:

Only $400 of the January 2005 distribution can be treated as a 2004 distribution. Because the distributions cannot exceed the greater of the trust income ($1,000) or the DNI ($ 800), only $400 remains after the $600 (July, 2004) distribution .

MULTIPLE TRUSTS TREATED AS A SINGLE TRUST

Under IRC Sec. 643(f), multiple trusts are treated as a single trust and taxed accordingly if the multiple trusts have substantially the same grantor or grantors and the same primary beneficiary or beneficiaries; there is substantially no independent purpose and tax avoidance is their principal purpose. For purposes of this rule, a husband and wife are treated as one. This rule does not apply to multiple trusts that were created before 3/2/84. Prior to 1984, individuals could save significant amounts of tax by creating multiple trusts so each trust could take advantage of the graduated rate structure.

THE SEPARATE SHARE RULE

If the amount paid or payable to the beneficiaries of a complex trust or estate exceeds DNI, the DNI must be allocated among the beneficiaries. This allocation is generally accomplished through the tier system. However, this tier system works an injustice when a trust or estate is administered in substantially separate shares.

Example #1

The JJ Trust has two beneficiaries and has DNI of $20,000. The trustee makes a mandatory distribution to John of $10,000 and accumulates the other half for a future distribution to beneficiary Jane. The trustee also makes a discretionary distribution of corpus to John. If DNI is allocated by the tier system, the entire DNI would be allocated and taxable to John. He would be taxed on the accumulated distribution to go to Jane at a future time.

Example #2

The same facts as above except there are two trusts, one for John and one for Jane. Each trust has DNI of $10,000. The trustee of John's trust distributes all the income and $10,000 in corpus. The trustee of Jane's trusts makes no distribution. John is only taxed on $10,000 which is the DNI of his trust. The fiduciary of Jane's trust is taxed on the DNI of her trust at the trust level.

IRC Sec. 663(c) contains a special rule for the allocation of separate share which achieves the two trust result but in one trust. In order to invoke IRC Sec. 663(c), the single trust must have more than one beneficiary and the beneficiaries must have substantially separate and independent shares. Separate share allocation cannot be used to get more than one deduction for the personal exemption or to split the undistributed income of the trust into several shares to be taxed at lower bracket rates. In many instances, a single trust with multiple beneficiaries is treated as though a separate trust or account is maintained for each beneficiary. Often the trust document will state that separate accounts or shares are to be maintained for each beneficiary. IRC Sec. 663(c) provides that the trust will be treated as though separate trusts were created to determine DNI.

The separate share rule is not elective and, if the rule applies, it must be used. Separate share treatment will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. The separate share rule prevents one beneficiary from being required to report DNI properly reportable by another. The separate share rule now applies to estates as a result of the '97 Act.

Separate Share Problem

The Mary Martin estate provides that two thirds of the residue goes to her son and one third to her step daughter. Separate shares have been established by the provisions in the will. In 2001 her step daughter starts a business and the executor makes an advance principal distribution of $100,000. No distribution was made to her son. In 2001, the trust earns taxable interest of $30,000 and dividends of $100,000. The trust pays trustee fees of $7,000 and accounting fees of $3,000, both allocated to income. There is no undistributed income from prior years.

Economics

See "Actual"

Terms of Instrument	Issues/Assumptions	Distributions	
Trustee disc. Income/Principal	1) Estate/$600 PE	Son	
to Beneficiaries	2) State Law Rules	Step Daughter	$100,000.00
Separate share rules apply			

(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
					TTI		SEC.		FORM 1041
ITEM	ACTUAL	ADJ	FAI	ADJ	B/F DD	ADJ	643 DNI	ADJ	TTI
Income:									
Interest	30,000		30,000		30,000		30,000		30,000
Dividends	100,000		100,000		100,000		100,000		100,000
Subtotal:	**130,000**		**130,000**		**130,000**		**130,000**		**130,000**
Deductions:									
Acct.	(7,000)		(7,000)		(7,000)		(7,000)		(7,000)
T/ee Fees	\								
Income	(3,000)		(3,000)		(3,000)		(3,000)		(3,000)
Principal									
Dist. Ded								(40,000)	(40,000)
PE								(600)	(600)
Subtotal:	**(10,000)**		**(10,000)**		**(10,000)**		**(10,000)**		**(50,600)**
Net:	**120,000**		**120,000**		**120,000**		**120,000**		**79,400**

TAX SPREADSHEET

I. FAI

Interest	30,000
Dividends	100,000
Gross FAI:	130,000
Accounting Fees	(7,000)
Trustee Fees	(3,000)
	(10,000)
FAI:	**120,000**

II. Trust Taxable Income Before the Distribution Deduction

Income	
Interest	30,000
Dividends	100,000
Gross Trust Taxable Income	130,000
Deductions	
Accounting Fees	(7,000)
T/ee Fees	(3,000)
	(10,000)
TTI b/f DD:	**120,000**

III. Sec. 643 DNI

TTI b/f DD	120,000
Add:	
Net Tax-Exempt	-0-
Sec. 643 DNI:	**120,000**

IV. DDNI

Sec. 643 DNI **120,000**

	Taxable	**Tax-Exempt**
a)	120,000	-0-

Actual Distribution

Tier 1	0
Tier 2	40,000
Total Dist:	**40,000**

	Taxable	**Tax-Exempt**
b)	40,000	-0-

DDNI = Lesser of a) or b): 40,000

V. Form 1041 - Trust Taxable Income

TTI b/f DD	120,000
DDNI	(40,000)
Personal Exemption	(600)
TTI:	**79,400**

VI. Allocation to Categories of Income

Item	Interest	Dividends	Tax-Ex Interest	Capital Gain	Total
Gross	30,000	100,000	-0-	-0-	130,000
Acct. Fee	(7,000)				(7,000)
Trustee Fees	(3,000)				(3,000)
Personal Ex				(600)	(600)
	(10,000)	(-0-)	(-0-)	(600)	(10,600)
Net:	**20,000**	**100,000**	**-0-**	**(600)**	**119,400**

Son's 2/3 Separate Share		Daughter's 1/3 Separate Share	
643 DNI 80,000		**643 DNI** 40,000	
Taxable 80,000	**Tax Exempt** -0-	**Taxable** 40,000	**Tax Exempt** -0-
Actual -0-		**Actual** 100,000	
Taxable -0-	**Tax Exempt** -0-	**Taxable** 100,000	**Tax Exempt** -0-

Taxable to A: $0
Taxable to Trust: $80,000

Taxable to B: 40,000

Separate Share Allocation to Beneficiaries

Item	Son	Step Daughter	Total
DNI	80,000	40,000	120,000
Dist.	-0-	40,000	40,000
Total:	80,000	-0-	80,000