VI. FEDERAL INCOME TAXATION OF TRUSTS AND ESTATES

A. Introduction

In many ways, the federal income taxation of trusts and estates is similar to the federal income taxation of individuals. Concepts such as gross income, taxable income and deductions are common to both sets of income tax rules. Certain characteristics of trusts and estates, however, contribute to the complexity of the income tax rules for trusts and estates. For example, ownership of trusts and estates is split into a legal interest owned by the fiduciary and an equitable interest owned by the beneficiaries. This split ownership causes difficulty in identifying the appropriate taxpayer.

This Chapter discusses the following topics related to the federal income taxation of trusts and estates:

- Working definitions.
- Computation of the tax.
- Taxation of simple trusts, complex trusts and estates
- Throwback tax
- Grantor trusts
- Duties and forms to file
- Income in respect of a decedent

B. Working Definitions

For trusts and estates, a preliminary issue is identifying who is subject to income taxation. For estates, it could be the estate or the beneficiaries. For trusts, it could be the trust, the grantor or the beneficiaries. The Internal Revenue Code sets forth tax rules devised specifically to deal with the varied: (1) interests of income and remainder beneficiaries; (2) distribution provisions in a given document; and (3) discretionary decisions that alter the balance from account-to- account and year-to-year.

To sort out this complex taxation issue, it is important to first understand some key terms in the taxation of trusts and estates. This section provides the reader with some working definitions. Generally, there are three ways of looking at income: (1) "taxable income," (2) "fiduciary accounting income," and (3) "distributable net income." In addition, for federal income tax purposes, every trust can be classified as a "grantor trust" or "non-grantor trust," and every non-grantor trust can be further classified annually as either a "simple trust" or "complex trust," depending on what distributions or accumulations the trust makes during the year. These terms are defined below:

1. Taxable Income

Generally, the computation and the definition of the "taxable income" of a trust or estate is the same as the computation and the definition of the taxable income of an individual, except as otherwise provided in Internal Revenue Code ("IRC") §§ 641 through 685. IRC § 641(b). IRC § 61 defines "gross income" for individual income tax purposes as income from whatever source derived, including (but not limited to) specifically enumerated items of income. Some of these listed items of income that also apply to trusts and estates include gross income derived from business, gains derived from dealings in property, interest, dividends, rents, royalties, income from life insurance and endowment contracts, the distributive share of partnership gross income, income in respect of a decedent under IRC § 691 and income from an interest in an estate or trust.

2. Fiduciary Accounting Income

a. <u>Definition</u>. The term "fiduciary accounting income" ("FAI") is defined as the amount of income of the trust or estate for the taxable year, as determined under the terms of the governing instrument and applicable local law. Extraordinary dividends or taxable stock dividends which the fiduciary deems to be allocable to the trust principal under the trust instrument and local law, however, are <u>not</u> considered FAI. IRC § 643(b).

FAI refers to the <u>non-tax</u> concept of classifying receipts and expenditures as income versus principal in order to determine the amount of income distributable to the income beneficiaries from the trust or the estate each year. FAI does not determine the amount of taxable income allocated between the trust or estate and the beneficiaries. Taxable income allocated to the beneficiaries is determined by a separate concept of income.

(1) <u>Income</u>. For FAI purposes, income is a net amount (*i.e.*, receipts minus expenditures), and is determined annually. Interest from bonds or certificates of deposit, cash dividends from stocks or mutual funds, rental income from investment real estate and other items of ordinary income are typically allocated to FAI. Fiduciary fees and administrative expenses are typically divided between income and principal but may be allocated entirely to income or to principal in accordance with the governing instrument or state law. When the controlling document is silent, allocation to accounting income and principal is determined under the Uniform Principal and Income Act or similar state law governing the trust or estate. Expenses that are typically allocated to income include income taxes, property taxes, maintenance costs and one-half of fiduciary fees.

(2) <u>Principal</u>. For FAI purposes, principal includes capital gains, stock dividends, stock splits and proceeds from the sale of principal property. For estates, principal includes all estate assets at the decedent's date of death. Fiduciary fees and administrative expenses are typically divided between income and principal, unless specifically related to a principal transaction. Expenses typically allocated to principal include commissions on the sale of an asset, the cost of capital improvements and one-half of fiduciary fees.

b. <u>Governing Law</u>. No generally accepted accounting principles or specific body of law govern FAI. Accordingly, income and principal for FAI purposes is generally determined with reference to the following sources in the order listed below:

- The governing instrument, whether a trust instrument or a will.
- Local law (generally a version of the Uniform Principal and Income Act).
- Uniform Principal and Income Act or court guidance.

If trust provisions fundamentally depart from the local law in determining what constitutes FAI income, the regulations provide that the trust will not be recognized for federal income tax purposes.

> **<u>EXAMPLE</u>:** The trust instrument directs that all income be paid to B but defines ordinary dividends and interest as principal (even though these items are usually items of income). The trust will not be considered a trust which requires the distribution of all of its income currently for federal income tax purposes under IRC § 642(b) (personal exemptions) and IRC § 651 ("simple trusts"). Treas. Reg. § 1.643(b)-1.

c. <u>Definition of Income Under IRC § 643(b)</u>. In response to changing market conditions and the enactment of state statutes governing prudent investing, the IRS crafted regulations regarding the definition of income under IRC § 643(b). Many trusts are investing primarily for capital appreciation, which has raised issues regarding whether an income beneficiary can receive more from a trust than what is traditionally labeled "income." This in turn has raised issues regarding the tax treatment of characterizing certain receipts as income or principal.

Under the final regulations, "income" is defined as the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. This definition is unchanged. The trust agreement and local law must follow traditional concepts of income and principal. Trust income, consistent with state law, may be defined as a unitrust amount or be determined in the trustee's discretion by making reasonable adjustments to trust income and principal to reflect total trust earnings, including ordinary and tax-exempt income, capital gains and appreciation. Treas. Reg. § 1.643(b)-1. Allocations to principal of traditional income items such as dividends or interest will be respected only in limited circumstances authorized by state law, including decisions by the state's highest court.

(1) <u>Adjustments to Income and Principal</u>. A state statute that "permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries" is generally considered a reasonable apportionment of total return. Id. The trustee's adjustments do not have to be consistent from year to year, as long as they comply with state law. This allocation will be respected regardless of the number of income beneficiaries and regardless of whether the income must be paid or may be accumulated by the trust.

(2) <u>Unitrust Percentages</u>. A unitrust interest in the range of 3% to 5% (inclusive) and in accordance with state law, is considered a fair apportionment to income of the trust's total return. The periodic redetermination of the fair market value of the trust may occur on a particular date each year or be calculated as an average over several years.

(3) <u>Switching Methods</u>. The final regulations also describe the rules for switching between methods of distributing income. If the trust complies with state law in both the manner of switching and the types of methods available, then the switch will not be a taxable sale or disposition under IRC § 1001 and will not be treated as a gift.

➔ **Planning Point:** Note, however, that if the methods of distributing income are not specifically authorized by state statute, but are valid under state law (such as a switch in accordance with a judicial decision or a binding non-judicial settlement), the switch may constitute a recognition event for purposes of IRC § 1001 and may result in a taxable gift. Treas. Reg. § 1.643(b)-1.

3. Distributable Net Income

a. Definition of DNI. Under IRC § 643(a), the term "distributable net income" ("DNI") is defined as, with respect to any taxable year, the taxable income of the trust or estate, computed with certain modifications. Some of these modifications include the following:

- No distribution deduction included in DNI under IRC §§ 651 and 661.
- No personal exemption included in DNI under IRC § 642(b).
- For simple trusts (defined later in this Chapter), extraordinary dividends and taxable stock dividends that the fiduciary does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to principal under the trust terms and applicable local law are excluded from DNI.
- "Net tax-exempt interest" (interest excluded from income under IRC § 103, reduced by the expenses allocated to tax-exempt interest that would be deductible but for IRC § 265) is included in DNI.

The term DNI only applies in the realm of income taxation of trusts and estates and their beneficiaries. DNI is the tax concept used to allocate taxable income between the trust or estate and the beneficiaries. As discussed later in this Chapter, DNI is the maximum deduction allowable to trusts and estates for amounts paid, credited, or required to be distributed to beneficiaries, and is used to determine the maximum amount paid, credited, or required to be distributed to a beneficiary that will be includible in his gross income. DNI also determines the character of distributions to the beneficiaries. Treas. Reg. § 1.643(a)-0.

b. Inclusion of Capital Gains in DNI Under Final IRC § 643(b) Regulations. Section 643(a)(3) provides that gains from the sale or exchange of capital assets generally are excluded from DNI to the extent that these gains are allocated to principal. However, an exception exists for capital gains that are either paid, credited or required to be distributed to a beneficiary during the year or paid, permanently set aside or to be used for charitable purposes. In these cases, capital gains are included in DNI, even though they are allocated to principal.

With regard to situations such as when the trustee is making adjustments between principal and income or when the trustee is distributing a unitrust amount following a statutory conversation, the final regulations under IRC § 643(b) state that "gains from the sale or exchange of capital assets are ordinarily excluded from [DNI] and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary." Treas. Reg. § 1.643(a)-3(a).

An exception to this rule states that capital gains will be included in the computation of DNI if: "pursuant to the terms of the governing instrument and applicable local law or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by local law)," such capital gains are:

- Allocated to income, but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of DNI determined without regard to this exception.
- Allocated to principal but treated consistently by the fiduciary on the books, records and tax returns as part of a distribution to a beneficiary.
- Allocated to principal but actually distributed to the beneficiary or used by the fiduciary in determining the amount that is distributed, or required to be distributed, to a beneficiary. Treas. Reg. § 1.643(a)-3(b).

The trustee may exercise discretion regarding capital gains differently for different trusts and different sales of assets.

➔ **Planning Point:** Trustees who exercise discretion in deciding whether to allocate capital gains to income either as part of their power to adjust between income and principal under a state statute or following a conversion to a unitrust must do so "consistently," and must provide evidence of this consistent treatment. However, the examples in the regulations show only federal income tax reporting as evidence of the trustee's intent. A trustee may wish to go farther and make a specific statement at the outset of the trust's administration of the manner in which the trustee intends to treat capital gains.

c. **Calculation of DNI.** The following is an example of the calculation of DNI:

EXAMPLE: Under the terms of the trust instrument, the income of a trust is required to be currently distributed to W during her life. Capital gains are allocable to principal and are not distributed or used in determining the amount to be distributed or required to be distributed to the beneficiary, and all expenses are charged against principal. During the taxable year the trust has the following items of income and expenses:

Dividends for domestic corporations:	\$30,000
Extraordinary dividends allocated to principal by the trustee in good faith:	\$20,000
Taxable interest:	\$10,000
Tax-exempt interest:	\$10,000
Long-term capital gains:	\$10,000
Trustee's commission and misc. expenses allocable to principal:	\$ 5,000

"Income" under IRC § 643(b) is \$50,000, calculated as follows:

Dividends for domestic corporations:	\$30,000
Taxable interest:	\$10,000
Tax-exempt interest:	\$10,000
Total Income :	\$50,000

"DNI" under IRC § 643(a) is \$45,000, calculated as follows:

Dividends for domestic corporations	\$30,000
Taxable interest :	\$10,000
Tax-exempt interest:	\$10,000
Expenses allocable to tax-exempt interest:	(\$1,000)
Expenses (\$5,000 less \$1,000 allocated to tax-exempt interest):	(\$4,000)
Total DNI:	\$45,000

d. **Tier System.**

(1) **Tier 1.** Income required to be distributed to beneficiaries in the current year is tier 1 income and carries out DNI first. For a simple trust (defined below), this

amount is the net accounting income. For a complex trust (defined below), this amount is generally a portion of FAI required to be distributed under the trust instrument. For most estates, no income is required to be distributed in the current year unless a support allowance of income is made by will or under state law. Income is included for this purpose if the trustee is legally required to distribute it even if the income has not been distributed when the return is filed. Treas. Reg. § 1.651(a)-2 and § 1.661(a)-2.

(2) **Tier 2.** Other amounts actually paid to beneficiaries (including discretionary distributions) are tier 2 distributions and carry out excess DNI on a pro-rata basis to beneficiaries receiving tier 2 distributions.

e. **Apportioning DNI Among Beneficiaries.** If the estate or trust made distributions to beneficiaries during the tax year, DNI passes the tax effects of those distributions through to the estate or trust beneficiaries. The apportionment of DNI among the beneficiaries depends on the amount and type of distribution made to each. The actual source of payment for each distribution (whether income or principal) is irrelevant. Tracing payments back to their source is not permitted. A trustee cannot designate which beneficiaries receive taxable income and which receive non-taxable distributions of principal. If DNI is less than the income required to be distributed currently, DNI is distributed proportionately among the beneficiaries receiving tier 1 distributions.

4. Grantor Trusts v. Non-Grantor Trusts

A grantor trust is a trust in which the grantor or another individual is treated as the owner of a portion or all of the trust because of certain powers retained by the grantor or the individual. Income of a grantor trust is essentially passed down to and payable by the owner. Grantor trusts are discussed later in this Chapter. A non-grantor trust is a trust where the trust entity itself is taxed for income tax purposes.

5. Simple Trusts

Under IRC § 651(a), a non-grantor trust is a "simple trust" if all of following requirements are met during the year in question:

- The trust terms require all of the income to be distributed currently.
- The trust terms do not provide that any amounts be paid, permanently set aside, or used for the charitable purposes described in IRC § 642(c).
- The trust must not actually distribute any amounts (other than the income required to be distributed currently).

Whether trust income is required to be distributed currently is determined under the trust terms and applicable local law. The regulations provide guidelines for making this determination. Treas. Reg. § 1.651(a)-2. In addition, the regulations state that the fact that the trust does not in fact distribute all income currently during the year does not disqualify the trust as a simple trust. Treas. Reg. § 1.651(a)-1.

EXAMPLE: A trust instrument directs that all income be paid to B annually. The trustee does not distribute the 2007 income to B until January 1, 2008. The trust will still qualify as a simple trust for 2007 even though the income was not actually distributed in 2007.

6. Complex Trusts

A "complex trust" is a non-grantor trust that does not meet the requirements of a simple trust. Accordingly, a non-grantor trust is a complex trust if any <u>one</u> of the following is true during the year in question:

- The trust terms require that any portion of the income be accumulated.
- The trust terms give the trustee discretion to accumulate or distribute income, even if all current income is actually distributed.
- The trust distributes principal.
- The trust makes a charitable contribution.

<u>EXAMPLE</u>: A trust instrument directs that all income be paid to B annually, and one-half of the trust principal be distributed to B at age 25. B turns 25 on December 31, 2007. The trustee distributes one-half of the principal to B on January 1, 2008. The trust will be considered a complex trust for 2008 when an actual distribution of principal is made.

➔ **<u>Planning Point</u>:** Whether a trust is a simple trust or a complex trust will affect its taxation. A trust may be simple one year and complex the next. A trust that is permitted but not required to distribute principal is a complex trust in years when principal is actually distributed, but may be a simple trust in a year when no distributions are made. A trust that can either distribute or accumulate income is always a complex trust even in years when all income is distributed. All non-grantor trusts are complex in their final year because all principal must be distributed when the trust terminates.

7. Estates

An "estate" for federal income tax purposes is a decedent's estate, which is comprised of assets subject to probate administration under applicable local law. Property not subject to probate is not included in the definition of "estate" for federal income tax purposes. Accordingly, property that passes by contract (*e.g.*, retirement benefits or life insurance proceeds payable to a beneficiary other than the estate) or by operation of law (*e.g.*, property held in joint tenancy with rights of survivorship) is not included in a decedent's estate for income tax purposes.

➔ **<u>Planning Point</u>:** Property includible in a decedent's "gross estate" for federal estate tax purposes may not necessarily coincide with property includible in the decedent's "estate" for federal income tax purposes. For example, life insurance proceeds payable to the decedent's spouse are included in the decedent's gross estate for federal estate tax purposes but are not included in the decedent's estate for income tax purposes. Life insurance proceeds payable to the decedent's estate, however, are included in the decedent's estate for both estate tax and income tax purposes.

Not surprisingly, the existence of the decedent's estate for income tax purposes commences with the decedent's date of death (regardless of when the probate estate is opened).

C. Computation of the Tax

1. General

The income tax liability of a non-grantor trust or estate is computed in much the same way as an individual's income tax liability is computed, with the exception of the distribution deduction, which is unique to trusts and estates:

- Gross Income (the total of all taxable income from all sources).
- Less: Deductions (much the same as for individuals with a few differences discussed later).
- Less: Distribution deduction (a device used to shift income tax liability to beneficiaries and thus avoid the trust or estate from always paying all the tax, as well as to avoid double taxation of the income).
- Less: Exemption (much the same as an individual's personal exemption, $600 for estates, $300 for trusts requiring all income to be distributed currently, and $100 for all others).
- Equals: Income taxable to the estate or trust.

2. Taxable Income

As discussed earlier, the taxable income of estates and non-grantor trusts generally is gross income less allowable deductions. If deductions exceed the gross income, the excess flows through to the beneficiaries only if the trust or estate has terminated during that year. IRC § 641(h).

3. Gross Income and Exclusions From Gross Income

The general definition of "gross income" in IRC § 61 applies for the most part to non-grantor trusts and estates. Not all items of income, however, will be taxed to the trust. For example, to the extent a portion or all of the trust is treated as a grantor trust, the income will not be taxed to the trust but to the individual treated as owner of the trust. Two examples of items of gross income received by a trust or estate include:

a. **Income in Respect of a Decedent**. If the estate receives an item of income in respect of a decedent ("IRD"), IRD will be includible in the estate's gross income. In general, IRD refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his or her death. It is all income that the decedent would have received had death not occurred. IRC § 691(a). Examples of IRD include deferred compensation received after death and installment sales obligations payable after death. When an estate or trust receives an item of IRD, the estate may be allowed a deduction for the estate tax attributable to such IRD. IRC § 691(c).

b. **<u>Capital Gains</u>**. A trust or estate will have gross income from the sale, exchange or other disposition of assets to the extent of the amount realized in excess of basis in the property.

4. Deductions

Non-grantor trusts and estates are entitled to many of the same deductions as individuals, subject to certain exceptions and additions.

> "To determine if a deduction is allowed to an estate or trust, one considers the statutory provision granting the deduction, other statutory provisions limiting the deduction, and the exceptions applicable to estates and trusts."

There are several deductions that differ between individuals and estates or trusts. The three most significant are: (a) the charitable deduction; (b) the deduction for costs of administration; and (c) the distribution deduction. Also discussed here is the option to take certain deductions on the estate or income tax return, the non-deductibility of expenses allocated to tax-exempt income, and excess deductions.

a. **<u>Charitable Deduction</u>**. An estate or complex trust can fully deduct charitable contributions paid from the current year's gross income if the will, trust instrument, or local law specifically requires the payment. Charitable contributions from principal are not deductible unless made from amounts included in the current year's gross income. Charitable contributions must be reduced by the proportion of tax-exempt income included in gross fiduciary accounting income. Unless the will, trust agreement, or state law requires payment from taxable income, charitable contributions are deemed to be paid from all types of income. Treas. Reg. § 1.642(c)-3(b)(2). This is a full deduction for charitable bequests as opposed to the limitations imposed on individuals to only a certain percentage of adjusted gross income that may be deducted for the year with any excess being carried forward for up to five years.

➔ **<u>Planning Point</u>:** All amounts which will be deductible under IRC § 642(c) should be paid or permanently set-aside in a year prior to the final year of the estate. Otherwise, they will be wasted.

Estates are also allowed a current deduction for amounts included in gross income permanently set-aside for qualifying charities. Only pooled income funds and trusts created before October 10, 1969 or by will executed before October 10, 1969 are allowed a set-aside deduction.

b. **<u>Deduction for Costs of Administration</u>**. Estates and trusts are subject to a 2% of AGI floor on miscellaneous itemized deductions. Miscellaneous itemized deductions for an estate or trust are generally the same kinds of expenses as those incurred by individuals (<u>e.g.</u>, final Form 1040 tax preparation fees, investment expenses, etc.). However, under IRC § 67(e), expenses connected with the administration of an estate or trust which would not have been incurred if the property were not held in such trust or estate are allowed as a deduction in arriving at adjusted gross income and are not subject to the 2% of AGI floor. See *Scott v. United States*, 328 F.3d 132 (4th Cir. 2003), *Mellon Bank N.A. v. United States*, 265 F.3d 1275 (Fed. Cir. 2001) and *Rudkin Testamentary Trust v. Commissioner*, 467 F.3d 149 (2nd Cir., 2006), *cert. granted by*

Knight v. Comm'r, 127 S.Ct. 3005 (June 25, 2007). Cf. *O'Neill v. Comm'r*, 994 F.2d 302 (6th Cir. 1993). Nor are other miscellaneous itemized deductions such as the personal exemption of $600, $300 or $100, and the distribution deduction discussed below.

The IRS released proposed regulations under IRC § 67(e) on July 27, 2007. REG- 128224-06, 72 FR 41243-01, 2007-36 I.R.B. 551. These proposed regulations would provide that expenses that are "unique" to estate or trust administration are not subject to the 2% of AGI floor. The proposed regulations would define "unique" to include "costs that could not have been incurred by an individual property owner." The IRS has provided a non-exclusive list of certain expenses that will be deemed "unique" and fully deductible, such as fiduciary accountings, fiduciary income tax and estate tax returns, trust or will contest or construction, etc. The IRS also has provided a non-exclusive list of non-unique expenses that are subject to the 2% floor. They include costs such as the custody or management of property; advice on investing for total return; the purchase, sale, maintenance, repair, insurance or management of non-trade or business property; etc. Prop. Reg. § 1.67-4. These proposed regulations may be effected by the U.S. Supreme Court before they become final. See *Rudkin*, supra.

c. **Distribution Deduction**. Taxable income earned by a trust or estate is taxable either to the trust or estate or to its beneficiaries but not to both. The trust or estate is allowed an income distribution deduction for income taxed to the beneficiaries. Beneficiaries receive Schedule K-1 informing them of the amount and types of income to include on their individual tax returns. Income passed through to the beneficiaries retains its original character (interest, dividends, capital gains, etc.).

Generally, the distribution deduction is the lesser of:

- Distributions less tax-exempt income included in distribution, or
- DNI less tax-exempt interest.

The effect of this deduction is to shift certain income treated as distributed currently, to the recipients of that income, rather than being taxed to the estate or trust. This deduction is granted under IRC §§ 651 and 661 and limited to DNI under IRC § 663. The distribution deduction is discussed in context later in this Chapter.

d. **Deductibility of Expenses.** In general, most estate or trust administrative expenses are deductible on Form 706 or Form 1041 but not on both. IRC § 642(g). Typical administrative expenses include the following:

- Trustee and personal representative estate or trust fees.
- Attorney and accountant fees for estate or trust administration.
- Form 1041, the decedent's final Form 1040, and other estate or trust tax return preparation costs.
- Court fees, court-required appraisal fees and other required expenses of the estate or trust.
- Investment expenses and advice, including expenses for managing, conserving, and maintaining estate or trust property.

➔ **Planning Point:** Since the lowest estate tax rate generally is higher than the highest income tax rate, when an estate owes estate taxes, the expenses should be taken on the Form 706, estate tax return. When there is no estate tax due to the size of the estate or use of the marital deduction or charitable deduction, expenses should be claimed on the Form 1041, fiduciary income tax return. Keep in mind that these expenses can also be apportioned between the two returns.

e. **Non-Deductibility of Expenses Allocated to Tax-Exempt Income**. Certain deductions that are otherwise allowable to an estate or trust are disallowed to the extent they are attributable or apportioned to tax-exempt income. IRC § 265. Tax-exempt interest includes interest on state and local bonds as well as tax-exempt interest dividends received from a mutual fund or other regulated investment company.

- Interest paid on debt used to purchase or carry tax-exempt obligations is not deductible.
- Administrative expenses under IRC § 212 directly attributable to tax-exempt interest are not deductible. Administrative expenses directly attributable to taxable income are fully deductible.
- A portion of indirect administrative expenses deductible under IRC § 212 must be allocated to tax-exempt interest, and that portion is not deductible. IRC § 265.

Indirect expenses are those not directly related to either taxable income or tax-exempt income.

EXAMPLE: Treas. Reg. § 1.652(c)-4 contains the following example:

Rents	$25,000
Dividends	50,000
Tax-exempt interest	25,000
Total	$100,000

Deductions:

Expenses directly attributable to rental income	$5,000
Trustee's commission	3,900

Based on this information, the expenses allocable to tax-exempt interest are equal to a fraction, with a numerator of $25,000 and a denominator of $100,000, multiplied by the trustee's fee of $3,900. This calculation ignores the direct expenses of $5,000 attributable to the rental income.

Thus $975 of the expenses (trustee's commission) is allocable to tax-exempt income, and as such, cannot be deducted against taxable income.

f. **<u>Excess Deductions</u>.** In its final year, an estate or trust will generally have no tax liability since all income is distributed and capital gains that would ordinarily be taxed to the entity are allocated to the beneficiaries. If an estate or trust has deductions in excess of gross income in its final year, the excess deductions are allowed as deductions on the beneficiary's tax return. Treas. Reg. § 1.642(h)-2. Charitable deductions and the personal exemption are not allowed as excess deductions. This pass-through of deductions is allowed only in the taxable year the estate or trust terminates. The beneficiary cannot carry the deduction over to the following year. A capital loss may also be distributed to the beneficiaries in the final year. A loss received from a trust or estate can be carried over by the taxpayer if not fully used in the termination year.

D. Taxation of Simple Trusts, Complex Trusts and Estates

1. Simple Trusts and Their Beneficiaries

Because of the deduction available to simple trusts, a simple trust is generally taxed on two sources of income: (a) items allocated to principal for FAI purposes but subject to income tax (*e.g.*, capital gains and extraordinary dividends or taxable stock dividends allocated to principal in good faith); and (b) items that are taxable income but not FAI (*e.g.*, partnership income allocated but not distributed to the trust). Beneficiaries of a simple trust are generally taxed on the trust's items of ordinary income, less deductions.

a. **<u>Simple Trusts</u>.** Subject to certain limitations discussed below, a simple trust is generally entitled to a distribution deduction for the amount of FAI required under the trust instrument to be currently distributed to the beneficiaries. Treas. Reg. § 1.651(b)-1. Again, whether FAI is required to be distributed currently is determined under the trust terms and applicable local law. The Regulations provide guidelines for making this determination. Treas. Reg. § 1.651(a)-2. The distribution deduction cannot exceed the DNI. In addition, no deduction is allowed for net tax-exempt income (*i.e.*, tax-exempt income, less expenses). Treas. Reg. § 1.651(b)-1.

➔ **<u>Planning Point</u>:** The maximum distribution deduction available to a simple trust is the lesser of the trust's FAI or DNI, then reduced by net tax-exempt interest. Accordingly, in order to determine the applicable distribution deduction for a simple trust, practitioners should first calculate both FAI and DNI.

b. **<u>Beneficiaries of Simple Trusts</u>.** A simple trust has only one tier of beneficiaries, the beneficiaries entitled to receive current distributions of the trust's FAI. IRC § 652 provides that the income beneficiary must include in income the lesser of FAI or DNI (reduced by net tax-exempt income), regardless of whether or not the FAI is actually distributed. For multiple beneficiaries, the included income is prorated in proportion to the FAI each is required to receive under the trust instrument. The included income retains the same character (*e.g.*, earned income, dividends, exempt income) in the hands of the beneficiaries as in the hands of the trust. The income is included in the tax year that ends with or includes the end of the trust's year for that income.

EXAMPLE: A trust instrument directs that one-third of income be paid to B annually, and two-thirds of income be paid to C annually. The income required to be distributed in 2008 is $60,000. B's income is $20,000 and C's income is $40,000. If the trust's DNI is only $30,000, however, B's income will be limited to $10,000, and C's income will be limited to $20,000.

2. Taxation of Complex Trusts and Estates and Their Beneficiaries

a. Taxation of Complex Trusts and Estates. IRC §§ 661 and 662 cover the taxation of complex trusts and estates and their beneficiaries.

(1) Distribution Deduction. A complex trust or estate is generally entitled to a distribution deduction equal to all of its distributions for the year to the extent of its DNI and subject to special rules for distributions in kind. IRC § 661(a). Specifically, the deduction is equal to the sum of: (a) the first-tier distributions; and (b) the second-tier distributions.

(a) First-Tier Distributions. First-tier distributions are "any amount of income for such taxable year required to be distributed currently (including any amount required to be distributed which may be paid out of income or corpus to the extent such amount is paid out of income for such taxable year)." IRC § 661(a)(1). Accordingly, first-tier distributions include distributions of income required to be distributed currently and annuity payments required to paid from income or principal.

(b) Second-Tier Distributions. Second-tier distributions are "any other amounts properly paid or credited or required to be distributed for such taxable year." IRC § 661(a)(2). Accordingly, second-tier distributions include discretionary distributions of income or principal, mandatory distributions of principal, and distributions out of principal for support of a person to whom the grantor or certain other persons are legally obligated to support or maintain.

b. Taxation of Beneficiaries of Complex Trusts and Estates. In a complex trust or estate, DNI may exceed the income required to be distributed currently. In that case, DNI is first apportioned dollar for dollar to the tier 1 beneficiaries. Excess DNI is divided proportionately among beneficiaries receiving tier 2 distributions.

EXAMPLE: A simple trust has $100,000 of dividend income and $5,000 of trustee's fees. The fees are charged one-half against income and one-half against corpus. The trust's distribution deduction is equal to $95,000 computed as follows:

(1) Fiduciary accounting income (FAI)

Dividends	$100,000
Less: 1/2 of trustee's fee	(2,500)

= Fiduciary accounting income	$97,500
(2) DNI =	
Dividends	$100,000
Less: trustee's fee	(5,000)
= Distributable Net Income	$95,000

Distribution Deduction = $95,000

Because DNI ($95,000) is less than FAI ($97,500), the distribution deduction is limited to $95,000.

EXAMPLE: Trust (T) has net accounting income of $60,000 for the current year. The trustee has the required income distribution language stated in each example below, and additional discretion to distribute income or principal to S and D. The trustee exercises its discretion and, in addition to the required amount of income, distributes $15,000 to S and $15,000 to D. T has no tax-exempt interest income.

(1) If T is required to distribute all income ($60,000) currently to S and D (one-third to S and two-thirds to D) and has $60,000 of DNI, S will have $20,000 of gross income (1/3 of DNI) and D, $40,000 (2/3 of DNI) for the first-tier distribution and no gross income from the second-tier distributions.

(2) If trust has $50,000 of DNI, and provides S is to have 25% of net accounting income and D is to have 50% of net accounting income, then S has $15,000 from his first-tier distribution and D $30,000 from her first-tier distribution. The remaining $5,000 of DNI ($50,000- 45,000) will be allocated $2,500 to S and $2,500 to D. Thus, S will have $17,500 of income and D will have $32,500 of income.

E. Throwback Tax

Under the throwback rules, certain income that represents undistributed portions of DNI from earlier years may be subject to additional tax in later years when actually distributed. Trusts that did not distribute all of the current year's income used to have to deal with throwback rules. Since August 1, 1997, most domestic trusts are no longer subject to these rules. Trusts that are subject to these rules include foreign trusts, some domestic trusts that were foreign trusts, and certain trusts that were created before March 1, 1984 if they are treated as multiple trusts under IRC § 643(f).

As discussed earlier, each year, the DNI for a trust is calculated as the maximum amount of income for the year that may be treated as passed through to the beneficiaries through distributions in that year. Any undistributed amount of DNI is taxed to the trust. This undistributed net income however may be subject to additional tax if in a future year: (1) an amount in excess of DNI for the current year is distributed; and (2) the income would have been taxed at a higher rate had it been distributed in the year originally earned. The calculation is complex, labor intensive, and due to the current compressed brackets for trusts, no longer generates the level of income it once did, and thus was eliminated for most domestic trusts.

F. Grantor Trusts

1. Definition of "Grantor"

The "grantor" is the person who creates a trust. For income tax purposes, however, the grantor may also be a substantial powerholder other than the person who created the trust. IRC § 678. When a person retains or is given substantial control of a trust, that person is considered the grantor for income tax purposes and is taxed on the trust's income, and the trust entity is disregarded for income tax purposes. IRC §§ 674(a); 675; 676; 678. If the grantor retains control of only part of a trust, the grantor is treated as the owner of only the portion of the trust controlled. Income from the other portion is taxed to the trust or its beneficiaries.

2. Adverse Party

Even if the grantor retains a power or right listed in the first four points below, he is not considered the owner of the trust for income tax purposes if an adverse party must consent to the grantor's exercise of control. An adverse party is a person who has a substantial beneficial interest in the trust and who would be adversely affected by the exercise or non-exercise of the grantor's power. IRC § 672(a). Trust beneficiaries generally are adverse parties. A beneficiary who has a right to only a portion of a trust's income or principal is only an adverse party as to that portion. A remainder beneficiary is generally not an adverse party with respect to a power over income. Income beneficiaries are generally adverse to distributions of principal only during the term of their interests. A grantor is also treated as owner of the trust if one of the powers listed in the first four points below is given to a non-adverse party. A grantor is considered to have retained any power or interest given to his spouse for transfers in trust after March 1, 1986. IRC § 672(e).

3. Independent Trustee

IRC § 674(a) sets forth a general rule that the grantor shall be treated as the owner of any portion of a trust where the beneficial enjoyment of income or principal is controlled by the grantor or a non-adverse party, or both, without the consent or approval of an adverse party. IRC § 674(c) provides that, if half or more of the trustees are "independent" (and neither the grantor nor his or her spouse is a trustee) within the meaning of IRC § 674, the general rule of IRC § 674(a) does not apply and the grantor will not be taxed on the trust's income. Who is "independent?" IRC § 674(c) defines this term in the negative:

> EXCEPTION FOR CERTAIN POWERS OF INDEPENDENT TRUSTEES.-- Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor . . . .

➔ **<u>Planning Point</u>:** If the grantor of an irrevocable trust desires not to limit income and principal distributions by "a reasonably definite…standard which is set forth in the trust instrument" (<u>see</u> IRC §§ 674(b)(5) and 674(d)), and assuming grantor trust treatment is not desired, a grantor should choose at least half "independent" trustees within the above definition.

Treas. Reg. §§ 1.674(c)-1 confirms that an independent trustee may hold the power to sprinkle income or principal to any beneficiary without causing grantor trust status.

4. Related or Subordinate Party

A trustee is deemed "related or subordinate" if the trustee is not an adverse party (as defined above) and is the grantor's spouse (if living with the grantor), parent, issue, brother or sister, an employee of the grantor, a corporation or any employee of a corporation in which the stockholdings of the grantor and the trust are significant with respect to voting control, or in which the grantor is an executive. IRC § 672(c).

<u>EXAMPLE</u>: Mother establishes a trust for the benefit of Son and Daughter and appoints her Brother as trustee. No distributions may be made that would discharge Mother's obligation of support. (<u>see</u> IRC § 677(b)). No one has the power to add beneficiaries to the trust (<u>see</u> IRC § 674(b) and (c)). Brother has no beneficial interest in the trust, and has the power to sprinkle income and principal between the beneficiaries. If Brother can exercise this discretionary distribution power without the consent of either beneficiary, Mother will be taxed on all trust income. The sprinkling power is held by a related or subordinate party, and no consent of an adverse party is required. If Brother has the discretionary distribution power but distributions to Son or Daughter must be approved by the other child, Mother will not be taxed on the trust income. The other child is an adverse party because any distributions to Son reduce the amount available to Daughter and vice versa.

What if Mother appoints Bank instead of Brother as the third trustee? In that case, the trust falls within the exception in IRC § 674(c) for powers held by independent trustees, so the trust will not be a grantor trust.

5. Grantor Trust Rules

The grantor trust rules generally apply when the grantor:

- Derives benefits from the income (IRC § 677),
- Retains the power to revoke the trust or withdraw trust property (IRC §§ 676 and 678),
- Retains power to control beneficial enjoyment (IRC § 674),
- Retains power to exercise certain administrative powers over the trust's operation (IRC § 675) or
- Retains a reversionary interest in either principal or income (IRC § 673).

a. <u>Benefits From Income</u>. A grantor is treated as owner of a portion of a trust of which income can be distributed to the grantor or the grantor's spouse, held or accumulated for future distribution to the grantor or the grantor's spouse or used to pay premiums on policies insuring the life of the grantor or the grantor's spouse. If trust income is applied to discharge the grantor's or the grantor's spouse's legal obligation of support, income will be taxed to the grantor to that extent. IRC § 677.

b. <u>Power To Revoke</u>. A power of revocation gives the grantor the power to end all or part of a trust and take back the trust property. The grantor is treated as owner of the trust to the extent of that power. IRC § 676.

c. <u>Control of Beneficial Enjoyment</u>. A grantor is treated as the owner of a portion of a trust over which the grantor and/or a non-adverse person has the power to control who receives income or principal from a trust without an adverse party's consent. IRC § 674. IRC § 674(b) enumerates eight exceptions for powers that can be held by anyone and <u>not</u> result in grantor trust status. The regulations discuss these eight powers in detail. Treas. Reg. § 1.674(b)-1(b). An example of such a power is a power to distribute principal to trust beneficiaries limited by a reasonably definite standard set forth in the trust instrument that is held by the grantor or another person. IRC § 674(b)(5). A reasonably definite standard is one that is clearly measurable and allows the holder to be held legally accountable. Treas. Reg. § 1.674(b)- 1(b)(5).

> **<u>EXAMPLE</u>:** A power to distribute principal for the education, support, maintenance or health of the beneficiary; for his reasonable support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency, would be limited by a reasonably definite standard. However, a power to distribute principal for the pleasure, desire or happiness of a beneficiary is not limited by a reasonably definite standard. Treas. Reg. § 1.674(b)-1(b)(5).

(1) <u>Power Over Income</u>. An additional exception to the general rule of IRC § 674 is IRC § 674(d). IRC § 674(d) provides that a power to distribute, apportion, or accumulate income limited by a reasonably definite standard can be given to any trustee other than the grantor or spouse. The power must be exercisable without consent of any other person. Treas. Reg. § 1.674(d)-1.

(2) <u>Power to Remove and Replace Trustee.</u> If the grantor holds an unrestricted power to remove, substitute or add trustees and to designate any person including the grantor as successor trustee, the trustee's powers are deemed to be exercisable by the grantor for purposes of determining grantor trust status and the trust will not qualify as a non-grantor trust under IRC §§ 674(c) and 674(d). Treas. Reg. § 1.674(d)-2.

d. <u>Administrative Powers</u>. Generally, if the grantor or a non-adverse party has the power to deal with trust property for less than adequate consideration, to substitute assets for other assets of equivalent value (acting in a non-fiduciary capacity), to borrow funds without adequate interest or security, or to control certain other trust administrative functions in a non-fiduciary capacity, the grantor is considered the owner of the trust for income tax purposes. IRC § 675.

e. **Reversionary Interest.** For transfers in trust after March 1, 1986, a grantor generally is treated as the owner of that portion of a trust in which he has a reversionary interest, if the value of the reversionary interest at the time of the transfer exceeds 5% of the total property, based on Internal Revenue Service ("IRS") valuation tables. IRC § 673.

6. Person Other Than Grantor Treated As Owner

A person other than the person who created and funded a trust may be considered the owner of all or part of the trust if he/she: (a) has an exclusive power to vest principal or income in himself/herself; or (b) previously released such a power and retained one of the rights that would cause the trust to be taxed to a grantor. IRC § 678(a). This rule does not apply to a power over income if the grantor is treated as the owner under IRC §§ 673-677. IRC § 678(b); Treas. Reg. § 1.678(b)-1. As an owner of the trust property for income tax purposes, the individual must include the trust income, deductions and credits on his or her personal income tax return instead of the trust's income tax return. IRC § 678 commonly applies in the case of beneficiaries who hold *Crummey* withdrawal rights. But see also, IRC § 677.

> ➔ **Planning Point:** IRC § 678 does not contain an explicit exception for a trustee whose powers are limited by an ascertainable standard. The same is true for beneficiaries who hold withdrawal rights. However, many practitioners believe such a trustee or beneficiary should not be taxed on trust income under IRC § 678. See *U.S. v. De Bonchamps* 278 F.2d 127 (9th Cir. 1960); cf. Treas. Reg. 1.678(c)-1(b), (c) (regarding the applicability of IRC § 678 to support trusts). But in PLR 8211057, the IRS applied IRC § 678 to a trustee who held withdrawal rights despite the existence of an ascertainable standard. A solution to this possible income tax problem is to designate a co-trustee to serve with the trustee who is also a beneficiary.

Note that IRC § 678 is the only provision of the Internal Revenue Code under which grantor trust status can apply, by the explicit terms of the statute, after the "real" grantor of the trust has died. Thus, any trust coming into existence under a post-death revocable trust or under a will cannot be a grantor trust for income tax purposes unless under IRC § 678.

7. Grantor Trust at Death

A grantor trust generally stops being a grantor trust when the grantor dies (unless there are multiple grantors). Income earned through the date of death is reported following the reporting requirements for grantor trusts. After-death income generally must be reported by the trust on Form 1041 as a simple or complex trust, even if the trust was not previously required to file a separate return because the grantor was taxed on all the income. As discussed in more detail below, a decedent's revocable trust may be treated as part of the estate for federal income tax purposes. IRC § 645.

G. Duties and Forms To File

1. Identification Number

All taxable entities must have an employer identification number ("EIN"). An individual generally uses his social security number. Estates and irrevocable trusts must have an employer identification number assigned. Even revocable trusts will need an employer identification number, unless the grantor is at least a co-trustee. Form SS-4 (Application for Employer Identification Number) can be used for this purpose. At some point, a revocable trust will become irrevocable and need its own employer identification number, so most corporate trustees have one assigned right away. Individuals acting as their own trustee usually prefer to maintain the use of their social security number until resignation, incapacity, or death.

➔ **Planning Point:** Often it takes about 4 weeks to get an EIN from the IRS. It is possible to apply by phone and obtain the number immediately, but Form SS-4 will still need to be filed. A deceased individual's identifying number must not be used to file any returns after the decedent's final tax return, nor to make estimated tax payments for a tax year after the year of death.

2. Notice of Fiduciary Relationship

When an individual or entity is appointed to act in any fiduciary capacity for another, the individual or entity must file a written notice with the IRS stating this. Form 56 (Notice Concerning Fiduciary Relationship) can be used for this purpose.

3. Final Income Tax Return

A final individual income tax return (Form 1040) must be filed for a decedent for the year of death and for any prior years in which returns were not filed. The final income tax return covers income earned by the decedent from January 1 of the year of death until the date of death.

> **EXAMPLE:** Decedent dies on March 19, 2007 having earned $35,000 since January 1. Her securities portfolio and rental property continue to earn another $60,000 through December 31. The amount reported on her final income tax return is $35,000. The return is due by her regular due date of April 15, 2008. Also, since she died before the due date of her 2006 tax return, a return will need to be filed for 2006 as well (assuming she did not already file it before her death). The $60,000 of income earned after death will be reported on one or more of her estate's fiduciary income tax return(s).

If the decedent was married at the time of death, the personal representative and spouse may file a joint return as long as the surviving spouse does not remarry before the end of the year of the decedent's death.

> **EXAMPLE:** Decedent dies on October 19, 2007, having earned $60,000 since January 1. His surviving spouse earns $120,000 for the year. Their combined income of $180,000 is reported jointly on an income tax return due by the regular due date of April 15, 2008.

4. Fiduciary Income Tax Return

Most estates and irrevocable trusts must file a Form 1041 annually as well as a separate Schedule K-1, or acceptable substitute, for each beneficiary. Schedule K-1 must be furnished to the beneficiary by the date on which the Form 1041 is filed.

➔ **Planning Point**: Since the due date of the Schedule K-1 is the day the tax return is filed, it often comes too late for a beneficiary to file her own tax return on time. Advance discussion of this issue will increase awareness and decrease frustration on the part of the beneficiary.

The due date of the return is three months and fifteen days after the end of the tax year. Estates and wholly charitable trusts can elect a fiscal year for tax reporting purposes, while all other trusts must report on a calendar year basis.

a. Estate as Taxpayer. Estates come into existence as a taxpayer for federal income tax purposes at the death of the decedent and terminate at the final distribution of assets, as long as this is done in a reasonable time. An estate may elect a fiscal year that is a twelve-month reporting period other than the calendar year. IRC §§ 441 and 7701(a)(1), (14). This election is made simply by the Personal Representative's filing the first tax return for the estate. The reporting period may be the end of any month not more than 12 months after the date of death.

> **EXAMPLE:** Decedent dies on March 3, 2007. His estate may elect a fiscal year ending on March 31, 2007 or any month-end until February 29, 2008. The executor elects a fiscal year ending June 30, 2007. The fiduciary income tax return is due three months and fifteen days after the end of the fiscal year; thus its due date is October 15.

Since estates may elect a fiscal year other than the calendar year and individuals report on a calendar year basis, there is an opportunity for the delay of taxation of distributions. Regardless of the year in which a distribution is received, the income is not recognized until the end of the estate's year when the amount and character of the distribution is determined and reported to the beneficiary. If this reporting takes place in a calendar year later than the distribution takes place, the beneficiary reports the income as of the later year rather than for the previous year in which the income was actually received.

> **EXAMPLE:** Decedent passes away on May 20, 2006. His estate elects a fiscal year ending on October 31, 2006. The fiduciary income tax return is due three months and fifteen days after the end of the fiscal year; thus its due date is February 15, 2007. A distribution is made to a beneficiary on November 12, 2006. It is not reported as income on the beneficiary's 2006 income tax return. The estate's fiduciary income tax return and related Schedule K-1 are filed on February 15, 2007. The income related to such distribution will be reported on the beneficiary's 2007 income tax return filed by April 15, 2008.

Every domestic estate with gross income $600 or more, or any beneficiary who is a nonresident alien must file a return. Estimated payments are only required for tax years ending two or more years after the decedent's death.

b. **<u>Trust as Taxpayer</u>**. Trusts come into existence as a taxpayer for federal income tax purposes at the initial funding of the trust and terminate at the final distribution of assets. A trust "does not automatically terminate upon the happening of the event by which the duration of the trust is measured." Rather, it terminates after "the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust." The trustee is given a reasonable time to "perform the duties necessary to complete the administration of the trust." Treas. Reg. § 1.641(b)-3(b).

A trust must report income on a calendar year basis unless it is wholly a grantor trust or a trust exempt from taxation as a wholly charitable trust. IRC § 644; Rev. Rul. 90-55, 1990-2 C.B. 161. Trusts, therefore, do not have the ability to delay taxation on distributions in the way estates do. Every trust with any taxable income, gross income $600 or more, or any beneficiary who is a nonresident alien must file a return. Estimated payments are required if tax is $1,000 or more. "Safe harbor" rules similar to those for individuals apply to estates and trusts. A trust or estate in its final year may allocate estimated tax payments to beneficiaries under IRC § 643(g).

c. **<u>Qualified Revocable Trusts</u>.** An election may be made to treat a "qualified revocable trust" ("QRT") as part of the decedent's estate for income tax purposes rather than as a separate trust. IRC § 645. Both the executor and the trustee must agree to the election, and, the election, once made, is irrevocable. This treatment is effective until the day before the "applicable date" or, if earlier, the date on which the assets of the trust and estate have been completely distributed. The applicable date is defined as the day that is the later of two years after the date of the decedent's death or six months after the date of final calculation of estate tax liability. Issuance of an estate tax closing letter is considered a final determination of estate tax liability. The primary benefit of this election is that it eliminates the need for separate income tax returns for the trust and the estate.

A QRT is any trust or part of a trust that the decedent was treated as owning under Section 676 due to the decedent's power to revoke the trust or part of the trust. Under Treas. Reg. § 1.645-1(b)(1), a decedent who was treated as owning a trust under IRC § 676 due to a power that was exercisable by the decedent with the consent of a nonadverse party meets the definition of a QRT (without applying the IRC § 672(e) rule attributing the powers of the grantor's spouse to the grantor). Also, if a power to revoke is exercisable by the decedent only with the consent of the decedent's spouse, the trust meets the definition of a QRT.

➔ **<u>Planning Point</u>:** A trust with respect to which the power to revoke is held solely by the decedent's spouse is not a QRT. Also, if a power is held solely by a nonadverse party, the trust is not a QRT.

➔ **<u>Planning Point</u>:** The regulations do not address whether a trust will be a QRT if, because of the grantor's incapacity, the power to revoke no longer exists at the grantor's death. The preamble to the final regulations, however, does comment on this common situation. It states that "[t]he IRS and the Treasury Department believe that, if an agent or legal representative of the grantor can revoke the trust under state law during the grantor's incapacity, the trust will qualify as a QRT, even if the grantor is incapacitated on the date of the grantor's death." T.D. 9032, 67 FR 78371-01.

➔ **<u>Planning Point</u>:** The preamble to the final qualified plan and IRA distribution regulations states that an electing trust will not fail to be a trust for purposes of the IRC § 401(a)(9) retirement plan distribution rules simply because the trust makes an election under IRC § 645 to be treated as an estate. T.D. 8987, 67 FR 18988-01.

(1) **<u>Manner of the Election</u>**. Under Treas. Reg. § 1.645-1(c), if an executor has been appointed, both the trustee and the executor must make the election by filing Form 8855, "Election to Treat a Qualified Revocable Trust as Part of an Estate." If an executor has not been appointed, the trustee may properly make the election by filing Form 8855. If an executor is later appointed, then a new election form must be filed by the trustee and the executor within 90 days of the executor's appointment. If this deadline is not met, the election is treated as terminating the day before the appointment of the executor.

The election must be made by the deadline for filing Form 1041 for the first tax year of the combined electing trust and related estate, if there is an executor, or the first tax year of the electing trust, if there is no executor. If an extension is granted for filing Form 1041, the time for making the election is equally extended. If an election will be made for a QRT, the trustee is not required to file a Form 1041 for the short tax year beginning with the date of the decedent's death and ending on December 31 of that year.

➔ **<u>Planning Point</u>:** If the trustee and the executor are unsure about whether an election will be made by the deadline for filing a Form 1041, the trustee should file a Form 1041 for the short tax year of the decedent's death.

These rules apply whether or not there is sufficient income to require the filing of a Form 1041.

(2) **<u>Filing Requirements After Election</u>**. During the election period, the QRT and the estate continue to be separate taxpayers for purposes of Subtitle F (procedure and administration). Thus, the trustee and the executor are still responsible for making sure that a proper return is filed and the correct tax paid with regard to their respective entities. The trustee must provide the executor with all the information necessary to file a timely and accurate Form 1041 for the combined electing trust and the related estate. The trustee and the executor must allocate the tax burden of the two entities in a manner that reasonably reflects their respective tax liabilities. If the tax liability is not reasonably allocated, the IRS may treat one of the entities as making a gift to the other entity.

(3) **Definition of Executor**. The regulations use the term "executor" rather than personal representative to denote the fiduciary of the decedent's estate. An individual is not an executor under Treas. Reg. § 1.645-1(b)(4), even if that individual has actual or constructive possession of the decedent's property (see IRC § 2203), unless that individual is also appointed or qualified as an executor, administrator or personal representative of the decedent's estate.

(4) **Obtaining an EIN.** Under Treas. Reg. § 301.6109-1(a)(3), the trustee of an electing trust or a QRT for which an election will be made must obtain an EIN on the grantor's death and furnish it to the payors of the trust. If no executor has been appointed, the trustee will use this same EIN for filing Form 1041 as an estate during the election period. If there is an executor, however, one Form 1041 will be filed each year for the combined estate and electing trust under the name and EIN of the related estate.

H. Income in Respect of a Decedent

1. In General

In general, the term "income in respect of a decedent" ("IRD") refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death. It is all income that the decedent would have received had death not occurred. IRC § 691(a). Examples of IRD include individual retirement accounts, qualified employee benefit plans, deferred compensation, installment sale contracts, royalties and insurance renewal commissions. When an estate or trust receives an item of IRD, the estate may be allowed a deduction for the estate tax attributable to such IRD. IRC § 691(c). Items of IRD do not receive any basis step-up at death. IRC § 1014(c).

2. Taxation of IRD

Under IRC § 691(a)(1), IRD must be included in the income of one of the following:

- The decedent's estate, if the estate receives it.
- The beneficiary, if the right to income is passed directly to the beneficiary and the beneficiary receives it.
- Any person to whom the estate properly distributes the right to receive it.

EXAMPLE: The decedent was entitled at the date of his death to a large salary payment to be made in equal annual installments over five years. Her estate, after collecting two installments, distributed the right to the remaining installment payments to the residuary legatee of the estate. The estate must include in its gross income the two installments received by it, and the legatee must include in his gross income each of the three installments received by him.

EXAMPLE: A widow acquired, by bequest from her husband, the right to receive renewal commissions on life insurance sold by him in his lifetime, which commissions were payable over a period of years. The widow died before having received all of such commissions, and her son inherited the right to receive the rest of the commissions. The commissions received by the widow were includible in her gross income. The commissions received by the son must be included in the gross income of the son.

If an estate transfers the right to receive IRD, the IRD is prematurely realized at that time. IRC § 691(a)(2). A transfer includes a sale, exchange or other disposition of the IRD, but it does not include a transfer to a person by specific bequest from a decedent.

3. Income Tax Deduction For Estate Tax Paid Attributable To IRD

IRC § 691 creates the potential for double taxation on the same asset, as illustrated by the following Example:

EXAMPLE: An unmarried employee dies in 2008 with a deferred compensation account valued at $350,000, plus $2,000,000 in other assets. The employee did not make any lifetime gifts. The deferred compensation account is included in the employee's gross estate under IRC § 2039. This generates federal estate tax of approximately $157,500. When the deferred compensation account is distributed to the employee's beneficiaries, all amounts distributed are included in the gross income of the beneficiaries. Without reference to the special deduction allowed under IRC § 691(c), and assuming the employee's beneficiaries have an average rate of income tax of 25%, the total income tax on the date of death plan balance will be approximately $87,500. The total effective rate of tax (both income and estate) on the deferred compensation plan is 70%.

To relieve the burden of this estate taxation and income taxation of the same asset, there is an income tax deduction, allowed under IRC § 691(c), for the federal estate tax attributable to IRD. This deduction is calculated with respect to the net value of all IRD items included in the decedent's estate, and then prorated among them. The tax attributable to IRD is calculated at marginal rates. It is measured as the difference between the federal estate tax, calculated on the estate *including* all items of IRD, and the federal estate tax, calculated on the estate *excluding* all items of IRD.

EXAMPLE: An unmarried employee dies in 2007 with a deferred compensation account valued at $350,000, plus $2,000,000 in other assets. The employee's total federal and state estate tax is approximately $169,640. The employee's state of residence imposes a "decoupled" state estate tax which represents $12,140 of the total estate tax. The federal estate tax represents the remaining $157,500. The entire estate tax is attributable to the deferred compensation account because, if that account were not included in the employee's gross estate, there would be no estate tax. (The entire estate tax would have been absorbed by the available applicable credit amount.) When the deferred compensation account is distributed to the employee's beneficiaries, all amounts distributed are included in the gross income of the beneficiaries. Taking into account the special deduction allowed under IRC § 691(c), and assuming the employee's beneficiaries have an average rate of income tax of 25%, the total income tax on the date of death plan balance will be 48,125. This is calculated as follows:

691 income:	$350,000
691(c) deduction:	(157,500)
Taxable amount:	$192,500
25% tax:	$48,125

Note that the IRC § 691(c) deduction is only available for the federal estate tax, not the state estate tax. The total effective rate of tax (both income and estate) on the deferred compensation plan (after the IRC § 691(c) deduction) is about 62%.

There are a number of important things to remember about the IRC § 691(c) deduction. First, it is complicated to calculate. The actual facts in an estate administration are rarely as simple as those assumed above. IRC § 691 income includes many items, such as accrued interest and dividends after the record date, and a number of offsets and deductions as well. Further, IRD can be, and often is, received over a period of several years. Second, the deduction is often forgotten or overlooked. Third, the deduction does not fully compensate for the double taxation of IRD at death. Finally, the IRC § 691(c) deduction is not available if the IRD is not subject to estate tax.

➔ **Planning Point:** In any administration of a taxable estate, be sure to calculate the IRC § 691(c) deduction. If the right to receive items of IRD are allocated to beneficiaries as part of their distributive share of the estate, be sure to advise them, *and their accountants*, of the amount of the IRC § 691(c) deduction they are entitled to claim against their share of IRD received.