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Taxation of Trusts and Estates

January 10, 2020

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What is taxation of trusts and estates?

A trust is created when you (the grantor) transfer property to a trustee for the benefit of a third person (the beneficiary). An estate is the assets and liabilities left by a person at death. Both a trust and an estate are separate, legal, taxpaying entities, just like any individual. Income earned by the trust or estate property (e.g., rents collected from real estate) is income earned by the trust or estate.

Two questions necessarily arise out of these situations. Is the transfer of property to a trust a taxable event subject to transfer taxes? And how is the income earned by the trust or estate treated for income tax purposes?

Transfer taxes

Transfer taxes refer to excise taxes that may be imposed when you transfer property to another, either by gift during life or by bequest at death.

Generally, property transferred to a trust during life may be subject to generation-skipping transfer taxes and/or gift taxes. In this case, Federal Form 709--United States Gift (and Generation-Skipping Transfer) Tax Return--must be filed by the donor (i.e., the transferor or the person funding the trust). Additionally, under certain circumstances, trust property may be included in a decedent's estate for estate tax purposes. In this case, Federal Form 706--United States Estate (and Generation-Skipping Transfer) Tax Return--must be filed by the estate representative.

Income taxation of trusts

Property in a trust generally earns income. How that income is taxed depends on who receives it or whether the grantor or powerholder (someone who holds a general power of appointment over the trust assets; i.e., someone who has the right to say who gets them) has retained an interest in the trust.

- Income retained by the trust--Generally, trusts are "pass-through entities." This means that trust income retained by the trust is taxed to the trust (but not if it is a charitable remainder trust), while distributed income is taxed to the beneficiary who receives it. In general, trusts are taxed like individuals for income tax purposes. General tax principles that apply to individuals also apply to trusts. A trust may earn tax-exempt income and may deduct expenses. Trusts are also allowed a small exemption. Income taxed to a trust is reported on Federal Form 1041 (U.S. Income Tax Return for Estates and Trusts). Federal Form 1041 is called a fiduciary income tax return because the trustee (i.e., the fiduciary) is responsible for filing it and for paying any taxes owed.
- Income distributed to beneficiaries--Income distributed by a trust is taxed to the beneficiary who receives it. The income is "passed through" on Federal Form 1041, Schedule K-1 (Beneficiary's Share of Income, Deductions, Credits, etc.). The beneficiary must report his or her share of the trust's taxable income on his or her personal income tax return (Federal Form 1040).
- Retained interest trusts--Trust income is taxable to the grantor or powerholder if the grantor has retained an interest in the trust (e.g., right of revocation) or if some other person is given a general power of appointment over the trust income or principal. Income taxable to the grantor or powerholder is not reported on Federal Form 1041; rather, it is reported on the grantor or powerholder's personal income tax return (Federal Form 1040). Then, either a copy of Federal Form 1040 is attached to a blank Federal Form 1041, or, in some circumstances, no Federal Form 1041 is filed at all.

Income taxation of estates

An estate may receive or earn income. How it is taxed depends on the nature of the income.

- Income earned prior to death--If a decedent was a cash method taxpayer, income received (actually or constructively) by the decedent prior to death is reported on the decedent's final 1040 . If the decedent was an accrual taxpayer, income accrued prior to death is reported on the final 1040.

Income earned by the taxpayer but not paid before death is reported on the income tax return of the recipient of the income. This is called income in respect of the decedent (IRD) . Examples of IRD include uncollected wages, accrued interest on bank accounts, and dividends declared but not collected. If the recipient of IRD is the decedent's estate, it is reported on Federal Form

1041 (the fiduciary tax return) by the estate representative. If the recipient is an estate beneficiary, it is reported on Federal Form 1041, Schedule B, and on the beneficiary's personal income tax return, Federal Form 1040.

- Income earned after death--Income earned by estate property after death is reported either on the estate's tax return (Federal Form 1041) or on the tax returns of the beneficiaries who receive the property directly from the decedent (Federal Form 1040).

Some facts about filing fiduciary income tax returns

Tax year

A trust must use the calendar year ending December 31. An estate can choose a fiscal year .

Taxpayer identification number

Any trust required to file Federal Form 1041 (except for revocable or grantor-type trusts) must obtain a Taxpayer Identification Number (TIN). A TIN for a decedent's estate is needed if the estate will earn any income or if the estate representative will file a fiduciary income tax return.

Each TIN applicant must: (1) apply using the revised Form W-7, Application for IRS Individual Taxpayer Identification Number, and (2) attach a federal income tax return to the Form W-7. Applicants who meet an exception to the requirement to file a tax return (see the instructions for Form W-7) must provide documentation to support the exception.

Send your Form W-7 and proof of identity documents to Internal Revenue Service, Austin Service Center, ITIN Operation, P.O. Box 149342, Austin, TX 78714-9342. You may also apply using the services of an IRS-authorized Acceptance Agent or visit an IRS Taxpayer Assistance Center in lieu of mailing your information to the IRS in Austin.

Filing requirements

Trusts with any taxable income, trusts with a nonresident alien beneficiary, and trusts with gross income of $600 or more must file Federal Form 1041.

Federal Form 1041 must be filed if the estate's gross income is $600 more or if one of its beneficiaries is a nonresident alien.

Filing deadline

Returns for trusts must be filed by April 15 of the year following the close of the tax year.

Returns for estates must be filed by the 15th day of the 4th month of the year following the close of the tax year (remember, an estate can choose its fiscal year). So, if the close of the tax year is August 31, 2012, the return is due on December 15, 2012.

Filing extensions

Federal Form 8736 extends the filing deadline for trusts for three months. An additional three-month extension may be granted with Federal Form 8800.

A three-month extension may be granted to estates by filing Federal Form 2758. An additional three-month extension may be granted with a second Federal Form 2758.

Penalties

A late-filing penalty of 5 percent of tax per month will be imposed (up to a maximum of 25 percent). This penalty is in addition to any late-payment penalties.

Please contact Branch Ads Supervision to obtain the appropriate Raymond James disclosure.

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