

# TRUST CONNECTION

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## MCF Private Trust

A Monthly Report  
on Trust News  
and Information

Our trust services enable us to seamlessly serve you and your family in a manner that is both cost-effective and efficient. We are able to serve as an investment advisor to your trust without sacrificing protection for trust beneficiaries. MCF Private Trust is a Trust Representative Office of National Advisors Trust Company, a national independent advisor-owned trust company.

## Fiduciary Income Tax Basics

Income tax plays a critical role in day-to-day investing, yet for many the concepts can get disorganized. What are the key issues that drive fiduciary income taxation, and how can we best represent and communicate those concepts to the client for optimal results? First, we need to go back to some of the basics.

### What Is Fiduciary Income Tax?

Fiduciary income tax returns report the income of estates and trusts. A fiduciary is an individual who manages a deceased person's estate and/or trust. They must also settle any tax liabilities before transferring the trust or estate to the legal heirs. Fiduciaries must pay any tax earnings after the grantor's death including interest on investments and deferred salary. Tax officials treat the income as if the deceased obtained the income while still alive. Fiduciary income tax must be filed using Form 1041 for both trusts and estates.

### Trusts and Estates as Taxpayers

When someone dies, an estate is created. A representative (fiduciary) oversees the estate during the settlement of all legal affairs of the deceased. The transition of the estate ends upon the distribution of the estate to the legal heirs of the deceased. A trust, on the other hand, is a legal arrangement where the grantor transfers legal ownership of an asset to the trustee who then passes it on to the beneficiary. The trust document contains all the terms of the grantor. Estate and trust representatives are responsible

for reporting fiduciary income to the government. The fiduciary of a domestic deceased's estate or trust files Form 1041 to report:

- The income, deductions, gains, losses, etc. of the estate or trust
- The income that is either accumulated or held for future distribution or distributed currently to the beneficiaries
- Any income tax liability of the estate or trust
- Employment taxes on wages paid to household employees

Determining taxable income, for both trusts and estates, bears some differences compared to an individual's personal taxes. The trust gets a deduction for the portion of the estate transferred to heirs. Anything remaining becomes taxable income for the trust or estate. The trust/estate pays tax on the taxable income applicable to the estate/trust while the legal heirs pay tax on the assets they receive. As compared to an individual taxpayer, trusts and estates receive significantly lower personal exemptions.

### Taxes on Irrevocable Trusts

In an irrevocable trust, a tax return will be submitted on behalf of that trust as a separate entity. The trustee makes sure that the tax return is filed and will report estate taxes using Form 1041 for estates



and trusts. On this form, clients will disclose any interest income, deductions, gains, and losses for the trust, and they will also report any distributions.

Clients will only need to complete and submit Form 1041 if the estate generates more than \$600 in gross income for the tax year. When money is distributed to beneficiaries, those distributions will need to be deducted and reported using the K-1 form (it breaks down the distribution, or how much of the distributed money came from principal versus interest. The K-1 lets the beneficiary know his/her tax liability from trust distributions). If necessary, an individual can file an extension as they would on an individual tax return.

### **Taxes on Revocable Trusts**

Unlike irrevocable trusts, revocable trusts can be changed, giving the client the option to add or revoke the trust at any time. For revocable trusts, clients are expected to pay taxes on the income they earn on the principal while they are still alive. However, just as with irrevocable trusts, the revocable trust becomes a separate entity once the client is deceased. If in the final year the trust earned income, the trustee will file that with their personal individual tax return for that year and pay taxes as the estate for the years to come. When distributions are made, those are

claimed as deductions on the estate's tax return, just like an irrevocable trust.

### **How to Determine Whether the Entity or Beneficiary Pays the Tax**

In the 1041 tax return form, the entity reports and pays its income taxes. However, it is also a return where an entity may deduct certain items from taxable income because that income is being reported on the tax return of the beneficiaries of the estate or trust. As a result, beneficiaries of a trust typically pay taxes on the distributions they receive from the trust's income, rather than the trust itself paying the tax.

### **Communication with Beneficiaries**

Every trust and estate, while similar, has a different nature. It is essential to stay up to date and communicate with the beneficiaries to clear up any confusion regarding the complex nature of fiduciary income tax.

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