

## 22. TAX REPORTING

### Reporting Taxes

Preparation of the necessary tax forms for certain Trust Services activities can be a complex matter. Someone on the staff of the trustee organization should be designated to be responsible for the preparation of all tax forms the fiduciary is required to file. Many of these forms are routine, with the information coming directly from the accounting records. However, some trust and estate matters are very complex and are encountered only occasionally. When such questions arise, qualified tax counsel should be sought.

Publishers such as CCH and RIA have regular publications that are up-to-date on all tax matters. At a minimum, one of the basic tax services should be available to the individuals responsible for the fiduciary tax form preparation in each office.

Over the years, church leaders have become accustomed to the idea that church entities do not have to pay tax. However, churches are subject to the general tax laws. The fact that churches do not generally pay taxes is a function of the tax law that exempts them. Unrelated business income, lobbying activities, and loss of tax exempt status as a result of breaking the rules under which the organization is tax exempt are examples of situations that could cause a tax liability.

Acting as fiduciary for trusts and estates in which the church has a substantial interest should not subject the charity to any tax. But the trusts and estates themselves, and the non-charitable beneficiaries of those trusts and estates, will often be subject to a tax liability. The fiduciary is responsible for filing the income tax forms and information forms required of all fiduciaries.

It should be noted that different tax returns are required for different types of trusts and estates. Sometimes forms must be filed giving information to the IRS, even though no tax is due. The detailed instructions which accompany all IRS forms should be carefully studied and followed.

### Grantor Trusts Defined

A grantor trust is a trust in which the grantor or another person has the right to control the enjoyment of the income and/or principal. Internal Revenue Code sections 671-679 and the related regulations describe the circumstances that will determine if a trust is to be taxed to the grantor or to another party. A trust may be partly a grantor trust and partly a non-grantor trust.

In general, if a person or his/her spouse has the right to receive the income or principal or the right to name or change the individuals who will receive the income or the principal or the beneficial enjoyment thereof, he/she will be required to report the income earned by the trust on his/her own personal tax return.

The trust will also be a grantor trust if the creator of the trust retains any administrative authority that would allow him/her to deal with the trust on less than an "arm's-length" basis. Borrowing

from the trust would show that this kind of administrative authority exists. **All revocable trusts are grantor trusts.**

For trusts created after March 1, 1986, the existence of a reversionary interest of more than 5% of the principal may make the trust a grantor trust. This provision in the Tax Act of 1986 made income shifting trusts such as the Clifford Trust and the spousal remainder trust ineffective for tax-avoidance purposes.

### **Simple Trust Defined**

A simple trust is a trust that is required to distribute all of its income currently; does not provide for any income amount to be paid to; or set aside for, a charitable purpose; and does not have any amounts other than income paid out during the year (IRC 651(a)). However, a trust may still be a simple trust if capital gains or losses are allotted to income under the governing instrument or local law.

### **Complex Trust Defined**

A complex trust is defined as any trust that is not a simple trust or a grantor trust. Any trust that distributes principal is a complex trust in any year that it distributes principal. A trust may be a simple trust in one year and a complex trust in another year. This could happen if the trustee is required to pay out the income and has discretion to pay out principal. In the years that only income is paid out, the trust would be a simple trust. In years when the trustee exercises its discretion and pays out principal, the trust would be a complex trust. A trust will never be a simple trust in the year in which it is closed, since the principal is distributed when closing the trust. Estates are treated like complex trusts.

### **Distributable Net Income Defined**

Distributable Net Income (DNI) is a very important concept in trust taxation because it is used to limit two important amounts. DNI is the maximum amount of distributions to beneficiaries that the trust can deduct from its gross income. DNI is also the maximum amount of trust income that the beneficiaries must include in their gross income. Where there is more than one beneficiary, each will report his/her share of trust income, up to his/her pro rata share of the DNI. DNI is a concept that also applies to income taxation of estates.

The following is a formula for calculating distributable net income. Start with taxable income (gross income minus deductions). Add to that the exemption, the distribution deduction, and net capital losses allocated to principal. Also add net tax exempt interest. Net tax exempt interest is all of the tax exempt interest earned by the trust, reduced by any expenses allocated to the tax exempt interest. Subtract from this any net capital gains attributable to principal, unless the trust requires that the gains be distributed to the beneficiaries or a charity. A trust will not include in DNI any extraordinary dividends or taxable stock dividends that are allocated to the principal.

### Distributable Net Income

Gross Income	\$	
(Minus) Deductions	\$	
<i>(Equals)</i>		\$
(Plus) Personal Exemption	\$	
(Plus) Distribution Deduction	\$	
(Plus) Net Capital Losses (unless charged to income)	\$	
(Plus) Net Tax Exempt Interest	\$	
(Minus) Net Capital Gain (unless allocated to income)	\$	
<i>(Equals) DNI</i>		\$

### Taxpayer Identification Numbers

The taxpayer identification number for an estate or trust is an employer identification number (EIN). The EIN is a unique 9 digit assigned by the IRS to each trust or estate for filing and reporting requirements. EINs are always in the format xx-xxxxxxx.

Generally every trust or estate which earns any income must have its own Taxpayer Identification Number. Final income tax forms (Form 1040) for a decedent are filed using the decedent's Social Security number. Self-trusted revocable trusts may also utilize the trustor's/trustee's Social Security number. Other trusts and estates require Employer Identification Numbers (EINs) provided by the IRS (use Form SS-4). You may also apply online and generally receive the EIN immediately at <http://www.irs.gov/businesses/small/article/0,,id=97860,00.html>.

### Final Form 1040 for Decedent

In the year that a person dies, his/her personal representative (or anyone responsible for his/her assets) is required to file a final Form 1040 reporting any income that he/she received during the tax year, through the day that he/she died. If the decedent has a surviving spouse, a joint return is allowed. The decedent's income through the date of death is included in the joint return. All of the applicable standard deductions are allowed, as if the decedent had been alive throughout the entire year.

### Estate Income Tax

At the death of the decedent, a separate taxable entity comes into being; namely the decedent's estate. Each estate that has income should apply for its own EIN. Form 1041 must be filed for each estate that has gross income in excess of \$600, a beneficiary who is a non-resident alien, or aggregate gross income of at least \$600 from an electing qualified revocable trust and the related estate.

## **Trust Income Tax**

All trusts are taxable entities, conduits for passing taxable income to someone else, or a combination of the two. Payment of the tax depends on who has a right to the income. If an individual has the right to the income, or the right to direct who receives the income (as the grantor in a grantor trust), he/she will be responsible for paying any tax that might be due on that income, even if that income is allowed to accumulate in the trust or is paid to someone else at the grantor's direction.

A Form 1041 must be filed any time the trust has any taxable income, gross income in excess of \$600, or a beneficiary who is a non-resident alien. Section 6034(a) requires that beneficiaries be informed of any trust income that should be taxed to the beneficiary.

As a matter of practice, the IRS generally will want to know why a form has not been filed if application has been made for an EIN or if a Form 1041 has been submitted in previous years. Many offices find that it is easier to file a 1041 for each trust than to try to decide whether one is necessary and answer IRS queries if one is not filed.

## **Revocable Trusts**

All revocable trusts are grantor trusts. The person who has the right to revoke is treated as the owner of the trust for income tax purposes and is obligated to pay any tax on trust income. If required, a Form 1041 should be filed with an explanatory schedule that shows the name, address, and Social Security number of the grantor along with details as to the amount and the character of all income that the trust earned during the year. This schedule is sometimes referred to as a substitute Schedule K-1. The substitute Schedule K-1 is sent to the grantor so that he/she will know what amount of income to report on his/her own income tax return. The tax year for a grantor trust is generally the calendar year. It should be noted that a revocable trust almost always ceases to be revocable upon the death or incompetency of the grantor. At the time of death or incompetency, a new EIN should be obtained. In that year, two Forms 1041 should be filed, one for the part of the year when the trust was a grantor trust and one for the part of the year when the trust was not a grantor trust. Separate K-1 schedules or appropriate substitutes should be filed with each Form 1041.

## **Irrevocable Trusts**

Irrevocable trusts can be simple, complex, or grantor trusts, depending on the terms of the trust instrument and how it is administered. Form 1041 should be filed if required. The income beneficiaries should be informed of the income that is taxed to them on Schedule K-1 or an acceptable substitute.

## Charitable Remainder Trusts

Charitable remainder unitrusts and charitable remainder annuity trusts have unique filing requirements that must be carefully followed. *Deferred Giving Specimen Forms*, published by *Taxwise Giving*, has a complete guide to tax return preparation for charitable remainder trusts.

Form 5227 must be filed for all charitable remainder trusts whether or not income is earned. Form 4720 is required if the trust violates any of the governing instrument's prohibitions against activities not allowed by a private foundation (i.e., self-dealing, taxable expenditures, etc.). As with all trusts or estates, a Schedule K-1 or appropriate substitute should be sent to all income beneficiaries to report any income taxable to the beneficiary. If there is any unrelated business taxable income (UBTI), the tax must be paid as an excise tax on Form 4720, with a form 990-T or similar schedule attached. The returns for split interest trusts (e.g. CRT) are required to be made available for public inspection upon request, but information about non-charitable beneficiaries need not be made publically available (IRC 6034 and Reg. Sec. 1.6034.1).

## Estimated Tax Payments

Any trust that owes tax may be required to pay the tax in quarterly installments. This tax must be estimated and paid with Form 1041-ES. Any potential tax liability should be studied carefully and estimates filed if necessary to avoid unnecessary penalties and interest.

## Trust Tax Report Form Flow Chart

To choose the correct form for the correct trust, answer the following questions, and follow the directions:

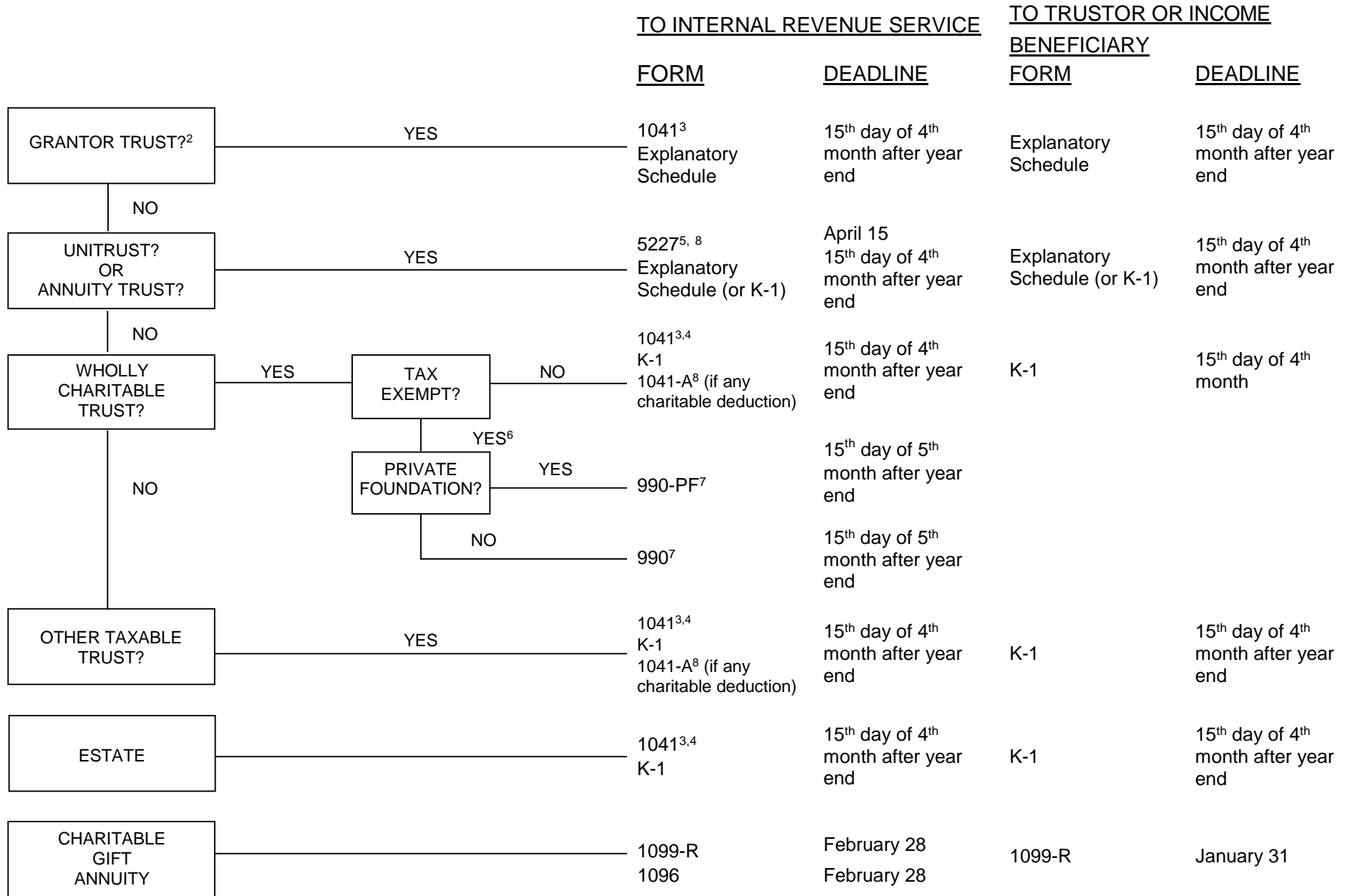
1. Is the trust a grantor trust? If it is, file a Form 1041 with a zero amount of income and a substitute Schedule K-1. A copy of the substitute K-1 also goes to the grantor.
2. Is the trust either simple or complex? If it is either one, file Form 1041 with the necessary schedules. Pay whatever tax is required. Give the tax information on a K-1 to the beneficiary, indicating his/her share of the DNI that must be reported.
3. Is the trust either a charitable remainder unitrust or a charitable remainder annuity trust? If it is either one, file Form 5227. Send the beneficiary any information concerning the income that he/she must report. If the trust has any UBTI additional forms may be required as described above.

## Estate Tax Returns

For decedents dying in 2010, 2011 or 2012 a return is required if the gross estate value is \$5,000,000 or more, indexed for inflation. However, for decedents dying in 2010, an election may be made to follow the pre-2010 rules that provide for no estate tax for 2010. If that election is made, then the estate assets will not qualify for a full step-up in basis for assets in excess of \$1.3 million or \$3 million passing to a surviving spouse. All assets owned by the decedent,

including joint property, certain life insurance policies, etc., are included in the gross estate. The personal representative/executor is responsible for filing the estate tax return. Most denominational planned giving and trust services personnel will not have a great deal of experience with Form 706, Estate Tax Return, and therefore, should seek competent tax counsel when the responsibility for filing Form 706 arises.

**SUMMARY OF FIDUCIARY TAX REPORTING REQUIREMENTS<sup>1</sup>**  
**By O. Richard Caldwell**



**Footnote Explanations for  
Summary of Charitable Fiduciary Tax Reporting Requirements Table**

1. Does not include Pooled Income Agreements or Charitable Lead Trusts.
2. A grantor trust exists if the grantor (or other party) retains too much control or other benefit from the trust (e.g., a revocable trust or an irrevocable trust where all trust income is required to be paid to the trustor). (IRC 671-679)
3. A 1041 is required for any trust that has gross income of \$600 or more, any taxable income, or any non-resident alien beneficiary. (IRC 6012(a)) Forms for extension of time to file—Form 2758 (estates) or 8736 (trusts).

Under the middleman reporting requirements (Reg. Sec. 1.6042 and 1.6049), if the minimum requirement for filing a 1041 is not met, a 1099 should be sent to the income beneficiary; however, no 1099 is required if a 1041 is sent, even though not required. Therefore, for uniformity, simplicity, and efficiency, it is recommended that a 1041 be used for all trusts and estates that earn any income.

4. Estimated Income Tax for Fiduciaries Form 1041-ES may have to be filed and estimated income tax payments made for any trust, or estate (and any trust that was treated as owned by the decedent and that received the residue of a decedent's estate under the will or if no will was admitted to probate, a trust primarily responsible for paying debts, taxes, and other expenses of administration) for any tax year ending two or more years after the decedent's death, if there is at least \$1,000 of net income tax due, and total withholding and credits are less than the smaller of 90% of the current year's net tax due or 100% of the prior year's net tax due. (NOTE: certain limitations exist regarding reference to the prior year's tax due.)
5. May also have to file Form 4720 if any private foundation excise taxes. If there is any unrelated business taxable income (UBTI) the UBTI must be paid as an excise tax on Form 4720, with Form 990-T or a similar schedule attached.
6. If tax-exempt status is applied for (Form 1023) within 15 months of the creation of the trust, the exempt status generally will be effective retroactively to the creation of the trust; if exempt status is applied for more than 15 months after the creation of the trust, the trust generally will be exempt only from the date the exemption is granted. An automatic 12-month extension is available.
7. May also have to file Form 990-T, Exempt Organization Business Income Tax Return, if \$1,000 or more of unrelated business income (UBI).
8. Any taxable trust claiming a charitable deduction is required to file Form 1041-A unless all trust income is required to be distributed currently to beneficiaries in the tax year. A Form 1041-A is no longer required for a split-interest trust (CRT). The returns for split-interest trusts are required to be made available for public inspection upon request, but information about non-charitable beneficiaries need not be made publicly available. (IRC 6034 and Reg. Sec. 1.6034.1)