Unedited transcript of

Estate Planning: Fiduciary Income Tax Planning

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>>: So this morning as Katie mentioned, we'll be talking about death and taxes. Nothing more fun than that. So we do -- as I mentioned we do a lot of, you know, tax returns after somebody passes away, and in order to properly set up an estate, I think it's so important to have a basic understanding of how it's going to play out in fruition, you know, whether it's on a federal estate tax return, a mass estate tax return or even on the income tax returns, because where there's such a discrepancy between the estate tax exemption for federal and mass purposes, we do a lot of planning and also on the income tax side to reduce any capital gains and what have you. So our agenda for the next section is where to begin. So we'll talk about that, different types of trusts that are -- that we have, the taxation, different elections to be made and also a summary just at the end and if we do have time at the end of the program, we will mention some proposals that are out there right now, which, you know, we'll be talking about this for the next hour and ten minutes, a certain proposal would throw it all out of whack, but some of them are a little crazy out there so I'm hoping none of them come to fruition, but we may touch on that at the end. So where to begin. The most important is to actually read the trust document and I'm sure Richelle has seen this many times and I've seen it many times where we may get a referral to do some tax returns and first thing I ask for all the time is okay where's the trust document? You cannot rely on previous tax returns. If, you know, a CPA or an attorney or somebody who's doing them prior to you receiving them, because I can't tell you the percentage that is wrong or done incorrectly. So it's important to read the trust document to see what kind of trust that you have, and

also, who's the beneficiary, who's the trustee, where it might be taxable. So it's so important to grab the trust and actually read it, and understand it. The different types of trusts, there's three basic different types. A simple trust, a complex trust, and also a grantor trust. A simple trust is required to distribute income -- accounting income annually. It doesn't make any principal distributions and makes no distributions to charity. So trust terminology that you'll find in the trust document will include words, such as shall, must, require. So a lot of times you may see a trust which says, you know, upon my passing, I want all income to be distributed out to my spouse or to my children. If it doesn't meet any other, you know, provisions for principal distributions, that would be a simple trust. So we see that on occasion where the person is just taking the income. So the trusts are taxed just like an individual on any income earned during the tax year. So if all the income comes in and goes out to the beneficiary, the trust will take a deduction for those distributions of income out to the beneficiary and the beneficiary will pay the tax. So that's basic, simple trust. Everything is going to go out. The beneficiary is going to be taxed on the income. There's also what's called a complex trust. This might accumulate income, so it might be, you know, income in principal going out or it might not be. It also makes discretionary distributions of in your or makes mandatory or discretionary distributions of principal. It can also make a distributions to charity, so the trust terminology, the key words that you want to look for is may, or in the trustee's discretion. So a lot of times, we'll set up trusts for when it goes to the next generation, for instance, assets will be held in trust and we'll give trustee discretion to give out income in principle. Different reasons for this. It may be for asset protection purposes, where if it's required to go out, outright to the beneficiary, there might not be any protection if one's going through a divorce or happens to have creditor issues. So a lot of times, we'll leave it in the trustee's discretion, and that would be a complex trust, for, you know, the trustee has the discretion to give it out or not give it out. Sometimes, trusts can bounce back and forth between a simple and a complex, so it doesn't have to stay that same year to year, if one year it just gives out income, distribution gives out all the income, doesn't give out any distributions of principal, that would be a simple trust for that year. The next year maybe the beneficiary needs a principal distribution. For that year it would be a complex trust. There's also what's called grantor trusts. So these -- the most common is somebody setting up a basic revocable trust. They set it up, they're the grantor. They're the beneficiary. That is a grantor trust, and the tax would be payable -- the tax would be owed by the grantor. Everything would just go right onto his 1040 or 1041 if you're filing the trust tax return, you do a 1041, you check off grantor trust. Everything is going to be taxable back to the grantor. A common misconception is a lot of times practitioners don't understand that an irrevocable trust can also be a grantor trust. They see the word irrevocable and they think it has to be treated differently, but not necessarily. So the grantor or beneficiary is one of the powers described in IR C-section 673 through 678. As a result all the income, expenses and credits will flow through and attach to the grantor or beneficiary, regardless of whether distributions are made. So chapter A through D., chapter J. do not apply to grantor trusts. So just as an example, I just saw one, I had a consult with a client and they had been -- they had set up a grantor trust years ago. It was for their grandson. It was going to be educational trust. It was a grantor trust. However, they were paying tax at the trust level, so they had been filing a trust tax return, which wasn't necessarily required. Their daughter was a trustee on it and their son was -- I mean, their grandson was a beneficiary and they lived out in California, so they were actually paying California tax on it for a number of years, where it was a grantor trust, their mass residence, it should have been taxable back to them. So California, like Massachusetts, loves its taxes so their tax rates were pretty high. They paid tax needlessly out in California. Someone provisions for grantor trust status. So the revocable trust. Typically, the grantor retains most of the powers included under IR C-section 673 to 678 in a common revocable living trust, power to control beneficial enjoyment, administrative powers, power to revoke so they can change anything, they can revoke the trust. Everything is going to throw through right together on their 1040 so they're going to be taxable on all of that. So the other -- where I mentioned the irrevocable trust is a common misconception, we do a lot of irrevocable grantor trusts. So there's two different types, on irrevocable trusts, there's many different types, but you can do a non-grantor trust and if you do a non-grantor trust, put assets into it, it's a completed gift for gift tax purposes and estate tax. And the trust is going to pay any tax that is accumulated during the tax year, unless it actually makes a distribution out to the beneficiary and then the trust could take a deduction for that amount going out and then the beneficiary would be taxable on it. We do a lot as intentionally defective grantor trusts rather than a non-grantor trust and the reason we do that is if somebody makes a gift of $1 million into an intentionally defective grantor trust, it's still going to be a completed gift for estate tax purposes, so they just removed $1 million from their taxable estate. However, it's going to be taxable back to them, and it's going to be taxable back to them for income tax purposes because they're going to retain certain powers. So they'll retain the power of substitution of assets, power to add charities as beneficiaries, power to enable the grantor to borrow against it. So it's almost another form of actually making a gift, so if we had put $1 million into an intentionally defective grantor trust, we've removed it from our taxable estate, but if it earns $50,000 during the tax year and the grantor is paying the tax on that, it doesn't count as a gift, but it's actually another gift which would be more money for the beneficiaries down the road. So that's why we do that where it's going to be taxable back to the grantor. And some of these powers work out extremely well, especially from an estate tax perspective, so if somebody makes a gift to these intentionally defective grantor trusts and 20 years later, there's a basis issue where all the assets now have grown and if anything is sold, it's going to be paying huge capital gains, sometimes, we'll have that power of substitution where we can, especially if the grantor is not doing well, we can substitute assets and save on capital gains basically. So it's a little advanced planning on that end, but as I mentioned, it's a common misconception because a lot of times people will see irrevocable trust and they think it's not taxable back to the grantor, but it certainly could be. So it's so important, as I mentioned, to read the document.

>>: So just to further Jim's point, most often when I'm getting trust questions presented to me, especially internally in my firm, my partners will come over and say the client has a trust and they want to do this and I'm like what type of trust is it? And they're like I don't know. Well, where is the trust estimate? We don't have it. We have to go back, read the trust document and make sure it's correct. And also to Jim's point of, a lot of times when you're taking over a trust for tax purposes, they're often not done correctly. So a lot of smaller practitioners, smaller firms that are doing predominantly individual work, because trusts are dictated under the individual code sections of the internal revenue code, they just assume

that they can do them just they do a 1040, but that's often not the case, because even though it's dictated under the same code sections, there's a lot of nuances with trusts that practitioners who are not familiar with it will not get correct. And so oftentimes, we are looking at trusts and potentially going back and amending back three years to make sure that they're corrected, or we make a decision to correct it going forward. So it's very common. So it's important to note that trusts are separate legal entities, just like if an individual creates a corporation or a partnership, that trust is now a separate legal entity. It has its own tax year, its own method of accounting and oftentimes not always, but oftentimes will have its own tax I. D. number. From a tax year perspective, trusts are required to have a calendar year. The only exception is when you have an estate. Estate is eligible to elect a fiscal year end. And the method of accounting defaults to a cash method of accounting. And just like an individual. As Jim mentioned, the income is going to be taxed either to the trust or to the beneficiary, if a distribution is made. Trusts are defined under the internal revenue code part one subchapter J., I've provided the various code sections there for your reference. In part two subchapter J. defines income in respective -- which is beyond the scope of today's discussion, but I wanted to provide you with the reference for that, as well. So trusts are at a disadvantage from an income tax perspective, as they are taxed at a very high rate, a very low level of income. So I've provided you with the 2021 fiduciary income tax rates. And you can see that once we get to just over $13,000, the trust is getting taxed at a 37% rate, which is the highest current tax rate. So contrast that to an individual taxpayer who doesn't hit 37% marginal rate until they're at about $525,000 of taxable income. For a married filing joint filer, it doesn't hit that until nearly $630,000. So there's a very wide discrepancy between when a trust gets into the highest tax rate versus an individual gets into the highest tax rate. Trusts are subject to the net investment income tax, which is defined under section 1411. And that rate is at 3.8% on net investment income. And again, for estates and trusts, that should say 2021 threshold -- is just over $13,000. So again, in contrast to an individual, a single individual does not become subject to the income tax until they reach $200,000 of net investment income versus a married filing joint taxpayer doesn't, isn't exposed until $250,000 of net investment income. So again, a disadvantage at the trust level that they're incurring this additional 3.8% tax at a much lower rate than the beneficiary would if the distribution was to be made. But we do get as you mentioned, we do get a deduction, both for income tax purposes and the debt invest income tax purposes if the distribution is to a beneficiary, that distribution will carry out taxable income and the trust will get a deduction for that distribution. So if the income is accumulated and not being distributed, it's going to be taxed to the trust of the estate. If the income gets distributed, the trust -- a deduction for the amount of the distribution up to what's called distributable net income and that is a calculation based on the income of the trustee, expenses of the trust for the current year. The beneficiary will receive a K1 from the trust which will distribute out their pro rata share of income and they will report that income on their individual income tax returns. So this is where there's a lot of planning opportunities, as I mentioned with the tax rates of the trust, getting to the highest rate at $13,000, versus the beneficiary who may be at a much lower tax rate. You may be at an advantage to make a distribution to the beneficiary and have that taxable income taxed at a lower rate. Now, we get into some discussions about this because we still need to think about the purpose of the trust, what the intentions of the donor were. If they didn't want their children to have this money outright, then it may not make sense to make a distribution and put that back in the hands of the beneficiary or -- next generation of grandchildren, then you may not want to make a distribution now to the second generation of children and not accomplish the goals of the grantor. So as Jim mentioned, trust account and income governs the amount of distributions for simple trusts. The trustee needs to allocate receipts and disbursements between the county income and the county principal. The allocation between income and principal is determined by the governing instrument where the instrument is defined by state law. So Massachusetts has the uniform income act which will dictate what types of income -- receipts should be allocated to income versus principal. The internal revenue code has no determination of trust accounting income. It is entirely a state law issue. And oftentimes, we'll get the question, because trust accounting income and distribute net income is two different things. Trust accounting income determines what amount the beneficiary is entitled to under the trust. Distributable net income will determine how much of that is taxable to the beneficiary. So oftentimes, I'll get the question from a trustee or from a beneficiary saying, but that was made out of principal. And just because it was made out of principal, it will still pull out taxable income pursuant to the amount of DNI or distributable net income in the trust. So as I mentioned, in general, the taxable income of an estate or trust is dictated under internal revenue code 641B., basically, the code says that generally, taxable income of an estate or trust is the same as the manner of an individual. So there are certain exemptions. The exemptions available for individual trusts are different. There are different rules for deductibility of charitable distributions. Depreciation deduction under an individual will stay with the individual. When we have a trust situation and there's depreciation within the trust, it may be allocated between the trust and the beneficiary based on distributions. A trust is entitled to deduct administrative expenses, and as we just mentioned, the trust is entitled to a distribution deduction for the balance paid out to beneficiaries. So the personal exemption for trusts is pretty low, just like our rate is pretty low. The state is entitled to a whopping $600. A simple trust is entitled to a $300 exemption. And a complex trust is entitled to a $100 exemption. As Jim mentioned earlier, simple trusts that distribute principal in a given year can convert to a complex trust in that year. The complex trust that's converted will still be entitled to the $300 exemption.

>>: As Richelle was saying, it's so important to see what the intention was in setting up the trust from the grantor or donor. Sometimes, you know, if you just look at it from a tax perspective, a lot of times it does make sense to distribute out the income to the beneficiaries, but as Richelle said, sometimes, the beneficiary might have special needs, might have spending issues or, you know, certain drugs, alcohol, where it doesn't make sense to give it out to them. So in those cases, you might be paying more tax, but it might be, you know, satisfying the goals of the donor or grantor in that case.

>>: I've also seen commonly with children with marital issues.

>>: Yes.

>>: That are potentially going to be going through a divorce, and when the divorce proceedings happen, if they see that the beneficiary has been receiving distributions from the trust year after year, you know, it becomes an expectation in the property settlement.

>>: Right. That's another thing and so many times I mentioned, we hold that for that asset protection, but as Richelle said, if it's going out every year, and it's basically, they're using it as you know, their living expenses and that might not be protected, at least not fully protected from the case of a divorce. So different deductions that the trust can take. The charitable deduction under section 642c, they can take a deduction if it's paid from gross income and paid pursuant to the governing document, so obviously, the document has to have established that, that the charity is a beneficiary. Generally, it must be paid in the current year by the end of the following year. Other deductions include ordinary and necessary expenses. So generally, that's what's going to be under business ordinary and necessary expenses. So interest, taxes, fiduciary fees, attorney, accountant return preparer fees and other deductions not subject to the 2% floor. So that would be other things like from a perspective if you have on your individual tax return some of them wiped out with the recent tax and jobs act, but you could take certain miscellaneous deductions subject to the 2% floor on the individual side, so the same applies to the trust and estate side in that case. So changes pursuant to the tax cut and jobs act, that applies from 2018 through 2025. As most of you know, the state and local income tax deductions is limited to $10,000 now, especially where it makes a big difference in the northeast where, you know, real estate expenses and others are extremely high. Miscellaneous deductions subject to the 10% floor are not deductible. Also 20% deduction under section 199a if the trust has business income from a sole proprietorship, partnership or S. corporation. So that's a big deduction change that happened in 2018 and set to sunset in 2026. Thresholds that apply to non-married taxpayers apply to trusts and estates. Deductions can be allocated between the trusts and its beneficiaries.

>>: I'll jump in here. So the miscellaneous deductions that are subject to the 2% floor. These are expenses that would have been subject to the 2% AGI floor for individuals and are also subject, the trust levels are the same limits and the most common of these is investment management fees. You know, on the individual side, that would also include tax preparer fees, but because the trust is incurring tax prep fees that it wouldn't otherwise incur if it didn't exist, the tax prep fees are allowed at the trust level. Similarly,

fiduciary fees at the trust level are deductible. Otherwise, if it's an individual, those would constitute 2% miscellaneous itemized deductions. So there's a little bit of variations between the individual regulations and those applicable to the trust. Other exceptions are expenses incurred during the administration of a state, things like valuation fees and appraisal fees, legal fees. Those would also be eligible at the trust level, as well.

>>: Richelle, we just had a question come in, and it's a good one. What is the 2% floor?

>>: Okay. So under the code, there are certain -- certain deductions that you have -- they have to exceed 2% of your adjusted gross income in order for them to be deductible. So if your adjusted gross income is $10,000, make sure that my math is right, your deductions have to be over 200? I don't do math in my head. But it's a calculation. You take your adjusted gross income, you multiply it by 2% and you're only going to get the deduction to the extent that they exceed that 2% threshold. So it's a limitation on your deduction.

>>: One of the big cases in this area is knight versus commissioner, and that was back in 2008. The final regulations were effective on May 9th, 2014. So basically, this came about -- especially we see it in a lot of trusts where say an investment firm is a trustee so they have a fee, they kind of bundle it all together, and they may be doing the investments, they may be acting as trustee, they may be doing tax returns. So they have, you know, one fee that was -- they are deducting it right at the trust level. So as a result of this case, the court has said a bundle fee must be allocated between the costs that are subject to the 2% floor and those that are not. So in my example, the trustee fees would be fully deductible, not subject to the 2% floor. The tax prep fees would be the same, but the investment fees would be subject to the 2% floor so the court had said these have to be broken out rather than if it's just paid from a bundle fee, it would be subject to the 2% and you wouldn't be able to deduct that. So out-of-pocket expenses billed to your estate of trust treated separate as the bundle of fees. You want to separately state those. Payments made from the bundled fee to third parties that would have been subject to the 2% floor if they had been paid directly by the estate are subject to it. And any

reasonable method may be used to allocate a bundled fee. So we want to be able to take as many deductions as we can. Sometimes, those, especially for higher trust assets that, you know, the investment fee might be very considerable. We want to be able to take as much as we can on the deductions. The unbundling exception. If a bundled fee is not computed on an hourly basis, only the portion of that fee that is attributable to investment advice is subject to the 2% floor. The remaining not the subject to that limitation, so we would be able to take the full amount at the trust level. So it's important for the investment firms and other firms that are handling, you know, different various roles as to unbundle their fees so that we would be able to deduct as much as possible.

>>: You're usually going to see this when you're dealing with a professional, institutional fiduciary. Most of the time, we're dealing with the trustee is a family member, and they're not charging a fee to the trust. And, you know, Morgan Stanley or whoever it may be is doing the investment guidance, and so that investment management fee is clearly purely investment management and not fiduciary related.

>>: Right. Other non-deductible expenses under 265, so sometimes, trusts will have investments in tax-exempt assets, so section 265 disallows any deduction, which is attributable to tax-exempt income. So it generally applies to deductions for production of income. If a trust or estate has tax-exempt income, a portion of the trustee executers and management fees are nondeductible. There's no specific allocation formula. The fiduciary can use any reasonable method. So basically, they're not going -- if you have 50% of your portfolio in a trust that's, you know, invested in tax exempt, and the other in nontax exempt, they're not going to allow you a full deduction in that case. They're going to say you can only deduct 50% of it because that's what's going to apply for production of income. So it's any reasonable method. So a lot of times, if you receive statements from an investment firm, they may actually break it out themselves as to what's attributable to the tax-exempt income and what's not. A lot of these tax software will break it out, depending on the income generated. They have an allocation method. So you just want to make sure you allocate that, you don't take the full deduction, but you also want to make sure that it's not being allocated twice, once from the investment firm on the statement itself

and then by the tax software. So you just want to make sure that you're making an allocation that's reasonable so you can take the deduction that's going to be attributable to the production of income.

>>: So we've thrown this term around a lot, distributable net income or DNI and as we mentioned, DNI governs the amount of -- for the beneficiary, as well as the amount the beneficiary accounts for on his or her individual income tax return. So how do you recompute DNI? We start with taxable income, we add back the distribution deduction, we add back the personal exemption, we subtract out capital gains and add back capital losses, we subtract out extraordinary dividends and taxable events, and we add back net tax-exempt income. And our result is our DNI's deduction. Generally speaking, capital gains are taxed at the trust or estate level and not included in DNI. There are some exceptions. The trust document can allow for trustee discretion, but again, it must be defined in the governing document and applicable by local law, and it must be reasonable and impartial exercise of discretion and it must be consistent from year to year. So I just had a case, a consultation recently with an estate attorney, first year of a trust, they want to get more income out to the beneficiary, so they were toggling back and forth between with including capital gains and not including capital gains, but knowing that they had to be consistent from year to year, they were concerned about what the longer-term effect of that would be and after kind of going through the case scenario, you know, the recommendation back to the trustee was not to include capital gains because going forward, the beneficiary will be in a good place with distributions. It was just an initial year anomaly. And the only other exception to capital gains not being included in DNI is in the year of termination. When you terminate a trust, everything goes out to the beneficiary. The trust incurs no tax liability in the termination year and the beneficiary will pick up all of the income in that year. So sometimes, there's planning to be done there because if there was a significant transaction, or the beneficiary, they don't want to burden the beneficiary with that tax liability, sometimes, we will keep a trust open for one more year so that the final K1 is essentially zero to the beneficiary and all the transactions are handled at the trust level. As I mentioned, earlier, from a trust accounting income perspective, even if it's a distribution of principal from trust accounting income, it will still carry out DNI. So to the extent that there's

DNI in a trust, distributions will carry out DNI. Any distributions in excess of DNI will be nontaxable to the beneficiary, but any time there's DNI, there will be DNI carried out and the beneficiary will be taxable. The only exception to carrying out DNI is -- and I always mess this up, is specific bequest. If a document says I give to Mary Sue gift thousand dollars upon my death. That $50,000 is a specific bequest and will not carry out DNI to Betty Sue. So a significant bequest is specific sum or amount of money. It must be paid all at once or not more than three installments, and again, as we said the beneficiary is not going to be taxable, so in agreement with that, the trust and estate does not receive a deduction for that distribution.

>>: And if I can jump in, Richelle, that can carry huge consequences. I recently had a case come over, I didn't draft the trust, but it had some very large, specific bequests to charities, and they had a lot of specific bequests, unfortunately, the way it was set up, and some to charities and non-charities, but they were receiving quite a bit of money and a lot that was funding the trust was retirement accounts with a lot of built-in income tax on that. So which would be normally just taxable to the trust in that case. And would have huge income tax consequences. So you know, in this situation, if it was done as a percentage and separated out that way, that income that's going to come into the trust could be distributed out to the beneficiaries and especially where we have charitable beneficiaries, we can kick out income to them, then they are not going to be paying tax on that. So it can have very big consequences if it's not done correctly, and that's why, you know, I tend to shy away from specific bequests.

>>: As I mentioned in the year of termination, it's a very different year. Everything will be distributed from the trust. Any excess deductions will be distributed out to the beneficiary. Unfortunately, in the beneficiary's hands those are classified as miscellaneous itemized deductions as we talked about subject to the 2% floor so they may not get a benefit there and under the tax cuts and jobs act, those deductions are not even allowed to individuals through 2026, until the provision sunsets. So if you do have a lot of excess deductions on the trust level, you know, there may be some planning that can be done there, as well. Sometimes, we have trusts prepay their final year expenses before the previous year end to make sure that they can get a deduction for it and -- at the beneficiary level. Also

as I mentioned, capital gains and losses will carry out on the final termination year, as well as any unused capital carry forwards and any unused passive loss carry forwards. So capital loss carry forwards can be carried forward indefinitely, used against future capital gains that the beneficiary may have. Unused carry forwards, unfortunately, they can only be used against past income. So again, carol attention should be paid there because if the beneficiary is never going to have a passive income, they will never get a benefit from those carry-forward losses. There may not be anything that can be done about that, but always want to be cognizant of that and paying close attention to those excess losses and carry-forwards carrying out at the year of termination. State income tax is very different. State taxation is dependent on a lot of factors and may include the revenues of the grantor, the residence of the decedent, if it's a testamentary trust, the residence of the trustees, the residence of the beneficiaries, location of real property, and where the assets are managed. So a lot of factors come into play and we are seeing a lot of issues in this area. With COVID, the pandemic, people working, living and working in different locations, you know, any time there is a change of trustee, any time a beneficiary moves, we need to take a look at what the facts and circumstances are in the states where the trust has any presence. So in Massachusetts, income tax law, testamentary trust is subject to mass jurisdiction. If the resident of any other state -- [Inaudible] To the extent the income of the trustee is from carrying on a profession, trade or business within Massachusetts. Oftentimes -- sometimes, it's going to be carrying on -- receiving a pay from an ongoing business. Oftentimes, we see this in rental real estate. Rez -- if at least are one trustee is a resident of mass and one of the following conditions. That's either at the creation of the trust the grantor was a mass resident. During any part of the year, income was computed, the grantor resided in mass. Or the grantor died a resident of mass. [Inaudible] To the extent that they have income derived from a profession, trade or business. Again, maybe an ongoing business that they have a shareholder or partnership interest in, that resides in the trust or oftentimes, it is a rental real estate situation. So when looking at where to file, every state has different laws defining what a resident trust is. So you have to again look at every state where the trust has a presence. The trustees, the assets, the beneficiary, the grantor. And then look at where you qualify in each of those states' laws. And you could end up that the trust is a resident of multiple states, which is not a great situation to be in, because then you're paying taxes to two different states. Or the trust may qualify as not a resident of any state. So I have several trusts that when we look at all the presence tests under the various state laws, that they don't qualify in any state and so we're just filing a federal income tax return for that trust. Again, this is a tremendous issue right now with beneficiaries, where even if it's temporary, the beneficiaries are moving, we need to be asking the question about where is the trustee, where are the beneficiaries now residing? Not just assuming everything's the same as prior.

>>: All right. And that's where there can be a lot of mistakes, as well, kind of what I alluded to at the beginning where somebody is signing in California when they didn't need to, so it's important to look at who are the players involved and question whether, you know, it's being filed correctly. As Richelle said, you could be in multiple states so it does allow also for planning opportunities, depending on the trust. If one of the children is the trustee and they live in a nontaxable state for income tax purposes, it might make sense to have them serve or something along those lines. So there are some planning opportunities to try to minimize it. Otherwise, as Richelle said, it could be state taxable in multiple states at the same time. So there's many common mistakes on where trusts are filed for the different states, so I wouldn't ever accept what's done in the past, and take a fresh look at it. As Richelle said, things change too. Circumstances change. It might be filing requirements have changed as well.

>>: And that always, you know, when dealing with clients, with trustees, trying to do planning around state taxation. We say don't let the tax tail wag the dog. If you hire a New Hampshire trustee you may be able to escape Massachusetts taxation but are you comfortable with that? If you don't know somebody there, you're looking at an estate trustee and does that fit your goals?

>>: That's a great point. A caveat, just as I mentioned before about distributions out to beneficiaries, you have to look at the overall and does it make sense? It might make tax sense necessarily, but not make sense to make distributions out or change trustees if it's not going to satisfy the goals of the trust. So different common elections to consider. There's

what's called a section 643 election, a section 645 election and a section six -- [Inaudible] We'll go through those different elections and what they do. The 643e3 election. This election permits a fiduciary to treat the distribution of in-kind properties having been sold by the entity to the beneficiaries at fair market value, thereby triggering potential gain, losses generally not recognized. So section 643e applies to discretionary distributions, applies to estates or complex trusts. It does not apply to simple trusts. So a lot of times you would not want to make this election, but basically, if a trust has, for example, cash and also a piece of real estate, if they're making distributions out to the beneficiaries, say 50/50 and the cash equals the value of the real estate, the trust can make a distribution to each of them, one real estate to one beneficiary, cash to another. It's not going to generally be treated as a taxable event at that point. A distribution out. But if section 643e3 election is made, it would be considered a taxable distribution at that point. So normally, the section 643e does not treat it as a realization event to the entity. Normally, we don't want to be paying tax at that point if we don't have to. As a result, the amount of the distribution is the lesser of the entity's basis in or the fair-market value of the distributed properties. So for an example, on our example, the real estate is worth $500,000 upon the passing of the grantor, say, two years later it's making a distribution out to the beneficiary. The beneficiary's basis in that property is going to be 500. So using today's real estate market, now that value could actually be $700,000, but their basis is going to be the $500,000 because that's what the value was on the data passing. So they're going to carry out that distribution and get the carryover basis from the trust. So as I mentioned, the basis will be the same, but they carry over basis in that case. So if the election is made, it's going to treat that as an in-kind distribution as a realization event. So in my example, the property is now worth $700,000, there's going to be $200,000 of capital gains so why would you want to make this election? Generally, you don't. So I don't see it too often in that case. However, it may be beneficial if the trusts has capital losses in excess of capital gains for the current year, so we want to treat it as an event to utilize those capital losses, or the trust has capital loss carryovers. The disadvantages of the election, as I mentioned it increases taxable income to the beneficiary right away. So normally, in the tax world, we want to defer, defer, defer as much as possible. But this would actually be a realization event and will generate capital gains in that case. So one of the other disadvantages, in our example, and now this $200,000 in capital gains, the beneficiary's basis in the property is $700,000 because they paid the tax on that, if they hold that property say for their lifetime and they pass away, they'll get a step-up in basis under the current law and if it's worth $1 million, $2 million on their passing, they've just wasted and paid capital gains on something they may never have sold. So if they're going to sell it in a couple of years, they're going to pay capital gains one way or another, but if they held until their passing and gets a full step-up, tax might have been paid, which never would have been paid, never had to be paid. So usually on this election, it's not beneficial to make it, except in those limited circumstances, so you want to be very careful in doing so. The next common election is a 645 election. This allows an executer or an estate and a trustee of a qualified revocable trust to elect to have the trust treated and taxed as part of such an estate. So a lot of times, people -- we do a lot of planning to avoid probate, so we'll have assets say in a revocable trust. The grantor passes away. If all the assets are in the trust, we're avoiding probate. There won't be an estate income tax return in that case. However, sometimes, assets don't get in the trust, and in that case if there's assets in the trust and you have to go through probate and part of the person's probate estate, then there's going to be -- any income generated by those assets, both in the trust and the estate, are going to have to be reported on an income tax return. This election rather than filing two separate ones, one for the trust, one for the estate, would allow just one tax return to be filed. This election can also result in tax deferral in certain circumstances. And so only the state is eligible to elect a -- (Inaudible) The trusts are on a calendar year so if somebody passes away during this tax year, they're going to be filing their tax years -- the trust is going to end on 12-31. However, there are some planning opportunities if there are both a trust and an estate income tax return due if we make the 645 election and the state elects to be treated by tax on a fiscal year end. A lot of times that can defer the tax so the estate might not be paying until mid the next year and that can result in the girl of some income tax. It can also simplify the filing process. Now, you're filing one tax return, you're not filing two in that case. The 645, this election is made by filing form 8855 by the due date of form 1041 for the first tax year of the estate or the filing trust. The next common election is the section 663b election. It's also referred to as the 65-day rule. So this election allows a fiduciary -- within the first 65 days following the close of the taxable year as being made on the last day of such taxable year. This applies to complex trusts and estates. So a lot of times, you know, we're handling a trust and we don't know the exact income on 1231, so we might have an idea on it, in December, but we don't know or the trustee doesn't know what income has been earned during the year. This election can be made after the close of the year to make sure we pass out all income to the beneficiary. So, as we mentioned a few times in this presentation, a lot of times from a tax perspective, it's more beneficial to pass out the income tax to the beneficiary at lower tax rates than the trust tax rate. So this election is more common because we want to make sure if all the income goes out to the beneficiaries, they're going to be paying tax at a lower tax rate than as Richelle said, a little over 13,000, they're going to be paying 37% in that case. So we want to pass it out to the beneficiaries most of the time. Otherwise, everything else is good. And pay overall the lowest tax that we can. Also this is coming into more just as to getting information from different financial institutions continues to take longer and longer. So as I mentioned, a lot of times you don't know on 12-31. You might not even know on February 28th unfortunately, but this election will allow us to take that deduction, even though it was made during the taxable year they're filing, not the previous one.

>>: So this is a lot easier to do when 1099's get sent out January 31st and we had a month to mull them over and make some decisions, but nowadays, we're not seeing 1099's until mid-February, late February, some even into March. It's gotten a lot more challenging in recent years.

>>: It would be nice if they extended the 65-day rule a little bit longer. The tax year, it will get shorter and shorter just because of getting information continues to take longer and longer from the financial institutions. So the election must be made by the due date of the return. The election is irrevocable once the due date of the return has passed. It is a year-by-year election so it's only good for one year so you would have to make it each year that you want to do that. And it's limited to the DNI less current year distributions, or taxable accounting income that's not distributed.

>>: And this is where I get into issues with trustees often because they

don't understand this limitation, and that you can't make a 65-day distribution if you don't have DNI to distribute. So if the current year distributions have already exceeded the DNI, there is nothing available. And often having these conversations of that is not going to be relayed back to the prior year. It's going to end up being a current year distribution because you don't have any amount to elect against.

>>: Very good. As I mentioned, the main benefit of making this election is to have the beneficiary pay the tax on the income at a lower tax rate. So coming into play also on this is making sure that trust beneficiaries don't -- some of them file tax returns immediately at the very beginning of the year. They want their refund that they've been banking on and when they're the beneficiary of a trust, they may be getting a K1 distributing out the income to them, so they have to be advised by their trustee, don't be file anything income tax returns because the trust tax return has to be filed first and they may be reporting income from a K1 on their individual income tax return. So we just want to make sure that -- because sometimes, the cost benefit, if everybody's filed their tax return, and, you know, then they have to file amended returns, sometimes, the costs add up in that case. The 663b election has become more important with the imposition of the net investment income tax. As we've mentioned, delays in tax reporting make the administration more difficult. 65 days used to feel like a long time before, but not so much now. One of the other considerations is mass does not have a 65-day election so it is not treated as a distribution in the year of election or in the year of distribution. So for mass purposes, it's going to be taxable at the trust or estate level. If the beneficiary is the resident of another state, the distribution may be taxed twice both at the entity level and the individual level. So the accounting can be very confusing when you have -- where mass doesn't follow the 65-day election, the trust is going to be making the payments for mass purposes, but not for federal purposes. So that gets a little tricky, which I'm sure you've seen, Richelle.

>>: If you're dealing with trusts in other states, you need to look at their specific rules for 65-day elections. There are other states that don't recognize the 65-day election, as well, so you know, it can result in double taxation. I've certainly seen that happen. You know, most fiduciaries don't

realize that it's not going to count for Massachusetts and don't understand that distribution, that taxable income is not carrying out for mass purposes to the beneficiaries served by the trusts. Even though the money has been passed out. So, you know, it's wetter to make it clear in the planning and the decision -- [Inaudible] And oftentimes if I see trusts that are, you know -- if they're doing it year after year after year after year, it's like well why don't you just make a distribution during the year rather than waiting for the 65-day election? Just make quarterly distributions during the year and you'll get the deduction on both sides.

>>: Right, and that's a great point because a lot of times we'll be looking at it during the tax year, and estimate the income and as long as, you know, all the income goes out to the beneficiary during the tax year, it makes it much better than having to make that election.

>>: So the next two slides are just examples of some of the tools that I use. Whenever I'm dealing with an it's or even when I'm dealing with just looking at clients' it's plan, I'm very visual, so I like to have a flow chart to say here's what happens, here are the players involved, here's the -- the personal representative of the trust and what happens at the time of the grantor's death? And keep some general notes about the provisions of the trust so that the question pops up, I don't have to go back and read it all over again. I have my notes on it. I'm able to do a quick review. But this is just something I like to do. I have a quick reference so that, like I said, if a question pops up or, all of a sudden, the -- calls me in, client just passed away. We're ready to hit the ground running and know which way we're headed. Similarly, I do this for clients when we're dealing with estates, because it is very confusing to them, between the estate tax, the estate income tax, the final individual returns, the trust return, what's being filed when and what are all the various due dates? Because it's just overwhelming, and especially when you get to the estate tax and the estate income tax, there's a lot of confusion as far as like well, I thought we already did that or I did that with the attorney, what am I doing with you? So I like to lay it out so that they're clear and I will update this as things are completed and make sure that it shows that it's marked off and done. And clients have had reception to it and helps them wrap their arms around it, especially in a very difficult time when you're dealing with an estate and a

distressed widow or widower. This is not their everyday lives, and it's overwhelming. Anything we can do to make it easier for them and give them kind of a road map and a checklist to say okay I know where I am, I know what needs to get done, I know what's coming. So this is just two tools that I use. So in summary, and then we'll -- I think we have a few minutes to talk about tax proposals, but, you know, basically, you need to have the trust document and you need to read the trust document. I'm not an attorney, I'm a CPA. I read trust documents almost every day of my career, but I will still go back. I will do my own review, my own analysis, and then I will try to go back to the drafting attorney, wherever possible and just confirm, to make sure that we are in agreement, my understanding is what was expected in the plan, to make sure that we're coordinating, collaborating as we're moving forward. Compute the trust income, calculate the taxable income, the distributed net income, determine the distributions to be made, allocate the DNI. If you've got multiple beneficiaries, the DNI will be allocated to them in proportion to the distribution, unless you're in a situation where you have a separate share trust, which is way beyond the contents of this discussion, but generally speaking, it will be proportionate to the beneficiaries' distributions. Complete the income tax return, send the K1 to the beneficiary and you're done. So thank god for tax software. It does a lot of these calculations for you. With that said, you can't just assume that it's right. It's all about how the input is done to make sure that the output is correct and understanding what it is you're looking at and the calculations that are being done. So this is not something to dabble in, this is not something to just, you know, start a practice and get off and running. I've been doing this for over 20 years and I can honestly say I'm still learning new things. And laws are changing. And new planning strategies are being implemented. We're seeing all sorts of new things coming out, as well. So it's an interesting area to work in.

>>: And on that point, you mentioned the al-- which you didn't get into, but, you know, we have to be careful too because you can take deductions for distributions made out to beneficiaries, but there's a number of beneficiaries and I've had this case a few times and maybe one or two of them need a distribution much more than the others and they may be waiting. You want to -- as trustee, you want to advise a trustee to be careful because if there's a lot of income earned by the trust that particular

year, so whether it's retirement accounts cashed out or something where there's a large capital gain and a lot of income earned, if it's only going out to a beneficiary or two and not to everybody, they may be having the brunt of that tax. So it might be, you know, being passed out to them if it's not being allocated proportionally out to the beneficiaries. So I've seen that on occasion and just want to be mindful to tell the trustees well, you know, they're going to be receiving a K1 showing that income and if that income is much higher than it's going to be down the road, they're going to be bearing the brunt of that.

>>: And I try to advise the trustees to make sure the beneficiaries are aware that there will be a K1 coming, because oftentimes, you know, if they're just used to filing their return based on a W2 in February, you know, they go ahead and file their return and, all of a sudden, they have a K1 from the trust distribution and have to go back and amend their returns. Also just to make sure that they're aware that to some extent, to the extent of DNI, that it will be taxable to them. That this is not a tax-free distribution. And that's -- that can be an education process. I had a trustee, basically, the donor passed away and the children were going to succeed to her interests and so now, going forward they're going to have a K1 sent to them on an annual basis, and so I had the trustee send a letter to the siblings saying, you know, be aware, you are entitled to benefits under this trust. These are the terms of the trust and you will be receiving a K1 on an annual basis going forward, for life, and you should wait to do your taxes, because that will need to be included in your individual income taxes. So it's a little bit of an education process at times, and it can be difficult when, you know, you may be distributing one year and not the next. It may be three beneficiaries getting distribution, and now, the fourth one's getting them. It can be new and unexpected.

>>: And part of the education too sometimes, a misconception is the beneficiary receives $50,000 during the tax year and they're thinking they're going to have to pay tax on that 50, but if their proportion of the income was only $10,000, that's all that they're going to be paying tax on. So sometimes, you have to educate the beneficiaries in that case. They're not going to be paying tax on the total distribution during the year necessarily, just what the trust income earned during that tax year, so their

proportion of that.

>>: Do we have any other questions?

>>: We don't have any other questions. And just to sort of go back to what you guys were mentioning throughout all of this, and to the audience in general, the likelihood that you are going to go out and prepare 1041s is probably slim, right? So why do we have this in MCLE basics for estate planning? Because this is one of the threads that is woven through your practice. So even if you are never going to prepare a 1041, you have to know what one is; you have to know how to have a conversation with your clients about it; and you have to know, to partner them with the right practitioners. So not all CPAs are well versed in 1041 preparation, as we talked about at the outset of this. And so it is super important that you partner your clients with someone who is good with fiduciary tax prep. And so you don't have to be experts in this like Richelle and Jim, but you have to know what you don't know, right? But you have to be able to have a conversation about it and know that this is a big piece of the practice, and whether you're doing -- certainly if you're doing any kind of planning with irrevocable trusts, you have to be able to have a conversation. We did just have a question come in. Can you clarify the step-up in basis rule a beneficiary will get a step-up in basis, let's say with real property regardless of whether the property is held in trust or not?

>>: Great. Do you want me to tackle that, Katie?

>>: Sure.

>>: So all right. So the basis step-up rule. So if mom or dad buys a piece of real estate, $40,000, and upon their passing, it's includable in their estate and the fair market value is $500,000 at that point, it gets a step-up in basis to the $500,000. So that will be the new cost basis going forward. So if a beneficiary receives that piece of real estate, they turn around and sell it the next week, there shouldn't be any capital gains because it's $500,000, their basis. They get a full step-up, they sell it, it's going to be not a taxable event for them. So especially in Mass, we see this all the time. A lot of times people want to save on income taxes -- I mean, on

estate taxes, so Mass has a low threshold, a million dollar exemption. They may want to gift assets to reduce their taxable estate for Mass purposes. However, a lot of times they may be creating huge capital gains if they do that because they've gifted their basis in the property. So in my example, if they gift that property that was worth $40,000 to their beneficiary before they passed away, there's no step-up in basis because it's not includable in their estate. Especially for Mass purposes, mass estate tax I'm sure you'll be talking about it ranges from 8-16%. So a lot of times it might fall around 10%. I don't want to gift assets with low basis to beneficiaries in order to save 10% if I'm going to create 25% in capital gains tax for the beneficiary down the road. So the step-up in basis is huge. Practitioners have to understand, like, the basic, you know, tax provisions like that, step-up in basis, so it applies to stock, real estate, that's where you see it the most and getting the step-up, it can be much more advantageous for the beneficiaries, even though you might pay some estate tax on it.

>>: And whether it's held in trust or not, so it depends on the type of trust. If it's in a irrevocable trust and it's included in the taxable estate, it's going to get a step-up. If it's not part of their taxable estate, it's not going to get a step-up. We had one more question come in, and what is the average cost for a simple trust tax prep? So I don't know -- both of you can tackle that and give the good old "it depends" but... [Laughs]

>>: I think a lot of it depends. Smaller firms' bill rates are going to be slower than a larger firm's bill rates. I will say oftentimes if I'm doing a simple trust, and it's part of -- it's not just a one-off return, it's part of another larger engagement, it's probably around 750 to $1,000. There's always the factor of the -- the client factor and how difficult they are to get information from, how many times you have to hound them, how late is the information, do we have to do an extension? So there are a lot of factors that come into play. Is there planning involved? Are there estimates involved? Is there coordination of estimates? So it can range wildly, but if you're talking about just like a basic trust, simple trust, paying out to the, you know, beneficiary, you know, it's not -- it's around that range.

>>: Yeah, that sounds similar to ours. Sometimes, if it's just one, you know, basic one 1099, I sometimes discount it to $500, but usually, it's right in the

$750 range or so for us. And a lot of times, as Katie mentioned, not all -- just because somebody as CPA or a tax preparer doesn't mean they know 1041, so a lot of times we'll handle it, but if clients want to go use their CPA, I'm like fine, a lot of times I'll review it just to make sure it's done correctly, because those step-up, you know -- as you just mentioned, one of those questions, we want to make sure assets are stepped up and what have you but a lot of times, you know, if somebody's doing 1040s, they may not even touch a 1041 and we'll end up doing it in that case.

>>: Excellent. All right. So that brings us to the end of the questions and the end of this section so I'm going to give you guys a break and everyone else a break and we will come back at 10:51. And then we will jump into some ethics type of materials with Jim and Richelle, as well. We'll take a quick five-minute break and we'll see everyone back in five minutes.