

THE INCOME TAXATION OF ESTATES & TRUSTS

The income taxation of estates and trusts can be complex because, as with partnerships, estates and trusts are a hybrid entity for income tax purposes. Trusts and estates are treated as an entity for certain purposes, but as an aggregate of its beneficiaries for others. The basic consequence of the rules under IRC §§ 641 through 685 is to treat the trust or estate as a taxable entity but, in certain circumstances, to allow the pass-through of income and deductions to the beneficiaries, who report the income and deductions on their individual returns. As with partnerships, these fiduciary taxation rules generally attempt to assign the burdens of taxation in an equitable manner to those who receive a benefit from the trust or estate. To the extent income cannot either be offset by deductions or passed to beneficiaries, the entity will be taxed.

Because of the hybrid nature of trusts and estates, several unique tax concepts apply, such as Distributable Net Income (DNI), Fiduciary Accounting Income (FAI), and the distribution deduction. Also, a distinction may be drawn between gifts of principal to a beneficiary, through a trust or estate, and the income that is produced by that principal. In general, the computation of the entity's taxable income begins in the same manner as for an individual, with a few modifications, to obtain a "tentative" taxable income. The fiduciary taxation rules are then applied to determine the amount of the entity's taxable income that passes to the beneficiary. The basic result is that the entity's tentative taxable income is reduced by the least of DNI, FAI, or the distribution deduction. Any taxable income in excess of the least of these three items is taxed in the trust. It is generally beneficial to pass income to the beneficiary as the fiduciary tax rates are highly compressed, reaching the 35% bracket for 2003 at \$9,350 of taxable income. In addition, the personal exemption for trusts is either \$100 or \$300, and the exemption for estates is \$600, allowing for little ability to shelter income within the entity.

TAXABLE YEAR

The taxable year of a trust is the calendar year, in most cases. However, an election under § 645 is available to treat certain grantor trusts as part of an estate, whether or not a probate estate is opened. This election is discussed in more detail below. An estate may use a fiscal or calendar year, with the first taxable year beginning on the date following the date of death. The taxable year of an estate is adopted by the filing of a tax return for that year. This can allow for tax planning strategies, by adopting a fiscal year that allows the deferral of income taxation. The pass-through of income to the beneficiary occurs on the last day of the entity's taxable year, regardless of the timing of distributions. Thus, if an estate has a January 31, 2008 taxable year end, that income is reportable by the beneficiary on his/her 2008 return, to be filed by April 15, 2009. Even if the estate makes a distribution in November of 2007, the income is not reportable by the beneficiary on his/her 2007 return. This applies only to the extent income passes to the beneficiary; any income that is taxable to the trust or estate must be reported on the entity's timely filed return, which is due by the 15th day of the fourth month after the year end (following the same rules as for individuals).

SIMPLE TRUST OR COMPLEX TRUST/ESTATE

There is a distinction in applying the taxation rules to a simple trust versus a complex trust or estate. A simple trust is a trust that meets the following three requirements:

1. the terms of the trust must require that all of its FAI be distributed currently;
2. the terms of the trust must not provide for any amounts to be paid, permanently set aside, or used for the taxable year for charitable purposes; and
3. the trust must not actually distribute any amounts during the year other than the income required to be distributed currently.

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The corollary of these rules is that a trust will be a complex trust:

1. for a year in which income is required to be accumulated;
2. for a year in which the trustee has the discretion to accumulate or distribute income, even if all of the trust's income for that year is actually distributed;
3. for a year in which principal is distributed; and
4. for a year in which a charitable contribution is made.

A trust is required to distribute all of its income currently if the governing instrument or state law requires the trustee to distribute all of the income at least annually. A trust is classified as a simple trust if all income is required to be distributed currently, regardless of whether the trustee actually distributes the income currently. However, a trust will not qualify as a simple trust, even if all income is required to be distributed currently under the trust instrument, if the trust's definition of income fundamentally departs from local law. Under these rules, a trust may be a simple trust in one year and a complex trust in another year. For example, a trust that meets the above rules, but also is permitted to distribute principal, will be a simple trust in years in which only income is distributed and a complex trust in years in which principal is distributed.

The basic, and generally the most important of these distinctions, is that all of the net income (FAI) of a simple trust automatically passes to the beneficiaries (up to the amount of DNI), whether or not actually distributed. The practical result of this is that simple trusts normally will not incur an income tax. There are, however, two notable exceptions. The first involves items that are allocated to principal for FAI purposes, but which are subject to income tax. This may include such things as capital gains, ordinary gain from the recapture of depreciation, and distributions from an IRA or pension plan.

The second exception are items of "phantom income", such as the distributive share of a partnership or S corporation, to the extent the distributive share exceeds the amount actually distributed to the trust or estate. This treatment occurs because, although the distributive share is taxable to the estate, there is no fiduciary accounting income under state law because the trust/estate did not actually receive any income. The limitation on passing income to beneficiaries (the least of DNI, FAI, or distribution deduction) prevents pass-through to the beneficiary because FAI is not increased by the distributive share, and consequently is less than DNI and probably less than taxable income (unless deductions exceed income).

It should be noted that these are merely stated as two exceptions to the normal rule that the net income of a simple trust passes to its beneficiaries. Both of these items also apply to complex trusts and estates. In addition, the issue of phantom income in a complex trust or estate has another factor – the distribution deduction. Even if a partnership makes a distribution to an estate, that income will be trapped in the estate unless a corresponding distribution is made to the beneficiary of the estate. Similarly, even if a distribution is made to the estate's beneficiary, the phantom income is trapped in the estate unless the partnership makes a corresponding distribution to the estate, within the same taxable year of the estate in which the phantom income is reportable.

DISTRIBUTABLE NET INCOME (DNI)

In general, DNI is the income earned by an estate or trust, whether taxable or tax-exempt and net of deductions, which may be distributed to the beneficiaries. DNI is both a quantitative measure of the income that can be passed to the beneficiaries and a qualitative measure of the character of that income. It is based on a tentative taxable income, with several modifications under § 643(a), as follows:

1. No distribution deduction is allowed;
2. No personal exemption for the entity is allowed;

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3. Capital gains are not be included, unless certain conditions are met;
4. Capital losses are allowed only to the extent they reduce the amount of capital gains actually paid or credited to beneficiaries;
5. The partial exclusion of capital gain on certain small business stock under '1202 is not allowed;
6. For simple trusts, extraordinary dividends or taxable stock dividends are not included, unless allocated to FAI;
7. Tax-exempt interest is included, net of the deductions attributable to such interest; and
8. The deduction for estate taxes attributable to IRD may not be allowable.

The distribution deduction is not allowed because it is a separate limitation on the determination of who reports the income. The personal exemption is not allowed because it is an attribute of the entity. DNI is a determination of the income that may pass to the beneficiaries, who offset that income with their own personal exemption.

CAPITAL GAINS

The general rule under § 643(a)(3) is that capital gains are not included in DNI, which has the effect of “trapping” capital gains in the trust, which is then subject to tax on those gains. However, capital gains are included in DNI and may be passed to the beneficiary, when the gains are:

1. allocated to FAI; or
2. allocated to principal and “paid, credited, or required to be distributed to any beneficiary during the year”; or
3. allocated to principal and “paid, permanently set aside, or to be used for [charitable] purposes specified in § 642(c)”.

An allocation of capital gains to income will be respected if it is made: 1) pursuant to the terms of the governing instrument and applicable local law; or 2) pursuant to a reasonable and consistent exercise of a discretionary power granted to the fiduciary by local law, or by the governing instrument if not inconsistent with local law. The general rules for capital gain is that it is excluded from DNI to the extent the gain is allocated to principal for FAI purposes. However, capital gains that are allocated to principal for FAI purposes are included in DNI if they are either paid, credited, or required to be distributed, to a beneficiary during the year, or paid, permanently set aside, or to be used for a charitable purpose. In some situations it is easy to determine that capital gains are paid to a beneficiary. For example, if a Will directs the sale of a particular asset, with the proceeds to be distributed to a specific beneficiary, then the capital gain recognized on the sale of that asset is properly treated as being paid to the beneficiary and is includible in DNI. However, the IRS has taken the position that circumstances in which recognized capital gain is used to determine the amount that is to be distributed to a beneficiary during the year are uncommon.

Capital gains that are allocated to principal and which are actually distributed to a beneficiary may be included in DNI if the trustee allocates the capital gain to the beneficiary pursuant to the governing instrument or state law. The IRS has ruled that this occurs only when there is an actual distribution of capital gains as required by the terms of the governing instrument upon the happening of a specific event. In general, this requires the executor or trustee to both be required to allocate the gain to the beneficiary (and to do so) and also to actually distribute that gain to the beneficiary. A fiduciary may also establish a practice of allocating gains to principal and distribute those gains to the beneficiary, even if not required to do so.

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In addition, capital gain will be treated as part of a distribution to a beneficiary, if the trustee allocates the gain to the distribution pursuant to a discretionary power granted by local law or by the governing instrument (if not inconsistent with local law) to make the allocation, but only if the power to allocate is exercised in a reasonable and consistent manner, and is entered on the trust's books, records, and tax returns.

The third exception is for capital gains that are allocated to principal and which are paid, permanently set aside, or to be used for one or more of the charitable purposes specified in § 642(c). In general, this permits a charitable deduction for the amount of capital gains, even if allocated to principal, if they are either distributed to a charity for which a charitable contribution deduction is allowed under § 170(c) or irrevocably set aside for a such a purpose.

Capital gains are always allocated to DNI in the year in which the trust or estate terminates.

TAX-EXEMPT INTEREST

Tax-exempt interest is included in DNI for a reason similar to why it is included in computing the increases to a partner's basis: to preserve the non-taxable character of the income in the hands of the beneficiary. However, in order to avoid the improper deduction of expenses attributable to tax-exempt interest against regular income, special rules govern how expenses are allocated against the entity's income when it has tax-exempt interest. In general, the expenses directly related to the tax-exempt interest (such as interest on a loan used to purchase municipal bonds) and a proportionate share of indirect expenses (such as trustee's fees) are allocated to the tax-exempt interest. Those allocated expenses are then disallowed as a deduction by § 265. In consequence, only the net amount of tax-exempt interest, after reduction by the allocated expenses, is included in DNI. The taxable income is therefore higher than it would be without the applying the allocation rules.

Once the amount of DNI is determined, the amount of FAI can be determined, which is the second limitation on the determination of the taxable income that passes to the beneficiary.

FIDUCIARY ACCOUNTING INCOME (FAI)

Unlike DNI, which is a federal tax concept, FAI is a state law concept. FAI is the income of the trust as determined for accounting purposes and affects the allocation of amounts received between income beneficiaries and principal (or residual) beneficiaries. This will be governed, in Nebraska, by the Uniform Principal and Income Act. Regulations have been issued to adapt the application of FAI for federal purposes to the Uniform Principal and Income Act, which has been enacted by several states and is under consideration in others. The preamble to these regulations discusses the regulations, in part, as follows:

Income under section 643(b) is the amount of income determined under the terms of the governing instrument and applicable local law. This concept of income is used as the measure of the amount that must be distributed from a trust in order for the trust to qualify for certain treatment under various provisions of the Internal Revenue Code. Trusts classified as simple trusts, pooled income funds, net income charitable remainder unitrusts, and qualified subchapter S trusts (QSSTs) are required to make distributions measured at least in part by the amount of trust accounting income. A similar concept applies to trusts that qualify for the gift and estate tax marital deductions. Because section 643(b) requires a determination of trust accounting income, it is not possible to ignore any distinctions between trust accounting income and principal as suggested by a commentator.

A trust instrument may provide for any amount to be distributed to beneficiaries currently. Trust provisions that measure the amount of the distribution by reference to income but define income differently from the state statutory definition of income generally will be

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recognized for state law purposes. However, Internal Revenue Code provisions that require the current distribution of income to qualify the trust for certain federal tax treatment are based on the assumption that the income beneficiary will receive what is traditionally considered to be income. In some situations, such as with QSSTs and marital deduction trusts for spouses who are U.S. citizens, the income beneficiary is permitted to also receive principal distributions as long as all the income is currently distributed. In other situations, as with pooled income funds and net income charitable remainder unitrusts, only the income may be distributed. In all these situations, the determination of income is critical. Thus, the definition of income under the terms of the governing instrument and applicable local law must not depart fundamentally from traditional concepts of income and principal, if the desired federal tax treatment is to be secured.

The IRS and the Treasury Department recognize that state statutes are in the process of changing traditional concepts of income and principal in response to investment strategies that seek total positive return on trust assets. These statutes are designed to ensure that, when a trust invests in assets that may generate little traditional income (including dividends, interest, and rents), the income and remainder beneficiaries are allocated reasonable amounts of the total return of the trust (including both traditional income and capital appreciation of trust assets) so that both classes of beneficiaries are treated impartially. Some statutes permit the trustee to pay to the person entitled to the income a unitrust amount based on a fixed percentage of the fair market value of the trust assets. Other statutes permit the trustee the discretion to make adjustments between income and principal to treat the beneficiaries impartially. Under the proposed regulations, a trust's definition of income in conformance with applicable state statutes will be respected for federal tax purposes when the state statutes provide for a reasonable apportionment of the total return of the trust.

Traditionally, items such as dividends, interest, and rents are allocated to income and the proceeds from the sale or exchange of trust assets are allocated to principal. An allocation to principal of items that are traditionally "income" normally will be respected for Federal tax purposes only if applicable state law has specifically authorized such an allocation in certain limited circumstances, such as when the allocation is necessary to ensure impartiality regarding a trust that invests for total return. Specifically, state statutes may permit adjustments when trust assets are invested under the state's prudent investor standard, the trust instrument refers to income in describing the amount that may or must be paid to a beneficiary, and the trustee, after applying the state statutory rules regarding the allocation of receipts and disbursements between income and principal, is unable to administer the trust impartially. Other actions may also constitute applicable state law, such as a decision by the highest court of the state announcing a general principle or rule of law that would apply to all trusts administered under the laws of that state. However, a court order that applies only to the trust before the court would not constitute applicable state law for this purpose (nor does a lower court order, such as the district court).

In general, the new regulations apply to estates and trusts with taxable years ending after January 2, 2004.

THE DISTRIBUTION DEDUCTION

As the name suggests, the basic purpose of the distribution deduction is to allow a deduction for the amounts of income distributed by a trust or estate to its beneficiaries. The distribution deduction in a simple trust is fairly basic, because all of the net income of a simple trust is deemed to be distributed, whether or not it is actually distributed. Therefore, a simple trust is generally entitled to a deduction for the amount of FAI it is required to distribute, subject to two limitations. First, the deduction is limited to DNI. Second, no deduction is allowed for net tax-exempt income. Therefore, if the trust has no net tax-

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exempt interest and FAI exceeds DNI, the trust's distribution deduction is limited to DNI. FAI may exceed DNI if deductions taken into account in computing DNI were properly charged against principal rather than income, such as a portion of a deductible trustee's fee charged against principal. As mentioned previously, the effect of capital gains and phantom income, along with certain other taxable income items may cause FAI to exceed DNI, potentially creating a tax liability for the simple trust.

An estate or a complex trust also is entitled to a distribution deduction for a taxable year, equal to all of its distributions for the year, but limited by the amount and character of DNI and subject to special rules for certain distributions made in kind. The computation of the distribution deduction for complex trusts and estates is similar to simple trusts, with several modifications. As stated previously, a trust is a complex trust for any year: 1) that the trust is not required to distribute all its income currently; 2) that amounts other than income are paid, credited, or required to be distributed; or 3) that has amounts which are paid, permanently set aside, or used for the purposes specified in § 642(c) [relating to charitable contributions]. In general, a complex trust (or estate) is allowed a distribution deduction for all amounts paid, credited, or required to be distributed, subject to the same two limitations that apply to simple trusts. However, a complex trust may have more than one class (or "tier") of beneficiaries. The existence of these tiers is a fundamental difference between the taxation of a simple trust and its beneficiaries and the taxation of a complex trust and its beneficiaries.

An estate or complex trust is allowed a deduction equal to the sum of:

1. any amount of income for the taxable year that is required to be distributed currently (including any amount required to be distributed that may be paid out of either income or corpus, to the extent it is actually paid out of income); and
2. any other amounts properly paid, credited, or required to be distributed for the year.

The first provision above defines the first tier, which is the distributions of income that are required to be distributed currently and annuity payments required to be paid from income or principal, to the extent income is available to pay these amounts. First-tier distributions qualify for the distribution deduction to the extent of taxable DNI.

First-tier beneficiaries are the beneficiaries, if any, that the trust instrument or local law requires income to be distributed to currently. However, they are first-tier beneficiaries only to the extent of such required distribution of income. For example, a trust that is required to distribute a stated dollar amount out of income or principal are first-tier beneficiaries to the extent the amount was paid out of income, but are second-tier beneficiaries as to the balance of the distribution. All remaining beneficiaries are in the second tier, which includes beneficiaries receiving discretionary distributions of income. As estates are seldom required to distribute income currently, under either local law or the Will, the beneficiaries of an estate will normally be in the second tier. However, under state law, a surviving spouse or dependent of the decedent may be entitled to receive an allowance for support during the administration of an estate, such as the homestead and family allowances. Such an allowance can qualify as a first-tier distribution if it is required to be paid out of income. Further, if the allowance is required to be paid out of either income or principal, it will be treated as a first-tier distribution to the extent the estate's FAI was not paid, credited, or required to be distributed to any other beneficiaries. In all other cases, the allowance qualifies as another amount properly paid, credited, or required to be distributed (a second-tier distribution).

Second-tier distributions, which are the second provision above, are all amounts of income that do not meet the definition of a first-tier distribution. Second-tier distributions include discretionary distributions of income or principal, as well as mandatory distributions of principal (such as annuity payments required to be made out of principal). Payments from a trust to the trust's beneficiary of IRA distributions that the trust itself, as beneficiary of the IRA, receives after the IRA owner's death are

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second-tier distributions, as is a deemed distribution to a beneficiary caused by an estate or trust election to treat a payment of estimated tax as made by the beneficiary. Distributions out of principal for the support of a person that the grantor or certain other persons are legally obligated to support also are in this tier.

In the definition of second-tier distributions, what does “properly paid” mean? A distribution is properly paid if it is made pursuant with the provisions of the will or trust governing when and to whom a distribution can or must be made or credited. If a will is silent as to the distribution of estate income, state law determines the proper disposition of such income. What amounts are “properly credited” to a second-tier beneficiary? Amounts are properly credited to a beneficiary if they are “irrevocably and unconditionally placed at the disposal of the beneficiary.” A mere bookkeeping entry is not enough; the funds or property must actually be credited so as to be beyond recall by the fiduciary and must be available for distribution upon demand. Crediting a distribution is similar in concept to the constructive receipt of income.

In some cases, a personal representative may make a partial distribution of an estate to its beneficiaries, conditioned upon the beneficiaries’ obligations to repay some or all of the amount distributed in order to satisfy obligations of the estate. The IRS normally will treat such amounts as properly paid or credited, even if the beneficiary may have to repay them. There is little, if any, incentive to accumulate income in a trust or estate because of the compressed tax rates, so this treatment generally is beneficial to the entity.

An elective share in the principal of a decedent’s estate can qualify for a distribution deduction, resulting in gross income to the surviving spouse under § 662. The elective share is treated as a separate share of the estate for the sole purpose of determining the amount of DNI allocable to that share. The allocation of gross income is made in proportion to the amount of income to which the separate share is entitled under the governing instrument and local law. Each share will calculate its DNI based on its portion of the estate’s gross income that is included in the estate’s DNI, plus its portion of any applicable deductions. The elective share may be a separate share whether or not it is entitled to share in income or appreciation, provided that it is determined as of the date of the decedent’s death. Thus, the surviving spouse is taxed only on the amount of income that belongs to that separate share.

Second-tier distributions are deductible by the estate or trust, to the extent of taxable DNI in excess of the first-tier distributions. If second-tier distributions exceed the remaining DNI (after DNI is reduced by the amount of the first-tier distributions), the DNI is allocated pro rata among the second-tier beneficiaries proportionately to the respective amount each second-tier beneficiary receives. This allocation is made among all second-tier beneficiaries, even to a beneficiary who is not entitled to share in the earnings of the estate or trust, and even if the DNI allocated to a beneficiary exceeds that beneficiary’s share of the estate’s or trust’s income. In these instances, inclusion of distributions in income is not based on the source of the distribution; the Subchapter J rules almost entirely eliminate the need for the tracing of principal and income.

In addition to first-tier and second-tier distributions, there is a third category of distributions from an estate or trust. This third category consists of gifts or bequests of specific sums of money or property that are payable in no more than three installments. These distributions are excluded from income (under §§ 663 and 102) because they qualify as gifts or devises. Consequently, they do not carry out DNI of an estate or trust.

THE 65-DAY RULE

If distributions of income or principal are required to be made, it does not matter for income tax purposes when such distributions are actually made. Thus, if the distribution occurs after the taxable year

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of the estate or trust in which the amount was required to be distributed, the actual distribution should be tax neutral. There is no deduction to the estate or trust and no gross income to the beneficiary in the later year of distribution because the tax consequences have already occurred. The same rule should apply to principal required to be distributed for a year (even though it is not actually distributed that year), if it is included in computing the distribution deduction and the beneficiary's gross income from the required distribution.

However, for discretionary distributions, the year in which the distribution actually occurs will generally be the year for which it is included in the distribution deduction for the trust or estate and included in the beneficiary's income. But, if an amount is properly paid or credited by an estate or trust within the first 65 days after its taxable year end, an election can be made to treat the distribution as having been made on the last day of the preceding taxable year. The trustee or personal representative may designate particular distributions from within the eligible period to be subject to the election and avoid making the election as to others. The election must be made no later than the extended deadline for filing the fiduciary income tax return for the taxable year for which the distribution is to be treated as having been made. It becomes irrevocable after the last day for making it. If a federal income tax return is required to be filed, the election must be made on the return. If a return is not required, such as because the trust has no taxable income or less than \$600 of gross income, the election is made by filing a statement with the IRS office where the return would be filed, if one had been required.

The regulations (but not the statute) restrict the amount as to which the election can be made, by providing that the amount cannot exceed the greater of accounting income for the prior year or DNI reduced by payments made, credited or required to be made in the prior year. The effect of this restriction is that distributions made within 65 days after a taxable year ends cannot be treated as made in the prior year if doing so would result in a tax-free distribution of principal due to the DNI limitation. However, this does not mean that a 65-day election cannot be made if the distribution will not result in gross income to the beneficiary. For example, a distribution for which the election is made may include net tax-exempt interest. This limitation makes the 65-day rule inapplicable to simple trusts in most situations, because a simple trust is always considered to have distributed its FAI, whether or not a distribution has occurred.

DISTRIBUTIONS IN KIND

An estate or trust may make a distribution either in cash and in kind. If the distribution is in kind, several issues arise:

1. Whether the estate or trust realizes gain or loss as a result of the distribution;
2. If a loss is realized, whether it is deductible;
3. If gain or loss is realized, but not recognized, whether the estate or trust can elect to recognize such gain or loss;
4. Whether some or all of the gain or loss is taken into account in computing DNI;
5. The value of the property that the estate or trust must use to compute its distribution deduction; and
6. The basis to the beneficiary who receives the distribution in kind.

If a personal representative or trustee distributes property in kind, the distribution may be treated as a taxable disposition, such as when a beneficiary is devised an amount of cash, but a distribution of other property is made instead. A nontaxable distribution in kind may occur when a beneficiary is entitled to receive a distribution of specific property which is in fact distributed to him. In general, a taxable disposition occurs when a beneficiary has the right to receive a pecuniary amount, such as a general bequest, but the executor satisfies the pecuniary amount by distributing property in kind. The trust or

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estate is treated as if it had sold the property, and will realize a gain or loss. Similarly, a disposition may occur when a beneficiary has a right to receive income, such as dividends on stock, but agrees to receive other property instead.

A deemed sale also may occur when a marital deduction devise is funded with non-cash property under a pecuniary formula clause. In contrast, the pro rata funding of a fractional share marital deduction clause will not result in gain or loss to an estate because a fractional share is not a pecuniary amount. Further, if a residuary devise to a surviving spouse qualifies for the marital deduction, the distribution of the residue in kind to the surviving spouse should not be treated as a deemed sale.

If a trust or estate realizes a loss on the distribution of depreciated property, § 267 may prevent current recognition of that loss. The distribution of depreciated property from a trust to a beneficiary in satisfaction of a pecuniary amount or other specific property comes within this rule. Similarly, distributions of depreciated property by an estate to a beneficiary generally result in disallowed losses. However, the definition of a “related party” for purposes of loss disallowance specifically exclude an executor and beneficiary of the same estate in the case of a distribution in satisfaction of a pecuniary bequest.

In connection with the issue of gain or loss recognition, the rules with respect to whether capital gain, depreciation recapture, and other items of income are included in DNI should be reviewed.

If a distribution is made in kind and gain or loss is recognized by reason of the distribution, the fair market value of the asset normally will be used for computing the distribution deduction. If gain or loss is not recognized, the adjusted basis of the asset immediately before the distribution should be used. The value used to compute the distribution deduction is the same as the value used to compute the amount of gross income.

When a beneficiary receives a distribution in kind, his or her basis in the asset will be the adjusted basis of such property in the hands of the estate trust immediately before the distribution, increased by any gain recognized by the estate or trust on the distribution, and decreased by any loss. This rule applies regardless of whether the beneficiary has gross income from the distribution. Under this rule, basis could be determined under § 1012 (if the personal representative or trustee purchased it), § 1014 (property acquired from a decedent), or § 1015 (for gifts).

THE § 645 ELECTION

Under § 645, if both the executor of an estate (if any estate is created) and the trustee of a qualified revocable trust (QRT) so elect, the trust is treated for income tax purposes as if it were part of the estate, rather than as a separate trust, during the election period. A QRT is any trust that on the date of death of the decedent was treated as owned by the decedent under § 676 by reason of a power held by the decedent [determined without regard to § 672(e)]. A trust that was treated as owned by the decedent under § 676 by reason of a power that was exercisable by the decedent with the consent or approval of a nonadverse party or the decedent’s spouse is a QRT. However, a trust in which the power to revoke is held only by a nonadverse party or the decedent’s spouse, and not by the decedent, is not a QRT.

The regulations use the term “executor” to denote the fiduciary of the decedent’s estate. It should be noted, however, that the definition of executor for the purposes of these regulations is not identical to the definition of an executor under § 2203 of the Code. Under the § 645 regulations, a person who has actual or constructive possession of property of the decedent is not an executor unless that person is also appointed, or qualified as an executor, administrator, or personal representative of the decedent’s estate.

The § 645 election may be made whether or not an executor is appointed for the decedent’s estate. If an executor is appointed for the decedent’s estate, the executor and the trustee of the QRT make the § 645 election by filing Form 8855. If an executor is not appointed for the decedent’s estate, the trustee

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makes the § 645 election by filing the election form. The election form must be filed by the extended due date of the Form 1041 for the first taxable year of the combined electing trust and related estate, if there is an executor, or of the first taxable year of the electing trust, if there is no executor (regardless of whether there is sufficient income to require the filing of that return). If an executor is appointed after the trustee of an electing trust has made the election, a new election form must be filed by the trustee and the newly appointed executor within 90 days of the executor's appointment.

Although the electing trust and related estate file a single, combined Form 1041, the electing trust and related estate continue to be separate taxpayers for purposes of Subtitle F. Therefore, the fiduciaries of the electing trust and the fiduciaries of the related estate each continue to have be responsible for filing the returns and paying the tax due for their respective entities even though a § 645 election has been made. The regulations require the executor to file a complete, accurate, and timely Form 1041 for the combined related estate and electing trust for each taxable year during the election period. The trustee of the electing trust must timely provide the executor of the related estate with all of the trust information necessary to permit the executor to file the combined Form 1041. The trustee and the executor must allocate the tax burden of the combined electing trust and related estate in a manner that reasonably reflects the respective tax obligations of the electing trust and related estate. If the tax burden is not reasonably allocated, gifts may be deemed to have been made. Each fiduciary is also responsible for insuring that the share of the tax burden for their respective entities is timely paid. The provisions of § 6654(l)(2)(A), relating to the 2-year exception to an estate's obligation to make estimated tax payments, will apply to each electing trust for which a § 645 election is made.

The trustee of the electing trust obtains an EIN upon the death of the decedent and furnishes this EIN to the payors of the trust. If there is no executor, the trustee of the electing trust uses this EIN to file Forms 1041 as an estate during the election period. If it is known that the election will be made, the trustee is not required to file a Form 1041 for the short taxable year of the QRT beginning with the decedent's date of death and ending December 31 of that year.

The election period terminates on the earlier of the day on which both the electing trust and related estate, if any, have distributed all of their assets, or the day before the "applicable date". If an executor is appointed after the trustee of an electing trust has made the election, and a new election form is not timely filed, the election period terminates the day before the appointment of the executor. If a Form 706 is required to be filed, the applicable date is the day that is the later of 2 years after the date of the decedent's death or 6 months after the date of final determination of liability for estate tax. If the issuance of an estate closing letter triggers the date of the final determination of liability, the date of the final determination of liability [for this purpose] is the date that is 6 months after the date the closing letter is issued, rather than the date the closing letter is issued. The election does not apply to successor trusts (trusts which are distributees under the trust instrument). If no Form 706 is required to be filed, the applicable date is the day that is 2 years after the date of the decedent's death.

At the close of the last day of the election period, the combined electing trust and related estate, if there is an executor, or the electing trust, if there is no executor, is deemed to distribute all the assets and liabilities of the electing trust to a new trust in a distribution to which §§ 661 and 662 apply. Thus, the combined electing trust and related estate, or the electing trust, as appropriate, is entitled to a distribution deduction, to the extent permitted under § 661, in the taxable year in which the election period terminates. The new trust must include the amount of the deemed distribution in gross income to the extent required under § 662. The net capital gains attributable to the electing trust are includible in the DNI of electing trust for the purpose of applying §§ 661 and 662 to the deemed distribution to the new trust.

If there is an executor and the electing trust terminates on or before the termination of the § 645 election period, the trustee must file a final Form 1041 under the name and EIN of the electing trust to

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notify the IRS that the trust no longer exists. However, this Form 1041 will not include any of the trust's items of income, deduction, and credit because those items will be included on the Form 1041 filed for the combined electing trust and related estate. If there is an executor, the trustee may not need to obtain an EIN for the new trust. If a new EIN is not required, the trustee must file Forms 1041 for the new trust under the EIN obtained for the QRT following the death of the decedent. If there is no executor, the trustee must obtain an EIN for the new trust. If a new EIN is required, the trustee must file Forms W-9 with the payors of the trust to provide them with the EIN to be used following the termination of the election period.

THE TAXATION OF BENEFICIARIES

A distribution to a beneficiary is taxable to the extent it is treated as carrying out taxable items of DNI. If distributions exceed DNI, DNI is allocated among the beneficiaries and the excess distributions are not taxable. It is in this situation that the distinction between first-tier and second-tier distributions becomes significant. First-tier distributions carry out DNI first. To the extent DNI exceeds the first-tier distributions, second-tier distributions are allocated their pro rata share of DNI. In contrast, if first-tier distributions equal or exceed DNI, second-tier distributions are not included in the beneficiary's gross income. If there are no first-tier distributions, second-tier distributions are included in each beneficiary's gross income to the extent of his or her proportionate share of DNI, which is the amount of DNI, as compared to total DNI, in the same proportion as the other amounts properly paid, credited, or required to be distributed to the beneficiary as compared to the other amounts properly paid, credited, or required to be distributed to all beneficiaries.

Once the DNI is allocated to each beneficiary by tier, the amount of gross income from each tier distribution is totaled per beneficiary. The character of this amount is then determined by reference to the character of the items in DNI. To the extent a distribution is treated as consisting of net tax-exempt interest, it is excluded from gross income. Gross income may also be categorized as capital gain, trade or business income, rental income, etc. It is reduced to a net amount by allocating direct and indirect expenses to various items in DNI. Generally, items of income and deduction are allocated to each beneficiary in proportion to their respective make-up in DNI. However, to the extent there is a special allocation under the Will, trust, or state law that has economic effect independent of its tax consequences, that special allocation will be respected. For example, if a trustee is required to sell a capital asset and distribute the net proceeds to a specific beneficiary, that distribution should result in a special allocation of the resulting gain to the DNI for that beneficiary.

Expenses that are directly attributable to a specific class of income are allocated to that class, such as real estate taxes paid on rental property. Indirect expenses, and direct expenses exceeding the class of income to which they relate (except for direct expenses directly attributable to tax-exempt interest), may be allocated in the fiduciary's discretion to one or more classes of income. However, a portion of indirect expenses is required to be allocated to tax-exempt interest and passive income, if any, so the preceding sentence applies only to the balance of the indirect expenses.

If a beneficiary and an estate or trust have the same taxable year, the income passing to the beneficiary for that year will be includible by the beneficiary in that year. If their taxable years differ, the beneficiary will include the income in the taxable year that includes the last day of the taxable year of the estate or trust. However, if a beneficiary dies prior to the entity's taxable year end, different rules may apply. In general, a beneficiary on the cash basis includes income actually distributed to him/her before death, even if there is no entity year-end within the decedent's last short taxable year. Income that is required to be distributed, but which is actually distributed to his estate, is reportable by the estate as income in respect of a decedent.

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GRANTOR TRUSTS

Special rules address the issue of whether the grantor of a trust or another person is treated as the owner of all or a portion of the trust for federal income tax purposes. These rules are contained in §§ 671 - 679 (§ 679 relates to certain foreign grantor trusts) and relate to certain powers the grantor may retain over the trust, such as the power to revoke or the power to direct beneficial enjoyment. Trusts that are subject to these rules are commonly called “grantor trusts” whether or not the grantor is the deemed owner, or another person is the owner. The general rules of Subchapter J do not apply to the extent the grantor or other person is treated as the owner of the trust income. If the grantor of a trust holds an interest or power described in §§ 673 - 678, he/she is treated as the owner of the portion of the trust property that is subject to the interest or power. To the extent the grantor is treated as the owner, the trust is not treated as a taxable entity or as an entity that may pass through its income or deductions to its beneficiaries. Instead, the grantor takes into account the trust income, deductions, and credits, whether or not the grantor has the right to receive distributions from the trust.

Items of income, deduction, and credit attributable to any portion of a trust that is treated as a grantor trust are not reported by the trust on Form 1041, but rather are shown on a separate statement to be attached to that form. However, a grantor trust may be eligible to use other reporting procedures if it is not:

1. A common trust fund;
2. A foreign trust or a trust having any of its assets located outside the United States;
3. A QSST;
4. A grantor trust with a deemed owner having a fiscal year;
5. A grantor trust treated as owned by a foreign person; or
6. A grantor trust with a deemed owner that is an exempt recipient for information reporting purposes (unless the trustee reports without regard to whether any of the grantors or other persons treated as owners of the trust are exempt recipients for information reporting purposes).

If the trust is eligible for the simplified tax reporting requirements, the deemed owner may report the trust’s income and deductions on his/her own return. The trustee then has no requirement to file a separate return. The three methods for doing this have similar basic requirements and one or more additional requirements.

In the case of a trust treated as owned only by one person, the trustee may furnish the name and Social Security number of the deemed owner to all payers required to obtain an identification number from the trust. If spouses file a joint return and are together the only deemed owners of the trust, they are deemed to be one person for this purpose. The deemed owner must provide the trustee with a completed Form W-9, even if they are the same person. This is the sole requirement when the deemed owner and the trustee are the same person.

If the deemed owner is not the trustee, the trustee must provide a statement to the deemed owner, by April 15, which includes the following information for the previous year:

1. Identification of all items of income, deduction and credit of the trust for the taxable year;
2. Identification of the payer of each item of income;
3. The information necessary to take the items into account in computing the deemed owner’s taxable income; and

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4. Informing the deemed owner that the items of income, deduction, credit and other information shown on the statement must be included on his/her income tax return.

If the above requirements are met, the trustee is not required to file any type of return with the IRS.

The second method is to provide the name, taxpayer identification number and address of the trust to the payers. This method would be appropriate if one or more of the payers, such as the FSA, will only report information using the trust's name and identification number. The trustee is required to file Forms 1099 to report to the deemed owner the income or gross proceeds paid to the trust during the taxable year. Each type of income is to be aggregated on the appropriate Form 1099. For example, if the trust receives \$25 of interest from each of four banks, the trustee will report \$100 interest on a single Form 1099-INT to the deemed owner.

However, the 1099's filed by the trustee will not include any amounts that are reported by the payer on an information return other than Form 1099. For example, if the trust owns a partnership interest, the interest and dividends reported on the Schedule K-1 from the partnership is not included on the 1099's filed by the trustee. Instead, the trustee is required to report these other items only on the statement given to the deemed owner, which must also include the amounts reported on the 1099's. This statement is the same, both as to due date and information required, as in the previous method, except that the statement need not identify the payer of each item of income.

The trustee is required to file the 1099's with the IRS by the normal due date (February 28 of the year following the payment). The trustee is not required to provide the deemed owner with a copy of the 1099's. Instead, the trustee is deemed to have fulfilled this part of the filing requirement by giving the deemed owner the required statement.

The third method applies when two or more persons are treated as owners of the trust. The reporting requirements are identical to the second method described above, except that the 1099's and statements must be provided to each owner, showing that person's allocable share of the trust. The normal Form 1099 filing requirements apply, so the trustee must provide copies of the 1099's to each owner by January 31, and still must provide the statements to the owners by April 15.

In the event a taxpayer identification number has been requested for the trust (for example, for FSA purposes), the IRS may issue a letter requesting a return or indicating that no return has been filed. In this case, the trustee may file a return reporting no income and write across the front of the form the following: "Pursuant to Section 1.671-4(g), this is the final Form 1041 for this Grantor trust." This may also be done if the trust has previously filed a return, but now wishes to discontinue filing returns under one of the three methods described above.

The ability of a grantor trust (or portion of a grantor trust) to report under the above methods ends with the death of the deemed owner of the trust. Therefore, the trust will have a short year having the same period as the deemed owner's final taxable year. If the trust was filing a Form 1041, as described above, during the life of the decedent, the due date of the Form 1041 for the taxable year ending with the decedent's death is the fifteenth day of the fourth month following the close of the 12-month period that began with the first day of the decedent's last taxable year. Thus, the due date of the final Form 1041 will conform with the due date of the decedent's final income tax return.

A grantor trust must obtain a new EIN after the death of the decedent if the trust will continue for a period of time following the death of the decedent. This includes a trust that continues for a period of time only to allow a winding up of the affairs of the trust following the death of the decedent. The Form 1041 for the trust will use this new EIN, beginning with the period which begins on the day following the deemed owner's date of death.

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CONCLUSION

The income tax rules that apply to trusts and estates are complex, due to the hybrid nature of these entities, as both separate entities and an aggregate of their beneficiaries. In general, trusts and estates compute taxable income similar in manner to individuals. However, the interaction between Distributable Net Income (DNI), Fiduciary Accounting Income (FAI), and the Distribution Deduction affects the determination of the amount of income that is taxable to the entity and how much passes to the beneficiaries. Distributions of property other than cash may cause the entity to recognize gain or loss on the distribution, as if the property had been sold at its fair market value. Special care must be given to capital gains and similar items of income that are treated differently for purposes of determining taxable income versus accounting income. Further, trusts and estates that hold interests in other pass-through entities must consider the treatment of the distributive share of the other pass-through entity.

To the extent that income passes to a beneficiary, it is reportable on the beneficiary's return for the year ending with the entity's taxable year or in which the entity's taxable year ends. However, a special rule allows an election to treat certain distributions that occur within 65 days after the entity's taxable year end to be treated as if made on the last day of the preceding taxable year. Income in the hands of the beneficiary retains the character it had in the hands of the entity. In most cases, income flows proportionately to all beneficiaries, even those who are not income beneficiaries under the terms of the governing instrument or state law. However, special allocations can be made to report income to a specific beneficiary when such treatment is appropriate.

Finally, grantor trusts are excluded from the above rules, with the trust income and deductions being reported directly on the deemed owner's return. There are several methods under which a trustee may report the trust's income and deductions to the deemed owner.

This discussion has necessarily been limited to an overview of the rules applying to trusts and estates. Many issues have not been addressed and the reader is cautioned to use this discussion only to obtain a general awareness to some of the issues that may affect the income taxation of trusts and estates.



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