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# Income Tax Issues in Trust and Estate Administration

Estate Planning Council of Greater Miami

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David S. Berezin, CPA

David S. Berezin brings 21 years of accounting and tax experience to his role as Principal of Berezin, CPA, P.A., a tax and accounting practice located in Miami, Florida. Mr. Berezin's experience includes 14 years at two of the largest CPA firms in Florida, where he concentrated his efforts in the practice of estate, gift and trust planning and compliance, and complex individual and business tax compliance and planning. His focus is primarily on high net worth individuals, businesses, trusts and estates, and charitable trusts and non-profit entities.

Mr. Berezin now leads a tax and accounting practice that concentrates on serving successful business owners and wealthy retired entrepreneurs. He focuses more of his efforts on income taxation compliance, planning and research, implementing estate and trust planning strategies while assisting clients with their individual and business accounting and tax needs. The firm's clients include successful professional services practices, as well as multi-state and international tax clients. In addition, Mr. Berezin has extensive experience with fiduciary accountings, and has served as a consultant numerous times in litigation matters concerning estate and trust, tax and accounting related matters. Mr. Berezin has lectured extensively on estate, gift and trust topics.

Mr. Berezin is a member of the American Institute of Certified Public Accountants and serves on the board of directors for the Estate Planning Council of Greater Miami. He received his B.S. degree in accounting from Florida State University and holds his CPA license in Florida.

**Professional & Civic Affiliations**

American Institute of Certified Public Accountants (AICPA)
Florida Institute of Certified Public Accountants (FICPA)
Estate Planning Council of Greater Miami

**Recent Seminars & Lectures**

The Tax Implications of Generation-Skipping Techniques: Planning to Minimize the GST Tax (Lorman Educational Services, July 2011 and June 2009), Seminar Leader
Accounting for Estates and Trusts (Lorman Educational Services, November 2007, November 2008), Seminar Leader

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# Tax issues connected with:

1. Formation of a Trust or Estate

2. Operational Issues Year to Year

3. Termination of a Trust or Estate

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# Trusts – Initial Considerations:

- ❑Date the trust is created vs. the date the trust is funded
- ❑Form 56 Notice of Fiduciary Relationship
- ❑Obtaining an EIN, Employer ID Number
- ❑Filing requirements:
  - ✓ Any taxable income for the year, or
  - ✓ Gross income of $600 or more, or
  - ✓ A non-resident alien beneficiary
- ❑Types of trusts – there are many – no time to cover all of them here – CRTs, CLTs, QRTs, SNTs, to name a few

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# Estate – Initial Considerations:

Form 4810 Request for Prompt Assessment – is this something to be considered? Could raise IRS scrutiny of the tax return – if the tax return is straightforward, does the fiduciary really have any risk anyway?

Obtaining an EIN, Employer ID Number
Filing Requirement – gross income of $600 or more, or a non-resident alien beneficiary, or a trust making a Sec 645 election, if the combined income of the trust and estate is $600 or more

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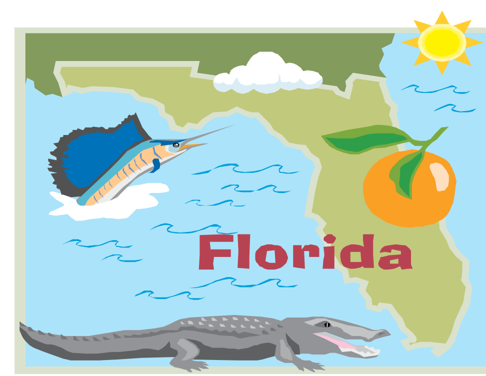
How many 1041s is the estate required to file?


Ancillary administration – separate 1041s are required by jurisdiction if there are multiple fiduciaries, one for each state's property

Example:  Florida executor responsible only for Florida property and Alabama executor responsible only for rental property in Alabama –the IRS requires separate 1041s to be filed by each executor

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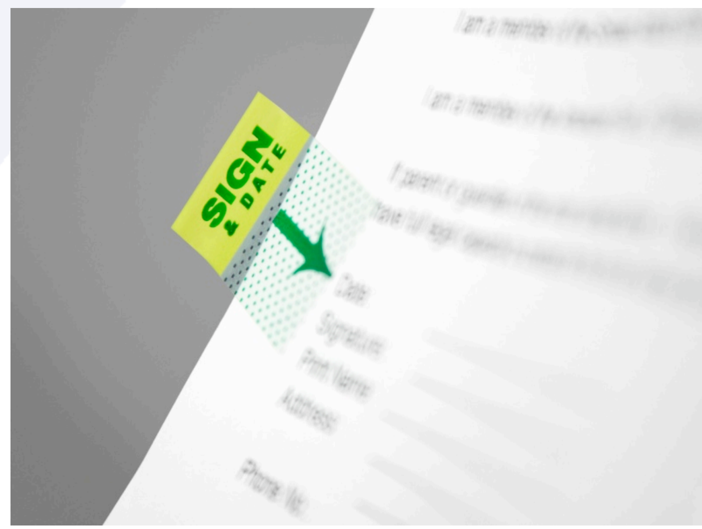
# Estates and Trusts – Initial Considerations:

Signing the tax returns – paid preparers can submit to the IRS a facsimile signature, but only with a manually signed cover letter including a statement under penalty of perjury declaring that the facsimile signature on the tax return is in fact the preparer's signature used to sign tax returns.

*Question: How many different signatures should I have in my daily life?*



# Operational Issues From Year to Year:

- Tax Forms: 1041, TDF 90.22-1, State returns? Note all due dates
- Selecting a Year End

  Many considerations to factor in:

  - Taxable estate?
  - Assets and income types
  - Beneficiaries – terms of distributions, needs of benes
  - Market/Economic conditions, and overall tax picture of estate/trust

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## ❑ Sec. 645 Election

- What is it, and when does it terminate?
- When is it a good idea? Often
- When is it a bad idea? Sometimes

## ❑ Accounting Methods

- Generally cash basis – but accrual basis may be required for businesses with inventory

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## Income

- ❑ **Similar to a 1040**
- ❑ **Limited partnerships**
  - ➢ Tricky in certain circumstances (example: marital trust, wicked stepmother)
  - ➢ Sec. 754 elections


- ❑ **S Corporations**
  - ➢ transferring stock in time to avoid terminating the S election
  - ➢ QSSTs and ESBTs
- ❑ **Final 1040 for decedent**
  - ➢ Allocation of income between 1040 and 1041

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# Fiduciary accounting income

What is it and who cares?

- Trust Accounting Income (TAI) is the same thing
- Uniform Principal and Income Act, local law, and the governing instrument(s)
- Different classes of beneficiaries care
- Income tax allocations – this issue can be a huge problem when there are larger amounts involved depending on the circumstances

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# Distributions from Simple Trusts

- What is a simple trust? It's simple – terms of the trust/estate documents:
  1. 100% of TAI is required to be distributed
  2. No amounts to be paid, set aside or used for charitable purposes
  3. No principal is distributed

- Must prepare 1041 as if income was distributed, whether it was or not

- See Termination Section for more on distributions

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There are many other operational accounting and tax issues that arise, too many to cover in 45 minutes – here are a few:

- ❑65 Day Elections
- ❑Sec. 643(e)(3) election to recognize gain on in kind property distribution (eg., to simple trust beneficiary)- must consider both the estate/trust capital loss "picture" and the individual benes capital loss "picture"
- ❑Phantom income distributions – leaving income at the trust level to be taxed, with no money to pay the taxes – this can happen, depending on the facts and allocations of income and principal
- ❑Sec. 179 depreciation is not allowed to be deducted by a trust or estate

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# Termination Issues:

- DNI – Distributable Net Income
  - Defined – generally includes tax exempt income, and does not generally include capital gains, except in the final year
  - DNI is the maximum amount of income that can flow to a beneficiary on a Schedule K-1 (example: $50K DNI and $1,000,000 distributed)

- Separate Share Rules
  - Purpose is to avoid unfair income allocations between beneficiaries. Accounting can get tricky. (example: 50/50 benes, distribute to bene #1 only)
  - HINT: distribute proportionately to all benes on the same date

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# Distributions from Estates and Trusts in Final Year(s):

- Property distributions in kind – generally no gain or loss – but there are exceptions


- There are 5 questions to be answered:
  1. Does the distribution require gain or, for estates, loss recognition?
  2. If gain recognition is not required, can it be elected under Sec. 643(e)(3)? Should it be?
  3. Does the distribution carry out DNI to the bene?
  4. What is the basis of the property distributed in the hands of the bene?
  5. What is the holding period of the property distributed in the hands of the bene?

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# The answers depend on the situation involved

- Distribution of Specific Property – generally no DNI, carry over basis (the estate's basis)

Example: Diamond ring with estate basis of $100,000, valued at $125,000 at the time of distribution. No income distribution deduction on 1041, and no DNI to bene (no K-1). If there are no other distributions to benes, and the estate has taxable net income, tax will be due. Consider 663(b) 65 day election. Basis for bene is $100,000 and holding period is long term.

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# Property Distributions that are NOT Specific Bequests

- Simple Trusts – using property to pay the TAI triggers gain on the excess of FMV over the adjusted basis. Bene gets stepped up basis in property and holding period starts on date of distribution – this is a deemed sale of the property distributed.

- Estates/Complex Trusts:
  - Generally no gain or loss on distribution – can make 643(e)(3) election to recognize gain
  - If no gain recognized, the income distribution deduction on the 1041 is limited to the lesser of adjusted basis or FMV, and this is also the amount of basis in the hands of the bene, and the holding period carries over

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- Depreciation Recapture Property – recapture amounts carry out if no gain is recognized


- Should disclose basis and holding period to benes when property is distributed to them

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# Termination of Estates and Trusts – what we did not cover

- Formula clauses and the interaction with the separate share rules
- Separate Share Rules in Depth
- So much more – 45 minutes just scratches the surface of this practice area

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# Conclusion

- Income tax issues for trusts and estates are not only challenging at times, but there are surprising hidden tax traps that can have a large impact, depending on the amounts involved.

- The best approach to making the tough decisions requires a full understanding of the income tax implications of all entities involved – the 706, 1041, and the beneficiaries 1040s

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# Questions?

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# Discussion Notes

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