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The Income Taxation of Complex Trusts and Estates

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Introduction

The income taxation of simple trusts was discussed in the last installment of this column. This installment discusses the income taxation of complex trusts and estates. While the taxation of simple and complex trusts is similar, the taxation of complex trusts involves some unique concepts. After reviewing some of the basic rules, the discussion will turn to those concepts that make complex trusts different from simple trusts. Those concepts will be discussed in this installment and in the next installment of this column.

Background

A “complex trust” is a trust that may accumulate income, distribute corpus, or make distributions to charity. The deduction for distributions is determined under Code Sec. 661. The inclusion of amounts in the income of beneficiaries is determined under Code Sec. 662. Special rules for complex trusts are found in Code Sec. 663.

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Unless otherwise indicated, the fiduciary income tax rules for complex trusts also apply to estates.

Basic Rule

A complex trust is allowed a deduction for the sum of any amount of trust accounting income that is required to be distributed currently (including any item—such as an annuity—payable out of income or corpus to the extent actually paid out of income), and any other amounts properly paid or credited or required to be distributed for the tax year.¹

Limitations on Distribution Deduction

There are some limitations on the distribution deduction. They pertain to distributable net income (DNI) and tax-exempt income. The deduction under Code Sec. 661(a) cannot exceed DNI as computed under Code Sec. 643(a). Likewise, a deduction is not allowed for any amount that is not included in the gross income of the trust (e.g., tax-exempt income).²

Income Required to Be Distributed Currently

A deduction is allowed for any “income required to be distributed currently” as determined under the terms of the will or trust instrument and applicable state law.³ In general, the trustee must be under a duty to distribute the income within the tax year. If such a duty exists, the trust is allowed a deduction even if distributions are not made within the tax year or are not made at all.⁴

Amounts Properly Paid, Credited or Required to Be Distributed

A deduction is also allowed for any “amounts properly paid or credited or required to be distributed.”⁵ The term “any other amounts properly paid or credited or required to be distributed” includes all amounts properly paid, credited or required to be distributed by an estate or trust during the tax year other than income required to be distributed currently. Examples of amounts properly paid, credited or required to be distributed include the following:

- Payments made from income or principal in the discretion of trustee.⁶
- Annuity payments made from principal.⁷
- Amounts used to discharge or satisfy a beneficiary’s legal obligation.⁸
- Amounts paid pursuant to court order or decree.⁹
- Payments in kind, i.e., distributions of trust property other than cash.¹⁰

The phrase “amounts properly paid or credited or required to be distributed” does not include a gift or bequest of a specific sum of money or of specific property.

Amounts are “properly credited” to a beneficiary when they are irrevocably and unconditionally placed at the disposal of the beneficiary. Transfers shown by book entries and on the annual work papers for the entity are not sufficient to treat the funds as credited for purposes of Code Secs. 661 and 662.¹¹ They must be credited so as to be beyond recall by the fiduciary and must be available for distribution upon demand.

The IRS will treat payments made to a beneficiary conditioned upon the beneficiary’s obligation to repay, if needed, for obligations of the estate, as properly paid or credited, even if the beneficiary may have to repay the distributions.¹²

Deductible payments may be made in cash or in kind. If a distribution is made in kind (e.g., a

distribution of common stock), the trust may be required to recognize capital gain on the distribution. A distribution in kind can result in the realization of a gain or loss if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount of specific property other than that distributed or of income as defined in Code Sec. 643(b) and the applicable regulations.¹³ The amount of any gain would be measured by the fair market value of the property distributed, less its adjusted basis for tax purposes at the time of distribution. However, in general, a trust will not realize a gain by reason of a distribution in kind unless the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount (or unless trust elects to recognize gain under Code Sec. 643(e)(3)).¹⁴ Losses generally cannot be recognized because of the related party rules of Code Sec. 267.

With respect to in-kind distributions, the amount deductible is, generally, the lesser of the basis of distributed property in the hands of the beneficiary or the fair market value of the property.¹⁵ However, if the trust makes a Code Sec. 643(e)(3) election, the amount deductible is the fair market value of the property.¹⁶

The phrase “amounts properly paid or credited or required to be distributed” does not include a gift or bequest of a specific sum of money or of specific property. According to Code Sec. 663(a)(1), the amount properly paid or credited under the governing instrument as a gift or bequest of a specific sum of money or specific property cannot be deducted if that figure is paid in a single sum or in not more than three installments. However, a gift or bequest that can be paid only out of income would be deductible under Code Sec. 661(a)(2). See Code Sec. 663(a)(1).

In addition, the phrase “amounts properly paid or credited or required to be distributed” does not include charitable distributions, under Code Sec. 663(a)(2), or amounts paid in the current year for which a deduction under Code Sec. 651 or Code Sec. 661 was allowable for a previous year.¹⁷

Character of Amounts Distributed; In General

The amount deductible for distributions to beneficiaries under Code Sec. 661(a) is 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 total DNI, i.e., a pro-rata approach.¹⁸

There are two exceptions to this general rule: if the governing instrument contains specific provisions for allocation of classes of income and if applicable state law requires non-pro-rata allocation of classes of income.

Example 1: If a trust with DNI of \$20,000 (consisting of \$8,000 of interest and \$12,000 of dividends) distributes \$5,000 to a beneficiary, the deduction for the trust under Code Sec. 661(a) is deemed to consist of \$2,000 of interest ($8/20 \times \$5,000$) and \$3,000 of dividends ($12/20 \times \$5,000$). The beneficiary is required to include the same amounts in gross income under Code Sec. 662.

Allocation of Deduction Items

In general, items of deductions that enter into the computation of DNI are allocated among items of income in DNI in accordance with the rules for simple trusts.¹⁹

Expense items directly attributable to one class of income are allocated to that class of income. For example, rental expenses (other than any depreciation allocated to beneficiaries) are allocated to rental income.²⁰

Indirect expenses, such as trustee commissions and state income taxes, may be allocated to any class of income.²¹ In regard to tax-exempt income, a portion of indirect expenses must be allocated to nontaxable income.

Example 2: If income of a trust consisted of \$10,000 of tax-exempt interest and \$40,000 of dividends and trustee fees were \$5,000, a portion of trustee fees must be allocated to tax-exempt interest. Using a pro-rata allocation, \$1,000 of trustee fees ($\$10,000/\$50,000 \times \$5,000$) would be allocated to tax-exempt interest and would be nondeductible.

Code Sec. 265 governs the allocation of expenses between taxable and tax-exempt income. The regulations provide that if an expense is

indirectly allocable to both a class of taxable income and tax-exempt income, a “reasonable proportion” of such expense “in light of all the facts and circumstances” must be allocated to each class.²² Thus, it is not mandatory to use a pro-rata allocation method.

In regard to capital gains, the IRS has ruled that a simple trust that does not distribute capital gains cannot include capital gains in the formula for allocating indirect expenses to tax-exempt interest.²³ Logically, the same rationale should apply to complex trusts.

Because capital gains are included in DNI in the year of trust termination, they would be included in the formula for allocating indirect expenses to tax-exempt interest for that year.

Typically, trustee termination expenses can be significant—in some cases, as much as two percent of trust assets. Can a trustee minimize the amount of such expenses allocated to tax-exempt income by distributing tax-exempt bonds in the year prior to charging a termination fee? The IRS has ruled that this strategy does not work. In Rev. Rul. 77-466, 1977-2 C.B. 83, the IRS required allocation of such 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.

As with simple trusts, the beneficiaries of estates and complex trusts include in gross income under Code Sec. 662 the amount for which the entity has received a distribution deduction under Code Sec. 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 as is the case with simple trusts. Estates and complex trusts may accumulate ordinary income, causing it to be taxed to the entity.

Effect of Charitable Contributions

Pro-rata allocation is required for charitable contributions. The charitable contributions deduction must be ratably apportioned to each class of income entering into the computation of DNI, unless the governing instrument or applicable state law requires a different apportionment.²⁴ If the trust has tax-exempt interest in the same year that it has a charitable contributions deduction, a portion of the charitable deduction will be lost to the extent allocated to tax-exempt interest.

A direction in the trust instrument to satisfy charitable contributions only out of taxable income would be effective only if there is significant “economic effect.”²⁵

The income taxation of complex trusts and estates is similar to the taxation of simple trusts. However, the income taxation of complex trusts and estates contains unique rules that do not apply to simple trusts.

Effect of Passive Activity Loss Rules

Limitations on passive activity losses and credits clearly apply to trusts and estates.²⁶ However, the ability of a trustee to allocate indirect expenses to any class of income, as described above, may enable fiduciaries to mitigate the impact of the passive activity loss rules. For example, a strategy of allocating trustee fees against “portfolio income”—such as dividends and interest—rather than against “passive” income—such as rental income or publicly traded partnership income—would increase passive income and decrease portfolio income, which is generally a desirable tax result.

The passive loss regulations for estates and trusts under Reg. §1.469-8T, currently unpublished and reserved since 1988, may provide some guidance, although such assistance has been in abeyance for well over two and a half decades. When these regulations are issued, it is unclear whether Reg. §1.652(b)-3(b) will also be amended to require pro-rata allocation of indirect expenses among passive and nonpassive items. What little guidance there is can be found in the instructions to Form 1041 (U.S. Income Tax Return for Estates and Trusts).

Conclusion

The income taxation of complex trusts and estates is similar to the taxation of simple trusts.

However, the income taxation of complex trusts and estates contains unique rules that do not apply to simple trusts. Now that the basic rules of the income taxation of complex trusts and estates has been discussed, the next installment will discuss the income taxation of complex trusts when there are multiple beneficiaries, some who are required to receive distributions of income and some who are discretionary beneficiaries of income and principal. This is the so-called tier system, under which distributable net income (DNI) is allocated to a beneficiary depending upon whether he or she is a mandatory income beneficiary (i.e., a first tier beneficiary) or a discretionary beneficiary of income and/or principal (i.e., a second tier beneficiary).

ENDNOTES

- ¹ Code Sec. 661(a).
- ² Code Sec. 661(c); Reg. §1.661-(c)(1).
- ³ Reg. §1.661(a)-2(b) and §1.651(a)-2.
- ⁴ Reg. §1.651(a)-2(a). For additional rules, see Reg. §1.651(a)-2.
- ⁵ Code Sec. 661(a)(2).
- ⁶ Reg. §1.661(a)-2(c).
- ⁷ *Ibid.*
- ⁸ Reg. §1.661(a)-2(d).
- ⁹ Reg. §1.661(a)-2(e).
- ¹⁰ Reg. §1.661(a)-2(f).
- ¹¹ *K. Johnson Est.*, 88 TC 225, CCH Dec. 43,675 (1987).
- ¹² Rev. Rul. 72-396, 1972-2 C.B. 312.
- ¹³ Reg. §1.661(a)-2(f).
- ¹⁴ *Ibid.*
- ¹⁵ Code Sec. 643(e)(2).
- ¹⁶ Code Sec. 643(e)(3)(A)(iii).
- ¹⁷ Code Sec. 663(a)(3).
- ¹⁸ Code Sec. 661(b); Reg. §1.661(b)-1.
- ¹⁹ Reg. §1.661(b)-2.
- ²⁰ Reg. §1.652(b)-3(a).
- ²¹ Reg. §1.652(b)-3(b).
- ²² Reg. §1.265-1(c).
- ²³ Rev. Rul. 77-355, 1977-2 C.B. 82.
- ²⁴ Reg. §1.661(b)-2.
- ²⁵ Reg. §1.642(c)-3(b)(2).
- ²⁶ Code Sec. 469(i).