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

THURSDAY, FEBRUARY 27, 2014, 1:00-2:50 pm Eastern

IMPORTANT INFORMATION

This program is approved for 2 CPE credit hours. To earn credit you must:

• **Participate in the program on your own computer connection and phone line (no sharing)** - if you need to register additional people, please call customer service at 1-800-926-7926 x10 (or 404-881-1141 x10). Strafford accepts American Express, Visa, MasterCard, Discover.

• **Respond to verification codes presented throughout the seminar.** If you have not printed out the “Official Record of Attendance”, please print it now. (see “Handouts” tab in “Conference Materials” box on left-hand side of your computer screen). To earn Continuing Education credits, you must write down the verification codes in the corresponding spaces found on the Official Record of Attendance form.

• Complete and submit the “Official Record of Attendance for Continuing Education Credits,” which is available on the program page along with the presentation materials. Instructions on how to return it are included on the form.

• To earn full credit, you must remain on the line for the entire program.

WHOM TO CONTACT

For Additional Registrations:
- Call Strafford Customer Service 1-800-926-7926 x10 (or 404-881-1141 x10)

For Assistance During the Program:
- On the web, use the chat box at the bottom left of the screen
- On the phone, press “0” (“star” zero)

If you get disconnected during the program, you can simply call or log in using your original instructions and PIN.
Tips for Optimal Quality

Sound Quality
If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial 1-866-873-1442 and enter your PIN when prompted. Otherwise, please send us a chat or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality
To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.
If you have not printed the conference materials for this program, please complete the following steps:

- Click on the ^ symbol next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides and the Official Record of Attendance for today’s program.
- Double-click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.
Form 1041: Estate and Trust Tax Reporting

Feb. 27, 2014

Robert E. Barnhill, III - CPA/PFS, CFP
Robert E. Barnhill, Attorney at Law, Lubbock, Texas
rebiii@att.net
Notice

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY THE SPEAKERS’ FIRMS TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.
ESTATE AND TRUST TAX RETURN FORM 1041
Estate and Trust Tax Return Form 1041

I. Objectives of course

A. Discuss latest changes in enforcement
B. Review steps to complete accurate 1041
C. Review computation of DNI and allocation between entity and beneficiaries
D. Questions and answers
Estate and Trust Tax Return Form 1041

I. Types of fiduciary entities
   A. DNI based - IRC Secs. 641-668
      1. Probate estates
      2. Most irrevocable trusts
   B. Grantor trusts - IRC Secs. 671-678
      1. Revocable trusts
      2. Irrevocable inter vivos trusts

II. Filing requirements
   A. DNI - Form 1041
   B. Grantor
      1. Revocable: Form 1040
      2. Irrevocable: Form 1040 and/or Form 1041
Estate and Trust Tax Return Form 1041

I. Where to begin

A. First: Read document
   1. Determine beneficiaries
   2. Special instructions to compute Trust Accounting Income (TAI)

B. Second: Compute TAI
   1. Governed by state law (Uniform Principal and Income Act)
   2. Document, Fiduciary, State Law, Corpus
   3. Two pots - income and corpus
   4. Cash accounting

C. Third: Allocate TAI between entity and beneficiaries
Estate and Trust Tax Return Form 1041

I. Computing Entity's Taxable Income
   A. Based on individual income tax rules - IRC Sec. 641(b)
   B. Form 1041, Line 9 Total Income
   C. Form 1041, Line 17 Adjusted Total Income

II. Computing Income Distribution Deduction - Form 1041, Line 18
    A. Amount of taxable DNI allocated to noncharitable beneficiaries

III. Allocation of DNI between beneficiaries
     A. Based on composition of DNI and distributions to beneficiary
I. Form 1041, Line 9 - Total Income

A. Gross Income less directly related related expenses

B. Except for Schedule D, use same support schedules as Form 1040

C. Qualified Dividends - same rules as individuals

D. Schedule C - possible audit trigger (sham trusts)
   1. Net operating loss
      a. Same rules as individuals
      b. Allocated to beneficiaries only in final year

E. Schedule D - same rules as individuals
   1. Basis
      a. IRC Sec. 1014 - assets included in Gross Estate
      b. IRC Sec. 1015 - assets gifted during life
Slide Intentionally Left Blank
I. Depreciation
   A. No IRC Sec. 179 deduction
   B. No IRC Sec. 179 allocated to estate or trust
   C. Amount of depreciation - same rules as individuals
   D. Allocation of depreciation
      1. Was TAI reduced for depreciation?
         a. If Yes, allocate tax depreciation to appropriate support schedule based on amount of accounting depreciation
         b. If No (or tax depreciation greater than accounting depreciation), allocate tax depreciation to beneficiaries based on amount of TAI received
         c. Amount allocated to beneficiaries - reported on Schedule K-1
      2. AMT
         a. Allocated in same manner
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
I. Passive activities
   A. Same rules as individuals (one exception)
   B. Rental real estate offset ($25,000)
      1. Trust not allowed to take
      2. Estates can take only if
         a. Decedent actively participated
         b. Surviving spouse does not take
         c. Only allowed for two tax years

II. Distribution of passive activity
   A. Contributed to trust during life
   B. Included in probate estate
   C. Distributed to beneficiary from estate or trust
Estate and Trust Tax Return Form 1041

I. Income in respect of a Decedent - Form 1041, Line 8
   A. Income realized, but not recognized, before death
   B. Receives a zero basis
   C. Type of Income determined by decedent
   D. Taxed when collected - itemize on schedule
   E. Must be included in probate estate or trust before shown on Form 1041

II. Deductions in respect of a Decedent - Form 1041, Line 15a
   A. Debts of decedent paid after death
   B. Deductible on both Form 706 and Form 1041
   C. Income tax deduction based on income tax rules
   D. Limited: Business, Interest, Taxes, IRC Sec. 212
   E. Medical, charitable, capital loss, NOL - not DRD
I. Itemized Deductions - Lines 10-15b
   A. Interest - Line 10
   B. Taxes - Line 11
   C. Fiduciary - Line 12
   D. Charitable - Line 13
   E. Attorney, accountant - Line 14
   F. Deductions not subject to 2% AGI floor - Line 15a
   G. Net operating loss - Line 15b
   H. Deductions subject to 2% AGI floor - Line 15c

II. Generally, subject to same rules as individuals

III. Exempt income allocation - Other information, Question 1, Page 2

IV. IRC Sec. 642(g) - double deduction
   A. Transmission; Management
Slide Intentionally Left Blank
Estate and Trust Tax Return Form 1041

I. Interest
   A. Investment Interest
   B. Qualified residential interest

II. Taxes - same as individuals, except, no sales tax

III. Section 212 expenses
   A. Production and collection of income
   B. Management, conservation or maintenance of property held for the production of income
   C. Determination, collection or refund of any tax
Estate and Trust Tax Return Form 1041

I. Charitable deduction - IRC Sec. 642(c)
   A. Same charities as individuals
   B. Must be authorized by document
      1. Personal assets of decedent
   C. Limited by Gross Income
   D. Must be distributed
   E. Charity does not receive a Schedule K-1 (Letter notification)
I. 2% AGI Rule

A. IRC Sec. 67 reduces deductibility of miscellaneous itemized deductions by 2% of AGI

B. Exception for expenses “unique” to an estate or trust - IRC Sec. 67(e)

C. Supreme Court - Knight (2008)
   1. Expenses commonly or customarily incurred by individuals
   2. If 2% rule applies to individual, applies to entity
   3. Only expenses not commonly incurred fully deductible

D. Investment adviser fees are second largest deduction

E. Test applies to all Section 212 expenses
Estate and Trust Tax Return Form 1041

I. Personal residence of Decedent

II. Takes on a neutral status after death
   A. Rental
   B. Investment
   C. Residence
Estate and Trust Tax Return Form 1041

I. Line 19: Estate tax deduction
   A. IRC Sec. 691(c)
   B. If federal estate taxes are paid and gross estate included IRD
   C. Deduction allowed only if entity will pay income taxes on IRD
   D. Deduction allocated to beneficiaries if IRD allocated to beneficiaries
   E. No discretion on who can take deduction

II. Personal exemption
   A. Estates: $600
   B. Trusts
      1. $300: if all TAI required to be distributed
      2. $100: if TAI not required to be distributed
      3. Some complex trusts can have $300 exemption
Estate and Trust Tax Return Form 1041

I. Types of fiduciary entities

A. Simple trusts - IRC Secs. 651-652
   1. All TAI required to be distributed (always distribute)
   2. No charitable contributions allowable
   3. No corpus distributions actually made

B. Complex trusts and estates - IRC Secs. 661-663

II. Can change from year to year (e.g. QTIP trust)

III. In final year, all trusts will be complex
Estate and Trust Tax Return Form 1041

I. Distributable Net Income - IRC Sec. 643(a)
   A. Can NEVER be negative

II. Computation
   A. Adjusted Total Income
   B. Add net tax-exempt interest
      1. Other information, Question 1
      2. Deductions paid with exempt interest removed
      3. Use schedule to determine
   C. Remove all capital transactions
   D. Add back, if allowed, capital gains

III. Taxable portion of DNI determines maximum Income Distribution Deduction (IDD)
Estate and Trust Tax Return Form 1041

I. Capital gains are included in DNI
   A. In final year
   B. If included in TAI
   C. If actually distributed

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

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

II. Tier I - only type made by simple trusts
   A. Deemed made on 12/31 unless made earlier
   B. Must be distributed by 4/15

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

II. Sales
   A. Involuntary
      1. Noncash distribution to satisfy pecuniary
      2. Estates, but not trusts, can recognize gains and losses
   B. Voluntary - IRC Sec. 643(e)(3)
      1. Annual election - all or nothing
      2. Only gains recognized
      3. Allows more DNI to be allocated without actually distributing more
I. Allocation of DNI to noncharitable beneficiaries
   A. Charities never receive DNI
   B. Beneficiaries that receive Tier I and Tier II distributions receive DNI

II. Lesser of DNI or sum of Tier I and Tier II distributions determines amount of DNI allocated
   A. Distributions exceed DNI, 100% of DNI allocated
   B. DNI exceed distributions, distributions equal amount of DNI allocated

III. If distributions made, DNI must be allocated

IV. Taxable portion of DNI allocated equals IDD
   A. Ice cream example
Estate and Trust Tax Return Form 1041

I. Schedule K-1

II. Character of DNI determines Schedule K-1 amounts
   A. How were deductions paid?
   B. Directly related deductions are paid with income generated by deduction
   C. Charity must receive some of every type of income in TAI
   D. Other expenses can be paid with choice of income
   E. No negative income

III. Tier I distributions are allocated DNI first

IV. Remaining DNI allocated to Tier II distributions

V. A’s share of Tier II distributions / Total Tier II distributions * DNI allocated to Tier II distributions = A’s share of DNI