



Welcome to *Trust Connection*, our monthly newsletter highlighting Trust news and information. Each month we will feature timely articles of interest.

## About Us

At Halliday Private Trust, it is our mission to assist our clients in the process of providing solutions, specifically through a wide range of financial advice.

Since 1982, we have utilized a full spectrum of financial services to help our clients navigate every major hurdle in their financial lives. Because we are an independent financial services firm, we utilize an open architecture approach to locating the most suitable investment options for our clients.

Our role is to help clients make smart decisions about their money. We understand that each client has unique needs and requires personalized solutions based on their goals, objectives and concerns.

## 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 tackle the concepts for optimal results? First, we need to start with some 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

## A LOCAL TRUST SOLUTION

Call us today at (800) 786-1598 to learn more about working with Halliday Private Trust.

For information and assistance, please feel free to contact one of our Trust Advisors:

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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. In this form, any interest income, deductions, gains, and losses for the trust will be disclosed, and any distributions will need to be reported.

Form 1041 will only need to be completed and submitted 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, which provides the option to add or revoke the trust at any time. For revocable trusts, you are expected to pay taxes on the income you earn in the principal while you are still living. However, just as with irrevocable trusts, the revocable trust becomes a separate entity after death. If in the final year the trust earned income, the trustee will file that with your 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*

Using 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 Advisors*

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

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