Key Issues for Trusts and Estates – Virginia (KITE4 VA)

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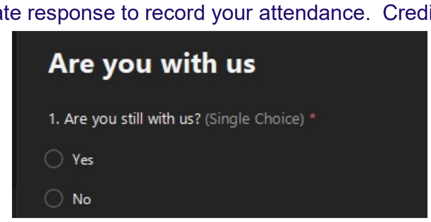

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Unit 1: Virginia Uniform Principal and Income Act

Learning Objectives

- After completing this unit, participants will be able to:
  - Identify distinct features of PIA accounting versus traditional for-profit GAAP accounting
  - Classify receipts properly between principal and income
  - Describe differences between taxable income and accounting income
  - Advise the executor or trustee on the proper allocations of trust income and expenses

VA Uniform Principal & Income Act

Refer to manual

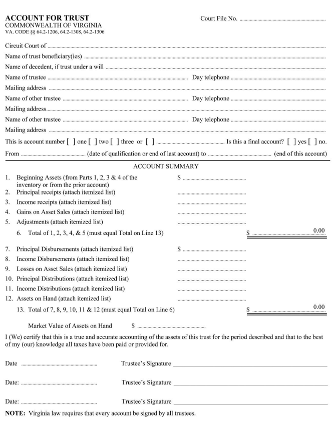
Principal and Income Act (PIA)

- The accounting in the act is based on law-derived principles
- It is different from tax accounting, GAAP accounting, or other familiar form
- Fiduciary accounting rules include a “fiduciary duty”; errors can result in personal liability
- The act is superseded by the language in a will or trust document—the law takes second place to the directions of the testator or grantor

Trust Accountings – Why?

- Track beneficiaries' rights to assets and income in the trust
- Zero sum game – if one beneficiary gets too much, someone else must get too little
- There is an obligation to ensure (and be ready to produce) a proper accounting

Example of Trust Accounting – Virginia Form CC-1684



ACCOUNT FOR TRUST Court File No. ....
COMMONWEALTH OF VIRGINIA
VA. CODE §§ 64.2-1206, 64.2-1308, 64.2-1306

Circuit Court of ....
Name of trust beneficiary(ies) ....
Name of decedent, if trust under a will ....
Name of trustee .... Day telephone ....
Mailing address ....
Name of other trustee .... Day telephone ....
Mailing address..................
Name of other trustee .... Day telephone ....
Mailing address ....
This is account number [ ] one [ ] two [ ] three or [ ] .... Is this a final account? [ ] yes [ ] no.
From .... (date of qualification or end of last account) to .... (end of this account)

ACCOUNT SUMMARY

1. Beginning Assets (from Parts 1, 2, 3 & 4 of the inventory or from the prior account) $ ....
2. Principal receipts (attach itemized list) ....
3. Income receipts (attach itemized list) ....
4. Gains on Asset Sales (attach itemized list) ....
5. Adjustments (attach itemized list) ....
   6. Total of 1, 2, 3, 4, & 5 (must equal Total on Line 13) $ 0.00
7. Principal Disbursements (attach itemized list) $ ....
8. Income Disbursements (attach itemized list) ....
9. Losses on Asset Sales (attach itemized list) ....
10. Principal Distributions (attach itemized list) ....
11. Income Distributions (attach itemized list) ....
12. Assets on Hand (attach itemized list) ....
   13. Total of 7, 8, 9, 10, 11 & 12 (must equal Total on Line 6) $ 0.00

Market Value of Assets on Hand $ ....

I (We) certify that this is a true and accurate accounting of the assets of this trust for the period described and that to the best of my (our) knowledge all taxes have been paid or provided for.

Date .... Trustee's Signature ______

Date: .... Trustee's Signature ______

Date: .... Trustee's Signature ______

NOTE: Virginia law requires that every account be signed by all trustees.

FORM CC-1684 MASTER 10/12

- Unless waived, the trustee of a testamentary trust must account to the Commissioner of Accounts for his/her financial actions in the administration of the trust if the assets exceed $25,000.00 or there is power of sale over real estate
- Must be signed by each of the Trustees
- The following rules apply:
  - The first account must cover the period beginning with the date the fiduciary qualified and ending on December 31 of the same year
  - Second and later accounts must cover the calendar year.
  - All accounts are due by May 1 of the following year, and no less frequently than annually thereafter

Article 1 – Definitions

- Beneficiary – income/remainder
- Income – money or property reserved as current return from principal asset and payable to income beneficiary, including current use of the property
- Mandatory income interest – right to receive income
- Principal – property held for distribution to remainder beneficiary

Article 2 – Fiduciary Duties

- Administer according to trust even if a different provision in PIA
- Act in good faith, based on what is fair to <u>all</u> beneficiaries
- Discretionary powers can result in allocations different from act or trust document
- Act is mandatory if neither of the above apply
- By default, receipts/disbursements go to principal

Article 2 – Fiduciary Duties

- Fiduciary has duty to act impartially
  - Unless trust evidences different provision
  - Decisions in accordance with act presumed fair and reasonable
  - Decisions will be not be changed by a court unless “abuse of discretion”
  - Fiduciary can ask a court to approve a decision in advance

Article 2 – Fiduciary Duties - CPAs

- As the CPA for a fiduciary, a CPA may have a quasi-fiduciary role and be responsible for errors in trust accounting
- Due diligence provisions
  - Adequate technical competence
- Conflict of interest issues
  - Conflicting interests of principal and income beneficiaries and executor/trustee
  - “Cannot serve two (or more) masters”
  - May not be able to represent a former client personally and as executor of an estate if he/she is a beneficiary as well

Accounting Rules for Trusts

- Primary goal is to properly track interests of income and principal beneficiaries respectively
- First source of trust accounting rules is the trust document
- Where the trust is silent, applicable PIA governs
- Document will spell out rights of beneficiaries—and thus, the key factors in the "tracking" for the trust

Discussion Question

Fiduciary accounting seems irrational and unconstrained. Why is "accounting" like this in place?

- Fiduciary accounting is not intended to produce statements that show business profit or proper matching of investment, income, expenses, and equity.
- Fiduciary accounting separates and records interests in property. It categorizes property rights between those who are entitled to the income and those who own the assets that produce that income.

Allocation of Receipts – Article 5

- Principal:
  - Assets received to start trust
  - Money from sale of principal asset
  - Capital gains
  - Amounts received from third parties to reimburse for expenses related to environmental matters
  - Income received when there is no income beneficiary (e.g., IRD)
  - Eminent domain awards other than amounts stated for reimbursement of income loss

Allocation of Receipts – Article 5

- Income
  - Rents from real or personal property
  - Interest income—taxable and tax-exempt
  - Insurance proceeds insuring against loss of occupancy, loss of use by income beneficiary, or loss of income to income

Allocation of Receipts – Article 5

- Principal
  - Security deposits held relative to rental property
  - Life insurance proceeds
  - Insurance proceeds on property which is part of corpus
  - Proceeds of policies protecting assets

Allocation of Receipts – Article 4

- Receipts from entities in which the trust or estate holds an interest—e.g., partnership, corporation, LLC, REIT, etc.
- Principal
  - Property other than cash
  - Money received in exchange for an interest in the entity
  - Money received in partial or total liquidation

Principal Receipts – Article 4

- Principal
  - Partnership distributions of capital gains and partners' capital accounts
  - Reinvested dividends—may require reimbursement from income
  - Capital gains dividend

Allocation of Receipts – Article 4

- Income
  - Cash receipts from entities in which the trust or estate holds an interest—e.g., partnership, corporation, LLC
  - Cash dividends—taxable and tax-exempt
  - Cash distributions of income from pass-through entities
  - Reinvested dividends essentially buy more principal with income and should result in a transfer of cash from principal to income

Allocation of Receipts – Article 4

- Distribution from trust or estate
  - Generally, need to determine if trust or estate made distribution from income or principal
  - Treatment the same in receiving trust

Allocation of Receipts – Article 4

- Business and other activities
  - May account for separately from other trust assets
  - Can determine cash that should be retained in business for working capital or depreciation of assets (so can effectively retain it rather than distribute or treat as income)

Allocation Receipts – Article 5

- Obligations to pay money
  - Interest received allocated to income without regard to amortization of premium
  - Amount received on > one-year obligations for sale or redemption all allocated to principal without regard to amortization of discount
  - If maturity < one year from acquisition, discount is treated as income

Allocation of Receipts – Article 6

- Deferred compensation and annuities
  - Payments specifically designated as interest, dividend, or payment made in lieu of interest or dividend allocated to income
  - Otherwise, the fiduciary must determine the internal income of the fund and allocate based on it
  - Otherwise, may assume a 4% return as income
- Special rules for marital deduction trusts

Allocation of Receipts – Article 6

- Liquidating assets
  - Asset that will produce receipts for limited time (leasehold, patent, copyright, royalty right, etc.)
  - 4% of the value of the asset to income
  - If value cannot be determined, allocate payments
    - 10% to income
    - 90% to principal

Allocation of Receipts – Article 6

- Liquidating assets
  - Received as delay rent or nominal annual rent on lease, allocate to income
  - Production payment—allocate to income if and to the extent agreement establishes a portion for interest—remainder to principal

Allocation of Receipts – Article 6

- Minerals, oil, water, natural resources
  - Annual lease or delay rental allocated to income
  - Generally, production payments are principal
  - Other payments received are allocated to income based on terms of agreement or "equity" (considered equitable if not in excess of federal depletion – generally 15%
  - Several "special" rules

Water – Article 6

- Water resource that is renewable—100% to income
- Water resource that is not renewable—based on agreement or equity (15% income)

Timber – Article 6

- All to income if amount of timber removed does not exceed the rate of growth
- To principal to extent payments exceed rate of growth
- If account for as business, this section does not apply
- To principal for advance payments, bonuses, and other payments not allocated under earlier methods

Allocation of Disbursements – Article 7

- Principal
  - Decedent's debts
  - Funeral expenses
  - Disposition of remains
  - Family allowances

Allocation of Disbursements – Article 7

- Principal
  - Trustee commissions on principal transactions
  - One half of
    - Trustee's compensation
    - Legal and accounting fees
  - Expenses incurred in connection with principal

Allocation of Disbursements – Article 7

- Principal
  - Expenses of proceedings that primarily concern trust principal
  - Premiums on insurance policies not covered by income rule (e.g., title insurance)
  - Estate, inheritance, and transfer taxes, including penalties

Allocation of Disbursements – Article 7

- Principal
  - Disbursements related to environmental matters
  - Payments of debt principal
  - Costs of investing or reinvesting principal
  - Termination costs and disbursements made to prepare property for sale

Allocations of Disbursements – Article 7

- Principal
  - Extraordinary repairs
  - Income taxes allocated to principal
  - Capital improvements to a principal asset, whether in the form of changes to an existing asset or the construction of a new asset, including special assessments

Allocation of Disbursements – Article 7

- Income
  - Ordinary expenses for administration and management and preservation of entity property—e.g., interest, repairs, recurring taxes against principal
  - One-half of
    - Trustee income commission
    - Attorney and accounting fees for periodic accounting
    - The costs of judicial proceedings
  - Insurance premiums covering loss of principal assets and loss of use of an asset

Discussion Question

I am the remainderman of a trust created by my grandfather. The trust has $10 million of assets and produces about $1 million per year in income that is sent to my cousin Joe who is disabled. Joe lives in a big house and seems to enjoy life.

While I am not resentful, I am wondering who pays the taxes on that income. Is it coming out of my assets? And my assets seem to get more valuable every year according to the statements I receive. Is there tax on that?

Discussion Question Answer

- If cousin Joe is getting a distribution of $1 million per year of income from the trust, he is paying the tax on the income he receives.
- If the principal of the trust is increasing due to gains in the value of the assets, the trust may be paying taxes on any recognized gains attributable to the principal.
- Or the gains may simply be due to appreciation in the value of the assets that will not be taxed until the assets are sold.
- As the remainderman, you have the right to an accounting and should request one from the trustee.

Depreciation – Article 7

- Depreciation, as commonly understood, is not applicable to trust accounting
- Trustee can retain reasonable amounts for the maintenance and replacement of business or other income producing assets that are subject to wear, tear, decay, corrosion, or gradual obsolescence
  - Effectively allows “depreciation” charge against income
  - Trustee charges income with the wear, tear, etc. and transfers it to principal
- Such charge is not required unless so stated in trust or will document

Tax Depreciation

- Tax depreciation has its own rules for trusts and estates
  - Tax depreciation is apportioned between an estate and the heirs based on the estate's income allocable to each
  - For a trust, if the trustee maintains a reserve, the deduction is first allocated to the trust, up to the amount of the reserve
  - Otherwise, the depreciation deduction is allocated to the income beneficiaries and the trust based on the trust income allocable to each

Income Taxes – Article 7

- Tax required to be paid on receipts allocated to income paid from income
- Tax required to be paid on receipts allocated to principal paid from principal (even if labeled an income tax)

Income Taxes – Article 7

- Allocate for income passed through from entity
  - To income if receipts allocated only to income
  - To principal if receipts allocated only to principal
  - Use ratio if allocated to both
  - But if tax exceeds receipts, excess comes from principal

Income Taxes – Article 7

- The trustee can shift allocation of taxes to offset shifting of economic or tax benefits between income and principal that arise from:
  - Elections and decisions made regarding tax matters
  - A tax that is imposed upon the fiduciary or a beneficiary as a result of a distribution from the estate or trust
  - The ownership by an estate or trust of an interest in an entity whose taxable income, whether distributed or not, is included in the income of the estate, trust, or a beneficiary

Property Not Productive of Income – Article 6

- Marital trust—surviving spouse has right to force income production
  - Applies if trust consists of assets not producing enough income from use of trust assets
  - Trustee must
    - Make property productive of income
    - Convert property to property productive of income in reasonable time
    - Exercise power to adjust (e.g., pay out of principal, establish unitrust)

Trustee's Power to Adjust – Article 2

- Must follow prudent investor rule (Virginia has adopted the Uniform Prudent Investor Act)
- Allows trustee to better invest and balance the assets of the trust under modern investment theory
- Courts hold the right to review for abuse
- Accountant must remember this is the trustee's power

Discussion Question

T is the successor trustee of a trust that provides income to A for life, remainder to B. T has received from the prior trustee a portfolio of financial assets invested 20% in stocks and 80% in bonds.

Following the prudent investor rule, T determines that a strategy of investing the portfolio 50% in stocks and 50% in bonds has risk and return objectives that are reasonably suited to the trust, but T also determines that adopting this approach will cause the trust to receive a smaller amount of dividend and interest income. A may object.

Can/should T reinvest the principal?

Discussion Question Answer

- T may reinvest the principal in a different way that will enhance the overall value of the assets. In fact, he may have a duty to do so.
- T must balance the interests of both the income beneficiary and the remainderman.
- And, after considering the factors Virginia Code § 64.2-1038, T may transfer cash from principal to income to the extent T considers it necessary to increase the amount distributed to the income beneficiary.

Discussion Question

Franken, an associate in your office, was given an assignment to maintain the fiduciary accounting for the Oak Tree Trust.

In reviewing the accounting, you find that Franken has allowed tax depreciation as a charge against the principal of the trust, which consists of several large commercial buildings. The trust document is silent on depreciation.

What would you do?

Discussion Question Answer

- Franken is lacking competent knowledge of fiduciary accounting. He should be closely managed on the assignment and monitored.
- The accounting must be corrected. Since the trust is silent, any depreciation charge must be based on the criteria set forth in the state UPAIA. In most cases this means no depreciation can be charged. At best, only a Section 104 discretionary reserve for actual measurable obsolescence is permitted. Or if accounted for as a separate business, a reasonable retention of receipts for future maintenance and replacement of the business assets is permitted under Section 403.

Unit 2: Allowable Deductions – Fiduciary and Beneficiary

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Learning Objectives

After completing this unit, participants will be able to:

- Demonstrate where to report specific items in the Form 1041
- Explain how to calculate various deductions, such as the following:
  - Estate taxes paid
  - Miscellaneous itemized deductions
- Advise when to claim administrative expenses in the Form 1041

Allowable Deductions

Deductions	10	Interest. Check if Form 4952 is attached ▶ ☐	10
	11	Taxes	11
	12	Fiduciary fees. If only a portion is deductible under section 67(e), see instructions	12
	13	Charitable deduction (from Schedule A, line 7)	13
	14	Attorney, accountant, and return preparer fees. If only a portion is deductible under section 67(e), see instructions	14
	15a	Other deductions (attach schedule). See instructions for deductions allowable under section 67(e)	15a
	b	Net operating loss deduction. See instructions	15b
	16	Add lines 10 through 15b ▶	16
	17	Adjusted total income or (loss). Subtract line 16 from line 9 — 17	
	18	Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)	18
	19	Estate tax deduction including certain generation-skipping taxes (attach computation)	19
	20	Qualified business income deduction. Attach Form 8995 or 8995-A	20
	21	Exemption	21
	22	Add lines 18 through 21 ▶	22

Allowable Deductions

- In general, same rules apply as apply to an individual with some exceptions
- Deductions in respect of a decedent are allowed on the same basis as income in respect of a decedent is included

Election to Claim Administrative

- Estate can claim either on 706 or 1041
- Election needed to claim on Form 1041

Deductions on Termination

- Special rules for unused deductions in final year
  - Excess deductions on termination rules have seen a major change following TCJA
  - Capital loss carryovers can only be carried forward by the beneficiary/heir
  - ESBT treated separately

Deductions on Termination

- Special rules for unused deductions in final year
  - Deductions retain their nature when picked up by the beneficiary
  - Most often will mean a deduction *in computing AGI for the beneficiary*

Deductible Expenses

- Interest – Line 10 –
  - Must actually be for a debt of the trust/estate (*Estate of McClatchy*, 127 TC 370, *aff'd* CA9)
  - Interest tracing rules apply to determine type of interest paid
  - Investment interest limitation rule also apply
  - Same for §163(j) limit on business interest

Deductible Expenses

- Taxes – same as individuals
  - As with individuals, the $10,000 cap applies
  - But does not apply to
    - ➢ Taxes related to a trade or business (including any passthrough entity tax applied at the partnership/S corporation level)
    - ➢ Taxes related to a §212 activity

Deductible Expenses

- Fiduciary fees
  - Deductible as an expense required due to assets being in trust/estate
  - Used in computing trust adjusted gross income.

Deductible Expenses

- Regulation §1.67-4 – the *Knight* regulations
  - IRC §67(e) allows a deduction in computing trust AGI for expenses incurred due to assets being in trust even if not otherwise allowed to an individual in computing AGI
  - Supreme Court in *Knight* ruled this only covered expenses not normally incurred by an individual
    - ➢ *Knight* involved payment for investment advisory fees trustee argued were only paid to fulfill fiduciary duty
    - ➢ SCOTUS rejected that view, found that virtually all investment fees fail this test (post-TCJA also means not deductible at all to the trust)

TCJA Change: Loss of 2% Deductions

- Effective for 2018, what used to be 2% deductions are non-deductible
- *Knight* case and related regulations are now extremely important
- Note this will generally increase DNI but not change accounting income

Expenses Customarily Incurred by an Individual

- Regulations provide details on which of these costs are/aren't §67(e) costs
  - Ownership Costs
  - Tax Preparation Fees
  - Investment Advisory Fees
  - Appraisal Fees
  - Other Specifically Excluded Costs

Expenses Customarily Incurred by an Individual

- Bundled Fees – The need to allocate
  - Hourly vs. Non-Hourly Fees
  - Expenses Specifically Excluded from Allocation
  - Reasonable Method

Charitable Deductions

Schedule A	Charitable Deduction. Don't complete for a simple trust or a pooled income fund.		
1	Amounts paid or permanently set aside for charitable purposes from gross income. See instructions	1	
2	Tax-exempt income allocable to charitable contributions. See instructions	2	
3	Subtract line 2 from line 1	3	
4	Capital gains for the tax year allocated to corpus and paid or permanently set aside for charitable purposes	4	
5	Add lines 3 and 4	5	
6	Section 1202 exclusion allocable to capital gains paid or permanently set aside for charitable purposes. See instructions .	6	
7	**Charitable deduction.** Subtract line 6 from line 5. Enter here and on page 1, line 13	7	

- Allowed only where the will or trust instrument provides for the contribution to be paid out of gross income
- The trust must show that the contribution came out of income and not trust corpus
- Form 1041-A filing requirement in most cases

Deductions Not Subject to Section 67(g) Disallowance

- Fiduciary fees and most professional fees
- Some appraisal and valuation fees (see prior discussion)
- Selling expenses of personal property
- Costs of discovering and collecting estate assets
- Death notice advertising and funding expenses of storing or maintaining estate or trust property until sale or distribution
- Litigation expenses to defend will, defend estate property claims, or protect estate assets
- Office expenses, clerical costs, etc.
- Probate costs and fees

Deductions Not Subject to Section 67(g) Disallowance

- Casualty or theft losses of business and income producing property
- NOL carryover and carryback. NOL carrybacks are generally repealed for taxable years beginning after 2020
- Deductions in respect of the decedent (DRD) related to IRD
- Repayments under a claim of right exceeding $3,000
- Deduction for Income Distribution
- Deduction for Estate Tax – Line 19

Expenses related to tax-exempt income

- Allocation required if not direct
- Allowable methods include the following:
  - Net income method
  - Gross income method
  - DNI method
  - Other reasonable method

Depreciation, Depletion, and Amortization

- For a trust, maintains a reserve – depreciation is first allocated to the trustee. This allocation is limited to the amount of the reserve
  - Any depreciation that is left over is allocated between the trustee and the beneficiary based on their allocable shares of the trust's accounting income
- For an estate – single level of allocation takes place
  - Allocation is based on accounting income allocable to each for the year in question

TCJA Change: Qualified Business Income Deduction

- In final conference bill, trusts and estates allowed qualified business income deduction
- Very roughly 20% of pass-through business income
- But has some complications in calculation
- Passive activities qualify

Unit 3: DNI – Distributable Net Income and Distribution Rules

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Learning Objectives

After completing this unit, participants will be able to:

- Discuss the concept of DNI and how to calculate it
- Determine the taxable portion of distributions
- Recognize when capital gains might be included in DNI calculation

Distributable Net Income (DNI)

- DNI is defined by IRC Section 643(a) as the taxable income of the estate or trust without the following:
  - Deduction for distributions to beneficiaries
  - Deduction for personal exemption
  - Excluding municipal bond interest
  - Capital gains allocable to trust corpus
    - Not paid, credited, or required to be distributed to any beneficiary during the tax year
    - Not set-aside permanently to be used for a charitable purpose
  - Capital losses

Calculation of DNI

- Expenses offset income in the following order
  - Gross income items reduced (but not below zero) by expenses directly allocable to each item
  - Remaining expenses may be allocated at the discretion of the fiduciary to reduce or eliminate other items of item
  - Make-up of remaining income determine makeup of amounts taxed to beneficiaries on K-1s

Distributable Net Income

Schedule B — Income Distribution Deduction

1	Adjusted total income. See instructions	1
2	Adjusted tax-exempt interest	2
3	Total net gain from Schedule D (Form 1041), line 19, column (1). See instructions	3
4	Enter amount from Schedule A, line 4 (minus any allocable section 1202 exclusion)	4
5	Capital gains for the tax year included on Schedule A, line 1. See instructions	5
6	Enter any gain from page 1, line 4, as a negative number. If page 1, line 4, is a loss, enter the loss as a positive number	6
7	**Distributable net income.** Combine lines 1 through 6. If zero or less, enter -0-	7
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law — 8	
9	Income required to be distributed currently	9
10	Other amounts paid, credited, or otherwise required to be distributed	10
11	Total distributions. Add lines 9 and 10. If greater than line 8, see instructions	11
12	Enter the amount of tax-exempt income included on line 11	12
13	Tentative income distribution deduction. Subtract line 12 from line 11	13
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-	14
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18	15

Effect of Losses

- NOL carryovers
- Capital loss carryovers
- Suspended passive losses (added to basis on termination)
- Minimum tax credit (lost on termination)
- Excess investment interest
- Excess deductions

Fiduciary Accounting Rules

- Governing instrument is the first place to look
- Applicable state Uniform Principal and Income Act
- Accounting income is not equal to taxable income, GAAP income, cash basis income, or other familiar form of income.

Fiduciary Accounting Rules

- Accounting income is a legal concept based on the rights of the principal and income beneficiaries
- Because accounting income established legal rights, getting it wrong produces legal claims.

Fiduciary Accounting Rules

- Fiduciary accounting income normally includes the following:
  - Rents from real or personal property
  - Interest income-taxable and tax-exempt
  - Cash dividends-taxable and tax-exempt
  - Ordinary income portion of mutual fund distributions
  - Net profits from business and farming based on accounting income
  - Cash distributions of income from pass-through entities
  - Payments on the lease for natural resources
  - Percentage of receipts for under productive or non-income-producing assets
  - Incremental value zero-coupon bonds
  - Royalty, overriding royalty or working interest on natural resource assets
  - Cash received as a distribution of income from other estates and trusts

Fiduciary Accounting Rules

- Fiduciary accounting income disbursements normally include the following:
  - Ordinary expenses for administration and management and preservation of entity property
  - One half of trustee income commission
  - One half of attorney and accounting fees for periodic accounting
  - Income taxes on undistributed taxable income in accounting income and
  - Depreciation

Fiduciary Accounting Rules

- Taxable receipts often allocable to corpus reported on Form 1041 include the following:
  - Capital gains, including mutual fund distributions
  - Insurance proceeds on property which is part of corpus
  - Receipts on the total or partial liquidation of a corporation
  - Partnership distributions of capital gains and partners' capital accounts
  - Amortization of bond discount
  - Recapture income on sale or exchange of principal assets
  - Imputed interest income
  - Statutory depletion on royalty or working interest in natural resources
  - Income in respect of the decedent accrued at date of death

Fiduciary Accounting Rules

- Deductible disbursements often charged to corpus by default under principal and income acts include the following:
  - One-half of trustee, attorney, and accounting fees for periodic accounting fees
  - Trustee commissions on principal transactions
  - Expenses reasonably incurred in connection with principal
  - Cost of investing or reinvesting principal
  - Expense of preparing property for sale
  - Extraordinary repairs
  - Income taxes allocated to principal
  - Amortization of bond premium
  - Legal fees to defend asset title
  - Estate, inheritance, and transfer taxes
  - Charitable contributions

Depreciation

- A trust may not charge depreciation against fiduciary accounting income unless:
  - The governing instrument or local law requires it, or
  - A reserve is permitted and the trustee actually maintains one

Allocation Between Principal and Income

- Power to adjust—advising the fiduciary
- Capital transactions
- Marital claims

Marital Trusts

- Distributions of income from a typical marital trust are distributions of DNI
- Deductible by the trust and taxable to the beneficiary

Tiered Distributions

- Tier 1—required to be made of accounting income
- Tier 2—other distributions:
  - Out of principal
  - Discretionary income distributions

Discussion Question

- How does your tax software allocate expenses to items of income by default when determining the make-up of DNI? Have you ever changed that allocation? How much flexibility do we have in such a case?

Allocation of DNI to Classes of Income

- Amounts deductible for distributions are treated as consisting of a proportionate amount of each class of income equal to the ratio of each class of income to total DNI

Unit 4: Income Taxed to Beneficiaries

Learning Objectives

After completing this unit, participants will be able to:

- Properly allocate income and deductions to beneficiaries
- Evaluate income tax issues when an estate or trust terminates
- Explain how to prepare Form K-1 for trust beneficiaries

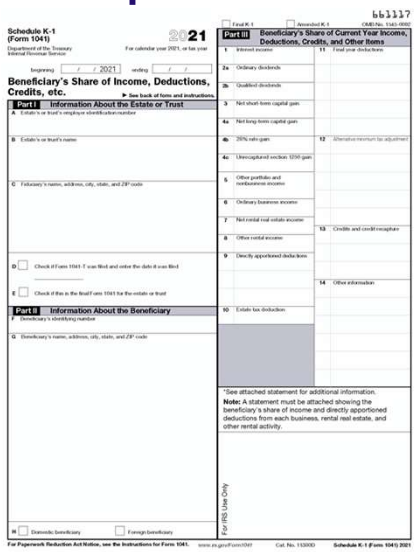
Allocation of Income to Beneficiaries

- Nature of income
  - Based on make-up of DNI
  - Not related to make-up of accounting income distributed to the beneficiary
- Allocation of deductions to classes of income for preparing K-1s – ties back to DNI allocations
- Year of income inclusion – calendar year in which trust/estate year ends

Property Transfers to Beneficiaries

- When recognition of gain is required – generally when used to pay a fixed liability
- When recognition of gain is elective
  - Election under IRC §643(e)(3)
  - Normally used to give beneficiary basis when there would be no net cost to the trust/estate
- Non-recognition of losses on distribution to beneficiaries

Reporting and Tax Compliance



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Final K-1 | Amended K-1 | OMB No. 1545-0092

Schedule K-1 (Form 1041) 2021

Department of the Treasury Internal Revenue Service

For calendar year 2021, or tax year

beginning / / 2021 ending / /

Beneficiary's Share of Income, Deductions, Credits, etc.

▶ See back of form and instructions.

Part I Information About the Estate or Trust

A Estate's or trust's employer identification number

B Estate's or trust's name

C Fiduciary's name, address, city, state, and ZIP code

D Check if Form 1041-T was filed and enter the date it was filed

E Check if this is the final Form 1041 for the estate or trust

Part II Information About the Beneficiary

F Beneficiary's identifying number

G Beneficiary's name, address, city, state, and ZIP code

H Domestic beneficiary | Foreign beneficiary

Part III Beneficiary's Share of Current Year Income, Deductions, Credits, and Other Items

1 Interest income
2a Ordinary dividends
2b Qualified dividends
3 Net short-term capital gain
4a Net long-term capital gain
4b 28% rate gain
4c Unrecaptured section 1250 gain
5 Other portfolio and nonbusiness income
6 Ordinary business income
7 Net rental real estate income
8 Other rental income
9 Directly apportioned deductions
10 Estate tax deduction
11 Final year deductions
12 Alternative minimum tax adjustment
13 Credits and credit recapture
14 Other information

*See attached statement for additional information.

Note: A statement must be attached showing the beneficiary's share of income and directly apportioned deductions from each business, rental real estate, and other rental activity.

For IRS Use Only

For Paperwork Reduction Act Notice, see the Instructions for Form 1041. www.irs.gov/Form1041 Cat. No. 11380D Schedule K-1 (Form 1041) 2021

Termination

- Trust termination
- Estate termination:
  - Termination event
  - Unduly prolonged administration
  - Planning
- Taxation

Special Rules

- 65-day rule
  - Can elect to look 65 days into following year to distribute from income in a complex trust
  - Must make the election and payment must actually be made
- Separate share rule

Unit 5: State Complications of Trusts

Learning Objectives

After completing this unit, participants will be able to:

- Explain state laws governing trusts
- Explain state taxing regimes for estates and trusts

State Law Governing Trusts

- State Principal and Income Act
- Prudent Investor Act
- Uniform Trust Code
- Other state trust laws

State Income Taxation Issues

- Tests for determining tax status
- Dealing with state income tax issues

State Income Taxes

- Lack of consistency
- Different tests to determine if filing is needed:
  - Sourced income will always trigger it in a state with income tax.
  - However, other factors may cause entity to be “resident.”

State Income Taxes

- Tax Planning with states
  - Danger: Multiple states tax the same income and no credit available
  - Opportunity: No state imposes its income tax
  - Note: Generally, if income is distributed, the residence of the beneficiary will trigger inclusion for K-1 items in beneficiary's residence state

State Income Taxes

Recent cases that change the landscape:

- *Kaester* – Supreme Court said contingent beneficiary resident not enough connection to tax trust
- Narrow facts and Court did not expand to define what would be sufficient nexus

State Income Taxes

- *Fielding vs. Commissioner* - issue where only link was that a grantor was a Minnesota resident when trust became irrevocable
- Minnesota Supreme Court ruled that was insufficient nexus with no other link to Minnesota (no assets in Minnesota, trustee not in Minnesota, trust not administered in Minnesota, and no Minnesota beneficiary.
- U.S. Supreme Court declined to hear this case

State Income Taxes

- Minnesota Supreme Court found following did not create nexus:
  - Trust grantor was a resident of the state in the year the trusts were established, and also in the year when the trusts were made irrevocable
  - A beneficiary was resident of state
  - Grantor used an in-state law firm to draft trust documents
  - Taxpayers held stock in a company which was incorporated in state, and which held physical property in state
  - The taxpayers' contacts with the state, which pre-dated the tax year at issue, were irrelevant

Discussion Question

- What impact do you think the Supreme Court's decision in the *Kaestner Trust* case and denial of review to the *Fielding Trust* decision will have on state taxation of trusts? In both cases, the state was found to have attempted to tax a trust the final court to rule found was in violation of the U.S. Constitution.

Thank You

Questions: timothy.dreyer@kaplan.com

Reminders

- **Post event evaluation:** Please complete the course evaluation that will be viewable once the session ends. We welcome your feedback!

KAPLAN

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