TRUST & ESTATE

INCOME TAXATION AND PLANNING STRATEGIES



TRUST TAXATION DEFINED

- The Internal Revenue Code does not specifically define a trust or provide a general test for classifying an arrangement as a trust. However, treasury regulation §301.7701-4(a) describes a trust as an arrangement created by will or lifetime transfer whereby a trustee takes title to property for beneficiaries in a manner that does not qualify as a profit-seeking business.
- Tax is "imposed on the taxable income of every estate and every trust" Subchapter A *§1(e).* How tax is imposed is governed by Subchapter J *§641-692. (NY Chapter 60, Article 22, Part 2 for NY taxation of trusts).*
- An individual may create a trust to provide professional oversight of assets, achieve estate planning goals, creditor protection, privacy, achieve charitable wishes, and control the flow of income and assets to family members.
- While 20 states currently allow for the grantor and beneficiary to be the same person to provide creditor protection ("domestic asset protection/self-settled trust"), New York does not allow this.

ESTATE TAXATION DEFINED

- An estate is created upon the death of a U.S. citizen or resident. A person who does not meet this definition may still have a U.S. filing requirement if they have U.S. situs assets (ex: real estate or corporate stock).
- A foreign person with U.S. situs assets is subject to a reduced estate tax filing exemption of $60,000. This low threshold may require the filing of Form 706-NA. Where U.S. situs assets are below this threshold, a transfer certificate may be necessary from the IRS to present to financial institutions to release funds to the estate.
- Death closes the individuals tax year and begins the estate's tax year. A final individual income tax return will be filed stating the date of death at the top and may include Form 1310 Refund Due a Deceased Taxpayer to authorize any refund due be paid to the executor.

FIDUCIARY INCOME TAX RETURNS

- The executor or trustee as fiduciary is personally responsible for the determination and payment of tax.
- A return is filed on Form 1041 (domestic) or Form 1040-NR (foreign) for an estate or trust if:
  - The estate has gross income of $600 or more for the tax year.
  - The trust has any taxable income, or gross income of at least $600 (regardless of taxable income).
  - Any beneficiary is a nonresident alien.
  - Form 8997 is required for a QOZ holding.
- The trust must use a calendar year for reporting unless it is a charitable trust or qualifying to elect under IRC 645 to be treated as part of an estate. An estate may use a fiscal year as determined with the initial tax return filing.
- The return is due on or before the 15th day of the fourth month following the close of the tax year. An automatic extension of 5$^{1/2}$ months is available.

FINAL 1 INDIVIDUAL INCOME TAX RETURN

- Capital losses and net operating losses are allowed on the tax return and do not carry over to the estate.
- Suspended passive activity losses are released and deducted on the tax return to the extent they exceed the §1014 step up in basis on the related asset.
- Election to treat medical expenses paid in the year after death as paid when incurred (IRC § 213(c)).
- To prevent IRS computerized form filing issues, where tax forms have not been divided between the decedent and the estate, the preparer will need to present annual income as shown on tax forms issued in the social security number of the decedent, then subtract out the portion allocated to the estate, presented under the EIN of the estate. Preparers should also be diligent in ensuring inherited assets have been listed on such forms with stepped up basis where appropriate, or otherwise adjust.
- Planning Note: Any RMDs not taken by the decedent during the year, must be withdrawn by the beneficiaries by the end of the following year. Inherited IRA rules and related planning have changed substantially in light of the Secure Act.

COMMON ISSUES

- Income and deductions improperly reported or allocated between the final individual tax return, fiduciary income tax return, and estate tax return.
- Improper reporting or no tracking of fiduciary accounting income.
- K-1 forms improperly issued or allocated to beneficiaries (specific pecuniary bequest, charities)
- No review of the will or trust agreements
- Missed step-up in basis on inherited assets included in the federal gross estate.
- Presumption inherited assets must be converted into cash
- Missed deductions in respect of a decedent (*§ 691(b)).*
- Inherited property not treated as long-term.
- Grantor trust filing as non-grantor trusts and vice versa.

- *Audits of fiduciary income tax returns remain very low with recent Publication 55B (IRS Data Book) indicating a .05% rate of audit. These are often the result of improper deductions or allocations of income, as well as to some degree sampling and computer review.*

OBBBA IMPACT

- Trust tax rates made permanent at 10,24,35, and 37%.
- SALT cap increased to $40,000 (S/MFJ) in 2025 (and adjusted by 1% annually thereafter).
  - Phase-down rate of 30% per $1 over threshold amount of $500,000 - $600,000 (back to $10k).
- Increase in use of non-grantor trusts for income tax benefits
  - SALT cap increase is temporary through 2029.
  - 643(f) anti-abuse rules when a grantor creates multiple trusts for the same beneficiary.
  - Trusts are ineligible for IRC 179.
  - S-Corp non-grantor trusts have more complex structuring and considerations as an ESBT or QSST.
  - Service business and legitimate partner issues.
  - PTET can not pass out to beneficiaries.
  - For a NY trust to utilize $40k of state tax deduction, the trust would need to have $500,000 of taxable income. How many of your trusts are producing that much income? Probably only UHNW.
- Pease limitation replaced – Reduction to itemized deductions of 2/37 on the lesser of: itemized deductions or taxable amount exceeding the start of the 37% bracket. Bluebook footnote 102 places trusts and estates under IRC 68's general rule, sparking concerns about the impact on the DNI deduction, charitable deduction, and administrative expenses.

FIDUCIARY TAX CALCULATIONS

- A trust will be classified as simple or complex (business and disability trusts are beyond the scope of this presentation)
  - A simple trust requires annual distributions of income, and only income. These trusts may not have a charitable beneficiary.
  - In any year principal is distributed, the trust is a complex trust. All trusts are complex trusts in the final year.
- The fiduciary income tax return requires three income calculations: Taxable income, distributable net income, and fiduciary accounting income.
  - Fiduciary Accounting Income
    - Determined pursuant to the trust agreement or local law (states version of the Uniform Principal and Income Act "RUPIA").
      This is the calculation of income required to be distributed currently by a simple trust and serves as the upper limit for the DNI deduction of simple trusts (DNI deduction to the lesser of FAI or DNI).
  - Distributable Net Income
    - Determined as taxable income adjusted for tax-exempt income, capital gains, extraordinary dividends, the distribution deduction, foreign income, and the exemption. (IRC 643(a)). An estate or trust may act as a conduit, distributing income out to beneficiaries. In this case income distributed is deducted by the estate or trust and reported to each beneficiary on Form K-1 and the tax determined on their personal income tax returns.

FISCAL YEARS

- Selection of the tax year is determined with the initial filing of the estate's income tax return. An estate is not bound by a tax year provided with an application for extension, application for tax identification number, or estimated payments (Reg 1.441-1(c)(1)). If adopting a fiscal year, the estates books and records must support the fiscal year election. These rules are not unique to estates and apply to business entities as well.
- Benefits of a fiscal year include deferral of income tax, planning opportunities around income and expense timing recognition, and potential to avoid late penalties.
- A fiscal year may be elected on a late filed tax return. If an estate did not have a filing requirement until years after the decedent's death, a fiscal year may be selected with the initial filing at such time, unless the estate administration is deemed unduly prolonged, and the assets deemed owned directly by the beneficiaries. (Reg 1.641(b)-3(a)). An estate may be deemed unduly prolonged where:
  - the executor takes an unreasonable time to administer the estate
  - has substantially distributed property and paid debts of the estate, but keeps the estate open.
  - While no bright line test, page 3 of the 1041 does request an explanation for the delay in closing an estate open beyond two years.

INCLUDING CAPITAL GAINS IN DNI

- Under the RUPIA, capital gains are allocated to principal and therefore not included in DNI (except for the final year of the entity). The IRS has issued regulations with examples explaining when capital gains can be allocated to income or otherwise includible in DNI as they were paid, credited, or otherwise required to be distributed. (Reg. 1.643(a)-3(e)).
  - Allocated to income and included in DNI if expressly allowed under the trust agreement and local law (if trust agreement is silent).
  - Allocated to principal, but included in DNI if treated consistently in the fiduciary books, records, and tax returns.
  - Allocated to principal, but included in DNI if capital gains are actually distributed or used to calculate the amount for distribution to beneficiaries.
- Capital gains are netted against capital losses (including carryovers) at the trust level under scenarios 1 and 2. Under scenario 3, they would not be netted (absent a specification in the trust agreement or a case made of regular practice of distributing net capital gains).
- Actual distributions from a pass-through entity to a trust, including capital gains, are fiduciary accounting income allowable in DNI (Exception for ESBTs).
- A trustee must consider total return investing and exercise impartiality to income and remainder beneficiaries when selling appreciated principal assets and allocating capital gains to income.

CHARITABLE DEDUCTIONS

- §642(c) governs deductibility of amounts paid or permanently set aside for payment to charity.
- Must be allowed and specifically identified in the governing instrument.
- The charitable organization must satisfy IRC 170(c).
- Such payments are excluded from DNI and deducted at the entity level on Schedule A of Form 1041.
- Must be paid out of gross income.
- Not available to simple trusts.

GRANTOR TRUST REPORTING

- Grantor Trusts (IRC *§671-679)*
  - The trust is not a separate taxpayer (while the grantor is living). May file and report under the traditional method or two alternative methods as prescribed in the regulations. (Reg §301.6109)
  - **Traditional Method:** A separate tax identification number is required and a Form 1041 filed for informational purposes only. Income and expense are reported on a grantor letter which must describe in detail these items for tax return preparation and expressly communicate to the grantor these items are to be included in their taxable income. Regardless of IRS requirements, banks usually request a tax identification number. Best when multiple grantors or the grantor/spouse is not a trustee (Reg §1.671-4(a)).
  - **Alternative Method 1:** A separate tax identification number is not required and all activity of the trust can be reported directly on Form 1040. Tax forms are issued in the name and tax id of the grantor and the address of the trust. Form W9 is maintained by the trustee. (Reg §1.671-4(b)(2)(i)(A)). This method is available to wholly owned grantor trusts and best when the grantor or spouse is also a trustee. If the grantor is not a trustee, an information statement must be furnished to the grantor making this reporting method less beneficial.

GRANTOR TRUST REPORTING

- Alternative Method II: Payors issue 1099s in the name and identification number of the trust, who in turn issues 1099s to the grantor from the trust as payor. An information statement is provided to the grantor from the trustee. Who is this best for? Nobody!
- A grantor and the grantors spouse are considered a single grantor for alternative reporting method purposes if they file a joint income tax return (meeting the definition of a wholly owned grantor trust).
- If a trust has foreign assets or situs, they must file under the traditional method.
- Upon death of the grantor, the trust must obtain a new tax id. This is required even if the trust previously had its own tax id.
- A trust may be a grantor trust in respect to only a portion of the trust. The grantor trust portion would be reported on the 1040 with the non-grantor portion reported on Form 1041.
- A trust may change from the traditional method to the alternate method by filing a final Form 1041 stating the return is filed pursuant to §1.671-4(g).

TRUST SITUS & RESIDENCY

- A trust may be classified as a resident, part-year resident, non-resident, or exempt resident.
- Similar to individuals, a resident is taxed on all income while a non-resident is taxed only on state sourced income. (Beneficiaries have a tax liability to the resident state of the trust on their share of DNI only to the extent such income is sourced to the resident state).
- Situs of a trust generally refers to the state whose laws and courts govern trust operations. The settlor determines the situs of the trust in the trust agreement (otherwise turns to trustee location). Situs may be changed later by the trustees and beneficiaries. A trust will have situs in states where the trust meets nexus requirements under that states laws.
- Documenting situs is not in it and of itself determinative of which state or states have the ability to tax income of the trust. There are 5 factors states consider to varying degrees when determining if a trust has nexus with that state. These include residency of trustees, residency of beneficiaries, state of trust administration, and assets located in the state. Most importantly, states heavily rely on the residence of the grantor at the time the trust is funded/formed. (30 of 50 states per Bloomberg Nexus Survey, NY Tax Law §605(b)(3), NY Tax Law §1305(c), NYC Admin Code §11-1705(b)(3)).
- A settlor of one state may engage a trustee in a separate state to perform all aspects of trust administration in that separate state. A tax-free jurisdiction with favorable, established trust laws and protections such as Delaware, South Dakota, and Nevada is chosen for this purpose.

NY EXEMPT RESIDENT TRUST

- An exempt resident trust is formed by a resident grantor, with all assets and trustees situated outside of New York, and the trust has no New York source income. These trusts are exempt from state tax. (NY Tax Law §605(b)(3)(D)).
- Such a trust still has to file a New York fiduciary income tax return indicating its status as a NY and/or NYC exempt-resident trust by checking the box on page 1 and attaching Form IT-205-C to certify its exempt status where the trust is required to file a federal tax return or has any New York taxable income. (TSB-M-10(5)I)
- A trust becomes an exempt-resident trust as of the time it satisfies the 3-prong test. This may result in being a part-year exempt resident trust. (TSB-A-10(4))
- Income accumulated in an exempt resident trust, later distributed to a New York resident beneficiary will be subject to New York income tax. Such a trust will be required to complete and attach Form IT-205-J to its fiduciary income tax return. The purpose of the throwback rules is to tax undistributed income as if it had been distributed to the beneficiary in prior years when received and prevent individuals from optimizing recognition or circumventing New York tax. (N.Y. Tax Law § 612(b)(40)).

EXECUTOR/TRUSTEE PROTECTIVE FILINGS

- Notice of Fiduciary Relationship – Form 56
  - Filed at onset of fiduciary relationship to notify IRS of your appointment.
  - Ensure correspondence sent to the decedents address are not missed.
  - Filed again at conclusion of estate administration to provide notice of termination of fiduciary relationship. (Reg §301.6903-1(b)).
- Request for discharge from personal liability - Form 5495
  - Filed once the tax returns have been accepted. Granted automatically to executor 9 months after filing (6 months to other fiduciary) unless notified otherwise of taxes due. (Reg §301.6905-1(a): Reg §20.2204-1(a)).
  - Executor/Trustee may still be liable for taxes in their capacity as a beneficiary.
- Request for prompt assessment under IRC §6501(d) – Form 4810
  - Reduce statute of limitations from 3 years to 18 months.
  - Does not apply if substantial omission of income.
- Consider reimbursement agreement between executor/trustee and beneficiaries.

COMMON ELECTIONS & CONCEPTS

- **Election to treat a qualified revocable trust as part of an estate (IRC §645)**
  - Irrevocable election made on Form 8855 to treat a revocable trust as part of an estate for tax purposes. Must be filed by extended due date of initial tax return and generally, is effective for a period of two years.
  - Electing trust and estate are treated as separate shares for computing DNI and accounting for distributions.
- **Election to treat income distributions to beneficiaries within 65 days of the tax year-end as distributed in prior year to the extent of DNI (IRC §663(b))**
  - Check the box election on page 2 of form 1041 and statement describing income distributed, date of distribution, and beneficiary.
- **Election to waive administration expenses on Form 706 and claim on Form 1041**
  - Attach as duplicate signed statement on the Form 1041 for eligible fiduciary expenses in whole or in part. Reduces the marital share on estate return.
- **Pass-Through Losses and Excess Deductions on Termination**
  - Only allowed in the final year of the trust or estate and applies only to capital losses and net operating losses (K-1 Box 11).
  - Suspended passive activity losses are added to basis of the passive activity. (IRC §469(g)(12)). AMT credits not used are lost.
  - Excess deductions on terminations are grouped into three buckets: (1) allowed in arriving at adjusted gross income (2) non-miscellaneous itemized deductions in arriving at taxable income or (3) miscellaneous itemized deductions. (Final Regs. 2020-21162). See Schedule 1 of Form1040, IRC 67(e) excess deduction line.

COMMON ELECTIONS & CONCEPTS

- **Election to treat estimated tax as Paid by Beneficiaries**
  - Form 1041-T is filed by a trust or final year estate to elect to treat overpayments from estimated tax paid by the entity as paid by the beneficiary. The election must be filed within 65 days of the tax year-end. The tax paid will be treated as paid on the last day of the tax year. (IRC §643(g))
- **Election to treat a charitable contribution as made in the prior year (IRC §642(c))**
  - Attach a statement to the return (or amended return) for which the charitable contribution deduction is being claimed. Must be filed by the extended due date of the later years tax return.
- **Election to recognize capital gains on distribution of in-kind property (IRC §643(e))**
  - Useful if a trust or estate has carryover losses or is in a low tax bracket relative to the beneficiaries.
    - Considerations for depreciable property and related parties may pose unforeseen consequences, especially where the appreciation is minimal (as in the case of an estate).
    - Check the box on page 2 of Form 1041. A separate statement is not required, but may be included.
    - Without an election, an in-kind distribution is at the lower of basis or fair market value, unless in satisfaction of a pecuniary bequest or income requirement of a simple trust.
      (IRC § 663(a))

FOREIGN TRUSTS

- Any trust that does not meet the definition of a domestic trust (U.S. court has primary jurisdiction over the trust administration and/or U.S person has control over substantial decisions) will be deemed a foreign trust.
- These trusts are required to report U.S. activity using the form 1040-NR and are taxed as foreign non-resident individuals, incorporating rules applicable to trusts and estates. (IRC § 641(b))
  - The trust pays U.S. tax on two classes of income:
    - U.S. source FDAP income at a flat rate of 30% (unless reduced by treaty).
    - U.S. ECI from a trade or business, net of deductions, at graduated tax rates.
- Form 3520 and Form 3520-A may be required where a U.S. person forms a foreign trust, receives a distribution from, or transfers property to a foreign trust, or where a U.S. person dies and a foreign trust is includible in the gross estate. Where a U.S person is the owner of the trust, the Form 3520 must be filed annually to report activity of the trust, or receives foreign gifts.
- Foreign asset reporting and disclosure applies to these trusts.
- The IRC contains a number of unfavorable provisions to diminish the use of foreign trusts, as they can otherwise be utilized to avoid U.S. income taxes. These include:
  - Income taxation on the contribution of appreciated assets to the trust.
  - Modifications to DNI calculation to include gross foreign income.
  - Throwback tax and interest charge for income earned in one year, distributed in a subsequent year. (IRC § 667-668).

BIOGRAPHY & CONTACT



Matthew Taus, CPA/PFS, CFP®, AEP® is chair of the Private Client Service Practice Group and Partner overseeing the firm's Trust, Estate, and Gift Tax practice. He advises high-net-worth families, real estate professionals, and closely held business owners on a broad range of tax matters including the areas of investment taxation, equity compensation, foreign investments in the U.S., estate planning, fiduciary income tax matters, entity structuring, rental real estate, multi-state taxation, and business sales. Prior to joining Wild, Maney, & Resnick LLP, he was a senior CPA with KPMG and later served as the tax lead of a Manhattan boutique advisory and accounting firm. Matthew is a member of the Estate Planning Council of Long Island, Financial Planning Association, National Conference of CPA Practitioners, American Institute of Certified Public Accountants, and New York State Society of CPA's. He regularly speaks and writes on tax matters for organizations and publications through which he has been recognized through professional awards for client service and accounting education. Matthew graduated Hofstra University in 2008 with a BBA with specialization in Accounting.

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