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Basic Fiduciary Income Tax Concerns

Fiduciary income tax rules apply to trusts and estates. Planners need to be familiar with these basic income tax concepts in order to take them into account in planning. The following discussion will focus on basics; there is a great deal of complexity which will not be covered. Also, we will not discuss planning for basis increases.

1. Trust Classification. Trusts and estates may be classified in several ways for purposes of income taxation.

a. Grantor Trusts. Grantor trusts are treated for tax purposes as in substance owned by the grantor of the trust (or sometimes by other persons) based on holding certain powers over income. IRC §§ 671-679. A typical revocable estate planning trust is a grantor trust. However, an irrevocable trust may be a grantor trust if the grantor retains, as trustee or otherwise, the proscribed powers. The result may be that transactions between the trust and the grantor are ignored (*e.g.* sales by the grantor to that grantor's grantor trust may be used to freeze values for estate tax purposes). The grantor pays tax on the income of the grantor trust, even if the income benefits others (*e.g.* this could enhance gifts for the benefit of children).

b. Simple Trust. If not a grantor trust, the trust could be either a simple or complex trust. This classification can change year by year. A simple trust is a trust which is required to annually distribute trust accounting income to income beneficiaries. No principal distributions are made and no charitable contributions are made. The beneficiaries pay tax on the trust's distributable net income (DNI, which is discussed below), whether or not distributed.

c. Complex Trusts and Estates. Complex trusts, in contrast, may distribute or accumulate income, may make discretionary or mandatory distributions of principal, may contribute to charity (or, if an estate, permanently set aside for charity). An estate is treated like a complex trust. The beneficiaries are taxed on the distributions they receive of DNI. The trust (or estate) is taxed on any DNI it does not distribute. The income taxed to the trust itself will likely be taxed at relatively high rates because trusts reach the top tax brackets (37% on ordinary income) at $12,500 (in 2018, indexed) compared to $600,000 for a joint return of a married couple or $500,000 for a single taxpayer (indexed).

d. Estates. An estate is created by death. As noted above it is treated for basic tax purposes as a complex trust. Assets passing outside the probate estate would generally not be included in the estate (*e.g.* trusts, beneficiary designations, joint tenancies). A revocable trust, with an election, may be treated for two years as if it is part of an estate (*e.g.* a revocable trust at the death of the grantor) in order to obtain certain benefits available for estates but not trusts. IRC § 645. Some such benefits include the charitable set aside, use of a fiscal year during estate administration, a single tax return, delay in the need to make estimated tax payments. The decedent and the decedent's estate are separate tax payers, thus deductions unused on the decedent's final return normally die with the decedent. *Estate of Russell v. Com'r*, 34 BTA 715; Rev. Rul. 74-175. However, some deductions or credit in respect of a decedent may survive for later use by the estate or a successor. IRC § 691(b) limits such deductions or credit to business expenses, interest, taxes, expenses for the production of income, depletion, and a foreign tax credit. Items left out of the list which die with the decedent include, among others, net operating losses, charitable carryovers, and alimony arrearages. However, an estate tax deduction could be possible for some items that would otherwise be lost, and if the item qualifies separately for a deduction by the estate, that income tax deduction could be possible.

2. Income. Income (and associated allowable expenses) can also be classified in several ways.

   a. Accounting Income. Fiduciary accounting income is determined under state law and the governing instrument. The Utah Uniform Principal and Income Act is UCA §§ 22-3-101 *et seq*. The purpose of this classification is to determine what amounts are to be distributed to trust or estate income beneficiaries.

      i. Included. It generally includes dividends, interest, rents, royalties, and tax exempt income and associated expenses (such as 50% of professional fees for legal, investment advice, and accounting, rental expenses, property taxes, ordinary repairs, business expenses, and income taxes on accounting income). See UCA §§ 22-3-501 and 502. Actual distributions (rather than K-1 income shares) received from S-corporations and partnership taxed organizations are included. Required minimum distributions (RMD) from IRAs or qualified plans generally are included at 10% of the distribution. See UCA § 22-3-409(3). If not RMD, the internal income of the IRA is treated as income, but if not determinable, 4% of the fund's value is income. UCA § 22-3-409(7).

      ii. Not Included. It generally does not include principal items such as long term or short term capital gains, IRA values at death, 90% (generally) of IRA or qualified plan required minimum distributions, taxable dividends paid in stock, liquidation or redemption proceeds, or expenses allocable to principal (such as for sales and fix-up costs, capital improvements and extraordinary repairs, the other 50% of professional fees, business or casualty losses, depreciation, taxes on capital gain, and transfer taxes).

b. Distributable Net Income. Distributable net income ("DNI") includes income preliminarily treated as taxable, including income in respect of a decedent (IRD), together with tax exempt income, but generally not capital gains.

   i. Capital Gains. Capital gain may be included in DNI in some cases, however, and these gains become taxable to the beneficiary rather than the trust itself, if:

      1. The trust instrument allows distributions of trust principal, which can be under an ascertainable standard (*e.g.* health, support, maintenance, and education), at trustee discretion, or otherwise under the instrument; and

      2. The instrument or law either allocates capital gain to fiduciary income, or the instrument gives the fiduciary discretion to so allocate capital gain and it is done in a reasonable, impartial, and consistent manner not prohibited by law (Reg. § 1.643(a)-(3)); and

      3. One of three methods apply: (1) The fiduciary may invest for total return with a discretionary power to adjust and allocate capital gains to income; (2) capital gains, from the beginning of when principal is distributed, have been consistently allocated as income on the books, or (3) capital gains were actually distributed to beneficiaries or used by the fiduciary in determining the amount to be distributed (*e.g.* tracing capital gain) – but under this method (3), there is no netting of capital loss against capital gain in allocating gain to DNI. See the Utah Unitrust Act, UCA § 22-7-101 *et seq.* allowing for trustees to convert to a unitrust with a 3% to 5% unitrust amount in some cases.

      4. Allocating capital gain to DNI helps push that income to the beneficiaries at their likely lower tax rates. If this can't be done, the trustee could, if allowed under the trust instrument, distribute the capital asset in kind (but not to satisfy a pecuniary bequest or to satisfy an obligation to distribute income) and let the beneficiary take a carry-over basis and sell the property and directly recognize the gain at the beneficiary's tax rate.

      5. IRC § 643(e)(3) provides for an election to recognize gain on in kind distribution; if made it applies to all distributions during the tax year. The estate or trust may do this to use up losses or take advantage of deductions. This would affect the beneficiary's basis, the taxability of various beneficiaries, the timing of gain and whether the tax is at ordinary rates or capital gain rates; some beneficiaries may be hurt and some may be helped. If there is a loss, the loss will be lost to the estate or trust due to the related

party rules of IRC § 267(b)(6) and (13) in any event whether or not the election is made; a sale to a third party would be better. Without the election, generally no gain is taxable to the estate, the beneficiary takes a carryover basis, and gain later recognized by the beneficiary on a sale will likely be taxed at capital gain rates. The distribution deduction for the trust or estate will be the lesser of basis or fair market value of the property, if the election is not made; if the election is made the distribution deduction is market value.

ii. Allocations. To the extent an expense is directly attributable to a class of income, it is allocated to that class. Indirect expenses or direct expenses exceeding the class of income to which they are allocable may be allocated by the trustee in its discretion to types of income included in accounting income. Reg. § 1.652(b)-3. Allocations of such deductions to income taxed at ordinary rates, rather than to qualifying dividends taxed at long-term capital gain rates, makes good sense. Allocations are, however, required to be made prorata to tax exempt income (without capital gain in the denominator where such gains are principal; Rev. Rul. 77-355, 1977-2 C.B. 82), and charitable deductions must be allocated proportionately to the various classes of income.

iii. Principal Allocations. Allocations of deductions to principal provide an indirect benefit to the income beneficiaries. They reduce the beneficiaries' taxable distributable net income (and the trust's deduction for it) without reducing the amount of a distribution which is measured by accounting income.

iv. Depreciation. Depreciation generally is chargeable to principal for determining fiduciary accounting income. The tax deduction for depreciation is allocated between the trust and the income beneficiaries first to any depreciation reserve established by the trustee, then in accordance with the allocation of trust accounting income under the instrument (and state law). IRC §§ 167(d) and 611(b)(3). The remainder beneficiaries thus do not under this rule benefit from the deduction unless the trustee has established a reserve, which in effect, moves income cash to principal cash. See UCA § 22-3-503. This rule, however, allows the deduction to be used where it otherwise may well be lost. To the extent income stays with the trust, it uses the deduction, to the extent income is distributed, the beneficiaries use it. The beneficiaries may use the deduction even if it is greater than the income derived from the property. Rev. Rul. 74-530, 1974-2 C.B. 188.

v. Partnership Depreciation. Depreciation from partnerships is similarly allocated between the trust and the income beneficiaries. However, partnership K-1 income is not tax accounting income; only actual cash distributions are fiduciary accounting income. This can result in phantom income to the trust or estate. For example: If a trust which is a partner in a partnership receives a K-1 from the partnership showing that the trust has $100,000 of gross income and an $80,000 depreciation deduction, and the partnership makes a $10,000 distribution to the trust which in turn distributes all $10,000 to the beneficiaries, the trust will have taxable income of $90,000 ($100,000 - $10,000 distribution) while the beneficiaries will have a $70,000 loss ($80,000 of depreciation - $10,000 of accounting income). The trustee will want to consider selling or distributing the partnership interest, asking the partnership to sell the depreciating asset, asking the partnership to distribute more cash to make a larger DNI deduction, or creating a depreciation reserve. Section 179 expensing deductions are not available to trusts or estates, including through partnerships. The trustee may want to ask the partnerships to depreciate the asset instead.

vi. Trapping Distributions. A distribution from the estate (or a trust) to a simple trust of distributable net income (usually along with a distribution of assets) is a distribution of income from the distributing estate, but for state law trust accounting is treated as the receipt of principal not distributable as income to the recipient simple trust's income beneficiaries. The trust ends up paying the tax on the distributable net income it received. With the trust rates reaching the highest marginal rates as quickly as they do now, this is seldom a good idea anymore, so it may be well in many cases to avoid trapping distributions.

vii. Income in Respect of a Decedent. Income in respect of a decedent (IRD) is included in DNI. IRD includes taxable items not previously taxed, such as IRAs and qualified plans, government savings bonds, and employee stock options. However, if these IRD items are donated in-kind to charity, the estate or trust may avoid the income associated with them. See Rev. Rul. 80-118, 1980-1 C.B. 254. Where the beneficiary of an IRA is a trust, the IRA can be transferred to a charity without triggering income to the trust, if allowable under the trust instrument. The transfer by the trust of the IRA in kind as an IRA account to the charity will not cause the trust to be treated as having made a taxable transfer of the IRA because, for purposes of IRC § 691(a)(2), a transfer of IRD (such as a traditional IRA which is always classified as IRD) is only considered to occur in the event of a "sale, exchange, or other disposition," but this expressly does not include a transmission at death to a person pursuant to the right of such person to receive such IRD by reason of the death of the decedent. IRC § 691(a)(2) (last sentence). Reg. § 1.691(a)-4(b). See Ltr. Rul. 200702007 (trust named as beneficiary of an IRA). Where the dispositive instrument does not make a specific bequest of the IRD asset (e.g., an IRA) to the charity, the trust does not recognize income on the transfer where pursuant to state law or the instrument the fiduciary has the power to make a non-pro rata distribution of property in kind to the residuary beneficiaries. See Ltr. Ruls. 200452004, 200633009, and 201330011.

c. Taxable Income. Taxable income of the trust is the amount of income on which the trust or estate pays the tax. The trust or estate gets a deduction for the DNI distributed to beneficiaries; undistributed income is taxed to the trust itself. Thus, the taxable income of the trust is typically accounting income, less deductions allocable to principal, less the DNI distribution deduction, plus capital gain, less the appropriate annual exemption.

d. Chart. The following chart may help in keeping track of how these categories relate.

Item	**Accounting Income**	**DNI**	**Fiduciary Taxable Income**
Corp. dividends	In	In	In
Interest	In	In	In
Tax-exempt Interest	In	In (less allocable expenses)	Out
Capital Gain	Out (generally corpus)	Out (with exceptions)	In
Income in Respect of Decedent (e.g., IRA)	10% In (generally) if RMD; If not RMD, internal income or if not determinable, 4% of value In	100% In	100% In
Partnership K-1 S-Corp K-1	N/A	In	In
Partnership Distribution	In	N/A	N/A
Fiduciary Fees and Cost Deduction	50% (other 50% to corpus)	100% less allocation to tax-exempt income	100% less allocation to tax-exempt income
Depreciation Deduction	Out (generally corpus)	In (usually)	In (to extent of any reserve), or else Out

3. Taxes. The types of taxes and rates applicable to the income of or derived from estates or trusts also come in several types.

a. Ordinary Income. The ordinary income of an estate or trust is taxed in very compressed tax brackets. For 2018 the brackets begin at 15% on income of $2,550 for trusts and estates (compared to 10% at $19,050 for married individuals filing jointly) and quickly reach the top brackets (37%) at $12,501. Individual beneficiaries who receive distributions are taxed more gently under broader tax brackets. The top bracket for individuals who are married filing jointly is not reached until $600,000 (2018), and for single individuals $500,000 (2018).

b. Capital Gains. Trusts and estates are taxed on long-term capital gains and qualified dividends at rates commencing at 15% at $2,601 but becoming 20% at the $12,701 and above (2018). For individuals, the capital gains tax rate for married taxpayers filing jointly (2018) would be 15% commencing at $77,201 and 20% commencing at $479,001. Again, the highest rate is reached sooner for trusts and estates.

c. Net Investment Income Tax. In addition to the tax on ordinary income and the tax on capital gains, there is a 3.8% tax on the lesser of undistributed net investment income, or adjusted gross income over the start of the highest tax bracket ($12,500 for 2018). IRC § 1411. This means the top tax rate can be 37% + 3.8% = 40.8% on income taxed at ordinary rates, and 20% + 3.8% = 23.8% on income taxed at long-term capital gain rates. (Compared to this, the threshold for the NII tax for married filing jointly is $250,000 and for single taxpayers is $200,000 (2018).) For the NII to be distributed out of the trust, it must first be included in DNI. NII includes investment income less deductions attributable to the NII. It includes interest, dividends, annuities, royalties, rents, passive activities in a trade or business, and the investment of working capital in an active trade or business. It does not include, in the trust and estate context, income in the ordinary course of an active trade or business (other than investing working capital), items excluded from taxable income (*e.g.*, state and local bond interest) or IRA or qualified plan distributions. Further exclusions apply to individuals (*e.g.* earnings from self-employment).

i. If a trust or estate holds a trade or business, how does the trust or estate actively participate in it (and thus reduce NII) under IRC § 469? The Service says the fiduciary must materially participate in the role of fiduciary and not as an employee of the business, but the courts may be more flexible. For example, courts have been willing to accept participation by a person hired by the fiduciary as counting toward material participation and have allowed the trustee to qualify as a real estate professional to meet the real estate professional exception to the passive activity rule (for rental activities) based on individual trustees working as employees of the real estate business owned by the trust. *Aragona Trust v. Com'r,* 142 TC 165 (2014); *Mattie K. Carter Trust v. U.S.*, 256 F. Supp. 2d 536 (N.D. Tx. 2003).

ii. A distribution of NII to beneficiaries reduces the NII of the estate or trust, but the distribution deduction is limited to the lesser of the income distribution deduction or the NII. Thus, it is possible, particularly in the final year, to have taxable NII even if all income is distributed. Reg. § 1.1411-3(e)(2).

iii. Where a distribution is made up of both NII and excludable income, the NII must be allocated in a manner similar to the general method of allocation between gross income and excluded income. *See* Reg. § 1.661(b)-1.

iv. If a trust is an electing small business trust (ESBT) holding S-corporation stock, the trust is treated as a single trust for NII purposes, but the NII is calculated in two separate stages, the S-portion and the non-S-portion, and then these two amounts are combined. Reg. § 1.1411-3(c)(1) and (c)(2). The adjusted gross income (AGI) of the non-S-portion is increased or decreased by the S-portion's net income or loss, treated as a single item of ordinary income or loss. Reg. § 1.1411-3(c)(2)(ii).

d. Alternative Minimum Tax. The Alternative Minimum Tax (AMT) is designed to require some tax be paid where there are tax preferences in the regular tax calculation. It is only payable if it exceeds the regular tax. It requires a recalculation of tax without a number of tax preferences. IRC § 55.

i. The fiduciary AMT exclusions (in 2017) was $24,100 less 25% of the Alternative Minimum Taxable Income (AMTI) exceeding $80,450. Thus, for 2017, the exemption phases out and there will be no exemption left at AMTI of $176,850. The new tax act effective from 2018 through 2025 did not increase the exemption amount for 2018 but did change the method for indexing it, and the new amount for 2018 is $24,600 less 25% of AMTI exceeding $81, 900; thus the exemption phases out altogether by AMTI of $180,300.

ii. Compare this to married people filing a joint return as where the exemption is $109,400 and the phase out of the exemption starts at $1,000,000 (in 2018). Again, trust income is at a disadvantage compared to individuals.

iii. In calculating AMT, the trust's DNI is recalculated under the AMT regime. Higher AMT DNI could result in more taxable income to the beneficiary (but not in excess of actual distributions).

iv. The tax is 26% of the taxable excess up to $191,500 and 28% over that (2018). It is annualized for short years (unlike regular tax).

v. There is a refundable credit, the AMT credit (IRC § 53) designed to allow the carry forward and use of unused AMT credits from earlier years arising from deferral adjustments (rather than exclusion preferences). The credit is used in carry-forward years when regular tax exceeds the AMT. If the difference in the trust's AMT DNI from its regular DNI arises from exclusion preferences (typically including state income tax paid on capital gains and tax exempt interest), the item is separately identified in the K-1 because exclusion preferences are not eligible for the credit. The credit expires on trust or estate termination.

4. DNI Distributions. As we have seen, DNI is the tool used to distinguish the amount of deduction the trust or estate receives for passing taxable income to beneficiaries. There is no deduction for DNI amounts arising from tax exempt income. To the extent a distribution exceeds DNI (and also in some other cases of special distributions we will come to) it is not taxable to the beneficiary, but is, essentially, a principal distribution. The character of the income distributed as DNI (ordinary, long term capital gain, exempt, etc.) is retained in the distribution and reported on the K-1 form the beneficiary receives.

a. Timing. Distributions from complex trusts or estates are evaluated and reported annually often as of the end of a year. However, because the accounting for all income to be distributed won't be ready on the last day, there is an election available to allow distributions made in the first 65 days of the next year (when there has been time for the accounting to be done) to be treated as if made on the last day of the prior year. IRC § 663(b).

b. Tier Rules. DNI distributions from complex trusts and estates are treated, with some exceptions, as being made in tiers in determining to which beneficiaries the DNI is allocated:

i. Tier One: all DNI goes first to those entitled to mandatory income distributions.

ii. Tier Two: beneficiaries receiving discretionary distributions receive the remaining DNI. All charitable contributions are allocated to this tier. Thus, only tier two beneficiaries benefit from the charitable deduction because taxable income for tier two beneficiaries is reduced by the charitable deductions as well as by the tier one distributions. *O'Bryan v. Com'r*, 75 TC 304 (1980).

c. Separate Shares. There is an exception to the tier rule for separate shares. It is not elective. It applies when each beneficiary has a substantially separate and independent share; in such event, each beneficiary is treated as the sole beneficiary of his or her own trust share, and DNI is separately computed as to each share. Trusts may create separate shares under the trust instrument. Estates, too, may have separate shares, such as the spousal elective share. If a revocable trust elects to be treated as part of the estate, it will be a separate estate share and may contain further separate shares.

d. Special Distributions. Some distributions do not carry any DNI with them. These are specific bequests of money, payable in no more than three installments, and specific bequests of particular property. Charitable bequests are not treated as distributions but as deductions under IRC § 642(c) (allocated to the second tier). Reg. § 1.663(a)-2. For Electing Small Business Trusts (ESBT) holding S-corporation stock, IRC § 170 will govern after 2017 because such a trust will use the charitable contribution rules applicable to individuals, including percentage limitations and carry forward provisions. Watch out for satisfying a pecuniary (money) bequest with some other asset. This is treated as a sale by the trust or estate and may trigger taxable income.

5. Deductions on Termination. Generally, trust and estate deductions reduce DNI, and once DNI has been reduced to zero, the deductions do not benefit the beneficiaries. Nevertheless, under IRC § 642(h)(1), prior to 2018 on the termination of a trust or estate an unused net operating loss carryover or a capital loss carryover of the trust or estate could be used by the beneficiaries. This continues to be true of capital loss carryovers under the new (2018) tax act since they are not itemized deductions. However, the unused deductions of the trust or estate over gross income, such as excess administrative expenses and net operating losses from the estate or trust (see Reg. § 1.642(h)-2(a)), are miscellaneous itemized deductions not excepted from the elimination of the deduction for miscellaneous itemized deductions under the new tax law (see IRC §§67(b) and 67(g)), and thus these deductions will no longer be usable by that trust or estate beneficiaries at termination of the trust or estate. On the other hand, deduction under IRC § 691(c) for estate taxes attributable to income in respect of a decedent can still be used by beneficiaries because it is not treated as a now disallowed miscellaneous itemized deduction (see IRC § 67(b)).

6. Excess Business Loss. The excess business loss limit after 2017 for taxpayers other than C-corporations appears to apply at the trust level and to be the lower $250,000 limit (trusts don't file joint returns). IRC § 461(l). Losses don't help beneficiares after DNI is reduced to zero and thus a trust can build up a NOL useable only against 80% of income. On trust termination the remianing NOL would otherwise (prior to 2018) contribute to a deduction for excess unused deductions on trust termination, but after 2017 will be disallowed as an itemize deduction. IRC §§ 67(b) and (g). Trusts that are partners or S-corp. shareholders have the limit applied to them because they are at the partner or shareholder level.

7. Some Planning Ideas. With the foregoing basic concepts in mind, some planning steps to consider, where appropriate under the instrument, include:

a. plan investments for capital gain or accounting income;

b. make the unitrust election under Utah's Unitrust Act;

c. distribute income to beneficiaries rather than accumulate it;

d. provide for grantor trust treatment to avoid adverse trust tax rates where income is accumulated;

e. make the IRC § 645 election to treat trust as part of an estate;

f. avoid passive NIIT by trying to have the fiduciary qualify for material participation under the passive activity rules;

g. give trustee discretion to include capital gain in DNI;

h. instruct fiduciary to apply taxable income (including IRD) to charitable gifts;

i. provide for in-kind distributions of IRD to charity;

j. distribute appreciated assets in kind in appropriate cases;

k. ask partnership for cash distributions to offset phantom income;

l. ask partnership to forego electing an IRC § 179 deduction in favor of depreciation;

m. make the 65 day distribution election;

n. avoid satisfying a pecuniary gift in kind;

o. avoid trapping distributions;

p. sell loss property to third parties rather than distribute them subject to the related party loss denial rules;

q. don’t let legal fees and other administrative expenses stack up at the termination of the trust when the deduction could be lost.