THE COMPLEXITY OF COMPUTING THE ADJUSTED GROSS INCOME FOR AN ESTATE OR TRUST

The computation of taxable income for an estate or trust is computed in the same manner as in the case of an individual.[1] Therefore, if an estate or trust has deductions which are limited by adjusted gross income, the estate or trust must determine the amount of adjusted gross income. For example, if an estate or trust has miscellaneous itemized deductions not exempted by § 67(e), these deductions are deductible only to the extent they exceed 2% of the estate or trust's adjusted gross income.

In January of 2008, the Supreme Court, in a unanimous decision, held that generally the costs of outside investment advice paid by trustees or executors are subject to the 2% adjusted gross income floor.[2] Because of the Supreme Court's holding, the computation of an estate or trust's adjusted gross income takes on added importance. The purpose of this article is to illustrate the complexity, under the existing law, of computing the adjusted gross income for an estate or trust.

Computing Adjusted Gross Income as per Form 1041 Instructions

The Code defines adjusted gross income for an estate or trust as identical to adjusted gross income of an individual with three exceptions.[3] The first exception is the deduction allowed for expenses which would not have been incurred but for the existence of the trust (e.g., trustee's fees). The second exception is distributions to beneficiaries of simple and complex trusts. The third exception is the deduction allowed in lieu of a personal exemption.[4] The regulations make it clear that nongrantor trusts do not pass through miscellaneous itemized deductions subject to the 2% limitation to the beneficiaries. Therefore, the 2% limitation will be imposed on the trust rather than the beneficiary.[5] Other than making the above mentioned point, the Regulations shed very little light on the actual computation of an estate or trust's adjusted gross income. The instructions for Form 1041 are helpful, but as will be shown, are limited as to the scope of the coverage.

To assist in making the subsequent analysis of the computation of adjusted gross income, a summary will follow as to the pertinent lines on Form 1041 (2009) and the items entered on those lines.

Form 1041

Line 9 - total income

Line 10 - interest expense

Line 11- taxes

Line 12 - fiduciary fees

Line 13 - charitable deduction

Line 14 - attorney, accountant, and return preparation fees

Line 15(a) - other deductions not subject to 2% of AGI

Line 15(b) - allowable miscellaneous itemized deduction subject to 2% of AGI (AMID)

Line 18 and Schedule B line 15 - income distribution deduction (DD)

Line 20 - exemption

Schedule A line 2 - tax-exempt income allocable to charitable contributions

Schedule B line 2 - adjusted tax-exempt income (ATEI)

Schedule B line 7 - distributable net income (DNI)

Actual distributions less than distributable net income (DNI)

When the actual distributions are less than DNI, the formula for computing AGI is as follows:

AGI = Line 9 - {(line 12) + (line 14) + [line 15(a)] + [line 18 (DD)] + (line 20)}

The application of the formula can be illustrated by the following example:

Example 1

Under the terms of the trust instrument, a reserve for depreciation must be maintained, capital gains are to be allocated to the principle account, and 50% of the trustee's fees are to be allocated to the principle account. The trustee is required to distribute $80,000 to the beneficiary and $10,000 to the Red Cross. The trust has the following items for the current year:

Rental income	$100,000
Dividends	35,000
Long-term capital gains	15,000
Rent expense	6,000
Depreciation	5,000
Trustee's fees	8,000
Investment advisory fees	4,000

Computation of AGI

Line 9

Rental income ($100,000 - $6,000 - $5,000)	$ 89,000

Capital gains	15,000
Dividends	35,000
Line 9 total	$139,000
Less	
Line 12 - trustee’s fees	(8,000)
Line 18 - distribution deduction	(80,000)
Line 20 - exemption	(100)
AGI	$ 50,900

AMID = $2,982 = [$4,000 - ($50,900 x 2%)] (line 15b)

After determining line 15b of Form 1041, the return can be completed with DNI and DD as follows:

DNI = $103,018 (Schedule B line 7)

DD = $80,000 (Schedule B line 15)

Actual distributions greater than distributable net income

When the income distribution is greater than DNI, the distribution deduction is limited to DNI. Therefore, the DNI must be computed taking into account the allowable miscellaneous itemized deductions (AMID) after application of the 2% floor. In this fact pattern, there are two unknown amounts: the AMID, and the DNI. The formulas for solving the problem are as follows:

AMID = [total miscellaneous itemized deductions subject to the 2% floor (TMID)] - {.02 x [(AGI before the distribution deduction) - (DD which in this case is DNI)]}

AGI before the distribution deduction = {(line 9) - [(lines 12 + 14 + 15(a) + 20)]}

DNI = {(line 9) - [(capital gains allocated to the principle account) + (lines 10 through

15(a)) + (AMID)]}

The application of the formulas can be illustrated by the following example:

Example 2

Assume the same facts as in **Example 1**, except the trustee distributes an $80,000 required distribution and a $40,000 discretionary distribution to the beneficiary.

Computation of AGI

Line 9

Rental income ($100,000 - $6,000 - $5,000)	$ 89,000
Capital gains	15,000
Dividends	35,000
Line 9 total	$139,000

Less

Line 12 - trustee's fees	(8,000)
Line 20 - exemption	(100)
AGI before DD	$130,900

AGI = $130,900 - DNI

DNI = $139,000 - $15,000 - $8,000 - $10,000 - AMID = $106,000 - AMID

AMID = $4,000 - {.02 x [$130,900 - ($106,000 - AMID)]}

AMID = $3,433

DNI = $106,000 - $3,433 = $102,567

Because DNI is less than the actual distribution ($120,000), the distribution deduction is limited to DNI. Therefore, AGI is $28,333 ($130,900 - $102,567).

AGI = \$28,333

AMID = \$3,433 (line 15b)

DNI = \$102,567 (Schedule B line 7)

DD = \$102,567 (Schedule B line 15)

Computing Adjusted Gross Income When Tax-Exempt Income is Present

The instructions for Form 1041 do not address the additional problems presented in computing adjusted gross income when an estate or trust receives tax-exempt income (TEI). Section 67(e)(2) states the distribution deductions allowed under §§ 651 and 661, shall be treated as allowable in arriving at adjusted gross income. Sections 651 and 661 state the distribution deduction must not include items not included in gross income and the deductions allocable thereto. Hence, the distribution deduction must not include any tax-exempt income or, the deductions allocable thereto, in the actual distribution.

Under Reg. § 1.643(a)-5, DNI includes any tax-exempt income excluded from gross income. This tax-exempt income is reduced by tax-exempt income allocable to charitable contributions (Schedule A-line 2) and direct expenses and allocated expenses associated with the tax-exempt income. The expenses allocated to tax-exempt income are only those expenses that are otherwise allowable.[6] Therefore, the investment advisory fees allocated to tax-exempt income must be reduced by 2% of adjusted gross income before the allocation can be made. Form 1041, Schedule B, line 2 computes adjusted tax-exempt income (ATEI). The formula for this computation is:

ATEI = TEI - {(Schedule A line 2) + (any expenses allowable under section 212 that are directly or indirectly allocable to tax-exempt income except those subject to the 2% of

AGI limitation) + [(TMID - 2%AGI) x (TEI)/(gross income included in DNI)]

Actual distributions less than DNI

If the actual distribution is less than DNI, the distribution deduction is the actual distribution reduced by the ATEI allocated to the actual distribution. The formulas for computing adjusted gross income must be modified as follows:

AGI = {Line 9 - [line 12 + line 14 + line 15(a) + line 18 (DD) + line 20]}

DD = {actual distribution - [(actual distribution/DNI) x ATEI]}

DNI = {(line 9 + ATEI) - [(capital gains allocated to the principle account) + (lines 10 through 15(a)) + (AMID)]}

AMID = {(TMID) - (2% x AGI) - [(TMID - 2%AGI) x (TEI/gross income included in DNI)]}

These formulas can be illustrated by the following example:

Example 3

Assume the same facts as in **Example 1** except the following:

Dividends	$25,000
Tax-exempt income	$10,000

The computation of ATEI is as follows:

Tax-exempt income (TEI)	$10,000
Less:	
Trustee’s fees allocated to tax-exempt income[7]	
[($10,000/$135,000) x $8,000]	(593)

Investment advisory fees allocated to tax-exempt income[8] [($4,000 - 2%AGI) x ($10,000/($135,000)]	unknown
Tax-exempt income allocated to charitable contributions[9] (Schedule A line 2 [($10,000/$135,000) x $10,000]	(741)

ATEI = $10,000 - {($741) + ($593) + [($4,000 - 2%AGI) x ($10,000/$135,000)]}

AGI = $129,000 - ($7,407 + DD + $100)

DD = {$80,000 - [($80,000/DNI) x ATEI]}

DNI = [($129,000 + ATEI) - ($15,000 + $7,407 + $9,259 + AMID)]

AMID = {($4,000 - 2%AGI) - [($4,000 - 2%AGI) x ($10,000/$135,000)]}

Solving this set of five equations for AGI involves simplifying by first substituting ATEI and AMID into the equation for DNI. This provides an equation for DNI in terms of AGI. In this case DNI = $102,000 + .02AGI. This equation for DNI is then substituted into the equation for DD as well as the equation for ATEI, to express DD in terms of AGI. The equation is as follows:

DD = {$80,000 - [($80,000($8,369.7037 + .00148AGI)/ ($102,000 + .02AGI))]

This equation can be simplified and expressed as:

$$DD = \$74,074 – (\$3.25622 \times 10^{9})/ (\$5,100,000 + AGI)$$

AGI is then computed by substituting DD into the formula for AGI.

$$AGI = \$121,493 - \{\$74,074 - \$3.25622 \times 10^{9} / (\$5,100,000 + AGI)$$

Solving for AGI provides the following quadratic equation:

$$0 = \text{AGI}^{2} + \$5{,}052{,}581 \text{ AGI} - 2.4510 \times 10^{11}$$

One method for solving quadratic equations is the formula, x = $-b \pm \frac{\sqrt{b^2 - 4ac}}{2a}$, where

x = AGI. Let $a = 1$, b = \$5,052,581 and c = - 2.4510 x 10^{11}, then AGI = \$48,052 and the remaining variables are as follows:

AMID = \$2,814 (line 15b)

ATEI = \$8,441 (Schedule B line 2)

DNI = \$102,961 (Schedule B line 7)

DD = \$73,441 (Schedule B line 15)

Actual distributions greater than DNI

When the actual distributions are greater than DNI, the distribution deduction is limited to DNI. The DNI is then reduced by the ATEI contained in the DNI computation. Hence, the formulas are the same as those used where actual distributions are less than DNI and tax-exempt income is present with the exception that the formula for the distribution deduction is now DD = DNI - ATEI. This can be illustrated by the following example:

Example 4

Assume the same facts as in **Example 3** except the actual distribution to the beneficiary is an $80,000 required distribution and a $40,000 discretionary distribution.

The equations for solving the problem are as follows:

ATEI = $10,000 - {($741) + ($593) + [($4,000 - 2%AGI) x ($10,000/$135,000)]}

AGI = $129,000 - ($7,407 + DD + 100)

DD = DNI - ATEI

DNI = [($129,000 + ATEI) - ($15,000 + $7,407 + $9,259 + AMID)]

AMID = {($4,000 - 2%AGI) - [($4,000 - 2%AGI) x ($10,000/$135,000)]}

This set of equations is solved similarly, by first substituting ATEI and AMID into the equation for DNI to obtain the following:

DNI = $102,000 + .02AGI

Substituting DNI and ATEI into the equation for DD results in the following:

DD = $93,630.2963 + .0185 AGI

Substitute DD into the equation for AGI. This equation results in AGI = $27,356, and the remaining variables are as follows:

ATEI = $8410 (Schedule B line 2)

DD = $94,137 (Schedule B line 15)

DNI = $102,547 (Schedule B line 7)

AMID = $3,197 (line 15b)

The computation of adjusted gross income, when no tax-exempt income is present, is fairly straight forward. When the distribution to beneficiaries is greater than distributable net income, the computation of adjusted gross income involves solving simultaneous equations. When tax-exempt income is present, the computation of adjusted gross income becomes extremely difficult. The computation involves five equations with five unknowns. Therefore, the computation of adjusted gross income requires an understanding of quadratic equations.

Conclusion

Under the current law and regulations, the correct computation of the adjusted gross income for an estate or trust can result in a very difficult and complex computation. The fact that there is very little statutory or regulatory guidance only enhances the difficulties. It is hard to imagine that the drafters of the statutory language envisioned the complexities associated with the computation of the adjusted gross income of an estate or trust. However, because the computation of adjusted gross income will become a more frequent concern, further statutory and regulatory changes, guidance, and clarification would certainly be welcome.

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1. § 641(b).
2. *Knight v. Comr.*, 128 S.Ct. 782 (2008), *aff'g sub nom. Rudkin Testamentary Trust v. Comr.*, 467 F.3d 149 (2d Cir. 2006).

3. § 67(e).

4. § 67(e)(2).

5. Reg. § 1.67-2T.

6. Reg. § 1.265-1(c).

7. Reg. § 1.652(c)-4, Reg. § 1,652(b)-3, and Rev. Rul. 77-355, 1977-2 CB 82.

8. Reg. § 1.652(b)-3(b). It is assumed that the investment advisory fees are not directly attributable to a specific class of income and hence, a portion is allocated to tax-exempt income.

9. Regs. § 1.642(c)-3(b)(2), (3), which refers to the DNI rules for allocating exempt income and determining the character of the other deductible amounts. Regs. §§ 1.643(a)-5; 1.662(b)-2; 1.662(c)-4, Ex. (e).