Income Taxation Of Trusts And Estates - Introduction

In this section we will be tackling the requirements and issues that arise in the taxation of trusts and estates; moreover, what kinds of trusts are available to an investor and what tax implications they are subject to.

Income Taxation Of Trusts And Estates - General Issues

General Issues

Filing Requirements
Trusts and estates must file an income tax return (Form 1041) for each taxable year if the trust has earned $600 in income, or has a beneficiary that is a non-resident alien.

For a grantor trust, assuming the individual grantor has reported all items of income and expenses on their own individual income tax return (Form 1040), are not required to file a 1041. This makes the grantor liable for the total taxes under their return.

Deadlines
Estate income tax returns and Trust income tax returns (Form 1041) share the same filing deadline as regular taxpayers of April 15th of the year following the actual tax year (adjusted later for holidays and weekends). Extensions of time can be granted for five months if the administrator files for an automatic extension request (Form 7004).

Choice of Taxable Year
Certain trusts (complex trusts) allow flexibility to the beneficiaries to receive or defer the trust income and principal for the given tax year depending on their personal preference for the year.

Reasons for doing this might include a charitable contribution from the trust utilizing the gross accounting income, bad year in the market or possibly the beneficiary has a substantially high tax rate on their individual return due to earned income and the trust would receive a more favorable tax rate. Whatever the reason and if the trust allows, the trustee can chose to pay income or allow the income to accumulate within the trust and have the trust pay the tax due.

Tax Treatment of Distributions to Beneficiaries
Trust or estate income is taxed to the beneficiary as if they had received the income directly from the original source and not the trust itself. To clarify, an ordinary income would be fully taxable, tax-exempt interest remains tax-free and capital gains are still treated as capital gains.

How Beneficiaries Report Income:

1. Dividends and Interest - Schedule B of Form 1040
2. Capital Gains - Schedule D of Form 1040
3. Real estate or business activities - shown on Schedule K-1 and reported on Schedule E (subject to passive activity restrictions)

Rate Structure
It's important to know about two separate potential tax issues when it comes to trust and estate planning and taxation. There's the federal "Income Tax Return for Trusts and Estates" (Form 1041) and also the "Estate Tax Return" (Form 706).

The rates in this tax table represent a substantial increase in the tax rate for trusts as a result of the American Taxpayer Relief Act, which has also raised the top capital gains rate for trusts to 20%. The 3.8% Obamacare tax also applies to all investment income that stays within a trust and is not distributed to beneficiaries. This change in the tax law will therefore have a major impact on estate planning strategies for both the wealthy and the middle class.

Estate Taxes
Estate tax computed on Form 706 is eliminated or reduced by the "unified credit," which applies to both the gift tax and the estate tax. Each taxpayer is given an exclusion amount that is exempt from federal estate tax. For 2013, that amount is $5.25 million. Estates over that amount would pay a maximum estate tax rate of 40%.

Income Taxation Of Trusts And Estates - Grantor / Non-Grantor Trusts

Grantor/Non-Grantor Trusts

Grantor Trust:

- Not considered a separate entity.
- Grantor retains certain powers or ownership interests.
- Income, deductions and credits are reported on the grantor's individual tax return.

Non-Grantor Trust:

- Trust is treated as a taxable entity.
- Assets treated as being owned by the trust.
- Trust is responsible for the tax consequences of income, deductions and credits.
- Separate tax return is filed on behalf of the trust.

"Inter-Vivos Trust" – A trust created during the trustor's lifetime.

"Testamentary Trust" – A trust established in the trustor's will.

Income Taxation Of Trusts And Estates - Simple / Complex Trusts

Simple/Complex Trusts

Simple Trust:

- Trust that is required to distribute all of its annual income to the beneficiaries.
- Beneficiaries cannot be charitable.
- Income of the trust is taxable to the recipient, even if left in the trust to accumulate.
- Not allowed to distribute corpus (principal).
- Capital gains are considered part of the corpus.

Complex Trust (must have one of the following):

- Retains current income in the trust.
- Distributes corpus.
- Distributions to charitable organizations.

Both the Simple and Complex Trusts are given deductions for the income distributed to beneficiaries, and both trusts are granted the standard exemption amount of $100.

Income Taxation Of Trusts And Estates - Revocable / Irrevocable Trusts

Revocable/Irrevocable Trusts

Revocable Trust:

- Has three parts - Grantor, Trustee and Beneficiary.
- Trust can be changed at any time.
- Separate tax return can be filed, but rarely done (requires grantor to obtain Tax ID Number).
- Common for grantor and trustee to be the same person.
- Grantor retains control of the assets - therefore they are responsible for paying the tax liability associated with the income and realized gains generated from the trust.
- Avoids probate.

Irrevocable Trust:

- Cannot be changed after the agreement is signed.
- Most trusts revert to irrevocable at death of grantor.
- Typically used for estate tax planning, asset protection, probate avoidance or charitable gift planning.
- Grantor, trustee and beneficiary are usually always different individuals or organizations.
- Separate tax identification number is issued.
- Taxes due from income, gains and losses are paid by the trustee, typically from the trust.

Income Taxation Of Trusts And Estates - Trust Income

Trust Income

Trust Accounting Income
Trust Accounting Income refers to all of the dividends, interest, ordinary gain, real

estate income, royalty income and any other income that is generated by the trust for a given tax year.

The importance of distinguishing accounting income from the corpus or principal of the trust again lies in the unique difference between simple and complex trusts. Simple trusts are required to pay out all of the accounting income to the beneficiary of the trust. Complex trusts are much more flexible in that they can pay out dividends and principal to the beneficiaries, or just let the accounting income accumulate within the trust.

Charitable donations (complex trusts only) can be deductible if they are paid specifically from the current year's gross accounting income.

Trust Taxable Income
Trust or estate taxable income will be treated as taxable income to either the beneficiary or the trust itself, but not taxable to both. Because the trust is allowed an "income distribution deduction" for income paid to a beneficiary, the beneficiary would be responsible for paying the tax if the trust distributes the income.

Income Distribution Deduction Is the Lesser of:

- Distributable Net Income (DNI) less tax-exempt interest

OR

- Distributions less tax-exempt income included in distribution

If the estate administrator or trustee elects not to pay out the income of the trust, then the legal representative of the trust is responsible for including the income on the trust's income tax return.

Distributable Net Income
Distributable net income (DNI) is the maximum allowable income that can be paid from a trust in a given year per the terms of the trust, regardless if a will or other document might specify a larger share "entitlement" to the beneficiary.

For Example:
Suppose that John's will specifies that Julie (his wife) and Debby (his daughter) were to receive $10,000 and $5,000, respectively, from the income of his estate trust each year. If the trust only had $12,000 of distributable net income for the year, then each beneficiary will only receive a pro-rata share of their amount.

Julie would receive **$8,000** [($10,000 / $15,000) x $12,000]

Debby would receive **$4,000** [($5,000 / $15,000) x $12,000]

*Beneficiaries entitled to receive current distributable income, generally must include in the gross income the entire amount due to them. However, if the DNI is less than the entitlement, then each beneficiary is only taxed on the actual amount received from the DNI, not their full entitlement amount.

Income Taxation Of Trusts And Estates - Estate Income Tax

Estate Income Tax
When an individual passes away, another "tax-paying" entity is created, known as the "decedent's estate." If the person died prior to filing the previous year's tax return, there will be three different returns that must be filed by the estate executor (administrator). They would include the following:

- The previous year's normal tax return (Form 1040)
- The final tax return (Form 1040) - for the beginning of the new year to the date of death and
- The estate tax return (Form 1041) - covering earnings from the date of death until the end of the New Year.

The estate may have an income tax filing requirement on Form 1041 for each year that it has $600 or more of gross income (or a non-resident alien beneficiary). This is calculated each year from the date of death, until the entire amount of the estate has been distributed to the beneficiaries.

"Income In Respect of a Decedent"
If a beneficiary receives income that was earned (but not paid) by the decedent before death, then this income is called "income in respect of a decedent" and it is reported on the beneficiary's tax return.

Examples include: lottery winnings, installment sale receipts, IRA distributions, etc.

Income Taxation Of Trusts And Estates - Sample Questions 1 - 5

1. All of the following are characteristics or true statements pertaining to an "inter-vivos " revocable trust EXCEPT:

A) The trust can be modified at any time while the grantor is alive.
B) The grantor can claim all income from the trust on their individual Form 1040.
C) This is a good trust for probate avoidance.
D) This is a good trust for asset protection.

2. Which of the following are characteristics of a Simple Trust?

(1) Corpus can be distributed to the beneficiary.
(2) Beneficiaries can be charitable.
(3) Capital gains are considered as part of the corpus.
(4) Income is taxable to the recipient even if left in the trust to accumulate.
(5) Trust is given a deduction for income paid out to a beneficiary.

A) 1, 2 and 3 only
B) 2, 3 and 4 only
C) 3 and 4 only
D) 3, 4 and 5 only

3. All of the following are TRUE statements concerning Trust and Estate Taxation EXCEPT:

A) The maximum estate tax rate is 45%.
B) Trust income above $11,950 is taxed at 39.6%.
C) Trusts must file Form 1041 in years where the trust income is $600 or more.
D) The estate tax exclusion amount is $5,250,000 in 2013.

4. Lester (divorced, age 75), has a traditional IRA with a local bank account worth $500,000. In September of this year, he died and named his daughter Jennifer as the beneficiary of his IRA. Before Jennifer had a chance to convert the IRA into an Inherited IRA, it automatically paid out Lester's required minimum distribution for the year. This check would be best described as:

A) Return of principal
B) Tax free earnings paid to a beneficiary
C) Income in respect of a decedent
D) Section 179 income inadvertently paid to a survivor

5. All of the following are good reasons to establish an Irrevocable Trust EXCEPT:

A) Ownership of Life Insurance
B) Maintain control of assets
C) Asset protection
D) Charitable gift planning

Income Taxation Of Trusts And Estates - Answer Key

1. D

Revocable trusts are not practical trusts for asset protection since they provide very little defense from creditors or other litigation. The irrevocable trust is a better tool for asset protection since you transfer the assets into the trust and give up control. In the revocable trust, the grantor still has control of the assets, thus making them vulnerable.

2. D

With Simple Trusts, two of the primary rules are no charitable beneficiaries and corpus must remain in the trust.

3. A

For 2013, the maximum estate tax rate is 40%.

4. C

"Income in respect of a decedent" is unexpected income paid to a beneficiary after the death of the owner, and it is included on the beneficiary's tax return. Withdrawals from traditional IRAs are typically fully taxable (unless a portion of the IRA was after-tax contributions). Section 179 is a one-time deduction for capital assets.

5. B

Loss of control (ownership) is a requirement when assets are re-titled to irrevocable trusts.