

# 2024 Fed/State Tax Institute

December 10, 2024

***Presented By:***

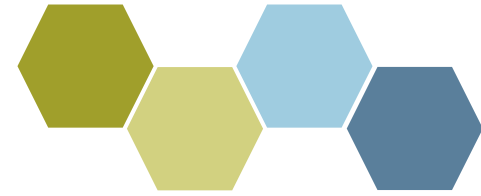
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The logo consists of the letters 'BLS' in a stylized, handwritten script font.

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# COMPLEX AND SIMPLE TRUSTS

## A High-Level Overview

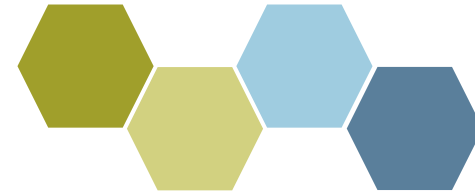
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## Goals

1. Define some general terms used with trust income tax return preparation
2. Calculate the income distribution deduction for simple and complex trusts
3. Calculate how items of taxable income flow to a K-1 of a beneficiary for a simple and complex trust

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# General Terms

- Simple Trust [Reg. 1.651(a)-1]
  - Trust terms require all income to be distributed currently
  - Trust cannot distribute principal
  - Trust terms do not allow any amounts to be set aside for charitable purposes
- Complex Trust ([Reg. 1.661(a)-1]
  - Trust other than a simple trust



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# A Simple Trust Example

	Taxable Income
Interest	\$10,000
Dividends	20,000
Capital Gains	3,000
Trustee Fees	<u>(5,000)</u>
Adjusted Total Income	28,000
Exemption	(300)
Income Distribution Deduction	<u>(25,000)</u>
Taxable Income	2,700

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# Simple Trust – Income Distribution Deduction Under IRC 651

- If the amount of income required to be distributed currently exceeds the distributable net income of the trust for the taxable year, the deduction shall be limited to the amount of distributable net income (DNI). **For this purpose, the computation of distributable net income shall not include items of income which are NOT included in the gross income of the trust and deductions allocable thereto.**
- In other words, the distribution deduction is the LESSER of the amount of accounting income required to be distributed or DNI
  - Tax-exempt interest is not considered in the distribution deduction

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# Accounting Income Under IRC 643

- The governing document and applicable local law
- Local Law generally follows the Uniform Principal and Income Act
  - General rule Income - Receipts of interest, dividends, distributions from pass-throughs are income net of allocable expenses
  - Corpus – Capital gains
- Expenses not allocated to accounting income are considered allocated to the principal of the trust, which does not have an impact on any of these calculations



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# Distributable Net Income (DNI) Under IRC 643

- Distributable Net Income – Taxable income of a trust with a series of modifications, with common modifications listed below:
  - No Income Distribution Deduction
  - No Personal Exemption
  - No capital gain or capital loss (generally)
  - Add tax-exempt interest net of allocable expenses to tax-exempt income

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# Revisit a Simple Trust Example

	Taxable Income
Interest	\$10,000
Dividends	20,000
Capital Gains	3,000
Trustee Fees	(5,000)
Adjusted Total Income	28,000
Exemption	(300)
Income Distribution Deduction	(25,000)
Taxable Income	2,700

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## Simple Trust Example #1: Taxable Income vs. DNI vs. Accounting Income

	Taxable Income	DNI	Accounting Income
Interest	\$10,000		\$10,000
Dividends	20,000		20,000
Capital Gains	3,000		-
Trustee Fees	<u>(5,000)</u>		<u>(2,500)</u>
Adjusted Total Income	28,000		
Exemption	(300)		
Income Distribution Deduction	<u>(25,000)</u>		
Taxable Income	2,700	2,700	
Modifications			
Capital Gain		(3,000)	
Exemption		300	
Income Distribution Deduction		<u>25,000</u>	
DNI or Accounting Income		\$25,000	\$27,500

## Simple Trust Example #1: A Different Presentation

	Taxable Income	DNI	Accounting Income
Interest	\$10,000	\$10,000	\$10,000
Dividends	20,000	20,000	20,000
Capital Gain	3,000	-	-
Trustee Fees	<u>(5,000)</u>	<u>(5,000)</u>	<u>(2,500)</u>
Adjusted Total Income	28,000		
Exemption	(300)		
Income Distribution Deduction	<u>(25,000)</u>		
Taxable Income	2,700		
DNI or Accounting Income		\$25,000	\$27,500

## Simple Trust Example #2: Nondeductible Fees

	Taxable Income	DNI	Accounting Income
Interest	\$10,000	\$10,000	\$10,000
Dividends	20,000	20,000	20,000
Capital Gains	3,000	-	-
Trustee Fees	<u>(5,000)</u>	<u>(5,000)</u>	(2,500)
Nondeductible Investment Fees	-		<u>(4,500)</u>
Adjusted Total Income	28,000		
Exemption	(300)		
Income Distribution Deduction	<u>(23,000)</u>		
Taxable Income	4,700		
DNI or Accounting Income		\$25,000	\$23,000

## Reg. 1.652(b)-3

- Except for tax exempt income, Reg. 1.652(b)-3 allows expenses to be allocated to higher taxed items. For example, indirect expenses can be allocated against interest income instead of qualified dividends.



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## Simple Trust Example #2: How do items of taxable income flow to the K-1? (IRC 652)

Character of Income	Lesser of DNI or FAI	Component of DNI Less Expenses	Total K-1 Income	Beneficiary 1	Beneficiary 2
Interest	23,000	$(10,000 - 5,000) / 25,000$	\$4,600	2,300	2,300
Dividends	23,000	20,000/25,000	<u>18,400</u>	<u>9,200</u>	<u>9,200</u>
Total			23,000	11,500	11,500

## Simple Trust Example #3: Tax-Exempt Interest

- Assume the same facts as example 2, except there is now \$5,000 of tax-exempt income
- Under Reg. 1.652(b)-3, expenses are required to be allocated to tax-exempt income and other items of DNI

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## Simple Trust Example #3: Tax-Exempt Interest

	Items Included in DNI	Allocable to Taxable Income	Allocable to Tax-Exempt
Interest	\$10,000		
Tax Exempt Interest	5,000		
Dividends	20,000		
Total	35,000		
Ratio		86% (30,000/35,000)	14% (5,000/35,000)
Trustee Fees	5,000	4,286	714

## Simple Trust Example #3: Tax Exempt Interest

	Taxable Income	DNI	Accounting Income
Interest	\$10,000	\$10,000	\$10,000
Tax Exempt Interest		5,000	5,000
Dividends	20,000	20,000	20,000
Capital Gains	3,000	-	-
Trustee Fees	(4,286)	(4,286)	<u>(2,500)</u>
Trustee Fees Allocable Tax Exempt	-	(714)	
Adjusted Total Income	28,714		
Exemption	(300)		
Income Distribution Deduction	<u>(25,714)</u>		
Taxable Income	2,700		
DNI or Accounting Income		\$30,000	\$32,500
Section 651 Adjustment		<u>(4,286)</u> [5,000-714]	
Distribution Deduction (lesser)		25,714	32,500

## Simple Trust Example #3: How do items of taxable income flow to the K-1? (IRC 652)

Character of Income	Lesser of DNI or FAI	Component of DNI Less Expenses	Total K-1 Income	Beneficiary 1	Beneficiary 2
Interest	30,000	$(10,000 - 4,286) / 30,000$	\$5,714	2,857	2,857
Dividends	30,000	20,000/30,000	20,000	10,000	10,000
Net-Tax-Exempt	30,000	$(5,000 - 714) / 30,000$	<u>4,286</u>	<u>2,143</u>	<u>2,143</u>
Total			\$30,000	\$15,000	\$15,000

# Complex Trust – The Income Distribution Deduction Under IRC 661

- For complex trusts that do not require the mandatory distribution of income, the distribution deduction is the LESSER of actual distributions or DNI
- Our example assumes income is not required to be distributed



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## Complex Trust Example #4

	Taxable Income	DNI	Actual Distribution
Interest	\$10,000	\$10,000	
Dividends	20,000	20,000	
Capital Gains	3,000	-	
Trustee Fees	<u>(5,000)</u>	<u>(5,000)</u>	
Adjusted Total Income	28,000		
Exemption	(100)		
Income Distribution Deduction	<u>(25,000)</u>		
Taxable Income	2,900		
DNI or Actual Distribution		\$25,000	\$30,000

## Complex Trust Example #4: How do items of taxable income flow to the K-1? (IRC 662)

Character of Income	Lesser of DNI or Actual Distribution	Component of DNI Less Expenses	Total K-1 Income	Beneficiary 1	Beneficiary 2
Interest	25,000	5,000/25,000	5,000	2,500	2,500
Dividends	25,000	20,000/25,000	<u>20,000</u>	<u>10,000</u>	<u>10,000</u>
Total			\$25,000	\$12,500	\$12,500

## Complex Trust Example #5

	Taxable Income	DNI	Actual Distribution
Interest	\$10,000	\$10,000	
Dividends	20,000	20,000	
Capital Gains	3,000	-	
Trustee Fees	<u>(5,000)</u>	<u>(5,000)</u>	
Adjusted Total Income	28,000		
Exemption	(100)		
Income Distribution Deduction	<u>(20,000)</u>		
Taxable Income	7,900		
DNI or Actual Distribution		\$25,000	\$20,000

## Complex Trust Example #5: How do items of taxable income flow to the K-1? (IRC 662)

Character of Income	Lesser of DNI or Actual Distribution	Component of DNI Less Expenses	Total K-1 Income	Beneficiary 1	Beneficiary 2
Interest	20,000	5,000/25,000	4,000	2,000	2,000
Dividends	20,000	20,000/25,000	<u>16,000</u>	<u>8,000</u>	<u>8,000</u>
Total			\$20,000	\$10,000	\$10,000

## Conclusion – Remember the Following

- Definition of simple and complex trusts
- Impact of accounting income and DNI on the distribution deduction for simple trusts
- Impact of actual distributions and DNI on the income distribution deduction for complex trusts
- Calculate how items of taxable income flow to a K-1 of a beneficiary for a simple and complex trust
- To include non-deductible items such as investment fees in the accounting income calculation for simple trusts
- To check a box to utilize Reg. 1.652(b)-3 to allocate expenses to higher taxable items



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# Thank You!

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