**Income Tax of Trusts & Estates Outline**

**Fall 2020 - Weissbart**

**I. Introduction:**

a. Overview of the Quasi-Conduit Regime:

* Possible Taxpayers:
  + Because the Code cannot tax a trust or estate like an existing entity – e.g., partnership, individual, or corporation – it created the Quasi-Conduit Regime.
  + This tax either the trust or the beneficiary to allocate the burden in the most equitable way – especially so because of the incongruity that the other systems had.
* Gifts & Bequests as Income:
  + § 61: Except as otherwise provided in this subtitle, gross income means ***all income from whatever source derived***, including (but not limited to) the following items. . . . **(15)** ***Income from an interest in an estate or trust***.
  + *Glenshaw Glass*: Income includes all “undeniable accessions to wealth, clearly realized and over which the taxpayers have complete dominion.”
  + However, IRC 102(a) 🡪 gross income does not include property acquired by gift, bequest, devise or inheritance.
  + Exception to 102(a) 🡪 102(b)(1) the income from the property referred to in (a) (the “fruit”) is taxable income.
    - Ex: A gives B a life estate in a building. B rents the building out; receives rental income.
      * B would not pay tax on the receipt of the life estate or the benefit of having the property rent free, but B would pay income tax on the rental income received from renting the building out.
  + Origins of Subchapter J were found in Irwin v Gavit 🡪 TPs should not pay tax on bequests, only the income generated from those bequests.
* Subchapter J Principals:
  + Trust corpus (the tree) should pass tax free – § 102(a)
  + Income from the corpus (the fruit) should be taxed – 102(b)(1)
  + Beneficiaries should be taxed on income distributed to them – § 102(b)(2)
  + Beneficiaries should not be taxed on income not distributed to them.
* Quasi-Conduit Regime:
  + IRC 651(a) 🡪 Trust gets deduction if it is required to distribute currently (FAI)
  + IRC 652(a) 🡪 amt of income required to be distributed must be included in gross income of beneficiaries.
* Definitions of Income:
  + Income Required to be distributed: § 1.651(a)-2: The determination of whether trust income is required to be distributed currently depends upon the ***terms of the trust instrument and the applicable local law***.
    - i.e., Fiduciary Accounting Income
  + Distributable Net Income (DNI): this is a tax concept, not a state law concept.
  + § 643: For purposes of this subpart and subparts B, C, and D, ***the term “income”***, when not preceded by the words “taxable”, “distributable net”, “undistributed net”, or “gross”, ***means the amount of income*** of the estate or trust for the taxable year ***determined under the terms of the governing instrument and applicable local law***.
  + Text

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  + § 651(b): If the amount of ***income required to be distributed currently*** exceeds the ***distributable net income*** of the trust for the taxable year, the deduction shall be limited to the amount of the distributable net income.
    - i.e., the distribution deduction is the lesser of FAI or DNI.

b. Fiduciary Accounting Rules – Defining Income & Principal:

* **Income 🡪** rental receipts allocated to income **UPIA 405.**
  + Does NOT matter if income is tax-free, still allocated to income under 406(a)
  + 406 🡪amt received as interest, whether variable, floating or fixed rate, is allocated as income. (Exception: the amount received from sale of an obligation to pay money is principal)
  + Dividends **🡪** are income
    - **Exception:** if the dividend received is a “partial liquidation” then under 401(d) and ©(3) this would be considered principal. If it is disproportionately large dividend, may be a partial liquidation (also results in cap gains).
* **Principal 🡪** all sale/exchange/liquidation/realized profit from “tree” **UPIA 404(2).**
  + Purchase of Property: the purchase of the property is essentially swapping assets (cash for property) so nothing changes.
  + Sale of Property: the property received in the sale of a principal asset is allocated to principal.
  + Stock dividends**:** this is a distribution of principal, not income. “property other than money” – 401(c)(1)
  + Stock redemptions:this is all allocated to principal. 401(b)
  + K-1 partnership income:this is not allocated to principal or income – this is phantom income, tax income only
  + Money received in “partial liquidation 401(d): if money received is greater than 20% of entity’s gross assets.
  + Purchase of Bonds: the interest payments on the bonds, whether municipal or corporate, are allocated to income. Principal payments are allocated to principal.
    - Bonds purchased at a premium: the interest payments are divided between income and principal. The interest rate X FV = income amount; remainder is the principal amount.
  + Zero Coupon Bonds **🡪** no accounting income, all principal (one exception: if owned for less than a year)
  + Junk Bonds: Interest is still income, but duty of imperiality might be breached.
* **Underproductive property 🡪** 
  + **UPIA 413.** May require the trustee to make property productive.
  + **EPTL 11-2.1 🡪** Allocates a portion of the net proceeds of a sale when net income has not been over 1% as delayed income.
* **Allocation of Expenses 🡪** 
  + **UPIA 501(1) & (2),** allocated 50/50 btw P/I for trustee fees, investment fees, accountings, custodial fees, and other interests involving both I and P interests.
  + **UPIA 501(3) 🡪** if it is for a principal expense (such as capital improvement) expense allocated to P; if for an Income expense (such as maintenance/repairs) allocated to Income
  + **UPIA 501(4) 🡪** recurring premiums on insurance covering loss of principal asset or loss of income or use of asset.
  + **UPIA 503(b)** 🡪 **Transfers from I to P for Depreciation:** Trustee also has power to adjust 🡪 if you have an income-producing asset that will eventually become worthless, trustee can exercise power to adjust I 🡪 P to compensate the remaindermen.
* **Differing Allocations 🡪** 
  + **UPIA § 103 🡪** provides that the governing instrument’s allocation of principal and income will govern, but will it be respected for tax law is the question.
* **Big Question:** will tax law respect allocations between I and P that are in accordance with state law and gov document, but which vary widely from tax law?
  + § 1.643(b)-1: Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized.

**II. Simple Trusts and the Quasi-Conduit Regime:**

a. Computation of the Taxable Income of a Trust & Estate:

* IRC 1(e) – every trust and estate is taxable, includes table. Highest bracket reached at $12,950 (1(j)(2)E).
* IRC 641(b) 🡪 trust/estate taxable income computed in same manner as individual, except:
  + 1) No standard deduction (IRC 63(c)(6))
  + 2) Different personal exemption (IRC 642(b)
    - $100 – Not required to distribute all income; 300 – Required to distribute all income; 600 – Estates.
    - No inflation adjustment, not phased out based on AGI
    - All estates get $600 (IRC642(b)(1))
    - All simple trusts and some complex trusts get $300 IRC 642(b)(2)(B)
    - Other complex trusts = $100 (IRC 642(b)(2)(A))
  + 3) Trusts and estates receive distribution deduction for income required to be distributed
    - Simple trusts – IRC 651
    - Complex Trusts IRC 661

b. Distributable Net Income (“DNI”):

* *Limitation on Deduction*: IRC 651(b) 🡪 if amt of income required to be distributed exceeds DNI for trust, deduction is limited to the DNI. (Lesser of FAI or DNI)
  + This keeps the distribution deduction closer in line with what is actually being distributed to the beneficiary.
* *Step-by-step Procedure for Calculating DNI:*
  + Calculate TTI: Gross income – deductions
    - This is the PE, capital losses, all of trustee’s commissions, etc.
  + Add back the Deduction in Lieu of Personal Exemption (100/300/600)
  + Subtract capital gains and add back capital losses.
  + \*\*\*Advanced procedures:
    - Adding tax-exempt interest
    - Excluding extraordinary dividends or simple trusts
    - Including capital gains/loss in DNI

c. Step-by-Step Procedure for Calculating the Income of a Simple Trust:

* Step 1) Calculate the Gross Income
  + Add up all items of taxable income earned by the trust.
  + Rents, interest, dividends, capital gains, partnership distributive share, OID, etc.
* Step 2) Compute the amount of TTI:
  + Reduce the amount from Step 1 by all deductions except for the distribution deduction.
    - PE, etc.
* Step 3) Compute the amount of the distribution deduction:
  + A) Determine the FAI: all items of income as defined under state law required to be distributed.
  + B) Determine DNI: step-by-step procedure above.
  + Take the lesser of FAI or DNI.
* Step 4) Compute the taxable income:
  + Reduce the TTI from Step 2 by the DD in Step 3.

d. Computation of Amount Included in the Gross Income of Beneficiaries:

* § 652(a): [T]he ***amount of income*** for the taxable year ***required to be distributed currently*** by a trust described in section 651 ***shall be included in the gross income of the beneficiaries*** to whom the income is required to be distributed, whether distributed or not. ***If such amount exceeds the distributable net income***, ***there shall be included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income as the amount of income required to be distributed to such beneficiary bears to the amount of income required to be distributed to all beneficiaries.***
* *Basic* Step-by-Step Procedure to Determine Amount included in a Beneficiary’s Gross Income:
  + Step 1) Compute FAI
  + Step 2) Compute DNI
  + Step 3) Determine the FAI required to be distributed currently (“FAIRTBD”) to each beneficiary
    - AKA – FAIRTBD(b)
  + Step 4) Identify the lesser of FAI or DNI:
    - If FAI < DNI, then the amount included in each beneficiary’s gross income is the FAIRTBD(B)
    - If FAI > DNI, then the amount included in each beneficiary’s gross income = DNI X (FAIRTBD(B)/FAI)

e. Character of Income Included in the Gross Income of Beneficiaries:

* IRC § 652(b): The amounts specified in subsection (a) shall have ***the same character in the hands of the beneficiary as in the hands of the trust***. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries.
* *Basic* Step-by-Step Procedure for Determining Character of Amounts Included in Beneficiary’s Gross Income:
  + Step 1) Compute DNI
  + Step 2) Determine the total amount included in each beneficiary’s gross income (section above)
  + Step 3) Identify all classes of gross income entering into DNI (i.e., make a list) and their amounts.
  + Step 4) Multiply the results from Step 2 by (the amount of each class / Total DNI)
    - Repeat this step for each item listed in Step 3.

f. Timing of Inclusion:

* § 652(a): [T]he ***amount of income*** for the taxable year ***required to be distributed*** currently by a trust described in section 651 ***shall be included in the gross income of the beneficiaries*** to whom the income is required to be distributed, ***whether distributed or not***.
* Reg. § 1.652(a)-1: Subject to the rules in §§ 1.652(a)-2 and 1.652(b)-1, ***a beneficiary of a simple trust includes in his gross income for the taxable year the amounts of income required to be distributed to him for such year, whether or not distributed***. Thus, the income of a simple trust is includible in the beneficiary's gross income for the taxable year in which the income is required to be distributed currently even though, as a matter of practical necessity, the income is not distributed until after the close of the taxable year of the trust.
* *Steingold v Commissioner* 🡪 Chancery court issued order requiring trustee to retain all trust income, IRS still claimed that Steingold had present right to receive income. Eventually the tax court elected not to challenge the lower-level state court decision.
  + Can be cited as support for the position that the decision of a state court should be decisive in a dispute over whether a trust is governed under Subpart B or C.
  + But consider *Bosch* – which said you give ‘proper regard’ to state court rulings, but they are not binding. So, for income tax, you can respect low level court decisions under Steingold, but for estate tax, you have to get order from highest court of state.
  + *Debraybant* Case 🡪 even if posthumously conceived children, had to resolve whether they were entitled to income, did not receive for years, still required to pay income tax on it even when not distributed.
  + *Steingold* could be dangerous to the IRS.
* Reg. § 1.651(a)-2(b) ***–*** *“Sprinkle Trust” if the fiduciary is required to distribute all income currently, but has discretion to sprinkle the income among a class of beneficiaries, all income is required to be distributed currently, even though the amount distributable is unknown until after fiduciary has exercised discretion*

g. Specific Allocations:

* § 652(b): The amounts specified in subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, ***unless the terms of the trust specifically allocate different classes of income to different beneficiaries***.
* Reg. § 1.652(b)-2(a): The amounts specified in§ 1.652(a)-1 which are required to be included in the gross income of a beneficiary are treated as consisting of the same proportion of each class of items entering into distributable net income of the trust . . . ***unless the terms of the trust specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation***. . . . [I]f the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, ***each beneficiary will be deemed to have received those items of income specifically allocated to him***.
* In Plain English:
  + Determine if there is a specific allocation:
    - If yes, use the allocation in the trust instrument to determine the character of the total amount included in each beneficiary’s gross income.
      * This may change the amount included. *See* § 652(a), subject to § 652(b).
      * i.e., when there is a specific allocation, the character is what is given to you.
    - If no, use DNI to determine the character of the total amount included in each beneficiary’s gross income.
* Specific Allocations when FAI > DNI:
  + If the specific allocation otherwise qualifies as such, use that specific allocation and if there is remaining income to distribute, use the following:
    - Step 1) Amt. Allocated to B = Specific Allocation Amt. + (FAI – Specific Allocation)/Total FAI.
    - Step 2) Character = Amt. Allocated to B X (Item Amt. in DNI)/(DNI – Specific Allocation)
    - \*\*\* Make sure the sum adds up to the total amount the B is supposed to receive.
* Economic Effect Requirement:
  + Reg. § 1.652(b)-2(b): The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, ***and only to the extent that it has an economic effect independent of the income tax consequences of the allocation***. For example:
    - (1) Allocation pursuant to a provision in a trust instrument ***granting the trustee discretion to allocate different classes of income*** to different beneficiaries ***is not a specific allocation*** by the terms of the trust.
    - (2) Allocation pursuant to a provision directing the trustee to pay all of one income to A, or $10,000 out of the income to A, and the balance of the income to B, but ***directing the trustee first to allocate a specific class of income to A's share*** (to the extent there is income of that class and to the extent it does not exceed A's share) ***is not a specific allocation*** by the terms of the trust.
      * The specific allocation must work every year.
      * Ex. Unit II, Prob. 18.
    - (3) Allocation pursuant to a provision ***directing the trustee to pay half the class of income*** (whatever it may be) to A, and the balance of the income to B, ***is a specific allocation by the terms of the trust***.
  + In Plain English:
    - The tax law will respect a specific allocation only when the following two requirements are present:
      * 1) The allocation is made pursuant to the governing instrument (Reg. § 1.652(b)-2(b)) or is required under local law (Reg. § 1.652(b)-2(a)).
      * 2) The specific allocation has to have an economic effect independent of tax consequences.
        + If the trust mandates that a specific class of income be allocated to a beneficiary, the allocation will be used to determine character. Reg. § 1.652(b)-2(c).
        + If the trust *gives the trustee discretion to determine the allocation* of classes of income to beneficiaries, the allocation will not be used to determine character. Reg. § 1.652(b)-2(a).
        + If the trust mandates that a specific class of income be first allocated to a beneficiary’s share, the allocation will not be used to determine character. Reg. § 1.652(b)-2(b).
      * The key question is *whether the allocation determines the ACTUAL AMOUNT received by the beneficiary*.
        + If it does not, then it is not respected.
    - The specific allocation must work every year; otherwise, it will not be respected as a specific allocation.
    - By directing the allocation based on which beneficiary is in the higher bracket, is a specific allocation. It does have an economic effect independent of tax consequences – it determines which of the two beneficiaries get the assets.
    - Good faith requirements: arguments for both sides. Would likely depend on how “good faith” is interpreted, would direct the answer here. If mandatory, not a specific allocation because would be 50/50 regardless. If not mandatory, would be a specific allocation.
      * Would be nearly impossible for a trustee to generate a 50/50 split on income.

h. Defining Simple Trusts (Subchapter J, Subparts A-C):

* Requirements for a Simple Trust § 651 (& Reg. § 1.651(a)-1):
  + 1) Trust must require that all income be distributed annually.
  + 2) No amounts may be paid, permanently set aside, or used in the taxable year for charitable purposes (as per Section 642(c)).
  + 3) For the taxable year, the trust must not distribute any amounts other than current income.
* Simple trusts are not the default🡪 (IRC 661(a)) must specifically qualify for treatment under subpart B.
* Every Simple trust is entitled to a $300 Personal Exemption.
  + A complex trust is able to have a $300 personal exemption – must be required to distribute all income at least annually.
  + Estates are ALWAYS complex (gov’d by Subpart C)
  + Also, if trust gov’d by state law which differs dramatically in allocation of P/I from federal law, then state law many not be respected and could cause simple trust to be complex.
* Important Terminology:
  + Reg. § 1.651(a)-1: A trust to which section 651 applies is referred to in this part as a “simple” trust. Trusts subject to section 661 are referred to as “complex” trusts.
* **Step-by-Step Procedure to determine whether a trust is taxed under Subpart B or C:** 
  + Step 1) Are you either an estate or a trust?
    - If you’re neither an estate nor a trust, then you are not taxed under Subpart B or C.
    - If you’re an estate, you taxed under Subpart C.
  + Step 2) If you’re a trust, is the trust (or any portion) treated as owned by the grantor or another person under rules of subpart E?
    - If so, the grantor or other person will pay the tax on the taxable income (or portion thereof) of the trust.
      * This is covered in Grantor Trust Taxation.
  + Step 3) If no one is treated as an owner, the trust is taxed a “Complex Trust” under Subpart C, unless it meets the 3 requirements for a “Simple Trust,” which is then taxed under Subpart B.
    - 1) trust must require that all income be distributed annually;
    - 2) no amounts may be paid, permanently set aside, or used in the taxable year for charitable purposes (per § 642(c));
    - 3) for the taxable year, the trust must not distribute any amounts other than current income.
* Personal Exemption
  + Estate allowed PE of $600
  + Everything other than trusts distributing all income currently entitled to $100.
  + Trusts distributing all income currently = $300 (even if also distributes PRINCIPAL)
* **Simple V Complex trust**
  + Complex trust will not be complex unless principal is ACTUALLY distributed.
  + Simple trust is still simple if all income is required to be distributed, even if trustee fails to distribute income.

**III. Complex Trusts and Advanced Application of the Quasi-Conduit Regime**

a. Introduction to Complex Trusts & Estates:

* § 661(a): In any taxable year there shall be allowed as a deduction in computing the taxable income of an estate or trust (other than a trust to which subpart B applies), the sum of—
  + (1) any amount of income for such taxable year required to be distributed currently; ***and***
  + (2) ***any other amounts properly paid or credited or required to be distributed for such taxable year***; but such deduction shall not exceed the distributable net income of the estate or trust.
* What is the same as Simple Trusts:
  + Income required to be distributed currently is still a part of the distribution deduction.
  + The distribution deduction cannot exceed DNI.
* What is different than Simple Trusts:
  + Applies to estate and trusts.
  + The distribution deduction also includes “other amounts property paid or credited or required to be distributed for such taxable year.”
* ***Basic* Step-by-Step Procedure to Compute the Distribution Deduction for Complex Trusts & Estates:**
  + Step 1) Determine the FAI required to be distributed currently – “FAIRTBD”
    - FAI
    - % required to be distributed
    - = FAIRTBD
  + Step 2) Add the sum of other amounts (a) property paid, (b) properly credited, or (c) required to be distributed for such. Taxable year – “OAPCRTBD”
  + Step 3) Add FAIRTBD + OAPCRTBD
  + Step 4) Compute DNI
  + Step 5) The distribution deduction is the lesser of Step 3 and Step 4.
  + \*\*\* more advanced procedures for annuities and tax-exempt income below.
* Inclusion of Amounts in Gross Incomes of Beneficiaries – The Tier System:
  + §§ 661 & 662 divide the distributions from complex trusts and estate into two tiers:
    - Tier 1: FAIRTBD
    - Tier 2: OAPCRTBD
  + You would rather be a Tier 2 beneficiary because the Tier 1 beneficiaries absorb the tax first.
  + FAIRTBD & OAPCRTBD refer to facts about state law.
  + Tier 1 and Tier 2 refer to amounts of gross income carried out to beneficiaries in virtue of FAIRTBD and OAPCRTBD, respectively.
* ***Basic* Step-by-Step Procedure to Compute the Amount Included in a Complex Trust/Estate Beneficiary’s Gross Income:**
  + Step 1) Compute FAIRTBD
  + Step 2) Compute DNI
  + Step 3) Identify the lesser of DNI or FAIRTBD
    - If FAIRTBD < DNI, then the Tier 1 amount that a beneficiary includes in income = FAIRTBD(B).
    - If FAIRTBD > DNI, then the Tier 1 amount that a beneficiary includes in income = DNI X (FAIRTBD(B)/FAIRTBD(All))
  + Step 4) Subtract FAIRTBD from DNI
    - This is the “Remaining DNI”
  + Step 5) Identify OAPCRTBD
  + Step 6) Identify the lesser of OAPCRTBD or Remaining DNI.
    - If OAPCRTBD(All) < Remaining DNI, the Tier 2 amount that a beneficiary includes in gross income = OAPCRTBD(B).
    - If OAPCRTBD(All) > Remaining DNI, then the Tier 2 amount that a beneficiary includes in gross income = Remaining DNI X (OAPCRTBD(B)/OAPCRTBD(All))
  + Step 7) Add Result from Step 3 (Tier 1 Amount) and Step 6 (Tier 2 Amount) for each beneficiary.
    - A beneficiary can be both a Tier 1 and Tier 2.
  + Step 8) The result in Step 7 is the Total Amount included the Beneficiary’s gross income.
* **Step-by-step Procedure for Determining Character of Amounts Included in Beneficiaries’ Gross Incomes:**
  + Step 1) Compute DNI
  + Step 2) Determine the total amount included in each beneficiary’s gross income.
    - This requires taking the sum of each beneficiary’s T1 & T2 gross income amounts.
  + Step 3) Identify all classes of gross income entering DNI and the amount of each class (i.e., make a list)
  + Step 4) Multiply the result in Step 2 by: (the amount of each class in DNI/Total DNI)
  + Step 5) Repeat Step 4 for all items listed in Step 3.
* Specific Allocations:
  + § 662(b): The amounts determined under subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust ***unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries****. . .*
  + Reg. § 1.662(b)-1: In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust ***unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in §1.652(b)–1 shall apply***.

b. Exclusions of Specific Gifts & Sums of Money:

* § 663(a)(1): There shall ***not be included as amounts falling within section 661(a) or 662(a)*** . . . [a]ny amount which, under the terms of the governing instrument, is properly paid or credited as ***a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments***.For this purpose an amount which can be paid or credited only from the income of the estate or trust shall not be considered as a gift or bequest of a specific sum of money.
* 4 Requirements for § 663(a)(1):
  + The gift must be:
    - 1) property paid or credited as a gift or bequest under the terms of the governing instrument;
    - 2) of a specific sum or specific property, ascertainable at death or inception of the trust;
    - 3) paid (under the terms of the governing instrument) in no more than 3 installments;
    - 4) not required to be paid from income.
* Ascertainability Requirement:
  + Reg. § 1.663(a)-1(b): *Definition of a gift or bequest of a specific sum of money or of specific property.* (1) In order to qualify as a gift or bequest of a specific sum of money or of specific property under section 663(a), the amount of money or the identity of the specific property ***must be ascertainable*** under the terms of a testator's will ***as of the date of his death, or*** under the terms of an inter vivos trust instrument as of ***the date of the inception of the trust***.
    - Look to the examples.
  + If the gift is net of expenses (of administration of estate, etc.), it is not ascertainable because we don’t know what those are at death or inception of the trust.
    - Residue of estate.
    - Gross estate is ascertainable, but “net” estate is not. Neither is “residue”. But “all tangible property” is. Does not matter if the gift abates, it is still ascertainable (gives $200K but estate is only $150K, eg)
    - Even the “credit shelter” amt is not ascertainable, because you can’t know the exemption amt without computing administration expenses because of deductions taken.
  + Examples of ascertainable:
    - A share of a specific stock;
    - Cash equal to the value of a specific share of stock at death;
    - A specific piece of property;
  + RR 66-2007: doesn’t matter if a portion of the gift will abate.
  + Not disqualified solely based on fact that gift is subject to condition (Reg 1.663(a)-1(b)(4))
  + You cannot determine what ½ of the principal will be when A turns 40. Must be as of the date of death or date of inception of trust.
  + If trustee has discretion to sell the specific property, it is in a gray area.
    - Argument either way.
  + If trust directs “all tangible property to . . . “ the distribution of the tangible property would be a ascertainable of property, but if it just directs the residue, not ascertainable.
  + A gift of the exemption amount is not ascertainable because you don’t know the deductions, etc., on the date of death or upon inception of the trust.
* 3-Installment Rule:
  + IRC 663(a)(1) 🡪 all at once or 3 payments or less.
    - Reg 1.663(a)-1(c)(2) ex 2 🡪 executor exercising discretion to pay out in installments a single bequest STILL qualifies.
      * There must be no time of payment specified in the will.
    - Does not matter how many items are included in single bequest.
      * What matters is how many installments for each thing.
    - Reg 1.663(a)-1(c)(1)(i) 🡪 exception for personal property to the 3-installment rule (so if gift a car each year for four years, that’s ok).
    - Reg 1.663(a)-1(c)(1) 🡪 for purposes of determining number of installments paid to beneficiary, a decedent’s estate and trust shall each be treated as a separate entity.
* Not Payable from Income Rule:
  + § 663(a)(1) 🡪 an amt which can be paid or credited only from income of T/E is not considered gift/bequest.
    - A gift of accumulated income will fail because it is required to come from income.

c. Definition of Paid and Credited:

* § 661(a): a deduction is allowed for any income required to be distributed currently and all other amts properly paid or credited…
  + What is not enough:
    - A memo to file;
    - Mere bookkeeping entries;
    - Providing an apartment/house rent free (would depend on the living situation of the beneficiary – rent free or paying rent; whether the trustee acquired the apartment for B.
    - Becoming the trustee
  + What is enough:
    - If Trustee writes a letter to beneficiary acknowledging the intended distribution and the beneficiary signs and returns the letter;
      * This is true even if the trustee promises to pay the amount in the future – i.e., a loan back to the trust.
      * It is also trust if the beneficiary promises to refund amounts if needed by the trust.
    - Paying rent or maintenance expenses for a beneficiary.
    - Buying a car for a beneficiary.
  + Unclear if an investment in a beneficiary’s business is properly paid or credited – like buying a house/paying rent on a house is arguable.

d. DNI & Tax-Exempt Interest:

* § 643(a): (5) Tax-exempt interest. — There shall be included any tax-exempt interest to which section 103 applies, reduced by any amounts which would be deductible in respect of disbursements allocable to such interest but for the provisions of section 265 (relating to disallowance of certain deductions).
* ***Advanced* Step-by-Step Procedure to Calculate DNI (when TEI Present):**
  + Step 1) Calculate TTI.
  + Step 2) Add back in the Deduction in Lieu of Personal Exemption.
  + Step 3) Subtract capital gains and add back capital losses.
  + Step 4) Add in tax-exempt interest (TEI).
* TEI is still not included in the gross income.
* TEI is included in the calculation of FAI.
* Make sure to use the ADJUSTED FAI in distribution deduction calculation for trust taxable income (subtract the tax-free income), so that trust doesn’t get a distribution deduction for tax free income.
  + § 651(b): If the amount of income required to be distributed currently exceeds the distributable net income of the trust for the taxable year, the deduction shall be limited to the amount of the distributable net income. ***For this purpose, the computation of distributable net income shall not include items of income which are not included in the gross income of the trust and the deductions allocable thereto***.
  + Reg. § 1.651(b)-1: In computing its taxable income, a simple trust is allowed a deduction for the amount of income which is required under the terms of the trust instrument to be distributed currently to beneficiaries. If the amount of income required to be distributed currently exceeds the distributable net income, the deduction allowable to the trust is limited to the amount of the distributable net income. For this purpose ***the amount of income required to be distributed currently, or distributable net income, whichever is applicable,*** does not include items of trust income (adjusted for deductions allocable thereto) which are not included in the gross income of the trust.
* **Procedure to Compute DD for simple trust with TEI (*imperfect – use complex trust computation*):**
  + Step 1) Compute Trust Tentative Taxable Income.
  + Step 2) Compute FAI
  + Step 3) Compute DNI
  + Step 4) Determine lesser of FAI and DNI
  + Step 5) Exclude tax exempt income from result in Step 4 (adjusted DNI/adjusted FAIRTBD) = Distribution Deduction
* **Rule is imperfect for Simple Trusts, where FAI is less than DNI**
  + Trust doesn’t get to take a distribution deduction, but beneficiaries are paying tax.
  + IRS got it right for COMPLEX TRUSTS in IRC 661(c) 🡪 no deduction allowed that would not be included in taxable income of trust.
  + It is more likely to occur in a complex trust.
  + He believes you can follow rule in complex trusts for both simple and complex trusts – based on the language in the instructions on Form 1041, page 30.
    - It backs out the TEI picked up by the beneficiary; makes no distinction between simple and complex trusts.
* ***Advanced* Step-by-Step Procedure to Compute the Distribution Deduction for Complex (and Simple) Trusts and Estates:**
  + Step 1) Determine FAIRTBD
  + Step 2) Determine OAPCRTBD
  + Step 3) Add Step 1 & Step 2 together.
  + Step 4) Compute DNI
  + Step 5) Identify the lesser of Step 3 and Step 4
    - This is the tentative DD
  + Step 6) Multiply the Tentative DD by: (TEI included in DNI)/DNI
    - Unless there is a specific allocation of TEI to a beneficiary.
    - This will be the amount excluded from DD
  + Step 7) subtract the result in Step 6 from the Result in Step 5
  + Step 8) The result in Step 7 is the DD.
* When FAIRTBD < DNI that means there could be other items in DNI not included in FAI or OPCRTBD.
  + In the situation where the FAIRTBD + OPCRTBD is included in GI, but the DNI determines character.
    - B can’t possibly pickup all of the TEI in the DNI.
* It won’t matter when FAI > DNI because all of the TEI will be picked up by the B.

e. Allocation of Deductions:

* Allocation Rules in Plain English:
  + 1) Allocate deductions directly attributable to a class of income to that income. Reg. § 1.652(b)-3(a).
    - E.g., repairs on a building allocated against rental income.
  + 2) Allocate deductions not directly attributable to a class of income to any item of income included in DNI, subject to the limitation in Rule 3. Reg. § 1.652(b)-3(b).
    - E.g., trustee commissions can be allocated against either rental income or dividend income in the fiduciary’s discretion.
  + 3) When there is tax-exempt income, a portion of the not directly attributable deductions must be allocated against TEI. Reg. § 1.652(b)-3(b).
    - E.g., if a trust has $10K of dividends, rents, and TEI with commissions of $3K, allocate 1/3 of the commissions against TEI.
  + 4) If directly attributable deductions exceed that class of income, the excess expense is treated as an indirect expense and can be allocated against any other item of taxable income, but no part needs to be allocated against TEI (*see* example in Reg. § 1.652(b)-3(d)); however, excess deductions directly attributable to TEI may not offset other income.
* **Advanced Procedure for Calculating DNI:**
  + Calculate tentative taxable income (i.e., taxable income without distribution deductions)
    1. Gross Income
    2. Add up items of deduction, including the “gross” Section 212 expenses
    3. Compute the portion of gross Section 212 expenses allocable to tax-exempt interest
    4. Subtract the result in step (c) from the amount in step (b)
    5. Subtract the result in step (d) from the amount in step (a)
  + Add back in the personal exemption
  + Subtract capital gains and add back in capital losses
  + Subtract the amount of section 212 expenses allocable to tax-exempt interest (as computed in step 1(c)) from the gross amount of tax-exempt interest
    - This is called “net tax-exempt interest”
  + Add net tax-exempt interest
    - This is the TEI less the Not Directly Attributable deduction allocated to TEI
* **Step-by-Step Procedure for Allocating Deductions Amount Items of DNI:**
  + Step 1) Compute DNI.
  + Step 2) Make a list of items of gross income (before deductions) entering into the computation of DNI, and their amounts.
  + Step 3) Make a list of items of deduction entering into the computation of DNI, and their amounts.
    - Ex. Of items not entering into computation of DNI:
      * Capital losses (because they are normally excluded from DNI);
      * Depreciation deductions to the extent required to be allocated to beneficiaries under § 167(d);
  + Step 4) Divide items in Step 3 into two categories: “Directly Attributable” and “Not Directly Attributable” to a specific class of income.
  + Step 5) Subtract the Directly Attributable items of deduction from the gross amounts of the classes of income to which they are attributable.
    - If Directly Attributable items exceed the class to which they are attributable, treat the excess as Not Directly Attributable with the following modifications:
      * No amount needs to be allocated against TEI;
      * Excess deductions attributable to TEI cannot reduce any other income.
  + Step 6) If there is no TEI, subtract the Not Directly Attributable items from the gross amount of any classes of income at the discretion of the fiduciary.
  + Step 7) If there is TEI, follow these steps:
    - Allocate a portion of the Not Directly Attributable items of deduction to TEI in accordance with this formula: Not Directly Attributable Item X (TEI in DNI)/ Total DNI Items.
      * The total DNI does not include the Not Directly Attributable Deductions.
    - Subtract this amount from the Not Directly Attributable Item of Deduction.
    - Allocate the remaining amount to any class of income at the discretion of the fiduciary.
  + Step 8) Check to confirm that the sum of classes of income, after subtracting items of deduction, equals DNI.
* DNI and Net TEI:
  + IRC 643 🡪 when calculating DNI and adding back Tax Exempt Interest, make sure to offset it with the deductions that are attributable to tax-exempt interest.
  + DNI CALCUALTION (including TEI and allocable expenses)
    - DNI = TTI + PE – CG + CL + TEI – section 212 expenses allocable to TEI.
  + For Distribution Deduction 🡪 remember that to get final DD, must multiply tentative distribution deduction against NET TEI/DNI
  + REVIEW PROBLEM 25 and 26 FOR HOW THIS AFFECTS CALCULATIONS
    - Remember that you must reduce each class of income by deductions when determining character and apportion non-directly attributable expenses.

f. Inclusion of Capital Gains in DNI: (will not be on calculation portion)

* Trustee and beneficiary may want to include Cap Gains in DNI for different reasons:
  + Trustee 🡪 can filter income out to beneficiaries
  + Beneficiary 🡪 can accelerate cap losses, bracket difference, and state income tax issues for trust situs
* Capital Gains are excluded from DNI unless:
  + 1) not allocated to corpus (i.e., allocated to FAI, or perhaps not allocated at all); or
  + 2) allocated to principal but “paid, credited, or required to be distributed to any beneficiary during the taxable year” or “paid, permanently set aside, or to be used for the purposes specified in § 642(c).
* Requirements:
  + Capital gain is included in DNI if (1) one of the 2 pre-requisites and (2) one of the 4 requirements are met:
    - Pre-Requisites:
      * 1) Mandatory allocation pursuant to the terms of the governing instrument **and** applicable local law.
      * 2) Discretionary allocation by the fiduciary, which is reasonable and impartial pursuant to (1) applicable local law or (2) by the governing instrument but only if not prohibited by local law.
    - Requirements:
      * 1) Capital gains allocated to income – Reg. § 1.643(a)-3(b)(2);
        + The allocation must be exercised consistently if income under state law is defined as a unitrust amount and the trustee’s power to allocate gains to income is discretionary.
      * 2) Allocated to corpus but treated consistently as part of the distribution to a beneficiary –Reg. § 1.634(a)-3(b)(2)
        + AKA the “Deeming Power”
      * 3) Allocated to corpus and actually distributed to the beneficiary – Reg. § 1.643(a)-3(b)3).
      * 4) Allocated to corpus and utilized to determine the amount distributed to a beneficiary – Reg. § 1.634(a)-3(b)(3).
  + Requirement 1) Capital Gains Allocated to Income:
    - Reg. § 1.643(a)-3(e), Ex. 4: Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit . . . . During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. . . . [P]ursuant to the terms of the governing instrument (in a provision not prohibited by applicable local law), capital gains realized by Trust are allocated to income. Because the capital gains are allocated to income pursuant to the terms of the governing instrument, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.
      * Ex #4: Pursuant to terms of trust are allocable to income.
      * Argument that it does not require both gov instrument and state law, but if it is in the gov instrument and not prohibited by local law it is good.
    - Providing the trustee the ability to allocate income to principal or the other way around creates planning opportunity, without the NEGATIVE implication of unitrust election, below.
      * Unitrust Elections 🡪 if trustee elects UNITRUST, the negative implication is that the allocation to income must be exercised consistently year to year. (Reg § 1.643(a)-3(b)(1))
  + Requirement 2) The Deeming Power:
    - If you allocate to corpus, but *treat consistently* as part of FAI, then it will be included in DNI. IRS invented this authority.
    - Reg § 1.643(a)-3(e) 🡪 examples
      * Ex #1: Trustee given discretionary power to invade principal and to deem discretionary distributions to be made from CGs. If trustee does not exercise the discretionary power during year one, must treat all discretionary distributions in the same manner going forward.
    - As a drafting tip: always include the power to include capital gain into DNI.
    - If state law is silent and the power is not in the governing instrument, you cannot deem it.
  + Requirement 3) Utilizing Capital Gain to Determine Amount Distributed from Corpus:
    - Reg § 1.643(a)-3(e): example
      * Trustee decides that discretionary distributions will only be made to extent that trust has realized cap gains. Because the trustee will use the amt of any realized cap gains to determine the amount of discretionary distribution to beneficiary, the CG is included in DNI.
    - This does not have the consistent requirement like the Deeming Power does.
  + Requirement 4) Actual Distributions of Gains Allocated to Corpus:
    - Reg § 1.643(a)-3(b)(3)
      * Ex #6: Trust directs to hold Blackacre for 10 years then sell it and distribute sales proceeds. Because trustee uses amt of sales proceeds that includes cap gain to determine amt required to be distributed to A, cap gain included in DNI.
      * Ex #7: all income paid to A under gov instrument. When A reaches 35, trust terminates and all principal paid to A. Because all assets will be distributed, all cap gains realized in year of termination included in DNI.
      * Ex #9: ½ principal as above at 35, then balance at 45. All assets are stock with FMV of $1M, adjusted basis of $300K. Trustee sells ½ and distributes sale proceeds. All sale proceeds including CG are actually distributed and therefore included.
      * Ex #10: same as above, but when A reaches 35 trustee sells all stock and distributes ½ to A, and if authorized by gov instrument + local law, may determine to what extent cap gain is distributed to A.
        + Thus, A can have MINIMUM of $200K gain and all principal of $300K and a MAXIMUM Of $500K of gain, with no principal. Trustee shows this election by including appropriate gain in DNI on 1041.
        + If trustee not authorized by governing instrument and applicable law, then ½ of the gain is attributed to the sale and included in DNI.

g. Extraordinary Dividends& DNI § 643(a)(4): (won’t be on calculation part of exam)

* Extraordinary Dividends and taxable stock dividends are included in DNI *unless* the follow requirements are met:
  + The trust is a Simple Trust;
  + The trustee, in good faith, does not distribute or credit these dividends to the income beneficiary;
  + Such dividends are allocable to corpus under the terms of the governing instrument and local law.

**IV. Impact of Fiduciary Powers on Taxation:**

a. Adjustments to Income & Principal:

* UPIA 104 🡪 Power to Adjust – Trustee can make I 🡪 P and reverse, to invest for total return. Power is “abuse of discretion” std = broad (UPIA 105)
* Breadth of the Power:
  + The court will not step in unless there is an abuse of discretion – i.e., they have broad discretion.
  + 3-5% is common.

b. Unitrusts:

* Many states have enacted optional “unitrust” election provision:
  + Redefining Income: unless the terms of the trust provide otherwise, the net income of any trust to which this section applies shall mean the unitrust amount as determine hereunder. EPTL 11-2.4(a).
  + Unitrust Amount: The unitrust amount for the year shall mean an amount equal to 4% of the net FMV of the assets held in trust. EPTL 11-2.4(b).
  + When applicable: This section shall apply to any trust if the governing instrument provides that this section shall apply to such trust. . . or before the last day of the second full year of the trust beginning after assets first become subject to the trust, the trustee, with the consent by or on behalf of all persons interested in the trust or his, her, or its discretion, elects to have this section apply to such trust. EPTL 11-2.4(e).
* Will the Tax Law recognize income paid when using a power to adjust or unitrust election?
  + Reg. § 1.643(b)-1: Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized.
    - trust provisions that depart “fundamentally” from traditional principles of I and P will generally not be recognized. (are unitrusts “traditional”?). Will be respected if local law provides for a “reasonable apportionment” -- 3-5%, e.g.
  + What about silent state statute, but instrument allows? Is it considered ‘required to be distributed’? Unclear.
  + Is it FAI or “other income required to be distributed”? If it is FAI, then it is Tier 1, if it is not, then partially Tier 2. He thinks you can get away with either, as long as consistent.

c. Annuities:

* Procedure for Allocating Annuity Payments between Tier 1 and Tier 2.
  + Step 1) Compute FAI.
  + Step 2) Compute FAIRTBD – not including the annuitant.
    - AKA Actual FAIRTBD
  + Step 3) Identify all other FAI paid or credited for the taxable year (other than any annuitant).
    - OFAIPC
  + Step 4) Subtract the sum of Actual FAIRTBD (Step 2) and OFAIPC (Step 3) from FAI (Step 1)
    - AKA Residual FAI
  + Step 5) Determine the lesser of the annuity amount and Residual FAI.
    - This amount is deemed to be a part of FAIRTBD.
    - AKA Deemed FAIRTBD
  + Step 6) Add Deemed FAIRTBD to the Actual FAIRTBD
    - This amount equals to the total distribution carrying out T1 gross income for the year.
    - All other amounts paid, credited, or required to be distributed carry out T2 gross income.
  + Step 7) Use the amount in Step 6 to compute both (i) the amounts included in T1 Beneficiary’s gross incomes and (ii) Remaining DNI that gets allocated among Tier 2 Beneficiaries.
  + Step 8) Subtract T1 amount from DNI to get Remaining DNI for T2 distribution.

d. 65-Day Rule:

* Procedure for Computing Amount that can be Treated as Paid or Credited in the Prior Year Under the 65-Day Rule:
  + Step 1) Compute FAI in the year for which the 65-Day Rule Election will be made (yr. 1)
  + Step 2) Compute DNI for year 1.
  + Step 3) Determine greater of FAI or DNI.
  + Step 4) Determine sum of all Amounts Paid, Credited, or Required to be Distributed for Yr. 1 (but not including amounts treated as paid in the prior year).
    - The Actual Amounts PCRTBD
  + Step 5) Subtract Actual Amounts PCRTBD from the amount in Step 3.
  + Step 6) The amount in Step 5 is the Maximum Amount that can be treated as paid or credited in Yr. 1.
    - The 65-Day Election Maximum.
  + Step 7) Do Tier analysis with FAIRTBD, OAPCRTBD, & RDNI.
* Time & Manner of Election:
  + Reg. § 1.663(b)-2(a)(1) 🡪 election cannot be made later than the time to file the return, including extensions. You have until tax return deadline to make election but have to make the distribution w/in 65 days.

e. Depreciation & Depletion Deductions:

* Procedure for Allocating Depreciation Deductions of a **Trust**:
  + Step 1) Identify the total cost recovery deduction (i.e., the total deprecation deduction).
  + Step 2) compute FAI before reserves for depreciation.
    - AKA Unreserved FAI
  + Step 3) Determine the amount of the unreserved FAI that is reserved for depreciation under the governing instrument or local law (or pursuant to discretionary authority in the governing instrument or local law).
  + Step 4) Subtract the Reserve Amount from total cost recovery deduction.
    - AKA Remaining Cost Recovery Deduction.
  + Step 5) Compute FAI (after reserves for deprecation).
  + Step 6) Determine each beneficiary’s share of FAI (i.e., the amount of FAI paid, recredited, or required to be distributed to him/her).
  + Step 7) For each beneficiary, multiply the remaining cost recovery deduction by: (the beneficiary’s share of FAI)/FAI
    - This amount is equal to the beneficiary’s share of the total cost recovery deduction.
  + Step 8) Determine the trust’s share of FAI (i.e., the amount of FAI not paid, credited, or required to be distributed to a beneficiary).
  + Step 9) Multiply the Remaining Cost Recovery Deduction by: (trust’s share of FAI)/FAI
  + Step 10) add step 3 (the Reserve Amount) and Step 9 (the trust’s share of the Remaining Cost Recovery Deduction)
    - This amount is equal to the trust’s share of the total cost recovery deduction.
* Procedure for Allocating Depreciation Deductions of an **Estate**:
  + Step 1) Identify the total cost recovery deduction (i.e., the total deprecation deduction).
  + Step 2) Compute FAI.
  + Step 3) Determine each beneficiary’s share of FAI (i.e., the amount of FAI paid, credited, or required to eb distributed to him/her).
  + Step 4) For each beneficiary, multiply the total cost recovery deduction by: (the beneficiary’s share of FAI)/FAI.
    - This amount is equal to the beneficiary’s share of total cost recovery deduction.
  + Step 5) Determine the estate’s share of FAI (i.e., the amount of FAI not paid, credited, or required to be distributed to a beneficiary).
  + Step 6) Multiply the total cost recovery deduction by: (estate’s share of FAI)/FAI
    - This amount is equal to the estate’s share of the total cost recovery deduction.

**V. Additional Mechanics of the Quasi-Conduit Regime:**

a. Miscellaneous Itemized Deductions:

* 3 Categories of Deductions:
  + 1) Deductions Allowed in Computing AGI (you want to be in this category):
    - Deductions described in § 62;
    - The § 642(b) deduction in lieu of personal exemption;
    - Distribution deductions under § 651or § 661; and
    - Deductions for costs which are paid or incurred in connection with administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.
      * Ex: cost of preparing 1041, fiduciary accounting, defense of a claim related to construction of a provision.
      * Ex: not condo fees for an apartment owned by a trust, investment advisor fees.
  + 2) Deductions not allowed in Computing AGI but that are on the § 67(b) List of Non-Miscellaneous Itemized Deductions:
    - Ex: deductions for medical expenses, interest, and the § 642(c) charitable distribution deduction.
  + 3) All other deductions are Miscellaneous Itemized Deductions that are Disallowed through 2025 and Reduced by 2% of AGI Thereafter.
* § 67(e) deductions are not § 67(g) deductions and as such, not disallowed.
* Pretty much all of the deductions we care about fall in the first category.
* Bundled Fees & Commissions:
  + Reg. § 1.67-4(c): In general, if estate/trust pays single fee for both costs, the fee must be allocated between costs subject to 2% floor and those that are not. However, if fee is not computed on an hourly basis, only portion that is investment related is subject to 2% floor.
    - How to allocate: any reasonable method (fact based)
      * Reg. § 1.67-4(c)(4): Any reasonable method may be used to allocate a bundled fee between those costs that are subject to the 2-percent floor and those costs that are not

b. Separate Share Rule: (not on calculation part of exam)

* If one trust is created for several beneficiaries, and each beneficiary’s share is separate and independent and administered separately, DNI is subdivided per share.
  + Specific bequests are not separate shares.
  + Does not apply if trustee has discretion to sprinkle or accumulate income or sprinkle principal, or if a distribution to one beneficiary will affect the proportionate share of any I/P of another.
* This is mandatory under 663(c), not elective.
* Separate share rule also applies to estates.
  + E.g., Fractional shares of residue, elective share of surviving spouse, pecuniary formula bequests under reduce-to-zero clause, income from specifically bequeathed property.
* Separate share rule only applies to COMPLEX trusts/estates. Not necessary for simple trusts, even if separate shares, because DNI will be allocated w/ respect to each beneficiary’s separate share.
  + Reg. § 1.663(c) -2(b)(1) – DNI allocated as if each share is separate trust
  + IRD – allocated on basis of relative value of shares funded with IRD, e.g., (but this is not on test).
* The Separate Share Rule:
  + Applies only to Complex Trusts and Estates, not to simple trust.
  + Mandatory – not elective.
  + Only affects the computation of separate shares of DNI.
    - Not filing obligations, amount of personal exemption, etc.
* Rules for Allocating Gross Income Among Share:
  + 1) Gross income included in both DNI and FAI in allocated in accordance with the amount of FAI to which each share is entitled – Reg. § 1.663(c)-2(b)(2).
  + 2) Phantom income (e.g., gross income flowing through a partnership) is allocated based on the relative values of the shares that could potentially be funded with IRD – Reg. § 1.663(c)-2(b)(3).
  + 3) Income in respect of a decedent (IRD), if not FAI, is allocated based on the relative values of the shares that could potentially be funded with IRD – § 1.663(c)-2(b)(3).
  + 4) Deductions and losses applicable solely to one share are not available to the other shares – Reg. § 1.663(c)-2(b)(5).
  + Allocation Methods:
    - In calculating each share’s DNI, the fiduciary must use “a reasonable and equitable method” to make the valuations, calculations, and allocations – Reg. § 1.663(c)-2(c).

c. In-Kind Distributions:

* Issues raised by In-Kind Distributions:
  + 1) Is there mandatory recognition of gain or loss?
    - If a loss is recognized, is it disallowed under the related-party loss rules of Section 267?
    - Does gain or loss enter into the computation of DNI?
  + 2) If recognition of gain is not mandatory, does (or should) the trust or estate elect to recognize gain under Section 643(e)(3)?
  + 3) If the distribution of property is a tier 2 distribution, what is the amount deemed to have been distributed?
  + 4) What is the beneficiary’s basis in the property?
* Mandatory Recognition🡪 Kenan case.
  + Simple Trust: If trust distributes property in kind as part of a requirement to distribute currently all income, trust treated as if it had sold property for FMV (G + L will be recognized). (1.651(a)-2(d))
  + Complex Trust: If the distribution is in satisfaction of a right to receive a specific dollar amount, or of specific property other than that distributed, OR of income as defined by 643(b), gain/loss should be realized by the trustee. (1.661(a)-2(f)).
  + Examples of Kenan Gain/Losses Events
    - Not automatically triggering G/L
      * Distribution of the same property that is specifically bequeathed
      * Distribution of property to a discretionary beneficiary
      * Pro rata distribution of each asset in kind to beneficiaries entitled to fractional share of estate or trust
      * In kind distributions to beneficiaries entitled to fractional shares of estate or trust
* Related Party Disallowed Loses:
  + 267(a)(1) & (b) 🡪 no deduction allowed for a trust/estate from any loss from sale/exchange with a beneficiary (with exception of distribution in kind in satisfaction of pecuniary bequest, between an executor of an estate and the beneficiary of the estate – no such exception exists for TRUSTS).
  + § 267(d) 🡪 If the beneficiary subsequent sells the distributed property for a gain, the beneficiary will only recognize gain to the extent the gain realized exceeds the previously disallowed loss.
* Basis of Property Distributed In-Kind:
  + 643(e)(1) 🡪 basis received by beneficiary is the adjusted basis in the hands of the trust/estate immediately before distribution, adjusted for any gain/loss recognized to the estate/trust on distribution.
    - If the loss was previously disallowed, the beneficiary can later use it to offset any gains (§ 267(d)).
  + Holding period = the period tacks – § 1223(2).
  + Election to Recognize Gain:
    - Under 643(e)(3), can elect to recognize gain, but must be consistent to all distributions in that year. Is not a permanent election, can elect one year and not the next. If election made, loss property should be sold, not distributed (deduction will be lost and may not be used by beneficiary)
  + Amt of Tier two Distribution:if distribute property, amt shall be lesser of the basis in the hands of beneficiary or the FMV.

d. Taxable Years of Trusts & Estates:

* All trusts on calendar year.
* Estate may select CY or FY.
* Planning Opportunity: this could allow for a beneficiary of an estate to choose to delay income received in 02/17 to 04/18, if he elects FY ending 1/31/17, e.g. *See* IRC 662(c).
  + This is not something done regularly.

**VI. Defining Estates & Trusts:**

a. Definition of Estate & Trust:

* What is a Trust:
  + Reg. § 301.7701-4(a): Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that *the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.*
  + Is a trust Always a trust:
    - Occasionally, for Subchapter J purposes, an arrangement designated as a trust will not be taxed as a trust, and arrangements called something else will be recharacterized and taxed as trusts.
      * Examples
        + Rev. Rul. 56-484: A custodial account for a minor is taxed to the minor
        + Rev. Rul. 75-61: A “power in trust” is taxed as a trust
        + Rev. Rul. 76-486: A “pet trust” is taxed as a trust even though it has no individual beneficiaries
        + *De Bonchamps* (9th Cir. 1960): Holders of life estate were taxed as trustees of a trust where they had fiduciaries duties to remaindermen that “clothed [the arrangement] with the characteristics of a trust”
        + Whether an arrangement is treated as a trust or a business entity depends on factors such as whether the beneficiaries voluntarily formed the “trust” to transact business and divide profits
        + If you are using the trust for a business purpose (why would you), the IRS could treat it as though it was something else.
  + Termination of Trusts:
    - Reg. § 1.641(b)-3(b): Depends on whether the property held in trust has been distributed rather than whether the trustee has rendered his final accounting.
      * A trust does not automatically terminate upon the happening of an event which the duration of the trust is measured – a reasonable time is permitted after for the trustee to perform the necessary duties to complete the administration of the trust.
        + Ex: if a trust is to terminate upon the death of the income beneficiary, it may continue after the death for a reasonable period to wind up affairs and distribute property to the remainder beneficiaries.
      * What is a reasonable period:
        + Reg. § 1.641(b)-3(b): the winding up cannot be unduly postponed. If it is unduly delayed, the trust is considered terminated for Fed. Income tax purposes after the expiration of a reasonable period of time.

Example:

Client died; under trust – at death, trust was to terminate, and all of the assets were to be dist. to a private foundation.

A couple years went by and the property wasn’t dist.

Could be classified as a private foundation. Would have been hit with big penalties; tax implications.

* On What day does an Estate Begin:
  + Treas. Regs. § 1.443-1(a)(2) and 1.691(a)-1(b) both assume that a decedent’s final taxable year includes the date of death
  + Planning opportunity: Inclusion of income received/accrued on date of death generates tax for decedent’s final year, which may be deducted for estate tax purposes.
  + Termination of Estates:
    - Reg. § 1.641(b)-3(a): If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Fed. Income Tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration.

**VII. Grantor Trusts – Guest Lecture:**

What is a grantor Trust:

* Generally, a trust in which the “grantor” retains certain interests or control that cause him or her to be treated as “owner” of the trust’s assets for income tax purposes
  + Applies regardless of the distributions from the trust to the grantor or anyone else.
  + These strings mentioned are different than those from estate & gift tax.
  + Can be grantor trust for income tax purposes and not included in estate in certain instances.

Benefit of Grantor Trust Status:

* Grantor’s payment of income tax on income earned by trust enables grantor to transfer wealth without paying estate or gift tax
  + If IDGT: This permits the grantor to make a tax-free gift to the trust each year equal to the income tax liability attributable to the trust assets.
    - Overtime with compounding, the savings can be very significant.

Potential Disadvantages:

* Grantor may not want to be responsible for paying tax on income accruing to trust
* May be able to reduce family’s overall federal, state and local income tax liability if trust is a nongrantor trust and state/local fiduciary income tax is not payable
* Nongrantor trusts are allowed an unlimited charitable deduction for gross income paid to charity pursuant to trust instrument

Rules found in Subpart E

* §671 describes the consequences of being treated as the “owner” of a trust
* §672 provides definitions and other rules of application relevant to the other sections of Subpart E
* §673 to§679 generally identify a grantor as “owner” of a trust if the grantor or certain other persons have particular interests in or powers over the trust.
  + The “strings.”
  + The grantor trusts were meant to be punishing, so they are fairly easy to qualify for.

Spousal Attribution:

* The grantor is treated as holding an power or interest held by the grantor’s spouse. §672(e)
* Spousal attribution rules generally do not apply for estate tax purposes.
* This is where the income tax rules and the transfer tax rules diverge.
  + Sometimes giving a spouse can be an important way/good way to make the trust qualify as grantor trust.

Who is the Grantor:

* Treas. Reg. § 1.671-2(e)(1) provides definition of “grantor”:
* “Grantor” includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust
  + Gratuitous transfer – not for FMV.
  + Does not mean taxable transaction.
* “For purposes of Part 1 of Subchapter J”
  + It is all of subchapter J except for IRD.
  + It applies not only for grantor trust rules, but for complex & simple trusts as well.
    - Title would mean the entire IRC; Chapter all of Income Tax.
    - Pay attention to these modifiers.

A portion of a trust can be a grantor trust:

* Grantor (or another person) can be treated as owner of:
  + entire trust
  + specific trust assets
  + trust principal
  + trust income
  + pecuniary share
  + fractional share
* Consequences of being treated of owner of a “portion” of a trust described in Treas. Reg.  
  § 1.671-3

Techniques to Avoid Grantor Trust Status:

* Objectives in selecting technique:
  + **Income tax objective**: Grantor trust as to entire trust (rather than grantor trust as to a portion)
  + **Transfer tax objective**: Completed transfer for gift tax purposes and not includible in grantor’s estate
  + **Flexibility**: Mechanism for changing status of trust from grantor trust to non-grantor trust, and possibly back to grantor trust again, depending on future circumstances

Spouse as Beneficiary – § 677(a)(1 & 2):

* Trust will be a grantor trust if the income of the trust may be distributed to or accumulated for the grantor or the grantor’s spouse without the consent of an adverse party