Fiduciary Income Taxation

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Introduction to Fiduciary Income Tax

- Fiduciary income tax rules found in subchapter J of chapter 1 of the Code, §§641 to 692 (“Subchapter J”)
- Types of trusts under Subchapter J:
  - Grantor trusts
  - Simple trusts
  - Complex trusts (and estates)
  - Certain subchapter S trusts (i.e., electing small business trusts)
  - Charitable remainder trusts

Non-Grantor Trusts: Objectives and Challenges

- Allocating tax burden among persons benefiting from estate or trust
- Separating gifts from income earned on gifts
  - Gifts and bequests not included in gross income (§102(a))
  - Income from property acquired by gift or bequest includible in gross income (§102(b))

Hybrid Entity/Conduit System

- Purpose
  - Distinguish Code §102(b) income from Code §102(a) principal when a distribution is made from a nongrantor trust.
- Characteristics similar to entity approach
  - Separate tax on income of trusts and estates (§641(a))
  - Taxable income of a trust or estate is computed in the same manner as for an individual, subject to modifications (§641(b))
- Characteristics similar to conduit approach
  - Distribution deduction (§§651 and 661)
  - Beneficiary inclusion (§§652 and 662)

Income Taxation of a Non-Grantor Trust

- Taxable income computed in the same manner as that of an individual, with modifications in subchapter J. (§641(b))
  - Gross income minus deductions
- Modifications to deductions include:
  - Distribution deduction (§§651, 661)
  - Charitable contribution deduction (§642(c))
  - Miscellaneous itemized deductions (§67(e)(1))
- Tax rate:
  - Non-grantor trust reaches highest tax rate of 37% on taxable income in excess of $13,450 in 2022. (§§1(e), (f) and (j))

Distributable Net Income (“DNI”)

- Purpose
  - Determine the extent to which a distribution from a non-grantor trust or an estate carries out gross income to a beneficiary
- Quantitative element
  - Helps determine how much of the income is taxed at the non-grantor trust or estate level and to the beneficiaries
- Qualitative element
  - Determines the character of income items taxable to the non-grantor trust or estate and beneficiaries

Computation of DNI

- Code §643(a) prescribes computation methodology
- Determine taxable income of trust, with certain modifications. For example:
  - Exclude distribution deduction
  - Generally, exclude capital gains and losses
    - Example: Trust has $20 of dividend income and $10 of capital gain. DNI generally would be $20 and would include the dividend income and not the capital gain.

Fiduciary Accounting Income (“FAI”)

- FAI is a state law concept of income
- Code §643(b): FAI is the amount of income of a trust or estate determined under the *terms of the governing instrument* and *applicable local law*.
  - State law likely a version of the Uniform Principal and Income Act (“UPIA”) or the more recent Uniform Fiduciary Income and Principal Act (“UFIPA”)
  - If the terms of a governing instrument are fundamentally different than traditional principles of income and principal, the terms will not be respected for income tax purposes. Reg. §1.643(b)-1

Significance of FAI

- Except with respect to Subpart E (the grantor trust rules), the term “income,” unless preceded by the words “taxable,” “distributable net,” “undistributed net” or “gross,” means FAI. §643(b)

Simple Trusts

- Must be required to distribute all FAI to beneficiaries currently
- No charitable contributions
- No distributions in excess of current income

Simple Trust – Tax Calculation

- Distribution deduction for trust (§651)
  - Generally equal to the lesser of FAI and DNI
- Income inclusion for beneficiaries (§652(a))
  - General limited to the lesser of FAI and DNI
- Character of income inclusion (§652(b))
- Trust level taxation

Simple Trust Tax Calculation – Example 1

- Example 1: A trust's only asset is stock of a C corporation. The trust receives a $20 regular dividend from the corporation during the tax year.

  - DNI = $20
  - FAI = $20
  - Distribution deduction = $20
  - Beneficiary's income inclusion = $20 (dividend income)
  - Trust's taxable income: $0

Simple Trust Tax Calculation – Example 2

- Example 2: Trust's only asset is a partnership interest. The trust is allocated $20 of ordinary income from the partnership but receives no distributions from the partnership during the tax year.

  - DNI = $20
  - FAI = $0
  - Distribution deduction = $0
  - Beneficiary's income inclusion = $0
  - Trust's taxable income = $20

Simple Trust –

Timing of Deduction and Inclusion

- If income is required to be distributed to a beneficiary in a tax year, but the distribution is not timely made during the tax year, the trust is nevertheless entitled to a deduction in the current year.
  - §651.

- A beneficiary includes in gross income amounts of income required to be distributed during the tax year, irrespective of whether the amounts actually are distributed.
  - §652(a); Treas. Reg. §1.652(a)-1.

Complex Trusts

- Most non-grantor trusts are complex trusts
- Examples:
  - A trust from which less than all FAI must be distributed currently (accumulation of income is permitted)
  - A trust making a distribution to charity
  - A trust in from which an amount other than FAI in fact is distributed
- The status of a trust as a simple trust or complex trust can change from year-to-year

Complex Trust – Tax Calculation

- Tier system for distribution deduction and income inclusion
  - Tier 1: Income required to be distributed currently
  - Tier 2: Any amounts properly paid, credited or required to be distributed, e.g.:
    - discretionary distributions of income or principal;
    - mandatory distributions of principal

Complex Trust – Tier System (cont'd)

- A beneficiary can be a Tier 1 and Tier 2 beneficiary
  - Example: A QTIP trust requires all income to be distributed to the settlor's spouse and gives the trustee discretion to make distributions of principal to the spouse. The trust has $100 of dividend income for the tax year and no other income. The trustee distributes $130 to spouse: $100 of current year income, and $30 of principal.
    - The spouse is a Tier 1 beneficiary with respect to the $100 of income required to be distributed to them.
    - The spouse is a Tier 2 beneficiary with respect to the $30 of accumulated principal distributed.

Complex Trust – Distribution Deduction

- Distribution deduction to trust:
  - In general, a complex trust is entitled to a distribution deduction for all amounts paid, credited or required to be distributed to both Tier 1 and Tier 2 beneficiaries, to the extent of DNI

Complex Trust – Income Inclusion to Beneficiaries

- If total distributions ≤ DNI: Tiers are irrelevant
- If total distributions > DNI: Tiers are relevant
  - If Tier 1 distributions > DNI
    - Each Tier 1 beneficiary includes his or her pro rata share of DNI, and Tier 2 beneficiaries have no inclusion
  - If Tier 1 distributions ≤ DNI
    - Each Tier 1 beneficiary includes his or her Tier 1 distribution, and each Tier 2 beneficiary includes his or her pro rata share of remaining DNI

Charitable Contribution Deduction

- Governed by §642(c)
- In lieu of a §170 deduction
- Requirements:
  - From gross income
  - For a charitable purpose specified in §170(c)
  - "Pursuant to" the governing instrument
    - But see CCAs 201747005 and 201651013
- No percentage limitation for deduction (but no carryover)
- Election to treat contributions as paid in preceding tax year

Miscellaneous Itemized Deductions

- Rules for individuals - §§ 67(a), (g)
  - For tax years through 2025, individuals are precluded from taking miscellaneous itemized deductions
  - For tax years beginning after 2025, individuals can deduct miscellaneous itemized deductions only to the extent that such deductions exceed 2% of adjusted gross income
- Special rules for nongrantor trusts and estates
  - Certain trust and estate administrative expenses are fully deductible, both at present and after 2025.
  - §67(e), Reg. §1.67-4 and Notice 2018-61

65 Day Rule

- Governed by §663(b)
- Requirements
  - Amount properly paid within 65 days of end of prior year
  - Limitation on amount
  - Election
  - Time and manner of election

Payable in Less Than Three Installments Rule

- Governed by §663(a)(1)
- Requirements – the gift or bequest must be:
  - Properly paid under the terms of the governing instrument
  - A payment of a specific sum or specific property
  - Ascertainable at death or inception of the trust
  - Paid in no more than 3 installments
  - Not required to be paid from FAI
- Tax consequences

Distributions in Kind

- Governed by §643(e)
- Rule
  - An estate or trust realizes gain or loss when it satisfies a pecuniary amount in kind
  - Basis adjustment for the beneficiary
- Disallowance of loss
- Election to recognize gain

Subchapter S Trusts

- What is a Subchapter S Trust?
  - A trust that is a permitted shareholder of an S corporation

Types of Subchapter S Trusts

- Grantor trusts
- Trusts that cease to be grantor trusts by reason of the death of the grantor, for 2 years following grantor's death
- Testamentary trusts
- Qualified Subchapter S Trusts ("QSSTs")
- Electing Small Business Trusts ("ESBTs")
- Voting trusts

Qualified Subchapter S Trust ("QSST")

- Requirements for a QSST similar to those for a QTIP
  - Single current beneficiary to whom all income payable
  - QSST election in effect
- Income tax treatment:
  - QSST treated as a grantor trust, deemed owned by its income beneficiary.

Electing Small Business Trust ("ESBT")

- Requirements
  - Can have only certain types of beneficiaries – individuals, estates, trusts and certain charitable organizations
  - ESBT election in effect
- Fiduciary income tax treatment
  - Subject to tax on allocable share of S corporation income
  - No distribution deduction