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INTRODUCTION

The income taxation of trusts and estates is one of the most complicated areas of the Internal Revenue Code. This outline seeks to demystify fiduciary income taxation and is broken down into four parts.

Part I provides an overview of the federal income taxation of trusts and estates. It discusses the differences between a grantor, simple and complex trust and the tax consequences of each to the trust and the beneficiary.

Part II discusses the technical aspects of computing a trust or estate’s taxable income. A detailed discussion of the fiduciary income tax charitable deduction and the allocation of a depreciation deduction between the estate or trust and its beneficiaries are among the topics discussed in this part.

Part III discusses compliance and procedural issues that the fiduciary needs to know.

Part IV is an example of a 2009 fiduciary income tax return for a complex trust.

This outline should be helpful in understanding how estates, trusts and beneficiaries are taxed as well as guidance on the procedural and compliance issues facing the executor or trustee.

PART I - OVERVIEW OF INCOME TAXATION OF TRUSTS AND ESTATES

I. Overview of Income Taxation of Trusts and Estates

Trusts and estates are separate taxable entities. They have their own tax year and tax accounting method. They receive income and pay expenses. Income is taxed to either to the trust/estate or to the beneficiaries, depending upon the terms of the governing instrument, local law and, in the cases of estates and complex trusts, whether distributions have been made.

a. If income is accumulated and not deemed distributed, it is taxed to the trust or estate.

b. If income is distributed or deemed distributed to the beneficiaries, the trust or estate is allowed a deduction for the amount of the distribution and the beneficiaries are required to include the amount distributed in their income.
The amount of the distribution deduction allowed to an estate or trust and the amount the beneficiary is required to account for is determined by the trust or estate’s distributable net income (hereinafter referred to as DNI).

DNI acts as a ceiling on the amount of the deduction a trust or estate is allowed for distributions to beneficiaries. DNI also acts as a ceiling for the amount of the distribution that the beneficiary must account for on his income tax return.

DNI is defined in §643(a) as taxable income with the following modifications:

a. **Add back** the distributions deduction

b. **Add back** the deduction for personal exemption.

c. **Subtract out** capital gains and **add back** capital losses allocable to principal (except in the year of termination or where they are allocated to income under the terms of the governing instrument or local law or allocated to principal and actually distributed). See Reg. 1.643(a)-3(a) for instances when capital gains are includible in DNI.

d. **Subtract out** extraordinary dividends and taxable stock dividends allocable to principal for simple trusts only.

e. **Add back net** tax-exempt interest i.e. tax-exempt interest less deductions allocable to tax-exempt interest. Note that the tax-exempt interest that must be added back to DNI is reduced not only by the expenses allocable to the tax-exempt interest, but also by the amount of the charitable deduction (Reg. 1.643(a)-5), if any, allocable to the tax-exempt income. This result would be different if the governing instrument specified that the charitable contribution be satisfied first from ordinary income, then from capital gains, then from other income and last from principal.

Note that as a general rule, capital gains will, except in the year the trust or estate terminates, be taxed at the trust or estate level. It is rare that in a year prior to the year of termination of the trust or estate that capital gains will be taxable to the beneficiary as a result of distributions from the trust or estate. Traditionally, three exceptions to the general rule that capital gains are excluded from DNI (except in the year of termination of a trust or estate) were contained in Reg. 1.643(a)-3(a). For an example of the use of one of these exceptions see *Don W. Crisp, Trustee v. United States*, 34 Fed. Cl. 112 (Ct. Fed. Cl. 1995) in which capital gains were included in DNI where the trust agreement authorized the trustee to distribute capital gains to the income beneficiary. The IRS revised these regulations on December 30, 2003. In addition to the changes in the definition of trust accounting income discussed below, the ability of a fiduciary to include capital gains in DNI has changed from the traditional to new rules allowing ordering rules in unitrust statutes and the adjustment powers under the Uniform Principal and Income Act to either allocate capital gains to DNI or not, provided the power is exercised consistently. If it is desired to have gains included in DNI, the trust document should be drafted to specifically have gains allocated to income - assuming that such a provision does not depart fundamentally from traditional concepts of income and principal. Otherwise, gains will be included in DNI only if allocated to principal by (1) a mandatory allocation pursuant to state law and the governing instrument or (2) a discretionary allocation pursuant to the reasonable and impartial exercise of a
power granted under state law or by the governing instrument. Even if the capital gain is so allocated to principal, one of the following two additional conditions must be met for the gains allocated to corpus to be part of DNI: the gains (1) must be treated consistently by the fiduciary on the trust’s books, records and tax returns as part of a distribution to a beneficiary, or (2) be actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to the beneficiary.

Generally, long-term capital gains incurred after May 5, 2003 and on or before December 31, 2010 are taxed at a maximum rate of 15% while long-term capital gains incurred on or before May 5, 2003 and after December 31, 2010 are taxed at a maximum rate of 20%. However, short-term capital gains are deemed to be ordinary income and are taxed at ordinary income tax rates.

As discussed below, the rules regarding DNI and the distributions deduction are applied differently to simple and complex trusts.

Note that except to the extent that §663(a)(1) (discussed below) applies, distributions of principal will carry out DNI just as will a distribution of income.

Types of trusts: Simple, Complex and Grantor

A simple trust is defined in §651 and Reg. 1.651(a)-1 as a trust which:

a. is required to distribute all of its income (meaning fiduciary accounting income) currently;

b. makes no principal distributions; and

c. makes no distributions to charity.

A complex trust is defined in Reg. 1.661(a)-1 as a trust that is not a simple trust i.e. one which:

a. accumulates income;

b. makes discretionary distributions of income or mandatory or discretionary distributions of principal; or

c. makes distributions to charity.

A grantor trust is a trust in which the grantor or the beneficiary has one or more of the powers described in §§673 to 678. To the extent a trust is classified as a grantor trust, it functions as a conduit i.e. all of the income, expenses, etc. flow through to the grantor or beneficiary and are taxed on their own personal tax return regardless of whether distributions are made from the trust. The general rules governing the income taxation of estates and trusts and their beneficiaries do not apply when the grantor is treated as the “owner” of the trust.

Trust Accounting Income (TAI).
The distribution rules contained in §§651, 652, 661 and 662 deal with income in the accounting sense rather than income in the tax sense. §643(b).

The trustee must determine what receipts and expenses are allocable to income and what receipts and expenses are allocable to principal in computing a trust’s accounting income.

A trust’s accounting income is determined by state law and by the governing instrument. The grantor or testator can trump state law rules by providing in the governing instrument whether income and expenses are allocated to income or principal. Such a provision will generally be respected unless it departs from fundamental concepts of income and principal.

The IRS issued final regulations defining trust accounting income on December 30, 2003. These regulations allow for the conversion of existing trusts into unitrusts pursuant to state law or the use of a power to adjust between income and principal by a state's Uniform Principal and Income Act. For those states which have a unitrust statute or the Uniform Principal and Income Act, the final regulations provide that amounts allocated between income and principal pursuant to applicable state law would be respected if the state law provides for a reasonable apportionment between income and remainder beneficiaries. In addition, the regulations provide that if, under the terms of the governing instrument or applicable local law, realized capital gains are treated as income to the extent the unitrust amount (under the “total return” concept) or equitable adjustment amount (under the UPIA) exceeds ordinary income, or if capital gains are consistently allocated to income by the fiduciary pursuant to a discretionary power, such capital gains would be included in DNI.

Massachusetts adopted the UPIA effective January 1, 2006 but does not have a unitrust statute. It appears that the only possible way for a Massachusetts trust to take advantage of the unitrust format is for the Massachusetts Supreme Judicial Court to hold that unitrusts are allowed for all trusts in Massachusetts. Absent that, the only other way for a trustee of a Massachusetts trust to take advantage of a unitrust format is to change the situs of the trust to a state that has unitrust legislation. The final regulations allow a trust to change its situs for such a reason.

II. Tax Rates of Trusts and Estates

The applicable rates with respect to the ordinary income earned by trusts and estates are (for 2010) as follows:

**Taxable Income**

<table>
<thead>
<tr>
<th>Over</th>
<th>Not Over</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$2,300</td>
<td>15%</td>
</tr>
<tr>
<td>$2,300</td>
<td>$5,350</td>
<td>$345 plus 25% of the amount over $2,300</td>
</tr>
<tr>
<td>$5,350</td>
<td>$8,200</td>
<td>$1,107.50 plus 28% of the amount over $5,350</td>
</tr>
<tr>
<td>$8,200</td>
<td>$11,200</td>
<td>$1,905.50 plus 33% of the amount over $8,200</td>
</tr>
</tbody>
</table>
$11,200 $2,895.50 plus 35% of the amount over $11,200

Note that the highest bracket for trusts and estates is reached at taxable income over $11,200. Trusts and estates no longer enjoy a slower ride up the brackets.

Compare the income tax rates of trusts and estates with the tax rates of individuals. The 35% tax rate does not apply to married persons filing separately until they have taxable income (for 2010) over $186,625. The 35% tax rate does not apply to married persons filing jointly, heads of households or single taxpayers until they have taxable income (for 2010) over $373,650.

**Example:** If a married individual has a modest taxable income of $40,000, his 2010 income tax will be only $5,163. If he dies, that same $40,000 of taxable income in his estate would be subject to tax of $12,976!!!

This disparity of tax treatment of trusts and estates may force fiduciaries to make distributions from trusts and estates in order to have the income taxed in the beneficiary’s lower tax bracket. Distributions to beneficiaries may or may not be possible depending upon the beneficiary’s particular tax situation.

1. A distribution to a beneficiary subject to the “Kiddie Tax” will accomplish little if the beneficiary’s parent is in the highest marginal tax bracket.

2. The intent of the grantor may have been to accumulate income for some purpose e.g. education. How does the fiduciary reconcile the grantor’s intent with the need to make distributions to save income taxes?

3. The trust instrument itself may provide that distributions may be made in limited circumstances e.g. distributions of income and/or principal pursuant to an ascertainable standard which can’t be met for the year in question.

4. The discretionary distribution may trigger the generation skipping tax if the beneficiary is a skip person.

5. If the beneficiary is already in the highest marginal tax bracket, little will be gained by making distributions to the beneficiary. However, an individual subject to the alternative minimum tax will have a marginal tax rate of, at most, 28%.

6. If a trust is a generation skipping exempt trust or grandfathered, it may be better to accumulate income enabling the income to be distributed to the next generation. The tax on accumulating the income may be lower than the transfer tax.

**Taxable Income.**

The taxable income of an estate or trust is computed in the same manner as in the case of an individual, with the following exceptions:

1. An estate or trust is not entitled to the personal exemption allowed to an individual under §151. In lieu of the personal exemption, an estate is allowed a $600 exemption, a
trust which is required to distribute all of its income currently is allowed a $300 exemption and all other trusts are allowed a $100 exemption. §642(b).

(2) Estates and complex trusts have different rules for deducting charitable contributions. Requirements:

a. Contribution must be made **pursuant to the governing instrument**.

b. The amount must be **paid from gross income**.

c. The contribution must be paid for a charitable **purpose** set forth in §170(c).

d. The deduction is not limited to a percentage of adjusted gross income.

(3) An estate or trust is allowed a deduction for depreciation and depletion only to the extent not allowable to the beneficiaries under §167(d) and §611(b).

(4) An estate or trust is disallowed a deduction for certain estate administration expenses which have been deducted on the estate tax return. §642(g).

(5) If in the year of **termination** of an estate or trust, the estate or trust has (1) a NOL carryover under §172, (2) a capital loss carryover under §1212, or (3) deduction in excess of gross income (without considering the exemption and charitable deduction), such carryover or excess deduction is allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust.

(6) An estate or trust is entitled to a deduction for its distributions not in excess of its DNI. However, no deduction is allowed for any item that is not included in the gross income of the estate or trust (e.g. tax-exempt income), or for any distribution that qualifies for the charitable deduction under §642(c).

(7) Estates and trusts are not eligible for the standard deduction.

(8) Estates and trusts have their own income tax rates. See the income tax rate schedule for estates and trusts, above. Generally, net long-term capital gains incurred after May 5, 2003 and on or before December 31, 2010 are taxed at a maximum rate of 15%. Generally, net long-term capital gains incurred on or before May 5, 2003 and after December 31, 2010 are taxed at a maximum rate of 20%.

(9) Although a trust (other than a wholly charitable trust) must have a calendar year for its taxable year, an estate may elect a fiscal year.

(10) Estates and trusts are not subject to the 2% floor for miscellaneous itemized deductions for expenses paid or incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in such estate or trust. See William J. O’Neill Jr. Irrevocable Trust v. Comr., 994 F2d 302 (6th Cir. 1993) where the court held that investment advisory fees, which the court deemed
unique to trust administration, are not subject to the 2% floor. See also Mellon Bank v. U.S., 265 F.3d 1275 (D.C. Cir. 2001) and Scott v. U.S., 358 F.3d 132 (4th Cir. 2003) and Rudkin Testamentary Trust v. Comm., 467 F3d 149 (2d Cir. 2006) where the court decided the same issue in favor of the Service. This issue was finally resolved by the United States Supreme Court in Knight v. Commissioner, 552 U.S. 181 (2008) which held that investment advisory fees incurred by a trust are subject to the 2% floor.

(11) The 2% floor does not apply to expenses incurred by a trust or estate that constitute adjustments to gross income rather than deductions from adjusted gross income (AGI) e.g. rental expenses related to rental income.

Adjusted Gross Income.

§67(e) defines “adjusted gross income” for trusts and estates for purposes of the 2% floor for itemized deductions as being identical to adjusted gross income for individuals, with two specific exceptions:

(1) §67(e)(2) provides that the exemption and the distributions deduction are subtracted from gross income to arrive at AGI.

(2) §67(e)(1) provides that “deductions for costs which are paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the property were not held in such trust or estate” are deducted from gross income to arrive at AGI.

The overall limitation on itemized deductions that apply to individuals under §68 does not apply to estates or trusts. §68(e).

Estimated Taxes.

Generally, estates and trusts must pay estimated income taxes. An estate or a grantor trust that receives the residue of the grantor’s estate does not have to pay estimated taxes for any taxable year ending before the date two years after the date of the decedent’s death. §6654(l).

When an income tax return is required.

An estate must file an income tax return if (1) it has gross income of $600 or more for the taxable year, or any beneficiary is a nonresident alien. §6012(a)(3) and (5).

A trust must file an income tax return if (1) it has gross income of $600 or more for the taxable year, (2) it has any taxable income for the taxable year, or (3) any beneficiary is a nonresident alien. §6012(a)(4) and (5).

III. Trust and Estate Distributions - Differences

Generally, the distribution rules apply to both trusts and estates. However, there are differences which will be noted elsewhere.
Beneficiaries of simple trusts (those required to distribute income currently, make no distributions of principal and make no distributions to charity) will be taxed on the simple trust’s DNI whether or not the income is actually distributed to them. Gains generally will be taxed at the trust level. There is little opportunity for tax planning by making distributions from simple trusts.

The focus for fiduciary income tax planning using distributions is limited to estates and complex trusts.

Distributions from estates and trusts are recognized by the beneficiary in the taxable year of the beneficiary with which or in which the taxable year of the trust or estate ends. §§652(c) and 662(c).

Trusts (unless exempt from tax under §501(a) or described in §4947(a)(1)) must report income based on a calendar year. §644. Estates, however, may chose any fiscal year ending on the last day of a month so long as the first fiscal year does not exceed 12 months. §441; Reg. 1.441-1(b)(3). §645 permits the trustee of a deceased grantor’s revocable trust and the executor of the grantor’s estate to elect to treat the trust as part of the estate for fiduciary income tax purposes. The §645 election enables a qualifying trust to have its income taxed on a fiscal year basis.

The estate’s ability to choose any fiscal year-end gives the fiduciary the opportunity to defer the recognition of income received from an estate. However, such deferral can lead to a bunching of income in the final year of the estate.

**Example:** The executor of an estate elects to report income on a January 31 fiscal year-end. The estate has $10,000 of DNI for the fiscal year beginning February 1, 2008 and ending January 31, 2009. On February 15, 2008, the executor makes distributions in an amount sufficient to carry out all of the estate’s DNI to the beneficiary. The beneficiary reports his income on a calendar year. The $10,000 of DNI distributed from the estate to the beneficiary on February 15, 2008 is reported on the beneficiary’s tax return for the year in which or with which the estate’s fiscal year ends i.e. 2009. Note the deferral opportunity available with estates (and trusts making the §645 election) - the income beneficiary received in February, 2008 is not reported by the beneficiary until the 2009 tax year. The tax is not paid (not considering the estimated tax payment requirements) until the due date of the 2009 income tax return of the beneficiary i.e. April 15, 2010.

The estate’s ability to chose any fiscal year-end gives the fiduciary the opportunity to increase the income reported on the decedent’s final joint income tax return in order to make maximum use of any available deductions. This is especially helpful if there will be a bunching of nonrecurring items of income in an estate shortly after death e.g. income in respect of a decedent, accrued vacation pay, bonuses, deferred compensation, Series E or EE bond interest, etc. This may dictate a short initial fiscal year-end or early distribution especially if the decedent died early in the year and the surviving spouse is the residuary beneficiary of the estate. This will enable the estate to take advantage of the last joint return of the decedent and the surviving spouse. On the other hand, large deductible expenses incurred by the estate would tend to make a long initial fiscal year end more desirable.

**Example:** Assume the decedent generated large deductions during the year of death (e.g. medical expenses) but did not receive much income during his final year. The fiduciary may have an opportunity to increase the income reported on the decedent’s final return. If the decedent files a
joint return with his surviving spouse and the fiduciary sets a fiscal year for the estate which ends on or before December 31 of the year of death, the fiduciary can make distributions to the surviving spouse which carry out DNI. The surviving spouse’s income will be increased by the estate income. This will enable the estate and the surviving spouse to take advantage of the decedent’s final year deductions.

Income from a partnership or S corporation make projection of the trust or estate income more difficult because the taxable income from these entities is reported on a Form K-1. However, this income can be deferred through the selection of a fiscal year-end for the estate.

Overall tax savings may be possible where it is possible to make distributions non-pro rata to several beneficiaries who may be in different tax brackets. Highly appreciated assets may be distributed to low-bracket taxpayers with the high-bracket beneficiaries receiving less highly appreciated assets. However, unless the governing instrument or state law allows non-pro rata distributions, the IRS will treat such a distribution as first a pro rata distribution of each asset followed by an exchange among the beneficiaries of their undivided interests in the assets. Rev. Rul. 69-486, 1969-2 C.B. 159. A draftsperson should include boilerplate language in a trust to allow a fiduciary to make non-pro rata distributions to avoid an argument by the IRS that such a non-pro rata distribution results in sale or exchange treatment. Note that the final separate share rule regulations may limit the fiduciary’s ability to shift income through the use of non-pro-rata distributions.

IV. Simple Trusts

A simple trust for any tax year is entitled to deduct all of its trust accounting income (but not in excess of its DNI) in determining the taxable income of the trust. In other words, a simple trust deducts the amount distributed or deemed distributed to its beneficiary. Generally, a simple trust is taxed on its capital gain and phantom income (taxable income allocated but not distributed to it). Examples of phantom income are S corporation or partnership income required to be reported by but not distributed to the trust in the year in question.

The amount of the income required to be distributed currently (but not in excess of the DNI of the simple trust) is includible in the beneficiary’s gross income to whom the income is required to be distributed, regardless of whether the income is actually distributed or not. §652(a). If the amount of income required to be distributed currently to beneficiaries exceeds the DNI of the trust, the beneficiaries include in income an amount equal to their proportionate share of DNI. Reg. 1.652(a)-2.

The income received by the beneficiary will have the same character as in the hands of the trust i.e. dividend income in the hands of the beneficiary will be dividend income in the hands of the beneficiary, tax-exempt income in the hands of the trust will be tax-exempt income in the hands of the beneficiary. §652(b). For this purpose, the amounts are treated as consisting of the same proportion of each class of items entering into the computation of DNI as the total of each class bears to the total DNI, unless the governing instrument specifically allocates different classes of income to different beneficiaries. §652(b).

Items of deduction entering into the computation of DNI are allocated among the income items comprising DNI in accordance with the following principles:
Direct expenses. All deductible items directly attributable to one class of income are allocated against that class of income. For example, rental expenses are allocated to rental income and business expenses are allocated to business income. To the extent deductions exceed a particular class of income to which they relate, they may be allocated to any other class of income (except that excess deductions allocated to tax-exempt income may not be allocated to any other class of income). Reg. 1.652(b)-3(a).

Indirect expenses. Deductible items not directly attributable to a specific class of income may be allocated against any item of income included in computing DNI. However, a pro rata portion must be allocated against exempt income. Reg. 1.652(b)-3(b).

V. Complex Trusts and Estates

As with simple trusts, the beneficiaries of estates and complex trusts include in gross income under §662 the amount for which the entity has received a distribution deduction under §661. The deduction for distributions from estates and complex trusts is limited only by DNI, rather than by the lesser of fiduciary accounting income or DNI. Estates and complex trusts may accumulate ordinary income, causing it to be taxed to the entity.

As with simple trusts, distributions from an estate or complex trust are generally considered to carry out a pro rata part of each item of DNI. §662(b). In other words, the distribution from a complex trust or estate is deemed to consist of the same proportion of each class of items entering into the computation of DNI as the total of each class bears to the total DNI. Reg. 1.662(b)-1. However, allocation of the distribution among various beneficiaries of a complex trust or estate is considerably more difficult than for the beneficiaries of simple trusts. This allocation is controlled by the “tier system”. The “tier system” of taxation is contained in §662(a).

The “tier system”

Distributions by complex trusts are categorized in two tiers:

1. Distributions of income required to be distributed pursuant to the terms of the governing instrument. These are known as first tier distributions.

2. Distributions of all other amounts properly paid, credited or required to be distributed. These are known as second tier distributions.

Under the tier system, DNI is taxed first to the beneficiaries of the first tier and any balance of DNI is allocated and taxed to beneficiaries of the second tier.

The amount that a trust or estate may deduct as a distribution deduction is limited by the trust or estate’s DNI. Reg. 1.661(a)-2(a). An estate or complex trust is entitled to deduct the sum of all first tier and second tier distributions, but not in excess of DNI.

First tier beneficiaries include in gross income all income required to be distributed but not in excess of DNI. If the amount required to be distributed currently to all first tier beneficiaries exceeds DNI, then each first tier beneficiary is required to include in gross income only that
beneficiary’s proportionate share of DNI. DNI is modified for first tier beneficiaries if the estate or trust is entitled to a charitable deduction.

Second tier beneficiaries include in gross income all amounts properly paid, credited or required to be distributed, but not greater than the amount by which DNI exceeds all first tier distributions. If second tier distributions are greater than the amount by which DNI exceeds first tier distributions, second tier beneficiaries include in gross income a proportionate share of such excess based on the amount distributed to each second tier beneficiary to the amount distributed to all second tier beneficiaries.

Example: Trust has $40,000 of DNI and accounting income. The trust is required to distribute 1/2 of the income annually to A, with the balance being distributable in the trustee’s discretion. The trustee distributes $20,000 to A and makes discretionary distribution of $20,000 to each B and C. A must include $20,000 in her gross income while B and C each include $10,000 in their gross income. Since A is a first tier beneficiary, 1/2 of the $40,000 DNI is allocable to A. The balance of the DNI after distributions to the first tier beneficiary ($40,000 less $20,000) is allocated equally between B and C, both second tier beneficiaries. Note that although all of the beneficiaries received the same distribution, the amount included in their gross income is different based upon their status as first or second tier beneficiaries.

As for simple trusts, the amounts distributed and deducted by the estate or trust are treated as consisting of the same proportion of each class of items entering into the computation of DNI as the total of each class bears to the total DNI, unless the governing instrument specifically allocates different classes of income to different beneficiaries. §662(b).

Items of deduction entering into the computation of DNI are allocated among the income items comprising DNI in accordance with the same principles that govern simple trusts, except that charitable distributions are first ratably apportioned among each class of items of income entering into the computation of DNI including tax-exempt income. Reg. 1.661(b)-2. This rule is not necessary for simple trusts because a simple trust, by definition, cannot have a charitable deduction.

Effect of the charitable deduction.

If an estate or trust is entitled to a charitable deduction, special rules apply for determining the amount taxable to first tier beneficiaries and the character of such amounts.

The second sentence of §662(a)(1) provides that if the amount of income required to be distributed exceeds DNI computed without the charitable deduction, then the first beneficiaries take into income the higher, modified, DNI. Such modified DNI sets the ceiling for taxing first tier beneficiaries. As a result, first tier beneficiaries never receive any advantage from the charitable deduction.

Example: Trust has DNI and trust accounting income of $50,000 and distributes the entire amount to A, who, under the trust instrument is required to receive all income annually (first tier beneficiary). Trust makes a $40,000 charitable contribution. Although under the general rule charitable contributions reduce DNI, so that in this case the available DNI is only $10,000, under the second sentence of §662(a)(1) the beneficiary is required to report the full $50,000 in his gross income. Note the result: first tier beneficiaries do not get the benefit of any charitable deduction.
Example: Facts are the same as above except that the mandatory distribution to A is only $20,000 and the trustee makes $25,000 of distributions to other beneficiaries (second tier beneficiaries). All of the first tier distribution to A is taxable. The DNI available for the second tier beneficiaries is zero - $50,000 less ($20,000 first tier distribution + $40,000 charitable distribution). Thus, there is no DNI available for the second tier beneficiaries. The charitable deduction comes “off the top” for second tier beneficiaries but comes “off the bottom” for the first tier beneficiary. Thus, the charitable deduction reduces the amount available for second tier beneficiaries. The charitable deduction can be thought of as a tier 1 1/2.

The last sentence of §662(b) provides that in determining the character of the amounts distributed to first tier beneficiaries, DNI is computed without regard to any portion of the charitable deduction that is not attributable to income of the taxable year (e.g. income paid in one year but elected to be treated as paid in the prior year.)

VI. Separate Share Rule and Unequal Distributions

Disproportionate distributions to beneficiaries from a trust or estate can lead to different tax treatment for the beneficiaries.

Example: Estate, which is on a calendar year, has $10,000 of DNI for 2009. Estate has 2 beneficiaries - A and B. Assume the separate share rule does not apply. The executor distributes $10,000 to A in 2009, promising to distribute the same amount to B in 2010. The distribution of $10,000 to A carries out all of the estate’s DNI to A. A must report the entire $10,000 on his 2009 income tax return. In 2010 when the estate’s DNI is $5,000, the executor distributes $10,000 to B. The distribution carries out the estate’s entire 2010 DNI ($5,000) to B. B must report the $5,000 on his 2010 income tax return. Note the problem - DNI acts as a ceiling on the amount of a distribution that a beneficiary must report. Even though both beneficiaries received the same distribution ($10,000), the amount included in their taxable income will depend upon the DNI of the estate for the year of the distribution. Had each of the beneficiaries received a $10,000 distribution in 2009, each would have been taxed on their proportionate share of DNI i.e. $5,000.

The separate share rule solves this problem for trusts and estates. Traditionally, the separate share rule applied only to trusts. Effective for decedents dying after August 5, 1997, the separate share rule now applies to estates as well. §663(c) states that for the sole purpose of computing DNI, substantially separate and independent shares of different beneficiaries of a trust are treated as separate trusts. Thus, the effect of the separate share rule is to treat multiple beneficiaries of a single trust or estate as if each were the sole beneficiary of a single trust with a proportionate share of DNI for the purposes of determining how much DNI each distribution carries out. The separate share rule prevents one trust or estate beneficiary who receives a distribution from receiving more than his pro-rata share of DNI.

Whether or not the separate share rule applies generally will depend on whether trust distributions are to be made in substantially the same manner as if separate trusts had been created. For example, if the governing instrument directs the trustee to divide the trust into separate shares for each of the grantor’s children and the trustee is given discretion with respect to each share to distribute or accumulate income and principal, separate shares will exist. Reg. 1.663(c)-3(a). The separate share rule can be summarized as follows:
1. The separate share rule applies to estates (for decedents dying after August 5, 1997) and complex trusts.

2. Under the separate share rule the DNI is computed separately for each share.

3. The executor or trustee is not required to maintain separate accountings for each share in order for the separate share rule to apply.

4. The separate share rule is not elective. If the requirements are met, the rule must be applied. Reg. 1.663(c)-1(d). Thus, the separate share rule may apply even though separate and independent accounts are not required or maintained for each share and even though no physical segregation of assets is made or required. Reg. 1.663(c)-1(c).

Example: Assume the same example as above except that each beneficiary’s share qualifies as a separate share. In 2009 the distribution of $10,000 to A in a year in which the trust had $10,000 of DNI would be treated as follows: DNI allocable to A’s share would be $5,000. Even though A received $10,000, the amount he is taxed on is limited to his share of DNI i.e. $5,000. Thus, A is taxed on only $5,000 in 2009 even though he received $10,000. The remaining $5,000 is deemed allocable to B and since it was not distributed in 2009 to B, it is accumulated and taxed at the trust level. In the following year, DNI is $5,000 and B receives $10,000. B is taxed on his share of the DNI ($2,500) and the remaining DNI allocable to A ($2,500) is accumulated and taxed at the trust level. Notice that the separate share rule taxes the trust beneficiary only on his share of the DNI for the year of the distribution. Note – the income tax on the $5,000 accumulated in 2009 is charged against A’s share and the income tax on the $2,500 accumulated in 2010 is charged against B’s share.

Final regulations dealing with the separate share rule are effective with respect to decedents dying after December 28, 1999. The regulations provide that the following are examples of separate shares:

(1) the surviving spouse’s elective share;

(2) a revocable trust, whether or not the election is made for the trust to be treated as a part of the decedent’s estate under §645 (this type of trust may itself contain two or more separate shares);

(3) any pecuniary formula bequest, whether or not entitled to income and to share in appreciation or depreciation under the governing instrument or local law;

(4) the residuary estate, or some portion of the residuary estate, if certain requirements are met; and

(5) the income on a gift or bequest of a specific sum of money or of specific property that is paid or credited in more than three installments if certain requirements are met.
If the separate share rule applies, the amount of DNI from each share must be calculated as if that share were a separate trust or estate. The fiduciary uses “a reasonable and equitable” method to make the allocations, calculations and valuations. Reg. 1.663(c)-2(c).

Reg. 1.663(c)-2(b)(3) states that income in respect of a decedent (IRD) must be allocated among all of the separate shares that could potentially be funded with IRD, whether or not the share is entitled to receive income under local law or the governing instrument. A person drafting an irrevocable trust must be alert to the potential that subtrusts may be funded with IRD. If so, the draftsperson must be careful to draft the trust so that the IRD will be distributed to the subtrust that the draftsperson wants to receive the IRD. For example, generally the IRD should be distributed to the marital share as opposed to the family trust. This will cause the marital trust to recognize and pay income taxes on the IRD, thus reducing the value of the marital trust that will ultimately be included in the surviving spouse’s estate. On the other hand, generally it is not desirable to have IRD distributed to the family trust which is funded with the decedent’s applicable exclusion amount. Funding the family trust with IRD will cause the value of the family trust to be reduced by the amount of income taxes paid on the IRD. To ensure that the IRD ends up in the correct trust, the draftsperson should draft to avoid the possibility that IRD could end up in the family trust. Otherwise, IRD will be deemed to have been used to fund both the marital and family trusts since each trust could potentially be funded with IRD.

The separate share rule only affects the determination of DNI for the separate shares. It does not permit the treatment of separate shares as separate trusts for any other purposes, such as filing separate returns, claiming multiple exemptions or the allowing the separate shares to have a separate run up the brackets for purposes of calculating the trust’s income tax liability.

Note that the application of the separate share rule can be intentionally avoided by drafting the trust in such a way that separate and independent shares do not exist. For example, a trust may be drafted as a “spray” trust.

VII. 65 Day Rule – Section 663(b) Election

Generally, for an estate or trust to take a distribution deduction, the distribution must be paid or credited to the beneficiary during the estate or trust’s taxable year. In other words, the actual distribution has to be made before year-end.

A problem occurs for an executor or trustee who wants to distribute the estate or trust’s entire DNI in a particular year. It may be difficult to determine the trust’s total income until after year-end when the estate or trust’s books are closed.

§663(b) allows an executor (for taxable years beginning after August 5, 1997) or trustee to elect to treat any portion of a distribution to a beneficiary made within the first 65 days of the estate or trust’s subsequent tax year as if it had been paid or credited to the beneficiary on the last day of the preceding tax year.

This election must be made no later than the due date of the return (including extensions), is made on an annual basis and is irrevocable after the last day prescribed for making it. Reg. 1.663(b)-2(a)(1). The election is effective only for the taxable year for which it is made i.e. the election is made on a year by year basis. Reg. 1.663(b)-1(a)(2). The election is made by checking the
appropriate box at the bottom of page two of Form 1041. If no return is due, the election is made
by filing a statement to that effect with the Internal Revenue office where the return would have
been filed and within the time such return would have been due. Reg. 1.663(b)-2(a)(2).

The sixty-five day rule applies to estates (for taxable years beginning after August 5, 1997) and
complex trusts. It does not apply to simple trusts.

The 65 day rule election (also known as the §663(b) election) provides greater flexibility in timing
distributions for tax purposes. The election allows the executor or trustee to make a decision based
on the actual income for the year. This will allow the fiduciary to better coordinate the income tax
planning for an estate or trust and its beneficiaries.

**Example:** Trust has $10,000 of DNI for the year 2009. Trustee may distribute income and
principal in the trustee’s discretion. During the year the trustee distributes $6,000 to the
beneficiaries. If the trustee make no further distributions, the trust will receive a $6,000
distributions deduction (and the beneficiary will report that income on his own tax return) and the
trust will pay tax on the remaining $4,000 of DNI. The trustee could exercise his discretion and
make a distribution of $4,000 to the beneficiary on or before March 5, 2010. (Caution: February
has 29 days in a leap year.) If the trustee makes the §663(b) election, the $4,000 distribution will
be treated as if it were made on December 31, 2009, the trust will get an income distribution
deduction of $10,000 and the beneficiary will report $10,000 on his tax return. The amount paid
pursuant to a §663(b) election is not deductible for the trust year in which the payment is actually
made (2010) – it is deductible in the year to which the §663(b) election applies (2009).

The election is limited to the greater of DNI (reduced by any amounts deductible for such year on
account of other amounts paid, credited or required to be distributed) or trust accounting income not
otherwise distributed for that year. Reg. 1.663(b)-1(a)(2).

**Example:** X Trust, a calendar year trust, has $1,000 of income (as defined in Reg. 1.643(b)-1) and
$800 of distributable net income in 2009. The trust property pays $550 to A, a beneficiary, on
January 15, 2009 which the trustee elects to treat under §663(b) as paid on December 31, 2008.
The trust also property pays to A $600 on July 19, 2009, and $450 on January 17, 2010. For 2009,
the maximum amount that may be elected under §663(b) to be treated as property paid or credited
on the last day of 2009 is $400, ($1,000 - $600). The $550 paid on January 15, 2009 does not
reduce the maximum amount to which the election may apply because that amount is treated as
properly paid on December 31, 2008.

VIII. Distributions Not Subject to the Distribution Rules - Section 663(a)(1)

Distributions which, under the terms of the governing instrument, are paid or credited as a gift or
bequest of a specific sum of money or of specific property and are paid or credited all at once or in
not more than three installments will not carry out DNI under §661 and §662. Amounts that by the
terms of the governing instrument may be paid only from income of the estate or trust are not
considered a specific sum of money. Amounts payable under §663(a)(1) are neither deductible by
the trust or estate nor taxable to the beneficiary.
In order to constitute the gift or bequest of a specific sum of money, the amount must be ascertainable under the terms of the testator’s will as of the date of death, or under the terms of an inter vivos trust as of the date of the inception of the trust. Reg. 1.663(a)-1(b).

If the governing instrument does not specify a time for the payment of the bequest, any payments are treated as required to be paid in a single installment. Reg. 1.663(a)-1(c)(1)(iii).

A draftsperson should structure a distribution as a specific bequest under §663(a)(1) whenever it is desirable to avoid having the beneficiary pay income tax on a distribution. A bequest leaving all of a person's tangible personal property qualifies under §663(a)(1) so that the beneficiary does not have to pay income tax on the value of the tangibles when distributed. Such bequests are intentionally used in a will or trust to avoid income tax consequences to the distributee.

**PART II - COMPUTATION OF TAXABLE INCOME**

**I. Introduction**

§§641 through 692 of the Internal Revenue Code (Subchapter J) contain the rules governing the income taxation of estates and many trusts. Generally, estates and trusts are taxed like individuals, with the fiduciary responsible for the payment of the tax. However, there are numerous special rules that apply to the taxation of estates and trusts that do not apply to individuals. The most important difference is that estates and trusts may deduct certain distributions made to beneficiaries, who are, in turn, required to include such distributions in their gross income.

Subchapter J of the Internal Revenue Code, which contains §§641 through 692, is divided into two parts: Part I and Part II.

Part of I of Subchapter J consists of the following subparts:

Subpart A - §§641 through 646 which deals with the general rules for taxation of trusts and estates.

Subpart B - §§651 through 652 and deals with the taxation of simple trusts.

Subpart C - §§661 through 664 and deals with the taxation of complex trusts and charitable remainder trusts.

Subpart D - §§665 through 668 and deals with accumulation distributions.

Subpart E - §§ 671 through 679 and deals with a taxation of grantor trusts.

Subpart F – §§ 681 through 685 which contain miscellaneous rules.
Part II of Subchapter J consists of §§691 through 692 and deals primarily with the taxation of income in respect of a decedent.

II. Fundamental Rules of Subchapter J

Under §641(b) the taxable income of an estate or trust is computed in the same manner as an individual. The adjusted gross income of an estate or trust is computed in the same manner as in the case of an individual, except that (1) deductions for costs incurred in the administration of an estate or trust that would not have been incurred if the property were not held in the trust or estate, (2) the distribution deduction and (3) the personal exemption are allowable in arriving at adjusted gross income. §67(e) and §67(b)(4).

In computing the taxable income of a trust or an estate, the first step is to compute the gross income. Next, the gross income is reduced by allowable deductions to arrive at the taxable income. Once the taxable income is determined, the tax rate schedule is applied to the taxable income to determine the tax. Finally, the tax is reduced by any available credits to determine the net tax due.

III. Exemptions for Estates and Trusts

Estates and trusts do not get the personal and dependent exemptions allowed to individuals under §151. Instead, under §642(b), estates and trusts receive a specific exemption. An estate is entitled to an exemption of $600. A trust that is required to distribute all of its trust accounting income currently to beneficiaries is entitled to an exemption of $300. All other trusts are entitled to a $100 exemption.

IV. Charitable Contributions - Section 642(c)

The charitable deduction allowed estates and trusts is different from charitable deductions allowed to individuals. The differences in the charitable deduction allowed to a trust or estate and an individual are as follows:

1. The fiduciary income tax charitable deduction is unlimited in amount. The individual charitable deduction is limited to a percentage of AGI.

2. Qualifying pre-10/10/69 trusts may deduct gross income permanently set aside for the benefit of charitable organizations, as well as income currently paid to or for the benefit of such charitable organizations.

3. A trust or estate can deduct a payment to charity on the income tax return for the year the contribution was made or for the preceding taxable year.

4. A trust or estate may make contributions to qualifying charities organized anywhere in the world. Individuals may deduct only contributions to organizations established in the United States (except as modified by treaty provisions).
5. A trust or estate may deduct only contributions made out of gross income (gross income meaning taxable income, not trust accounting income) i.e. they can't deduct contributions made out of tax-exempt income.

6. A trust or estate must show specific authority in the governing instrument for the payment to charity.

There are basically two requirements for a trust or estate to qualify for a fiduciary income tax charitable deduction under §642(c):

1. the amount paid to charity is paid from the gross income of the estate or trust, and

2. the amount is paid pursuant to the governing instrument

Example: Individual has $5,000 of cash and a painting worth $5,000. He'll get a charitable deduction if he gives either one to charity i.e. either the cash or the painting. A trust or estate would get no fiduciary income tax charitable deduction if it gave the painting to charity (the painting is not an item of gross income). A trust or estate would only get a deduction for the $5,000 of cash if it represented “gross income” to the estate or trust and the governing instrument authorized the payment to charity.

Example: Estate has $5,000 of income. The only beneficiary of the estate is the decedent's son. Son tells executor to give $5,000 to Harvard and the executor does so. The estate is not allowed a fiduciary income tax charitable deduction. The amount was paid out of the gross income of the estate but there was no direction in the will to pay any amount to charity so the amount was not paid pursuant to the governing instrument.

A question that arises is whether a trust or estate is entitled to a fiduciary income tax charitable deduction if the fiduciary has the discretion to pay the amounts to charity. Old Colony Trust v. Comm., 301 U.S. 379 (1937) says that if the fiduciary has the discretion to pay the amounts to charity and does pay it to charity, that will be considered to have been paid pursuant to the terms of the governing instrument.

"Pursuant to the Governing Instrument"

In FSA 200140080, the Chief Counsel’s Office advised that a complex trust or a trust that would otherwise be a simple trust should be allowed a §642(c) charitable deduction, even if the trust’s governing instrument does not authorize the trustee to make charitable contributions, for the trust’s distributive share of charitable contributions made by a partnership of which the trust is a partner if the contributions are made from the partnership’s gross income that is not UBTI. This holding has recently been followed in Rev. Rul. 2004-5 where the IRS stated that a trust is not prohibited from taking a charitable deduction for the trust’s distributive share of a charitable contribution made by a partnership from the partnership’s gross income even though the trust’s governing instrument did not authorize the trustee to make charitable contributions. Although not mentioned in Rev. Rul. 2004-5, the Chief Counsel said in FSA 200140080 that if the trust were part of a tiered-trust scheme where an upper-tiered trust made charitable contributions pursuant to its governing
instrument and attempted to pass the charitable deduction through to the lower-tiered trust, then no charitable deduction would be allowed to the lower-tiered trust because a trust cannot pass a charitable deduction through to a beneficiary.

In Brownstone v. United States, 465 F.3d 525 (2d Cir. 2006) the 2nd Circuit held that a distribution of $1 million prompted by a widow’s exercise of a power of appointment is not a deductible charitable contribution under §642(c)(1) as the distribution was not made pursuant to the “governing instrument. In Brownstone, the decedent’s will created a marital trust for the benefit of his wife. The trust gave the wife a testamentary power of appointment. She exercised her power in favor of her estate which, in turn, made distributions to charitable organizations. The husband’s trust claimed a fiduciary income tax charitable deduction for the payments made by the trust to his wife’s will pursuant to her exercise of her testamentary power of appointment. The trustees of the husband’s trust claimed that the husband’s will coupled with the wife’s general testamentary power of appointment constituted the “governing instrument.” The 2nd Circuit held that only the husband’s trust alone, which contained no charitable intent, constituted the governing instrument. As such, the payments to the charities under the wife’s will were not made pursuant to the governing instrument (the husband’s trust).

Will & Trust Contests and Settlements

Generally, the IRS takes the position that a payment to charity made pursuant to a settlement agreement is made "pursuant to the governing instrument". The IRS will usually hold that the settlement agreement "relates back" to the date of death so that payments made to charity before court approval of the settlement will be deductible especially if the instrument gives the fiduciary authority to settle will and trust contests. Note, however, that the estate or trust must demonstrate the amount of gross income that actually would be available for charity after all superior bequests and claims have been satisfied. Rev. Rul. 59-15, 1959-1 C.B. 164 holds that a settlement agreement arising from a will contest qualifies as a governing instrument. See also TAM 9037004 and PLR 9044047.

"Paid from Gross Income"

A trust or estate gets a fiduciary income tax charitable deductions only for amounts of gross income contributed to charity. No deduction is allowed for payments made from either tax-exempt income or principal. If a trust has income from a trade or business, a charitable contribution deduction may be reduced or eliminated by reason of §681 which disallows a charitable deduction for any amount allocable to the trust’s “unrelated business income.”

Accumulated Income

Old Colony Trust Co., supra, held that payments charged to accumulated income could be deducted, and that the deduction was not limited to gross income realized in the year that the contribution was made. (Trustees maintained a separate accumulated income account rather than adding accumulated income to principal. They charged their accumulated income account with the payments to charity). If accumulated income is added to principal, it would be hard to argue that income
continued to constitute gross income. Thus, payments from principal couldn’t be traced to accumulated income. Thus, if payments to charity are likely, separate accounts for accumulated income and principal should be maintained.

**Definition of Gross Income**

Gross Income for purposes of the §642(c) means income in the tax sense rather than in the accounting sense e.g. capital gains constitute gross income even though gains would constitute principal for trust accounting purposes. §643(b) says that the term “income” when preceded by the word “gross” means taxable income rather than accounting income.

**Example:** X, a life insurance agent, was entitled to commissions on premiums paid by insureds under policies he sold, and his estate was entitled to receive such commissions after his death. X’s will bequeaths his renewal commissions to a qualified charity. Under §691, the commissions are included in the gross estate as income in respect of a decedent (IRD). The estate may claim an income tax charitable deduction for these payments even if the commissions are treated as principal for trust accounting purposes. Thus, the deduction is allowed for payments out of forms of gross income that would constitute principal distributions under trust accounting rules, as long as the amount is taxable income. Note that capital gains qualify for the fiduciary income tax charitable deduction under §642(c). Rev. Rul. 78-24, 1978-1 C.B. 196; Rev. Rul. 57-507, 1957-2 C.B. 511.

**Gross Income Not Actually Received**

Courts have not allowed a fiduciary income tax charitable deduction for items of gross income not actually received by the trust or estate, although includible in its gross income.

**Example:** Trust A, whose income is payable to a qualified charity is a member of XYZ partnership which has taxable income of $30,000 in 2009 of which Trust A's share is $10,000. The Partnership makes no distributions during 2009. Trust A distributes $10,000 to charity pursuant to the governing instrument. Trust A has no other income in 2009. No deduction is allowed for the $10,000 included in its gross income for 2009. If the partnership had distributed the $10,000 to Trust A, the trust would be allowed to claim a charitable deduction for the $10,000 distributed to charity. Note that the disallowance of the charitable deduction is supportable because if the partnership doesn’t distribute the income, the charity may never actually receive anything.

**Deductible contribution may not be made from Tax-Exempt Income**

Charitable payments made from tax-exempt income realized by the estate or trust do not qualify for a fiduciary income tax charitable deductible because the deduction would provide a double tax benefit. The regulations allocate charitable payments to tax-exempt income based on the ratio of tax-exempt income to DNI. Reg. 1.661(b)-2, Reg. 1.642(c)-3(b) and Reg. 1.643(a)-5(b).
Example: A trust distributes $10,000 of gross income to charity pursuant to the trust instrument. The trust has $50,000 of DNI of which $5,000 is tax-exempt income. The trust is allowed to deduct $9,000 as a charitable deduction. The remaining $1,000 is disallowed as being allocable to tax-exempt income. The charitable deduction is calculated as follows:

\[
\frac{5,000 \text{ exempt income} \times 10,000}{50,000 \text{ DNI}} = 1,000 \text{ nondeductible portion}
\]

Payments must be made for qualifying charitable purposes

A trust or estate can deduct under Section 642(c)(1) amounts of gross income that are "paid for a purpose" described in Section 170(c). Section 642(c)(2) allows estates and pre-10/9/69 trusts to deduct gross income that is either permanently set aside for a purpose specified in Section 170(c) or that is to be used exclusively for religious, charitable, scientific, literacy or educational purposes. It is unclear whether a noncharitable trust can deduct contributions to an organization that is not otherwise eligible for tax-exempt status. Section 642(c)(1) refers to a distribution "paid for a purpose specified in Section 170(c) rather than distributions "paid to an organization described in Section 170(c). Certainly, payments to any organizations "organized and operated exclusively for religious, charitable, scientific, literacy, or educational purposes or for the prevention of cruelty to children or animals" and which have received an IRS determination of their qualification under Section 170(c) are deductible, even if the organization is not organized within the United States and, therefore, could not receive deductible contributions from an individual. However, it is not clear that the other requirements of Section 170(c) apply to distributees of trusts and estates. For example, Section 170(c) also requires that, with respect to organizations described therein, no part of the net earnings inure to the benefit of any private shareholder or individual, and that the organization not engage in substantial amounts of lobbying activity or attempts to influence elections. However, the specific language of Section 642(c)(1) suggests that a qualifying purpose is the only relevant requirement for purposes of the income tax deduction under this Section, and that trusts and estates may deduct contributions to organizations that do not satisfy the other requirements of Section 170(c). Note the difference in language between §642(c)(1) and §642(c)(2).

No Distribution Deduction

If a charitable deduction is disallowed (because of a failure to comply with the "pursuant to the governing instrument" or the "payment from gross income" requirement), a distribution deduction will not be allowed. Rev. Rul. 68-667, 1968-2 C.B. 289; Mott v. United States, 462 F. 2d 512 (Ct.Cl. 1972) cert denied, 409 U.S. 1108 (1973); Estate of A. Lindsay O'Connor, 69 T.C. 165 (1977) appeal denied (2d Cir. 1980); Pullen v. United States, 80-1 U.S.T.C. ¶9105 (D.C. Neb. 1979) aff'd (8th Cir. 1980); United States Trust Company v. United States, 803 F2d 1363 (5th Cir., 1986); Rebecca K. Crown Income Charitable Fund v. Comm, 98 T.C. 327 (1992), aff'd 8 F.3d 571 (7th Cir. 1993); Crestar Bank v. Comm, 99-1 USTC ¶50545 (D. Va. 1999). The deduction for charitable distributions under Section 642(c) is the sole source of a deduction for payments to a charity. §663(a)(2); Reg.
1.663(a)(2). A §661 distribution deduction is not allowed for a distribution to charity. Allowing a §661 deduction for payments to charity would eliminate the need for §642(c).

Set Aside Deduction for Estates and Pre-1969 Trusts

ESTATES & PRE 10/9/69 TRUSTS

The 642(c) deduction is allowable for an estate or a qualifying pre-10/10/69 trust even though no income is actually paid to charity during the taxable year. It is sufficient if the amount is permanently set aside for charity.

Example: D's will leaves 100 shares of ATT to Harvard. Dividends are paid on the stock but the executor doesn't actually pay the dividends to charity. The executor has to report the dividends on the estate 1041. Under probate law the income on specifically bequeathed property all has to be paid to the beneficiary i.e. the charity in this case. All of the dividends coming in each year eventually has to be paid to Harvard i.e. when the stock is distributed. Thus, the income is permanently set aside for charity. If $1,000 of dividends is earned on the ATT stock this year, the executor reports it on his 1041 and he takes a corresponding charitable deduction under Section 642(c) for this amount of estate gross income that is permanently set aside for charity even though he doesn't pay it this year to Harvard.

Example: D's will gives income to A for life and when A dies the corpus goes to charity. During the year the estate sells some property at a $10,000 gain. Under Massachusetts law capital gains are not allocable to trust income in a trust accounting sense (they don't go to the income beneficiary). Capital gains are allocable to principal and go to the remainderman. Although the estate has $10,000 of capital gain, it gets a 642(c) deduction for the $10,000 that is paid or permanently set aside for charity. It doesn't go to charity this year but it is going to go to charity ultimately when the estate terminates. If the amount has to be paid out of gross income in order to qualify for the charitable deduction, and under Massachusetts law capital gains are not treated as income (it is treated as principal) why would there be a Section 642(c) deduction? The answer is that there is a difference in income for trust accounting purposes and income in a tax sense. “Gross income” for purposes of §642(c) means gross income in the tax sense (and capital gains are taxable income) and not gross income in the accounting sense.

SET ASIDE RULES

The 1969 Tax Reform Act made significant changes in the fiduciary income tax deduction for amounts "permanently set aside" for charity. The changes made by the 1969 Tax Reform Act eliminated the set aside charitable deduction for all trusts created after October 9, 1969 and for most trusts created prior to that date. The 1969 Tax Reform Act did not disturb the set aside deduction for estates.

For a trust created after 10/9/69 the amount must actually be paid to charity during the taxable year in order to get a charitable deduction under Section 642(c). There is no longer a set aside charitable deduction for a trust created after 10/9/69.
In addition, a provision was added in the 1969 Tax Reform Act which permits a trustee to elect to treat distributions to charity which are paid out of the trust within one year after the end of the taxable year as though they had been paid out during the taxable year. In other words, the executor or trustee may elect to deduct charitable contributions in a taxable year that were actually made in the next taxable year. This election is to be made no later than the time prescribed for filing the income tax return for the subsequent tax year (including extensions), and is made with the tax return or amended return for the taxable year in which the contribution is treated as paid. Reg. 1.642(c)-1(b).

**Example:** If a Trustee pays an amount to charity anytime before 12/31/09 he can elect to have it treated as though it was paid in 2008.

To summarize, the 1969 Tax Reform Act omitted the "set aside" charitable deduction for all trusts created after 10/9/69 and for many trusts created prior to 10/9/69. However, it permitted trustees to elect to treat distributions which are paid to charity within one year after the end of the taxable year as though they were actually paid during the taxable year. The set aside charitable deduction for estates was not affected.

Trusts created before 10/10/69 that are still permitted to have a "permanently set aside" charitable deduction are in Section 642(c)(2). There are 2 categories:

a. **Inter Vivos Trusts** where there is either

   i. an irrevocable charitable remainder

   or

   ii. where the trust can't be modified at any time after 10/9/69 because the grantor is mentally incompetent to do so. §642(c)(2)(A)(i); Reg. 1.642(c)-2(b)(3)(i),(ii).

b. **Testamentary Trusts** where

   i. the trust is created before 10/9/69 where the trust is established under a will which was executed before 10/10/69 and it appears the grantor died before 10/9/72 without changing the will after 10/9/69 or

   ii. if the testator hasn't died before 10/9/72 he must have been mentally incompetent to change his will. §642(c)(2)(B)(i), (ii),(iii); Reg. 1.642(c)-2(b)(4).

For grandfathered trusts, the set aside must be compelled under the terms of the governing instrument. No deduction will be allowed for discretionary set asides.

*Contingent Charitable Remainder Interests*
Is a trust entitled to a fiduciary income tax charitable deduction if the charity is to receive an interest only if and when a previous interest in the trust fails?

Example: Trust pays income to A for life, remainder to A's issue, but if A dies without issue, remainder to charity.

Before the 1969 Tax Reform Act the charitable deduction was allowed if the chances that the charity wouldn't get the property was "so remote as to be negligible". After the 1969 Tax Reform Act the interests are deductible only if they are in the form of a charitable remainder unitrust, a charitable remainder annuity trust or a pooled income fund. In addition, a charitable income tax deduction is allowed for the remainder interest in a personal residence or farm subject to a "conventional" life estate in a noncharitable beneficiary. To be deductible, there can be no power of invasion. These deductions are allowed under Section 664, not Section 642(c).

Unrelated Business Taxable Income (UBTI)

UBTI refers, generally, to net income derived from the conduct of an active trade or business (versus investment activity or real estate ownership or rental) and net income derived from most debt-financed property.

Estates and trusts are denied a charitable deduction to the extent attributable to UBTI. §681(a). When a trust has multiple beneficiaries including charities and other persons or entities, and multiple sources of income, the deduction is denied to the extent attributable to UBTI. The amount of the denied deduction is equal to the ratio of UBTI to total gross income (including capital gains) of the estate or trust for the year. Reg. 1.681(a)-2(b).

Example: T’s will creates trust which distributes 60% of net income to charity and 40% to T’s daughter, D. T runs a dry cleaning business which T’s trust is required by the trust to retain. For the current year, the business generates $200,000 in net profit (which would be UBTI if a tax-exempt charitable organization operated the business). In addition, the trustees earn $50,000 in interest income on a portfolio of stock and bonds. They pay $150,000 to the charity and $100,000 to D. Distribution to charity is deemed to include $120,000 of net profit from the operation of the grocery store and $30,000 of interest income. The trust will have to reduce its charitable deduction under §642(c) for part of the net profit distributed to charity.

Trusts and estates subject to the unrelated business income tax are allowed under §512(b)(11) to deduct contributions made to other qualifying charitable organizations, subject to the percentage limitations of §170(b). Reg. 1.681(a)-2(b)(3). In other words, the amount of UBTI allocated to the charitable contribution may be deducted up to the limits applicable to individual (50% or 30% of the total UBTI depending on whether the charitable beneficiary is or is not a “private operating foundation.”)

Example: A trust makes a charitable contribution of $25,000 of which $20,000 is allocated to UBTI and $5,000 to taxable income. The trust may deduct $5,000 under §642(c) and $10,000 (50% of the $20,000 UBTI – the limits apply to the amount of UBTI, not the trust’s
AGI) under §681 for a total of $15,000 (assuming the charity is a public charity). Note that the charitable deduction limits apply to the amount of UBTI, not the trust’s AGI.

When is the Charitable Deduction Taken?

A trust or estate can deduct a payment to charity on the income tax return for the year the contribution was made or for the preceding taxable year. In PLR 200138027 the IRS granted a Reg. 301.9100-3 extension for making the election where the trust administrator had acted in good faith and granting the extension would not prejudice the government’s interests where the trust administrator had filed an amended return in year 4 for year 1 claiming a §642(c) deduction in year 1 for the amount paid to charity in year 2 where the trust administrator had failed to make the election required by Reg. 1.642(c)-1(b)(3).

How is the Fiduciary Income Tax Charitable Deduction Taken?

The charitable deduction is allowable in computing "adjusted gross income". §67(b)(4). The charitable deduction allowed under §642(c) is not a miscellaneous deduction subject to the 2% floor. See §67(b)(4) as amended by TAMRA which provides that "miscellaneous itemized deductions" does not include "the deductions under...Section 642(c)."

V. Net Operating Loss Deduction

Like an individual or corporation, an estate or trust could be carrying on an unincorporated business and could suffer a net operating loss (NOL) during the period of administration. A net operating loss occurs when expenses and other deductions incurred in the operation of a trade or business during a taxable year exceed the sum of the gross income from that business plus the taxable income earned from all other sources.

Nonbusiness deductions are deductible only to the extent of nonbusiness income in computing the amount of the NOL. In computing the net operating loss, neither the deduction for charitable contributions nor the deduction for distributions to beneficiaries may be taken into account in computing the NOL. Reg. 1.642(d)-1(b).

Example: The NOL from a trade or business is $60,000, nonbusiness gross income is $20,000 and nonbusiness deductions are $10,000. The NOL is $50,000 ($60,000 less ($20,000 - $10,000)).

In determining whether an estate or trust has a net operating loss which entitles the estate or trust to carry back or forward any excess of deductions over its gross income, a distinction must be made between an activity of a trust or estate that constitutes a "trade or business" and those that constitute a "mere investment". The distinction is important because a NOL can only be generated by an activity that constitutes a trade or business. For example, management and ownership of a portfolio of securities is merely an investment and does not constitute a trade or business. Thus, a loss incurred in managing the securities does not constitute a NOL.

A net operating loss incurred by an estate or trust in a taxable year beginning after August 5, 1997 may be carried back 2 years and carried forward 20 years. The trust or estate may
elect to forego the carryback period and carryforward the entire loss. When a net operating loss is carried back or carried forward, the deduction for that year reduces the distributable net income for the year to which the NOL is applied. In the event of a net operating loss carryback, income beneficiaries may have included a larger amount in their gross income for the year to which the NOL is carried back, based upon the distributable net income before the loss. The carryback of a net operating loss will result in a reduction of the distributable net income allocable to a beneficiary. This will enable an income beneficiary to claim a refund based upon the reduced amount of distributable net income for the year of the carryback. Rev. Rul. 61-20, 1961-1 C.B. 248.

**Example:** In 2009 a trust has taxable income before deducting a distribution of $20,000 to A. A is fully taxable on this distribution in 2009. In 2010, the trust realizes a $15,000 net operating loss, which is carried back to 2009. Thus, the trust's 2009 distribution net income is retroactively reduced to $5,000. Thus, A is required to include $5,000 in his 2009 income, rather than the $20,000 originally reported. A should amend his 2009 return to obtain a refund.

When an estate or trust with a net operating loss terminates, the net operating loss remaining on the termination of the estate or trust is carried over to the beneficiaries for the balance of the remaining 20 year net operating loss carryover period. In determining the balance of the remaining 20 year net operating loss carryover period, the last taxable year of the trust or estate and the first taxable year of the beneficiary during which the net operating loss may be used are treated as separate years. Reg. 1.642(h)-1(b). Note, however, that the Second Circuit in Dorfman v. Commissioner, 294 F.2d 651 (2d Cir. 1988) held Reg. 1.642(h)-1(b) invalid to the extent it reduces the number of carryover years.

**Example:** An estate sustains a net operating loss in 2002. The 20 year carryover period will run until the year 2022. If the estate stays in existence until the year 2022, it would have the benefit of this net operating loss through 2022. Assume the estate terminates in the year 2005 and hasn't used up the entire net operating loss. The balance of the net operating loss carries out to the beneficiaries and may be used by them for the balance of the 20 year period that wasn't used by the estate. However, the last taxable year of the estate and the first taxable year of the beneficiary who succeeds to the net operating loss are treated as two separate years. If the estate terminated on July 1, 2005, the estate's year from January 1, 2005 to July 1, 2005 is year 3 of the carryover period and the beneficiary's year 2005 is year 4. Thus, instead of the net operating loss 20 year carryover period expiring in 2022 (if the estate had stayed in existence), the termination of the estate causes the 20 year net operating loss carryover period in the hands of the beneficiary to expire at the end of 2021. Thus, the net operating loss carryover period is reduced by 1 year anytime a trust or an estate terminates before the end of the 20 year carryover period. As stated above, the regulation requiring this result has been held invalid by the Second Circuit.

If the estate or trust terminates in the 20th year of the carryover period and the entire net operating loss has not been utilized, Reg. 1.642(h)-(2)(b) says that if the net operating loss is not completely absorbed in the 20th year and the trust or estate is terminated in that year, any balance of the net operating loss that
hasn't been used up carries out to the beneficiary, not as a net operating loss, but as an excess deduction. Note that this special savings provision under Reg. 1.642(h)-2(b) applies only if the trust terminates in the same year that the 20 year NOL carryover period expires.

A net operating loss carryover that carries out to a beneficiary upon termination of a trust or an estate can never be carried back by a beneficiary. A net operating loss carryover that goes to a beneficiary upon the termination of a trust or an estate can only be carried forward. Rev. Rul. 61-20, 1961-1 CB 248.

VI. Depreciation - §642(e)

A trust or an estate may derive income from assets which have a limited or ascertainable useful life. In this case, the trust or an estate may be able to offset the receipt of income from those assets by a depreciation deduction.

The tax treatment of depreciation on property held by estates and trusts is governed by §642(e). §642(e) refers to §167(d). §167(d) deals with the allocation of the depreciation deduction. §167(d) says "In the case of property held in trust, the allowable deduction [for depreciation] shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees and devisees on the basis on the income of the estate allocable to each." (Emphasis supplied). Thus, as a general rule the depreciation deduction is allowable to the fiduciary and the beneficiary on the basis of their respective shares of the trust or estate income.

For these purposes, "income" refers to accounting income (not income in the tax sense). §643(b).

Example: The sole asset of a trust is an apartment building and the depreciation deduction allowable for 2009 is $5,000. The trust instrument is silent on the allocation of depreciation. If all of the trust accounting income is paid, credited or required to be distributed to the beneficiary, then the beneficiary gets the entire depreciation deduction. This is true even though there was no income during the year.

Thus, the general rule is that the depreciation deduction is divided between the trust or the estate and the beneficiary on the basis of their respective shares of trust or estate accounting income. This rule does not allow a trustee to exercise his discretion in making income distributions to affect the division of the depreciation deduction. Rev. Rul. 60-47, 1960-1 C.B. 250.

Note that the depreciation deduction is allocable to the beneficiaries directly, unlike other kinds of deductions that reduce the trust or estate’s distributable net income and hence indirectly reduces the amount taxable to beneficiaries (or to the estate or trust as an entity). The beneficiary’s share of depreciation is deducted before the entity’s distributable net income is computed. Thus, the depreciation deduction will enter into the calculation of the
trust or estate's distributable net income only to the extent that the income of the estate or
trust is accumulated. To the extent that the income of the estate or trust is distributed
to a beneficiary, the depreciation deduction does not enter into the calculation of
the trust or estate's distributable net income. Rather, the depreciation deduction
is reported as a separate item to the beneficiary on the Form K-1.

The depreciation allocated to the beneficiary under §167(d) may even exceed the amount of
income allocated to the beneficiaries. In that case, the beneficiaries would still be permitted
to deduct the full amount of the depreciation so allocated. Rev, Rul. 74-530, 1974-2 C.B.
188.

The general rule that the depreciation deduction is divided between the beneficiary
and the entity based upon their respective shares of accounting income is subject to
two exceptions, both of which apply to trusts.

Exception #1: If the trust instrument or local law provides who get the
depreciation deduction, then that person gets the entire depreciation deduction
regardless of his share of trust income.

Exception #2: If the trustee is permitted or required either by the terms of the
trust instrument or by local law to maintain a reserve for depreciation, then the
entire depreciation deduction goes to the fiduciary to the extent the trustee takes
some trust income and transfers it to a reserve for depreciation. Reg. 1.167(h)-1(b).

Example: The depreciation deduction for a trust is $5,000 for 2009. The
trust accounting income for 2009 is $20,000 and under the terms of the trust
instrument, 50% of the income goes to A and 50% of the income is to be retained.
Assume that the trust instrument or local law requires or permits the trustee to maintain
a reserve for depreciation to keep the trust principal intact. Of the $10,000
retained by the trustee pursuant to the power to maintain a reserve for depreciation,
the trustee actually takes $5,000 of trust income that was retained and transfers it into a
reserve for depreciation to keep the trust principal intact. In this case, the entire
$5,000 of depreciation is allocable to the fiduciary and none of the depreciation
is allocable to the beneficiary.

Before Massachusetts adopted the UPIA on January 1, 2006, Massachusetts law was silent
on the necessity of maintaining a reserve for depreciation. Thus, if a trustee wanted to take
advantage of either of these two exceptions, either the trust instrument had to provide who
gets the depreciation deduction or the trust instrument had to permit the trustees to maintain
a reserve for depreciation.

Note that §13(a)(2) of the 1962 Revised Uniform Principal and Income Act
requires all fiduciaries to charge against income "a reasonable allowance for
depreciation on property subject to depreciation". Not all states that have
adopted the 1962 Revised Uniform Principal and Income Act have adopted this
section. The 1997 Uniform Principal and Income Act §503 gives the trustee discretion to
charge against income an allowance for depreciation.
When a trust or estate is a beneficiary of another trust or estate, the amount of the depreciation deduction is first apportioned to the recipient entity by the entity that actually owns the property. The recipient then apportions the deduction between itself and its beneficiary, in accordance with the rules previously outlined. Rev. Rul. 61-211, 1961-2 C.B. 124, clarified by, Rev. Rul. 66-278, 1966-2 C.B. 439, modified, by Rev. Rul. 74-71, 1974-1 C.B. 158.

**Example:** Under the terms of a particular trust #1, one-fourth of the net income produced by trust #1 is payable to the trustees of trust #2. Under trust #2, one-half of all the net income received by trust #2 is payable to beneficiary A, and the balance of the net income is accumulated and added to principal. In 2009, the depreciation allowance on trust #1’s property is $40,000. Of the total depreciation allowance, $10,000 is allocated to trust #2, and one-half of that $10,000 ($5,000) is allocated to beneficiary A. The balance of the amount allocated to trust #2 ($5,000) is deducted by the fiduciary of trust #2.

When a trust instrument directs that some income be paid to a charity, the charitable payment is deductible in computing taxable income, but some depreciation must still be allocated to the payment to the charity. For purposes of §167(d), the term "beneficiaries" includes charitable beneficiaries. Reg. 1.642(e)-1. The allocation of a portion of the depreciation deduction to charity is based on the proportion of the trust’s accounting income paid to charity. Reg. 1.642(e)-1.

**Example:** A trust owns an apartment building. It provides that 60% of the net income (for fiduciary accounting purposes) shall be paid to individual A, and 40% to charity. No depreciation reserve is required. For 2009 the trust has $50,000 net rental income. Depreciation is $40,000. 60% of the depreciation goes to A (60% x $40,000 = $24,000) and 40% goes to charity (40% x $40,000 = $16,000). Thus, $16,000 of the depreciation deduction is wasted. The Regs. say this result cannot be altered by special allocation. Reg. 1.167(d)-1(b).

**VII. Unused Loss Carryovers and Excess Deductions on Termination of Trusts and Estates**

§642(h) says that on the termination of an estate or trust, if the estate or trust has a net operating loss (§172) or a capital loss carryover (§1212), or, if for the last taxable year of the estate or trust it has deductions in excess of gross income (computed without using the deduction for exemptions or the charitable deduction), such NOL, capital loss carryovers and such "excess deductions" shall be allowed to the beneficiary in a manner provided in the regulations. In other words, the Code permits beneficiaries who "succeed to the property of the estate or trust" to inherit some or all of the entity's unexpired net operating loss and capital loss carryovers when it terminates, and to deduct any excess deductions realized by the entity.

There are two different types of items under §642(h):
1. Loss carryover - §642(h)(1). This includes both a net operating loss as well as a capital loss carryover.

2. Excess deductions - §642(h)(2).

A trust or estate's net operating loss and net capital losses, whether arising in the year of termination or in prior years, pass through to the beneficiaries if the entity does not use them before it terminates. The rules relating to net operating loss carryovers have been discussed in a previous section of this outline.

**Capital Loss Carryovers.** If an estate or trust terminates before its own capital loss carryovers have been used up, the unused capital loss is available to the beneficiary. There is no time limit on using up capital loss carryovers.

**Example:** In 2009, a trust incurs a long term capital loss of $30,000. In 2010 the trust terminates without incurring any capital gains or losses for the 2010 taxable year. A, the beneficiary, is entitled to inherit a $30,000 net long term capital loss carryover from the trust. A may use these carryovers to offset his own personal capital gains, realized in all future years, until the carryovers are absorbed. He may also deduct up to $3,000 of the carryover each year against his ordinary income.

**Excess Deductions.** If in the last taxable year of a trust or estate, the entity has more current income tax deductions than it has income, then it has "excess deductions". Charitable deductions allowable under §642(c) and the personal exemption under §642(b) are ignored when computing the amount of excess deductions. Excess deductions incurred in the trust or estate's last taxable year are allowable to the beneficiaries and they can deduct the excess deductions on their own personal income tax return. Excess deductions are deductible as a miscellaneous itemized deduction subject to the 2% floor. Thus, if the beneficiary doesn't itemize, he doesn't get the benefit of the excess deductions. §67(b).

The deduction can only be taken in the beneficiary's year within which or with which the estate or trust final taxable year ends. If it exceeds a beneficiary's other taxable income, it cannot be carried back or forward. Deductions in excess of income of the trust or estate for years prior to the year of termination, not attributable to net operating losses or capital losses, do not pass through to beneficiaries and, as such, are wasted. Thus, the timing of payment of expenses is important. This can be accomplished by delaying the payment of expenses such as legal and executor’s fees until the final year of the estate or trust. The excess deduction is claimed by the beneficiary as a miscellaneous itemized deduction. The benefit of an excess deduction may be reduced in the hands of the beneficiary due to the 2% floor that applies to miscellaneous itemized deduction. In other words, part or all of the excess deduction may not be deductible by the beneficiary due to the 2% floor on miscellaneous itemized deductions.

**Example:** In 2008, a trust has gross income of $30,000 and allowable deductions of $50,000. The trust terminates in 2010. Neither the trust nor any of its beneficiaries may use the $20,000 of excess deductions realized in the year 2008. Thus, the
$20,000 excess deduction is wasted.

The beneficiaries who are entitled to the excess deductions are the "beneficiaries succeeding to the property of the estate or trust". Reg. 1.642(h)-2. The phrase "beneficiaries succeeding to the property of the estate or trust" means in the case of an intestate estate, the heirs and next of kin to whom the estate is distributed and in the case of a testate estate, it means the residuary beneficiaries. Reg. 1.642(h)-3(b) and (c).

The beneficiaries share in the excess deductions and unused loss carryovers distributed to them in accordance with their share of the estate. See generally Reg. 1.642(h)-3 and 4 for allocation of excess deductions and loss carryovers among the beneficiaries.

**Example:** In 2010, an estate has gross income of $20,000 and deductions (primarily executor’s and attorney’s fees) of $50,000. The estate terminates in 2010. The estate has excess deductions of $30,000 ($20,000 income less $50,000 fees) which may be passed through and deducted by the beneficiary on his 2010 individual income tax return as a miscellaneous itemized deduction subject to the 2% floor. Note that deductions in excess of income for years prior to the year the estate terminates do not pass through to the beneficiary and are wasted.

**Terminating the estate or trust.**

A fiduciary will want to carefully time the termination of an estate to avoid the bunching of income.

**Example:** Estate’s fiscal year ends on January 31. The estate is terminated on August 31, 2010. The beneficiary must report on his 2010 return not only the income distributed to him for the full fiscal year ending January 31, 2010 but also the income for the short fiscal year from February 1, 2010 through August 31, 2010.

In the estate or trust’s final year, capital gains enter into the calculation of DNI. Thus, any capital gains and losses will be taxed to the beneficiaries in the year the trust or estate terminates. Beneficiaries should be made aware of any gains or losses which will be reported to them in the estate or trust’s final year in order to protect against the underestimation penalty and to ensure they have adequate cash to pay the tax on any gain.

**VIII. Administration Expenses**

Administration expenses such as attorney's fees, executor's commissions, accountant's fees, filing fees, surety bond premiums, appraisal fees, etc., are deductible from the gross estate under §2053(a)(2) or on the fiduciary income tax return under §165, §212, and §641. §642(g) prohibits the "double deduction" of administration expenses by providing that the fiduciary may deduct administration expenses on either the estate tax return or on the fiduciary income tax return, but not both. The fiduciary must elect to deduct administration expenses on either the estate return or the
fiduciary income tax return. §642(g). The §642(g) election is required only if the fiduciary deducts the expenses on the fiduciary income tax return. The election is made by filing a statement, in duplicate, that the amounts deducted have not been claimed or allowed as deductions on the estate tax return and that all rights to have such items allowed at any time as deductions on the estate tax return are waived. Reg. 1.642(g)-1. This statement may be filed at any time before the expiration of the statutory period of limitations applicable to the taxable year for which the deduction is sought. Once the statement electing to claim administration expenses on the fiduciary income tax return is filed, it is irrevocable. In actual practice, the statement electing to use the administration expenses on the fiduciary income tax return is rarely filed with the return. Not filing the statement gives the executor added flexibility to shift administration expenses between the estate tax and the fiduciary income tax return at a later date.

The election to use administration expenses on either the estate tax return or the fiduciary income tax return is not an all or nothing situation. The executor may elect to take some of the administration expenses on the fiduciary income tax return and some of the expenses on the estate tax return. Reg. 1.642(g)-2; Rev. Rul. 70-361, 1970-2 C.B. 133. The executor can elect to split one particular administration expense (e.g., the executor's fee) and claim part on the fiduciary income tax return and part on the estate tax return. In addition to administration expenses paid by an estate, expenses incurred in administering property not subject to claims are also deductible on either the estate tax return or the fiduciary income tax return. Reg. 20.2053-8. A typical example of expenses incurred in administering property not subject to claims would be expenses incurred in connection with the administration of a trust established by the decedent during his lifetime. Reg. 20.2053-8(a). To be deductible under §2053, expenses incurred in administering property not subject to claims must be paid within the statutory period for making estate tax assessments. Reg. 20.2053-8(a).

Generally, administration expenses deducted on the fiduciary income tax return are not subject to the 2% floor on the "miscellaneous itemized deductions". §67(e) provides that "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate…shall be treated as allowable in arriving at adjusted gross income." In other words, expenses that are unique to the administration of an estate or trust are deductions in computing adjusted gross income. Such expenses include executor’s and attorney’s fees, trustee’s fees, appraisal fees and probate filing fees. Investment related fees deductible under §212 are a different story. In Knight v. Commissioner, 552 U.S. 181 (2008) the United States Supreme Court held that investment advisory fees are subject to the 2% floor unless such expenses were uncommon (or unusual or unlikely) for an individual to incur. Prior to the Knight decision this issue was in doubt.

By way of background, the court in O’Neill v. Comm. 994 F2d 302 (6th Cir. 1993) held that investment advisory fees paid by a trustee were not subject to the 2% floor. The IRS did not agree with that decision. See AOD CC-1994-006. In Mellon Bank v. U.S., 265 F.3d 1275 (Fed. Cir. 2001) the trustee deducted fees paid by the trustees for two types of services: (1)
investment strategy advice provided by private investment advisors and (2) accounting, tax preparation and management services provided by Richard K. Mellon & Sons. The Federal Circuit affirmed the Federal Court of Claims holding that the trustee’s costs are subject to the 2% floor unless the costs occur only in the context of trust administration and are not routinely incurred by individual investors. The court noted that investment advice and management fees are commonly incurred outside trusts and that individual investors not bound by fiduciary duties are likely to incur such costs when managing large sums. See also Scott v. U.S. 328 F.3d 132 (4th Cir. 2003) and Rudkin Testamentary Trust v. Commissioner 124 T.C. 304 (2005) where the court decided the same issue in favor of the Service. The Knight decision (the Rudkin case at the Tax Court level) resolved the conflict between the circuits.

On June 27, 2007, prior to the issuance of the United State Supreme Court’s decision in Knight, the IRS issued proposed regulations under §67 providing guidance on which costs by estates and trusts are subject to the 2% floor. The proposed regulations state that only costs that are “unique” (expenses that could not have been incurred by an individual) are not subject to the 2% floor. The Knight case specifically disapproved of the “could not” language so the proposed regulations will have to be altered to conform to the Knight decision. The proposed regulations state that the expenses subject to the 2% floor are to be determined by the type of services provided rather than on the taxpayer’s characterization or label of the services. The proposed regulations would not allow taxpayers to circumvent the 2% floor by bundling investment advisory fees and trustee fees together. If the expenses are bundled, the proposed regulations require the taxpayer to use a reasonable method to allocate a single fee between the two types of costs. The proposed regulations provide a nonexclusive list of services that are exempt or nonexempt from the 2% floor.

Selling expenses necessarily incurred in estate administration (such as commissions on the sale of securities or real property where the sale is necessary to raise money for payment of estate taxes) may be deducted on either the fiduciary income tax return or the estate tax return, but not both.

The following factors should be considered when making the §642(g) election:

1. Comparison of estate tax and fiduciary income tax brackets. It is generally more advantageous to deduct administration expenses on the estate tax return if a federal estate tax is due, since the federal estate tax rates are generally higher than the marginal fiduciary income tax rates. This comparison only holds true if the income of the estate is accumulated by the estate and the income tax would be paid at the estate level. If distributions are made or contemplated being made from the estate in the same year as deductible expenses are incurred, the executor should compare the estate tax bracket with the income tax bracket of the beneficiaries. The executor should avoid incurring administration expenses in excess of the income of the estate in any year prior to the termination of the estate. Expenses in excess of income of an estate or trust in any year prior to the termination of the estate or trust are wasted.
Alternatively, in the year of termination of an estate or trust, expenses which exceed the income of the estate or trust (so-called "excess deductions") can be passed out to the beneficiaries and used as miscellaneous itemized deductions on the beneficiaries own individual income tax return. §642(h). These "excess deductions" are deductible as a miscellaneous itemized deduction subject to the 2% floor. §67(b).

If administration expenses are to be deducted on the fiduciary income tax return and part of the estate or trust income consists of tax-exempt income, a portion of the administration expenses will be non-deductible under §265(a)(1). The non-deductible portion can be claimed as an estate tax deduction and therefore will not be wasted. Rev. Rul. 59-32, 1959-1 C.B. 245.

Certain expenses are deductible on both the estate tax return and the fiduciary income tax return. §642(g), which disallows some double deductions, does not apply to deductions allowed under §691(b). §691(b) specifically provides for the deduction by the estate of various items for which the decedent was liable prior to his death but which were not deductible on his final income tax return. §691(b) deductions are limited to §162 business expenses, §163 interest expenses, §164 taxes, §212 investment related expenses, §611 depletion expenses and the §27 foreign tax credit. These items are referred to as "deductions in respect of a decedent".

A distinction has to be made between administration expenses governed by §642(g) and §691(b). §642(g) covers only administration expenses arising after the date of the decedent's death. §691(b) is a true double deduction. §691(b) relates to deductible expense items which arise before the date of the decedent's death but were not deducted by the decedent on his final income tax return. Since the decedent still owes the §691(b) expense at the date of his death, they are deductible as debts of the estate (for Federal estate tax purposes) under §2053 on the estate tax return and are deductible under §691(b) on the income tax return of whoever pays them.

IX. Computation of the Tax Liability

Once a fiduciary has determined the trust or estate's taxable income and has taken the appropriate distribution deduction, the trust or estate tax liability before credits can be computed. An estate or trust pays tax at the rates set forth in §1(e) based on its taxable income after deducting the distribution deduction. Generally, the income of a trust or estate reaches the maximum marginal income tax bracket at a lower taxable income than any other tax rate schedule. For 2010, an estate or trust with over $11,200 of taxable income will be taxed at the highest marginal income tax rate. This is a substantially more compressed rate schedule than that applicable to individuals. For example, a married couple filing a 2010 joint return would have to have taxable income of over $373,650 to reach the maximum marginal income tax bracket.

X. Credits Available to Entities and Beneficiaries
Generally, credits earned at the trust or estate level (or in a pass-through entity in which the trust or estate holds an interest) must be allocated between the trust or estate and its beneficiaries. Credits are generally allocated between the entity and its beneficiaries on the basis of the accounting income allocated to each. This rule is similar to that governing the allocation of depreciation.

XI. Non-Deductible Expenses

Generally, §265 disallows any deduction attributable to the realization of tax-exempt income. Generally, the denial of deductions related to tax-exempt income involves those deductions normally allowed under §212 "for the production of income or the management or conservation of property held for the production of income." Deductions allowed under the business expense provisions (§162) and the loss provision (§165) are not restricted by §265(a)(1).

The allocation of expenses between taxable income and tax-exempt income may be computed on the basis of trust tax-exempt income divided by total trust income.

Generally, there are two types of expenses to which the allocation rules most frequently apply:

(1) Annual trustees commissions and (2) Termination commissions.

There is no specific allocation formula specified in the Internal Revenue Code. An example of the allocation of expenses to tax-exempt income is provided in Reg. 1.652(c)-4. Generally, the fiduciary may select an allocation based upon any reasonable method. Reg. 1.265-1(c). See Rev. Rul. 63-27, 1963-1 CB 57 which states that no particular allocation formula is required and Rev. Rul. 73-565, 1973-2 CB 90 which upheld the allocation of tax-exempt income divided by total income (including capital gains).

As a general rule, a different formula is applied for irrevocable trusts (capital gains are not included in the denominator of the fraction) and revocable trusts (where capital gains are included in the denominator or the fraction).

See Rev. Rul. 63-27 which states that no particular allocation formula is required and Rev. Rul. 73-565 which upheld the allocation of tax exempt income divided by total income (including capital gains). The IRS in Rev. Rul. 77-355, 1977-2 C.B. 82 abandoned the flexible approach in Rev. Rul. 63-27 and Rev. Rul. 73-565 when it stated that capital gains not included in DNI may not appear in the denominator of the allocation fraction. This results in the denominator of the allocation fraction for revocable trusts including capital gains whereas the allocation fraction for irrevocable trusts does not include capital gains. Since capital gains are included in DNI in the year of termination, they would be included in the formula for allocating indirect expenses to tax-exempt interest for that year.

A question may arise as to whether a trustee can minimize the amount of such expenses allocated to tax-exempt income by distributing tax-exempt bonds in the year prior to charging the expenses. The IRS has ruled against this strategy. See Rev. Rul. 77-466,
1977-2 C.B. 83 in which the IRS required allocation of termination expenses based on the ratio of tax-exempt income received to total income received (including realized and unrealized capital gains) over the life of the trust.

Note that the portion of the administration expenses disallowed under §265 may still be claimed as an estate tax deduction. Rev. Rul. 59-32, 1959-1 C.B. 245.

*Special Rule for Termination Fees.* The cases and rulings hold that it is reasonable to allocate the termination fee on the basis of all the trust income received over the trust’s lifetime, including capital net gains. Whittemore v. U.S., 383 F 2d 824 (8th Cir. 1967); Rev. Rul. 77-466, 1977-2 C.B. 83; Fabens v. Comm, 519 F 2d 1310 (1st Cir. 1975).

XII. Miscellaneous Itemized Deductions

Generally, estate and trust expenses that are treated as adjustments in arriving at adjusted gross income are excluded from the 2% floor. Deductions for costs which are paid or incurred in connection with the administration of an estate or trust and would not have been incurred if the property were not held in such trust or estate are treated as adjustments in arriving at adjusted gross income, i.e., are deductible without regard to the 2% floor. §67(e). For further details on this issue see the discussion on the deductibility of administration expenses in Section VIII, above.

The fiduciary income tax return form and associated instructions indicate that fiduciary fees, attorney fees, accountant fees and tax return preparation fees and certain other deductions are exempt from the 2% floor. On Form 1041, fiduciary fees are deducted on line 12, attorney, accountant and return preparer fees are deducted on line 14 and miscellaneous deductions that are not subject to the 2% floor are deducted on line 15(a). Only “other miscellaneous itemized deductions” are apparently subject to the 2% floor – these are deducted on line 15(b) after reduction for the floor. This approach is generous to taxpayers.

§67(e) states that the adjusted gross income of an estate or trust excludes deductions allowed "under §642(b), §651 and §661." This means that the trust's or estate's deduction for distributions made to beneficiaries, whether under §651 or §661, will not be subject to the 2% floor on deductibility. The inclusion in §67(e) of the deduction allowed “under §642(b)” in the allowable adjustments to gross income for a trust or estate means that the trust or estate may deduct in full its $100, $300 or $600 exemption.

XIII. Alternative Minimum Tax

The alternative minimum tax applies to estates and trusts. However, the alternative minimum taxable income (AMTI) of a trust or estate is determined by applying the rules of Subchapter J. §59(c). That means that fiduciaries must compute distributable net income (DNI) on both a regular tax and alternative minimum tax (AMT) basis. Fiduciaries must report to beneficiaries their share of DNI computed under both the regular tax and AMT.

Generally, an estate or trust will be subject to the alternative minimum tax if they have substantial amounts of tax preference items or other items receiving beneficial tax treatment
for purposes of the regular tax. The trust or estate must compute its tax for regular tax purposes and alternative minimum tax purposes. The trust or estate is liable for whichever tax is greater. Trust or estate beneficiaries receiving distributions report their share of the trust or estate’s DNI computed on an alternative minimum tax basis on their personal return.

An estate or trust is entitled to a $22,500 exemption amount, phased out if the estate or trust’s AMTI exceeds $75,000. The exemption amount is reduced by 25% of the excess over $75,000. Thus, the exemption is completely phased out if the estate or trust’s AMTI exceeds $165,000.

The alternative minimum tax is the sum of (1) 26% of the alternative minimum taxable income (AMTI) up to $175,000 plus (2) 28% of the AMTI exceeding $175,000. The AMT is compared with the regular tax and the higher tax is paid. The alternative minimum tax can exceed the regular tax because fewer deductions and exclusions are allowed in computing the AMTI than in computing regular taxable income.

Trusts and estates are most likely to be effected by the preference for interest on tax-exempt private activity bonds, miscellaneous itemized deductions and state and local income taxes. These items are deductible for regular tax purposes but are not deductible for purposes of computing the alternative minimum tax.

In general, an estate or trust computes its AMTI by starting with its regular taxable income and then making the following modifications:

1) Making specified adjustments for certain types of deductions such as depreciation deductions which are computed in a different manner for alternative minimum tax purposes than for regular tax purposes.

2) Eliminating deductions for certain items such as miscellaneous itemized deductions, personal exemptions and taxes which are not allowed in computing the alternative minimum tax. (An administration expense not subject to the 2% floor is fully deductible by the trust for both regular and AMT purposes. On the other hand, excess deductions upon termination are not deductible for AMT purposes. Excess deductions are miscellaneous itemized deductions subject to the 2% floor.)

3) Adding back specified items of tax preferences such as tax-exempt interest on private activity bonds issued after August 7, 1986.

Administrative costs that would not have been incurred were the property not held in trust are not added back to the tax base to arrive at AMTI. §56(b)(1) and §67(e). Such expenses are thought to include fiduciary fees, attorneys fees, and accounting fees for preparing fiduciary accounts. It is uncertain whether costs incurred in preparing fiduciary income tax returns are covered by this rule.

As stated above, the AMTI of an estate or trust and its beneficiary is determined "by applying Part I of Subchapter J" with the adjustments provided in the minimum tax provisions. The trust or estate will compute its DNI on an alternative minimum tax basis (called its DNIAMTI, or in tax lingo, the DAMNIT amount). This is computed by making
the adjustments to DNI (computed the normal way) for the tax preference adjustments specified in §56 and §58 and by adding the items of tax preference under §57. The resulting figure represents the estate or trust’s DNI on an alternative minimum tax basis i.e. the DNIAMTI. The estate or trust distribution rules are then applied to determine how much of the DNI on an alternative minimum tax basis is carried out to the beneficiaries based on distributions to them and how much is retained at the estate or trust level. In other words, the distribution rules apply for AMT purposes in the same way as they do for regular tax purposes. As adjustments are made to taxable income for AMT purposes, the same adjustments are also made for purposes of computing DNI on an AMT basis. This means that estates and trusts compute their distributable net income for alternative minimum tax purposes on the basis of the alternative minimum tax rules. Distributions will then carry out alternative minimum taxable income to the extent of distributable net income determined for alternative minimum tax purposes in the same way that distributions carry out distributable net income determined for regular tax purposes.

The difference between the income reported to the beneficiary on a regular tax basis and the income reported to the beneficiary on an AMT basis is reported by the individual beneficiary on the beneficiary’s Form 6251. The fiduciary computes its AMT on Schedule H of the Form 1041.

Regulations have not been issued on computing AMT for estates and trusts. The report of the Joint Committee on Taxation merely indicates that DNI is to be calculated on a minimum tax basis.
Example of a 2009 Fiduciary Income Tax Return for a Complex Trust

Jeremiah W. Doyle IV
Senior Vice President
Bank of New York Mellon Corporation
Private Wealth Management
Boston, MA

Assume that a trust provides that 50% of the income must be paid currently to Will. In 2009 the trustee makes the following discretionary distributions: 25% to Cam and 25% to charity. No reserve for depreciation is required. The following income and expenses occurred in 2009:

**Income**

<table>
<thead>
<tr>
<th>Income</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rents</td>
<td>$40,000</td>
</tr>
<tr>
<td>Taxable interest</td>
<td>30,000</td>
</tr>
<tr>
<td>Tax-exempt interest</td>
<td>15,000</td>
</tr>
<tr>
<td>Long-term capital gain</td>
<td>8,000</td>
</tr>
</tbody>
</table>

**Expenses**

<table>
<thead>
<tr>
<th>Expenses</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation of rental property</td>
<td>6,000</td>
</tr>
<tr>
<td>Real estate rental expenses</td>
<td>14,000</td>
</tr>
<tr>
<td>Trustee expenses - Principal</td>
<td>1,000</td>
</tr>
<tr>
<td>Trustee expenses - Income</td>
<td>2,000</td>
</tr>
</tbody>
</table>

**Distributions**

Required: 50% to Will
Discretionary: 25% to Cam
25% to charity

**1. Computation of Trust Accounting Income:**

<table>
<thead>
<tr>
<th>Income</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rents</td>
<td>$40,000</td>
</tr>
<tr>
<td>Taxable interest</td>
<td>30,000</td>
</tr>
<tr>
<td>Tax-exempt interest</td>
<td>15,000</td>
</tr>
<tr>
<td>Gross trust accounting income</td>
<td>85,000</td>
</tr>
<tr>
<td>Less: Rental real estate expenses</td>
<td>(14,000)</td>
</tr>
<tr>
<td>Trustee expenses - income</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Trust accounting income</td>
<td>69,000</td>
</tr>
</tbody>
</table>

(Enter on Form 1041, Sch B, Line 8)
Note: Tax-exempt interest is an item of trust accounting income. Its tax character is irrelevant. Capital gains are usually allocated to principal and are not part of trust accounting income.

2. Amount of trust accounting income received by each beneficiary:

<table>
<thead>
<tr>
<th></th>
<th>Amount of trust accounting income received by each beneficiary:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Will</td>
<td>50% x 69,000 TAI = $34,500</td>
</tr>
<tr>
<td>Cam</td>
<td>25% x 69,000 TAI = 17,250</td>
</tr>
<tr>
<td>Charity</td>
<td>25% x 69,000 TAI = 17,250</td>
</tr>
<tr>
<td>Total</td>
<td>69,000</td>
</tr>
</tbody>
</table>

3. Taxable income (before income distribution deduction):

<table>
<thead>
<tr>
<th>Income</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental income</td>
<td>$40,000</td>
</tr>
<tr>
<td>Taxable interest</td>
<td>30,000</td>
</tr>
<tr>
<td>Tax-exempt interest ($15,000)</td>
<td>0</td>
</tr>
<tr>
<td>Long-term capital gains</td>
<td>8,000</td>
</tr>
<tr>
<td>Gross income</td>
<td>78,000</td>
</tr>
<tr>
<td>Less: rental real estate expenses</td>
<td>(14,000)</td>
</tr>
<tr>
<td>trustees compensation</td>
<td>(2,471)*</td>
</tr>
<tr>
<td>Charitable deduction</td>
<td>(14,206)**</td>
</tr>
<tr>
<td>Exemption</td>
<td>(100)</td>
</tr>
<tr>
<td>Taxable income before distribution deduction</td>
<td>47,223</td>
</tr>
</tbody>
</table>

Note: The expenses must be allocated to the various items of income. The real estate rental expenses are allocated against rental income because such expenses are attributable directly to rental income. However, a portion of the trustee’s compensation and the charitable deduction must be allocated against tax-exempt interest and, as a result, such portion is not deductible. The portion is proportionate to the total of the tax-exempt interest ($15,000) divided by the gross trust accounting income ($85,000). Thus, the portion of the commissions and charitable distribution that is not deductible is computed as follows:

* Trustee’s commissions attributable to tax-exempt interest:

$3,000 x 15,000/85,000 = 529
$3,000 - 529 = 2,471

** Charitable deduction attributable to tax-exempt interest:

$17,250 x 15,000/85,000 = 3,044
$17,250 - 3,044 = 14,206

Note: If the trustee does not establish a reserve for depreciation, the depreciation deduction is apportioned between the income beneficiaries and the trust on the basis of the trust accounting income allocable to each. Here, since all of the trust accounting income is allocated to the beneficiaries, the trust is not entitled to deduct any depreciation.
4. Calculation of DNI:

Taxable income before income distribution deduction 47,223
Add: Exemption (§643(a)(2)) 100
Tax-exempt interest (§643(a)(5) 15,000
Less: trustee comp allocable (529)
Less: charitable deduction allocable (3,044) 11,427
Less: Long-term capital gain (8,000)
DNI - Put on Form 1041, Sch. B, Line 7 50,750

The items of DNI can be broken down into the following categories of income:

<table>
<thead>
<tr>
<th>GI as % of TI</th>
<th>47.06%</th>
<th>35.29%</th>
<th>17.65%</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental Income</td>
<td>40,000</td>
<td>30,000</td>
<td>15,000</td>
<td>85,000</td>
</tr>
<tr>
<td>Taxable Interest</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax-exempt Interest</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Less:

Rental expenses (14,000)
Commissions ** (1,412) (1,059) (529) (3,000)
Charitable deduction * (8,118) (6,088) (3,044) (17,250)
Totals 16,470 22,853 11,427 50,750

* Charitable distributions must be apportioned ratably among each class of items of income. Reg. 1.661(b)-2.

** The commissions can be allocated against any class of income. Reg. 1.652(b)-3.

5. Distributions deduction:

Income required to be distributed currently-
tier-one distribution 34,500
All other amounts properly paid-
tier-two distributions 17,250
Total 51,750
Limited to DNI 50,750

Note: The difference between the income required to be distributed and properly paid and DNI is the trustee’s compensation of $1,000 allocated to principal.

§661(b): Character of amount deductible under §661(a) is same as character of DNI:

Taxable character of DNI: $39,323
Tax-exempt character of DNI 11,427*
Distribution deduction 39,323

* The trust does not get a distribution deduction for the tax-exempt income. §661(c); Reg. 1.661(c)-1.

6. Taxable income of the trust:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable income before distribution deduction</td>
<td>47,223</td>
</tr>
<tr>
<td>Distribution deduction</td>
<td>(39,323)</td>
</tr>
<tr>
<td>Taxable income</td>
<td>7,900</td>
</tr>
</tbody>
</table>

Note: The taxable income equals the long-term capital gains less the exemption. This is correct because all of the trust accounting income was distributed.

7. Tax consequences to beneficiaries:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Will - first tier beneficiary</td>
<td>34,500</td>
</tr>
<tr>
<td>(Received $34,500; limited to DNI of 50,750)</td>
<td></td>
</tr>
<tr>
<td>Cam - second tier beneficiary</td>
<td>16,250</td>
</tr>
<tr>
<td>(Received 17,250; limited to remaining DNI: 50,750 - 34,500)</td>
<td></td>
</tr>
<tr>
<td>Total (equal to DNI)</td>
<td>50,750</td>
</tr>
</tbody>
</table>

8. Character of DNI:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable character: 39,323/50,750 = 77.48%</td>
<td></td>
</tr>
<tr>
<td>Exempt character: 11,427/50,750 = 22.52%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Will: taxable 34,500 x 77.48% =</td>
<td>26,731</td>
</tr>
<tr>
<td>Less: 50% share of depreciation (3,000)</td>
<td></td>
</tr>
<tr>
<td>Net taxable:</td>
<td>23,731</td>
</tr>
<tr>
<td>Cam: taxable 16,250 x 77.48% =</td>
<td>12,592</td>
</tr>
<tr>
<td>Less: 25% share of depreciation (1,500)</td>
<td></td>
</tr>
<tr>
<td>Net taxable:</td>
<td>11,092</td>
</tr>
</tbody>
</table>

The individual items of income that comprise Will and Cam’s respective distribution also can be illustrated. Will receives 34,500/50,750 of each item and Cam receives 16,250/50,750 of each item.
<table>
<thead>
<tr>
<th>Rental Income</th>
<th>Taxable Interest</th>
<th>Tax-exempt Interest</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Will (.679803)</td>
<td>11,196</td>
<td>15,536</td>
<td>7,768</td>
</tr>
<tr>
<td>Cam (.320197)</td>
<td>5,274</td>
<td>7,317</td>
<td>3,659</td>
</tr>
<tr>
<td>Total</td>
<td>16,470</td>
<td>22,853</td>
<td>11,427</td>
</tr>
</tbody>
</table>

9. Who gets taxed on what:

- Taxable income before distribution deduction: 47,223
- Depreciation deductible by beneficiaries: (4,500)
- Income which is taxed: 42,723
- Taxed to trust: 7,900
- Taxed to Will: 23,731
- Taxed to Cam: 11,092
- Total: 42,723