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Completing Form K-1 for Trust Distributions: Determining Filing Requirements

WEDNESDAY, JANUARY 18, 2023, 1:00-2:50 pm Eastern

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FOR LIVE PROGRAM ONLY

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Completing Form K-1 for Trust Distributions: Determining Filing Requirements

January 18, 2023

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The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

Raimondo Pettit Group

Certified Public Accountants and Business Consultants

Completing Form K-1 for Trust Distributions: Determining Filing Requirements

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January 18, 2023

Erin S. Fukuto, CPA, MST

Biography

Erin Fukuto

Erin S. Fukuto, is a Tax Partner and the Director of the Estate and Trust Tax Services for Raimondo Pettit Group (RPG), a certified public accounting firm with offices in Irvine, Long Beach and Torrance.

With nearly 30 years of experience, Erin provides tax compliance, planning and consulting services for high net worth individuals, business succession and perpetuation planning for closely-held businesses and non-profit organizations. Her expertise includes estate and trust plan review and development, implementation and administration, tax compliance and strategic consulting services that allow her to work with complex estates and family wealth transfer issues.

Erin obtained her Bachelor of Science in Accounting from the University of Southern California and her Masters degree in Taxation from Golden Gate University. Erin is a member of the American Institute of Certified Public Accountants and the California Society of Certified Public Accountants. She is also the Former Chair for the Orange County Estate Planning Council and Former Chair of the State Estate Planning Interest Group for the California Society of Certified Public Accountants.

Rules for When a Trust is Required to Issue a K-1

GENERAL RULE

No K-1 is required if no Form 1041 is required to be filed.

- When is a Form 1041 required to be filed?

  - IRC 6012(a)(4)-Any trust with either

    - Any taxable income for the year; or
    - Gross income in excess of $600

  - IRC 6012 (a)(5)-Any trust with a beneficiary who is a nonresident alien

EXCEPTION

A grantor trust is not required to file a Form 1041 when the trustee and the grantor is the same individual. If the trust is revocable and the grantor and trustee are the same person, the grantor reports all income and deductions of the trust directly on their individual return.

BEST PRACTICES

When the trust is irrevocable or when the grantor and trustee are different individuals, it is best practice to file a Form 1041 which states that all income is reportable by the grantor. The grantor is given a letter (called a grantor letter) which outlines the items of income and deductions to be separately reported.

Form **1041** Department of the Treasury - Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts **2021** OMB No. 1545-0092
▶ Go to www.irs.gov/Form1041 for instructions and the latest information.

For calendar year 2021 or fiscal year beginning , 2021, and ending ,

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

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

Name and title of fiduciary
JOHN SMITH
TRUSTEE

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

City or town, state or province, country, and ZIP or foreign postal code
TORANCE , CA 90503

C Employer identification number
88 1114446

D Date entity created
06/03/2019

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 ▶

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) "UNDER THE TERMS OF THE TRUST	5	
6	Farm income or (loss). Attach Schedule F (Form 1040) INSTRUMENT, THIS IS A	6	
7	Ordinary gain or (loss). Attach Form 4797 GRANTOR TRUST. IN ACCORDANCE WITH	7	
8	Other income. List type and amount SECTIONS 671-679 IRC, 1986, ALL	8	
9	Total income. Combine lines 1, 2a, and 3 through 8 INCOME IS TAXABLE TO THE ▶	9	

Deductions

10	Interest. Check if Form 4952 is attached ▶ [ ] GRANTOR. STATEMENTS OF INCOME,	10	
11	Taxes DEDUCTIONS AND CREDITS ARE ATTACHED."	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	

- When is a K1 required?

  - IRC 6034A requires the issuance of a K-1 to a beneficiary when:

    - Form 1041 is required under 6012(a); and either

      - ✓ The beneficiary actually received a distribution from the trust; or

      - ✓ Any item with respect to such taxable year is allocated.

Case 1

- Trust collected $1,000,000 death benefit payment on a life insurance policy and $500 of municipal bond interest.
- No 1041 required.

Case 2

- Trust has received $10,000 in qualified dividends and incurred $50,000 in capital gains from stock transactions during the year. The trustee allocates these items to principal.

- A 1041 is required as the gross income was over $600.

Case 3

- Trust has received $30,000 in rental income and paid mortgage interest of $29,999

- A 1041 is required as there is $1 of taxable income.

Case 4

- Trust has $1,000,000 of income. This is an irrevocable trust with the power to substitute assets of the trust with assets of equivalent value.

- Even though no 1041 would be required as this is a grantor trust, it is best practice to file a 1041

Case 5

- Trust distributed $10,000 to beneficiary out of principal.
- A K-1 is required even though no income was allocated to the beneficiary

Allocating Taxable Income Amounts Between Trust and Beneficiary

- Review of Trust Taxation and Trust Distributions

  - **Computation of Trust Taxable Income**

    - Total Trust Income
      -Minus Deduction
      =Adjusted Total Income
      -Minus **Income Distribution Deduction**
      -Minus Exemption
      =Trust Taxable Income

- Review of Trust Taxation and Trust Distributions (Continue)

  - **Fiduciary Accounting Income (FAI)**

    - Trust accounting rules (look to state law concerning trust accounting rules) are set forth in the Uniform Principal and Income Act (UPIA) – Adopted by California and many other states.

- Fiduciary Accounting Income (FAI) (Continue)

- Look to the trust document for any provision dealing with specific trust accounting guidance especially depreciation and capital gains. These trust provision may modify or override specific state law provisions dealing with a specific treatment.

- FAI is a financial concept which states how to compute beneficiary distributions. This computation is different and should not be confused with tax concepts

- Review of Trust Taxation and Trust Distributions (Continue)

  - **Distributable Net Income (DNI)**

    - DNI is set forth in IRC 643(a)

    - DNI is a tax concept used to determine the Income Distribution Deduction in arriving at Trust Taxable Income

- Distributable Net Income (DNI) (Continue)

- Issue – Is capital gains includible in DNI?

- General Rule – Capital gains are allocated to principal and not included in DNI unless there is an exception.

- The tax burden on distributed capital gains will not pass to the beneficiary unless the capital gains are include in DNI.

- Distributable Net Income (DNI) (Continue)

- <u>Exceptions</u>
  - ✓ Capital gains are include in DNI in the year of termination
  - ✓ Capital gains are included in DNI if part of charitable contribution
  - ✓ Capital gains are included in DNI if it is income in the trust document.

- Distributable Net Income (DNI) (Continue)

- Inclusion of Capital Gains in DNI
  - ✓ Trustee has authority to distribute principal or include capital gains in DNI
  - ✓ Look to the state's Uniform Principal & Income Act for rules permitting
  - ✓ Look to Treasury Regulation 1.643(a)-3

- Distributable Net Income (DNI) (Continue)

- Treasury Regulation 1.643(a)-3
  - ✓ Capital gains are included in DNI pursuant to the governing document and applicable local law, or
  - ✓ Pursuant to a reasonable and impartial exercise of discretion by the fiduciary in accordance with a power granted to the fiduciary by applicable local law or by the governing document.

- Treasury Regulation 1.643(a)-3 (Continue)

  ✓ 3 Methods Allowable

    - Allocate to Income in a accordance with the trust document or state law

    - Allocated to Principal, but treated consistently year to year, treating principal distributions as coming from capital gains realized.

    - Allocated to Principal, but actually distributed, no consistency required

- Trust Distributions

  - Look to the Trust documents for how the trustee is instructed to distribute income and principal of the trust.

  - The terms of the trust may:

    - Required all of the trust’s net income be distributed annually (Simple Trusts)

    - Allow discretionary distribution of income and principal (Complex Trusts)

      - ✓ HELMS
      - ✓ Other Scheme

- **Simple Trust**

  - 3 Requirements:

    - All the “Income” is required to be distributed
    - No other distributions made by the Trustee
    - No Charitable Contributions

- Simple Trust (Continue)

  - FAI determines the actual distribution to the beneficiary.

  - Issue when appreciated in-kind property is used to satisfy the trust distribution.

    ✓ Treat as sale of the property by the trust

    ✓ Resulting gain will be taxable to the Trust (this is referred to as the Kenan Gain)

- **Complex Trust**

  - 65-Day Rule – IRC 663(b) allows a trustee to elect to treat distributions made during the first 65 days of the current tax year as having been made the preceding tax year.

- Complex Trust (Continue)

  - Discretionary Distributions of In-Kind property (IRC Sec. 643(e)).

    - General rule: Distribution of property does not result in the trust recognizing gain or loss.

    - IRC Sec 643(e) allows the trust to elect to treat the property distribution as a sale to the beneficiary and recognize gain or loss on the distribution.

- Complex Trust (Continue)

  - The Tier System for Complex Trust-Tier 1 & 2

    - Tier 1: Required Distribution – amount required to be distributed by the trust instrument

    - Tier 2: Discretionary Distribution – any other amounts paid, credited, or required to be distributed (and actually distributed)

• Complex Trust (Continue)

- The Separate Share Rule – This rule which is set forth in IRC Sec 663(c) and the appurtenant Treasury Regulations, eliminates the disparate income tax liability among multiple beneficiaries with separate shares in complex trusts.

  - If the terms of the trust instrument create separate shares, the application of the separate share rule is mandatory, not elective. The rule applies even though there is no physical segregation of assets or no separate and independent set of books are maintained for each share.

  - The trustee would determine the FAI of each share and allocate the DNI between the shares.

  - This rule does not permit the treatment of separate shares as a separate trust for purposes of filing tax returns and payment of tax liability.

Sample Case Study

- Facts:

Dividends	$30,000
Tax Exempt Interest	$15,000
Capital Gains	$30,000
Rental Income	$25,000
Rental Expenses	$12,000
Trustee Fee	$ 5,000
Investment Fee	$ 1,000

Terms of the Trust – Half of the income to spouse, Discretionary Distributions to Children for HEMS $30,000

Fiduciary Accounting Income

INCOME	
INCOME	
DIVIDENDS	30,000
TAX EXEMPT INTEREST	15,000
RENTAL INCOME	25,000
EXPENSES	
RENTAL EXPENSES	12,000
TRUSTEE FEES - HALF	2,500
INVESTMENT FEE - HALF	500
FIDUCIARY ACCOUNTING INCOME	55,000
PRINCIPAL	
CAPITAL GAINS	30,000
TRUSTEE FEES - HALF	(2,500)
INVESTMENT FEES - HALF	(500)
NET PRINCIPAL RECEIPTS	27,000

Form 1041

Raimondo Pettit Group

Certified Public Accountants and Business Consultants

Form **1041** Department of the Treasury - Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts
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2021 OMB No. 1545-0092

For calendar year 2021 or fiscal year beginning , 2021, and ending ,

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- [ ] Bankruptcy estate-Ch. 7
- [ ] Bankruptcy estate-Ch. 11
- [ ] Pooled income fund

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

Name and title of fiduciary
JOHN SMITH
TRUSTEE

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

City or town, state or province, country, and ZIP or foreign postal code
TORANCE , CA 90503

C Employer identification number
88 1114446

D Date entity created
06/03/2019

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 ▶ [ ]
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B Number of Schedules K-1 attached ▶ 2

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	
	2 a	Total ordinary dividends	SEE STATEMENT 2	2a	30,000.
	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	30,000.
	5	Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040)		5	13,000.
	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	73,000.
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	SEE STATEMENT 3	12	3,929.
	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	
	15 a	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	3,929.
	17	Adjusted total income or (loss). Subtract line 16 from line 9	17 69,071.		
	18	Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)		18	39,071.
	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	100.
	22	Add lines 18 through 21 ▶		22	39,171.
	23	Taxable income. Subtract line 22 from line 17. If a loss, see instructions		23	29,900.

Schedule B	Income Distribution Deduction		
1	Adjusted total income. See instructions	1	69,071.
2	Adjusted tax-exempt interest	2	13,929.
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	-30,000.
7	**Distributable net income.** Combine lines 1 through 6. If zero or less, enter -0-	7	53,000.
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law — 8 — 55,500.		
9	Income required to be distributed currently	9	27,500.
10	Other amounts paid, credited, or otherwise required to be distributed	10	30,000.
11	Total distributions. Add lines 9 and 10. If greater than line 8, see instructions	11	57,500.
12	Enter the amount of tax-exempt income included on line 11	12	13,929.
13	Tentative income distribution deduction. Subtract line 12 from line 11	13	43,571.
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-	14	39,071.
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18	15	39,071.

Schedule D (Form 1041) 2021 Page **2**

Part III Summary of Parts I and II **Caution:** *Read the instructions* **before** *completing this part.*		**(1)** Beneficiaries'	**(2)** Estate's or trust's	**(3)** Total
17 Net short-term gain or (loss)	17		30,000.	30,000.
18 Net long-term gain or (loss):				
a Total for year	18a			
b Unrecaptured section 1250 gain (see line 18 of the worksheet)	18b			
c 28% rate gain	18c			
19 Total net gain or (loss). Combine lines 17 and 18a ▶	19		30,000.	30,000.

Note: *If line 19, col (3), is a net gain, enter the gain on Form 1041, line 4 (or Schedule A (Form 990-T), Part I, line 4a). If lines 18a and 19, col (2), are net gains, go to Part V, and* **don't** *complete Part IV. If line 19, column (3), is a net loss, complete Part IV and the* **Capital Loss Carryover Worksheet,** *as necessary.*

661117

Schedule K-1 (Form 1041)
Department of the Treasury
Internal Revenue Service

2021

For calendar year 2021, or tax year
beginning ______
ending ______

Beneficiary's Share of Income, Deductions, Credits, etc.

▶ See page 2 and instructions.

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0092

Part I Information About the Estate or Trust

A Estate's or trust's employer identification number
88-1114446

B Estate's or trust's name
FELLOW FAMILY TRUST

C Fiduciary's name, address, city, state, and ZIP code
JOHN SMITH
TRUSTEE
111 ANYWHERE STREET
TORANCE , CA 90503

D ☐ Check if Form 1041-T was filed and enter the date it was filed ______

E ☐ Check if this is the final Form 1041 for the estate or trust

Part II Information About the Beneficiary

F Beneficiary's identifying number
333224444

G Beneficiary's name, address, city, state, and ZIP code
SPOUSE

H [X] Domestic beneficiary ☐ Foreign beneficiary

Part III Beneficiary's Share of Current Year Income, Deductions, Credits, and Other Items

1	Interest income		11	Final year deductions
2a	Ordinary dividends	14,144.		
2b	Qualified dividends			
3	Net short-term capital gain			
4a	Net long-term capital gain			
4b	28% rate gain		12	Alternative min tax adjustment
4c	Unrecaptured section 1250 gain			
5	Other portfolio and nonbusiness income			
6	Ordinary business income			
7 *	Net rental real estate income	6,129.		
8	Other rental income		13	Credits and credit recapture
9	Directly apportioned deductions			
			14	Other information
			A	6,662.
10	Estate tax deduction		E*	14,144.

*See attached statement for additional information.

Note: A statement must be attached showing the beneficiary's share of income and directly apportioned deductions from each business, rental real estate, and other rental activity.

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110921 12-15-21

11 1

661117

Schedule K-1 (Form 1041)
Department of the Treasury
Internal Revenue Service

2021

For calendar year 2021, or tax year

beginning ____________

ending ____________

Beneficiary's Share of Income, Deductions, Credits, etc. ▶ See page 2 and instructions.

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0092

Part I Information About the Estate or Trust

A Estate's or trust's employer identification number
88-1114446

B Estate's or trust's name
FELLOW FAMILY TRUST

C Fiduciary's name, address, city, state, and ZIP code
JOHN SMITH
TRUSTEE
111 ANYWHERE STREET
TORANCE , CA 90503

D ☐ Check if Form 1041-T was filed and enter the date it was filed

E ☐ Check if this is the final Form 1041 for the estate or trust

Part II Information About the Beneficiary

F Beneficiary's identifying number
222116666

G Beneficiary's name, address, city, state, and ZIP code
CHILDREN

H [X] Domestic beneficiary ☐ Foreign beneficiary

Part III Beneficiary's Share of Current Year Income, Deductions, Credits, and Other Items

1	Interest income		11	Final year deductions	
2a	Ordinary dividends	13,115.			
2b	Qualified dividends				
3	Net short-term capital gain				
4a	Net long-term capital gain				
4b	28% rate gain		12	Alternative min tax adjustment	
4c	Unrecaptured section 1250 gain				
5	Other portfolio and nonbusiness income				
6	Ordinary business income				
7 *	Net rental real estate income	5,683.			
8	Other rental income		13	Credits and credit recapture	
9	Directly apportioned deductions				
			14	Other information	
			A		7,267.
10	Estate tax deduction		E*		13,115.

*See attached statement for additional information.

Note: A statement must be attached showing the beneficiary's share of income and directly apportioned deductions from each business, rental real estate, and other rental activity.

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Raimondo Pettit Group was established in October 1992 when Carol Raimondo and Tim Pettit acquired the South Bay location, staff and clients of BDO Seidman, an international public accounting firm. The mission of the firm is to address the business issues facing the entrepreneur, the privately held company, and high net worth individuals.

RPG offers accounting and auditing, tax, business management, and consulting services through the efforts of an outstanding group of professionals with international public accounting backgrounds and extensive experience in various industries and specialties. Our commitment is to offer highly technical and timely service in an efficient and effective manner so that our clients find us to be an essential resource in the decision-making process.

Our offices in Torrance, Long Beach and Irvine consist of five principals over forty associates. Our exclusive professional service concept requires a low ratio of partners to staff. We recruit experienced staff members, with training and experience obtained at national CPA firms. We anticipate significant growth, and will attract additional high quality professionals to meet our clients' specific needs.

Raimondo Pettit Group believes that the accounting profession must be proactive in responding to the challenges of the 21st Century and changes to maintain and improve client service through increased partner involvement. An organization’s access to the resources of their accounting firm is imperative to ensure that strategic business decisions are made without delay.

Questions?

Raimondo Pettit Group

Certified Public Accountants and Business Consultants

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Suite 1250
Torrance, CA 90503
T: 310.540.5990
F: 310.543.3066

Allocation of Pass-Through Income

Neal B. Jannol
10850 Wilshire Boulevard, Suite 825
Los Angeles, CA 90024
njannol@nj4law.com
424-442-2100

Allocation of Pass-Through Income

- Situation:

- Trust holds an interest in pass-through entity (taxed as partnership or S corporation), such as LP or LLC.

- As a result, trust receives **taxable income** on a K-1 from pass-through entity every year.

- Distinction between **taxable Income** versus **actual cash distributions** from the entity (which are generally fiduciary accounting income to the trust).

- How are these amounts reported on K-1 to beneficiary?

Allocation of Pass-Through Income

- It is important to know what type of trust is at issue for purposes of the K-1 from the trust:
- Simple trust – A simple trust **must** distribute all of its trust accounting income (or FAI) annually, either under the terms of the document or under state law.
- Cash received from the entity from non-capital transactions is fiduciary accounting income.
- That income is then paid out to the beneficiary as distributable net income, and reported on the appropriate "character" box – boxes 1-8 of the K-1.

Allocation of Pass-Through Income

- Complex Trust - A complex trust does not have to distribute all of its income or make principal distributions.
- However, regardless of how much is distributed, the distribution deduction is limited to Distributable Net Income.
- The K-1 will look different depending on whether the distribution is of Distributable Net Income or from principal.
- For instance, in year 1, the trustee might accumulate all $100,000 of income. In year 2, the trust has no income, but the trustee makes a distribution of $50,000. That $50,000 is principal (and was taxed already in year 1), and would not be deductible, unless there is fiduciary accounting income in year 2. Based on the “sourcing” of the distribution, the K-1 will look different.

Allocation of Pass-Through Income

- Grantor Trust - A grantor trust taxes the income to the grantor, and not the beneficiary.

- If the client has participated in an “Intentionally Defective Grantor Trust” and the grantor trust receives income from the entity, the grantor trust usually does not have a separate income tax return.

- The grantor trust will generally not need to issue a K-1 to the grantor.

- If a Form 1041 is filed. it will state that all income is being reported to the grantor.

Allocation of Pass-Through Income

- Code section 199A deduction – if the entity qualifies for this deduction, the entity must report additional information on the K-1 issued to the trust.
- Each entity must determine if any of its trades or businesses are specified service trades or businesses, and report this as such on the K-1.
- If the trust has a Code section 199A deduction, it must report such deduction to the beneficiary in Box 14 of the K-1.

Allocation of Pass-Through Income

- Preliminary Considerations for the Unwary:
- For trusts with interests in partnerships:
- Is there a 754 election in place? Can one be made – usually happens at death of settlor and can result in significant income tax benefits.
- Watch for trust’s share of partnership debt in outside basis; Be careful if the debt is in excess of basis – transfers of the trust’s interest may result in income.
- Beware of “hot” assets of partnership.

Allocation of Pass-Through Income

- For trusts with interests in S corporation:
- Has trust elected to be taxed as QSST or ESBT?
- If not, has less than 2 years elapsed a transfer of stock to trust due to death of previous owner?
- If not, is it a grantor trust?
- Elections are made according to the requirements of the regulation under Code section 1361. A QSST election must be made by the beneficiary, while an ESBT election must be made by the trustee.

Allocation of Pass-Through Income

- Phantom Income and Pass-Through Entities:
- Pass-through means exactly that – **ALL** items of taxable income are passed through.
- As an example, a trust (simple or complex does not matter) is a 30% member of a real estate LLC.
- The LLC has $140,000 in rental income and $40,000 in tax deductible expenses.
- The trust will receive $30,000 in taxable income.

Allocation of Pass-Through Income

- How much of that $30,000 is available for distributions to the beneficiary so that the trust can claim a distribution deduction?

- Remember, a trust can only distribute fiduciary accounting income.

- Generally, fiduciary accounting income (often called trust or estate accounting income or simply “net income”) is the amount of **money** the fiduciary allocates to income, and calculates to be on-hand and available to currently distribute to the income beneficiaries of a trust or an estate.

Allocation of Pass-Through Income

- In the context of an entity, only actual money distributions from the entity are fiduciary accounting income.
- Taxable income from a pass-through entity is not fiduciary accounting income, only the cash received is fiduciary accounting income.
- There is a possibility that an entity will pass through taxable income to the trust, but will not distribute money on a dollar for dollar basis to match the taxable income.
- The problem of phantom income.

Allocation of Pass-Through Income

- Assume that the LLC uses the remaining $100,000 in cash as follows:

- $50,000 to pay down principal on debt, $30,000 to establish a reserve to resolve deferred maintenance, and $20,000 for distributions to members.

- The trust still has $30,000 of taxable income – the paydown of principal and the reserve are not tax deductible.

- The trust only receives $6,000 (30% of cash distributions).

- If the trust is a simple trust, that $6,000 must be distributed, and the trust is left with $24,000 in taxable income with no funds to pay the tax bill.

Allocation of Pass-Through Income

- As a result, the trust is taxed on phantom income – it does not flow through to beneficiary or grantor of nongrantor trust.
- A trust must always have sufficient cash and liquid assets on hand to pay the tax, especially if the pass-through entity does not make “tax” distributions.
- This is a timing mismatch because the trust pays tax on undistributed pass-through income from principal.
- When the trust later receives distribution of cash from the LLC (in excess of taxable income for that year), it is tax-free.
- By that time, there may be another beneficiary due to the death of the beneficiary who was “robbed” of distributions during the phantom income year.

Allocation of Pass-Through Income

- What distributions from entities are fiduciary accounting income?
- California Probate Code section 16350 / UPIA section 401.
- General Rule: Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.
- The intent is that regular distributions such as rent, interest, and dividends received by the entity and distributed to the trust are allocated to income.

Allocation of Pass-Through Income

- Exceptions:

- Property other than money – if the LLC distributes shares of stock to the members (this might occur if the LLC believes that the members should receive LLC investments in kind).

- Money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity – a large liquidation payment from the LLC to the trust is clearly not "income" – it is principal

Allocation of Pass-Through Income

- Money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a **capital gain dividend** for federal income tax purposes.

- Discretionary exceptions – these are in the California version of the "Act" – they are not part of the Act and these represent the work of California practitioners advising the legislature.   The Act uses must more "mathematical" tests.

Allocation of Pass-Through Income

- Large distributions - A trustee may determine that money is received as a return of capital if and to the extent that the money received exceeds the total amount of income tax that the beneficiaries must pay on their respective shares of the taxable income of the entity and the trust must pay from income.

- Capital gain distributions – The trustee may determine that money which represents gain upon the sale or other disposition of property described in section 16350(e) is a return of capital.

Allocation of Pass-Through Income

- Return of Capital Distributions – The trustee may rely upon and determine the weight to be given to any information concerning the source of the money from which the distribution is made which is reasonably available to the trustee, including, but not limited to, information concerning any of the following:

- The size of the distribution compared with past distributions;

- Whether the distribution is from "normal'" activities or from sales of the business;

Allocation of Pass-Through Income

- Whether money has accumulated in the entity, to the extent that the entity has decided the money is no longer needed for the business or investment needs of the entity.

- The amount of income tax, if any, that each beneficiary has paid on the undistributed income of the entity before the year of the distribution and the amount of income tax on the undistributed income of the entity that the trust has paid from the income or principal of the trust.

- The borrowing of the entity.

Allocation of Pass-Through Income

- Trustee discretion:
- “If a trustee determines that only a portion of a distribution is a return of capital and is in doubt about the amount of the distribution that is a return of capital, the trustee shall resolve the doubt by allocating to income the amount, if any, the trustee determines is not a return of capital and by allocating the balance of the distribution to principal.”

Allocation of Pass-Through Income

- Code section 199A limitations depend on trust's taxable income:
- Once trust income exceed $164,900 (from all sources), a set of complicated phaseouts apply.
- First, if the trust engages in an "SSTB", such as most professional services, there is no deduction if total income is over $214,900.
- Even if the trust is not engaging in an SSTB (active real estate may qualify), there can be a limitation based on W-2 wages or basis of the trust's assets.

Allocation of Pass-Through Income

- Recap:
- K-1 to beneficiary will include pass-through income when:
- Trust is not grantor trust with respect to grantor or beneficiary in question.
- Trust has share of partnership income for the year;
- Cash is actually distributed to trust in same year, that is not in liquidation or redemption of interest in pass-through, such that it is allocated to FAI.
- Some or all of this same cash is distributed in same year to one or more beneficiaries

Allocation of Pass-Through Income

- QSST requirements:
- Distributes or required to distribute all income to one U.S. citizen or resident beneficiary and trust distributes no principal other than to income beneficiary
- Income beneficiary's interest terminates at earlier of death or when trust terminates
- If trust terminates during income beneficiary's life, trust assets must be distributed to income beneficiary
- Income <u>beneficiary</u> must <u>elect</u> to be treated as owner of portion of trust consisting of S corporation stock – this is the so-called "QSST election"

Allocation of Pass-Through Income

- ESBT – Electing Small Business Trust
- Used when trust will not qualify as a QSST (for instance, an accumulation bypass trust or irrevocable children’s trust that does not require distributions to the beneficiary.
- Income must be taxed at highest individual income tax rate (currently 37% federal).

Completing Form K-1 for Trust Distributions: Treatment of Specific Bequests

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Specific Gifts and Bequests: General Rules

- IRC §102 provides that "the value of property acquired by gift, bequest, devise, or inheritance" is excluded from gross income.
- The income from such property, gift, devise, or inheritance is not excluded under §102 and thus constitutes gross income. See *Irvin v. Gavit*, 268 U.S. 161 (1925).
- In addition, a gift, devise, or inheritance of income from property is not excluded from income.

Specific Gifts and Bequests: General Rules

IRC §663(a)(1) provides rules that treat specific gifts or bequests as excluded gifts or devises of property under §102.

IRC § 663(a)(1) applies to "[a]ny amount which, under the terms of the governing instrument, is properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited **all at once or in not more than 3 installments**." (emphasis added)

Distributions that meet the conditions of §663(a)(1) are not deductible to the estate or trust under §661 and are not taxable to the beneficiary under §662.

This provision is based on the assumption that an individual providing for a specific gift or bequest to another intends for such specific gift or bequest not to be charged with any income tax.

Specific Gifts and Bequests: General Rules

If the distributions are in kind and are excludible, the basis of the assets is determined in accordance with the rules for gifts under §1015 (i.e., the grantor's basis, except when determining pre-gift losses), or the rules for devises and inheritances under §1014 (i.e., fair market value on date of death, or alternate or special valuation).

Specific Gifts and Bequests: Example

Example: Paul's will provides for a specific bequest of $50,000 to his sister, Martha. The logical assumption is that Paul intended Martha to receive $50,000, unreduced by income taxes. And that is the result of §663(a)(1).

…

Amounts received by intestacy cannot qualify under §663(a)(1) because there is no gift or bequest "under the terms of [a] governing instrument."

Specific Sum or Property

To qualify under §663(a)(1), the will or trust instrument must provide for a gift or bequest of a specific sum of money or of specific property. The money or property must be ascertainable under the terms of the will as of the decedent's death or ascertainable under the terms of an irrevocable trust instrument as of the date of the trust's inception. Treas. Reg. §1.663(a)-1(b).

For this purpose an amount which can be paid or credited only from the income of the estate or trust is not considered as a gift or bequest of a specific sum of money.

Examples of Specific Sums or Property

- A gift of $100,000 from an irrevocable trust, payable when the beneficiary reaches age 25;
- A bequest of the decedent's interest in a specific partnership;
- A bequest in trust of assets, in cash or in kind, with a value as of the date of distribution equal to $50,000, with the personal representative having the discretion to select the assets, is a bequest of a specific sum of money, even though it may be satisfied by a distribution in kind. Rev. Rul. 86-105; Rev. Rul. 66-207.
- Where a decedent makes a lifetime transfer of stock to one child and directs in his will to distribute his residuary equally to his two children, taking into account the date of death value of the stock given to one child during lifetime, such direction is a bequest of a specific sum of money because the amount is ascertainable under the terms of the will as of the date of death. Rev. Rul. 82-4.

Examples of Items That Are Not Specific Sums or Property

- A bequest and devise of the residuary of the decedent's estate is not a bequest of specific property ascertainable at the decedent's death. But, a gift of $25,000 payable from the residue will qualify as a specific sum of money ascertainable at the decedent's death, if the possibility that the residue will be decreased to less than $25,000 is remote. Rev. Rul. 57-214.
- A gift or bequest will not be of a specific sum of money or of specific property if the amount of money or the identity of the property is dependent on the exercise of the fiduciary's discretion and on the payment of administrative expenses or other charges. As a result, a bequest to the decedent's surviving spouse of a pecuniary amount, based on a formula clause, equal to the smallest amount that can be funded with no estate tax, is not a specific sum of money ascertainable as of the decedent's death, because it depends on factors not ascertainable as of the decedent's death, such as deductible administration expenses. Treas. Reg. §1.663(a)-1(b)(1); Rev. Rul. 60-87

Examples of Items That Are Not Specific Sums or Property

- An irrevocable gift in trust of one-third of the trust's principal, payable when the beneficiary reaches age 25, is not a gift of specific property ascertainable at the trust's inception.
- A bequest of a specific dollar worth of stock owned by the decedent at death, to be valued at date of distribution, is not a bequest of specific property because the amount of property is not ascertainable at the time of death.

Specific Bequest or Not???

Bequests that are stated in the alternative, for example, the lesser of $[dollars] or [percentage]%, may raise questions whether or not the specific sum exception applies.

In Rev. Rul. 72-295, the IRS ruled that the following bequest was <u>not</u> a bequest of a specific property or of a specific sum: a will gave a beneficiary a specific dollar amount of Z stock, but not more than all of the Z stock, and the value of the stock was to be determined as of the date of distribution.

Pecuniary Formula (Not a Specific Bequest)

A pecuniary formula marital clause (or a pecuniary formula credit shelter clause) is not a bequest of a specific sum of money for purposes of §663(a), even though it is treated as a fixed and ascertainable amount for other purposes. Treas. Reg. §1.663(a)-1(b)(1); Rev. Rul. 60-87.

The satisfaction of a pecuniary marital deduction formula clause will result in a gain. See *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940) (distributions in kind when made to satisfy a marital deduction pecuniary amount formula clause caused gain)

Specific Bequest or Not???

In Rev. Rul. 86-105, the decedent's will provided:

> I give assets, in cash or in kind or partly in each, the selection of which shall be in the absolute discretion of my executor, with a fair market value at the date of distribution equal to 2,000x dollars, to the trustee hereinafter named, to be held, administered and distributed as hereinafter provided.

The IRS ruled that such bequest qualified under §663(a)(1) as a bequest of a specific sum of money. The IRS further ruled that the estate realized a gain or loss to the extent the executor used appreciated or depreciated property to satisfy that amount.

Details: Three-Installment Rule

The regulations provide that if the governing instrument requires the specific sum or property to be paid or credited in more than three installments, it will <u>not</u> qualify under §663(a)(1). Treas. Reg. §1.663(a)-1(b)(2)(iv).

A gift or bequest that is subject to a condition precedent may qualify under §663(a)(1) if the condition is met so that the gift or bequest is properly paid. Treas. Reg. §1.663(a)-1(b)(4).

Thus, a gift of $25,000, payable one-half when the beneficiary reaches age 25, and one-half at age 30, qualifies as a gift or bequest of a sum payable in no more than three installments.

Details: Three-Installment Rule

Treas. Reg. §1.663(a)-1(c) sets forth five rules that modify or interpret the three-installment rule:

(1) Gifts or bequests of items of personal or household use are disregarded, even when the will requires that they be distributed in more than three installments. Treas. Reg. §1.663(a)-1(c)(1)(i).

Details: Three-Installment Rule

(2) Real estate that vests in the devisee at the testator's death is not taken into account because it would not constitute an amount paid, credited or required to be distributed under §661. Treas. Reg. §1.663(a)-1(c)(1)(i), §1.663(a)-1(c)(1)(ii).

The regulations do not address whether a specific devise of real property, where title does not pass directly at death, can qualify under §663(a)(1) if the other rules are met because the devise is not a bequest. IRC §663(a)(1)

However, given the purpose of §663, a specific devise should qualify and the word "bequest" should not be interpreted so narrowly. Also, because the regulation refers to specifically devised real property that vests directly in the devisee as not qualifying under §663, then one must assume that specifically devised real property that does not vest directly in the devisee does qualify under §663. Otherwise, the regulation should simply refer to specifically devised real estate without any distinction in vesting.

Details: Three-Installment Rule

(3) All gifts and bequests under a decedent's will (which are not disregarded pursuant to the above exceptions) for which no time of payment or crediting is specified, and which are to be paid or credited in the ordinary course of administration of the decedent's estate, are considered as required to be paid or credited in a single installment. Treas. Reg. §1.663(a)-1(c)(1)(iii).

Details: Three-Installment Rule

(4) All gifts and bequests (which are not disregarded pursuant to the first two exceptions discussed) payable at any one specified time under the terms of the governing instrument are taken into account as a single installment.

Details: Three-Installment Rule

(5) All gifts and bequests made to one beneficiary are not aggregated with gifts and bequests made to another beneficiary, and the decedent's estate is considered a separate entity from a testamentary trust. Treas. Reg. §1.663(a)-1(c)(1)(iv).

Thus, the three installment rule under a will is not disqualified by a fourth installment required to be paid from the testamentary trust.

DNI Income Allocation Rules Do Not Apply To All Distributions

Pre-residuary bequests, including specific distributions of identified property, such as shares of stock in a corporation or valuable tangible property, and general bequests of specific amounts that are paid all at once or in three or fewer installments, are not subject to the application of the DNI income allocation rules. IRC §663(a)(1).