Income Taxation of Trusts and Estates

ACTEC Heart of America Fellows Institute

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Oklahoma City, Oklahoma

Janet Rae Montgomery
Daluga Boland and Montgomery, LLC
200 West Adams Street, Suite 2500
Chicago, Illinois 60606
312-262-5093
jrm@dbmtaxlaw.com

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PART I -- INTRODUCTION TO INCOME TAXATION OF TRUSTS

A. Why is fiduciary income tax important?

For estate planners, the issue of planning for the transfer tax (estate, gift, and generation-skipping) has been eclipsed by the necessary income tax planning for trusts and estates, particularly by issues of basis. In addition, income kept in the trust or estate is subject to substantial erosion by the very high income tax rates that apply to trusts and estates. It is far more likely that a trust will be in the top income tax bracket than that it will subject to the 40-percent transfer tax. For example, for 2019, a trust is in the highest tax bracket of 37 percent at only $12,750 of income, while an individual is in that same bracket only after $510,301 of income. Rev.Proc. 2018-57.

The very high estate tax exemptions and the very low income tax thresholds for trusts mean that the income tax effects of using a trust must be even more carefully examined and more thoroughly explained to the client than ever before. Indeed, the tax climate suggests that basis and income issues (for capital gains and income tax purposes) have eclipsed transfer tax planning for the majority of our clients. Add to this the NII surtax (Obamacare tax) on investment income, and efforts to find a trustee "materially participated" in a business so as to avoid the 3.8% surtax AND NOW the TCJA promise in §199A of excluding up to 20% of certain business income for qualifying owners -- many of which are trusts -- and the income taxation of a trust has grown both in importance and in complexity.

B. Basic Rules and Concepts

The rules of Subchapter J are rational and fairly easy to manage. Keep in mind that there are only a few general concepts that provide the foundation of trust taxation.

1. Trusts are frequently ignored for income tax purposes. When the grantor or another person possesses certain powers over the trust, then that person is treated for tax purposes as the owner of the trust property. In the case of these so-called "grantor trusts," the deemed owner reports the income, expenses, and credits of the trust on his or her personal income tax return just as if the trust did not exist. The use of grantor trusts in the estate planning area has grown substantially. Such "income tax defective" trusts use the IRS income tax rules to require a grantor to pay the income taxes for a trust — even though the grantor no longer owns the principal of that trust. The use of the grantor trust rules can have tremendous estate freezing implications. As a result, an alphabet soup of

ideas and concepts is flourishing, such that a thorough understanding of the grantor trust rules is a basic necessity for estate planning practitioners.

2. The notion of “trust income” has two distinct definitions. One definition is the definition used under state law to allocate receipts and expenditures for administration as “income” or “principal”. Each state has its own Principal and Income Act (even if only through court decisions – thank you Rhode Island). Usually, but not always it is the Uniform Principal and Income Act, or some revised version thereof. This is the “fiduciary accounting income” (FAI) of the trust. The other definition of income is used to measure and characterize taxable income or loss for purposes of income taxation. This is the trust’s “tax accounting income.” The rules in Subchapter J are designed to approach fiduciary accounting income concepts for taxable income, but they do so only imperfectly. It is important not to mix the tax income concepts with the fiduciary accounting income rules.

3. A trust is taxed only on the income retained by the trust and not on the income distributed to the beneficiaries. Income retained by the trust is taxed basically on the same basis as an individual is taxed on income. Distributed income is taxed to the beneficiary. The allocation of taxable income between the trust and the beneficiary is accomplished through the trust’s “distributions deduction” and the concept of “distributable net income” (DNI). Together, these two mechanisms, unique to trust taxation, both measure and characterize the income taxed to the trust and to the beneficiary.

4. Whenever property (other than cash) is the subject of any transfers to or from a trust, special rules apply concerning recognition or nonrecognition of gain or loss.

5. When a trust terminates, special rules apply to the terminating distributions and final tax year of the trust. Those rules changed under the Tax Cut and Jobs Act when the deductions subject to the 2% floor were largely eliminated, and are still (as of this writing) in flux.

6. Often, trusts are beneficiaries of estates and other trusts, and close attention must be paid to these rules and transfers between trusts and estates, particularly as to the recognition of gain or loss and to different rules concerning terminating distributions between trusts and estates.

7. Also, trusts frequently own interests in pass-through entities such as S Corporations, LLCs and partnerships, and close attention to the pass-through income reportable by the estate or trust must also be paid.

8. Finally, the final income tax return of the decedent/grantor in the year of death needs to be coordinated with the initial trust or estate income tax returns following death. Give consideration to pre-death planning (such as realizing losses before death rather than suffering a step-down in basis at death).

In approaching any of the income tax issues and problems presented, the attorney should review the Treasury Regulations that have, for the most part, been in place since 1956 and are clear and succinct. The Code and the regulations contain many practical examples and should be referred to whenever the attorney approaches any income tax issue for a trust. In addition, a review of the Form 1041, U.S. Income Tax Return for Estates and Trusts, its associated schedules, and the other tax forms called for on Form 1041 provides a general guideline as to what the IRS expects the trust to report. The separate instructions for each IRS form contain information useful in preparing that form and should be consulted. Almost all of the income tax differences between an estate and a revocable trust have been eliminated from the income tax provisions of the Code so that the types of assets owned or the tax result from their disposition should not now depend on whether the decedent's property is disposed of by will or through the use of a revocable trust. Forms, regulations, and rulings are available from the IRS at www.irs.gov.

Part II provides an overview of the federal income taxation of trusts and estates. It discusses the differences between a grantor, simple, and complex trust, and the tax consequences of each to the trust and the beneficiary.

Part III - taxing trusts and estates - is an in-depth discussion of Subchapter J.

Part IV discusses the technical aspects of computing a trust or estate's taxable income. A detailed discussion of the fiduciary income tax charitable deduction and the allocation of a depreciation deduction between the estate or trust and its beneficiaries are among the topics discussed in this part.

Part V discusses compliance and procedural issues that the fiduciary needs to know.

Part VI is an example of a 2018 fiduciary income tax return for a complex trust.

PART II - OVERVIEW OF INCOME TAXATION OF TRUSTS AND ESTATES

A. In General.

Trusts and estates are separate taxable entities. They have their own tax year and tax accounting method. They receive income and pay expenses. Income is taxed to either to the trust/estate or to the beneficiaries, depending upon the terms of the governing instrument, local law and, in the cases of estates and complex trusts, whether distributions have been made.

If income is not distributed but instead accumulated, it is taxed to the trust or estate.

If income is distributed or deemed distributed to the beneficiaries, the trust or estate is allowed a deduction for (all or part of) the amount of the distribution and the beneficiaries are required to report the amount distributed as their income.

B. Distributable Net Income.

Distributable Net Income (DNI) determines both the amount of the distribution deduction allowed to an estate or trust, and the amount the beneficiary is required to report.

DNI is important for three reasons: (1) it acts as a ceiling on the amount of the deduction a trust or estate is allowed for distributions to beneficiaries, (2) it acts as a ceiling on the amount of the distribution that the beneficiary must account for on his income tax return, and (3) it characterizes the income (e.g. taxable interest, tax-exempt interest, dividends, etc.) that is distributable to the beneficiary.

Reduced to simple terms:

DNI approximates accounting income less tax deductions.

DNI is defined in §643(a) as taxable income with the following modifications:

1. *Add back* the distributions deduction

2. *Add back* the deduction for personal exemption.

3. *Subtract out* capital gains and *add back* capital losses allocable to principal (except in the year of termination or where they are allocated to income under the terms of the governing instrument or local law or allocated to principal and actually distributed). See Reg.§1.643(a)-3(b) for instances when capital gains are includible in DNI.

4. *Subtract out* extraordinary dividends and taxable stock dividends allocable to principal for simple trusts only. Thus, extraordinary dividends or taxable stock dividends allocated to principal are included in a complex trust's DNI but not in a simple trust's DNI. The impact of this is that a simple trust will be taxed on extraordinary dividends or taxable stock dividends allocated to principal but in a complex trust the beneficiaries will be taxed on the dividends, depending upon the amount of distributions and DNI.

5. *Add back* net tax-exempt interest i.e. tax-exempt interest less deductions allocable to tax- exempt interest. Note that the tax-exempt interest that must be added back to DNI is reduced not only by the expenses allocable to the tax-exempt interest, but also by the amount of the charitable deduction (Reg.§1.643(a)-5), if any, allocable to the tax-exempt income. The sample complex trust example at the end of this outline illustrates this calculation.

Example: Trust has $10,000 of interest income and $15,000 of dividends and $5,000 of trustee's commissions. Trust makes no distributions. Taxable income is $19,900 consisting of $10,000 of interest income, $15,000 of dividends less $5,000 of trustee's commissions and less the $100 personal exemption. The DNI of the trust is $20,000. The calculation of DNI starts with taxable income of $19,900 and adds back the personal exemption.

Example: The facts are the same as in the previous example except that the trust has a $30,000 long-term capital gain. The taxable income of the trust is $49,900 consisting of $10,000 of interest income, $15,000 of dividends and $30,000 of long term capital gain less $5,000 of trustee's commissions and less the $100 personal exemption. The DNI of the trust is $20,000. The calculation of DNI starts with taxable income of $49,900 and adds back the $100 personal exemption and subtracts out the $30,000 capital gain.

Example: The facts are the same as the previous example except that the trust earns $5,000 of tax-exempt income. Taxable income is $50,733 consisting of $10,000 of taxable interest income, $15,000 of dividends, $30,000 of long term capital gains less deductible expenses of $4,167 and less the $100 personal exemption. Only $4,167 of the trustee's commissions is deductible. The portion of the trustee's commission allocable to tax-exempt interest is nondeductible. The $833 portion of the trustee's commissions that is nondeductible is calculated by multiplying the $5,000 of trustee's commissions by a fraction consisting of the $5,000 of trustee's fees over the $30,000 of items entering income the calculation of trust accounting income ($10,000 dividends plus $15,000 of dividends plus $5,000 of tax-exempt income). The DNI of the trust is $25,000. The calculation of DNI starts with taxable income of $50,733 and adds back the $100 personal exemption, subtracts out the $30,000 long term capital gain and adds back the $4,167 net tax exempt income ($5,000 of tax-exempt income less the $833 of nondeductible trustee's commissions allocated to tax-exempt income).

Example: Trust requires the income to be distributed currently to A. Capital gains are allocated to principal and all expenses are charged to principal. During the year the trust has the following items of income and expenses:

Dividends	$30,000
Extraordinary dividends (principal)	$20,000
Taxable interest	$10,000
Tax-exempt interest	$10,000
Long-term capital gains	$10,000
Trustee's fees allocated to principal	$ 5,000

The trust accounting income determined under §643(b) is $50,000 computed as follows:

Dividends	$30,000
Taxable Interest	$10,000
Tax-exempt interest	$10,000
Total $50,000	

The trustee's fees allocated to tax-exempt interest is $1,000 ($10,000 tax exempt interest/$50,000 trust accounting income x $5,000 trustee's fees).

The taxable income of the trust is $65,700 computed as follows:

Dividends	$30,000
Extraordinary dividends	$20,000
Taxable interest	$10,000
Long-term capital gain	$10,000
Total	$70,000
Less: Trustee's fees Less: Exemption	($ 4,000)
	($ 300)
Taxable Income	$65,700

The DNI of the trust is $45,000 computed as follows:

Taxable income	$65,700
Add back:	
	$300
Personal exemption	
Net tax-exempt income:	$10,000
Tax-exempt interest	(1,000)
Less: Allocated Trustee's fees	$9,000
	(10,000)
Subtract out:	(20,000)
Long-term capital gain	
Extraordinary dividends (principal)	
DNI	$45,000

C. Inclusion of Capital Gains in DNI

The tension between the fiduciary's duty of impartiality in administering the trust -- trying to keep income beneficiaries and future remainder beneficiaries happy – is never more vivid than in making decisions about minimizing taxes through the distribution of capital gains (normally allocated to principal).

Generally, capital gains are *not* included in DNI and will be taxed at the estate or trust level, except in the year the trust or estate terminates. §643(a); Reg.§1.643)(a)(3). Because of the compressed tax rates applicable to trusts, distributions of capital gains to beneficiaries may shift the tax burden on these gains to individuals in lower tax brackets. Moreover, the beneficiaries may have capital losses to offset the gains.

The Uniform Principal and Income Act (UPIA) and revisions to the §643(a) regulations have provided fiduciaries with flexibility in making distributions of capital gains to beneficiaries. The regulations under §643 provide three exceptions to the general rule that capital gains will not be included in DNI. In a year prior to the year of termination, capital gains will be included in DNI if they are: (a) pursuant to the terms of the governing instrument and applicable local law, or (b) pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law):

Exception 1 - allocated to trust accounting income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to subparagraph §1.643(a)-3(b));

Exception 2- allocated to principal but treated consistently by the fiduciary on the trust's books, records and tax returns as part of a distribution to a beneficiary; or

Exception 3 - allocated to principal but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

The revised §643 regulations are the IRS' response to state statutes, such as the UFIPA (Uniform Fiduciary Principal and Income Act, new for 2019), UPIA and unitrust statutes, that change the traditional concepts of income and principal to recognize investment strategies seeking total positive return on trust assets.

It helps to see what the revisions consisted of in order to understand the possibilities opened up in this area.

Redline Between Proposed and Final Regulations for Capital Gain Inclusion: Consistency Required?

(b)Capital gains included in distributable net income. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and ~~consistent~~ *impartial* exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by *applicable* local law or by the governing instrument if not ~~inconsistent with~~ *prohibited by applicable* local law-

> (1) Allocated to income *(but if income under the state statute is defined as. or consists of. a unitrust amount. a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(Q))*;
>
> (2) Allocated to corpus but treated *consistently* by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
>
> (3) Allocated to corpus but *actually distributed to the beneficiary or* utilized by the fiduciary in determining the amount ~~which~~ *that* is distributed or required to be distributed to a beneficiary.

1. Exception 1- Allocated to Income.

Capital gains actually allocated to income either by the governing document or a reasonable and impartial exercise of discretion by the fiduciary may be included in DNI. Reg.§1.643(a)-3(b)(1).

Example: A state statute regarding unproductive property provides that if trust property does not produce an average annual net return of at least 1% of its cost or value when acquired, a statutory share of such proceeds from the sale of the trust property would be treated as "delayed income" and allocated to income instead of principal. When the trust property was liquidated resulting in a capital gain to the trust, a portion of the proceeds were allocated to income and that portion was included in DNI. The IRS approved of the allocation and calculation of DNI. Rev. Rul. 85-116, 1985-2 C.B. 174.

The power to adjust under Section 104 of the UPIA may be a way for a trustee to include gains in DNI. Section 104 allows the fiduciary to adjust between income and principal if (1) the fiduciary manages the trust assets as a prudent investor, (2) the terms of the trust describe the amount that may or must be distributed by referring to the trust's income, and (3) the trustee exercises the power to adjust impartially and based on what is fair and reasonable to all beneficiaries. Under the power to adjust, a fiduciary could transfer a

portion of the capital gain from principal to income to the extent the fiduciary impartially determines such a transfer is necessary to be fair and reasonable to all the beneficiaries.

Example: Trust is required to distribute all the income to A for life, remainder to B. The state has adopted the 1997 version of the UPIA. In 2018 the trust receives $8,000 of dividends and $20,000 of capital gain. Under normal circumstances, the trust accounting income is $8,000 and the $20,000 of gain is allocable to principal. The $8,000 income is distributed to A, the trust receives an $8,000 income distribution deduction and the $20,000 of gains are taxed to the trust since they are not included in DNI. The trustee could exercise his power to adjust under the UPIA to allocate some or all of the $20,000 gains to income. The gains allocated to income would be included in DNI and distributed and taxed to A. However, note that the §643 regulations do not include examples of the tax treatment of the power to adjust.

State unitrust statutes are another way to shift capital gains to income. A unitrust statute allows a fiduciary to calculate trust accounting income as a percentage of the trust's assets as of either the beginning of the year or under some type of averaging method. The tax treatment depends on whether the state unitrust statute has an ordering rule. Some state unitrust statues provide that the unitrust distribution be considered paid from the highest-taxed income first. In those states that do not have an ordering rule, the determination of the type of income distributed is left to the trustee's discretion. If so, and the trustee distributes capital gains to the beneficiary, the trustee must follow a consistent and regular practice of including capital gains in the distribution. Such gains will be included in income limited to the amount by which the unitrust amount exceeds ordinary income and tax-exempt income. See Reg.§1.643(a)-3(e), Example 13.

Example: The applicable state provides that a trustee may make an election to pay an income beneficiary an amount equal to 4% of the fair market value of the trust assets, as determined at the beginning of each year, in satisfaction of the beneficiary's right to income. The state statute has an ordering rule whereby the unitrust shall be considered paid first from ordinary income and tax-exempt income, then from short-term capital gain, then from long-term capital gain and finally from principal. The trust provides that A is to receive each year income as defined under the statute. The trustee makes the unitrust election. At the beginning of the year the trust assets are valued at $500,000. During the year the trustee receives $5,000 of dividend income and realizes $80,000 of net long-term capital gain from the sale of capital assets. Trustee distributes $20,000 (4% of$500,000) to A in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the statute and is included in DNI for the year. Reg.§1.643(a)-3(e), Example 11.

A unitrust statute will enable a trustee to shift some, but, in most cases, not all capital gains to trust accounting income and into DNI. If the state has an ordering rule, the trustee need not do so consistently. However, if the state does not have an ordering rule and the trustee exercises his discretion, the trustee must consistently include capital gain in income to the extent the unitrust amount exceeds ordinary and tax-exempt income of the trust. Can the

trustee change methods of calculating income for an existing trust? The preamble to the final regulations indicate that a trustee that is using a different method for calculating income under a state statute can select a new method for determining income despite the fact that the trustee has calculated income differently in the past. Thus, a trustee is allowed to deviate from prior practice for an existing trust that is implementing a unitrust method for calculating trust accounting income. See T.D. 9102, preamble. See also Exception 3.

The IRS issued final regulations defining trust accounting income on December 30, 2003. The regulations indicate that amounts allocated between income and principal pursuant to applicable local law will be respected if the local law provides for a reasonable apportionment of the year's total return, including ordinary income and tax-exempt income, capital gains and appreciation, between the income and principal beneficiaries. T.D. 9102, 69 Fed. Reg. 12 (1/2/2004). The regulations approve of state statutes that define income as a unitrust amount of 3% to 5% of the fair market value of the trust's assets determined either annually or averaged on a multiple year basis. They also permit a trustee to make adjustments between income and principal to satisfy a trustee's duty of impartiality between the income and remainder beneficiaries.

Gains from pass-through entities like a partnership should also be allocated to income. In *Crisp v. U.S.,* 34 Fed. Cl. 112 (1995) the court allowed $6 million in gains from a partnership owned by the trust to be allocated to income and included in DNI. The court reasoned that trust owned an interest in the partnership, not the underlying securities. Thus, the securities were not principal of the trust. If the trust owned the securities directly, the gains would be allocated to principal. This presents a planning opportunity for a trustee that would like to have capital gains allocated to income. A trustee wishing to have capital gain allocated to income could accomplish that result by having a partnership in which the trust was a partner hold and sell securities rather than having the trust own the securities. Any gain on the sale of securities by the partnership would flow through to the trust and, under the Crisp decision, be allocated to income. Under the Uniform Principal and Income Act, cash distributions from a partnership are generally deemed to be income. 1997 UPIA 401.

2. Exception 2 - Allocated to Principal but Treated Consistently as Part of a Distribution.

Capital gain allocated to principal but consistently treated by the trustee on its books, records and tax returns as part of a distribution to a beneficiary may be included in DNI. Reg.§1.643(b)(2).

A trustee can treat discretionary distributions of principal as being paid first from capital gains and include the gains in DNI. However, if the trustee does so, he or she must continue to treat principal distributions as coming from capital gains in all future years.

How does this apply to existing trusts? Apparently, the consistent practice must be adopted in the trust's first tax year. Reg.§1.643(a)-3(e), Example 2. It is uncertain if an existing trust can adopt a new consistent practice of including gains in DNI.

3. Exception 3- Allocated to Principal But Actually Distributed.

Capital gains may be included in DNI if they are allocated to principal and (1) actually distributed to the beneficiary or (2) utilized by the fiduciary in determining the amount that is distributed or required to be distributed to the beneficiary. Reg.§1.643(a)-3(b)(3).

This exception consists of two alternatives: (1) capital gains allocated to principal but actually distributed and (2) capital gains allocated to principal but utilized by the fiduciary in determining the amount that is distributed or required to be distributed to the beneficiary.

Under the first alternative, the trust would actually distribute the gains to the beneficiary. The examples in the regulations seem to indicate that this alternative only applies if a distribution of principal is mandated by the governing instrument or where the proceeds of a specific asset must be distributed to a beneficiary.

Example: Trust pays income to A. A is entitled to 1/3 of principal at 25, 1/3 of principal at 30 and the balance at 35. When the beneficiary reaches age 25 the trustee sells 1/3 of the assets and distributes the proceeds to A. The capital gain is included in DNI since it is actually distributed to the beneficiary. Reg.§1.643(a)-3(e), Examples 9 and 10.

It is also unclear whether or not this alternative will apply if the trustee has enough cash to satisfy the required distribution. In such a case it would not be necessary to sell the asset to make the required distribution.

Under the second alternative, the trustee could use the amount of capital gains to determine the amount that will be distributed to the beneficiary. For example, the trustee could make discretionary distributions to the beneficiary based on the amount of gains realized by the trust.

Example: A trust instrument requires all the income to be paid to A for life. The trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. The trust has $5,000 of dividend income and $10,000 of capital gains from the sale of securities. Trustee distributes to A $5,000 representing A's right to income. The trustee decides that discretionary distributions will be made only to the extent trust has realized capital gains during the year and makes a discretionary distribution of $10,000. Since the trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in the trust's DNI for the taxable year. Reg.§1.643(a)-3(e), Example 5.

4. Short-Term Capital Gains From Mutual Funds.

Short-term capital gains from mutual fund distributions may constitute a fourth exception to the general rule that capital gains do not enter into the calculation of DNI. The IRS has held that short-term capital gains distributed by mutual funds are treated as ordinary

income and are included in DNI even though they are allocated to principal for trust accounting purposes. PLR 9811036 and 9811037. The IRS reasoned that §852(b)(3)(B) treats a capital gain dividend as a long-term capital gain but makes no similar provision for short-term gains. Thus, short-term gain must be treated as ordinary income by the recipient and in computing DNI.

5. Capital Gains and Charitable Contributions.

A fifth exception exists for capital gains given to charity. If capital gains are paid, permanently set aside, or to be used for the purposes specified in §642(c), so that a charitable deduction is allowed under §642(c) in respect of the gains, the gains must be included in DNI.

6. Capital Gains in Year of Termination.

In the year of termination of an estate or trust, capital gains are included in DNI and flow through to the beneficiaries. This constitutes a sixth exception to the general rule that capital gains are not included in DNI.

Generally, long-term capital gains are currently taxed at a maximum rate of 20%. However, short-term capital gains are deemed to be ordinary income and are taxed at ordinary income tax rates, currently a maximum of 39.6%. In addition, net investment income not distributed from the trust or estate, which usually includes capital gains, is subject to an additional 3.8% surtax in certain situations.

As discussed below, the rules regarding DNI and the distributions deduction are applied differently to simple and complex trusts.

Distributions of principal will carry out DNI just as will a distribution of income unless the distribution qualifies as a specific bequest under §663(a)(1).

D. Types of Trusts: Simple, Complex and Grantor

A **simple** trust is defined in §651 and Reg.§1.651(a)-1 as a trust which:

a. is required to distribute all of its income (meaning fiduciary accounting income) currently; 2017b. makes no principal distributions; and c. makes no distributions to charity.

A **complex** trust is defined in Reg.§1.661(a)-1 as a trust that is not a simple trust i.e. one which:

a. is required or has discretion to accumulate income;

b. makes discretionary distributions of income or mandatory or discretionary distributions of principal; or

c. makes distributions to charity.

The classification of a trust as simple or complex is made on a year by year basis based on whether it meets the above definitions for the year in question. A trust can be a simple trust in one year because it is required to distribute income and makes no distributions of principal or charitable contributions and a complex trust in another year because it accumulates income, makes a distribution of principal or makes a charitable contribution.

An estate is always taxed as a complex trust with most beneficiaries treated as second tier beneficiaries.

A **grantor** trust is a trust in which the grantor or the beneficiary has one or more of the powers described in §§673 to 678. The general rules governing the income taxation of estates and trusts and their beneficiaries do not apply when the grantor is treated as the "owner" of the trust. To the extent a trust is classified as a grantor trust, it functions as a conduit i.e. all of the income, expenses, etc. flow through to the grantor or beneficiary and are taxed on the grantor's own personal tax return regardless of whether distributions are made from the trust. Rev.Rul.85-13.

The grantor is treated as the owner of the trust if the grantor retains any of the powers specified in §§673-677.

A beneficiary is treated as the owner of the trust if the beneficiary has a power specified in §678.

E. Trust Accounting Income (TAI)

The trustee must calculate trust accounting income – that is, the trustee must determine whether receipts and disbursements are allocated to income or principal – if for no other reason than to answer the burning question of the beneficiaries: How much do I get?.

The calculation of trust accounting income is an important part of the income taxation of estates and trusts for a number of reasons. First and most importantly, it determines the amount of income distributable to the income beneficiary and the amount ultimately payable to the remainder beneficiaries. Second, the amount of a trust or estate's personal exemption depends on whether the trust is required to distribute all of its income currently. Third, beneficiaries of complex trusts are allocated distributable net income under the tier system. Beneficiaries are assigned to tiers based on whether they are required to receive income or are merely discretionary beneficiaries. A beneficiary's right to receive income will determine which tier they are assigned to which, in turn, will determine if the distribution to them is a taxable distribution of income, or a nontaxable distribution of principal. Fourth, the distribution of income affects the allocation of depreciation and depletion deductions.

Overall, the personal exemption under §642(b), the computation of distributable net income under §643(a}, the depreciation and depletion deductions, the distribution deduction under §651 or §661, the taxation of distributions under §652 or §662, or the tax-free nature of distributions under §663 all depend on whether receipts and disbursements are allocated to income or principal.

Trust accounting income is defined in §643(b) as "the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law." There is no standard method for calculating trust accounting income. Rather, the trustee must review the governing instrument and state law. Most states have enacted a version of the Uniform Principal and Income Act (UPIA) which sets forth rules for calculating trust accounting income. Currently, 46 states and the District of Columbia have enacted some form of the 1997 UPIA. Illinois, Georgia, and Louisiana currently operate under the 1962 UPIA. Rhode Island has not adopted any version of the UPIA. Recently, the Uniform Fiduciary Principal and Income Act (UPIA) has been introduced by the Uniform Law Commission, but so far not adopted in any state.

Although the statute is designed to be "uniform" from state to state, the statute of the governing state must be reviewed as most state legislatures have not adopted all of the provisions of the uniform act. The UPIA will govern in all situations where the governing instrument is silent. Thus, a trustee must first look to the trust instrument to determine rules on calculating trust accounting income and if the trust is silent, the trustee must then look to governing state law.

The distribution rules contained in §§651,652, 661and 662 deal with income in the accounting sense "determined under the terms of the governing instrument and applicable local law" rather than income in the tax sense. §643(b). The grantor or testator can trump state law rules by providing in the governing instrument whether income and expenses are allocated to income or principal. Such a provision will generally be respected unless it departs from fundamental concepts of income and principal.

PART III – TAXING TRUSTS AND ESTATES

A. In General.

Unlike individuals, trusts and estates no longer enjoy a slower ride up the brackets. The rates for trusts and estates are adjusted annually for inflation, as they are for all taxpayers. The applicable rates with respect to the ordinary income earned by trusts and estates are (for 2019) as follows (§1(e)):

Rate	
10%	Up to $2,600
24%	2,601 - $9,300
35%	9,301 - 12,750
37%	12,751 and over

It should also be noted that the “Kiddie Tax” is now imposed on investment and other unearned income for persons under age 18 (or a full-time student age 19-24) at the same rates as trusts and estates. This tax is no longer affected by the tax situation of the child’s parent or the unearned income of any siblings. However, note that a parent may elect to report a child’s income if totaling less than $10,500 on the parent’s return.

The income tax rates for trusts and estates are compressed compared to that of individuals.

2019 Income Tax Brackets

Rate	Individuals	Married Filing Jointly	Trusts and Estates
10%	Up to $9,700	Up to $19,400	
12%	$9,701 - $39,475	$19,401 - $78,950	
22%	$39,476 - $84,200	$78,951 - $168,400	
24%	$84,201 - $160,725	$168,401 - $321,450	
32%	$160,726 - $204,100	$321,451 - $408,200	
35%	$204,101 - $510,300	$408,201 - $612,350	
37%	$510,301+	$612,351+	$12,750 +

While estates and trusts will reach the maximum tax rates for ordinary income (37%) and capital gains (20%) at taxable income over $12,750, individuals will not reach those same maximum tax rates until they have taxable income over $510,300 for an individual and $612,350 for married filing jointly.

Example: If a married individual has a modest taxable income of $40,000, his 2019 federal income tax will be only $4,800. If he dies, that same $40,000 of taxable income in his estate would be subject to tax of $14,800!

Effective for tax years beginning after 2012, the Health Care and Education Reconciliation Act of 2010 (Obamacare) enacted §1411which imposes a surtax on an estate or trust's unearned income. This additional tax is 3.8% on the lesser of the trust or estate's (a) undistributed net investment income for the tax year or (b) the excess (if any) of the estate or trust's adjusted gross income (calculated under §67(e)) for the tax year over the dollar amount at which the highest §1(e) tax bracket begins for the tax year ($12,400 in 2016). This disparity of tax treatment of trusts and estates may force fiduciaries to make distributions from trusts and estates in order to have the income taxed in the beneficiary's lower tax bracket.

Distributions to beneficiaries may or may not be possible depending upon the beneficiary's particular tax situation.

1. The intent of the grantor may have been to accumulate income for some purpose (e.g. education), leaving the fiduciary with the challenge of reconciling the grantor's intent with the need to make distributions to save income taxes.

2. The trust instrument itself may provide that distributions may be made in limited circumstances e.g. distributions of income, principal, or both, pursuant to an ascertainable standard which was not met for the year in question.

3. The discretionary distribution may trigger the generation skipping tax if the beneficiary is a skip person.

4. Little will be gained by making distributions to a beneficiary who is already in the highest marginal income tax bracket. However, an individual subject to the alternative minimum tax will have a marginal tax rate of, at most, 28%.

5. If a trust is a generation skipping exempt trust or grandfathered from the generation skipping tax because it was irrevocable on September 25, 1985 and no additions have been made since that date other than accumulating income and adding it to principal, it may be better to accumulate income, enabling the income to be distributed to the next generation. The tax on accumulating the income may be lower than the transfer tax.

1. Taxable Income.

The taxable income of an estate or trust is computed in the same manner as in the case of an individual, with the following exceptions:

(1) An estate or trust is not entitled to the standard exemption allowed to an individual under §151. In lieu of the standard exemption, an estate is allowed a $600 exemption, a trust which is required to distribute all of its income currently is allowed a $300 exemption and all other trusts are allowed a $100 exemption. §642(b).

(2) Estates and complex trusts have different rules for deducting charitable contributions. Requirements under §642(c) include the following:

a. Contribution must be made pursuant to the governing instrument.

b. The amount must be paid from gross income.

c. The contribution must be paid for a charitable purpose set forth in §170(c).

d. The deduction is not limited to a percentage of adjusted gross income.

(3) An estate or trust is allowed a deduction for depreciation and depletion only to the extent not allowable to the beneficiaries under §167(d) and §611(b).

(4) An estate or trust is disallowed a deduction for certain estate administration expenses that have been deducted on the estate tax return. §642(g).

(5) If, upon its termination, an estate or trust has (1) a net operating loss (NOL) carryover under §172, (2) a capital loss carryover under §1212, or (3) deduction in excess of gross income (without considering the exemption and charitable deduction), such carryover or excess deduction is allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust.

(6) An estate or trust is entitled to a deduction for its distributions not in excess of its DNI. However, no deduction is allowed for any item that is not included in the gross income of the estate or trust (e.g. tax-exempt income), or for any distribution that qualifies for the charitable deduction under §642(c).

(7) Estates and trusts have their own income tax rates, as set forth above.

(8) Generally, a trust (other than a wholly charitable trust or trusts exempt under §501(a)) must have a calendar year for its taxable year. §644. An estate may elect a fiscal year as long as it ends on the last day of the month and the first fiscal year does not exceed 12 months. §§441(b), 443 and 7701(a)(1), (14); Reg.§1.441-1(b)(5)(A). A trust making a §645 election may elect a fiscal year. The taxable year of a new taxpayer is adopted by filing its first federal income tax return using that taxable year. Reg.§1.441-1(c)(1). The filing of an application for automatic extension of time to file a federal income tax return, the filing of an application for an employer identification number or the payment of estimated taxes for a particular taxable year do not constitute an adoption of that taxable year.

(9) Estates and trusts are not subject to the 2% floor for miscellaneous itemized deductions for expenses paid or incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in such estate or trust. §67(e); *Knight v. Commissioner*, 552 U.S. 181 (2008).

(10) The 2% floor does not apply to expenses incurred by a trust or estate that constitute adjustments to gross income rather than deductions from adjusted gross income (AGI) e.g. rental expenses related to rental income.

2. Adjusted Gross Income.

Section 67(e) defines "adjusted gross income" for trusts and estates for purposes of the 2% floor for miscellaneous itemized deductions as being identical to adjusted gross income for individuals, with two specific exceptions:

(1) Section 67(e)(2) provides that the exemption allowed under §642(b) ($100/$300/$600) and the distributions deduction allowed under §§651 and 661 are subtracted from gross income to arrive at AGI; and

(2) Section 67(e)(1) provides that "deductions for costs which are paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the property were not held in such trust or estate" are deducted from gross income to arrive at AGI.

The §67(e) definition of AGI applies only for purposes of determining the deductible amount of miscellaneous itemized deductions. TCJA disallows almost all itemized deductions. Miscellaneous itemized deductions are deductions other than those listed in §67(b). For example, §67(b)(4) allows the §642(c) fiduciary income tax charitable deduction in calculating the adjusted gross income of an estate or trust. In addition, miscellaneous itemized deductions do not include above-the-line deductions taken into account in computing AGI. Itemized deductions for interest under §163, taxes under §164, personal casualty losses under §165(c)(3), and estate taxes paid on income in respect of a decedent under §691(c) are not miscellaneous itemized deductions. Thus, the foregoing amounts are above-the-line deductions available in computing AGI.

As mentioned above, the §67(e) definition of AGI applies only for purpose of determining the deductible amount of miscellaneous itemized deductions. For example, a different definition of AGI is used in computing the limitation on personal casualty losses. "Deductions for costs paid or incurred in connection with the administration of the estate or trust" are deducted from gross income to compute AGI when computing the limitation on personal casualty losses. §165(h)(5)(C). The deductions for costs paid or incurred in connection with the administration of the estate or trust are not limited to those that would not have been incurred if the property were not held in the estate or trust as in the case of the §67(e) limitation. The overall limitation on itemized deductions that apply to individuals under §68 does not apply to estates or trusts. §68(e).

3. Estimated Taxes.

Generally, estates and trusts must pay estimated income taxes. An estate or a grantor trust that receives the residue of the grantor's estate does not have to pay estimated taxes for any taxable year ending before the date two years after the date of the decedent's death. §6654(1).

4. When an income tax return is required.

An estate must file an income tax return if (1) it has gross income of $600 or more for the taxable year, or any beneficiary is a nonresident alien. §6012(a)(3) and (5).

A trust must file an income tax return if (1) it has gross income of $600 or more for the taxable year, (2) it has any taxable income for the taxable year, or (3) any beneficiary is a nonresident alien. §6012(a)(4) and (5).

B. Trust and Estate Distributions - Differences

1. In General.

Generally, the distribution rules apply to both trusts and estates. As discussed below, however, there are certain differences in how each is handled.

Beneficiaries of simple trusts (those required to distribute income currently, make no distributions of principal and make no distributions to charity) will be taxed on the simple trust's DNI whether or not the income is actually distributed to them. Reg. §1.651(a)-2. Gains generally will be taxed at the trust level. There is little opportunity for tax planning by making distributions from simple trusts.

The focus for fiduciary income tax planning using distributions is limited to estates and complex trusts.

In situations where a beneficiary has a different taxable year from the trust or estate, the beneficiary recognizes distributions from the trust or estate in the taxable year of the beneficiary with which or in which the taxable year of the trust or estate ends. §§652(c) and 662(c). In other words, distributions are deemed to be made to a beneficiary on the last day of the estate or trust's tax year.

2. Taxable Years.

Trusts must report income based on a calendar year. §644. Estates, however, may chose any fiscal year ending on the last day of a month, so long as the first fiscal year does not exceed 12 months. §441; Reg.§1.441- l(b)(3).

Section 645 permits the trustee of a deceased grantor's revocable trust and the executor of the grantor's estate to elect to treat the trust as part of the estate for fiduciary income tax purposes. The §645 election enables a qualifying trust to have its income taxed on a fiscal year basis.

The estate's ability to choose any fiscal year-end gives the fiduciary the opportunity to defer the recognition of income received from an estate. However, such deferral can lead to a bunching of income in the final year of the estate.

Example: The executor of an estate elects to report income on a January 31 fiscal year-end. The estate has $10,000 of DNI for the fiscal year beginning February 1, 2017 and ending January 31, 2018. On February 15, 2017, just a couple of weeks after the beginning of the fiscal year, the executor makes distributions in an amount sufficient to carry out all of the estate's DNI to the beneficiary. The beneficiary reports his income on a calendar year. The $10,000 of DNI distributed from the estate to the beneficiary on February 15, 2017 is reported on the beneficiary's tax return for the year in which or with which the estate's fiscal year ends i.e. 2018. Note the deferral opportunity available with estates (and trusts making the §645 election) – the income the beneficiary received in February, 2017 is not reported by the beneficiary until the beneficiary's 2018 tax year. The tax is not paid (not considering the estimated tax payment requirements) until the due date of the 2018 income tax return of the beneficiary i.e. April 15, 2019.

The estate's ability to choose any fiscal year-end gives the fiduciary the opportunity to increase the income reported on the decedent's final joint income tax return in order to make maximum use of any available deductions. This is especially helpful if, shortly after death, the estate will have a bunching of nonrecurring items of income, such as income in respect of a decedent, accrued vacation pay, bonuses, deferred compensation, Series E or EE bond interest, etc. This may dictate a short initial fiscal year-end or early distribution, especially if the decedent died early in the year and the surviving spouse is the residuary beneficiary of the estate. This will enable the estate to take advantage of the last joint return of the decedent and the surviving spouse. On the other hand, large deductible expenses incurred by the estate would tend to make a long initial fiscal year end more desirable.

Example: Where the decedent has substantial deductible expenses during the year of death (e.g. medical expenses) but did not receive much income during his final year, the fiduciary may have an opportunity to increase the income reported on the decedent's final return. If the decedent files a joint return with his surviving spouse and the fiduciary sets a fiscal year for the estate which ends on or before December 31 of the year of death, the fiduciary can make distributions to the surviving spouse which will carry out DNI. The surviving spouse's income will be increased by the distribution received from the estate. This will enable the estate and the surviving spouse to take advantage of the decedent's final year deductions. This would also allow the decedent's final return to take advantage of any of the decedent's expiring capital loss carryovers or net operating loss carryovers.

Ownership of a partnership or S corporation can make projection of the trust or estate income more difficult because the taxable income from these entities is reported on a Form K-1. However, this income can be deferred through careful selection of a fiscal year-end for the estate.

Example: Decedent dies on March 3, 2017 and the estate selects a fiscal year ending November 30. The estate owns an interest in a partnership that is on a calendar year. In the first taxable year of the estate, it will not recognize any income from the partnership because its taxable year ended before the taxable year of the partnership. Instead, the estate's share of the partnership income for 2017 will be reported on the estate's income tax return for its year ending November 30, 2018. Using a November fiscal year allows a deferral of the income from the partnership.

The tax savings that once were possible by making distributions non-pro rata to several beneficiaries in different tax brackets. Highly appreciated assets could be distributed to low- bracket taxpayers, with the high-bracket beneficiaries receiving less highly appreciated assets. There must be non-tax purpose expressed for the non-pro rata distribution. Otherwise, the IRS will treat such a distribution as a pro rata distribution of each asset followed by an exchange among the beneficiaries of their undivided interests in the assets. Rev. Rul. 69-486, 1969-2 C.B.159.

C. Simple Trusts

1. In General

A "simple trust" is a trust that is required by its governing instrument to distribute its accounting income at least annually. A simple trust does not make distributions of corpus and does not make distributions to charity. Reg. §1.651(a)-1.

The trust's deduction for distributions is determined under § 651.

The inclusion of amounts in income of beneficiaries is determined under § 652.

2. Distribution Deduction

A simple trust for any tax year is entitled to deduct all of its trust accounting income (but not in excess of its DNI) in determining the taxable income of the trust. §651(a), (b); Reg.§1.651(b)-1. Thus, the maximum distribution deduction for a simple trust is the lesser of it trust accounting income or it DNI. In determining the amount of DNI that is deductible, items of income not included in gross income (e.g. tax-exempt income) are not deductible. §651(b).

Generally, a simple trust is taxed on (1) its ordinary income in excess of trust accounting income, (2) capital gains that are not part of DNI, (3) "phantom income" (taxable income allocated but not distributed to it) and (4) receipts from other trusts and estates that are

principal for trust accounting purposes but income for tax purposes (so-called "trapping distributions"). Examples of phantom income are S corporation or partnership income required to be reported by, but not distributed, to the trust in the year in question.

Example: A simple trust owns an interest in a partnership. The partnership issues a K-1 to the trust reporting $10,000 of taxable income to the trust but the partnership does not distribute any cash to the trust. The $10,000 is included in the trust's income and is part of the DNI. However, the trust has no income to distribute to the beneficiary. This "phantom income" is taxed to the trust.

Example: A simple trust receives a $20,000 pour-over distribution from an estate. The estate issues a K-1 to the trust reporting the $20,000 as a taxable distribution. The distribution is allocated to principal for trust accounting purposes but still constitutes taxable income to the trust. None of the $20,000 may be distributable to the beneficiary. The $20,000 distribution from the estate is trapped at the trust level and taxed to the trust.

A simple trust will have taxable income if its net accounting income is less than DNI because the distribution deduction for a simple trust is limited to the lower of trust accounting income or DNI.

3. Tax Consequences to the Beneficiary.

The tax consequences to the beneficiary of a simple trust are as follows:

First, the amount of the income required to be distributed currently (but not in excess of the DNI reduced by net tax-exempt income of the simple trust) is includible in the beneficiary's gross income.

Example: In 2018 a simple trust with one beneficiary has $40,000 of qualified dividends, $10,000 of taxable interest, $20,000 of capital gains and $8,000 of trustee's fees which are allocated $5,000 to trust accounting income and $3,000 to principal. The trust accounting income is $45,000 consisting of $40,000 of qualified dividends, $10,000 of taxable interest and less $5,000 of trustee's fees allocable to income. The trust's DNI is $42,000 consisting of $40,000 of dividends, $10,000 of taxable income and less $8,000 of trustee's fees. The amount of income required to be distributed is $45,000 but the amount the beneficiary must report on his income tax is limited to the $42,000 of DNI. The trustee's fee allocated to principal benefits the income beneficiary. The $20,000 of capital gain is taxable to the trust reduced only by the trust's $300 exemption. Thus, the trust has taxable income of$19,700. Notice that the trustee's fee allocated to principal ($3,000) benefits the income beneficiary because it enters into the calculation of DNI. The $3,000 trustee's fee allocable to principal does not reduce the capital gain that is taxed to the trust.

Second, the income will be included in the beneficiary's income regardless of whether or not the income is actually distributed by the trust. §652(a).2017

Example: Trust instrument requires the trustee to distribute all the income to A. In 2018 the trust makes no distributions of principal and makes no charitable contributions. The trustee makes quarterly distributions of income, the last quarterly distribution being made on January 15, 2019. Even though the last quarterly distribution of income is made on January 15, 2019, the trust is a simple trust because the governing instrument requires that the income be distributed currently. A trust that is required to distribute all of its income currently is a simple trust whether or not that income is actually distributed. A will be required to report all of the income in 2018 and the trust will receive an income distribution deduction in 2018.

Third, if there is more than one income beneficiary, the included income is apportioned among them in proportion to the trust accounting income each is required to receive. The total amount of gross income included by all the income beneficiaries is limited to DNI, prorated among the beneficiaries. The amount of DNI allocated to a beneficiary is a fraction equal to the amount of trust accounting income distributed to a beneficiary divided by the total trust accounting income required to be distributed. 652(a}, second sentence. Reg.§1.652(a)-2.

Example: Trust instrument requires one-third of the trust accounting income to be distributed to A and two-thirds of the trust accounting income to be distributed to B. The trust accounting income and DNI for the year is $9,000. A must report $3,000 (1/3 of $9,000) and B must report $6,000 (2/3 of $9,000).

Fourth, the items of income retain the same character in the hands of the beneficiaries as they had in the hands of the trust (e.g. dividend income in the trust remains dividend income in the hands of the beneficiary, taxable interest in the hands of the trust remains taxable interest in the hands of the beneficiary, rental income in the hands of the trust remains rental income in the hands of the beneficiary, etc.). A beneficiary is treated as receiving his or her proportionate share of each item entering into the calculation of DNI. Reg.§1.652(b)-2. In other words, the amounts are treated as consisting of the same proportion of each class of items entering into the computation of DNI as the total of each class bears to the total DNI, unless the governing instrument specifically allocates different classes of income to different beneficiaries. §652(b).

Example: A simple trust's DNI and trust accounting income is $30,000 consisting of$10,000 of dividends, $15,000 of interest income and $5,000 of rental income. The beneficiary will be deemed to receive $10,000 of dividends, $15,000 of interest income and $5,000 of rental income.

Example: Under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter. The DNI of the trust (after allocation of expenses) consists of dividends of $10,000, bank interest of $10,000, and tax-exempt interest of $4,000. A will be deemed to have received $5,000 of dividends, $5,000 of taxable interest, and $2,000 of tax-exempt interest; B and C will each be deemed to have received $2,500 of dividends, $2,500 of

taxable interest, and $1,000 of tax-exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him or her. (The trust would have to say: "I give all of my tax-exempt income to A. I give the balance of the income to A (up to 50% of the total income, and I direct that the balance of the income is split between B and C.")

Fifth, the income is included in the beneficiary's tax year with which on in which the taxable year of the trust ends. Basically, the beneficiary is deemed to receive the income on the last day of the trust's taxable year.

Example: A simple trust is on a calendar year. It makes a distribution in 2018 to the beneficiary who is also on a calendar year. The beneficiary reports the income in 2018, the year with which the taxable year of the trust ends. Assume, instead, that the beneficiary received a distribution from an estate which is on a January fiscal year-end. The estate makes a distribution on December 15, 2018. The distribution will be included in the beneficiary's 2019 taxable year, the year in which the taxable year of the estate ends. The distribution from the estate is deemed made on January 31,2019 even though it was actually made on December 15, 2018.

4. Death of a beneficiary.

The normal rule is that a beneficiary includes a distribution in his income in the year in which or with which the year of the estate or trust ends. There is an exception to this rule when a beneficiary dies. In the year the beneficiary dies, the beneficiary is taxed only on the income he actually received before death. Any income owned to him at death is taxed to his successor as income in respect of a decedent. The DNI is computed for the entire year and allocated to the deceased beneficiary and his successor according to the distributions received by them. Reg.§1.652(c)-2.

5. Distribution In Kind.

A trust that distributes appreciated property in kind as part of the requirement to distribute all its accounting income currently will be treated as having sold the property for fair market value on the date of the distribution i.e. it is a gain or loss realization event. Reg.§1.651(a)-2(d). If the amount distributed by the trust during the year does not exceed the accounting income, the trust will still qualify as a simple trust even though it distributed property in kind (principal). Reg.§1.651(a)-2(d).

6. Allocation of Expenses.

Deductions entering into the computation of DNI are allocated among the income items comprising DNI in accordance with the following principles:

(A) Direct expenses

All deductible items directly attributable to one class of income are allocated against that class of income. For example, rental expenses are allocated to rental income and business expenses are allocated to business income. To the extent deductions exceed a particular class of income to which they relate, they may be allocated to any other class of income (except that excess deductions allocated to tax-exempt income may not be allocated to any other class of income). Reg.§1.652(b)-3(d).

(B) Indirect expenses

Deductible items not directly attributable to a specific class of income may be allocated against any item of income included in computing DNI. However, a portion must be allocated against exempt income. Reg.§1.652(b)-3(b). Trustee's fees are an example of an indirect expense.

Example: A simple trust has $5,000 of interest income, $10,000 of dividend income, $15,000 of tax exempt interest income and $20,000 of rental income. It has rental expenses of $6,000 and trustee's fees of $8,000. The rental expenses are directly related to the rental income and therefore the entire amount of the rental expenses are allocated to the rental income. The trustee's fees are an indirect expense and may be allocated against any item of income as long as a portion is allocated against tax-exempt interest. The trustee allocates the trustee fees pro-rata to each class of income. The allocation (where the percentage shown is the percentage of total income represented by that type of income) is summarized below:

10%	20%	30%	40%	100%
Taxable Interest	Dividends	T/E Interest	Rental Income	Total
$5,000	$10,000	$15,000	$20,000	$50,000
			($6,000)	($6,000)
(800)	(1,600)	(2,400)	(3,200)	(8,000)
$4,200	$8,400	$12,600	$10,800	$36,000

The ability to allocate indirect expenses to any class of income presents a planning opportunity. H a trust has qualified dividend income (taxed at a maximum 20% rate currently), it may advantageous to allocate indirect expenses to income, such as taxable interest, that is taxed at a higher rate. In addition, it may be advisable to allocate indirect expenses to items of net investment income that are taxed at the highest rate (such as taxable interest income) to reduce the trust's exposure to the 3.8% surtax on net investment income. For example, allocating the $1,600 of indirect expenses allocated to dividends (which are taxed at a maximum rate of 20%) to either the rental income or the taxable interest would reduce those classes of income which could be subject to the maximum 39.6% ordinary income tax rate and potentially the 3.8% surtax.

D. Complex Trusts and Estates

1. Background

A "complex trust" is a trust that may accumulate income, distribute corpus, or make distributions to charity.

The trust's deduction for distributions to its beneficiaries is determined under §661.

The inclusion of amounts in income of beneficiaries is determined under §662.

Special rules for complex trusts are found in §663.

Unless otherwise indicated, the fiduciary income tax rules for complex trusts also apply to estates.

2. Basic Rule

A complex trust is allowed a deduction for the sum of any amount of trust accounting income that is required to be distributed currently (including any item-such as an annuity-payable out of income or corpus to the extent actually paid out of income) and any other amounts properly paid or credited or required to be distributed for the taxable year. §661(a).

3. Limitations on Deductions

There are some limitations on distribution deduction. They pertain to distributable net income (DNI) and tax-exempt income. The deduction under § 661(a) cannot exceed DNI as computed under §643(a). Likewise, a deduction is not allowed for any amount that is not included in the gross income of the trust, e.g. tax-exempt income, or property inherited from a retirement account (which is treated as principal or 90% principal under UPIA)). § 661(c); Reg. §1.661-(c)(1).

4. Income Required to Be Distributed Currently

A deduction is allowed for any "income required to be distributed currently" as determined under the terms of the will or trust instrument and applicable state law. Reg. §§1.661(a)-2(b) and 1.651(a)-2. In general, the trustee must be under a duty to distribute the income within the taxable year. If such a duty exists, the trust is allowed a deduction even if distributions are not made within the taxable year or are not made at all. Reg. §1.651(a)-2(a). For additional rules, see Reg. §1.651(a)-2.

5. Amounts Properly Paid, Credited or Required to Be Distributed

A deduction is also allowed for any "amounts properly paid or credited or required to be distributed." §661(a)(2). The term "any other amounts properly paid or credited or required to be distributed" includes all amounts properly paid, credited or required to be distributed by an estate or trust during the taxable year other than income required to be distributed currently. Examples of amounts properly paid, credited or required to be distributed include the following:

- •Discretionary payments made from income or principal by the trustee. Reg. §1.661(a)-2(c).
- •Annuity payments made from principal. Reg. §1.661(a)-2(c).
- •Amounts used to discharge or satisfy a beneficiary's legal obligation. Reg. §1.661(a)-2(d).
- •Amounts paid pursuant to court order or decree. Reg. §1.661(a)-2(e).
- • Payments in kind, i.e., distributions of trust property other than cash. Reg. §1.661(a)-2(t).

Amounts are "properly credited" to a beneficiary when they are irrevocably and unconditionally placed at the disposal of the beneficiary. Transfers shown by book entries and on the annual work papers for the entity are not sufficient to treat the funds as credited for purposes of §§661 and 662. *Johnson v. Commissioner,* 88 T.C. 225 (1987). They must be credited so as to be beyond recall by the fiduciary and must be available for distribution upon demand.

The IRS will treat as properly paid or credited any payments made to a beneficiary that are conditioned upon the beneficiary's obligation to repay, if needed, for obligations of the estate. Rev. Rul. 72-396, 1972-2 C.B. 312.

Deductible payments may be made in cash or in kind. If a distribution is made in kind (e.g., a distribution of common stock), the trust may be required to recognize capital gain on the distribution. A distribution in kind can result in the realization of a gain or loss if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed or of income as defined in §643(b) and the applicable regulations. Reg.§1.661(a)-2(t). The amount of any gain would be measured by the fair market value of the property distributed, less its adjusted basis for tax purposes at the time of distribution. However, in general, a trust will not realize a gain by reason of a distribution in kind unless the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount (or unless trust elects to recognize gain under § 643(e)(3)). Reg. §1.661(a)-2(t). Losses generally cannot be recognized because of the related party rules of §267.

With respect to in-kind distributions, the amount deductible is, generally, the lesser of the basis of distributed property in the hands of the beneficiary or the fair market value of the property. §643(e)(2). However, if the trust makes an §643(e)(3) election, the amount deductible is the fair market value of the property. §643(e)(3)(A)(iii).

The phrase "amounts properly paid or credited or required to be distributed" does not include a gift or bequest of a specific sum of money or of specific property. According to §663(a)(1), the amount properly paid or credited under the governing instrument as a gift or bequest of a specific sum of money or specific property cannot be deducted if that figure is paid in a single sum or in not more than three installments. However, a gift or bequest that can be paid only out of income would be deductible under § 661(a)(2). See §663(a)(1).

In addition, the phrase "amounts properly paid or credited or required to be distributed" does not include charitable distributions, under § 663(a)(2), or amounts paid in the current year for which a deduction under §§ 651 or 661 was allowable for a previous year. §663(a)(3).

6. Character of Amounts Distributed

(A) In General

The amount deductible for distributions to beneficiaries under §661(a) is treated as consisting of the same proportion of each class of items entering into the computation of DNI as the total of each class bears to total DNI, i.e., a pro rata approach. § 661(b); Reg. §1.661(b)-1.

There are two exceptions to this general rule: if the governing instrument contains specific provisions for allocation of classes of income and if applicable state law requires non-pro rata allocation of classes of income.

Example. H a trust with DNI of $20,000 (consisting of $8,000 of interest and $12,000 of dividends) distributes $5,000 to a beneficiary, the deduction for the trust under §661(a) is deemed to consist of $2,000 of interest (i.e., 8/20 x $5,000) and $3,000 of dividends (i.e., 12/20 x $5,000). The beneficiary is required to include the same amounts in gross income under § 662.

(B) Allocation of Deduction Items

In general, items of deductions that enter into the computation of DNI are allocated among items of income in DNI in accordance with the rules for simple trusts. Reg. §1.661(b)-2.

Expense items directly attributable to one class of income are allocated to that class of income. For example, rental expenses (other than any depreciation allocated to beneficiaries) are allocated to rental income. Reg. §1.652(b)-3(a).

Indirect expenses, such as trustee commissions and state income taxes, may be allocated to any class of income. Reg. §1.652(b)-3(b). In regard to tax-exempt income, a portion of indirect expenses must be allocated to nontaxable income.

Example. If income of a trust consisted of $10,000 of tax-exempt interest and $40,000 of dividends and trustee fees were $5,000, a portion of trustee fees must be allocated to tax-exempt interest. Using a pro rata allocation, $1,000 of trustee fees ($10,000/$50,000 x $5,000) would be allocated to tax-exempt interest and would be nondeductible.

Section 265 of the Internal Revenue Code governs the allocation of expenses between taxable and tax-exempt income. The regulations provide that if an expense is indirectly allocable to both a class of taxable income and tax-exempt income, a "reasonable proportion" of such expense "in light of all the facts and circumstances" must be allocated to each class. Reg. §1.265-1(c). Thus, it is not mandatory to use a pro rata allocation method.

In regard to capital gains, the IRS has ruled that a simple trust that does not distribute capital gains cannot include capital gains in the formula for allocating indirect expenses to tax-exempt interest. Rev.Rul. 77-355, 1977-2 C.B. 82. Logically, the same rationale should apply to complex trusts.

Because capital gains are included in DNI in the year of trust termination, they would be included in the formula for allocating indirect expenses to tax-exempt interest for that year.

Typically trustee termination expenses can be significant. Can a trustee minimize the amount of such expenses allocated to tax-exempt income by distributing tax-exempt bonds in the year prior to charging a termination fee? The IRS has ruled that this strategy does not work. See Rev. Rul. 77-466, 1977-2 C.B. 83, in which the IRS required allocation of such expenses based on the ratio of tax-exempt income received to total income received (including realized and unrealized capital gains) over the life of the trust.

As with simple trusts, the beneficiaries of estates and complex trusts include in gross income under §662 the amount for which the entity has received a distribution deduction under §661.

The deduction for distributions from estates and complex trusts is limited only by DNI, rather than by the lesser of fiduciary accounting income or DNI as is the case with a simple trust. Estates and complex trusts may accumulate ordinary income, causing it to be taxed to the entity.

(C) Effect of Charitable Contributions

Pro rata allocation is required for charitable contributions. The charitable contributions deduction must be ratably apportioned to each class of income entering into the computation of DNI, unless the governing instrument or applicable state law requires a

different apportionment. Reg. §1.661(b)-2. If the trust has tax-exempt interest in the same year that it has a charitable contributions deduction, a portion of the charitable deduction will be lost to the extent allocated to tax-exempt interest. An example of this allocation is illustrated in the comprehensive example in Part III of these materials.

A direction in the trust instrument to satisfy charitable contributions only out of taxable income would be effective only if there is significant "economic effect." Reg. 1.642(c)-3(b)(2).

(D) Effect of Passive Activity Loss Rules.

Limitations on passive activity losses and credits clearly apply to trusts and estates. §469(i). However, the ability of a trustee to allocate indirect expenses to any class of income, as described above, may enable fiduciaries to mitigate the impact of the passive activity loss rules. For example, a strategy of allocating trustee fees against "portfolio income"--such as dividends and interest--rather than against "passive" income such as rental income or publicly traded partnership income would increase passive income and decrease portfolio income, generally a desirable tax result.

The passive loss regulations for estates and trusts under Reg. §1.469-8T, currently unpublished and reserved since 1988, may provide some guidance, although such assistance has been in abeyance for well over two and a half decades. When these regulations are issued, it is unclear whether Reg. §1.652(b)-3(b) will also be amended to require pro rata allocation of indirect expenses among passive and nonpassive items. What little guidance there is can be found in the instructions to Form 1041.

E. The Distribution System

The key to understanding the distribution rules for complex trusts and estates and the allocation of DNI consists of understanding four important concepts. They are:

(1) the "tier system" of distributions,

(2) the separate share rule,

(3) the 65 day rule under §663(b) and

(4) specific bequests under §663(a)(1).

These topics are discussed in the material that follows.

F. The "Tier System"

1. In General

The key difference between simple and complex trusts is the treatment of accumulated income and the treatment of distributions made to mandatory and discretionary beneficiaries.

As with simple trusts, distributions from an estate or complex trust are generally considered to carry out a pro rata part of each item of DNI. §662(b). In other words, the distribution from a complex trust or estate is deemed to consist of the same proportion of each class of items entering into the computation of DNI as the total of each class bears to the total DNI. Reg.§1.662(b)-1. However, allocation of the distribution among various beneficiaries of a complex trust or estate is considerably more difficult than for the beneficiaries of simple trusts. How is DNI allocated when there are multiple beneficiaries, some of whom are entitled to net income and others are who are discretionary beneficiaries? This allocation is controlled by the "tier system". The "tier system" of taxation is contained in §662(a).

Distributions by complex trusts are categorized in two tiers:

1. Distributions of income *required* to be distributed pursuant to the terms of the governing instrument. This includes any amount required to be distributed that may be paid out of income or corpus to the extent such amount is paid out of income for the year. These are known as first tier distributions.

2. Distributions of all other amounts properly paid, credited or required to be distributed. This includes discretionary distributions of income or principal and mandatory distributions of principal. These are known as second tier distributions.

If total distributions do not exceed DNI, the tiers are irrelevant. Amounts paid, credited or required to be distributed carry out DNI dollar for dollar, each reflecting its proportionate share of the items of income and deductions in DNI. The remaining DNI is taxed to the trust.

If distributions exceed DNI, the tier of a distribution is important in determining the tax consequences to the beneficiary.

Under the tier system, DNI is allocated first to the beneficiaries of the first tier – the mandatory income beneficiaries, – and any balance of DNI is allocated and taxed to beneficiaries of the second tier.

The amount that a trust or estate may deduct as a distribution deduction is limited by the trust or estate's DNI. Reg.§1.661(a)-2(a). An estate or complex trust is entitled to deduct the sum of all first tier and second tier distributions, but not in excess of DNI.

First tier beneficiaries include in gross income all income required to be distributed but not in excess of DNI. If the amount required to be distributed currently to all first tier beneficiaries exceeds DNI, then each first tier beneficiary is required to include in gross income only that beneficiary's proportionate share of DNI. DNI is modified for first tier beneficiaries if the estate or trust is entitled to a charitable deduction. See the example below.

Second tier beneficiaries include in gross income all amounts properly paid, credited or required to be distributed, but not greater than the amount by which DNI exceeds all first tier distributions. If second tier distributions are greater than the amount by which DNI exceeds first tier distributions, second tier beneficiaries include in gross income a proportionate share of such excess based on the amount distributed to each second tier beneficiary to the amount distributed to all second tier beneficiaries.

Example: A trust instrument requires the trustee to distribute $30,000 of income to A and gives the trustee to discretion to distribute income and principal to B. The trust has $40,000 of DNI. The trustee distributes $30,000 to A and $20,000 to B. If the normal pro rata rules were applied to the distributions, A would report $24,000 of DNI ($30,000/$50,000 x $40,000 DNI) and B would report $16,000 of DNI ($20,000/$50,000 x $40,000 DNI). The DNI would be allocated pro rata to each beneficiary based on distributions to each. The tier system requires a different result. Under the tier system, DNI would be allocated first to A to the extent of the income required to be distributed to A ($30,000) and the balance of the DNI after taking into consideration the distribution to A ($40,000 DNI less $30,000 DNI allocated to A or $10,000) would be allocated to B. The $10,000 balance of the $20,000 distributed to B is treated as a tax- free distribution of principal to B.

Example: Trust has $40,000 of DNI and accounting income. The trust is required to distribute 1/2 of the income annually to A, with the balance being distributable in the trustee's discretion. The trustee distributes $20,000 to A and makes discretionary distribution of $20,000 to each B and C. A must include $20,000 in her gross income while B and C each include $10,000 in their gross income. Since A is a first tier beneficiary, 1/2 of the $40,000 DNI is allocable to A. The $20,000 balance of the DNI after distributions to the first tier beneficiary ($40,000 less $20,000) is allocated equally between B and C, both second tier beneficiaries. Note that although all of the beneficiaries received the same distribution, the amount included in their gross income is different based upon their status as first or second tier beneficiaries.

A beneficiary may be both a first and second tier beneficiary.

Example: Under the terms of Trust X, A and B are each required to be paid 25 percent of net income quarterly. The trustee has discretion to pay other amounts of income and principal to A, B and C. For the trust's taxable year, trust accounting income (TAI) is $100,000, DNI is $90,000, and, in addition to TAI required to be distributed to A and B, the trustee made discretionary payments of $10,000 to A and $90,000 to C. What income

from Trust X should the beneficiaries include in gross income for the taxable year? The table below illustrates the allocation of DNI under the tier system.

	A	B	C	DNI
First-Tier	$25,000	$25,000	$ 0	$50,000
Second-Tier	4,000	0	$36,000	40,000
Total	$29,000	$25,000	$36,000	$90,000

Fifty percent of the TAI is required to be distributed currently to A and B. These are first-tier amounts, and A and B are first-tier beneficiaries. Thus, A and B are each allocated $25,000 of DNI. Next, any remaining DNI--$40,000 in the example--is allocated to second-tier beneficiaries A, B and C. A received 10 percent of second-tier distributions and is allocated $4,000 of the remaining DNI (10% of $40,000 remaining DNI). C received 90 percent of second-tier distributions, and $36,000 of the remaining DNI (90% of $40,000 remaining DNI) is allocated to C.

As for simple trusts, the amounts distributed and deducted by the estate or trust are treated as consisting of the same proportion of each class of items entering into the computation of DNI as the total of each class bears to the total DNI, unless the governing instrument specifically allocates different classes of income to different beneficiaries. §662(b).

Deductions entering into the computation of DNI are allocated among the income items comprising DNI in accordance with the same principles that govern simple trusts, except that charitable distributions are first ratably apportioned among each class of items of income entering into the computation of DNI including tax-exempt income. Reg.§1.661(b)-2. This rule does not apply to simple trusts because a simple trust, by definition, cannot have a charitable deduction.

2. Effect of the charitable deduction

If an estate or trust is entitled to a charitable deduction, special rules apply for determining the amount taxable to first tier beneficiaries and the character of such amounts.

The second sentence of §662(a)(1) and the last two sentences of §662(b) provide that if the amount of income required to be distributed exceeds DNI computed without the charitable deduction, then the first beneficiaries take into income the higher, modified, DNI. Such modified DNI sets the ceiling for taxing first tier beneficiaries. As a result, first tier beneficiaries never receive any advantage from the charitable deduction. The language of §662(a) requires that the income required to be distributed be considered as distributed first to the individual beneficiaries and then to charities.

Example: Trust has DNI and trust accounting income of $50,000 and distributes the entire amount to A, who, is required under the trust instrument to receive all income annually (i.e. A is a first tier beneficiary). Trust makes a $40,000 charitable contribution. Although under

the general rule charitable contributions reduce DNI, so that in this case the available DNI is only $10,000, under the second sentence of §662(a)(1) the beneficiary is required to report the full $50,000 in his gross income.

Note the result: first tier beneficiaries do not get the benefit of any charitable deduction.

Example: Facts are the same as above except that the mandatory distribution to A is only $20,000 and the trustee makes $25,000 of distributions to other beneficiaries (second tier beneficiaries). All of the first tier distribution to A is taxable. The DNI available for the second tier beneficiaries is zero - $50,000 less ($20,000 first tier distribution + $40,000 charitable distribution). Thus, there is no DNI available for the second tier beneficiaries. The charitable deduction comes "off the top" for second tier beneficiaries but comes "off the bottom" for the first tier beneficiary. Thus, the charitable deduction reduces the amount available for second tier beneficiaries. The charitable deduction can be thought of as a tier 1-1/2.

The last sentence of §662(b) provides that in determining the character of the amounts distributed to first tier beneficiaries, DNI is computed without regard to any portion of the charitable deduction that is not attributable to income of the taxable year (e.g. income paid in one year but elected to be treated as paid in the prior year.)

3. When Distributions are Taxable to Beneficiaries

If a beneficiary and an estate or trust have the same taxable year, the distributions are included in the beneficiary's income in that year. If a beneficiary and an estate or trust have different taxable years, the beneficiary will report the distribution for the taxable year that includes the last day of the taxable year of the estate or trust. §662(c). This is the same rule that applies to simple trusts.

4. Death of a beneficiary

The normal rule is that a beneficiary includes a distribution in his income in the year in which or with which the year of the estate or trust ends. There is an exception to this rule when a beneficiary dies. In the year the beneficiary dies, the beneficiary is taxed only on the income he actually received before death. Any income owned to him at death is taxed to his successor as income in respect of a decedent. The DNI is computed for the entire year and allocated to the deceased beneficiary and his successor according to the distributions received by them. Reg. §1.662(c)-2.

G. Separate Share Rule and Unequal Distributions

1. General Rule

The general rule is that DNI is allocated proportionately to beneficiaries based on distributions made to each. However, disproportionate distributions to beneficiaries from a trust or estate can lead to different tax treatment for different beneficiaries. The separate share rule is designed to cure this inequity. The separate share rule allocates DNI among the beneficiaries based on distributions of their "share"of DNI. §663(c). Distributions to beneficiaries who don't have separate shares are allocated DNI based on the distributions made to them over the total distributions made to all the beneficiaries in a particular year i.e. a proportionate share of DNI.

The separate share rule can be summarized as follows:

(A) The separate share rule applies to estates (for decedents dying after August 5, 1997) and complex trusts.

(B) Under the separate share rule DNI is computed separately for each share.

(C) The executor or trustee is not required to maintain separate accountings for each share in order for the separate share rule to apply. Thus, the separate share rule may apply even though separate and independent accounts are not required or maintained for each share and even though no physical segregation of assets is made or required. Reg.§1.663(c)-1(c).

(D) The separate share rule is not elective. If the requirements are met, the rule must be applied. Reg.§1.663(c)-1(d).

The separate share rule says that if a single trust (or estate) has more than one beneficiary and if different beneficiaries have substantially separate and independent shares, their shares are treated separately for the sole purpose of determining the amount of DNI allocable to the beneficiaries under §§ 661 and 662. Reg. §1.663(c)-1(a). The trust is taxed as one trust but each share is treated as a separate trust for purposes of computing the distribution deduction for each share and the inclusion of income for each share.

The separate share rule will be significant where income is accumulated for beneficiary A but a distribution is made to beneficiary B of both income and principal in an amount exceeding the share of income that would be distributable to B had there been separate trusts. Absent the separate share rule, B would be taxed on income which is accumulated for A. The division of DNI into separate shares will limit the tax liability of B. Reg. §1.663(c)-1(a).

The separate share rule will not apply where a single trust is split into several separate trusts, as opposed to separate shares of the same trust. Reg. §1.663(c)-1(a).

If separate shares exist, DNI is computed separately for each share. Deductions or losses solely attributable to one share are not available to the other. Reg. §1.663(c)-2.

Note that the application of the separate share rule can be intentionally avoided by drafting the trust in such a way that separate and independent shares do not exist. For example, a trust may be drafted as a "spray" trust. Alternatively, a trust document may subdivide the trust into separate trusts. Each trust, being a separate trust, would file its own tax return.

2. Applicability

Generally speaking, the separate share rule will apply if "the governing instrument and the applicable local law create separate economic interests in one beneficiary or class of beneficiaries of [an] estate or trust. Ordinarily, a separate share exists if the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries."Reg. § 1663(c)-4(a).

The preamble to the final regulations explains that "a separate share generally exists only if it includes both corpus and the income attributable thereto and is independent from any other share. Thus, income earned on assets in one share (first share) and appreciation and depreciation in the value of those assets have no effect on any other share. Similarly, the income and changes in value of any other share have no effect on the first share."

Bequests of specific property and specific sums of money under § 663(a)(1) are not separate shares. However, the income on bequeathed property is a separate share if the recipient of the specific bequest is entitled to such income.

Example: D's will directs the executor to distribute X stock and all the dividends thereon to child A and the residue of the estate to child B. The estate has two separate shares-the income on the X stock bequeathed to A and the residue of the estate bequeathed to B. The bequest of the X stock is a specific bequest and therefore is not a separate share. If any distributions other than the shares of X stock are made during the year to either A or B, gross income attributable to dividends on the X stock must be allocated to A's separate share, and any other income must be allocated to B's separate share. See Reg. §1.663(c)-5, Example 8.

Example: A will bequeaths XYZ stock to A and the residue of the estate to B. In 2017, the only income earned in the trust is a $10,000 dividend on XYZ stock to which A is entitled to under the applicable state law. The executor distributes $15,000 to each A and B. Without the applicable of the separate share rule, each beneficiary would have reported $5,000 of income based on his pro-rata share of DNI ($10,000 DNI x $15,000/$30,000). Under the separate share rule, the $10,000 of dividends are allocable to A's separate share and A is taxed on $10,000, the DNI allocable to his share. B's share earned no DNI in 2017 so the distribution to B is tax-free.

The final regulations state that the separate shares come into existence at the earliest moment that the fiduciary can determine--based on the known facts--that a separate share exists. Reg. §1.663(c)-2(a). The point at which the fiduciary can make this determination is usually the moment of death.

The separate share rule causes the fiduciary to lose control over the allocation of DNI among the distributees.

Given the apparent complexity of the application of the separate share rule, the final regulations state that the fiduciary is instructed to use "a reasonable and equitable method to make the allocations, calculations, and valuations required by" the final regulations. Reg. §1.663(c)-2(c). In other words, the fiduciary must use a reasonable and equitable method to determine the value of each separate share and the calculation of DNI allocable to each.

Application of the separate share rule is easiest if the fiduciary first determines whether an estate or trust has separate shares and, if so, then determines what those shares are.

The separate share rule applies only if the estate or trust has multiple beneficiaries. If there are multiple beneficiaries, there may be separate shares even if the corpus may eventually pass to someone other than the income beneficiary and even if the interests are not vested. The final regulations also state that a separate share may itself have multiple beneficiaries and that a particular beneficiary may be a beneficiary of more than one separate share. Reg. §1.663(c)-4(c).

Absent the separate share rule, the application of the distribution system to disproportionate distributions from an estate or trust with multiple beneficiaries in a given year could result in an inequitable allocation of the tax burden among the beneficiaries. For example, in *Harkness v. United States,* 469 F.2d 310 (Ct.Cl. 1972), the decedent left one-half of his residuary estate to his spouse. During the 1955 tax year the estate distributed $36 million to all beneficiaries. The spouse received $27 million (75%) of the total $36 million distribution. DNI for the 1955 tax year was $1 million. The spouse claimed that she should be taxed on only half the year's DNI. The court, however, held that she was subject to pro-rata share of DNI (75%) of $1 million or $750,000. The spouse claimed that since she was only entitled to one-half of the residue, it was2017inequitable to tax her on more than one-half of the DNL However, prior to 1997 the separate share rule did not apply to estates. DNI was allocated to beneficiaries based strictly on distributions. If the separate share rule applied, the spouse would have been taxed on only $500,000 (50% of the $1 million of DNI). The separate share rule as set forth in Reg.§1.663(c)-1 seeks to avoid this inequity by treating separate shares of a single trust as separate trusts for purposes of computing DNI. If an estate or trust has "substantially separate and independent shares," the regulations require the executor or trustee to apply the separate share rule in computing DNI. The separate share rule protects the beneficiaries from being taxed on m ore than their proportionate share of DNI.

The following types of interests in estates and trusts are always treated as separate shares:

- a spouse's elective share if it shares in estate income, or if it does not share in income but is determined as of the date of death;

- a formula pecuniary bequest if it shares in the income of the estate or trust, or if it does not share in income but the governing instrument does not expressly require that it be paid in more than three installments;

- a qualified revocable trust under § 645 (whether or not the Section 645 election is made); and

- the income on specifically bequeathed property if the beneficiary of that property is entitled to the income thereon i.e. not qualifying as a specific bequest under §663(a)(1). Reg. §1.663(c)-4(a), (b). (Note that the final regulations expressly state that the specific bequest itself is not a separate share, even though the income thereon is a separate share.)

The following example of the first type of interest noted above is suggested by Reg. §1.663(c)-5.

Example: D dies in 2017 and is survived by a spouse and three adult children. D's will divides the residue of the estate equally among the three children. The surviving spouse elects her statutory share (one-third). The elective share statute provides that the spouse is not entitled to any of the estate's income and does not participate in appreciation or depreciation in estate assets. Under the statute, the spouse is, however, entitled to interest on the elective share. During 2017, the estate distributes $5,000,000 to the spouse in partial satisfaction of the elective share and pays $200,000 of interest on the delayed payment of the elective share. During the year, the estate receives dividend income of $3,000,000 and pays deductible expenses of $60,000. The estate has four separate shares--the surviving spouse's elective share and each of the children's residuary bequests. Since the spouse is not entitled to income, none of the gross income is allocated to the spouse's separate share for purposes of determining that share's DNI. Thus, for the $5,000,000 distribution, the estate gets no distribution deduction, and no amount is included in the spouse's gross income. The $200,000 of income must be included in the spouse's gross income under § 61. Since no distributions were made to any other beneficiaries during the year, there is no need to compute the DNI of the other three separate shares. Thus, the taxable income of the estate is $2,939,400 ($3,000,000 dividend less $60,000 expenses less $600 exemption). The estate's $200,000 interest payment is a nondeductible personal expense. See Reg. §1.663(c)-5, Example 7.

A qualified revocable trust for which the §645 election has been made is always treated as a separate share. In addition, the final regulations state that the qualified revocable trust itself may have separate shares within it. Reg. §1.663(c)-4(a).

Pecuniary formula bequests constitute separate shares of the estate. Any pecuniary formula bequest that is entitled to income and shares in appreciation or depreciation is a separate share under the general rules. If the pecuniary formula shares in appreciation and depreciation but not income, the bequest is not a separate share.

The final regulations contain a special rule whereby a pecuniary formula bequest that is not entitled to income and does not share in appreciation or depreciation is also treated as a separate share as long as the governing instrument does not provide that it be paid or credited in more than three installments. Reg. §1.663(c)-4(b). Thus, if the governing instrument requires that the bequest be made in four or more installments, the bequest is not a separate share.

3. Allocating Income and Deductions to the Share.

After the fiduciary has identified the separate shares, the fiduciary must allocate the items of income and deductions among those shares to compute the DNI for each share. The portion of gross income that is income under § 643(b) must be allocated among the separate shares in accordance with the amount of income each share is entitled to under the terms of the governing instrument or applicable local law. Reg. §1.663(c)-2(b)(2). Similar rules govern the amount of gross income not attributable to cash received by the trust or the estate that is included in DNI--such as the trust or estate's share of original issue discount (OID), partnership or S corporation income. Reg. §1.663(c)-2(b)(4). This income is allocated among the separate shares in the same proportion as §643(b) income from the same source would be allocated. Reg. §1.663(c)-2(b)(4).

Any expense or loss that is applicable solely to one separate share is allocable to that share and may not be deducted against any other share. Reg. §1.663(c)-2(b)(5).

Estate and trust expenses that are deductible for income tax purposes also must be allocated among the separate shares. The preamble to the final regulations states that "[t]hese final regulations do not change the long standing rule under [Reg. §] 1.663(c)-2 that any expense which is applicable solely to one separate share of a trust is not available as a deduction to any other share of the same trust." T.D. 8849,64 Fed.Reg. 72,540 (Dec. 28, 1999), corrected by 65 Fed.Reg. 16,317 (Mar. 28, 2000). Expenses that are not attributable directly to a particular separate share presumably are subject to the same general allocation rules that apply to income.

Example: A trust creates separate equals shares for A and B. The trust is required to distribute all of the income from each share. The trust has $40,000 of trust accounting income. The trustee makes a $10,000 discretionary distribution of principal to B from his share. DNI is $50,000 for the year. The trust has no tax-exempt income. The trust's distribution deduction is $45,000, calculated as follows:

A's share:	
First-tier distribution	$20,000
Second-tier distribution	0
Total	$20,000
A's share of DNI (50% of $50,000 DNI)	$25,000

The distribution deduction on A's distribution is $20,000.

B's share:	
First-tier distribution	$20,000
Second-tier distribution	$10,000
Total	$30,000
B's share of DNI (50% of$50,000 DNI)	$25,000

The distribution deduction on B's distribution is $25,000

A will report $20,000 of income from the income distribution. B will report $25,000 of income from the income and principal distributions. B's income is limited to his share of DNI.

The trust distributed $50,000 but will receive a distribution deduction of only $45,000 due to the fact that $5,000 of A's share of DNI was not distributed. The $5,000 of DNI that was not distributed is taxed to the trust and the income tax on the $5,000 should be charged against A's share.

If the separate share rule did not apply, DNI would be allocated to A and B pro-rata based on the distributions made to them. A would report income of $20,000 and B would report income of $30,000 and the trust would receive an income distribution deduction of $50,000. Notice that B would receive $5,000 more of DNI even though his share did not receive the additional $5,000 of DNI.

4. Special Allocation Exception for Income in Respect of a Decedent (IRD).

An important exception to the allocation rules applies to income in respect of a decedent (IRD). The final regulations provide that IRD "is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of gross income allocated to each share is based on the relative value of each share that could *potentially* be funded with such amounts. [Emphasis added.] Reg. §1.663(c)-2(b)(3).

This potential allocation of IRD could shift income tax liabilities to trusts that the decedent's transfer tax exemptions protect from estate or generation-skipping transfer (GST) taxes.

Practitioners may want to draft to limit or eliminate the potential recipients of IRD. Although the final regulations do not address the issue directly, expenses that are directly attributable to items of IRD presumably should be allocated in the same manner as the IRD itself-i.e., these expenses would be allocated among the separate shares that could potentially be funded with the IRD in proportion to the relative values of those shares.

Example (no allocation): D dies in 2017 and is survived by spouse and child. D's will provides for a pecuniary formula bequest to be paid in not more than three installments to a trust for the child in the amount needed to reduce the federal estate tax to zero, with the residue going to the spouse. The will provides that the bequest to the child's trust is not entitled to any of the estate's income and does not share in appreciation or depreciation in estate assets. During 2017, the estate receives a distribution of$900,000 from the decedent's IRA that is included in the estate's gross income as IRD. The $900,000 is allocated to the corpus under local law. Both the separate share for the child's trust and the separate share for the surviving spouse may potentially be funded with proceeds from the IRA. Therefore, a portion of the $900,000 gross income must be allocated to the trust's separate share. The amount allocated must be based on the relative values of the two separate shares, using a reasonable and equitable method. The estate is entitled to a distribution deduction for the portion of the $900,000 that is properly allocated to the trust's separate share, and the trust must include this amount in income. See Reg. §1.663(c)-5, Example 6.

Example 6 of Reg. §1.663(c)-5 (above) shows how the special rule for allocating IRD among separate shares can alter the results. Even though the decedent's will in this example excluded the formula pecuniary bequest from sharing in estate income, the formula pecuniary bequest potentially could be satisfied with the IRA proceeds. As a result, the special allocation rule for IRD causes a pro rata portion of the IRA to be allocated to the separate share of the formula pecuniary bequest. The share of IRD so allocated would be carried out to the beneficiary of the bequest by the funding. Thus, the child's trust would be allocated part of the IRA proceeds even though, from a tax point of view, it would make more sense to have the IRA proceeds be allocated to the spouse. If the IRA proceeds were allocated to the spouse, the IRA proceeds would be reduced by the income tax attributable to the IRA, thereby reducing the amount of the IRA proceeds that would be includible in the spouse's estate.

Example (allocation):. D's will directs the executor to divide the residue of the estate equally between D's two children, A and B. The will directs the executor to fund A's share first with the proceeds of D's IRA. The fair market value of the estate is $9,000,000. During the year, the $900,000 balance in D's IRA is distributed to the estate, which is allocable to corpus under local law. The estate has two separate shares-one for A and one for B. If any distributions are made to either A or B during the year, then, for purposes of determining the DNI for each separate share, the $900,000 of IRD must be allocated to A's share. See Reg. §1.663(c)-5, Example 9.

(A) More Separate Share Rule Examples

Official examples of the application of the separate share rule under the final regulations are contained in Reg. §1.663(c)-5. Some other examples follow.

Example – fractional formula clause: D dies in 2017, survived by a spouse and 2 children. D's will contains a fractional formula bequest dividing the residuary estate between the surviving spouse and a trust for the benefit of the children. The marital bequest is 60% of the estate and the children's trust is to receive the remaining 40% of the estate. Executor makes partial proportionate distribution of $1,000,000 ($600,000 to spouse and $400,000 to children's trust). DNI of the estate is $12,000. The fractional formula bequest to the spouse and the children's trust are two separate shares. This is a fractional formula bequest of the residue so that the income and any appreciation in value of the estate assets are proportionately allocated between the marital share and the trust share. Thus, the DNI is divided 60% to the marital (60% x $12,000 = $7,200) and 40% to the children's trust (40% x $12,000 = $4,800). Reg.§1.663(c)-5, Example 2.

Application of the separate share rule becomes more difficult when the fiduciary only partially funds a bequest or makes a disproportionate distribution. Reg.§1.663(c)-5, Example 3 includes an example of a disproportionate distribution. After the disproportionate distribution, the share that receives the greater distribution is entitled to less of the remaining balance in the funding trust. Thereafter, the fiduciary is required to use a reasonable and equitable method to allocate income and expenses among the shares. The regulations recognize this problem. It instructs the fiduciary to take into consideration in determining the separate share's allocable portion of DNI that after the disproportionate distribution the relative size of the distributee's separate share is reduced and the relative size of the other share is increased.

Example -- partial funding of fractional formula clause: Same facts as in the previous example except that in 2017 the executor makes the payment to partially fund the children's trust but makes no payment to the surviving spouse. Once there has been a partial funding of one share but not the other, it may no longer be reasonable or equitable to determine the DNI for the trust" share by allocating to it 40% of the DNI. The computation of DNI for the trust's share should take into account that after the partial distribution to the children's trust, the relative size of the trust's separate share is reduced and the relative size of the spouse's separate share is increased. Reg.§1.663(c)-5, Example 3.

Example – specific bequest and split of residue. The decedent's will leaves S corporation stock to his son and the residue of the estate equally to the son and the decedent's two daughters. Under state law, the son is entitled to all S corporation dividends the estate receives. The separate share rule results in there being four separate shares in this example. The specific bequest of the S corporation stock is not a separate share by reason of § 663(c). However, the income paid on that specific bequest is a separate share. The interest of the son and two daughters in the residue are also separate shares.

If the estate makes a distribution to one of the daughters when it has no income other than the S corporation income, the distribution would not carry out any of the DNI resulting from the S corporation income. If the estate has income in addition to the S corporation income, only one-third of the residue's separate share DNI would be carried out to the daughter who received the distribution. When the S corporation stock is ultimately distributed to the son with all the dividends earned on the stock for the period of administration, the amount of DNI allocable to him in the year of distribution will not exceed the S corporation's share of income for the year of distribution.

Example – bequest from will with pour-over to revocable trust: Decedent leaves amount payable over five years to a friend. The residue of the estate pours over to a revocable trust that is distributable free of trust to the decedent's children. The Section 645 election is not made. The amount payable to the friend over five years, the residue of the estate and the revocable trust are each separate shares. The shares of each child are also separate shares.

A typical application of the separate share rule is where a trust has separate shares, one of which provides that one beneficiary is entitled to the income of his or her share, while the income is *accumulated* for the beneficiary of the other share.

Example – mandatory payments to one beneficiary and discretionary payments to the other beneficiary: The will creates a trust under which half the income must be paid to the decedent's daughter and the other half of the income is payable to the decedent's son in the trustee's discretion. If the son is paid his share of the income, DNI will be allocated equally to son and daughter. On the other hand, if the trustee accumulates the income from the son's share, half the DNI will be reported by the daughter, and the half of the income accumulated for the benefit of the son will be taxed to the trust. (Note that the tax on the son's half of the income that is accumulated should be allocated to share.)

Example – unequal distributions. Assume the same facts as in the preceding example, except that the trustee makes a principal distribution of a parcel of real estate to the son but the value of the real estate exceeds the son's share of the DNI for the year of distribution. In this case, half the DNI will be reported by the daughter (due to her distribution of half the income of the trust) and half the DNI will be reported to the son (due to distribution of the real estate). (Note that the DNI is reported equally to the son and the daughter even though the distributions during the year to the daughter and the son were unequal.) The application of the separate share rule leads to the above result. If the trust had been a sprinkling trust (so that the separate share rule would not apply), DNI would be allocated to the daughter and the son based on the fraction that the value of the distributions payable to each bears to the total distributions from the trust.

The preceding example illustrates what happens when a trust is not subject to the separate share rule – the basic rules allocate DNI to the beneficiaries, pro rata, based on all the distributions made by the trust during the year.

(B) Formula Bequests.

The regulations clarify that formula marital deduction provisions (whether or not pecuniary formula is used) create separate shares. Reg. §1.663(c)-5, Examples2-4. Example 4 of Reg.§1.663(c)-5 deals with a formula pecuniary bequest that, under terms of the governing instrument, was not entitled to share in income. Accordingly, no income was allocable to the separate share represented by the pecuniary bequest, and none of the estate's income was carried out by the bequest's funding. Since the bequest was funded with appreciated property that was distributed in kind, the estate also had to recognize and pay tax on the capital gain realized on the distribution. The recipient of the formula pecuniary bequest received no taxable income because of the distribution. The entire income tax burden was borne by the estate and, indirectly, the residuary beneficiaries.

Example. D dies in 2017 survived by spouse and child. D's will provides for a pecuniary formula bequest to be paid in not more than three installments to a trust for the child in the amount needed to reduce the federal estate tax to zero, with the residue going to a trust for the spouse. The will provides that the bequest to the child's trust is not entitled to any of the estate's income and does not share in appreciation or depreciation in estate assets. During the year, the estate has dividend income of $200,000 and pays deductible expenses of $15,000. The executor funds the child's trust by distributing appreciated securities having a fair market value of $380,000 but a basis of $350,000. The trust therefore realizes a long-term capital gain of $30,000. The estate has two separate shares--the formula pecuniary bequest to the child 's trust and the remainder bequest for the benefit of the spouse. Since, under the terms of the will, no estate income, and no appreciation or depreciation is allocated to the bequest to the child's trust, the DNI for that trust's share is zero. With respect to the $380,000 distribution to the child's trust, the estate receives distribution deduction and no amount is included in the trust's gross income. Since no distributions were made to the spouse, there is no need to compute DNI applicable to the marital share. The taxable income of the estate for 2017 is $214,400 ($200,000 dividends plus $30,000 capital gain less $15,000 expenses and less the $600 exemption). See Reg. §1.663(c)-5 Example 4.

The result in Example 4 makes sense because the formula pecuniary bequest was not entitled to share in any of the income.

(C) Residuary Bequests

The regulations also point out that a residuary bequest that distributes the residue in equal shares to the decedent's children creates separate shares for each of the children. Reg. §1.663(c)-5, Example 7. As a result, estates and trusts with multiple beneficiaries will most likely be subject to the separate share rule unless the power to pay income or principalis discretionary with the fiduciary.

(D) Special Situations - Interest on Pecuniary Bequest

Example 7 of Reg. §1.663(c)-5 makes it clear that interest paid on the late payment of a pecuniary bequest is not entitled to an income distribution deduction and hence is not governed by the distribution rules of § 661 and §662. Thus, the payment of interest on the late payment of a pecuniary bequest results in no income being carried out from the estate to the beneficiary. The interest payment is taxable income to the beneficiary under the general §61. The estate treats the interest payment as personal interest that is not deductible by the estate under §163(h). Reg. §1.663(c)-5, Example 7. See also Rev. Rul.73-322, 1973-2 C.B. 44. (Note that this treatment may result in double taxation--the beneficiary reports the interest income, and the estate receives no deduction for the payment because it is nondeductible personal interest and, in addition, does not qualify for a distribution deduction.)

(E) Special Situations-S Corporation Stock

If a trust that has multiple beneficiaries holds S corporation stock, the fiduciary may have to make a "qualified Subchapter S election"(QSST). Section1361(d) of the Code states that if a trust has multiple beneficiaries who are treated as having separate shares under §663, each separate share is counted as a separate trust. Each separate trust is counted as a separate shareholder for purposes of the shareholder limit applicable to ownership of an S corporation. A separate QSST election must be made for each of the separate shares. (Note also that under §1361(d), a successor of a QSST is to have made the QSST unless the successor beneficiary affirmatively refuses to consent to the election.)

3. How the Final Separate Share Regulations Affect Drafting

Application of the separate share rule is a function of how the trust was drafted. For example, if distributions from an irrevocable trust are discretionary, the separate share rule does not apply. Thus, drafting a trust as a sprinkle trust renders the separate share rule inapplicable.

The final separate share regulations require the practitioner to pay attention to the income tax aspects of IRD. The kinds of issues that can arise are illustrated by Examples 9 and 10 of Reg.§1.663(c)-5. Example 9 indicates that a specific direction in the governing instrument about allocating IRD will be recognized as overriding the regulation's requirement of allocation among recipients. In Example 9, the estate received a distribution from an IRA. The will provided for distribution of the residue in equal shares to the decedent's two children. The will also directed that one child's share be funded first with the IRA proceeds. The results in Example 9 confirm that the IRA income will be allocated to that child's share, instead of being allocated to each child as would have been required absent the direction in the will to allocate the IRD to one particular child. Often practitioners intentionally fund gifts or bequests of IRD to the surviving spouse, if this can be done without triggering an income tax. This is usually accomplished by making a specific bequest of the IRD to the spouse. Such a bequest allows the estate of the surviving spouse

to be reduced by the income tax that will have to be paid on the IRD, thereby decreasing the potential future tax on the spouse's death. This also avoids"wasting"the decedent's unified credit or GST exemption on amounts that will be paid to the government as income tax. Thus, a specific bequest of IRD or a specific direction about using IRD in funding is necessary to avoid the final regulation's requirement of a proportionate allocation of IRD among all recipients.

A person drafting an irrevocable trust must be alert to the potential that subtrusts may be funded with IRD and be careful to draft the trust so that the IRD will be distributed to the subtrust the draftsperson wants to receive the IRD. For example, generally the IRD should be distributed to the marital share as opposed to the family This will cause the marital trust to recognize and pay income taxes on the IRD, thus reducing the value of the marital trust that will ultimately be in the surviving spouse's estate. On the other hand, generally it is not desirable to have IRD distributed to the family trust which is funded with the decedent's applicable exclusion amount. Funding the family trust with IRD will cause the value of the family trust to be reduced by the amount of income taxes paid on the IRD. To avoid this result, the trust instrument should clearly exclude the possibility that IRD could end up in the family trust. Otherwise, IRD will be deemed to have been used to fund both the marital and family trusts since each trust could potentially be funded with IRD.

Any practitioner who anticipates the possibility of a disclaimer must consider the income tax effects of a disclaimer under the final separate share regulations. A disclaimer might create or eliminate separate shares of an estate or trust.

Finally, the practitioner may want to intentionally design the estate plan to avoid the separate share rules. Drafting the trust to create separate trusts under the same instrument renders the separate share rule inapplicable. Likewise, division into separate trusts as early as possible is another way to eliminate the application of the separate share rule.

In the event that the use of multiple trusts is undesirable (due to administration costs), the trusts may be drafted as a sprinkle trust. The separate share rule does not apply to discretionary trusts.

H. 65 Day Rule – Section 663(b) Election

Generally, for an estate or trust to take a distribution deduction, the actual distribution has to be made before year-end. A problem occurs for an executor or trustee who wants to distribute the estate or trust's entire DNI in a particular year. It may be difficult to determine the trust's total income until after year end when the estate or trust's books are closed.

Section 663(b) allows an executor or trustee to elect to treat any portion of a distribution to a beneficiary made within the first 65 days of the estate or trust's subsequent tax year as if it had been paid or credited to the beneficiary on the last day of the preceding tax year.

The 65 day rule applies to estates and complex trusts. It does not apply to simple trusts.

The 65 day rule election (also known as the §663(b) election) provides greater flexibility in timing distributions for tax purposes. The election allows the executor or trustee to make a decision based on the actual income for the year. This will allow the fiduciary to better coordinate the income tax planning for an estate or trust and its beneficiaries.

While the distribution must be made within 65 days of the new year, the election must be made no later than the due date of the return (including extensions). The election is made on an annual basis and is irrevocable after the last day prescribed for making it. Reg. §1.663(b)-2(a)(1), A late election (or revocation) is possible under Reg.§1.9100-1 if the trustee can demonstrate that it acted reasonably and acted promptly to request an extension once the error was discovered. PLRs 200834006, 200617004, 200250003. The election is effective for the taxable year for which it is made i.e. the election is made on a year by year basis. Reg.§663(b)-1(a)(2). The election is made by checking the appropriate box at the bottom of page two of Form1041. If no return is due, the election is made by filing a statement to that effect with the Internal Revenue office where the return would have been filed and within the time such return would have been due. Reg. §1.663(b)-2(a)(2). The election does not need to be made for all the distributions made in the first days – the fiduciary may designate the distributions that he or she wants to subject to the 65 day rule election. Reg §1.663(b)-1(a).

Example: Trust has $10,000 of DNI for the year 2017. Trustee may distribute income and principal in trustee's discretion. During the year the trustee distributes $6,000 to the beneficiaries. If the trustee make no further distributions, the trust will receive a $6,000 distribution deduction (and the beneficiary will report that income on his own tax return). The trust will pay tax on the remaining $4,000 of undistributed income. On the other hand, the trustee could exercise his discretion and make an additional distribution of $4,000 to the beneficiary on or before March 5. (Caution: February has 29 days in a leap year.) If the trustee makes the §663(b) election, the $4,000 distribution will be treated as if it were made on December 31, 2017.The trust will get an income distribution deduction of $10,000 and the beneficiary will report $10,000 on his tax return. The amount paid pursuant to a §663(b) election is not deductible for the trust year in which the payment is actually made (2017)- it is deductible in the year to which the §663(b) election applies (2018).

The election is limited to the greater of DNI (reduced by any amounts deductible for such year on account of other amounts paid, credited or required to be distributed other than those amounts considered paid or credited in a preceding year by reason of a §663(b) election) or trust accounting income not otherwise distributed for that year. Reg.1.663(b)-1(a)(2). The effect of this restriction is that distributions made with 65 days after a taxable year ends cannot be treated as made in a prior year if doing so would result in a tax-free distribution of principal because of the DNI limitation.

Example: X Trust, a calendar year trust, has $1,000 of income (as defined in Reg. §1.643(b)-1) and $800 of distributable net income in 2017. The trust properly pays $550

to A, a beneficiary, on January15, 2018 which the trustee elects to treat under §663(b) as paid on December 31, 2017. The trust also properly pays to A $600 on July 19, 2018, and $450 on January 17,2019. For 2017, the maximum amount that may be elected under §663(b) to be treated as properly paid or credited on the last day of 2018 is $400 ($1,000 less the $600 paid in July) The $550 paid on January15, 2018 does not reduce the maximum amount to which the election may apply because that amount is treated as properly paid on December 31, 2017.

The 65 day rule election is a valuable tool for executors and trustees. It can be used to have trust income taxed to the beneficiaries rather being subject to an estate or trust's compressed income tax brackets. In addition, it may be useful in avoiding net investment income earned by an estate or trust subject to the 3.8% surtax.

I. Distributions Not Subject to the Distribution Rules - §663(a)(1)

Section 663(a)(1) is an exception to the §661 and §662 rules governing distributions from estates and complex trusts. If a distribution meets the requirements of §663(a)(1), the estate or trust is not entitled to a distribution deduction under §661 and the beneficiary is not required to include the distribution in income under §662.

Distributions which, under the terms of the governing instrument, are paid or credited as a gift or bequest of a specific sum of money or of specific property and are paid or credited all at once or in not more than three installments will not carry out DNI under §661 and §662. §663(a)(1). For these purposes, amounts that by the terms of the governing instrument may be paid only from income of the estate or trust are not considered a "specific sum of money." Amounts payable under §663(a)(1) are neither deductible by the trust or estate nor taxable to the beneficiary.

Three requirements must be met for a distribution to qualify under §663(a)(1). First, the distribution must be of specific property or a specific, pecuniary sum of money. The regulations indicate that a gift or bequest is "specific"if the amount of money or the identity of the property is ascertainable under the terms of the testator's will as of the date of death or under the terms of an inter vivos trust instrument as of the date of the inception of the trust. Reg.§1.663(a)-1(b)(1). Second, the distribution must be paid either all at once or in not more than three installments. Third, §663(a)(1) provides that a distribution is not considered to be a gift or bequest of a specific sum of money if it can be paid only from income. (See the last sentence of §663(a)(1).)

Example: Decedent leaves $10,000 in the will to Skyler. Since the bequest is ascertainable at the date of the decedent's death, Skyler is not required to report any of the $10,000 as income and the estate does not get a distribution deduction for the $10,000 distribution.

Example: Decedent's will says,"I leave my grand piano to Stacy, the child of my sibling Cameron." The bequest of the grand piano is a bequest of specific property under §663(a)(1). As a result, Stacy is not required to include the value of the grand piano in her income and the estate does not get a distribution deduction for the value of the grand piano.

Example: A bequest of trust assets, in cash or in kind, with a value as of the date of distribution of $25,000 with the personal representative having the discretion to select the assets to satisfy the bequest, is a bequest of a specific sum of money, even though it may be satisfied by a distribution in kind. Rev. Rul. 86-105, 1986-2 C.B. 82; Rev. Rul. 66-207, 1966-2 C.B. 243.

Example: A gift of 25% of the trust's principal when the beneficiary reaches age 25 is not a gift of specific property or a specific sum of money because the amount that will be distributable to the beneficiary cannot be determined as of the date of the trust's inception. To qualify as a bequest of specific property, the property must be identifiable both as to its kind and as to its amount at the time of death.

Example: A bequest of a specific dollar amount of XYZ stock, but not more than all of the XYZ stock, where the value of the stock was to be determined as of the date of distribution is not a bequest of specific property or of a specific sum. Rev. Rul. 72-295, 1972-1 C.B. 197. The amount of stock to be distributed could only be determined as of the date of distribution. Thus, only the type of property could be identified as of the date of death, but not the amount.

A formula marital or credit shelter bequest, although treated as fixed and ascertainable for other purposes, is *not* a bequest of a specific sum of money for purposes of §663(a)(1). Reg.§1.663(a)-1(b)(1); Rev. Rul. 60-87, 1960-1 C.B. 286. The identity of the property and the amount of assets are dependent both on the exercise of the executor's discretion and on the payment of administration expenses and other charges, neither one of which are determinable as of the decedent's death.

Example: Decedent's will leaves Jordan a sum of money equal to 10% of the estate's adjusted gross estate as defined in §§6166(b)(6) (gross estate less deductions allowed under §2053 and §§2054). The amount Jordan will receive is not ascertainable as of the decedent's death. This is due to the fact that the executor may elect to claim administration expenses either as an estate tax deduction or a fiduciary income tax deduction. If the executor elects to deduct administration expenses on the estate's income tax return, the amount of the formula bequest will be higher than if those expenses were deducted on the estate tax return. Thus, the base amount of the adjusted gross estate is not ascertainable until that election is made at some point after the decedent's death, i.e., the base amount is not ascertainable as of the date of the decedent's death. The distribution carries out DNI to Jordan and the estate will receive a corresponding income distribution deduction.

If a bequest of a specific sum of money is satisfied with appreciated or depreciated property or if a bequest of specific property is satisfied with different property, the distribution may result in a gain or loss. Reg.§1.661(a)-2(f).

The beneficiary who receives a §663(a)(1) distribution from an estate or trust that was included in the decedent's gross estate will receive a basis in the asset equal to the date of death (or alternate valuation) value under §1014, with any adjustments made for the period the property was held in the estate. The beneficiary who receives a §663(a)(1) distribution from an irrevocable trust that was not included in the decedent's estate will receive a basis in the asset determined under §1015 whereby there may be one basis for determining gain and another for determining loss, each adjusted for the period the property was held in the trust.

If the governing instrument requires the specific sum or property be paid or credited in more than three installments, it will not qualify as a specific bequest under §663(a)(1). Reg. §1.663(a)-1(b)(2)(iv).

Reg. §1.663(a)-1(c) contains five modifications to the three installment rule:

First, gifts of items of personal or household use are disregarded, even when the will requires that they be distributed in more than three installments.

Second, real estate that vests in the devisee at the testator's death is not taken into account – it does not constitute an amount paid, credited or required to be distributed under §661. Reg.§1.663(a)-1(c)(1)(iii); Reg. §1.661(a)-2(e); Rev. Rul. 68-49, 1968-1 C.B. 304.

Third, gifts and bequests under a decedent's will for which no time of payment or crediting is specified and which are to be paid or credited in the ordinary course of administration of the decedent's estate, are considered as required to be paid or credited in a single installment.

Fourth, the number of installments required by the trust instrument governs regardless of the number of installments actually made.

Fifth, gifts to one beneficiary are not aggregated with gifts made to another beneficiary and the decedent's estate is deemed a separate beneficiary from a testamentary trust.

Example: A decedent's will makes a specific bequest to a beneficiary of $40,000. Although not required by the will, the personal representative makes partial distributions of the bequest over four installments. As long as the distributions are accomplished within the ordinary course of administration and the will does not specify the time for payment, the distributions are considered to be paid in a single installment and will qualify as a specific bequest.

A distribution of the income earned by a specific bequest is not exempt under §663(a)(1). It will qualify for a distribution deduction under §661 and be includible in the beneficiary's income under §662.

Example: A will leaves a specific bequest of XYZ stock to B. State law requires that the income earned on the specific bequest follow the bequest. The bequest of the stock qualifies as a specific bequest under §663(a)(1). The dividends on the stock do not meet the requirements of §663(a)(1). When the dividends are distributed to B they will be taxable to B and deductible by the estate.

The estate planner should structure a distribution as a specific bequest under §663(a)(1) whenever it is desirable to avoid having the beneficiary pay income tax on a distribution. A bequest leaving all of a person's tangible personal property qualifies under §663(a)(1) so that the beneficiary does not have to pay income tax on the value of the tangibles when distributed. Such bequests are intentionally used in a will or trust to avoid income tax consequences to the distributee.

J. §645 Election to Treat a Trust as Part of an Estate.

Section 645, enacted in 1997, allows the trustee of a decedent's "qualified revocable trust" and the executor of the decedent's estate to make an irrevocable election to treat the trust as part of the decedent's estate for Federal fiduciary income tax purposes rather than as a separate trust..

1. The Election

The election is made jointly by both the personal representative of the estate and the trustee of each revocable trust making the election (or by the trustee only if no executor is appointed). §645(a); Reg. 1.645-1(c)(1). The election is made on Form 8855, Election to Treat a Qualified Revocable Trust as Part of the Estate.

Both the estate's personal representative and the trustee must sign the election. If there is more than one trustee or more than one executor, only one must sign the required statement, unless local law or the governing instrument requires otherwise.

If there is no probate estate, the election can be made by the trustee. In that case, a tax identification number must still be obtained for the estate and only a trustee of the qualified revocable trust must sign the Form 8855.

The election must be made no later than the due date of the fiduciary income tax return for the first taxable year of the estate (including extensions) regardless of whether there is enough income to require the filing of a return. §645; Reg. §1.645-1(c)(1)(i), (2)(i). Once made, the election is effective from the date of death and is irrevocable.

The election can only be made for a "qualified revocable trust." A "qualified revocable trust" is any trust (or portion thereof) that on the date of death of the decedent was treated as owned by the decedent under §676 by reason of a power held by the decedent and not by a power attributed to the decedent by reason of a power held by the decedent's spouse. Reg.§1.645-1(b)(1). Thus, the power of revocation must be held by the decedent. This includes a trust where the power is exercisable by the decedent only with the approval or consent of a nonadverse party or with the approval or consent of the decedent's spouse. Reg.§1.645-1(b)(1). If the trust is treated as owned by the decedent under §676 solely by reason of a power held by a nonadverse party or the decedent's spouse, it is not a "qualified revocable trust." Reg.§1.645-1(b)(1).

2. Duration of the Election.

The election lasts for a limited period of time.

The §645 election period begins on the date of the decedent's death and ends on the earlier of the day on which both the electing trust and the estate, if any, have distributed all their assets or (1) if no federal estate tax return is required to be filed, the election continues for all taxable years of the estate before the second anniversary of the decedent's death and (2) if an estate tax return is required to be flied, the election continues for the later of 2 years or all taxable years of the estate until 6 months after the date of the final determination of the estate tax liability. §645(b)(2). Reg.§1.645-1(f)(1), (2). See Reg.§1.645-1(f)(2)(ii) which sets forth the five different possible dates for the final determination of the estate tax liability.

3. Filing Requirements.

If there is an executor, the executor files a single income tax return annually under the name and taxpayer identification number of the estate for the combined estate and electing trust. The name and TIN of each electing trust must be provided on the Form 1041.

If there is no executor, the trustee of the electing trust must, during the election period, file a Form 1041 under the TIN obtained by the trustee upon the death of the decedent, treating the trust as an estate. The trustee of the electing trust treats the electing trust as an estate for all purposes of Subtitle A of the Internal Revenue Code during the election period.

If the §645 election is made, the trustee is not required to file a Form 1041 for the short taxable year of the qualified revocable trust from the date of the decedent's death to December 31 of the year of death. Reg. §1.645-1(d)(2).

If the §645 election is made, the qualified revocable trust is treated as a separate share of the estate for purposes of computing the estate's distributable net income (DNI) and for purposes of the distribution provisions of §§661 and 662. Reg.§1.645-1(e)(2)(iii);

Reg.§1.663(c)-4(a). The share making the distribution reduces its DNI by the amount of the distribution deduction it would ordinarily receive and the share receiving the distribution increases its DNI by the amount received. Reg.§1.645-1(e)(2)(iii)(B).

If the executor is appointed after the trustee has made a §645 election, the executor must consent to the trustee's election and the IRS must be notified of the executor's consent by filing a revised election form within 90 days of the executor's appointment. If the executor does not consent or if the revised election form is not timely filed, the election period terminates the day before the executor is appointed. Reg.§1.645-1(g)(1).

The regulations permit an electing trust and estate to file a single Form 1041 combining the income of the electing trust and estate. However, the electing trust and estate are considered to be separate taxpayers for administration purposes. The fiduciaries of the electing trust and estate have a responsibility to file returns and pay the tax due for their respective entity. Reg. §1.645-1(c)(1)(ii), (2)(ii), (e)(4). The trustee and executor must allocate the tax burden of the combined return in a manner that reasonably reflects the respective tax obligations of the electing trust and estate. Reg. §1.645-1(c)(1)(ii), (2)(ii).

The final regulations require that the trust obtain a new TIN after the decedent's death, even if the trust elects to file with the estate under the estate's TIN. The trust must obtain a new TIN after the decedent's death even if it had a separate TIN prior to the decedent's death. Reg. §301.6109-1(a)(3).

If there is no executor appointed, the trust will use its new TIN to file the fiduciary income tax return as an estate during the election period. If there is no executor, at the termination of the election period the trust will continue as a new trust and must therefore obtain a new TIN.

4. Tax Consequences at Termination of Election.

At the end to the election period the estate, or, if there is no estate, the electing trust, is deemed to distribute all its assets and liabilities attributable to the electing trust to a new trust. Reg. §1.645-1(h)(1). The distribution from the estate to the new trust is deemed to carry out DNI from the estate to the new trust. Reg. §1.645-1(h)(1). The distribution would carry out any net capital gains attributable to the electing trust as if the estate were in the year of termination as to the assets attributable to the electing trust. Reg. §1.645-1(h)(1). The estate is entitled to a distribution deduction and the recipient trust reports the income under the normal distribution rules applicable to estates and trusts. Reg. §1.645-1(h)(1).

Upon the termination of the §645 election period the trustee must obtain a new TIN.

5. Why Make the §645 Election.

(1) The income, deduction and credits of the trust and estate are combined and reported on the estate's fiduciary income tax return;

(2) The personal exemption is the one applicable to estates, i.e. $600;

(3) The income may be reported on a fiscal year basis (estates can elect a fiscal year whereas a trust must adopt a calendar year);

(4) The estate fiduciary income tax charitable deduction is available if the amount is "set aside" under §642(c) (whereas the "set aside" rule does not apply to most trusts);

(5) The trust will be able to hold S corporation stock for the period of administration of the estate or until the termination of the §645 election, whichever is sooner. The election will allow a trust to own S corporation stock for at least two years (minimum §645 election period) after the grantor's death without having to meet the requirements of §1361. An estate, but only certain trusts, may own S corporation stock. A qualified revocable trust for which the election is made is treated as part of the estate for purposes of determining whether the trust can own S corporation stock even though the trust does not qualify as a S corporation shareholder under §l361(c). Note, however, that a revocable trust treated as part of an estate pursuant to a §645 election would be so treated only until the "applicable date" (i.e., two years after the date of death if an estate tax return is not required to be filed, or six months after the final determination of the estate tax liability if an estate tax return is required to be filed). Thereafter, the trustee must distribute the S corporation stock to an eligible S corporation shareholder or make a timely election to treat the trust as an ESBT or QSST prior to the applicable date;

(6) The election does not affect the GST status of a trust. A §645 election will not permit a trust to make distributions and treat them as direct skips from an estate which would be taxed more favorably than a taxable distribution or taxable distribution. The tax on a direct skip is based on the value of the property that the transferee receives, i.e. the tax is computed on a tax exclusive basis. §2623, §2621. The tax on a distribution or termination, however, is based on the property the transferee receives plus the amount of GST paid, i.e. on a tax inclusive basis. §2621, 2622. Thus, with respect to the GST tax, a trust subject to a §645 election is treated as an estate only for purposes of the different transferor and separate share rules of §2654(b). In other words, the portions of a trust attributable to transfers from different transferors and substantially separate and independent shares of different beneficiaries in a trust are treated as separate trusts;

(7) The $25,000 deduction for passive losses from real estate activities for each of the first two years of the estate or trust under §469(4)(i) is available if the decedent actively participated before his death i.e. the trust enjoys a waiver of the active participation requirements to this extent;

(8) Any depreciation deduction will be allocated to the beneficiary based upon the trust accounting income distributed to the beneficiary i.e. the terms of the trust instrument are ignored in allocating the depreciation deduction;

(9) Any loss may be recognized under §267(b)(13) upon the satisfaction of a pecuniary bequest with assets whose fair market value is less than their basis;

(10) An income tax deduction is allowed on the decedent's income tax return under §213(c) for payment of the decedent's medical expenses from the trust within a year of the decedent's death;

(11) Charitable deductions attributable to unrelated business taxable income are not denied as is the case with a trust whose charitable deduction consists of unrelated business taxable income.

(12) The trust is not obligated to make estimated tax payments for any taxable year ending within 2 years of the decedent's death. Reg.§1.645-1(e)(4).

K. Distribution in Kind- §643(e) Election

1. In General.

Section 643(e) was enacted by the Tax Reform Act of 1984 to close a loophole in the law that allowed an estate or trust to fund a residuary bequest with appreciated property without having to recognize any gain. Under the old law, funding a residuary bequest with appreciated property gave the distributee a basis in the distributed property equal to the fair market value of the property at the date of distribution so that the distribution would "step up" the property's basis without requiring the estate or trust to recognize gain on the distribution of the appreciated property. As a result, the Tax Reform Act of 1984 changed the law by adopting §643(e).

Under current law, when an estate or trust distributes property in-kind, §643(e)(3) allows the fiduciary to elect to treat the distribution as a sale to the beneficiary and recognize gain or loss on the distribution.

Because the above loophole affected only residuary bequests, the legislative history of the Tax Reform Act of 1984 indicates that §643(e) applies only to residuary bequests. S. Rep. No. 169. 98th Cong. 2d Sess., 246 (1984); H.R. Rep. No. 861, 98th Cong., 2d Sess., at 870 (1984). Reg. §1.661(a)-2(f) continues to apply to funding bequests of specific property and specific dollar amounts with property. Pursuant to Reg.§1.661(a)-2(f) and Reg.§1.1014-4(a)(3) gain or loss will be recognized and the property in the hands of the distributee beneficiary will receive a basis equal to the fair market value of the property as of the date of distribution, subject to the rules denying loss recognition in related party transactions.

The rules for the distribution of property in kind to fund a residuary bequest under §643(e) may be summarized as follows:

(1) The distributing estate or trust may elect, but is not required, to recognize gain or loss as if the property had been sold at its fair market value to the distributee. §643(e)(3).

(2) Distributed property carries out DNI to the beneficiary but the amount of the DNI depends on whether the estate or trust elects to recognize gain or loss. §643(e)(2) and (3).

(3) The basis of the distributed property to the distributee beneficiary is equal to the basis of the property in the hands of the estate or trust plus or minus any gain or loss the estate or trust elects to recognize on the distribution. §643(e)(1).

The distribution of property in kind to fund a residuary bequest under §643(e) has the following tax consequences:

(A) The distributed property carries out DNI to the beneficiary but the amount of the DNI depends upon whether the estate or trust elects to recognize gain or loss under §643(e). §663(a)(1) does not apply to residuary bequests. Reg.1.663(a)(1)-(b)(2)(iii).

(B) The amount the distributee beneficiary must include in his gross income and that the estate or trust may deduct depends upon whether the estate or trust elects under §643(e) to recognize gain or loss. If the estate or trust does not elect to recognize gain or loss, the distribution carries out DNI equal to the lesser of the basis of the property or the property's fair market value on the date of distribution. §643(e)(2). Accordingly, the amount treated as a distribution deduction under §661(a)(2) and included in the beneficiary's income under §662(a)(2) is the lower of the basis or fair market value of the distributed property. If the estate or trust elects to recognize gain or loss, the distribution carries out DNI equal to the property's fair market value. §643(e)(3). Accordingly, the amount treated as a distribution deduction under §661(a)(2) and included in the beneficiary's income under §662(a)(2) is the fair market value of the distributed property.

(C) The estate or trust is not required to recognize gain or loss on the funding of a residuary bequest with appreciated property because a residuary bequest is not a bequest of a specific dollar amount or specific property. Reg.§1.661(a)-2(f); Reg.§1.663(a)-1(b)(2)(iii); PLRs 8104015, 8447003; Rev. Rul. 60-87, 1960-1 C.B. 286. However, §643(e) permits the estate or trust to elect to recognize gain or loss when satisfying a residuary bequest with appreciated property. §643(e)(3). However, there may be a denial of loss recognition under §267 for distributions between related parties.

(D) The basis of the distributed property to the distributee beneficiary is equal to the basis of the property in the hands of the estate or trust plus or minus any gain or loss the estate or trust elects to recognize on the distribution. §643(e)(1).

(E) The holding period of the distributed asset carries over to the distributee and, as such, the holding period tacks under §1223(2). Under §643(e)(1) the basis of the distributed asset appears to be determined with reference to the trust or estate's basis. Under §1223(2), if the basis of the distributed asset is determined in whole or in part with

reference to the asset's basis in the hands of the transferor, the holding period of the transferor tacks to the holding period of the transferee. Thus, the basis of the distributed asset carries over to the distributee and, as such, results in the tacking of the holding period under §1223(2). If the asset was held at the date of death and included in the decedent's gross estate for federal estate tax purposes, the holding period of the transferor will be an automatic long-term holding period under §1223(10).

Example: A trust has DNI of $50,000. The trustee funds a residuary bequest by transferring stock with a fair market value of $50,000 and a basis of $20,000. The trustee makes a §643(e) election. The distribution of stock carries out $50,000 of DNI (the fair market value of the stock). The §643(e) election causes the trust to recognize gain of $30,000 ($50,000 FMV less $20,000 basis). The beneficiary takes a $50,000 basis in the distributed stock (the trust's $20,000 basis plus the $30,000 of gain recognized by the trust). Since the beneficiary's basis is determined in whole or in part by reference to the trust's basis in the stock the trust's basis of the stock is tacked onto the beneficiary's holding period for purposes of determining if the gain is long-term or short-term.

The §643(e) election gives the fiduciary the opportunity to shift tax consequences between the estate or trust and its beneficiaries. For example, it gives the fiduciary an opportunity to shift capital gains and losses to the beneficiaries in a year before termination. Generally, capital gains and losses are taxed to the estate or trust and get passed out to the beneficiaries only in the year the estate or trust terminates. Reg.§1.643(a)-3(a).If the fiduciary funds a residuary bequest using appreciated property and does not make the §643(e) election, the beneficiary takes the property with the same basis as it had in the trust or estate's hands. The beneficiary can then sell the asset and realize the gain or loss on its own. This allows the beneficiary to time the recognition of gain and losses. The beneficiary may then recognize gains to offset its own losses or to recognize losses to offset its own gains. Alternatively, the gain will be eliminated if the property is held by the beneficiary until death and the asset receives a step-up in basis.

2. Making the Election.

A §643(e) election is made by the estate or trust on its return for the taxable year for which the distribution was made. The election is made by checking a box on the bottom of page 2 of the Form 1041. The election applies to all property distributions made during the year with the exception of §663(a) property distributions. §643(e)(3)(B), (e)(4). Thus, the estate or trust may not make a §643(e) election in a particular year for some property distributions but not for others. Once made, the election may only be revoked with the consent of the Secretary of the Treasury. §643(e)(3)(B), last sentence. The election is made on a year-by-year basis i.e. it can be made for property distributions in one year but not the next. The revocation of the §643(e) election may be approved through a Reg. 301.9100 relief request. PLR 9641018.

3. Planning with §643(e).

§643(e) gives the fiduciary a number of planning options. Perhaps most important, it gives the fiduciary the option of choosing whether the fiduciary or the beneficiary will report the gains and losses on property which is distributed in-kind to the beneficiary.

The fiduciary has the following options:

(A) Make the election to realize gains at the estate or trust level to offset the estate or trust's previously recognized losses.

(B) Make the election in order to carry out the maximum amount of DNI to the beneficiary i.e. DNI equal to the fair market value of the distributed property.

(C) Make the election to incur a loss at the estate or trust level in order to offset previously realized gains.

(D) Do not make the election and distribute low basis/high fair market value property to a beneficiary, thus giving the beneficiary the opportunity to sell the property and realize the gain, either to offset a prior loss or to have the gain taxed at a lower rate than it would have been taxed in the estate or trust. Alternatively, the beneficiary could hold the property until his death and the step-up in basis allowed under §1014 will eliminate the gain.

(E) Do not make the election when distributing high basis/low fair market value assets enabling the beneficiary to realize a loss on a subsequent sale.

(F) Make the election when funding a residuary or fractional bequest with an interest in a passive activity in order to trigger a deduction against nonpassive income for any unused suspended passive activity losses (PALs) applicable to the PALs transferred.

The §643(e) election will also affect the amount and the character of the income taxable to the estate or trust and the beneficiaries.

Example: Trust has DNI of $3,000 and the trustee distributes appreciated property to the beneficiary. The property has an adjusted basis of $1,000 and a fair market value of $2,500. If the §643(e) election is made, the beneficiary will have a basis of $2,500 in the property and will be required to report $2,500 of ordinary income pursuant to §662(a)(2). If no §643(e) election is made, the beneficiary will have a basis of $1,000 in the property and will be required to report $1,000 of ordinary income. Therefore, by not making the election, the beneficiary benefits by having $1,500 of ordinary income converted into potential capital gain i.e. the potential gain is shifted to the beneficiary. On the other hand, if the §643(e) election is not made, the trust suffers by converting $1,500 of capital gain into $1,500 of ordinary income.

A fiduciary should be aware of the impact of the §643(e) election when there are multiple beneficiaries and the trustee distributes cash to some and property to others. These concerns are eliminated if the separate share rule applies to the distributions.

Example: Trust has $3,000 of DNI. Assume the separate share rule does not apply. Trustee distributes $5,000 in cash to beneficiary A and distributes property with a basis of $2,500 and a fair market value of $5,000 to beneficiary B. If no §643(e) election is made, under §662(a)(2) beneficiary B is treated as receiving a distribution equal to the basis of the property ($2,500) and will be taxed on only $1,000 of income ($3,000 DNI x $2,500 distribution/$?,500 total distribution). Beneficiary A will recognize $2,000 of income ($3,000 DNI x $5,000 distribution/$7,500 total distribution). If the §643(e) election is made to recognize gain in the trust, both A and B are treated as receiving equal amounts under §662 and both will be required to report $1,500 of income ($3,000 DNI x $5,000 distribution/$10,000 total distribution).

If a fiduciary makes a §643(e) election to recognize capital gain and the capital gain is included in DNI, any distribution to the beneficiary will cause the gain to be carried out and taxable to the beneficiary.

Example: In the year of termination of a trust, the trustee distributes property with a fair market value of $35,000 and a basis of$20,000. The trustee makes a §643(e) election. The trust recognizes a capital gain of $15,000. The $15,000 becomes part of DNI in the year of termination. Assuming the distribution carries out all of the trust's DNI, the beneficiary is taxed on the gain.

Another word of caution for the fiduciary. Section 1239 will convert any gain recognized by the trustee as a result of the §643(e) election to ordinary income if the appreciated property distributed by the fiduciary to the beneficiary may be depreciated by the beneficiary. If §1239 causes gains recognized as a result of a §643(e) election to become ordinary income, this may cause the ordinary income generated by the election to become part of DNI. Generally, gains do not enter into the calculation of DNI. Inclusion of the "deemed gain" in DNI due to the operation of §1239 will generally result in a higher tax due to the change in character from capital gain to ordinary income. In addition, potentially more DNI will be carried out to the beneficiary due to the increase in DNI and the use of the fair market value of the asset to determine the amount of DNI carried out to the beneficiary. For tax years beginning after August 5, 1997, the same rule applies to estates except in the case of appreciated property used to satisfy a pecuniary bequest. §1239(b)(3).

If an executor or trustee distributes property that has a basis in excess of its fair market value (i.e. loss property), the distribution will carry out DNI equal to the fair market value of the property whether or not the trustee makes the §643(e) election. The reason for this is that whether or not the §643(e) election is made, gain or loss is recognized as if the property were sold to the beneficiary at its fair market value. If the distribution is made to a related taxpayer, §267 will disallow the loss. In either event, the amount taken into account §661(a)(2) and 662(a)(2) will be the fair market value of the property and the basis

of the property in the hands of the beneficiary will be the same as the trust's basis in the property immediately before the distribution. Stated differently, if property has declined in value, the amount taken into account under §661(a)(2) and §662(a)(2) and the property's basis will be the property's fair market value, whether or not an election is made.

Example: Trustee funds a residuary bequest by transferring stock with a fair market value of $30,000 and a basis of $50,000. The trustee does not make a §643(e) election. The amount taken into account under §661(a)(1) and §662(a)(2) is the fair market value of the stock (1ower of FMV and trust's basis) and the trust's basis in the stock carries over to the beneficiary (no gain or loss is recognized so trust's basis carries over to beneficiary). If the trustee made a §643(e) election, §267 would disallow recognition of the loss. The amount taken into account under §661(a)(1) and §662(a)(2) is the fair market value of the stock (FMV pursuant to §643(e)(3)(A)(iii)) and the trust's basis in the stock carries over to the beneficiary (no gain or loss is recognized so trust's basis carries over to beneficiary pursuant to §643(e)(1)). Thus, where a fiduciary distributes property that has a basis in excess of its fair market value, the tax results are the same whether or not the trustee makes the §643(e) election.

L. Qualified Subchapter S Trust (QSST)

Special rules are provided under §1361(d) for "Qualified Subchapter S Trusts" (QSST). A QSST is an eligible shareholder of *S* corporation stock provided that the benefits of the S corporation stock are largely dedicated to one individual beneficiary and that the beneficiary agrees to be treated as the deemed owner of the trust.

Section1361(d)(3) (flush language) permits a share of a trust to be treated as a separate trust for QSST purposes if the share qualifies as a "substantially separate and independent share of a trust within the meaning of §663(c)." This provision permits multiple beneficiaries without requiring multiple trusts. Each separate share counts as one shareholder because each share is a separate trust. The separate share rule may be applied even though separate and independent accounts are not maintained or required and no physical segregation of assets is maintained or required. The five requirements of a QSST under §§136l(d)(3) are as follows:

1. The trust distributes or is required to distribute all of its accounting income annually to one U.S. citizen or resident;

2. The trust distributes no principal other than to the income beneficiary;

3. The income beneficiary's interest terminates at death or when the trust terminates, which ever occurs first;

4. If the trust terminates when the income beneficiary is alive, the trust assets must be distributed to the income beneficiary; and

5. The income beneficiary must elect to be treated as the owner of that portion of the trust consisting of the S corporation stock.

A trust becomes a QSST only upon an affirmative election by the income beneficiary.

The election causes the income beneficiary to be treated as the owner of that portion of the trust consisting of the S corporation stock, as if the beneficiary owned the trust under §678. §136l(d)(1)(B). Thus, all of the income, deductions and credits attributable to the QSST flow through and are taxed to the beneficiary. Reg.§1.1361-1(j)(7). An exception to this rule is when a disposition of the S stock occurs. In that case, the beneficiary is not treated as the owner and any resulting gain or loss that is recognized will be reported by the trust. Reg.§1.1361-1(j)(8). Note that because a QSST is treated as a grantor trust as to the beneficiary, the character of the income and the test for material participation is determined at the beneficiary (deemed owner) level instead of at the trust level, and this applies to the net investment income as well. The active or passive nature of any gains or losses on the disposition will be determined at the trust level rather than on material participation by the beneficiary. Reg.§1.1411-7(b)-(c) sets forth rules for determining the net investment income results for the sale of S corporation stock.

The election must be made separately with respect to each S corporation whose stock is owned by the trust. §1361(d)(2).

The election must be filed within the time period described by Reg.§1.1361-1(j)(6)(iii), although relief is available for the inadvertent failure to file a timely election. Rev. Proc. 2003-43, 2003-23 I.R.B. 998. Generally, the election must be made within two months and 16 days after S corporation stock is transferred to the trust or, if the trust holds stock of a corporation that makes an Selection, after the Selection is effective. Once made, the election is irrevocable. §1361(d)(2)(C). The election is effective up to 15 days and 2 months before the date the election was made. §1361(d)(2)(D). Moreover, once the election is made, it is treated as being made for successive beneficiaries unless such a beneficiary affirmatively refuses to consent to the election within two months and 15 days of becoming the current income beneficiary. §1361(d)(2)(B)(ii); Reg.§1.1361-1(j)(9), (10). Thus, an income beneficiary of a QSST has a right that direct shareholders of an S corporation do not have to terminate the S election individually.

A trust ceases to be a QSST as of the date it no longer satisfies any of the QSST requirements. §1361(d)(4)(A); Reg. §1.1361-1(j).

M. Electing Small Business Trust (ESBT)-- §1361(e)

The trustee of a trust holding S corporation stock may elect to have the trust treated as an electing small business trust (ESBT). If that election is made, all the income from the S corporation is taxed to the trust at the highest income tax bracket, regardless of whether any income is distributed to a beneficiary. §641(c). The portion of the trust that holds the

S corporation stock is treated as if it is a separate trust. The trust will not receive a distribution deduction for any distributions made from the ESBT to the beneficiaries.

An ESBT is any trust other than a QSST, all the beneficiaries of which are U.S. individuals, estates or certain charitable organizations eligible to be S corporation shareholders, no interest of which is acquired by purchase or other taxable transfer.

A charitable organization may hold contingent remainder interests in an ESBT but cannot be an ESBT. Thus, a charitable remainder trust cannot be an ESBT.

A trust is an ESBT only if the trustee elects to have it so treated by filing a statement with the IRS Service Center where the S corporation files its income tax return. The election, once made, applies for the year it is made and all future years, unless revoked with IRS consent. §1361(e)(3). The election is made by the trustee and consent of the beneficiaries is not needed. Guidance on making the election is outlined in Reg.§1.1361-1(m)(2).

Unlike a QSST, an ESBT may have two or more beneficiaries, accumulate income and distribute both income and principal among the beneficiaries. Each potential current beneficiary of an ESBT is counted as a shareholder for purposes of the 100 shareholder S corporation limitation. A "potential current beneficiary" is defined as any person who is currently entitled to receive or may, in the discretion of the trustee, receive a distribution from the income or principal of the trust. For tax years after 2004, §1361(e)(2) provides that a potential current beneficiary is determined without regard to any power of appointment to the extent such power remains unexercised at the end of the period.

The law, anticipating that a trust may accumulate income, provides for the ESBT itself to be treated as the shareholder for purposes of the 100 shareholder limitation.

The portion of an ESBT that consists of stock of an S corporation to which the ESBT election applies is a separate trust for income tax purposes. Reg.§1.64l(c)-1(a), (b)(2). The ESBT share trust is taxable on its share of S corporation income i.e. the normal rules of Subchapter J trust is taxable on its share of S corporation income i.e. the normal rules of Subchapter J governing the income taxation of trusts and estates are ignored. The ESBT is taxed at the highest trust income tax rate i.e. currently 39.6% on ordinary income and 20% on long-term gains. §641(c)(2)(A). The separate tax calculation applies not only to the items of S corporation income but also to all gains and losses from the sale of S corporation stock.

The income tax on an ESBT is computed with limited deductions, generally administrative expenses and state taxes attributable to income taxable as an ESBT. §64l(c)(2)(C). Thus, the ESBT does not receive an income distribution deduction as would a normal estate or trust. Thus, the ordinary fiduciary income tax rules do not apply to an ESBT. Along these lines, the income of an ESBT is not included in the trust's distributable net income or in a beneficiary's gross income. §641(c)(3). Thus, the non-ESBT share of a trust does not include the ESBT's income in calculating the non-ESBT's distributable net income or

distribution deduction. The normal fiduciary income tax rules apply to the non-ESBT share. Thus, normally two shares are present - a ESBT portion and a non-ESBT portion. The regular Subchapter J rules for the taxation of trusts apply to the non-ESBT portion while the special ESBT rules apply to the ESBT portion.

Reg.§1.1411-3(c) provides special rules in calculating the net investment income of an ESBT. The regulations require a three step calculation. First, the regulations require the trust to calculate the undistributed net investment income separately for each the S portion and the non-S portion of the trust and then to combine the result. Second, the trust must calculate the trust's adjusted gross income by combining the adjusted gross income of S portion and the non-S portion. Finally, the trust calculates the 3.8% surtax on the lesser of the trust's total undistributed net investment income or the excess of the trust's adjusted gross income over the threshold ($12,150 for 2017). Reg.§1.1411-3(c)(2)(iii). These rules only apply if the trustee does not materially participate in the operation of the S corporation.

ESBTs allow trusts which accumulate income or make discretionary distributions to hold S corporation stock. The cost of this flexibility will often be a higher income tax on the S corporation's net income for a trust that would normally distribute most of its income.

A special QSST election procedure is available for an ESBT that converts to a QSST. Reg.§1.1361-1(m).

PART IV- COMPUTATION OF TAXABLE INCOME

Sections through 692 of the Internal Revenue Code (Subchapter J) contain the rules governing the income taxation of estates and many trusts. Generally, estates and trusts are taxed like individuals, with the fiduciary responsible for the payment of the tax. However, there are numerous special rules that apply to the taxation of estates and trusts that do not apply to individuals. The most important difference is that estates and trusts may deduct certain distributions made to beneficiaries, who are, in turn, required to include such distributions in their gross income.

Subchapter J of the Internal Revenue Code, which contains §§641 through 692, is divided into two parts: Part I and Part II.

Part of I of Subchapter J consists of the following subparts: Subpart A - §§641 through 646 deals with the general rules for taxation of trusts and estates.

Subpart B - §§651- 652 deal with the taxation of simple trusts.

Subpart C - §§661 - 664 deal with the taxation of complex trusts and charitable remainder trusts.

Subpart D - §§665 - 668 deal with accumulation distributions.

Subpart E - §§ 671 - 679 deal with the taxation of grantor trusts.

Subpart F- §§ 681 - 685 contain miscellaneous rules.

Part II of Subchapter J, that is §§691- 692, deals primarily with the taxation of income in respect of a decedent (IRD).

A. Fundamental Rules of Subchapter J

Under §641(b) the taxable income of an estate or trust is computed in the same manner as an individual. The adjusted gross income of an estate or trust is computed in the same manner as in the case of an individual, except that the following are allowed in arriving at adjusted gross income: (1) deductions for costs incurred in the administration of an estate or trust that would not have been incurred if the property were not held in the trust or estate, (2) the distribution deduction and (3) the personal exemption. §67(e).

The §67(e) definition of AGI applies only for purposes of determining the deductible amount of miscellaneous itemized deductions. Miscellaneous itemized deductions are deductions other than those listed in §67(b). For example, §67(b)(4) allows the §642(c) fiduciary income tax charitable deduction in calculating the adjusted gross income of an estate or trust In addition, miscellaneous itemized deductions do not include above-the-line deductions taken into account in computing AGI. Itemized deductions for interest under

§163, taxes under §164, personal casualty losses under §165(c)(3), and estate taxes paid on income in respect of a decedent under §691(c) are not miscellaneous itemized deductions. Thus, the foregoing amounts are above-the-line deductions available in computing AGI.

In computing the taxable income of a trust or an estate, the first step is to compute the gross income. Next, the gross income is reduced by allowable deductions to arrive at the taxable income. Once the taxable income is determined, the tax rate schedule is applied to the taxable income to determine the tax. Finally, the tax is reduced by any available credits to determine the net tax due.

B. Exemptions for Estates and Trusts

Estates and trusts cannot claim the personal and dependent exemptions allowed to individuals under §151. Instead, under §642(b), estates and trusts receive a specific exemption. An estate is entitled to an exemption of $600. A trust that is required to distribute all of its trust accounting income currently to beneficiaries is entitled to an exemption of $300. All other trusts are entitled to a $100 exemption.

C. Charitable Contributions -- Section 642(c)

1. Background.

The general rule set forth in Section 642(c) is that estates and complex trusts are permitted a deduction in computing taxable income (in lieu of the deduction allowed under Section 170(a) for any amount of gross income, without limitation, which pursuant to the terms of the governing instrument are during the taxable year paid for a purpose specified in Section 170(c) determined without regard to Section 170(c)(2)(A).

Section 642(c) provides for deduction from gross income in two specific situations: (1) where income is actually distributed (§642(c)(1)) and (2) where the income is set aside for future distributions to charity (§642(c)(2)).

The charitable deduction allowed estates and trusts is different from charitable deductions allowed to individuals. The differences are as follows:

1. The fiduciary income tax charitable deduction is unlimited in amount. The individual charitable deduction is limited to a percentage of AGI.

2. Trusts created on or before October 9, 1969 and meeting certain other conditions may deduct gross income permanently set aside for the benefit of charitable organizations, as well as income currently paid to or for the benefit of such charitable organizations. Estates, regardless of when established, can deduct gross income permanently set aside for charity.

3. A trust or estate may deduct a payment to charity on the income tax return for the year the contribution was made or for the preceding taxable year.

4. A trust or estate may make contributions to qualifying charities organized anywhere in the world. Reg.§1.642(c)-1(a)(2). Individuals may deduct only contributions to organizations established in the United States (except as modified by treaty provisions). Section 642(c) states that income is deductible if paid for a purpose specified in Section 170(c) without regard to §170(c)(2)(A). Section 170(c)(2)(A) refers to organizations created in the United States. Thus, distributions to foreign charities are deductible for income tax purposes under Section 642(c) even though such contributions would not be deductible for individual income tax purposes under Section 170.

5. A trust or estate may deduct only contributions made out of gross income (gross income meaning taxable income, not trust accounting income) i.e. they can't deduct contributions made out of tax-exempt income.

6. A trust or estate must show specific authority in the governing instrument for the payment to charity.

7. Estates and some trusts may deduct amounts paid for a charitable purpose as opposed to qualifying tax-exempt charities.

There are basically four requirements for a trust or estate to qualify for a fiduciary income tax charitable deduction under §642(c):

1. the amount paid to charity is <u>paid from the gross income</u> of the estate or trust;

2. the amount is paid pursuant to the governing instrument;

3. the amount is actually paid (or permanently set aside in the case of an estate or a pre-October 10, 1969 trust) during the tax year (or in the next year and elected to be deemed paid in the prior year); and

4. the amount is paid for a purpose specified in §170(c).

Example: Individual has $5,000 of cash and a painting worth $5,000. He'll get a charitable deduction if he gives either one to charity i.e. either the cash or the painting. A trust or estate would get no fiduciary income tax charitable deduction if it gave the painting to charity (the painting is not an item of gross income). A trust or estate would only get a deduction for the $5,000 of cash if it represented "gross income" to the estate or trust and the governing instrument authorized the payment to charity.

Example: Estate has $5,000 of income. The only beneficiary of the estate is the decedent's son. Son tells executor to give $5,000 to Harvard University and the executor does so. The estate is not allowed a fiduciary income tax charitable deduction. The amount

was paid out of the gross income of the estate but there was no direction in the will to pay any amount to charity so the amount was not paid pursuant to the governing instrument.

2. Payments Made "Pursuant to the Governing Instrument"

(A) In General.

If the terms of the will or the trust does not specifically provide for charitable contributions, the estate or trust is precluded from taking a fiduciary income tax charitable deduction.

(B) Discretionary payments.

A question arises as to whether a trust or estate is entitled to a fiduciary income tax charitable deduction if the fiduciary has the discretion to pay the amount to charity. Old Colony Trust v. Comm., 301 U.S. 379 (1937) says that if the fiduciary has the discretion to pay the amount to charity and does pay it to charity, that will be considered to have been paid pursuant to the terms of the governing instrument.

(C) Power of Appointment.

The courts have interpreted the "paid pursuant to the governing instrument" requirement narrowly when an individual beneficiary of an estate or trust exercises a withdrawal right or a power of appointment in favor of charity. In those situations the courts have taken the position that the distribution of trust assets to a charity pursuant to a withdrawal right or a general power of appointment is not made pursuant to the terms of the governing instrument.

> **Example:** Trust, which otherwise has no provisions for charity, gives Kim a general power of appointment over the trust assets. Kim exercises the power of appointment by appointing the trust assets charity. Trustee distributes the income of the trust to the charity pursuant to the exercise of the general power of appointment. The courts have denied a §642(c) charitable deduction on the basis that the original instrument expressed no charitable intent and the power of appointment was is not considered a modification of the trust. *Weir Foundation v. United States,* 362 F. Supp. 928 (SDNY 1973), aff'd 508 F2d 894 (2d Cir. 1974); *Estate of O'Connor v. United States,* 69 TC 165 (1977). In *Brownstone v. United States,* 465 F.3d 525 (2d Cir. 2006) the U.S. Court of Appeals for the Second Circuit held that a distribution of $1 million prompted by a widow's exercise of a power of appointment is not a deductible charitable contribution under §642(c)(1) because the distribution was not made "pursuant to the governing instrument." The Second Circuit held that only the husband's trust alone, which contained no charitable intent, constituted the governing instrument.

In PLR 200906008 the Service allowed a §642(c) deduction for a distribution to a charity pursuant to the exercise of the trust beneficiary's special power of appointment where the

only permissible appointees were charities. The Service held that the special power of appointment under the trust instrument satisfied the "governing instrument" requirement. Similarly, in PLR 201225004 the Service held that a distribution of gross income from a trust to one or more charitable organization, made pursuant to a beneficiary's exercise of a limited power of appointment granted under the trust terms, will qualify for the charitable contribution deduction under §642(c).

(D) Pass-Through Contributions.

In Field Service Advice (FSA) Memorandum 200140080 (September 4, 2001), the Chief Counsel's Office advised that a complex trust or a trust that would otherwise be a simple trust should be allowed a §642(c) charitable deduction, even if the trust's governing instrument does not authorize the trustee to make charitable contributions for the trust's distributive share of charitable contributions made by a partnership of which the trust is a partner if the contributions are made from the partnership's gross income that is not unrelated business taxable income (UBTI). Further, the Chief Counsel said that if the trust were part of a tiered-trust where an upper-tiered trust made charitable contributions pursuant to its governing instrument and attempted to pass the charitable deduction through to the lower- tiered trust, no charitable deduction would be allowed to the lower-tiered trust because a trust cannot pass a charitable deduction through to a beneficiary.

(E) Will & Trust Contests and Settlements.

The IRS views the "pursuant to the governing instrument" requirement more liberally in the settlement area. Generally, the IRS takes the position that a payment to a charity made pursuant to a settlement agreement is made "pursuant to the governing instrument". The IRS will usually hold that the settlement agreement "relates back" to the date of death. Thus payments made to charity before court approval of the settlement will be deductible, especially if the instrument gives the fiduciary authority to settle will and trust contests. Note, however, that the estate or trust must demonstrate the amount of gross income that actually would be available for charity after all superior bequests and claims have been satisfied. Rev. Rul. 59-15, 1959-1 C.B. 164 holds that a settlement agreement arising from a will contest qualifies as a governing instrument. See also Technical Advice Memorandum (TAM) 9037004 and PLR 9044047.

However, the Service requires that in order for a distribution of income to charity under settlement agreement to be considered "paid pursuant to the governing instrument," there must be an actual conflict over the disposition of a trust or estate. In CCA 200848020 the Service held that the accelerated outright payment of a portion of an individual retirement account to charity pursuant to a settlement agreement was not made "pursuant to the governing instrument"where there was no actual conflict and the purpose of the settlement agreement was to eliminate a charitable beneficiary so that the individual beneficiaries would be allowed to take minimum required distributions from the individual retirement account over the oldest beneficiary's life expectancy.

3. Payments "Paid from Gross Income"

A trust or estate is allowed a fiduciary income tax charitable deductions only for amounts of gross income contributed to charity. No deduction is allowed for payments made from either tax-exempt income or principal. If a trust has income from a trade or business, a charitable contribution deduction may be reduced or eliminated by reason of §681 which disallows a charitable deduction for any amount allocable to the trust's "unrelated business income."

Section 642(c) requires that the amounts distributed to charity, to be deductible, must be paid from gross income. This requires tracing i.e. the payment must be traced to an item that constitutes gross income. The rules governing distributable net income prohibit tracing by deeming a beneficiary to have received all or a proportionate share of the trust's income items comprising distributable net income. Unlike the other provisions of Subchapter J, §642(c) requires that the source of the charitable contribution be traced to gross income. For example, see Rev. Rul. 2003-123, IRB 2003-50, 1200 where the IRS held that a trust is not allowed either a charitable deduction under §642(c) or a distribution deduction under §661(a)(2) with respect to a contribution to charity of trust principal- in this case a donation of a qualified conservation contribution. Thus, a bequest to a charity from an estate or trust will be deductible for estate tax purpose but will not be deductible for income tax purposes because satisfaction of a bequest is a distribution of principal.

Example: Trust sells property in order to raise money to pay a charitable bequest. A distribution of cash realized on the sale will not be deductible because the distribution was not required to be paid out of the sales proceeds.

Example: Trust makes a substantial partial distribution to charity. If the distribution is principal under state law and not otherwise taxable income, a charitable deduction will not be allowed under Section 642(c) because the distribution is not from gross income.

4. Meaning of "Paid."

"Paid" means actual delivery of money or property to a qualifying charitable recipient, which can include foreign charities. Property must constitute "gross income"to the trust or estate in order to qualify for the §642(c) deduction. Workpaper entries by accountants are not considered payment to a charity -- actual payment must be made. *Estate of Johnson v. Commissioner,* 88 T.C. 225 (1987).

5. Accumulated Income.

An estate or trust is allowed to deduct a distribution made to charity from accumulated income. In *Old Colony Trust Co. v. Commissioner,* 301 U.S. 379 (1937) the trustees maintained a separate accumulated income account rather than adding accumulated income to principal. They charged their accumulated income account with the payments to charity. The U. S. Supreme Court held that the payments charged to accumulated

income could be deducted, and that the deduction was not limited to gross income realized in the year that the contribution was made. If accumulated income is added to principal, it would be hard to argue that income continued to constitute gross income. Thus, payments from principal couldn't be traced to accumulated income. Thus, if payments to charity are likely, separate accounts for accumulated income and principal should be maintained.

Chief Counsel Advice 201042023 involved an interesting twist to the deductibility of accumulated income. The trust instrument gave the trustee discretion to distribution trust income to charity. The trust used its income to purchase non-cash assets. The trust distributed those non- cash assets to charity in a subsequent year. The purchase of the non-cash assets distributed to charity could be traced to the prior year's income. The trust claimed a §642(c) deduction for the fair market value of the assets rather than the lower amount the trust paid for the assets. The Service allowed a deduction for the amount the trust paid for the non-cash assets rather than their fair market value. The IRS stated that appreciation in value, unrealized by sale or other disposition, is not gross income for charitable deduction purposes.

6. Definition of Gross Income.

Gross Income for purposes of the §642(c) means income in the tax sense rather than in the accounting sense, so that capital gains constitute gross income even though gains would constitute principal for trust accounting purposes. §642(c). Rev. Rul. 78-24, 1978-1C.B. 196; Rev. Rul. 57-507, 1957-2 C.B. 511. Under §643(b), the term "income," when preceded by the word "gross," refers taxable income rather than accounting income.

Example: The deduction is allowed for payments from forms of gross income that would constitute principal distributions under trust accounting rules, as long as the amount is taxable X, a life insurance agent, was entitled to commissions on premiums paid by clients under policies he sold, and his estate was entitled to receive such commissions after his death. X's will bequeaths his renewal commissions to a qualified charity. Under §691, the commissions are included in the gross estate as income in respect of a decedent (IRD). The estate may claim an income tax charitable deduction for these payments even if the commissions are treated as principal for trust accounting purposes.

Example: In PLR 200221011, a decedent's estate was the beneficiary of his IRA. The residue of his estate was payable to charity. After all of the pre-residuary bequests were paid from assets other than the IRA, the IRA was distributed to the estate to satisfy the residuary bequests. The IRS said that under Rev. Rul. 92-47, 1992-1 C.B. 198, a distribution to the beneficiary of a decedent's IRA at the decedent's death is income in respect of a decedent that is includible in the beneficiary's gross income in the year of receipt. Therefore the IRA would be income in respect of a decedent to the estate and the IRA would be gross income permanently set aside and deductible by the estate under §642(c)(2).

7. Gross Income Not Actually Received

Courts have not allowed a fiduciary income tax charitable deduction for items of gross income not actually received by the trust or estate, although includible in its gross income. Thus, a consent dividend, taxable income from a partnership that does not distribute cash or the undistributed income of a S corporation owned by an estate or trust cannot qualify for a charitable deduction. *Esposito Estate v. Commissioner,* 40 T.C. 459 (1993), acq. 1964-1 C.B. 4; *Freund v. Commissioner,* 303 F.2d 30 (2nd Cir. 1962); *Richardson Foundation v. United States,* 430 F.2d 710 (5th Cr. 1970). A charitable deduction under §642(c) requires an actual payment to the charity.

Example: Trust A, whose income is payable to a qualified charity is a member of XYZ partnership which has taxable income of$30,000 in 2017. Trust A's share of this income is $10,000 but the partnership makes no distributions during 2017. Trust A distributes $10,000 to charity pursuant to the governing instrument. Trust A has no other income in 2017. No deduction is allowed for the $10,000 included in its gross income for 2017. If the partnership had distributed the $10,000 to Trust A, the trust would be allowed to claim a charitable deduction for the $10,000 distributed to charity. The charitable deduction is disallowed because if the partnership does not distribute the income, the charity may never actually receive anything.

8. Deductible Contribution May Not Be Made From Tax-Exempt Income.

Charitable payments made from tax-exempt income realized by the estate or trust do not qualify for a fiduciary income tax charitable deductible because the deduction would provide a double tax benefit. The regulations allocate charitable payments to tax-exempt income based on the ratio of tax-exempt income to DNI. Reg.1.661(b)-2, Reg.§1.642(c)-3(b) and Reg.§1.643(a)-5(b).

Example: A trust distributes $10,000 of gross income to charity pursuant to the trust instrument. The trust has $50,000 of DNI of which $5,000 is tax-exempt income. The trust is allowed to deduct $9,000 as a charitable deduction. The remaining $1,000 is disallowed as being allocable to tax-exempt income. The nondeductible portion of the charitable deduction is calculated as follows:

$$\frac{\$5{,}000 \text{ exempt income}}{\$50{,}000 \text{ DNI}} \times \$10{,}000 \text{ distribution} = \$1{,}000 \text{ nondeductible portion}$$

Generally, a trust instrument cannot allocate tax-exempt income to a non-charitable beneficiary and taxable income to charity unless the allocation has economic effect independent of the income tax consequences. Reg.§1.642(c)-3(b)(2). The amount to which §642(c) applies is deemed to consist of the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all classes. Reg.§1.642(c)-3(b)(2). In other words, an amount an estate or trust pays or permanently sets aside for a charitable purpose consists of a pro rata portion of each type of income

that the estate or trust received unless there is an ordering provision that has economic effect independent of the income tax consequences.

Reg. §1.642(c)-3(b)(2) can present a problem for trusts seeking to avoid income tax on income in respect of a decedent by seeking to distribute the income in respect of a decedent to charity. In order to satisfy the "paid out of gross income" and "paid pursuant to the governing instrument" requirements of §642(c), many trusts contains boilerplate language that directs a charitable bequest be satisfied from income in respect of a decedent such as a decedent's interest in an individual retirement account. Normally, the direction to pay from the individual retirement account would not have economic effect independent of the income tax consequences. As a result, the amount paid to charity would be deemed to be paid proportionately from various income items of the trust or estate. This result could be avoided by naming the trust directly as the beneficiary of the individual retirement account or providing for a specific bequest of the individual retirement account to the charity.

9. Payments must be made for qualifying charitable purposes.

A trust or estate can deduct under Section 642(c)(1) amounts of gross income that are "paid for a purpose" described in Section 170(c). Section 642(c)(2) allows estates and pre-October 10, 1969 trusts to deduct gross income that is either permanently set aside for a purpose specified in Section 170(c) or that is to be used exclusively for religious, charitable, scientific, literacy or educational purposes.

It appears from the language of the statute that a noncharitable trust can deduct contributions to an organization that is not otherwise eligible for tax-exempt status. Section 642(c)(1) refers to a distribution "paid for a purpose specified in Section 170(c) rather than distributions "paid to an organization described in Section 170(c). Certainly, payments to any organizations that have received an IRS determination letter of their exempt status under Section 170(c) are deductible.

A literal reading of the statute indicates that estates and trusts are not governed by the requirements of Section 170(c). Thus, distributions to foreign charities should be eligible for a §642(c) fiduciary income tax charitable deduction even if the organization could not receive deductible contributions from an individual. However, whether the other requirements of Section 170(c) apply to distributees of trusts and estates is unclear. The language of Section 642(c)(1) suggests that a qualifying purpose is the only relevant requirement for purposes of the §642(c) fiduciary income tax charitable deduction, and that trusts and estates may deduct contributions to organizations that do not satisfy the other requirements of Section 170(c). Contributions actually paid in the current or immediately following year to a foreign charity will qualify for the §642(c)(1) charitable deduction but amounts "set aside" under §642(c)(2) apparently will not. Note the difference in language between §642(c)(1) (general rule) and §642(c)(2) (amounts permanently set aside).

10.. No Distribution Deduction.

If a charitable deduction is disallowed because of a failure to comply with the "pursuant to the governing instrument" or the "payment from gross income" requirement, a distribution deduction will not be allowed. Rev. Rul. 68-667, 1968-2 C.B. 289; *Mott v. United States,* 462 F. 2d 512 (Ct.Cl. 1972) cert denied, 409 U.S. 1108 (1973); *Estate of A. Lindsay O'Connor,* 69 T.C. 165 (1977), appeal denied (2d Cir. 1980); *Pullen v. United States,* 80-1 U.S.T.Ct. 9105 (D.C.Neb. 1979) aff'd (8th Cir. 1980); *United States Trust Company v. United States,* 803 F.2d 1363 (5th Cir. 1986); *Rebecca K. Crown Income Charitable Fund v. Comm.*, 98 T.C. 327 (1992), aff'd 8 F.3d 571 (7th Cir. 1993); *Crestar Bank v. Comm,* 47 F. Supp. 2d 670 (E.D. Va. 1999).

The deduction for charitable distributions under §642(c) is the sole source of a deduction for payments to a charity. If the distribution to charity does not qualify for a charitable deduction under §642(c), the distribution is not deductible at all. §663(a)(2); Reg.§1.663(a)(2). A distribution deduction under §661 is not allowed for a distribution to charity. Allowing a §661 deduction for payments to charity would eliminate the need for §642(c).

11. Set Aside Deduction for Estates and Pre-October 10, 1969 Trusts

The §642(c) deduction is allowable for an estate or a qualifying pre-October 10, 1969 trust even though no income is actually paid to charity during the taxable year. It is sufficient if the amount is permanently set aside for charity.

Example: D's will leaves 100 shares of ATT to Harvard University. Dividends are paid on the stock but the executor does not actually pay the dividends to charity. The executor has to report the dividends on the estate's Form 1041. Under probate law, the income on specifically bequeathed property all has to be paid to the beneficiary, in this case the charity, Harvard University. All of the dividends coming in each year eventually have to be paid to Harvard, i.e. when the stock is distributed. Thus, the income is permanently set aside for charity. If $1,000 of dividends is earned on the ATT stock this year, the executor reports it on the estate's Form 1041 and takes a corresponding charitable deduction under Section 642(c) for this amount of estate gross income which is permanently set aside for charity even though he does not pay it this year to Harvard.

(A) Qualifying pre-October 10, 1969 Trusts

Trusts created before October 10, 1969 that are still permitted to have a "permanently set aside" charitable deduction are specified in Section 642(c)(2). There are two categories:

a. Inter Vivos Trusts where:

(1) there is an irrevocable charitable remainder, or

(2) the trust cannot be modified at any time after October 9, 1969 because the grantor is mentally incompetent to do so.

b. Testamentary Trusts where the trust is established by a will executed on or before October 9, 1969, and

(1) the testator died before October 9, 1972, without changing the will at any time after October 9, 1969; or

(2) the testator did not have the legal right to change the relevant portions of the will at any time after October 9, 1969; or

(3) the will was not changed before October 9, 1972, and the testator was mentally incompetent to change it on that date and at all times thereafter.

§642(c)(2)(A)(i)-(ii); Reg.§1.642(c)-2(b)(3)(i)-(ii).

Example: An irrevocable trust created in 1966 requires the trustee to distribute 20% of the income to a public charity and also directs the trustee to accumulate 30% of each year's capital gain for future distribution to the same charity when the trust terminates. In 2017 the trust had $30,000 of taxable interest, $20,000 of dividends and $40,000 of capital gain. If the only $40,000 capital gain). Since the trust was created prior to October 10, 1969, a set aside deduction is allowed for the $12,000 of capital gain set aside for charity. If the distributing entity was an estate as opposed to a trust, the $12,000 set aside deduction would be allowed regardless of the date the estate came into existence because the set-aside deduction is always available for estates (or trusts making the §645 election).If the trust were created after October 9, 1969, the trust would only get a deduction for the $10,000 it actually distributed to charity in the current year or paid before the end of 2015 and elected to be treated as paid in 2017. The gain would be taxed to the trust.

For grandfathered trusts, the set aside must be compelled under the terms of the governing instrument. This is due to the fact that §642(c) says the distribution must be "required by the terms of its governing instrument to set aside amounts." No deduction will be allowed for discretionary set asides.

In addition, the set aside amount must be from income on assets transferred to the trust on or before October 9, 1969. Reg.§1.642(c)-2(b)(2). Gross income from assets transferred to the trust after October 9, 1969 is not eligible for the set aside deduction. However, such income will qualify for a charitable deduction if it is actually paid out currently or during the immediate succeeding year and elected to be treated as paid in the immediately preceding year.

Finally, if the gross income is to be permanently set aside, a deduction will be allowed only if the possibility that the income being diverted to a nonqualified purpose or use is so remote as to be negligible. Reg.§1.642(c)-2(d). The IRS takes the position that the ability of trustee to allocate capital gains between income and principal will result in loss of the

set-aside deduction. Rev. Rul. 73-95, 1973-1 C.B. 322. The IRS concluded that when a trustee has the power to allocate capital gains between income and principal, the gains are not permanently set aside for charity. Even if the capital gains are actually allocated to principal, a board discretionary power to allocate capital gains between income and principal means that the possibility that the charity may not take is not so remote as to be negligible. In *Hunt v. U.S.,* 2005-1 USTC 350,357 (D. N.H. 2003), the trustee's discretion to allocate capital gains to income or principal resulted in a denial of the §642(c) charitable deduction in a pre-October 10, 1969 trust even though the trustee had never allocated any gains to income. Likewise, in PLR 200142011 the IRS disallowed a §642(c)(2) charitable deduction for amounts set aside for charity in a pre-October 10, 1969 trust because a modification to the trust made the possibility that the amounts set aside would not be used for charitable purpose not so remote as to be negligible. See also TAM 9714001. Under pre-1969 law, a charitable deduction is denied if the chance that charity will not take is not so remote as to be negligible.

(B) Additional Set Aside Rules.

The changes made by the 1969 Tax Reform Act eliminated the set aside charitable deduction for all trusts created after October 9, 1969 and for most trusts created on or prior to that date. The 1969 Tax Reform Act did not disturb the set aside deduction for estates. For a trust created after October 9, 1969 the amount must actually be paid to charity during the taxable year in order to get a charitable deduction under Section 642(c). However, a qualifying trust making a Section 645 election will be treated as an estate and will be eligible for a set aside deduction.

In addition, a provision was added in the 1969 Tax Reform Act which permits a trustee or administrator to elect to treat distributions to charity that are paid out of a complex trust or estate within one year after the end of the taxable year as though they had been paid out during the taxable year. §642(c)(1); Reg.§1.642(c)-1(b). In other words, the trustee may elect to deduct charitable contributions as made in a given taxable year even if they were actually made in the next taxable year. This election is to be made no later than the time prescribed for filing the income tax return for the subsequent tax year (including extensions), and is made with the tax return or amended return for the taxable year in which the contribution is treated as paid. Reg. §1.642(c)-1(b).

Example: If a Trustee pays an amount to charity anytime before December 31, 2018, he can elect to have it treated as though it was paid in 2017.

12. Contingent Charitable Remainder Interests.

Under certain trust provisions, a charity will receive an interest from the trust only if a previous interest in the trust fails. For example, "Trust pays income to A for life, remainder to A's issue, but if A dies without issue, remainder to charity." For such contingent charitable remainder interests, trusts will be entitled to fiduciary income tax charitable deductions only under certain circumstances.

Before the 1969 Act, the charitable deduction was allowed if the chances that the charity would not get the property were "so remote as to be negligible". After the 1969 Act, such interests are deductible only if they are in the form of a charitable remainder unitrust, a charitable remainder annuity trust or a pooled income fund. §664. In addition, a charitable income tax deduction is allowed for the remainder interest in a personal residence or farm subject to a "conventional" life estate in a noncharitable beneficiary. §170(f)(3)(B). To be deductible, there can be no power of invasion. These deductions are allowed under §664, not §642(c).

13. Unrelated Business Taxable Income (UBTI).

Unrelated business taxable income (UBTI) refers, generally, to net income derived from the conduct of an active trade or business (versus investment activity or real estate ownership or rental) and net income derived from most debt-financed property.

Trusts are denied a charitable deduction to the extent attributable to UBTI. §681(a). When a trust has multiple beneficiaries including charities and other persons or entities, and multiple sources of income, the charitable deduction is denied to the extent attributable to UBTI. The amount of the denied deduction is equal to the ratio of UBTI to total gross income (including capital gains) of the estate or trust for the year. Reg.§1.681(a)-2(b).

Example: Tyler's will creates trust that distributes 60% of net income to charity and 40% to Tyler's child Hunter. Tyler runs a grocery store that the trust instrument requires the trust to retain. For the current year, the business generates $200,000 in net profit (which would be UBTI if a tax-exempt charitable organization operated the business). In addition, the trustees earn $50,000 in interest income on a portfolio of stock and bonds. They pay $150,000 to the charity and $100,000 to Hunter. Distribution to charity is deemed to include $120,000 (60% x $200,000 business income) of net profit from the operation of the grocery store and $30,000 (60% of $50,000 interest income) of interest income. The trust will have to reduce its charitable deduction under §642(c) for part of the net profit distributed to charity.

Trusts subject to the unrelated business income tax are allowed under §512(b)(11) to deduct contributions made to other qualifying charitable organizations, subject to the percentage limitations of §170(b). Reg.§1.681(a)-2(b)(3). In other words, the amount of UBTI allocated to the charitable contribution may be deducted up to the limits applicable to individuals (50% or 30%) of the total UBTI depending upon the classification of the recipient organization as a public charity or a private non-operating foundation.

Example: A trust makes a charitable contribution of $25,000 of which $20,000 is allocated to UBTI and $5,000 to taxable income. The trust may deduct $5,000 under §642(c) and $10,000 (50% of the $20,000 UBTI--the limits apply to the amount of UBTI, not the trust's AGI) under §681 for a total of $15,000 (assuming the charity is a public charity). If the charity were a private non-operating foundation, the deduction for the UBTI portion would be limited to $6,000 (30% of the $20,000 UBTI). Note that the charitable deduction limits apply to the amount of UBTI, not the trust's AGI.

Section 681, which denies a deduction for amounts of UBTI paid to a charity, does not apply to estates and, therefor, presumably, does not apply to trusts that make a §645 election to be treated as an estate.

14. Timing of the Charitable Deduction.

A trust or estate can deduct a payment to charity on the income tax return for the year the contribution was made or for the preceding taxable year. §642(c)(1); Reg. §1.642(c)-1(b). The fiduciary may elect to have a charitable contribution treated as made in the immediately preceding year. The election is irrevocable and must be made on a timely filed return (including extensions). Reg.§1.642(c)-1(b). The election is made by filing a statement with the return containing the information listed in Reg.§1.642(c)-1(b)(3). Extension of time to make the election may be granted by the IRS.

In PLR 200138027 the IRS granted an extension under Reg. §301.9100-3 for making the election where the trust administrator had acted in good faith, and granting the extension would not prejudice the government's interests. Under the facts described in the ruling, the trust administrator had filed an amended return in year 4 for year 1, claiming a §642(c) deduction in year 1 for the amount paid to charity in year 2 but failed to make the election required by Reg.§1.642(c)-1(b)(3). For other situations where the IRS granted an extension to make the election, see PLRs 200939001, 200905027, 200626021, 200517012, 200444003 and 200418040.

The time to make the election extends beyond the maximum extended period for filing the income tax return for the year the charitable deduction is taken. Unless distributions are made to the charities before the return is filed, the fiduciary will have to pay the tax, omit the charitable deduction and then file an amended return if the required charitable payments are made before the end of the subsequent year. Reg.§1.642(c)-1(b)(3).

15. How is the Fiduciary Income Tax Charitable Deduction Taken?

The charitable deduction is allowable in computing "adjusted gross income". §67(b)(4). The charitable deduction allowed under §642(c) is not subject to the 2 percent floor generally applicable to a miscellaneous deductions. See §67(b)(4) as amended by the Technical Miscellaneous Revenue Actof1988 (TAMRA) which provides that "miscellaneous itemized deductions" does not include "the deductions under...Section 642(c)."

D. Net Operating Loss Deduction

Like an individual or corporation, an estate or trust could be carrying on an unincorporated business and could suffer a net operating loss (NOL) during the period of administration. A net operating loss occurs when expenses and other deductions incurred in the operation of a trade or business during a taxable year exceed the sum of the gross income from that business plus the taxable income earned from all other sources. §172(c).

Nonbusiness deductions are deductible only to the extent of nonbusiness income in computing the amount of the NOL. §172(d)(4). In computing the net operating loss, neither the deduction for charitable contributions nor the deduction for distributions to beneficiaries may be taken into account. Reg.§1.642(d)-1(b).

Example: The NOL from a trade or business is $60,000, nonbusiness gross income is $20,000 and nonbusiness deductions are $10,000. The NOL is $50,000 ($60,000 less ($20,000 - $10,000)).

In determining whether an estate or trust has a net operating loss that entitles the estate or trust to carry back or forward any excess of deductions over its gross income, a distinction must be made between an activity of a trust or estate that constitutes a "trade or business" and those that constitute a "mere investment". The distinction is important because a NOL can only be generated by an activity that constitutes a trade or business. For example, management and ownership of a portfolio of securities is merely an investment and does not constitute a trade or business. Thus, a loss incurred in managing the securities does not constitute a NOL.

A net operating loss incurred by an estate or trust in a taxable year beginning after August *5,*1997 may be carried forward 20 years. §172(b)(1)(A). For tax years after 2018, and for most taxpayers (except farmers) there is no 2-year carryback. When a net operating loss is carried forward, the deduction for that year reduces the distributable net income for the year to which the NOL is applied.

When an estate or trust with a net operating loss terminates, the net operating loss remaining on the termination of the estate or trust is carried over to the beneficiaries for the balance of the remaining 20 year net operating loss carryover period. In determining the balance of the remaining 20 year net operating loss carryover period, the last taxable year of the trust or estate and the first taxable year of the beneficiary during which the net operating loss may be used are treated as separate years. Reg.§1.642(h)-1(b). Note, however, that the Second Circuit in *Dorfman v. Commissioner,* 294 F.2d 651 (2d Cir. 1988) held Reg.§1.642(h)-1(b) invalid to the extent it reduces the number of carryover years.

Example: An estate sustains a net operating loss in 2018. The 20 year carryover period will run until the year 2038. If the estate stays in existence until the year 2038, it would have the benefit of this net operating loss through 2038. Assume the estate terminates in the year 2025 and hasn't used up the entire net operating loss. The balance of the net operating loss carries out to the beneficiaries and may be used by them for the balance of the 20 year period that was not used by the estate. However, the last taxable year of the estate and the first taxable year of the beneficiary who succeeds to the net operating loss are treated as two separate years. If the estate terminated on July 1, 2025, the estate's year from January 1, 2025 to July 1, 2025 is year 7 of the carryover period and the beneficiary's year 2025 is year 8. Thus, instead of the net operating loss 20 year carryover period expiring in 2038 (if the estate had stayed in existence), the termination of the estate causes the 20 year net operating loss carryover period in the hands of the beneficiary to expire at the end of 2037. Thus, the net operating loss carryover period is reduced by 1

year anytime a trust or an estate terminates before the end of the 20 year carryover period. As stated above, the regulation requiring this result has been held invalid by the Second Circuit.

If the estate or trust terminates in the 20th year of the carryover period, any balance of the NOL that has not been used up or absorbed carries out to the beneficiary, not as a net operating loss, but as an excess deduction. Reg.§1.642(h)-2(b). Note that this special savings provision under Reg.§1.642(h)-2(b) applies only if the trust terminates in the same year that the 20 year NOL carryover period expires.

A net operating loss carryover that goes to a beneficiary upon the termination of a trust or an estate can only be carried forward. Rev. Rul. 61-20, 1961-1 CB 248.

A NOL incurred by a decedent (rather than by his or her estate) does not carry over to the estate. Instead, it must be used on the decedent's final income tax return. Rev. Rul. 74-175, 1974-1 C.B. 52. Otherwise it is lost.

E. Depreciation - §642(e)

A trust or an estate may derive income from assets which have a limited or ascertainable useful life. In this case, the trust or an estate may be able to offset the receipt of income from those assets by a depreciation deduction.

The tax treatment of depreciation on property held by estates and trusts is governed by §642(e). Section 642(e) in turn refers to §167(d) which deals with the allocation of the depreciation deduction. Section 167(d) says

> "In the case of property held in trust, the allowable deduction [for depreciation] shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees and devisees on the basis of the income of the estate allocable to each."

§167(d). Thus, as a general rule the depreciation deduction is allowable to the fiduciary and the beneficiary on the basis of their respective shares of the trust or estate income. For these purposes, "income" refers to accounting income (not income in the tax sense). §643(b).

Example: The sole asset of a trust is an apartment building and the depreciation deduction allowable for 2017 is $5,000. The trust instrument is silent on the allocation of depreciation. If all of the trust accounting income is paid, credited or required to be distributed to the beneficiary, then the beneficiary gets the entire depreciation deduction. This is true even though there was no income during the year.

Thus, the general rule is that the depreciation deduction is divided between the trust or the estate and the beneficiary on the basis of their respective shares of trust or estate accounting income. In applying this rule, however, a trustee is not allowed to exercise his discretion in making income distributions to affect the division of the depreciation deduction. Rev. Rul. 60-47, 1960-1 C.B. 250.

Note that the depreciation deduction is allocable to the beneficiaries directly, unlike other kinds of deductions that reduce the trust or estate's distributable net income and hence indirectly reduces the amount taxable to beneficiaries (or to the estate or trust as an entity). The beneficiary's share of depreciation is deducted before the entity's distributable net income is computed. Thus, the depreciation deduction will enter into the calculation of the trust or estate's distributable net income only to the extent that the income of the estate or trust is accumulated. To the extent that the income of the estate or trust is distributed to a beneficiary, the depreciation deduction does not enter into the calculation of the trust or estate's distributable net income. Rather, the depreciation deduction is reported as a separate item to the beneficiary on the Form K-1.

The depreciation allocated to the beneficiary under§167(d) may even exceed the amount of income allocated to the beneficiaries. In that case the beneficiaries would still be permitted to deduct the full amount of the depreciation so allocated. Rev, Rul. 74-530, 1974-2 C.B. 188.

The general rule that the depreciation deduction is divided between the beneficiary and the entity based upon their respective shares of accounting income is subject to two exceptions, both of which apply to trusts.

Exception #1: If the trust instrument or local law provides who get the depreciation deduction, then that person gets the entire depreciation deduction regardless of his share of trust income.

Exception #2: If the trustee is permitted or required either by the terms of the trust instrument or by local law to maintain a reserve for depreciation, the entire depreciation deduction goes to the trustee to the extent the trustee takes some trust income and transfers it to a reserve for depreciation. Reg.§1.167(h)-1(b).

Example: The depreciation deduction for a trust is $5,000 for 2017. The trust accounting income for 2017 is $20,000. Under the terms of the trust instrument, 50% of the income goes to A and 50% of the income is to be retained. Assume that the trust instrument or local law requires or permits the trustee to maintain a reserve for depreciation to keep the trust principal intact. Of the $10,000 retained by the trustee pursuant to the power to maintain a reserve for depreciation, the trustee actually takes $5,000 of trust income that was retained and transfers it into a reserve for depreciation to keep the trust principal intact. In this case, the entire $5,000 of depreciation is allocable to the fiduciary and none of the depreciation is allocable to the beneficiary. If the facts were the same but the depreciation deduction was $10,000, the first $5,000 of depreciation (amount equal to the reserve) would be allocated to the trust and the remaining $5,000 balance would be divided

equally between the trust and A since each is entitle to half the accounting income. Thus, the trust would be entitled to a depreciation deduction of $7,500 ($5,000 + $2,500) and A would be entitled to a depreciation deduction of $2,500.

Note that §13(a)(2) of RUPIA *requires* all fiduciaries to charge "a reasonable allowance for depreciation on property subject to depreciation" against income. The prior Act, UPIA gave the trustee *discretion* to charge an allowance for depreciation against income. Check your own state act.

When a trust or estate is a beneficiary of another trust or estate, the amount of the depreciation deduction is first apportioned to the recipient entity by the entity that actually owns the property. The recipient then apportions the deduction between itself and its beneficiary, in accordance with the rules outlined above. Rev. Rul. 61-211, 1961-2 C.B. 124, clarified by, Rev. Rul. 66-278, 1966-2 C.B. 439, modified, by Rev. Rul. 74-71, 1974-1 C.B. 158.

Example: Under the terms of Trust #1, one-fourth of the net income produced by Trust #1 is payable to the trustees of Trust #2. Under Trust #2, one-half of all the net income received by Trust #2 is payable to beneficiary A, and the balance of the net income is accumulated and added to principal. In 2017, the depreciation allowance on Trust #1's property is $40,000. Of the total depreciation allowance, $10,000 is allocated to Trust #2, and one-half of that $10,000 ($5,000) is allocated to beneficiary A. The balance of the amount allocated to Trust #2 ($5,000) is deducted by the fiduciary of Trust #2.

When a trust instrument directs that some income be paid to a charity, the charitable payment is deductible in computing taxable income, but some depreciation must still be allocated to the payment to the charity. For purposes of §167(d), the term "beneficiaries" includes charitable beneficiaries. Reg.§1.642(e)-1. The portion of the depreciation deduction allocated to charity is based on the proportion of the trust's accounting income paid to charity. Reg.§1.642(e)-1.

Example: A trust owns an apartment building. It provides that 60% of the net income (for fiduciary accounting purposes) shall be paid to individual A, and 40% to charity. No depreciation reserve is required. For 2017 the trust has $50,000 net rental income. Depreciation is $40,000. 60% of the depreciation goes to A (60% x $40,000 = $24,000) and 40% goes to charity (40% x $40,000 = $16,000). Thus, $16,000 of the depreciation deduction is wasted. Per the regulations, this result cannot be altered by special allocation. Reg. §1.167(d)-1(b).

An allocation of the depreciation deduction is not allocated to the person who receives income from the property subject to deprecation. Instead it is allocated based on the allocation of the estate or trust income in general. A slightly different rule applies to depletion. The regulations allocate the depletion deduction "on the basis of trust income from such property allocable to each." Reg. §1.611-1(c)(5). Accordingly, the depletion deduction is allocated to the beneficiary who receives income from the property subject to

depletion. Thus, a beneficiary must actually receive income from the asset that generates the depletion deduction.

An estate or trust cannot deduct the §179 expense that flows through on a K-1 from a partnership or S corporation. §179(d)(4). The business entity that generated the §179 expense does not reduce its basis in the property by the §179 expense passed through to the estate or trust and it may depreciate its property to the extent the §179 expense deduction is disallowed.

F. Unused Loss Carryovers and Excess Deductions on Termination

Section 642(h) provides that, on the termination of an estate or trust with a net operating loss (§172), a capital loss carryover (§1212), or, for the last taxable year of the estate or trust, deductions in excess of gross income (computed without using the deduction for exemptions or the charitable deduction), such NOL, capital loss carryovers and "excess deductions" shall be allowed to the beneficiary in a manner provided in the regulations. Thus, the Code permits beneficiaries who "succeed to the property of the estate or trust" upon termination to inherit some or all of the entity's unexpired net operating loss and capital loss carryovers when it terminates. In addition, beneficiaries should be able to take the excess deductions on termination as a miscellaneous itemized deduction. While the TCJA suspended miscellaneous itemized deductions through 2025 (§67(g)), according to IRS Notice 2018-61, the Treasury intends to issue regulations clarifying the effect of the TCJA on the excess deductions.

There are two different types of items under §642(h):

> 1. Loss carryover- §642(h)(1). This includes both a net operating loss as well as a capital loss carryover.
>
> 2. Excess deductions - §642(h)(2).

A trust or estate's net operating loss and net capital losses, whether arising in the year of termination or in prior years, pass through to the beneficiaries if the entity does not use them before it terminates.

The rules applicable to NOLs have been discussed in a previous section of these materials.

1. Capital Loss Carryovers.

If an estate or trust terminates before its own capital loss carryovers have been used up, the unused capital loss is available to the beneficiary. There is no time limit on using up capital loss carryovers.

Example: In 2016, a trust has a long term capital loss of $30,000. In 2017 the trust terminates without incurring any capital gains or losses for the 2017 taxable year. Chris,

the beneficiary, is entitled to inherit a $30,000 net long term capital loss carryover from the trust. §642(h)(1). Chris may use these carryovers to offset his own personal capital gains, realized in all future years, until the carryovers are absorbed. Chris may also deduct up to $3,000 of the carryover each year against ordinary income. §1211(b).

2. Excess Deductions.

Expenses that are paid or incurred in the administration of an estate or trust and that would not have been incurred if the property were not held in such an estate or trust are deductible under § 67(e)(1). Expenses deductible under § 67(e) include costs paid for tax preparation fees for most returns, appraisal fees, and certain fiduciary expenses, as outlined in Reg. §1.67-4. Costs that are not deductible under this section are those that customarily would be costs of a hypothetical individual holding the same property, such as ownership costs (e.g., homeowners association fees, insurance, and maintenance). Because § 67(e) explicitly states that deductions for administration costs are an adjustment against adjusted gross income, not an itemized deduction, many practitioners argued that § 67(g) did not apply to these deductions.

Fortunately, Treasury and the IRS agreed, and Notice 2018-61 indicates that the future regulations will clarify that trusts and estates will continue to be able to deduct expenses described in § 67(e)(1) as well as amounts allowable as deductions under §642(b) (personal exemption), and §§651 and 661 (income distribution deductions). In addition, the notice states that the regulations will make clear that deductions detailed in §§ 67(b) and (e) continue to remain outside the definition of "miscellaneous itemized deductions" and thus are unaffected by § 67(g). (The §67(g) guidance does not, unfortunately, apply to the limitation on the deduction for state and local taxes (SALT) under new §164(b)(6) created by the TCJA.)

If in the last taxable year of a trust or estate, the entity has more current income tax deductions than it has income, then it has "excess deductions". Charitable deductions allowable under §642(c) and the personal exemption under §642(b) are ignored when computing the amount of excess deductions. Excess deductions in the trust or estate's last taxable year are allowable to the beneficiaries, and they can deduct the excess deductions on their own personal income tax return. Excess deductions are deductible as a miscellaneous itemized deduction subject to the 2% floor. Thus, a beneficiary who does not itemize will not get the benefit of the excess deductions. §67(b).

The deduction can only be taken in the beneficiary's year within which or with which the estate's or trust's final taxable year ends. If the deduction exceeds a beneficiary's other taxable income, it cannot be carried back or forward.

Deductions in excess of income of the trust or estate for years prior to the year of termination, not attributable to net operating losses or capital losses, do not pass through to beneficiaries and, as such, are wasted. Thus, the timing of payment of expenses is important. This can be accomplished by delaying the payment of expenses such as legal and executor's fees until the final year of the estate or trust. The excess deduction is

claimed by the beneficiary as a miscellaneous itemized deduction subject to the 2% floor. In other words, part or all of the excess deduction may not be deductible by the beneficiary due to the 2% floor on miscellaneous itemized deductions. Section 67(b) specifically sets forth the itemized deductions that are not subject to the 2% floor and excess deductions on termination are not included.

Example: In 2017, a trust has gross income of $30,000 and allowable deductions of $50,000. The trust terminates in 2017. Without clarification of the effect of TCJA, neither the trust nor any of its beneficiaries may use the $20,000 of excess deductions realized in the year 2017. Thus, the $20,000 excess deduction is wasted. However, the IRS may clarify that the excess deductions may be taken by the beneficiaries.

The beneficiaries who are entitled to the excess deductions are the "beneficiaries succeeding to the property of the estate or trust". Reg.§1.642(h)-2. The term "beneficiaries succeeding to the property of the estate or trust" is defined in the regulations as the beneficiaries who "bear the burden"of such losses or excess deductions. Reg.§1.642(h)-3.

The phrase "beneficiaries succeeding to the property of the estate or trust" means, in the case of an intestate estate, the heirs and next of kin to whom the estate is distributed and, in the case of a testate estate, it means the residuary beneficiaries. Reg.§1.642(h)-3(b) and (c).

The beneficiaries share in the excess deductions and unused loss carryovers distributed to them in accordance with their share of the estate. See generally Reg. §1.642(h)-3 and 4 for allocation of excess deductions and loss carryovers among the beneficiaries.

Example: In 2017, an estate has gross income of $20,000 and deductions (primarily executor's and attorney's fees) of$50,000. The estate terminates in 2017. The estate has excess deductions of $30,000 ($20,000 income less $50,000 fees) which may be passed through and deducted by the beneficiary on his 2017 individual income tax return as a miscellaneous itemized deduction. Deductions in excess of income for years prior to the year the estate terminates do not pass through to the beneficiary and are wasted.

G. Terminating the Estate or Trust.

A fiduciary will want to carefully time the termination of an estate to avoid the bunching of income.

Example: Estate's fiscal year ends on January 31. The estate is terminated on August 31, 2017. The beneficiary must report on his 2017 return not only the income distributed to him for the full fiscal year ending January 31, 2017 but also the income for the short fiscal year from February 1, 2017 through August 31, 2017.

In the estate or trust's final year, capital gains enter into the calculation of DNI. Thus, any capital gains and losses will be taxed to the beneficiaries in the year the trust or estate terminates. Beneficiaries should be made aware of any gains or losses which will be

reported to them in the estate or trust's final year in order to ensure they pay appropriate estimated taxes, and that they have adequate cash to pay the tax on any gain.

H. Administration Expenses

1. Rules governing deduction.

Administration expenses such as attorney's fees, executor's commissions, accountant's fees, filing fees, surety bond premiums, appraisal fees, expenses of selling assets etc., are deductible from the gross estate under §2053(a)(2) or on the fiduciary income tax return under §165, §212, and §641. §642(g) prohibits the "double deduction" of administration expenses by providing that the fiduciary may deduct administration expenses on either the estate tax return or on the fiduciary income tax return, but not both. The disallowance of a double deduction is only for administration expenses allowed under §2053(a)(2).

§642(g) does not grant an income tax deduction. Rather, it merely disallows a deduction for the same item on both the estate tax and the fiduciary income tax return.

The fiduciary must elect to deduct administration expenses on either the estate return or the fiduciary income tax return. §642(g). The §642(g) election is required only if the fiduciary deducts the expenses on the fiduciary income tax return. The election is made by filing a statement, in duplicate, that the amounts deducted have not been claimed or allowed as deductions on the estate tax return and that all rights to have such items allowed at any time as deductions on the estate tax return are waived. Reg.§1.642(g)-1. This statement may be filed at any time before the expiration of the statutory period of limitations applicable to the taxable year for which the deduction is sought. Once the statement electing to claim administration expenses on the fiduciary income tax return is filed, it is irrevocable. In actual practice, the statement electing to use the administration expenses on the fiduciary income tax return is rarely filed with the return. Not filing the statement gives the executor added flexibility to shift administration expenses between the estate tax and the fiduciary income tax return at a later date.

The election to use administration expenses on either the estate tax return or the fiduciary income tax return is not an all or nothing situation. The executor may elect to take some of the administration expenses on the fiduciary income tax return and some of the expenses on the estate tax return. Reg.§1.642(g)-2. A personal representative may elect to deduct part of the expense in one year for estate tax purposes and another part of the expense in another year for income tax purposes, as long as a deduction for the same amount is not taken on both returns. Rev. Rul. 70-361, 1970-2 C.B. 133. The executor can elect to split one particular administration expense (e.g., the executor's fee) and claim part on the fiduciary income tax return and part on the estate tax return. In addition to administration expenses paid by an estate, expenses of administering property not subject to claims are also deductible on either the estate tax return or the fiduciary income tax return. Reg. 20.2053-8. A typical example of expenses of administering property not subject to claims would be expenses incurred in the administration of a trust established by the decedent during his lifetime. Reg. 20.2053-8(a). To be deductible under §2053,

expenses incurred in administering property not subject to claims must be paid within the statutory period for making estate tax assessments. Reg. 20.2053-8(a).

Generally, administration expenses deducted on the fiduciary income tax return are not subject to the 2% floor on the "miscellaneous itemized deductions". §67(e) provides that "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate...shall be treated as allowable in arriving at adjusted gross income." In other words, expenses that would only be incurred in the administration of an estate or trust are deducted in computing adjusted gross income. Such expenses include executor's and attorney's fees, trustee's fees, appraisal fees and probate filing fees.

Investment related fees deductible under §212 has resulted in frequent litigation culminating in *Knight v. Commissioner,* 552 U.S. 181 (2008). In the *Knight* case the United States Supreme Court held that investment advisory fees are subject to the 2% floor unless such expenses were uncommon (or unusual or unlikely) to be incurred by an individual. Such expenses include fiduciary fees, appraisal fees, and probate filing fees.

Selling expenses necessarily paid in estate administration (such as commissions on the sale of securities or real property where the sale is necessary to raise money for payment of estate taxes) may be deducted on either the fiduciary income tax return or the estate tax return, but not both.

The following factors should be considered when making the §642(g) election:

When deciding where to take administration expenses, (706 or 1041), the fiduciary should take into consideration the estate tax and fiduciary income tax brackets. In the past, it was generally more advantageous to deduct administration expenses on the estate tax return if a federal estate tax was due, since the federal estate tax rates were generally higher than the marginal fiduciary income tax rates. This comparison only holds true if the income of the estate was accumulated by the estate and the income tax would be paid at the estate level. If distributions were made or contemplated being made from the estate in the same year as deductible expenses were incurred, the executor would have compared the estate tax bracket with the income tax bracket of the beneficiaries. The executor would avoid incurring administration expenses in excess of the income of the estate in any year prior to the termination of the estate. As noted above, expenses in excess of income of an estate or trust in any year prior to the termination of the estate or trust are wasted. Alternatively, in the year of termination of an estate or trust, expenses which exceed the income of the estate or trust (so-called "excess deductions") can be passed out to the beneficiaries and used as miscellaneous itemized deductions on the beneficiaries own individual income tax return. §642(h). These "excess deductions" are deductible as a miscellaneous itemized deduction subject to the 2% floor. §67(b).

Currently, the maximum federal estate tax (40%) and) federal income tax rates (37.0% plus a possible 3.8% surtax on net investment income) are just about the same. Thus, the decision of where to take the administration expenses is not as easy as in the past.

If administration expenses are to be deducted on the fiduciary income tax return and part of the estate or trust income consists of tax-exempt income, a portion of the administration expenses will be non-deductible under §265(a)(1). The non-deductible portion can be claimed as an estate tax deduction and therefore will not be wasted. Rev. Rul. 59-32, 1959-1 C.B. 245.

Certain expenses are deductible on both the estate tax return and the fiduciary income tax return. Section 642(g), which disallows some double deductions, does not apply to deductions allowed under §691(b). §691(b) specifically provides that the estate may deduct various items for which the decedent was liable prior to death but which were not deductible on his final income tax return. Section 691(b) deductions are limited to §162 business expenses, §163 interest expenses, §164 taxes, §212 investment related expenses, §611 depletion expenses and the §27 foreign tax credit. These items are referred to as "deductions in respect of a decedent".

A distinction has to be made between administration expenses governed by §642(g) and §691(b). §642(g) covers only administration expenses arising after the date of the decedent's death. Deductions allowed under §691(b) are true double deductions. §691(b) relates to deductible expense items which arise before the date of the decedent's death but were not deducted by the decedent on his final income tax return. Since the decedent still owes the §691(b) expense at the date of his death, they are deductible as debts of the estate (for Federal estate tax purposes) under §2053 on the estate tax return and are deductible under §691(b) on the income tax return of whoever pays them.

A chart following this page attempts to list the deductions and where they may be taken, including deductions that can be taken on the decedent's final 1040.

I. Taking Deductions on the Proper Return

1. *Items Deductible ONLY on the Decedent's Final Income Tax Return.*

    a. Expenses qualifying as itemized deductions paid prior to date of death. §§161-223.

    b. Capital loss carryforward of the decedent. §1212(b).

    c. Charitable contributions carryforward of the decedent. §170(d)(1).

    d. Net operating loss carryforwards of the decedent. §172(b).

    e. Disallowed investment interest carryforward of the decedent. §163(d)(2).

    f. Disallowed S corporation carryforward of the decedent. §1366(d)(2).

    g. Investment tax credit carryforward of the decedent. §46(b).

2. *Items Deductible EITHER on the Decedent's Final Income Tax Return OR on the Estate's Death Tax Return.*

    Medical expenses of the decedent paid out of his estate within one year after date of death. §213(c).

3. *Items Deductible ONLY on the Estate's Death Tax Return.*

    a. Funeral expenses. §2053(a)(1); Reg. §20.2053-2.

    b. Claims against the estate of a personal non-deductible nature (e.g., federal income and gift taxes unpaid at date of death). §2053(a)(3).

    c. Administration expenses attributable to tax-exempt income. Rev. Rul. 59-32,1959-1 CB 245.

4. *Items Deductible ONLY on the Estate's Income Tax Return.*

    a. State, local and windfall profit taxes on estate income. §§164(a);2053(c)(1)(B).

    b. Real estate taxes not accrued prior to death. §§164(a); 2053(c)(1)(B).

    c. Interest accruing after date of death on indebtedness incurred by the decedent or the estate which are not allowable as expenses of administration under local law. §§163(a); 2053(c)(1)(B).

5. *Items Deductible EITHER on the Estate's Income Tax Return OR on the Estate's Death Tax Return.*

   a. Administration expenses, except administration expenses attributable to tax-exempt income, may be taken on the Form 1041 or the Form 706. Any administration expenses, including those attributable to tax-exempt income, not claimed on the Form 1041 can be claimed on the Form 706. §§212; 642(g); 2053(a). See Rev. Rul. 59-32, 1959-1 CB 245.

   b. Casualty and theft losses. §§165; 642(g); 2054.

6. *"Deductions in Respect of a Decedent" - Items Deductible BOTH on the Estate's Income Tax Return AND on the Estate's Death Tax Return.*

   a. Business expenses accrued prior to death. §§163; 2053(a).

   b. Interest expenses accrued prior to death. §§163; 2053(a).

   c. Taxes accrued prior to death. §§164, 2053(a); 2053(c)(1)(B). Remember, real estate taxes in Illinois are assessed a year in arrears, but the taxes become a lien on the property as of January 1, even though they won't be due until the following calendar year. So a decedent who dies in February 2011 before the issuance of the 2011 real estate tax bills in 2012, nevertheless can deduct both 2011 taxes and 2012 taxes (a lien at the date of death even though not payable until 2013).

   d. Expenses incurred for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection or refund of any tax accrued prior to death. §§212; 2053(a).

   e. Alimony or separate maintenance payments accrued prior to death. §§215; 2053(a). See Rev. Rul. 67-304. 1967-2 CB 224.

J. Computation of the Tax Liability

Once a fiduciary has determined the trust or estate's taxable income and has taken the appropriate distribution deduction, the trust or estate tax liability before credits can be computed. An estate or trust pays tax at the rates set forth in §1(e) based on its taxable income after deducting the distribution deduction. Generally, the income of a trust or estate reaches the maximum marginal income tax bracket at a lower taxable income than any tables at page 15.

As of 2013, certain high-income taxpayers are subject to a 3.8% Medicare tax on net investment income – that is, interest, dividends, annuities, royalties, rents, passive activity income, and capital gains. Investment income does not include distributions from qualified pension plans, nonqualified deferred compensation, or municipal bond interest. The Medicare surtax on investment income also applies to estates and trusts. In the case of an estate or trust, the 3.8% surtax applies to the lower of (1) the undistributed net investment income for the taxable year or (2) the excess of the estate or trust's adjusted gross income (as defined in §67(e)) for the taxable year over the dollar amount at which the highest tax bracket begins for estates and trusts ($12,750 for 2019).

1. Minimizing the Impact of the 3.8% Medicare Surtax on Estates and Trusts

The 3.8% Obamacare tax can be minimized or avoided with careful planning. The 3.8% surtax is imposed on three classes of income: (1) gross income from interest, dividends rents, royalties and annuities, (2) gross income from a (i) passive activity or (ii) a trade or business of trading in financial instruments or commodities, and (3) net gain. NIT includes interest, dividends, annuity distributions, rents, royalties, net capital gain derived from the disposition of property (other than property held in a trade or business), trade or business income from a passive activity, income or gain from the investment of working capital, income from the trade or business of trading in financial instruments or commodities, less "properly allocable" expenses. Sec. 141l(c)(1).

NIT does not include salary, wages or bonuses, distributions from IRAs or qualified plans, any income subject to self-employment tax, income from an active business, gain on the sale of an active interest in a partnership or S corporation, and items otherwise excluded or exempt from income under the income tax law such as interest on tax-exempt bonds, capital gains excluded under §121, etc. §1411(c)(5) and (6).

Example: An estate has net investment income (AGI) of $225.000. The tax is equal to 3.8% of the lesser of (1) UNII ($225,000) or (2) the excess (if any) of AGI as defined in Sec. 67(e) ($225.000) over the dollar amount at which the highest bracket begins for estates and trusts ($12,400 for 2016). Thus, the tax is $225,000 less $12,400 multiplied by 3.8% or $8,079.

Example: Same as the preceding example except that the estate makes a distribution of $100,000 to its beneficiary, Jamie. The tax is equal to 3.8% of the lesser of (1) UNII ($225,000 less distributions of $100,000 or $125,000) or (2) the excess (if any) of AGI

($225,000 less distributions of $100,000, or $125,000) over the dollar amount at which the highest bracket begins for estates and trusts ($12,400 for 2016). Thus, the tax is $125,000 less $11,950 multiplied by 3.8% or $4,279. Jamie, the beneficiary would include the $100,000 distribution in his income and would be required to include the distribution in his income to determine if he is subject to the 3.8% surtax.

Make a distribution – because beneficiaries are almost always below the NII threshold. Estates and trusts which find themselves subject to the higher income tax rates and the 3.8% surtax on NII should keep in mind the following four distributions alternatives:

(a) discretionary distributions,
(b) the 65 day rule election,
(c) including capital gains in DNI and
(d) in-kind distributions under Section 643(e).

(a) Discretionary Distributions.

Complex trusts and estates do not necessarily distribute all of their DNI to the beneficiaries each year. If the trust or estate would retain some DNI by distributing only income, the fiduciary should determine if he or she is allowed under the terms of the governing document to make discretionary distributions to the beneficiaries. If so, distributions from a trust whose taxable income exceeds the highest threshold will cause the DNI to be taxed to the beneficiary. Distributions to individual beneficiaries will save income tax if they are in a lower tax bracket than the estate or trust and will avoid the surtax. If the estate or trust has multiple beneficiaries, the DNI and Nil could be spread among multiple beneficiaries, increasing the likelihood of saving taxes.

(b)The 65 Day Rule Election.

The 65 day rule election gives the fiduciary a chance to take a second look after the end of the taxable year and elect to have distributions made in the first 65 days of the new year treated as if they were paid in the preceding year. This results in the amount subject to the 65 day rule election being taxed to the beneficiaries.

(c) Including Capital Gains in DNI.

The fiduciary of an estate or trust that has capital gains that will be taxed at the highest tax rate and subject to the 3.8% medicare surtax should determine if capital gains can be included in DNI under one of the three exceptions contained in the regulations. If so, and if the individual beneficiaries are in a lower tax bracket and are not subject to the surtax, there may be tax savings.

(d) In-Kind Distributions Under Section 643(e).

Section 643(e) gives the fiduciary an opportunity in some situations to control whether a capital gain is taxed to the estate or trust or to the individual beneficiaries. The general rule of §643(e) is that an estate or trust does not recognize gain or loss on the in-kind distribution of appreciated property to a beneficiary. An in-kind distribution of property carries out DNI at the lesser of the property's basis or its fair market value. The beneficiary, in effect, takes the estate or trust's basis (a carryover basis) in the property. §643(e)(1). A fiduciary may, however, elect to recognize gain as if the property was sold at its fair market value. §643(e)(3). If so, DNI is carried out to the extent of the fair market value of the property distributed and the beneficiary takes a basis in the distributed property equal to the estate or trust's basis plus any gain and minus any loss recognized on the distribution i.e. a basis equal to the fair market value of the property distributed. §643(e)(3)-(A)(iii); §643(e)(i).

Section 643(e) allows the fiduciary to determine where the gain will be recognized -- at the entity level or at the beneficiary level. If it make more sense to have the beneficiary report the gain (because he or she is in a lower tax bracket and not subject to the 3.8% surtax), the fiduciary would not make the §643(e) election. The basis of the property distributed to the beneficiary will take a carryover basis from the estate or trust. The beneficiary can then time the sale of the property and the recognition of the gain, hopefully to a time when he or she is in a lower income tax bracket and not subject to the 3.8% surtax. In addition, a beneficiary who holds the property until death will receive a step-up in basis eliminating any gain.

2. Credits Available to Entities and Beneficiaries

Generally, credits earned at the trust or estate level (or in a pass-through entity in which the trust or estate holds an interest) must be allocated between the trust or estate and its beneficiaries. Credits are generally allocated between the entity and its beneficiaries on the basis of the accounting income allocated to each. This rule is similar to that governing the allocation of depreciation.

3. Non-Deductible Expenses

Generally, §265 disallows any deduction attributable to the realization of tax-exempt income. Generally, the denial of deductions related to tax-exempt income involves those deductions normally allowed under §212 "for the production of income or the management or conservation of property held for the production of income." Deductions allowed under the business expense provisions (§162) and the loss provision (§165) are not restricted by §265(a)(1).

If a §212 expense is directly related to the production of tax-exempt interest or to the property that produces the tax-exempt interest, it is not deductible for income tax purposes. For example, if the trust pays a broker an investment management fee to invest 100% in

municipal bonds, none of the fee is deductible because it is directly related to the production of tax-exempt income.

If a §212 expense is indirectly related to tax-exempt income, only a portion of the expense is deductible. Reg.§1.652(b)-3(b) requires that a portion of indirect expenses be allocated to tax- exempt income. The allocation of expenses between taxable income and tax-exempt income may be computed on the basis of trust tax-exempt income divided by total trust income.

Generally, there are two types of expenses to which the allocation rules most frequently apply: (1) Annual trustee's commissions and (2) Termination commissions.

(A) Annual Trustee's Commissions.

There is no specific allocation formula specified in the Internal Revenue Code. An example of the allocation of expenses to tax-exempt income is provided in Reg.§1.652(c)-4. Generally, the fiduciary may select an allocation based upon any reasonable method. Reg.§1.265-1(c).

As a general rule, a different formula is applied for irrevocable trusts (capital gains are not included in the denominator of the fraction) and revocable trusts (where capital gains are included in the denominator of the fraction). However, modern income tax planning for trusts often treats capital gains as part of DNI and so part of the denominator.

The IRS in Rev. Rul. 77-355, 1977-2 C.B. 82 abandoned the flexible approach in Rev. Rul. 63-27 (which stated that no particular allocation formula is required) and Rev. Rul. 73-565 (which upheld the allocation of tax exempt income divided by total income (including capital gains)) when it stated that capital gains not included in DNI may not appear in the denominator of the allocation fraction. This results in the denominator of the allocation fraction for revocable trusts including capital gains whereas the allocation fraction for irrevocable trusts does not include capital gains. Since capital gains are included in DNI in the year of termination, they would be included in the formula for allocating indirect expenses to tax-exempt interest for that year.

Note that the portion of the administration expenses disallowed under §265 may still be claimed as an estate tax deduction. Rev. Rul. 59-32, 1959-1 C.B. 245.

(B) Special Rule for Termination Fees.

The cases and rulings hold that it is reasonable to allocate the termination fee on the basis of all the trust income received over the trust's lifetime, including capital net gains. *Whittemore v. U.S.*, 383 F 2d 824 (8th Cir. 1967); Rev. Rul. 77-466, 1977-2 C.B. 83; *Fabens v. Comm*, 519 F2d 1310 (1st Cir. 1975).

A question may arise as to whether a trustee can minimize the amount of termination fees allocated to tax-exempt income by distributing tax-exempt bonds in the year prior to

charging the expenses. The IRS has ruled against this strategy. See Rev. Rul. 77-466, 1977-2 C.B. 83 in which the IRS required allocation of termination expenses based on the ratio of tax-exempt income received to total income received (including realized and unrealized capital gains) over the life of the trust.

4. Miscellaneous Itemized Deductions

Generally, estate and trust expenses that are treated as adjustments in arriving at adjusted gross income are excluded from the 2% floor. Deductions for costs which are paid or incurred in connection with the administration of an estate or trust and would not have been incurred if the property were not held in such trust or estate are treated as adjustments in arriving at adjusted gross income, i.e., are deductible without regard to the 2% floor. §67(e).

The fiduciary income tax return form and associated instructions indicate that fiduciary fees, attorney fees, accountant fees and tax return preparation fees and certain other deductions are exempt from the 2% floor. On Form 1041, fiduciary fees are deducted on line 12, attorney, accountant and return preparer fees are deducted on line 14 and miscellaneous deductions that are not subject to the 2% floor are deducted on line 15(a). Only "other miscellaneous itemized deductions" are subject to the 2% floor- these are deducted on line 15(c) after reduction for the floor. This approach is generous to taxpayers.

Section 67(e) states that the adjusted gross income of an estate or trust excludes deductions allowed "under §642(b), §651 and §661." This means that the trust's or estate's deduction for distributions made to beneficiaries, whether under §651 or §661, will not be subject to the 2% floor on deductibility. The inclusion in §67(e) of the deduction allowed "under §642(b)" in the allowable adjustments to gross income for a trust or estate means that the trust or estate may deduct in full its $100, $300 or $600 exemption.

Miscellaneous itemized deductions are allowed only to the extent they exceed 2% of adjusted gross income, commonly referred to as the 2% floor. §67(a). However, an exception is provided for estates and non-grantor trusts. Expenses incurred by an estate or non-grantor trust which would not have been incurred if the property were not held in an estate or non-grantor trust are fully deductible. §67(e)(1). Litigation over whether investment advisory fees fell within the exception and were fully deductible resulted in a split in the U.S. Courts of Appeal. Finally, in *Knight v. Commissioner,* 552 U.S. 181 (2008), the United States Supreme Court held that a determination of whether such fees were deductible depended upon whether a hypothetical individual who held the same property outside of a trust "commonly" or "customarily" would incur the expenses. The Supreme Court held that investment advisory fees incurred by the trustees of non-grantor trusts will generally be subject to the 2% floor. However, incremental costs or special additional fees or fees for an unusual investment objective, other than what is paid by an individual taxpayer, will be fully deductible.

Under the final regulations, costs that are commonly or customarily incurred by a hypothetical individual owning the same property, as well as most investment advisory

fees, are subject to the 2% floor. Conversely, certain tax preparation fees, certain appraisal fees and certain fiduciary expenses are not subject to the 2% floor. Bundled trustee's fees (where both fiduciary and investment services are rendered) have to be separated into those that are and are not subject to the 2% floor.

The key features of the §67(e) final regulations are as follows:

1.General Rule. An expense will be subject to the 2% floor if it falls under the §67(b) definition of a miscellaneous itemized deduction, is incurred by an estate or non-grantor trust and would commonly or customarily be incurred by a hypothetical individual. Under the final regulations, it is the type or product or service provided, not its name or label, which determines if the expense would be commonly or customarily incurred by a hypothetical individual.

2.Ownership costs. Expenses associated with ownership of property will be subject to the 2% floor if incurred simply by reason of ownership. Such costs include condominium fees, insurance premiums and property maintenance expenses. Reg.§1.67-4(b)(2). Such costs would also include a custody fee for holding securities. Ownership costs that are fully deductible under other sections of the Internal Revenue Code, such as real estate taxes (subject to the TCJA SALT limitations) and costs incurred in a trade or business or for the production of income, are fully deductible as they are not miscellaneous itemized deductions.

3.Tax preparation fees. The final regulations provide an exclusive list of tax preparation fees that are not subject to the 2% floor. They are (1) estate and generation-skipping transfer tax returns, (2) fiduciary income tax returns and (3) the decedent's final income tax return. §1.67-4(b)(3). The cost of preparing all other returns, including gift tax returns, are subject to the 2% floor.

4.Investment advisory fees. As a general rule, after the decision in *Knight*, investment advisory fees are subject to the 2% floor. Reg.§1.67-4(b)(4). However, the final regulations retain the exception mentioned by the Supreme Court in Knight. As a result, incremental costs of investment advice beyond the amount normally charged to an individual investor are not subject to the 2% floor. Such incremental expenses include a special additional charge that is added solely because the investment advice is rendered to a trust or estate rather than to an individual, or is attributable to an unusual investment objective or the need for specialized balancing of the interests of various parties (other than the usual balancing of the interests of the income beneficiaries and the remaindermen). Reg.§1.67-4(b)(4). The fact that the investment advice is highly specialized does not make the investment advisory fee deductible-the fee must also exceed the fee charged to a hypothetical individual client.

5. Appraisal fees. Certain appraisal fees are not subject to the 2% floor. Those fees include appraisal fees incurred by an estate or non-grantor trust to determine the fair market value of assets as of the decedent's date of death (or alternate valuation date), to determine value for purposes of making distributions, or as otherwise required to properly prepare the

estate's or trust's tax returns or a generation-skipping tax return. Reg.§1.67-4(b)(5). The cost of appraisal fees for other purposes, such as for insurance purposes, is subject to the 2% floor. For example, the cost of a real estate appraisal in preparing an estate tax return would be fully deductible whereas a real estate appraisal to refinance the property to obtain funds for a renovation would be subject to the 2% floor.

6. Certain fiduciary expenses. Fiduciary expenses not subject to the 2% floor include probate court fees and costs, fiduciary bond premiums, legal publication costs or notices to creditors or heirs, the cost of certified copies of the decedent's death certificate and costs related to fiduciary accounts. Reg. §1.67-4(b)(6).

5. Alternative Minimum Tax

The alternative minimum tax applies to estates and trusts. However, the alternative minimum taxable income (AMTI) of a trust or estate is determined by applying the rules of Subchapter J. §59(c). That means that fiduciaries must compute distributable net income (DNI) on both a regular tax and alternative minimum tax (AMT) basis. Fiduciaries must report to beneficiaries their share of DNI computed under both the regular tax and AMT. Trusts and estates are most likely to be effected by the preference for interest on tax-exempt private activity bonds, miscellaneous itemized deductions and state and local income taxes. These items are deductible for regular tax purposes but are not deductible for purposes of computing the alternative minimum tax.

In general, an estate or trust computes its AMTI by starting with its regular taxable income and then making the following modifications:

1) Making specified adjustments for certain types of deductions such as depreciation deductions which are computed in a different manner for alternative minimum tax purposes than for regular tax purposes.

2) Eliminating deductions for certain items such as miscellaneous itemized deductions, personal exemptions and taxes which are not allowed in computing the alternative minimum tax. (An administration expense not subject to the 2% floor is fully deductible by the trust for both regular and AMT purposes. On the other hand, excess deductions upon termination are not deductible for AMT purposes. Excess deductions are miscellaneous itemized deductions subject to the 2% floor.)

3) Adding back specified items of tax preferences such as tax-exempt interest on private activity bonds issued after August 7, 1986.

Administrative costs that would not have been incurred were the property not held in trust are not added back to the tax base to arrive at AMTI. §56(b)(1) and §67(e). Such expenses include fiduciary fees, attorneys fees, accounting fees for preparing fiduciary accounts and costs incurred in preparing fiduciary income tax returns.

If the trust makes a distribution to a beneficiary that carries out income, the difference between the income reported to the beneficiary on a regular tax basis and the income reported to the beneficiary on an AMT basis is reported by the individual beneficiary on the beneficiary's Form 6251. The fiduciary computes its AMT on Schedule H of the Form 1041.

Example: A simple trust with one beneficiary has qualified dividend income of $100,000, trustee's fees of$5,000 (allocated to income) and state income tax on capital gains (allocated to principal) of $35,000. Trust accounting income for regular tax and alternative minimum tax purpose is $95,000 ($100,000 qualified dividends less $5,000 trustee's fees allocated to income). Regular tax DNI is $60,000 ($100,000 qualified dividends less $5,000 trustee's fees and $35,000 state income taxes). Alternative minimum taxable DNI is $95,000 ($100,000 qualified dividends less $5,000 trustee's fees). The state income tax is not allowed as a deduction in computing the alternative minimum tax.

The income distribution deduction for regular tax purposes is $60,000 (the lower of trust accounting income of $95,000 or DNI of $60,000). The income distribution deduction for alternative minimum tax purposes is $95,000 (the lower of trust accounting income of $95,000 or alternative minimum tax DNI of $95,000).

The beneficiary of the simple trust would receive a Schedule K-1 reporting the following:
- $60,000 income for regular tax purposes
- $95,000 income for alternative minimum tax purposes
- $35,000 adjustment for minimum tax purposes (difference between $95,000 income for alternative minimum tax purposes and $60,000 income for regular tax purposes).

The $35,000 adjustment for alternative minimum tax purposes would be reportable by the beneficiary as an adjustment in computing the beneficiary’s own alternative minimum tax on Form 6251, "Alternative Minimum Tax- Individuals" or on Form I of Form 1041 if the beneficiary is an estate or another trust.

PART V - PROCEDURE, ADMINISTRATION, AND COMPLIANCE

A. Taxpayer Identification Number

The fiduciary of a newly created trust or estate should apply for a taxpayer identification number (TIN). Taxpayer identification numbers can be obtained by using one of the following methods: (1) the online EIN Application (1-EIN) process, (2) the Tele-TIN program, (3) the Fax-TIN program or (4) submitting a Form SS-4 by mail to the appropriate Internal Revenue Service Center. Previously, fiduciaries who represented numerous trusts and estates could make a single request for multiple taxpayer identification numbers under the procedure outlined in Rev. Proc. 89-37, 1989-1 C.B. 919 and assign a taxpayer identification number to a particular trust or estate as they were appointed to act as a fiduciary. Rev. Proc. 89-37 was made obsolete by Rev. Rul. 2004-90 and has been supplanted by the Service's online EIN application (1-EIN) process. The taxpayer identification number will be used by the fiduciary in filing the fiduciary income tax return and in reporting distributions to beneficiaries on the Form K-1. In addition, the taxpayer identification number will be used by payors of interest, dividends and other items to the fiduciary.

Trusts that are wholly treated as grantor trusts due to the fact that the grantor retains a power to revoke under §676 where the grantor is a trustee or co-trustee, should not obtain a separate TIN. These trusts should use the grantor's personal TIN. Reg.301.6109-1(a)(2); Reg.§1.671-4(b)(1). Also, no TIN is required for a trust if a husband and wife are the sole grantors, one or both spouses serve as trustees or co-trustees, one or both spouses are treated as the entire owner of the trust under §676 (a trust which the grantor retains the right to revoke) and the spouses file a joint return for the year. Reg.§1.671-4(b)(2).

A trustee of a grantor trust should obtain a TIN for the trust once the rules stated in the preceding paragraph no longer apply. Thus, the trustee should review the need for a separate trust TIN upon the death of the grantor, when the grantor no longer has the right to revoke the trust, or when the grantor resigns as the trustee.

B. Grantor Trust Reporting Requirements

The obligation of the fiduciary of a grantor trust to obtain a taxpayer identification number for the trust depends upon which of the three alternative methods the trustee elects to use to satisfy the grantor trust's reporting requirements. Effective January 1, 1996, regulations allow a grantor trust to use one of two Form 1099 reporting methods or the traditional From 1041 reporting method. The regulations clarify that the Form 1099 reporting alternative is optional and not mandatory. In general, a trustee would have three filing options. The requirements to obtain a taxpayer identification number can be summarized as follows:

1. The 1041 alternative- Reg.§1.671-4(a)

The trustee applies for an employer identification number for the trust. The trustee files a Form 1041 information return and attaches a statement of items of income, deductions

and credits for the year in question. The statement (usually a Form K-1) is furnished to the grantor for use in preparing his income tax return. This is the method that has traditionally been used by most fiduciaries.

2. The 1099 Grantor-TIN alternative - Reg.§1.671-4(b)(2)(i)(A)

The trustee "need not obtain" an taxpayer identification number (TIN) until either (1) the first taxable year in which the trust, or any part of the trust is no longer a grantor trust, or (2) the first taxable year of the trust in which the trustee does not report using the grantor-TIN alternative. The trustee provides all payors of reportable income with the name and TIN of the grantor and the address of the trustee. The trustee is not required to file either a Form 1041 or Form 1099 with the IRS. Payors of the income to the trust send Form 1099 to the trust showing the reportable income as taxable to the grantor. The trustee is required to furnish the grantor with a detailed statement of the applicable items of income, deductions and credits by the due date (including extensions) of the Form 1041. If the grantor is the trustee or a co-trustee of the trust, the statement need not be furnished to the grantor.

3.The 1099 Trust-TIN alternative-Reg.§1.671-4(b)(2)(i)(B)

The trustee applies for a TIN for the trust. The trustee provides all payors of reportable income with the name, TIN and address of the trust. The trustee is not required to file Form 1041 but must file Form 1099. Payors of income send the Form 1099 to the trust showing the reportable income as taxable to the trust. The trustee is required to file Form 1099 with the IRS by the end of February, reporting the total interest and dividends received on a 1099-INT or 1099-DIV, whichever is applicable, showing the trust as the payor and the grantor as the payee. Gross proceeds of sales are reported separately for each sale on a 1099-B. Copies of the Form 1099 are not sent to the grantor. Instead, the trustee sends a statement summarizing this information to the grantor by the due date of the Form 1041. If the grantor is a trustee or co-trustee of the trust, the statement need not be furnished to the grantor.

C. Notice of Fiduciary Relationship

Once a fiduciary of a trust or an estate has been appointed, he or she should notify the Internal Revenue Service of his or her appointment. §6903. Form 56 (Notice Concerning Fiduciary Relationship) is used for this purpose. A fiduciary must submit, along with the Form 56, evidence of their authority to act, such as a certified copy of the appointment as executor or administrator or a certified copy of the trust instrument.

Once the fiduciary has given the IRS notice of his appointment, the fiduciary succeeds to all the rights, privileges and liabilities of the taxpayer. §6903. This authority continues until the IRS is notified of the termination of the relationship. Once a Notice of Fiduciary Relationship has been filed, the IRS will direct all correspondence to the fiduciary named in the Form 56.

Filing a notice of fiduciary relationship is not mandatory and there are no specific penalties for failing to file such a notice. However, if the notice is not filed, the IRS will send its correspondence to the last known address of the entity and the fiduciary may be bound by notices not actually received. In the absence of fling a Form 56, signing and filing the initial return of the estate or trust should be an effective way of informing the Internal Revenue Service of the fiduciary's name and address.

The notice should be filed with the District Director for the district where the decedent's return is required to be filed. Reg. 301.6903-1(b). Since the residence of the fiduciary, rather than the residence of the decedent, determines the district in which the decedent's return should be filed, notice is required to be filed with the District Director for the district where the fiduciary is domiciled. §6091(b)(1)(A)(i); Reg. 301.6091-2(a); Reg. 301.6903-1(b).

D. Accounting Periods

All trusts, except those that are exempt from tax under §501(a) or described in §4947(a)(1) (wholly charitable), are required to file their tax returns on a calendar year accounting period. §644. Grantor trusts always use the same taxable year as the grantor which may or may not be a calendar year. Rev. Rul. 90-55, 1990-2 CB 161.

Estates are not required to adopt a calendar year. Instead, estates may adopt any fiscal year selected by the executor or administrator as long as the first fiscal year does not exceed twelve months. §441; Reg.§1.441-1(b)(3).

Section 645 permits the trustee of a deceased grantor's revocable trust and the executor of the grantor's estate to elect to treat the trust as part of the estate for fiduciary income tax purposes. The §645 election enables a qualifying trust to have its income taxed on a fiscal year basis.

Selecting a fiscal year for an estate gives the fiduciary a number of tax planning options. Establishing a short fiscal year, for example, allows the executor or administrator to control the amount of the first year's taxable income. The selection of an estate's fiscal year-end may also enable the beneficiaries to defer the recognition of the income.

D. Estimated Tax Requirements

1. General Payment Requirements

Trusts and estates expected to owe at least $1,000 in tax (after taking withholding into account) must pay their income tax liability in quarterly estimated income tax payments on or before the 15th day of the fourth, sixth and ninth months of the taxable year and on or before the 15th day of the first month of the succeeding taxable year. §6654(c)(1). If the total estimated tax payments plus tax withheld from other sources are less than 90% of the final tax liability reported on the return, an under-estimation penalty may be imposed. The estimated tax payment requirements must be met on a quarterly basis. If the payment for

any particular quarter is below that required by the estimated tax payment rules, an under-estimation penalty may be imposed for that quarter.

2. The Amount of the Installment

Trusts and estates may compute their installment payments under any one of three alternative methods. Failure to comply with any one of these three methods may result in an under- estimation penalty being imposed.

Method #1• 90% of current year's tax liability. (80% for 2018 to avoid penalty)

A trust or estate may base its estimated tax payments on an amount equal to 90% of the current year's tax liability. Each quarterly payment must be equal to at least 22.5% of the total tax liability for the current year. §6654(d)(1)(A), §6654(d)(1)(B)(i). Thus, the payment for the first quarter must be at least 22.5% of the current year's tax liability, the payment for the first and second quarter payments must equal at least 45% of the current year's tax liability and the total estimated tax payments for the first three quarters must equal at least 67.5% of the current year's tax liability. Any under-payment for a particular quarter may result in an under- estimation tax penalty being imposed.

Method #2 --100% (110%) of prior year's tax liability.

If the proceeding year of the trust or estate was a full 12-month year and the entity filed a return, the fiduciary can make estimated tax payments based upon 100% of the prior year's tax liability if certain requirements are met. Thus, a trust that paid no tax for the previous taxable year will not be required to pay estimated tax payments as long as the preceding year was a taxable year of 12 months. §6654(e)(2). This rule does not apply if a trust is in its first year as the trust will not have previously filed a tax return. Each quarterly installment under this method must be equal to at least 25% of the income tax liability for the trust or estate for the previous taxable year. §§6654(d)(1)(A), 6654(d)(1)(B)(ii).

Method #3 -- Annualization

Under this method a trust or estate can base its quarterly estimated tax payments on 90% of the annualized tax for the current year. Under this method, the trust or estate would be required to pay the tax for 22.5% of the annualized current year's income for the first quarter, 45% of the annualized income of the current year for the second quarter, 67.5% of the annualized income for the current year for the third quarter and 90% of the annualized income for the current year for the fourth quarter. The annualized income is based upon the trust's or estate's taxable income and/or alternative minimum taxable income for the month ending more than one month before the installment in question is due, annualized over the entire taxable year. §6654(1)(4). Thus, trusts and estates will generally have 45 days (instead of 15 days available to individuals) to compute their estimated tax payments under this method. If the trust has an interest in one or more common trust funds, see Notice 87-32, 1987-1 CB 477, Q & A 11 for determining common trust fund income for purposes of the annualized income rule.

3. Estates

Estates are not subject to the estimated tax payment until the taxable year that ends 2 years after the decedent's death. §6654(1)(2). In addition to estates, a grantor trust that receives the residue of the probate estate under the grantor's will is also exempt from the estimated tax requirements for the first two years after the grantor's death.

A trust that makes a §645 election is not obligated to make estimated tax payments for any taxable year ending within 2 years of the decedent's death. Reg.§1.645-l(e)(4). This is the same rule that applies to estates.

4. Timing of Installment Payments

Trusts on a calendar year must pay estimated tax payments on April 15th, June 15th,September 15th and January 15th following the close of the year. §6654(c)(2). Fiscal year taxpayers must follow the same schedule based on the corresponding dates within their fiscal year; i.e. the 15th day of the 4th, 6th, 9th months of the year and the 15th day of the month following the close of the fiscal year. §6654(k)(1)

5. Tax Liabilities Of Less Than $1,000

No estimated tax payment is required if the tax liability for the current year is less than $1,000. §6654(e)(1). A fiduciary can reduce taxable income and the tax liability of a trust or estate by making distributions to beneficiaries that are deductible under §651 and §661. Simple trusts should not be subject to estimated tax payment requirements except in years in which they realize capital gains or have phantom income or trapping distributions from other estates or trusts.

6. Allocation of Credits for Estimated Tax to Beneficiaries

Trustees (but not executors, except for the estate's final year) may elect to allocate part or all of their estimated tax payments to beneficiaries. §643(g). The amount of the estimated tax payment that is allocated to a beneficiary is treated as a distribution to the beneficiary on the last day of the calendar year and as a payment made by the beneficiary on January 15th following the close of the year. §§643(g)(1)(B), 643(g)(1)(C). The allocation is not prorated to all installments. Instead, it is treated as being made by the beneficiary on January 15th following the close of the year.

This election can only be made for estimated tax payments made in excess of the reported tax liability of the trust. The election must be made by the fiduciary by filing a Form 1041-T with the appropriate Service Center on or before the 65th day after the close of the taxable year of the trust. §643(g)(2). The instructions to Form 1041 state that the failure to file Form 1041-T timely will result in an invalid election and the beneficiaries will not be able to obtain credit for the amounts allocated to them. The amounts applied to each beneficiary should also be reported to the beneficiary on Form 1041 Schedule K-1.

The fiduciary may also distribute excess estimated tax payments to the beneficiary of an estate in any taxable year reasonably expected to be the last taxable year of an estate. §643(g)(3). Note that this election applies for estates and, specifically, in the last taxable year of an estate. Although the Code does not address the issue, a literal reading of §643(g) indicates that the trust's estimated tax payments may be allocated unequally among the beneficiaries.

7. Short Taxable Years

If a short taxable year is required because the estate or trust terminates, installments must be paid on the regular due date through all installments due before the end of the taxable year, and a final installment must be paid on the 15th day of the month following the month in which the entity terminates. Notice 87-32, Q&A 3. This problem is more theoretical than real. When an estate or trust terminates, all DNI (including capital gains) flow out to and is reported by the beneficiary, leaving the estate or trust with no taxable income.

E. Income Tax Returns

Fiduciaries of estates must file an income tax return for any year in which the gross income exceeds $600. §6012(a)(3). A trust income tax return must be filed for any year in which the gross income exceeds $600 or in which it has any taxable income at all, regardless of the amount of gross income. §6012(a)(4). If any beneficiary of an estate or trust is a non-resident alien, the fiduciary must file a return for that entity regardless of the amount of gross or taxable income. §6012(a)(5).

The return is filed with the Internal Revenue Service Center for the region in which the trustee resides or has its principal place of business. If the trustee does not reside or have its principal place of business (or any place of business) within the United States, the return should be filed with the Internal Revenue Service Center, P.O. Box 409101, Ogden, Utah 84409.

1.. Reporting to Beneficiaries

Personal representatives of estates and trustees are required to provide beneficiaries who receive any distribution or allocation of items from the estate or trust a Form K-1 showing the beneficiary's share of estate and trust items that could affect the computation of the beneficiary's tax liability. §6034A. The statement required by §6034A must be furnished to the beneficiary before the due date of the return. §6034A(a).

2. Signature on Returns

Estate and trust income tax returns must be signed by at least fiduciary. §6061; Reg. §1.6061-l(a). If there is more than one fiduciary, any of them may sign the return and bind all of the fiduciaries.

In addition to the fiduciary's signature, income tax returns prepared by a paid preparer (other than the fiduciary) must be signed by the paid preparer. §6695(b); Reg.§1.6695-1(b)(A). In the usual case, the paid preparer must sign the return manually.

The Internal Revenue Service will accept facsimile signatures for the tax return preparer on a fiduciary income tax return. However, paid preparers desiring to use a facsimile signature must obtain prior permission from the Internal Revenue Service. This prior permission is obtained by having the preparer submit a manually signed letter listing all returns that are signed by a facsimile signature. The preparer must retain a copy of the list of returns signed by the facsimile signature for further review by the Internal Revenue Service. See Notice 89-48, 1989-1 CB 688 for more information on facsimile signature requirements.

3. Time for Filing Returns

The fiduciary income tax return is due on the 15th day of the fourth month following the close of the taxable year for the estate or the trust. §6072. Since trusts (other than those making the §645 election) are required to be on a calendar year, the filing date for a trust fiduciary income tax return is generally April 15th. The fiduciary income tax return of an estate (which is allowed to select a fiscal year-end) must file its return on the 15th day of the fourth month following the close of its taxable year. A trustee of a "qualified revocable trust" may elect to be treated as part of a decedent's estate thereby allowing the filing of the fiduciary income tax return based on the estate's fiscal year end. Estates and trusts can obtain an automatic five-month extension for filing the fiduciary income tax return by filing Form 7004.

4. Filing Requirements For Charitable Trusts

Charitable trusts (including charitable remainder trusts, pooled income funds, and wholly charitable trusts) are exempt from U.S. income tax on income other than unrelated business taxable income. Regardless of the fact that charitable trusts are exempt from U.S. income tax, they are subject to extensive annual reporting requirements. §6033. Charitable remainder trusts, pooled income funds, and charitable lead trusts that pay an annuity or unitrust amount must file a special information return, Form 5227, which details the types of income the trust received and its distributions. Reg.§1.6034-l(a). If the trust is subject to one of the private foundation excise taxes, it must also file a return of these taxes on Form 4720.

Charitable lead trusts are not exempt from tax. Non-grantor charitable lead trusts with at least $600 of gross income must file Form 1041 along with their Form 5227. Charitable remainder trusts with any unrelated business taxable income must also file a Form 1041 to show the amount of tax on that income. Reg.§1.6034-3(a).

Most wholly charitable trusts must file an annual information return on Form 990 (Form 990PF for private foundations), on or before the 15th day of the fifth month after the close of their fiscal year. Wholly charitable trusts with less than $5,000 in gross receipts (as

well as employee benefit trusts, churches, certain religious organizations and instrumentalities of the United States) need not file the annual information return. Reg. 1.6033-2. Wholly charitable trusts with unrelated business taxable income must file Schedule T to accompany the return computing their tax on that income. Wholly charitable trusts that have violated any of the private foundation excise tax rules must file Form 4720 to report their excise taxes. Reg. §53.6011-1.

F. Protecting the Fiduciary

The fiduciary is personally liable for the decedent's **unpaid income and gift taxes** if other debts are satisfied before paying taxes due as of the date of death. This liability is broadly described in the Federal Claims Priority Act 31USC §3713(b) and in §6901(a). The executor is personally liable for any unpaid taxes of the decedent to the extent of the value of other debts paid by the executor over the outstanding priority claims of the United States. "Debt" includes a distribution of a bequest or a portion of the residuary estate to the named beneficiaries under the decedent's will or under the law of intestate distribution. Personal liability attaches even where there may be a beneficiaries' agreement to pay the unpaid tax, or where the executor is contractually indemnified by the beneficiaries. (There are federal reimbursement statutes that may be applicable as to property subject to estate tax that passes outside of probate; see §§2204–2207.) The statute of limitations is six years.

Priority claims include funeral and administrative expenses and family allowances. PLR 8341018.

An executor's exposure for personal liability for unpaid taxes of the decedent can be mitigated in several ways. First, an executor who is appointed and qualified to act under state law as such can apply for and receive a discharge from personal liability for estate tax by written application and early determination by the IRS of the tax owed. The determination must be made within nine months after the return is filed, or within nine months after the written application is made for the determination by the executor, whichever is later.

1. Discharge from Personal Liability - §6905

Executors (but not a trustee) can protect themselves from personal liability for unpaid income and gift taxes of the decedent (for which returns have been filed), and from personal liability for unpaid estate taxes, by requesting in writing a discharge from personal liability from the Internal Revenue Service. §6905, §2204. The application is filed with the District Director of the Service Center with whom the tax return is required to be filed. Reg. §301.6905-l(a); Commissioner's Delegation Order No.134, April 20, 1973, 38 F.R. 10164. If no estate tax return is required, the application should be filed in the District where the decedent's final return is required to be filed. Reg. §301.6905-l(a). The Internal Revenue Service Restructuring and Reform Act of 1988 reorganized the Service eliminating the district director. See Notice 2003-19, 2003-14 I.R.B. 704 which indicates the new address to use in filing certain notices but does not mention where to file the request for discharge

of personal liability. In previous years the request could be flied by a separate letter or by filing Form 5495.

The IRS has nine months to notify the executor of the amount of tax due. If no notification is received within nine months, the executor is automatically discharged from personal liability. Reg. §301.6905-1(a). If the IRS notifies the executor of the amount of tax due, the executor is discharged from all personal liability upon payment of the amount due. The discharge is effective only to the executor in his personal capacity and to his personal assets. It does not apply to the executor's liability in his fiduciary capacity to the extent of the estate's assets in his possession or control. Reg. §301.6905-l(a). The discharge applies to all open returns of the decedent (except years where no return was filed).

The request may be filed by a separate letter or by filing Form 5495. A discharge from personal liability, if granted, will protect the executor from personal liability for making distributions. However, the discharge from personal liability does not protect the beneficiaries of the estate who receive the distributions from transferee liability.

It is recommended that the request for a discharge from personal liability be sent by certified mail, return receipt requested.

B. Request for Prompt Assessments -- §6501(d)

A fiduciary who requests in writing a prompt assessment of the decedent's income tax and gift tax liability and the estate's fiduciary income tax liability (for which returns have been filed) can protect both themselves and the transferees §6501(d). The request for a prompt assessment shortens the normal three-year statute of limitations to a period ending eighteen months after the filing of the request for the prompt assessment or three years following the return date, if earlier. The request for a prompt assessment does not shorten the statute of limitations on assessment if no return has been filed or if there was a substantial omission of income. §650l(c)(3); (e)(1). The special 18 month period of limitations does not apply to any return filed after the request has been submitted unless an additional request is made. Reg. §301.650l(d)-1(b).

The regulations require that the request must be a separate document and mailed in a separate envelope. Rev. Rul. 57-319, 1957-2 C.B. 855. In addition, it must set forth the classes of tax and the taxable periods and clearly indicate that it is a request for prompt assessment. The request for prompt assessment can be made by filing a Form 4810 or by a separate letter requesting a prompt assessment under §6501(d). Generally, the request for a prompt. assessment should be sent to the district director of the Internal Revenue Service district in which the income or gift tax return was filed. As mentioned above, the concept of a district director has been eliminated. The current version of Form 4810 (Feb., 2009) states that the request should be sent "to the Internal Revenue Service office where you filed your returns." It should be sent by certified mail, return receipt requested. Filing the request for prompt assessment by certified mail, return receipt requested, enables the fiduciary to prove the date when the 18-month period begins to run.

PART VI -
EXAMPLE OF A 2018 FIDUCIARY INCOME TAX RETURN FOR A COMPLEX TRUST

Facts:
Assume that a trust provides that 50% of the income must be paid currently to Robin. In 2018, the trustee makes the following discretionary distributions: 25% to Pat and 25% to charity. No reserve for depreciation is required. The following income and expenses occurred in 2018:

Income

Rents	40,000
Taxable interest	30,000
Tax-exempt interest	15,000
Long-term capital gain	8,000

Expenses

Depreciation of rental property	6,000
Real estate rental expenses	14,000
Trustee expenses - Principal	1,000
Trustee expenses - Income	2,000

Distributions

Required: 50% of income to Robin

Discretionary:
25% of income to Pat
25% of income to charity

1. Computation of Trust Accounting Income:

Rents	40,000
Taxable interest	30,000
Tax-exempt interest	15,000
Gross trust accounting income	85,000
Less: Rental real estate expenses	(14,000)
Trustee expenses - income	(2.000)
Trust accounting income	69,000

(Enter on Form 1041, Sch B, Line 8)

Note: Tax-exempt interest is an item of trust accounting income. Its tax character is irrelevant. Capital gains are usually allocated to principal and are not part of trust accounting income.

2. Amount of trust accounting income received by each beneficiary:

Robin	50% X 69,000 TAI =	34,500
Pat	25% X 69,000 TAI =	17,250
Charity	25% X 69,000 TAI =	17.250
Total		69,000

3. Taxable income (before income distribution deduction):

Rental income	40,000
Taxable interest	30,000
Tax-exempt interest	(15,000)
Long-term capital gains	8,000
Gross income	78,000
Less:	
Rental real estate expenses	(14,000)
Trustee's compensation	(2,471)*
Charitable deduction	(14,206)**
Exemption	(100)
Taxable income	47,223

Note: The expenses must be allocated to the various items of income. The real estate rental expenses are allocated against rental income because such expenses are attributable directly to rental income. However, a portion of the trustee's compensation and the charitable deduction must be allocated against tax-exempt interest, and the portion so allocated is not deductible. The portion is proportionate to the total of the tax-exempt interest ($15,000) divided by the gross trust accounting income ($85,000). Thus, the portion of the commissions and charitable distribution that is not deductible is computed as follows:

*Trustee's commissions attributable to tax-exempt interest:
$3,000 X 15,000/85,000 = 529
$3,000- 529 = 2,471

**Charitable deduction attributable to tax-exempt interest:
$17,250 X 15,000/85,000 = 3,044
$17,250 - 3044 = 14,206

Note: If the trustee does not establish a reserve for depreciation, the depreciation deduction is apportioned between the income beneficiaries and the trust on the basis of the trust accounting income allocable to each. Here, since all of the trust accounting income is allocated to the beneficiaries, the trust is not entitled to deduct any depreciation.

4. Calculation of DNI:

Taxable income before income distribution deduction			47,223
Add:	Exemption (§643(a)(2))		100
	Tax-exempt interest (§643(a)(5)	15,000	
	Less: Trustee comp allocable	(529)	
	Less: charitable deduction allocable	(3,044)	11,427
Less: Long-term capital gain			(8,000)
DNI - Put on Form 1041, Sch. B, Line 7			50,750

The items of DNI can be broken down into the following categories of income:

Gross Inc as % of Txbl Inc	47.06% Rental Income	35.29% Taxable Interest	17.65% Tax-exempt Interest	100% Total
Gross trust accounting income	40,000	30,000	15,000	85,000
Less:				
Rental expenses	(14,000)			(14,000)
Trustees fees *	(1,412)	(1,059)	(529)	(3,000)
Charitable deduction**	(8,118)	(6,088)	(3,044)	(17,250)
Totals	16,470	22,853	11,427	50,750

* The trustees fees can be allocated against any class of income. Reg.§1.652(b)-3.
** Charitable distributions must be apportioned ratably among each class of items of income. Reg.§1.661(b)-2.

5. Distributions deduction:

Income required to be distributed currently--tier-one distribution	34,500	
All other amounts properly paid--tier-two distributions	17,250	
Total	51,750	
BUT Deduction Limited to DNI		50,750

Note: The difference between the income distributed and properly paid, and DNI is the trustee's compensation of $1,000 allocated to principal.

§661(b): Character of amount deductible under §661(a) is same as character of DNI:

Taxable character of DNI:	39,323
Tax-exempt character of DNI	11,427*
Distribution deduction	39,323

*The trust does NOT get a distribution deduction for the tax-exempt income. §661(c); Reg. §1.661(c)-1.

6.Taxable income of the trust:

Taxable income before distribution deduction	47,223
Distribution deduction	(39,323)
Taxable income	7,900

Note: The taxable income equals the long-term capital gains less the exemption. This is correct because all of the trust accounting income was distributed.

7.Tax consequences to beneficiaries:

Robin - first tier beneficiary (Received $34,500; limited to DNI of 50,750)	34,500
Pat - second tier beneficiary (Received 17,250; limited to remaining DNI: 50,750- 34,500)	16,250
Total (equal to DNI)	50,750

8. Character of DNI:

Taxable character: 39,323/50,750 = 77.48%

Exempt character: 11,427/50,750 = 22.52%

Robin-Taxable 34,500 x 77.48% =	26,731
Less: 50% share of depreciation	(3,000)
Net taxable:	23,731
Pat - Taxable 16,250 x 77.48% =	12,592
Less:25% share of depreciation	(1,500)
Net taxable:	11,092

The individual items of income that comprise Robin's and Pat's respective distribution also can be illustrated. Robin receives 34,500/50,750 of each item and Pat receives 16,250 / 50,750 of each item.

Income	Rental Interest	Taxable Interest	Tax-exempt Interest	Total
Robin (.679803)	11,196	15,536	7,768	34,500
Pat (.320197)	5,274	7,317	3,659	16,250
Total	16,470	22,853	11,427	50,750

9. Who gets taxed on what?

Taxable income before distribution deduction	47,223
Depreciation deductible by beneficiaries	(4,500)
Income that is taxed	42,723
Taxed to trust	7,900
Taxed to Robin	23,731
Taxed to Pat	11,092
Total	42,723

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APPENDIX A
IMMEDIATE PRE-MORTEM INCOME TAX PLANNING . . . .

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IMMEDIATE PRE-MORTEM INCOME TAX PLANNING

A. Consider Gifts That Might Be Made or Received By the Dying Client

1. Non-Appreciated Property Might be Gifted Away. If the dying client is going to make lifetime gifts, it will usually be desirable to make gifts of cash or of property which has a basis close to its fair market value. Generally, the client should NOT gift highly appreciated property with a low tax basis because the stepped up basis on the asset if owned by the client at death will be lost.

2. Loss Property Might be Gifted Away. The client should consider gifts of property in a loss position, to the extent that the client cannot himself use such losses during life. Remember that the "step up" rule under IRC §1014(e) is also a step down rule. It is more correctly referred to as a change of basis at death. The donor's existing basis will be lost unless the gift is made. The donee can hold the gifted asset and if it appreciates in the hands of the donee, can avoid some gain upon later disposition of such asset. IRC §§1014 and 1015.

3. Appreciated Property Might be Received as a Gift. The dying client without an estate tax problem – whether because his gross estate is under $5,000,000 ($3,500,000 for an Illinois resident if all taxes are to be avoided), or because the marital deduction will be used to eliminate the estate tax – may wish to receive gifts of appreciated property prior to death. Such property will be entitled to stepped up basis at the decedent's death unless reacquired by the transferor by inheritance within one year. IRC §1014(e). It appears that such property could be given to the dying spouse by the other spouse within one year of the dying spouse's death and qualify for stepped up basis if such property were left to a wholly discretionary family trust.

4. Client Might be Given (and Exercise) a General Power of Appointment. Rather than giving property to a terminally ill individual, suppose that you simply grant that person a general power of appointment over the property. For example, H could create a revocable trust, funded with low basis assets, and grant W a general power of appointment over the assets in the trust. The general power of appointment will cause the property in the trust to be included in W's estate under IRC § 2041(a)(2). In that event, the property should receive a new cost basis upon W's death. IRC §1014(b)(9). The IRS takes the position that the principles of §1014(e) apply in this circumstance if H reacquires the property, due either to the exercise or the non-exercise of the power by W. See PLR 200101021 ("Section 1014(e) will apply to any Trust property includible in the deceased Grantor's gross estate that is attributable to the surviving Grantor's

contribution to Trust and that is acquired by the surviving Grantor, either directly or indirectly, pursuant to the deceased Grantor's exercise, or failure to exercise, the general power of appointment.", citing H.R. Rept. 97-201, 97th Cong., 1st Sess. (July 24, 1981)). If W were to actually exercise the power in favor of (or the taker in default was) another taxpayer, such as a bypass-style trust for H and their descendants, the result should be different. For estates of persons dying in 2010 whose executors opt out of the federal estate tax, simply holding a general power of appointment over property would not be sufficient to cause the property to be treated as "owned by the decedent" as required by the modified carry-over basis rules in IRC § 1022. As a result, no part of the decedent's basis allocation could be used to increase the basis of these assets. IRC §1022(d)(1)(B)(iii).

5. Certain Charitable Gifts Might be Made During Life. The charitably-inclined client may wish to make charitable gifts during his lifetime (particularly if he already plans to do so at death). That way, the client will get both a charitable income tax deduction for such gifts and remove the gifted property from his taxable estate. Charitable gifts made at death are an estate tax deduction, but are not entitled to be taken as an income tax deduction.

6. Certain Property Might be Gifted to Charity at Death. The client making charitable gifts at death may wish to designate specific property to satisfy charitable gifts, such as IRA proceeds, pension benefits, other items of income in respect of a decedent (such as zero basis crops in storage, renewal commissions receivable, and installment notes receivable). The charity won't have to pay income tax upon receipt of the cash from such items, while family members would.

B. Planning to Optimize Gains, Losses and Credits.

1. Generally Do Not Dispose of Appreciated Property. As noted above, the dying client will want to retain appreciated property that will be entitled to stepped up basis at death. IRC §1014.

2. Capture Capital Losses. If the dying client has incurred capital gains during the year, consider selling high basis assets at a loss during lifetime in order to capture capital losses to offset the gains. The dying client will want to realize losses during his lifetime to the extent usable to offset gains (plus $3,000), as the basis of loss property is stepped down to its fair market value at the client's death and the losses are lost. IRC §1014. Rev.Rul. 74-175, 1974-1 C.B. 52.

3. Recognize Losses in Marital Deduction Trust. Assets with unrealized losses held in a marital deduction trust for the benefit of the dying client will have their cost basis adjusted downwards (to fair market value) at

the death of such trust's beneficiary. IRC §§1014, 2041 and 2044. But if such losses are realized prior to the beneficiary's death, they will be preserved for succeeding beneficiaries and, if not used within the trust, will pass out to the ultimate beneficiaries upon termination of the trust. IRC §642(h).

4. Swap High Basis Assets for Low Basis Assets in Grantor Trust. If the dying client has created an intentionally defective grantor trust – that is a trust in which the grantor of the trust is treated as the owner of the trust property for federal income tax purposes, but not for gift or estate tax purposes – he should consider transferring high basis assets to that trust, in exchange for low basis assets of the same value owned by the trust. The grantor trust status should prevent the exchange of these assets during the grantor's lifetime from being treated as a sale or exchange. Rev. Rul. 85-13, 1985-1 CB 184. The effect of the exchange, however, will be to place low basis assets into the grantor's estate, providing an opportunity to receive a step-up in basis at death. But for the exchange of these assets, the low basis assets formerly held by the trust would not have acquired a step-up in basis as a result of the grantor's death. This same swap avoids a step-down in basis at death. Since the grantor is treated for income tax purposes as the owner of all of the assets prior to death, the one-year look-back of IRC § 1014(e) should not apply to limit the step-up in basis of the exchanged assets. (Note that this swapping power under IRC §675(4)(C) is the one commonly used to make the trust defective for income tax purposes.)

5. Dispose of Passive Activity Loss Assets. The dying client may wish to dispose of passive activity loss assets in a taxable transaction to use suspended passive activity losses that would otherwise be lost at death. IRC §469(g).

6. Terminate Sales Agreement That Will Generate IRD. The client who has recently entered into a large installment sale of an asset may wish to terminate the sales agreement and reacquire or retain the property in order to avoid the loss of stepped up basis at death.

7. Accelerate Income to Avoid Wasting Tax Benefits. It may be advantageous for the client to recognize income during lifetime where there are net operating losses, charitable losses, unused investment tax credits, unused capital losses, or other tax benefits that will be lost upon the taxpayer's death. Ideally, such tax benefits will be used to offset the tax liability from items of income in respect of a decedent which will not qualify for stepped up basis at death (such as pension benefits, renewal commissions receivable, and installment notes receivable). The client could elect out of installment sales treatment on

sales, collect pension and IRA proceeds while still alive, elect to be taxed on accrued E and EE bond interest, etc.

8. Accelerate Income to Generate Estate Tax Deduction. It may be useful to trigger gain during lifetime so that the income tax paid (or still due at death) relating to the sale of the appreciated asset will be deductible for estate tax purposes. The IRS has historically taken the position that the income tax liability that would be due upon the liquidation of a corporation is speculative and, if available, should be heavily discounted. Where the client has a C corporation holding land that will generate a great deal of income tax liability upon liquidation and such corporation will be liquidated anyway in the near term, a deathbed liquidation may make sense.

9. Pay Medical Expenses. Substantial medical expenses are often incurred for terminally ill patients in the year before their death. These medical expenses may be deductible for federal income tax purposes if they exceed 7.5% of the taxpayer's adjusted gross income. IRC §213(a). This threshold may be easier to meet in the year of the decedent's death, especially if the decedent dies early in the year before earning significant AGI, since there is no requirement to annualize income or make other adjustments to reflect a "short" year. Reg. §1.443-1(a)(2). Expenses outstanding at the date of death, if paid within one year after the date of death, may be deducted on the decedent's final income tax return, or may be deducted as a debt on the decedent's estate tax return. IRC §213(c)(1). A "double" deduction is not allowed. IRC §213(c)(2). Note, however, that if the taxpayer actually pays outstanding medical expenses prior to death, they are eligible for deduction on his or her income tax return. At the same time, the individual's cash has decreased as a result of the payment, which has the same effect as deducting them on the estate tax return, since the decedent's estate is effectively decreased by the amount of the expenses paid. Even paying the medical expense by credit card prior to death should be sufficient to allow this double tax benefit. Rev. Rul. 78-39, 1978-1 CB 73.

10. Accelerate Death Benefits. If a taxpayer is covered by a policy of life insurance, the taxpayer may seek to obtain a pre-payment of the death benefits available under the policy. If the payments are received at a time when the taxpayer is terminally ill or chronically ill, the payments may be excluded from gross income. IRC §101(g). The exclusion for prepayment of death benefits applies only to payments received from the insurance company that issued the policy, or from certain licensed "viatical settlement providers." A "viatical settlement" is a transaction in which a third party purchases the policy from the insured. If the insured is terminally ill, payments are tax-free. This exclusion from income applies to both accelerated death benefits and to payments made by a viatical settlement provider (but only if the provider meets

licensing or other requirements). IRC §101(g). For this purpose, a "terminally ill" individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less. IRC §101(g)(4)(A). If the insured is chronically ill, payments are tax-free only if detailed requirements are met. IRC §101(g)(3), IRC §§ 101(g)(4)(B); 7702(c)(2)(A); IRC §§ 101(g)(3)(D); 7702B(d); Rev. Proc. 2010-40, 2010-46 IRB 663 §3.29.

C. Structuring or Restructuring Business Interests

1. Negotiate to Require Section 754 Election. Where the client owns an interest in a partnership holding appreciated assets, it will be beneficial to negotiate to require the partnership to make an IRC §754 election so that an inside basis adjustment can be made pursuant to IRC §743(b) upon the death of a partner. In the alternative, it may be possible to achieve the same result (i.e., stepped up basis) under IRC §732 if a liquidation of the partnership or sale of the partnership's appreciated assets can be accomplished within two years of the deceased partner's death.

2. Negotiate Short Year S Corporation Tax Reporting Treatment. S corporation shareholders are taxed on their pro rata share of income, deductions, and credits for the year of death on their final Form 1040. However, an option exists either to prorate the income on a per day basis, or to close the books upon a shareholder's death and use an exact method. IRC §1366. In the case of a seasonal business it may be desirable to agree in a shareholder agreement which method is to be used.

3. Assure that S Corporation Status Can Continue After Death. Certain individuals and trusts do not qualify to hold stock in an S corporation, and the client's estate plan must be carefully examined to assure that S corporation stock will pass to a qualified shareholder upon the client's death. Generally, a Qualified Subchapter S Trust (QSST) must have a single beneficiary during such beneficiary's lifetime and must distribute all of its accounting income on an annual basis. IRC §1361.

D. Rearranging Joint Tenancy Interests

1. Sever Certain Joint Tenancies With Non-Spouses. Consider severing joint tenancies between owners who are not married to each other. This will avoid the time and expense (and sometimes the futility) of the required tracing of contribution. IRC §2040.

2. Sever Certain Joint Tenancies Between Spouses. Tax rules now in effect provide that one-half of the property held by husband and wife as joint tenants is included in the estate of the first spouse to die and that

the deceased spouse's one-half interest is subject to having its basis adjusted. IRC §§1014 and 2040. However, it has been held that joint tenancy property acquired by a husband and wife prior to 1977 is subject instead to the pre-1977 rules which require a tracing of contribution to determine what portion of it is included in the deceased spouse's gross estate and qualifies for the basis adjustment. *Gallenstein v. United States*, 91-2 USTC ¶60,088 (D.C. Ky. 1991), affirmed 92-2 USTC ¶60,114 (C.A. 6, 1992). Pursuant to Gallenstein (and District Courts in the *Patten* and *Anderson* cases in the 4th Circuit), if husband and wife have pre-1977 joint tenancy property which is in a loss position, and if the spouse who is about to die contributed most (or all) of the consideration, then consider changing title to the property in order to avoid tracing and the step-down in basis and to preserve more basis in the hands of the survivor. Likewise, if the client who is about to die made no contribution to the purchase of appreciated pre-1977 property, an application of *Gallenstein* would suggest that such joint tenancy ownership should be terminated prior to such spouse's death in order to allow the presumption of a 50% basis step-up to apply that would otherwise be denied because of tracing.

➧ Planning Point:

E. Track Defective Grantor Trust Income Separately. As long as we are on the topic of Grantor Trusts: The income and deductions of those trusts – which remain income taxable to the grantor even though the grantor no longer owns the trust assets for estate purposes – are reported by the grantor on his own 1040. Such a grantor trust does not file its own income tax return, or, if it does, it is a shell 1041 stating that all items of income and gain are reported on the return of the grantor and providing the grantor's name and Social Security Number. However, once the grantor has died, the planner would like to assist the family in understanding if sufficient estimated income tax payments have been made, and what assets are included in the grantor's estate. While we would like to look to the 1040 for a quick list of assets, the picture is substantially complicated by this grantor trust activity. We cannot use the 1040 as a checklist for what is owned at death (the grantor trust assets are not owned), and we cannot use it as a guide for what income the surviving spouse or other family members can expect to receive or need to pay tax on, because the grantor trust income is going to be reported separately by the now separate trust filing its own 1041 as of the date of death. Accordingly, during the grantor's lifetime, consider reporting grantor trust income on Schedule E of the grantor's 1040 (and consider doing this from the outset of the establishment of the defective grantor trust). That way the Schedule E assets can be more readily analyzed separately from the rest of the assets on the grantor's return. In other words, don't mix the grantor trust income in with the other income, even though you could.

APPENDIX B - WHO IS A RELATED PARTY?

Although the Code has many different provisions dealing with related parties, the key Section is §267 which is used by most of the other sections with respect to rules for related party transactions. Pursuant to §267(b), related parties include:

II. Members of a family as defined in subsection (c)(4) [i.e., brothers and sisters (half-blood and whole-blood), spouse, ancestors, and lineal descendants];

III. An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

IV. Two corporations that are members of the same controlled group (as defined in subsection (f));

V. **A grantor and a fiduciary of any trust;**

VI. A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

VII. A fiduciary of a trust and a beneficiary of such trust;

VIII. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

IX. **A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;**

X. A person and an organization to which Section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;

XI. A corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock in the corporation, or more than 50 percent of the capital interest, or the profits interest, in the partnership;

XII. An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;

XIII. An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

XIV. **Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.**

Also, there are complex attribution rules which also come into play in determining who is a related party.

How can the Related Parties Rules Harm Our Clients?

1. Section 1031 Exchanges Between Related Parties. Normally, taxpayers who do a 1031 exchange with each other do not care what the other party does with the exchange property after the deal is closed. However, if a taxpayer exchanges property with a related person in a Section 1031 tax-free exchange and within two years of the last transfer which was part of the exchange, either party disposes of the property received by that party in the exchange, then the original transaction does not qualify for the non-recognition of gain or loss under Section 1031 for either party. §§267 and 1031(f).

2. Sales of Depreciable Assets to Related Party. Gain on the sale of a capital asset is usually capital gain income (unless the recapture provisions contained in §§1245 and 1250 apply). However, in the sale or exchange, directly or indirectly, of property between related parties, any gain recognized by the transferor is treated as ordinary income if the property in the transferee's hands is depreciable property. §§267 and 1239.

   Note that §1239, which applies to the sale of depreciable property between related parties, does not appear to apply to depletable property. PLR 8139052 (June 30, 1981).

3. Appreciated Property Acquired By Decedent By Gift Within One Year of Death. In the case of a decedent dying after 1981, if appreciated property was acquired by the decedent within one year prior to the decedent's death, and if such property is subsequently reacquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), then the original donor of such property will not receive a basis step-up at death. For example, a person owning highly appreciated assets could not gift them to his or her terminally ill spouse and get a stepped-up basis if such assets were subsequently reacquired by inheritance within a year. §1014(e).

4. Disallowance of Losses on Sales Between Related Parties. A loss can normally be claimed when investment property is sold at a loss. However, loss is NOT recognized on the sale or exchange of property between related parties (including a trust and its beneficiaries). Any disallowed loss is carried forward and can be applied to reduce the gain that would otherwise be recognized on the subsequent disposition of the property. §267.

➧ ***Planning Point:*** An estate and its beneficiaries are not deemed to be related parties for this purpose, so an estate CAN recognize a loss if it funded a pecuniary bequest with loss property. A trust can make a §645 election to be treated as a part of the estate and avoid the disallowance of losses.

5. Guarantee of Loans to Related Parties. Normally, a guarantor's payment on a debt will be deductible, as either a business bad debt or non-business bad debt. A parent's payment as guarantor on a child's liability will usually not be deductible by the parent. It has been determined that it does not matter whether such a deduction was a business bad debt or nonbusiness bad debt because Reg. §1.166-9(e) allows bad debt deductions only where the taxpayer received reasonable consideration for making the guarantee and provides that consideration received from a spouse or other defined family member must be direct consideration in the form of cash or property. *Lair v. Commissioner,* 95 T.C. 35 (1990).

6. Installment Sale to Related Party. Normally, a taxpayer who sells property on an installment basis does not care how or when the buyer of the property subsequently disposes of it. However, if an installment sale is made to a related party who subsequently resells such property before the original seller has been fully paid (with a 2-year cutoff for property other than marketable securities), the sale by the second party accelerates the recognition of gain to the original seller. §453(e).

7. Non-Recognition of Gain or Loss Between Spouses. When one spouse enters into a sale transaction with the other spouse, the transaction is ignored for income tax purposes (i.e., no gain or loss occurs, so basis is unchanged). §1041.

8. Transfer for Value of Life Insurance. Life insurance proceeds are generally not taxed as income to the payee at the death of the insured. However, if an existing life insurance policy is transferred for value to a non-excepted transferee (i.e., someone other than the insured, a partner of the insured, a partnership including the insured, or a corporation of which the insured was a shareholder or officer), then any proceeds realized in excess of basis will be income to the recipient. §101(a)(2).

APPENDIX C - BASIS ADJUSTMENTS AT DEATH

1. General Rule.

2. Exceptions to General Basis Rules.
   a. Alternate Valuation Exception.
   b. Special Use Valuation Exception.
   c. Income in Respect of a Decedent (“IRD”) Exception.
      (1) General Rule.
      (2) Special Rules for Partnerships.
      (3) Special Rules for S Corporations.
      (4) Reporting Savings Bond Interest.
   d. Certain Lifetime Constructive Sales.
   e. Exception for Qualified Conservation Easement.
   f. Exception for Certain Recently Gifted Property.
   g. Exception for Previously Gifted Property.
   h. Exception for Certain Spousal Joint Tenancies.
   I. Exception for Community Property Interests.
   j. Exception for Stock in a Foreign Personal Holding Company.
   k. Exception for Stock in a DISC.

3. Other Basis Issues.
   a. Appraisal Necessary.
   b. Where No Form 706 Required.
   c. Impact on Depreciation, Depletion, etc
   d. Elective Partnership Basis Adjustments.
   e. Appreciated Undistributed Devises Due Decedent.
   f. Post-Death Capital Gains and Losses.

BASIS ADJUSTMENTS AT DEATH

1. General Rule. The basis of property acquired from a decedent generally becomes the fair market value of that property at date of death unless one of the exceptions outlined below applies. §1014. Property acquired from a decedent includes virtually any property deemed owned by the decedent for estate tax purposes (i.e., included in the decedent's gross estate), including probate and non-probate property, whether or not the decedent's gross estate was large enough to require the filing of a Form 706 Federal Estate Tax Return.

    Example: Often missed, especially where no estate tax return is due, are adjustments which should be made to the basis of non-probate assets such as UGMA and UTMA accounts where the donor was serving as custodian, the home of an elderly parent which was titled in joint tenancy with (or wholly in the name of) the children to avoid probate, etc.

2. Exceptions to General Basis Rules.

    a. Alternate Valuation Exception. If alternate valuation has been elected under §2032, the §2032 value becomes the new basis. §1014. Alternate valuation can only be elected where the gross estate and estate tax due are both reduced as a result of the election. If alternate valuation is elected, ALL estate assets are subjected to the alternate valuation rules. There is no pick and choose. Alternate valuation causes the value of the assets six months after date of death to be used, unless the assets are disposed of or distributed sooner, in which case their value at such earlier date of disposition or distribution is used. Joint tenancy property is treated like probate property for alternate valuation purposes. Death (and the resulting passage of ownership to the surviving joint tenant) is not a disposition for alternate valuation purposes, but the subsequent disposition (by gift or sale) by the surviving joint tenant within the six months after the decedent's death is such a disposition. Rev. Rul. 59-213, 1959-1 CB 244.

    b. Special Use Valuation Exception. If special use valuation has been elected under §2032A, the §2032A value becomes the new basis. §1014. If the special use property is disposed of so that additional estate tax is due, it is necessary to elect increase the property's basis to its date of death value. §§1016(c)(1) and 1016(c)(5)(B); Reg. §301.9100-4T(f). If no election is made, there is no adjustment to the property's basis. Conf. Rept. No. 97-215 (PL 97-34), p. 251. Note that there is no similar provision applied to §2057 qualified family-owned businesses receiving a valuation break (that provision is structured as an exclusion, rather than as a deduction), so such qualified family-owned businesses get full date of death fair market value basis.

c. Income in Respect of a Decedent ("IRD") Exception.

i. General Rule. Items of income in respect of a decedent under §691 are not entitled to stepped-up basis at the decedent's death. Examples of such items include IRA and pension plan proceeds, renewal commissions, deferred compensation, and installment notes receivable.

ii. Special Rules for Partnerships. The basis of a partnership interest acquired from a decedent is the date of death (or alternate) value, increased by the estate's (or other successor's) share of partnership liabilities and reduced by the income in respect of a decedent attributable to such partnership interest. Reg. §1.742-1.

iii. Special Rules for S Corporations. The basis of S corporation stock is date of death or alternate value, reduced by the income in respect of a decedent attributable to such stock. §1367(b)(4).

iv. Reporting Savings Bond Interest. A taxpayer may elect to report all previously unreported Series E or EE Bond interest and thereafter report all Series E or EE Bond Interest as it is accrued. § 454(a). The executor may make this election on behalf of the decedent on the final Form 1040. Rev. Rul. 68-145, 1968-1 C.B. 203. The executor may also make this election for bonds held in the decedent's revocable trust at the time of death. Rev. Rul. 79-409, 1979-2 C.B. 208. If the § 454(a) election is not made, interest will be taxable as IRD to the ultimate recipient. If the interest is IRD, a deduction is available under § 691(c) for any estate tax attributable to the interest. Rev. Rul. 64-104, 1964-1 C.B. 223. If the § 454(a) election is made, no § 691(c) deduction will be applicable, but a deduction for federal estate tax purposes will be generated for the amount of the income tax created on the decedent's final return. Ltr. Rul. 9232006. If federal estate tax is due, making the § 454(a) election will generally lower the overall tax liability.

d. Certain Lifetime Constructive Sales. Certain lifetime constructive sales, amounting to hedging (constructive sale) transactions, such as going "short against the box" during lifetime in order to lock in profit and pull out cash, are no longer be able to be closed out income tax free after death, as the pre-death portion of the gain is considered IRD taxable to the estate or other successor. §1259.

e. Exception for Qualified Conservation Easement. A carryover of the decedent's income tax cost basis occurs with respect to that portion of a property excluded from the decedent's estate by reason of a qualified conservation easement. §§170,1014, 2031, and 2032A.

f. Exception for Certain Recently Gifted Property. Property received as a gift by the decedent within one year of the decedent's death which is gifted by the decedent back to the donor will not receive an adjustment to basis by reason of the decedent's death. §1014(e).

g. Exception for Previously Gifted Property. Property gifted during lifetime that is nevertheless included in the decedent's estate for estate tax purposes (such as §§2035, 2036, 2037, or 2038 property) will be entitled to an §1014 basis adjustment by reason of the decedent's death, but the transferee must reduce such new date of death basis by any depreciation, depletion, or amortization taken by such transferee. Reg. §1.1014-3(d). Conceptually difficult issues are raised when previously gifted property included in the decedent's estate (such as §§2036, 2037, or 2038 property) has been sold and reinvested in something else prior to the decedent's death. For estate tax purposes, the original property is deemed included in the decedent's estate. But if it has been sold, can the donee file and amended income tax return and claim the date of death value as the adjusted basis? See *Humphrey's Estate v. Commissioner,* 162 F.2d 1 (5th Cir), cert. denied, 332 US817 (1947); Rev. Rul. 72-282, 1972-1 CB 306.

h. Exception for Certain Spousal Joint Tenancies. The current rules relating to estate taxation of joint tenancy interests provide that one-half of a spousal joint tenancy asset is included in the deceased spouse's estate under §2040, which results in the deceased spouse's one-half of the asset having its basis adjusted under §1014 and the surviving spouse's one-half of the asset being left with its historic cost basis. Prior to 1982 (pursuant to TRA 1981), the portion of a spousal joint tenancy asset included in the deceased spouse's estate was determined with reference to the deceased spouse's relative contribution to the acquisition of the asset (the so-called "tracing of contribution" test). Accordingly, before 1982 as little as 0% or as much as 100% of a spousal joint tenancy asset might have been included in the deceased spouse's estate under §2040 (and have its basis adjusted in §1014). Several cases have now held that the TRA 1981 amendments to §2040(b)(2) did not repeal the effective date of §2040(b)(1), the net impact of which is to still apply the tracing of contribution rules to spousal joint tenancy assets acquired before 1977. See *Gallenstein v. U.S.,* 975 F.2d 286 (6th Cir. 1992); *Patten v. U.S.,* 116 F.3d 1029 (4th Cir., 1997); *Anderson v. U.S.,* 78 AFTR 2d 96-6555 (DC MD 1996), and *Hahn v. U.S.,* 110 TC 140 (1998).

i. Exception for Community Property Interests. The survivor's one-half interest of community property, as well as the decedent's one-half interest in such property, gets new basis (equal to the fair market value of such assets) at the decedent's death. §1014(b)(6). It is thus essential to ascertain whether or not the decedent and his or her spouse ever lived in one of the community property states (i.e., Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), and if so, if community property was thereby created (and subsequently preserved) --- even if the client resided

in a non-community property state at death. Additionally, Alaska has adopted an elective form of community property. Some states now allow community property to be held in joint tenancy, and it is unclear whether the joint tenancy or community property rules will apply to such arrangements. See *Estate of Wayne-Chi Young,* 110 TC No. 24, Doc. 98-14934 (1998).

j. Exception for Stock in a Foreign Personal Holding Company. The post-death basis of stock in a foreign personal holding company becomes the lower of (a) its fair market value at the date of the decedent's death, or (b) its basis in the decedent's hands. §1014(b)(5).

k. Exception for Stock in a DISC. The post-death basis of stock in a Domestic International Sales Corporation (DISC) becomes its fair market value, reduced by the amount that would have been treated as ordinary income under §995 if the decedent had been alive and sold the stock on the estate tax valuation date. §1014(d).

2. Other Basis Issues.

a. Appraisal Necessary. The applicable date for determining fair market value is "as of" the decedent's date of death, unless alternate valuation date is elected under §2032. The appropriate values will appear on the Form 706.

b. Where No Form 706 Required. Successors to the decedent's property are entitled to new basis even if no estate tax was due by reason of the decedent's death. The fiduciary should obtain an appraisal or other proof to support the new cost basis even if no Form 706 is required (i.e., because the decedent's gross estate totals less than the estate tax exemption-equivalent).

c. Impact on Depreciation, Depletion, etc. Be mindful of the need to recompute future depreciation, depletion, and amortization relative to assets (or that portion of an asset) included in the decedent's gross estate for federal estate tax purposes. Such assets will get a new basis and date of acquisition after the decedent's death, which may also result in a new life and method of depreciation as to such asset (or portion of an asset). Consider electing cost depletion where appropriate.

d. Elective Partnership Basis Adjustments. A partnership (or other entity taxed as a partnership, such as an LLC) may elect to adjust the inside basis of its assets to reflect the outside basis adjustment occurring by reason of a partner's death. §754.

e. Appreciated Undistributed Devises Due Decedent. The death of a beneficiary due undistributed appreciated assets as beneficiary of another estate may or may not result in such undistributed assets having their basis adjusted, depending upon which authority you believe. Compare *Manufacturers Hanover Trust Company v. U.S.,* 410 F.2d 767 (Ct. Cl. 1969) with *Connecticut National Bank v. U.S.,* 937 F.2d 90 (6th Cir. 1991).

f. Post-Death Capital Gains and Losses. All capital gains or losses that occur after death are long-term capital gains or losses if the property sold was included in the gross estate of the decedent, regardless of the length of the post-death holding period. §1223(11). Such long-term treatment may be valuable where a gain occurs, inasmuch as long-term capital gains have historically been afforded favorable tax treatment. Such long-term treatment may be unfavorable where a loss occurs, inasmuch as long-term capital losses in excess of offsetting capital gains can only be utilized to offset ordinary income to the extent of $3,000 per year.