A SIMPLE ESTATE, A TANGLED WEB: FIDUCIARY INCOME TAX IN REAL LIFE

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DISCLAIMER

This presentation is for informational purposes only and is not intended to constitute legal, tax, or accounting advice.

Recipients should consult their own advisors before making decisions based on the material presented.

INTRODUCTION – GOALS

1. Introduce key fiduciary income tax concepts in a practical context.
2. Walk through a simple estate administration.
3. Highlight common pitfalls and complexities.
4. Focus area for improving real-world estate administration skills.

'EITHER/OR' TAXPAYER

- Estates and trusts are 'either/or' taxpayers.
- Either the estate/trust pays the income tax or the beneficiary does.
- Allocation depends on income character and the governing instrument.
- Subchapter J governs who bears the tax burden.

DISTRIBUTABLE NET INCOME (DNI)

- DNI determines the amount of income taxed to beneficiaries.
- Certain distributions carry out DNI; others do not.

KENAN GAINS – CONCEPT OVERVIEW

- Occurs when appreciated property is used to satisfy pecuniary gifts.
- Treated as a deemed sale; estate/trust incurs tax.
- Not reported on a 1099 – invisible unless tracked carefully.

THE ESTATE PLAN

- Decedent: Wendy Dinero, died 07/01/2021.
- Spouse: Hank Dinero - receives all TPP, including a Rembrandt painting
- Pecuniary Gift: $50,000 to friend Fiona.
- Marital Deduction Gift: Formula gift to Marital Trust designed to minimize federal estate tax liability (Date of Distribution valuation of funding).
- Residuary Estate: Divided equally between daughter Debra Smith and son Sam Jones (children from prior marriage).

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ADMINISTRATIVE EXPENSES

None of the administrative expenses have been deducted on the estate tax return.

Therefore, they are available for income tax deduction.

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FISCAL YEAR END ELECTION

- Fiscal year end chosen: 01/31/2022
- Estate: elects by filing return
- Revocable Trust: must make §645 election
- Alter timing of income reporting for beneficiaries
- Practical (simplify administration)

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FISCAL YEAR RULES – MAXIMUM LENGTH & START DATE

- Fiscal year cannot exceed 12 months.
- Start date: Always date of death.
- Income on date of death reported on final Form 1040.
- Example: Decedent dies 06/30 → longest fiscal year can end 05/31 next year.

YEAR 1 – RECEIPTS (07/01/2021 – 01/31/2022)

Category	Amount ($)
Dividends	40,000
Taxable Interest	20,000
Tax-Exempt Interest	30,000
Long-Term Capital Gain	20,000

YEAR 1 – DISBURSEMENTS (07/01/2021 – 01/31/2022)

Executor's Commissions	(15,000)
Attorney's Fees	(15,000)

SPECIFIC DEVISE – REMBRANDT PAINTING

- Distributed: 12/01/2021
- Date of Death Value: $1,000,000 → Distribution Value: $1,500,000
- Income Tax Impact: None
- Specific devise does not carry out DNI
- Not subject to Kenan gains

PECUNIARY GIFT – 50K TO FRIEND

- Distribution Date: 12/01/2021
- Property: ABC Stock
- Date of Death Value: $20,000 → FMV at distribution: $50,000
- Income Tax Impact: Kenan gain of $30,000 long-term capital gain
- DNI Impact: None (pecuniary gift fixed at death)

MARITAL DEDUCTION FORMULA GIFT

- Distribution Date: 12/01/2021
- Property: XYZ Corp Stock
- Date of Death Value: $20,000 → Distribution Value: $40,000
- Income Tax Impact: Kenan gain of $20,000 long-term capital gain
- DNI Impact: Yes (pecuniary gift not fixed at death)

RESIDUARY GIFT – SON (CASH)

- 10/20/2021 → $20,000 income cash to Son
- 01/15/2022 → $20,000 principal cash to Son
- No Kenan gain (no appreciated property; residuary gift)
- DNI Impact: Yes, distribution carries out DNI

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NON-TRACING RULE

- Fiduciary accounting: income vs. principal exists for bookkeeping
- Tax perspective: non-tracing rule applies
- Any distribution can carry out DNI
- Key for Subchapter J: Was a distribution made?

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RESIDUARY GIFT – DAUGHTER (PDQ STOCK)

- Distribution Date: 12/01/2021 → Daughter
- Property: PDQ Stock
- Date of Death Value: $40,000 → FMV at Distribution: $80,000
- Income Tax: No Kenan gain (residuary gift)
- DNI: Yes, carried at lower of basis or FMV (no §643(e) election)

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YEAR 1 TASKS

- Calculate taxable income of the estate
- Include all income, deduct expenses, include Kenan gains
- Determine tax consequences for beneficiaries
- Allocate DNI carried out
- Identify taxable distributions

OVERVIEW OF ANALYTICAL FRAMEWORK

- **Fiduciary Accounting Income (FAI):** Determine the amount of fiduciary accounting income under the governing instrument and state law. For a simple trust, this is the income distributable to the income beneficiary.
- **Tentative Taxable Income (TTI):** Compute taxable income before considering the distribution deduction.
- **Distributable Net Income (DNI):** Determine the estate's DNI – the ceiling on the amount that can be taxed to beneficiaries.
- **Distribution Deduction (DD):** Compute the amount deductible by the estate/trust for income required or actually distributed.
- **Estate/Trust Taxable Income (TI):** Determine the estate's final taxable income after the distribution deduction.
- **Beneficiary Taxable Income (TI):** Determine the amount and character of income taxed to each beneficiary.

STEP 1 – FIDUCIARY ACCOUNTING INCOME (FAI)

Category	Income	Principal
Dividends Received	40,000	
Taxable Interest Received	20,000	
Tax-Exempt Interest Received	30,000	
Long-Term Capital Gain		20,000
Kenan Gain ABC → FRIEND		30,000
Kenan Gain XYZ → MT		20,000
Executor's Commission		(15,000)
Attorney's Fees		(15,000)
FAI	90,000	

DISTRIBUTIONS TABLE

Asset	Husband	Friend	Marital Trust	Son	Daughter
ABC Corp. Stock		50,000			
Painting	$1MM				
XYZ Corp.			40,000		
Cash Income				20,000	
Cash Principal				20,000	
PDQ Corp.					40,000

STEP 2 – TENTATIVE TAXABLE INCOME (TTI)

	Amount ($)	DNI Impact
Dividends Received	40,000	+
Taxable Interest Received	20,000	+
Tax-Exempt Interest Received	30,000	+
Long-Term Capital Gain	20,000	–
Kenan Gain (stock to F)	30,000	–
Kenan Gain (partial funding MT)	20,000	–
Total Income	160,000	
Tax-Exempt Interest (Exclusion)	(30,000)	
Gross Income	130,000	
Deduction in Lieu of Personal Exemption	(600)	
Executor's Commission Paid	(10,000) (1/3 allocated to Tax Exempt 30,000/90,000)	
Attorney's Fees Paid	(10,000) (1/3 allocated to Tax Exempt 30,000/90,000)	
TTI (Step 2)	109,400	

STEP 3 – CALCULATE DISTRIBUTABLE NET INCOME (DNI)

Category	Amount ($)
TTI	109,400
(+) Deduction in Lieu of Personal Exemption	600
(–) Capital Gains	(70,000)
(+) Net Tax-Exempt Interest	20,000
DNI (Step 3)	60,000

DNI RECAP

Category	Dividends ($)	Taxable Interest ($)	Tax-Exempt Interest ($)	Total ($)
Revenues	40,000	20,000	30,000	90,000
Indirect Expenses				
Executor Commissions	(10,000)	–	(5,000)	(15,000)
Attorney's Fees	(10,000)	–	(5,000)	(15,000)
Net Revenues	20,000	20,000	20,000	60,000

DISTRIBUTION DEDUCTION (STEP 4)

DNI: 60,000

Net Tax-Exempt Interest: (20,000)

DD tentative: 40,000

DD final: 40,000 (after actual deductions)

TAXABLE INCOME (TRUST) – STEP 5

Category	Amount ($)
TTI (Step 2)	109,400
DD (Step 4)	(40,000)
TI (Step 5)	69,400

BENEFICIARY DISTRIBUTION BREAKDOWN

Beneficiary	Total Distribution ($)	Dividends ($)	Taxable Interest ($)	Tax-Exempt Interest ($)	Total Income ($)
Marital Trust (MT)	40,000	6,667	6,667	6,667	20,000
Son (S)	40,000	6,667	6,667	6,667	20,000
Daughter (D)	40,000	6,667	6,667	6,667	20,000
Totals	**120,000**				

§662(C) TIMING

Per §662(c) and Treas. Reg. §1.662(c)-1, income includible by beneficiaries in year estate's tax year ends.

Income reported on beneficiaries' 2022 income tax returns

FINAL POINTS

- Excess Deductions
- Capital Losses
- Net Operating Losses

CONCLUSION

THANK YOU!

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