A Fiduciary Income Tax Primer

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This paper is not intended to provide legal advice applicable to a particular situation. If the reader seeks legal advice, the services of a professional advisor should be obtained.

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1. Introduction

The purpose of this paper is to summarize the basic elements of the fiduciary income tax for the benefit of professionals (particularly attorneys and trust officers) who administer trusts and estates or who advise fiduciaries. Those professionals and their clients will regularly make administrative decisions that will impact the fiduciary income taxation of trusts and estates, and those decisions will also impact the individual income taxation of beneficiaries (including the taxation of trusts that are beneficiaries of estates, or are beneficiaries of other trusts). Because administrative decisions have a significant impact on income tax consequences, attorneys and trust officers who administer trusts and estates should familiarize themselves with the basics of fiduciary income taxation. Even if an accountant experienced with the fiduciary income tax is part of the professional team advising an estate or trust, attorneys and trust officers should be conversant on the subject of fiduciary income taxation, if only to spot issues that need to be discussed with the accountant.

This paper is devoted primarily to the federal fiduciary income tax, but discussion of Oregon law and the Oregon fiduciary income tax is also included.

The fiduciary income tax is imposed on the income of all trusts and estates, to be reported by each trust or estate on a Form 1041 federal fiduciary income tax return (and on a Form 41 Oregon fiduciary income tax return). In some cases, the income tax will actually be paid by the trust or estate, but in many cases the income will be taxed to the beneficiaries (or even to the grantor), and the trust or estate will escape tax on that same income. The income allocable to the beneficiaries appears on one or more Schedules K-1 (one for each beneficiary) attached to the Form 1041. In general, the income of a trust or estate will be taxed only once, either to the trust or estate, or to the beneficiaries, or to the grantor. But beneath that general rule lie a myriad of other rules and exceptions to those rules.

Nearly every estate and trust presents fiduciary income tax issues that must be dealt with by the attorneys, accountants, and trust officers administering those estates and trusts. Even an uncomplicated estate involving only a residence, an investment account, and a retirement account will present many fiduciary income tax issues.

The fiduciary income tax is governed by Subchapter J of Subtitle A of the Internal Revenue Code (Internal Revenue Code §§641-692) and the regulations promulgated thereunder. The number of Code sections that govern fiduciary income taxes are relatively few, but they provide an elegant framework that efficiently allocates trust and estate income among the trust, the estate, the beneficiaries, and/or the grantor. In addition, much of the rest of the Internal Revenue Code applies to trusts and estates, because trusts and estates are defined as persons under §7701(a)(1), because taxpayers are defined as persons subject to tax under §7701(a)(14), and because trusts and estates are taxed in the same manner as individuals, with certain exceptions. §641(b).

The general statutes of Subchapter J appear in Subpart A (§§641-646). The statutes applicable to simple trusts appear in Subpart B (§§651-652). The statutes applicable to estates and complex trusts appear in Subpart C (§§661-664). (The distinction between simple trusts and complex trusts is discussed below.) The statutes applicable to grantor trusts appear in Subpart E (§§671-679).

A caution to the reader: Although the general rules governing the fiduciary income tax are relatively simple, the many nuances and exceptions can be very complex; many of the general rules stated in this short paper are subject to exceptions that are not discussed in this paper. In addition, changes to the law may have occurred after this paper was published. References to Internal Revenue Code sections, along with regulations and cases, are included in this paper; please review those Code sections, the applicable regulations, and the case law when applying the general rules to your particular situation, in order to make certain that you are correctly applying the many exceptions and the current law. Other Code sections, regulations, and cases may be applicable that are not cited in this brief summary. Selected additional research materials are listed at the end of this paper. The author would appreciate hearing from readers who have corrections, suggestions, or updates to offer.

A fiduciary must take care to ensure that all of the tax obligations of the estate or trust are satisfied. If a fiduciary were to distribute assets of a trust or estate without completely satisfying those obligations, then two forms of liability are created. First, the fiduciary will become personally liable for those tax obligations, to the extent assets were distributed by the fiduciary. Second, the beneficiaries will be liable for those tax obligations to the extent the beneficiaries received assets. §6901(a). The former is known as fiduciary liability, while the latter is known as transferee liability. In general, these two types of liability are created by state law, but enforced by federal procedural law; §6901(a) is merely a federal procedural statute. *Sawyer v. Commissioner*, T.C. Memo 2011-298; *Julia R. Swords Trust v. Commissioner*; 142 T.C. No. 19 ___ (2014)(appeal pending 4th Cir. 2015); *Feldman v. Commissioner*, ___ F3d ___, Docket No. 12-3144 (7th Cir. 2015). In some situations, state law might even govern the calculation of interest on the transferee tax liability. *Schussel v. Commissioner*, ___ F.3d ___, 114 AFTR2d ¶2014-5038 (2nd Cir. 2014). An additional year is tacked on to the normal statute of limitations if the IRS finds it necessary to enforce fiduciary liability or transferee liability. §6901(c); *see also* Reg. §1.641(b)-2; 31 U.S.C. §3713(b); *United States v. Coppola*, 85 F.3d 1015, 1020 (2d Cir. 1996). The statute of limitations does not even begin to run if no return has been filed, and the tax can be assessed at any time. §6501(c)(3). The obligation for an estate or trust to pay taxes includes the obligation to pay the tax liabilities of the decedent. *United States v. Shriner*,113 AFTR 2d ¶2014-616 (DC Md. 2014). These rules apply to income taxes, estate taxes, and gift taxes. *See also* §6324 regarding estate and gift taxes. The moral of this story: Don't risk the personal assets of the fiduciary in order to save the beneficiaries a few dollars of tax.

Many of the words and phrases used in this paper are terms of art, defined in the Internal Revenue Code, the regulations, or elsewhere. Whenever possible, those exact terms will be employed. For purposes of clarity, practitioners should become accustomed to using that same terminology.

2. Entities not Taxed as Trusts

The fiduciary income tax does not apply to grantor trusts, which include revocable living trusts (while the grantor is alive) and certain other trusts that are specifically designed to be taxed to the grantor. (A brief summary of grantor trusts appears at the end of this paper.) Similarly, assets held in custodianships for minors are not taxed as trusts; income generated by a custodianship is taxed directly to the minor. *Anastasio v. Commissioner*, 67 T.C. 814 (1977), *affirmed without opinion*, 573 F.2d 1287 (2nd Cir. 1977). For the same reason, conservatorships are not taxed as trusts. §7701(a)(6); §6012(b)(2).

3. Tax Rates

Practitioners dealing with trusts, estates, and beneficiaries must keep in mind one fundamental principle: trusts and estates are usually taxed at much higher income tax rates than are most individuals. In 2015, individuals reach the highest tax bracket (39.6%) at $413,200 of taxable income ($464,850 for married couples filing jointly). §1(a), (c). But trusts and estates reach the highest tax bracket at only $12,300 of taxable income. §1(e). Those figures will be adjusted for inflation in future years. *See* Rev. Proc. 2013-35, 2013 I.R.B. 537. (The purpose of those compressed brackets is to prevent taxpayers from using trusts as income tax reduction devices.) For that reason, fiduciaries have a strong incentive to make certain that their trust or estate has very little taxable income, or possibly no taxable income. The most common techniques for minimizing the income of a trust or estate can be summarized as follows, and are discussed in detail in other parts of this paper:

a. Maximizing the use and timing of deductions for administration expenses. This is usually done by paying such expenses before the end of the fiscal year, and by electing to take those deductions on the fiduciary income tax return, and not on the estate tax return. (In some cases, the reverse is better, as is discussed below.) If done properly, the taxable income of the trust or estate can be reduced to a small amount, or possibly to zero. (In an estate, some administration expenses, such as attorney fees and personal representative's fees, require prior court approval; plan ahead.) These various deductions are discussed below, as is the election whether to take the deductions for income tax purposes or estate tax purposes.

b. Maximizing the use and timing of the distribution deduction by making distributions to beneficiaries. §651; §661. In general, those distributions need to be made before the end of the tax year, or within 65 days following the end of the tax year. If done properly, the taxable income of the trust or estate can be reduced to a small amount, or possibly to zero, and the income will then be taxed to the beneficiaries at their lower tax rates. §652; §662. (In an estate, distributions require prior court approval; plan ahead.) The distribution deduction is discussed in greater detail below.

c. Closing an estate on or before the end of the fiscal year, or terminating a trust on or before the end of its fiscal year. If this is accomplished, then all of the income, gains, deductions, and other tax attributes of the trust or estate for that final tax year will flow out to the beneficiaries to be taxed at the beneficiaries' rates, not at the higher rates of the trust or estate. §662; §643(a)(3); Reg. §1.643(a)-3(d). In many cases, the estate or trust can be commenced and closed within the same tax year, so that year becomes both the first tax year and the final tax year. In many cases, that will often be the simplest solution. (In an estate, final distributions require prior court approval; plan ahead.) The final year is discussed in greater detail below.

Many years ago, trusts were taxed in lower brackets than individuals. Because some taxpayers were able to minimize taxation by accumulating income in trusts and distributing that income in subsequent years, Congress enacted what are known as the throwback rules to increase the taxation of such distributions. §§665-667. Although those statutes are still on the books, they have little impact due to subsequent changes in the tax rates applicable to trusts and estates. In addition, 1997 amendments to the throwback rules now make them primarily applicable to foreign trusts.

4. Simple vs. Complex Trusts; Credit Shelter Trusts

Trusts are generally divided into two types for purposes of the fiduciary income tax:

- A simple trust is one that is required to distribute all of its income on a current basis, and it may not pay or permanently set aside funds for charitable purposes. §651(a). If during any particular tax year a simple trust distributes principal, it will be treated as a complex trust for that tax year. §651(a)(2); Reg. §1.651(a)-3(b). If it does not distribute any principal in the following year, it will regain its status as a simple trust. Reg. §1.651(a)-3(b). Similarly, an in-kind distribution causes a simple trust to be reclassified as a complex trust. Rev. Rul. 67-74, 1967-1 C.B. 194. See the discussion of in-kind distributions, below. Because distributions of principal cause a trust to be taxed as a complex trust, all trusts are complex trusts in their final year.

- A complex trust is any trust that is not a simple trust. §661. Thus a complex trust may accumulate income, may distribute corpus, and may make charitable contributions. If a trust qualifies as a simple trust under §§651 and 652, then it will be governed by those sections and not by §661. For example, if a trust is permitted to distribute principal, but in a particular year it distributes only income, it will be taxed as a simple trust. Reg. §1.661(a)-1. Thus the Code establishes a priority that trusts be classified as simple trusts if possible.

The Code does not use the terms simple and complex, but the regulations adopt that terminology. Reg. §1.651(a)-1.

An estate is neither a simple trust nor a complex trust, but it is taxed in the same manner as a complex trust. §661; §662; Reg. §1.661(a)-1.

Where does a credit shelter trust fit into this scheme? Is it a simple trust or a complex trust? Or is it a grantor trust? (See the discussion of grantor trusts, below.) A typical credit shelter trust has the following characteristics:

a. It was created by the will or revocable trust of the first spouse to die.

b. The surviving spouse is the trustee.

c. The surviving spouse is entitled to receive all of the net income of the trust for the rest of her life.

d. The surviving spouse may receive discretionary distributions of principal under an ascertainable standard that permits distributions of principal for her health, education, maintenance, and support in order to maintain her standard of living. This is known as a HEMS standard.

e. After the death of the surviving spouse, the remainder of the trust passes to the children of the couple.

Such a trust is a simple trust, except for those years in which principal is distributed, in which event it would be a complex trust for that year. §651(a)(2); Reg. §1.651(a)-3(b). As a simple trust, it is required to file a separate income tax return (Form 1041), which would report the ordinary income as passing out to the surviving spouse and taxable to the surviving spouse, regardless of whether that ordinary income is actually distributed or not. §652(a). The result would be the same if it were classified as a complex trust; if it is required to distribute ordinary income, that required amount will be taxed to the surviving spouse regardless of whether it is actually distributed. §662(a)(1).

But could it be classified as a grantor trust, thus eliminating the need for the surviving spouse to file a separate income tax return for the credit shelter trust created by her late husband? Couldn't the surviving spouse simply report the income (and capital gains) on her individual income tax return (Form 1040)? The grantor trust statutes include within the definition of a grantor trust any trust subject to the power of a person to vest the income *or* the principal in that person. §678(a)(1). Thus a typical credit shelter trust might appear to be a grantor trust.

Is it a regular (simple or complex) trust, or is it a grantor trust? The question is much debated. Clearly, the surviving spouse is taxed on the ordinary income, and §678(a)(1) states that such a trust is a grantor trust. But who is taxed on the capital gains? Some practitioners believe that a trust can be a grantor trust as to income, while not being a grantor trust as to principal, and §678(a) itself does state that a person shall be treated as the grantor if that person holds a power over "any *portion* of a trust" with respect to which the person holds a power to withdraw income *or* principal. (Emphasis added.)

The Ninth Circuit, sitting *en banc*, has held that a credit shelter trust is not a grantor trust. In *United States v. DeBonchamps*, 278 F.2d 127 (9th Cir. 1960), the Ninth Circuit held that a surviving spouse who had the right to withdraw income, but whose right to withdraw principal was limited by a standard, would be taxable on the income, but not on the capital gains, even though the standard was a rather loose one. In *DeBonchamps*, the rights were created by a deed that granted to the surviving spouse an income interest, along with the right to withdraw principal under a standard, with the remainder passing to a remainderman. Although a trust was not expressly created, the court held that the situation would be taxed as if it were a trust, the grantor trust statutes would not apply, and the capital gains would be taxed to the trust, not to the surviving spouse. See also, Blattmachr, Gans, and Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, ACTEC Journal, Vol. 35, No. 2, Fall 2009, which reached the conclusion that the right to withdraw income, combined with the right to withdraw principal under an ascertainable standard, did not trigger grantor trust status under §678(a)(1).

Thus the safest answer seems to be that a typical credit shelter trust is not a grantor trust, and it should obtain its own EIN (employer identification number) and file a separate return, in which case the surviving spouse will be taxed on the ordinary income through the issuance of a K-1, and the trust will be taxed on the capital gains. This also means that a personal residence held in a credit shelter trust is not eligible for the capital gains exclusion on personal residences provided by §121. PLR 200104005; PLR 199912026; Reg. §1.121-1(c)(3). See the discussion of capital gains and losses, below.

5. Filing Thresholds

An estate must file a Form 1041 if it has gross income of $600 or more, or has a nonresident alien beneficiary. Reg. §1.6012-3(a)(1)(i).

A trust must file a Form 1041 if it has any taxable income for the year, gross income of $600 or more, or a beneficiary who is a nonresident alien. Reg. §1.6012-3(a)(1)(ii).

For purposes of determining whether a trust or estate has gross income in excess of $600, gross income does not necessarily include gross proceeds from the sale of a capital asset. Instead, gross income includes an amount equal to gross proceeds minus basis. Reg. §1.61-6(a).

6. Estimated Taxes

Estates and trusts are required to pay quarterly estimated federal fiduciary income taxes in a manner similar to individuals. §6654(l)(1). (The state of Oregon does not require estimated fiduciary income taxes.) The quarterly installments for calendar year trusts and estates are due on April 15, June 15, September 15, and January 15.

Estates need not pay estimated taxes for tax years ending before the second anniversary of the date of death. §6654(l)(2). Trusts are obligated to pay such estimated taxes, but not if the trust has made a §645 election to use a fiscal year as part of the decedent's estate. Reg. §1.645-1(e)(4). See the discussion of a trust's election to use a fiscal year, below. (Regarding estimated taxes for the decedent's final individual income tax return, see the next section.)

Nor are estimated taxes due if the preceding tax year was a twelve-month year and had no tax liability. §6654(e)(2). Form 1041 specifically asks whether the estate has been open for more than two years, and if so, an explanation is requested.

Estimated taxes are not required unless the estate or trust is expected to owe at least $1,000 in tax, §6654(e)(1), or the withholdings and credits are expected to be the lesser of ninety percent of the current year's tax or 100% of the prior year's tax, assuming the prior year was a twelve-month year. §6654(d)(1). If the adjusted gross income is more than $150,000, then the 100% requirement becomes 110%. §6654(d)(1)(C)(i).

A trust (or an estate in its final year) is permitted to elect to treat its estimated tax payments as if the payments had been made by the beneficiaries. §643(g)(1)(A). The election must be made within sixty-five days following the end of the taxable year, and a late election is not valid. §643(g)(2). The election is made by filing a Form 1041-T. As a result of this election, the estimated tax payments of the estate or trust are allocated to the beneficiaries to reduce the tax liability of the beneficiaries. The estimated tax payments are allocated to the beneficiaries as of the last day of the tax year of the trust, and are treated as if the beneficiaries had paid those estimated taxes on January 15 of the following year. §643(g)(1)(C)(ii). Because the estimated payments are deemed to have been paid on January 15 of the following year, the §643(g) election is of little assistance to beneficiaries who should have made estimated payments in earlier quarters. (The trustee might consider advising the beneficiaries that such an election does not retroactively cure any problems of beneficiaries who are under-estimated for prior quarters.) The allocation is treated as a second tier distribution to the beneficiaries, and thus it is shown on Form 1041 Schedule B as an "other amount paid." (See the discussion of tiers below.) The Schedule K-1 provided to each beneficiary will reflect the allocation.

The allocations of estimated tax to multiple beneficiaries need not be equal; the Form 1041-T allows unequal allocations. The election applies to estimated taxes only; it does not apply to tax withholdings. §643(g)(1)(A).

7. The Decedent's Final Tax Year and the First Tax Year of an Estate or Trust

Like all taxpayers, trusts and estates are required to adopt a taxable year. With some exceptions (see the following section), trusts are required to use a calendar year, §644(a), while estates are permitted to use either a fiscal year or a calendar year. §441(e).

The taxable year of a decedent ends on the date of death, and his executor or trustee is obligated to file a final personal income tax return (Form 1040) for the short year beginning on January 1 and ending on the date of death. Reg. §1.443-1(a)(2). That return is not due until April 15 of the following year, regardless of when during the year the decedent died. Reg. §1.6072-1(b). Subject to some exceptions, the surviving spouse is permitted to file a joint return for that tax year. That joint return will report the surviving spouse's income for the entire year, and the decedent's income for the short year during which he was alive. §6013(a)(3); Reg. §1.6013-1(d). The allocation of the income tax liability between the decedent and the surviving spouse is determined under Reg. §20.2053-6(f).

A final return for the decedent is not required to be filed if the decedent's income was under the filing threshold for the year of death. The filing threshold varies from year to year, and is based on the decedent's age, the standard deduction, the personal exemption, and the filing status of the decedent. §6012(a). *See also* Reg. §1.443-1.

The decedent's final individual income tax return is usually signed by either the personal representative (or trustee) or, in the case of a joint return, by the surviving spouse (who signs as surviving spouse if a fiduciary has not been appointed). Section 6012(b)(1) authorizes the decedent's final return to be signed by "his executor, administrator, or other person charged with the property of such decedent." See also the instructions to Form 1040, §7701(a)(6), and CCA 201334040. The fiduciary income tax return is signed by the personal representative or trustee. §6061; Reg. §6061-1(a). If two fiduciaries are serving as co-fiduciaries, then only one needs to sign the fiduciary income tax return. See the instructions to Form 1041. In contrast, if two or more fiduciaries are serving, all need to sign the Form 706 estate tax return, Reg. §20.6018-2, although the instructions to the Form 706 state that only one fiduciary needs to sign. See also §2203 regarding the signing of estate tax returns. Although §2203 states that if no executor is appointed, any person in possession of the decedent's property may sign an estate tax return, that code section does not apply to income tax returns.

If the decedent's final individual income tax return shows a refund due, the filing of a joint return by the surviving spouse is sufficient to claim the refund. If the surviving spouse is a court-appointed fiduciary, a copy of the court appointment should be attached to the Form 1040. Other filers need to attach a Form 1310 to the return. See the instructions to Form 1040.

A decedent's estate (or trust) is not required to make estimated payments on the decedent's individual (Form 1040) tax liability after the date of death. PLR 9102010 (10/10/90). However, a surviving spouse may need to continue to make estimated payments.

The personal representative of an estate (or the trustee of a formerly-revocable trust) should file a Form 56 (Notice Concerning Fiduciary Relationship) with the IRS to ensure that the fiduciary will receive any notices concerning the decedent's tax liability. If an income tax refund is owing to the decedent, a federal Form 1310 should be filed with the return, and/or an Oregon Form 243 should be filed. Under some circumstances, a fiduciary can ask to be released for certain income tax liabilities, or can request a prompt assessment of such liabilities. For a discussion of releases and requests for prompt assessment, see Mitchell, *Tax Procedure Issues for Estates and Trusts*, Oregon State Bar Estate Planning and Administration Section Newsletter, Vol. XXVII, No. 3, July 2010.

If the decedent's assets were held in a revocable trust, the successor trustee will usually obtain an EIN (employer identification number) for the now-irrevocable trust and then proceed to administer the trust and eventually distribute the assets to the beneficiaries and file a final fiduciary income tax return. However, in some cases distributing trust assets immediately following a terminating event (such as the death of the decedent) is a simple and advantageous alternative. Thus, when a revocable trust calls for termination of the trust upon the death of the trustor, the successor trustee has two choices. First, the successor trustee may continue the trust as a new trust with its own EIN, which will then carry out the various administrative tasks and file fiduciary income tax returns for the period of administration. Such a trust is often described as an administrative trust, even though it might continue in existence for a year or two or more. Second, in the alternative, the successor trustee might decide to forgo the administrative trust and simply distribute the assets of the trust to the beneficiaries in a prompt fashion, without obtaining an EIN or filing fiduciary income tax returns. If that second alternative is chosen, then the successor trustee will supply appropriate income tax information to the beneficiaries, and the beneficiaries will each report their share of the income earned after the date of death, along with their share of the deductions. Reg. §1.641(b)-3(d). This second alternative might be appropriate if the post-mortem administration of the trust is very straight-forward, such as is the case with a small trust that has no need to file federal or Oregon estate tax returns.

The first tax year of a decedent's estate (or formerly-revocable trust) begins on the day after the death of the decedent, regardless of the time of day that death took place, and regardless of when the personal representative is appointed. However, transactions carried out after the moment of death are likely to be viewed as transactions of the estate, not the decedent. This point is not entirely clear. Some practitioners believe that transactions that take place on the date of death, but after the moment of death, are still included in the decedent's final tax year, and are not included in the first tax year of the estate. They base that opinion on the following language of §691(a)(1):

(a) Inclusion in Gross Income.
   (1) General rule. -- The amount of all items of gross income in respect of a decedent which are not properly includable in respect of *the taxable period in which falls the date of his death* or a prior period ... shall be included in the gross income for the taxable year when received, of [the estate]. (Emphasis added.)

The tax year of the estate ends on the last day of a month selected by the executor, as long as the first tax year does not exceed twelve months. §441(e). As a result, the first tax year of an estate is almost always a short year, unless the decedent died on the last day of a month. If the decedent died in the middle of a month, then the first tax year could be as short as two weeks, or as long as eleven and a half months. For example, if a decedent died on May 10, 2013, the first tax year of the estate could end as early as May 31, 2013, or as late as April 30, 2014, but the first tax year could not possibly extend beyond April 30, 2014.

The selection of an ending month for the fiscal year is made by filing an initial fiduciary income tax return for the period ending on the last day of that month. Reg. §1.441-1(c)(1). The election may be made on a late-filed return. Reg. §1.441-1(c)(1). The filing of an extension request, or the filing of a Form SS-4 (application for EIN), or the payment of estimated taxes, does not constitute the making of an election to use a fiscal year, nor does it constitute the selection of an ending month, even though the Form SS-4 asks for the ending month of the fiscal year.

The selection of a fiscal year has important tax implications for the beneficiaries of a trust or estate, in addition to the tax implications for the trust or estate itself. If a trust or estate makes a distribution of distributable net income (DNI) to a beneficiary (or income is deemed to be taxable to the beneficiary under §652(a) or §662(a)(1)), then the beneficiary will be taxed on that distribution in the tax year of the beneficiary in which the tax year of the estate or trust ends. §662(c); Reg. §1.662(c)-1. In some cases, it may be desirable to select a first fiscal year that is as long as possible, in order to defer taxation. Selecting a long fiscal year also increases the possibility of completing the administration of the estate or trust within one year, so that the first fiscal year is also the final year, thus allowing all of the income (or the excess deductions) to be carried out to the beneficiaries, with no chance that any of the income will be taxed at the higher income tax rates of the trust or estate. §662; §643(a)(3); Reg. §1.643(a)-3(d). See the discussion of the final tax year, below.

The selection of a fiscal year can be used to prevent a trust from earning sufficient income in the first tax year to put the trust or estate in the highest income tax bracket. If need be, the trustee or personal representative can monitor the income as it is received, and then terminate the tax year before the amount is reached that would place the estate or trust in the highest bracket.

The selection of a fiscal year can also help solve the following related problem. Assume that an estate has experienced a significant taxable event, such as the withdrawal of significant funds from an IRA. If the estate has also experienced significant expenses and needs to make certain that those expenses are incurred in the same tax year as the taxable event, the selection of a fiscal year can help achieve that goal. Or perhaps the estate has experienced a significant taxable event that occurred within the first twelve months of the estate administration, but that first twelve-month period has now ended, and the estate failed to distribute that income to the beneficiaries. These problems can often be addressed by selecting a year-end that causes the estate to have a very short first year (say, a first fiscal year of only three or four months), followed by a full twelve-month second year. That decision can be made at any time prior to the filing of the first fiduciary income tax return, and it can be made even though it causes the return for the short first year to be overdue, since the election of a fiscal year can be made on a late-filed return. This technique cannot be used if the tax issues occur in a formerly-revocable trust that has elected under §645 to use the fiscal year of the estate (discussed in the following section), since the §645 election cannot be made on a late-filed return. §645(c).

For example, assume that a decedent died in February, 2013. The longest possible first fiscal year of the estate would end on January 31, 2014, and the personal representative made a tentative decision to use that year end for the fiscal year. The estate withdrew all of the funds in a large IRA account in October 2013, but no significant expenses were incurred in 2013, nor were any distributions made. In April 2014, the personal representative realized that using a fiscal year end of January 31, 2014, would result in a significant tax due at the highest rates, because of the lack of deductible expenses and the lack of deductible distributions. What can the personal representative do in April 2014 to remedy this situation? Rather than use a year end of January 31, the personal representative could decide to use a year end of September 30. Although the income tax return for a year ending September 30 was due on January 15, the personal representative could nevertheless file a late return and make the election to use September 30 as the year end (paying particularly close attention to any applicable interest and penalties.) The personal representative would then have until September 30, 2014, to mitigate the large taxable event that occurred in October 2013. That mitigation could take the form of (a) paying deductible expenses, (b) making distributions that carry out income to the beneficiaries, or (c) closing the estate in order to carry the income out to the beneficiaries in the final tax year.

If the beneficiary has the same year-end as the trust or estate, distributions to the beneficiary will cause the beneficiary to be taxed on the trust or estate income in the same year that the trust or estate received the income. §652(c). If the beneficiary is on a different tax year, the beneficiary will be taxed in his or her tax year in which the trust or estate tax year ends. §652(c). This is a deferral opportunity: If the trust or estate tax year ends on January 31, 2013, the income earned during most of 2012 will not be taxable to the beneficiary until 2013, and the tax will not be payable by the beneficiary until April 15, 2014 (subject, of course, to the need for the beneficiary to make estimated tax payments of his individual tax liability).

If a decedent's will creates a testamentary trust, the first tax year of the testamentary trust does not begin on the date of death, because the trust typically acquires no assets on that date. Instead, the first tax year of a testamentary trust begins when the trust first acquires assets, which is usually on the date that the probate estate distributes its assets to the testamentary trust. *United States v. Britten*, 161 F.2d 921 (3rd Cir. 1947); *Maresca Trust v. Commissioner*, T.C. Memo 1983-501. If a partial distribution is made to the trust from the estate prior to the termination of the estate, then the trust will have been created on that earlier date of the partial distribution.

An annual fiduciary income tax return is due within three and a half months following the end of each taxable year. §6072(a). The federal form is 1041; the Oregon form is 41. Thus an estate or trust with a tax year ending on December 31 will file its annual fiduciary income tax return on or before April 15, while an estate with a tax year ending June 30 will file its annual fiduciary income tax return by October 15.

An automatic extension of the time within which to *file* a return for a trust or for an estate can be obtained by filing a Form 7004 on or before the due date of the return. *See* §6081; Reg. §1.6081-6(a). (Form 8736 is no longer used.) Unlike extensions for individual returns that are for six months, the automatic extension for a fiduciary return is for only five months. Extensions of time to *pay* the tax are not authorized. Reg. §1.6081-6(c). Further extensions to file beyond the original five-month extension are not authorized. Reg. §1.6081-6(a). The extension of the time to file a return for a trust or estate does not extend the time for the beneficiaries to file their returns or to pay their tax. Reg. §1.6081-6(d). As a result, a fiduciary who extends the time for filing a fiduciary income tax return should advise the beneficiaries to obtain their own extensions of time to file their individual returns, and should advise them to pay an estimated tax at the time that the beneficiaries extend their own returns.

8. Formerly-Revocable Trust Election to Use a Fiscal Year

Although trusts are generally required to use a calendar tax year, §644(a), a formerly-revocable living trust may elect to use a fiscal year following the death of the grantor. §645. This election is made by filing a Form 8855, in which the revocable living trust (which is now neither revocable nor living) elects to be taxed as if it were part of the decedent's estate. The form is normally filed with the first fiduciary income tax return filed for the estate. It is due by the due date of the return, or the extended due date; the election cannot be made on a late return. §645(c). The §645 election is irrevocable. §645(c). The election is available regardless of whether a probate estate is actually being administered for the decedent, but an EIN (employer identification number) must nevertheless be obtained for the estate, and the estate will file the Form 1041 under that EIN. The trust will also obtain an EIN, but the trust will not file a return; the EIN of the trust will be listed on Part III of the Form 8855, and the trust will be treated as a separate share of the estate for purposes of the separate share rule. Reg. §1.663(c)-4(a). (The trust itself might consist of two or more separate shares; see below for a discussion of the separate share rule.) If a probate estate is being administered, then both the estate and the trust will report their income on the same Form 1041, which will be the income tax return of the estate.

The election to be treated as part of the decedent's estate may not be continued indefinitely. If a federal estate tax return is not filed, the election may remain in place for up to two years following the date of death. §645(b)(2)(A). If a federal estate tax return is filed, the election may remain in place until six months after the estate tax liability is finally determined. §645(b)(2)(B). The filing of a state estate tax return is not relevant for the purpose of this rule.

The election may be used only by (and applies only to) a Qualified Revocable Trust (QRT) as defined by Reg. §1.645-1(b)(1). The election cannot continue to be used by subsequent trusts that are created by or funded by the QRT. Reg. §1.645-1(f)(1).

After the period during which a fiscal year is permitted has expired, the trust will then be required to file a short-year return ending December 31, and subsequent returns will be full-year returns ending December 31. Reg. §1.645-1(h)(4)(ii). At the end of the §645 election period, the trust is deemed to have distributed its assets and all of its tax attributes to a new trust in a distribution to which §661 and §662 apply. Reg. §1.645-1(h)(2). The trustee may need to obtain a new EIN for the trust, depending on whether an estate exists. *See* Reg. §1.645-1(h)(3); Reg. §301.6109-1(a)(4).

The election to be treated as part of the decedent's estate, and to use the fiscal year of the estate, also triggers several other fiduciary income tax benefits that estates are allowed, compared to trusts. Those benefits include fewer obligations to pay estimated taxes, use of the charitable set-aside deduction, use of the exemption applicable to estates, and fewer restrictions on holding S corporation stock, among others. Those benefits are discussed separately under those topics.

9. The Final Tax Year

Special rules apply to the final tax year of all trusts and estates. The primary purpose of most of these special rules is to shift all of the tax liability for the final year to the beneficiaries. As a result, all trusts and all estates pay no income taxes for income received (or gains realized) in their final year, but they nevertheless must file a final return. The reason why no tax is due: the Code is designed to permit trusts and estates to distribute all of their assets to their beneficiaries at the end of their final year, without any need to hold back a reserve to pay income taxes. All of the income, capital gains, and deductions are reported on the final return, but then a distribution deduction is allowed for all of the income and capital gains (unlike a non-final year), and then all of the income, deductions, and gains are carried out to the beneficiaries. §662; §643(a)(3); Reg. §1.643(a)-3(d).

This is a very important rule, and so it bears repeating: trusts and estates pay no taxes in their final year; all of their income, gains, deductions and other tax attributes flow out to the beneficiaries in the final year; and the beneficiaries pay the resulting tax or obtain the benefit of any excess deductions. §662(b). Although the Code does not expressly state that the final year involves no tax liability for an estate or trust, that is the net effect of §§662 and 643.

For that reason, simple trusts are no longer classified as simple trusts in their final year; they are classified as complex trusts. The mechanism that forces that classification is §661(a)(2) and the last sentence of §651(a). Reg. §1.651(a)-3(a).

Any excess deductions in the final year flow out to the beneficiaries to be used by the beneficiaries on their individual tax returns, subject to two restrictions. §642(h). Excess deductions are defined as the amount by which deductions exceed gross income in the final year. §642(h); Reg. §1.642(h)-2(a). For purposes of calculating the excess deductions, the personal exemption and the charitable deduction are disregarded. §642(h)(2). In effect, the charitable deduction in the final year is wasted. *O'Bryan v. Commissioner*, 75 T.C. 304 (1980). The distribution deduction is also disregarded. §643(a)(1).

Although §642(h) provides that excess deductions in the final year flow out to the beneficiaries to be used by the beneficiaries on their individual tax returns, two restrictions apply. Because of those two restrictions, some beneficiaries will not be able to use the excess deductions. Those restrictions stem from the fact that excess deductions are considered to be miscellaneous itemized deductions on the individual income tax returns of the beneficiaries. §67(b). Miscellaneous itemized deductions can be used by a beneficiary (1) only if the beneficiary itemizes his deductions, and (2) even then the deductions can be utilized by the beneficiary only to the extent that his miscellaneous itemized deductions exceed two percent of the beneficiary's adjusted gross income (known as the two percent floor). §67(a); §642(h); Reg. §1.642(h)-2(a); Rev. Rul. 59-392, 1959-2 C.B. 163. Those excess deductions cannot be carried forward or backward by a beneficiary to a subsequent year or a prior year; they may be used, if at all, in the beneficiary's year in which the trust's final year or the estate's final year ended. Reg. §1.642(h)-2(a). If the trust or estate passes out a net operating loss carryover or a net capital loss, the beneficiaries may continue to carry over the losses. Reg. §1.642(h)(1).

When does a trust terminate? A trust does not end its existence simply because the governing document states that the trust terminates upon the happening of a particular event. Instead, the trust continues in existence until it has distributed all (or almost all) of its assets. Reg. §1.641(b)-3(b); Reg. §1.641(b)-3(c)(1); *Dominion Trust Co. of Tenn. v. United States*, 786 F.Supp. 1321 (M.D. Tenn. 1991) *affirmed* 7 F.3d 233 (6th Cir. 1993; unpublished opinion); *Herbert v. Commissioner*, 25 T.C. 807 (1956), *acq*. 1956-2 C.B. 6; Rev. Rul. 55-287, 1955-1 C.B. 130. For example, if a trust document states that the trust terminates upon the death of the life income beneficiary, and the document then requires that the trust distribute all of its assets to a remainderman, the trust does not actually terminate on that date of death. Similarly, a revocable living trust might provide that it terminates on the death of the trustor, but the trust usually continues in existence for the purposes of paying debts, resolving claims, filing the decedent's final income tax return, filing an estate tax return, filing income tax returns for the trust, resolving an estate tax audit, liquidating assets, formulating a plan of distribution, obtaining releases, etc. Not all of those tasks are required of every trust, but nearly all trusts have tasks to complete before the assets can be distributed to the ultimate beneficiaries. In *Dominion Trust*, the completion of those tasks took more than three years. In *Lowery v. Evonuk*, 95 Or. App. 98 (1989), the court held that a trustee had not administered a trust within a reasonable period of time when the post-mortem administration of the trust took more than twenty-one months. Of course, what constitutes a reasonable time depends of the facts and circumstances of each case; twenty-one months might be too short for a large, complex trust. Even if a court orders a trust to be terminated, the trust does not terminate until it has accomplished the tasks necessary to effectuate a full distribution of its assets. *Richards v. Campbell*, 21 AFTR2d 1122, 68-1 USTC ¶9288 (N.D. Tex. 1968). However, ORS 130.730 requires that a trustee proceed expeditiously to distribute trust property following a terminating event, and thus a trustee has an obligation to complete those tasks with reasonable promptness. *See also* Reg. §1.641(b)-3(a).

Although a trust terminates for tax purposes when it has disposed of all of its assets, the trust may retain a reserve for contingencies and still be treated as having been terminated. Reg. §1.641(b)-3(a), (b).

If the goal is to distribute all of the assets of a trust or estate before the last day of the final fiscal year, and then file the final fiduciary income tax returns a few months later, this question is often posed: How will the fiduciary pay for the preparation of the final returns when the fiduciary holds no assets? Some attorneys hold back a reserve for that purpose, but a simpler solution is to ask the accountant to agree to a pre-determined fixed fee for the preparation of the final returns. That fee can then be paid to the accountant immediately before the final distribution of all of the remaining assets to the beneficiaries. After all, no tax will be due with the final returns.

If the final tax year concludes prior to the end of a calendar year, some accountants are reluctant to file a final return until the following tax season, when new tax forms become available, new tax return preparation software becomes available, and end-of-year forms 1099 are issued. For example, if a decedent dies in January 2014 and the estate fully distributes its assets and closes in August of 2014, the final Form 1041 is due December 15, 2014, and the return is supposed to be filed using 2014 tax forms, but 2014 forms (and 2014 tax return preparation software and 2014 1099s) won't become available until January of 2015. Filing that return during the subsequent tax season in early 2015 usually causes no harm (even though it is technically late), but some fiduciaries prefer to file the final return sooner, in order to fully and finally satisfy their all of their duties. One solution: the IRS usually will accept that final 2014 return filed on 2013 forms if the "2013" in the upper-right corner of the forms is crossed out and "2014" is written in bold digits above the struck-out "2013." For tax return preparers who are required to file all of their returns electronically, a special "opt-out" Form 8948 can be attached to the return and will permit the preparer to file such a return in paper form.

Note that the beginning date of a fiscal year (not the ending date) governs the year of the Form 1041 to be used. A fiscal year beginning July 1, 2014, and ending June 30, 2015, should be filed using 2014 forms, not 2015 forms. See Form 1041 and its instructions. That solves of the problem of needing tax forms and tax preparation software, but it does not solve the problem of needing 2014 1099s.

As discussed above, fiduciary income tax returns are signed by the personal representative or trustee. §6061; Reg. §6061-1(a). But because the final tax year ends when all of the assets have been distributed, the personal representative or trustee usually finds himself signing the final fiduciary income tax returns after the trust or estate has been closed or terminated. In an estate, the personal representative has usually been discharged by the time the final fiduciary returns are prepared and are ready to be signed and filed. And a trustee, who no longer holds any assets, is technically no longer serving as trustee. Can these former fiduciaries nevertheless sign the final income tax returns? There is no legal authority directly on point, but most attorneys believe that such fiduciaries do have the authority, and the obligation, to sign and file the final returns. (In Washington, RCW 11.68.114 provides that a personal representative of a closed probate retains the authority to deal with taxing authorities, and may retain a reserve of up to $3,000.) Reg. § 1.641(b)-2(a) is clear that the obligation continues after the discharge:

> The fiduciary is required to make and file the return and pay the tax on the taxable income of an estate or of a trust. Liability for the payment of the tax on the taxable income of an estate attaches to the person of the executor or administrator up to and <u>after his discharge</u> if, prior to distribution and discharge, he had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed. (emphasis added)

10. Fiduciary Accounting Income

Fiduciary accounting income is essentially the income of a trust or estate defined by the will or trust, and by local law. §643(b). In general, the IRS will not honor definitions of income contained in a trust document that fundamentally vary from state law. Reg. §1.643(b)-1. In most states, the principal source of that law is the Uniform Principal and Income Act, which has been enacted in Oregon as chapter 129 of the Oregon Revised Statutes. Because fiduciary accounting income is based on state law, it is usually expressed as a dollar amount net of expenses. The Uniform Principal and Income Act refers to it as net income. ORS 129.205(8).

The fiduciary income tax provisions of the Internal Revenue Code refer to fiduciary accounting income whenever the word income is not preceded by the words gross, taxable, distributable net, or undistributed net. §643(b).

A trust or estate is permitted to compute its taxable income under the cash method, the accrual method, or other permissible methods. §446(c); *see also* §641(b); §7701(a)(1), (14). Once a method has been adopted, however, the method cannot be changed without the permission of the IRS. §446(e).

The primary purpose for the term fiduciary accounting income is to distinguish between principal (including capital gains) and income, particularly since many trusts call for the distribution of income to one beneficiary, followed by a distribution of principal (including capital gains) to a different beneficiary, such as a remainderman. But fiduciary accounting income also has important uses in determining DNI and the distribution deduction, as noted below.

However, fiduciary accounting income will usually not trump the definition of taxable income contained in the Internal Revenue Code. For example, assume that a trust received the proceeds of an annuity that had been owned by a decedent. Under the Uniform Principal and Income act, much of the proceeds of an annuity is considered to be principal. (In Oregon, see ORS 129.355.) Despite that state law definition, the federal tax laws might reach a different result: a significant portion of the annuity proceeds is often considered to be taxable income under §72 of the Code. (Note that some of that amount is probably also income in respect of a decedent under §691.) Because a portion is taxable income, that portion is included in the distributable net income (DNI) of the trust, for the simple reason that taxable income is the starting point in the definition of DNI. §643(a). If that amount is distributed to the beneficiary of the trust, that amount would be treated as a deductible §661(a)(2) distribution of DNI, because that subsection includes "any other amounts," not just income. And then it would be included in the taxable income of the beneficiary under §662(a)(2), because that subsection includes "all other amounts properly paid," not just income. That treatment of a portion of the proceeds as taxable income would take place even though the amount distributed might be considered to be principal under the state law definition of fiduciary accounting income. As a result, the tax laws would determine that the distribution was income, even though the fiduciary accounting laws would treat it as principal. (However, in that situation the trustee of the trust will need to carefully review the distributive provisions of the trust to make certain that principal, as defined by the state law, may be distributed under the terms of the trust.)

In that situation, DNI exceeded fiduciary accounting income. In other situations, DNI might be less than fiduciary accounting income. For example, a trust might deduct for income tax purposes an amount that the Uniform Principal and Income act requires be allocated to principal. If so, the distribution deduction will nevertheless be limited to the amount of DNI. §651(b); §661(a). The amount taxable to the beneficiaries will similarly be limited to the amount of DNI. §652(a); §662(a). See the discussions of distributable net income and the distribution deduction, both below.

The definition of fiduciary accounting income also causes special problems when a trust or estate holds an interest in an S corporation or a partnership. The income of such entities is generally taxed to the shareholders/partners, regardless of whether the income is actually distributed to them. If the entity earns income, but does not distribute it, then the K-1s issued to the shareholders/partners will show income taxable to the shareholders/partners, but the shareholder/partners will have received no cash with which to pay the tax on that taxable income. Such income unaccompanied by cash is known as phantom income. But the problem is even more complicated if the shareholder/partner is a trust or estate. Under the Uniform Principal and Income Act enacted in most states, income is generally limited to amounts received in cash. *See, e.g.,* ORS 129.300(2). Items that do not qualify as income are deemed to be principal. ORS 129.300(3)(a). Amounts actually distributed by the entity will be treated as income, and will be included in DNI. But amounts not actually distributed by the entity are not included in fiduciary accounting income, nor are they included in DNI. Yet they are taxable to the trust or estate. And the trust or estate is not able to distribute such income to the beneficiaries and cause it to be taxed to the beneficiaries, because §§651(a) and 661(a) allow distribution deductions only for income actually distributed or required to be distributed, and it is not possible for the fiduciary to distribute income which the fiduciary has not actually received. Yet for income tax purposes, the fiduciary is deemed to be taxed on that income, and the beneficiary will not be taxed on that income. See the next section for a further discussion of partnership and S corporation interests held in an estate or trust.

11. Partnerships and S Corporations

S corporations pose special problems in estate and trust administration after an S corporation shareholder has died. Only certain kinds of trusts are eligible to be shareholders in S corporations, and some of those trusts are eligible only for brief periods following the death of a shareholder. The types of trusts eligible to hold S corporation stock include grantor trusts, revocable trusts within two years following the death of the shareholder, testamentary trusts within two years of the receipt of S corporation stock, estates during a reasonable period of administration, Qualified Subchapter S Trusts (QSSTs), and Electing Small Business Trusts (ESBTs). See §1361 and Reg. §1.1361-1. For more detail on this subject, see Heath and Schnell, *Estate Planning with S Corporation Stock*, Oregon State Bar Estate Planning and Administration Section Newsletter, Vol. XXVII, No. 3, July 2010. A trust may be treated as an estate for purposes of these rules if the trust has made a §645 election to use a fiscal year as part of the decedent's estate. Reg. §1.645-1(e)(3)(i). See the discussion of a trust's election to use a fiscal year, above.

If a decedent owned an interest in a partnership or an LLC, the partnership or LLC may make an election under §754 to adjust the basis of partnership assets with respect to the transferee partner only (the person taking the interest as a result of the death of the partner). This adjustment is made pursuant to §743(b). The amount of the §743(b) adjustment is equal to the difference between the transferee's initial basis in his partnership interest (fair market value as of the date of death) and his proportionate share of the adjusted basis of partnership property. The adjustment can be a positive or a negative adjustment. Once the election is made, the §743(b) adjustment applies to all transfers of partnership interests by sale or exchange or upon the death of a partner until the election is formally revoked. The election must be filed with a timely partnership return for the taxable year during which the transfer occurs. Reg. §1.754-1(b). In the case of death, this would be the return for the year of death. Section 743(b) basis adjustments are mandatory if the partnership has a substantial built-in loss immediately after the transfer of a partnership interest. A substantial built-in loss exists where the adjusted basis of all partnership property exceeds its fair market value by at least $250,000. Reg. §1.754-1(d)(1).

Assuming the adjustment is positive, the benefit of the election is that the transferee is allowed an increase in his or her basis in the partnership assets. This in turn reduces the transferee's share of capital gain realized on the sale of any of the assets. A §743(b) basis adjustment has no effect on the partnership's computation of any item under §703, nor does it impact the transferee's capital account.

The disadvantages of the election to adjust the basis of partnership assets include:

a. The election is essentially irrevocable (except with IRS consent).

b. If the transferee's basis in partnership assets exceeds his or her basis in his or her partnership interest, the §743(b) adjustment would decrease his or her basis in partnership assets.

c. It applies to both transfers of partnership interests and distributions of partnership assets. This could result in future decreases in basis depending upon subsequent events.

d. The election adds accounting and record keeping complexity for the partnership.

e. If a §743(b) election is not made, the gain that could have been avoided by the basis increase will be recognized. However, since this gain increases the partner's basis in his partnership interest, upon a sale of his partnership interest the partner would have an offsetting recovery of the amount earlier recognized.

12. Distributable Net Income (DNI)

The concept of distributable net income is central to understanding the fiduciary income tax. DNI is essentially the taxable income of the estate or trust, including both taxable income and tax-exempt income. §643(a). Since it is based on taxable income, DNI is calculated after reducing the income by deductible administration expenses, such as attorney fees, executor fees, and other expenses, but DNI is not reduced by distributions to beneficiaries, or by the personal exemption of the trust or estate. When including tax-exempt income in DNI, the income is reduced by expenses that are non-deductible by reason of having been allocated to the tax-exempt income. §643(a)(5). See tax-exempt income, below.

The primary function of the DNI calculation is to serve as a limit on how much of a distribution to beneficiaries may be deducted under the distribution deduction. §651(b);

§661(a). That fact explains why DNI is calculated without taking into account the distribution deduction. See the discussion of the distribution deduction, below.

DNI does not include most capital gains, except in the final year. §643(a)(3); Reg. §1.643(a)-3(d). See the discussion of the final year, above. The exclusion of capital gains from DNI explains why capital gains are subtracted from adjusted total income on Schedule B of Form 1041 in order to calculate DNI. The fact that DNI does not include capital gains (except in the final year) explains why most capital gains are taxed to the trust or estate, and not to the beneficiaries, except in the final year. §643(a)(3).

Because DNI is based on taxable income, charitable deductions have already been removed from DNI, and no further adjustment to DNI is needed with respect to charitable deductions. This rule prevents non-charitable beneficiaries from being taxed on income distributed to charity or set aside for charitable purposes, with one exception: tier 1 beneficiaries receive no benefit from a charitable distribution of income. §662(a)(1). In effect, tier 1 beneficiaries have priority to be taxed on the income of a trust or estate, and charitable distributions of income are treated as a lower priority, but a higher priority than tier 2 distributions. See the discussions of the charitable deduction and the tier system, both below.

The calculation of DNI is made without subtracting the §691(c) deduction for estate taxes paid on income in respect of a decedent. Reg. §1.691(c)-2(a)(2). See income in respect of a decedent, below.

As noted below, the fiduciary may elect to deduct some expenses on an estate tax return under §642(g), in which case those particular expenses may not be deducted on the fiduciary income tax return, and in that event such expenses will not reduce DNI. Nor may expenses deducted on the estate tax return also be used to reduce capital gains on a fiduciary income tax return. §642(g).

13. Capital Gains and Losses

In general, capital gains and losses are taxed to trusts and estates in much the same fashion as they are taxed to individuals. The general rule, subject to many exceptions, is that in each year long-term gains are netted against long-term losses, and short-term gains are netted against short-term losses. Then the long-term net gain/loss is netted against the short-term net gain/loss. If the result is a gain, it is taxed to the trust or estate at 20%, or 15% if taxable income is less than $12,150. §1(h). That number will increase to $12,300 for 2015. If the result is a loss, it can be deducted up to the amount of $3,000 in that year, and the excess can be carried over into future years indefinitely until it has been consumed in those future years. §1212(b). *See also* §1.643(a)-3(d).

Trusts and estates reach the highest capital gain rates at a much lower threshold than do individuals. An individual single person does not reach the maximum 20% rate unless taxable income is above $400,000 in 2013, and joint-filing married taxpayers do not reach the maximum 20% rate unless taxable income is above $450,000 in 2013. §1(h). In 2014, those numbers increased to $406,750 and $457,600, and in future years those numbers will continue to be adjusted for inflation. *See* Rev. Proc. 2013-35. In 2015, those numbers increased to $413,200 and $464,850.

Assets acquired from a decedent and disposed of within one year after the death are automatically deemed to have been held by the recipient for more than one year, even if the recipient disposes of the asset shortly after the death of the decedent. §1223(9). As a result, any gain realized is deemed to be long-term. This rule applies not only to estates, but also to revocable trusts that became irrevocable upon the death of the decedent. §1014(b). In fact, this rule applies to any asset where the basis is determined by §1014 (basis of property acquired from a decedent). §1223(9). See the discussion of basis step-up, below.

In general, capital gains and losses do not pass out to the beneficiaries; the trust or estate pays the income tax on the net gains, and the net losses are deductible by the trust or estate subject to the limitations described above. That result is brought about by the fact that such gains and losses are not included in DNI. §643(a)(3). That result is based in part on state law, which typically allocates capital gains to principal. ORS 129.310. However, in the final year of a trust or estate, all of the tax attributes of that tax year pass out to the beneficiaries as part of DNI, so that any capital gains realized in that final year will be reported by the trust or estate on the fiduciary income tax return, but then the gains will be carried out to the beneficiaries on their K-1s, as will the losses. §662; §643(a)(3); Reg. §1.643(a)-3(d). See the discussion of the final year, above.

Under some circumstances, capital gains are included in DNI in a non-final year of a trust or estate, and thus those exceptions allow capital gains to be passed out to the beneficiaries. Those exceptions are described in §643(a)(3) and Reg. §1.643(a)-3:

a. Gains that are allocated to fiduciary accounting income, under state law and the governing instrument, or pursuant to the exercise of the fiduciary's discretion if authorized by state law, or authorized by the governing instrument if not prohibited by state law.

b. Gains that are allocated to principal, but are actually paid, credited, or required to be distributed to any beneficiary during the taxable year.

c. Gains that are paid or permanently set aside for charitable purposes under §642(c).

The regulations under §643 clarify that capital gains can be included in DNI if the gains are allocated to income by state law and under the governing instrument; or are consistently treated by the fiduciary on the books, records, and tax returns of the trust or estate as part of a distribution to a beneficiary; or are allocated to principal but actually distributed to a beneficiary, or treated by the fiduciary as required to be distributed to a beneficiary. Reg. §1.643(a)-3. Capital gains are also included in DNI if paid or permanently set aside for charitable purposes. Reg. §1.643(a)-3(c).

The regulations under §643 provide fourteen examples to illustrate how §643(a)(3) operates to allow capital gains to be passed out to beneficiaries. Those examples demonstrate that the second exception described above can be used only if the governing instrument or state law permits such distributions. Reg. §1.643(a)-3(e).

In many modest estates, capital gains are relatively few and small, particularly since the assets will have received a stepped-up basis for income tax purposes. In a relatively small estate, often the only significant capital transaction is the sale of the decedent's personal residence. Let's assume that the house is sold on the open market a few months after the date of death, through the services of a professional real estate broker. That sale usually determines the fair market value of the residence, and it is not unreasonable to use that sale price as the fair market value on the estate tax return and as the post-mortem income tax basis of the residence. But how are the broker's commission, the title insurance premium, and related closing costs handled for tax purposes? As noted below in the discussion of deductions, the expenses of sale are not usually deductible against ordinary income for fiduciary income tax purposes. Instead, those expenses are offsets against the selling price to reduce gain or to increase loss. §642(g). But because the sale price is also the basis, offsetting those closing costs will produce a capital loss. That loss can be offset against capital gains, and if the losses exceed the gains (as noted above), the excess can be deducted up to $3,000 per year against ordinary income. If the sale takes place in the final year of the estate (and modest estates often have only one tax year, which is both the first tax year and also the final tax year), then the loss flows out to the beneficiaries, who can use the loss to offset their own capital gains, and any net loss of each beneficiary can be deducted against ordinary income by each beneficiary up to $3,000 per year under §1211(b). §1.642(h)-1(c). (The IRS once took the position that a loss on the postmortem sale of a personal residence could not be deducted unless the estate had rented out the residence, SCA 1998-012, but apparently the IRS no longer takes that position. See IRS Publication 559.)

Unless it is a grantor trust, a trust is not eligible for the capital gain exclusion on the sale of a personal residence provided by §121. PLR 200104005; PLR 199912026; Reg. §1.121-1(c)(3). (For individuals, the amount of that exclusion is $250,000, or $500,000 for married couples.) If the trust is deemed to be partially a grantor trust, then the grantor may exclude that portion of the gain. PLR 200104005.

Occasionally an undivided half interest in a personal residence is placed in a credit shelter trust, while the other half interest continues to be owned by the surviving spouse. Under the prior version of §121, the owner of a partial interest could exclude that owner's portion of the gain. Rev. Rul. 67-234, 1967-2 C.B. 78; Rev. Rul. 67-235, 1967-2 C.B. 79. Presumably that result is still available under the current version of §121. (The amount of gain that can be excluded under §121 is $250,000 for an individual and $500,000 for a married couple.)

For purposes of determining whether a trust or estate has gross income in excess of the $600 filing threshold, gross income does not necessarily include gross proceeds from the sale of a capital asset. Instead, gross income includes an amount equal to gross proceeds minus basis. Reg. §1.61-6(a).

14. Exemptions

Under §642(b), an estate is allowed a personal exemption of $600, a simple trust is allowed a personal exemption of $300, and a complex trust is allowed a personal exemption of $100. These exemptions are not available in the final year of a trust or estate because the trust or estate pays no taxes in the final year and the exemption may not be passed out to the beneficiaries as an excess deduction. §642(h)(2).

A trust is allowed to use the larger $600 exemption of an estate if the trust has made a §645 election to use a fiscal year as part of the decedent's estate. Reg. §1.645-1(e)(2)(ii)(A). See the discussion of a trust's election to use a fiscal year, above.

15. Calculating Taxable Income; Deductions

Estates and trusts are generally taxed in the same manner as individuals, with several exceptions. §641(b). Calculating the taxable income of an estate or trust involves several steps. The most important steps are:

a. <u>Determine gross income</u>. Gross income generally does not include the proceeds of life insurance received due to the death of the decedent. §101(a)(1). Also, gross income does not include tax-exempt income. §103. In the following discussion of deductions, deductions relating to tax-exempt income must be allocated in full or in part to the exempt income, and the portion so allocated may not be deducted. §265. For example, a trustee's fee for investment management must be allocated between taxable investments and tax-exempt investments.

b. <u>Deduct the above-the-line deductions</u>. These are deductions defined by §62 as deductions from gross income to determine adjusted gross income (AGI). They are known as above-the-line deductions because they are deducted from gross income, not from adjusted gross income. These are primarily deductions incurred in carrying on a trade or business, including ordinary and necessary business expenses under §162, business interest under §163, business taxes under §164, business losses under §165, and depreciation of business assets under §167, 168, and 642(e). If the business generates a net operating loss, the NOL may be carried back two years and then may be carried forward up to twenty years. §642(d); §172(b).

c. <u>The result would normally be adjusted gross income (AGI)</u> as it is defined by §62 if it were calculated for an individual taxpayer, but §67(e) makes several significant changes to the calculation of adjusted gross income if it is being calculated for a trust or estate. Section 67(e), which establishes a test known as the 2% floor, requires that four deductions that would normally be below-the-line deductions from adjusted gross income must, in the case of trusts and estates, be subtracted in order to calculate adjusted gross income. Those four deductions are (1) administration expenses that "would not have been incurred if the property were not held in such trust or estate," (2) the personal exemption under §642(b), (3) the distribution deduction for simple trusts under §651, and (4) the distribution deduction for complex trusts under §661. Note that §67(e) does not actually permit those four deductions to be taken above-the-line; it merely provides that they should be subtracted when calculating adjusted gross income "[f]or purposes of this section." In other words, those four deductions will be subtracted for purposes of determining AGI, but only for purposes of determining the 2% floor, which is applied later in the tax calculation (see below). Those deductions that are subtracted from gross income for purposes of this calculation of adjusted gross income will be deducted below for purposes of calculating adjusted total income and eventually taxable income, but in this step the calculation simply takes a minor detour to calculate the special definition of adjusted gross income for purposes of estates and trusts. Because adjusted gross income is later used to determine the 2% floor on some of those deductions, and because those deductions are used to calculate adjusted gross income and taxable income, a simultaneous (circular) calculation is often required.

d. <u>The result is adjusted gross income, as it is specially defined by §67(e)</u> for trusts and estates for purposes of calculating the 2% floor (discussed below). However, because of the circular nature of the calculation, the term adjusted gross income is not actually used in the calculation of the tax; it is used only to calculate the 2% floor. For example, the Form 1041 does not actually use the term adjusted gross income on the form itself, although the term is used in the instructions to calculate the 2% floor. The instructions give an example of how to manually perform the circular calculation. Most practitioners, however, use commercial tax return software, which eliminates the need for the manual calculation. The circular calculation is not required in every case; for example, some trusts have no miscellaneous itemized deductions that are subject to the 2% floor. In another example, some trusts distribute less than DNI, and their distribution deduction is therefore less than DNI, and thus the distribution is not limited by DNI. In that situation, the impact that AGI has on DNI does not affect the distribution deduction.

e. <u>Deduct the below-the-line deductions</u>. These are defined by §63(d)(1) as deductions other than the above-the-line deductions. They are referred to as below-the-line deductions because they are deductions that are normally (in the case of individuals) deducted *from* adjusted gross income, not deductions taken to *determine* adjusted gross income. In the case of an estate or trust, however, adjusted gross income is given a special definition (see above) that in some cases results in a circular calculation. For that reason, these below-the-line deductions are not actually deducted from adjusted gross income. Instead, they are merely deducted as the next step after deducting the above-the-line deductions. These below-the-line deductions include itemized deductions and a subset of itemized deductions known as miscellaneous itemized deductions. §63(d)(1). The itemized deductions include expenses relating to property or investments held for the production of income, including ordinary and necessary expenses under §212 for the production of income, including administration expenses. Reg. §1.212-1(i). Administration expenses generally include personal representative's fees, trustee's fees, attorney's fees, and accountant's fees under §212; interest under §163; state and local taxes under §164; losses under §165; bad debts under §166; depreciation under §§167, 168 and 642(e); and tax advice and tax preparation costs under §212(3). Miscellaneous itemized deductions are defined by §67(b) as *not* including interest under §163, state and local taxes under §164, the charitable deduction under §642(c), and estate taxes under §691(c). Thus miscellaneous itemized deductions are defined by §67(b) to include most itemized deductions, and those miscellaneous itemized deductions are subject to a restriction known as the 2% floor. Thus the only below-the-line itemized deductions that are not subject to the 2% floor are interest under §163, state and local taxes under §164, the charitable deduction under §642(c), and estate taxes under §691(c). The deduction of miscellaneous itemized deductions, and the restrictions on those deductions, are described in the following step. In this particular step, however, we are merely deducting the itemized deductions that are not considered to be miscellaneous itemized deductions, which are deducted below. Expenses incurred in selling property are generally not deductible as administrative expenses, but are offsets against the selling price to reduce gain or to increase loss. §642(g). However, if an asset must be sold in order to pay taxes, to pay claims, or to satisfy pecuniary bequests, then the expenses of sale become deductible. *Estate of Jenner v. Commissioner*, 577 F.2d 1100 (7th Cir. 1978); *Estate of Joslyn v. Commissioner*, 566 F.2d 677 (9th Cir. 1977). A sale for the convenience of the beneficiaries so that they will not end up owning the asset as tenants in common would not fall into that exception.

f. Deduct miscellaneous itemized deductions. Pursuant to §67(e), estates and trusts are permitted to deduct miscellaneous itemized deductions, but only to the extent that the miscellaneous itemized deductions "would not have been incurred if the property were not held" in a trust or estate. §67(e)(1). If a deduction fails that test, then that deduction may be deducted only to the extent that the total miscellaneous itemized deductions exceed 2% of the adjusted gross income of the trust or estate (as AGI is specially defined for purposes of estates and trusts). §67(a). The Supreme Court has interpreted that statute as exempting from the 2% floor such miscellaneous itemized deductions that an individual would have been unlikely to incur. *Knight v. Commissioner*, 552 U.S. 181, 128 S.Ct. 782, 101 AFTR2d 2008-544 (2008); Jones, *Supreme Court Rules - Negatively - on Deductibility of Trust Investment Advisor Fees*, Journal of Taxation, February 2008, Vol. 108 No. 2; Jones, *Final Regulations on Trust Administration Expenses – No Surprises*, Journal of Taxation, July 2014, Vol. 121 No. 1. Attached to this paper as Appendix A is a table describing how miscellaneous itemized deductions are affected by the *Knight* opinion and the final regulations that were published following the *Knight* opinion. In general, those regulations allow full deductibility (not subject to the 2% floor) of administration expenses that "would not have been incurred if the property were not held in [an] estate or trust." Reg. §1.67-4(a). Those regulations are effective for tax years beginning after December 31, 2014. After the miscellaneous itemized deductions are divided into the ones that are 100% deductible and those that are deductible only to the extent they exceed 2% of adjusted gross income, those deductions (after the application of the 2% floor) are referred to in the Form 1041 instructions as adjusted miscellaneous itemized deductions (AMID).

g. <u>After the above deductions are taken, the result is referred to by Form 1041 as adjusted total income</u>, although the Code itself does not use that term. Occasionally this amount is called the tentative taxable income, but the precise definition of that term is elusive.

h. <u>Deduct the distribution deduction under §651 or §661, the estate tax deduction under §691(c), and the personal exemption under §642(b)</u>. Note that two of these deductions were taken into account above in calculating adjusted gross income for purposes of the 2% floor of §67(a), but they were not actually deducted at that stage, which is another reason why the calculation of the tax of an estate or trust is often circular.

i. <u>The result is taxable income</u>. §63. If the taxable income is a negative, the excess deductions will flow out to the beneficiaries, but only the deductions incurred in the final year of the trust or estate. §642(h). In non-final years, the only negatives that may be carried over to the next tax year are capital loss carryovers and business net operating losses. §642(h).

j. <u>Apply the tax rate table to the taxable income</u>. §641(a); §1(e). The result is the tax due, but some trusts might be subject to two additional taxes. First, some trusts might be subject to the alternative minimum tax (AMT) under §455. See Schedule I of Form 1041. The 2014 AMT exemption amount for estates and trusts is only $23,500, much lower than the exemption amount for married couples ($82,100) or single individuals ($52,800). §55(d)(1). Those amounts are expected to increase to $23,800, $83,400, and $53,600 in 2015. And the AMT exemption for estates and trusts phases out at much lower levels as well. §55(d)(3). See Rev. Proc. 2013-35. In addition, miscellaneous itemized deductions are not deductible for purposes of calculating the alternative minimum tax, even if they exceed the 2% floor; taxes are also not deductible. §56(b)(1)(A). Second, some trusts and estates will also be required to pay an additional tax on net investment income; see the following section.

16. The Net Investment Income Tax

The net investment income tax became effective on January 1, 2013. §1411. It imposes a 3.8% tax on the net investment income of individuals, trusts, and estates. The tax is reported on Form 8960 attached to the Form 1041. As in the case of the maximum income tax rate, the threshold for applying this tax is much lower for trusts and estates than for individuals. While individuals are subject to this tax if their adjusted gross income exceeds $200,000 ($250,000 for married couples filing jointly), the 2014 threshold level for trusts and estates is $12,150 of undistributed net investment income. §1411(a), (b). The threshold for estates and trusts is inflation-adjusted annually, but the threshold for couples and individuals is not adjusted. §1411(a), (b); *see* Rev. Proc. 2013-35. In 2015, the threshold for estates and trusts will increase to $12,300. The tax is applied to the lesser of (a) the undistributed net investment income, or (b) the excess of adjusted gross income over the threshold amount. §1411(a)(2).

The tax is imposed on three types of income described in §1411(c):

a. Interest, dividends, annuities, rents, royalties, and certain other passive income.

b. Trade or business income ("covered business income") derived from trading in financial instruments or commodities, passive activity income under §469, and income generated by investing working capital.

c. Net gain from the disposition of property, with some exclusions. This includes most capital gains, with some exceptions.

The net investment income tax does not apply to distributions from retirement plans, including qualified plans and IRAs. §1411(c)(5).

The U.S. Tax Court has held that a trust will be deemed to have materially participated in real estate business activities under §469(c)(7), and thus the real estate business will not be deemed to be a passive activity under §469, if the trustees personally performed sufficient services to meet the exception described in §469(c)(7). *Aragona v. Commissioner*, 142 T.C. No. 9 ___ (3/27/14). That exception permits a real estate business to not be a passive activity if more than half of the personal services performed by the taxpayer in trades or businesses were performed in real estate activities in which the taxpayer materially participated, and the taxpayer performed more than 750 hours in its material participation in real estate businesses. In *Aragona*, the trustees were individuals who actively worked in the real estate business of the trust as trustees, and some of the trustees were also employees of a real estate LLC that was wholly-owned by the trust. The court held that their activities as trustees and as employees could be aggregated to determine whether the trust materially participated in the real estate business, because under local trust law trustees who operate a trust business through a corporation controlled by the trust continue to have the same fiduciary responsibilities that trustees have. (Oregon law is similar. ORS 130.655(7).) That decision has important implications for the application of the net investment income tax to trusts, because §1411(c) exempts taxpayers who materially participate in a trade or business under the standards of §469. However, the Tax Court in *Aragona* limited its holding to the facts and arguments of that case (the arguments advanced by the IRS in that case were somewhat narrow), and the court specifically declined to express an opinion whether a trust could materially participate through employees who were not trustees.

Although the imposition of the maximum income tax rates on the taxable income of trusts and estates in excess of $12,150 ($12,300 in 2015) has in recent years given fiduciaries a strong incentive to distribute income to beneficiaries (who will often be in lower income tax brackets), the imposition of this new investment income tax will give fiduciaries an even stronger incentive to distribute income, because trusts and estates do not pay this new tax on income that is distributed to the beneficiaries, and the beneficiaries might not be subject to the tax if their adjusted gross income is below the threshold level for individuals, which is much higher than the threshold level for trusts, as discussed above. In the alternative, the fiduciary could minimize investments that produce investment income, and maximize investments that produce tax-exempt income or produce little dividend income but offer greater future growth potential. Of course, the fiduciary would need to consider the investment objectives of the trust and of the individual beneficiaries.

However, the taxation of income that is passed out to the beneficiaries is not always entirely clear. Section 652(b) provides that income passed out to the beneficiary of a trust "shall have the same character in the hands of the beneficiary as in the hands of the trust." Reg. §1.652(b)-1 states the same rule, but that same regulation states that the tax status of amounts passed out to beneficiaries "depends upon the beneficiary's status with respect to them not upon the status of the trust." That latter statement seems at odds with §652(b). The only explanation offered by Reg. §1.652(b)-1 is an example of income received by a beneficiary of a foreign trust that is passing through foreign income. In that example, the includibility of that income in the gross income of the beneficiary depends on "his taxable status with respect to that income."

17. The Election to Take Deductions on the Fiduciary Income Tax Return

Decedents' estates decedent's trusts are permitted to make an election to deduct their administration expenses either on the fiduciary income tax return (Form 1041) for the year in which the expense is incurred, or on the estate tax return (Form 706) for the decedent. §642(g); §2053(a)(2). The choice is often made by comparing the marginal estate tax rate (combined federal and state) with the marginal income tax rate (combined federal and state). If the estate tax rate is higher than the income tax rate, then claiming the deductions on the estate tax returns is usually most beneficial. If the income tax marginal rate is higher than the estate tax marginal rate, then claiming the deductions on the fiduciary income tax returns is usually most beneficial. If no estate tax returns (federal or state) are being filed because the estate is below the estate tax filing thresholds (or no tax is due because of the marital deduction), then taking the deductions on the estate tax returns might appear to be pointless, but deducting those expenses on the estate tax return might nevertheless have the beneficial effect of increasing the size of the credit shelter trust, and that benefit should be weighed against the possible benefit of deducting those expenses on the fiduciary income tax return, as is discussed below. The estate tax filing thresholds (federal and state) are based on the size of the gross estate, not the size of the taxable estate, so the deductions do not affect whether estate tax returns are required to be filed, but the taking of deductions on the estate tax returns might either reduce the estate tax due or eliminate the estate tax due.

When calculating bequests under formula clauses that calculate the amounts to be used to fund a credit shelter (bypass) trust, or to fund a marital trust, or to fund an outright marital bequest, the §642(g) election can alter the amounts to be placed in those parts of the estate. In general, electing to take the administration expense deductions on the income tax returns causes a portion of the estate (equal to the administration expenses) to be exposed to the estate tax, because those deductions are not being deducted on the estate tax returns. Formula clauses in tax-planning wills and trusts are usually designed to reduce the estate tax to zero through the use of two tools: the unified credit and the marital deduction. Since the administration expense deduction will not be available on the estate tax returns if the election is made to take those deductions on the income tax returns, then one of those two tools must be used to shelter that amount from tax, or a tax will result. Obviously, those expenses do not qualify for the marital deduction. As a result, a portion of the unified credit must then be used to shelter from estate tax the portion of the estate that was used to pay those expenses. The credit shelter trust will then be reduced by that amount; the formula clauses used in most wills and trusts will require that result. For a fuller discussion of this subject, see Jones, *Calculating Bequests Under Formula Clauses*, Oregon State Bar Estate Planning and Administration Section Newsletter, Vol. XXVI, No. 4, October 2009.

It should also be noted that IRS regulations divide administration expenses into two types. These are the infamous *Hubert* regulations that were developed after the Supreme Court decided *Commissioner v. Estate of Hubert*, 520 U.S. 93 (1997). The holding in *Hubert* is now of merely academic interest, because the regulations take an entirely different approach than the Supreme Court opinion. The regulations divide administration expenses into management expenses and transmission expenses. Management expenses are incurred to maintain estate assets; they include investment advisory fees. Transmission expenses include the costs of marshaling estate assets, paying debts and taxes, and distributing the assets; they include fiduciary fees and attorney fees. Reg. §20.2056(b)-4(d)(1). Management expenses paid from the marital share will reduce the marital deduction only if those expenses are deducted on the estate tax return. Transmission expenses paid from the marital share will always reduce the marital deduction. Reg. §20.2056(b)-4(d)(2) (3).

Another factor to consider is whether taking the administration expense deductions on the income tax return will actually cause a reduction in tax. If the estate does not have sufficient income to absorb the deductions, then excess deductions will result, and those excess deductions will often be wasted (and will always be wasted in a non-final year). If those excess deductions are incurred in the final year of the estate or trust, the excess deductions can be passed out to the beneficiaries, §642(h), but in some cases the beneficiaries will not be able to use those excess deductions, because excess deductions are classified as miscellaneous itemized deductions in the hands of the beneficiaries, even though not all of those deductions were classified as miscellaneous itemized deductions on the income tax return of the estate or trust. Reg. §1.642(h)-2(a). Those excess deductions can be used by the beneficiaries only if the beneficiaries itemize their deductions, and even then the deductions can be utilized by the beneficiaries only to the extent that the deductions exceed two percent of the beneficiary's adjusted gross income. §67(a); Reg. §1.642(h)-2(a).

The §642(g) election is made by filing a statement, in duplicate, with the fiduciary income tax return to the effect that the deductions have not been allowed as deductions on the estate tax return, and the right to claim them on the estate tax return is being waived. Reg. §1.642(g)-1. If the election is not made, and the deductions are claimed on the estate tax return, no statement is needed. *Estate of Keitel v. Commissioner*, T.C. Memo 1990-416 (1990). Even if the deductions are claimed on the fiduciary income tax return, many practitioners don't bother to file the statement with the income tax return, since the regulations provide that the statement can be filed at any time before the running of the applicable statute of limitations. Reg. §1.642(g)-1. That approach permits flexibility, since the filing of the statement with the income tax return precludes later claiming the deductions for estate tax purposes. Reg. §1.642(g)-1.

This election need not be made on a blanket basis. It can be made for some deductions and not others, or it can be made for parts of some deductions and not other parts. Reg. §1.642(g)-2.

Funeral expenses are not subject to this election. They may be deducted only on the estate tax return, and not on the fiduciary income tax return. §2053(a)(1). The fiduciary income tax statutes contain no provision for deducting funeral expenses. *Estate of Yetter v. Commissioner*, 35 T.C. 737 (1961).

Similarly, claims against the estate can be deducted only on the estate tax return, not on the fiduciary income tax return. §2053(a)(3). The same rule applies to income taxes and gift taxes owing as of the date of death, even if those taxes have not yet been calculated as of the date of death; they may be deducted only on the estate tax return. Reg. §20.2053-6.

Similarly, the medical expenses of the decedent paid by the estate are not deductible on a fiduciary income tax return. Reg. §1.642(g)-2. They may be deducted either on the final individual income tax return of the decedent (even if paid after his death, but they must be paid within one year of his death) or on the decedent's estate tax return. §213(c); Reg. §1.642(g)-2; §2053. A 7.5% of adjusted gross income floor applies to medical expenses deducted on the decedent's final income tax return, but that limitation does not apply to the estate tax return. §213.

The §642(g) election does not apply to deductions in respect of a decedent, which should be deducted on both the fiduciary income tax return and on the estate tax return. Reg. §1.642(g)-2. See income in respect of a decedent, below.

The same §642(g) election is available for purposes of the Oregon fiduciary income tax. OAR 150-316.272; 150-118.010(2). The Oregon statutes permit independent (inconsistent) elections for federal and state purposes. ORS 118.010(8).

18. The Distribution Deduction

As a general rule, a trust or estate that has DNI will pay income tax on that DNI if the trust or estate retains that income, but distributions to beneficiaries in the same tax year will usually cause that DNI to be carried out to the beneficiaries receiving those distributions. §662(a).

The DNI of a simple trust will be taxed to the beneficiaries regardless of whether it is distributed. §652(a). Similarly, if a complex trust is required to distribute income, that required amount will be taxed to the beneficiaries regardless of whether it is distributed. §662(a)(1).

If the DNI is carried out to the beneficiaries, then the beneficiaries will be taxed on that DNI, and the trust or estate will not be taxed. Thus the income will be taxed only once. The exact mechanism used by the Code to carry out that single taxation is the distribution deduction: amounts distributed to beneficiaries are deductible by the trust or estate, up to the amount of DNI. §651(b); §661(b). (One exception: A distribution of a specific bequest does not carry out DNI to the recipient beneficiary. §663(a)(1). As a result, the trust or estate will not be entitled to a distribution deduction under §661, nor will the beneficiary be taxed under §662. See the discussion of specific bequests below.)

For example, if a complex trust has $40,000 of DNI for the tax year 2014, but the trust distributes $25,000 to its beneficiaries, then the trust will be taxed on the $15,000 of DNI retained by the trust, and the beneficiaries will be taxed on the $25,000 of DNI distributed to them. If that same trust were to distribute $60,000 to the beneficiaries in that tax year, then the trust would be able to deduct only $40,000 of the amount distributed, and the beneficiaries would be taxed on only $40,000 of the amount distributed. The other $20,000 of distributions to the beneficiaries would not be deductible by the trust (since it exceeds DNI), nor would the beneficiaries be taxed on that other $20,000. Instead, that $20,000 would be treated as a distribution of principal, which is not taxable to the beneficiaries nor deductible by the trust. §661(a); §662(a)(2).

DNI includes tax-exempt income, but the distribution deduction is limited to the taxable portion of DNI. §§651(b); 661(c). See the discussion of tax-exempt income, below.

Simple trusts deduct the income they are required by the terms of the trust to distribute, regardless of whether that income is actually distributed. §652(a). Estates and complex trusts deduct both the income that is required to be distributed and other amounts that are "properly paid or credited or required to be distributed." §661(a)(2). Both deductions, however, are limited to the amount of DNI. §651(b); §661(a). And both deductions cause income to be taxed to the beneficiary. §652(a); §662(a).

Charitable distributions are not included in the distribution deduction. §661(b); §663(a)(2); Reg. §1.663(a)-2. Instead, they are deductible under §642(c), and they may not be deducted through the distribution deduction. Reg. §1.663-(a)-2. However, charitable distributions out of income, which are deductible under §642(c), reduce DNI, so that the non-charitable beneficiaries will not be taxed on the income distributed to charity. §661(b); §663(a)(2). However, that rule does not apply to tier 1 beneficiaries, who will still be taxed on the income required to be distributed each year, regardless of any charitable distribution. §662(a)(1). See the discussion of the charitable deduction, below, and the discussion of the tier system, also below.

If a trust is required by the terms of the trust to maintain a residence for the use of a beneficiary, the amounts spent by the trust to maintain the residence are not considered to have been distributed to the beneficiary, are not deductible as a distribution, and are not taxed to the beneficiary. Instead, the income used to pay those expenses is taxed to the trust. *Commissioner v. Plant*, 76 F.2d 8 (2nd Cir. 1935); PLR 8341005. The Tax Court and the Fifth Circuit have both held that expenses paid by a trust to maintain a residence owned by the trust, but used by a beneficiary, are not deductible, either as expenses of the trust or as distributions to the beneficiary. *A.I. DuPont Testamentary Trust v. Commissioner*, 574 F.2d 1332 (5th Cir. 1978) affirming 66 T.C. 761 (1976) and 514 F.2d 917 (5th Cir. 1975), affirming 62 T.C. 36 (1974). When drafting such a trust, the better practice (for tax purposes) might be to require distributions to the beneficiary, and then the trust should require the beneficiary to pay the maintenance expenses, in order to avoid the high income tax rates of trusts.

19. Tax-Exempt Income

The income carried out to the beneficiaries takes with it the income tax attributes that the income had in the trust or estate. §652(b); §662(b). For example, tax-exempt municipal bond interest earned by an estate or trust and carried out to the beneficiaries is reported by the beneficiaries as tax-exempt income. Similarly, interest distributed to the beneficiaries retains its character as interest, dividends retain their character as dividends, etc. The beneficiaries are deemed to have received each of those items in the same percentage as each of those items bears to the total DNI, unless the trust instrument allocates the different types of income in a different manner. §652(b); §662(b).

DNI includes tax-exempt income, but gross income does not. §103; §643(a)(5). However, the distribution deduction does not include tax-exempt income distributed to the beneficiaries. §651(b); §661(c). And as noted above, §§652(b) and 662(b) require that the income allocable to the beneficiaries will be deemed to include the same proportion of the tax attributes as was received by the estate or trust. The net effect of these rules can be illustrated by the following examples. Assume a trust has $50,000 of ordinary taxable income and $20,000 of tax-exempt income, for a fiduciary accounting income of $70,000, a gross income of $50,000 and a DNI of $70,000. If that trust distributes $100,000 to its beneficiaries, the trust will have $50,000 of gross income, which is then reduced by a $50,000 distribution deduction. The beneficiaries will then be taxed on $50,000 of ordinary income, but they will not be taxed on the $20,000 of tax-exempt income they received. The same result would have taken place if the trust had distributed only $70,000. If the trust distributes only $60,000, DNI will still be $70,000, but the distribution deduction will be reduced to $42,857, or 85.7% of its level in the previous example (60,000/70,000 = .857). In that event, the beneficiaries will be deemed to have received $42,857 of taxable income and $17,143 of tax-exempt income, for a total taxable and exempt income of $60,000. The trust will then be taxed on the other $7,143 of ordinary income, and will be deemed to have retained $2,857 of tax-exempt income. The net effect of these rules is that if the trustee of this particular trust wishes to distribute all of the taxable income to the beneficiaries and obtain the benefit of a distribution deduction for all of that distributed taxable income, then the trustee must distribute all of the taxable income *and* all of the exempt income. §652(b); §662(b).

Keep in mind that deductions relating to tax-exempt income must be allocated in whole or in part to the exempt income, and the portion so allocated may not be deducted. §265. For example, a trustee's fee for investment management must be allocated between the taxable investments and the tax-exempt investments.

20. Specific Bequests

Specific bequests include two types of bequests: a pecuniary bequest of a specific amount of money, and a specific bequest of a particular item of property. A bequest of $1,000 is a specific bequest because it is a pecuniary bequest. A bequest of 100 shares of General Motors stock is also a specific bequest, but it is not a pecuniary bequest.

Distributions of specific bequests do not carry out DNI to the recipient beneficiary. §663(a)(1). As a result, the trust or estate will not be entitled to a distribution deduction under §661, nor will the beneficiary be taxed under §662. The logic behind this rule is that such distributions are in the nature of principal, not income. §102.

A specific bequest is defined as "a gift or bequest of a specific sum of money or of specific property." §663(a)(1). So a bequest of $1,000 or of 100 shares of General Motors stock is clearly a specific bequest. The amount of money or the identity of the specific property must be ascertainable under the will as of the date of death, or ascertainable under the terms of an intervivos trust as of the date of inception of the trust. Reg. §1.663(a)-1(b). A bequest of an amount of money to be calculated by the fiduciary (or of property to be selected by the fiduciary) equal to a stated fraction or percentage of the estate is not considered to be a specific bequest. Reg. §1.663(a)-1(b); Rev. Rul. 60-87, 1960-1 C.B. 286; *see* PLR 200210002. There is some debate over whether a pecuniary formula (as opposed to a fractional share formula or a percentage share formula) is a specific bequest, but the consensus seems to be that a pecuniary formula bequest is not a specific bequest, and thus it does carry out DNI.

Several exceptions apply to this general rule that specific bequests do not carry out income. The following distributions will carry out DNI:

a. If the governing document requires the amount to be paid from income. §663(a)(1).

b. If the bequest is a residuary bequest. Reg. §1.663(a)-1(b)(2)(iii).

c. If the bequest is required by the governing document to be paid in three or more installments. §663(a)(1).

After a distribution is made pursuant to a specific bequest, the basis of the distributed property in the hands of the beneficiary will be determined under either §1014 (property acquired from a decedent, if the bequest was in a will, in a formerly-revocable trust, or in a testamentary trust) or §1015 (property acquired by gift, if the asset was acquired by the trust through an intervivos gift), and the beneficiary will receive the same basis as the trust or estate had in the property immediately before the distribution.

21. In-Kind Distributions

An in-kind distribution (a distribution of assets other than cash) raises several questions:

a. Does the in-kind distribution carry out DNI to the recipient? If the distribution is made pursuant to a specific bequest (a bequest of a particular item of property, such as 100 shares of stock in General Motors), then the distribution does not carry out DNI. §663(a)(1). Similarly, if a trust distributes securities in satisfaction of a pecuniary bequest (such as a bequest of $1,000), then the distribution does not carry out DNI to the recipient beneficiary. §663(a)(1). In both situations, the trust or estate will not be entitled to a distribution deduction. §663(a)(1). But in other situations, such as a distribution of property in-kind to satisfy a residuary bequest, the distribution will carry out DNI to the beneficiary. §662.

b. Will the estate or trust recognize gain or loss as a result of the in-kind distribution? The general rule is that the estate or trust does not recognize gain or loss on an in-kind distribution, unless the distribution is being made in satisfaction of an obligation to pay money or an obligation to distribute property other than the property distributed in kind. Reg. §1.661(a)-2; *Kenan v. Commissioner*, 114 F.2d 217 (2nd Cir. 1940). Thus gain or loss will be recognized if assets are distributed in-kind to satisfy a pecuniary bequest. Rev. Rul. 66-207, 1966-2 C.B. 243. (That rule applies even if the estate is insufficient to fully fund the pecuniary bequest and the bequest in effect becomes a residuary bequest. Rev. Rul. 66-207.) Gain or loss is also recognized when an asset is distributed in-kind to a creditor in satisfaction of a debt in the form of a specific dollar amount. *First Trust & Deposit Co. v. United States*, 58 F.Supp. 162 (N.D.N.Y. 1944); Reg. §1.661(a)-2(f). Gain or loss is also recognized if the trust or estate was obligated or permitted to make an income distribution to the beneficiary (or the trust or estate was obligated to distribute a pecuniary amount, or was obligated to distribute specific property other than that distributed), but the trust or estate chose instead to distribute in-kind assets equal in value to the required distribution. Reg. §1.661(a)-2(f); Rev. Rul. 67-74, 1967-1 C.B. 194; *Suisman v. Eaton*, 15 F.Supp. 113, 36-2 USTC ¶9443 (D.Conn. 1935), *aff'd* 83 F.2d 1019 (2nd Cir. 1936), *cert. denied* 299 U.S. 573 (1936). For example, if a will requires a $100,000 cash bequest to a beneficiary, and rather than distributing cash to the beneficiary the estate distributes marketable securities with a current value of $100,000 and a basis of $60,000, the estate will recognize a gain of $40,000. Thus the result is the same as if the estate had sold the securities and then distributed the cash to the beneficiary. The same gain would be recognized if the trust distributed appreciated securities to a beneficiary in lieu of distributing income. The same gain would be recognized if the trust distributed appreciated securities to a creditor in satisfaction of a claim. Rev. Rul. 74-178, 1974-1 C.B. 196. If the trust distributed securities that had decreased in value, then a loss will be recognized. In most cases, however, any resulting loss will be disallowed under the related-party rules of §267, which applies to both trusts and estates.

c. If no gain or loss is required to be recognized on an in-kind distribution, may the fiduciary nevertheless elect to recognize gain or loss? Yes, the fiduciary may elect under §643(e)(3) to recognize gain or loss on an in-kind distribution. If the election is made, then the trust or estate will be deemed to have sold the asset at its then fair market value, and the beneficiary will receive the asset with a basis equal to that fair market value. If the election is not made, the beneficiary's basis will be the basis of the asset in the hands of the fiduciary, and that basis will be used to calculate both the distribution deduction and the amount includable in the income of the beneficiary. §643(e). This election does not apply to in-kind distributions made in satisfaction of pecuniary bequests or in-kind distributions made in satisfaction of specific bequests that are made in less than three installments. §643(e)(4); §663(a)(1). The election applies to all eligible in-kind distributions made during the year, not just selected in-kind distributions; the fiduciary cannot pick and choose. §643(e)(3)(B). This is a complex subject that warrants careful consideration by the fiduciary. The fiduciary will need to weigh the possible recognition of gain by the estate or trust, the availability of a distribution deduction, the income tax consequences to the beneficiary, and the resulting basis in the hands of the beneficiary. For example, the trust or estate might have losses or deductions that can be used to offset the gain resulting from the election. If the estate or trust does not have such losses or deductions, then oftentimes it is best to not make the election, and the beneficiary will receive the asset with a lower carry-over basis. If the beneficiary subsequently dies with the asset in his possession, the gain will be forgiven due to the stepped-up basis rule of §1014(a). For a more detailed explanation of the election and its consequences, see Janiga, Harrison, and Morris, *Is a Section 643(e)(3) Election Advisable?*, Practical Tax Strategies, October 2014.

d. If the in-kind distribution carries out DNI, what is the value of the in-kind distribution for purposes of calculating the distribution deduction? If gain or loss is recognized on the distribution (due to a §643 election or for the other reasons described above), then the distribution deduction will include the fair market value of the asset. If no gain or loss is recognized, then the distribution deduction will include only the adjusted basis of the asset, the amount taxable to the beneficiary will be that same amount, and the basis of the asset in the hands of the beneficiary will be the same. §643(e).

e. What is the income tax basis of the asset in the hands of a beneficiary? The general rule is that the beneficiary will receive the same basis that the asset had in the hands of the estate or trust, except that the basis will be increased by any gain recognized by the estate or trust and decreased by any loss recognized by the estate or trust. §643(e). In other words, if gain or loss was recognized by the estate or trust on the distribution of the asset, then the basis of the asset in the hands of the beneficiary will be the fair market value of the asset on the date of distribution. Rev. Rul. 67-74, 1967-1 C.B. 194; §1012. If no gain or loss was recognized by the estate or trust on the distribution of the asset, then the basis of the asset in the hands of the beneficiary will be the income tax basis of the asset in the hands of the fiduciary immediately before the distribution. §§1014 and 1015.

f. Can a simple trust make an in-kind distribution? No, an in-kind distribution causes a simple trust to be reclassified as a complex trust. Rev. Rul. 67-74, 1967-1 C.B. 194.

For a discussion of the income tax consequences of funding the various shares of a tax-planning will or trust, including the funding of pecuniary marital bequests and fractional-share marital bequests, see chapter 17 of *Administering Trusts in Oregon* (Oregon State Bar, 2007), particularly §§17.100 through 17.117.

22. Charitable Deduction

Estates and complex trusts (but not simple trusts) may deduct charitable contributions of gross *income* that are paid or permanently set aside. §642(c). This deduction does not apply to simple trusts, because a simple trust will be reclassified as a complex trust in any year in which it makes charitable contributions, regardless of whether those contributions are from income or principal. §651(a); Reg. §1.651(a)-3(a).

The charitable contribution deduction for estates and trusts is more generous than the charitable deduction available for individuals, in four respects:

a. Trusts and estates may deduct charitable contributions in any amount of income up to the total amount of gross income (including capital gains), and are not limited to a ceiling of 50% of adjusted gross income. §642(c)(1); Rev. Rul. 78-24, 1978-1 C.B. 196.

b. An estate or trust may elect to deduct a charitable contribution made in one year as if it had been paid in the prior year. §642(c)(1).

c. A trust or estate may deduct a contribution to a foreign charity. §642(c)(1).

d. Estates and trusts may deduct portions of income that are actually paid to charity. §642(c)(1). Estates (but not most trusts) may also deduct those portions of net income that are permanently set aside for charitable purposes, even though that income has not yet been distributed to charity. §642(c)(2). However, a trust may take advantage of this set-aside deduction if the trust has made a §645 election to use a fiscal year as part of the decedent's estate. Reg. §1.645-1(e)(2)(iv), (e)(3)(i). See the discussion of a trust's election to use a fiscal year, above. In order to take advantage of this "permanently set aside" exception, the possibility that those funds might be diverted away from the charity must be so remote as to be negligible. Reg. §1.642(c)-2(d); Rev. Rul. 70-452, 1970-2 C.B. 199. For example, if the estate faces possible future litigation that might deplete assets, then this exception would not apply. See *Belmont v. Commissioner*, 144 T.C. ___ No. 6 (2015) and the cases cited therein.

The ability to elect to treat charitable contributions as if made in the prior year can have significant advantages in the final year of a trust or estate, when the trust or estate is prohibited from passing out charitable deductions as excess deductions. §642(h)(2). In that situation, the fiduciary may elect to treat the charitable contributions made in the final year as if made in the prior year, thus allowing a deduction in the prior year.

To be deductible, the contribution must be made pursuant to the terms of the governing instrument (the will or trust). The governing instrument need not require the contribution; it need only permit it. §642(c).

Special substantiation requirements apply to charitable deductions in excess of $250. In general, the estate or trust must obtain (prior to the filing date of the return) a written acknowledgment from the charitable donee, confirming the donation received, the amount of the donation, a description of any property received, whether any goods or services were provided by the donee, and a description of any such goods or services. Property (other than cash or publicly-traded securities) with a value of $5,000 or more requires an appraisal. §170(f)(8); Reg. §1.170A-13(f).

The amount deducted must be a portion of gross income (including capital gains and income in respect of a decedent, but not including tax-exempt income), not principal. §642(c); Reg. §1.642(c)(3); *Crestar Bank v. Commissioner*, 47 F.Supp.2d. 670 (E.D.Va. 1999); Rev. Rul. 2003-123, 2003-50 I.R.B. 1200. Distributions of principal, such as a simple charitable bequest, will usually qualify for an estate tax charitable deduction, but not a fiduciary income tax deduction. §2055; §642(c). For those reasons, charitable contributions need to be traced to their source as either distributions of income or distributions of principal. *Mott v. United States*, 462 F.2d 512 (Ct. Cl. 1972); *Riggs National Bank v. United States*, 352 F.2d 812 (Ct. Cl. 1965). (This is one of the few examples of a distribution from a trust or an estate that needs to be traced to the source of the distribution.)

As noted above, a charitable deduction is not eligible to be passed out to the beneficiaries as an excess deduction in the final year of the trust or estate. §642(h)(2); *O'Bryan v. Commissioner*, 75 T.C. 304 (1980).

See the discussion of the distribution deduction, above, regarding the interplay between the distribution deduction and the charitable deduction.

23. The Sixty-Five Day Rule

As a general rule, income retained by an estate or a complex trust is taxed to the estate or trust, and income distributed to the beneficiaries during the taxable year is taxed to the beneficiaries. §662(a). Thus a distribution of current income carries that income out to the beneficiaries, to be taxed to the beneficiaries, and not taxed to the trust or estate. If income is retained by an estate or a complex trust, but distributed in a later year, that later distribution has no income tax significance; it is treated as if it were a distribution of income that was already taxed to the trust or estate in the prior year. (See below for a different rule for simple trusts.) In effect, it is treated as if it were a distribution of principal. §663(a)(3). (However, if in that later year the trust or estate has undistributed DNI, then a distribution of principal will carry out that undistributed DNI, since the distribution rules do not require any tracing of a distribution to determine whether it came from income or principal. See the tier rules, discussed below.)

However, §663(b) permits a significant exception to that rule: If an amount is distributed within sixty-five days following the end of the tax year, and if a §663(b) election is made by checking a box on the Form 1041, then the distribution will be treated as if made on the last day of that preceding tax year. For example, if a calendar year trust earns income in 2013, and a distribution of that amount is made within the first sixty-five days of 2014, and the §663(b) election is made, then the distribution can be deducted on the trust's 2013 return, and that amount will then be taxed to the beneficiaries on their 2013 returns.

The purpose of this election is to permit a trust or estate to calculate its taxable income in the first sixty-five days of the following tax year, after the trust or estate has received its Forms 1099 and other tax information for the year. The trust or estate can then distribute the exact amount necessary to carry that income out to the beneficiaries. Without this election, many fiduciaries would need to make an estimate of the trust or estate income, and then distribute that estimated amount to the beneficiaries prior to December 31 in order to carry the income out to the beneficiaries.

Although §663(b) distributions must be made within the sixty-five day period, the election is not made until the Form 1041 is filed, either on time or under an extension. The election cannot be made on a late return. Reg. §1.663(b)-2(a). Once made, it is irrevocable after the last day prescribed for making it, but it may be revoked up until that date. Reg. §1.663(b)-2(a). The election is made by checking a box on the Form 1041. The election applies only to that particular tax year; it does not affect subsequent or previous tax years. Reg. §1.663(b)-1(a)(2). Thus, if desired, the election needs to be made each and every year.

For calendar-year trusts, the deadline for making the §663(b) distributions is March 6. In leap years, it is March 5.

The sixty-five day rule applies only to estates and complex trusts. Simple trusts, which are required to distribute all of their income in the year in which it is earned, are always treated as if that income were distributed currently, regardless of whether the income is actually distributed. §652(a). As a result, making a §663(b) election for a simple trust would have no effect.

The sixty-five day rule applies only to distribution deductions. It does not apply to other deductions, such as administration expenses. §663(b). If a deduction for administration expenses is needed for a particular year, those expenses must actually be paid before the end of the year, and not within the first sixty-five days of the following year.

The §663(b) election need not apply to all distributions made within the first sixty-five days of the following year; some distributions may be designated for the election, while other distributions not so designated will not be affected by the election. Reg. §1.663(b)-1(a), (2)(a).

Query: Can a §663(b) election be used to terminate a trust or estate? In other words, may a fiduciary distribute all of the assets of a trust or an estate within the first 65 days of a tax year and then treat the trust or estate as having terminated in the previous year, such that the previous year is deemed to be the final year of the trust or estate? The answer is no. Section 663(b)(1) states that the distribution must be made within the first 65 days "of any taxable year," and if the effect is to terminate the trust or estate, then the distribution will not have been made within a taxable year. In addition, Reg. §1.663(b)-1(a)(2) limits the election to distributions of income, not principal.

24. Tiers of Distributions and Beneficiaries

When the income of a trust or estate is taxed to the beneficiaries, it is taxed on a tier system. Neither the Code nor the regulations utilize the word tier, but that is the common parlance.

The first tier consists of the income that is required to be distributed on a current basis, regardless of whether it is actually distributed. §662(a)(1).

The second tier consists of other amounts that may be distributed, but are not required to be distributed as part of the first tier. §662(a)(2). For example, the second tier includes discretionary distributions of income, distributions of principal, and distributions of income accumulated from prior years. *Broadhead Trust v. Commissioner*, T.C. Memo 1972-196.

In the case of both the first and second tiers, the amount that is taxable to the beneficiaries is limited to the amount of DNI for the year, and in particular is limited to the taxable portion of DNI. §651(b); §661(c). If the amount of first tier income is less than DNI, and no second tier distribution is made, then the distribution deduction will be limited to the amount of the first tier income. If the amount of first tier income exceeds DNI, the deduction will be limited to the amount of DNI. In that latter case, each beneficiary will be deemed to have received (and will be taxed on) a portion of the DNI based on that beneficiary's right to receive tier 1 income. For example, if income is required to be distributed 75% to Beneficiary A and 25% to Beneficiary B, then 75% of the DNI will be allocated to Beneficiary A and 25% will be allocated to Beneficiary B. §662(a)(1).

Beneficiaries will be deemed to have received second tier income only if DNI exceeds the first tier distributions. §662(a)(2). The purpose of this rule is to give priority to the taxation of first tier income, and to give priority to the taxation of first tier beneficiaries. One of the benefits of this rule is to eliminate the need to trace a particular distribution to its source in order to determine whether the distribution consisted of income or principal. For example, assume Beneficiary A is entitled to receive $10,000 of current income annually, and Beneficiary B may receive discretionary distributions of income or principal. If DNI is $12,000, and each beneficiary receives $10,000, then Beneficiary A will be taxed on $10,000 of tier 1 income and Beneficiary B will be taxed on $2,000 of tier 2 income. The other

$8,000 received by Beneficiary B is deemed to be a distribution of principal, which is not taxable to Beneficiary B.

The tier system applies not only to types of income, but also to types of beneficiaries. Tier 1 beneficiaries are the recipients of mandatory current income distributions, while tier 2 beneficiaries may receive other distributions. The beneficiaries are taxed on a priority system: DNI is allocated to tier 1 beneficiaries first, and DNI is allocated to tier 2 beneficiaries only to the extent that the DNI is not allocated to tier 1 beneficiaries. Reg. §1.662(a)-3(c). After all of the DNI has been allocated, any distributions in excess of DNI are treated as distributions of principal. In some cases, a beneficiary might be both a tier 1 beneficiary and a tier 2 beneficiary.

If the total amount distributed is less than DNI, then the tier system becomes irrelevant; every amount received by a beneficiary carries out DNI and is taxable to the beneficiary, and the portion of DNI not distributed is taxed to the estate or trust, because the distribution deduction will be limited to the amount distributed. §661(a).

Simple trusts have only one tier of distributions; all distributions are deemed to be tier 1 distributions, and all beneficiaries are deemed to be tier 1 beneficiaries.

25. Income in Respect of a Decedent (IRD); Deductions in Respect of a Decedent (DRD)

Income in respect of a decedent (also known as IRD) is income that was earned by the decedent, or accrued to the benefit of the decedent, during his lifetime, but it was not actually received by the decedent during his lifetime. §691. IRD is not well-defined in the Code or in the regulations, because the definition is intended to be broad enough to encompass a wide variety of situations. Examples usually include:

a. Wages earned during life, but not paid until after death.

b. Other forms of deferred compensation not paid until after death.

c. Interest accrued during life, but not received until after death.

d. Assets held in an Individual Retirement Account (but not a Roth IRA) as of the date of death.

e. Assets held in other qualified retirement accounts as of the date of death.

f. Gains or losses from assets sold during life, but not received until after death.

If the decedent held an annuity, the general rule is that the portion of the proceeds in excess of basis is taxable as ordinary income. §72(a) and (b). If proceeds of an annuity are received after the decedent's death, the taxation of those postmortem proceeds is governed partly by the annuity taxation rules of §72 and partly by the IRD rules of §691(a)(5). *See also* §691(d)(2)(D) and (E) and the discussion of annuities in the section pertaining to fiduciary accounting income, above.

The gross income of a trust or an estate includes any IRD received by the trust or estate, to be reported as taxable income in the tax year in which it is received. §691(a)(1). IRD does not receive a stepped-up basis on the date of death. §1014(c).

As a result, one of the duties of a fiduciary is to carefully manage (or postpone) the receipt of IRD. If an estate receives a paycheck resulting from pre-death work performed by the decedent, the estate has no choice but to include that IRD in gross income. But if the estate is the beneficiary of a retirement account (which is usually 100% IRD), the estate has some flexibility regarding when to withdraw that IRD, and thus the estate has some flexibility to decide when that IRD will be taxed.

Section 691 also permits an estate or trust to take certain deductions that accrued during the decedent's lifetime, but could not be claimed on the decedent's individual income tax returns. §691(b). These deductions are known as deductions in respect of a decedent (DRD). For example, business expenses, interest, or taxes that were incurred or accrued during the life of the decedent, but were not paid during his lifetime, would be considered to be deductions in respect of a decedent, if paid by the estate.

Not only is IRD included in gross income for income tax purposes, it is also included in the gross estate for estate tax purposes. If an estate is required to include IRD in its gross income for a particular year, then it is entitled in that year to deduct the federal estate tax attributable to that IRD. §691(c). This deduction applies only to that part of the IRD that was not distributed or was not required to be distributed to the beneficiaries during that year. §691(c)(1)(B). If that restriction applies, then the beneficiaries are taxed on the IRD that they received, and they may take the §691(c) deduction. Reg. §1.691(c)-1. But the §691(c) deduction is available to the beneficiary only if the beneficiary itemizes his or her deductions, since the deduction is not listed in §62. Rev. Rul. 78-203, 1978-1 C.B. 199. However, the deduction is not considered to be a miscellaneous itemized deduction. §67(b)(7).

The deduction is limited to the federal estate tax paid on items of IRD; no deduction is allowed for state estate taxes or state inheritance taxes. §691(c)(2)(a). If the item of IRD is not taxable in Oregon for purposes of the Oregon income tax, then ORS 316.680(2)(c) denies an Oregon income tax deduction under §691(c) for the federal estate tax paid with respect to that item.

See the following section for a discussion of the IRD aspects of retirement accounts.

Installment sale proceeds are another common example of IRD. When a taxpayer receives a payment on an installment sale of an asset, the payment is normally reported by the recipient as the receipt of three elements: (1) interest, which is taxable as ordinary income, (2) the portion of principal that represents gain, which is often taxable as capital gain, and (3) the portion of principal that represents a return of basis, which is not taxable. §453; §453A; §453B. The relative portions of principal that represent gain and return of basis are usually calculated by applying the same ratio that the purchase price bears to the gain and the basis.

When an installment obligation is acquired from a decedent seller (as opposed to an installment obligation created by an estate when the estate sells an asset), the portion of each payment that represents gain is treated as IRD. §691(a)(4); Reg. §1.691(a)-5. As with other items of IRD, no step-up in basis takes place on the death of the decedent. §1014(c).

Thus payments received by the estate or beneficiary on an installment obligation will continue to be reported by the estate or beneficiary in the same manner that the payments were being reported by the decedent. Reg. §1.691(a)-5. Thus the gain is not accelerated on the death of the decedent or on the transfer of the obligation to a beneficiary who is entitled to receive it under the will or trust. Instead, the estate or beneficiary will continue to report the gain over time, as the payments are received. Reg. §1.691(a)-5. See below for a different rule if the beneficiary is also the obligor.

If the estate or the beneficiary sells the installment obligation or transfers the obligation to a non-beneficiary, the seller must recognize gain as IRD, using the fair market value of the obligation and the decedent's basis in the sold asset, adjusted to reflect the portions of basis that were previously received by the decedent or by his estate. §691(a)(2). The receipt of basis is not considered to be an item of IRD. §691(a)(4).

If a decedent bequeaths an installment obligation to the person who is obligated to pay the installment payments, then the estate realizes a gain equal to the amount of gain that had not yet been reported by the decedent. §691(a)(5). The gain is measured by the difference between the fair market value of the obligation and the decedent's remaining basis in the obligation. §691(a)(5). That same result takes place if the decedent discharges the debt at the death of the decedent. §691(a)(5). If the decedent discharges the debt at death, and the decedent and the obligor are related, then the value of the obligation will not be less than its face value. §691(a)(5)(B). In the case of such a discharge or bequest of the debt to the obligor, the estate must recognize the gain no later than the conclusion of the estate administration, unless some act of cancellation occurs prior to that time. PLR 8806048; S. Rep. No. 96-1000, 27 (1980-2 C.B. 494, 508; 1980 WL 356610). However, a residuary bequest that includes the installment obligation does not automatically transfer the obligation to the obligor; instead, the transfer takes place in the tax year during which the obligation is actually transferred to the obligor. PLR 8806048. That result is correct even if state law provides that the assets of the estate vest immediately in the beneficiaries, subject only to the administration of the estate. PLR 8806048. (Oregon law so provides. ORS 114.215(1)(a).) If the cancellation takes place at death, the cancellation is to be treated as if the transfer had been made by the estate of the decedent. S. Rep. No. 96-1000, 27 (1980-2 C.B. 494, 508; 1980 WL 356610). Presumably, that transfer will be deemed to have taken place in the first tax year of the estate. The Senate Report goes on to state, "However, if the obligation were held by a person other than the decedent, such as a trust, the cancellation will be treated as a transfer immediately after the decedent's death by that person."

26. Retirement Accounts

The largest and most commonly-encountered forms of income in respect of a decedent (IRD) are retirement accounts.

Retirement accounts (except Roth IRAs) are almost always made up of IRD, which is taxable income to an estate, trust, or beneficiary who withdraws assets from a retirement account. In other words, neither a retirement account nor the assets in a retirement account receive a stepped-up basis on the death of the owner of the retirement account. §1014(c). Funds withdrawn from the retirement account are considered to be ordinary income (with some exceptions), to be reported on an income tax return of the recipient in the year of withdrawal.

That fact makes retirement accounts very dangerous to deal with, since an inadvertent withdrawal (or an inadvertent closing of the account) can trigger a very large income tax liability. Proceed with caution.

Because of the IRD nature of retirement accounts, such assets make ideal candidates for charitable dispositions. If a person holds both regular (after-tax) investments and pre-tax retirement accounts, and that person desires to leave some of his assets to his family and other assets to a charity, the charity should be designated as the beneficiary of the retirement accounts, because the charity is tax-exempt and will not be required to pay income tax when the retirement assets are withdrawn from the retirement account. In contrast, if the retirement account were left to family members, the family members would be required to pay income tax on their withdrawals from the retirement account.

The taxation of retirement accounts depends primarily on who the beneficiary is:

- Family Members. In most cases, the designated beneficiaries of the retirement account will be family members (such as children of the decedent) or the surviving spouse. In those situations, the attorney representing the personal representative or representing the trustee will often be called on by family members to give advice on how to handle the retirement account. If the fiduciary is not also the beneficiary, maintain an awareness of who your client is, and watch for conflicts of interest.

- The Estate or a Trust. In some cases, the beneficiary of the retirement account is the estate or trust, and not an individual family member. If so, the attorney will need to carefully advise the fiduciary about how the actions of the fiduciary will affect the timing of the taxation of the account.

- No Beneficiary Named. In some instances, the decedent may have neglected to name a beneficiary for a retirement account. In those instances, the retirement plan document must be reviewed in order to determine the identity of the default beneficiary. Often, the default beneficiary will be the estate of the decedent or the surviving spouse, but plans vary. A 2014 survey indicated that 30% of retirement plans default to the estate of the decedent, 43% default to the surviving spouse and then to the estate, and 22% default to the spouse, and then to the estate, and then to the children.

Typically, the surviving spouse is the designated beneficiary of most retirement accounts, including IRAs. If the spouse is the beneficiary, the spouse can usually roll the account over into her own name without triggering income tax. §408(d)(3)(C). The income tax will then be postponed until the spouse makes withdrawals.

If the estate is the beneficiary of an IRA, the fiduciary must exercise extreme care. If the estate is the beneficiary, the fiduciary should carefully consider methods that might be used to postpone the taxation of that account, keeping in mind that a withdrawal from the account is a taxable event, but the assignment of the account intact is typically not a taxable event. If the account is a small one, then perhaps the simplest answer would be to withdraw all of the assets and pay the tax. But if the account is a large one, the fiduciary should consider assigning the account to the beneficiaries in the form of one or more inherited IRA accounts, without making any actual withdrawals from the IRA. If the decedent had three children, for example, the account can typically be divided into three separate inherited IRAs, one for each of the three children. The three children could then each decide when each of them would like to withdraw funds from their respective separate accounts, and thus each of them can control when they will each be taxed on the withdrawals. This is particularly helpful if the beneficiaries are in different circumstances: One beneficiary might not need the income, and might wish to postpone withdrawals and taxation for as long as possible, while another beneficiary might be in need of income and might be willing to make a withdrawal and pay tax immediately.

Before taking action with respect to a retirement account, consider every possible alternative in order to minimize (i.e., postpone) the exposure to income taxation. Typically, the alternatives include the following (in this discussion, a reference to a beneficiary means the beneficiary of the retirement account, not the beneficiary of an estate or trust):

a. Have the beneficiary withdraw all of the assets from the retirement account, which is a taxable event for the beneficiary. This is usually not the best choice, unless the account is small and the tax consequences minor.

b. If the beneficiary is the surviving spouse, she can roll the account into an IRA in her own name. Note that this does not involve a withdrawal; the assets stay within an IRA. Taxation will not take place until the spouse, as the beneficiary of the rollover IRA, makes a withdrawal from the rollover account. This rollover option is often the best choice for a spouse beneficiary.

c. If the spouse is not the beneficiary (the beneficiaries are the children of the decedent or are non-relatives), the beneficiaries cannot do a rollover, but they can do something similar: they can convert the account into one or more inherited IRAs. Note that this does not involve a withdrawal; the assets stay within the inherited IRAs and are not taxed until withdrawn from one of the inherited IRAs. Rev. Rul. 78-406, 1978-2 C.B. 157.

d. If the beneficiary is the estate or a trust, the estate or trust may wish to continue to maintain the account as an inherited IRA for the benefit of the estate or trust, but that would require keeping the estate or trust open. In most cases, the estate or trust will prefer to convert the account into one or more inherited IRAs for the benefit of the beneficiaries of the estate or trust.

Keep in mind that some retirement plans, or some plan custodians, will not permit a retirement account to be divided into separate inherited accounts for each beneficiary; contact the plan custodian/administrator and review the plan document to determine what is permitted.

The primary purpose of the techniques described above is to permit the beneficiary to postpone withdrawals for the longest period of time permitted by the tax laws, although the beneficiary is also free to make withdrawals on a more accelerated basis, if that is what the beneficiary desires. The length of that possible deferral period depends on several factors. Attached to this paper as Appendix B is a summary of the general rules governing those time periods, entitled "Retirement Plan Distributions After Death." Exceptions may apply to those general rules. See also, Duffy, *Beneficiary Designation: More Prominent Considerations in Today's Estate Tax World*, Oregon State Bar Estate Planning and Administration Section Newsletter, Vol. XXX, No. 3, July 2013.

27. Separate Share Rule

If multiple trusts are established for the respective benefit of multiple beneficiaries, then each of those trusts will be treated for tax purposes as a separate and different trust, each calculating its own income and deductions and each filing its own income tax return. But if a single trust (or an estate) is designed to benefit multiple beneficiaries and the terms of the trust or will prevent distributions to one beneficiary from affecting the interests of the other beneficiaries, then §663(c) requires the application of the separate share rule. Reg. §1.663(c)-3. The separate share rule is stated very simply in §663(c), with nearly all of the detail provided in regulations. Reg. §1.663(c)-1.

If the separate share rule applies, then the result is that each separate share of the trust or estate will calculate its own DNI, separate and apart from the other shares of the trust or estate. §663(c). The rule does not apply for any other purpose.

This rule is mandatory; it is not elective. Reg. §1.663(c)-1(d). It does not require or permit the creation of separate trusts, nor does it require or permit the filing of separate tax returns. Reg. §1.663(c)-1(b). Instead, the separate share rule operates within a single trust to ensure that the tax attributes of one separate share held for the benefit of one beneficiary do not affect the taxation of any other share held for the benefit of any other beneficiary. As a result of the separate share rule, if it is applicable, a beneficiary will not be taxed on income distributed to, or accumulated for the benefit of, another beneficiary. Reg. §1.663(c)-1.

A separate share is defined as that portion of a trust that is administered as if it were a separate trust. Reg. §1.663(c)-3. For example, if a trust created for the benefit of three beneficiaries requires that distributions to each beneficiary may be made only from the respective share of that particular beneficiary, then the separate share rule will apply. It does not apply if the trust document actually requires the creation and administration of a separate trust for each beneficiary. And it does not apply to trusts where the trustee has the power to sprinkle distributions of income or principal from the entire trust among the various beneficiaries, because distributions to one beneficiary will affect the interests of the other beneficiaries. Reg. §1.663(c)-3(b). A specific bequest that is paid in three or fewer installments is not considered to be a separate share, because it does not carry out DNI. §663(a)(1); Reg. §1.663(c)-4. The separate share rule never applies to a simple trust, because its application is unnecessary; the DNI of any separate shares contained within a simple trust will be allocated to each separate share in any event.

The mechanism used to achieve the goal of the separate share rule is the calculation of separate DNI and a separate distribution deduction for each separate share. Reg. §1.663(c)-2(b). Once those separate distribution deductions are calculated per share, they are then added together to create one distribution deduction for the entire trust. That one combined distribution deduction is then subtracted from the adjusted total income of the trust to determine taxable income, and then the trust files a single income tax return for all of the shares. The separate share rule does not result in separate trusts that file separate returns.

The separate share rule can apply to both estates and trusts. §663(c).

In 2013, the Oregon legislature enacted a new trust statute, providing that if a trust calls for the creation of separate shares for the benefit of separate beneficiaries, then each of those separate shares will be deemed to be a separate trust for the sole benefit of its beneficiaries, and the trust (or portion of the trust) from which those new trusts were created will be deemed to have terminated to the extent of the new trusts. ORS 130.232 (SB 592, Oregon Laws 2013 ch. 529, §24). Query: As a result of this new legislation, will the separate share rule of §663(c) rarely apply in Oregon? This new statute appears to require separate trusts under the same conditions that the separate share rule would treat the original trust as one trust with separate shares that calculate their own DNI and distribution deduction. If so, then in Oregon such trusts will be treated as separate trusts, and not separate shares, and the separate share rule will not apply. Under this new statute, it is difficult to imagine the terms of an Oregon trust that would become subject to the separate share rule. (ORS 130.232 is under consideration for revision at the 2015 session of the legislature; check the current status of that statute.)

28. Basis Step-up

The income tax basis of property acquired by an estate from a decedent is its fair market value on the date of death, §1014(a), or its alternate value on the alternate valuation date if elected under §2032, or its special use value if elected under §2032A. This is known as the basis step-up, although in times of declining values it becomes a basis step-down. §1014(a).

The basis step-up generally applies to all assets included in the gross estate by reason of any Code section, not just assets held in the individual name of the decedent. Reg. §1.1014-1(a). One exception: Income in respect of a decedent (IRD) does not receive a basis step-up. See the discussion of IRD, above.

The basis step-up takes place even if the estate was too small to file an estate tax return or was not required to pay estate tax. Rev. Rul. 56-215, 1956-1 C.B. 324. Because only half of property held joint by a husband and wife is included in the gross estate of the first spouse to die, only half of the property receives a new basis. §1014(a) and (b)(9).

In contrast, the basis of property acquired by gift or by an intervivos transfer into an irrevocable trust remains the same basis that the property had in the hands of the donor or transferor. §1015. This is known as carry-over basis.

As a result, the basis of assets held by an estate, a testamentary trust, or a post-mortem revocable trust is the date of death value, or the alternate valuation date value if elected under §2032, or the special use value if elected under §2032A. The same rule applies to other forms of transfers at death. But intervivos transfers do not receive a new basis, unless for some reason the transfer became included in the gross estate of the decedent for estate tax purposes. §1014(b).

This is a very important point because in most situations a trust, estate, or beneficiary receiving a decedent's property that appreciated significantly during the decedent's lifetime can sell that asset after death with little or no capital gain realization or recognition. (See the discussion of capital gains and losses, above.) And depreciable assets transferred at death receive a new income tax basis that the estate, trust, or beneficiary may begin depreciating all over again. However, the new income tax basis of depreciable assets transferred at death must be reduced by any depreciation taken by the taxpayer (not the decedent) during the life of the decedent. §1014(b)(9); Reg. §1.1014-6(a)(1); Rev. Rul. 58-130, 1958-1 C.B. 121.

Section 1014(e) denies a stepped-up basis for appreciated property acquired from a decedent who had acquired the property from the beneficiary within the one-year period prior to the decedent's death. It is an open question whether the denial of the basis step-up applies not only to the beneficiary, but also to a trust for the benefit of the beneficiary. Thus if Wife conveys appreciated property to Husband, and Husband dies within one year and then bequeaths the property to a credit shelter trust for the benefit of Wife (or to a QTIP trust for the benefit of Wife), whether the trust receives a stepped-up basis is uncertain. Siegel, *I.R.C. Section 1014(e) and Gifted Property Reconveyed in Trust*, 27 Akron Tax J. 33 (2012). Regulations under §1014(e) have not yet been promulgated, but the IRS has taken the position that §1014(e) does deny a basis step-up for appreciated property left in trust for the benefit of the spouse who conveyed the property to the decedent within one year prior to death. PLRs 200101021 and 200210051.

29. State Fiduciary Income Taxes

Some states impose their own fiduciary income taxes, in addition to the federal fiduciary income tax, but the rules vary widely from state to state regarding when a state considers a particular trust to be subject to its state fiduciary income tax. The rules applicable to California, Oregon, and Washington are:

California - The California fiduciary income tax applies to trusts that have a California resident trustee or a California resident non-contingent beneficiary. (If only one of several trustees is a California resident, then only a proportionate fraction of the income is taxed. The same rule applies if only one of several beneficiaries is a California resident.) The tax also applies to estates if the decedent was a resident of California. Income distributed to the beneficiaries is generally not taxed to the estate or trust; it is taxed to the beneficiaries, as in the federal system. If the beneficiary is a nonresident of California, the beneficiary will not be taxed by the state of California unless the income is California-source income. The initial (lowest) income tax rate is 1% on the first $7,582 of taxable income; the maximum rate is 13.3% on income in excess of $1 million. Cal. Rev. and Tax. Code §§17041, 17043, 17742. For a fuller discussion of the California fiduciary income tax, see Kinyon, Marois, and Johnson, *California Income Taxation of Trusts and Estates*, ACTEC Law Journal, Vol. 39, No. 1 & 2, 69 (Spring/Fall 2013). See also California Form 541 and its instructions.

Oregon - The Oregon fiduciary income tax (reportable on Form 41) applies to both resident Oregon trusts and nonresident trusts, but in different ways. A trust is deemed to be a resident trust if the trust has one Oregon trustee or co-trustee, or the administration of the trust is carried on in Oregon. ORS 316.282(1)(d); OAR 150-316.282(3), (5) ex. 3. Administration is defined as fiduciary decision-making, not incidental execution of decisions made by others. ORS 316.282(3); OAR 150-316.282(5). A resident trust is a trust with a resident fiduciary or if the administration is being carried on in Oregon, even if the trustee is a corporate trustee with headquarters elsewhere. ORS 316.282(1)(d); OAR 150-316.282(5). Nonresident trusts are defined as trusts other than resident trusts. ORS 316.302. The Oregon fiduciary income tax also applies to an estate if the fiduciary was appointed by an Oregon court or the administration of the estate is carried on in Oregon. ORS 316.282(1)(b); OAR 150-316.282(2). A principal probate and an ancillary probate in two different states are considered to be one estate, but if the principal administration takes place in Oregon, all of the income of both estates will be taxed in Oregon. If the principal administration takes place in another state, then the estate will be taxed as a non-resident estate. OAR 150-316.282(2). The calculation of the Oregon fiduciary income tax on resident trusts and estates is made in much the same manner as the Oregon individual income tax, with some exceptions. ORS 316.272; OAR 150-316.282(6). Similarly, Oregon taxes the Oregon-source income of nonresident trusts and nonresident estates as if the trust or estate were a nonresident individual. ORS 316.307(3); ORS 316.312; OAR 150-316.307. The taxable income of an estate or trust is based on federal taxable income, but an Oregon fiduciary adjustment is made. ORS 316.282; ORS 316.287. The initial (lowest) rate of the Oregon fiduciary income tax is 5% on the first $3,250 of taxable income; the maximum rate is 9.9% on income in excess of $125,000. ORS 316.037; ORS 316.282; OAR 150-316.282(3), (4). Under some circumstances, Oregon grants a credit for fiduciary income taxes paid to other states. ORS 316.082 (residents); ORS 316.131 and 316.292 (nonresidents). A nonresident beneficiary of a trust or estate (resident or nonresident) is taxed in the same manner as if the beneficiary had received the income directly, and not through a trust or an estate. OAR 150-316.282(7). As a result, a nonresident beneficiary of a resident Oregon trust will be taxed in Oregon if the income resulted from the ownership or disposition of tangible property (real or personal) in Oregon, or from the operation of a trade or business in Oregon. ORS 316.127; OAR 150-316.127-(D).

Washington – Washington has not enacted a fiduciary income tax.

In other western states, fiduciary income taxes have been adopted in Idaho (maximum rate 7.4%) Arizona (maximum rate 4.54%) and Hawaii (maximum rate 8.25%). Fiduciary income taxes have not been adopted in Alaska or Nevada.

30. Revocable Trusts and Grantor Trusts

A detailed discussion of grantor trusts (including revocable trusts) is beyond the scope of this paper, but here is a brief summary of the basic elements of revocable trusts and grantor trusts.

A grantor trust is essentially a trust that a person (usually the grantor or trustor, but not always) has sufficient control over, such that some aspects of the trust are taxed to that person. The most common example is a trust that is treated as a grantor trust for income tax purposes because the grantor has retained certain powers that make the income of the trust taxable to that person for income tax purposes. Other trusts grant the trustor such powers that the trust becomes part of the trustor's gross estate for estate tax purposes, but the term grantor trust is usually used primarily in the income tax context. (See the above discussion of credit shelter trusts for a discussion of whether a typical credit shelter trust is a grantor trust.)

Grantor trusts typically fall into two primary categories:

First, a revocable living trust is a grantor trust for purposes of both the income tax (during the grantor's life) and the estate tax (at the grantor's death). It is primarily a probate-avoidance tool, and the trustor of a revocable living trust is not intending to achieve any particular income tax advantages or estate tax advantages, although revocable living trusts often create post-mortem trusts that have estate tax advantages for the surviving spouse of the trustor. Several alternative methods are available for reporting the income of a revocable living trust. The most commonly-used method is for the grantor to file an individual income tax return, using the grantor's social security number; that return will report all of the income and capital gains received by the trust or by the grantor. Reg. §1.671-4(b)(2)(i)(A). The same is true for a husband and wife who have a joint revocable trust and file a joint return. Reg. §1.671-4(b)(8). In both cases, no further reporting is needed, but if the grantor is not the trustee then certain specified information must be supplied to the grantor by the trustee. Reg. §1.671-4(b)(2)(ii). See Reg. §1.671-4 for alternative reporting methods.

Second, other grantor trusts are often created that are designed to be grantor trusts for income tax purposes, but not for estate tax purposes. (These trusts are sometimes referred to as intentionally defective grantor trusts, or IDGTs.) These trusts are designed to offer certain income tax advantages during the life of the trustor, but the assets also avoid estate tax on the death of the trustor. For example, a trustor might create a grantor trust during his lifetime, and then sell an appreciated asset to that trust. The income generated by the trust might be payable to the trustor's children, and on the grantor's death the principal of the trust would be distributed to his children or be held in further trust for the benefit of his children. But because the trust is a grantor trust for income tax purposes, the sale of the appreciated asset is not a taxable event, because the trustor has in effect sold the asset to himself. In some cases, the asset is not sold to the trust, but instead is gifted to the trust, and a completed taxable gift will have taken place, because the children received a vested interest in the trust. Following the sale or gift, any income earned by the asset in the hands of the trust is taxed to the trustor, because the trust contains certain provisions that trigger the grantor trust provisions of the Code, such as §§673 through 677. However, the income earned by the trust is not payable to the trustor, even though the trustor is taxed on that income for income tax purposes. Such a trust typically contains no provisions that would trigger estate tax on the death of the trustor. In particular, the trust contains no provisions that would trigger the string sections of the estate tax statutes. (Sections 2036 through 2038 are colloquially known as the string sections, because they will result in inclusion in the gross estate of the donor or grantor if the lifetime transfers were made with certain strings attached, such as retention of an income interest, retention of a right to revoke, etc.) Thus a trustor can reduce his taxable estate by transferring assets to a grantor trust, and then further reduce his estate by paying the income tax on the income generated by the grantor trust, all the while excluding the transferred assets (and the income generated by those transferred assets) from his gross estate for estate tax purposes. The payment of the income taxes by the grantor is not considered to be a gift to the trust or to its beneficiaries.

To invoke grantor trust status without triggering estate tax on the death of the trustor, the grantor trust must be carefully designed to trigger the income tax grantor trust statutes without triggering the estate tax statutes. To avoid the latter, the trust must not give the trustor the right to receive the income of the trust, or the right to amend, alter, or revoke the trust. §§2036 through 2038. To trigger the grantor income tax provisions, the trustor is typically given the power to borrow trust assets without adequate security or adequate interest, or the trustor is given the power to reacquire trust assets and replace them with property of equivalent value. §675(2); §675(4)(C). Or the grantor could give a nonadverse party the power to add a charitable beneficiary. *Madorin v. Commissioner*, 84 T.C. 667 (1985).

The income, including capital gains, earned by an irrevocable life insurance trust is taxable to the grantor because §677(a)(3) provides that if trust assets may be applied to the payment of premiums on the life of the trustor, or his spouse, then the trust will be treated as a grantor trust for income tax purposes.

Selected Additional Research Materials

Acker, *Income Taxation of Trusts and Estates*, Portfolio 852-3d, Bloomberg Bureau of National Affairs: Tax Management Estates, Gifts and Trusts Portfolios (2010).

Acker, *Income in Respect of a Decedent*, Portfolio 862-3d, Bloomberg Bureau of National Affairs: Tax Management Estates, Gifts and Trusts Portfolios (2010).

Zaritsky and Lane, *Federal Income Taxation of Estates and Trusts*, Warren Gorham, and Lamont (3d ed. 2003).

Federal Income Taxes of Decedents, Estates and Trusts, CCH Tax Spotlight Series (23d ed. 2007).

Choate, *Life and Death Planning for Retirement Benefits*, Ataxplan Publications (7th ed. 2011).

Kantor and Miller, eds., *Administering Trusts in Oregon*, Oregon State Bar, 2007.

Appendices

Appendix A: Miscellaneous Itemized Deductions of Trusts and Estates

Appendix B: Retirement Plan Distributions After Death

Appendix A
Miscellaneous Itemized Deductions of Trusts and Estates on Form 1041
under §67(e), *Knight v. Commissioner*, and Reg. §1.67-4 (TD 9664; 5/8/14)

Type of Deduction	**Fully Deductible**	**Deductible Subject to 2% Floor**
Trustee Fees and Investment Management Fees	Fees attributable to estate or trust administration, including specialized balancing of trust beneficiary interests, allocation of income and principal among beneficiaries, distribution of assets to beneficiaries, pursuit of unusual fiduciary investment objectives, and specialized fees applicable only to trusts and estates.	Fees attributable to investment management or balancing investments between current beneficiaries and remaindermen. Unitary trustee fees that compensate for both trust administration and investment management must be unbundled or allocated between trust administration and investment management, beginning with tax years starting after 5/9/14.
Attorney Fees	Most attorney fees are fully deductible, because most are not commonly incurred by individuals.	Fees not unique to trusts and estates, such as attorney fees expended in defense of claims.
Will and Trust Contests	All.	None.
Court fees	Most court fees, including most probate court fees and legal publication costs.	Fees incurred defending against claims.
Fiduciary Accountings and Bond Premiums	All, including certified copies of the death certificate.	None.
Appraisal Fees	Fully deductible if obtained to determine estate taxes, GST taxes, gift taxes, or to determine distributions.	Appraisals obtained for insurance purposes.
State and Local Taxes	All (not a Miscellaneous Itemized Deduction). §67(b)(2).	None.
Real Estate Management	None, unless the trust or estate is engaged in real estate business. §62. Business expenses are not itemized deductions. §62(a)(1).	Real estate management fees, insurance, property repairs and maintenance, condo association fees, utilities.
Estate and GST Tax Return Preparation	All.	None.
Gift Tax Return Preparation	None.	All.
Income Tax Return Preparation	Fiduciary income tax returns. Decedent's final income tax return.	All other income tax returns. Returns for sole proprietorships and retirement plans may be deducted under §162.

This summary was prepared by Philip N. Jones of Duffy Kekel LLP. 3/20/15. Review the statutes, court opinion, and regulations for application to particular situations. The regulations became final on 5/9/14.

Appendix B
Retirement Plan Distributions After Death

Status of Account	Death Before Age 70.5	Death After Age 70.5
Individual Designated Beneficiary named	Beneficiary may withdraw over the beneficiary's single life expectancy table.	Beneficiary may withdraw over the beneficiary's single life expectancy table.
No Designated Beneficiary named	Beneficiary must complete withdrawals within five years (by the end of the year containing the fifth anniversary of the death).	Beneficiary must begin withdrawals by the end of the year following death, and may thereafter follow the decedent's remaining life expectancy.
Surviving Spouse named as beneficiary	Surviving spouse may roll the account over into an IRA in the surviving spouse's name. Spouse may then defer withdrawals until age 70.5, and may then use her own life expectancy table.	Surviving spouse may roll the account over into an IRA in the surviving spouse's name. Spouse may then defer withdrawals until age 70.5, and may then use her own life expectancy table.
Estate is named as beneficiary	Estate cannot qualify as a Designated Beneficiary. See No Designated Beneficiary named, above.	Estate cannot qualify as a Designated Beneficiary. See No Designated Beneficiary named, above.
Trust is named as beneficiary and qualifies as a Designated Beneficiary	Withdrawals may be made over the life expectancy of the oldest beneficiary.	Withdrawals may be made over the life expectancy of the oldest beneficiary.
Marital Trust named as beneficiary, and does not qualify as a Designated Beneficiary	Surviving spouse must complete withdrawals within five years (by the end of the year containing the fifth anniversary of the death).	Surviving spouse must begin withdrawals by the end of the year following death, and may thereafter follow the decedent's remaining life expectancy.
Account (but not withdrawals from the account) is used to fund a pecuniary bequest from an estate or trust	IRS contends that IRD income is realized immediately by the estate or trust under §691(a)(2). See CCA 2006-44020. This conclusion is probably incorrect.	IRS contends that IRD income is realized immediately by the estate or trust under §691(a)(2). See CCA 2006-44020. This conclusion is probably incorrect.
Decedent had not yet taken an RMD for the year of death	Not applicable. No RMDs required.	Beneficiary must timely withdraw the RMD.

Compiled by Philip N. Jones and Peter J. Duffy, of Duffy Kekel LLP. Some exceptions apply. 3/20/15.
See also OSB Estate Planning and Administration Section Newsletter, July 2013.