Drafting and Administering Trusts to Save Annual Income Tax

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Drafting and Administering Trusts To Save Annual Income Tax

- Slides
- ACTEC Comments on The One Big Beautiful Bill Act to the US Treasury (fiduciary income tax and other issues)
- Newsletter article on 2025 Tax Law Changes
- Supporting PDF (several thousand pages – cross-references are in parentheticals in slides)

Navigate between Slides and Big PDF

- Open both documents
- Highlight cross-reference in slides
- Ctrl-c to copy
- Go to FULL TABLE OF CONTENTS in big PDF
- Crtl-f to find
- Ctrl-v to paste
- Click ENTER to execute search (might need to specify “exact” or “whole word” search
- ***Browsing the FULL TABLE OF CONTENTS is often faster than executing a search***

Itemized Deductions (II.G.4.n.i.)

2/37 of the following deductions will be disallowed for taxpayers in the 37% bracket (including estates and nongrantor trusts due to repeal of Code § 68(e)):

- Code § 163 (relating to interest)
- Code § 164 (relating to taxes)
- Code § 165(a) for casualty or theft losses described in paragraph (2) or (3) of Code § 165(c) or for losses described in section 165(d)
- Code §§ 170 (relating to charitable, etc., contributions and gifts) and 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose)...

Itemized Deductions (II.G.4.n.i.)

2/37 of the following deductions will be disallowed for taxpayers in the 37% bracket (including estates and nongrantor trusts):

- Code § 213 (relating to medical, dental, etc., expenses),
- Impairment-related work expenses
- Code § 691(c) (relating to deduction for estate tax in case of income in respect of decedent)
- Expenses connected with personal property used in short sale
- Code § 1341 (computation of tax where taxpayer restores substantial amount held under claim of right) (II.G.4.m.i)…

Itemized Deductions (II.G.4.n.i.)

2/37 of the following deductions will be disallowed for taxpayers in the 37% bracket (including estates and nongrantor trusts):

- Code § 72(b)(3) (relating to deduction where annuity payments cease before investment recovered)
- Code § 171 (relating to deduction for amortizable bond premium)
- Code § 216 (relating to deductions in connection with cooperative housing corporations)

Itemized Deductions (II.G.4.n.i.)

- Applying this limitation to trusts/estate that pass entirely to charity generates an unjustified income tax
- Code § 691(c) partial disallowance makes pre-mortem acceleration of IRD more attractive to save federal and state estate tax and to reduce post-mortem 2/37 disallowance (increases pre-mortem 2/37 disallowance, but saves estate tax)
- Paying IRAs and qualified retirement plans directly to charity is more important than ever

Itemized Deductions (II.G.4.n.i.)

More on fighting Code § 691(c) partial disallowance:

- Roth conversion (pre-mortem)
- Assign installment note (pre-mortem)
- Accelerate accrued savings bond interest (pre-mortem or post-mortem final return)

Overview

- Basics of how taxable items are allocated to a trust/estate or its beneficiaries
- Determine how health, education, maintenance, and support (HEMS) can be flexible and the estate and gift tax consequences of using HEMS or no standard
- Define what items comprise distributable net income (DNI) that is not necessarily fiduciary accounting income (FAI)
- Identify when capital gains are included in FAI and how to distribute capital gains

Trust Essentials

- Grantor
  - Person who makes gift to a trust
  - Also known as settlor, trustor, trustmaker
- Trustee
  - Person who administers, invests, and distributes assets
  - Your client for tax return preparation
- Beneficiary
  - Person who receives distributions
  - May or may not also be trustee

Trust Essentials

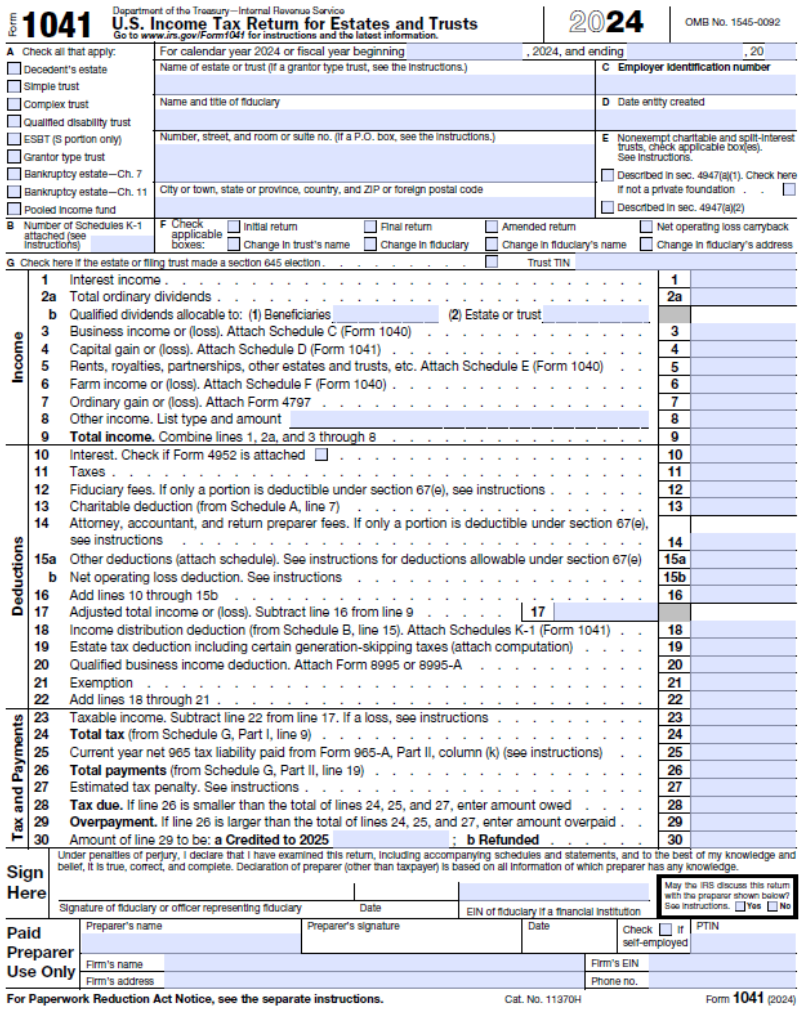
- Grantor trust
  - Grantor or perhaps a beneficiary is the deemed owner for income tax purposes
  - May be revocable or irrevocable
  - If wholly owned by deemed owner:
    - Might use deemed owner's tax ID
    - If use trust's tax ID, report items on grantor information statement
- Nongrantor trust – any trust that is not a grantor trust
- Estate
  - Probate estate of decedent's assets
  - Qualified revocable trust may elect treatment as an estate

Overview

Nongrantor trusts are the focus:

- Standards for making distributions
  - ascertainable standards (HEMS - health, education, maintenance, and support)
  - no standard at all (welfare or best interests)
- Distributable net income (DNI)
- Fiduciary accounting income (FAI)

Form 1041



Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts
Go to www.irs.gov/Form1041 for instructions and the latest information.
2024 OMB No. 1545-0092

A Check all that apply: Decedent's estate; Simple trust; Complex trust; Qualified disability trust; ESBT (S portion only); Grantor type trust; Bankruptcy estate—Ch. 7; Bankruptcy estate—Ch. 11; Pooled income fund

For calendar year 2024 or fiscal year beginning , 2024, and ending , 20

Name of estate or trust (If a grantor type trust, see the instructions.) | C Employer identification number

Name and title of fiduciary | D Date entity created

Number, street, and room or suite no. (If a P.O. box, see the instructions.) | E Nonexempt charitable and split-interest trusts, check applicable box(es). See instructions. Described in sec. 4947(a)(1). Check here if not a private foundation . . Described in sec. 4947(a)(2)

City or town, state or province, country, and ZIP or foreign postal code

B Number of Schedules K-1 attached (see instructions)

F Check applicable boxes: Initial return; Final return; Amended return; Net operating loss carryback; Change in trust's name; Change in fiduciary; Change in fiduciary's name; Change in fiduciary's address

G Check here if the estate or filing trust made a section 645 election . . . Trust TIN

Income	1	Interest income	1	
	2a	Total ordinary dividends	2a	
	b	Qualified dividends allocable to: (1) Beneficiaries (2) Estate or trust		
	3	Business income or (loss). Attach Schedule C (Form 1040)	3	
	4	Capital gain or (loss). Attach Schedule D (Form 1041)	4	
	5	Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040)	5	
	6	Farm income or (loss). Attach Schedule F (Form 1040)	6	
	7	Ordinary gain or (loss). Attach Form 4797	7	
	8	Other income. List type and amount	8	
	9	**Total income.** Combine lines 1, 2a, and 3 through 8	9	
Deductions	10	Interest. Check if Form 4952 is attached	10	
	11	Taxes	11	
	12	Fiduciary fees. If only a portion is deductible under section 67(e), see instructions	12	
	13	Charitable deduction (from Schedule A, line 7)	13	
	14	Attorney, accountant, and return preparer fees. If only a portion is deductible under section 67(e), see instructions	14	
	15a	Other deductions (attach schedule). See instructions for deductions allowable under section 67(e)	15a	
	b	Net operating loss deduction. See instructions	15b	
	16	Add lines 10 through 15b	16	
	17	Adjusted total income or (loss). Subtract line 16 from line 9	17	
	18	Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)	18	
	19	Estate tax deduction including certain generation-skipping taxes (attach computation)	19	
	20	Qualified business income deduction. Attach Form 8995 or 8995-A	20	
	21	Exemption	21	
	22	Add lines 18 through 21	22	
Tax and Payments	23	Taxable income. Subtract line 22 from line 17. If a loss, see instructions	23	
	24	**Total tax** (from Schedule G, Part I, line 9)	24	
	25	Current year net 965 tax liability paid from Form 965-A, Part II, column (k) (see instructions)	25	
	26	**Total payments** (from Schedule G, Part II, line 19)	26	
	27	Estimated tax penalty. See instructions	27	
	28	**Tax due.** If line 26 is smaller than the total of lines 24, 25, and 27, enter amount owed	28	
	29	**Overpayment.** If line 26 is larger than the total of lines 24, 25, and 27, enter amount overpaid	29	
	30	Amount of line 29 to be: **a Credited to 2025** ; **b Refunded**	30	

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of fiduciary or officer representing fiduciary | Date | EIN of fiduciary if a financial institution | May the IRS discuss this return with the preparer shown below? See instructions. Yes No

Paid Preparer Use Only Preparer's name | Preparer's signature | Date | Check if self-employed | PTIN

Firm's name | Firm's EIN

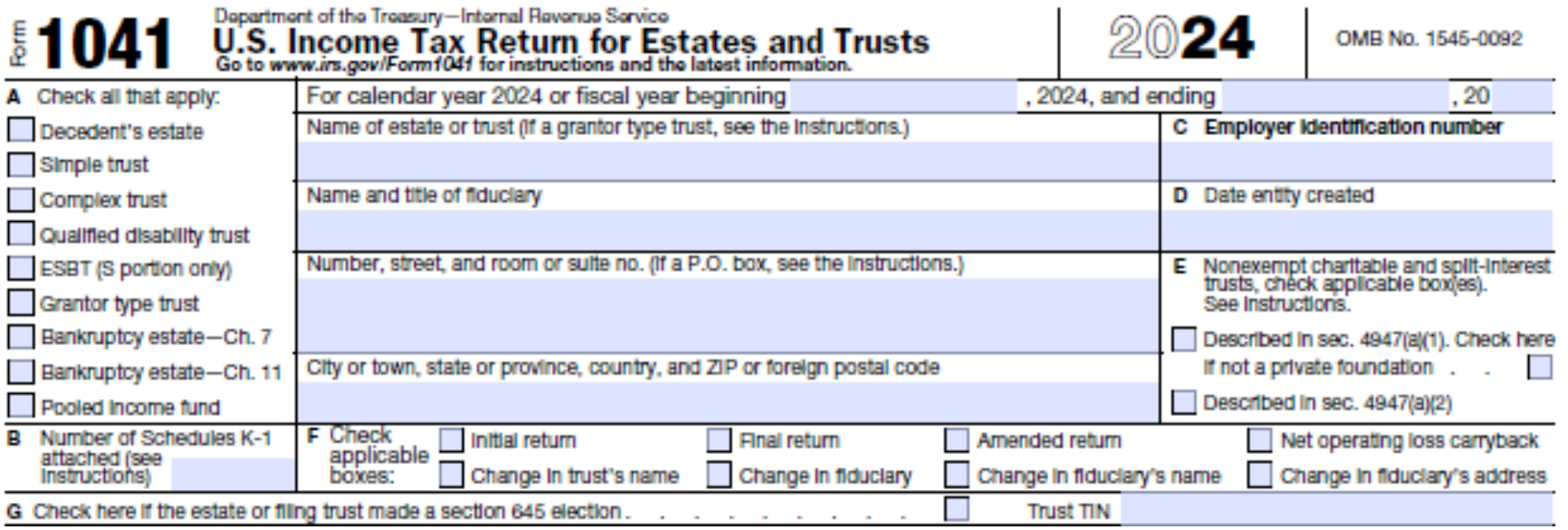
Firm's address | Phone no.

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11370H Form **1041** (2024)

- General information
- Income
- Deductions
- Tax and Payments

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Form 1041 – General Information



Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts
Go to www.irs.gov/Form1041 for instructions and the latest information.
2024 OMB No. 1545-0092

A Check all that apply:
- ☐ Decedent's estate
- ☐ Simple trust
- ☐ Complex trust
- ☐ Qualified disability trust
- ☐ ESBT (S portion only)
- ☐ Grantor type trust
- ☐ Bankruptcy estate—Ch. 7
- ☐ Bankruptcy estate—Ch. 11
- ☐ Pooled income fund

For calendar year 2024 or fiscal year beginning , 2024, and ending , 20

Name of estate or trust (If a grantor type trust, see the instructions.)

Name and title of fiduciary

Number, street, and room or suite no. (If a P.O. box, see the instructions.)

City or town, state or province, country, and ZIP or foreign postal code

C Employer identification number

D Date entity created

E Nonexempt charitable and split-interest trusts, check applicable box(es). See instructions.
- ☐ Described in sec. 4947(a)(1). Check here if not a private foundation . . ☐
- ☐ Described in sec. 4947(a)(2)

B Number of Schedules K-1 attached (see instructions)

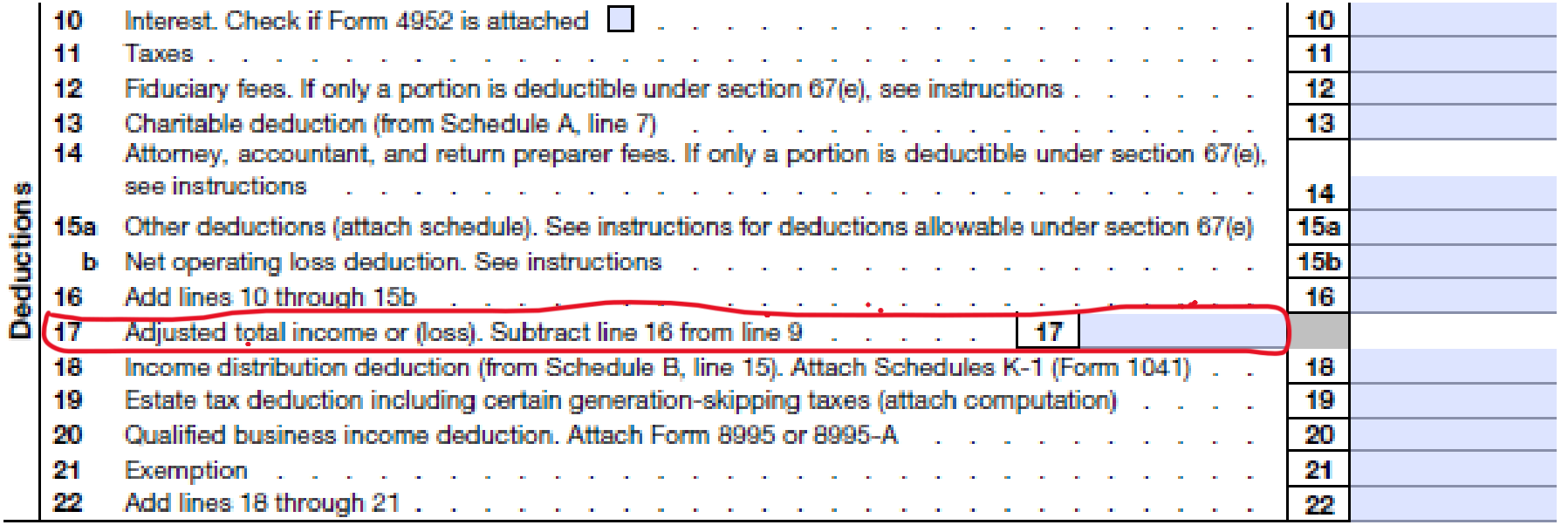
F Check applicable boxes:
- ☐ Initial return
- ☐ Final return
- ☐ Amended return
- ☐ Net operating loss carryback
- ☐ Change in trust's name
- ☐ Change in fiduciary
- ☐ Change in fiduciary's name
- ☐ Change in fiduciary's address

G Check here if the estate or filing trust made a section 645 election . . . . . ☐ Trust TIN

Form 1041 – Income

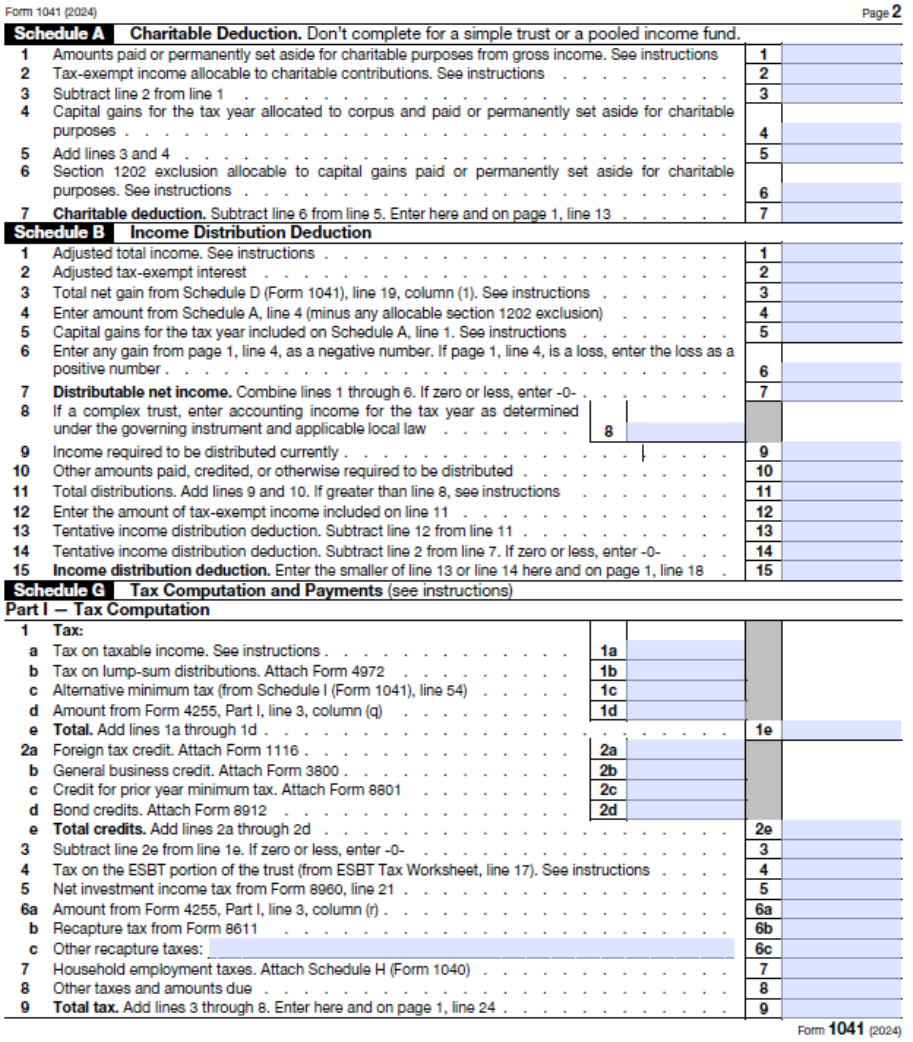
Income	1	Interest income	1	
	2a	Total ordinary dividends	2a	
	b	Qualified dividends allocable to: (1) Beneficiaries _____ (2) Estate or trust _____		
	3	Business income or (loss). Attach Schedule C (Form 1040)	3	
	4	Capital gain or (loss). Attach Schedule D (Form 1041)	4	
	5	Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040)	5	
	6	Farm income or (loss). Attach Schedule F (Form 1040)	6	
	7	Ordinary gain or (loss). Attach Form 4797	7	
	8	Other income. List type and amount _____	8	
	9	**Total income.** Combine lines 1, 2a, and 3 through 8	9	

Form 1041 – Deductions



Deductions				
	10	Interest. Check if Form 4952 is attached ☐	10	
	11	Taxes	11	
	12	Fiduciary fees. If only a portion is deductible under section 67(e), see instructions	12	
	13	Charitable deduction (from Schedule A, line 7)	13	
	14	Attorney, accountant, and return preparer fees. If only a portion is deductible under section 67(e), see instructions	14	
	15a	Other deductions (attach schedule). See instructions for deductions allowable under section 67(e)	15a	
	b	Net operating loss deduction. See instructions	15b	
	16	Add lines 10 through 15b	16	
	17	Adjusted total income or (loss). Subtract line 16 from line 9	17	
	18	Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)	18	
	19	Estate tax deduction including certain generation-skipping taxes (attach computation)	19	
	20	Qualified business income deduction. Attach Form 8995 or 8995-A	20	
	21	Exemption	21	
	22	Add lines 18 through 21	22	

Form 1041, Page 2



Form 1041 (2024) Page 2

Schedule A **Charitable Deduction.** Don't complete for a simple trust or a pooled income fund.

1	Amounts paid or permanently set aside for charitable purposes from gross income. See instructions	1	
2	Tax-exempt income allocable to charitable contributions. See instructions	2	
3	Subtract line 2 from line 1	3	
4	Capital gains for the tax year allocated to corpus and paid or permanently set aside for charitable purposes	4	
5	Add lines 3 and 4	5	
6	Section 1202 exclusion allocable to capital gains paid or permanently set aside for charitable purposes. See instructions	6	
7	**Charitable deduction.** Subtract line 6 from line 5. Enter here and on page 1, line 13	7	

Schedule B **Income Distribution Deduction**

1	Adjusted total income. See instructions	1	
2	Adjusted tax-exempt interest	2	
3	Total net gain from Schedule D (Form 1041), line 19, column (1). See instructions	3	
4	Enter amount from Schedule A, line 4 (minus any allocable section 1202 exclusion)	4	
5	Capital gains for the tax year included on Schedule A, line 1. See instructions	5	
6	Enter any gain from page 1, line 4, as a negative number. If page 1, line 4, is a loss, enter the loss as a positive number	6	
7	**Distributable net income.** Combine lines 1 through 6. If zero or less, enter -0-	7	
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law — 8		
9	Income required to be distributed currently	9	
10	Other amounts paid, credited, or otherwise required to be distributed	10	
11	Total distributions. Add lines 9 and 10. If greater than line 8, see instructions	11	
12	Enter the amount of tax-exempt income included on line 11	12	
13	Tentative income distribution deduction. Subtract line 12 from line 11	13	
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-	14	
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18	15	

Schedule G **Tax Computation and Payments** (see instructions)

Part I — Tax Computation

1	**Tax:**			
a	Tax on taxable income. See instructions	1a		
b	Tax on lump-sum distributions. Attach Form 4972	1b		
c	Alternative minimum tax (from Schedule I (Form 1041), line 54)	1c		
d	Amount from Form 4255, Part I, line 3, column (q)	1d		
e	**Total.** Add lines 1a through 1d		1e	
2a	Foreign tax credit. Attach Form 1116	2a		
b	General business credit. Attach Form 3800	2b		
c	Credit for prior year minimum tax. Attach Form 8801	2c		
d	Bond credits. Attach Form 8912	2d		
e	**Total credits.** Add lines 2a through 2d		2e	
3	Subtract line 2e from line 1e. If zero or less, enter -0-		3	
4	Tax on the ESBT portion of the trust (from ESBT Tax Worksheet, line 17). See instructions		4	
5	Net investment income tax from Form 8960, line 21		5	
6a	Amount from Form 4255, Part I, line 3, column (r)		6a	
b	Recapture tax from Form 8611		6b	
c	Other recapture taxes:		6c	
7	Household employment taxes. Attach Schedule H (Form 1040)		7	
8	Other taxes and amounts due		8	
9	**Total tax.** Add lines 3 through 8. Enter here and on page 1, line 24		9	

Form **1041** (2024)

- Schedule A - Charitable Deduction
- Schedule B – Income Distribution Deduction
- Schedule G – Tax Computation and Payments

Form 1041, Page 2, Schedule B

Schedule B **Income Distribution Deduction**

1	Adjusted total income. See instructions		1
2	Adjusted tax-exempt interest		2
3	Total net gain from Schedule D (Form 1041), line 19, column (1). See instructions		3
4	Enter amount from Schedule A, line 4 (minus any allocable section 1202 exclusion)		4
5	Capital gains for the tax year included on Schedule A, line 1. See instructions		5
6	Enter any gain from page 1, line 4, as a negative number. If page 1, line 4, is a loss, enter the loss as a positive number		6
7	**Distributable net income.** Combine lines 1 through 6. If zero or less, enter -0-		7
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law	8	
9	Income required to be distributed currently		9
10	Other amounts paid, credited, or otherwise required to be distributed		10
11	Total distributions. Add lines 9 and 10. If greater than line 8, see instructions		11
12	Enter the amount of tax-exempt income included on line 11		12
13	Tentative income distribution deduction. Subtract line 12 from line 11		13
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-		14
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18		15

- Distributable net income (DNI) in line 7 includes tax-exempt items that are pulled out in line 14
- Distributions actually made or required to be made are added up in line 11 and reduced by tax-exempt items to get distributions in line 13 that may carry out income
- Income distribution deduction in line 15 is lesser of distributions in line 13 or DNI in line 14

Form 1041, Page 2, Schedule B Distributions

8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law	8		
9	Income required to be distributed currently		9	
10	Other amounts paid, credited, or otherwise required to be distributed		10	

- Simple trust
  - Code § 651
  - Mandatory income (fiduciary accounting income – FAI)
  - No charitable distributions
  - No principal distributions
- Complex trust
  - May have mandatory or discretionary income and principal
  - If mandatory income, treatment of that income is similar to simple trust

Form 1041 – Taxable Income

17	Adjusted total income or (loss). Subtract line 16 from line 9	17		
18	Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)		18	
19	Estate tax deduction including certain generation-skipping taxes (attach computation)		19	
20	Qualified business income deduction. Attach Form 8995 or 8995-A		20	
21	Exemption		21	
22	Add lines 18 through 21		22	
23	Taxable income. Subtract line 22 from line 17. If a loss, see instructions		23	

Learning Objectives

- How HEMS can be flexible
- Estate and gift tax consequences of using HEMS or no standard
- What items comprise DNI that are not necessarily FAI
- When capital gains are included in FAI
- How to distribute capital gains
- How ownership of partnerships and S corporations complicates the interaction between DNI and FAI; what to do about it

What Income is Carried Out (II.J.8.f.)

- Deduct lesser of distributable net income (DNI) or actual or deemed (required) distributions
- DNI means the trust's taxable income, with certain modifications
- Whether the taxable income constitutes fiduciary accounting income (FAI) is irrelevant, except perhaps for capital gains
- Generally, FAI is relevant only for mandatory income trusts, in terms of what is deemed to be required

DNI vs. FAI

- As of date of owner's death, traditional IRAs payable to a trust are 100% principal but constitute DNI when distributed; post-mortem growth may be FAI or principal but are 100% DNI
- K-1 income from pass-through entity is DNI, but generally FAI is limited to part or all of cash distributions

Distributions after Yearend to Carry Out Income to Beneficiaries (II.J.4.a)

- Rough draft of return in February
- Compare to beneficiaries' tax rates/posture
- Distributions by 65 days after yearend (March 6, 2026 for 2025 returns) (II.J.2.)
- Distributions can carry out capital gains (see below)
- When in doubt (often still lack information by end of February), distribute extra (if also advisable for nontax reasons)
- When file return, can decide how much of post-yearend distributions to count for the year

Charitable Distributions (II.J.4.c.)

- Although charities can be beneficiaries, distributions are deductions rather than carrying out income; charities do not get K-1s
- Distributions made by the end of the following taxable year may count as distributions for the current year
- Distributions must be made out of gross income and must be authorized under the trust agreement (except for contributions on a K-1 the trust received from a pass-through entity)
- Contributions offset income (including net investment income), which is better than an itemized deduction

Standards for Distributions

- Estate and gift tax concerns
- Nontax issues

Ascertainable Standard

Grantor trust purposes (III.B.2.h.vii.(a)) or gift tax purposes (II.J.2.b.):

- Education, support, maintenance, or health
- Reasonable support and comfort
- Accustomed standard of living
- Emergency

Ascertainable Standard (II.J.2.b.)

Gift tax issue:

- If beneficiary is the trustee and makes distributions to others than does or may diminish current or future distributions to that beneficiary, then those distributions may constitute a gift
- Because theoretically the other beneficiaries may enforce an ascertainable standard, a distribution under an ascertainable standard does not constitute a gift (per regulations)

Ascertainable Standard

Grantor trust purposes (III.B.2.h.vi.(a)) or gift tax purposes (II.J.2.b.) can't use:

- Pleasure, desire, or happiness
- Trustee's determination conclusive

Why not use? Beneficiary can't go to court and criticize trustee's decision

Ascertainable Standard

Estate tax purposes (II.H.2.k.):

- Health, education, support, or maintenance
- "Reasonably measurable in terms of his needs for health, education, or support (or any combination of them)"
- "Support" and "maintenance" are synonymous and not limited to the bare necessities of life

Ascertainable Standard (II.H.2.k.)

Examples for estate tax purposes:

- "Support"
- "Support in reasonable comfort"
- "Maintenance in health and reasonable comfort"
- "Support in his accustomed manner of living"

Ascertainable Standard (II.H.2.k.)

Examples for estate tax purposes:

- "Education, including college and professional education"
- "Health"
- "Medical, dental, hospital and nursing expenses and expenses of invalidism"

Ascertainable Standard (II.H.2.k.)

Estate tax purposes not ascertainable:

- "Comfort"
- "Welfare"
- "Happiness"

Ascertainable Standard (II.H.2.k.)

For estate tax purposes:

In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

Gorin Document Provisions (II.J.2.b.)

Ascertainable standard:

Distributions for a person's "support" means distributions for a person's support and maintenance in reasonable comfort, medical care and education (including a course of instruction at an elementary school, secondary school, vocational school, art school, college, university, and graduate school, as well as private tutoring, internships and apprentice work). Distributions for the support of a beneficiary shall be based upon the standard of living to which such beneficiary shall have become accustomed. If and to the extent the power to distribute for support can be exercised to distribute assets to a new trust, the person holding this power may exercise it by modifying the existing trust rather than being required to distribute assets to a new trust.

Gorin Document Provisions (II.J.2.b.)

- Not an ascertainable standard:

  Distributions for a person's "welfare" means distributions for such person's comfort, welfare and best interests, all as determined in the trustee's absolute discretion. Pursuant to this standard, the trustee is authorized, in the trustee's absolute discretion, to determine that such person's welfare is enhanced by making a distribution to or for the benefit of such person of none, part or all of the trust. If and to the extent the power to distribute for welfare can be exercised to distribute assets to a new trust, the person holding this power may exercise it by modifying the existing trust rather than being required to distribute assets to a new trust.

- "To or for the benefit of" is intended to authorize decanting (II.J.18.c)

Gorin Document Provisions (II.J.2.b.)

- Consideration of Other Resources:

  In the exercise of the trustee's discretionary power to distribute income or principal of a trust for the support or welfare of any beneficiary, the trustee may consider the other income and financial resources known by the trustee to be reasonably available to such beneficiary, including the legal obligation of any other person to provide for such beneficiary's support. If the beneficiary fails to provide the information requested by the trustee, the trustee shall make such assumptions as the trustee deems appropriate. Except as specifically provided in this Agreement to the contrary, the trustee may either ignore the existence of such other income and financial resources in making the distribution or require the beneficiary to use all or any portion of such other income and financial resources as a condition to the distribution.

- Client might vary if wants client beneficiary to have minimal access

When Sole Beneficiary is Sole Trustee

- Beneficiary can distribute income and principal for support
- Other trustee can distribute income and principal for welfare if not controlled by beneficiary

Distributions While Grantor Living

- Any trustee can distribute principal for support
- Any trustee can distribute income for support without triggering gift/estate tax consequences, but additional consideration is needed for grantor trust purposes

Distributions While Grantor Living

- Distributions for welfare should be reserved to trustee who is not grantor, not spouse, not beneficiary, and not related or subordinate to grantor
- But, if spouse is beneficiary, then grantor trust anyway (Code § 677), and need trustee who is not grantor and not controlled by grantor to distribute for spouse's welfare so income taxes can be paid

When Beneficiary Is Trustee

- Beneficiary who is trustee may distribute income and principal for beneficiary's support
- Trustee who is not beneficiary and not controlled by beneficiary may distribute income and principal for beneficiary's support (further caveats if grantor is living)

"Controlled" Trustee

- Trustee is deemed controlled by grantor or beneficiary if appointed by that person after the trust was created and the trustee is a related or subordinate party with the respect to that person
- See Section 11.5, "No Discharge Of Support Obligations And Other Limitations," which is written for revocable trusts and needs to be modified for irrevocable trusts created during grantor's life (II.J.2.b.)

Flexibility in Trust Income Taxation

- Support – check for considering or ignoring other resources
- See whether distributions for welfare are permissible – check living client's estate plan for welfare and 5% withdrawal right (described further below)

Ideal Trust Distribution Provisions

- Distributions of income and principal for support
- Distributions of income and principal for welfare by independent trustee
- Consider 5% withdrawal right exercisable that trustee can turn off before the taxable year begins

Using Distributions for Welfare

- If appropriate, beneficiary can appoint person who is not a related or subordinate party (Code § 672(c))
- Distributions can carry out capital gain
- Can decant into more suitable trust or facilitate estate inclusion to get basis step-up at death

Additional Tax Issues

- Estate tax on beneficiary's estate – may be able to amend to grant formula general power of appointment (II.H.2.k)
- Distribution in kind to include in beneficiary's estate for basis step-up (II.J.8.d.)

Consider Trust Purposes

- Protecting beneficiary from third parties
- Protecting beneficiary from self
- Avoiding estate tax at beneficiary's death (increased exemption might change this need)

Protective Nature of Trust

- Very real creditor or spousal issues
- Burning a hole in the beneficiary's pocket
- Beneficiary saves but might one day have creditors

Top Bracket (II.J.3.)

	2026	2025
Single	$640,600	$626,300
Married filing jointly	$768,700	$751,600
Trust	$16,000	$15,900

Additional 5% Capital Gain Tax (II.J.3.)

	2026	2025
Single	$545,500	$533,400
Married filing jointly	$613,700	$600,050
Trust	$16,250	$15,900

Zero Capital Gain Rate (II.J.3.)

	2026	2025
Single	$49,450	$48,350
Married filing jointly	$98,900	$96,700
Trust	$3,300	$3,250

3.8% Tax on Net Investment Income (II.I.3.)

	Threshold
Single	$200,000
Married	$250,000
Trust	$16,250 ($15,900 for 2025)

Indexed for trusts but not individuals

Capital Gain Elections (II.J.4.b)

- Tax preparation software traps capital gain in the trust unless take special steps
- Next slides discuss strategic issues, law, and practical issues (II.J.8.)

Capital Gain is DNI Unless Excluded (II.J.8.a.)

Code § 643(a)(3): capital gain excluded from DNI only if:

- From sale of capital asset and allocated to corpus and not paid, credited, or required to be distributed to a beneficiary, or
- Paid, permanently set aside, or to be used for charitable purposes

Capital Asset (II.J.8.a.i.)

Not a capital asset:

- Code § 1231 property
- Amortized goodwill (self-created goodwill not amortizable is a capital asset)

Thus, gain on sale is DNI even though it generally is principal

Mechanism for Distributing Capital Gain: Reg. § 1.643(a)-3(b) (II.J.8.c.)

1. Allocated to income
2. Allocated to corpus but distributed consistently
3. 65-day rule distribution

Allocated to Income (II.J.8.c.i.)

- Trust agreement can allocate capital gain to income
- Cannot "depart fundamentally from traditional principles of income and principal" per Reg. § 1.643(b)-1
- 3%-5% should be OK

Allocated to Income (II.J.8.c.i.)

- "Power to adjust" principal
- Uniform Principal & Income Act reflects Prudent Investor Rule; UPIA becoming UFIPA (Uniform Fiduciary Income & Principal Act) (Uniform Law Commission adopted in 2018)
- No duty of consistency from year to year except unitrust

Resources

- Uniform Law Commission: https://www.uniformlaws.org/home
- Web site for UFIPA: https://www.uniformlaws.org/committees/community-home?CommunityKey=1105f9bb-eb93-4d4d-a1ab-a535ef73de0c
- Web site for UFIPA has a Documents tab, with a link to the Enactment Kit that includes mapping Principal & Income Act to its UFIPA counterparts

Power to Adjust (II.J.5.b.ii.(a).)

Under the Uniform Principal and Income Act, a trustee may adjust between principal and income to the extent the trustee considers necessary if:

- The trustee invests and manages trust assets as a prudent investor,
- The trust's terms describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and
- The trustee determines that the adjustment is necessary to fulfill the trustee's duty of impartiality between the beneficiaries.

Power to Adjust (II.J.5.b.ii.(a).)

- UFIPA § 203(a) requires only that the trustee determine that "the exercise of the power to adjust will assist the fiduciary to administer the trust or estate impartially."
- Thus, UFIPA requires only that power to adjust will be helpful, not necessary.
- UFIPA - trustee not liable for failing to exercise power
- UFIPA - trustee not liable for decision in good faith

Power to Adjust (II.J.5.b.ii.(a).)

Factors a fiduciary must consider (adjust or unitrust):

- the terms of the trust
- the nature, distribution standards, and expected duration of the trust
- the effect of the allocation rules, including specific adjustments between income and principal, under Articles 4 through 7

Power to Adjust (II.J.5.b.ii.(a).)

Factors a fiduciary must consider (adjust or unitrust):

- the desirability of liquidity and regularity of income
- the extent to which an asset is used or may be used by a beneficiary
- the increase or decrease in the value of principal assets, reasonably determined by the fiduciary

Power to Adjust (II.J.5.b.ii.(a).)

Factors a fiduciary must consider (adjust or unitrust):

- whether and to what extent the terms of the trust give the fiduciary power to accumulate income or invade principal or prohibit the fiduciary from accumulating income or invading principal
- the extent to which the fiduciary has accumulated income or invaded principal in preceding accounting periods
- the effect of current and reasonably expected economic conditions
- the reasonably expected tax consequences of the exercise of the power

Power to Adjust (II.J.5.b.ii.(a).)

A fiduciary cannot adjust if would:

- Reduce the amount payable to a current income beneficiary from a trust that qualifies for a special tax benefit, except to the extent the adjustment is made to provide for a reasonable apportionment of the total return of the trust between the current income beneficiary and successor beneficiaries
- Change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets under the terms of the trust
- Affect charitable set-aside

Power to Adjust (II.J.5.b.ii.(a).)

A fiduciary cannot adjust if adjusting would:

- Cause a person to be treated as the owner of all or part of the trust for federal income tax purposes (but can appoint special trustee)
- Cause all or part of the value of the trust assets to be included in the gross estate of an individual for federal estate tax purposes (but can appoint special trustee)

Power to Adjust (II.J.5.b.ii.(a).)

A fiduciary cannot adjust if adjusting would:

- Cause an individual to be treated as making a gift for federal gift tax purposes (but can appoint special trustee)
- Be done by fiduciary who is not an independent person
- Affect eligibility for public benefits
- Change a unitrust

Unitrust (II.J.5.b.ii.(b).)

- A fiduciary cannot convert to, modify, or turn off unitrust if would violate certain tax rules
- If trust qualifies for a special tax benefit or a fiduciary is not an independent person, then the unitrust rate must be 3%-5%
- Terms of the trust may write rules, in whole or in part

Unitrust (II.J.5.b.ii.(b).)

Trustee adopts unitrust policy, including:

- the unitrust rate or the method for determining the unitrust rate
- the method for determining the applicable value
- the application of certain mandatory or permissive rules

Unitrust (II.J.5.b.ii.(b).)

Unitrust policy may include providing methods and standards for:

- Determining the timing of distributions;
- Making distributions in cash or in kind or partly in cash and partly in kind; or
- Correcting an underpayment or overpayment to a beneficiary based on the unitrust amount if there is an error in calculating the unitrust amount; or

Unitrust (II.J.5.b.ii.(b).)

Unitrust policy may include:

- [see prior page];
- Specify sources and the order of sources, including categories of income for federal income tax purposes, from which distributions of a unitrust amount are paid; or
- Provide other standards and rules the fiduciary determines serve the interests of the beneficiaries.

Comparing Power to Adjust to Unitrust
(II.J.5.b.ii.(c).)

- Generally, a fiduciary exercises the power to adjust annually and the power to modify a unitrust only once or occasionally
- Exercising a power to adjust generally is included in annual reports, whereas adopting, modifying, or revoking unitrust provisions requires specific notice to the beneficiaries

Comparing Power to Adjust to Unitrust
(II.J.5.b.ii.(c).)

- However, UFIPA allows a power to adjust to apply to all future periods and also authorizes frequent changes to a unitrust policy, so the above generalization about frequency is not necessarily accurate
- Unitrust probably generates capital gain on distribution in kind (definitely does for CRUT)
- Power to adjust more flexible for tax planning

Allocated to Corpus But Distributed Consistently (II.J.8.c.ii.)

- Existing trusts – probably did NOT allocate capital gain to DNI
- Solution discussed later
- New trusts – generally allocate capital gain to DNI unless beneficiary in higher federal & state combined bracket (including phase-outs)

Actual or Deemed Distribution (II.J.8.c.iii.)

- Tracing actual distribution often not practical unless terminate trust
- Referring to capital gain suffices – 65-day rule distribution when trustee refers to capital gain
- Can be inconsistent from year to year

Fairness Issues (II.J.8.c.v.)

- Fair for cash distribution to carry out taxable income
- If not, “gross up” distribution for taxes paid by distributee
- “Gross up” payment costs remaindermen less than if the trust paid the tax

K-1s vs. Distributions from Business Entities (III.A.4.)

- K-1 income from pass-through entities tends to exceed distributions
- To shift taxation to beneficiaries may require the trustee to make distributions from other sources
- Exception – QSST (III.A.3.e.)

Distributions from Business Entities

UFIPA retained some and improved on other aspects:

- Uniform Principal & Income Act § 505, now UFIPA § 506, continues to allow the trustee to pay taxes on K-1 income from pass-through entities before making income distributions
- UFIPA § 401 retained basic principles but provides a lot more flexibility for the trustee to characterize distributions as income or principal, based on various facts and circumstances that the trustee knows or infers

Distributions from Business Entities (III.A.4.)

- Circular calculation
- Paying taxes must take priority over making distributions to beneficiary
- Fairness? Compare pass-through reinvestments to C corporation reinvestments, the latter being "out of sight, out of mind"
- Might need to sell asset
- Equitable adjustments (II.J.12.)

Conclusion

- Free quarterly newsletter includes most recent version of the PDF and comparison against prior quarter's PDF
- Completing form at https://www.thompsoncoburn.com/forms/gorin-newsletter gets you newsletter and opportunity to subscribe to Heckerling reports