

# The Preparation of Form 1041 - Understanding the Law

Werner-Rocca Seminars, Ltd.

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## General Rule – Taxation of Income

- A general rule of income taxation of estates and trusts is as follows: Income, if taxable at all, is only taxed once:
  - To the Trustor (if the Trust is a Grantor Trust);  
or
  - To the Trust (or Estate) itself; or
  - To the Beneficiary

## General Rule – Character of Income

- A general rule with regard to the character of income within an estate or a trust is that the entity does not change the character of the income within it when the income leaves the entity
  - Tax-free income remains tax-free
  - Ordinary income remains ordinary income
  - Capital gains remain capital gains

## 1041 Income Tax Rate Schedule – 2017 (with compressed tax brackets)

<u>Income Amount</u>	<u>Marginal Rate</u>
0 - \$2,549	15%
\$2,550 - \$5,999	25%
\$6,000 - \$9,149	28%
\$9,150 - \$12,499	33%
\$12,500 and above	39.6%

**(Note: The 10% and 35% brackets that apply to individuals do not apply to fiduciary entities!)**

## 1041 Income Tax Rate Schedule – 2018 (with compressed tax brackets)

<u>Income Amount</u>	<u>Marginal Rate</u>
0 - \$2,550	10%
\$2,551 - \$9,150	24%
\$9,151 - \$12,500	35%
\$12,500 and above	37%

**(Note: The 12%, 22%, or 32% brackets that apply to individuals do not apply to fiduciary entities!)**

## Affordable Care Act Taxes

- Estates and Trusts are subject to the 3.8% surtax on the lesser of:
  - Undistributed net investment income, or
  - the amount by which adjusted gross income exceeds the top bracket for estate and trust income taxation.

## Deductions

- Generally, similar to those of individual income taxation
- Differences
  - Allocation of deductions to non-taxable income
  - No standard deduction
  - Loss carry-forwards will pass to beneficiaries at final return

## Exemptions

- Amounts
  - Simple Trust - \$300
  - Complex Trust - \$100
  - Estates - \$600
- Have not changed in amount since 1976!

## Fiduciary Accounting

- Allocation of Income and Principal
- Again, governing instrument is the key
- When the governing instrument is silent, then state law is relied on (The Income and Principal Act of the specific state)
- If the Income and Principal Act of the state can not address the issue, then the Common Law is researched

## Distribution Deduction

- Unique to income taxation of estates and trusts
- Any amount of income that is properly distributed from an estate or a trust is deducted from the entity and is included as taxable income (in it's character) to the beneficiary

## Distribution Deduction (cont.)

- The deduction is computed on Schedule B of the Form 1041
- Essentially, the deduction is limited to the lower of accounting income, taxable income, or the actual distribution itself.

## Overview

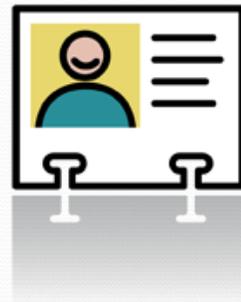
- This portion of the course is designed to teach the participant how to prepare a Federal Form 1041 “line-by-line”
- An understanding of the basics of Subchapter J of the Internal Revenue Code would be helpful to the participant.

## Reviewing the Form 1041

- The main portion of the Form 1041 can be broken down into three separate areas:
  - The “Information” Portion
  - The “Body”
  - The “9 Questions”

## The “Information” Portion

- Name of Entity
- Name and title of Fiduciary
- Address of Entity



## Part A – Type of Entity

- Decedent's Estate
- Simple Trust
- Complex Trust
- Qualified Disability Trust
- ESBT

## Part A – Type of Entity (continued)

- Grantor Type Trust
- Bankruptcy Estate – Chapter 7
- Bankruptcy Estate – Chapter 11
- Pooled Income Fund



## Parts B, C, D, and E

- Number of Schedule K-1s Attached
- Employer Identification Number
- Date Entity Created
- Non-Exempt Charitable and Split-Interest Trusts

## Part F – Check Applicable Boxes

- Initial Return
- Final Return
- Amended Return
- Change in Trust's Name
- Change in Fiduciary
- Change in Fiduciary's Name
- Change in Fiduciary's Address

## Part G – The “645” Election

- IRC §645
  - The Taxpayer Relief Act of 1997 created a new type of entity under IRC Sec. 645.
  - By election, a qualified revocable trust (QRT) can be treated as an estate for income tax purposes.

## Part G – The “645” Election (cont.)

- When this election is made, all of the rules relating to:
  - Tax Elections
  - Fiscal years
  - Methods of Accounting
  - Termination of a Probate Estate

## Part G – The “645” Election (cont.)

- Election is made when there is both:
  - An Estate; and
  - A Revocable Trust
  - (Can be made when there is a Revocable Trust that become irrevocable upon the Trustor’s death)

## Part G – The “645” Election (cont.)

- Advantages of the IRC §645 Election
  - The use of a fiscal year
  - The \$25,000 PAL deduction for active participation for two years after the date of death under IRC §469(i)(4)
  - The qualification by the combined or electing entity as an S corporation shareholder

## Part G – The “645” Election (cont.)

- Advantages of the IRC §645 Election (cont.)
  - Charitable contribution deduction is allowed for income set aside as well as actually paid
  - A loss deduction is available for a pecuniary bequest satisfied with depreciated property even though the parties are “related” under IRC §267

## The “Ten Questions”

- **1.** Did the Estate or Trust receive tax-exempt income?
- **2.** Did the Estate or Trust receive contract assignment earnings?
- **3.** Did the Estate or Trust have an interest in a bank account in a foreign country?

## The “Ten Questions” (cont.)

- **4.** Did the Estate or Trust receive a distribution from a foreign trust?
- **5.** Did the Estate or Trust receive or pay qualified residence interest?



## The “Ten Questions” (cont.)

- **6.** The IRC §663(b) election (The “65 Day Rule”)
  - Distributions made within 65 days of the estates or trust's subsequent tax year end may be deemed to have been made as of the last day of the tax year
  - The estate or trust will still be afforded a distribution deduction

## The “Ten Questions” (cont.)

- **7.** The IRC §643(e)(3) election
  - Allows a Fiduciary to realize a capital gain inherent in the assets that are subject to distribution
  - The capital gain is recognized by the entity (subject to pass-through to a beneficiary)
  - The Beneficiary takes a fair market value basis in the property distributed.

## The “Ten Questions” (cont.)

- **8.** Is the Estate open for more than 2 years?
- **9.** Are any present or future Trust Beneficiaries “Skip Persons”?
- **10.** Was the trust a specified domestic entity required to file Form 8938 for the tax year?

## The “Body”

- This is the main portion of the Form 1041
- It is divided into “Income”, “Deductions”, and “Tax Payment” sections
- Other Schedules flow into these line items

## Income Line Items

- **Line 1** – Interest Income , and **Line 2** – Dividend Income
  - **Note** - There is no equivalent of a 1040 “Schedule B”
  - **Note** – There could be a 1099 discrepancy

## Example – 1099 Discrepancy



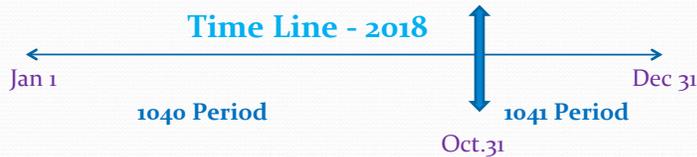
**Facts: Client dies on October 31**  
**1099s for the year 2018:**  
\$2,400 Interest Income from ABC Bank  
\$1,200 Dividend Income from XYZ, Inc.

## Example – 1099 Discrepancy (cont.)



**Facts: Client dies on October 31**  
**1099s for the year 2018:**  
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## Example – 1099 Discrepancy (cont.)



**Facts: Client dies on October 31**  
**1099s for the year 2018:**

\$2,400 Interest Income from ABC Bank

\$1,200 Dividend Income from XYZ, Inc.

**Allocation can be proportionate or actual**

## Income Line Items (cont.)

- **Line 3** – Business Income or Loss, and **Line 6** – Farm Income or Loss
  - Use 1040 Schedule C (or Schedule F)
  - No SE Tax for the 1041 period!
  - Same post-mortem opportunity as Lines 1 and 2

## Income Line Items (cont.)

- **Line 4** – Capital Gain or Loss
  - Use special 1041 Schedule D
  - **Issue:** Decedent's assets generally subject to full step up
  - **Issue:** Holding period is deemed to be “long-term” for decedent's capital assets

## Income Line Items (cont.)

- **Line 5** – Rents, Royalties, Partnerships, and other Estates and Trusts
  - Use 1040 Schedule E
  - No SE Tax for the 1041 period!
  - Same post-mortem opportunity as Lines 1 and 2

## Income Line Items (cont.)

- **Line 7** – Ordinary gain or loss
  - Form 4797 is attached
- **Line 8** - Other Income
  - List all items on a separate schedule
  - Usually, this is where IRD is listed

## Deduction Line Items

- **Special Issue:** Estate Administration Expenses
  - Can be deducted either on Form 706 or on Form 1041 or split - **but never can the deduction be taken twice!**
  - Examples: Attorney Fees, Accounting Fees, Executor Commissions, Probate Fees, Filing Fees, Costs of Protecting Estate Assets, and Appraisals

## Deduction Line Items (cont.)

- **Line 10** – Interest
- **Line 11** – Taxes
- **Line 12** – Fiduciary Fees
- **Line 13** – Charitable Deduction
  - From 1041 Schedule A
  - Documents must allow for it
- **Line 14** – Attorney, Accountant, and Return Preparer Fees

## Deduction Line Items (cont.)

- **Line 15a** – Miscellaneous deductions not subject to the 2% floor
- **NOTE** – Miscellaneous deductions subject to the 2% floor have been eliminated for 2018!
- **SUBTOTAL (line 16)**: Add lines 10 through 15b
- **SUBTOTAL (line 17)**: Subtract line 9 from line 16 to get “Adjusted Total Income”

## Deduction Line Items (cont.)

- **Line 18** – Income Distribution Deduction
  - Be patient! Discussion on Schedule B to follow
- **Line 19** – Estate Tax Deduction
- **Line 20** – Exemption
- **SUBTOTAL Line 21):** Add Lines 18 through 20

## The Income Distribution Deduction

- Form 1041, Schedule B (page 2 of the 1041)
- Distributable Net Income (DNI)
  - DNI creates a tax presumption that any distribution is made from income first
  - It helps determine how much of the income of a trust or estate is taxed to the fiduciary and how much is taxed to the beneficiaries.
  - It also determines the character of the income taxed to each

## The Income Distribution Deduction (cont.)

- Distributable Net Income (DNI) (cont.)
  - The amount of this distribution deduction is equal to the lesser of:
    - The taxable portion of DNI, or
    - The amount actually distributed or required to be distributed.

## The Income Distribution Deduction (cont.)

- The distribution deduction is calculated on Schedule B of Form 1041
- While this calculation determines the distribution deduction, it also determines the amount of taxable income allocated to a particular beneficiary
- Therefore, the sum of the Schedule K-1 allocations should equal the total distribution deduction

## The Income Distribution Deduction (cont.)

- DNI is strictly a tax concept, a fiction that is one of many that we tax practitioners must deal with constantly.
- It departs from the customary income-principal concept that forms the basic fiduciary accounting rules.
- Once you calculate fiduciary accounting income, you must put that number aside and concentrate on the different inquiry of trust taxable income.

## The Mechanical Calculation of DNI

- IRC §643 (DNI) is a hybrid of taxable income and fiduciary accounting income
- The starting place for its calculation is trust taxable income followed by a series of adjustments as described below

## The Mechanical Calculation of DNI (cont.)

- Begin with trust taxable income
  - Add back the personal exemption
  - Add back capital losses (if added to corpus)
  - Add back net tax-exempt income that is allocated to income for FAI purposes
  - Reduce taxable stock dividends and extraordinary cash dividends allocated to corpus
  - Reduce capital gains allocated to corpus

## Computing the DNI

- Schedule B compares the IRC §§651 or 661 DNI (the taxable portion of IRC §643 DNI) with the taxable portion of the actual distribution.
- The deduction for distributions to beneficiaries is the lesser of :
  - The total amount of distributions made or required to be made to the beneficiaries, or
  - The DNI of the trust or estate

## Distributable Net Income (DNI)

- The income distribution deduction allowable to estates and trusts for amounts paid, credited, or required to be distributed to beneficiaries is limited to distributable net income (DNI).
- This amount is also used to determine how much of an amount paid, credited, or required to be distributed to a beneficiary will be includable in his or her gross income.

## Contact Information

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