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Untaxingly Yours

What Every Tax Professional Needs to Remember About Fiduciary Income Tax

By Brian T. Whitlock

In this world nothing can be said to be certain, except death and taxes.

— Benjamin Franklin

As tax professionals, we are frequently exposed to a diverse range of tax topics impacting individuals, business entities, and exempt organizations. Income taxes, payroll taxes, sales taxes, excise taxes, and transfer taxes weave their way through the lives of each entity. While it is impossible to be experts in all tax-related topics, it is important that we at a minimum have some rudimentary knowledge of each general area.

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Just as death is an inevitable event for all of us, at some point in either our personal or professional lives we will be exposed to the fiduciary income. The purpose of this month's column is to review some of the basic principles of fiduciary income taxation and highlight a few of the key concepts that we need to retain as they will impact not only our professional practices, but ultimately, someday, our own families.

An Overview—The Origin of Trusts

Trusts can in part be traced back to early Rome where they are rooted in property which was transferred at death and administered under the terms of a person' last will and testament. We find trusts also in medieval England where landowner's riding off to fight in the Crusades transferred the legal title of their real estate to a legal holder, while he was absent, subject to an agreement to return the property to the true owner, when he returned from his campaign.

The persons responsible for managing a trust or an estate may be known by differing names depending upon the State that they are operating in and its local law. They might be referred to as executors, administrators, trustees, or guardians, but generically they are all known by the generic title of "fiduciary." The word fiduciary is rooted in the Latin word "Fides" the name of the goddess of trust (good faith). A fiduciary is expected to be "super honest" because they are holding assets that have been entrusted to them by someone for the benefit of one or more persons. If there are multiple beneficiaries, a fiduciary is expected to act

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with some level of objectivity and impartiality. This can be an onerous task for an individual especially if there is one than one beneficiary. Professional fiduciaries are frequently called upon to serve in situations where difficult assets and problematic beneficiaries may be present.

Let's look at a fairly easy example: Grant transfers $1,000,000 to Pat to hold in trust for the benefit of Bernie and her three children. Under the trust agreement, Pat must distribute all of the income to Bernie, at least annually. Principal is to be retained in the trust, and distributed to the children only after Bernie's death.

Hopefully, this exposure to fiduciary income taxes will prepare you for the casual cocktail party query from family or friends or perhaps even stir your curiosity further.

Who are the key players in our example? Grant is the "Grantor" (sometimes referred to as the Settlor or creator) of the trust. Pat is the "Trustee" or fiduciary. Bernie is the Current Income beneficiary, and if all remains in place until Bernie's death, then her children are the Presumptive Remainder beneficiaries. We will return to this example, so keep the players in mind.

The Basic Principles of the Fiduciary Income Tax

The first, and most important, principle of fiduciary income taxation is that Trust Taxable Income (TTI) is computed in the same manner for fiduciaries as it is for individuals. Gross income, exclusions, and deductions (*i.e.*, Code Secs. 61 through 291) form the core for the computation of taxable income for both individuals and fiduciaries.

The second important principle is that the fiduciary income tax rates mirror the individual income tax rates. The brackets may be narrower (or more compressed) for trusts, causing fiduciary income to be taxed at increasing higher rates much more rapidly for trusts than for individuals, but nevertheless essentially the same rates apply across differing types of income: ordinary income is taxed at ordinary income rates; qualified dividends and long-term capital gains are taxed at the lower capital gains tax rates; Net Investment Income (NII) is subject to the 3.8% Medicare Surtax; and the Alternative Minimum Tax may apply, if there are an abundance of tax preferences or adjustments.

The third important principal is that trusts are taxed upon a Conduit Theory. In order to understand the Conduit Theory, one should envision a tube or a piece of pipe. As income flows into the pipe, we take note of its characteristics (ordinary income, qualified dividends, short-term vs long-term capital gains, tax-exempt income, *etc.*). Expenditures made by the fiduciary from the funds generated will be offset against the income. Some of the expenses will be eligible as deductions against the gross income, others may not be tax deductible. If the net Trust Accounting Income (TAI) is required by the terms of the organizing documents to be distributed, then to the extent permitted by the tax law it will be deducted from the fiduciary's taxable income, and it will be taxed to the same beneficiaries that are required to receive the distributions in the same proportions to which they are entitled to receive the distributions. If the trust's receipts are not required to be distributed, then to the extent that they are retained by the fiduciary, they will likely be taxed at the fiduciary's income tax rates, but to the extent that they are nonetheless actually distributed, even though not required, they will be taxable to the beneficiaries. The character of TAI that is distributed will be the same in the hands of the beneficiary, as it would have been in the hands of the fiduciary, and the same tax rates (albeit wider tax brackets) will apply to the individual beneficiaries.

That's it, three basic principles that you need to remember. These principles form the foundation of fiduciary income tax, and if you take away nothing else from here on in, then we can both claim success. Nevertheless, with the basics in hand, if you are interested, a deeper dive is possible and may in fact prove to be informative.

Classifications of Fiduciary Income Tax Returns

A quick glance at the upper left-hand corner of IRS Form 1041—*U.S. Income Tax Return for Estates and Trusts* reveals of list of no less than nine possible entities that could use this form for its income tax preparation. The list includes: Decedent's estate, Simple Trust, Complex Trust, Qualified Disability Trust (QDT), Electing Small Business Trust (ESBT) (S portion only), Grantor type trust, Bankruptcy

Estate—Ch. 7, Bankruptcy Estate—Ch. 11 and Pooled income fund. Before we press on, it is useful to understand some of the differences between the various entity classifications.

Decedent's Estate

Probate is the judicial process governing the management of assets and liabilities related to both deceased and legally disabled persons. The guardians of legally disabled persons (*e.g.*, minors and adults lacking the legal capacity to make financial decisions) are required to report to the probate court regarding the administration and management of the disabled person's property, but they are not required to file fiduciary income tax returns. Instead, the guardians continue to file IRS Form 1040, U.S. Individual Tax Returns for the disabled person.

Fiduciaries managing assets for deceased individuals, on the other hand, are subject to the fiduciary income tax reporting requirements. Probate administration for deceased individuals involves the collection of assets, the resolution of financial claims both for and against the deceased, the payment of administration expenses, and the orderly distribution of the deceased's property to heirs and legatees.

Estates are permitted a $600 exemption and must use today's compressed fiduciary income tax brackets for ordinary income which reaches the top tax income tax rate of 37% at $12,950 in 2020.

Grantor Type Trust

All trusts have Grantors (sometimes also referred to as Settlors) who create and fund a trust by signing a trust agreement or transferring assets, but not all trusts are Grantor Type trusts in the eyes of the tax law. Grantor Type trusts are specifically delineated under Code Secs. 671–678. If a trust meets one of the many possible criteria outlined in Code Secs.671 through 678, then the trust which is a valid legal entity, separate and apart from its creator, is nevertheless disregarded for Federal Income Tax purposes. A little history lesson, may help in understanding how and why this result is dictated by the tax law.

Prior to 1954, trusts were commonly used by wealthy persons as tax havens. Each and every trust that a person created was eligible for its own set of income tax brackets. The tax law in 1953 contained 24 tax brackets ranging from a low of 20.4% to a high of 92%. "Winning the tax game" became a matter as simple as creating multiple entities across which income could be divided and taxed using the benefit of low marginal tax brackets and avoiding having income reach into the high marginal tax rates. In an attempt to eliminate the abuse of using multiple trusts, Congress substantially rewrote The Internal Revenue Code in 1954 and inserted Code Secs. 671–678. As summarized in Table 1, Code Secs. 673 through 677 create multiple powers, any of which if retained by the Grantor, would cause the trust to be a disregard entity and result in all of the income, deductions and credits associated with the trust being reportable on the tax return of the deemed Grantor.

In addition to the retained powers provisions of Code Secs. 673–677 there are two "actions" which may cause a trust to be taxed to the Grantor, as a result of trust operations. First, under Code Sec. 675(3) a Grantor will be taxed on all of the income of a trust during any year in which the Grantor has directly or indirectly borrowed the income or the principal of the trust and not completely repaid such loan, including interest, before the beginning of the taxable year. Second, under Code

TABLE 1. TYPICAL GRANTOR POWERS

Code Sec.	Para	Description of Power
673		Grantor has retained a reversionary interest (right to receive assets back)
674	(b) (4)	Power in a non-adverse trustee to allocate among Charitable Beneficiaries
674	(d)	Power in any person to add a beneficiary to receive income or corpus
675	(1)	Power in grantor to purchase or exchange, or otherwise deal with the trust for less than full and adequate consideration
675	(2)	Power to borrow without adequate interest or security
675	(4)(C)	Power of any person acting in a non-fiduciary capacity to reacquire trust corpus by substituting other property of an equivalent value
676		Power to Revoke the trust
677	(a)(3)	Where income may be applied to the payment of premiums on policies of life insurance on the life of the grantor or the grantors spouse
678		Power to vest income or corpus of trust in self

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Sec. 677(b) where income of the trust is actually applied or distributed to a person that the Grantor is legally obligated to support, then the trust will be disregarded for income tax purposes.

Code Sec. 678(a) has a slightly different focus, under this final Grantor Type trust rule, a person, other than the creator of the trust, may be "a deemed Grantor" and may thus be taxed on the taxable attributes of the trust, where that person has the sole power to vest that income or principal solely in himself, without the consent of a party having an interest in the trust that is adverse (opposed) to his own. The "wild card provision" of Code Sec. 678(b) provides that during the lifetime of creator of the trust, if any other provision of Code Secs. 673 through 677 is present that could cause the trust to be disregarded and taxed to the original Grantor (Settlor), then this power will override Code Sec. 678(a)'s classification of another person as the deemed Grantor. As a result, Code Sec. 678(a) will likely only take effect, after the death of the original creator of the trust.

Simple Trust

Where the trust agreement requires the fiduciary to annually distribute all TAI, then this trust is classified as a "Simple Trust." Simple Trusts typically use the words "must" or "shall" when describing the fiduciary's power to distribute income to a named beneficiary. There should be no hint of any discretion in the language of the trust agreement regarding the trustee's requirement to make distributions of TAI. If a trustee in fact distributes any funds to charity or distributes more than TAI to a beneficiary, then the trust will not be classified as a Simple Trust during that tax year.

Simple Trusts are permitted a $300 exemption, and they must use today's compressed fiduciary income tax brackets for ordinary income which reach the top tax income tax rate of 37% at $12,950 in 2020.

Complex Trust

Where the trust agreement grants the fiduciary the power to accumulate TAI, or where the agreement gives the fiduciary discretion over distributions of TAI, then this trust is classified as a "Complex Trust". Complex Trusts typically use the words "may" or "as necessary" when describing the amounts that are required to be distributed to a named beneficiary. If a trustee in fact distributes any funds to charity or distributes more than TAI to a beneficiary, then the trust will be classified as a Complex Trust during that tax year. Complex Trusts are permitted to claim an Income Distribution Deduction (IDD) for the taxable portion of any Distributable Net Income (DNI) which is actually distributed by the fiduciary. (This concept will be explained in excruciating detail shortly). This deduction permits the fiduciary to shift a portion of the income tax burden, attributable to income initially earned by the trust, to the beneficiaries.

Complex Trusts are permitted a $100 exemption, and they must use today's compressed fiduciary income tax brackets for ordinary income which reach the top tax income tax rate of 37% at $12,950 in 2020.

Qualified Disability Trust

A QDT is an irrevocable trust created for the sole lifetime benefit of a person who is under age 65, disabled under the Social Security Act, and therefore eligible for Supplemental Security Income (SSI) or Social Security Disability Income (SSDI) benefits. A QDT may be either a Supplemental Needs Trust (created with third party funds) or a Special Needs Trust (created with the disabled person's funds) provided that the trust is not otherwise classified as a Grantor Type trust. After the death of the sole disabled beneficiary, the assets of a Special Needs Trust must be used to reimburse the State for any government benefits paid to the disabled person. Supplemental Needs Trusts are not required to reimburse the State, instead they may be paid to siblings of the disabled or other family members, after the death of the disabled beneficiary.

Unlike the preceding entities, QDTs are permitted to claim a large personal exemption of $4,300 in 2020 and 2021, and they are permitted to use the tax rates and brackets applicable to single individuals.

Bankruptcy Estates

A bankruptcy estate is created when an individual debtor files a petition in the Federal Bankruptcy Court under either chapter 7 or 11 of title 11 of the U.S. Code. The bankruptcy estate is treated as a separate taxable entity. The income earned after the filing of the petition is not part of the debtor's individual income tax filings. The bankruptcy trustee or debtor-in-possession must file IRS Form 1041[1] for the estate of an individual involved in Federal Bankruptcy proceedings under chapter 7 or 11 of title 11 of the U.S. Code, if the gross income for the tax year is in excess of the standard deduction ($12,400 in 2020).

> **Note.** A separate taxable entity is not created when a partnership or corporation files a petition in the Federal Bankruptcy Court under any chapter of title 11 of the U.S. Code.

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Pooled Income Fund

A pooled income fund is a type of charitable mutual fund created from cash and securities donated by various persons and entities for the ultimate benefit of charity. The funds are invested for the possible current benefit of both the investors and the charities.

The Devil's Triangle

This is the point in the discussion, where most readers will get lost, but as they say the devil is in the details. The devilish part of trust taxation lies in the confusion that commonly sets in when distinguishing between three important concepts: TAI, TTI, and DNI. I like to refer to this as the Devil's Triangle.

Trust Accounting Income

TAI involves the classification of the receipts and expenditures as either "Income" or "Principal." This classification is important because it will have an economic impact on the potential trust distributions. Whether a receipt or an expenditure is related to Income or Principal, will be determined by the interpretation of the trustee (in consultation with its advisors) of the instructions contained in the trust agreement (or Will). If the document does not give specific instructions, then the interpretation will rely upon the local law that controls the actions of the trustee. This local law is typically found in an aptly titled "Income and Principal Act" enacted by the State Legislature.

Let's return to our example of Grant, Pat, Bernie and her kids. If Bernie invests the $1,000,000 in a certificate of deposit (CD) earning 2% per annum, the task of classifying income and principal are straight forward. The interest earned on the CD is income, and the capital invested is the principal. Pat will distribute all the income ($20,000) each year to Bernie. When Bernie dies Pat will cash in the CD and distribute the net proceeds to the children.

Trust Taxable Income

TTI involves the classification of the receipts and expenditures as either "taxable" or "tax-exempt." The tax practitioner in essence runs the same figures through a second "taxable" filter. This filter does not change the computation of TAI or the economic interests of the beneficiaries, but it will be important in determining the tax nature of those distributions and the relative income tax burdens of the trust and the beneficiaries. TTI requires multiple steps. First, we calculate Adjusted Taxable Income (Loss). [Gross Income minus Deductible expense and Net Operating Loss]. Second, we reach TTI by subtracting any Income Distribution Deduction (IDD), we will return here shortly, any Qualified Business Income (QBI) deduction, available under Code Sec. 199A, and the available exemption.

Returning to our example, assume that Pat invests the $1,000,000 in a stock mutual fund. The fund pays out cash in the form of dividends and capital gains. First, compute TAI. Under most Income and Principal Acts, the dividends will be income (distributable to Bernie), whereas the capital gains will be principal (retained and reinvested for the children). Next compute, TTI. Both the dividends and the capital gains are gross income, but the dividends will, as we will see, become eligible for the IDD. Any qualified portion of the dividends distributed to Bernie will be taxable on her individual income tax return at the preferred rate for qualified dividends. Any non-qualified portion of the dividends will be taxable to her at her ordinary income tax rates. The capital gains accumulated in the trust, minus the applicable exemption, will be taxed on IRS Form 1041. Any long-term capital gains will be taxed to the trust at the preferred capital gains rate. Short-term capital gains will be taxed to the trust at ordinary income tax rates.

Distributable Net Income

The third leg of the triangle is DNI. If you think, DNI sounds like the IDD that we needed to calculate TTI, you are correct. We have the potential for a circular equation.

The calculation of DNI starts in a manner of speaking, where the calculation of TTI ends. DNI is TTI before the subtraction of the IDD and the exemption, minus capital gains and losses which are treated at TAI allocated to principal, plus income (net of expenses) which are related to tax-exempt income. The distinction between IDD and DNI is that whereas DNI includes both taxable and tax-exempt income, IDD is limited to only to taxable income portion of DNI. If your head is spinning at this point, you are experiencing the Devil's Triangle.

Let's return one last time to our example. Assume that in addition to investing in a stock mutual fund Pat also invests in a municipal bond fund. The stock mutual fund distributes $10× of qualified dividends and $20× of long-term capital gains. The municipal bond fund distributes $7× of muni bond dividends and $15× of long-term capital gains. TAI is equal to the qualified dividends plus the muni bond dividends for a total of $17×. TTI is equal to the qualified dividends and the long-term capital gains from both mutual fund investments for a total $45×,

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minus the IDD and the exemption. DNI is equal to the qualified dividends plus the muni bond dividends for a total of $17×, but IDD is limited only to the taxable portion of the DNI (*i.e.*, the $10× of qualified dividends). Therefore, TTI is equal to $45× minus $10× (the IDD) for a net of $35 (which was the long-term capital gains) minus the exemption.

Fiduciary Tax Elections

Periods and Methods of Accounting

Unlike trusts which must generally report income on a calendar year under Code Sec. 644, decedent estates are permitted to use a fiscal year, beginning with the day after the decedent's death and ending with any calendar month end of 12 months or less. The decedent's estate may continue to use this fiscal year for up to two years following the decedent's death, if the fiduciaries were not required to file an IRS Form 706, *U.S. Estate Tax Return*. If Form 706 was required, then fiscal year may be continued until six months after the final determination of the estate tax liability. After the permitted period, the fiduciary must convert to a calendar year and file a short year return, despite the fact that the Probate Estate might still be open in the state courts.

Trusts begin their tax year on the date that the trust is funded. Estates begin their tax year on the day after the decedent's date of death. Income earned by the deceased, up to and including the date of death, is reported on the deceased individual's final IRS Form 1040.

Attorneys file accountings on behalf of Guardians and Executors with the Probate Court strictly on a cash method of accounting. Preparing the fiduciary income tax returns on the same cash method seems like a natural extension, but it is not required. Fiduciary income tax returns can be prepared on an accrual method. It is relatively easy to switch from the cash method to accrual method for income tax purposes. The ease of this election is, however, a one-way street. In order to switch back from the accrual method to the cash method of accounting, permission of the Secretary of Treasury is first required.

The accrual method of accounting should be considered where large professional or administration retainer fees are paid, and in the final year of administration for an estate or trust. The accrual method may allow a better matching of income and expenses and avoid having expenses exceed income during early years of administration. Unlike business losses which are classified as "net operating losses." Losses generated as a result of professional fees and administration expenses being in excess of gross income, that are not associated with a trade or business held by the fiduciary, are classified as non-business losses. Non-business losses cannot be carried either forward or back to offset taxable income in other years.[2]

Excess Code Sec. 67(e) expenses in the final year of administration can be passed out to the beneficiaries on IRS Form 1041 (Schedule K-1), line 11 as "Final year deductions." These excess Code Sec. 67(e) expenses are deductible as by the individual beneficiaries "above the line"[3] on Schedule 1, Line 22 and should be identified as such on the line by the notation "ED67(e)."[4] Adopting the accrual method of accounting in the final year of administration can permit the fiduciary to deduct expenses before they are physically paid.

Election to Treat Trust as an Estate

Over the last 50 years, attorneys have increasing encouraged their clients to create and fund revocable living trusts in order to avoid holding all of their assets in their personal name at death and thus being subject to the jurisdiction of the Probate Courts. The revocable living trust (sometimes referred to a "loving trust") generally works in tandem with the last will and testament of the deceased to transfer the assets of the deceased to heirs and legatees.

Code Sec. 645 recognizes this tandem relationship for certain Qualified Revocable Trusts (QRTs) and permits the fiduciaries to make an election with the filing of IRS Form 8855, which permits the QRT to file one IRS Form 1041 on a consolidated basis with the deceased's estate, and thus permit the QRT to take advantage of the fiscal year end rather than be forced to file on a calendar year end.

65 Day Election

Code Sec. 663(b) permits an estate or a Complex Trust to treat distributions made during the first 65 days of the following tax year as if they had been paid to the beneficiary on the last day of the prior tax year. The election can be made for all or any portion of an amount distributed within the 65 days of the year end, up to the greater of TAI or DNI. The election is made by checking a box on page 2, line 6 of IRS Form 1041.

Election to Recognize Gain on Distributions

As a general rule, under Code Sec. 643, distributions of appreciated property to a beneficiary only carry out DNI to the extent of the lesser of the adjusted basis of the property and its fair market value. As expected, the beneficiary's basis in the property would normally be the same amount (*i.e.*, carryover basis).

Code Sec. 643(e) permits the fiduciary to elect to recognize gain on the distribution of appreciated property.

The election, if made, carries out DNI equal to the fair market value of the property distributed, and the beneficiary receives the property at its stepped-up basis. The election is made by checking a box on page 2, line 6 of IRS Form 1041.

The election to recognize gain on the distribution of appreciated property is useful where the trust has unused Capital Loss carryforwards which can easily absorb the gain, or where the beneficiaries all agree that the burden of the tax on the capital gain should be shared by all the beneficiaries of the trust rather than carrying over to the recipient of the appreciated property.

Election to Deduct Estate Administration Expenses

The fiduciary has the option under Code Sec. 642(g) of deducting administration expenses related to the death of the deceased taxpayer on IRS Form 1041, so long as the fiduciaries agree not to report the same expenses on IRS Form 706. The election is made by attaching a statement to the return claiming the deduction. The statement must contain wording waiving the right to claim the deductions on the other return.

Election to Allocate Credit for Tax Payments to Beneficiaries

Code Sec. 643(g) allows trustees and executor's in the final tax year to elect to allocate part or all of the fiduciary's estimated income tax payments to the beneficiaries. The election must be made by filing IRS Form 1041-T on or before the 65th day after the close of the taxable year. The amounts allocated to each beneficiary are also required to be reported to the beneficiaries on IRS Form 1041 (Schedule K-1).

The amounts allocated are treated as distributions made on the last day of the taxable year, and the credit may only be claimed by the beneficiary as a payment made as of January 15, following the close of the year for the purposes of any individual estimated income tax penalty.

Trust Elections Related to S Corporations

Three classifications of trusts are generally permitted to hold the common stock of a corporation operating under Subchapter S of the Internal Revenue Code: Grantor Type Trusts, Qualified Subchapter S Trusts (QSSTs), and Electing Small Business Trusts (ESBTs).

Grantor Type trusts are disregarded entities for income tax purposes. They do not require any special elections in order to be permitted holders of S Corporation common stock. Instead, we look through the trust in order to determine whether the deemed Grantor is a qualified shareholder.

QSSTs and ESBTs on the other hand require elections to be filed with the Internal Revenue Service, within 75 days of their first holding S Corporation common stock, in order to be qualified S Corporation shareholders. Failure to file a timely election is a common error, and it can be cured by seeking relief under Reg. §301.9100-1, since it is a requirement set forth not in the Statute but in another Treasury Regulation.

Fiduciary Income Tax Reporting of S Corporation Attributes

The tax attributes (income, deductions, and credits) allocable to deemed Grantors of Grantor Type trusts are reportable directly on the individual income tax returns of the deemed Grantors.[5]

Where a QSST Election is in place, the S Corporation must report the income under the Tax Identifying Number (TIN) of the trust, and the QSST must file IRS Form 1041. The tax attributes related to the S Corporation portion are reported by the S Corporation to the fiduciary on IRS Form 1120-S (Schedule K-1). These tax attributes are not reported by the fiduciary on the face of IRS Form 1041. Instead, they are reported on a separate statement attached to the Form 1041 and linked to the beneficiary's SSN. In this way, the reporting is similar to a Grantor Type trust where the Grantor and the fiduciary are not the same person.[6] If the fiduciary is holding cash and other assets (in addition to the S Corporation common stock), then the fiduciary will report only the income attributable to the other assets on the face of Form 1041. This second portion of the trust will likely be treated as a Simple Trust.[7]

Where an ESBT election is in place, the tax reporting of the trust is bifurcated into two separate portions. One portion consists of the allocable S Corporation tax attributes. These tax attributes (together with the trust's allocable portion of administrative expenses and state and local taxes) are reported on the ESBT Tax Worksheet contained in the instructions to IRS Form 1041, as part of a separate tax computation. The allocable income and deductions are netted against each other and then then multiplied by the top income tax rates appropriate to such income (currently 37% for ordinary income and 20% for qualified dividends and long-term capital gains) and the total ESBT tax is then reported on Form 1041, Page 2, Schedule G, line 4. Most tax preparation software vendors print something equivalent to the ESBT Tax Worksheet as part of the IRS Form 1041 submission.[8] If the fiduciary is holding

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cash and other assets (in addition to the S Corporation common stock), then the fiduciary will report only the income attributable to the other assets on the face of Form 1041.

The non-ESBT portion of the trust will likely be treated as a Complex Trust.[9]

Fiduciary Tax Surprises

The void that arises between differences in book income and tax income are common for tax professionals. These "book-tax differences" in the area of fiduciary income taxation can be particularly treacherous.

Book income for a fiduciary is TAI, a concept that we explored earlier. As you may recall, TAI is the amount which the fiduciary may be "required" to distribute as part of a Simple Trust.

DNI as you may recall is rooted in taxable income. DNI will determine the amount of the IDD that the fiduciary is allowed to subtract in determining TTI. The IDD is limited to the lesser of TAI or DNI.

As a result, where TAI is less than DNI for a Simple Trust, some taxable income will remain inside of the Trust and that income will be taxable to the fiduciary at compressed tax rates. What are some common examples of book-tax differences for fiduciaries?

Administration Expenses

Code Sec. 67(g) of the Tax Cuts and Jobs Act of 2017 (TCJA) suspended the deductibility of miscellaneous itemized deductions for individuals (and fiduciaries) for tax years 2018 through 2025. As discussed earlier, a fiduciary handling the post-mortem administration of an estate or trust may elect to deduct administration expenses on IRS Form 1041. Exactly which administration expenses are deductible has been a point of controversy for several years.[10] Non-deductible administration expenses such as investment advisory fees reduce TAI but not DNI. As a result, where a fiduciary has significant non-deductible expenses TAI will be significantly lower than DNI.

Partnership Income

Taxable income flows from a partnership to each of its partners through their allocable share of partnership tax attributes on IRS Form 1065 (Schedule K-1). The Uniform Income and Principal Act, however, defines partnership income for the purposes of TAI as only the cash that is physically distributed from the partnership to the fiduciary. If the Schedule K-1 tax attributes are greater than the cash that is physically distributed, then there will be a difference between TAI, and the IDD that may be deducted from taxable income as part of DNI.

Beneficiary Tax Surprises

The book-tax differences for S Corporations may be less of an issue for QSSTs than they are is for partnerships. As you will recall, the QSST portion of a trust is taxable as a Grantor Type Trust. As a result, the fiduciary's allocable share of the S Corporation tax attributes will be reported directly on the individual income tax return of the QSST beneficiary, no portion of the QSST taxable income is reported on the face of the fiduciary income tax return. For QSSTs, the tax surprise is reversed. The income tax burden of the beneficiary may well be greater than cash distributions received by the fiduciary from the S Corporation, which form the basis for TAI and thus consistute the income distributable to the beneficiary. As a result, the QSST beneficiary of a Simple Trust may not receive enough cash to pay its income tax burden on its share of the S Corporation income.

The Fiduciary "Hot Seat"

The knee jerk solution to both problems could be found by asking the fiduciary to distribute more cash to the income beneficiary. The larger cash distribution (from trust principal) could distribute the remaining DNI, and the IDD claimed by the fiduciary would "zero out" the TTI and eliminate the fiduciary income tax. Similarly, distributing more cash from principal to the beneficiary of the QSST could make the beneficiary whole for any income taxes which the beneficiary might owe as a result of the S Corporation tax attributes reported on the beneficiary's Form 1040.

Nevertheless, remember that the axiom "Don't let the tax tail wag the dog" should serve as an ample warning to fiduciaries. The prospect of paying tax in the "wrong place" or at "higher than anticipated rates" needs to be looked at globally, or as part of the "big picture," because the cure may be worse than the illness. Let's look at an example:

> At her death, Penny's Will created a QTIP Marital Trust for the benefit of Fabio (her fourth husband, age 35). At Fabio's death, the then balance of the trust will be distributed to Penny's son, Max (45) and Minnie (42), or their descendants if they fail to survive Fabio. Penny's best friend, Prudence, is the trustee. Under the terms of the QTIP Marital Trust all income must be distributed

to Fabio, and if any principal distributions are to be made, they may also only be made to Fabio. Fabio has no investment income, but he does earn an ample stream of income from his work as a professional hand model. The trust holds some partnership investments, and Prudence incurs significant investment advisory fees through her broker. During calendar year 2020, the trust has $100K of TAI and $300K of DNI. If only the TAI is distributed to Fabio, Prudence will report nearly $200K of ordinary income and NIIT, and the trust will be taxed at the maximum tax rates. If some or all of the DNI in excess of TAI is distributed to Fabio, there will be a significant tax savings.

Hopefully, this extreme set of facts highlights the conundrum that Prudence faces. Surely, the best tax result is distributing more DNI to Fabio. However, what would Max and Minnie think of distributing cash to Fabio in excess of what is necessary or reasonable under the terms of the QTIP Marital Trust. Prudence needs to consider the broader picture, if she wishes to avoid being dragged into a legal dispute with the remainder beneficiaries.

Conclusion

Hopefully, this exposure to fiduciary income taxes will prepare you for the casual cocktail party query from family or friends or perhaps even stir your curiosity further. If you are interested in a more in-depth study of TAI and Fiduciary income taxation, please allow me to recommend two excellent "must haves" for your home or office library: Fran Schafer and the late Byrle Abbin's Treatise entitled *Income Taxation of Fiduciaries and Beneficiaries*[11] and Carol Cantrell and Gordon Spoor's, *Fiduciary Accounting Answer Book*.[12] Through my involvement on and off over the past 30 plus years as a volunteer on the AICPA Trust and Estate Technical Review panel, I have had the immense opportunity to work alongside of all four of the distinguished authors, and I have learned much from those experiences.

> *Being ignorant is not so much a shame, as being unwilling to learn.*
>
> — Benjamin Franklin

ENDNOTES

1. A detailed discussion of the fiduciary income taxation of bankruptcy estates is beyond the scope of this column. Please consult IRS Publication 908 for an excellent discussion of the compliance aspects and elections available to filers in this arena.
2. *See* IRS Publication 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts* (Revised July 2020) for an excellent recitation of how to not only calculate but carry NOLs to other periods.
3. The phrase "above the line" refers to the fact that the amount is deductible in arriving at Adjusted Gross Income (AGI). Historically, AGI was the last line of page 1, line 1040. This deduction appears before (or above) the line for AGI, rather than "below the line" as an itemized deduction. Above the line treatment is advantageous, because a smaller AGI may yield state income tax savings and larger itemized deductions. The amount of AGI impacts itemized deductions such as medical expenses and charitable contributions which are limited to a percentage of AGI.
4. Instructions to IRS Form 1040 and 1040-SR for tax year 2020 (revised February 2021) at 94.
5. Reg. §1.671-4 permits the trustee to either obtain a separate Tax Identifying Number (TIN) and then file a Form 1041 as an informational return tracing the income to the deemed Grantor's Social Security Number (SSN). Alternatively, where the Grantor and the Trustee are the same person, the Regulation also permits the Trustee to share the Grantor's SSN directly with the S Corporation so that SSN can be listed directly on the Schedule K-1.
6. Many tax preparers attach the QSST's Form 1120-S (Schedule K-1) directly to their Form 1041 with a statement that declares "All the tax attributes listed on the attached Schedule K-1 are reported directly on the IRS Form 1040 of _______________" listing the beneficiary's name and SSN.
7. The QSST portion of the trust must be drafted with language that requires the fiduciary to distribute the TAI at least annually. However, it is possible that the trust agreement could direct that the non-QSST portion of the trust could subject to discretionary distribution rules and thus be classified as a Complex Trust. Regardless of the classification, the fiduciary should be expected to check multiple boxes on the top left-hand corner of IRS Form 1041 indicating the proper classification of both the S Corporation portion of the trust and the non-S Corporation portion of the trust.
8. It continues to be personally frustrating to the author that the IRS has to date not chosen to convert the ESBT Tax Worksheet into a formal tax schedule. Nevertheless, the author is relieved that at least the worksheet is now printed in the instructions and the IRS has formally dedicated line 4 in Schedule G, Part I, line 4 to the reporting of the "Total ESBT Tax." Prior to 2019, tax preparers were not provided with an ESBT Tax Worksheet and were forced to report the ESBT Tax to the left of a line in Schedule G preceded by the words "Sec. 641(c)" and then add the amount to any other taxes related to non-ESBT income. Perhaps someday, the ESBT will no longer be the IRS equivalent of the "red-headed stepchild" (with apologies to Little Orphan Annie).
9. It is possible that the non-ESBT portion of the trust could be classified as either a Simple Trust or as a Complex Trust, depending upon the language contained in the trust agreement. Regardless of the classification, the fiduciary should be expected to check multiple boxes on the top left-hand corner of IRS Form 1041 indicating the proper classification of both the S Corporation portion of the trust and the non-S Corporation portion of the trust.
10. In 2008, the U.S. Supreme Court decided *Knight*, 552 US 181 (2008) which addressed the tax deductibility of investment advisory expenses paid by a trust. In determining whether expenses were subject to the 2% of AGI limitation the Court laid out a standard whereby fiduciaries would need to determine whether a particular expense was caused by the fact that the property was held in trust or whether an individual would have incurred such costs in the absence of a trust. This standard in the absence of clear guidelines has proved to be difficult to apply.
11. Byrle M. Abbin and Frances Way Schafer, *Income Taxation of Fiduciaries and Beneficiaries*, CCH Incorporated (June 30, 2020).
12. Carol A. Cantrell and F. Gordon Spoor, *Fiduciary Accounting Answer Book*, CCH Publications (Nov. 19, 2019).

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