

TRUSTS AND THE FEDERAL INCOME TAX MAN

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Simple vs. Complex

- Simple
 - All trust accounting income required to be distributed annually
 - No distributions of principal
- Complex
 - Generally, all other trusts



Trust Taxation

- Generally, taxable income of a trust is computed in the same manner as an individual
- Exceptions applicable to the general rule are contained in Internal Revenue Code §§641-685

Trust Taxation

- Trust accounting income
- Less deductible trust expenses
- Less personal exemption amount
- Equals taxable income before distribution deduction
- Less distribution deduction (limited by DNI)
- Equals taxable income

Trust Accounting Income

- Trust accounting income is determined under the terms of the trust agreement and state law
- IRC does not determine or affect trust accounting income
- Read the governing instrument
- Be familiar with Michigan's Principal and Income Act

Trust Accounting Income

Interest	\$10,000
Dividends	<u>\$10,000</u>
Trust Accounting Income	\$20,000

- Under the terms of the trust agreement, 50% of trust income is distributed to Homer, the trustee has discretion to distribute principal to Homer, and capital gains are allocated to principal

Deductions

- Personal exemption
 - Normally \$100 for complex trusts
- All ordinary and necessary expenses can be deducted
 - Trustee, legal, and accounting fees
 - Miscellaneous expenses



Deductions

Trustee fees	\$2,500
Legal and accounting fees	<u>\$1,500</u>
Total deductions	\$4,000

Distributable Net Income

- DNI is the maximum amount of income that is taxed to beneficiaries as result of distributions to the beneficiaries
- DNI is taxable income before
 - Personal exemption
 - Distribution deduction
 - Capital gains

Taxable Income Before Distribution Deduction

Income	\$45,000
Less deductions	(\$4,000)
Less exemption	<u>(\$100)</u>
Taxable income before distribution deduction	\$40,900



Distributable Net Income

Taxable income before distribution deduction	\$40,900
Plus exemption	\$100
Less capital gain	<u>(\$25,000)</u>
Distributable net income	\$16,000

Distribution Deduction

- The distribution deduction equals the sum of
 - Income required to be distributed
 - Other amounts required to be or actually distributed
- However, the distribution deduction is limited to the lesser of distributions or DNI

Distribution Deduction

Total Distributions

50% of income distributed to Homer	\$10,000
Principal distributed to Homer	<u>\$15,000</u>
Total distributions to Homer	\$25,000

Distribution Deduction

Distributions to Homer	\$25,000
Distributable net income	\$16,000
Distribution deductions (lesser of these amounts)	\$16,000

Taxable Income

Taxable income before distribution deduction	\$40,900
Distribution deduction	<u>(\$16,000)</u>
Taxable income	\$24,900

