Income Taxation of Trusts and Estates

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How are trusts and estates taxed for income tax purposes?

A trust is created when you (the grantor) transfer property to a trustee for the benefit of a third person (the beneficiary). An estate is the assets and liabilities left by a person at death. Both a trust and an estate are separate, legal, taxpaying entities, just like any individual. Income earned by the trust or estate property (e.g., rents collected from real estate) is income earned by the trust or estate.

Who is liable for taxes on income earned by a trust depends on who receives or retains benefits from the trust (i.e., the trust entity, the beneficiaries, the grantor, or the powerholder). Who is liable for taxes on income received by an estate depends on how the income is classified (i.e., income earned by the decedent, income earned by the estate, income in respect of the decedent, or income distributed to beneficiaries).

In general, trusts and estates are taxed like individuals. General tax principles that apply to individuals also apply to trusts and estates. A trust or estate may earn tax−exempt income and may deduct certain expenses. Each is allowed a small exemption ($300 for a simple trust, $100 for a complex trust, $600 for an estate). However, neither is allowed a standard deduction. The tax brackets for income taxable to a trust or estate are much more compressed and can result in higher taxes than for individuals.

> **Technical Note:**
> Income tax returns for trusts and estates are known as fiduciary tax returns (Form 1041). That is because the fiduciary (the trustee or estate representative) is generally responsible for filing the return and paying any taxes owed. Trusts and estates may also be required to file a state income tax return. You should consult an attorney or accountant to determine the requirements for your state.

What are the general income tax rules for trusts?

Generally, income is taxable to trust entity or trust beneficiaries

Trust income retained by the trust is taxed to the trust, while distributed income is taxed to the beneficiary who receives it. Thus, trust income is taxable to the trust or to the beneficiary but not to both. This result is obtained though the use of the distributable net income (DNI) concept.

Except grantor−type trusts or charitable remainder trusts

There are two exceptions to the general rule. First, if the grantor has retained an interest in the trust (e.g., right of revocation) or if some other person is given a general power of appointment over the trust income or principal, trust income is taxable to the grantor or powerholder. These are known as grantor−type trusts−−an example is the revocable trust where all income is taxed to the grantor. Second, if the trust is a charitable remainder trust because the charity is tax exempt, retained trust income is generally not taxable to the trust, but any distributions are taxed to the beneficiaries.

> **Tip:** In computing tax liability, multiple trusts are treated as one trust and their incomes are aggregated if they have substantially the same grantors and/or beneficiaries.

What are the general income tax rules for estates?

How income is reported

- Income of the decedent: If a decedent was a cash method taxpayer, income received (actually or constructively) by the decedent prior to death is reported on the decedent's final 1040. If the decedent was an accrual taxpayer, income accrued prior to death is reported on the final 1040. For more information on a decedent's final 1040, see Filing a Final Income Tax Return .
- Income of the estate: Income earned by the decedent but not paid before death is reported on the income tax return of the recipient of the income. This income is called income in respect of the decedent (IRD). Examples of IRD include uncollected wages, accrued interest on bank accounts, and dividends declared but not collected. If the recipient of IRD is the decedent's estate, it is reported on Federal Form 1041 (the fiduciary tax return) by the estate representative. If the recipient is an estate beneficiary, it is deducted on Schedule B and reported to the beneficiary on Schedule K−1 for inclusion on the beneficiary's personal return. Other income (non−IRD) earned by estate property after death and retained by the estate is reported on the estate's tax return (Form 1041). Other income (non−IRD) earned by estate property after death and distributed by the estate to a beneficiary is deducted on Schedule B and reported to the beneficiary on Schedule K−1 for inclusion on the beneficiary's personal return.
- Income of the beneficiary: The beneficiary may receive income (or income−producing property) directly from the decedent at the time of death. The beneficiary must include this income on his or her individual tax return.

What deductions are allowed

Generally, the same deductions allowed for individuals are allowed for estates.

Some expenses for administering an estate can be deducted on either the estate tax return (Form 706) or the fiduciary return but not both. The personal representative may also elect to split an expense and deduct a portion on each return. The following deductions are allowed on Form 1041:

- Probate expenses, such as court costs, bonds, and professional fees
- Expenses for selling estate property
- Uninsured casualty losses

Tip: If administration expenses are deducted on Form 1041, be sure to attach two copies of a statement, signed by the estate's personal representative, listing those expenses and stating, "These expenses have not been claimed as deductions for federal estate tax purposes, and all rights to claim such deductions are waived." The waiver is irrevocable. It is required even if the estate is not required to file Form 706.

Tip: The rule against double taxation does not apply to expenses in respect of a decedent. Such expenses can be deducted on both the estate tax return and Form 1041. Similarly, claims against the estate for amounts owed by the decedent at the time of death (e.g., state property taxes) may be deducted on both returns.

What is trust income for income tax purposes?

Accounting income

Trusts are generally set up to pay income annually to a beneficiary (the income beneficiary), while preserving the principal for another (the remainder beneficiary). Income earned by the trust can be in the form of interest, dividends, ordinary income, or capital gain. The trust document can allocate which beneficiary is to receive which type of income.

Accounting income is used to determine the amount that is required to be distributed to the income beneficiary. Taxable income allocated to a beneficiary is determined by the income distribution deduction. Accounting income affects taxable income to the extent that it is a limitation in the calculation of the income distribution deduction .

Accounting income refers to trust income that is allocated to the income beneficiary and not to the remainder beneficiary. For example, a capital gain is generally added to the principal for the benefit of the remainder beneficiary. A trust's accounting income can be defined by the trust agreement, and if it is not, it is determined by state law.

Example(s): In Year 1, the Jones Family Trust earns $10,000 in taxable interest and realizes a $12,000 capital gain. The trust's accounting income is $10,000 (the taxable interest). The amount required to be distributed to the beneficiary is $10,000. The income distribution deduction to the trust is $10,000. The beneficiary's taxable income is $10,000. The $12,000 capital gain remains in the trust and is taxable to the trust.

Tax−exempt income/allocation of expenses

A trust may earn tax−exempt income, just as any individual taxpayer. Expenses directly related to the production of tax−exempt income cannot be deducted. By comparison, expenses directly related to the production of taxable income are fully deductible. All indirect expenses are allocated between taxable and tax−exempt income. This allocation is calculated as follows:

Gross tax−exempt income / gross accounting income = percentage of expenses not deductible against taxable income

> **Example(s):** In Year 1, the Jones Family Trust earns $10,000 in interest on municipal bonds, $5,000 in interest on CDs, and realizes a $12,000 capital gain. The trust's accounting income is $15,000 ($10,000 + $5,000). The trust's tax−exempt income is $10,000 (interest on municipal bonds). Thus, the percentage of indirect expenses not deductible is 67 percent ($10,000 divided by $15,000).

Gross income

For income tax purposes, gross income of a trust or estate is similar to that of an individual (i.e., ordinary income, capital gains, and business and rental income). This may include income that is to be distributed currently or held for payment of expenses or for future distributions, but the tax liability on the income may rest on either the beneficiary or the trust or estate.

Capital gain

Capital gain is taxed to the trust where the gain must be or is added to the principal. If the gain is actually distributed, it is taxed to the beneficiary.

> **Caution:** The gain on the sale of appreciated property transferred to a trust is taxed at the grantor's marginal tax rate if sold within two years of the transfer. Gain from the sale or exchange of depreciable property between related parties is treated as ordinary income.

- Losses: If losses exceed gains, all losses are allocated to the trust. Capital losses can be deducted against ordinary income (lesser of net loss or $3,000). Excess capital losses may be carried forward indefinitely. Unused capital loss carryovers can be passed through to the beneficiary at the termination of the trust.

  Caution: A trust may not deduct a loss from the sale or exchange of property between related taxpayers (e.g., trustee and grantor, trustee and beneficiary).

- Basis: Basis (for the purpose of gain or depreciation) of property acquired by a trust or estate from a decedent is its fair market value (FMV) at the date of death, unless the alternate valuation date was elected. Basis (for the purpose of gain or depreciation) of property acquired by a trust as a gift from the grantor is the grantor's adjusted basis plus gift taxes paid.

  Caution: Property acquired by a trust or estate from a person who dies in 2010 (when the estate tax is scheduled to be repealed) will receive a carryover basis and not a step−up in basis to FMV.

What deductions can a trust take?

Deductions allowed

Generally, deductions allowed to individuals are also allowed on fiduciary returns.

These include:

- State, local, and real property taxes
- Administrative expenses (e.g., trustee fees)
- Estate expenses
- Miscellaneous itemized deductions subject to 2 percent adjusted gross income (AGI) limitation

Deductions not allowed

- Depreciation and depletion: Depreciation and depletion expenses generally follow income unless there is a reserve. However, in the case of a trust, this expense must be apportioned between the trust and the beneficiary. This is done on the basis of accounting income allocated to each unless state law allows the trustee to maintain a reserve.

  Example(s): Edna Smith receives 50 percent of the accounting income from the John Smith Trust and the trust retains the other 50 percent. The property in the trust that generates the income depreciates $1,000 in Year 1. The John Smith trust is allowed to deduct $500 (50 percent of $1,000) on the fiduciary tax return, while Edna is allowed to deduct $500 (50 percent of $1,000) on her personal income tax return.

- Charitable deduction: Charitable contributions paid from current trust income are deductible only if the will or trust agreement authorizes such payments. Charitable contributions from trust principal are not deductible.

  Tip: The trust can elect to "push−back" part or all of a contribution made with current−year income to the immediately preceding tax year. This election must be made by the due date of the current year's tax return.

  Tip: A few trusts are allowed a "set−aside" deduction. That means that the deduction is allowed in the current year for amounts set aside for charity but actually paid in a later year.

What is the income distribution deduction?

Broadly speaking, a trust is allowed to deduct an amount equal to the amount distributed to the income beneficiary. This is referred to as the income distribution deduction. Specifically, a trust's income distribution deduction is the lesser of:

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- Distributions less tax−exempt income, or
- Distributable net income less tax−exempt income

Example(s): In Year 1, the Jones Family Trust earns $10,000 in interest on municipal bonds, $5,000 interest on CDs, and realizes a $12,000 capital gain. The trust's tax exempt income is $10,000 (interest on municipal bonds). Additionally, the trust distributed $15,000 to Fred. The trust's income distribution deduction is $5,000 ($15,000 − $10,000).

What is distributable net income (DNI)?

Distributable net income (DNI) is a calculation used to allocate income between a trust and its beneficiaries. DNI is used to restrict the amount of the deduction allowable to a trust for distributions to a beneficiary. Beneficiaries are taxed only to the extent of DNI. Distributions made in excess of DNI are treated as tax−free distributions of principal. Here is the DNI calculation:

- Total trust income (excluding tax−exempt income)
- Less deductible expenses
- Plus tax−exempt interest reduced by expenses not allowed in the computation of taxable income and the portion used to make charitable contributions
- Plus capital gains if:
    1. Gain is allocated to accounting income
    2. Gain allocated to principal is required to be distributed or is consistently and repeatedly distributed by the trustee
    3. Gain allocated to principal is paid or set aside for charity
- Less capital losses if they enter the calculation of any capital gain distributed or required to be distributed

In a simple trust, DNI is apportioned and taxed to the income beneficiaries. The trust pays taxes only on capital gains and other income remaining with the principal.

In a complex trust, DNI may exceed the income required to be distributed currently if, for example, capital gains are included in DNI. DNI is first apportioned dollar for dollar to the beneficiaries who receive the income required to be distributed currently. Remaining DNI is divided proportionately among beneficiaries receiving discretionary distributions or other payments.

Payments are considered made from DNI to the extent of DNI. IRS rules do not require or allow tracing of the actual source of payment. These rules are intended to prevent the trustee from manipulating distributions so that the beneficiaries in higher tax brackets receive nontaxable distributions of principal while beneficiaries in lower tax brackets receive distributions of taxable income. Beneficiaries who receive distributions of principal may be required to report some of the distribution as taxable income. Although this sounds like double taxation, it is really a shift of the tax on the capital gain from the trust to the beneficiaries.

Example(s): In Year 1, the Jones Family Trust earns $10,000 in interest on municipal bonds, $5,000 interest on CDs, and realizes a $12,000 capital gain. The trust's taxable income and DNI is $17,000 ($5,000 + $12,000). The trust's accounting income is $15,000 ($10,000 + $5,000). Additionally, the trust is required to distribute $5,000, plus 25 percent of the principal, to Fred annually, 25 percent of the principal to Jack, and 50 percent of the principal to Sid.

The trust distributes $8,000 to Fred, $3,000 to Jack, and $6,000 to Sid.

The first $5,000 of DNI is allocated to Fred, the income beneficiary. The remaining DNI is allocated to Jack and Sid according to their shares of the remaining distributions.

Fred $5,000 + (25 percent of $12,000) = $8,000 DNI

Jack (25 percent of $12,000) = $3,000 DNI

Sid: (50 percent of $12,000) = $6,000 DNI

Tip: Amounts required to be distributed are deductible in the current year regardless of whether they are actually distributed. Discretionary distributions, however, are generally deductible only in the year they are made. A trust may elect to treat amounts distributable in the first 65 days of the next tax year as though they were made in the current year (this is known as the 65−day rule). For more information, see Limits on Trusts .

What are simple and complex trusts and how are they taxed?

Simple trusts

A simple trust is one that (1) is required to distribute, and actually does distribute, all income in the year in which it is earned, (2) does not have a charitable beneficiary, and (3) does not distribute principal.

In a simple trust, DNI is apportioned and taxed to the income beneficiaries. The trust pays taxes only on capital gains and other income remaining with the principal.

Example(s): Alan makes an irrevocable transfer of cash, stocks, and bonds to the Alan B. Trust. The trust provides financial security for Alan's daughters, Phoebe and Mona, by giving them an income interest. All accounting income from interest and dividends are split equally and distributed to Alan's daughters. All capital gains are retained by the trust. At the end of 20 years, the trust will end and the principal will be distributed to the two daughters and Alan's four grandchildren under the terms of his will.

Complex trusts

A complex trust is one that is allowed to accumulate income, has a charitable beneficiary, or distributes principal. An estate is generally treated as a complex trust.

In a complex trust, DNI may exceed the income required to be distributed currently, if, for example, capital gains are included in DNI. DNI is first apportioned dollar for dollar to the beneficiaries who receive the income required to be distributed currently. Remaining DNI is divided proportionately among beneficiaries receiving discretionary distributions or other payments.

> **Example(s):** Mary sets up an irrevocable trust for her only son, Adam (age 20). Under the terms of the trust, the trust is to retain all income until the year Adam turns 25. In that year, the trustee is to distribute all current income plus $150,000 to Adam. The trust will continue to distribute all income to Adam until Mary dies, at which time the principal will be distributed to Adam.
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> **Tip:** A trust may be simple one year and complex the next. All trusts are complex in their final year because all principal must be distributed when the trust ends. A trust that is permitted but not required to distribute principal is complex in the years it actually does distribute but is simple in the years it does not. A trust that can either distribute or accumulate income is always a complex trust even in the years it does not actually make distributions.

What are grantor−type trusts and how are they taxed?

Grantor retained interest trust

If a grantor does not surrender control over a trust, it is considered a grantor trust. The grantor is considered the owner of the trust assets, and income from the trust is taxable to the grantor. If the grantor retains control of only part of the trust, the grantor is treated as the owner of only the assets controlled, and income from other assets is taxed to the trust or the beneficiaries.

Income taxable to the grantor is not reported on Form 1041. It is reported on the grantor's personal income tax return (Form 1040). The grantor is said to retain control if he or she:

- Derives benefits from the income: The grantor is treated as the owner of income to the extent that he or she receives a benefit (directly or indirectly) from the trust.
- Retains the power to revoke the trust: A revocable trust gives the grantor the power to end all or part of the trust. The grantor is treated as the owner of the trust to the extent of that power.
- Retains power over beneficial enjoyment: A grantor who retains the power to control which beneficiaries will receive income or principal is treated as the owner of the trust.
- Is able to exercise certain administrative powers over the trust's operation: If the grantor has the power to purchase principal for less than adequate consideration or to borrow funds without adequate security or interest, he or she could benefit from the trust. The grantor is considered the owner to the extent of that power.

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- Retains a reversionary interest in either the income or principal: If the terms of the trust provide that the trust "reverts back" to the grantor if the income or remainder beneficiary dies before the grantor, income will be taxable to the grantor unless the value of the reversionary interest on the date of transfer is not more than 5 percent of the trust.

  Tip: A trustee may elect to pay tax on a qualified preneed funeral trust that would otherwise be treated as a grantor trust. To qualify, a trust must arise from a contract with a professional funeral or burial service and its sole purpose must be to hold and invest funds for such services. Contributions may not exceed $8,000 (figure for 2004, up from $7,800 in 2003).

  Tip: At a grantor's death, a revocable trust may be treated as part of the estate for that tax year. This election must be made by both the trustee and the estate representative on or before the due date of the estate's first income tax return.

General power of appointment

A holder of a general power of appointment over a trust is treated as the owner of that portion of the trust over which he or she holds the power unless the grantor is treated as the owner under the grantor retained interest rules, or the powerholder disclaims the power within a reasonable time after becoming aware of the power's existence. For more information of general powers of appointment in general, see Powers of Appointment .

What are charitable remainder trusts and how are they taxed?

Generally, income earned by a charitable remainder trust is not subject to income tax, unless the trust has unrelated business income, but is taxable to any noncharitable beneficiaries upon distribution.

Special rules apply to income taxation of a charitable remainder annuity trust (CRAT) and charitable remainder unitrust (CRUT). If you are the income beneficiary of a CRAT or CRUT, you will owe income tax on any payments you receive. So, although a CRAT or CRUT escapes paying capital gains tax on the sale of an asset, this benefit does not trickle down to you−−you must pay income tax on any part of the income that is distributed to you.

The extent to which the payment is taxable depends on the character of the payment, which in turn is determined under a special income tax calculation formula unique to trusts.

The IRS uses a four−tier accounting procedure, also known as the ordering rules, to determine the tax character of the income distribution to the beneficiary. The acronym used to describe this accounting rule is WIFO, which stands for "worst in, first out." The amounts distributed by a trust are classified as follows:

- Ordinary income: Ordinary income earned by the trust in the current year, along with any undistributed ordinary income from prior years (ordinary income includes dividends and/or interest).
- Capital gain: Capital gain earned by the trust in the current year, along with any undistributed capital gain from prior years.

- Nontaxable income: Nontaxable income earned by the trust in the current year, along with any undistributed nontaxable income from prior years.
- Principal: The IRS imposes the highest taxes on ordinary income. If the required annual payment cannot be paid out of ordinary income, it is then paid from capital gains. If the payment still cannot be met after exhausting capital gains, it is paid from tax−exempt income and finally, if necessary, from the principal of the trust.

  Tip: The trustee must keep track of all sales made and gains realized by the trust to make these calculations−−a daunting task often completed by a computer tracking system.

Final Page - Disclaimer

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