

**RECENT CHANGES IN THE INCOME TAXATION OF ESTATES AND TRUSTS  
AND PLANNING OPPORTUNITIES CREATED THEREFROM**

GARY A. ZWICK, CPA, LLM  
WALTER & HAVERFIELD P.L.L.  
1300 TERMINAL TOWER  
CLEVELAND, OHIO 44113

I. GENERAL TAX SCHEME.

A. Types Of Trusts. IRC §651, 661.

1. There are two types of Trusts.
  - a. Simple Trusts (IRC §651) - Trusts which require all income to be paid out each year, from which there are no distributions of corpus during the year and there are no amounts paid or permanently set aside for charitable purposes.
  - b. Complex Trusts (IRC §661) - All Trusts that are not Simple Trusts.

B. Estates.

1. Are taxed like Complex Trusts (IRC §661).

C. Overview of Taxation.

1. Simple Trusts -
  - a. All income whether or not paid out, is taxed currently to the beneficiary.
  - b. Capital gains are generally taxed to the Trust except in limited circumstances. If anyone has a general power of appointment over the principal, capital gain would be taxed to the holder of the power.
  - c. Income is taxable to the beneficiary to the extent of distributable net income (DNI).
2. Complex Trusts -
  - a. Income is taxable to the beneficiary to the extent paid out. Any accumulated income is taxed to the Trust.
  - b. Capital gains are generally taxed to the Trust except in limited circumstances.

- c. Income taxation of the beneficiary is limited to distributable net income. (IRC §661(c); IRC §662(a)).
- d. Amounts distributed within 65 days after the end of the Trust year may, by election of the Trustee, be treated as distributed in the prior year. IRC §663(b).

D. Special Rules.

- 1. Alternative minimum tax applies to Trusts. The AMT exemption is \$22,500. (IRC §55(d)(1)(C)). To the extent income is paid out to the beneficiary, alternative minimum tax DNI is calculated. The difference between regular DNI and alternative minimum tax DNI will show up as a preference on the beneficiary's tax return. The amounts accumulated in the Trust are also subject to alternative minimum tax. The calculation is quite complex.
- 2. Income paid out to beneficiaries retains its character to the beneficiary. Income is deemed to be paid pro rata out of the income of the Trust. However, since capital gain is not generally part of Trust income, capital gain is only reached after ordinary income and tax exempt income is paid out. This is in contrast to the ordering rule under charitable remainder trusts. (IRC §662(b); 652(a)).
- 3. Distributions of specific amounts of money or specific property as a gift or bequest under the governing instrument do not carry out DNI to the beneficiary (IRC §663(a)(1)).
- 4. Distributions of property in kind other than specific bequests or gifts under the governing instrument.
  - a. General rule is to treat distributions as a distribution of basis of the property with no capital gain triggered. (IRC §643(e)). The beneficiary takes the basis that the Trust had in the property (or the fair market value if less) and the holding period is tacked.
  - b. At the election of the Trustee, the Trust may treat the property as having been sold at fair market value to the distributee triggering potential capital gain or ordinary income. Losses would be disallowed under IRC §267. (IRC §643(e)(3)).
    - (1) In this case, the beneficiary takes a fair market value basis in the property received.
- 5. The throwback rule has been repealed for most trusts effective for tax years beginning after August 5, 1997. Therefore, future distributions of income which have been accumulated in a Trust are no longer subject to a recalculation of the tax as if the amounts had been distributed to the beneficiary.
  - a. Query: Whether the Ohio throwback rule still applies.

6. Grantor Trusts (IRC §671-678).
  - a. An entirely Grantor Trust, for example, a revocable living trust, is not a taxpaying entity. It is ignored for income tax purposes. If the Grantor is a Trustee, the Trust need not file a tax return and all items of income and expense are shown on the Grantor's tax return. If the Grantor is not a Trustee, the same is true but a Form 1041 must be filed with a Grantor Trust statement on the front page.
  - b. Trusts containing defective powers which make the Grantor the owner of the entire Trust should be treated the same as in Item a. Some powers are defective as to income or principal only.
7. Taxable year and tiered structures.
  - a. Except for Trusts which are entirely charitable, all Trusts must have a calendar year end.
  - b. There is no grandfathering, therefore there should be no existing noncalendar/noncharitable trusts.
  - c. Charitable remainder unitrusts and charitable remainder annuity trusts as well as charitable lead trusts are not wholly charitable trusts and therefore must use calendar years.
  - d. Ownership by a Trust of a partnership, LLC or S corporation creates a tiered structure under IRC §444 and therefore the entity must also have a calendar year.
    - (1) Exception for business purpose tax years.
  - e. Beneficiaries are taxed in the year in which the Trust year ends regardless of when distributions are made.
  - f. Estates may continue to have noncalendar years. Beneficiaries of estates are also taxed in the year in which the estate's year ends regardless of when distributions are made.
8. Estimated Tax.
  - a. Trusts are subject to estimated tax requirements similar to individuals. However, a Trust which was treated as a grantor trust and to which the residue of the estate will pass has no estimated tax liability until the year which ends after the date which is 2 years after death.
  - b. Estates are also not subject to estimated tax requirements until the year ending after the estate has been open for at least 2 years.

9. State Taxation - Ohio.
  - a. Ohio does not generally tax Trusts. There is no form for the calculation of Trust taxable income nor for the payment of tax.
  - b. Estates do pay tax to the State of Ohio using the same rate schedule as an individual. The Ohio Estate Tax is calculated backing out the personal exemption allowed for federal purposes and putting in the Ohio personal exemption. Adjustments to Ohio taxable income are similar to those for individuals.
  - c. Query - Whether the Ohio throwback rule still applies?
  - d. House Bill 802 introduced recently into the Ohio House would tax all electing small business trusts. This would be effective retroactively to January 1, 1998. The bill appears to have little chance of passage at this time.

## II. CHANGES AND NEW RULES CREATED BY THE 1996 AND 1997 TAX ACTS.

### A. The Changes Created by the 1996 and 1997 Tax Acts Include the Following:

1. Elimination of the throwback rule (IRC §665(b) and (c)) - Effective for distributions to beneficiaries made in tax years beginning after August 5, 1997, the throwback rule has been repealed for all domestic trusts created after March 1, 1984 and domestic trusts created before March 1, 1984 if they would not be treated as multiple trusts under IRC §643(f). Under the former throwback rule, income accumulated in a Trust was later taxed to the beneficiary upon payout. The beneficiary would calculate the amount of tax on the income as if it had been paid out in the year it was accumulated. The individual also received a credit for the tax paid by the Trust. The effect of the rule was to make it so that there was no advantage to accumulating income in a Trust and use the Trust's potentially lower income tax brackets. However, because there was no interest factor on the taxes that were deferred, there still was a benefit to using Trust tax brackets. Exceptions to the old rule included income accumulated while the beneficiary was under 21 years of age was not subject to the throwback rule. In addition, capital gain was not subject to the throwback rule, at least to the extent it was not included in DNI. The reason for the repeal of the throwback rule is a combination of the fact that Trusts for the most part no longer have low tax brackets and so accumulations in Trusts did not gain a lot of tax savings. In addition, the throwback rules are extremely complex and their elimination makes sense.
  - a. Ohio throwback rule - Although Ohio does not tax Trusts, the state does have a throwback rule that taxes a limited amount of accumulated income in a Trust later paid out. Since the repeal of the federal throwback rule, the status of the Ohio throwback rule is in question. The Ohio throwback rule does depend on the throwback rules in IRC §665 for its definition. IRC §665 was not repealed and thus the potential issue is still out there. Thus it is still up in the air as to whether the Ohio throwback rule survives. Administration of this rule will be extremely difficult.

2. New rules for transfers to Foreign Trusts and definition of Foreign Trusts. (IRC §684).
  - a. The definition of a Foreign Trust has been expanded to include any Trust over which a foreign individual has investment decision authority. This could include a Trust Advisor. This will bring many more Trusts into the definition of a Foreign Trust. (IRC §7701(a)(30)E).
    - (1) Exceptions:
      - (a) Trusts that are Grantor Trusts (IRC §684(b));
      - (b) Where these Trust powers are created by and retained by the non-U.S. person who is the settlor; and
      - (c) Elections to continue to treat a trust as a U.S. Person - Notice 98-25.
    - b. The consequences of being a Foreign Trust:
      - (1) Settlor must check the boxes at the bottom of Schedule B of his or her personal tax return indicating that he or she is the grantor of or has powers over a Foreign Trust.
      - (2) Form 3520 must be filed for the Trust annually and Form 3520A must be filed by any person transferring property to the Trust in the year of the transfer.
      - (3) Transfers to the Trust or property in a Trust when a non-foreign Trust becomes a foreign Trust are deemed sold and the gain is taxed to the transferor. (IRC §684(c)).
        - (a) Former excise tax of 35% under IRC §1491 is repealed.
    - c. Reformation of Trust possible under one of several IRS notices.
  3. Special tax rules for the taxation of electing small business trusts (ESBT).
    - a. Tax consequences of being an ESBT - IRC Sec. 641(d).
      - (1) That portion of the trust consisting of stock in one or more S corporations is treated as a separate trust.
      - (2) The tax imposed on that separate trust is based on the highest marginal individual tax rate.
      - (3) The income from that separate share is not part of distributable net income.

- (4) Distributions with respect to that share do not carry out distributable net income and are not further taxed to the recipient beneficiary when paid. However, according to Notice 97-49, distributions are deemed out of DNI first to the extent of distributions.
  - (5) For purposes of determining alternative minimum tax (AMT) on this share of the trust the alternative minimum tax exemption shall be zero.
  - (6) That separate share's income shall be computed including the flow through items of income, expense, deduction and credit under IRC Sec. 1366 plus or minus any gain or loss from the disposition of stock in an S corporation less allocable state and local income taxes and administrative expenses attributable to any of the above two items.
  - (7) If the trust ceases to be an electing small business trust, any carryover or excess deduction of the separate trust may be used by the entire trust.
- 4. Repeal of tax on includable gain on appreciated property.
    - a. Under prior law, the gain on the sale of appreciated property within 2 years of contribution to a trust was taxable at the contributor's marginal tax rate. This rule has been repealed effective for sales or exchanges after August 5, 1997.
  - 5. Consistency rule - beneficiaries of any trust or estate and owners of any part of a foreign trust (IRC §6034A(c) and 6048(d)(5)).
    - a. Effective for returns of beneficiary and owners filed after August 5, 1997, Beneficiaries of trusts and estates must prepare their tax returns consistent with the K-1 or make a proper disclosure. Owners of foreign trusts must do the same. If the entity does not file a return, the beneficiary is required to file a notice of inconsistent treatment.
  - 6. 65-day rule extended to estates.
    - a. Previously, estates, although taxed like complex trusts, did not have the luxury of the 65-day rule applicable to complex trusts. Therefore, payments after the year end but within 65 days of the year end could not be treated as having been made as distributions to beneficiaries for the prior year. This rule has now been extended to estates. This makes sense given the new rule treating certain trusts as part of the estate after the death of the Grantor. This will be discussed below.
  - 7. Separate share rule extended to estates.
    - a. As with a 65-day rule, the separate share rule never applied to estates even though estates were taxed like complex trusts. As a practical matter, estates rarely have separate shares for income tax purposes. However, since certain Trusts will now be

includable on the estate's income tax return for a period of time after the decedent's death, the extension of the separate share rule to estates is a natural extension.

8. Executor and beneficiaries are considered related parties under IRC §267.
  - a. IRC §267 prescribes rules for related party transactions in certain situations. There are two situations where §267 comes into play. The first is when two parties that are related enter into a sale transaction. In this case, the parties are related and if there is a loss in the transaction, it is not immediately recognizable. Generally speaking, the loss is recognized when the related party sells the property later to a third party. The second situation is where the related parties use different accounting methods. An example would be where the estate is on the accrual method and the individual beneficiary is on the cash method. In this case, items which would be income to a cash method recipient but are deductible by an accrual basis payor may not be accrued by the payor until such time as the recipient (who is related) takes that amount into income. From a practical standpoint, the loss on the sale of assets between related parties is the one which will be most prevalent in the estate and beneficiary situation.
  - b. Until the Tax Act of 1997, estates and beneficiaries were not related parties. It is not unusual for a beneficiary to purchase assets from the estate either to provide liquidity to the estate or because the beneficiaries of the estate wanted to realign asset ownership. Since the estate receives a step-up in basis in the asset, there may be situations where the ultimate sale will produce a loss. Under the new rule, the loss will not be deductible by the estate for income tax purposes and the beneficiary purchaser may or may not later recognize that loss when that property is later sold.
  - c. In situations where a revocable trust becomes irrevocable upon death and the Executor and the Trustee treat the trust as being part of the estate, a distribution of property in kind to a beneficiary of the trust could be treated as a sale transaction at the election of the Trustee/Executor. If this is the case and if a loss is produced, the loss will not be deductible by the estate.
  - d. In a situation where the beneficiary purchases assets from the estate, if there is a loss that you desire to take on the estate's income tax return, one solution might be to hold off the sale until the buying beneficiary no longer has property to receive from the estate and is therefore no longer a beneficiary of the estate.
9. Tax treatment of pre-need funeral trusts.
  - a. Effective for tax years ending after August 5, 1997, at the election of the trustee, certain pre-need funeral trusts may pay tax on earnings rather than having it treated as a grantor trust. The trust must not have accepted more than \$7,000 (as indexed) in contributions for any individual. The Trust gets compressed tax rates and no personal exemption.
  - b. See Notice 98-6 for rules on making the election.

10. Election to treat revocable trusts as part of the estate (IRC §646).
  - a. For estates of decedents dying after August 5, 1997, at the election of both the Executor/trix, and the Trustee of the Trust, assets that are already in a Living Trust which are included in the gross estate for estate tax purposes, may be treated as being part of the estate for income tax purposes. This allows the Executor and the Trustee to file one Form 1041 for all the assets in the estate and the assets in the Trust until such time as six months after the final estate tax liability has been determined for the estate or if there is no Form 706 filing required, two years after date of death.
  - b. Presumably the assets in the Trust would be administered in accordance with the Trust document with regard to the payment of income and principal.
  - c. The election is made with the filing of the Form 1041 for the first year of the estate. The election must be filed by the due date of that return including extensions. The election is irrevocable.
  - d. By making this election, the income of the estate or trust or both can be reported on a fiscal year basis since estates can use a fiscal year whereas a Trust may not.
  - e. One negative to making this election is that in Ohio, the estate income would be subject to Ohio tax whereas Trust income would not.
  - f. Because of this change and in accordance with the discussion above, the 65-day rule, the related party rules between beneficiary and executor and the separate share rule have all been extended to estates and beneficiaries so as to bring the income tax treatment of the estate into virtual conformance with the income taxation of a complex trust.
  - g. Certain passive losses will be deductible in the first 2 years if the trust makes this election (IRC §469(i)(4)).

B. Planning.

1. The election to treat Trust property as part of the estate could be advantageous in several situations:
  - a. Where there is a desire to use a fiscal year to defer the recognition of income. This can be accomplished with an estate but not a Trust. There is at least one trade-off which is taxation by the State of Ohio.
  - b. If the estate has as one of its assets, stock of an S corporation, there may be an income tax advantage to having the S corporation income, taxed to the estate. One reason might be that the Trust, which holds the stock, may be designed as an ESBT taxed in the highest marginal tax bracket. If income of the S corporation is low, either because the company didn't make enough or because the date of death of the

owner requires a proration of income that allocates relatively low income to the estate or trust, then a lower income tax may be payable.

- c. If the trust is to become an ESBT and the time frame for making the ESBT election has passed, by treating the Trust property as part of the estate, you may buy yourself several years before the ESBT election is required.
- d. If you want to make an ESBT election over the Trust which holds the S corporation stock but you elect to include the income of the Trust in the estate's income tax return, you may make that election (according to informal discussions with the Internal Revenue Service National Office). Query - Whether an ESBT election over the S corporation stock could avoid Ohio taxation on the S corporation income while allowing the rest of the income to flow through to the estate's Form 1041 and have tax paid based on the estate's tax bracket?

## 2. Taxation of ESBTs.

- a. As stated above, an ESBT is taxed at the Trust level, in the highest marginal tax bracket of an individual, but only on that portion of the Trust which is made up of the S corporation stock. Therefore, if distributions are made from the S corporation to the ESBT and if the Trust invests that money, the income from the investments outside of the S corporation are taxed under the normal trust rules. However, income accumulated in the S corporation and invested there, throwing off interest dividends and capital gains, will be taxed at the Trust level at the highest marginal rate. In situations where everyone involved is in the highest marginal tax bracket, accumulating the money in the S corporation and investing it there may be advantageous because of the ability to avoid Ohio tax. If marginal tax brackets are somewhat lower, it may be more advantageous for the S corporation to distribute cash to the Trust and have the Trust do the investing.
- b. Generally speaking, state and local taxes are an itemized deduction for an individual. In situations of high income, itemized deductions may be phased out or state and local taxes may be limited or not deductible at all because of alternative minimum tax. Income accumulated in the Trust may not be subject to Ohio tax at all but may be subject to city tax. In addition, the law may change and Ohio tax may apply. In either case, it may be more advantageous for the state and local tax to be paid at the Trust level than to have income flow through to an individual beneficiary of the Trust and have that individual pay state and local tax. Remember that Trusts are subject to alternative minimum tax and so a delicate balance must be struck.

- 3. Paying Out Capital Gains. Sometimes, because of the alternative minimum tax, the beneficiary and/or the Trust will be an alternative minimum tax. If this is the case, certain itemized deductions will go unused and other deductions may be usable only in a relatively low tax bracket. It is usually advisable to find the point in which there is no alternative minimum tax. Where capital gains are prominent in the Trust, there is a danger that alternative minimum tax will apply. Where capital gains are

prominent on the individual's tax returns, the same is true. It may be advantageous to pay out capital gains from a Trust and have them taxed to the beneficiary.

Where the trustee has the power to allocate capital gain as between income and principal and the trustee actually pays out the capital gain, it may be possible to find the cross-over point.

4. **Separate Share Rule.** Where a Trust or estate by its terms splits into separate shares for the benefit of more than one income beneficiary, IRC §663(c) and Treas. Reg. §1.663(c), indicate that the capital gain is taxed in the Trust as if it was one Trust. If one Trust tax return is filed, then the K-1s reflect the income of each separate share. Where the Trust by its terms splits into more than one Trust, then the corpus is split and capital gains and accumulated income are taxed as if there are separate Trusts. It is appropriate for each Trust to get its own federal identification number and file its own tax return. Some practitioners erroneously treat separate share trusts as separate trusts. Treas. Reg. §1.663(c)(1)(b).
5. **Stub Years.** There is nothing that says that the first or last tax year of an estate must be 12 months. Some practitioners have a natural inclination to select a fiscal year which is 12 months after the date of death. Often, because many entities are now on a calendar year, a January 31st year end for an estate is very appropriate. This can provide for an 11-month deferral of income from entities such as partnerships, LLCs and S corporations. Distributions can be made from the estates to the beneficiaries or to the Trusts that are beneficiaries of the estate before the January year end and the income will be taxed in the next calendar year of the beneficiary. If desired, distributions can be made out of the estate in January to bring the estate's income tax down and that income will not be taxed until the next calendar year.
6. **Pro-rating income on pass-through entities.**
  - a. On death of a partner or shareholder.
  - b. Upon contribution of stock or units to a trust.
  - c. Upon funding of a trust by an estate.