FIDUCIARY INCOME TAX: ISSUES AND OPPORTUNITIES

Milwaukee Estate Planning Forum
November 4, 2015

Attorney Philip J. Miller
Whyte Hirschboeck Dudek S.C.

555 East Wells Street, Suite 1900
Milwaukee, Wisconsin 53202-3819
(414) 978-5422
pmiller@whdlaw.com
www.whdlaw.com

I. INTRODUCTION

The reporting and payment of fiduciary income taxes can become a task done by rote, especially in this modern era in which the return preparation is often done via data entry into a software program instead of filling out a return line by line. This presentation takes a look at issues and provisions that may often be overlooked, resulting in lost opportunities for tax savings in some cases, and costly mistakes in others.

II. ISSUES RELATED TO INCOME

A. Distribution of Property In Kind

1. Under §643(e) IRC, property distributed to beneficiaries in kind has a basis in the hands of the beneficiary equal to the lesser of the basis in the hands of the estate or trust, or the fair market value of the property at the time of the distribution.

    a. There is an adjustment for the amount of any gain or loss recognized by the estate or trust on the distribution.

    b. §643(e) does not apply to distributions in satisfaction of a specific bequest, nor to distributions which qualify for the charitable income tax deduction under §642(c) IRC.

2. An election is available under §643(e)(3) to recognize gain and treat the distribution as if it were a sale to the beneficiary for fair market value.

3. The election probably should not be made if the property will be held until the death of the beneficiary and qualify for a step-up in basis at that time.

4. When to consider the election:

    a. The estate or trust has losses or deductions that can be offset by the gains. Remember, all beneficiaries will be taxed on the recognized gain when the property is sold and no election was made, but not all beneficiaries will benefit from excess deductions on termination, and those that do will only benefit to the extent that their share exceeds 2% of adjusted gross income.

    b. The election can be used to increase the amount of the distribution deduction and avoid trapping income in the trust. Consider the following example from BNA:

        (1) A trust has DNI of $3,000, comprised of ordinary income. The trustee distributes appreciated property that has an adjusted basis of $1,000 and a fair market value of $2,500. The beneficiary will have a basis of $1,000 and will be treated as having received $1,000 of DNI, all of which is ordinary income. The trust will have a distribution deduction of $1,000, leaving $2,000 of ordinary income in the trust.

        (2) If a §643(e) election is made, the beneficiary will have a basis of $2,500 and will be treated as having received $2,500 of DNI, all of which is ordinary income. The trust has a distribution deduction of $2,500, leaving only $500 of ordinary income in the trust, but will now also recognize $1,500 of capital gain.

        (3) If the beneficiary is in a lower bracket than the trust or the trust may be able to offset the capital gain with losses that are not available to the beneficiary, the election will result in an overall tax savings.

5. If the property distributed will be subject to depreciation in the hands of the beneficiary, then the gain recognized by the trust will be ordinary income under §1239 IRC.

6. The §643(e) election also applies to losses, but §267 prevents an estate or trust from recognizing losses on a sale to a beneficiary. With or

without an election, the distribution deduction will be limited to the fair market value of the property, and the basis will be the same as the basis for the estate or trust. Accordingly, an estate or trust is better off selling loss property to an unrelated third party and recognizing the loss.

B. Income in Respect of a Decedent

1. Income in respect of a decedent ("IRD") is income receivable by the estate, a trust, or an individual after the death of a decedent, which would have been taxable income to the decedent if it had been received prior to the decedent's death. §691 IRC.

    a. Income in respect of a decedent retains its character as taxable income following the death of the decedent, and is recognized as taxable income by the person who receives it following the death of the decedent. It does not qualify for a step-up in basis under §1014 due to §1014(c).

    b. Examples include interest accrued to date-of-death, income from employment or self-employment, accrued vacation pay, dividends declared prior to death but payable after death, and IRAs and retirement plan benefits.

2. The opposite of income in respect of a decedent are deductions in respect of a decedent ("DRD"). Deductions in respect of a decedent are items that would have been deductible by the decedent had the decedent lived, which remain deductible by the estate of the decedent following his or her death. Common examples include state and local income taxes, property taxes, and mortgage interest.

3. Logic would dictate that the decedent's estate receive an estate tax deduction for the income tax that will be payable on IRD. Instead, §691(c) provides for the opposite; the recipient of IRD is entitled to an income tax deduction for the federal estate tax paid on net IRD.

    a. "Net" IRD means all items of IRD net of DRD.

    b. The income tax deduction for estate tax paid on net IRD is determined by recomputing the federal estate tax without including net IRD in the taxable estate. The difference between this amount and the actual federal estate tax paid is the federal estate tax on net IRD. It is then multiplied by a fraction, the numerator of which is the amount of IRD being reported on the

return in question, and the denominator of which is the total amount of net IRD.

c. The deduction is a miscellaneous itemized deduction not limited to the 2% floor.

4. If property includable in the decedent's gross estate is subject to a contract for sale at the time of the decedent's death but the sale has not yet closed, the property is not entitled to a basis adjustment and the gain is IRD. *Trust Co. of Georgia v. Aubrey C. Ross*, (1967, CA5) 21 AFTR 2d 311, 392 F2d 694, 68-1 USTC ¶9133, cert. den. (1968, S. Ct.) 393 US 830, 21 L Ed 2d 101; Rev. Rul. 78-32, 1978-1 C.B. 198. However, if substantive preconditions or contingencies exist at the time of death which could affect the completion of the transaction, then an eventual sale by the estate or trust will be treated as a post-death sale following a basis adjustment under §1014 IRC. *Napolitano, Ernest G. Est.*, (1992) TC Memo 1992-316, RIA TC Memo ¶92316 , 63 CCH TCM 3092; IRS Letter Ruling 200744001.

5. IRD should not be used to satisfy a pecuniary marital deduction formula or other pecuniary bequest, as doing so will accelerate the recognition of all of the income.

6. Where possible, IRD should be allocated to a marital deduction trust instead of a credit shelter trust to avoid reducing the credit shelter amount by the income tax that will be paid, or to a charitable bequest so that the beneficiary is one who will not be taxed on the income.

7. Estate tax return preparers should remember to provide beneficiaries with the information necessary to calculate the deduction, and income tax return preparers whose clients receive K-1s from an estate or trust, or payments from an inherited IRA or retirement plan should think to ask whether the deduction is available.

C. Trapping Distributions

1. Trapping distributions are distributions received by one trust from an estate or another trust that carry out DNI, but which constitute principal of the recipient trust. For example, an estate makes a funding distribution to a revocable trust that carries out DNI. Trapping distributions can also occur when a revocable trust makes funding distributions to a marital trust, credit shelter trust, or other subtrust.

2. Even in the case of a "simple" trust, marital trust or other trust that is required to distribute all income annually, the DNI in the distribution received is not accounting income, so it is not required to be distributed to the beneficiary.

3. Trapping distributions can be avoided through timing, or by using capital losses in the distributing estate or trust or the recipient trust to offset the income.

4. Trapping distributions are not necessarily all bad, in that even with a simple trust they allow income to run through the brackets more than once. Because of the compressed income tax rates that apply to trusts and estates, trapping distributions really become disadvantageous once the trapping trust enters a bracket that is higher than that of the beneficiary.

5. Even though trapped DNI is not distributable to a beneficiary as income, the character of this DNI can affect the character of the DNI received by the beneficiary. In *Van Buren v. Commissioner*, 89 T.C. 1101 (1987), an estate generated $110,000 of DNI made up of dividends, taxable interest, tax exempt interest, and other income. The estate made a trapping distribution to a testamentary trust which had generated mostly tax exempt income.

    a. The beneficiary claimed that the DNI she received from the testamentary trust was made up of the DNI she was entitled to receive, ie. the tax exempt interest.

    b. In ruling that the beneficiary received a proportionate part of all items of income comprising the DNI of the trust, the Tax Court stated that the concept of DNI was introduced precisely to avoid having to trace the source of trust distributions.

D. Savings Bond Interest

1. Interest earned on Series E and EE Savings Bonds is required to be recognized at the earlier of the time the bonds are redeemed, disposed of in a taxable transaction, or reach final maturity.

2. When a bond owner dies, the interest is IRD that will eventually be recognized by a co-owner, P.O.D. beneficiary, estate, or estate beneficiary.

3. At the option of the person filing the deceased owner's final income tax returns (usually the Personal Representative), the interest may be recognized on the decedent's final return. Electing to recognize the interest on the decedent's final return is advantageous when the decedent dies early in the year or his/her income puts him/her in a bracket that is less than that of the estate or its beneficiaries.

E. Treating Capital Gains as Income

1. For fiduciary accounting purposes, capital gains are normally allocated to principal. §701.1118, Wis. Stats.

2. For fiduciary income tax purposes, capital gains are taxable to the estate or non-grantor trust generating them, except for the final year in which all gain or loss is passed through to the beneficiaries. §643(a)(3) IRC.

3. §701.1108, Wis Stats., provides that "[u]nless prohibited by the will or trust instrument, a fiduciary may cause gains from the sale or exchange of estate or trust property, as determined for federal income tax purposes, to be taxed for federal income tax purposes as part of a distribution of income that has been increased by an adjustment from principal to income under s. 701.1104, of a unitrust distribution, of a fixed annuity distribution, or of a principal distribution to a beneficiary."

   a. §701.1104, Wis. Stats., authorizes a trustee to adjust between principal and income under certain circumstances.

   b. §701.1106, Wis. Stats., allows a trust to be converted to a unitrust under certain circumstances.

   c. A trust may already be drafted as an express unitrust or annuity trust.

   d. A trust may contain language authorizing a Trustee to allocate capital gains to income, but that is not required under §701.1108.

4. Treasury Regulation §§1.643(b)-1 and (a)-3 address the circumstances under which capital gains may be allocated to income and included in the computation of distributable net income, or "DNI."

   a. §1.643(b)-1 provides in part that "an allocation of amounts between income and principal pursuant to applicable local law

will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. . . . Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. . . . In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made *either* pursuant to the terms of the governing instrument *and* applicable local law, *or* pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law." (emphasis added).

b. Examples of trust language authorizing an allocation of capital gains to income:

(1) "The Trustee may allocate realized short-term capital gains and/or realized long-term capital gains to trust income or to trust principal, and such gains shall be included in the distributable net income of the trust to the extent that such gains are allocated to income, or if such gains are allocated to principal, to the extent that they are distributed to the trust beneficiary or used by the Trustee in determining the amount distributable to the beneficiary, or treated consistently in the Trustee's accounting and income tax returns as a part of a distribution to the beneficiary."

(2) "The Trustee is authorized to allocate receipts or expenses between income and principal, except where specifically prohibited by law or by other provisions of this instrument."

c. Under §1.643(a)-3(b), gains from the sale or exchange of capital assets are included in <u>distributable net income</u> to the extent they are, pursuant to the terms of the governing instrument *and* applicable local law, *or* pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law *or* by the governing instrument if not prohibited by applicable local law):

(1) allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to subparagraph §1.643(a)-3(b));

(2) allocated to corpus but treated consistently by the Trustee on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) allocated to corpus but actually distributed to the beneficiary or utilized by the Trustee in determining the amount that is distributed or required to be distributed to a beneficiary.

d. Things to note:

(1) Capital gains do not have to be allocated to income to be included in DNI.

(2) Allocations to income in a unitrust and allocations to principal that are treated as part of a distribution to a beneficiary require that the Trustee act consistently in the Trustee's treatment of capital gains.

e. Regulation §1.643(a)-3(e) contains 14 examples of the inclusion of capital gains in DNI under different fact situations.

5. Planning Opportunities

a. Allocating capital gains to income or converting to a unitrust can boost the income distributable to an income-only beneficiary who cannot receive discretionary distributions of principal under the trust instrument.

b. Even where discretionary distributions of principal are authorized, allocating capital gains to income or including them in DNI, or converting to a unitrust, allows the Trustee to remain impartial as between income beneficiaries and remainder beneficiaries, and to account for the total return of the trust.

c. Including capital gains in DNI reduces the net investment income of the trust and passes capital gains out to beneficiaries who have a higher threshold before the net investment income tax applies.

III. ISSUES RELATED TO DEDUCTIONS

A. Deductions Subject to the 2% Floor Versus Those That Are Not

1. §67 IRC provides for miscellaneous itemized deductions, but only to the extent that the aggregate of such deductions exceeds 2% of adjusted gross income.

2. §67(e) provides that the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except 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, ie. they are not subject to the 2% floor.

3. An issue that often arises concerns the phrase "which would not have been incurred if the property were not held in such trust or estate."

4. The Supreme Court addressed this issue as it applies to investment advisory fees in *Knight v. Commissioner*, 128 S. Ct. 782, 790 [101 AFTR 2d 2008-544] (16 Jan. 2008).

   a. Chief Justice Roberts, writing for a unanimous Court, stated that "[t]he statute does not ask whether a cost was incurred because the property is held by a trust; it asks whether a particular cost 'would not have been incurred if the property were not held in such trust,' §67(e)(1)."

   b. Put another way, would the costs commonly or customarily be incurred by an individual?

   c. The Trustee unsuccessfully argued that the investment advisory fees he incurred were incurred because of his fiduciary duties under Connecticut's Uniform Prudent Investor Act. The Court rejected this claim in finding that the prudent investor rule looks to what an individual investor would do, and individuals do routinely hire investment advisors.

d. While the *Knight* decision only deals with investment advisory fees, its analysis is helpful in analyzing the deductibility of other costs.

5. Proposed Treasury Regulations had been issued in 2007 on this subject, but they were not consistent with the Court's decision in *Knight*. In Notice 2008-32, 2008-11 I.R.B. 593, the Service issued interim guidance, saying that for tax years beginning before January 1, 2008 taxpayers would not be required to determine the amount of "Bundled Fiduciary Fees" that are subject to the 2% limitation. In Notice 2008-116, 2008-52 I.R.B. issued on December 29, 2008, the Service announced that this interim guidance was extended for tax years that begin before January 1, 2009, because regulations would not be issued in time to be applicable to the 2008 tax year. In Notice 2010-32, 2010-16 I.R.B. issued on April 19, 2010, the Service announced that this interim guidance was extended for tax years that begin before January 1, 2010, and in Notice 2011-37, 2011-20 I.R.B. issued on May 16, 2011, the Service announced that this interim guidance is extended for all tax years that begin before final regulations are issued under §1.67-4.

   a. "Bundled Fiduciary Fees" are defined in the Notice as investment advisory costs and other costs subject to the 2% floor under §67(a) IRC that are integrated as part of one commission or fee paid to the trustee or executor.

   b. The Notice applies to estates and non-grantor trusts.

6. On September 6, 2011, new proposed regulations were issued, and on May 9, 2014 the regulations were made final.

   a. With respect to investment advisory fees, Reg. 1.67-4(b) provides that fees for investment advice that are commonly or customarily incurred by a hypothetical individual investor are subject to the 2% floor, while incremental costs beyond the amount that normally would be charged to an individual investor are not subject to the 2% floor. Reg. 1.67-4(c) provides that if the estate or non-grantor trust pays a single fee, commission, or other expense, including attorney's fees and accountant's fees, for costs that are subject to the 2% floor and those that are not, the single fee, commission, or expense must be allocated between those subject to the 2% floor and those that are not.

b. The Regulations goes beyond investment advisory fees to address costs and expenses in general. Reg. 1.67-4(a) provides that a "cost is subject to the 2-percent floor to the extent that it is included in the definition of miscellaneous itemized deductions under section 67(b), is incurred by an estate or non-grantor trust, and commonly or customarily would be incurred by a hypothetical individual holding the same property."

c. 1.67(b) says that in analyzing a cost to determine whether it commonly or customarily would be incurred by a hypothetical individual owning the same property, it is the type of product or service rendered rather than the description of the cost of that product or service, that is determinative.

(1) Legal fees related to the preparation and filing of probate documents, and court appearances are not subject to the 2% floor, while fees and costs related to the defense of a claim against the estate are subject to the 2% floor.

(2) Costs that are incurred by an owner of property simply by reason of being an owner are subject to the 2% floor.

(3) The cost of preparing estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual tax returns are not subject to the 2% floor, while the cost of preparing other individual income tax returns, gift tax returns, and other tax returns is subject to the 2% floor.

7. Other deductions that are subject to the 2% floor:

a. Safe deposit box fees

b. Other expenses under §212 IRC

8. Other deductions that are not or should not be subject to the 2% floor:

a. Income distribution deduction under §651 or §661 IRC

b. Personal Exemption under §642(b) IRC

(1) $600 for an estate

(2) $100 for a (complex) trust

(3) $300 for a (simple) trust required to distribute all of its income currently

c. §691(c) deduction for the federal estate tax paid on income in respect of a decedent.

d. Personal Representative and Trustee fees

e. Fiduciary's bond premium

f. Additional insurance expenses because property is held by an estate or trust rather than by an individual

B. Where to Take Deductions

Description	Code §	706 and 1041	706 or 1041 or split	706 or 1040	706 only
trade or business expenses	162	X			
interest	163	X			
taxes	164	X			
expenses for the production or collection of income	212	X			
expenses for the management, conservation, or maintenance of property held for the production of income	212	X			
expenses in connection with the determination, collection, or refund of any tax	212	X			
deductible alimony	215	X			
Estate administration expenses	642(g)		X		
medical expenses of the decedent paid within one year	213(c)			X	
funeral expenses	2053(a)				X
casualty or theft losses not compensated by insurance	165(c)(3)	X			

C. Medical Expenses

1. §2053 IRC allows a deduction for estate tax purposes of certain debts and expenses incurred by a decedent prior to death which remained unpaid at the time of the decedent's death.

2. Some of these constitute "deductions in respect of a decedent," or DRD, which can be deducted both on the estate tax return and on the income tax return of the estate when they are actually paid. Examples include real estate taxes, interest, and trade or business expenses.

3. Medical expenses stand alone in that the Personal Representative may elect to deduct medical expenses paid within one year of the date of death on *the decedent's* final income tax return.

4. Medical expenses are not DRD, so this is an either/or election. A Personal Representative electing to deduct medical expenses on the decedent's final income tax return must attach a statement to the return indicating that the expenses will not be deducted on the estate tax return.

5. Medical expenses are only deductible for income tax purposes to the extent that they exceed 7.5% of adjusted gross income.

   a. Under the current rate structure, they should always be taken as an estate tax deduction if a federal estate tax is actually payable.

   b. Even a decedent who normally could not deduct medical expenses from year to year may get a benefit from the deduction on his/her final return if his/her death was earlier in the year so that income is less, and/or if the expenses are higher than normal because of a final illness.

6. Just as during life, medical expenses are not deductible if they were paid from the decedent's MSA or health savings account.

IV. OTHER ISSUES

A. Selection of Fiscal Year

1. §644 IRC requires trusts to be on a calendar year, except for certain tax exempt or charitable trusts.

2. §645 IRC provides an exception for a qualified revocable trust that elects to be treated as part of the deceased grantor's estate.

   a. "Qualified revocable trust" means any trust treated as a grantor trust under §676 IRC.

   b. The election must be made by the Personal Representative (if any) and Trustee.

   c. An election is good for two years after the date of the decedent's death if no federal estate tax return is required to be filed, or the date which is six months after the date of the final determination of federal estate tax liability if a federal estate tax return is required to be filed (generally, the date that is one year after the date on an Estate Tax Closing Document or audit settlement agreement).

   d. The election must be made by the due date (including extensions) of the first taxable year of the estate, and is irrevocable once made.

3. Reasons for selecting a fiscal year / making the §645 election:

   a. Where there is a probate estate and a qualified revocable trust, combining the reporting lessens administrative expenses (one set of returns versus two), although for larger estates this must be balanced with the loss of the estate as a separate, intermediate taxpayer.

   b. Selecting a fiscal year allows a small estate or trust to file one first and final set of fiduciary income tax returns and thereby lessen administrative expenses.

   c. Extending the length of the estate's or trust's first tax year into the next calendar year defers the payment of income taxes by the estate or trust, or its beneficiaries. Beneficiaries recognize DNI in the calendar year in which the fiscal year of the estate or trust ends.

      (1) If a qualified revocable trust adopts a calendar year, distributions carrying out DNI in 2015 will be reportable by the beneficiaries on their 2015 income tax returns, and any tax due will be payable on April 15, 2016.

(2) If the same qualified revocable trust makes a §645 election and adopts a fiscal year that ends in 2016, distributions carrying out DNI in 2015 will be reportable by the beneficiaries on their 2016 income tax returns, and any tax due will be payable on April 17, 2017.

d. Selecting a short initial year can also defer the payment of income taxes, and minimize the income taxable to beneficiaries. The typical tax year end for the estate or trust of a decedent who dies in January is December 31st. By selecting a fiscal year end of January 31st, the estate or trust will minimize the income carried out to beneficiaries in the first year, defer the payment of taxes into the next calendar year, and create a longer time period in which the estate or trust will incur administration expenses which may be used to offset income.

e. Selecting a short initial year will help spread income evenly over two tax years. For estates or trusts which will deduct administration expenses on the estate tax return and have little or no deductions to offset income, selecting a fiscal year part way through the calendar year will lower the amount of income reportable on the first year's return, and possibly on the second year's return as well. Furthermore, the estate or trust will likely be in a better position to make distributions in the second year.

B. 65 Day Election

1. An election is available to estates and trusts under §663(b) IRC to treat distributions made within the first 65 days of a taxable year as being made in the prior taxable year.

2. The election must be made by the deadline for filing the return in question, including extensions.

3. An election becomes irrevocable after the last day for making it (Treas. Reg. §1.663(b)-2(a)(1),(2)), meaning that an election can be revoked if revocation is made prior to the time for filing the return.

4. The election can be made even if no return is required to be filed. In such cases, the election is made by filing a statement with the Internal Revenue Service office where the return would be filed (Treas. Reg. §663(b)-2(a)(2)).

5. The election does not need to be made for all distributions made in the first 65 days

6. The amount for which the election may be made is limited by the Regulations to the greater of fiduciary accounting income for the prior year or distributable net income for the prior year, reduced by payments made, credited, or required to be distributed in the prior year. See Treas. Reg. §1.663(b)-1(a)(2)(i).

7. When to consider making the election:

    a. The trust instrument requires that fiduciary accounting income be distributed to the beneficiary annually (eg. marital trust) and the trustee is unable to determine fiduciary accounting income by the end of the year

    b. The income beneficiaries are in a lower bracket than is the estate or trust and the fiduciary wants to increase the income distribution deduction

    c. The income beneficiaries have losses which can be used to offset income and the estate or trust does not

C. Estimated Tax Payments and Withholding

1. Trusts are required to make estimated tax payments. Estates and revocable trusts are required to make estimated tax payments for taxable years ending two years or more after the date of the decedent's death (generally, starting in the third year of the estate or revocable trust). §6654 IRC.

2. Federal estimated payments are required if the estate or trust expects to owe $1,000 or more after withholding and credits and it expects its withholding and credits to be less than the smaller of 90% of the tax shown on its return for the year or 100% of the tax shown on its prior year return.

3. Care should be taken to make sure that estates and trusts make estimated payments when required. Some inter-vivos irrevocable trusts will begin making estimated payments after their first tax year, but others, such as life insurance trusts, may go many years before they generate the income required to trigger estimated payments.

4. §643(g) allows a trustee of a trust that makes estimated tax payments to treat all or any portion of such payments as having been made by a beneficiary or beneficiaries.

   a. The election is made on Form 1041-T, Allocation of Estimated Tax Payments to the Beneficiaries, and may be made up to 65 days after the end of the taxable year.

   b. The amount for which the election is made is treated as an amount properly paid or credited to the beneficiaries on the last day of the trust's taxable year. Accordingly, it may carry out DNI.

   c. The §643(g) election is helpful to the trustee of a discretionary trust that may make larger distributions in some years than others, thereby creating a larger income distribution deduction. It can also be helpful in the final year of a trust where all income passes out to the beneficiaries.

5. §643(d) addresses the allocation of backup withholding between an estate or trust and its beneficiaries. If withholding occurs for an estate or trust, §643(d) allocates the tax withheld between the estate or trust and the beneficiaries on the basis of their respective shares of any such payment taken into account under Subchapter J. §643(d)(2) treats the beneficiaries' shares as a deemed distribution to the beneficiary.

6. Wisconsin requires estimated tax payments if the amount due will be $200 or more after withholding and credits. Wisconsin provides the same two year exemption for estates and revocable living trusts funded on the death of the grantor.

7. A trust or estate that has one or more beneficiaries who are nonresidents of Wisconsin is required to withhold tax on the income allocable to the nonresident beneficiaries.

   a. A nonresident beneficiary includes an individual who is not domiciled in Wisconsin; a partnership, limited liability company, or corporation whose commercial domicile is outside Wisconsin; and an estate or trust that is nonresident under §71.14(1) to (3m), Wis. Stats.

   b. Exceptions apply for beneficiaries who are exempt from Wisconsin tax and beneficiaries whose only Wisconsin income

is that attributable to the estate or trust, and that amount is less than $1,000.

c. Form PW-1 is used to pay the withholding and is due with payment by the 15th day of the 4th month following the close of the trust's or estate's taxable year. It must be filed and payment must be made by electronic means unless a waiver applies or electronic filing and payment presents an undue hardship.

D. Net Investment Income Tax

1. §1411 IRC imposes a Net Investment Income Tax ("NIIT") on estates and trusts to the extent that they have undistributed net investment income or adjusted gross income (AGI) exceeding the dollar amount at which the highest tax bracket for estates and trusts begins for a taxable year ($12,300 for 2015).

2. The tax is equal to 3.8% of the lesser of the undistributed net investment income for the taxable year or the amount of adjusted gross income in excess of the dollar amount at which the highest bracket begins.

3. Net investment income is the excess of gross income from interest, dividends, annuities, royalties, and rents (other than those derived in the ordinary course of business that is a non-passive activity), gross income derived from a trade or business, and net gain attributable to the disposition of property (other than property held in a trade or business) over the deductions allocable to that income or gain.

a. Net investment income does not include distributions from retirement plan benefits and IRAs.

b. "Trade or business" means passive activities as defined by §469 IRC. Income earned in the active conduct of a trade or business is not included.

c. An issue identified early on is whether a Personal Representative or Trustee can actively participate in a trade or business. In *Frank Aragona Trust v. Commissioner*, 142 T.C. 9 (3/27/14), the Tax Court ruled that the Trustee of a trust is capable of performing personal services and therefore can satisfy the rental real estate activity exception to the passive activity rules.

4. For purposes of determining the gain or loss on the disposition of an interest in a partnership or S corporation, §1411(c)(4) provides that gain is only taken into account to the extent of the gain that the transferor would have recognized if the partnership or S corporation (passthrough entity) had sold all of its assets at fair market value immediately before the disposition.

5. §641(c) IRC provides that the portion of an electing small business trust ("ESBT") that consists of stock in one or more S corporations is treated as a separate trust, however §1411 combines the net investment income of the S and non S portions for purposes of determining total net investment income and adjusted gross income.

6. Strategies for reducing the NIIT:

   a. The threshold amount is $250,000 for married taxpayers filing jointly ($125,000 for married taxpayers filing separately), and $200,000 for taxpayers filing as single or head of household. To the extent the tax can be avoided by making distributions to beneficiaries with net investment income below their respective threshold amounts, and subject to the distribution standard set forth in the trust instrument, this tax may be avoided by distributing net income currently.

   b. Allocating capital gains to income or otherwise including them in DNI pursuant to §701.1108, Wis. Stats. and Treasury Regulation §1.643(a)-3 will reduce the trust's net investment income (see the discussion at II.E. above).

   c. Investment in tax-exempt municipal bonds will lower net investment income because the income from these bonds is not included in net investment income or modified adjusted gross income.

   d. Timing the recognition of income from the disposition of property for years when other income is low can reduce the amount of net investment income on which the tax is computed.

   e. Use of installment sales will reduce the amount of net investment income in any one year.

E. Consistency in Basis

1. The Surface Transportation and Veteran's Health Care Choice Improvement Act of 2015, Public Law 114-41, was enacted on July 31, 2015.

2. The Act adds §§1014(f) and 6035 to the Internal Revenue Code.

   a. §1014(f) provides that the basis of property to which 1014(a) applies (ie. property acquired from a decedent) shall not exceed the final value determined for estate tax purposes, or if the final value has not been determined for estate tax purposes, the value provided in a statement to the decedent's recipients.

   b. §6035 requires the executor of any estate required to file a federal estate tax return to furnish to the IRS and each person acquiring an interest in property included in the decedent's gross estate a statement identifying the value of each interest in such property as reported on the estate tax return and such other information as the Treasury may prescribe.

      (1) The statement is required to be furnished no later than the earlier of 30 days after the estate tax return is filed or required to be filed.

      (2) The effective date is the date of enactment, meaning that the reporting requirements apply to estates of decedents who died prior to July 31, 2015 if the estate tax return is due after July 31, 2015. However, in Notice 2015-57, the IRS indicated that it is delaying the due date for reports under this new law to February 29, 2016.

   c. The 20% accuracy-related penalty under §6662 applies if a taxpayer reports a higher basis than the estate tax value.

   d. Penalties are also provided for failing to furnish the statement of values.

V. CONCLUSION

Knowing the ins and outs of fiduciary income taxation can result in tax savings for the trust or estate and its beneficiaries.