A FIDUCIARY INCOME TAX PRIMER

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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.

If you are new to the fiduciary income tax, and you would like an abbreviated introduction to the most important aspects of the tax, consider reading the following sections of this paper first: 3, 7, 8, 9, 12, 13, 17, 18, 20, 23, and 26.

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, along with some discussion of Washington law.

This paper does not discuss city or county income taxes that are imposed on estates and trusts. For example, the City of Portland and Multnomah County impose a business income tax on business activities, including the business activities of trusts and estates (such as the rental of real estate or the sale of real estate, or other business activities), and that tax liability cannot be passed on to the beneficiaries, even in the final year of an estate or trust. The tax is a combination of the City of Portland Business License Tax and the Multnomah County Business Income Tax, and it is administered by the City of Portland Revenue Division. It has a $50,000 annual exemption. See Portland City Code Chapter 7.02, Business Tax Administrative Rule 200.95-1A, and Form E-2018.

This paper does not discuss the taxation of foreign trusts, which are generally taxed in the same manner as nonresident aliens. §641(b). Foreign estates are also not discussed.

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 OR-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).

This paper is devoted primarily to the taxation of non-grantor trusts. The taxation of grantor trusts is discussed occasionally, particularly in section 30, below.

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 foregoing paragraph is particularly applicable to the changes enacted by the Tax Cuts and Jobs Act of 2017 (P.L. 115-97), which was enacted in late 2017. In general, those changes became effective on January 1, 2018. Some of the changes made by that Act were corrected and/or amended in March of 2018 by the Consolidated Appropriations Act of 2018 (H.R. 1625; P.L. 115-141). The 2017 Act made many changes to the income tax laws, and many of those changes are complex and not yet fully understood. In addition, new regulations interpreting those changes will likely not be published for some time to come. Many of the provisions of the 2017 Act will sunset at the end of 2025, and old law will be restored on January 1, 2026, unless future legislation changes that schedule. As a result of those complexities, practitioners should proceed cautiously regarding matters affected by the new law.

The author would appreciate hearing from readers who have corrections, suggestions, or updates to offer regarding this paper.

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, and the estate was then insolvent and unable to pay those taxes, 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); Reg. §20.2002-1; Rev. Rul. 80-112, 1980-1 C.B. 306; *Lee v. Commissioner,* TC Memo 2021-92. The former is known as fiduciary liability, while the latter is known as transferee liability. Transferee liability not only applies to initial transferees, but also to successive transferees. *Hawk v. Commissioner*, T.C. Memo 2017-217. 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. 317 (2014); *Feldman v. Commissioner*, 779 F3d 448 (7th Cir. 2015). The determinations of liability under state law and of transferee status under federal law are separate and independent determinations. *Hawk v. Commissioner*, T.C. Memo 2017-217. In most cases, the state law is the Uniform Fraudulent Transfer Act, also known as the Uniform Voidable Transactions Act. In Oregon, see ORS chapter 95. In Washington, see RCW chapter 19.40. In some situations, state law might even govern the calculation of interest on the transferee tax liability. *Schussel v. Commissioner*, 758 F.3d 82, 114 AFTR2d ¶2014-5038 (1st Cir. 2014). For a transferee liability case that originated in Oregon, see *Marshall v. Commissioner*, T.C. Memo 2016-119, affirmed by 124 AFTR2d ¶2019-5072 (9th Cir. 7/23/19, docket no. 17-72955; unpublished opinion). For a discussion of what constitutes insolvency of an estate, see *Singer v. Commissioner*, T.C. Memo 2016-48. 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); *U.S. v. McNicol*, 829 F.3d 77, 118 AFTR 2d ¶2016-5038 (1st Cir. 2016; cert. den. 1/9/17). For a case applying the statutes of limitation in a §6166 setting, see *U.S. v. Johnson*, 920 F.3d 639, 123 AFTR2d 2019-1272 (10th Cir. 2019). In some cases, the IRS may be able to collect against a fiduciary or a transferee without having made an assessment against the fiduciary or transferee. *U.S. v. Geniviva*, 16 F.3d 522 (3rd Cir. 1994); *U.S. v. Botefuhr*, 309 F.3d 1263 (10th Cir. 2002); *U.S. v. Russell*, 532 F.2d 175 (10th Cir. 1976). 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 (D.C. Md. 2014); §6012(b). In a transferee liability case or a fiduciary liability case, the IRS has the burden to prove the liability, but the transferee or fiduciary has the burden to disprove the amount of tax. §6902(a). These rules apply to income taxes, estate taxes, and gift taxes. For an example of an estate, two marital trusts, and a surviving spouse all being held responsible for transferee liability, see *Hawk v. Commissioner*, T.C. Memo 2017-217. Regarding estate and gift taxes, see also §6324(a)(2) (which imposes fiduciary liability even without a conveyance) and ORS 118.210, and see ORS 316.382 and OAR 150-316-0445 regarding the decedent's Oregon income taxes. See also ORS 314.310 and ORS 116.063(3)(c). In Washington, see RCW 83.100.120. Finally, keep in mind that the claims limitation period (four months in Oregon) does not apply to the federal government. *U.S. v. Summerlin*, 310 US 414 (1940). 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. Here are two tax terms that every person dealing with a trust (or any other taxpayer) should know: Income is realized when it is received by a cash-basis taxpayer, but it is recognized when it is reported on an income tax return.

As you read this paper, you will note seven recurring themes:

(1) Trusts and estates are usually taxed at higher rates than individuals. See section 3, below.
(2) Those higher-rate taxes are often avoidable by deducting administration expenses. See sections 15 and 17, below.
(3) Those higher-rate taxes are often avoidable by making distributions to beneficiaries, which are generally deductible. The beneficiaries then become taxed. See sections 18 and 23, below. This ability to cause income to be taxed to the beneficiaries generally applies only to ordinary income; capital gains are usually taxed to the trust or estate. See section 13, below.
(4) Income is taxed only once (to the trust/estate, or to the beneficiaries, but not to both). See section 18, below.
(5) Estates and some trusts can select their own fiscal year-end. See sections 7 and 8, below.
(6) After a death, estates and trusts can often elect whether to take their administration expense deductions either on the income tax return or on the estate tax return, but not on both. See section 17, below.
(7) Estates and trusts usually pay no income tax in their final year. The beneficiaries pay the tax in the final year, both on ordinary income and capital gains. See section 9, below.

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), *aff'd without opinion*, 573 F.2d 1287 (2nd Cir. 1977). For the same reason, conservatorships and guardianships are not taxed as trusts. §7701(a)(6); §6012(b)(2); Reg. §1.641(b)-2(b). Split-interest trusts, such as charitable remainder trusts, are not subject to the regular fiduciary income tax rules; they have their own rules that trigger taxation of the noncharitable beneficiaries. See §664, Reg. §1.664, and Form 5227. In some cases, the Internal Revenue Service may disregard the existence of a trust, and treat the trust as a sham, if the trust lacks economic substance apart from the tax consequences. *Markosian v. Commissioner*, 73 T.C. 1235 (1980); *Full-Circle Staffing, LLC v. Commissioner*, T.C. Memo 2018-66.

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 2022, individuals reached the highest tax bracket (37%) at $539,900 of taxable income ($647,850 for married couples filing jointly). In 2023, individuals reached the highest tax bracket (37%) at $578,125 of taxable income ($693,750 for married couples filing jointly). §1(a), (c). But trusts and estates reach the highest tax bracket at only $13,450 in 2022 and $14,450 of income in 2023. §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 Oregon estate, some administration expenses, such as attorney fees and personal representative's fees, require prior court approval; plan ahead.) Ideally, enough administration expenses could be paid and deducted each year to exactly reduce the taxable income to zero. By doing so, that strategy would minimize the amount of excess deductions to be passed out to the beneficiaries in the final tax year. 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 Oregon 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, but for estates that have filed an estate tax return it might be necessary to wait for an estate tax closing letter (either state, federal or both), since the fiduciary often does not wish to distribute the assets until the estate tax liability has become fixed and final. That fact often prevents the estate from ending in the first fiscal year. (In an Oregon 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.

Keep in mind that some beneficiaries under the age of 24 might be taxed on investment income at very high rates, due to the Kiddie Tax found in §1(g), which applies to investment income in excess of $2,300. In 2017, the child will be taxed at the same rate as his parents. In 2018, the child will be taxed at the same rate as estates and trusts. As a result, under some circumstances distributions to young beneficiaries might not produce tax savings. Those 2017 changes were repealed in 2019, and now the children will again be taxed at their parents' rates, and an election can be made to start that change in 2018 or 2019.

The Internal Revenue Code prevents taxpayers from using multiple trusts in an attempt to divide income among multiple trusts, thus avoiding the high tax brackets of trusts. If several trusts have the same grantor/grantors, and the same primary beneficiary/beneficiaries, then the trusts will be treated as one trust. §643(f); Reg. §1.641(a)-0(c). Regulations have yet to be published under §643(f).

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); Reg. §1.651(a)-1. 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 does not cause a simple trust to be reclassified as a complex trust, unless the value of the in-kind distribution exceeds trust income. 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. Simple trusts and their beneficiaries are treated as if the mandatory income distributions were distributed to the beneficiaries, regardless of whether the distributions were actually made. §651(a); §652(a). If a simple trust has multiple beneficiaries, each beneficiary is treated as receiving a prorate portion of the income based on the ratio required to be distributed to that beneficiary. §652(a); Reg. §1.652(a)(2).

- 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. If a complex trust calls for mandatory income distributions (as well as permitting principal distributions), the mandatory income distributions will be deemed to have been distributed to the beneficiaries regardless of whether the income was actually distributed. §661(a); §662(a). For a discussion of local law and the vesting of assets and income in the beneficiaries and the effect of that vesting on the taxation of the income, see *Hibernia Nat'l Bank v. Donnelly*, 121 F. Supp. 179, 188 (E.D. La.), *aff'd*, 214 F.2d 487 (5th Cir. 1954).

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. §1.651(a)-5; Reg. §1.661(a)-1. The regulations are particularly succinct on that point, providing that "Subpart B has no application to an estate." Reg. §1.651(a)-5. Subpart B pertains to simple trusts.

A revocable trust typically becomes a complex trust upon the death of the trustor, because it typically contains no requirement that income be distributed currently. A formerly-revocable trust typically directs the trustee to pay debts, expenses, and taxes, and then distribute the assets to the beneficiaries. The administration of such a trust might take a year or two, but the trust typically does not mandate interim income distributions. As a result it is a complex trust. §651(a); Reg. §1.651(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 usually 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 fiduciary 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 the trust were classified as a complex trust; if the trust 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). Note that §§671-678 govern grantor trusts, but §678 is the only section that permits grantor trust status to be applied to a trust the income of which is taxed to a person other than the person who contributed the assets to the trust. All of the other sections limit grantor trust status to trusts where the person who contributed the assets is the same person to whom the income is being taxed. In most cases, §678 applies grantor trust status only to trusts where the assets of the trust may be withdrawn by the person to whom the trust is being taxed. See the discussion of grantor trusts, below.

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 income tax 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.

For a discussion of what should be done if various postmortem trusts are inadvertently not properly funded (or not timely funded), see Jones, *Unfunded Trusts*, Oregon State Bar Estate Planning and Administration Section Newsletter, Vol. XXXV, No. 1, January 2019.

A QTIP trust is a trust for the benefit of a surviving spouse that was made eligible for an estate tax marital deduction because it was the subject of a QTIP election under §2056(b)(7). Such trusts typically provide that the surviving spouse is to receive all of the income of the trust on an annual basis. Such trusts are subject to the fiduciary income tax in the same manner as other irrevocable trusts. The QTIP status affects the estate tax status of the trust, but not the fiduciary income tax status. QTIP status is attained by making an election on the estate tax return of the first-to-die spouse. To determine the timeliness of a QTIP election, see Reg. §20.2056(b)-7(b)(4). In general, the election is timely if made on the last estate tax return filed by the due date, including extensions, or if not timely filed, the first estate tax return if filed after the due date. Oregon follows the federal rules for Oregon QTIP elections, but the Oregon Department of Revenue has informally indicated that Oregon Special Marital Property elections are not subject to the federal QTIP rules, and may be made on an amended Oregon estate tax return if not made on the original return.

The next question is whether a credit shelter trust that has an Oregon QTIP election over part of it, or an Oregon Special Marital Property election over part of it, or a Washington QTIP election over part of it, needs to be treated as two trusts with two EINs and the resulting need to file two annual income tax returns. The answer is no. The two parts can be held in two separate accounts at a brokerage, for example, or the two parts can be held in one account with one percentage deemed to be the QTIP portion and another percentage deemed to be the non-QTIP portion. The advantage of two separate accounts is that the surviving spouse might decide to spend down the QTIP portion and not spend down the non-QTIP portion, in order to minimize state estate taxes on the second death. Regardless of whether one account or two accounts are used, only one EIN need be used, and only one income tax return needs to be filed. However, the use of one trust and one EIN to report the income of the entire trust on one income tax return is not universally accepted. Some accountants, for example, might insist on two trusts, two accounts, two EINs, and two tax returns. But the QTIP regulations specifically state that two trusts are not required. Reg. §20.2056(b)-7(b)(2)(ii). In fact the regulations state that if a single trust is to be divided into a QTIP trust and a non-QTIP trust, and "if, at the time of the filing of the estate tax return, the trust has not yet been divided, the intent to divide the trust must be unequivocally signified on the estate tax return." See also Reg. §20.2044-1(d)(3); Reg. §25.2519-1(c)(3).

Most QTIP trusts provide that upon the death of the surviving spouse, the accumulated but undistributed income must be paid to the estate of the surviving spouse. Such a provision was once required for QTIP trusts, but the IRS no longer requires such a provision. Reg. §20.2056(b)-7(d)(4), adopted in 1994. For the litigation over that issue before the regulation was adopted, see *Estate of Howard*, 91 TC 329 (1988), rev'd by 910 F2d 633 (9th Cir., 1990); *Estate of Shelfer*, 103 TC 10 (1994), rev'd by 86 F.3d 1045 (11th. Cir., 1996).

A spousal lifetime access trust (SLAT) is usually similar to a credit shelter trust, but in most cases it also includes provisions that trigger grantor trust status with respect to the donor spouse. (But since most spouses file joint returns, the income is effectively taxed to both of them.) If it is a grantor trust, it will usually become a nongrantor trust upon the death of the donor spouse. However, a SLAT can be drafted as a nongrantor trust from its inception. See the discussion of grantor trusts, below. The main purpose of a SLAT is to make use of the donor's unified credit during the donor's lifetime (particularly if the donor believes that the unified credit might decrease), thus protecting the assets from estate tax on the death of the donor spouse. The credit shelter trust aspects of a SLAT protect the assets from estate tax on the death of the beneficiary spouse. As a result, the advantage of a SLAT is that the assets held in a SLAT usually pass to the next generation free of estate tax. The disadvantage is that the assets do not receive a stepped-up basis upon either death.

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).

In some cases, a trustee might not bother to file a fiduciary income tax return. For example, a trustee might prefer to promptly distribute the assets of a revocable living trust shortly after the death of the trustor, and then supply each beneficiary with a "tax letter" informing them of the amounts and character of the income they each need to report on their individual returns. This might be appropriate in the case of a small estate, particularly if the amount of income does not reach the filing threshold. The same might be true in the case of a final return that does not meet the filing threshold. Or it might be true of an interim return that does not meet the filing threshold. But there is much to be said for the formality of filing a return even when the filing threshold has not been met, and sending each of the beneficiaries a Schedule K-1.

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, and Washington does not impose a fiduciary income tax.) 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). (Form 1041 specifically asks whether the estate has been open for more than two years, and if so, an explanation is requested.) Formerly-revocable trusts are obligated to pay estimated taxes, but not during the first two years following the grantor's death 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).

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).

The penalty for failure to make adequate estimated payments is essentially the payment of interest at the IRS underpayment rate. §6654(a)(1); §6621(a)(2). If a trust has made estimated tax payments, they should be tracked carefully and reported on the Form 1041 accurately. Any penalty is reported on Form 2210, filed with the 1041. If a trust reports an underpayment and pays an underpayment penalty, and the Service or the taxpayer later discovers estimated tax payments that were not reported, thus reducing or eliminating the penalty, the IRS will not administratively refund the penalty. Instead, the IRS will require the trust to file an amended return in order to claim the refund.

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, this §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 of the estimated tax among the beneficiaries. The allocations of estimated tax to multiple beneficiaries need not be equal; the Form 1041-T allows unequal allocations following a §643(g) election. The §643 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

Fiduciaries are obligated to file a final individual income tax return (Form 1040) for the final tax year of the decedent, and for any prior years that remain unfiled. §6012(b)(1); Reg. §1.6012-3(b)(1). Fiduciaries are also obligated to file any unfiled gift tax returns of the decedent. Reg. §25.6019-1(g).

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. §6013(a)(3). 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). No adjustment need be made to reflect the fact that the decedent's tax year was a short year. Reg. §1.443-1(a)(2). The allocation of the income tax liability between the decedent and the surviving spouse is determined under Reg. §20.2053-6(f). The same regulation states that it also governs the allocation of any income tax refund that might be due. (That regulation governs what is reportable or deductible on an estate tax return, if one is being filed, but that regulation does not necessarily state that the spouses have a right of contribution between themselves. If a surviving spouse is concerned about the contribution issue, she should consider declining to sign a joint return. For more information on how local law applies to such allocations, see 67 ALR 1038.) If both spouses die within the same tax year, their executors may file a joint return. §6013(a)(3); Reg. §1.6013-1(d)(3). The return for the final year of a decedent is filed with the service center based on where the executor (or surviving spouse) is located, not where the decedent lived. §6091(b)(1)(A)(i); Reg. §1.6091-2(a).

If, for the final year of the decedent's life, the decedent and his spouse file as married filing separately, and if one of them itemizes their deductions, the other will be disallowed the use of the standard deduction. §63(c)(6).

A final return for the decedent is not required to be filed if the decedent's income was less than 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." This could include personal representatives, trustees, claiming successors, surviving joint owners, and beneficiaries of various accounts. See also the instructions to Form 1040, §2203, §7701(a)(6), Reg. §1.6012-3(b)(1) and CCA 201334040. If a decedent left behind both a probate estate and a formerly-revocable trust, it is not entirely clear whether the personal representative or the trustee should sign the decedent's final individual return, but Rev. Rul. 79-409, 1979-2 C.B. 208, suggests that the personal representative has primary responsibility for filing the decedent's final individual income tax return. SCA 200139031 agrees.

The fiduciary income tax return is signed by the personal representative or trustee. §6061; Reg. §6061-1(a); §7701(a)(6). 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 and §6018(a)(1) regarding the signing of estate tax returns, which state that the court-appointed executor is required to sign the estate tax return. See also Reg. §20.6018-2. Although §2203 states that if no executor is appointed, any person in possession of the decedent's property is required to file an estate tax return, that code section does not apply to income tax returns, although many practitioners apply that rule to income tax returns. However, CCA 201405016 indicates that the IRS Chief Counsel does not consider that statute to be applicable to income taxes, gift taxes, or GST taxes. (If a person holds assets that are to be included in the gross estate but declines to cooperate in the preparation of the estate tax return, §6018(b) requires the executor to supply their name(s) to the IRS. That fact can be used to encourage their cooperation.)

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 might need to continue to make estimated payments due to her own personal income.

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 income tax liability. §6903; Reg. §301.6903-1. A copy of the Form 56 should also be sent to the Oregon Department of Revenue, for the same reason. Ideally, the Form 56 should be completed to include multiple years of personal income taxes of the decedent, multiple years of fiduciary income taxes of the fiduciary, and estate taxes of the decedent. A Form 56 can also be used if the trustee acquires a new address, or a Form 8822-B can be used. (Note that the 8822-B is for returns filed under the EIN of the estate or trust. For estate or gift taxes, which are filed under the decedent's social security number, use Form 8822.) Filing a Form 1041 fiduciary income tax return with a new address does not always effectively change the address of the fiduciary in the IRS records, although the 1041 should definitely reflect the new address. The first page of the Form 1041 also has boxes that can be checked if the name of the trust has changed or if the name of the trustee has changed.

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 from the decedent's personal income tax liabilities (both state and federal), or can request a prompt assessment of income tax liabilities (decedent's personal income tax liability and also fiduciary income tax liability, both state and federal). For a discussion of releases, requests for prompt assessment, Form 1310, and Form 243, see Mitchell, *Tax Procedure Issues for Estates and Trusts*, Oregon State Bar Estate Planning and Administration Section Newsletter, Vol. XXVII, No. 3, July 2010.

When filing a Form 56 following a death, the name, address, and social security number of the decedent should exactly match the name, address and social security number used by the decedent to file his personal income tax returns. If the name, address, and social security number are incorrect (i.e., do not match the IRS records), the Form 56 will be rejected.

If a Form 56 is filed with the IRS, the Form 56 should be terminated if the fiduciary leaves office and a new fiduciary is named. See §6903(a). To terminate a Form 56, use Part II of the form. The new fiduciary should file a new Form 56, and the Part II of the form permits the former fiduciary to inform the IRS of the name and address of the new fiduciary. If the trust or estate simply ends, and a new fiduciary is not taking office, the effectiveness of a Form 56 termination is questionable, as indicated in Reg. §301.6903-1(e). In that event, the fiduciary might not want to terminate the Form 56, since the (former) fiduciary would probably want to be aware of any subsequent notices sent by the IRS.

The Form 56 should be used to notify the IRS of a fiduciary relationship, and a Form 8822 should not be used. The Form 8822 is a change of address form, and should be used only if the fiduciary (who has previously filed a Form 56 or filed a tax return) changes addresses. The decedent did not change addresses; the decedent merely died.

Fiduciaries are required to file fiduciary income tax returns for trusts and estates. §6012(a); Reg. §6012-3(a). See the discussion of the filing thresholds, above.

If a probate estate is being opened, an EIN for the personal representative will need to be obtained soon after the personal representative is appointed. If the personal representative is an individual, that person will need to provide their SSN on the application for a new EIN (Form SS-4). If the personal representative is an entity, the SS-4 asks for the name of a responsible party, and starting in early 2019 the form asks for that person's SSN. If the fiduciary is an entity (such as a trust company), providing the personal SSN of a trust officer is problematic. If the SS-4 is faxed to the IRS, rather than filed online, the personal SSN of an entity representative is apparently not required, and so trust companies should consider that option. This suggestion also applies to trusts and entity trustees.

If the estate is actually a small estate under the Oregon small estate procedure (ORS 114.505 et seq.), the claiming successor should have no difficulty in obtaining an EIN by completing the Form SS-4 as if the small estate were actually a probate estate.

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. That is because the grantor trust status of the trust ended on the date of death, and the trust became an irrevocable trust which is a separate taxable entity that needs its own EIN. Reg. § 301.6109-1(a)(3)(i)(A); Rev. Rul. 57-51, 1957-1 C.B. 171. 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. During that time the administrative trust operates as a full-fledged trust and is subject to local trust law and federal fiduciary income tax law, just as any other trust is subject to those laws. 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 (in the form of what is known as a "tax letter"), and the beneficiaries will each report their respective shares of the income earned after the date of death, along with their share of the deductions. 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 state estate tax returns. Reg. §1.641(b)-3(d) tends to support this approach, although that regulation primarily describes estates and trusts that have been terminated, as opposed to estates and trusts whose administration never commenced. However, there is much to be said in favor of the formality of a tax return (and sending each beneficiary a Schedule K-1), even if the amount of income received does not rise to the level of the filing threshold.

If an EIN is obtained and the fiduciary later decides to not use it, or it is unnecessary for any other reason, the IRS is not willing to cancel the EIN. But the IRS is willing to close the business account that was created for that EIN. The account can be closed by mailing a letter to the IRS at either of the following addresses: MS 6055, Kansas City, MO 64108, or MS 6273, Ogden, UT 84201. The letter should include the complete legal name of the entity, the EIN, the business address and the reason for closing the account. Also include a copy of the EIN Assignment Notice that was issued when the EIN was assigned, if the notice is available.

When commencing the administration of an estate, it is helpful to obtain an IRS power of attorney (Form 2848) from the personal representative, in order to ease any future dealings with the Internal Revenue Service. In fact, three Forms 2848 should be obtained and retained for future use, as needed. One should be obtained in the name of the estate, using the estate EIN, and it should indicate that it pertains to fiduciary income tax. (As a general rule, the IRS will accept a Form 2848 that applies to the current year and the future three-year period.) The second should be obtained in the name of the decedent, using the decedent's social security number, and it should indicate that it pertains to the decedent's individual income tax, estate tax, and gift tax (if applicable). The third should be obtained in the name of the executor, using the executor's social security number (in the case of an individual) or EIN (in the case of a corporate executor), and it should indicate that it pertains to the Form 8971 (basis reporting), if that form will be necessary; otherwise the third Form 2848 will not be needed. Failure to follow this protocol will result in rejection of one or more of the Forms 2848 when (and if) they are eventually submitted to the IRS, and the letter sent by the IRS rejecting the Form 2848 will not adequately explain the reason for the rejection. Although it might seem odd to obtain a power of attorney in the name of a decedent, it is because the income tax returns, estate tax return, and gift tax returns are filed under the decedent's name and social security number, not under the estate's EIN. In contrast, the fiduciary income tax return is filed under the EIN of the estate, and the Form 8971 is filed under the identifying number of the executor. All three Forms 2848 will be signed by the personal representative in her capacity as personal representative. (If a post-mortem revocable trust is involved, rather than a probate, the same principles apply, but the Forms 2848 will be signed by the trustee.) Although Forms 2848 are not normally attached to tax returns when the returns are filed, it is a common practice to attach a Form 2848 to the estate tax return. For a further discussion of Form 8971, see the section on basis reporting, below. Another form to consider filing is Form 8821, which allows accountants, attorneys, etc., to receive information from the IRS regarding a taxpayer, but does not allow those persons to represent (speak on behalf of) the taxpayer. That form is useful, for example, if the trustee or personal representative would like to authorize her accounting firm to receive information concerning an estate, a trust, or a decedent.

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 first tax year of a decedent's estate (or formerly-revocable trust) most likely begins on the day after the date of 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. These points are not entirely clear. For example, IRS Publication 559 states that the tax year of the decedent ends on the day *before* the date of death. Reg. §1.6012-3(b)(1) states that the decedent's tax year ends "with the date of his death," but then it goes on to provide that "the return shall cover the period during which he was alive." The instructions to Form 1041, under the category of accounting periods, states that "For a decedent's estate, the moment of death determines the end of the decedent's tax year and the beginning of the estate's tax year." Section 1014(a) grants a basis adjustment to property not disposed of "before the decedent's death," which seems to suggest that the moment of death is the dividing line, not necessarily the date of death. 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 problem is that there is no definitive authority on this issue. Or perhaps this issue is really two issues: (1) In which tax year did the sale take place and should be reported? and (2) Did the asset receive a new basis as a result of the death? It might be possible that the transaction should be reported on the decedent's final individual return, but the asset nevertheless received a new basis as a result of the death. That position seems to be most consistent with the authorities cited above.

If the decedent died in a different time zone than his domicile, the date of death will be based on the time and date of the death in his domiciliary time zone. Rev. Rul. 66-85, 1966-1 C.B. 213, modified by Rev. Rul. 74-424, 1974-2 C.B. 294. This could result in a small (but significant) difference for estates where the decedent died overseas.

Because the decedent's final return reports the income received before death, and the first fiduciary income tax return reports the income received after death, the income must be allocated between the two periods (and the two returns) based on when the income was received relative to the date of death. Invariably, some of the income allocable to the fiduciary income tax return will be incorrectly reported on 1099s showing the decedent's name and social security number, due to delays in closing the decedent's accounts and opening accounts for the estate. The accountant preparing the two returns will need to make appropriate adjustments/allocations, and most accountants are very adept at doing so. Some accountants report the full amounts of the 1099s on the decedent's final return, and then show negative entries for amounts properly reportable on the fiduciary return, in hopes of avoiding inquiries from the IRS asking about mismatches between the 1099s and the decedent's final return.

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, 2017, the first tax year of the estate could end as early as May 31, 2017, or as late as April 30, 2018 (for an 11.5-month year), but the first tax year could not possibly extend beyond April 30, 2018. §441(e).

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). (Prior versions of this regulation required a timely return. That requirement was dropped in regulations proposed in 2001 and finalized in 2002. REG-106917-99 and T.D. 8996.) 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 on a late return contrasts with the election under §645, in which a trust elects to be taxed as part of an estate, thus enabling the trust to use a fiscal year. That §645 election cannot be made on a late return. See the discussion of §645, below.

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 might 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. Reg. §1.441-1(c)(1). 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.

For a discussion of which version (which year) of the Form 1041 to file for an estate or trust, see the discussion in the section dealing with the final tax year, below.

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 tax 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 and a half months (five months for tax years beginning before January 1, 2016). Reg. §1.6081-6(a)(1); Temporary Reg. §1.6081-6T (T.D. 9821, 7/18/17). 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 the fiduciary should advise them to pay an estimated tax at the time that the beneficiaries extend their own returns.

If a fiduciary resigns or is removed, and a new fiduciary is appointed, there is little authority on the question of which of the two fiduciaries is required to file the fiduciary income tax return for periods during the administration of the former fiduciary. The consensus seems to be that the new fiduciary should file the return with information supplied by the former fiduciary, but both are probably responsible for seeing to it that the return is filed.

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, and a box is checked on page 1 of the initial and subsequent returns. Form 8855 is due by the due date of the fiduciary income tax 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 §645 election by a trust to be taxed as part of an estate (thus enabling the trust's use of a fiscal year) contrasts with the selection of a fiscal year by an estate on its initial return. That selection, which does not involve a trust, can be made on a late-filed return. The §645 election cannot be made on a late return. See the discussion of the selection of a fiscal year by an estate, above.

The election is available regardless of whether a probate estate is actually being administered for the decedent. If a probate is not being administered, there is some debate as to whether an EIN (employer identification number) must nevertheless be obtained for the nonexistent estate. The instructions to Form 8855 state that the trust's EIN should be entered in both Part I of the form (for the estate) and Part III of the form (for the trust), which would support the view that no estate EIN is needed if no probate is being administered. If a probate is being administered, both the estate and the trust should obtain separate EINs, and the estate will file the Form 1041 under the estate EIN; the trust will not file a separate return. 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.) Thus 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. Each beneficiary will receive only one K-1, which will combine the income of the trust and of the estate. But because of the application of the separate share rule, two beneficiaries might be taxed differently.

If, at the time of filing the Form 8855, no probate is being administered, but a probate is later commenced, an amended Form 8855 must be filed. See the instructions to Form 8855.

If a §645 election is made, Subtitle F of the Internal Revenue Code (§§6001-7874, the procedural portion of the Code) still applies to the trust and the estate (if any) as separate taxpayers, with the exception of §6654(l)(2)(A), which grants a two-year exception to the obligation to make estimated tax payments. See the section above on the subject of estimated taxes.

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 required to be filed, the election may remain in place for tax years ending up to two years following the date of death. §645(b)(2)(A). If a federal estate tax return is required to be filed, the election may remain in place for tax years ending up to 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 purposes of this rule. For a fuller discussion of the applicable time periods, see the regulations under §645. Reg. §1.645-1(f).

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). If the decedent left more than one QRT, those QRTs need not all join in the election. Reg. §1.645-1(c)(ii).

If a tax payment is made following a §645 election, in some cases care should be taken that the payment is made from the estate, or from the trust, that actually generated the tax (earned the taxable income). If not, it is possible that a deemed gift will result if the beneficiaries of the estate and the trust are not the same. Reg. § 1.645-1(c)(1)(ii)(A)(3). However, if the estate is governed by a pourover will (one that merely pours over to the revocable trust, and thus the ultimate beneficiaries are the same), a gift will not result.

After the period has expired during which a fiscal year is permitted to be used, 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 might 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, fewer restrictions on holding S corporation stock, and the ability to take a loss on the distribution of an in-kind asset in satisfaction of a pecuniary bequest, among others. Those benefits are discussed separately under those topics.

Some practitioners believe that if a decedent's formerly-revocable trust is being administered in one state, and a probate is being conducted in a second state, a §645 election will expose the trust to the fiduciary income tax of that second state, but there is little or no authority, one way or the other, on that issue.

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 estates (with rare exceptions) 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); §1.643(e), Ex. 7.

This is a very important rule, and so it bears repeating: with rare exceptions, 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).

There are a few rare exceptions to the rule that a trust or estate pays no tax in its final year. Listed here are three such exceptions; there may be others. An estate will be illustrated in these examples, but the examples also apply to trusts.

1. If an estate has income, but also has nondeductible expenses, then the amount available to distribute to the beneficiaries might be less than the amount of income recognized on the final return, and not all of the income will be carried out to the beneficiaries, and thus the distribution deduction will be less than the DNI, and that excess DNI will remain in the estate to be taxed to the estate. Examples of nondeductible expenses might include debts of the decedent (claims against the estate), state inheritance taxes, or administration expenses that were deducted on the estate tax return under §642(g). Other assets might be used to carry the income out to the beneficiaries, but the situation is complicated if the other assets consist of IRD. If an estate with DNI distributes an IRA account in kind (intact), the account usually has a zero basis, and thus does not carry out income, and the estate ends up paying tax on the DNI. §643(e)(2). This situation is most likely to occur when the estate is concentrated in only one or two assets. See the section below on in-kind distributions, and the section below on retirement accounts. Below is a hypothetical that illustrates how this first example might work in practice.

2. If an estate has DNI, but its specific bequests are so large that the assets of the estate are consumed by the bequests, then no assets are left that can be used to fund the residue. Since the specific bequests do not carry out income, even when they cause the residue to be exhausted, the estate ends up paying tax on

the DNI in the final year. Rev. Rul. 66-207, 1966-2 C.B. 243. The result in this example is not entirely clear. It is possible that §663(a)(1) might cause some of the final distributions to not be treated as specific bequests. That section provides that "an amount which can be paid or credited only from the income of the estate or trust shall not be considered as a gift or bequest of a specific sum of money." If the estate is holding income that is used to satisfy a specific bequest, perhaps that portion of the distribution will not be deemed to be a specific bequest, and will actually carry out income.

3. Similar to exception #2, if an estate consists entirely of DNI derived from a retirement account that has been cashed in, and the estate holds no other assets, but it is required to pay several cash specific bequests, those cash specific bequests will not carry out DNI. As a result, the DNI used to fund those specific bequests will be taxed to the estate.

Here is a hypothetical example illustrating the first exception. An estate was fully administered in its first fiscal year, so that its first fiduciary income tax return was also its final fiduciary return. The sole asset of the estate was a traditional IRA with a value of $2,000,000 payable to the estate as the beneficiary. Nine months into the fiscal year, the estate paid $100,000 in state estate tax. The estate raised the funds to pay that tax by withdrawing $100,000 from the IRA. That withdrawal was a taxable event, but the payment of the state estate tax was not deductible, because state estate taxes are deductible only on the federal estate tax return, not on the fiduciary income tax return. As a result, the income realized when the withdrawal was made will not be offset by a related deduction. The estate then distributed the remaining $1,900,000 IRA to the decedent's children as inherited IRA accounts (distributed intact, without making any further withdrawals). That distribution did not generate a distribution deduction under §662(a) because §643(e)(2) does not permit a zero-basis asset (such as a traditional IRA) to carry income out to the beneficiaries. As a result, the estate was left with a fiduciary income tax liability in its final fiscal year, but the estate no longer had any assets with which to pay that tax liability, and that lack of funds then triggered fiduciary liability and transferee liability. One solution to this problem would have been to liquidate the entire IRA and distribute cash to the beneficiaries, but that would have triggered immediate taxation of the entire account, which most beneficiaries would prefer to postpone for as long as possible. A better solution would be to withdraw about $145,000 from the IRA, pay $100,000 in state estate tax, and use the remaining $45,000 to pay the fiduciary income tax on the $145,000 IRA withdrawal. The calculation of the amount needed to be withdrawn can be made through a simultaneous equation.

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 several complicated conditions and 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). Reg. §652(b)-3(a) requires that deductions directly attributable to a particular class in income must be allocated to (and reduce) that particular income. Income not allocable directly to a particular class of income may be allocated to any income (including capital gains), except that a portion must be allocated to tax-exempt income, if any.

Following the enactment of §67(g) in the 2017 Tax Act, it was thought that excess deductions could no longer be passed out to the beneficiaries in tax years after 2017 and before 2026. But in 2020, the Service issued Proposed Reg. §1.642(h)(2); REG-113295-18 (5/7/20), which clarified that excess deductions may still flow out to the beneficiaries, as long as the estate or trust classifies those excess deductions into three categories: (1) deductions allowable in determining adjusted gross income (so-called above-the-line deductions), (2) non-miscellaneous itemized deductions, and (3) miscellaneous itemized deductions. Each of those three categories of deductions must be so categorized to the beneficiaries, and each retains its character in the hands of the beneficiaries. Proposed Reg. §1.642-(h)(2); REG-113295-18 (5/7/20). Thus a beneficiary who receives excess deductions from an estate or trust comprised of all three categories of deductions may deduct the first category in arriving at the individual's adjusted gross income, may deduct the second category as a non-miscellaneous itemized deduction, and may deduct the third category as a miscellaneous itemized deduction subject to the 2% floor (except the third category is not deductible by individuals in tax years after 2017 and before 2026). The final regulations were issued in September 2020 (TD9918), and those final regulations largely followed the proposed regulations.

That proposed regulation is effective for tax years beginning after May 7, 2020, but the preamble to the proposed regs states that taxpayers may rely on them for tax years beginning after December 31, 2017. Note that under the 2017 Tax Act, individuals will not be able to deduct miscellaneous itemized deductions in tax years after 2017 and before 2026. §67(g).

In July of 2020, the Service provided guidance regarding where on the Form 1040 the excess deductions should be entered. The first category (above-the-line deductions) should be entered on Form 1040 itself. The second category (non-miscellaneous itemized deductions) should be entered on Schedule A. The third category (miscellaneous itemized deductions) should not be entered at all, because they are not deductible in tax years after 2017 and before 2026.

For purposes of calculating the excess deductions, all of the following adjustments are made in the calculation. Net operating loss carryovers under §172 and capital loss carryovers under §1212 are included. §642(h) and Reg. §1.642(h)-1. The personal exemption and the charitable deduction are disregarded. §642(h)(2). In effect, the charitable deduction in the final year is wasted for purposes of calculating the excess deductions. *O'Bryan v. Commissioner*, 75 T.C. 304 (1980). The distribution deduction is also disregarded for purposes of calculating the excess deductions. §643(a)(1). It is important to note that the deductions disregarded for purposes of calculating the excess deductions are not disregarded for purposes of calculating the taxable income of the trust or estate; those deductions are still available for that purpose, but they may not be used to calculate the excess deductions.

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 to the portion of the excess deductions that are considered to be miscellaneous itemized deductions (apart from the fact that miscellaneous itemized deductions cannot be deducted by individuals in tax years after 2017 and before 2026). Because of those two restrictions, some beneficiaries will not be able to make use of some of the excess deductions. §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 (this latter rule is 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 to a prior year; they may be used, if at all, only 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.

Section 642(h) provides that the excess deductions flow out to the beneficiaries "succeeding to the property of the estate or trust." For a discussion of which beneficiaries so qualify, see Reg. §1.642(h)-3. But after 2017 and before 2026, some excess deductions may no longer be deducted by the beneficiaries, because some excess deductions are classified as miscellaneous itemized deductions, which individuals may no longer deduct, due to the provisions of the Tax Cuts and Jobs Act of 2017 (P.L. 115-97). But trusts are still allowed to deduct miscellaneous itemized deductions under §67(e), which permits such deductions that "would not have been incurred if the property were not held" in a trust or estate. But what if the beneficiary of a trust with excess deductions in the final year were itself a trust? Can that beneficiary trust deduct the excess deductions it receives? The answer is probably no, because those deductions do not relate to the administration of the beneficiary trust.

If a trust or estate lacks sufficient income to fully absorb administration expenses, and if the beneficiaries can make use of the excess deductions, then consideration should be given to paying most of the administration expenses in the final year of the trust or estate, so that the deductions will flow out to the beneficiaries. On the other hand, because of the restrictions on the deductibility of the excess deductions by the beneficiaries, the ideal strategy might be to pay enough administration expenses each year to reduce the taxable income to zero, thus minimizing the excess deductions to be passed out to the beneficiaries in the final year, while still keeping the trust or estate taxable income to a minimum each year. (Again, some excess deductions that are considered to be miscellaneous itemized deductions cannot be deducted by beneficiaries in tax years after 2017 and before 2026. §67(g).)

The bottom line regarding miscellaneous itemized deductions: Estates and trusts are permitted to deduct miscellaneous itemized deductions, but the ones that are commonly experienced by individuals are subject to the 2% floor, as described in Appendix B. In the final year of an estate or trust, excess deductions can be passed out to individual beneficiaries, but in tax years after 2017 and before 2026 individuals are not allowed to deduct the portion of the excess deductions that are attributable to miscellaneous itemized deductions.

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) *aff'd* 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. Reg. §1.641(b)-3(b) is particularly clear on this point:

> A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. Thus, if under the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainderman, the trust continues after the death of the life

beneficiary for a period reasonably necessary to a proper winding up of the affairs of the trust.

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, formulating a plan of distribution, liquidating assets, 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. While those tasks are being completed, the trust is often referred to as an administrative trust, but it is still a trust for tax purposes and for purposes of trust law. In *Dominion Trust*, the completion of those tasks took more than three years; that period of time is somewhat typical for an estate in which the estate tax return is audited by the IRS. 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. In Washington, see *Greider Family* Trust, 18 Wn. App2d 1073, 2021 WL 961132 (2021; unpublished); *Blankenship's Survivor's Trust*, ___ Wn. App2d ___, 2021 WL 3615025 (2021; Dkt. No.81466-4-I; unpublished). Of course, what constitutes a reasonable time depends on 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). See the section on grantor trusts, below, for a discussion of whether an administrative trust is a grantor trust.

The regulations give the Service the power to determine that the administration of an estate or trust has been unreasonably prolonged. In that situation, the estate or trust is deemed to have terminated for federal income tax purposes after the expiration of a reasonable time period for completion of administration. Reg. §1.641(b)-3(a) and (b).

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). The regulation does not specify the permitted size of the reserve or how long it can be held.

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.

An estate or trust files the version of the Form 1041 published for the year in which the tax year *begins,* according to the Form 1041 instructions. 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. Using the prior year's form for a short-year return is specifically authorized by the instructions to the Form 1041, if the estate or trust is filing a short-year year return, the new forms have not yet been published, and the preparer takes into account any tax law changes.

Note that the beginning date of a fiscal year (not the ending date) governs the year of the Form 1041 to be used (this rule does not apply to Forms 1040). Thus 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 sometimes solves the problem of needing tax forms and tax preparation software, but it does not solve the problem of needing 2014 1099s.

Although in Oregon ORS 116.083(3)(a) requires that each probate final accounting must make a representation to the court that all required tax returns have been filed, most practitioners interpret that statute as not requiring the filing of the final fiduciary income tax returns prior to filing the final accounting with the court, since the final 1041 is not required to be filed until after the final accounting has been approved and the estate has been fully distributed. See also ORS 116.113.

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 estate or trust 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 or principal contained in a trust document that fundamentally vary from state law; a "reasonable apportionment" is required. Reg. §1.643(b)-1. In most states, the principal source of that law is the Uniform Principal and Income Act (UPIA), which has been enacted in Oregon as chapter 129 of the Oregon Revised Statutes, and in Washington as RCW 11.104. Because fiduciary accounting income is based on state law, it is usually expressed as a dollar amount of income net of expenses.

The Uniform Principal and Income Act refers to it as net income. ORS 129.205(8); RCW 11.104A.005(8); RCW 11.104B.005(13) after 1/1/22. (In June of 2018, the National Conference of Commissioners on Uniform State Laws revised the UPIA and renamed it the Uniform Fiduciary Income and Principal Act (UFIPA). It has not yet been adopted by Oregon, but it has been adopted in Washington effective 1/1/22. The new act has been codified as RCW 11.104B.) Five other states have also adopted the UFIPA.

When reviewing the provisions of the UPIA or the UFPIA, always check the version adopted by your particular state, because state legislatures are in the habit of making slight customizations to the uniform acts, so that the state versions are not entirely uniform.

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. In Washington, see RCW 11.104A.180. After 1/1/22, see RCW 11.104B.280.) Despite that state law definition, the federal tax laws will likely 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. See the discussion of IRD, below.) 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. (For much the same reason, a lifetime gift of an annuity contract triggers income taxable to the donor. §72(e)(4)(C).)

That situation, where DNI exceeds fiduciary accounting income, might also occur if the Internal Revenue Code disallows an income tax deduction for an expense that the principal and income act allocates as an expense against income. For example, changes made by the Tax Cuts and Jobs Act of 2017 (P.L. 115-97) disallows some deductions that were previously allowed. If a deduction is disallowed for an expense that is allocated to income by the principal and income act, then DNI might be larger than fiduciary accounting income.

However, in that situation (where DNI exceeds fiduciary accounting income) the trustee of the trust will need to carefully review the distributive provisions of the trust to make certain that principal, as defined by state law, may be distributed under the terms of the trust. See also Reg. §1.662(a)-2(c). If not, then the trust will be unable to distribute to the beneficiary the full amount of the DNI, and some of the taxable income will be trapped in the trust, to be taxed at the higher marginal rates applicable to 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 a distribution 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) and §662(a), but if the full amount of fiduciary accounting income is distributed to the beneficiary, the amount distributed to the beneficiary in excess of DNI will be treated as principal for income tax purposes, even though it is income for purposes of fiduciary accounting. 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 shareholders/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 of the trust or estate, due to the provisions of the UPIA cited above. Yet they are taxable to the trust or estate under the sections of the Internal Revenue Code that govern S corporations and partnerships. *Van Buren v. Commissioner*, 89 T.C. 1101 (1987). 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, nor will income be deemed to have been distributed if the UPIA does not define it as income. Yet for income tax purposes, the fiduciary is taxed on that income, and the beneficiary will not be taxed on that income. Thus when an entity such as a partnership or an S corporation fails to distribute cash to a trust or estate when the entity has taxable income, that taxable income is effectively trapped in the trust or estate and taxed to the trust or estate at the usually higher rates applicable to trusts and estates. *Van Buren v. Commissioner*, 89 T.C. 1101 (1987). To prevent that trapping from taking place, cash should be distributed from the entity to the trust or estate (so that the trust or estate will have received fiduciary accounting income), and then (in the case of an estate or a complex trust) cash should be distributed to the beneficiaries. In the case of a simple trust, the cash need not be distributed to the beneficiaries, because the income of the trust is eligible for a distribution deduction regardless of whether it is actually distributed. §651(a). 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.

See the previous section for a discussion of fiduciary accounting income when a trust or estate holds an interest in an S corporation or a partnership.

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). (The partnership or LLC might already have a §754 election in place, either because a partner previously died or because a partner purchased an interest and desired to get increased depreciation deductions.) 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, and revocation is difficult or impossible. 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 a transfer caused by a death, this would be the return for the year of the 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. If the assets are depreciable, then the increased basis in the assets results in increased depreciation, which appears on the K-1 issued to the transferee.

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. The election 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

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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); Reg. §1.643(a)-5(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); Reg. §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); §1.643(e), Ex. 7. 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).

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 and are discussed in the next section.

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. §643(a). 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.

Deductible items that enter into the calculation of DNI must be allocated among the income items received by the estate or trust. Deductions directly attributable to a particular class of income are first deducted against that class of income, and the excess may then be deducted against other classes of income, unless the excess is attributable to tax-exempt income. Reg. §1.652(b)-3.

If an estate or trust has both tax-exempt income and a charitable deduction, the tax-exempt income (reduced by deductions attributable to the tax-exempt income) is included in DNI, but the tax-exempt income included in DNI is reduced by the portion deemed to have been distributed to (or set aside for) the charity. Reg. §1.643(a)-5(b).

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 $12,500 for 2017. §1(h). That number increased to $12,700 for 2018 and $12,950 in 2019. It increased to $13,150 in 2020 and 13,250 in 2021. It increased to $13,700 in 2022, and $14,650 in 2023. 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, and in 2016 they increased to $415,050 and $466,950. In 2017, those numbers increased to $418,400 and $470,700. In 2018, those numbers increased to $425,800 for single persons and $479,000 for married couples. In 2020, those numbers increased to $441,450 for single persons and $496,600 for married couples. In 2021, those numbers increased to $445,800 for single persons and $501,600 for married couples. In 2022, those numbers increased to $445,800 for single persons and $501,600 for married couples. In 2023, those numbers increased to $492,300 for single persons and $553.850 for married couples

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 disposed 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; RCW 11.104A.130. Regarding capital loss carryovers, see §642(h). However, in the final year of a trust or estate, all of the tax attributes of that tax year (almost always) 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. In general, those exceptions require that the allocation of capital gains to income must be done pursuant to the terms of the governing instrument, or pursuant to the provisions of local law, or pursuant to a reasonable and impartial exercise of discretion granted by the governing instrument or by local law. Once those hurdles are crossed, the available exceptions are:

a. Gains that are allocated to fiduciary accounting income by the fiduciary.

b. Gains that are allocated to principal, but are consistently treated by the fiduciary on the books, records, and tax returns of the trust as distributed to a beneficiary.

c. Gains that are actually distributed to a beneficiary, or are used by the fiduciary to determine the amount distributed or required to be distributed to a beneficiary.

In addition, gains can be treated as part of income if paid or permanently set aside for charitable purposes under §642(c) by an estate (not a trust, with some exceptions, such as trusts making a §645 election). See the discussion of the charitable deduction, below.

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 exceptions described above can be used only if the governing instrument or state law permits such distributions. Reg. §1.643(a)-3(e).

In general, the inclusion of capital gains in DNI pursuant to any of these exceptions requires a consistent treatment by the trustee in each year after the decision is made to allocate capital gains to income, as indicated in the examples in the regulations. In 2015, the Oregon legislature amended ORS 130.715 to make it easier for a trustee to include capital gains in DNI. (Oregon Laws 2015 Ch. 126 §3; 2015 HB 2331). Prior to the latest version of the regulations, the IRS had a history of not concluding that a consistent practice was present that would allow the allocation of capital gains to income. PLRs 8105028, 8324002, 8429005, 8506005 and 8324002.

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. §1014(a). In a relatively small estate, oftentimes 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, escrow fees, and related closing costs handled for tax purposes? As noted below in the discussion of deductions, the expenses of sale are usually not deductible on an estate tax return under §2053(a)(2) or against ordinary income for fiduciary income tax purposes. Instead, those expenses are offsets against the selling price to reduce gain or to increase loss. *Scull v. Commissioner*, T.C. Memo 1994-211, n. 14. 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. For examples of cases that have held that the sale of a personal residence by an executor is always entered into for a profit motive, and thus losses are deductible, see *Waterman Estate v. Commissioner*, 195 F.2d 244 (2d Cir. 1952), reversing 16 T.C. 467 (1951); *Wilmington Trust Co. v. U.S.*, 76-1 USTC ¶9372 (Ct. Cl. 1976), adopting 76-1 USTC ¶9163 (Ct. Cl. 1976). In other cases, the sale of a residence was not deemed to have been entered into for a profit motive when the fiduciary allowed a beneficiary to use the property as a personal residence. *Barnes v. U.S.*, 222 F. Supp. 960 (D. Mass. 1963), *aff'd* 326 F.2d 825 (1st Cir.); *Meurir v. Commissioner*, 221 F.2d 223 (2d Cir. 1955). In *Watkins v. Commissioner*, T.C. Memo 1973-167, a husband sold his deceased wife's personal residence shortly after she died, although he lived in it briefly after she died. The Tax Court reasoned that if the wife had sold the residence during her lifetime, a loss could not have been deducted, but property acquired by inheritance has a neutral status, and the state of mind and/or conduct of the executor or heir after the owner's death must be examined in order to decide whether a profit motive was present. The court decided that the husband's dominant purpose was a profit motive, regardless of his temporary use of the residence. A similar result was reached in *Miller v. Commissioner*, T.C. Memo 1967-44, when there was no personal use of the residence after the death.

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.

On the other hand, if the residence is not placed in a trust following the death of one spouse, the surviving spouse may still take advantage of the full $500,000 exclusion if the residence is sold within two years after the death and the other eligibility requirements of §121 were met immediately before the date of death. §121(b)(4).

If a single person dies owning a residence, and her estate sells the residence, no §121 exclusion will be available to the estate, for the simple reason that §121 contains no provision allowing an exclusion to an estate. At one time such an exclusion was allowed by §121(d)(11), but that provision was repealed in 2010 by P.L. 111-312. The lack of an exclusion will normally not produce a very harsh result, since the estate will have received a stepped-up basis as of the date of death. §1014(a)(1). See the discussion of Basis Step-up and Basis Reporting, below.

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 usually 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.

The above exemptions were not altered by the Tax Cuts and Jobs Act of 2017 (P.L. 115-97).

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. Determine gross income. 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, such as municipal bond 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. Deduct the above-the-line deductions. 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 on business assets under §167, 168, and 642(e). The allocation of depreciation deductions between trusts, estates, and their beneficiaries is governed by §642(e), §167(d) and §611(b). If the trade or business generates a net operating loss, the loss can be used to offset nonbusiness income in the year of the loss (and reduce DNI), but nonbusiness deductions can be offset only against nonbusiness income; nonbusiness deductions cannot be offset against business income when calculating the net operating loss. If the NOL is not fully utilized in the year of the loss, it may be carried back two years and then may be carried forward up to twenty years. §642(d); §172(b). Beneficiaries are not permitted to deduct the NOL of a trust or an estate in the year of the loss, except for the final year, §642(h). See the discussion of the final tax year, above. But if an NOL is carried back then the beneficiary may file an amended return to reflect the DNI reduction caused by the carryback. Trusts and estates are not allowed a deduction under §179, even if the deduction is received from a pass-through entity. Reg. §1.179-1(a).

c. The result would normally be adjusted gross income (AGI) 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 an estate. Section 67, 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. Thus those four deductions are deducted as if they were above-the-line deductions. 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. §67(e). 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. Deduct the below-the-line deductions. 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). (Trusts and estates are not permitted to take a standard deduction. §63(c)(6).) 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). It should be noted that estates and trusts are not subject to the §68 reduction in itemized deductions that applies to high-income individuals. 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 (including property 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). For tax years after 2017 and before 2026, tax preparation costs are no longer deductible, except for the preparation of returns unique to a trust or an estate. §67(e) and (g). Miscellaneous itemized deductions are defined by §67(b) as *not* including interest under §163, state and local taxes (including property 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 (including property taxes) under §164, the charitable deduction under §642(c), and estate taxes under §691(c). In tax years after 2017 and before 2026, state and local taxes are no longer deductible to the extent they exceed $10,000, but taxes paid in connection with a trade or business, or under §212 in connection with the production of income, may still be deducted, despite the limitation. See footnote 171 of the Joint Explanatory Statement to the Tax Cuts and Jobs Act of 2017 (P.L. 115-97). 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 (real estate brokers' commissions, title insurance premiums, and escrow fees) are generally not deductible as administrative expenses, but are offsets against the selling price to reduce gain or to increase loss, because such expenses reduce the amount realized under §1001(b). *Scull v. Commissioner*, T.C. Memo 1994-211, n. 14. 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 as administration expenses. *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 does not fall into that exception. *Hibernia Bank v. U.S.*, 581 F.2d 741 (9th Cir. 1978). The fact that the local court may have approved the expenses does not necessarily make the expenses deductible as administration expenses. *Pitner v. U.S.*, 388 F.2d 651 (5th Cir. 1967); *Smith v. Commissioner,* 510 F.2d 479 (2nd Cir. 1975). A provision in the governing document requiring a sale of a particular property (or properties) might be helpful in this regard. Note regarding property taxes: Property taxes paid before death are deducted as an itemized deduction on the decedent's final form 1040 individual income tax return. §161; §164(a)(1). Property taxes accrued before death but paid after death are deductible on the estate tax return as a debt. §2053(c)(1)(B). Property taxes accrued after death are deductible as an administration expense on either the estate tax return or the fiduciary income tax return. §164(a)(1); §2053. (Note that in tax years after 2017 and before 2026, property taxes are no longer deductible in excess of $10,000 annually, except for property taxes paid in connection with carrying on a trade or business or under §212 for the purpose of producing income.) Note regarding interest: The interest deductible under §163 does not include personal (non-business) interest, and most interest paid by an estate or trust is personal interest, unless the estate or trust is engaged in a trade or business. §163(h). However, post-mortem interest is usually deductible on an estate tax return as an administration expense under §2053. See, for example, Rev. Rul. 1979-252, 1979-2 C.B. 333, which held that interest on an estate tax deficiency is deductible for estate tax purposes. See also Reg. §20.2053-4(e)(2). Although interest on estate tax deferred under §6166 is no longer deductible for estate tax purposes due to §2053(c)(1)(D), interest on estate tax deferred under §6161 is deductible for estate tax purposes if a §6166 election is not in place. Interest on state inheritance taxes is deductible for estate tax purposes, since §2053(c)(1)(D) does not limit deductions for interest on state estate taxes, but interest is generally not deductible for fiduciary income tax purposes, unless it is business interest. §163(h). For a summary of interest deductions available (or not available) on a fiduciary income tax return and/or on an estate tax return, see Appendix A.

Care should be taken with respect to deductions for personal representative's fees. The IRS has ruled in Rev. Rul. 66-167, 1966-1 CB 20, that a personal representative will be taxed on fiduciary fees unless the personal representative waives the fee in writing within six months following appointment, although that result can be avoided through an implied waiver. The ruling does not explain in detail how a waiver can be implied, but the ruling does suggest that claiming a deduction on the fiduciary income tax return for the fiduciary fees is inconsistent with a waiver.

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 B 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. The regulations became final on 5/9/14. 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 those 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). However, the 2017 Act has disallowed (for tax years after 2017 and before 2026) the deduction of any miscellaneous itemized deductions, except those miscellaneous itemized deductions that are not subject to the 2% floor. See §67(g). Some commentators feared that the enactment of §67(g) in 2017 would disallow trust and estate deductions for all miscellaneous itemized deductions, including those deductions exempted from the 2% floor by §67(e). However, on 7/13/18, the IRS issued Notice 2018-61, 2018-31 I.R.B. 278, which clarified that deductions described in §67(e) would still be deductible by trusts and estates, and will not be subject to the 2% floor. As described above, those §67(e) deductions are the ones not normally incurred by individuals. For example, tax preparation costs for fiduciary income tax returns will still be deductible, since they fall into the category that is exempt from the 2% floor under the *Knight* opinion. The IRS reaffirmed that estates and trusts may still deduct §67(e) deductions when it issued proposed regulations under the 2017 Act. Proposed Reg. §1.67-4; REG-113295-18 (5/7/20). That proposed regulation is effective for tax years beginning after May 7, 2020, but in prior years taxpayers may still rely on Notice 2018-61, 2018-31 I.R.B. 278. The final regulations were issued in September 2020 (TD9918), and those final regulations largely followed the proposed regulations. For a discussion of how those deductions are handled in the final year of an estate or a trust, see the discussion of the final year, above.

The bottom line regarding miscellaneous itemized deductions: Estates and trusts are permitted to deduct miscellaneous itemized deductions, but the ones that are commonly experienced by individuals are subject to the 2% floor, as described in Appendix B. In the final year of an estate or trust, excess deductions can be passed out to individual beneficiaries, but in tax years after 2017 and before 2026 individuals are not allowed to deduct the portion of the excess deductions that are attributable to miscellaneous itemized deductions.

g. After the above deductions are taken, the result is referred to by Form 1041 as adjusted total income, 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. Deduct the distribution deduction under §651 or §661, the estate tax deduction under §691(c), and the personal exemption under §642(b). 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. These deductions were not impacted by the Tax Cuts and Jobs Act of 2017 (P.L. 115-97). See IRS Notice 2018-61 and Proposed Reg. §1.67-4; REG-113295-18 (5/7/20). The final regulations were issued in September 2020 (TD9918), and those final regulations largely followed the proposed regulations.

i. Deduct 20% of qualified business income. This new deduction was created by the Tax Cuts and Jobs Act of 2017 (P.L. 115-97), in order to reduce the discrepancy between the new low corporate income tax rates and the higher rates applicable to individuals, estates, and trusts, which are now allowed to deduct 20% of business income generated by sole proprietorships, partnerships, LLCs, and S corporations. §199A(b)(2)(A). As a result of this deduction, the maximum income tax rate on such income is reduced from the normal maximum rate of 37% to 29.6%. The qualified business income (QBI) eligible for this 20% deduction must have been generated by an active trade or business, but the rules applicable to the determination of qualified business income, and the resulting deduction, are very complex and complicated. See new §199A for details on how this new deduction works, but here is a brief synopsis: The deduction is limited to 50% of the trust's (or estate's) prorata share of the total W-2 wages paid by the business (with an adjustment for tangible depreciable property). §199A(b)(2)(B) and (b)(6)(A). In the case of trusts and estates, the W-2 wages are allocated between the fiduciary and the beneficiaries pursuant to §199(d)(1)(B)(i) and Reg. §1.199-9(d) and (e). §199A(f)(1)(B). The business income does not include investment income (capital gains and dividends); interest is not included unless the interest is related to a trade or business. §199A(c)(3)(B). Rent is apparently not included unless significant services are performed in connection with the rental activity. In proposed regulation contained in Notice 2019-7, the IRS has proposed that the deduction will be available for rental real estate income if separate books and records are maintained for each rental enterprise, and the taxpayer must spend a minimum of 250 hours each year on rental real estate activities, although apparently the service hours may be performed by the taxpayer, its employees, or contractors. The QBI deduction is not available for certain service industries, including health, law, accounting, actuaries, performing arts, consulting, athletics, financial services, brokers, or business where the principal asset is the reputation or skill of one or more of its employees, but oddly income from engineering firms and architectural firms is eligible for the deduction. §199A(d)(2). The wage limitation and the service industry limitation do not apply to trusts or estates with taxable income of less than $157,500 (indexed for inflation), but the QBI deduction is phased out over the next $50,000 of income in excess of $157,500 (indexed for inflation). §199A(d)(3)(B) and (e)(2). This summary barely scratches the surface of the complexities and exceptions described in §199A; practitioners should be very careful when trying to determine the effect of §199A, which sunsets after 2025. Even worse, the penalty for a substantial understatement of tax attributable to this new deduction is subject to a lower threshold than other substantial understatements. §6662(d)(1)(C). For additional analysis of this new statute, see the proposed regulations issued on Aug. 8, 2018, consisting of 80 pages of regulations and 104 pages of preamble. IR-2018-162. Those proposed regulations purport to limit under §643(f) the ability of a taxpayer to utilize multiple trusts in an attempt to obtain multiple §199A deductions. See Prop. Reg. §1.643(f)-1 and §1.199A-6(d)(3)(v). Those proposed regulations also provide that, in determining whether a trust's taxable income exceeds the $157,500 ceiling, that income will be measured *before* the distribution deduction is subtracted. Reg. §1.199A-6(d)(3)(iii).

j. <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). After enactment of the 2017 Tax Act, it was believed that excess deductions could not flow out to the beneficiaries in tax years after 2017 and before 2026, but in 2020 the IRS issued regulations to clarify that some excess deductions can still flow out to the beneficiaries during those years. See the discussion of the final tax year, above.

k. Apply the tax rate table to the taxable income. §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 was only $23,500, much lower than the exemption amount for married couples ($82,100) or single individuals ($52,800). §55(d)(1). Those amounts increased to $23,800, $83,400, and $53,600 in 2015. In 2016, they increased to $23,900, $83,800, and $53,900. In 2017, they increased to $24,100, $84,500, and $54,300. In 2018 (under the 2017 Act), those amounts were changed to $24,600, $109,400, and $70,300. In 2019, those amounts were changed to $25,000, $111,700, and $71,700. In 2020, those amounts were changed to $25,400, $113,400, and $72,900. In 2021, those amounts were changed to $25,700, $114,600, and $73,600. . In 2022, those amounts were changed to $26,500, $118,100, and $75,900. In 2023, those amounts were changed to $28,400, $126,500, and $81,300. And the AMT exemption for estates and trusts phases out at much lower levels as well. In 2020, the phase-out for estates and trusts starts at $84,800, and in 2021 it is $85,700. In 2022 it is $88,300. In 2023 it is $94,600. §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 2015 threshold level for trusts and estates was $12,300 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 2017, the threshold for estates and trusts increased to $12,500, in 2018 it increased to $12,700, and in 2019 it increased to $12,750. In 2020, it increased to $13,150, in 2021 it increased to $13,250 and in 2022 it increased to $13,700. In 2023 it increased to $14,650. 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. 165 (2014). 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 also trustees.

Although the imposition of the maximum income tax rates on the taxable income of trusts and estates in excess of $12,500 in 2017 and in 2018 ($12,750 in 2019 and $12,950 in 2020) 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. (The net investment income is also reduced if some or all of the income is eligible for a charitable income tax deduction under §642(c). See the instructions to Form 8960.) 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 future application of the tax to capital gains, while also considering the investment objectives of the trust and of the individual beneficiaries.

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, and clarifies 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." An example offered by Reg. §1.652(b)-1 involves income received by a beneficiary of a foreign trust that is passing through foreign income. In that example, the includability of that income in the gross income of the beneficiary depends on "his taxable status with respect to that income." Another possible example might be a tax-exempt charity that receives taxable income from a trust. In that situation, the income would have been taxable to the trust if retained by the trust, but it will not be taxable if distributed to a charity.

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

Decedents' estates and 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.

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, brokerage commissions, custodial fees, and interest. 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 some excess deductions are classified as miscellaneous itemized deductions in the hands of the beneficiaries. Reg. §1.642(h)-2(a). Those excess deductions can be used by the beneficiaries only if the beneficiaries itemize their deductions, and some of those deductions will be classified as miscellaneous itemized deductions, which 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). Note that individuals will not be able to deduct miscellaneous itemized deductions in tax years after 2017 and before 2026. §67(g).

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. If an estate is filing an Oregon estate tax return, but not a federal estate tax return, then the administration expenses could be claimed on the federal income tax return *and* on the Oregon estate tax return, since no deductions will be claimed on a federal estate tax return. But in that situation, the deductions may not be claimed on the Oregon fiduciary income tax return. See below.

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); Reg. §2053-2. 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 150-316-0390; 150-118-0040. The Oregon statutes permit independent (inconsistent) elections for federal estate tax and state estate tax purposes. ORS 118.010(8). For examples of Oregon fiduciary income tax adjustments that must be made if inconsistent elections are made regarding administration expense deductions, see OAR 180-118-0400. Washington does not allow inconsistent elections for federal estate tax and state estate tax purposes, except for elections pertaining to the marital deduction. RCW 83.100.047(1)(a). As a result, even though Washington does not impose a fiduciary income tax, amounts deducted for federal income tax purposes are not allowed as deductions for purposes of the Washington estate tax. RCW 83.100.047(2). For further discussion of inconsistent elections and their effect on basis, see Basis Step-up and Basis Reporting, below.

18. The Distribution Deduction

As a general rule, a trust or estate that has DNI in a particular tax year will pay income tax on that DNI if the trust or estate retains that income, but distributions (of income *or* principal) to beneficiaries in the same tax year will usually cause that DNI to be carried out to the beneficiaries receiving those distributions. §662(a). Distributions made in the first sixty-five days of the following tax year can also qualify; the sixty-five day rule is discussed in a separate section below.

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).

Thus trusts and estates operate differently than partnerships and S corporations. The income of partnerships and S corporations is taxed to the partners/shareholders regardless of whether the income is distributed, but the income of estates and complex is taxed to the beneficiaries only if distributed to the beneficiaries. Rev. Rul. 75-61, 1975-1 C.B. 180. However, the DNI of a simple trust will be taxed to the beneficiaries regardless of whether it is distributed. If a simple trust has more than one beneficiary, each the beneficiaries will be taxed on their prorata share of the income, based on the ratio that income is required by the governing document to be distributed to each of the beneficiaries. §652(a); Reg. §1.652(a)(2).

A distribution of income or principal usually qualifies as a distribution of income (to the extent income is present) because of the tier system (see the discussion of the tier system, below), which causes income to be deemed to have been distributed with the highest priority, even if the distribution was actually made in the form of an asset classified as principal. *Van Buren v. Commissioner*, 89 T.C. 1101 (1987). However, the tax laws do not alter the trust laws, which provide that the trustee cannot make distributions that are not permitted by the terms of the trust. For example, if a trust permits distributions of income but does not permit distributions of principal, problems can develop. That trust might have received a distribution from an annuity or from a retirement plan that is classified as principal for fiduciary accounting purposes, but that distribution is classified as taxable income for purposes of the fiduciary income tax. Because the trust does not permit principal distributions, the trust will be prevented from passing that income out to the beneficiaries. A more permissively-drafted trust would have solved this problem.

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).

If the amount distributed to the beneficiaries exceeds DNI for the year, then each beneficiary will be taxed on his or her prorata share of the DNI, based on the relative amounts received by each of the beneficiaries. §662(a); Reg. §1.662(a)-2(b); Reg. §1.662(a)-3; Reg. §1.662(b)-1. For example, assume a trust has $10,000 of DNI and it distributes $14,000 to four beneficiaries: A receives $5,000, and B, C, and D each receive $3,000. A will be deemed to have received income of $3,571 (5/14ths of $10,000) and B, C, and D will each be deemed to have received income of $2,143 (3/14ths of $10,000). And A will be deemed to have received principal of $1,429 (5/14ths of $4,000), and B, C, and D will each be deemed to have received principal of $857 (3/14ths of $4,000). Reg. §1.662(a)-3(d).

The amounts included in the distribution deduction are deemed to include a portion of each class or character of amounts included in DNI, in the same proportions, unless the governing instrument or local law provides for a different allocation. §661(b); Reg. §1.661(b)-1. Thus a trust that received rents, interest, and dividends will be deemed to have distributed those same amounts, in the same proportions as those amounts were included in DNI. But if the governing instrument or local law provides for a special allocation of certain classes of income, those allocations will not be given effect unless they have economic effect independent of the tax consequences. Reg. §1.652(b)-2. Thus the allocation will not be followed unless it actually increases or decreases the amounts passing to particular beneficiaries. *Van Buren v. Commissioner*, 89 T.C. 1101 (1987). (The regulations that deal with the allocation of various classes of income to particular beneficiaries, including charities, are sometimes referred to as the ordering rules, and a provision in a governing document that calls for a special allocation is sometimes referred to as an ordering provision.) If one of the beneficiaries is a charity, the regulations are particularly clear on this point: the regulations under §661 make reference to Reg. §1.643(a)-5(b), which provides that an allocation in the trust agreement to charities will not be given effect unless the allocation has independent economic effect. Reg. §1.661(b)-2. Although Reg. §1.643(a)-5(b) governs tax-exempt income, the cross-reference to it in Reg. §1.661(b)-2 appears to make it applicable to any class of income if a charitable income tax deduction is involved. For a discussion of the independent economic effect rule, see the sections below regarding tax-exempt income, charitable deductions, retirement accounts, and the separate share rule. Regarding the interplay between the distribution deduction and the charitable deduction, see below in this section.

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. Thus a simple trust is entitled to a distribution deduction equal to the lesser of (a) the income required to be distributed currently, or (b) DNI, but in either case the amount is reduced by the portion attributable to tax-exempt income. §652(b). A complex trust is entitled to a distribution deduction equal to the lesser of (a) the amount paid or required to be distributed, or (b) DNI, but in either case the amount is reduced by the portion attributable to tax-exempt income. §661(c); §662(b).

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).

In general, simple trusts pay fiduciary income tax on ordinary income in excess of fiduciary accounting income, capital gains, phantom income from pass-through entities that do not distribute cash to the trust, and trapping distributions (distributions from an estate or trust that carry out income to the simple trust but cannot be distributed by the simple trust to the beneficiaries, because the distribution is treated as principal under fiduciary accounting rules or for other reasons.)

Because complex trusts deduct the income that they are required to distribute, a complex trust will receive a distribution deduction (and the beneficiary will be taxed) even if the required distribution is less than all of the income. For example, a complex trust with $5,000 of income that is required to distribute $2,000 of income to the beneficiary annually, will receive a $2,000 distribution deduction (and the beneficiary will be taxed on that $2,000), even if the distribution is not actually made, or is not made until a later year. §661(a); §662(a); Reg. §1.662(a)-2.

Distributions that are "properly paid or credited" include distributions of income, or principal, or both, since §661(a)(2) describes "any other amounts" without limiting those amounts to either income or principal. In order to carry income out to the beneficiaries, the distribution need not come from income, and thus there is no need to trace the source of a distribution to income or to principal. §661(a)(2). Any distribution (except distributions of specific bequests) will carry out income if the trust or estate has DNI for that tax year.

The trust or estate income taxable to the beneficiary is reported to the beneficiary and to the IRS on a Schedule K-1 attached to the fiduciary income tax return. The IRS receives a copy of the K-1 when the fiduciary income tax return is filed, and a separate copy of the K-1 is mailed to the beneficiary. The beneficiary does not necessarily receive a full copy of the tax return. The beneficiary is required to report the income on his or her individual income tax return in a manner that is consistent with the K-1. §6034A(c)(1). If the beneficiary wishes to report the income in an inconsistent manner, the beneficiary is required to file a Form 8082, Notice of Inconsistent Treatment.

Charitable distributions are not included in the distribution deduction. §651(a)(2); §661(b); §663(a)(2); Reg. §1.663(a)-2; Rev. Rul. 68-667, 1968-2 C.B. 289. Instead, they are deductible under §642(c), and they may not be deducted through the distribution deduction. Reg. §1.663(a)-2; Reg. §1.661(a)-1(last sentence); Reg. §1.662(a)-1(last sentence). Even if some of the charitable distribution does not qualify for a charitable income tax deduction, that portion is still not eligible for a distribution deduction. Rev. Rul. 68-667, 1968-2 C.B. 289. Thus a distribution of income to charity that does not qualify for the charitable income tax deduction does not qualify for any income tax deduction whatsoever. As a result, distributions of income to a charity do not appear on a Schedule K-1 issued to the charity, and in fact a charity normally does not receive a K-1, because a distribution of income to a charity does not result in a distribution deduction. Instead, it results in a charitable deduction. §642(c). The upshot of this is that distributions to charity do not carry out income. And if principal is distributed to a charity, neither a distribution deduction nor a charitable deduction is allowed for income tax purposes, although a charitable deduction will usually be available for estate tax purposes. §2055.

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). The taxation of that mandatory income distribution will reduce the income available to be taxed to tier 2 beneficiaries, as will income distributions to charities. In effect, income is treated as having been distributed in the following order of priority: tier 1, charities, and tier 2. See the discussion of the charitable deduction, below, and the discussion of the tier system, also below.

In the past, certain distributions were commonly made from an estate to a simple trust using a technique that would cause income to be carried out from the estate to the simple trust, but without causing the simple trust to treat the income as having been distributed to the trust beneficiary. These were known as trapping distributions. The technique worked like this example: the estate would distribute $50,000 of principal to the simple trust. The estate had $15,000 of DNI, which was carried out to the trust for income tax purposes, but the entire $50,000 was treated by the trust as principal for fiduciary accounting purposes. Thus the simple trust had received no income from the estate for purposes of fiduciary accounting, and thus the terms of the trust did not require that any of the $50,000 be distributed to the beneficiary. However, the trust did have $10,000 of ordinary income of its own, which (because it is a simple trust) is required to be distributed to the beneficiary, who will be taxed on that $10,000 regardless of whether the $10,000 was actually distributed. But the beneficiary will not be taxed on the $15,000 of estate income; that income was "trapped" in the trust and thus was taxed to the trust. This was a popular technique prior to the time that the fiduciary income tax rate brackets were compressed; back then, trusts were often in lower income tax brackets than individual beneficiaries. Now, with fiduciary income tax brackets usually higher than individual beneficiary income tax brackets, the use of trapping distributions has lost most of it popularity.

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); *Fuller v. Commissioner*, 9 T.C. 1069 (1947), aff'd. 171 F.2d 704 (3rd Cir. 1948); *Prince v. Commissioner*, 35 T.C. 974, 978 (1961); *Commissioner v. Plant*, 76 F.2d (2d Cir. 1935), affirming 30 B.T.A. 133. For a contrary result, with no significant legal analysis, see *Moreell v. U.S.*, 221 F.Supp. 864 (W.D. Pa. 1963). When drafting such a trust, the better practice (in order to avoid the high income tax rates of trusts) might be to require distributions to the beneficiary, and then the trust should require the beneficiary to pay the maintenance expenses as a condition of living in the residence.

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. But 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 an amount equal to (or greater than) all of the taxable income *and* all of the tax-exempt income. §652(b); §661(c); §662(b); Reg. §1.661(c)-1.

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. Reg. §1.652(c)-4(d). As a result, trusts and estates with tax-exempt income will need to calculate a disallowance ratio, which will vary from year to year. The ratio will be the ratio between tax-exempt income and the total income included in DNI. *Manufacturers Hanover Trust Co. v. U.S.*, 312 F.2d 785 (Ct.Cl. 1963). The portion disallowed, however, may be deducted on the estate tax return under §2053. Rev. Rul. 59-32, 1959-1 C.B. 245.

If the will or trust (or local law) attempts to allocate a greater share of tax-exempt income to one beneficiary, and not to another beneficiary, that allocation will be given effect only if the allocation has economic effect independent of the income tax consequences. §1.652(b)-2(b); *Van Buren v. Commissioner*, 89 T.C. 1101 (1987). That rule is particularly applicable if a charitable income tax deduction is present. Reg. §1.643(a)-5(b).

If the economic effect rule is applicable, is the rule satisfied if the allocation contained in the governing instrument *could* result in an independent economic result, or must the allocation actually have an independent economic result in order to satisfy the rule? For example, assume that a trust agreement bequeaths to charity the greater of $50,000 or the proceeds of the decedent's IRA, and the trust also directs that the bequest shall be funded first with IRD. The decedent then dies with an IRA balance of $45,000, payable to the trust as beneficiary. The charity later receives a check from the trust in the amount of $50,000. Is the IRD entirely allocated to the charity? Or does the independent economic effect rule prevent the IRD from being allocated to the charity, and instead the IRD must be allocated prorata among all of the beneficiaries? If the IRA had held $55,000, then the bequest would have had actual independent economic effect, and the IRD will be allocated entirely to the charity. But the IRA held only $45,000, and thus the allocation lacked actual independent economic effect. Reg. §1.642(c)-3 states that a special allocation will be honored to the extent it "has" economic effect, not "might have." Reg. §1.643(a)-5(b) uses the same language, as does Reg. §1. 652(b)-2(b). As a result, in this example the IRD will be allocated prorata among all of the beneficiaries, and the special allocation will be disregarded. Reg. §1.642(c)-3(b)(2); Reg. §1.643(a)-5(b); Reg. §1.652(b)-2; §662(a); Reg. §1.662(a)-2(b); Reg. §1.662(b)-1; *Van Buren v. Commissioner*, 89 T.C. 1101 (1987). Yet see Reg. §1.663(c)-5, Example 9, where such a special allocation was effective, although a charity was not involved in that example.

One could make the argument that an allocation (stated in a will or trust) of tax-exempt income to one beneficiary, and not to the other beneficiaries, will be effective for fiduciary income tax purposes, even if the allocation does not have an independent economic effect. If an independent economic effect is lacking, the regulations under §643 dealing with tax exempt income prohibit such allocations if a charitable income tax deduction is being taken. Reg. §1.643(a)-5(b). But no such prohibition appears in that regulation if a charity is not involved. Similarly, the regulations describing the classes of income deemed to have been distributed by a complex trust allow such allocations if provided for in the governing instrument or by local law, with no mention of economic result. Reg. §1.661(b)-1. But the section of those regulations that applies when a charitable income tax deduction is present includes a cross-reference to Reg. §1.643(a)(5), which requires independent economic effect. Reg. §1.661(b)-2. And an example in the separate share regulations suggests that no economic effect is required when allocating classes of income among separate shares in a setting where no charitable income tax deduction is present. Reg. §1.663(c)-5, Example 9. See the discussion of the separate share rule, below.

But the position adopted by the Service seems to be that allocations of tax-exempt income will not be effective without independent economic effect, even when a charitable income tax deduction is not present. The regulations under §652 (which deal with the classes of income includable in the income of a beneficiary of a simple trust) have provided since 1956 that special allocations of classes of income will not be given effect unless the allocations have independent economic effect, regardless of whether a charitable deduction is involved. Reg. §1.652(b)-2(b). In 2012, when the Service amended the regulations under §642 and §643 to incorporate the independent economic effect rule, the Service explained that the economic effect rule is "a principal that applies throughout Subchapter J" and is "the general rule imposed throughout Subchapter J in the case of all kinds of complex trusts." T.D. 9582, 4/30/12.

Yet the regulations are not exactly a work of art when it comes to clarity, even after the 2012 amendments. When Reg. §1.662(b)-1 describes allocations made when no charitable income tax deduction is present, it appears to allow such allocations, regardless of whether independent economic effect is present. But then a cross-reference is made to Reg. §1.652(b)-1, even though the economic effect rule is actually contained in a different regulation, Reg. §1.652(b)-2. And when Reg. §1.662(b)-2 describes allocations made when a charitable income tax deduction is present, it similarly cross-references Reg. §1.652(b)-1, and not Reg. §1.652(b)-2. Reg. §1.662(b)-2 also cross-references Reg. §1.643(a)-5, which requires independent economic effect if an allocation is made when a charitable income tax deduction is present. A clear answer is elusive.

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). Thus 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. See Reg. §1.663(a)-1(b)(1).

This explains why every will contains (or should contain) a specific bequest of the decedent's tangible personal property. By containing such a bequest, the distribution of the tangible personal property will not carry out income to the recipients.

Query: If a testator leaves a bequest equal to "the greater of $100,000 or 10% of my net estate," is that a specific bequest? Under the regulations, a specific bequest must be ascertainable as of the date of death. Reg. §1.663(a)-1(b). Thus it would appear that such a bequest is not ascertainable as of the date of death, because the size of the net estate cannot be determined as of the date of death. For example, if the size of the bequest is dependent on the payment of administration expenses, then the bequest is not specific. Reg. §1.663(a)-1(b). Note that the issue of whether a bequest is specific enough is a different issue than whether a bequest is pecuniary and thus triggers gain when it is funded with appreciated property. Rev. Rul. 60-87, 1960-1C.B. 285; Reg. §1.663(a)-1(b).

Another query: Assume that an estate requires the payment of several large pecuniary bequests, with the residue paid to another beneficiary. Assume that the estate has significant taxable income, but lacks assets to pay all of the specific bequests. In other words, the residue is nonexistent, and all of the specific bequests will need to abate on a prorata basis under local law. In the final year, each specific devisee receives 80% of his/her specific bequest, and the trust terminates. Is the income carried out to the specific devisees, or is the estate forced to pay the income tax because specific bequests do not carry out income? Clearly, the size of each bequest was not known on the date of death, because postmortem income and postmortem expenses were not known on the date of death. So it would appear that the specific bequests were not actually specific bequests, as specific bequests are defined by Reg. §1.663(a)-1(b). Yet in Rev. Rul. 66-207, 1966-2 C.B. 243, the Service ruled that specific bequests that were underfunded retain their character as specific bequests, and thus do not carry out income, even in the final year of the estate. If that ruling is correct, then this might be one of the rare examples of an estate paying income tax in its final year. See the discussion of the final tax year, above.

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. The basis determined under §1014 is usually referred to as a stepped-up basis (although it can also be stepped-down), and the basis determined under §1015 is usually referred to as carryover basis.

If property is specifically bequeathed to a beneficiary, and instead of distributing the asset to the beneficiary, the trust or estate sells the asset at the request of the beneficiary and then distributes the proceeds to the beneficiary, the gain or loss will be taxable to the beneficiary. The transaction will be treated as if the asset had been distributed to the beneficiary and the beneficiary had returned the asset to the trust or estate with instructions to sell the asset on behalf of the beneficiary. Rev. Rul. 68-666, 1968-2 C.B. 283. As a result, the trust or estate will not recognize gain or loss in that situation, but the beneficiary will recognize gain or loss. A logical result of that ruling is that, because the asset will have been deemed to have been distributed to the beneficiary, no DNI will have been carried out to the beneficiary, since the asset was distributed as a specific bequest.

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). See the previous section. 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. With one exception: the amount deemed to have been distributed shall be equal to the lesser of the asset's basis or the fair market value of the asset. §693(e)(2) (P.L. 369, 98th Cong. 2d Sess. §81 (1984)). For example, if an IRA account lacks basis (as is often the case), then the distribution of that account intact (in-kind, without withdrawing any assets from the account) to a beneficiary does not carry out DNI to the beneficiary. For a similar result under prior law, see Rev. Ru. 68-195, 1968-1 C.B. 305 (without explanation); *Rollert Residuary Trust v. Commissioner*, 80 T.C. 619 (1983), *aff'd.*, 752 F.2d 1128 (1985); *Dean v. Commissioner*, T.C. Memo 1983-276.

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(f); *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. Reg. §1.663(c)-5, Example 4; Rev. Rul. 66-207, 1966-2 C.B. 243; Rev. Rul. 83-75, 1983-1 C.B. 114. (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 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); Reg. §1.1014-4(a)(3); 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 making a required income distribution. 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. Similarly, distributing appreciated assets in satisfaction of a pecuniary formula bequest will trigger gain. Rev. Rul. 83-75, 1983-1 C.B. 114. (In contrast, in-kind distributions in satisfaction of a fractional formula bequest will not result in recognition of gain or loss, because a fractional formula is not pecuniary.) If the trust distributed securities that had decreased in value in satisfaction of a pecuniary bequest, 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. But note §267(b)(13), which permits an estate (but not a trust) to recognize a loss on an in-kind distribution in satisfaction of a pecuniary bequest. That statute might be an additional incentive to make a §645 election for a trust to be treated as part of an estate. See the discussion, above, on the subject of a trust election to use a fiscal year. For a discussion of the tax consequences of using IRD to satisfy a pecuniary bequest, see the discussion of retirement accounts, below. Finally, if a trust or estate is not permitted by its governing instrument or local law to make nonprorata distributions, but it does so in satisfaction of a pecuniary bequest as a result of an agreement among the beneficiaries, the beneficiaries will recognize gain or loss as if the assets had been distributed prorata and then exchanged among the beneficiaries. Rev. Rul. 69-486, 1969-2 C.B. 159. But if the governing document or local law permits the fiduciary to make nonprorata distributions, then no gain or loss will be recognized when in-kind assets are distributed in satisfaction of a pecuniary bequest. Rev. Rul. 69-486, 1969-2 C.B. 159.

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. The election is made by checking a box on Form 1041. 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). Thus it appears that the election applies only to residuary bequests. 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). If the election is made, the distribution will be deemed to have carried out DNI in an amount up to the value of the property. §643(e)(3). But if the election is not made, the distribution carries out DNI in an amount equal to the lesser of the basis in the property or the property's fair market value. §643(e)(2). 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. The beneficiary might have losses of his own that might be available to offset the gain the beneficiary might realize when he sells the low-basis asset he has received from the trust. 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). And a §643(e) election might cause the distribution of an IRD asset to trigger tax. 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. If the basis in the hands of the fiduciary is greater than fair market value as of the date of distribution, then the basis in the hands of the beneficiary will be the fair market value. §1015.

f. Can a simple trust make an in-kind distribution? Yes, but an in-kind distribution with a value in excess of trust income will cause a simple trust to be reclassified as a complex trust for that tax year. Rev. Rul. 67-74, 1967-1 C.B. 194.

g. What holding period will the beneficiary be deemed to have with respect to the asset received in an in-kind distribution? The general rule under §1223(2) is that the holding period of the fiduciary will tack onto the holding period of the recipient if the basis of the asset in the hands of the recipient is determined by the basis of the asset in the hands of the fiduciary. In other words, if gain or loss was recognized, the beneficiary will be required to start a new holding period. But if gain or loss was not recognized, then the holding period of the beneficiary will tack onto the holding period of the fiduciary.

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, 2018), particularly §17.11.

22. Charitable Deduction

Estates and some complex trusts (but not simple trusts) may deduct charitable contributions of gross *income* that are paid to a charity or permanently set aside for later payment to a charity. §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 a charitable contribution, regardless of whether the contribution is from income or principal. §651(a); Reg. §1.651(a)-3(a). For a complex trust to qualify for the set-aside deduction, it must make an election under §645, as discussed below. Most trusts that claim a charitable income tax deduction under §642(c) will need to file a Form 1041-A. §6034(b); Reg. §1.6034-1. See the instructions to Form 1041-A.

The charitable contribution deduction for estates and trusts is more generous than the charitable deduction available for individuals, in six 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. (Starting in 2018, the 50% ceiling was raised to 60%.)

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); Reg. §1.642(c)-1(2). See the discussion of this subject below. But an estate or trust cannot carry over to a subsequent year excess contributions from a prior year, since §642(c) contains no carryover provisions.

c. A trust or estate may deduct a contribution to a foreign charity. §642(c)(1); Reg. §1.642(c)-1(3)(b). But the foreign contribution must actually have been paid; the set-aside provisions do not apply to amounts held for distribution to a foreign charity.

d. An estate or trust need not distinguish between contributions to public charities and private foundations, while individuals must comply with separate limitations on deductions to private foundations. Section 642(c) does not include such limitations.

e. An estate or trust apparently does not need to comply with the detailed §170 substantiation requirements, while individuals are subject to those rules. See the discussion below.

f. Estates and trusts may deduct portions of income that are actually paid to charity. §642(c)(1). But 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. The set-aside deduction is discussed further below.

Unlike individuals, trusts and estates are not permitted to carry forward a charitable income tax deduction. 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).

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. The election needs to be made no later than the due date (including extensions) for filing the income tax return for the succeeding year (the year in which the distribution was actually made). Reg. §1.642(c)-1(b)(2). The election becomes irrevocable on that date. However, the election itself is made by attaching a statement to the return (or the amended return) for the prior tax year (the year in which the distribution will be deemed to have been made). Reg. §1.642(c)-1(b)(3). That same regulation describes the required content of the statement. The statement must state the date of the payment, and so it is apparent that the deduction cannot be taken in the earlier year until the payment has actually been made in the succeeding year.

Section 642(c)(1) provides that the fiduciary income tax deduction is available for expenditures for a charitable *purpose*, not just distributions to charitable organizations, although there is little authority that elaborates on that provision.

To be deductible as a charitable contribution, the contribution must be made pursuant to the terms of the governing instrument (the will or trust). The wording of the statute and the regulations suggests that the governing instrument need not require the contribution; it need only permit it. §642(c); Reg. §1.642(c)-1(a)(1). As noted below, the safest approach to specifically authorize that distributions to charity may be made from income. The Supreme Court has ruled under the precursor of §642(c) that the governing instrument need not require that the distribution be made from income; the governing instrument need only authorize the fiduciary to make a discretionary decision to pay the charitable contribution from income. *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379, 383, 19 AFTR 489 (1937). The prior version of §642(c) authorized a charitable income tax deduction if the distribution of income was made "pursuant to the terms of the will or deed creating the trust." §162 (1928). The current version of §642(c) uses identical language: "pursuant to the terms of the governing instrument." Thus the holding in *Old Colony Trust* is still good law. The Second Circuit has agreed. *Weir Foundation v. U.S.*, 2d 894, 35 AFTR2d 75-538 (2nd Cir. 1974), affirming 362 F. Supp. 928, 32 AFTR2d 73-5649 (D.C.N.Y. 1973); *Brownstone v. U.S.*, 465 F.3d 525, 98 AFTR2d 2006-6889 (CA2 2006). In *Weir* and *Brownstone*, a beneficiary exercised a general power of appointment to make a distribution to charity, when the governing instrument made no mention of charity; the charitable income tax deduction was denied. Similarly, in Chief Counsel Advice 201651013 and 201747005, a trust was modified to permit charitable distributions, but the Service ruled that such distributions were not deductible because the trust before the modification was not ambiguous, nor was the grantor's intent in question. Instead, the modification was made solely to acquire tax benefits. However, see also PLR 200906008 and PLR 201225004, both of which concluded that the exercise of a limited power of appointment to appoint trust income to a charitable organization is made pursuant to the governing instrument, and thus a fiduciary income tax charitable deduction is allowed under §642(c). In the latter of those two rulings, the trust specifically authorized the holder of the power to appoint principal or income to a charitable organization, while in the earlier of the two rulings the trust authorized the holder to appoint "all or any portion of the trust estate" to a charitable organization without specific reference to income or principal. In both rulings, the charitable deduction was allowed after the holder specified that income of the trust was being appointed.

An even safer approach would be to draft the governing instrument to *require* that the charitable distributions be made from income. See CCA 200644020. If a trust makes distributions to charity when the instrument does not provide for charitable distributions, those amounts may not be deducted as charitable contributions or as distributions to the beneficiaries. *Crown Income Charitable Fund v. Commissioner*, 98 T.C. 327 (1992), *aff'd* 8 F.3d 571 (7th Cir. 1993). The governing instrument must not only authorize the distribution, it should ideally authorize the distribution to be made out of income. If the governing instrument is silent on the question of whether a charitable distribution should be made from income, look to local law, but the safest approach would be to include the authorization in the instrument itself. Rev. Rul. 71-285, 1971-2 C.B. 248; Rev. Rul. 68-667, 1968-2 C.B. 289. For an example of a trust that collected the proceeds of an IRA and then distributed the proceeds to a charity, but was denied a charitable income tax deduction because the trust instrument did not authorize distributions of income to the charity, see ILM 200848020. If the governing document directs that a pecuniary charitable bequest be made first out of income, and principal is used to fund the bequest, then the charitable income tax deduction will be limited to the gain recognized by the use of appreciated assets to fund the pecuniary bequest. Rev. Rul. 83-75, 1983-1 C.B. 114.

The requirement that the governing instrument must permit the charitable contribution is strictly construed. If a trust document authorizes charitable distributions upon termination of a trust, a deduction will not be allowed for distributions made prior to termination. Rev. Rul. 55-92, 1955-1 C.B. 390.

As noted above, estates and trusts may deduct amounts of income that are paid to charity (if the requirements of §642(c) are complied with), but estates (not most trusts) may also deduct amounts of income that are set aside for charitable purposes. The deduction will not be allowed unless those amounts are permanently set aside under the terms of the governing document and the circumstances of the particular case are such that the possibility that the funds might not eventually be distributed to charity is so remote as to be negligible. Reg. §1.642(c)-2(d); Rev. Rul. 70-452, 1970-2 C.B. 199; PLR 200336020. For example, if the estate faces possible future litigation that might deplete assets, then the set-aside deduction will not be available. See *Belmont v. Commissioner*, 144 T.C. 84 (2015); *DiMarco v. Commissioner*, T.C. Memo 2015-184; and the cases cited therein. The regulations do not indicate how an estate should go about setting aside funds for charity. Presumably setting funds aside in a separate account will be helpful, but the existence of a separate account does not necessarily protect the funds from creditors.

Special substantiation requirements apply to charitable deductions in excess of $250 made by individuals, but there is some debate whether those substantiation requirements apply to trusts and estates. In general, individuals 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. Final regulations under §170 regarding those substantiation requirements were issued 7/30/18. TD 9836. Whether those same substantiation requirements apply to trusts and estates has not been clearly established. Section 642(c), which governs the income tax charitable deductions of trusts and estates, provides that that subsection allows a charitable income tax deduction "in lieu of the deduction" allowed to individuals under §170(a), which hints that the substantiation requirements of §170(f)(8) do not apply. See also Reg. §1.642(c)-1(a). In addition, §170(f)(8) states that deductions under §170(a) will not be allowed without the §170(f)(8) substantiation, which again suggests that the substantiation requirements of §170(f)(8) do not apply to deductions taken by trusts and estates under §642(c). And Part IV of the preamble to the 2018 final regulations (TD 9836) states that the substantiation regulations apply only to deductions under

§170. The instructions to Form 1041 make no mention of the substantiation requirements. And the substantiation rules could not possibly be satisfied in the case of a set-aside charitable deduction by an estate or trust.

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 or unrelated business income), not principal. §642(c); §681(a); Reg. §1.642(c)-3(a); Reg. §1.642(c)-3(b); Reg. §1.642(c)-3(d); *Crestar Bank v. Commissioner*, 47 F.Supp.2d. 670 (E.D.Va. 1999); Rev. Rul. 2003-123, 2003-50 I.R.B. 1200; Rev. Rul. 78-24, 1978-1 C.B. 196. 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, and distributions of principal will not qualify as a charitable income tax deduction. *Mott v. United States*, 462 F.2d 512 (Ct. Cl. 1972); *Riggs National Bank v. United States*, 352 F.2d 812 (Ct. Cl. 1965); *O'Connor v. Commissioner*, 69 T.C. 165 (1977); *Van Buren v. Commissioner*, 89 T.C. 1101 (1987); *Crestar Bank v. IRS*, 47 F.Supp.2d 670, 83 AFTR2d 99-2555 (D.C. Va. 1999); Rev. Rul. 2003-123, 2003-50 I.R.B. 1200. The income need not necessarily be traced to income earned in the year of the charitable contribution; tracing to income earned in a prior year is sufficient. *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379, 383, 19 AFTR 489 (1937). If the distribution is made from assets that make up principal, the fact that the trust had sufficient amounts of income on hand will not justify a charitable income tax deduction. *W.K. Frank Trust v. Commissioner*, 145 F.2d 411 (3rd Cir. 1944). 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; it is a rare exception to the general rule of fiduciary income taxation that tracing is not required. *Crestar Bank v. IRS*, 47 F.Supp.2d 670, 83 AFTR2d 99-2555 (D.C. Va. 1999). For that reason, it might be helpful to keep income in a separate account if it is destined to be used to fund a charitable bequest.

The §681 prohibition on charitable deductions for contributions of unrelated business income applies only to trusts, not estates. An estate may take such a deduction, and presumably a trust electing to be taxed as an estate under §645 is also eligible for such a deduction.

If the income of the trust or estate was derived from a pass-through entity, such as an S corporation or a partnership, the tracing requirement will be difficult or impossible to satisfy if the entity did not actually distribute cash income to the estate or trust, but instead was deemed to have distributed phantom income unaccompanied by cash. In *Richardson Foundation v. U.S.,* 430 F.2d 710 (5th Cir. 1970), *reh. den.* 430 F.2d 710, *cert. den.* 4/5/1971, *reh. den.*, 403 US 912 (1971), the Fifth Circuit disallowed a fiduciary charitable income tax deduction when an S corporation had taxable income that was not distributed to the shareholder estate, but which was taxable to the estate. The court held that such income was never received by the estate, was never subject to the provisions of the will, and thus could not be considered to have been paid to the charity or set aside for the charity. See the discussion of S corporations and partnerships, above. Effective beginning in 2018, Electing Small Business Trusts (ESBTs) are no longer governed by the charitable income tax deduction rules of §642(c), but instead are subject to the same §170 rules that are applicable to individuals, as a result of the 2017 Act. That change is permanent, and does not sunset in 2026.

One exception to the charitable tracing rule: if a trust has both taxable income and tax-exempt income, charitable distributions of income will produce charitable income tax deductions that are reduced by the ratio between the tax-exempt income and DNI, regardless of whether the charitable distribution was made from taxable income or tax-exempt income. Reg. §1.642(c)-3. Attempts in the governing document to allocate taxable income to charity will be unsuccessful unless the allocation has economic effect independent of the income tax consequences. Reg. §1.642(c)-3(b)(2); §1.643(a)-5(b); §1.661(b)-2. The allocation of taxable income and tax-exempt income to the §642(c) charitable distribution takes place before any other deductions are allocated among the items of DNI. Reg. §1.661(b)-2; Reg. §1.662(b)-2. See the examples in that regulation. The economic effect rule is discussed in greater detail below in this section, and in the section on retirement accounts.

In a case of first impression, the Tenth Circuit has held that a trust, whose governing document authorized its trustee to make charitable distributions out of income, may not deduct the current full fair market value of real estate donated to charity if the real estate was purchased in earlier years using the gross income of the trust to fund the purchase price. Instead, the deduction will be limited to the trust's adjusted basis in the property, since that was the amount that was originally included in gross income. *Green v. U.S.*, 880 F.3d 519, 121 AFTR2d 2018-427, 2018 WL 386656 (10th Cir. 2018), reversing 144 F.Supp.3d 1254, 116 AFTR2d 2015-6668, 2015 WL 6739089 (D.C. OK 2015).

If a trust holds an interest in a partnership which makes a charitable contribution from gross income, the trust must take into account its share of the partnership's income, credits, and deductions (including the charitable deduction). §702(a)(4). For a discussion of the effect of a charitable contribution by a partnership in which a trust or estate holds an interest, in a situation where the governing document was silent on the subject of charitable contributions, see Rev. Rul. 2004-5, 2004-1 C.B. 295. In that revenue ruling, the trust was allowed a deduction. See also *Bluestein v. Commissioner,* 15

T.C. 770 (1950) *acq.* 1951-1 C.B. 1; *Lowenstein v. Commissioner*, 12 T.C. 694 (1949); PLR 200140080. Regarding S corporations, see Reg. §1.641(c)-1(d)(2).

See the discussion of the distribution deduction, above, regarding the interplay between the distribution deduction and the charitable deduction. That section discusses the fact that a distribution of income to a charity does not result in a distribution deduction. §663(a)(2); Reg. §1.663(a)-2. Instead, it results in a charitable deduction. And if principal is distributed to a charity, neither a distribution deduction nor a charitable deduction is allowed for income tax purposes, but a charitable deduction is most likely available for estate tax purposes. §2055. In other words, distributions of income under §642(c) are the exclusive means for a charitable income tax deduction by a trust or estate; distributions to charities do not produce a distribution deduction under §661. Reg. §1.663(a)-2; Rev. Rul. 2003-123, 2003-50 I.R.B. 1200; Rev. Rul. 68-667, 1968-2 C.B. 289; Chief Counsel Advice 201651013 and 201747005; Reg. §1.661(a)-1(last sentence). Some commentators have questioned whether the statute justifies this conclusion reached by the regulations, but the courts have agreed with the regulations. *Mott v. U.S.*, 462 F.2d 512 (Ct. Cl. 1972), cert. denied 409 U.S. 1108 (1973); *O'Connor v. Commissioner*, 69 T.C. 165 (1977).

A distribution of IRD (income in respect of a decedent) to a charity is even more complicated. As noted in the discussion of IRD below, IRD is included both in the gross estate for estate tax purposes and in gross income for fiduciary income tax purposes. If an item of IRD (such as a retirement account) is distributed to a charity before the income is collected (the retirement account is distributed intact before funds are withdrawn from the account) and before the income is realized, then the charity will realize and recognize the income from the retirement account in the year in which the charity withdraws the funds from the account. But the estate will not realize or recognize income when it distributes the account intact, and the estate need not claim a charitable income tax deduction. §691(a)(2); Reg. §691(a)(4)(b); *Rollert v. Commissioner*, 752 F.2d 1128 (6th Cir. 1985); PLR 2005-20004; PLR 200002011. And, of course, charities don't pay income taxes. Thus distributing the account to the charity intact, prior to any withdrawals, might be the best option to avoid income taxation. In some situations, such a distribution might require language in the governing instrument (or local law) authorizing nonprorata distributions. In Oregon, see ORS 130.725(22). In Washington, see RCW 11.98.070(15) and 11.68.090(1). But if the estate collects the income (withdraws funds from the retirement account) and then distributes the funds to charity, the estate will realize and recognize the income, and a charitable income tax deduction under §642(c)(1) will be desirable, preferably all in the same tax year in order to offset the IRD income. PLR 201611002. If the income is not paid out in the same year, then a charitable set-aside deduction under §642(c)(2) might be available. When seeking a charitable income tax deduction for retirement account proceeds, keep in mind that Reg. §1.642(c)-3(a) provides that income in respect of a decedent is included in the gross income of the estate or trust in the year in which the IRD is received, and thus the estate or trust will be eligible for a charitable income tax deduction when that income is distributed to charity. *Green v. U.S.*, 880 F.3d 519, 121 AFTR2d 2018-427 (10th Cir. 2018). Also keep in mind that the governing instrument must authorize the distribution of income. §642(c)(1); Reg. §1.642(c)-1(a)(1). For that reason, some practitioners suggest that every will or trust that includes a charitable bequest should direct that the charitable bequest should be paid first out of income in respect of a decedent, if the estate or trust has any IRD.

When an item of IRD is payable to charity, oftentimes both an estate tax charitable deduction and an income tax charitable deduction will be available. That might seem odd that the same dollars might generate two separate deductions (one for estate tax purposes and one for income tax purposes, but both for the very same dollars), but that is the result of the fact that IRD is included both in the gross estate for estate tax purposes and in gross income for fiduciary income tax purposes. See *Crestar Bank v. IRS*, 47 F.Supp.2d 670, 83 AFTR2d 99-2555 (D.C. Va. 1999). (If a private foundation receives IRD from a retirement account, that IRD will not be subject to the two percent excise tax on investment income under §4940. PLR 9838028 and 2000-03055.)

If an estate or trust is making a charitable bequest of a particular class of income (for example, the will or trust specifically directs that a charitable bequest must be funded with IRD from a retirement account), that designation of a particular class of income will not be honored for purposes of the charitable income tax deduction unless the designation has an economic effect independent of the income tax consequences. This rule applies to any particular class of income, not just IRD. Reg. §1.642(c)-3(b)(2). For example, a bequest of $10,000 to a charity, with a direction that to the extent possible the bequest should be paid from IRD, will cause the direction to be ineffective for tax purposes, because the actual amounts to be received by the various beneficiaries will not be increased or decreased by the amount of IRD available; each beneficiary will receive the exact same amount, regardless of the amount of IRD available. In that situation, all of the beneficiaries will be deemed to each have received a prorata share of each type of income, both IRD and non-IRD. Reg. §1.642(c)-3(b)(2); Reg. §1.643(a)-5(b); Reg. §1.652(b)-2; §662(a); Reg. §1.662(a)-2(b); Reg. §1.662(b)-1; *Van Buren v. Commissioner*, 89 T.C. 1101 (1987). But a bequest of all of the ordinary income of a trust or estate to a charity will have independent economic effect (the charitable bequest will increase or decrease depending on the amount of ordinary income generated by the estate or trust), and thus such a bequest will cause the tax-exempt charity to receive that income, and the charity will be deemed to have received that income for fiduciary income tax purposes, and the estate or trust will be able to make use of a charitable income tax deduction for the full amount of ordinary income passing to charity. See the examples in Reg. §1.642(c)-3(b)(2). Or a bequest that requires the trust or estate to distribute to charity all of the proceeds of the decedent's IRA to charity will permit a charitable income tax deduction, because the amount passing to charity will vary depending on the amount held in the IRA at death. PLR 201611002. This economic effect rule is important to remember when drafting estate plans that contemplate using retirement accounts to fund charitable bequests. The economic effect rule does not necessarily disallow a charitable income tax deduction. Instead, it affects the allocation of certain classes of income to the charity, and thus it might reduce the charitable income tax deduction, particularly if tax-exempt income is present. In some cases, the application of the economic effect rule might decrease the charitable income tax deduction while simultaneously increasing the distribution deduction for distributions to noncharitable beneficiaries. Thus the economic effect rule might cause income to be shifted away from a charity and thus cause noncharitable beneficiaries to be taxed on a larger share of the income than would have been the case had the rule not applied. The economic effect rule can be avoided by naming the charity (not the trust or the estate) as the beneficiary of the retirement account. Or the rule can be avoided by having the trust or estate transfer the retirement account intact to the charity prior to making any withdrawals from the account. By doing so, the trust or estate will not have realized income, and thus a charitable income tax deduction will not be needed in order to offset the IRD income. PLR 9123036; PLR 9537011. However, the estate or trust will nevertheless recognize income if the IRA is transferred to a charity in satisfaction of a pecuniary charitable bequest. But if the will or trust authorizes the distribution of income to the charity, then an offsetting charitable income tax deduction will be available. Rev. Rul. 83-75, 1983-1 C.B. 114. See the discussion of in-kind distributions, above, and the discussion of retirement accounts, below.

To illustrate one possible impact of the economic effect rule, consider the following situation. Father's will leaves a bequest of $50,000 to Charity, with the entire residue passing to Daughter. Assume that the estate collected the proceeds from an IRA in the amount of $20,000, all of which was IRD. In addition to the $20,000 of IRD, the estate had other taxable income of $30,000 from dividends and interest, for total taxable income of $50,000. Father's will directs that the charitable bequest is to be satisfied first from income, both IRD and ordinary income, and then from principal. However, that language has no economic effect, because the charity will receive $50,000, no more and no less, regardless of how much IRD and/or other income might be received by the estate. Because that language has no economic effect, it will be disregarded. Reg. §1.642(c)-3(b)(2). The estate distributed $50,000 to Charity (in full satisfaction of the charitable bequest) and $50,000 to Daughter (in partial satisfaction of her residuary interest). Charity received its funds from a separate bank account that consisted solely of the IRD and the ordinary income, and thus the funds received by Charity will be traceable to income, as required by §642(c) in order to be eligible for a charitable income tax deduction. However, because the special allocation lacked economic effect, the allocation was disregarded and Daughter and Charity will each be deemed to have received their prorata share of the income, so that each will be deemed to have received $25,000 of income (half of the total of $50,000 of income). Reg. §1.642(c)-3(b)(2); Reg. §1.643(a)-5(b); Reg. §1.652(b)-2; §662(a); Reg. §1.662(a)-2(b); Reg. §1.662(a)-3(d); Reg. §1.662(b)-1; *Van Buren v. Commissioner*, 89 T.C. 1101 (1987). Of the $25,000 of income that Charity and Daughter will each be deemed to have received, each will be deemed to have received 40% IRD and 60% ordinary income, since the IRD was $20,000 and the ordinary income was $30,000. Thus Charity is deemed to have received $25,000 of income, which was made up of $10,000 of IRD and $15,000 of ordinary income, while and Daughter is deemed to have received $25,000 of income, which (just like Charity) was made up of $10,000 of IRD and $15,000 of ordinary income. The balance received by Charity and Daughter will be deemed to be principal, in the amount of $25,000 each. Although Father attempted to allocate all of the $50,000 of income to Charity, thus sparing Daughter from paying any income tax on her residuary bequest, that attempt failed and Daughter was taxed on part of the income, all because the economic effect rule disregarded Father's attempted allocation. It is important to note that the estate was nevertheless able to deduct all of its income, both IRD and ordinary income: Half of the IRD and half of the ordinary income were deducted under §642(c) as a charitable income tax deduction, and the other half was deductible as a distribution to Daughter under the §662(a) distribution deduction. In effect, the estate's charitable income tax deduction was reduced due to the disregard of the special allocation, but the estate's distribution deduction was increased by the amount of the reduction in the charitable deduction. So the estate did not suffer any adverse income tax consequences as a result of the economic effect rule. But Daughter did suffer an adverse income tax consequence, since she was taxed on income that her Father attempted to allocate to Charity. (The result in this illustration would have been the same even if all of the income had been IRD, or if all of the income had been ordinary dividends and interest.)

In the above illustration, if the special allocation had been honored (even though it had no economic significance independent of the tax consequences), then Charity would have received $50,000 of taxable income, and Daughter would have received $50,000 of nontaxable principal; neither would pay any income taxes on their respective distribution.

The result described in that illustration appears to be the result intended by the economic effect regulations. Yet that conclusion is not entirely certain or clear. Three arguments could be made to the contrary:

First, the regulations that create the tier system (discussed in a separate section below), provide that income will be taxed to beneficiaries in a priority known as the tier system. The highest priority to be taxed are Tier 1 beneficiaries, who receive mandatory income distributions, if the trust provides for mandatory income distributions. Other beneficiaries (Tier 2 beneficiaries, who received discretionary distributions) will be taxed only if they received distributions and the total distributions to all beneficiaries exceeded the Tier 1 income. But charitable distributions are classified as a separate tier, intermediate between Tier 1 and Tier 2. Thus charitable distributions have a higher priority to be allocated income than Tier 2 distributions. See the discussion of §662(a)(1) and §662(a)(2) in the section on the tier system, below. And Tier 1 distributions have a higher to be allocated income than charitable distributions. As a result, Tier 1 beneficiaries do not receive any benefit from a charitable fiduciary income tax deduction. In the illustration above, Tier 1 is absent, and the distribution to the charity is considered to be an intermediate tier with higher priority than the Tier 2 distribution to the daughter. As a result, the charity has a higher priority to be deemed to have received income than the daughter, all of the income will be deemed to have been distributed to the charity, and no income will be deemed to have been distributed to the daughter. Thus the special allocation contained in the will was unnecessary, and the disregarding of that allocation (due to a lack of economic effect) has no effect. See Example 1 in Reg. §1.662(b)-2. This argument boils down to a simple question: Do the tier regulations override the economic effect regulations?

Second, if the separate share rule (discussed below) is applicable, then Reg. §1.663(c)-2 indicates that income will be allocated among the separate shares in accordance with the governing instrument or local law, apparently without regard to the economic effect rule, and Example 9 in Reg. §1.663(c)-2(b)(3) permits such an allocation that has no economic effect. Thus it appears that if the separate share rule applies, allocations lacking economic effect will nevertheless be honored. However, a strong argument could be made that a charitable bequest is not a separate share. For example, the application of the separate share rule exists for the sole purpose of determining DNI in the application of §661 and §662. §663(c); Reg. §1.663(c)-1(b). Yet DNI cannot be allocated to a charity under §661 and §662, particularly because the charitable distribution has already been removed from DNI. §643(a); *Mott v. U.S.*, 462 F.2d 512 (Ct. Cl. 1972). This conclusion is consistent with the rule that a charitable distribution is deductible under §642(c), and cannot be deducted as part of the distribution deduction. Reg. §1.663(a)-2. See Boyle and Blattmachr, *IRD and Charities:*

The Separate Share Regulations and the Economic Effect Requirement, Real Property, Trust and Estate Law Journal, Winter 2018.

Third, it could be argued that the economic effect rule of Reg. §1.642(c)-3(b)(2) deals only with the character of the income deductible under §642(c), and does not specifically state that the economic effect rule will actually cause a trust or an estate to be denied a §642(c) deduction. Yet that same regulation states that an allocation will be disregarded if it lacks economic effect, and if an allocation is disregarded it seems possible that the charitable income tax deduction will be reduced, as in the illustration above.

Also, an argument could be made that when the economic effect regulations discuss a special allocation of income, those regulations refer to income, not principal, and IRD is considered to be principal under local law, particularly the Uniform Principal and Income Act. Thus the economic effect regulations do not apply to IRD. That argument is difficult to accept, since IRD is income for income tax purposes. After all, they don't call it *Income* in Respect of a Decedent for nothing.

The addition of the economic effect rule to the charitable deduction regulations took place in 2012. T.D. 9582, 4/30/12. Prior to 2012, the economic effect rule appeared only in §1.652(b)-2(b), which governs the inclusion of income by beneficiaries of simple trusts. The regulations governing inclusion of income by beneficiaries of complex trusts did not include an economic effect rule, but did include a cross reference to the §652 regulations, together with an indication that the principles of §652 "generally apply" to both simple trusts and complex trusts. Reg. §1.662(b)-2. The regulations under §652 also generally require a prorata allocation of the various elements of income. Reg. §1.652(b)-2(a). In 2012, when the economic effect rule was added to Reg. §1.642(c)-3(b)(2) (dealing with charitable deductions) and Reg. §1.643(a)-5(b) (dealing with tax-exempt income), some practitioners complained that the Code did not justify that rule, but the Service argued that the economic effect rule had always been generally applicable throughout the fiduciary income tax, and that the 2012 changes merely clarified that fact. See also Reg. §1.661(b)-2, which appears to make Reg. §1.643(a)-5(b) applicable to any class of income, not just tax-exempt income. The Service also argued that although §652(b) allows governing instruments to allocate different classes of income to different beneficiaries, the very next sentence authorizes the Treasury to adopt regulations on that subject. T.D. 9582, 4/30/12.

One possible solution to the problem of charity and IRD might be to distribute to the other beneficiaries their full distributive shares of the trust using non-IRD assets, so that the remaining assets (which are IRD) will be payable entirely to the charity. And then, in the following year, the IRD can be withdrawn from the retirement account and can be distributed to the charity, and a charitable income tax deduction will then be allowed in the final year for the full amount of the IRD, since the charity will be the sole beneficiary in that year, and none of the IRD will be allocable to the other beneficiaries. Even though the charitable deduction cannot be carried out as an excess deduction in the final year, the charitable deduction will nonetheless reduce the IRD income of the trust to zero. The charity will usually not receive a K-1, since a charitable deduction will be taken, not a distribution deduction. See the section on the distribution deduction, above, which points out that distribution deductions are generally not available for distributions to charity, and thus distributions to charities generally do not carry out income. This solution has been discussed with approval by several commentators and practitioners, but there is no legal authority directly on point.

If that solution works, will the reverse work? If the IRA is cashed in by the trust and the proceeds distributed to the charity in full satisfaction of its distributive share, but no distributions are made to the individual beneficiaries in that same fiscal year, it would appear that a charitable income tax deduction would be available, and the taxable income (consisting of IRD) of the trust would be reduced to zero. Then the following year could be the final year of the trust, and the remaining individual beneficiaries would receive the rest of the trust assets, and the principal and income of the trust in that final year (none of which would constitute IRD) would flow out to the individual beneficiaries. But there is no authority on point, and the commentators who believe the first solution will work are reluctant to opine that the reverse will work. So the jury is still out.

Another possible solution has been suggested. In lieu of a specific pecuniary bequest to charity, a governing instrument might direct that all of the trust income (subject to a pecuniary cap) will be paid to charity. The pecuniary cap would be in lieu of a pecuniary bequest. For example, instead of a $50,000 bequest to charity, the governing instrument might provide that all of the income of the trust will be paid to charity, but not to exceed $50,000. If the trust has income in excess of $50,000, then the net economic effect of this provision will be identical to a $50,000 bequest. But such a provision would appear to be effectively identical to a $50,000 specific bequest accompanied by an allocation directing that the bequest be satisfied out of income, and Reg. §1.642(c)-3(b)(2) specifically states that such an allocation will be disregarded due to a lack of an independent economic effect. Since the substance of the two provisions appears to be the same, perhaps the form of the bequest will be disregarded, and it will be treated as a specific bequest with a disregarded special allocation. If this provision is employed, and if it is successful in generating an income tax charitable deduction, the estate tax charitable deduction will most likely not be available, since the charitable bequest will not be satisfied by assets held on the date of death. (This proposal has been suggested by Prof. Christopher Hoyt.)

By the way, statistics show that fiduciary income tax returns are rarely audited. But anecdotal evidence suggests that a charitable income tax deduction might be a triggering factor.

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 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. Reg. §1.663(b)-1(a)(1). Reg. §1.663(b)-2(a)(1). 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 an estate or a complex trust 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 for that tax year.

Although §663(b) distributions must be made within the sixty-five day period, the election is not made until the Form 1041 is filed for the prior year, 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. Reg. §1.663(b)-1(a)(1). If no return is required to be filed, the election is made by filing a statement with the IRS service center where a return would have been required to be filed. Reg. §1.663(b)-2(a)(2). 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. See Reg. §1.663(b)-2(a)(2) for the election procedure in situations when no return is required to be filed.

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. Also, the sixty-five day rule does not apply to distributions to charity, because the application of §663(b) is limited to §661 and §662. That inapplicability extends not only to distributions that are eligible for the charitable income tax deduction under §642(c), but also to other distributions to charity (such as principal distributions) that are not eligible for a charitable income tax deduction. That result is brought about by the fact that a distribution to charity is not eligible for a distribution deduction under any circumstances. §663(a)(2); Reg. §1.663(a)-2. See the sections above regarding the charitable deduction and the distribution deduction.

If income was received in one year, and deemed to have been distributed in that year under the rules governing simple trusts, or deemed to have been distributed in that year under the sixty-five day rule applicable to distributions made early the next year, that income distribution cannot be used to support a distribution deduction in the next year. Reg. §1.663(a)-3.

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, for three reasons. First, §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 in the prior tax year, then the distribution will not have been made within a taxable year. Second, Reg. §1.663(b)-1(a)(2) limits the election to distributions of income, not principal, although the statute is silent on this point. But according to the regulation, the deduction cannot exceed the greater of DNI or fiduciary accounting income. Naturally, when a trust or estate terminates, it distributes all of its assets, both income and principal, and the terminating principal distribution will not be deemed by §663(b) to have been distributed in the prior tax year, and the trust or estate will be deemed to hold assets in the subsequent tax year. Third, a distribution made under the sixty-five day rule will carry out the income received in the prior year, but it will not carry out the income received in the subsequent year, and thus income will be present in the subsequent year, which prevents the prior year from being the final year. Reg. §1.641(b)-3(b); Reg. §1.641(b)-3(c)(1); §1.663(b)-1(a)(2).

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); Reg. §1.662(a)-2(a).

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 and distributions exceed first tier income. §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. Thus the first dollars distributed by a trust or estate will be deemed to carry out first tier income, up to a limit equal to the lesser of first tier income or DNI. 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. *Crestar Bank v. IRS*, 47 F.Supp.2d 670, 83 AFTR2d 99-2555 (D.C. Va. 1999). (Prior to 1954, tracing was often required. See *Van Buren v. Commissioner*, 89 T.C. 1101 (1987).)

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 exceeds the amount 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). Tier 1 income is an exception to this rule; tier 1 income is taxed to tier 1 beneficiaries regardless of whether it is distributed. §652(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. If a simple trust distributes more than tier 1 income in any one year, the trust will be treated as a complex trust for that year. §651(a)(2); Reg. §1.651(a)-3(b).

If unequal distributions are made to two or more beneficiaries, all of whom are in the same tier, then the income will be allocated among them on a prorata basis. Reg. §1.662(a)-3(c) and (d).

If a charitable income tax deduction is being claimed, then an intermediate tier exists between tier 1 and tier 2. The income distributed (or set aside) for charity under §642(c) is subtracted from DNI after the tier 1 income is subtracted, but before the tier 2 income is subtracted. That result is caused by a parenthetical that appears in §662(a)(1), but does not appear in §662(a)(2). The result is that tier 1 beneficiaries do not benefit from a charitable fiduciary income tax deduction.

25. Income in Respect of a Decedent (IRD)

Income in respect of a decedent (known as IRD) is an item of gross income that was earned by the decedent, or accrued for the benefit of the decedent, during his lifetime, but it was not actually received by the decedent during his lifetime. §691. As a result, the income was not taxed during his lifetime.

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. In *Peterson v. Commissioner*, 667 F.2d 675 (8th Cir 1981), *affirming* 74 T.C. 630 (1980), IRD was defined using a four part test: (1) the decedent had entered into a legally significant agreement, (2) the decedent had performed the substantive tasks required by the contract, (3) there were no economically significant contingencies that would have prevented the decedent from receiving the funds, and (4) the decedent would have received the funds had the decedent not died. And remember the elements required by §691: the item must be an element of gross income (it must be taxable as income), earned or accrued during life, but received after death.

Examples of IRD 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.

Savings bond interest that has accumulated during the lifetime of a decedent is usually, but not always, income in respect of a decedent. See IRS Publication 550.

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, regardless of whether the amount is received before or after death. §72(a) and (b); Rev. Rul. 2005-30, 2005-1 C.B. 1015. Basis is generally what the decedent paid for the annuity. 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). In general, each payment received is divided into taxable income and return of basis, using an exclusion ratio, so that a portion of each payment is excludable as a return of basis and a portion is includable in income as ordinary income or (in the case of a decedent) income in respect of a decedent. §72(b)(1). One of the primary disadvantages of an annuity is that it does not receive a stepped-up basis at death. §1014(b)(9)(A). See also §691(d) and the discussion of annuities in the section pertaining to fiduciary accounting income, above. (Annuities are usually categorized as qualified or nonqualified. A qualified annuity is usually held in a retirement arrangement, such as an IRA, in which case the annuity usually has no basis. A nonqualified annuity is usually purchased with after-tax dollars and the purchase price constitutes basis.)

Oddly enough, §72 does not refer to basis. Instead, it consistently refers to "investment in the contract." It appears that "investment in the contract" is identical to basis.

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). Because IRD is part of taxable income, it is also part of DNI. §643(a); Reg. §1.663(c)-5, Exs. 6 and 9. IRD is ordinary income for fiduciary income tax purposes, and it is not capital gain, despite any definition of fiduciary accounting income or the provisions of the Uniform Principal and Income Act. CCA 2006-44016. 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 funds from that account, 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. These are known as double deductions, because they are allowed to be taken on both the estate tax return and the fiduciary income tax return. Reg. §1.642(g)-2. These deductions were not impacted by the Tax Cuts and Jobs Act of 2017 (P.L. 115-97). See IRS Notice 2018-61.

Not only is IRD included in gross income for income tax purposes, it is also included in the gross estate for estate tax purposes. Thus it might be taxed twice, once for income tax purposes and once 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 limitation applies, then the beneficiaries are taxed on the IRD that they received, and they may take the §691(c) deduction in the year in which the IRD was taxed. Reg. §1.691(c)-1(a). 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). As a result, the §691(c) deduction was not suspended by the 2017 Act. §67(g). But, as in the case of other itemized deductions, high-income individuals are subject to the §68 reduction in itemized deductions (the Pease limitation), and so the §691(c) deduction might not be fully available to all beneficiaries. (The Pease limitation was suspended by the 2017 Act for years after 2017 and before 2026.)

The calculation of the §691(c) deduction is complicated. The statute requires that the first step is to determine the estate tax attributable to all of the IRD items. Then a ratio is determined equal to the ratio that the IRD items reported for income tax purposes by the recipient taxpayer bear to all of the IRD items reported for estate tax purposes. That ratio is then applied to the amount of estate tax attributable to the IRD items. §691(c)(1)(A); Reg. §1.691(c)-1(a)(2). But the calculation of the estate tax itself is also complicated. The amount of estate tax attributable to the IRD items is determined by calculating the estate tax twice, once with the IRD items included and once with the IRD items excluded. In making the second calculation, it might be necessary to recompute any estate tax deductions that are based on the gross estate. The recomputed deductions could include the marital deduction and the charitable deduction. Reg. §1.691(c)-1(a)(2). Thus even though property passing to the surviving spouse or to charity normally does not generate any estate tax (due to the marital and charitable deductions), the surviving spouse and charitable beneficiaries can be eligible for a §691(c) deduction, or a portion of the deduction. For discussions of the relationship between the marital deduction and the §691(c) deduction, see *Kincaid v. Commissioner*, 85 T.C. 25 (1985); *Cherry v. U.S.*, 133 F.Supp.2d 949, 87 AFTR2d 2001-814 (W.D. KY 2001); *Findlay v. Commissioner*, 39 T.C. 580 (1962), *aff'd* 332 F.2d 620 (2nd Cir. 1964); PLR 200316008 (Dec. 31, 2002). The same rule applies to IRD passing to a charity. *Chastain v. Commissioner*, 59 T.C. 461 (1972). In the case of a charity, however, the deduction will be of no use to the charity, but the portion of the deduction available to the charity will not be available to the taxable beneficiaries who received other portions of the IRD.

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.

The most common form of IRD encountered by estates and trusts is a retirement account. 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. Within each payment, 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 make 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 on the death of the obligee; 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."

Another possible type of IRD is the refund received after the death of a resident of a continuing care retirement community (CCRC). When the decedent entered the CCRC, usually a large deposit (entrance fee) was made, and occasionally the decedent was advised that part of that deposit was deductible in the year of payment as a medical expense. When a resident of a CCRC moves out or dies, oftentimes a large refund is received, and the prior deduction might cause part of the refund to be taxable as income to the resident, or IRD to his estate, under the tax benefit rule. Rev. Rul. 76-481, 1976-2 C.B. 82, Rev. Rul. 78-292, 1978-2 C.B. 233; and Rev. Rul. 75-302, 1975-2 C.B. 86; §213; Reg. §1.213-1(g)(1)); §111. However, a 1998 article in the Virginia Law Review suggests (without citing any authority) that none of the post-death refund is IRD. 18 Va. Tax Rev. 1 (1998). In order to assist in resolving this question after a death has occurred, keep good records of the amount of the original deposit and how much of it was deducted in the year of payment.

For the same reason, a state income tax refund, received after death for taxes that were deducted during life, is most likely IRD.

Another example of IRD is created when the decedent entered into an enforceable contract to sell real estate, but died before closing the sale. If the contract was binding as of the date of death, and the prerequisites to the consummation of the closing had been satisfied, then the resulting gain is considered to be IRD. Rev. Rul. 78-32, 1978-1 C.B. 198.

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 the estate, trust, or beneficiary who withdraws assets from a retirement account. §408(d)(1). As a result, 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 (the participant). §1014(c). Funds withdrawn from the retirement account are considered to be ordinary income, and must be reported on the income tax return of the recipient in the year of the withdrawal. In general, the taxation of receipts from an IRA are governed by §72, which governs annuities.

The presence of IRD in retirement accounts makes retirement accounts very dangerous to deal with, since an inadvertent withdrawal (or an inadvertent closing of the account, which is the same as a withdrawal) can trigger a very large income tax liability. Proceed with caution.

The income tax treatment of a retirement account under the Internal Revenue Code takes place despite the fact that local law often characterizes required retirement account withdrawals as constituting 10% income and 90% principal. For example, see Uniform Principal and Income Act §409. In Oregon, see ORS 129.355. In Washington, required retirement account withdrawals constitute 4% income and 96% principal. RCW 11.104A.180; RCW 11.104B.200(2) after 1/1/22. Although those local law provision are not followed for income tax purposes (due to the characterization of retirement accounts as IRD, and thus as ordinary income), the local law plays a large role in determining what distributions may be made under the terms of the governing instrument. For example, a trust agreement that prohibits distributions of principal will be constrained by local law definitions of principal and income. For example, such a trust will be unable to distribute to the trust's beneficiary distributions that the trust received from an IRA, because those IRA distributions will be categorized as principal (in whole or in part) under trust law, but will constitute taxable income under tax law.

One exception to the income tax rule that retirement accounts are usually made up entirely of IRD: in some cases portions of a retirement account are attributable to after-tax (non-deductible) contributions. Those portions have income tax basis and are not considered to be IRD. The challenge is finding out whether the decedent made any non-deductible contributions. Such contributions were supposed to have been reported to the IRS annually with the decedent's individual income tax return (Form 1040), using Form 8606. One hopes that the decedent did so, and kept copies of his tax returns. Another example is a Roth IRA, which is generally not made up of IRD.

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

- Family Members. In most cases, the 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 will be 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 might have neglected to name a beneficiary for a retirement account. In those instances, the retirement plan document must be carefully 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 retirement 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.

- Charity Named as Beneficiary. If a charity is named as the beneficiary of a retirement account, the income taxation of the account is usually avoided. Because of the IRD nature of retirement accounts, such assets make good candidates for charitable dispositions. If a person holds both regular (after-tax) investments and a pre-tax retirement account, 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 account, 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. If the retirement account is left to charity through an estate or trust (the estate or trust is designated as the beneficiary of the retirement account, as opposed to the designation of a charity as the beneficiary), see the discussion of the charitable deduction, above, particularly the portion discussing a bequest of IRD to a charity.

Typically, the surviving spouse is the beneficiary of most retirement accounts, including IRAs. If the spouse is the beneficiary, the spouse can usually roll the account over into a new retirement account in her own name without triggering income tax. §408(d)(3)(C). Or the spouse may elect to treat the decedent's IRA as her own IRA by redesignating the account as owned by the spouse. Thus the spouse is no longer the beneficiary, but instead is the owner. Reg. §1.408-8 Q-5. In either case, the income tax will then be postponed until the spouse makes withdrawals from the new account or the redesignated account. This is usually the optimum result, since surviving spouses are generally permitted to defer withdrawals longer than other beneficiaries.

If the estate is the beneficiary of an IRA, the fiduciary must exercise extreme care. In such instances, 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 assignment is to a person who is entitled to receive the IRD under the governing document (will or trust). §691(a)(2); Reg. §691(a)(4)(b). 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 as beneficiaries of his estate, for example, the account can typically be divided into three separate inherited IRAs, one for each of the three children. Each of the three children could then decide when to withdraw funds from their respective separate accounts, and thus each of them can control when each will be taxed on the withdrawals, because the funds will not be taxed until withdrawn from one of the inherited IRAs. Reg. §1.691(a)-4(b). 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. (Some IRA custodiams have a policy that an IRA payable to an estate cannot be converted into separate inherited IRAs for the beneficiaries of the estate. If you have an IRA payable to the estate, check with the custodian early in the probate process to determine what the custodian will allow. If may be that the IRA will need to be moved to a friendlier custodian, and that process might take some time.)

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, or elect to become the owner of the existing account, as discussed above. Note that these options do not involve a withdrawal; the assets stay within an IRA. Taxation will not take place until the spouse, as the beneficiary of the IRA, makes a withdrawal from the account. §408(d)(3)(C). These options are usually the best choices for a spouse beneficiary, since the spouse can defer withdrawals for a longer period than other beneficiaries. Also, the spouse can name her own beneficiaries of the account, to take effect upon her death.

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 later withdrawn from one of the inherited IRAs. §691(a)(2); Rev. Rul. 78-406, 1978-2 C.B. 157.

d. If the beneficiary is the estate or a trust, the estate or trust might 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. In effect, the estate or trust will have transferred the retirement account intact to one or more beneficiaries without having actually made any withdrawals from the account. The transfer of an IRA account from an estate or a trust as a result of the death of the owner is not a taxable event. §691(a)(2); Reg. §1.691(a)-4(b). (But see the discussion of pecuniary bequests, below.) Thus a taxable event does not take place until a withdrawal is made from the account by the beneficiary who received it from the trust or estate. PLR 200520004. It might be necessary to check your governing instrument or your local law to determine whether nonprorata distributions are permitted. In Oregon, see ORS 130.725(22). In Washington, see RCW 11.98.070 and 11.68.090. If the estate or trust feels the need to make an actual withdrawal from the account, perhaps the withdrawals could be made over two or more years, and hopefully that income can be offset by administration expense deductions or distribution deductions, but distributing the account intact to the beneficiaries is usually the safest approach. But see below regarding trusts that qualify as a Designated Beneficiary. In some situations, the IRS will permit an estate to withdraw the funds from the retirement account, then pay those funds to the surviving spouse, who can then roll the funds over to her personal IRA. PLR 201821008. In that ruling, the surviving spouse was the personal representative and the sole heir of the estate. The ruling concluded that she would be treated as having acquired the funds directly from the decedent and not from his estate, she would be eligible to roll over the distribution to her IRA, and she would not be required to include the distribution in her gross income.

e. If the beneficiary is a charity, the charity can withdraw funds from the account with impunity, since the charity will not be taxable on the IRD. If the beneficiary is the estate or a trust, but the estate or trust benefits (in whole or in part) a charity, then the situation becomes much more complicated. See the discussion of the charitable deduction, above.

The complexity of the issues described above requires careful drafting of beneficiary designations and the dispositive provisions of wills and trusts that pertain to distributions from retirement accounts to beneficiaries, or to trusts or estates. And the beneficiary designations and the dispositive provisions must be carefully coordinated.

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 C 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. For a discussion of how these rules apply to trusts that become a beneficiary of a retirement account, see Marmion, *Retirement Benefits and Lifetime Trusts*, Oregon State Bar Estate Planning and Administration Section Newsletter, Vol. XXXV, No. 1, January 2019. For deaths after December 31, 2019, see Appendix D and see below regarding the SECURE Act.

When a trust is named as the beneficiary of a retirement account, the trust might distribute the account intact (without making withdrawals from the account) to the trust beneficiaries in the form of one or more inherited IRAs, as discussed above. Or the trust could retain ownership of the account as an inherited IRA, but that choice does not allow a maximum stretch-out of the required minimum distributions (RMDs). However, a trust can be specially designed and drafted as a "see-through trust" (also known as a look-through trust), which can be categorized as a Designated Beneficiary if it meets certain criteria. A see-through trust allows the life expectancy of the oldest beneficiary to be used to maximize the stretch-out. See Reg. §1.401(a)(9) for a discussion of the requirements to be classified as a see-through trust. A see-through trust can be drafted in one of two ways: The trust could be drafted as a conduit trust, in which the trust agreement requires the trustee to distribute to the beneficiaries (generally in the same tax year) any distributions that the trust might receive from the retirement account. A conduit trust is considered to be a safe-harbor, in that it automatically qualifies as a see-through trust. Any trust not considered to be a conduit trust is considered to be an accumulation trust, since it allows the trustee to accumulate funds withdrawn from the retirement account, rather than distributing the withdrawals as they are made. An accumulation trust will qualify as a see-through trust if all of the eligible beneficiaries are identifiable individuals. Another alternative might be to use an individual retirement trust, also known as a trusteed IRA. The details of these alternatives are beyond the scope of this paper. See the Choate book listed in the Selected Additional Research Materials at the end of this paper.

If the fiduciary transfers the retirement account to a non-beneficiary (in satisfaction of a debt, for example, or in return for consideration), then the estate or trust will immediately realize income in an amount equal to the IRD in the account. §691(a)(2). But if the transfer is to a beneficiary in satisfaction of the beneficiary's right to inherit a non-pecuniary bequest from the estate or trust (such as a residuary bequest), that rule does not apply, the estate or trust will not be taxed on the IRD, and the beneficiary will not be taxed until the time that the beneficiary makes a withdrawal from the account. §691(a)(1)(C) and (a)(2). But if the transfer is in satisfaction of a pecuniary bequest, there is some debate as to whether the transfer will trigger realization of income. Although the IRS has indicated in CCA 200644020 and in PLR 201438014 that a transfer of an IRA account to a beneficiary in satisfaction of a pecuniary bequest will trigger IRD to the estate or trust, §691(a)(2) suggests that the estate or trust will not realize IRD, and the beneficiary will realize IRD only when the beneficiary makes withdrawals from the account. Reg. §1.691(a)-2; Reg. §1.691(a)-4(b). In CCA 200644020, the IRS specifically stated its disagreement with that interpretation. Until this question is resolved, using the transfer of a retirement account to satisfy a pecuniary bequest is not without risk. See also PLR 9315016.

If the fiduciary makes a withdrawal from a retirement account (causing realization of ordinary income), and then makes a distribution to one of several beneficiaries, the tax situation becomes considerably more complicated if the separate share rule applies. See the discussion of the separate share rule in the following section. The problem is determining whether the IRD will be deemed to have been received prorata by all of the separate shares, or received (and distributed) by only one of the separate shares. The separate share rule might, under some circumstances, allocate only some of the IRD to the beneficiary who actually received the entire amount of the IRD. In order to avoid the impact of the separate share rule, one option might be to provide in the governing instrument that the IRD will be allocated to just one of the shares. That allocation will normally be respected for purposes of the separate share rule. Reg. §1.663(c)-2(b)(3); Reg. §1.663(c)-5, Example 9. However, that allocation will not be respected if the IRD is being distributed to a charity, unless the allocation has independent economic effect. Reg. §1.642(c)-3(b)(2); Reg. §1.663(a)-2. See the discussion of the independent economic effect rule in the sections on the distribution deduction, tax-exempt income, and the charitable deduction, above, and the separate share rule, below.

A second option would be to distribute the account itself to one or more beneficiaries without the estate or trust making any withdrawals from the account, thus preventing the DNI from being realized by the estate or trust. In that situation, the separate share rule would not apply to the IRD for the simple reason that the trust or estate did not receive (realize) any IRD, and thus need not report (recognize) any IRD.

A third option might be to distribute non-IRD assets in a prior year in full satisfaction of the other beneficiaries' interests in the estate or trust, thus creating a situation in a subsequent year where the estate or trust has only one beneficiary, the separate share rule will not apply, and the beneficiary receiving the IRD will be taxed on all of it, not just part of it. This technique might be useful to direct all of the IRD to a charity, which will not pay tax on the IRD it is deemed to have received. See the discussion of the charitable deduction, above.

The separate share rule (discussed in the following section) applies to shares of a trust that are independent of one another, such that a distribution from one share to that share's beneficiary does not diminish the share of any other beneficiary. Once it is determined that the separate share rule applies, the manner in which it applies to an item of IRD depends in part on whether the item constitutes principal or income under fiduciary accounting rules. As noted above in the discussion of fiduciary accounting income, the distinction between fiduciary accounting income and principal is defined by local law and the governing instrument. §643(b). The separate share regulations contain a special provision that governs the portion of IRD that is considered to be principal for fiduciary accounting purposes. Reg. §1.663(c)-2(b)(3). (Note that all IRD is taxable as income for income tax purposes, but not all IRD is defined as income for fiduciary accounting purposes.) Most states have adopted a version of the Uniform Principal and Income Act (UPIA). The Oregon version defines required distributions from a retirement account as constituting 90% principal and 10% income. ORS 129.355. (In Washington, required retirement account withdrawals constitute 4% income and 96% principal. RCW 11.104A.180; RCW 11.104B.200(2) after 1/1/22.) If no part of the withdrawal was required to be made, then the withdrawal is considered to be 100% principal. ORS 129.355; RCW 11.104A.180. Under Reg. §1.663(c)-2(b)(3) of the separate share regulations, the principal portion of the IRD is allocated among the separate shares that "could potentially" be funded with the IRD, and the allocation is then made on a prorata basis, depending on the relative values of the shares. Reg. §1.663(c)-5, Examples 6 and 10. The income portion of the IRD (as defined for fiduciary accounting purposes) is allocated among the separate shares according to the terms of the governing instrument and local law, apparently without regard to whether the allocation has any independent economic effect. Reg. §1.663(c)-2(b)(2). However, if the allocation made by the governing document or by local law involves a charitable income tax deduction, then the allocation will not be honored for income tax purposes unless it has independent economic effect. Reg. §1.642(c)-3(b)(2); Reg. §1.663(a)-2. See PLR 201611002 for an example of an allocation that had economic effect and was honored.

If a trust receives an IRD distribution, and the trust agreement *requires* that the IRD be paid or held for the benefit of the share of Beneficiary A, then that allocation will be respected by the separate share regulations, because no other share could potentially be funded with the IRD. Reg. §1.663(c)-2(b)(3) (See the discussion above regarding charitable IRD distributions, which are subject to the independent economic effect rule. Reg. §1.642(c)-3(b)(2); Reg. §1.663(a)-2.) But if the trust agreement permits the IRD to be shared among the separate shares, then the regulation requires that the IRD be allocated prorata among those shares. Reg. §1.663(c)-2(b)(3). This result can be altered using several different techniques. First, the governing document could make the allocation mandatory. Second, the governing document could be drafted to alter the definition of principal or income, which would alter the application of that regulation, since that regulation applies only to principal. However, the ability of the governing document to make that change might be limited by Reg. §1.643(b)-1, which provides that the IRS will not honor definitions of income contained in a trust document that fundamentally vary from state law. Third, the retirement account could be distributed intact (without making any withdrawals from the account) to one beneficiary, thus preventing the trust from realizing IRD, and thus causing that one beneficiary to realize IRD whenever that one beneficiary makes a withdrawal from the account. §691(a)(2); Reg. §1.691(a)(4)(b); PLR 200234019. Fourth, the other shares could be fully funded with non-IRD assets, and then in a subsequent tax year the IRD could be withdrawn by the trust and then paid to the share of Beneficiary A, and the other shares would not be allocated any IRD because in the subsequent year those other shares would no longer exist, and thus the separate share rule would not apply. In the third and fourth situations, such distributions might require language in the governing instrument (or local law) authorizing nonprorata distributions. In Oregon, see ORS 130.725(22). In Washington, see RCW 11.98.070 and 11.68.090.

When a retirement account is distributed intact, the amount deemed to have been distributed will be equal to the lesser of the asset's basis or the fair market value of the asset. §693(e)(2) (P.L. 369, 98th Cong. 2d Sess. §81 (1984)). For example, if an IRA account lacks basis (as is often the case), then the distribution of that account intact (in-kind, without withdrawing any assets from the account) to a beneficiary does not carry out DNI to the beneficiary. This poses a significant problem for a trust or estate that has realized income and is attempting to pass that income out to a beneficiary, but lacks non-retirement account assets that can be used to carry out that income. For a similar result under prior law, see Rev. Ru. 68-195, 1968-1 C.B. 305 (without explanation); *Rollert Residuary Trust v. Commissioner*, 80 T.C. 619 (1983), *aff'd.*, 752 F.2d 1128 (1985); *Dean v. Commissioner*, T.C. Memo 1983-276.

As noted in the above discussion, a *requirement* in the governing document that a particular class of income (such as IRD) must be allocated to a particular share will usually be effective to cause that allocation to be honored for purposes of the separate share rule. Reg. §1.663(c)-2(b)(3); Reg. §1.663(c)-5, Example 9. But such a provision will not be effective for purposes of the separate share rule if the governing instrument merely *permits* the trustee to allocate the IRD to other shares. Although such a mandatory provision can be effective for purposes of the separate share rule, it will not be effective for purposes of the charitable income tax deduction unless the provision has independent economic effect. Reg. §1.642(c)-3(b)(2); Reg. §1.663(a)-2. See the discussion of the independent economic effect rule in the sections on tax-exempt income and on the charitable deduction, above.

The question of whether an income interest in a trust or a retirement account qualifies as an income interest for purposes of a QTIP election and the estate tax marital deduction is not discussed here. See Rev. Rul. 2000-2, 2000-1 C.B. 305, for a discussion of making a QTIP election for an IRA and the trust named as the beneficiary of the IRA. By the way, to determine the timeliness of a QTIP election, see Reg. §20.2056(b)-7(b)(4). In general, the election is timely if made on the last estate tax return filed by the due date, including extensions, or if not timely filed, the first estate tax return if filed after the due date. Oregon follows the federal rules for Oregon QTIP elections, but the Oregon Department of Revenue has informally indicated that Oregon Special Marital Property elections are not subject to the federal QTIP rules, and may be made on an amended Oregon estate tax return if not made on the original return.

The SECURE Act. Appendix C reflects the applicable law governing IRA withdrawals for decedents (participants) dying before January 1, 2020. (In this discussion, the decedent can also be referred to as the participant.) For decedents dying after December 31, 2019, the SECURE Act (HR 1865), enacted by Congress late in 2019, applies, with several exceptions. The new law is summarized in Appendix D. In general, under the SECURE Act beneficiaries will be required to withdraw the balance of a retirement account within ten years after the date of death of the participant, although the withdrawals may be delayed and then all made during the tenth year. (The tenth year is defined as ending December 31 of the calendar year that contains the tenth anniversary of the death of the participant.) Several exceptions are made to the ten-year rule. First, beneficiaries who are not classified as Designated Beneficiaries will continue to be governed by prior law (described in Appendix C), and will generally be required to withdraw the funds in the account within five years if the participant died before his required beginning date (generally age 70 ½), or if the decedent died on or after his required beginning date the funds could be withdrawn over the decedent's remaining life expectancy. In that situation, the nondesignated beneficiary might be better off than a Designated Beneficiary if the decedent died after his required beginning date, since the decedent's remaining life expectancy might be greater than the ten-year period required by the SECURE Act. (If the five-year rule applies, the fifth year is defined as ending December 31 of the calendar year that contains the fifth anniversary of the death of the participant.)

Under the new law, beneficiaries who are classified as Designated Beneficiaries must withdraw the funds under the ten-year rule. But five other exceptions from the ten-year rule are available for five categories of Designated Beneficiaries: surviving spouses, minor children (but not minor grandchildren), disabled persons, chronically ill persons, and individuals not more than ten years younger than the participant. Those five exceptions are known as Eligible Designated Beneficiaries (EDBs). Those Eligible Designated Beneficiaries will not be subject to the ten-year rule, but may instead withdraw funds from an IRA under the prior law (except minors will be subject to the ten-year rule once they reach the age of majority, so in most such cases the withdrawals will need to be completed by age 28). Some students under the age of 26 will qualify as minors.

In other words, beneficiaries described in those five exceptions (EDBs) will be able to utilize the rules available under prior law, which means that they may make withdrawals from an IRA over their own life expectancies, if prior law allowed such withdrawals, as shown in Appendix C.

If the EDB qualifies for the life-expectancy exception, then the ten-year rule will kick in upon the subsequent death of the EDB.

If individual family members are named as beneficiaries in an estate plan existing before the enactment of the SECURE Act, it is possible that no change in the plan is needed. Although some of those beneficiaries might not be EDBs, and thus might be subject to the ten-year rule, your client might not have much in the way of alternatives.

If a trust is named as the beneficiary of the IRA, then a careful review of the estate plan and of the SECURE Act might be needed. For purposes of these rules, see-through trusts (conduit trusts and most accumulation trusts, discussed above) continue to be defined as under prior law. As a result of the SECURE Act, estate plans that previously included conduit or accumulation trusts intended to receive IRA distributions over a period longer that ten years following the date of death may need to be re-examined and possibly re-written, particularly if one of the purposes of the trust is to keep funds away from a spendthrift beneficiary for a lengthy period of time (more than ten years). But if the trust beneficiary is a spouse or one of the other EDBs, then a longer period of time will still be available under the SECURE Act and/or under prior law, and no change to the estate plan will be required. Or the owner of the account, who is leaving the account to a see-through trust, might decide that a ten-year period is acceptable, and thus no change to the estate plan is needed. But in the case of a conduit trust that previously would have allowed distributions from an IRA to be distributed to the beneficiary of the trust over the beneficiary's life expectancy, but now will be distributed within ten years because it is not an Eligible Designated Beneficiary, perhaps an accumulation trust should be considered if the participant wants to postpone some or all of the distributions to the beneficiary until a point outside of the ten-year period. In short, a conduit trust is no longer a good idea for an irresponsible beneficiary. But if an accumulation trust is to be considered, that decision will need to take into account the higher tax brackets that the trust might be exposed to, compared to the tax brackets of the beneficiary. If those options are not desirable, a trust that does not benefit an EDB might now be an undesirable future beneficiary of an IRA, and alternatives may need to be considered. One option might be to suggest to your client that an IRA should be converted into a Roth IRA, thus triggering taxation at the individual (or married couple) rates, as opposed to the presumably higher trust tax rates. Another option might be to leave the IRA to a beneficiary who is responsible and can handle the accelerated distribution required by the SECURE Act, and leave non-IRA assets in trust for the irresponsible beneficiary. If the participant has already died, some families will want to consider modifying a conduit trust in order to convert it into an accumulation trust, but such a modification will need to be completed by September 30 of the year following the calendar year of the death of the participant.

These new rules apply to regular IRAs and Roth IRAs, but the impact on Roth IRAs is less because Roth IRAs generally do not include IRD, and thus the distributions are not taxable. But the timing of withdrawals from Roth IRAs are nevertheless governed by these new rules, and non-spousal beneficiaries will generally be required to withdraw the assets within ten years following the death of the participant. (Roth IRAs have no RMD requirements during the life of the participant, but RMD rules do apply after the participant dies.)

All of these new law changes make even more desirable the idea of designating a charity as the beneficiary of an IRA, since a charity will not be subject to income tax on the IRA withdrawals. Or perhaps a regular IRA should be converted to a Roth IRA.

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. The determination of whether the rule applies is made on a year-to-year basis; a trust or estate might be subject to the rule in one year and not in another. TAM 200733024.

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, without affecting the shares of the other beneficiaries, 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 unequal distributions of income or principal from the entire trust among the various beneficiaries, because such 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.

One example of a separate share is a formula pecuniary bequest if the bequest receives a share of the income of the trust or estate. §1.663(c)-4(b). 7Another example is a qualified revocable trust, regardless of whether a §645 election has been made. See the discussion of formerly revocable trusts, above.

The separate share rule is mandatory if the requisite facts are present; it is not elective. The trustee has no discretion whether to apply it or not. Reg. §1.663(c)-1(d). As a result, the decision whether the separate share rule will apply is made in the drafting stage. The rule can apply to both estates and trusts. §663(c). However, the separate share rule for estates varies slightly from the separate share rule for trusts, while qualified revocable trusts are subject to the separate share rule applicable to estates, even if no election is made under §645 to treat the trust as a part of the estate. For a discussion of the different treatment of trusts and estates, see Reg. §1.663(c)-3 and (c)-4.

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). That result is significant for two reasons. First, and most obvious, the calculation of DNI within each share is independent of the calculation of DNI in any of the other shares. Second, and less obvious, the application of the separate share rule, and the division of the trust or estate into separate shares for income tax purposes (if the rule is applicable) takes place before the calculation of DNI within each share. Reg. §1.663(c)-5, Example 11.

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 statute states that the separate share rule exists for the "sole purpose" of determining DNI in the application of §661 and §662. §663(c); Reg. §1.663(c)-1(b). The former section deals with distribution deductions by estates and complex trusts; the latter deals with the inclusion the distributions in the gross income of the recipient beneficiaries. The separate share rule does not apply for any other purpose. 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.

For example, let's assume that a trust is established for the benefit of three beneficiaries. The terms of the trust provide that the trust is to be held as one trust, but in three shares, one share for each of the three beneficiaries. The trustee is authorized by the trust to distribute discretionary amounts of income and discretionary amounts of principal up until each beneficiary reaches the age of thirty-five years. At that time, each respective share will be distributed to the beneficiary of that share at age thirty-five. Any distributions prior to that age will be considered to be an advancement from each respective share, so that any beneficiary who receives discretionary distributions will receive less at age thirty-five. As a result, any discretionary distributions to one beneficiary will not affect the respective shares of the other two beneficiaries. Under those facts, the separate share rule will apply, and the DNI and the distribution deduction will be calculated separately for each share. If in one year the entire trust receives \$15,000 of net income, each share will have DNI of \$5,000. If in that same year one beneficiary receives a distribution of \$12,000, that beneficiary will be deemed to have received \$5,000 of income and \$7,000 of principal. The trust will take a distribution deduction of $5,000, and the other $10,000 of DNI will be taxed to the trust. Reg. §1.663(c)-5, Example 1.

In the previous example, if the trust agreement had directed that the discretionary distributions would be made from the trust as a whole, so that a distribution to one beneficiary would reduce the shares of all three beneficiaries, then the separate share rule would not apply. Under those circumstances, the beneficiary receiving the distribution of $12,000 would be taxed on DNI of $12,000, and the trust would be taxed on the $3,000 of undistributed DNI. The other two beneficiaries (who received no distributions) would not be taxed. This illustrates how the applicability (or inapplicability) of the separate share rule can alter the relative manner in which the various beneficiaries are taxed, along with altering the manner in which the trust is taxed.

Because the separate share rule expressly applies only to §661 and §662, it apparently does not affect the charitable deduction under §642(c). §663(a)(2); Reg. §1.663(a)-2. As a result, a charitable bequest or a charitable share is most likely not a separate share under the separate share rules. (This conclusion is not entirely clear. See Reg. §1.663(c)-5, Example 11, the facts of which are unusual, and thus the conclusion reached by that example is ambiguous.) Thus it appears that an attempt to use the separate share rule to allocate special classes of income (such as IRD or tax-exempt income) to charity or away from charity will not be successful. Reg. §1.642(c)-3(b)(2); Reg. §1.663(a)-2.

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 fact that the separate share rule is inapplicable to simple trusts is evidenced by the fact that the first sentence of §663(c) limits its application to the determination of DNI under §661 and §662 (which apply to estates and complex trusts) and no mention is made of §651 and §652 (which apply to simple trusts).

In order for the separate share rule to apply, the governing document need not describe the shares as separate shares. For example, a trust that creates a residue that is payable in equal thirds to three beneficiaries might appear to be a single residue. Yet that single residue actually constitutes three separate shares. Reg. §1.663(c)-5, Example 11. If all three shares receive the same income and are distributed at the same time, then the tax result brought about by the separate share rule will be the same as if the rule had not applied, but if the three shares are distributed at different times, particularly in different years, then the separate share rule will produce a different result. For example, if one of the three beneficiaries receives a distribution that exceeds the total DNI received by the trust, and the other beneficiaries receive no distributions in that same year, then only a third of the DNI will be carried out to the beneficiary who received the distribution and he will be taxed on that one-third of the DNI, and the other two-thirds of the DNI will be taxed to the trust.

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 (2013 SB 592, Oregon Laws 2013 Ch. 529, §24). However, that 2013 legislation was further amended in 2015 to permit the governing document to determine whether separate trusts or separate shares are created. ORS 130.232 (2015 HB 2331, Oregon Laws 2015 Ch. 126, §3).

28. Basis Step-up and Basis Reporting

The income tax basis of property acquired by an estate (or a formerly-revocable trust) from a decedent is its fair market value on the date of death, §1014(a)(1), or its alternate value on the alternate valuation date if elected under §2032, or its special use value if elected under §2032A. §1014(a)(2) and (3). 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. §1014(b)(9); Reg. §1.1014-1(a). One exception: Income in respect of a decedent (IRD) does not receive a basis step-up. §1014(c). 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 the estate was not required to pay estate tax. Rev. Rul. 56-215, 1956-1 C.B. 324. Because only half of property held in joint name 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). If the couple holds community property, then both halves of the property acquire a new basis upon the death of the first spouse to die. §1014(a) and (b)(6).

In contrast, the basis of property acquired by a lifetime 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 formerly-revocable trust is the date of death value under §1014(a)(1), or the alternate valuation date value if elected under §2032, or the special use value if elected under §2032A. The basis step-up at death for assets held in a revocable trust is stated in Reg. §1.1014-2(a)(2). 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). For example, a lifetime gift with a retained income interest will be brought back into the gross estate of the donor under §2036.

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, so that the estate, trust, or beneficiary may begin depreciating the assets all over again. However, the new income tax basis of depreciable assets transferred to a recipient at death must be reduced by any depreciation taken by the recipient (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. §1014(e). As a result, gifting low-basis assets to a terminally ill relative, only to receive it back again when the relative dies, does not increase the basis. 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 on Husband's death 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. See also PLRs 9026036 and 9321050.

If an estate (or a trust) makes inconsistent federal and Oregon elections on the federal and Oregon estate tax returns as authorized by ORS 118.010(8), then ORS 316.716 requires that different tax bases be used on the federal and Oregon income tax returns of the taxpayers who receive assets from the estate. That statute very broadly requires that any differences between federal and Oregon law that affect basis will result in different bases on the federal and Oregon income tax returns. More specifically, that statute requires that an amount be added to (or subtracted from) federal taxable income in order to adjust for the difference in Oregon basis. Those differences could come about as a result of inconsistent elections concerning the marital deduction, the alternate valuation date, special use valuation, and other elections. ORS 118.010(8) describes several inconsistent elections that might be made, but it also permits other inconsistent elections that are not specified there. This adjustment is considered to be part of the fiduciary adjustment described in ORS 316.287 and 316.697. Taxpayers reporting a difference in basis will need to attach a Schedule OR-ASC to their returns. For an intriguing discussion of inconsistent QTIP elections in Washington, see Fujimoto, *Washington Estate Tax Surprises Along the Way to a Federal Second Step-up in Basis*, Real Property, Probate and Trust Section Newsletter, Washington State Bar Association, Vol. 42, No. 1, Winter 2014-2015. For examples of Oregon fiduciary income tax adjustments that must be made if inconsistent elections are made regarding administration expense deductions, see OAR 180-118-0400.

If a beneficiary disposes of an interest in a trust prior to the termination of the trust, the fiduciary income tax rules of Subchapter J oftentimes do not apply. Instead, the uniform basis rules of §1001(e)(1) are often applicable to determine the basis and gain applicable to such a transaction. A discussion of the uniform basis rules is beyond the scope of this paper. For a detailed discussion, see Boyle, Zaritsky, and Wallace, *The Uniform Basis Rules and Terminating Interests in Trusts Early*, American Bar Association Real Property, Trust and Estate Law Journal, Vol. 55, p. 1, Spring 2020.

Historically, there was some debate whether the beneficiary of an estate was required to use, for income tax basis purposes, the values shown on the estate tax return, or whether the beneficiary could produce evidence to overcome those values. See, for example, Rev. Ruling 54-97, 1954-1 C.B. 113. Effective for estate tax returns filed after July 31, 2015, beneficiaries of estates and trusts are now required to use a basis that does not exceed the value as finally determined for federal estate tax purposes. §1014(f) (§2004(a) P.L. 114-41). Penalties apply to violations of this consistency provision by a beneficiary, including the 20% accuracy-related penalty. §6662. This new consistency requirement applies only to those assets whose inclusion in the estate actually increased the estate tax liability. §1014(f)(2).

In order to encourage beneficiaries to comply with new §1014(f), fiduciaries who file estate tax returns after July 31, 2015, are now required to report valuation (basis) information to the beneficiaries and to the IRS within thirty days after filing an estate tax return. §6035 (§2004(b) P.L. 114-41). The IRS has issued a new Form 8971 to be used for reporting basis information, along with instructions for the form. The form requires a separate Schedule A for each beneficiary to be attached to the Form 8971 and to be supplied to each beneficiary, showing exactly what assets were acquired from the estate by each beneficiary. Each beneficiary will receive his or her own Schedule A, but the beneficiaries will not receive a copy of Form 8971, nor will they receive the Schedules A that pertain to any of the other beneficiaries. The Form 8971 is to be filed with the IRS, along with copies of all of the Schedules A. Although the form was originally required to be filed in Cincinnati, in 2020 the address listed in the instructions was changed to Florence KY.

This basis information reporting requirement does not apply to estate tax returns filed solely for the purpose of electing portability under §2010(c)(4). Reg. §1.6035-1(a)(2). With the doubling of the estate tax exemption effective January 1, 2018, through December 31, 2025, it seems likely that the number of federal estate tax returns filed (both regular returns and portability returns) will dramatically decrease beginning in 2018. As a result, the number of Forms 8971 filed will likely also decrease.

If the values shown on the estate tax return are later adjusted, or assets are discovered that were omitted from the estate tax return, supplemental reports must be provided to the beneficiaries and to the IRS. Reg. §1.6035-1(e).

This basis reporting requirement applies to both estates and trusts. Values reported should not be reduced by mortgages. Reg. §1.6035-1(a)(2). Penalties apply for failure to provide these reports; the penalties are particularly steep if the failure to file is willful. §6721(e); §6722(e); §6724; Reg. §1.6035-1(h). If willful, the penalty could be as high as 10% of the value of the assets required to be reported. §6721(e)(2). The penalties apply even if no estate tax was payable, and even if the beneficiary was not subject to the consistency requirement. An inconsequential error or omission on the Form 8971 will not generate a penalty, but an incorrect value, or an incorrect name of a beneficiary, or an incorrect EIN of a beneficiary, is considered to be consequential, according to the Form 8971 instructions. The instructions discuss the penalties in some detail. Because the code and regulations provide no penalty for over-reporting, but do provide penalties for under-reporting, when in doubt the safest course of action is to fully report or possibly over-report, either on an original Form 8971, or if subsequent changes occur, on a supplemental Form 8971, discussed below.

The basis reporting rules under §6035 and the basis consistency rules under §1014(f) vary somewhat. They are two different statutes, they are supported by two different sets of regulations, and their requirements are not entirely consistent. For example: Although a beneficiary is not required to use the estate tax value of an asset as his income tax basis unless the inclusion of the asset actually increased the estate tax liability, the fiduciary is nevertheless required to report the estate tax value to the beneficiary and to the IRS regardless of whether the inclusion of the asset increased the estate tax liability. §1014(f)(2); §6035.

For a summary of the §6035 basis reporting rules and the §1014(f) basis consistency rules, and the differences between the two, see the attached Appendix E.

One of the exceptions to the reporting and consistency rules pertains to assets that were sold by the estate or trust, and thus a gain or loss was recognized. Reg. §1.6035-1(b)(1)(iv). That makes sense, because the assets will not be distributed. Instead, the proceeds will be distributed, and the basis in the proceeds will not be established by the estate tax return. But no exception exists for assets distributed to a beneficiary in circumstances such that a gain or loss is recognized upon distribution, such as assets distributed in kind in satisfaction of a pecuniary bequest, and thus the assets received an adjusted basis. In that situation, the assets should be reported on the Form 8971 at their new basis, not at the value reported on the estate tax return.

Although the estate tax value of an asset (usually its fair market value on the date of death under §2031) usually establishes the beneficiary's basis (usually its fair market value on the date of death under §1014), there are some exceptions to that general rule. For example, an appreciated asset gifted to the decedent within one year prior to death will be denied a stepped-up basis if the asset is bequeathed back to the donor of the gift. §1014(e). In that case, the estate tax value reported on both the Form 706 and the Form 8971 will be higher than the beneficiary's basis. For that reason, it would not be technically correct to state that the Form 8971 notifies the beneficiary of his basis (although it almost always does). Instead, it would be technically correct to state that the Form 8971 merely provides to the beneficiary the estate tax value, which is not always the basis. This is consistent with §1014(f)(1), which states that the basis reported by the beneficiary "may not exceed" the estate tax value. However, see 1.1014-10(a)(2), which provides that the basis used by the beneficiary may be subject to post-mortem adjustments, such as gain or loss recognized by the estate upon distribution of the property. But that provision does not apply to the reporting requirements, which are limited to the value finally determined for estate tax purposes. Reg. §1-6035-1(a)(1) and §1.1014-10(c).

In early March 2016, proposed regulations were issued to provide guidance regarding many unanswered questions concerning this new basis information reporting and the basis consistency requirement. T.D. 9757; REG-127923-15; FR Doc. 2016-04718, 3/4/16. This discussion of basis reporting and basis consistency is based on those proposed regulations. In the future, check to see if final regulations have been published. The new regulations will appear in Reg. §1.1014-10, §1.6035-1, and §1.6035-2. The IRS once indicated that the final regulations would likely be published by January 2017, but when that date arrived the IRS stated that the final regulations would be delayed. A new due date of June 30, 2018, has since been announced, but that date might be extended.

The Form 8971, the instructions, and the proposed regulations now provide the following answers, although these answers are subject to change when the proposed regulations are revised and made final. (This is a brief summary of the answers; review the regulations for details. See FR Doc. 2016-04718, 3/4/16.) The basis reporting must be performed by any person who is an executor or is deemed to be an executor, and the reporting must be supplied to the IRS and to the beneficiaries, including those beneficiaries who are also serving as executors. Reg. §1.6035-1(c)(1). The definition of an executor is very broad. §2203, §7701(a)(6), Reg. §1.6012-3(b)(1) and CCA 201334040. If a trust is a beneficiary of an estate, the basis information from the estate needs to be supplied to the trustee, and not to the trust beneficiaries. Reg. §1.6035-1(c)(2).

The Form 8971 is to be accompanied with separate schedules (Schedule A), one for each beneficiary, and the Form 8971 and all of the Schedules A must be filed with the IRS. Each Schedule A is required to describe the assets (and the basis of each asset) to be received by each beneficiary. Each beneficiary is to receive his or her own Schedule A, and is not to receive copies of the Schedules A for the other beneficiaries, nor are any of the beneficiaries to receive a copy of the Form 8971. If the fiduciary does not yet know which assets will be distributed to which beneficiaries, then each beneficiary will receive a Schedule A listing all of the assets that *could* be used to distribute to each beneficiary his or her share of the estate or trust. Reg. §1.6035-1(e)(3)(B). The instructions to Form 8971 and Reg. §1.6035-1(e)(3)(B) state that in such circumstances, a supplemental Form 8971 may later be filed, but isn't required. Thus finalization of the funding does not require the filing of a supplemental Form 8971. However, if the original basis reporting was incorrect or incomplete, or values are later adjusted for other reasons (such as an estate tax audit), or assets are discovered that were not previously reported, then supplemental reporting is required within thirty days after the event causing the change. Reg. §1.6035-1(e)(4).

The ability to report all of the assets that could be used to distribute to each beneficiary makes the basis reporting relatively easy if the assets to be distributed to each beneficiary have not yet been selected within thirty days following the filing of the estate tax return. In that situation, all of the assets (or all of the reportable assets) can be reported on each of the Schedules A, and then the selection of assets to be distributed to each beneficiary can be made at a later date, with no need to engage in supplemental reporting. That approach might be particularly useful if all of the beneficiaries will be receiving equal shares. But if the beneficiaries will be receiving unequal shares, and the fiduciary would prefer to not disclose the full extent of the estate assets to all of the beneficiaries, then such an approach might lead to friction among the beneficiaries.

According to a controversial provision of the proposed regulations, if an asset is omitted from the estate tax return, and the inclusion of that asset would have increased the federal estate tax, and the statute of limitations on assessment of the tax has expired, then the recipient beneficiary will have a zero basis in that asset. Reg. §1.1014-10(c)(3)(i)(B). This situation can be remedied if a supplemental return is filed before the expiration of the statute of limitations expires on the assessment of the tax. Reg. §1.1014-10(c)(3)(i)(B). If no estate tax return was filed under circumstances such that the return should have been filed and tax paid, the basis of *all* of the inherited property will be zero until the property is reported and its basis established. Reg. §1.1014-10(c)(3)(ii).

Some commentators have questioned the validity of this zero basis rule, since the statute itself makes no mention of a zero basis. In response, the IRS argues that the zero basis rule is based on the statute, which provides that the basis employed by the beneficiary cannot exceed the basis established for federal estate tax purposes, and since the asset was not reported for estate tax purposes, no basis was established. §1014(f) (§2004(a) P.L. 114-41). It is important to note that the zero basis rule applies only to assets which, if included on the estate tax return, would have increased the federal estate tax. Reg. §1.1014-10(b)(1); §1.1014-10(c)(3)(ii).

The zero basis rule, the possible penalties, and the required filing of a supplemental Form 8971 for newly discovered assets represents a substantial change in the law. Previously, there was little or no authority that required the filing of a supplemental estate tax return if assets were discovered after the return was filed. In the income tax arena, amended returns are generally not required, although they might be advisable. *Broadhead v. Commissioner*, T.C. Memo 1955-328; *Goldring v. Commissioner*, 20 T.C. 79, 83 (1953). In the past, many practitioners have followed that same rule with respect to estate tax returns, and some of those practitioners felt very strongly that no such obligation existed. Other practitioners have felt that the filing of a supplemental estate tax return is often advisable, depending on the circumstances. But now, under some circumstances (described above) the §6035 regulations *require* the filing of a supplemental Form 8971 and impose penalties and a zero basis on taxpayers who fail to do so, and presumably anyone who files a supplemental Form 8971 will also want to file a supplemental Form 706.

These new reporting rules do not apply to cash distributions (other than coins or bills with numismatic value). Reg. §1.6035-1(b)(1)(i). As a result, a fiduciary may avoid the basis reporting process entirely by liquidating the assets before distributing the cash proceeds to the beneficiaries. Life insurance proceeds which were paid to a beneficiary in the form of a check will most likely be treated as cash for purposes of the reporting rules.

The reporting rules also do not apply to bequests of tangible personal property for which no appraisal is required under Reg. §20.2031-6(b). These new rules also do not apply to IRD assets (although they probably apply to assets that are part IRD). Marital deduction distributions and charitable deduction distributions are not subject to the mandatory consistency rules, but they nevertheless must be reported to the beneficiaries who receive them. The Schedule A is required to inform the beneficiaries regarding which assets did (or did not) increase the estate tax, and thus the beneficiaries who receive assets that did not increase the tax will not be obligated to use the estate tax values as their basis. Reg. §1.1014-10(b)(1).

The question of which assets increased the federal estate tax liability, and which assets did not, is answered by the proposed regulations. If an estate tax is due, even after the application of the unified credit, then all of the assets are deemed to have increased the estate tax, except for marital and charitable bequests. Reg. §1.1014-10(b)(3). All of the assets will be reported on the Form 8971, but the marital and charitable bequests will be marked with an "N" to indicate that those bequests did not increase the estate tax. On the other hand, if no estate tax is due (because of the application of the unified credit, other credits, and various deductions), then all of the bequests will be marked with an "N," and basis consistency will not be required. In both cases, however, a Form 8971 will still need to be filed to report the basis to the IRS and to the beneficiaries. Reg. §1.6035-1(b)(1).

The first draft of the instructions to the Form 8971 was published in late 2015. Draft revised instructions were published in late January, 2016, and then were revised again in early June, 2016, effective September 2016. The draft revised instructions surprisingly indicated that the required information must be supplied on one or more

Schedules A without the use of attachments to the Schedules A, but the final instructions issued in June 2016 permit the use of attachments. Appraisals should not be attached to the Schedules A, according to the instructions.

The instructions indicate that if co-fiduciaries are serving, only one need sign the Form 8971, but all co-fiduciaries will be responsible for the content of the submitted form.

In some circumstances, an executor will be required to supplement the Form 8971 if certain facts change after the initial filing of the Form 8971. Those circumstances include the discovery of property that should have been reported on the original Form 8971, a change in value (basis) as a result of an estate tax audit or estate tax litigation, a change in the identity of a beneficiary, or the disposition of property in a transaction in which the basis was carried over to a new asset (such as a like-kind exchange). Reg. §1.6035-1(e). If such a supplemental filing is required, it is due within thirty days after the event that caused the change. Reg. §1.6035-1(e)(4).

If a beneficiary subsequently transfers any of the estate assets to a related party transferee in a transaction in which the transferee's basis is determined in whole or in part with reference to the beneficiary's basis, then the beneficiary must file a Form 8971 and supply a Schedule A basis report to the transferee and to the IRS, and apparently that obligation continues for decades, regardless of when the second transfer takes place. Reg. §1.6035-1(f). And if the estate has not yet reached a final value of the assets, then that reporting of a subsequent transfer must also be submitted to the executor, and the executor must give the transferee (and not the original beneficiary) notice of any subsequent changes in basis. Reg. §1.6035-1(f). For purposes of this reporting of subsequent transfers to related parties, the regulations provide a definition of related parties. Reg. §1.6035-1(f). Those related parties include family members, controlled entities, and grantor trusts. But they apparently do not include nongrantor trusts. Reg. §1.6035-1(f), which refers to §2704(c)(2). Thus if an estate transfers assets to a trust (and reports the basis to the IRS), and then later the trustee transfers the assets to a beneficiary who is an individual, the trustee need not file a basis report, because the trust and the individual are apparently not related under the definition of related parties. This conclusion is not entirely clear, but does seem to flow from the language of the regulation. The fact that the regulation requires reporting of a transfer to a grantor trust seems odd, since the grantor trust will be reporting its income on the grantor's income tax return. Perhaps this uncertainty will be cleared up in the final regulations.

When filing a Form 8971, the instructions suggest that a Form 2848 power of attorney should be attached if the executor would like the return preparer to be able to discuss the Form 8971 with the IRS. In that instance, the September 2016 version of the Form 8971 instructions states that the taxpayer listed on the Form 2848 should be the executor, not the estate, and the executor's EIN should be listed, not the estate's EIN nor the decedent's social security number. The instructions also state that the Form 8971 should be listed on the Form 2848 as one of the matters that the preparer is authorized to discuss. It seems odd that the Form 8971 instructions call for the use of the executor's EIN on the Form 2848 associated with the Form 8971, since the Form 8971 is closely related to the Form 706 estate tax return, which is filed under the decedent's SSN, not the executor's EIN.

Forms 8971 are filed by mailing them to a designated mail stop at the IRS Cincinnati Service Center. See the instructions for the Form 8971. This is a different address than that used for a Form 706. When the Form 8971 is received by the IRS, it is normally forwarded to whichever IRS office has the estate tax return. As a result, if the estate tax return is being audited, the Form 8971 will be sent to the office auditing the estate tax return.

The IRS delayed the earliest due date of the Form 8971 basis reports to June 30, 2016. As a result, reports relating to Forms 706 filed between July 31, 2015, and May 31, 2016, were due on June 30, 2016, and reports relating to Forms 706 filed after May 31, 2016, will be due thirty days after the Form 706 is filed. Notice 2015-57, I.R.B. 2015-36; Notice 2016-19, I.R.B. 2016-09; Notice 2016-27; TD 9797.

29. State Fiduciary Income Taxes

Most states impose their own fiduciary income taxes (only eight do not), 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. In 2019, the U.S. Supreme Court held unconstitutional a North Carolina statute that attempted to impose North Carolina fiduciary income tax on a New York trust that had a North Carolina beneficiary who was not currently receiving distributions from the trust. *N.C. Dept. of Revenue v. Kaestner*, 588 U.S. ___, 139 S. Ct. 2213 (6/21/19).

State fiduciary income taxes typically tax both ordinary income and capital gains, without distinguishing between the two. 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 Oregon Form OR-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 150-316-0400(4), (5) ex. 3. Administration is defined as fiduciary decision-making, not incidental execution of decisions made by others. ORS 316.282(3); OAR 150-316-0400(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 150-316-0400(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 316.362(1)(c) and 316.282(1)(b); OAR 150-316-0400(2). A principal probate and an ancillary probate in two different states are considered to be one estate and need only one EIN, 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 150-316-0400(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 316.267; ORS 316.272; OAR 150-316-0400(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 150-316-0420. The Oregon tax applies to both ordinary income and capital gains, at the same rates; capital gains are not taxed at a lower rate, with some exceptions. 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; OAR 150-316-0410. 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. As a general rule, Oregon taxes resident estates and trusts on both Oregon-source income and non-Oregon source income, but 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 150-316-0400(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 150-316-0171. If an asset has a different basis for Oregon purposes than it has for federal purposes, see the discussion of basis step-up, above.

Washington – Washington has not enacted a fiduciary income tax. Washington is one of eight states that do not tax the income of trusts and estates. In fact, Washington has no income taxes of individuals, much less trusts and estates. However, in 2021 the Washington legislature enacted a 7% tax on the capital gains of individuals, effective 1/1/2022. One commentator has suggested that the new tax does not apply to trusts and estates, and has further suggested that individuals owning low basis assets might consider trying to avoid the imposition of the new tax by transferring low basis assets to irrevocable (non-grantor) trusts. Coppieters, *Trust Planning and the Washington State Capital Gains Tax*, 45 Seattle U. L. Rev. Supra 24 (1921). Of course, such a transfer would prevent the step-up in basis at the death of the donor.

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. Overall, forty-three states have adopted state fiduciary income taxes.

Keep in mind that state fiduciary income taxes are deductible for purposes of the federal fiduciary income tax. §67(b)(2). See the section above on calculating taxable income. See also Appendix B.

30. Revocable Trusts and Grantor Trusts

A detailed discussion of grantor trusts (including revocable trusts) is beyond the scope of this paper, but the following 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 contributed assets to a trust and 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 (like wills) 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. One method (described in Reg. §1.671-4(a)) is for the trustee to file a Form 1041, and to check the box on the first page of the form to indicate that the trust is a "grantor type trust." If that method is chosen, the income, deductions, and credits of the trust are not reported on Form 1041 and its various schedules, but instead they are all shown on a separate statement attached to the return. The statement is then supplied to the grantor, who does not receive a Schedule K-1, but nevertheless is required to report on his individual return the items of income and deductions on his individual return. That method is somewhat cumbersome and is not often used. The most commonly-used method (described in Reg. §1.671-4(b)(2)(i)(A)) is for the grantor to supply his or her social security number to all of his or her financial institutions, and then 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. §1.671-3(a)(1). §1.671-4(b)(2)(i)(A). This method is sometimes referred to as Form 1099 Filing Method 1. 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 or a co-trustee, then certain specified information must be supplied to the grantor by the trustee. Reg. §1.671-4(b)(2)(ii). An alternative method is to supply the trust's EIN to financial institutions under Reg. §1.671-4(b)(2)(i)(B). This method is sometimes referred to as Form 1099 Filing Method 2. See Reg. §1.671-4 for alternative reporting methods, but most practitioners prefer by far Method 1 that does not require the grantor trust to obtain an EIN, partly because the lack of an EIN greatly simplifies the tax reporting during the grantor's lifetime. After the grantor dies, the pre-death income is reported on the final individual income tax return of the grantor using the decedent's SSN, and the post-death income is reported on a fiduciary income tax return using a newly-obtained EIN. Also see the instructions to Form 1041, particularly the section of the instructions entitled "Special Reporting Instructions," for details on these various reporting methods. When a grantor trust is asked to complete a Form W-9 in order to supply its EIN to a financial institution, the various reporting methods will dictate how the W-9 should be completed. See the instructions to the Form W-9, particularly the handy table on page 5 of the instructions.

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 (and reported using his SSN), 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). Upon the death of the grantor, a grantor trust usually becomes a nongrantor trust.

See also the discussion of credit shelter trusts and SLATs in section 4, above.

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. For that reason, most ILITs do not file income tax returns, but most obtain an EIN in order to open a trust bank account. Although a revocable living trust usually does not obtain an EIN, many practitioners prefer to obtain an EIN for other grantor trusts; doing so is optional.

Many trusts state that the trust terminates upon the death of the income beneficiary, or in the case of a revocable trust upon the death of the grantor, at which time the trust becomes distributable outright to the named beneficiaries (oftentimes the next generation). But the trustee has considerable administrative work to do following the death, as is discussed above in the section on the final tax year of a trust. Because the trust is distributable outright to the remaindermen, does the trust become a grantor trust as to the remaindermen upon the death of the income beneficiary? Although there is little authority on point, the answer appears to be no. Even though the trust might vest in the remaindermen, they have no right to demand the assets until the trustee has completed the various administrative tasks, which could take considerable time. Thus §678 (the power to vest the principal solely by himself) would not apply. And §678 appears to apply only to withdrawal rights, not mandatory distributions. And if the trust was a qualified revocable trust that made a §645 election, it is treated as an estate, not a trust.

Selected Additional Research Materials

Acker, *Income Taxation of Trusts and Estates*, Portfolio 852-4th, Bloomberg Bureau of National Affairs: Tax Management Estates, Gifts and Trusts Portfolios (2017).

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

Ferguson, Freeland, and Ascher, *Federal Income Taxation of Estates, Trusts, and Beneficiaries,* CCH/Wolters Kluwer (2015).

Berek, *Federal Income Taxes of Decedents, Estates and Trusts*, CCH Tax Spotlight Series, CCH/Wolters Kluwer (2017).

Choate, *Life and Death Planning for Retirement Benefits*, Ataxplan Publications (8th ed. 2019).

Kantor, Miller, Newcomb, and Richardson, eds., *Administering Trusts in Oregon*, Oregon State Bar, 2018.

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

Appendix A: Interest Deductions by Trusts and Estates

Note: Interest is not a miscellaneous itemized deduction. §67(b).

Type of Interest	Estate Tax Deduction	Fiduciary Income Tax Deduction
Business interest accrued pre-death	Deductible. §2053(a)(3); Reg. §20.2053-1; §20.2053-4(e)(1).	Deductible, above the line. §62; §163(h)(2)(a).
Postmortem business interest	Deductible. §2053(a)(2); Reg. §20.2053-3; §20.2053-4(e)(2).	Deductible, above the line. §62; §163(h)(2)(a).
Investment interest accrued pre-death	Deductible. §2053(a)(3); Reg. §20.2053-1; §20.2053-4(e)(1).	Deductible, below the line. §163(h)(2)(B).
Postmortem investment interest	Deductible. §2053(a)(2); Reg. §20.2053-3; §20.2053-4(e)(2).	Deductible, below the line. §163(h)(2)(B).
Personal interest accrued pre-death	Deductible. §2053(a)(3); Reg. §20.2053-4(e)(1).	Not deductible. §163(h)(1).
Postmortem personal interest	Deductible. §2053(a)(2); Reg. §20.2053-3; §20.2053-4(e)(2).	Not deductible. §163(h)(1); Reg. §1.663(c)-5, Example 7.
§6166 interest	Not deductible. §2053(c)(1)(D).	Not deductible. §163(h) and (k).
§6161 interest	Not deductible while a §6166 election is in place. §2053(c)(1)(D). Otherwise deductible. §2053(a)(2); Reg. §20.2053-3; §20.2053-4(e)(2); Rev. Rul. 79-252.	Not deductible. §163(h) and (k).
Interest on federal estate tax, other than §6161 or §6166.	Deductible. §2053(a)(2); Reg. §20.2053-1; §20.2053-3; §20.2053-4(e)(2); Rev. Rul. 79-252.	Not deductible. §163(h) and (k).
Interest on state estate tax	Deductible. §2053(a)(2); Reg. §20.2053-1; §20.2053-3; §20.2053-4(e)(2); Rev. Rul. 79-252.	Not deductible. §163(h).

Compiled by Philip N. Jones, of Duffy Kekel LLP, Portland, OR. This is a summary only; read the statutes, regulations, and rulings before applying these conclusions to your situation. 4/3/23.

Appendix B: Miscellaneous Itemized Deductions of Trusts and Estates

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. See IRS Notice 2018-61 (7/13/18).	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 12/31/14.
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/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, or for purposes of refinancing.
State and Local Taxes (incl. property taxes)	All (not a Miscellaneous Itemized Deduction). §67(b)(2); §164(a)(1). After 2017 and before 2026, deductions for state and local taxes are limited to $10,000, §164(b)(6), except for business pursuits and for the production of income under §212.	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.
Income Tax Return Preparation	Fiduciary income tax returns. Decedent's final income tax return.	All other income tax returns and gift tax returns. Returns for sole proprietorships and retirement plans are deductible. §162.

Review the statutes, court opinion, and regulations for application to particular situations.

Appendix C: Retirement Plan Distributions After Death (pre-SECURE)

For deaths before 1/1/20. Does not reflect the SECURE Act (HR 1865, 12/19)

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 200644020. This conclusion might be incorrect.	IRS contends that IRD income is realized immediately by the estate or trust under §691(a)(2). See CCA 200644020. This conclusion might be 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 of Duffy Kekel LLP. Some exceptions apply. 4/3/23. See also OSB Estate Planning and Administration Section Newsletter, July 2013.

Appendix D: Retirement Plan Distributions After Death (post-SECURE)

For deaths after 12/31/19. Reflects changes made by the SECURE Act (HR 1865, 12/19)

Status of Account	**Death Before Age 72**	**Death After Age 72**
Individual Eligible Designated Beneficiary is named	Beneficiary may withdraw over the beneficiary's single life expectancy table.	Beneficiary may withdraw over the beneficiary's single life expectancy table.
Individual Designated Beneficiary is named, but is not an Eligible Designated Beneficiary	Beneficiary must complete withdrawals within ten years.	Beneficiary must complete withdrawals within ten years.
No Designated Beneficiary is named	Beneficiary must complete withdrawals within five years.	Beneficiary must begin withdrawals by the end of the year following death, and may thereafter follow the decedent's remaining life expectancy.
Surviving Spouse is 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 72, 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 72, and may then use her own life expectancy table.
Estate is named as beneficiary.	Estate is not a Designated Beneficiary. Withdrawals must be completed within five years.	Beneficiary must begin withdrawals by the end of the year following death, and may thereafter follow the decedent's remaining life expectancy.
Conduit Trust is named as beneficiary and is fbo an Eligible Designated Beneficiary other than spouse	Withdrawals may be made over the life expectancy of the oldest beneficiary.	Withdrawals may be made over the life expectancy of the oldest beneficiary.
Conduit Trust is named as beneficiary and is fbo the surviving spouse	Withdrawals may be postponed until participant would have reached 72, and then may be taken over the spouse's life expectancy.	Withdrawals may be postponed until participant would have reached 72, and then may be taken over the spouse's life expectancy.
Conduit Trust is named as beneficiary and is not fbo an Eligible Designated Beneficiary	Withdrawals must be completed within ten years.	Withdrawals must be completed within ten years.

Status of Account	Death Before Age 72	Death After Age 72
Accumulation Trust fbo a disabled or chronically ill beneficiary	Withdrawals may be made over the life expectancy of the beneficiary.	Withdrawals may be made over the life expectancy of the beneficiary.
Accumulation Trust not fbo a disabled or chronically ill beneficiary	Withdrawals must be completed within ten years.	Withdrawals must be completed within ten years.
Accumulation trust fbo the surviving spouse	Withdrawals must be completed within ten years.	Withdrawals must be completed within ten years.
Trust is named as beneficiary and is a Designated Beneficiary, but not an Eligible Designated Beneficiary	Withdrawals must be completed within ten years.	Withdrawals must be completed within ten years.
Trust is named as beneficiary and is not a Designated Beneficiary	Withdrawals must be completed within five years.	Beneficiary must begin withdrawals by the end of the year following death, and may thereafter follow the decedent's remaining life expectancy.
Marital Trust named as beneficiary, and does not qualify as a Designated Beneficiary	Surviving spouse must complete withdrawals within five years.	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 200644020. This conclusion might be incorrect.	IRS contends that IRD income is realized immediately by the estate or trust under §691(a)(2). See CCA 200644020. This conclusion might be 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 of Duffy Kekel LLP. Some exceptions apply. 4/3/23.

Appendix E: Basis Reporting and Consistency

Type of Asset	§6035 Basis Reporting Required	§1014(f) Basis Consistency Required
Asset Does Not Increase Estate Taxes	Yes. §6035(a)(1); Reg. §1.6035-1(a)(1); Reg. §1.6035-1(b).	No. §1014(f)(2); Reg. §1.1014-10(b)(1).
Marital Deduction Assets	Yes. §6035(a)(1); Reg. §1.6035-1(a)(1); Reg. §1.6035-1(b).	No. §1014(f)(2); Reg. §1.1014-10(b)(2).
Charitable Deduction Assets	Yes. §6035(a)(1); Reg. §1.6035-1(a)(1); Reg. §1.6035-1(b).	No. §1014(f)(2); Reg. §1.1014-10(b)(2).
Cash (including coins & bills with no numismatic value)	No. Reg. §1.6035-1(b)(1)(i).	Not applicable (cash basis equals face value)
Tangible Personal Property - Small Amounts	No. Reg. §1.6035-1(b)(1)(iii).	No. Reg. §1.1014-1(b)(2).
Estate Tax Returns Filed for Portability Purposes Only	No. Reg. §1.6035-1(a)(2).	No. §1014(f)(2); Reg. §1.1014-10(b)(3).
Estate Tax Returns Filed for GST Allocation Only	No. Reg. §1.6035-1(a)(2).	No. §1014(f)(2); Reg. §1.1014-10(b)(3).
Income in Respect of a Decedent	No. Reg. §1.6035-1(b)(1)(ii).	No. IRD receives no basis step-up at death.
Assets Sold by the Estate and Gain or Loss is Recognized	No. Reg. §1.6035-1(b)(1)(iv).	No. Asset not distributed to a beneficiary.
Gross Estate Less Than Filing Threshold	No. Reg. §1.6035-1(a)(2).	No. §1014(f)(2); Reg. §1.1014-10(b)(3).
Other Assets, in General	Yes. §6035(a)(1); Reg. §1.6035-1(a)(1); Reg. §1.6035-1(b).	Yes. §1014(f)(1); Reg. §1.1014-10(b).

Compiled by Philip N. Jones of Duffy Kekel LLP. Based on the proposed regulations published 3/4/16. FR Doc. 2016-04718 (TD 9757). Some exceptions apply; review the relevant statutes and regulations for applications to particular situations. 4/3/23.