Form 1041 Schedule D: Reporting Capital Gains for Trusts and Estates

THURSDAY, SEPTEMBER 13, 2018, 1:00-2:50 pm Eastern

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SCHEDULE D CAPITAL GAIN & LOSS REPORTING FOR FORM 1041 FOR TRUSTS AND ESTATES

OBJECTIVES OF COURSE

- Demonstrate calculating and allocating capital gains and losses to beneficiaries v. taxed to the trust or estate.
- What is distributable net income (DNI)?
- Rules of IRC 643(a)
- Line by line guidance on completing Schedule D
- Issues of basis consistency reporting
- Split-interest trust allocations
- Form 8949 issues

7 OBJECTIVE OF COURSE, CONT'D

- What are the differences between Schedule D reporting of capital gains and losses between individual Form 1040 and trusts and estates Form 1041?
- How to reconcile capital gain statements
- How to compute net investment income
- Get a copy of the trust agreement
- Does the trust agreement discuss how capital gains will be included in DNI
- Capital Losses and the beneficiary

PART 1. CALCULATING CAPITAL GAINS & LOSSES

CAPITAL ASSETS

- A capital asset is any property held by an estate or trust, except depreciable or real property used in the taxpayer's trade or business, inventory, accounts or notes receivable or specified literary or artistic property (copyrights).

Examples of capital assets include:

- – Stock and bonds
- – Land
- – Personal residence
- – Personal property such as household furnishings and jewelry
- – Collectibles (such as coins or art)

COMPUTATION OF CAPITAL GAINS AND LOSSES

Introduction

- Capital gain is classified as long-term when the property sold was held for more than one year.

- Under the traditional rules, when property is acquired from a decedent, the taxpayer is deemed to have held the property for more than one year. This rule allows most capital gains and testamentary trusts to receive the favorable long-term capital gain rate regardless of the length of time the underlying property is actually held by the fiduciary.

- Even if the decedent's estate or trust property was sold the day after the decedent died the property is still considered long-term.

- The estate's basis in property acquired from a decedent is generally the fair market value of the property on the decedent's date of death (or alternative valuation date). Therefore, the beneficiary's basis will be the FMV at the date of death – the same as the estate's.

- As of July 31, 2015, an executor or other person required to file a Form 706 is required to file a Form 8971 with the attached Schedule A and to provide each beneficiary listed on the Form 8971 with that beneficiary's Schedule A – giving that beneficiary a record of the cost basis to ensure basis consistency.
- Normally capital gains are taxed within the trust rather than reported to the income beneficiaries on their Schedule K-1 and taxed to them personally.
- However, if the governing instrument or state law authorizes allocating capital gains to the income beneficiaries it may be beneficial to do so to take advantage of the capital gain rate or if the income beneficiaries have net capital losses to offset the net capital gains distributed to them.

13 CAPITAL GAIN RATES

- The maximum tax rate on an estate or trust's net long-term capital gain is 15% for taxable income under $12,500 (for 2018) and 20% for fiduciaries in the 35% ordinary income tax bracket.
- In addition, many trusts and estates are subject to the 3.8% net investment income tax. This surtax applies to undistributed capital gains on dispositions of assets held for investment if the fiduciary's adjusted gross income exceeds $12,500 (for 2018) making a federal long-term capital gain rate as high as 23.8%.
- The long-term capital gain rate for estates or trusts that are in the 15% ordinary income tax bracket is 0%, but only to the extent the gain would otherwise be in that ordinary income tax bracket. These reduced rates also apply for alternative minimum tax purposes.
- Collectibles are taxed at 28%.

CAPITAL GAINS/LOSSES

- Must complete Schedule D of Form 1041
- The resulting net gain/loss is carried to Line 4, subject to an annual net capital loss deduction limitation against ordinary income of $3,000
- Schedule D of Form 1040 should not be used in conjunction with the preparation of Form 1041
  - Capital gains are offset in full by capital losses
- Form 8949 must be completed and associated with Schedule D—indicates cost basis info reported by brokerages, etc.

SCHEDULE D OF FORM 1041

- Part I is used to compute the short term capital gains and losses (assets held 1 year or less)
- Part II is used to compute long-term capital gains and losses (assets held more than 1 year)
- Part III is used to combine the net short and long-term gains and losses for the current tax year
  - Use column 1 when the beneficiary is taxed and column 2 when the trust/estate is taxed
  - Where property involving “Unrecaptured Section 1250 Gain” was sold, (Line 14b) the Unrecaptured Section 1250 Gain Worksheet must be completed and gain will be taxed at 25%
  - Where there is either a sale of collectibles or a §1202 exclusion from the eligible gain on the sale of qualified small business stock line 14c must be completed
    - The sale of these properties are taxed at 28% and the 28% Rate Gain Worksheet must be completed

SCHEDULE D OF FORM 1041

- Part IV must be filled out when an entity has realized a net capital loss for the year
  - A loss up to $3,000 may be used to offset other income–with any other loss being carried forward
    - Capital Loss Carryover Worksheet must be completed
- Part V must be completed where the estate/trust has realized a net long-term capital gain for the year, or if there are short or long-term capital gains and losses for the year and qualified dividends
  - If unrecaptured §1250 gain or 28% rate gain is present, don't complete Part V—complete Schedule D Tax Worksheet to calculate tax on all of the entity's taxable income. Resulting tax liability in entered on Form 1041, Schedule G, Line 1a

DIFFERENCES IN INCOME TAX BASIS BETWEEN TRUSTS AND ESTATES

ESTATES

- Equal basis to the value of property at the decedent's date of death and a deemed long-term holding period regardless of how long an asset is held (§1014, §1223(11))
- Items meeting the definition of "income in respect of a decedent" do not receive a basis equal to the value of the asset on the date of death

TRUSTS

- Testamentary trust property may receive a date of death basis
- Property used to fund an inter vivos trust, which was funded prior to the death and not included in the taxable estate, takes a carryover basis from the grantor-donor (§1015)

19 BENEFICIARIES

- When inherited property is sold, report the sale as part of the long term capital gain/loss section of Schedule D
  - Enter “Inherited” or “Various” in column (b) asking for “Date Acquired”
- Any capital gains allocated to beneficiaries are reported to the beneficiaries on Schedule K-1
- Capital losses and unused loss carry forwards are allocated to the fiduciary and may not be passed to to the beneficiaries (except in the final year) (§642(h)(1))

20 DISTRIBUTABLE NET INCOME

- DNI has several purposes:
  - Established the max income distribution deduction that may be claimed by a trust or estate (§651 & §661)
  - Establishes the max amount of the entity’s annual income taxable to the beneficiaries (§652(a) & §662(a))
  - Determines the character of the items of income taxable to the beneficiaries (§652(b) & 662(b))§

DISTRIBUTABLE NET INCOME

- DNI refers to: taxable income + tax-exempt interest – allocable expenses
  - Expenses are modified to exclude:
    - Deduction for distributions to beneficiaries
    - Annual exemption
    - Capital gains allocated to principal and not paid, set aside or required to be distributed to beneficiaries during the taxable year
    - Capital gains paid, permanently set aside for charity, or otherwise used for charitable purposes
    - Capital losses
- Capital Gains
  - May be included in DNI when the trust instrument requires the inclusion of capital gains in income and the distribution of capital gains to beneficiaries
  - Are included in DNI in the year of termination of an estate or trust

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EXCEPTION TO THE GENERAL RULE

- General Rule: Distributions from an entity to a beneficiary carry out DNI to that beneficiary to the extent of the entity's DNI
- Exception:
  - Specific bequests of property or a specific sum of money (payable in less than 3 installments) do not carry out DNI (§663(a)(1))
    - A formula pecuniary gift is not considered the gift of a specific sum, and will always carry DNI
      - EX: "I leave an amount equal to 1/10 of my residuary estate to my grandchildren"
  - Payments of required bequests to charities do not carry DNI (§663(a)(2))

23 DNI AND FILING THE RETURN

- If beneficiaries receive distributions in excess of the entity's DNI for the taxable year, the beneficiaries report only their respective shares of the DNI as indicated on Schedule K-1 of Form 1041
  - Any excess distribution of the entity's DNI is treated as a non-taxable principal payment to the beneficiary
- DNI is computed on Schedule B of Form 1041

PART 2. ALLOCATING GAINS & LOSSES BETWEEN TRUST/ESTATE AND BENEFICIARIES (PART III)

FORM 1041, SCHEDULE D, PART III

- Part III reports how gains or losses are divided between beneficiaries and the trust (or estate).
- But before we get there, a quick primer on when, exactly, capital gains can ever be allocated to a beneficiary…

26 CAPITAL GAINS UNDER PRINCIPAL & INCOME RULES

- By default, state-level Principal and Income Acts categorize receipts in return for appreciated property (i.e., capital gains) as principal.
- Income tax rules follow that presumption, and will generally exclude capital gains from Distributable Net Income (DNI), so that gains are taxed to the trust. See Internal Revenue Code §643(a).

- Traditionally recognized exceptions to the exclusion of gains from DNI:
- Trust termination;
- Partial termination (e.g., distribution of 1/3 or 1/2 of principal when beneficiary reaches a certain age);
- Specific allocations under the instrument, departing from state default rules.
- See Treas. Reg. §1.643(a)-3.

- Modern trend has been towards more flexible inclusion of capital gains in DNI:
- Equitable adjustment/total return trusts. Under Treas. Reg. §1.643(b)-1, income tax rules will respect actual allocations, if local law provides for reasonable apportionment of the total return of the trust, or if it is permitted under the terms of the instrument and not inconsistent with local law. This allows the trustee to allocate capital gain to accounting income and treat it as part of DNI for the year.
- "Actually distributed" gains . Under Treas. Reg. §1.643(a)-3(b)(3), gains can be included in DNI if "allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." The trustee must ensure that the distribution is consistent with the terms of the trust instrument, but is not obligated to exercise discretion consistently.

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SCHEDULE D, PART III…

- Line 17: Divide short-term gains or losses between beneficiaries and the trust.
- Only report losses as allocated to a beneficiary if the losses are used to offset the gains paid, credited, or required to be distributed to the beneficiary. Otherwise, such losses must be allocated to the trust.
- Include short-term gains which are paid or set aside for a charitable purpose under Internal Revenue Code 642(c). These are included here, but deducted on Schedule A, Line 4.

30 SCHEDULE D, PART III (CONTINUED)

- Line 18a: Same calculations and allocations as Line 17, but for long-term gains or losses.
- Line 18b: Applies if the trust had Section 1250 gain for the year (capital gain on real estate that was previously depreciated).
- Line 18c: Applies if the trust had gain or loss on collectibles (metals, gems, artwork, and most other tangible property investments), or a Section 1202 exclusion on sale of qualified small business stock.
- For both 18b and 18c, complete the separate Worksheets in the Schedule D Instructions. Why? To properly allocate rate differentials between beneficiaries and trust.

PART 3. CAPITAL LOSS LIMITATION (PART IV)

SCHEDULE D, PART IV

- Line 20, Capital Loss Limitation:
- If the total capital losses (beneficiaries and trust) exceed $3,000, annual deduction is capped at $3,000. Balance may be carried over for future years.

LOSSES ALLOCATED TO BENEFICIARIES

- Losses can not be allocated to Beneficiaries until the final year of the return.

PART 4. TAX COMPUTATION USING MAXIMUM CAPITAL GAINS RATE (PART V)

- Calculating Capital Gains Tax
- For tax year 2018, the 20% maximum capital gain rate applies to estates and trusts with income above $12,500.
- The 0% rate applies up to $2,600.
- The 15% rate applies to amounts over $2,600 and up to $12,500.

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- See Schedule D Tax Worksheet Attached.

- See Form 1041 Instructions attached for tax rate schedule

PART V. NAVIGATING BASIS CONSISTENCY RULES

IRC 1014(F) BASIS MUST BE CONSISTENT WITH ESTATE TAX RETURN

For purposes of this section—

(1) In general The basis of any property to which subsection (a) applies shall not exceed—

(A) in the case of property the final value of which has been determined for purposes of the tax imposed by chapter 11 on the estate of such decedent, such value, and

(B) in the case of property not described in subparagraph (A) and with respect to which a statement has been furnished under section 6035(a) identifying the value of such property, such value.

(2) Exception - Paragraph (1) shall only apply to any property whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate.

(3) Determination - For purposes of paragraph (1), the basis of property has been determined for purposes of the tax imposed by chapter 11 if—

(A) the value of such property is shown on a return under section 6018 and such value is not contested by the Secretary before the expiration of the time for assessing a tax under chapter 11,

(B) in a case not described in subparagraph (A), the value is specified by the Secretary and such value is not timely contested by the executor of the estate, or

(C) the value is determined by a court or pursuant to a settlement agreement with the Secretary.

IRC 6035 - BASIS INFORMATION TO PERSONS ACQUIRING PROPERTY FROM DECEDENT

(a) Information with respect to property acquired from decedents

(1) In general - The executor of any estate required to file a return under section 6018(a) shall furnish to the Secretary and to each person acquiring any interest in property included in the decedent's gross estate for Federal estate tax purposes a statement identifying the value of each interest in such property as reported on such return and such other information with respect to such interest as the Secretary may prescribe.

(2) Statements by beneficiaries - Each person required to file a return under section 6018(b) shall furnish to the Secretary and to each other person who holds a legal or beneficial interest in the property to which such return relates a statement identifying the information described in paragraph (1).

(3) Time for furnishing statement

(A) In general - Each statement required to be furnished under paragraph (1) or (2) shall be furnished at such time as the Secretary may prescribe, but in no case at a time later than the earlier of—

(i) the date which is 30 days after the date on which the return under section 6018 was required to be filed (including extensions, if any), or

(ii) the date which is 30 days after the date such return is filed. (B) Adjustments - In any case in which there is an adjustment to the information required to be included on a statement filed under paragraph (1) or (2) after such statement has been filed, a supplemental statement under such paragraph shall be filed not later than the date which is 30 days after such adjustment is made.

Proposed Regulations: Temporary and proposed regulations, released March 2, 2016 provide additional guidance regarding the basis consistency and information reporting requirements of new §§1014(f) and 6035. Some of the highlights and surprises include the following:

The final value for estate tax purposes sets the initial basis; normal post-death basis adjustments are still applicable;

For property subject to non-recourse debt, the basis is the gross value of the property, not just the net value reported on the estate return;

The reporting requirement **does not apply** to estates that are not required to file estate tax returns but do so merely to make the portability election;

Property that qualifies for the marital or charitable deduction is not subject to the basis consistency requirement (1014(f)), but is subject to the reporting requirements (6035);

Tangible personal property that does not have a marked artistic or intrinsic value over $3,000 is not subject to the basis consistency or reporting requirements;

After-discovered or omitted property gets a basis of **<u>zero</u>** if the property is not reported on an estate tax return before the period of limitations on assessments has expired;

The Form 8971 and Schedule(s) A to beneficiaries can omit cash, IRD, tangible personal property (as described above), and property sold before the information reports are due;

For bequests to a trust, estate or entity the Schedule(s) A are given to the trustee, executor or entity (not the trust beneficiaries);

For life estates, Schedule(s) A must be sent to the life tenant and presumptive remainderman (and if the initial remainderman dies before the life tenant, the executor apparently must send supplemental reports to the IRS and to the new remainderman);

If the executor has not determined what property will be distributed to a beneficiary when the information report is due, all property that could be used to satisfy the bequest must be included on the Schedule A to that beneficiary

NO supplemental reporting to the IRS or beneficiary required after the bequest is funded

The executor must file a supplemental Form 8971 with the IRS and send supplemental Schedule(s) A to beneficiaries if any previously reported information is incorrect or incomplete (such as if the final estate tax value is changed); and

If a recipient of an asset in the gross estate makes a subsequent gift or distribution to a "related transferee" the recipient must file a Schedule A with the IRS and transferee reporting the change in ownership and final estate tax value of the property;

PART 6. REPORTING CAPITAL GAINS FOR SPLIT-INTEREST TRUSTS ON FORM 5227

48 ATTRIBUTES OF SPLIT-INTEREST TRUSTS

Charitable Remainder Trusts provide an annual stream of payments to one or more non-charitable beneficiaries for a term of years or for life. When the non-charitable interest expires, the remainder trust passes to the charity.

If assets with a low basis are transferred to a charitable remainder trust (CRT) and the CRT sells those assets, which have the carryover basis of the donor, then no income tax is due on the realized capital gains since the CRT is exempt from income tax.

There are three specific types of Charitable Remainder Trusts

– Charitable Remainder Annuity Trust (CRAT) – designed to pay a fixed amount, at least annually, to a non-charitable beneficiary.

– Charitable Remainder Unitrust (CRUT) – designed to pay a fixed percentage of the FMV of the trust's assets valued annually.

– Pooled income funds – donors receive a lifetime income interest based on the rate of the return earned by the trust.

ATTRIBUTES OF SPLIT-INTEREST TRUSTS

- Charitable Lead Trusts (CLT) provide a specified amount (at least annually) to a charitable organization for a term of years of for the life of designated individuals. The remainder interest either reverts to the donor or is paid to one or more non-charitable beneficiaries at the termination of the lead interest.
- – It is the mirror image of a CRT.

- Grantor Charitable Lead Trusts
- The donor/grantor is taxed only on that portion of the trust he is treated as owning.
- The reversionary interest requires the donor to be the owner of the principal and must recognize any capital gain items.

- Four-Tier accounting for payments to the beneficiaries unique to CRTs – (1) ordinary income (2) capital gains (3) other (tax-exempt) income (4) corpus
- Within the capital gains category of distributions there could be four different tax rates:
- Short-term capital gains taxed as high as 35%
- Collectible gains taxed at 28%
- Unrecaptured 1250 gains taxed at 25%
- Other long-term capital gain taxed at 15% or as high as 20%

- A CRT itself is exempt from the net investment income tax imposed by section 1411.
- However, the capital gains distributed to the beneficiaries are includible subject to their net investment income if they are distributed from a tax rate class subject to the 3.8% surtax.
- This is why the accumulation of net investment income is important for the preparation of Form 5227.
- A CLT is not exempt from the NIIT except that investment income distributed to the income beneficiary (which is normally a tax-exempt organization)is not taxed on its net investment income.

- Treasury regulations provide trustees with two alternative methods for accounting for NIIT.
- Section 664 method (the default method) requires that each tax rate class that the NIIT applies be divided into two tax rate classes. 1) Undistributed amounts within a class at 12/31/12 is not subject to the 3.8% NIIT (2) Other income not subject to the 3.8% NIIT such as an IRA)
- The simplified method accumulates net investment income items and non-net investment income on a cumulative basis from the later of January 1, 2013, or the date the CRT was first funded into two buckets.
- The simplified method in only available for CRTs created prior to January 1, 2013, if the method was elected for the 2013 return.