Estate and Trust Form 1041 Issues for Tax Return Preparers
Allocating Income and Deductions, Calculating DNI, Understanding Reporting Rules for Trusts, and More

WEDNESDAY, FEBRUARY 27, 2013, 1:00-2:50 pm Eastern

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Estate and Trust Tax Return
Form 1041

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Estate and Trust Tax Return Form 1041

- Objectives of course
  - Discuss latest changes in enforcement
  - Review steps to complete accurate 1041
  - Review computation of DNI and allocation between entity and beneficiaries
  - Questions and answers
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- Types of fiduciary entities
  - DNI based – IRC Secs. 641-668
    - Probate estates
    - Most irrevocable trusts
  - Grantor trusts – IRC Secs. 671-678
    - Revocable trusts
    - Irrevocable inter vivos trusts

- Filing requirements
  - DNI – Form 1041
  - Grantor
    - Revocable: Form 1040
    - Irrevocable: Form 1040 and/or Form 1041
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• Where to begin
  • First: Read document
    • Determine beneficiaries
    • Special instructions to compute Trust Accounting Income (TAI)
  • Second: Compute TAI
    • Governed by state law (Uniform Principal and Income Act)
    • Document, Fiduciary, State Law, Corpus
    • Two pots – income and corpus
    • Cash accounting
  • Third: Allocate TAI between entity and beneficiaries
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• Computing Entity's Taxable Income
  • Based on individual income tax rules – IRC Sec. 641(b)
  • Form 1041, Line 9 Total Income
  • Form 1041, Line 17 Adjusted Total Income

• Computing Income Distribution Deduction – Form 1041, Line 18
  • Amount of taxable DNI allocated to noncharitable beneficiaries

• Allocation of DNI between beneficiaries
  • Based on composition of DNI and distributions to beneficiary
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• Form 1041, Line 9 – Total Income
  • Gross Income less directly related related expenses
  • Except for Schedule D, use same support schedules as Form 1040
  • Qualified Dividends – same rules as individuals
  • Schedule C – possible audit trigger (sham trusts)
    • Net operating loss
      • Same rules as individuals
      • Allocated to beneficiaries only in final year
  • Schedule D – same rules as individuals
    • Basis
      • IRC Sec. 1014 – assets included in Gross Estate
      • IRC Sec. 1015 – assets gifted during life
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- **Depreciation**
  - No IRC Sec. 179 deduction
  - No IRC Sec. 179 allocated to estate or trust
  - Amount of depreciation – same rules as individuals
- **Allocation of depreciation**
  - Was TAI reduced for depreciation?
    - If Yes, allocate tax depreciation to appropriate support schedule based on amount of accounting depreciation
    - If No (or tax depreciation greater than accounting depreciation), allocate tax depreciation to beneficiaries based on amount of TAI received
  - Amount allocated to beneficiaries – reported on Schedule K-1
- **AMT**
  - Allocated in same manner
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- Example
- Tax Depreciation $15,000
- Accounting Depreciation $10,000
- Schedule C $10,000
- Allocation of TAI: A-50%, B-30%, C-20%
- Schedule K-1:
  - A-$2,500, B-$1,500, C-$1,000
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• Passive activities
  • Same rules as individuals (one exception)
  • Rental real estate offset ($25,000)
    • Trust not allowed to take
    • Estates can take only if
      • Decedent actively participated
      • Surviving spouse does not take
      • Only allowed for two tax years

• Distribution of passive activity
  • Contributed to trust during life
  • Included in probate estate
  • Distributed to beneficiary from estate or trust
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• Income in respect of a Decedent – Form 1041, Line 8
  • Income realized, but not recognized, before death
  • Receives a zero basis
  • Type of Income determined by decedent
  • Taxed when collected – itemize on schedule
  • Must be included in probate estate or trust before shown on Form 1041

• Deductions in respect of a Decedent – Form 1041, Line 15a
  • Debts of decedent paid after death
  • Deductible on both Form 706 and Form 1041
  • Income tax deduction based on income tax rules
  • Limited: Business, Interest, Taxes, IRC Sec. 212
  • Medical, charitable, capital loss, NOL – not DRD
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- Itemized Deductions – Lines 10-15b
  - Interest – Line 10
  - Taxes – Line 11
  - Fiduciary – Line 12
  - Charitable – Line 13
  - Attorney, accountant – Line 14
  - Deductions not subject to 2% AGI floor – Line 15a
  - Deductions subject to 2% AGI floor – Line 15b
- Generally, subject to same rules as individuals
- Exempt income allocation – Other information, Question 1, Page 2
- IRC Sec. 642(g) – double deduction
  - Transmission
  - Management
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• Interest
  • Investment Interest
  • Qualified residential interest

• Taxes – same as individuals, except, no sales tax

• Section 212 expenses
  • Production and collection of income
  • Management, conservation or maintenance of property held for the production of income
  • Determination, collection or refund of any tax
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- Charitable deduction – IRC Sec. 642(c)
  - Same charities as individuals
  - Must be authorized by document
    - Personal assets of decedent
  - Limited by Gross Income
  - Must be distributed
  - Charity does not receive a Schedule K-1 (Letter notification)
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- 2% AGI Rule
  - IRC Sec. 67 reduces deductibility of miscellaneous itemized deductions by 2% of AGI
  - Exception for expenses “unique” to an estate or trust – IRC Sec. 67(e)
  - Supreme Court – Knight (2008)
    - Expenses commonly or customarily incurred by individuals
    - If 2% rule applies to individual, applies to entity
    - Only expenses not commonly incurred fully deductible
  - Investment adviser fees are second largest deduction
  - Test applies to all Section 212 expenses
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- Personal residence of Decedent
- Takes on a neutral status after death
  - Rental
  - Investment
  - Residence
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- Line 19: Estate tax deduction
  - IRC Sec. 691(c)
  - If federal estate taxes are paid and gross estate included IRD
  - Deduction allowed only if entity will pay income taxes on IRD
  - Deduction allocated to beneficiaries if IRD allocated to beneficiaries
  - No discretion on who can take deduction

- Personal exemption
  - Estates: $600
  - Trusts
    - $300: if all TAI required to be distributed
    - $100: if TAI not required to be distributed
    - Some complex trusts can have $300 exemption
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• Types of fiduciary entities
  • Simple trusts – IRC Secs. 651-652
    • All TAI required to be distributed (always distribute)
    • No charitable contributions allowable
    • No corpus distributions actually made
  • Complex trusts and estates – IRC Secs. 661-663
    • Can change from year to year (e.g. QTIP trust)
    • In final year, all trusts will be complex
• Distributable Net Income – IRC Sec. 643(a)
  • Can NEVER be negative
• Computation
  • Adjusted Total Income
  • Add net tax-exempt interest
    • Other information, Question 1
    • Deductions paid with exempt interest removed
    • Use schedule to determine
  • Remove all capital transactions
  • Add back, if allowed, capital gains
• Taxable portion of DNI determines maximum Income Distribution Deduction (IDD)
Capital gains are included in DNI
  • In final year
  • If included in TAI
  • If actually distributed

IRC Sec. 643(b) regulations
  • Consistent treatment allows capital gains to be in DNI
  • If corpus distributions are consistently reflected to included capital gains, then capital gains in DNI

Capital losses never reduce DNI
  • Allocated to corpus beneficiaries in final year
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• Distributions
  • Tier I: required TAI distributions
  • Tier II: all other actual distributions

• Tier I – only type made by simple trusts
  • Deemed made on 12/31 unless made earlier
  • Must be distributed by 4/15

• Tier II
  • Must actually distribute
  • IRC Sec. 663(a) – specific bequests
  • IRC Sec. 663(b) – 65-day rule
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- Noncash distributions
  - Types of estate distributions: specific, pecuniary, residual
  - Deduction equals lesser of adjusted basis or FMV on date distributed

- Sales
  - Involuntary
    - Noncash distribution to satisfy pecuniary
    - Estates, but not trusts, can recognize gains and losses
  - Voluntary – IRC Sec. 643(e)(3)
    - Annual election – all or nothing
    - Only gains recognized
    - Allows more DNI to be allocated without actually distributing more
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- Allocation of DNI to noncharitable beneficiaries
  - Charities never receive DNI
  - Beneficiaries that receive Tier I and Tier II distributions receive DNI
- Lesser of DNI or sum of Tier I and Tier II distributions determines amount of DNI allocated
  - Distributions exceed DNI, 100% of DNI allocated
  - DNI exceed distributions, distributions equal amount of DNI allocated
- If distributions made, DNI must be allocated
- Taxable portion of DNI allocated equals IDD
  - Ice cream example
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• Schedule K-1
• Character of DNI determines Schedule K-1 amounts
  • How were deductions paid?
  • Directly related deductions are paid with income generated by deduction
  • Charity must receive some of every type of income in TAI
  • Other expenses can be paid with choice of income
  • No negative income
• Tier I distributions are allocated DNI first
• Remaining DNI allocated to Tier II distributions
• A’s share of Tier II distributions/Total Tier II distributions
  * DNI allocated to Tier II distributions = A’s share of DNI