ACCOUNTING
CONTINUING EDUCATION

Estate Planning for the 99% - Portability and More

(EPP4)

KAPLAN

Estate Planning for the 99% - Portability and More

(EPP4)

Edward K. Zollars, CPA

KAPLAN

ESTATE PLANNING FOR THE 99% - PORTABILITY AND MORE (EPP4)

Published in 2020 by Kaplan Financial Education.

Printed in the United States of America.

ISBN: 978-1-07-880228-4

TABLE OF CONTENTS

Unit

1

Tax Issues When an Individual Dies

LEARNING OBJECTIVES

- List the taxes that an individual's estate may need to deal with
- Determine if a taxpayer has a federally taxable estate or if there will be a need to file a state estate and/or inheritance tax return

This section contains various reference items that may be of use to CPAs with trust or estate clients to get an overview of tax issues that will arise when an individual dies.

Decedent's estates can face transfer taxes, although the federal exemptions have been set high enough to eliminate the requirements for the vast majority of the decedent's estates to file a federal estate tax return.

Nevertheless, there are tax issues to be considered. For one, when a decedent dies, there still will likely be the need to file a federal estate and/or trust income tax return. As well, a number of states impose transfer taxes that will apply to estates well below the federal filing limits.

FEDERAL INCOME TAX RATES FOR TRUSTS AND ESTATES

For tax years beginning in 2020:

If taxable income is:	The tax is:
Not over $2,600	10% of the taxable income
Over $2,600 but not over $9,450	$260 plus 24% of the excess over $2,600
Over $9,450 but not over $12,950	$1,904 plus 35% of the excess over $9,450
Over $12,950	$3,129 plus 37% of the excess over $12,950

For tax years beginning in 2019:

If taxable income is:	The tax is:
Not over $2,600	10% of the taxable income
Over $2,600 but not over $9,300	$260 plus 24% of the excess over $2,600
Over $9,300 but not over $12,750	$1,868 plus 35% of the excess over $9,300
Over $12,750	$3,075.50 plus 37% of the excess over $12,750

The net investment income tax for 2020 and 2019 applies at 3.8% on the lesser of undistributed net investment income or adjusted gross income in excess of $12,950 (2020) and $12,750 (2019).

The maximum rate on net long-term capital gains and qualified dividends is 20% for both tax years.

FEDERAL INCOME TAX RETURN FILING REQUIREMENTS FOR TRUSTS AND ESTATES

An estate must file an income tax return (Form 1041) if the estate:

- Has gross income of $600 or more *or*
- Has a nonresident alien beneficiary.

Most domestic trusts (other than a grantor trust) must file (Form 1041) if the trust:

- Has any taxable income *or*
- Has gross income of $600 or more.

FEDERAL ESTATE OR TRUST INCOME TAX RETURN FILING DEADLINES

The original tax return is due by the fifteenth day of the fourth month following the tax year end. The estate or trust may file Form 7004 to request a five and one half month automatic extension of time to file the tax return on or before the original due date of the return. However, the estate or trust must estimate and pay any tax expected to be due with the extension.

For a calendar year estate or trust, the original due date is April 15 and the extended due date is September 30.

FEDERAL APPLICABLE ESTATE AND GIFT TAX EXCLUSION AMOUNTS

Year	Applicable Exclusion Amount
2017	$5,490,000
2018	$11,180,000
2019	$11,400,000
2020	$11,580,000

Note that the GST exclusion amount for each of the years is set to the same amount as the applicable exclusion amount for estate and gift taxes.

FEDERAL ESTATE TAX RETURN

A federal estate tax return (Form 706) is required for estates with lifetime transfers at or above the applicable exclusion amounts. The maximum tax rate on such transfers is set at 40% for all three years.

If an estate tax return (Form 706) is required, the original due date is nine months following the date of death. An automatic six month extension to file the estate tax return (not the estate income tax return) is available to the estate by filing Form 4768 on or before the due date of the estate tax return.

If the decedent had a surviving spouse, an estate tax return must be filed if the spouse wishes to claim the use of the deceased spouse's unused exclusion amount (DSUE) under the portability provisions of IRC Section 2010. If a Form 706 is otherwise required, the election is made on that form.

If no Form 706 is otherwise required, a Form 706, which is subject to some simplified filing rules, must be filed by the date a Form 706 would have been due had the form been required. Again, the estate may use Form 4768 to request a six month extension of time to file this Form.

Per Revenue Procedure 2017-34, automatic permission will be granted to make a late election for portability if:

- The decedent died with a surviving spouse on or after January 1, 2011
- No Form 706 was either actually filed or was required to be filed by the decedent's estate *and*
- A Form 706, prepared in accordance with the requirements of Revenue Procedure 2017-34, is filed by the later of:
  - January 2, 2018 *or*
  - The date two years after the decedent's date of death

STATE ESTATE AND INHERITANCE TAXES

Some states impose state estate and/or inheritance taxes. In some cases, the existence of these taxes will cause the creation at the first death of the bypass trust even though it may no longer be needed (and arguably counterproductive) at the federal level.

Following is summary of those states that tax transfers.

Estate Taxes

Following is a list of states that have an estate tax as of January 1, 2018, along with their exemptions and maximum tax rates. (Source: Tax Foundation *Does Your State Have An Estate or Inheritance Tax?* https://taxfoundation.org/state-estate-tax-inheritance-tax-2019/)

State	Exemption	Maximum Rate
Connecticut	$3,600,000	12%
Hawaii	$5,500,000	15.7%
Illinois	$4,000,000	16%
Maine	$5,700,000	12%
Maryland	$5,000,000	16%
Massachusetts	$1,000,000	12%
Minnesota	$2,700,000	16%
New York	$5,300,000	16%
Oregon	$1,000,000	16%
Rhode Island	$1,500,000	16%
Vermont	$2,800,000	16%
Washington	$2,200,000	20%
District of Columbia	$5,700,000	16%

Delaware and New Jersey have repealed their estate taxes effective for 2018. However, as is noted in the next section, New Jersey retains its inheritance tax.

Inheritance Taxes

A smaller number of states impose an inheritance tax. Unlike an estate tax, an inheritance tax most often imposes different rates of tax on different classes of heirs, most often granting lower rates and/or full exemptions to the closest relatives and higher rates to more distant relatives or those note related to the decedent.

With the repeal of New Jersey's estate tax, only Maryland now imposes both an estate and an inheritance tax. (Source: Tax Foundation *Does Your State Have An Estate or Inheritance Tax?,* https://taxfoundation.org/state-estate-tax-inheritance-tax-2019/)

State	Maximum Inheritance Tax Rate
Iowa	15%
Kentucky	16%
Maryland	10%
Nebraska	18%
New Jersey	16%
Pennsylvania	15%

FUNDAMENTAL CHANGE: THE NEW DEATH TAX IS THE INCOME TAX

Not that many years ago, a good portion of CPAs' clients faced a real possibility of having estate tax due at the passing of the second to die in a married couple if there was not some work done on properly planning the estate. The goal of that planning was to attempt to make sure that assets bypassed the estate of the surviving spouse.

While that bypass meant those assets would not obtain a stepped up basis at the second death, the estate tax rate was far higher than the capital gain rates and applied to the entire value of the asset immediately upon death. The lack of a basis step-up only meant that a potential capital gain tax would have to be paid on the appreciation through the date of death—and only if the assets were sold.

Now fast forward to the current law, where we have (at least temporarily) a unified credit that allows over $11,000,000 to pass to the next generation free of estate tax from a single decedent. Even if we believe the exemptions won't stay at that level and come down as scheduled, that still means a married couple can, with only making a portability election at the first death, pass over $11,000,000 tax free to their heirs.

While a large portion of most CPA firms' married clients had combined assets in excess of $1,000,000, far fewer even approach the $11,000,000 level. For those taxpayers, the federal estate tax is no longer a tax imposed when they die. But if they have not modified their estate plan, the devices will still kick in to keep assets out of the estate of the second to die.

In many cases, the heirs turn the potential capital gain tax into an actual one, as they rush to convert their inheritances to cash shortly following the passing of the second to die. In this environment, we now have to seriously consider attempting to ensure that all assets flow through both taxable estates in order to pick up the basis adjustment under IRC §1014. This means that CPAs have to radically change their assumptions regarding a proper estate plan for most clients.

Today's course is meant to help you consider how to plan in an environment when, for most of our clients, the federal income tax is the real toll that will be paid following the death of the second to die.

Unit 2

Transfer Taxes

LEARNING OBJECTIVES

- Apply the various types of transfer tax planning techniques that may be involved in handling the decedent's estate
- Determine if there is a required filing of a Form 706 for the decedent's estate
- List the pros and cons of a portability election for a surviving spouse

One of the unfortunate side effects of tax planning for a decedent's estate is that when the decedent passes, the estate plan may be out of sync with the current law.

The 2010 revisions to the estate tax (made permanent at the beginning of 2013) were changes that rendered many taxpayers' pre-existing estate plans sub-optimal in terms of achieving a goal of reducing taxes. This was largely because the major tax risk ceased to be the imposition of an estate tax at over 50% rates, but rather the income tax that would be imposed on gains on the disposition of property by heirs.

In this unit, the current state of the estate and transfer taxes is examined. While we will look at handling a Form 706 for those estates that are still required to file, what may be far more important will be an understanding of the impact of the portability provisions for surviving spouses and determining how to both advise a surviving spouse and document such advice.

However, this unit is not meant to provide comprehensive coverage of either transfer tax planning or the preparation of transfer tax forms. Such topics are complex enough to provide plenty of material for a full unit of their own. Instead, this unit will provide an outline of the basics in this area. A CPA who decides to take on responsibilities in providing estate planning services or preparing the transfer tax forms should consult additional resources.

TRANSFER TAXES AS THEY NOW EXIST

For over a decade (2001-2012), the estate tax put a premium on dying in the "right" year. During 2010 was best, because there was no estate tax for taxpayers who died that year. Other years fell at different points on the "prime death year" continuum. In early 2013, this all changed.

In 2010, Congress decided to make permanent the Tax Relief Act revisions to the estate and gift tax regimes. Among other changes, this resurrected the estate tax, provided for a $5 million lifetime exemption for estates, as well as a 35% estate tax rate. The gift tax exemption remained at $1 million.

In 2017, Congress again revisited the lifetime exemption issue as part of the Tax Cuts and Jobs Act (TCJA), enacting a temporarily higher estate tax exemption. This time, the estate exemption almost doubled the exemption that would have been in place under the 2013 law. It should be noted that this doubled exemption amount is currently set to expire at the end of 2025. At that point, without intervening legislation, the exemption would go back to being calculated under the 2013 law – cutting the exemption approximately in half.

One key problem CPAs will run into given this rocky history of the estate tax is that the decedent's documents may not have been updated to take into account the current state of the estate tax. For example, the client's estate plan may not have considered an amount over the $11 million exemption. Clients often don't like to think about their mortality. Trying to get them to revise their estate planning documents requires them to confront that fact of life, and thus can be challenging.

In other cases, the CPA will run into documents that have been customized to deal with the new regime. Such documents, especially for individuals who don't have large estates (the overwhelming majority of taxpayers under the current law) may also be structured differently than the CPA has been used to seeing before 2010 or even 2017 depending upon how much confidence the parties have in Congress making the increased TCJA exemption permanent. In short, estate planning looks very different if you have an $8 million estate and you believe that the increased exemption amount will continue, as opposed to if you don't.

Regardless of the documents, though, the CPA must determine if there is a transfer tax issue early in the administration of the estate. For a decedent with a surviving spouse, another issue arises—should a Form 706 be filed, despite the fact that the estate is not large enough to trigger a mandatory filing. There is some advantages to filing even if one does not have to.

The Much Larger Re-Unified Credit

The 2010 act introduced a number of new estate tax provisions. These provisions include:

- a $5 million (adjusted for inflation) lifetime exemption [IRC §2010(c)(2)] that is temporarily doubled through 2025; and
- the portability provisions of IRC §2010(c)(4) (to be discussed later in this unit).

The fact that these provisions have now been made permanent will allow taxpayers to again return to estate planning without having to constantly worry about the scheduled obsolescence of the law.

The exclusion is also inflation adjusted, so rather than sitting at a fixed level for long periods of time as it had prior to 2001. And, unlike the period from 2001 through 2010, the exclusion will not be fixed in the law and require congressional action to change.

For decedents who die in 2017, the unified credit results in an exemption of $5,490,000, while for those dying in 2020, the exemption amount under the TCJA has now risen to $11,580,000.[1]

One thing to remember is that this applies to both taxable transfers (those in excess of the annual gift tax exclusion or which did not qualify for the annual gift tax exclusion) during the taxpayer's lifetime. For example, in 2020, the annual gift tax exclusion is $15,000 per donor per donee. In 2020, if a taxpayer were to make a gift of $20,000 to a family member, the taxpayer's lifetime exemption would be reduced by $5,000 ($20,000 – $15,000 = $5,000). The CPA should make inquiries both to determine whether any gift tax returns had been filed by the decedent during her lifetime as well as inquiring if there may have been gifts made that should have been, but were not, reported on Forms 709.

Anti-Clawback Regulations

After having faced criticism for not addressing the clawback issue in previous tax laws, Congress granted the IRS explicit authority[2] to issue regulations to prevent "clawback" of prior gifts if the increased basic exclusion amount (BEA) provided for in the Tax Cuts and Jobs Act (TCJA) reverts to a lower amount after 2025 as also provided for in TCJA. In November 2019, the IRS finalized proposed regulations (REG-106706-18) providing information on the anti-clawback protect to be provided for the estates of those "unlucky" enough to live to see 2026.

The preamble to the regulations outlines the clawback and other problems as the IRS begins a discussion of the regulations:

> Given the cumulative nature of the gift and estate tax computations and the differing manner in which the credit is applied against these two taxes, commenters have raised two questions regarding a potential for inconsistent tax treatment or double taxation of transfers resulting from the temporary nature of the increased BEA.[3] First, in cases in which a taxpayer exhausted his or her BEA and paid gift tax on a pre-2018 gift, and then either makes an additional gift or dies during the increased BEA period, will the increased BEA be absorbed by the pre-2018 gift on which gift tax was paid so as to deny the taxpayer the full benefit of the increased BEA during the increased BEA period? Second, in cases in which a taxpayer made a gift during the increased BEA period that was fully sheltered from gift tax by the increased BEA but makes a gift or dies after the increased BEA period has ended, will the gift that was exempt from gift tax when made during the increased BEA

[1] Revenue Procedure 2019-44

[2] IRC §2001(g)(2) as added by the Tax Cuts and Jobs Act

[3] Basic Exclusion Amount

> period have the effect of increasing the gift or estate tax on the later transfer (in effect, subjecting the earlier gift to tax even though it was exempt from gift tax when made)?

The IRS looks at four situations in the preamble of the regulations that may raise issues about the proper use of the BEA, but determines that only one requires regulatory changes.

> The first situation considered is whether, for gift tax purposes, the increased BEA available during the increased BEA period is reduced by pre-2018 gifts on which gift tax actually was paid. This issue arises for donors, who made both pre-2018 gifts exceeding the then-applicable BEA, thus making gifts that incurred a gift tax liability, and additional gifts during the increased BEA period. The concern raised is whether the gift tax computation will apply the increased BEA to the pre-2018 gifts, thus reducing the BEA otherwise available to shelter gifts made during the increased BEA period and, in effect, allocating credit to a gift on which gift tax in fact was paid.

The IRS outlines why this does not, in fact, cause a loss of the increased exemption:

> Step 3 of the gift tax determination requires the tentative tax on all gifts from prior periods to be subtracted from the tentative tax on the donor's cumulative gifts (including the current gift). The gifts from prior periods include the pre-2018 gifts on which gift tax was paid. In this way, the full amount of the gift tax liability on the pre-2018 gifts is removed from the current year gift tax computation, regardless of whether that liability was sheltered from gift tax by the BEA and/or was satisfied by a gift tax payment. Steps 4 through 6 of the gift tax determination then require, in effect, that the BEA for the current year be reduced by the BEA allowable in prior periods against the gifts that were made by the donor in those prior periods. The increased BEA was not available in the years when the pre-2018 gifts were made and thus, was not allowable against those gifts. Accordingly, the gift tax determination appropriately reduces the increased BEA only by the amount of BEA allowable against prior period gifts, thereby ensuring that the increased BEA is not reduced by a prior gift on which gift tax in fact was paid.

The IRS then looks at a similar situation, but instead looking at the estate, rather than the gift, tax implications:

> The second situation considered is whether, for estate tax purposes, the increased BEA available during the increased BEA period is reduced by pre-2018 gifts on which gift tax actually was paid. This issue arises in the context of estates of decedents who both made pre-2018 gifts exceeding the then allowable BEA, thus making gifts that incurred a gift tax liability, and die during the increased BEA period. The concern raised is whether the estate tax computation will apply the increased BEA to the pre-2018 gifts, thus reducing the BEA otherwise available against the estate tax during the increased BEA period and, in effect, allocating credit to a gift on which gift tax in fact was paid.

The IRS also concludes that the law will avoid penalizing the estate in such a situation:

> Step 3 of the estate tax determination requires that the hypothetical gift tax on the decedent's post-1976 taxable gifts be subtracted from the tentative tax on the sum of the taxable estate and adjusted taxable gifts. The post-1976 taxable gifts include the pre-2018 gifts on which gift tax was paid. In this way, the full amount of the gift tax liability on the pre-2018 gifts is removed from the estate tax computation, regardless of whether that liability was sheltered from gift tax by the BEA and/or was satisfied by a gift tax payment. Step 4 of the estate tax determination then requires that a credit on the amount of the BEA for the year of the decedent's death be subtracted from the net tentative estate tax. As a result, the only time that the increased BEA enters into the computation of the estate tax is when the credit on the amount of BEA allowable in the year of the decedent's death is netted against the tentative estate tax, which in turn already has been reduced by the hypothetical gift tax on the full amount of all post-1976 taxable gifts (whether or not gift tax was paid). Thus, the increased BEA is not reduced by the portion of any prior gift on which gift tax was paid, and the full amount of the increased BEA is available to compute the credit against the estate tax.

The third situation involves the impact of the decrease of the basic exclusion amount (BEA) on gift taxes:

> The third situation considered is whether the gift tax on a gift made after the increased BEA period is inflated by a theoretical gift tax on a gift made during the increased BEA period that was sheltered from gift tax when made. If so, this would effectively reverse the benefit of the increased BEA available for gifts made during the increased BEA period. This issue arises in the case of donors who both made one or more gifts during the increased BEA period that were sheltered from gift tax by the increased BEA in effect during those years, and made a post-2025 gift. The concern raised is whether the gift tax determination on the post-2025 gift will treat the gifts made during the increased BEA period as gifts not sheltered from gift tax by the credit on the BEA, given that the post-2025 gift tax determination is based on the BEA then in effect, rather than on the increased BEA.

And, again, the IRS determines that, in fact, there is no negative impact in this situation:

> Just as in the first situation considered in part V(2) of this Background section, Step 3 of the gift tax determination directs that the tentative tax on gifts from prior periods be subtracted from the tentative tax on the donor's cumulative gifts (including the current gift). The gift tax from prior periods includes the gift tax attributable to the gifts made during the increased BEA period. In this way, the full amount of the gift tax liability on the increased BEA period gifts is removed from the computation, regardless of whether that liability was sheltered from gift tax by the BEA or was satisfied by a gift tax payment. All that remains is the tentative gift tax on the donor's current gift. Steps 4 through 6 of the gift tax determination then require that the credit based on the BEA for the current year be reduced by such credits allowable in prior periods. Even if the sum of the credits allowable for prior

> periods exceeds the credit based on the BEA in the current (post-2025) year, the tax on the current gift cannot exceed the tentative tax on that gift and thus will not be *improperly inflated. The gift tax determination anticipates and avoids this situation, but no credit will be available against the tentative tax on the post-2025 gift.*

Finally, the IRS looks at the situation which, without new guidance being issued, there would be a negative impact from the decrease in BEA. That would take place for the estate tax for decedents dying after 2025 that had made lifetime gifts in excess of the now reduced exclusion amount:

> The fourth situation considered is whether, for estate tax purposes, a gift made during the increased BEA period that was sheltered from gift tax by the increased BEA inflates a post-2025 estate tax liability. This will be the case if the estate tax computation fails to treat such gifts as sheltered from gift tax, in effect reversing the benefit of the increased BEA available for those gifts. This issue arises in the case of estates of decedents who both made gifts during the increased BEA period that were sheltered from gift tax by the increased BEA in effect during those years, and die after 2025. The concern raised is whether the estate tax computation treats the gifts made during the increased BEA period as post-1976 taxable gifts not sheltered from gift tax by the credit on the BEA, given that the post-2025 estate tax computation is based on the BEA in effect at the decedent's death rather than the BEA in effect on the date of the gifts.

The IRS then gives two examples of the negative impact that would take place in the absence of anti-clawback regulations:

> In this case, the statutory requirements for the computation of the estate tax, in effect, retroactively eliminate the benefit of the increased BEA that was available for gifts made during the increased BEA period. This can be illustrated by the following examples.
>
> Example 1. Individual A made a gift of $11 million in 2018, when the BEA was $10 million. A dies in 2026, when the BEA is $5 million, with a taxable estate of $4 million. Based on a literal application of section 2001(b), the estate tax would be approximately $3,600,000, which is equal to a 40 percent estate tax on $9 million (specifically, the $9 million being the sum of the $4 million taxable estate and $5 million of the 2018 gift sheltered from gift tax by the increased BEA). This in effect would impose estate tax on the portion of the 2018 gift that was sheltered from gift tax by the increased BEA allowable at that time.
>
> Example 2. The facts are the same as in Example 1, but A dies in 2026 with no taxable estate. Based on a literal application of section 2001(b), A's estate tax is approximately $2 million, which is equal to a 40 percent tax on $5 million. Five million dollars is the amount by which, after taking into account the $1 million portion of the 2018 gift on which gift tax was paid, the 2018 gift exceeded the BEA at death. This, in effect, would impose estate tax on the portion of the 2018 gift that was sheltered from the gift tax by the excess of the 2018 BEA over the 2026 BEA.

The preamble goes on to explain the mechanics of why this negative impact takes place:

> This problem occurs as a result of the interplay between Steps 2 and 4 of the estate tax determination, and the differing amounts of BEA taken into account in those steps. Step 2 determines the credit against gift taxes payable on all post-1976 taxable gifts, whether or not included in the gross estate, using the BEA amounts allowable on the dates of the gifts but determined using date of death tax rates. Step 3 subtracts gift tax payable from the tentative tax on the sum of the taxable estate and the adjusted taxable gifts. The result is the net tentative estate tax. Step 4 determines a credit based on the BEA as in effect on the date of the decedent's death. Step 5 then reduces the net tentative estate tax by the credit determined in Step 4. If the credit amount applied at Step 5 is less than that allowable for the decedent's post-1976 taxable gifts at Step 2, the effect is to increase the estate tax by the difference between those two credit amounts. In this circumstance, the statutory requirements have the effect of imposing an estate tax on gifts made during the increased BEA period that were sheltered from gift tax by the increased BEA in effect when the gifts were made.

The IRS explains what the proposed (now final) regulations provide to remedy this situation:

> Pursuant to section 2001(g)(2), the proposed regulations also would amend §20.2010-1 to provide a special rule in cases where the portion of the credit as of the decedent's date of death that is based on the BEA is less than the sum of the credit amounts attributable to the BEA allowable in computing gift tax payable within the meaning of section 2001(b)(2). In that case, the portion of the credit against the net tentative estate tax that is attributable to the BEA would be based upon the greater of those two credit amounts.

The IRS outlines the agency's justification for taking this approach:

> In the view of the Treasury Department and the IRS, the most administrable solution would be to adjust the amount of the credit in Step 4 of the estate tax determination required to be applied against the net tentative estate tax. Specifically, if the total amount allowable as a credit, to the extent based solely on the BEA, in computing the gift tax payable on the decedent's post-1976 taxable gifts, whether or not included in the gross estate, exceeds the credit amount, again to the extent based solely on the BEA in effect at the date of death, the Step 4 credit would be based on the larger amount of BEA. As modified, Step 4 of the estate tax determination therefore would require the determination of a credit equal to the tentative tax on the AEA as in effect on the date of the decedent's death, where the BEA included in that AEA is the larger of (i) the BEA as in effect on the date of the decedent's death under section 2010(c)(3), or (ii) the total amount of the BEA allowable in determining Step 2 of the estate tax computation (that is, the gift tax payable).

The IRS provides a basic example of how this rule would work:

> For example, if a decedent had made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by a BEA of $10 million applicable on the dates of the gifts, and if the decedent died after 2025 when the BEA was $5 million, the credit to be applied in computing the estate tax is that based upon the $9 million of BEA that was used to compute gift tax payable.

The change is inserted in the regulations at Reg. §20.2010-1(c). The actual text of the rule reads as follows:

> Changes in the basic exclusion amount that occur between the date of a donor's gift and the date of the donor's death may cause the basic exclusion amount allowable on the date of a gift to exceed that allowable on the date of death. If the total of the amounts allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts, within the meaning of section 2001(b)(2), to the extent such credits are based solely on the basic exclusion amount as defined and adjusted in section 2010(c)(3), exceeds the credit allowable within the meaning of section 2010(a) in computing the estate tax, again only to the extent such credit is based solely on such basic exclusion amount, in each case by applying the tax rates in effect at the decedent's death, then the portion of the credit allowable in computing the estate tax on the decedent's taxable estate that is attributable to the basic exclusion amount is the sum of the amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts. The amount allowable as a credit in computing gift tax payable for any year may not exceed the tentative tax on the gifts made during that year, and the amount allowable as a credit in computing the estate tax may not exceed the net tentative tax on the taxable estate. Sections 2505(c) and 2010(d).

The final regulations also contain more detailed examples at Reg. §20.2010-1(c)(2):

> (i) Example 1. Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $10 million in basic exclusion amount allowable on the dates of the gifts. A dies after 2025 and the basic exclusion amount on A's date of death is $5 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million basic exclusion amount used to determine those credits) exceeds the credit based on the $5 million basic exclusion amount applicable on the decedent's date of death, under paragraph (c)(1) of this section, the credit to be applied for purposes of computing the estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on the post-1976 gifts made by A.
>
> (ii) Example 2. Assume that the facts are the same as in Example 1 of paragraph (c)(2)(i) of this section except that A made cumulative post-1976 taxable gifts of $4 million. Because the total of the amounts allowable as a credit in computing the gift

tax payable on A's post-1976 gifts is less than the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing A's estate tax is based on the $6.8 million basic exclusion amount as of A's date of death, subject to the limitation of section 2010(d).

(iii) Example 3. Individual B's predeceased spouse, C, died before 2026, at a time when the basic exclusion amount was $11.4 million. C had made no taxable gifts and had no taxable estate. C's executor elected, pursuant to §20.2010-2, to allow B to take into account C's $11.4 million DSUE amount. B made no taxable gifts and did not remarry. The basic exclusion amount on B's date of death is $6.8 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on B's post-1976 gifts attributable to the basic exclusion amount (zero) is less than the credit based on the basic exclusion amount allowable on B's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing B's estate tax is based on B's $18.2 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.4 million DSUE amount, subject to the limitation of section 2010(d).

(iv) Example 4. Assume the facts are the same as in Example 3 of paragraph (c)(2)(iii) of this section except that, after C's death and before 2026, B makes taxable gifts of $14 million in a year when the basic exclusion amount is $12 million. B is considered to apply the DSUE amount to the gifts before applying B's basic exclusion amount. The amount allowable as a credit in computing the gift tax payable on B's post-1976 gifts for that year ($5,545,800) is the tax on $14 million, consisting of $11.4 million in DSUE amount and $2.6 million in basic exclusion amount. This basic exclusion amount is 18.6 percent of the $14 million exclusion amount allocable to those gifts, with the result that $1,031,519 (0.186 × $5,545,800) of the amount allowable as a credit for that year in computing gift tax payable is based solely on the basic exclusion amount. The amount allowable as a credit based solely on the basic exclusion amount for purposes of computing B's estate tax ($2,665,800) is the tax on the $6.8 million basic exclusion amount on B's date of death. Because the portion of the credit allowable in computing the gift tax payable on B's post-1976 gifts based solely on the basic exclusion amount ($1,031,519) is less than the credit based solely on the basic exclusion amount ($2,665,800) allowable on B's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing B's estate tax is based on B's $18.2 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.4 million DSUE amount, subject to the limitation of section 2010(d).

Conforming changes were made to the definition of the basic exclusion amount at Reg. §20.2010-1(e)(3). The IRS also clarified in the final regulations that the BEA amounts cited in the examples were inflation adjusted.

Tax Rates on Taxable Estates

The 2012 rate schedule increased the rates for estates of over $500,000, imposing a marginal rate of 37% up through $750,000, a marginal rate of 39% through $1 million, and a marginal rate of 40% for values in excess of $1 million [IRC §2001(c)]. With the $5 million+ exclusion that generally means the first dollar of tax actually paid in most cases will be paid at a 40% estate tax rate.

While lower than rates under old laws, the rate is higher than the rate that applied from 2010 through 2012 (which was 35%).

Filing Deadlines

If a tax return is required, or if a portability election is going to be made, a return is due nine months following the decedent's death [IRC §6075(a)]. The actual date the return is due is, per the regulation, "the day of the ninth calendar month after the decedent's death numerically corresponding to the day of the calendar month on which death occurred. However, if there is no numerically corresponding day in the ninth month, the last day of the ninth month is the due date." [Reg. §20.6075-1]

EXAMPLE

Mary dies on December 1, 20XX. The estate tax return is due by September 1, 20XX+1 unless an extension is applied for.

However, if Mary dies on December 31, 20XX, the estate tax return or portability election is due on October 1, 20XX+1, since there is no September 31.

An extension of time may be requested to file Form 706. For Form 706 (though not for other Form 706 variants needed in special cases, such as a Form 706-A, 706-D, 706-NA, or 706-QDT), an automatic extension of six months is available by timely filing Form 4768 on or before the unextended due date for filing Form 706 [Reg. §20.6081-1(b)].

To obtain an automatic extension, the form must be filed with the IRS office designated in the instructions (or via the hand carried procedures with the person responsible for receiving hand carried returns at the local IRS office [Reg. §301.6901-1(b)(1)]) and must include an estimate of the estate and GST tax liabilities for the estate.

One unique feature of the extension provisions for Form 706 is that, in addition to the automatic extension provisions noted previously, Regulation §20.6081-1 provides a secondary extension option for "good cause" found at Regulation §20.6018-1(c).

Therefore, it is possible, if good cause can be shown, to obtain an extension of time (and thus escape failure to file penalties) though more than nine months have passed since the decedent's death.

The regulation provides that such a good cause extension is to be requested on Form 4768, but that the regulations provide that, "[i]f an estate did not request an automatic extension of time to file Form 706 under paragraph (b) of this section, Form 4768 must also contain an explanation showing good cause for not requesting the automatic extension." [TD 8957 Par. 3. §20.6081- 1(c)]

For an example of case where a District Court (though not the IRS, obviously) found reasonable cause, see the case of *Proske, Paul Est v. U.S.*, (2010, DC NJ) 105 AFTR 2d 2010-2613 (not published). In that case, the estate was able to persuade a U.S. District Court it had reasonable cause for not applying for the extension due the following matters outlined by the estate in the case:

- The amount of estate taxes due could not be ascertained as a result of tensions among the daughter-beneficiaries delayed filing of the return.
- The Estate's attorney was missing a document that was material to calculating the tax liability.
- The Estate's assets were largely illiquid preventing the Plaintiff from paying estimated taxes until after the expiration of the original filing period.
- There were a number of communications between the decedent's widow and the Estate regarding her bequest that complicated calculating of the tax liability.
- The Estate was especially complex.

But, note that the agent denied the request initially simply because it was late. While that was found to be an abuse of discretion, prudence suggests that the "good cause" for not requesting the automatic extension should be avoided by filing for the extension. Otherwise, the CPA should not be surprised if the request is denied—and that may require litigation to attempt to get a better result, as was tried in the *Proske* case.

The CPA should also remember that the estate relying on an adviser to file for the extension who fails to file the document will not be considered good cause under virtually any situation—the duty to assure documents are filed generally cannot be delegated.[4]

Generation Skipping Transfer Tax

The generation skipping transfer (GST) tax is another tax that may apply to the decedent's estate. While this is not a course in the intricacies of the GST tax, a basic outline will be presented.

One thing to realize, though, is that if the first time a GST issue is uncovered is when the decedent dies, the result may prove to be very unfortunate for the affected parties. For all practical purposes, the GST was designed to be a punitive tax that is not generally expected to be paid.

Rather, the tax was to eliminate the possibility of accessing bypassing an estate tax at intermediate generations by establishing devices that granted only an income interest to intermediate generations. Thus, this imposed only a single estate tax on a transfer but managing to move the enjoyment of the

[4] *United States v. Boyle,* US Supreme Court, 469 U.S. 241, 245 (1985)

wealth down multiple generations before it would again pass through the estate of another member of the family.

The tax is imposed as a second tax, imposed at the highest rate applicable for estate and gift taxes (currently 40%), on transfers either outright or in trust to a beneficiary more than one generation below the decedent. For purposes of the "more than one generation" rule, if an individual's parent is deceased at the measuring date and that parent was a descendant of the grantor, that person "steps up" a generation.

EXAMPLE

Jeffrey is the son of Mary, and grandson of Harold. Mary is Harold's daughter. Normally, Jeffrey would be two generations removed from Harold and thus transfers to Jeffrey would potentially be subject to GST. However, if Mary dies, Jeffrey now "moves up" to step into Mary's shoes. For initial transfers that take place after Mary dies, Jeffrey is no longer considered two generations below, but only a single generation below Harold.

The tax is imposed on the occurrence of any of the following events:

- Termination of a trust if, after the termination, all interests are held by or for the benefit of a person more than one generation below the grantor/decedent—the trustee will file a Form 706GS(T) to pay the tax.
- Distribution of income or principal from a trust to or for the benefit of a person more than one generation below the grantor/decedent—the trustee will pay the tax on a Form 706GS(D).
- A direct skip, where the property is transferred either by gift or at death to or for the benefit of a person more than one generation below the grantor/decedent—in this case the tax is paid either by the donor (on a Form 709) or by the estate (on Form 706).

However, the law grants each individual a lifetime GST exemption equal to the basic exclusion (which would be $11,580,000 for 2020).[5] Consequently, each individual can transfer down multiple generations amounts equal to that amount, either directly or in trust, up to that amount.

For direct skips, this is a simple transaction. Trusts are more complicated, for what matters is the status at the time of the transfer (for determining who are skip persons), but the tax will be imposed based on who receives distributions.

So, if a person was a skip person at the time the trust was funded, an inclusion ratio is computed. The inclusion ratio is computed as:

$$1 - \frac{\text{GST exemption allocated to transfer}}{\text{amount of transfer}}$$

[5] Revenue Procedure 2019-44

The ratio of GST exemption to the transfer is called the *applicable fraction* and is computed to the nearest one-thousandth (.001) [Reg. 26.2642-1(a)].

What complicates this problem is that, for many trusts, it may not be clear whether distributions will ultimately be made to the immediately following generation (so no need to "burn" GST) or to a skip person who may succeed to the interest of the non-skip person (and so allocating GST may make sense).

It will be important to determine if there have been either formal or implicit allocations of GST when dealing with the decedent's estate if this appears to be an issue. If GST exemption is available and there are either direct skips (transfers directly to a second or later generation) or potential indirect skips, careful planning is needed to determine proper allocation of the GST exemption.

One important fact to note is that while the estate tax exemption is eligible for a portability election, that election does not bring forward a predeceased spouse's GST exemption. Thus, GST planning will still need to use traditional methods at the death of the first spouse.

PORTABILITY

One of the big changes made in the 2010 act was the addition of an election under §2010(c) that is referred to as a *portability* election.

Portability in General

In Treasury Decision 9593 the IRS issued temporary regulations implementing the special provisions of the portability rules under the estate tax provisions adopted at the end of 2010. The portability provisions provide the ability for a surviving spouse or her estate to use any amount of the applicable exclusion amount not used on the estate tax return of the last predeceased spouse. The amount added to the amount that generally would be exempt from transfer taxes is referred to as the *DSUE amount*.

Some key terms that are used throughout this discussion are specifically defined in regulation §20.2010-1T. These include the following:

- Basic exclusion amount—This is, effectively, the old applicable exclusion amount, which will become the applicable exclusion amount if there is no DSUE involved [Reg. §20.2010-1 (d)(3)].
- Deceased spousal unused exemption amount—This is the unused portion of a decedent's applicable exclusion amount (computed under the new rules) that is not in excess of the basic exclusion amount in the year of the decedent's death. For a decedent that had no DSUE involved, this would be the remaining basic exclusion amount [Reg. §20.2010-1 (d)(4)].
- Applicable exclusion amount—The applicable exclusion amount is defined as the total of the decedent's basic exclusion amount and DSUE amount [Reg. §20.2010-1(d)(2)].
- Last deceased spouse—This is the most recently deceased individual who, at the decedent's death, was married to the decedent when that prior spouse died [Reg. §20.2010-1(d)(5)].

Election

Regulation 20.2010-2 outlines procedures for making the portability election. Regulation §20.2010-2(a)(1) requires that a timely Form 706 estate tax return (taking into account any extension of time applied for and granted) be filed to make this election. The due date for determination of timely filing will be the date that the return would have been required to have been filed had there been a taxable estate, if the estate is not otherwise required to file a return [Reg. §20.2010-2(a)(1)].

On this issue the IRS effectively took care of a drafting problem in the law that Congress passed. An estate that had less than the applicable exclusion amount in total taxable transfers had no estate tax return filing requirement and thus no due date for the return. The IRS solved this drafting quirk by simply providing that even though not required otherwise, for an estate that wishes to make the portability election it will be deemed to be an estate required to file a return pursuant to IRC §6018(a). That means you have the same due date discussed earlier for a taxable estate (nine months after the date of death).

The filing of a complete and properly prepared estate tax return itself will serve as electing the applicability of the DSUE provisions unless the executor specifically elects not to have the provisions apply to the estate [Reg. §20.2010-2(a)(2)]. Similarly, if the executor fails to file a complete and properly prepared estate tax return on time, the estate will be treated as electing out of the operation of DSUE [Reg. §20.2010-2(a)(3)]. In other words, if no estate tax return is filed for the first deceased spouse, the portability election is lost. (However, see sections on relief provisions that follow.)

If an executor has been appointed for the estate of the decedent, that person must make the election. If no executor is appointed, then any person in actual or constructive possession of any property of the decedent may make the election. Once any such person makes an election, that election cannot be overridden by a contrary election made by another person in the same status. Thus, the first election (in or out) made will control [Reg. §20.2010-2(a)(6)(ii)].

Unfortunately, this provision opens up the possibility of warring heirs rushing to be the first to file a Form 706 to ensure the election is or is not made. Note that if an executor is appointed, that person will have full control of the election. This problem opens a new consideration that the estate's counsel will need to consider if a probate otherwise would not need to be opened for the estate, or if the estate plan contemplated no probate being opened.

If the estate was not otherwise required to file a return but is doing so in order to make the DSUE election (or perhaps to elect out to ensure no other person elects in if there is no appointed executor), the value of property qualifying for the marital deduction will not be required to have specific values reported on the Form 706 in most cases [Reg. §20.2010-2(a)(7)(ii)(A)]. The estate, instead, will be required to disclose which range of values the total gross estate based on the executor's best estimate [Reg. §20.2010-2(a)(7)(B)]. However, all other assets will be required to have a proper value reported in accordance with the normal estate tax return requirements [Reg. §20.2010-2(a)(7)(A)(i)].

Computing the DSUE

The DSUE is computed as the lesser of the following two amounts:

- The basic exclusion amount in the year of the death of the decedent [$11.18 million for 2018]
- The excess of:
  - the decedent's applicable exclusion amount over, or
  - the sum of the taxable estate and adjusted taxable gifts determined on the estate tax return [Reg. §20.2010-2(c)(1)]

The computation is illustrated by the following example, derived from the example in the regulations:

> *Facts.* In 2002, having made no prior taxable gift, Husband (H) makes a taxable gift valued at $1,000,000 and reports the gift on a timely-filed gift tax return. Because the amount of the gift is equal to the applicable exclusion amount for that year ($1,000,000), $345,800 is allowed as a credit against the tax, reducing the gift tax liability to zero. H dies on September 29, 2020, survived by Wife (W). H and W are US citizens and neither has any prior marriage. H's taxable estate is $1,000,000. The executor of H's estate timely files H's estate tax return and elects portability, thereby allowing W to benefit from H's DSUE amount.
>
> Application. The executor of H's estate computes H's DSUE amount to be $9,580,000 based on the lesser of the following two computations.

Basic exclusion amount for 2020		
Basic exclusion amount	$ 11,580,000	$ 11,580,000
DSUE (last deceased spouse)	0	
Applicable exclusion amount	11,580,000	
Taxable estate	−1,000,000	
Taxable gifts	−1,000,000	
Tentative DSUE		$ 9,580,000

Note that the IRS retains the right to examine the decedent's estate return to determine the proper amount of the DSUE regardless of how long ago that return was filed. This holding is consistent with the general rule that although there is a statute of limitations on assessing tax, there is not a statute on looking at the details previously reported on a return in order to determine the proper tax on a later return on which the statute is open. Even though Congress introduced a special limitation on this power for properly disclosed gifts, such a special rule was not included for DSUEs, and in the regulations the IRS makes clear they have the right to look at the computation when the DSUE finally impacts tax due [Reg. §20.2010-2T(d)].

Due to this extended statute of limitations on examining valuations by the IRS, advisers will need to counsel the parties involved to retain all supporting documents related to the values used in computing the DSUE up until such time as the DSUE would no longer potentially impact any returns that have been filed on which the statute has expired and there is no future return whose tax due may be impacted by the amount of the DSUE.

Prior Gifting and the DSUE

Another area of concern clarified in this ruling is what happens if gift tax had previously been paid by the decedent in a year when the exclusion amount applicable to gifts is lower than the applicable exclusion amount in the year of death. If there are taxable gifts made by the decedent on which gift tax had been paid, those gifts will be removed from the amount of adjusted taxable gifts solely for purposes of computing the DSUE [Reg. §20.2010-2(c)(2)].

The IRS provides the following example, modifying the previous one, assuming that H had made a $2,000,000 rather than $1,000,000 gift back in 2002.

> In 2002 the applicable exclusion for gifts was $1,000,000, thus tax would have been paid on the $2,000,000. The result ends up being the same as above. The $1,000,000 of gifts on which tax was paid is subtracted from the $2,000,000 of lifetime adjusted taxable gifts, bringing the number back down to only include gifts that had "used up" applicable exclusion at the time the gift was made.

Last Deceased Spouse Rule

Regulation §20.2010-3T looks at the implications for the surviving spouse. The regulation makes clear that the surviving spouse can only use the DSUE (if any) from the last person that the surviving spouse was married to previously who died while still married to that surviving spouse. If that person had no DSUE, or the person's estate elected out of the DSUE provisions, then the DSUE for the surviving spouse is zero [Reg. §20.2010- 3(a)].

EXAMPLE

Mary was married to Joe when he passed away in June of 2019. She married Mel in September of 2019, but was divorced from him in February 2020. She married Fred in June of 2020. Mel died in October of 2020. Mary dies in December of 2020.

Mary's last predeceased spouse is Joe. While she married Mel after Joe died and he died before Mary did, Mel was not married to Mary when he died. Similarly, Fred, having not yet died, is also not the last predeceased spouse. Thus Mary's executor would look to Joe's DSUE, if any, in preparing Mary's Form 706.

This predeceased spouse provision creates apparent issues if a surviving spouse makes gifts that reduce the DSUE of one spouse and then another spouse dies later, displacing the first surviving spouse. In that case, the spouse's DSUE will be the sum of:

- the DSUE of the last deceased spouse, and
- the DSUE of each previously deceased spouse to the extent that DSUE was applied to one or more taxable gifts made by the surviving spouse [Reg. §20.2010-3(b)].

A surviving spouse is deemed first to make any subsequent taxable gifts out of any available DSUE at the time the gift is made [Reg. §25.2505-2(c)].

Late Election Issues

A taxpayer may apply for (and pay for) a private letter ruling under the terms of regulation §301.9100-3 to make a late portability election under section 2010. However, if an estate tax return was required (whether or not filed), the IRS will claim the agency is unable to grant relief.

In Revenue Procedure 2017-34 the IRS published a simplified method to obtain permission for an extension of time under Reg. §301.9100-3 to file a Form 706 and elect portability without the need to apply for a private letter ruling and pay the associated fee.

General Relief Requirements

Under IRC §2010, a surviving spouse may make an election to claim any lifetime transfer tax exclusion that was not used to reduce the estate tax on the deceased spouse. This amount, known as the deceased spouse unused exclusion amount (DSUE), can end up being equal to the entire maximum lifetime transfer amount ($11,580,000 for 2020)[6] especially if the deceased spouse left his entire estate to his spouse.

However, under IRC §2010(c)(5)(A) the election is only effective if made by the due date of the estate tax return (including extensions received) for the deceased spouse. In Reg. §20.2010-2(a)(1) the IRS provided that for an estate that would not otherwise be required to file a return, that due date would be the date on which an estate tax return would have been due had one been required for the decedent. That same regulation provides that if an estate tax return was required for the decedent, no extension of time to file a portability election will be available under Reg. §301.9100-3.

Reg. §301.9100-3 provides for the method by which a taxpayer may request IRS permission to make an election after the date prescribed by regulation for an election to make. The provision cannot be used to obtain an extension of time to make an election if the date for the election is set by Congress in the Internal Revenue Code, as the IRS's view is that the agency lacks the authority to override the Code on this issue without specific authorization from Congress.

[6] Revenue Procedure 2019-44

Automatic Late Election Relief

Shortly after the due dates passed for the first individuals to die that had estates eligible to elect portability, the IRS began receiving requests to grant relief to make the portability election on a "late" Form 706. As the IRS pointed out in Chief Counsel Email 201650017, such relief has been granted to estates where no Form 706 was otherwise required, but the agency's position was that it lacked the authority to grant relief if a Form 706 was otherwise required to be filed. While that offered relief to many estates, it still required filing a private letter request and paying the often substantial fee for such a ruling, along often with fees to professionals to shepherd the request through the letter ruling process.

Despite the cost and complications of making such a request, the IRS has received a relatively large number of such requests. Rev. Proc. 2017-34 notes:

> Treasury and the Service have determined that the considerable number of ruling requests for an extension of time to elect portability received since December 31, 2014, indicates a need for continuing relief for the estates of decedents having no filing requirement under § 6018(a).
>
> Further, the considerable number of ruling requests received has placed a significant burden on the Service. Accordingly, this revenue procedure provides a simplified method to the estates of decedents having no filing requirement under § 6018(a) to obtain an extension of time under § 301.9100-3 to elect portability, provided that certain requirements (set forth in sections 3.01 and 4.01 of this revenue procedure) are met.

The IRS had received requests that an automatic procedure provide for an unlimited period to make a request, but the procedure notes that the IRS felt this was not appropriate. For this reason, Rev. Proc. 2017-34 limits its relief to estate having no requirement to file a Form 706 that requests the relief by the second anniversary of the decedent's date of death.[7]

Section 3 of Rev. Proc. 2017-34 provides the scope of the relief. Relief is available if all the following requirements are satisfied:

- The decedent:
  - was survived by a spouse;
  - died after December 31, 2010; and
  - was a citizen or resident of the United States on the date of death.

[7] Rev. Proc. 2017-34, Section 2.02(6)

- The executor is not required to file an estate tax return under § 6018(a) as determined based on the value of the gross estate and adjusted taxable gifts and without regard to the need to file for portability purposes.
- The executor did not file an estate tax return within the time required by § 20.2010-2(a)(1) for filing an estate tax return.

EXAMPLE

Joe dies on January 2, 2019, leaving everything to his spouse, Denise. His estate was valued at $11.1 million. The surviving spouse meets a CPA in March of 2020 and the CPA notes that since the combined estate that is now in Denise's name entirely is now close to the maximum she can pass tax free, a portability election might make sense. Denise agrees.

Even though no estate tax return was filed (since none was required) and no election was made by the due date in September 2019, under the relief provision a portability election can still be made by Denise and filed in 2020.

Relief is not available if an estate tax return was timely filed by the executor even if a return was not required.

EXAMPLE

Assume Joe's estate was valued at $12,000,000. Again, no estate tax return was filed since Denise knew that there was no tax on a transfer to a surviving spouse.

Despite the fact that no tax would be due, an estate tax return was still required since Joe's estate exceeded the amount whose tax could be offset by the credit. Because a return was required to be filed, the relief provisions do not apply and no late portability election can be made.

As the ruling notes, "Such an executor either will have elected portability of the DSUE amount by timely filing that estate tax return or will have affirmatively opted out of portability in accordance with § 20.2010-2(a)(3) (i)."

The requirements referenced previously for qualified estates to obtain relief are the following:

- A person permitted to make the election on behalf of the estate of a decedent—that is, an executor described in § 20.2010-2(a)(6)—must file a complete and properly prepared Form 706, United States Estate (and Generation Skipping Transfer) Tax Return, on or before the second annual anniversary of the decedent's date of death. The Form 706 will be considered complete and properly prepared if it is prepared in accordance with § 20.2010-2(a)(7).
- The executor filing the Form 706 on behalf of the decedent's estate must state at the top of the Form 706 that the return is "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)."

If it is later determined that the estate was originally required to file an estate tax return, the election is deemed to be void—that is, there is no DSUE for the surviving spouse.

A grant of relief under this procedure will not allow a surviving spouse to obtain a refund of overpaid gift or estate taxes due to the increase in DSUE if the statute of limitations for claiming a refund of that tax has expired before the grant of automatic relief. This will generally affect those filing under the special "January 2, 2018" relief date for decedents that passed away after the portability provisions came into the law, since normally the statute should still be open if relief is granted within two years of the decedent's date of death.

However, the procedure does authorize the filing of protective claim for refund if the statute is still open in anticipation of filing a Form 706 under this procedure. So, if the statute of limitations period for claiming a refund on a gift or estate tax return will shortly expire, a protective claim would be filed under the provisions of Section 5.02 of Revenue Procedure 2017-34.

If an estate qualifies to use this procedure, this procedure will be the exclusive method to obtain an extension of time to file a portability election—the IRS will not consider a request for a traditional letter ruling under Reg. §301.9100-3.

EXAMPLE

Harry dies on January 1, 2018. Mary, Harry's widow, does not seek advice until March of 2019 (after the nine month due date has passed) from a tax adviser. It is determined that while Harry's estate was not large enough to require filing an estate tax return, Mary does want to file for portability when the working is explained to her. Under Rev. Proc. 2017-34, Harry's estate qualifies for automatic late filing relief. If Mary complies with the steps required in the procedure by January 1, 2020, Harry's estate will be deemed to have made a timely portability election.

EXAMPLE

The same facts as in the last example, except Harry's total taxable estate was $12,000,000, all of which was left to Mary. While there would be no estate tax due, Harry's estate was required to file an estate tax return. Harry's estate is not eligible to qualify for the automatic relief.

Applying for a Letter Ruling to Make the Election

If an estate was eligible to make the election but fails to do so and does not notice the problem until the two year period is up, all is not lost—the regular process of filing for a ruling under Reg. §301.9100-3 will be available to the estate, though it will require asking for a private letter ruling and paying the applicable fee.

Advising the Surviving Spouse

A key issue for CPAs concerning the surviving spouse is to have a conversation about the advisability of making a portability election if, in fact, the entire applicable exclusion amount of the deceased spouse is not fully utilized at his death.

While the rules provide for a simplified accounting of the values of assets at the filing of the Form 706, a Form 706 will still need to be prepared. That is a cost that would not otherwise be incurred. Also, the extended statute means that evidence will need to be maintained until the statute closes on the estate of the surviving spouse to defend the amount of the DSUE. That defense will likely mean a need to get complete and defensible values for any assets that did not go to the surviving spouse at the first death (because they would have utilized a portion of the applicable exclusion amount).

Moreover, the one person certain not to benefit from the election will be the surviving spouse. Tax will only be saved after that person dies—so this is being done solely for the benefit of the heirs, though the cost and hassle is being borne by the surviving spouse.

Finally, the adviser will need to have what may be a very awkward conversation about any future remarriage and its impact on DSUE.

What is clear is that the decision must be made by the executor/personal representative of the decedent's estate, which often is the surviving spouse. A CPA can (and almost certainly should) tell the decision maker what she would do in the situation, but also explain clearly that there are factors that argue both ways—and it's perfectly okay if an opposite decision is made.

If it is decided that portability should be elected, the CPA should coordinate with the client's attorney regarding who is going to handle the Form 709 and should follow up to insure that it is timely filed.

Protecting the Adviser from "Monday Morning Quarterbacking"

One other factor must be considered. When taxes eventually end up being paid related to any decision made regarding the estate, it's likely the parties the CPA will be answering to will be the heirs—and it's very likely they were not directly involved in the original decision.

More to the point, if the decision was made by the surviving spouse, that person will not be available to testify about what was said and when. For this reason, a CPA should be sure to carefully document all conversations and advice in writing, sending confirming letters to the client regarding each major decision.

DEVICES LIKELY TO BE FOUND IN THE DECEDENT'S ESTATE PLAN

When a CPA becomes involved with the decedent's estate, the CPA needs to have familiarity with various devices that may exist in the documents. These traditional devices have at least a partial tax planning context that the CPA must understand.

Bypass Trust

Until the 2010 act, bypass trusts were a virtually mandatory fact of life for any married taxpayers who undertook even the most rudimentary forms of tax planning in the transfer tax arena.

The bypass trust was meant to solve a simple problem created by the interaction of two tax provisions:

- Each individual is granted a lifetime exemption for gifting and estate tax purposes.
- Transfers to a spouse are usually fully exempt from estate and gift taxes.

The problem is that, for most couples, each spouse will want to leave all assets initially to their spouse and only pass assets on to the next generation if their spouse predeceases them.

This results in the entire combined values of both spouses' estates residing in the estate of the last spouse to die.

EXAMPLE

Fred and Karen are married. Each has assets in their own personal names valued at $11,580,000 and they want to ensure that the second one of them to die will still have the enjoyment of all assets they both owned until that person dies.

The obvious way to achieve that goal is for each of them to name the other as the beneficiary of the entirety of their estate and, only if the spouse predeceases them, then transfer the estates to their sole son Jerry.

For simplicity, let's assume no inflation adjustments take place, the assets do not grow over time and that the lifetime exclusion remains at $11,580,000. Fred dies in year 1. At that time, the entire $11,580,000 of his estate is transferred to Karen. No tax is due because the marital deduction would apply and, in any event, the amount is below the number that would trigger an estate tax.

In year 5, Karen dies, leaving her entire estate to Jerry. Karen's estate is now $23,160,000. Karen passes $11,580,000 tax free because that is her exclusion. However, the $11,580,000 above that is subject to the 40% estate tax, resulting in a payment of taxes of $4,632,000 at Karen's death. Jerry thus receives $18,528,000 after the payment of the taxes.

The problem there is that Fred's $11,580,000 was effectively wasted because the assets remained at the same generation. By the time the assets were transferred to the succeeding generation, only a single $11,580,000 exclusion was available.

Contrast this with what would have happened if we change the will a bit.

EXAMPLE

Let's assume Fred, instead of leaving the assets to Karen, passes them directly to Jerry. When Fred dies, again no estate tax is due, this time because the assets are not above Fred's lifetime exemption amount of $11,580,000.

When Mary dies, the same is true—so Jerry ends up with a full $23,160,000 transferred to him instead of the lower amount.

Now Jerry is happy, but Mary is likely not so happy. The problem is that Mary lost access to one half of the assets she had previously been able to rely upon should she need them, as well as the income they generate. At this point, if Mary runs into a crisis that burns through her entire $11,580,000 estate, she will have to depend on the generosity of her son.

Regardless of how unlikely it might be that Mary would end up in a destitute position, the reality is that Mary is just not likely going to be as comfortable with those assets moving totally out of her access than she would be having those funds available just in case.

A bypass trust is meant to accomplish the preservation of the use of the exclusion of the first spouse to die, while still providing protection to the surviving spouse that does not rely on begging for assistance from the children in a worst case situation.

EXAMPLE

Instead of leaving the funds to Jerry, Fred's will provides that the $11,580,000 (an amount equal to the lifetime exemption amount) will instead be put into a trust. During her life, Mary will have the right to the income of the trust. If the trustee determines, under a properly ascertainable standard, that it is necessary to invade the corpus of the trust for Mary in order to provide for reasonable needs not otherwise able to be met by her resources, he can distribute a portion of that corpus. At Mary's death, the corpus of the trust passes to Jerry.

In this case the transfer to the trust is not deemed to be a marital transfer. As well, due to the ascertainable standard provisions for invasion of principal, the assets are also not included in Mary's estate at her death. Thus, when Mary dies Jerry will receive the $11,580,000 of Mary's own asset along with the $11,580,000 of value in the trust.

There are both upsides and downsides to the use of a bypass trust. These weren't really changed by the 2010, 2013, and 2017 revisions, but the importance of each has been changed in many actual situations.

- Assets in a bypass trust are likely better protected from the claims of creditors than assets passed directly to the surviving spouse.
- The decedent retains control of the ultimate disposition of the assets in the bypass trust. That is, the survivor is not able to reroute the assets to a party other than those specified in the document. This would be unfair to the beneficiary.
- Growth in value of the assets will escape the estate tax. If a portability election is made in lieu of a bypass trust, it is true the $11,580,000 would move over to Mary's estate. But if those assets grow to $20,000,000, that growth would still be subject to estate taxes.
- Assets in the bypass trust will not receive a basis adjustment upon Mary's death. Because the assets bypass Mary's trust, they also bypass the basis adjustment provisions of IRC §1014. Note that this problem means that, unless the estate grows beyond what could be protected by portability, there will likely be *more* tax paid eventually then if portability had been used in lieu of a bypass trust, as the heir will pay capital gain taxes on a greater amount of any sales proceeds.
- A bypass trust will require an annual filing of a trust income tax return (Form 1041) in most cases, as well as state law accountings for the activities of the trust to determine income/corpus amounts. Especially in a late-life marriage with children from an earlier marriage as corpus beneficiaries, the issues arising from proper trust accounting may become subject to numerous disputes. In such cases, a CPA may find herself second guessed by heirs at the death of the

surviving spouse, with the children claiming the spouse illegally removed trust assets—and looking to the CPA to make them "whole" in such a case.

Mandatorily Funded Trust

A review of the appropriate document (will or revocable living trust) is in order to determine how the estate plan will handle the bypass trust. Traditional planning tended to provide that the bypass trust would be funded with an amount equal to the maximum amount of the decedent's estate that could be put into the trust (up to the balance of the estate) without triggering an estate tax (not exceeding the lifetime exemption). Such a plan is often referred to as a *formula trust*, as the trust document contains a formula that will insure as much of the credit as possible is used at the first death.

Such language is likely to be seen less often in future plans because the balance directed into the bypass trust has grown from $600,000 to $11,580,000 (and increases each year). This means that, in the majority of cases, the entire estate (rather than what was expected to be a small component of the estate) will end up in the trust.

In addition, assuming that the combined estates do not and are not expected to exceed $11,580,000, a simple "I love you" will with nothing more would result in fewer expenses (no annual trust return) and lower taxes for the heirs (assuming the assets appreciate during the period between the first and second death). And even if they would exceed that amount but would not go beyond twice that level, a portability election would gain the basis step-up with only the cost of preparing the Form 706 (once) rather than annual Forms 1041.

Obviously, the best solution to this problem is to have the estate plan modified before the passing of the individual involved. Of course, today's course deals with how the CPA handles matters after the decedent has passed, so let's assume that the matter was not changed.

If the decedent's estate is large enough, the plan may still make the most sense. While the amount going to the trust may be more than the surviving spouse expected, there are still advantages to having a formula trust if one is going to be used.

Most importantly, unlike the disclaimer trust described shortly, the surviving spouse in a formula trust can be given a special power of appointment over assets and beneficiaries unless the power is limited by an ascertainable standard—which likely defeats the entire purpose of giving the spouse the power to use the option in many cases [Reg. §25.2518-2(e)(2)].

Assuming that the estate tax is the most likely problem on the horizon (i.e., the estate is likely going to face estate taxes), a bypass trust normally would be funded with assets that are expected to appreciate, while wasting assets would generally remain outside the trust.

One potentially "expecting to appreciate" asset that will generally be left out of the trust is the residence of the surviving spouse unless it is clear the spouse will never sell the residence before his death. The problem is that IRC §121 (the exclusion of gain on the sale of personal residences) only applies to residences owned by an individual (or via a disregarded entity, such as a 100% grantor trust). So if the residence is placed in the bypass trust, any appreciation in value will create a tax event on sale.

That said, in some cases there are no “good” assets that can be used to fund the trust. In that case, the CPA and counsel should, in consultation with the trustee/personal representative/executor, try to find a way to achieve the “least bad” result, based on reasonable expectations and considering the interests of all affected parties.

Another reason why a formula trust might make sense is for a totally non-tax reason—by having the assets enter into the trust, the decedent’s wishes can control where the assets go upon the death of the surviving spouse. If assets are left directly to the surviving spouse, that spouse will have the ability to redirect those assets in her own estate planning documents.

Finally, as was noted earlier, a minority of states still impose an estate or gift tax and do not adopt the federal law portability rules. Thus, if a taxpayer will be subject to tax by one of those states, a bypass trust might be necessary for state tax law reasons. But if it is expected, the only tax in question will be the state imposed one, then the formula clause would likely be tied to the state law equivalent of the unified credit amount.

As will be discussed later, there may be a way to salvage and protect the wishes of the first to die while still preserving a basis step-up on the second death. The idea would be to ensure that the assets went to a trust that met all the requirements to be treated as a QTIP trust.

If the survivor makes a QTIP election, the assets would, due to being included in the survivor’s estate, obtain the step-up in basis but the terms of the QTIP trust would serve to limit the survivor’s ability to redirect the assets. A QTIP election is made by listing the assets covered by the election on Schedule M of Form 706 or Schedule A of Schedule 709.

What if the estate tax is clearly not an issue and there was no concern about the survivor misusing the assets, but the language of the documents contains a strict formula clause? In that case, the CPA should very strongly recommend consulting with legal counsel regarding any potential options for achieving approval for a modification of the documents (if it is deemed possible) or whether any disclaimer options might be available to achieve a better result.

Disclaimer Bypass Trust

Another option for funding a bypass is referred to as a *disclaimer trust* with the term referring to the fact that it uses the process of a disclaimer to fund the trust.

In an estate planning document, the will or trust provides that upon the death of a party, all assets are left to the other spouse. Should that spouse predecease the party, assets are then directed to the bypass trust. The language is worded in this fashion specifically to grant the surviving spouse the option to decide whether or not to fund the bypass trust.

Obviously, the spouse who puts such language in her estate planning document is going to need to trust that (a) the surviving spouse will seek and obtain proper advice in a timely fashion so that the disclaimer, if deemed advisable, is properly executed, and (b) the surviving spouse will not end up redirecting the assets that don’t go to a bypass trust in some fashion the decedent would not have approved of.

What is gained, however, is a lot of flexibility—something that has proven incredibly useful during times when transfer taxes have been changing on a regular basis. Also, the option works well where the couple may decide they probably won't need a bypass trust, but the inclusion of the language will allow damage control to be performed if, at the time of the first death, it now appears advisable to have such a trust, but there had not been time before the first death to revise the documents.

Because of the detailed provisions that apply to make a valid disclaimer, if the documents are rigged to allow for a disclaimer trust funding, the issue must be addressed as soon as possible. The key task is to ensure that actions are not taken that foreclose the option of using a disclaimer before the earlier of:

- nine months after the date of death;
- when it is finally decided that it will not be appropriate to fund a bypass trust; or
- when the disclaimer is actually executed to fund the bypass trust.

As was noted in the last section, one disadvantage in using a disclaimer option involves additional restrictions imposed on the grant of special powers of appointment to the surviving spouse if he has disclaimed the assets involved [Reg. §25.2518-2(e)(2)]. In a sort of odd trade-off, allowing the spouse the disclaimer option initially often grants the survivor nearly complete control over final disposition of assets. But if the survivor decides to actually fund the bypass trust, the spouse will be allowed fewer options to affect the final disposition of assets than would have been true if a formula clause had forced the funding.

Additionally, the disclaimer option does, as was noted previously, grant the surviving spouse the option to totally ignore the wishes of the decedent in most cases toward the ultimate disposition of assets once the survivor passes. Especially if there are children who are not descendants of the surviving spouse, failing to provide for a trust to protect their interests (or at least leave amounts outright to them) may create friction and disputes.

Lined up against those disadvantages are some advantages to be considered.

- If the survivor decides not to disclaim, her heirs will get a (hopefully) step-up on all assets, not just those that did not pass to the bypass trust. If no estate tax is due, the increased basis will mean, eventually, an overall lower tax bill than if the bypass trust was used.
- No trust is created that must be administered if no disclaimer is made. Many CPAs find that while many surviving spouses tolerate bypass trusts, they rarely like the trusts. And there's little reason they should. The trust does impose restrictions on access to the assets (even if arguably they are far from unreasonably restrictive), requires paying for an annual tax return that is not otherwise necessary, and imposes all of the hassle of having to account for a separate entity.
- The final decision on what to do about a bypass trust is delayed until the time when those working with the estate are going to have the best information to help make the decision. If a formula clause is used, the decision was made based on information on hand at the time the document is written, which could end up being decades before the trust is funded upon a death.

The disclaimer trust is more forgiving with regard to changes in law and circumstances if planning documents are not frequently updated. So, for instance, if the couple relocated from a state with an estate tax to one without one (or vice versa), even if the couple failed to update their estate planning documents (which is definitely not advisable when the state in question changes for many non-tax reasons).

It's likely that CPAs will begin to see far more disclaimer trust documents, where the disclaimer trust is put into the estate planning document not because it is expected to be used but just in case circumstances or laws change—that is, to allow the flexibility to have one last chance to decide whether to fund a bypass trust at the first death.

Irrevocable Life Insurance Trust

Another document the CPA may run into is an irrevocable life insurance trust, which has been a heavily used planning document to enable the of use life insurance to provide liquidity at the time estate taxes were expected to be due.

At first glance, life insurance seems to be the perfect device to use to fund estate taxes. After all, it pays out upon a death, which is when the estate tax is going to be triggered. Normally, a full death benefit is available once the policy is taken out, so the risk of the taxpayer not living long enough to accumulate sufficient liquid assets to have on hand to pay estate taxes would be provided for.

But there is one fundamental problem with the taxpayer simply buying a life insurance policy—if the taxpayer owns the policy, the death benefits end up being included in the decedent's estate. So that $1 million of life insurance that was bought to pay tax on the $2.5 million value of the estate in excess of the exclusion ends up adding $400,000 to the estate tax bill—necessitating the purchase of even more life insurance, which will also increase the tax bill.

Under IRC §2042, the possession of any incident of ownership in a life insurance policy will cause inclusion of the policy in the decedent's estate. Such incidents of ownership include:

- the power to change beneficiaries;
- the right to assign the policy or to revoke an assignment;
- the ability to pledge the policy as security for a loan;
- the ability to borrow from the insurer against the policy's cash surrender value; and
- the right to surrender or cancel the policy.

If any such right was held by the decedent within three years of her death, the value of the policy will still come back into the decedent's taxable estate even though no such rights were held at death [IRC §2035(a)(2)].

Irrevocable life insurance trusts, if properly structured, will hold the policy and make sure the insured never held any incident ownership. If a CPA discovers such a trust exists, the CPA should attempt to assure herself that, in fact, the trust did operate to keep the proceeds out of the deceased's taxable estate.

Key problems that may be uncovered in such trusts include the following:

- The policy was never issued to the trust, but was always held in the name of the insured (and now the decedent). Unfortunately, this problem crops up from time to time due to all professionals assuming someone else was taking care of this. Often, the underwriting process begins with the insured as the proposed owner in order to determine whether, in fact, it will be possible to acquire the insurance in question at a price that makes sense. Once the answer comes back "yes," the attorney will then draft the insurance trust. Where the ball is often dropped is in a failure to substitute the trust for the insured as the proposed owner before the policy is issued.

- Another problem that occurs if counsel is not skilled in dealing with these issues is when the trust directs the trustee to use funds to pay the decedents estate taxes. In such a case, having this clause means the estate retained the economic benefits of the policy, yanking it back into the estate.

That second problem often causes confusion for those new to this sort of planning. It's important to note that the issue is not that the funds cannot be used to pay estate taxes—just that it cannot be mandated. Most often, the expectation is that the trustee will use the proceeds to purchase assets from the estate at fair value. That will enable the estate to use the cash to pay estate taxes.

Inexperienced counsel, following the "belts and suspenders" mantra that attorneys often use, will be tempted to write in a clause to ensure that the trustee does the expected. In this case, such a clause is fatal to the purpose of the trust – keeping life insurance proceeds out of the estate.

Rather, the fact that if the funds are not used to purchase the assets from the estate then those assets will be lost (having to be sold at a "fire sale" to obtain liquidity to pay the tax), most often serves as more than enough incentive for the trustee to do the expected.

Other Estate Tax Planning Devices

CPAs will see other estate planning vehicles from time to time. We will not be spending much time on these vehicles except to briefly explain their nature and use. CPAs who encounter such items who are not familiar with them should consult additional resources.

Charitable Remainder Trusts (CRATs/CRUTs)

Split-interest charitable trusts are sometimes used by individuals who have a charitable intent. While they are often funded during life (so that the grantor may obtain an income tax deduction), sometimes they will be funded upon the death of a grantor, usually the first spouse to die.

A CRT grants a current interest to one party (most often an individual). That interest can either be a fixed amount per year (for a CRAT) or a percentage of the value of assets each year (for a CRUT). Variations are allowed on such concepts—for instance, the unitrust amount may be limited to the lesser of the unitrust percentage or trust income. In such a case, the trust may or may not also include a "makeup" provision to allow for catching up on lost unitrust payments.

The term of the payout may either be a fixed number of years or for the life of the income interest holder. However, the value expected to pass to charities must meet certain limits for the trusts be respected.

For transfer tax purposes, the value of the interest must be divided between the charitable and non-charitable portion. The allowable deduction is based on actuarial tables provided by the IRS to divide the value of the assets between the charity and the income beneficiary.

The CPA likely will need to inquire if such trusts exist with whoever will be handling the trust. As well, it's possible that the decedent previously funded such a trust. In that case, the CPA will need to determine whether the trust will now terminate with the balance going to charity (true if a life payout was called for) or whether the payouts will continue for a term of years.

In such a case, the value of the assets transferred (the income interest) will need to be determined.

Intentionally Defective Grantor Trusts

CPAs should be on the lookout for IDGTs. Such trusts are designed to be treated as grantor trusts for income tax purposes (so that all income is taxed to the grantor), but to be treated as completed gifts for estate and gift tax purposes.

EXAMPLE

Lewis transfers $1,000,000 worth of securities to a trust for benefit of his son Wayne. The trust provides that Lewis has the absolute right to substitute assets of equal value for any assets in the trust at any time. The retention of that right causes the trust to be treated as a grantor trust for income tax purposes under IRC §675(4), but it still remains a completed gift for transfer tax purposes.

Larry will report the income from the trust on his personal return, paying the tax personally. This amounts to an indirect gift to Wayne, giving him the right to the income of the trust without the cost of paying the tax and it also depletes Larry's estate.

Therefore, even though income from the trust has shown up on the decedents return for years, the underlying assets will not be treated as part of the decedent's estate.

Such trusts are created normally by including a power that will invoke the income tax grantor trust rules but will not cause the transfer to fail to be a completed gift for transfer tax purposes. For instance, the trust often contains a clause allowing the grantor an unrestricted right to substitute property of equal value for any trust property.

It's not necessary that the grantor ever exercise such a power or even have any intention whatsoever of ever considering an exercise of such a power—the existence of the power creates an income tax grantor trust. Conceptually this allows the grantor to indirectly increase his gifting to the beneficiary by subsidizing the trust by covering the income tax expense.

CPAs should understand that not all grantor trusts are IDGTs. In fact, most grantor trusts (such as revocable living trusts) are treated as nonentities for both income tax and estate tax purposes. So, for example, all of the assets in a traditional revocable living trust of the decedent will be included in his estate.

Similarly, not all grantor trusts are revocable trusts. In fact, generally, an IDGT cannot be revocable by the trustor because the ability to simply revoke the trust and claim back all the assets will place them in the grantor's taxable estate. Instead, the CPA must study the trust document to check for the telltale signs of one of the grantor powers [IRC §§673- 677] being included in the trust.

ISSUES ARISING FOR PLANS NOT UPDATED FOR REVISED TRANSFER TAXES

CPAs may encounter estate planning documents that have not been updated in years when the decedent passes. In such cases, consideration may need to be given to what types of damage control can be undertaken following the death to try and mitigate any problems.

Bypass Trusts and the Surviving Spouse

Bypass trusts may now exist or be required to be created by tax planning documents in cases where, in fact, their only effect will be to do two things:

- Cause increased expenses due to annual accounting and tax return filing requirements for the trust
- Effectively increase taxes paid following the second death, as the only taxes that will ever be paid (capital gain taxes on the sale of property) are higher due to a lack of a basis step-up

As was discussed earlier, one of the things that should be considered in any estate is whether the documents were drafted in such a way to provide for a disclaimer trust. If that is the case, the CPA will want to insure a clear decision is made regarding whether or not the bypass trust will be funded. In many cases income tax considerations will argue for not funding the bypass trust.

In all cases, an attempt should be made to involve the counsel that drafted the documents in handling of the estate. The counsel that authored the document most likely has a detailed understanding both of how the plan was intended to function and any possible relief valve options in the document.

If the counsel that drafted the document is not available (too often the CPA will find that counsel that drafted the document years ago is now long retired), other counsel should be brought in to handle the legal issues, as well as consider any options that might exist if it appears it would be in the best interests of all to somehow avoid extreme funding of the bypass trust.

The one thing a CPA must avoid is attempting to "play attorney" and give legal advice. Clients who want to know whether it's okay to ignore the trust funding obligation, or if there is a way to do so, should be clearly told that such issues are legal issues for which legal advice must be sought.

QTIP Portability Trust

If the bypass trust is funded (or no way is found to avoid doing so), consideration may need to be given to the issue of whether a qualified terminable interest property (QTIP) election on the bypass trust would allow it to be included in the surviving spouse's estate, potentially used in conjunction with a portability election. Similarly, even if an "I Love You" estate plan is desired, perhaps the spouses will want some assurance the survivor won't change the plan they've both agreed upon and change the disposition of assets.

A QTIP portability trust can serve to both provide a step-up in basis and give some of the non-estate tax advantages of the old bypass trust structure.

Revenue Procedure 2016-49 modifies the conditions under which a QTIP election will be deemed invalid that was contained in Revenue Procedure 2001-38.

The QTIP election under IRC §2056(b)(7) is designed to allow a trust to be created to hold property passing to a surviving spouse with an interest that terminates at the spouse's death, with ultimate disposition controlled by the trust document itself. When the election is made, the surviving spouse agrees to treat the property as part of her estate despite having an interest that normally would be considered solely a life estate. With that election in place, the property qualifies for the unlimited marital exclusion at the first death.

In 2001, the IRS issued Revenue Procedure 2001-38 to provide automatic relief when an estate erroneously made a QTIP election for an estate where it was not necessary to reduce the estate tax to zero. The IRS had noted that some estates would accidentally make the elections on such trusts, which would cause them to be included in the surviving spouse's estate. In such a case, the mistaken election could very lead to the estate of the surviving spouse owing estate tax when none would have been due had the election not been made.

In the old ruling, a QTIP election would be considered wholly or partially invalid automatically to the extent the election did not reduce the estate tax at the first death.

The arrival of the portability provisions under IRC §2010 created a situation where it very often would be desired to be able to put assets in a trust that insured the ultimate disposition at the second death would continue to be as it existed at the first death (giving assurance to each spouse that the other spouse could not redirect the assets following the first death), but to still have those assets included in the estate of the second spouse to die to obtain the income basis adjustment under IRC §1014 at the second death.

When a portability election has been made, the surviving spouse's estate is allowed to add to the decedent's normal estate tax exclusion any unused exclusion (DSUE amount) for the last predeceased spouse of the decedent (assuming that estate made the portability election). Thus, a total of well over $10 million worth of assets can be passed tax free at the second death—and those assets included in the estate of the second to die will obtain a basis equal to fair market value at that second death.

Under the new Revenue Procedure, the IRS will treat QTIP elections that do not reduce the estate tax as void if the estate takes certain actions unless the estate has made a portability election under IRC §2010.

Specifically, the new ruling provides that an election will continue to be treated as void if the following conditions are met:

- The estate's federal estate tax liability was zero, regardless of the QTIP election, based on values as finally determined for federal estate tax purposes, thus making the QTIP election unnecessary to reduce the federal estate tax liability.
- The executor of the estate neither made nor was considered to have made the portability election as provided in §2010(c)(5)(A) and the regulations thereunder.
- The requirements of section 4.02 of this revenue procedure are satisfied (requiring the estate to file a revised Form 706 and notify the IRS the election should be treated as void).

The election will not be treated as void if:

- a partial QTIP election was required with respect to a trust to reduce the estate tax liability and the executor made the election with respect to more trust property than was necessary to reduce the estate tax liability to zero;
- a QTIP election was stated in terms of a formula designed to reduce the estate tax to zero. See, for example, §20.2056(b)-7(h), Examples 7 and 8;
- the QTIP election was a protective election under §20.2056(b)-7(c);
- the executor of the estate made a portability election in accordance with §2010(c)(5)(A) and the regulations thereunder, even if the decedent's DSUE amount was zero based on values as finally determined for federal estate tax purposes; or
- the requirements of section 4.02 of this revenue procedure are not satisfied (the revised Form 706 and notice regarding the election being void are not followed).

Disclaimers

A post-death planning opportunity that should always be considered is the use of a qualified disclaimer. While such disclaimers work best if the estate planning documents were drafted contemplating their use, they may still work in some cases where they were not initially anticipated.

A disclaimer is a provision under which a gift or inheritance may be avoided by an heir or donee who refuses acceptance. Technically, what happens in that case is, just for this particular step in the transfer process, the party disclaiming is assumed to have predeceased the decedent (or died before accepting the gift).

In such a case, the asset then simply moves on to whatever party would be next in line to receive the asset under the terms of the will. Just before that happens, the disclaimant effectively is brought back to the presumed world of the living. That is, an individual could disclaim property that would then drop into a trust in which she is a current beneficiary. The rule does not require that the trust treat the person as having died.

However, disclaimers must be valid both under state law and must meet specific federal rules to be treated as valid for estate tax purposes.

Under IRC §2518(b), a disclaimer must:

- be in writing;
- be received by the transferor or the representative of the estate within nine months of the later of:
  - the date on which the transfer creating the interest in the person was made; or
  - the date on which the person turns 21.

The party must not have accepted the interest or any of its benefits (this is the key problem provision if the issue is raised early on).

As a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer to:

- the spouse of the decedent; or
- someone other than the person making the disclaimer.

Within certain limits, a person can disclaim partial interests in property. For instance, an undivided interest in property can be successfully disclaimed so long as the amount disclaimed is a fractional portion of all substantial rights in the property and the disclaimer runs for the entire term of the disclaimant's interest in the property.

EXAMPLE

James inherited a $1,000,000 IRA account. James disclaims 50% of the interest in a manner that is valid under state law, is done within 9 months of the date of death and James did not take funds from the account (except for the decedent's mandatory distribution for year of death, if applicable) prior to the disclaimer. The partial IRA interest will go to the party or parties that would have inherited the IRA if James had died prior to the decedent.

The two big issues are, first, ensuring the individual does not take possession and enjoyment of the property, including taking benefits from the property (such as rents, dividends, etc.) [Reg. §25.2518-2(d)(1)].

The second problem is that the disclaimant cannot control where the property goes—rather, it simply “falls through” wherever it would otherwise fall under the terms of the governing document. If the possibility of a disclaimer was considered when the documents were drafted, that fall through will likely be some place the disclaiming party would like the property to go.

But if the issue was not considered, then a determination must be made where the property will go. Legal counsel should always be consulted to ensure the property will end up going where the parties believe it will go when a disclaimer is made.

If a disclaimer is deemed advisable, it is very important to document the timeliness of the disclaimer and the fact that no acceptance of the property took place.

BASIS REPORTING OBLIGATION

Beginning with those inheriting from estates required to file an estate tax return after July 31, 2015, heirs are banned from claiming a basis for inherited property in excess of amounts reported on a Form 706 for estate tax purposes.

The executor who files a Form 706 is required to file an Information Return to the IRS and payee statements giving the value reported. Form 8971 will be used to report the basis information, with a separate Schedule A prepared for each beneficiary. The Schedule As will be filed with the IRS and a copy provided to each beneficiary.

Basis Reporting and Form 8971

In the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (H.R. 3236), Congress added new IRC §6035. The provision imposed two reporting mandates on estates in order to prevent estates from paying estate tax based on one claimed value and then later having heirs claim a higher basis in the asset for income tax reporting, arguing that the estate’s value was in error or, more likely, just betting that the IRS would never actually discover the discrepancy.

The reporting requirement is imposed by IRC §6035(a)(1) which provides the following:

> (1) In general
>
> The executor of any estate required to file a return under section 6018(a) shall furnish to the Secretary and to each person acquiring any interest in property included in the decedent’s gross estate for Federal estate tax purposes a statement identifying the value of each interest in such property as reported on such return and such other information with respect to such interest as the Secretary may prescribe.

Thus, the estate must furnish a statement to the IRS identifying the reported value of each asset that was included in the gross estate, as well as giving that information to each person who acquired the interests and identifying these individuals in the report to the IRS. Form 8971 and the related Schedule A to Form 8971 are used to report these items.

The due date for both filing this form to the IRS and for providing the information to beneficiaries is outlined in IRC §6035(a)(3) which provides the following:

> (3) Time for furnishing statement
>
> (A) In general
>
> Each statement required to be furnished under paragraph (1) or (2) shall be furnished at such time as the Secretary may prescribe, but in no case at a time later than the earlier of—
>
> (i) the date which is 30 days after the date on which the return under section 6018 was required to be filed (including extensions, if any), or
>
> (ii) the date which is 30 days after the date such return is filed.
>
> (B) Adjustments
>
> In any case in which there is an adjustment to the information required to be included on a statement filed under paragraph (1) or (2) after such statement has been filed, a supplemental statement under such paragraph shall be filed not later than the date which is 30 days after such adjustment is made.

The proposed regulations found in REG-127923-15 are far more significant. While issued solely as proposed regulations, the regulations provide that taxpayers may rely upon these regulations before the date of publication of the final rules. As a practical matter, because they represent the only real guidance the IRS has issued on the topic, professionals preparing Form 8971 will need to consult these rules, as will taxpayers preparing income tax returns for taxpayers who have received covered property from an estate.

The proposed regulations are issued under three separate IRC Sections. Proposed regulation §1.1014-10 deals with reporting of consistent basis by taxpayers who receive covered property from an estate, proposed regulations §§1.6035-1 and 2 deal with the reporting requirements imposed on covered estates (including determining which estates are required to file the form), while proposed regulation 1.6662-8 deals with the accuracy related penalty to be imposed on taxpayers who report a basis higher than that reported by the estate on Form 8971 on their income tax returns.

Information Reporting Regulations (Proposed Regulation §1.6035-1)

Proposed regulations §§1.6035-1 and 2 are most logical starting point for looking at these rules, because the existence of the requirement for the estate to file these information reporting forms is what triggers the consistent reporting requirement at the beneficiary level.

One major issue that lead to concerns was whether estates that may not have technically been required to file a return, but nevertheless did so (e.g., to make a portability election under IRC §2010 to allow use of the unused exemption on the surviving spouse's estate) were required to file this form.

The final regulations provide specific exceptions, including an exception for those estates filing solely to make a portability election. Proposed regulation §1.6035-1(a)(2) provides the following:

> **(2) Exception.** Paragraph (a)(1) of this section applies only to the executor of an estate required by section 6018 to file an estate tax return. Accordingly, notwithstanding § 20.2010-2(a)(1), the executor does not have to file or furnish the Information Return or Statement(s) referred to in paragraph (a) (1) of this section if the executor is not required by section 6018 to file an estate tax return for the estate, even if the executor does file such a return for other purposes, e.g., to make a generation skipping transfer tax exemption allocation or election, to make the portability election under section 2010(c)(5), or to make a protective filing to avoid any penalty if an asset value is later determined to cause a return to be required or otherwise.

The actual reporting is governed by proposed regulation §1.6035-1(a)(1) which provides that the values being reported are the *final values* as defined in proposed regulation §1.1014-10(c).

Generally, *final value* is defined by proposed regulation §1.1014-10(c)(1), providing for a checklist-style list of final values:

> (c) Final value -- (1) Finality of estate tax value. The final value of property reported on a return filed pursuant to section 6018 is its value as finally determined for purposes of the tax imposed by chapter 11. That value is --
>
> (i) The value reported on a return filed with the Internal Revenue Service (IRS) pursuant to section 6018 once the period of limitations for assessment of the tax under chapter 11 has expired without that value having been timely adjusted or contested by the IRS,
>
> (ii) If paragraph (c)(1)(i) of this section does not apply, the value determined or specified by the IRS once the periods of limitations for assessment and for claim for refund or credit of the tax under chapter 11 have expired without that value having been timely contested;
>
> (iii) paragraphs (c)(1)(i) and (ii) of this section do not apply, the value determined in an agreement, once that agreement is final and binding on all parties; or
>
> (iv) paragraphs (c)(1)(i), (ii), and (iii) of this section do not apply, the value determined by a court, once the court's determination is final.

Obviously, in a normal situation, none of those tests will be met when the Form 8971 is required to be filed. The presumption will be that the first rule will apply—the Form 706 values, if not challenged by the IRS, will become the final values. But, if those are changed, the estate will be required to supply new values. Until such time as there is a change, though, the beneficiary will be required to respect the originally reported numbers on the Form 8971 [Prop. Reg. §1.1014-10(c)(2)].

The property for which reporting is required, as well as property exempt from reporting, is found in proposed regulation §1.6035-1(b)(1) which provides the following:

> (b) Property for which reporting is required -- (1) In general. The property to which the reporting requirement under paragraph (a)(1) of this section applies is all property reported or required to be reported on a return under section 6018. This includes, for example, any other property whose basis is determined in whole or in part by reference to that property (for example as the result of a like-kind exchange or involuntary conversion). Of the property of a deceased nonresident non-citizen, this includes only the property that is subject to U.S. estate tax; similarly, this includes only the decedent's one-half of community property. Nevertheless, the following property is excepted from the reporting requirements --
>
> (i) Cash (other than a coin collection or other coins or bills with numismatic value);
>
> (ii) Income in respect of a decedent (as defined in section 691);
>
> (iii) Tangible personal property for which an appraisal is not required under §20.2031-6(b); and
>
> (iv) sold, exchanged, or otherwise disposed of (and therefore not distributed to a beneficiary) by the estate in a transaction in which capital gain or loss is recognized.

The property described in (iii) is usually the household and personal effects reported on the estate tax return that don't trigger the special rule for articles having a marked artistic or intrinsic value that require an appraisal (such as the furniture in the home).

As CPAs should be aware, income in respect of a decedent items include items such as IRA and retirement accounts.

This list clears up a number of questions raised by practitioners regarding this form, eliminating assets for which there is little or no benefit to be realized by the government in having them listed on Schedule A—after all, the government has no real problem dealing with basis of cash received and assets that have been sold by the estate also present no threat (as well as no obvious way to report those assets on the form).

Proposed regulation §1.6035-1(c) has information in regards to identifying and reporting to beneficiaries.

Proposed regulation §1.6035-1(c)(1) contains the following language dealing with certain beneficiaries who are not directly receiving property:

> For purposes of this provision, the beneficiary of a life estate is the life tenant, the beneficiary of a remainder interest is the remainderman(men) identified as if the life tenant were to die immediately after the decedent, and the beneficiary of a contingent interest is a beneficiary, unless the contingency has occurred prior to the filing of the Form 8971.

One important item to note is that an executor may have a duty to supplement if the contingency is eventually resolved so that the contingent beneficiary does not receive assets from the estate. As the proposed regulation continues:

> If the contingency subsequently negates the inheritance of the beneficiary, the executor must do supplemental reporting in accordance with paragraph (e) of this section to report the change of beneficiary.

In general, proposed regulation §1.6035-1(c)(2) provides that if the beneficiary is not an individual, the estate reports to the appropriate representative of the entity (for a trust or estate) or the entity itself (for a business entity).

However, if that entity later transfers the assets to another party in a transaction in which there is carryover of basis to the receiving party, supplemental reporting by the executor is required.

If, by the time the reporting is required under this rule, the executor has not determined what property will be transferred to each beneficiary, proposed regulation §1.6035-1(c)(3) provides the following:

> **(3) Beneficiary not determined.** If, by the due date provided in paragraph (d) of this section, the executor has not determined what property will be used to satisfy the interest of each beneficiary, the executor must report on the Statement for each such beneficiary all of the property that the executor could use to satisfy that beneficiary's interest. Once the exact distribution has been determined, the executor may, but is not required to, file and furnish a supplemental Information Return and Statement as provided in paragraph (e)(3) of this section.

Effectively, the beneficiary is given a list of everything he *might* receive, even though the beneficiary will not receive all of it. This time the executor is *not* required to file a supplemental return when the issue is resolved, though the executor may do so.

The regulations also address the situation where the executor has been unable to locate the beneficiary by the date for filing the form, as well as dealing with the case where the executor is never able to locate that beneficiary and eventually distributes that property to a different beneficiary. In that case, proposed regulation §1.60351(c)(4) provides the following:

> (4) Beneficiary not located. An executor must use reasonable due diligence to identify and locate all beneficiaries. If the executor is unable to locate a beneficiary by the due date of the Information Return provided in paragraph (d) of this section, the executor must so report on that Information Return and explain the efforts the executor has taken to locate the beneficiary and to satisfy the obligation of reasonable due diligence. If the executor subsequently locates the beneficiary, the executor must furnish the beneficiary with that beneficiary's Statement and file a supplemental Information Return with the IRS within 30 days of locating the beneficiary. A copy of the beneficiary's Statement must be attached to the supplemental Information Return. If the executor is unable to locate a beneficiary and distributes the property to a different beneficiary who was not identified in the

Information Return as the recipient of that property, the executor must file a supplemental Information Return with the IRS and furnish the substitute beneficiary with that beneficiary's Statement within 30 days after the property is distributed. See paragraph (e)(1) of this section. A copy of the substitute beneficiary's Statement must be attached to the supplemental Information Return.

The duty to supplement is going to create a number of concerns with executors. The proposed regulations provide a general requirement to supplement, as well a list of cases where no supplemental report is required.

The general rule for providing supplemental reporting is found in proposed regulation §1.6035-1(e), which provides the following:

> (e) Duty to supplement. -- (1) In general. In the event of any adjustment to the information required to be reported on the Information Return or any Statement as described in paragraph (e)(2) of this section, the executor must file a supplemental Information Return with the IRS including all supplemental Statements and furnish a corresponding supplemental Statement to each affected beneficiary by the due date described in paragraph (e)(4) of this section.
>
> (2) Adjustments requiring supplement. Except as provided in paragraph (e)(3) of this section, an adjustment to which the duty to supplement applies is any change to the information required to be reported on the Information Return or Statement that causes the information as reported to be incorrect or incomplete. Such changes include, for example, the discovery of property that should have been (but was not) reported on an estate tax return described in section 6018, a change in the value of property pursuant to an examination or litigation, or a change in the identity of the beneficiary to whom the property is to be distributed (pursuant to a death, disclaimer, bankruptcy, or otherwise). Such changes also include the executor's disposition of property acquired from the decedent or as a result of the death of the decedent in a transaction in which the basis of new property received by the estate is determined in whole or in part by reference to the property acquired from the decedent or as a result of the death of the decedent (for example as the result of a like-kind exchange or involuntary conversion). Changes requiring supplement pursuant to this paragraph (e)(2) are not inconsequential errors or omissions within the meaning of § 301.6722-1(b) of this chapter.

Those items exempt from the supplemental reporting mandate are found in proposed regulation §1.6035-1(e)(3)—and the list is not terribly long:

> (3) Adjustments not requiring supplement -- (i) In general. A supplemental Information Return and Statement may but they are not required to be filed or furnished --
>
> (A) To correct an inconsequential error or omission within the meaning of § 301.6722-1(b) of this chapter, or

> (B) To specify the actual distribution of property previously reported as being available to satisfy the interests of multiple beneficiaries in the situation described in paragraph (c)(3) of this section.

The second exception is one we already noted (when the executor finally distributes property to the beneficiary where the basis of assets available had been disclosed), so the inconsequential error is the one we'll look at in more detail.

This exception references existing regulation §301.6722-1(b), which discusses a failure to furnish correct payee statements. There is a limited exception found there that provides the following:

> In general. An inconsequential error or omission is not considered a failure to include correct information. For purposes of this paragraph (b), the term "inconsequential error or omission" means any failure that cannot reasonably be expected to prevent or hinder the payee from timely receiving correct information and reporting it on his or her return or from otherwise putting the statement to its intended use. [Reg. §301.6722-1(b)(1)]

However, the regulation goes on to note that some errors can never be an inconsequential error or omission. Regulation §301.6722-1(b)(2) provides the following:

> (2) Error or omission that are never inconsequential
>
> Errors or omissions relating to the following are never inconsequential:
>
> (i) A dollar amount,
>
> (ii) The significant items in the address of a payee, which is the address provided by the payee to the filer,
>
> (iii) The appropriate form for the information provided (i.e., whether or not the form is an acceptable substitute for an official form of the Internal Revenue Service), and
>
> (iv) The manner of furnishing a statement required under sections 6042(c), 6044(e), 6049(e), and 6050N(b). The Internal Revenue Service may, by administrative pronouncement, specify other types of errors or omissions that are never inconsequential.

The rules also can impact the recipient of the property if that person gifts or otherwise transfers the property to another related party where the recipient's basis is determined in whole or in part by the transferor's basis. Proposed regulation §1.6035-1(f) examines this situation.

The rule begins with the following:

> If all or any portion of property that previously was reported or is required to be reported on an Information Return (and thus on the recipient's Statement or supplemental Statement) is distributed or transferred (by gift or otherwise) by the

> recipient in a transaction in which a related transferee determines its basis, in whole or in part, by reference to the recipient/transferor's basis, the recipient/ transferor must, no later than 30 days after the date of the distribution or other transfer, file with the IRS a supplemental Statement and furnish a copy of the same supplemental Statement to the transferee. The requirement to file a supplemental Statement and furnish a copy to the transferee similarly applies to the distribution or transfer of any other property the basis of which is determined in whole or in part by reference to that property (for example as the result of a like-kind exchange or involuntary conversion). [Prop. Reg. §1.6035-1(f)]

Thus, if a child receives property from a parent's estate and then, 10 years later, gifts that property to her son, the child will need to file a Form 8971 to supplement their parent's original Form 8971, now reporting the property is in the hands of the grandchild of the original decedent.

If the original recipient transfers the property before the estate is required to file a Form 8971, the original recipient still must file this form but has a more limited reporting responsibility. The proposed regulation continues with the following:

> In the case of a supplemental Statement filed by the recipient/transferor before the recipient/transferor's receipt of the Statement described in paragraph (a) of this section, the supplemental Statement will report the change in the ownership of the property and need not provide the value information that would otherwise be required on the supplemental Statement. [Prop. Reg. §1.6035-1(f)]

In some cases, the basis of the property will have changed because the property was distributed to the beneficiary (such as if the property has been subject to depreciation). In that case, the transferor still must report the original basis received from the estate but can provide information on the adjustment as noted:

> If the transferor chooses to include on the supplemental Statement provided to the transferee information regarding any changes to the basis of the reported property as described in § 1.1014-10(a)(2) that occurred during the transferor's ownership of the property, that basis adjustment information (which is not part of the requirement under section 6035) must be shown separately from the final value required to be reported on that Statement.

In a case when the transfer occurs before a final value is set, the following provisions apply to push future notifications back on the executor who now will send future reports to the new holder of the property:

> In the event the transfer occurs before the final value is determined within the meaning of proposed § 1.1014-10(c), the transferor must provide the executor with a copy of the supplemental Statement filed with the IRS and furnished to the transferee in order to notify the executor of the change in ownership of the property. When the executor subsequently files any Return and issues any Statement required by paragraphs (a) or (e) of this section, the executor must provide the Statement (or supplemental Statement) to the new transferee instead of to the transferor.

Consistent Basis Reporting by Beneficiary Rules (Proposed Regulation §1.1014-10)

The other key issue involves the basis reporting by the beneficiary. Generally, a beneficiary who receives property from an estate takes over a fair market value under IRC §1014 that is either tied to the date of death or, if applicable, the alternate valuation date. Congress has now added a consistency requirement to reporting, backing it up with an accuracy related penalty should a beneficiary report a higher basis than was claimed by the estate.

The general consistent basis rule is described in proposed regulation §1.1014-10(a)(1):

> (a) Consistent basis requirement -- (1) In general. The taxpayer's initial basis in property described in paragraph (b) of this section may not exceed the property's final value within the meaning of paragraph (c) of this section. This requirement applies whenever the taxpayer reports a taxable event with respect to the property to the Internal Revenue Service (IRS) (for example depreciation or amortization) and continues to apply until the property is sold, exchanged, or otherwise disposed of in one or more transactions that result in the recognition of gain or loss for Federal income tax purposes, regardless of whether the owner on the date of the sale, exchange, or disposition is the same taxpayer who acquired the property from the decedent or as a result of the decedent's death.

Property that is subject to this rule is generally described in proposed regulation §1.1014-10(b)(1), which provides the following:

> (b) Property subject to consistency requirement -- (1) In general. Property subject to the consistency requirement in paragraph (a)(1) of this section is any property that is includable in the decedent's gross estate under section 2031, any property subject to tax under section 2106, and any other property the basis of which is determined in whole or in part by reference to the basis of such property (for example as the result of a like-kind exchange or involuntary conversion) that generates a tax liability under chapter 11 of subtitle B of the Code (chapter 11) on the decedent's estate in excess of allowable credits, except the credit for prepayment of tax under chapter 11.

However, there is a broad exclusion for property for which a change in the reported value on the Form 706 would not have changed the estate tax.

This exclusion is described in proposed regulation §1.1014-10(b)(2) as follows:

> (2) Exclusions. For purposes of paragraph (b)(1) of this section, property that qualifies for an estate tax charitable or marital deduction under section 2055, 2056, or 2056A, respectively, does not generate a tax liability under chapter 11 and therefore is excluded from the property subject to the consistency requirement in paragraph (a)(1) of this section. For purposes of paragraph (b)(1) of this section, tangible personal property for which an appraisal is not required under § 20.2031-6(b) is deemed not to generate a tax liability under chapter 11 and therefore also is

> excluded from the property subject to the consistency requirement in paragraph (a)(1) of this section.

Also, an exception is provided for a true “no tax” estate even if there is a requirement that the estate file an estate tax return. Proposed regulation §1.1014-10(b)(3) provides the following:

> (3) Application. For purposes of paragraph (b)(1) of this section, if a liability under chapter 11 is payable after the application of all available credits (other than a credit for a prepayment of estate tax), the consistency requirement in paragraph (a)(1) of this section applies to the entire gross estate (other than property excluded under paragraph (b)(2) of this section) because all such property contributes to the liability under chapter 11 and therefore is treated as generating a tax liability under chapter 11. If, however, after the application of all such available credits, no tax under chapter 11 is payable, the entire gross estate is excluded from the application of the consistency requirement.

The proposed regulations also address the issue of when the basis of an asset is modified by operation of the IRC. Some commentators had expressed concern that the provision as written suggested that no such basis adjustments would be allowed for inherited property subject to the consistency requirement.

In proposed regulation §1.1014-10(a)(2), the IRS allows for such changes, providing the following:

> (2) Subsequent basis adjustments. The final value within the meaning of paragraph (c) of this section is the taxpayer's initial basis in the property. In computing at any time after the decedent's date of death the taxpayer's basis in property acquired from the decedent or as a result of the decedent's death, the taxpayer's initial basis in that property may be adjusted due to the operation of other provisions of the Internal Revenue Code (Code) governing basis without violating paragraph (a)(1) of this section. Such adjustments may include, for example, gain recognized by the decedent's estate or trust upon distribution of the property, post-death capital improvements and depreciation, and post-death adjustments to the basis of an interest in a partnership or S corporation. The existence of recourse or non-recourse debt secured by property at the time of the decedent's death does not affect the property's basis, whether the gross value of the property and the outstanding debt are reported separately on the estate tax return or the net value of the property is reported. Therefore, post-death payments on such debt do not result in an adjustment to the property's basis.

What about the issue when property was either omitted from the estate tax return or discovered after the return was filed? The IRS has determined the consistency rules still apply—and if taxpayers and executors aren’t careful, that basis will become zero.

Proposed regulation §1.1014-10(c)(3) provides for dealing with this property.

If the error is discovered and an original or supplemental Form 706 is filed with the IRS before the expiration of the statute of limitations on the assessment of estate tax against the estate, then the standard supplemental or original reporting rules apply. Therefore, the beneficiary's basis will be tied to the basis reported by the estate [Prop. Reg. §1.1014-10(c)(3)(i)(A)].

If the error is discovered after the statute of limitations period has expired on assessing estate tax against the estate, then the result is that the basis of this unreported property becomes zero in the hands of the beneficiary [Prop. Reg. §1.1014-10(c)(3)(i)(A)]. Note that this opens up a number of issues regarding the IRS challenging long after the fact whether, for instance, property held in a family's limited partnership should have been brought back into the estate under the retained life estate provisions of IRC §2036.

If no estate tax return was filed, but the newly discovered property would have required a return to be filed, the basis of the property will be set to zero as an incentive file on the potentially very late Form 706. Proposed regulation §1.1014-10(c)(3)(ii) provides the following:

> (ii) No return under section 6018 filed. If no return described in section 6018 has been filed, and if the inclusion in the decedent's gross estate of the after-discovered or omitted property would have generated or increased the estate's tax liability under chapter 11, the final value, for purposes of section 1014(f), of all property described in paragraph (b) of this section is zero until the final value is determined under paragraph (c)(1) or (2) of this section. Specifically, if the executor files a return pursuant to section 6018(a) or (b) that includes this property or the IRS determines a value for the property, the final value of all property described in paragraph (b) of this section includible in the gross estate then is determined under paragraph (c)(1) or (2) of this section.

Form 8971

The latest version of Form 8971 (January 2016) and the related Schedule A are reproduced on the following pages.

Form **8971** (January 2016) Department of the Treasury Internal Revenue Service

Information Regarding Beneficiaries Acquiring Property From a Decedent

► Information about Form 8971 and its separate instructions is at *www.irs.gov/form8971*.

OMB No. 1545-2264

Check box if this is a supplemental filing ☐

Part I Decedent and Executor Information

1 Decedent's name	2 Decedent's date of death	3 Decedent's SSN
4 Executor's name (see instructions)	5 Executor's phone no.	6 Executor's TIN

7 Executor's address (number and street including apartment or suite no.; city, town, or post office; state or province; country; and ZIP or foreign postal code)

8 If there are multiple executors, check here ☐ and attach a statement showing the names, addresses, telephone numbers, and TINs of the additional executors.

9 If the estate elected alternate valuation, indicate the alternate valuation date: ____________

Part II Beneficiary Information

How many beneficiaries received (or are expected to receive) property from the estate? ________ For each beneficiary, provide the information requested below. If more space is needed, attach a statement showing the requested information for the additional beneficiaries.

A Name of Beneficiary	B TIN	C Address, City, State, ZIP	D Date Provided

Notice to Executors:

Submit Form 8971 with a copy of each completed Schedule A to the IRS. To protect privacy, Form 8971 should not be provided to any beneficiary. Only Schedule A of Form 8971 should be provided to the beneficiary. Retain copies of all forms for the estate's records.

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, all information reported herein is true, correct, and complete.

Signature of executor | Date

May the IRS discuss this return with the preparer shown below? See instructions . . . . ☐ Yes ☐ No

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ►			Firm's EIN ►	
Firm's address ►			Phone no.	

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 37794V Form **8971** (1-2016)

Form 8971 (1-2016)

SCHEDULE A—Information Regarding Beneficiaries Acquiring Property From a Decedent

▶ **Information about Form 8971 (including Schedule A) and its separate instructions is at *www.irs.gov/form8971*.**

Check box if this is a supplemental filing ☐

Part 1. General Information

1 Decedent's name	2 Decedent's SSN	3 Beneficiary's name	4 Beneficiary's TIN

5 Executor's name	6 Executor's phone no.

7 Executor's address

Part 2. Information on Property Acquired

A Item No.	B Description of property acquired from the decedent and the Schedule and item number where reported on the decedent's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. If the beneficiary acquired a partial interest in the property, indicate the interest acquired here.	C Did this asset increase estate tax liability? *(Y/N)*	D Valuation Date	E Estate Tax Value *(in U.S. dollars)*
1	Form 706, Schedule ______________ , Item __________ Description —			

Notice to Beneficiaries:

You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

Page A-1

Form 8971 (1-2016)

SCHEDULE A—Continuation Sheet

Use only if you need additional space to report property acquired (or expected to be acquired) by the beneficiary.

Check box if this is a supplemental filing ☐

Part 1. General Information

1 Decedent's name	2 Decedent's SSN	3 Beneficiary's name	4 Beneficiary's TIN
5 Executor's name			6 Executor's phone no.
7 Executor's address			

Part 2. Information on Property Acquired

A Item No. *(continue from previous page)*	B Description of property acquired from the decedent and the Schedule and item number where reported on the decedent's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. If the beneficiary acquired a partial interest in the property, indicate the interest acquired here.	C Did this asset increase estate tax liability? *(Y/N)*	D Valuation Date	E Estate Tax Value *(in U.S. dollars)*

Notice to Beneficiaries:

You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

Page A-2

COMMUNITY PROPERTY

Community property provisions exist in a minority of jurisdictions in the United States (following is a complete list). For the most part, the provisions exist in states that trace their colonial history back to Spanish rule (or, in the case of Louisiana, French) and the basic rules in those states tend to be based on the rules of the applicable nation.

This method of handling marital property is substantially different from the regimes in place in the other states. Advisers must be aware of the impact of community property when dealing with property passing into trusts or estates. Because there is no federal property law, community property laws impact taxes because they define the ownership of items of income and property.

General Operation

While every community property jurisdiction has its own set of specific rules, some general comments can be discussed.

The rules commonly govern all property acquired through the efforts of either spouse (or domestic partners in some states) during a valid marriage or registration. This is true even if the efforts of only one spouse were involved. For example, in a household where only one spouse works, the property acquired during the marriage is generally shared equally between the couple. The property is deemed owned by the marital (or domestic partnership) community, with each member generally having an undivided one-half interest in such property.

Some property is not treated under community property rules. Such property is generally referred to as *separate property* and is treated as the sole property of one spouse or partner. Some items that usually are treated as separate property include:

- property acquired by gift or inheritance, and
- property acquired before marriage or registration.

Care must be taken, though, because such property can lose its status as separate property if not properly handled. Community property jurisdictions generally impose a presumption that all property is community unless clearly shown not to be such property.

This presumption gives rise to the issue known as *commingled property*, which can serve to, for all practical purpose, change separate property into community property (referred to in many jurisdictions as *quasi-community property*). Property is typically considered *commingled* if it is impossible to separate out the portions of the account or similar mixed structure that represents separate property.

Whether property is considered community property or separate property can have significant consequences both for estate tax purposes and for purposes of dividing the marital property in a divorce. If a taxpayer has property that is separate property and the taxpayer wishes to retain that status, consultation with counsel that is skilled in community property issues in the jurisdiction in question is highly recommended.

Community Property Jurisdictions

With some differences, the following states are community property jurisdictions:

- Arizona
- California
- Idaho
- Louisiana
- Nevada
- New Mexico
- Texas
- Washington
- Wisconsin

There are general similarities in the laws in different groups of states. For instance, California's rules tend to form the basis of the laws (although with minor differences specific to each state) of Arizona, Idaho, Nevada, Wisconsin, and Washington. Texas and New Mexico also have very similar laws. Louisiana's provisions are the most unique, largely because the community property laws there derive from the French rather than Spanish variant of community property rules.

Value Included in Estate

One half the value of community property is reported in the estate of the deceased spouse.

Special Basis Rule

Both the surviving spouse's share of community property and the decedent's share are treated as property acquired from the decedent. If permitted by federal law, both shares of community property get a stepped-up basis, even though only one half is included in the estate [IRC §1014(b) (6)].

Note that the step-up is specifically limited to property held as community property with a surviving spouse. Therefore, if property is community in nature but is held by individuals who are in a domestic partnership in a state that provides community property rules apply to domestic partners, that property will not get a dual step-up upon the death of one partner.

Under Revenue Ruling 2013-17 such individuals are not treated as married for federal tax purposes. That is true regardless of whether the individuals are same-sex or opposite-sex individuals who are members of the partnership.

In most community property jurisdictions, the spouses have the right to retitle property out of community property status. Care must be taken to ensure property does not accidentally get retitled in a form that is not community property under the laws of the state in question. That is because such property will not get the double basis step-up on the death of the first spouse.

For instance, in many states, joint tenancy property is not considered community property. Rather, many community property states offer a status that is known as *community property with right of survivorship* that is meant to stand in for joint tenancy when the property is meant to retain its community property status.

Most often, advisors will encounter this problem when clients have previously lived in a non-community property state or deal with a financial advisor who has come from such a non-community property state. In those states, spouses often hold property in joint tenancy with right of survivorship to simplify administration of the estate after the first spouse dies. Such "normal practices" can have serious unintended consequences in a community property state resulting in a loss of basis to the surviving spouse.

Effect of Premarital and Postnuptial Agreements

Spouses may execute an agreement to treat all property, however acquired, as community property, separate property, or joint ownership with right of survivorship.

Reporting of Income by Estate of Deceased Spouse

The surviving spouse's share of community property is not part of the estate of the deceased spouse. This will mean that much of the income will have to be split between the surviving spouse's share and the share that is allocable to the decedent's estate. This situation will continue usually until the assets are formally divided between those being retained by the surviving spouse and those that go into the estate of the spouse who passed away.

Expenses paid or incurred and administration of a community property estate, not deductible by the estate because they are attributable to the surviving spouse's share of community property, may be deducted on the surviving spouse's personal Form 1040 as investment expenses if they otherwise qualify.

Unit 3

Retirement Plans

LEARNING OBJECTIVES

- List the issues that arise upon the death of the employee/IRA account holder
- Compare and contrast the options available to beneficiaries for an inherited retirement account interest
- Describe the special provisions that apply to interests passing to the decedent's spouse

RETIREMENT ACCOUNTS AND THE DECEDENT

A number of retirement account issues emerge when an individual passes. The nature of each account is important in helping heirs to determine what benefits may be available, as well as how their disposition is determined.

As was noted in the earlier unit, these benefits are generally nonprobate assets. That is, the account provides for a beneficiary, and that beneficiary designation (not the will or the revocable living trust) determines who should receive the benefit unless the will or revocable trust is named as the beneficiary.

Also, these assets are administered by a plan administrator (in the case of employer-provided retirement benefits) or a custodian (in the case of an IRA). There, entities retain control of the assets pending a resolution of who is the beneficiary.

Employer Retirement Accounts

Many employers offer some form of retirement benefits to their employees and, in many cases, those benefits will survive the passing of the individual employee.

This was not necessarily always the case, nor does it have to be today. "Traditional" employer retirement plans were of the defined benefit variety. In those plans, the employee received a payout per month, generally for life that began upon retirement. That payment was most often tied in some way to a formula that was based upon earnings (average, high years, etc.) and years of service with the plan sponsor as an employee. The most common example of a defined benefit plan is a pension.

In some cases, the annuity was a joint and survivor (or joint and a lower percentage for the survivor), but in other cases it was purely a single life annuity. Such a retirement plan expired at the same time as the decedent and generally offered (aside from potentially a benefit for a surviving spouse) no real issues once the decedent passed, apart from notifying the payor.

More recently, there has been a massive shift to defined contribution retirement plans. These do not provide for a set benefit to pay that is computed via formula—rather, the beneficiary has a separate account balance that is tracked for her, with earnings allocated back to that account. Common examples of defined benefit plans are 401K plans, SIMPLE plans, and SEP IRAs.

Upon reaching retirement, the employee may have an option to purchase an annuity, which could be the simple life annuity type structure that would have come from a defined benefit plan, but this time with a payment based on what the balance will buy based on the employee's various risk factors to the insurance carrier issuing the policy. However, the employee typically also can have amounts distributed from time to time or take a full distribution and roll the balance to an IRA.

Such plans, if not exhausted by participant distributions prior to the death of the participant, will have a balance available at the death of the participant that survives that person and passes to a named beneficiary.

Such inherited funds will still be taxable, just as if paid to the participant, because such distributions are considered IRD under IRC §691 [see PLR 9253038].

A key factor with employer-sponsored retirement plans is that most—aside from single participant plans—are governed by federal law [e.g., the Employee Retirement Income Security Act of 1974 (ERISA)]. Another key factor to keep in mind is that, under ERISA, the federal benefit law overrides any potentially contrary state law governing the benefit—a concept known as *ERISA pre-emption* under the law.

ERISA provides protection for such retirement accounts from the claims of creditors due to the anti-alienation provisions of the law. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) generally expanded that protection to such funds when transferred out to rollover IRAs. But, as we'll discuss briefly, in the 2014 case of *Clark v. Rameker*, 113 AFTR 2d ¶2014 889, the U.S. Supreme Court indicated that such protections for the IRA will not apply to inherited IRAs.

Individual Retirement Accounts

Individual retirement accounts and their close relative, individual retirement annuities, generally referred to by the acronym IRAs, were initially adopted as an option for individuals who did not have access to an employer-sponsored retirement plan to provide for their own retirement.

Under the original law, the contributions were limited to $2,000 per year, and an individual could only contribute in a year in which they were not covered by any employer-sponsored plan. In 2020, the contribution limit is $6,000 (with a $1,000 catch-up contribution for those 50 or older).

Over time, the law was changed to provide for increased contributions, as well as dropping the requirement that an individual could not be covered by an employer plan to make a contribution (though eventually the law would restrict the deduction of such contributions for those covered by a plan based on their adjusted gross income).

Moreover, the IRAs were used to allow individuals to park retirement funds from employer plans when they qualified for a full distribution from the plans—the acceptance of a rollover. Also, such amounts could be rolled from IRAs into employer plans. Initially, such IRA-to-plan rollovers were restricted only to funds coming from IRAs that had only received contributions via employer rollovers (what were called *conduit IRAs* by most professionals), though that restriction was later removed from the law.

BAPCPA provided that up to $1 million of funds held in an IRA are exempt from the claims of creditors. Additionally, amounts rolled over from a retirement plan into a rollover IRA will be fully exempt from creditors, even if the amount exceeds $1 million.

But this protection does not survive death—at least for nonspouse beneficiaries. In the case of *Clark v. Rameker*, 113 AFTR 2d ¶2014 889 (2014), the U.S. Supreme Court held that an inherited IRA ceases to be retirement funds of the type protected by the 2005 act and so are available to satisfy creditor's claims against the party that inherits the account.

The ruling dealt with an account passing to a nonspouse beneficiary, so it's not clear at this point whether an amount passing to a spouse who elects to treat the account as her own would be protected—and whether that spouse must make the election in order to obtain the protection.

What is clear is that legal counsel should be sought if asset protection is required regarding the disposition or handling of any IRA account balances.

Traditional IRAs

The original IRAs were traditional IRAs and, in the beginning, their tax treatment was very straightforward. The only funds that were contributed to them were funds for which a deduction was allowed for federal income tax purposes, so any distributions from the account were always 100% taxable to the recipient, as the recipient had zero tax basis in the account.

These amounts are also considered IRD under IRC §691 [See PLR 9237020]. What that means is that the death of the beneficiary does not create basis under the standard provisions of §1014 to render any distributions nontaxable.

EXAMPLE

Mary inherits IBM stock which her father had paid $10,000 for from her father at his passing. She sells it immediately after his passing at the value it had at the time he died, $100,000. Under the standard rules of §1014, Mary's basis steps up to $100,000 when the stock in inherited, so there is no income tax to be paid when she immediately sells it for that price.

Mary also inherited her father's IRA which was also worth $100,000 when died. All contributions to the IRA were deductible, so her father had no basis in the IRA. Mary cashes this account out as well immediately after her father's death.

In this case, §691 requires Mary to pay tax on the $100,000 income that would have been triggered if her father had received the distribution. The basis rules of §1014 are overridden by the IRD rules of §691.

Had Mary's father made nondeductible contributions to the IRA and had basis in the account, Mary would have taken over that amount as her basis in the account. The basis would not have been taxable when she cashed in the IRA, but the remaining amount would still have been IRD.

Congress eventually added rules that provided that an individual who was a participant in an employer-sponsored retirement plan would be restricted not in what he could contribute to an IRA, but rather in what he could deduct with regard to that contribution. Now in 2020, almost anyone can contribute up to $6,000 to an IRA. Under IRC §408(o) though, such amounts may be considered nondeductible IRA contributions and reported on Form 8606. In that case, the individual will have basis in his IRA account equal to the aggregate amount of nondeductible contributions made.

Both deductible and nondeductible contributions can be made to the same IRA and, for recovery of basis purposes, all of the individual's IRAs are treated as one. Under IRC §408(d)(2), every distribution is considered to carry out a prorated portion of the basis of the individual's IRA accounts. This means that in order to fully recover the taxpayer's basis, a taxpayer must take a distribution of all balances in all IRAs.

Roth IRAs

Former Senator William Roth, at the time, chairman of the Senate Finance Committee, in 1998 championed the creation of an additional form of IRA account that bears his name [IRC §408A]. The Roth IRA differs from the traditional IRA in that no deduction is ever allowed for a contribution to the account.

The maximum contribution amount is tied to the maximum contributions allowed for traditional IRA contributions. Also, a contribution to a Roth IRA reduces the amount that can be contributed to a traditional IRA on a dollar for dollar basis, and the reverse is true as well [IRC §408A(c)].

In exchange for not taking a deduction, though, the individual has the chance to not only escape tax on the distributions related to the contributions that were made but, unlike the traditional nondeductible IRA, also escape tax on the earnings inside the account.

The Roth IRA does have some limitations not found for traditional IRAs. First, no contribution for any year in which a taxpayer's adjusted gross income exceeds certain limits, and the amount of the contribution phases out as the taxpayer's income approaches those limits [IRC §408A(c)(3)].

Second, distributions are taxed under a different set of rules depending upon whether they are qualified or nonqualified distributions.

A qualified distribution is entirely nontaxable when received by the taxpayer. A qualified distribution is one which is both:

- made:
  - on or after the individual reaches age 59½;
  - to a beneficiary or the owner's estate following the owner's death;
  - after the owner become disabled as defined in IRC §72(m)(7); or
  - for a qualified first time homebuyer expense as defined at IRC §72(t)(2)(F); and
- made after the expiration of the five-year holding period [IRC §408(d)(2)].

The five-year holding period begins with the first tax year in which the individual makes a contribution to an IRA established for the individual [IRC §408A(d)(2)(B)].

If the individual dies before the five-year holding period is established, the running of that period continues for that account, independent of any five-year holding period for the successor beneficiary on her own Roth IRA accounts [Reg. §1.408A-6, Q&A 7(b)].

If a surviving spouse elects to treat the interest in his deceased spouse's Roth IRA of which he was named a beneficiary as his own, the five-year period will end on the earlier of:

- the expiration of the five-year period for the decedent's Roth IRA; or
- the expiration of the five-year period for the spouse's own Roth IRA [Reg. §1.408A-6, Example 7(b)].

If the contribution is not a qualifying contribution, then the distributions are deemed first to come from the owner's contributions to the Roth IRA [Reg. §1.408A-6, Q&A 1(b)]. Note this is significantly different than the treatment for a nondeductible traditional IRA, though in both cases it will be the earnings that are deemed taxable.

In addition to contributing to a Roth IRA, an individual may elect to convert the balance in a traditional IRA to a Roth IRA [IRC §408A(d)(3) (C)]. Prior to 2010, a conversion was limited only to taxpayers whose adjusted gross income was $100,000 or less and who did not file with a married filing separate filing status. However, those caps have been removed in their entirety.

Assuming the five-year period is allowed to pass before any distributions are made (which have happened prior to the death of the account holder), distributions to a beneficiary following death will not be subject to income taxation. Therefore, the Roth IRA also gets around the complication of the IRD rules of §691 that cause issues (and confuse heirs) for traditional IRAs.

REQUIRED MINIMUM DISTRIBUTION RULES

In order to understand the issues when dealing with IRAs and retirement plans in an estate, the CPA must have a solid understanding of the basic retirement plan distribution and beneficiary designation rules.

In this section, we'll begin with the basic rules and then expand out from there.

Required Minimum Distribution (RMD) Provisions Prior to the Death of the Beneficiary

Beginning at age 59½ a taxpayer may begin to take distributions from an IRA or an employer-sponsored retirement plan without the risk of triggering the 10% additional tax on premature distributions. A special rule applies to participants in employer-sponsored plans who separate from the employer's service after age 55, but it is important to note that rule does not apply to IRA accounts, nor if the employee has not separated from service.

Regardless of whether the individual has taken payments earlier, the RMD rules come into play generally when an individual attains age 70½ [IRC §409(a)(9), §408(a)(6), §408(b)(3)]. A Roth IRA is not subject to the minimum distribution rules until after the death of the owner of the account (or the spouse of the owner if she elects to treat the Roth IRA as her own) [IRC §408A(c)(5)].

Minimum required distributions must begin no later than April 1 of the year following the year a taxpayer attains age 70½, though they can be made before the end of the year the taxpayer turns age 70½. So if a taxpayer turns 70½ on January 1, 2020—or any day in 2020—he must begin RMD no later than April 1, 2021. While the first RMD will be for 2020, the taxpayer must take the 2021 distribution before December 31, 2021. In short, the taxpayer may end up taking two RMDs in the same tax year and declaring the taxable income for both distributions on his 2021 tax return.

Failure to take the RMD allows the IRS to assess a penalty of 50% of the amount by which distributions fell short of the minimum required. The penalty can be abated for reasonable cause and provided that reasonable steps are taken to correct the problem.

Any excess withdrawn above the RMD does not count toward a subsequent year's RMD, but does reduce the capital balance on which the RMD will be computed.

The RMD must be calculated for each IRA separately, and then totaled. The total RMD may be taken from one or any combination of IRAs.

This rule becomes important because the options for RMDs are different depending on whether or not the retirement account or IRA is "pay" status (that is, RMDs have begun) when the original participant or account holder dies.

One key issue to note is that if the account is pay status and the minimum distribution for the year had not been taken (or not completely taken) by the time the participant dies, the remaining balance of that year's RMD will need to be taken before December 31.

Death Prior to Entering Pay Status

To understand the options we'll look first at the issues involved when an IRA or retirement account holder dies before the required beginning date with a named beneficiary who is not the account holder's spouse.

As a general rule, the account holder's spouse can always accept the same result as if he was not the spouse—but being the spouse opens up additional alternatives that may serve to stretch out the IRA distributions over a longer period.

Because a Roth IRA does not have a required beginning date, it would always be in "pre-pay" status when the account owner dies.

A key fact to remember is that while these options are available, the actual plan document (for an employer plan) or the IRA custodial agreement (for an IRA) may set default options or limit the options for the participant.

As such, the documents related to the plan or IRA should be consulted in addition to the material noted following for use in planning actions related to the retirement accounts.

Life Expectancy (One Year) Rule

Under this rule, the requirement minimum distribution for the year following the year of death of the account owner will be based on the life expectancy of the designated beneficiary. If there are multiple beneficiaries, the life expectancy of the one with the shortest life expectancy will be used to compute the payout for the entire account [Reg. §1.401(a)(9) 5, Q&A 7(a)(1)].

Only individuals may be designated beneficiaries under these rules. If even a single beneficiary is not an individual as of the September 30 measuring date described in the following (e.g., a charity or most trusts), the account is treated as having no designated beneficiary, even though there may be individual beneficiaries. Without a designated beneficiary, the life expectancy rule described in this section is not available for the account [Reg. §1.409(a)(9) 4, Q&A 3].

EXAMPLE

Dave leaves 95% of his IRA to his son, Wayne, and 5% to a local charity. In this case, the IRA has no designated beneficiary, since the charity is not an individual. This will foreclose the use of the life expectancy rule.

The IRC provides that the life expectancy rule is the rule to be used if the plan does not specify (or allow the election to use) another rule and the participant has a designated beneficiary (measured as of September 30 of the year following the year of death) [Reg. §1.401(a)(9) 3, Q&A 4(a)].

The plan document may allow a choice of methods or may even require the use of the five-year rule even if the participant has a designated beneficiary [Reg. §1.401(a)(9) 3, Q&A 4(c)]. If such an election is allowed, it must be made no later than the earlier of:

- December 31 of the calendar year in which distributions would have to start to satisfy the requirements of the life expectancy distribution provision (normally the year after of death); or
- the end of the fifth calendar year following the year of the employee's death.

Because the election deadline date is most often the end of the year following the year of death of the participant, the life expectancy rule is sometimes referred to as the *one-year rule* (for the period during which an election must be made).

Let us consider an example of the use of this rule:

EXAMPLE

Joe dies on June 1, 2019 with an IRA account balance of $100,000. The account names Mary, his daughter, as his sole beneficiary. Joe had not yet passed his required beginning date at the time of his death. The IRA document is silent with regard to the distribution method.

On December 1, 2020, Mary comes to her CPA asking about how much has to be distributed out of the IRA. No distributions have been made at this point and the account retained its value of $100,000 as of December 31, 2019. Mary's life expectancy under the IRS tables is 20 years.

The RMD must be determined under the life expectancy rules. Thus the distribution is equal to the following:

$$\frac{\$100{,}000}{20\ years} = \$5{,}000$$

Mary must take this distribution by December 31, 2020.

Assume that the account also had named a charity as a 10% beneficiary. Mary pays out the $10,000 amount left to the charity in a distribution to the charity in June of 2020.

Because only eligible designated beneficiaries exist in the account at September 30, the life expectancy rules are used.

Assume all the same facts as in the first case except the IRA provides that the five- year rule must be used and the funds are in this IRA on September 30, 2020. In that case there is no required distribution that must be made by December 31, 2020.

However, the entire balance will need to be distributed by the end of 2024.

One item to note, which applies for all cases discussed in this section except where the spouse treats the IRA as her own, is that the distribution now switches to a single life calculation of life expectancy and is not recalculated annually. So, if the life expectancy of the designated beneficiary turns out to be 20 years, the account will be fully distributed over that 20-year period even if only RMD distributions are taken.

In the following year, one will be subtracted from the factor instead of going back to the table to recompute the individual's life expectancy. So for the second year in this case, the factor would be 19 years.

One other caveat is that if the spouse is the beneficiary but does not elect to treat the account as his own, the single life is recalculated annually until the spouse dies.

Also, if the owner had not passed his required beginning date, the spouse can delay distributions until the date in which the now deceased participant would have attained age 70½.

Five-Year Rule

The five-year rule is required to be used in a case where the participant did not have a designated beneficiary as of the September 30 date (which would include cases with a non-individual beneficiary of the account that would eliminate the ability for the account to have a designated beneficiary) or if the plan document requires that the five-year method be used [Reg. §1.401(a)(9) 3, Q&A 4].

Under the five-year rule, the entire balance in the account must be distributed by the end of the fifth calendar year following the employee's death [Reg. §1.401(a)(9) 3, Q&A 2].

EXAMPLE

In the previous example, Mary could hold the entire $100,000 along with any earnings in the account until 2024 and then withdraw the entire balance.

Furthermore, she could withdraw any or all of the account in the intervening years. But the entire balance will have to be paid out by end of 2024.

Inherited IRAs and Prohibition on Rollovers

Distributions made to anyone other than to an employee, an employee's surviving spouse, or an employee's former or current spouse under a qualified domestic relations order (QDRO) are not eligible for rollover treatment [Reg. §1.402(c)-2, Q&A 12(b)]. Specifically, balances in an inherited IRA are not eligible for this treatment [IRC §408(d)(3)(C)(i)].

What can be done are transfers from one custodian to another—that is a trustee-to-trustee transfer or a direct rollover of the account balance [Revenue Ruling 78-406].

EXAMPLE

Joe is upset with the IRA custodian, XYZ Bank, that held is father's IRA, which Joe became the beneficiary of upon his father's passing. He has the bank issue him a check directly from his father's IRA in the belief he then has 60 days during which he will be able to deposit those funds into an IRA with another custodian.

Joe is mistaken in that belief. The funds, once having "escaped" the inherited IRA can no longer be deposited into an account with another custodian. Thus, the entire distribution is taxable to Joe.

Instead of getting a check, Joe opens an account titled as an inherited IRA with ABC Brokerage and has the funds transferred directly from XYZ Bank to ABC Brokerage. This transfer meets the requirements of Revenue Ruling 78 406 and is not taxable to Joe.

Unfortunately, many taxpayers have read on the internet about the ability to borrow from an IRA if they return the funds within 60 days. Regardless of the general inadvisability of doing that on an account the taxpayer controls (if the money doesn't get back in, the IRS will almost certainly *not* grant a request for a late rollover, so the holder is playing a high stakes, no-mistakes-allowed game), the option is simply not available at all for an inherited IRA.

Death After Entering Pay Status

The rules change somewhat following a participant passing her required beginning date. Under these rules the five-year rule goes away, replaced now by a choice of life expectancy payouts.

As a result, if the participant had not taken her required distribution for the year in which she died, that distribution will be taken under the calculation that is applicable prior to the participant's death, paid out by the required distribution date to the name beneficiary (or beneficiaries) of the account.

Generally, the RMD is made based upon the longer of:

- the participant's remaining life expectancy at the date of death (as odd as that sounds); or
- the life expectancy of the designated beneficiary.

The participant's remaining life expectancy at death is based upon the single life (rather than the joint life with a presumed 10-year-younger beneficiary or, if a longer factor, a joint life expectancy with the participant's spouse), using the participant's age as of his birthday for the year of death [Reg. §1.401(a)(9)-5, Q&A 5(c)].

The life expectancy of the designated beneficiary who is not the participant's spouse is determined using that person's age as of his birthday for the year following the year of death of the participant [Reg. §1.401(a)(9)-5, Q&A 5(c) (1)].

If the designated beneficiary is the employee's spouse who does not elect to treat the account as her own, the factor is still a single life factor but it is recalculated each year through the spouse's death [Reg. §1.401(a)(9)-5, Q&A 5(c)(2)].

If there is no designated beneficiary, then the participant's life expectancy must be used.

EXAMPLE

Harry dies in March 2019 after beginning minimum distributions. He has named a trust that does not qualify for look-through status as the sole beneficiary of his IRA. The minimum distribution for 2019 will be based on Harry's single life for his age on his 2019 birthday (even if that birthday was after the date of his death).

For future years, the minimum distribution will be reduced by one each year.

Harry names his brother Jack as the beneficiary of the IRA. Harry's life expectancy based on his 2019 birthday is 10, while Jack's life expectancy based on his age upon his birthday in 2020 is 14. The 14 will be used for 2020 as the factor to determine the minimum required distribution to Jack. The 14 will be reduced by one each year for future distributions. But if Harry had not taken his minimum distribution for 2019 before he died, that distribution (which will be taken by Jack) will be based on the 10-year factor tied to Harry's life before switching to Jack's life expectancy in the following year.

Spouse as a Beneficiary

Special rules exist for dealing with a spouse who is the beneficiary of the retirement account.

Treating an IRA as the Spouse's Own Account

If the sole beneficiary of the IRA is the owner's surviving spouse, the spouse can elect to treat the IRA as her own account. To do so, the spouse must have the right to take unlimited withdrawals from the IRA account. A spouse cannot make this election if a trust is the beneficiary of the IRA, even if the spouse is the sole beneficiary of the trust [Reg. §1.408-8, Q&A 5(a)].

Once the election is made, the RMD rules are computed treating the spouse as the IRA owner for the year the election is made and for each subsequent year, unless the election is made in the year the owner dies. For that year, the RMD rules are governed by the rules applicable to the now deceased owner of the account [preamble to TD 8987].

If the spouse receives a distribution from an inherited IRA from her deceased spouse that the surviving spouse had not yet elected to treat as her own, the spouse may nevertheless roll the balance over within 60 days. Also, if the amount is received prior to the date the owner of the account would have turned 70½, no amount of the distribution is treated as an RMD solely for purposes of the rollover rules [preamble to TD 8987].

The spouse can make the election a number of ways:

- The spouse simply retitles the IRA in her name and not as an inherited IRA.
- The spouse fails to take a required RMD distribution under the inherited IRA rules.
- A contribution is made to the IRA.

A spouse who makes this election gains some advantages but may also face some disadvantages.

The primary advantage is that the spouse's RMDs are now governed by the owner's rules, which look not only to the single life expectancy of the surviving spouse but add on the assumed 10-year-younger beneficiary. Thus, distributions can be extended over a longer period.

A less significant advantage is that, as her IRA, the account may receive contributions and the spouse can combine this account with her own IRAs, simplifying the number of accounts to keep track.

Though not totally clear, it also seems likely that once the election is made the funds would again be retirement funds and subject to protection under BAPCPA. It should be noted, though, that the Supreme Court did not directly address this in its decision in the *Clark v. Rameker* case. It is possible that a creditor may try and argue that either the funds are available to it during the period immediately following death or that the funds cease to be retirement funds once an owner dies even if they are later treated by the tax law as the spouse's own IRA.

Rollover from Retirement Plan by Surviving Spouse

A surviving spouse receiving a distribution from a retirement plan is also eligible to roll the distribution into a retirement plan if the distribution would have been eligible had the surviving spouse been the plan participant [IRC §409(c)(9)].

The rollover can be made to any eligible plan—thus in addition to placing the funds in an IRA (the most often seen rollover), the surviving spouse, if an eligible participant in a plan, may also roll the balance over to employer-sponsored plans (plans under §§401(a), 403(a), 403(b) or 457).

Nonspouse Trustee-to-Trustee Transfers from Employer Plans to IRAs

A nonspouse beneficiary, while not eligible to rollover funds distributed from an employer-sponsored retirement plan to the beneficiary's own IRA, may nevertheless transfer funds in a trustee-to-trustee transfer from the deceased participant's balance in an employer plan to a new inherited IRA account [IRC §402(c)(11)(A)].

Normally, plans must offer nonspouse beneficiaries the option of a trustee- to-trustee transfer to an inherited IRA [IRC §401(a)(31)]. The law was clarified beginning in 2010 to make clear that a plan could not restrict this offering only to spouses of the deceased participant.

Remember, though, that these individuals must insure that there is a trustee-to-trustee transfer and not take a check from the plan. As was described earlier, once a nonspouse beneficiary takes a distribution, there's no way to put the funds back into a retirement account.

September 30 Rule

Selecting a beneficiary when RMDs begin is no longer critical. A taxpayer may now change beneficiaries at will, because choosing a beneficiary will have no impact on how fast the retirement account must be paid out during his lifetime or after death. In fact, the actual beneficiary does not even have to be determined until September 30 of the year following death.

That little proviso allows a primary beneficiary (such as a spouse) to disclaim the account in favor of a younger contingent beneficiary (such as a child or grandchild). The newly named beneficiary could then take RMDs from what's left in the retirement account over her life expectancy in that year [Reg. §1.409(a)-4, Q&A 4(a)]. Result? A significantly delayed payment of income taxes on the amount in the IRA.

Even more importantly, that provision allows for getting rid of (as in paying out their share) "problem" beneficiaries who have no life expectancy, such as a charitable organization.

The fundamental rule is that we can generally subtract beneficiaries (by paying them out or transferring their share to a separate IRA account) but not add beneficiaries between the day the owner dies and September 30 of the following year. In PLR 201021038, the IRS refused to respect a state court order, issued after the date the taxpayer died, that sought to retroactively modify a trust so that there would be designated beneficiaries, that order was not given retroactive effect when determining designated beneficiaries.

It is essential to make sure that these actions take place by September 30 of the year following the year of death—because the beneficiaries of the account at that date are those who will be pooled from which designated beneficiaries will be taken.

A special rule applies if a designated beneficiary dies before the September 30 testing date. If that interest is not disclaimed, the deceased individual will be treated as a beneficiary as of September 30 of the year following the year of death without regard to the successor beneficiary. That means the age of the original beneficiary, and not the age of his heir, will be used for the purposes of finding the beneficiary with the shortest life expectancy [Reg. §1.409(a)-4, A-4(c)].

Special Rules for Roth IRAs

Remember that Roth IRAs avoid the minimum distribution rules until the funds pass to a beneficiary who is not treated as the owner of the account. However, once the funds pass to a nonspouse beneficiary, there will be annual RMDs due from the account.

TRUSTS AND IRAS

As was discussed previously, generally a trust would not qualify as a designated beneficiary. However, if a trust meets certain requirements, the look-through rule will allow treating the beneficiaries of the trust, instead of the trust itself, as the beneficiaries for purposes of finding the designated beneficiary of the account.

In making the look-through determination, if the trust had beneficiaries who are not individuals (and thus not eligible to be treated as designated beneficiaries), even if they are only contingent beneficiaries, the trust will taint the account and it will not be treated as having a designated beneficiary [PLR 201021038].

To qualify for the look-through treatment, the following must be true:

- The trust must be valid under state law (or would be valid if funded).
- The trust must either be irrevocable or must become irrevocable upon the death of the participant.
- It must be possible to identify the beneficiaries.
- The trust must provide to the plan administrator documentation required under the documentation rules.

Such a trust is often referred to as a conduit trust.

All current and potential beneficiaries of the trust must be counted in making the determination if any unallowable beneficiaries exist. Thus, if the trust is allowed to accumulate funds, a determination must be made for all possible recipients of such funds. From a practical standpoint, this generally means that the distributions will need to flow through to the individual beneficiaries during their life in order to avoid issues with potentially disqualified contingent beneficiaries receiving accumulated funds.

For RMDs for inherited IRAs, by October 31 of the year following the year of death, the trustee must provide to the plan administrator or custodian:

- a copy of the trust document; or
- a final list of all beneficiaries of the trust as of September 30 of the year following the year of death and certify that the list is complete and that all requirements for a valid conduit trust are met and provide that the trust document will be made available upon request [Reg. §1.409A-4 Q&A 6(b)].

As a practical matter, often to ensure that a trust will qualify, a separate trust document will be drawn up that will be the conduit trust to which IRA funds will flow.

A reference book many in the field use for handling various issues with qualified plan and IRA planning, but especially with regard to trusts meant to be used as plan and IRA beneficiaries, is Boston attorney Natalie Choate's book, *Life and Death Planning for Retirement Benefits*, 8th Edition 2019.

Unit

4

Income Taxation of Estates and Trusts

LEARNING OBJECTIVES

- Apply the income tax law to estates and trusts
- Compute and understand the importance of distributable net income (DNI)
- Describe the conditions under which utilizing the 65-day distribution window might be advantageous
- List the implications of the tax on net investment income as it applies to trusts and estates

Death does not terminate income tax issues—rather, the income tax issues move on to the decedent's estate (or deemed estate) for income tax purposes. The taxation of estates for income tax purposes is governed by the rules that deal with fiduciary income tax returns in general.

Similarly, a byproduct of many estates is the creation of newly formed and longer-lived trust entities. These trusts may serve a tax purpose (e.g., bypass trusts) or may be created primarily for non-tax reasons (e.g., to provide an education fund for surviving grandchildren or to protect family assets from the survivor's creditors).

In this unit we will look at income tax issues impacting estates and trusts.

TAXATION OF ESTATES AND TRUSTS

A decedent's estate, for income tax purposes, is taxed under fiduciary rules very similar to the taxation of trusts. Also, trusts are often established as a primary tax planning vehicle or by operation of the estate planning documents.

For that reason we'll start out with a discussion of general trust taxation rules and then look at issues for estates in particular. Generally speaking, taxation of estates and trusts is largely the same as taxation of individuals. As a rule of thumb, if it is income for an individual, it is income for the estate or trust. If it is a deduction for an individual, it is a deduction for the estate or trust.

In order to give tax advice and provide compliance services to a trust or estate, you must not only be familiar with applicable state law, you must also read and understand the governing instrument. All state laws offer wide latitude to drafters of wills and trusts to permit expression of the settlor's or decedent's wishes. Some systems you will run into to handle the disposition of a decedent's assets will be quite complex.

Most often, UPAIA provides default treatment for various items as well as default responsibilities for the various parties, but those treatments may be overridden by explicit language in the governing document. In addition, the governing document will provide specific details on the various beneficiaries, under what conditions assets may be distributed to them, and specific duties and obligations of the trustee. In short, the will or trust instrument will generally dictate tax treatment.

Estates are created by the death of an individual, and accounting for the taxable income of an estate and reporting it in the income tax return of either the estate or a beneficiary is governed by state law unless there is a will. When there is a will, the terms of the will govern whether income is reported in the estate's tax return or in the return of one or more beneficiaries.

Revocable Trusts

A revocable trust is a trust established by a person, the grantor, who is both trustee and beneficiary while living. The grantor retains the right to revoke that trust—that is, transfer all assets back out of the trust and into the grantor's hands.

Such trusts will normally be subject to what are known as the *grantor trust* rules for federal income tax purposes. In essence, these rules provide that if the grantor retains too much control over the trust assets, they should still be treated as though they belong to the taxpayer. The grantor then shows the income and expenses from the grantor trust on her personal return. While a trust does not have to be revocable in order to be treated as a grantor trust, the possession of such a power will make the trust into a grantor trust for income tax purposes [IRC §676].

During the lifetime of the grantor, all income of such a trust is reported in the income tax return of the grantor. Upon the death of the grantor, such a trust becomes irrevocable and income will be distributed and reported based on the terms of the trust instrument.

For a revocable living trust, the following items can typically be said:

- The grantor is treated as owner.
- The trust can be changed, altered, or revoked at the grantor's discretion.
- The trust may remain unfunded until the grantor's death, although doing so often removes the major reason why many people adopt such trusts.

Quite often the revocable living trust serves as a stand-in of sorts for the issues traditionally dealt with in the individual's will. That is, it will deal with the disposition of the grantor's assets once he dies. A special will (a "pour over" will) is often adopted along with the trust that provides any assets that end up not titled in the name of the trust will be left to the trust on the grantor's death.

Some of the advantages of a revocable living trust include the following:

- Grantor retains control
- Assets held by trust before grantor's death escape probate
- Escape public disclosure
- Save time
- May receive assets at grantors death from "pour over" will and contain asset disposition instructions, preserving marital deduction, etc.
- Provide safeguard against senility or incapacity
- May be used to segregate community property
- Harder to challenge than a will

Disadvantages of the revocable living trust after death of grantor, if no election is made to combine with the decedent's estate include the following:

- Trust must use calendar year
- No section 1244 deduction
- Two year limit on S stock ownership
- Cannot claim some losses and deductions

Irrevocable Trust

An irrevocable trust is a trust established by a person, the grantor, appointing another person as trustee and, typically, designating other persons as beneficiaries. An irrevocable trust may be established during the lifetime of the grantor or created pursuant to the terms of a decedents will. The trust may be classified as simple or complex for income tax purposes or may even be treated as a grantor trust if the grantor, even though not allowed to revoke the trust, retained certain powers that trigger the grantor trust rules.

Often an irrevocable trust that ends up triggering the grantor trust rules is one that did so by design and is used frequently in estate planning. Such a trust is most often referred to as an IDGT and, while virtually ignored for income tax purposes, nevertheless is treated as being an effective transfer for estate tax purposes.

EXAMPLE

Laura sets up an irrevocable trust with her daughter as the income and corpus beneficiary. She transfers a portfolio of securities to this trust. The transfer is treated as a completed gift for estate purposes.

The trust provides that Laura can substitute assets of equal value for any assets in the trust without requiring the approval of the fiduciary. This retained right triggers the income tax grantor trust rules and the assets are treated, for income tax purposes only, as owned by Laura. Laura pays tax on all income and gains incurred by the trust on her personal return, even though she does not have a right to receive that income or withdraw corpus without putting in assets of equal value.

Laura is making what is, economically, an indirect t gift to her daughter of the income tax. That income tax burden is not borne directly by her daughter and, as well, the income tax escapes tax in Laura's estate since the funds simply won't be there.

Simple Trust

To be classified as a simple trust, the trust must both contain certain language mandating the distribution of trust income to the trust income beneficiary, and the trust also must not actually distribute any corpus during the year. Therefore, a trust can easily swap between simple and complex from year to year if the trust requires distribution of income but allows for the distribution of corpus [Reg. §§1.651(a) 1, 1.651(a) 2].

Technically, a trust is a simple trust for a year if it meets three requirements:

- The governing instrument requires all trust income to be distributed currently.
- The governing instrument does not provide that any amounts may be paid, permanently set aside, or used for charitable purposes.
- The trust makes no distributions other than those from current income [Reg. §1.651(a)-1].

A simple trust must be required to distribute all of its income currently to a designated beneficiary. The trustee/fiduciary has no discretion to retain income. However, most state trust statutes provide that capital gains are not income. So, absent an overriding provision in the trust document, that means capital gains are reported in a return of the trust, while such things as interest, dividends, and rents are reported to the beneficiary on a Form K-1.

If the trust does not meet all three requirements for the tax year, it is treated and taxed under the rules applicable to complex trusts.

The big difference in treatment is that a simple trust is given an income distribution deduction that is the lesser of:

- the income the trust required to distribute currently (even if not actually distributed due to administrative issues until the following year); or
- the trust's DNI—a special limitation defined in IRC §643 and computed on lines 1–6 of Schedule B of Form 1041.

The regulations contain some clarifications about whether the terms of a trust serve to require a current distribution of income.

The regulation provides the following:

> If the trust instrument provides that the trustee in determining the distributable income shall first retain a reserve for depreciation or otherwise make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the retention of current income for that purpose will not disqualify the trust from being a 'simple' trust. [Reg. §1.651(a)-2(a)]

However, the rules go on:

> If the terms of a trust require that none of the income be distributed until after the year of its receipt by the trust, the income of the trust is not required to be distributed currently and the trust is not a simple trust. [Reg. §1.651(a)-2(a)]

Then again, the same regulation notes:

> The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust's taxable year. For example: Under the terms of the trust instrument, all of the income is currently distributable to A. The trust reports on the calendar year basis and as a matter of practical necessity makes distribution to A of each quarter's income on the fifteenth day of the month following the close of the quarter. The distribution made by the trust on January 15, 1955, of the income for the fourth quarter of 1954 does not disqualify the trust from treatment in 1955 under section 651, since the income is required to be distributed currently. [Reg. §1.651-2(a)]

The tests are made based upon the operation of the law governing the trust agreement.

Complex Trust

Trusts that are neither grantor trusts nor simple trusts generally will be treated as complex trusts for tax purposes.

A trust allowing the trustee to retain income or distribute income to one or more income beneficiaries will, by definition, be a complex trust because it will fail the first criteria noted previously necessary for a trust to be treated as a simple trust.

Unless the trust instrument specifically directs otherwise, like the simple trust, capital gains will be reported in the fiduciary's tax return. Ordinary income items would also be reported in the fiduciary's tax return unless distributed to the beneficiaries.

Because the trustee has discretion, only income actually distributed to the beneficiary will open up the ability for the trust or estate to claim an income distribution deduction, unlike the case for the simple trust.

However, there is a special 65-day rule that allows the trust a short period to distribute income after the end of the tax year but elect to treat it as paid out during the year [IRC §663(b)].

Generally, a complex trust gets an income distribution deduction equal to the sum of:

- amounts of income required to be distributed currently under the trust's operating agreement; and
- any other amounts properly paid, credited, or required to be distributed [IRC §661(a)].
- For income tax purposes, a decedent's estate has its income distribution deduction computed under the complex trust rules noted previously.

Estates

Some special issues apply to an estate. Conceptually, an estate takes over the position of the decedent as owner of the various assets and rights to income upon the death of the decedent. This entity, therefore, has its own income tax filing responsibilities and faces potential income tax liabilities.

Taxable income of a decedent's estate includes all income from the decedents assets transferred to control of a fiduciary following the decedent's death. Income produced by those assets before the date of death is reported in the final Form 1040 of the decedent. Income produced by those assets after the date of death, but before distribution to a testamentary trust or to beneficiaries, is reported in a Form 1041 prepared by the fiduciary.

Because full ownership of jointly held property passes to the survivor at the moment of death, income from jointly owned property is not reported in Form 1041. Similarly, income from other property passing outside of probate will also bypass the estate income tax return. Such property will often include items such as retirement accounts (IRAs, employer plans, etc.) and annuities.

Similarly, if the property was held in a revocable trust prior to the grantor's death, that property bypasses the probate estate and, absent an election, will be reported as part of the trust's income and not as the income of the estate. However, certain revocable trusts are eligible to elect, with the consent of the executor/personal representative of the grantor's estate, to jointly report as part of the grantor's estate [IRC §645].

When Income Tax Returns are Due

The date of filing of the fiduciary return is the 15th day of the 4th month following the end of the entity's tax year.

A decedent's estate has complete flexibility in picking its fiscal year for tax purposes. The estate is not bound by the tax year stated in the letter which says that the IRS has assigned the estate a tax ID. Despite the fact that the Form SS-4 provides an entry for the fiscal year of the entity, the actual election of fiscal year is made by filing the first return for the estate or filing a request for an extension to file that first return on a timely basis.

The estate's first tax year may be any of 12 months or less that ends on the last day of any month. The first year must be 12 months or less, so generally you have to pick one of the months ending before the first anniversary of the decedent's passing.

EXAMPLE

Harry dies on April 22, 2019. Harry's estate can elect to use a March fiscal year, so that the first tax year won't end until March 31, 2020, and the first estate income tax return will not be due until July 15, 2020. The K-1s to beneficiary for their share of income (if any) to reported also will not be issued until that year end, and thus not taxable until 2020.

There are both advantages and disadvantages to selecting a non-calendar year end for the estate. One advantage is that the first return is delayed as long as possible. Similarly, its income is distributed to beneficiaries the taxation of which is also delayed.

However, doing this increases the complexity of the estate's return. Many personal representatives are not business people who are used to fiscal years, and as such, are likely to find the concept confusing. In turn, even though there is a deferral of income in the first year, any year in which the estate terminates errors may conduct with a bunching of income.

Trusts do not generally have this level of flexibility in selecting their fiscal year. A trust must adopt a calendar year unless it is a:

- tax-exempt trust (IRC Sec. 501(a),
- charitable trust (IRC Sec. 4947),
- grantor trust (IRC Secs. 671 – 679), or
- revocable trust merged with an estate pursuant to an election under IRC §645[IRC §644].

One of the key considerations in determining whether to make the election to merge the trust with the estate is the availability of the fiscal year election during the period of administration of the estate even if there is no probate estate because all assets work in the revocable trust.

A five and one-half month automatic extension is applied for using Form 7004, Application for Automatic Extension of Time to File Certain Business Income, Information, and Other Returns. [Reg. §1.6081-6].

INCOME TAXATION OF TRUSTS AND ESTATES—INCOME

Generally, trusts and estates are taxed much like individuals, though some modifications are made. Here we'll discuss the various types of income reported by a trust or estate.

Interest and Dividends—Lines 1 and 2a & 2b

The same rules that apply to an individual's interest and dividend income apply to trusts and estates. That includes the availability of the lower capital gains rate on qualified dividends received by the trust. Given the trusts and estates get to the 37% maximum rate very quickly, the benefit of the lower capital gains rate is very important here. That's true even though that rate now rises to 20% rather than 15%.

A decedent's final Form 1040 should report interest and dividends earned up to the date of death. Any dividends and interest received after that date should be reported on the return of the estate or, if applicable, the trust.

Note that because executors do not get an employer ID number the moment after someone passes (nor would we really expect them to do so), often there will be some portion of the interest or dividends that should be reported on the estate that will be found on the Form 1099 issued to the individual.

The return preparer should take care to ensure that these erroneously reported amounts are properly categorized on the tax returns for the decedent and the estate. In addition, the preparer should make sure that the items are properly disclosed in order to avoid IRS matching issues.

- Complete the return reporting income as it is reported to the decedent, the estate, or the trust
- Show amounts properly reported by other taxpayers as negative numbers on reporting schedule
- Attach a worksheet reconciling amounts reported in each return

As with an individual, municipal bond interest is not included in taxable gross income of an estate or trust. However, remember that the state with which the estate or trust files most likely will tax municipal bond interest that is paid from another state. Similarly, if distributions are made to beneficiaries, those distributions will carry out the nature of the municipal bond interest distributed. That may mean that interest, which would not be taxable in the decedent's state, will nevertheless be a taxable strike at the state level to the beneficiary who may reside in another state.

If municipal bond interest has been received by a trust or estate, then administrative expenses must be allocated between taxable and tax-exempt income just as is true for an individual.

This type of income does pose a very practical problem for us. The problem is that the due date for providing a Consolidated Form 1099 from brokerages to the trust or estate is now February 15. Even then, frequently a number of amended Forms 1099 are issued over the next couple of months.

The problem this presents is that a complex trust must make its distribution decision by the 65th day following the end of the tax year, or shortly after the initial Form 1099 receipt. Advisors may need to work from year-end statements, understanding that there likely will be differences with what is reported on the Form 1099 that will ultimately be received from the broker. But that should allow the fiduciary to attempt to make an informed decision about the impact of making or not making a distribution during the 65-day period and making the election.

Capital Gains and Losses—Line 4 (from Schedule D)

As with dividends and interest, the same rules that apply to an individual's capital gains apply to trusts and estates. The estate or trust reports capital gains and losses on Schedule D, Form 1041, which will enter onto that form either directly from a Form 1099-B on which the basis of securities has been properly reported, or from Forms 8949 on which the details of sales are reported.

Details do not need to be reported on Form 8949 if both the sales proceeds and basis have been properly reported by the brokerage firm on Form 1099.

As before, Schedule D also picks up items treated as capital gains from Forms 4684, 6252, 6781, 8824, as well as capital gains and losses flowing from partnerships and S corporations.

Income tax basis of property acquired from the decedent may be determined by reference to the law in effect on the date of death and forms filed by the estate. In most cases, that basis will be the fair market value on the date of the decedent's death. But there are a number of special cases where that may not be the case.

For instance, the estate may have used the alternate valuation date and if so the value of the asset on that date would be used as the basis of the asset. Also, advisers must remember the potential for a modified carryover basis if the decedent passed away in 2010. In such a case, an inquiry needs to be made about whether or not the estate elected to use the no estate tax provisions in place for that year, or whether the estate was taxed under the regular rules and used the traditional fair market value basis rules.

One thing to be aware of is that brokerage firms often do not properly reflect adjustments to basis of assets that passed through an estate. So some inquiry should be made before relying upon a report from the brokerage regarding computed gains or losses on the sale of various securities. Similarly, such organizations often don't grasp the rules involved if the decedent lived in a community property state at the time of his demise.

The holding period of all assets received from the decedent is long term even if the decedent acquired the assets the day before she died and the estate is selling it a day later. Normally, your tax software will flag this asset as being an inherited asset. Again, this is an area where at times certain brokerage firm reports will fail to pick up this issue, and will treat these sales as short term in their reports.

A personal residence generally becomes an investment asset to the estate or beneficiaries and will retain that status unless converted to personal use by a beneficiary (*Estate of Pauline Miller*, TC Memo 1967-4 and *H.V. Watkins*, TC Memo 1973-167). As such, the sale of the property, if it occurs at a loss, may generate deductible capital loss.

A 1998 Office of Chief Council Service Center Advice (SCA 1998-012) caused a bit of controversy by asserting that a trust or estate could only claim a loss if it had actively converted the property to an income producing item, such as by renting the property out, if the property had been used for personal purposes by the decedent.

However, in Publication 559, Survivors, Executors, and Administrators, the IRS provided the following description of the proper treatment of the sale of the decedent's residence:

> **Sale of decedent's residence.** If the estate is the legal owner of a decedent's residence and the personal representative sells it in the course of administration, the tax treatment of gain or loss depends on how the estate holds or uses the former residence. For example, if, as the personal representative, you intend to realize the value of the house through sale, the residence is a capital asset held for investment and gain or loss is capital gain or loss (which may be deductible). [emphasis added] This is the case even though it was the decedent's personal residence and even if you did not rent it out. If, however, the house is not held for business or investment use (for example, if you intend to permit a beneficiary to live in the residence rent-free and then distribute it to the beneficiary to live in), and you later decide to sell the residence without first converting it to business or investment use, any gain is capital gain, but a loss is not deductible.

This guidance appears to be more in line with the court cases that existed that suggest so long as there is no disqualifying use, any loss on disposal would be deductible. While some will complain that an IRS publication is not binding (which it is not), neither is a Service Center Advice binding on either the taxpayers or, more importantly, the courts.

Capital gain rates for estates and trusts are the same as for individuals. Consequently, the maximum rate imposed on long-term capital gains for the trust or estate is set at 20%. The maximum capital gain rate for 2019 applies for income in excess of $12,750.

Under the UPAIAs enacted in various states, capital gains are allocated to trust principal and are reportable by the fiduciary unless allocated to income beneficiaries by:

- will or trust document,
- state law, or
- actual distribution of proceeds from the capital gains transaction.

Net capital losses are only reportable by the estate or trust during the period of administration, and are limited to offsetting no more than $3,000 of ordinary income. There is no option to pass those losses through to the beneficiaries during any year except the last even if the trust document provides that capital gains are considered part of trust income.

Unused capital losses are allocated to beneficiaries in the final return of an estate or trust.

Rents, Royalties, Partnerships, S corporations, Other Estates, and Trusts, Etc.—Line 5

The amount reported on line 5 should be the aggregate of the entity's net income and loss from all rents, royalties, partnerships, S corporations, estates, trusts, and LLCs. These items will be reported on Schedule E. That is the same treatment as we would see on an individual income tax return. Interestingly enough, the Form 1041 instructs you to use the Form 1040 Schedule E, not a specialized Form 1041 version.

Similarly, non-business income, interest, dividends, and capital gains from pass-through entities are reported on the appropriate line, not line 5. As with an individual, these items are not reported on Schedule E but flow directly onto the appropriate line of the return.

Rent and royalty income is reported using the first page of Schedule E, Form 1040.

- Be sure to identify IRD. That would include rents that were due but not yet paid on the date the decedent died.
- Some deductions incurred in the rental may be allocable to income beneficiaries.
- An estate is eligible for the $25,000 rental loss exception to passive activity loss limitation rules, while a trust is not.
- There are no rules that would allow an estate or trust to be treated as a real estate professional (see Chief Counsel Email 201244017).

Trusts and estates are subject to the passive activity loss rules and the at risk rules in the same manner as an individual.

The majority of the seven tests under temporary regulation §1.469-5T(a) for determining if an activity is or is not a passive activity look at the taxpayer's actions with regard to the activity and the amount of time spent on such items.

There are two ways to view a trust under the tax law:

- A trust creates a complication, because a trust is not so much an *entity* as a *relationship* between the grantor, trustee, and the beneficiary, where the trustee holds and manages the assets of the trusts provided by the grantor for the benefit of the various beneficiaries. Thus, the trust is not an entity (though it files a tax return), but rather a relationship. The trustee is the only party, once the trust has been established, who acts on behalf the trust and only to the extent authorized to do so by the trust documents or applicable law.

- A trust, being a tax entity, should be treated for tax purposes as having an existence separate and apart from its trustee(s), grantor, and beneficiary.

IRS actions in the passive activity area have tended to the first view. In the IRS's view, to be considered not a passive activity, the trust must show the trustee, acting in his capacity as a trustee, meets the requirements of the tests found in temporary regulation §1.469-5T(a). The fact that the trustee might otherwise be involved with the entity is, in the IRS's view, not relevant.

Historically, the IRS held that, in its view, a trust absolutely could function as a real estate professional under IRC §469(c)(7) (see Chief Counsel Email 201244017, 11/2/12) and, for all practical purposes, a trust would have an extraordinarily difficult time meeting the material participation tests for a trade or business to escape passive treatment for income or loss from the activity.

For a long time, we had very little case law guidance here (a single District Court case, *Mattie K. Carter Trust v. U.S.*, 256 F.Supp.2d 536). While that guidance was taxpayer favorable, rejecting the IRS "trustee only" test, it was a single District Court case, which often is a shaky foundation on which to rest a position.

Today, we have a lot more—the U.S. Tax Court weighed in with a published opinion rejecting the IRS views entirely. The case is the *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9.

First, the court explicitly rejected the IRS view that a trust, by the nature of being a trust, could not perform the personal services necessary to meet the real estate professional definition necessary to apply IRC §469(c)(7). The Tax Court noted, "If the trustees are individuals, and they work on a trade or business as part of their trustee duties, their work can be considered "work performed by an individual in connection with a trade or business. Sec. 1.469-9(b)(4), Income Tax Regs. We conclude that a trust is capable of performing personal services and therefore can satisfy the section 469(c)(7) exception."

The court went on to note the following:

> Indeed, if Congress had wanted to exclude trusts from the section 469(c)(7) exception, it could have done so explicitly by limiting the exception to "any natural person". In section 469(i), the Internal Revenue Code does exactly that. Section 469(i) grants a $25,000 allowance to "any natural person" who fulfills certain requirements. That Congress did not use the phrase "natural person" but instead used the word "taxpayer" in section 469(c)(7) suggests that Congress did not intend to exclude trusts from the section 469(c)(7) exception, despite what the IRS argues here.

The court also gave short shrift to the IRS's broader view that material participation must be met by the trustees only and only if acting purely in their capacity as trustees. The court comments:

> On the basis of these legal principles, the IRS would have us ignore the activities of the trust's non-trustee employees. 14 Additionally, the IRS would have us ignore the activities of the three trustees who are employees of Holiday Enterprises, LLC. It reasons that the activities of these three trustees should be considered the activities of employees and not fiduciaries because (1) the trustees performed their activities as employees of Holiday Enterprises, LLC, and (2) it is impossible to disaggregate the activities they performed as employees of Holiday Enterprises, LLC, and the activities they performed as trustees.

The court concludes that it is not proper to ignore the employee-trustees. Governing law requires them to act in the interests of the beneficiaries, and in this case their employer was an entity 100% owned by the trust. Therefore, the court effectively found it absurd to ignore their activities when counting material participation.

While a victory for the taxpayer, it is important to note the facts recited in the previous paragraph—this was a case of a trust with trustees who were employees of an entity wholly owned by the trust. In most cases, things won't be quite that simple—and, for now, we are left to wonder about the impact if the trust was a minority shareholder for instance.

An estate or trust must complete Form 8582, Passive Activity Loss Limitations and attach that form to Form 1041.

Unused passive activity losses are added to nondepreciable basis of property distributed to beneficiaries upon termination of estate or trust.

Pass-Through Income from Estates and Trusts is Subject to Special Rules

If a beneficiary of a trust or estate dies during the years, things get a bit more complicated. Amounts actually distributed before date of death are included in the final Form 1040 of the decedent.

Amounts required to be distributed to the decedent but actually received by the estate are IRD. All items reported by the pass-through entity, not reported on decedents final return will be reported in the estate Form 1041 for the year of death.

Partnership and S Corporation Income

This income is required to be prorated between the final return of the decedent and the estate or trust in the year the partner or shareholder dies.

Self-employment income of a partner is prorated based on the number of whole months in the partial year before the partner died.

Taxable income of the partner or shareholder is determined by closing the taxable year as to a deceased partner.

S corporations generally use per-share, per-day allocation rules. However, there can be an election to terminate the S corporation tax year as to a deceased shareholder with consent of all affected shareholders. In most cases, the only affected shareholders will be the decedent and the decedent's estate.

If a partnership has made, or will make, an election under code section 754, the basis of a deceased partner's share of partnership, assets may be adjusted to their fair market values as of the date of death. The ability to elect a step-up in basis on the death of the partner is one of the advantages of a partnership over an S corporation. But the election is under the full control of the partnership, not the estate.

The advisor should also note that a transfer due to the death of a partner via inheritance will not trigger a technical termination of the partnership. However, if that interest is purchased by the remaining partners as individual partners and not as partnership redemption, such a transaction does have to be considered under the technical termination rules.

A special rule applies to reduce IRD, and reduce basis in S corporation stock, when the income has been included in valuing the stock in an estate.

Other Income—Line 8

You should attach a separate listing of income items aggregated for reporting on line 8.

Many of the income items reported on line 8 will be IRD (such as distributions from an IRA), and that detail should be captured when preparing Form 1041. IRD is income earned by the decedent, but not reported in any income tax return of the decedent.

IRD items are included as assets in the estate of the decedent at their fair market value but do not receive a stepped-up basis. Whoever ultimately receives an item of IRD is entitled to an income tax deduction for any federal estate tax paid on the IRD.

Active Business or Farming Income—Lines 3 and 6

If the estate includes operation of an unincorporated business or a farm Schedule C (Form 1040) or Schedule F (Form 1040) will be included with Form 1041 to report that income. As a new taxpayer, the fiduciary may make new income tax elections on behalf of the estate.

Business or farm income earned by an estate or trust is not subject to self-employment tax. If operation of a business generates a net operating loss (NOL), the loss may be carried back within the estate for two years and forward 20 for losses generated in 2017 and earlier years. The Tax Cuts and Jobs Act (TCJA) removed the option to carry back the vast majority of net operating losses, though there is no longer an expiration on the period losses may be carried forward. When estate or trust is terminated, unused NOL is distributed to beneficiaries who may carry it forward.

Fiduciary accounting principles treat an NOL as chargeable against principal, and not a carry forward to future accounting periods. That means the remainder interests incur the economic loss while current income interests benefit from reduction of income tax liability.

While the estate's NOL transfers to the beneficiaries upon termination, the same is not true when a decedent dies and has a NOL. A NOL of the decedent cannot be carried forward from the final Form 1040 to the estate's Form 1041.

Ordinary Gain or Loss—Line 7

Form 4797 is used to report ordinary gain or loss from the sale of property other than capital assets, using the same rules that apply to individuals. The recapture provisions of code sections 1245, 1250, 1252, 1254, and 1255 apply to dispositions of business assets by estates and trusts.

Recapture reported to an estate or trust on a Form K-1 is to be reported through Form 4797 into Form 1041.

DEDUCTIONS FOR TRUSTS AND ESTATES

Estate and Trust Deductions in General

As stated earlier, estates and trusts may claim many of the same deductions that are claimed by individual taxpayers. There are, however, some significant differences that you need to be concerned with when preparing a Form 1041, many of which we will discuss in this unit.

Distributions of income to beneficiaries are deductible subject to special rules. This area was discussed briefly in the Unit discussing income of the trust or estate.

Administrative expenses may be claimed either as income tax or estate tax deductions. A key to handling estate returns involves the decision tree used to make this decision as to where to best claim these deductions.

Expenses relating to tax-exempt income are not allowed on the Form 1041. That includes allocating expenses that apply to all types of income, making sure the portion that relates to tax-exempt income is not allowed as a deduction. This is the same rule that applies to individual returns. However, because trusts and estates often consist mainly of investment assets, the impact of the exclusion can be more significant.

Some deductions are required to be allocated between a trust or estate and its beneficiaries. As was discussed earlier, this is quite common with a decedent's estate. Especially in a community property state, assets are often held during the administration jointly by the decedent and the decedent's spouse.

Charitable contributions are not subject to a percentage of income limitation in a fiduciary return, unlike what is true for either an individual or a corporation.

Certain items of income are reduced by directly related expenses before being entered on the appropriate line in Form 1041.

Only expenses incurred in the collection, conservation, and management of the entity's assets are deductible by an estate or trust. However, such expenses may cover more items in a decedent's estate. For instance, utility expenses for the decedent's former residence become expenses for preservation of the value of the home, so long as the home remains an asset being held for sale. While the decedent was alive, this was a personal expense.

Depreciation, income tax withheld, and income tax credits are distributed to beneficiaries in proportion to the distribution of income.

Interest—Line 10

A deduction is allowed to the trust or estate for interest the trust or estate is obligated to pay under the provisions of IRC §163, the same session that governs the deduction for interest for individuals and other taxable entities. If the decedent was on the cash basis of accounting for income tax purposes, payment of interest accrued but unpaid at the date of death is a deduction in respect of a decedent. So, that interest would be properly claimed as a deduction for both estate and income tax purposes, assuming the interest is properly deductible for income tax purposes.

The interest is only deductible if the estate or trust is obligated to pay it. In the 1949 case of the *Estate of E.K. McClatchy v. Commissioner*, 12 TC 370, *aff'd, per curiam*, CA-9, 179 F2d 678, no deduction was allowed to the estate for payment of interest on state inheritance taxes because the beneficiary was obligated under the state law for the inheritance tax.

More recently, an estate was denied a deduction for interest paid on funds borrowed to pay the estate tax. The funds had been borrowed because the beneficiaries preferred not to liquidate assets to pay the tax *(Estate of D.E. Lasarig*, TC Memo 1999-307).

The interest tracing rules of Regulation §1.163-8T apply to a trust or estate. Thus, interest that traces to a passive activity has to be treated as such on the trust or estate Form 1041. Such interest does not become deductible without limitations merely because it is paid by a trust or estate.

To comply with the tracing regulations, the estate or trust must document the use of borrowed funds and be prepared to defend the treatment if challenged by the IRS.

The investment interest limitation rules apply [IRC §163(d)], and Form 4952 must be filed with Form 1041 to claim an investment interest deduction. The box next to line 10 on Form 1041 is to be checked if a Form 4952 is attached.

Taxes—Line 11

Taxes deductible as an expense include generally the same taxes an individual may deduct, which includes the following:

- State and local income taxes

- State, local, and foreign real property taxes
- State and local personal property taxes
- State income taxes paid on capital gains allocated to the principal of the simple trust
- State income taxes paid on interest exempt from federal tax
- Foreign income in excess of profits taxes
- GST on income distributions [IRC §164(a)]

Because taxes are allowed as a deduction under a separate provision from the section allowing deductions for administrative expenses, state income tax deductions do not have to be reduced to the extent they are allocable to federally tax-exempt income. However, state income taxes on other tax-exempt income are subject to allocation [Revenue Ruling 61 86].

Taxes listed as accrued and unpaid at death are deductions in respect of the decedent and may be deducted on both Form 1041 as taxes and on Form 706 as debts.

The TCJA introduced limits on the deduction of state and local taxes that are not paid or accrued in carrying on a trade or business or an activity described in Section 212.[8] Section 212 activities are, generally, activities conducted:

- for the production or collection of income;
- for the management, conservation, or maintenance of property held for the production of income; or
- in connection with the determination, collection, or refund of any tax.

Such deductions cannot exceed $10,000. That would include the trust's state income taxes and likely would include real estate taxes paid on property that is not being held for generation of income.

The limits would not apply, however, to real estate taxes paid on property being rented by the estate or trust, nor would it apply to any state or local taxes incurred directly by a trade or business being conducted by the trust or estate.

Fiduciary Fees—Line 12

Fiduciary fees are established by state law or the controlling instruments. These items are reported on line 12 and represent items not normally incurred by the individual, therefore, they are not subject to the 2% of adjusted gross income limitation that is applicable to fiduciary returns in the same way it applies to individual tax returns.

[8] IRC §164(a)(6) as added by the Tax Cuts and Jobs Act

Why is it important that these be expenses of a type not normally incurred by the individual? In the case of *Knight v. Commissioner*, SCt, 2008-1 USTC ¶50,132, 552 US 181, 128 SCt 782, the Supreme Court ruled that only fees not normally incurred by an individual for administering an estate are exempt from the 2% of adjusted gross income limitation found in IRC §67 on itemized deductions.

Under IRC §67(e), deductions allowable in computing a trust or an estate's adjusted gross income includes, "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." Deductions allowed in computing adjusted gross income are not itemized deductions, therefore, they would not be subject to the 2% limitation on miscellaneous itemized deductions.

In the Knight case, the fiduciary argued that due to the requirement to exercise due care as a fiduciary for the investments of the trust, amounts paid for investment fees should be considered items that would not have been incurred if the property and not been held in trust.

While the Sixth Circuit Court of Appeals had, in an earlier case, accepted this view, the Supreme Court did not agree with that view. Rather, the Supreme Court put forward the "not normally incurred by the individual" test to determine if an expense is one that would not have been incurred if the property were not held in a trust or estate.

Individuals regularly pay investment advice fees. Because of that, any amount of a fee paid for investment advice by trust or estate is not used in computing adjusted gross income but rather is itemized deductions subject to the 2% limit.

This introduces a complication for trusts and estates that have corporate trustees. In many cases, these organizations charge a single bundled fee for both administering the trust or estate and providing investment management advice. Under the Knight decision, such fees must be unbundled, and the IRS has proposed regulations to require just such a treatment.

See the discussion of miscellaneous deductions later in this Unit for details on the regulations that apply to such bundled fees.

Some commentators had expressed a concern that IRC §67(g), added by the Tax Cuts and Jobs Act, would serve to block all deductions for a trust or estate other than those that an individual would be able to deduct in computing adjusted gross income or which were listed as not miscellaneous itemized deductions in the list found at IRC §67(b). If that position was taken by the IRS and sustained by the courts, the trust would have lost deductions for items such as trustee's fees, along with accounting and legal fees.[9]

The good news is that Notice 2018-61 provides that IRC §67(g) does *not* serve to block deductions that are allowed under IRC §67(e)(1) and Reg. §1.674-4. Those items are not miscellaneous itemized deductions to the trust or estate and thus are not barred as a deduction.

---

[9] Stephanie Cummings, "Deductibility of Executor, Trustee Fees Under Review at IRS", *Tax Notes Today*, 2018 TNT 29-8, February 12, 2018

Charitable Deductions—Line 13

A charitable deduction is allowed only when the will or trust instrument provides for the contribution to be paid out of gross income [IRC §642(c)(1)]. The trust must show that the contribution came out of gross income and not from trust corpus (though, see next paragraphs).

One potentially confusing issue with this rule is that *gross income* is a tax term (IRC §61) and does not share the same meaning as *income* does under the applicable principal or income act, or the trust/estate's own definitions. Accordingly, an item may be part of *gross income* under this rule but not part of *income* for trust/estate accounting purposes.

In the case of an estate and a very limited subset of trusts, a deduction may also be claimed for amounts permanently set aside for a charitable purpose. However, the IRS has successfully attacked such deductions claimed under a set aside claim if there exists any sort of claim against the assets of the trust or estate that could have or does end up eating into the assets that were set aside [see *Estate of Belmont v. Commissioner*, 144 TC No. 6 (2015) and *Estate of DiMarco v. Commissioner*, T.C. Memo. 2015-184].

If a trust or estate wants to make use of the set aside rule, the adviser should consider inquiring of the executor or trustee the reasons why the assets were not simply transferred to the charity and whether these assets would remain available to pay administrative expenses or the claims of various parties.

If possible, to avoid IRS scrutiny, the trust or estate should attempt to ensure the funds are transferred to the charity by the end of year following the year in which the deduction is claimed. Doing so allows for an election to be made under the following year rule described later, sidestepping the issue of whether a set aside was permanent or not.

Revenue Ruling 71-285 discusses how to make the determination if an amount was paid out of income or corpus. If the trust document requires the payment to come out of income, that document will generally control. However, if the document is silent, the ruling indicates that applicable state law must be consulted to determine the source of the contribution. Therefore, the trust must be able to show that the state UPAIA will treat the payment as being allocable to trust income and not come directly out of trust corpus.

An estate or trust may elect to claim a charitable contribution paid in the following year in the current taxable year [IRC §642(c)(1)]. Regulation §1.642(c)-1(b) has the details of making the election. The election can be made up through the extended due date of the return for the succeeding year.

The election is filed with the return for the year in which the deduction is claimed. The election should contain the following items:

- The name and address of the fiduciary
- The estate or trust for which the fiduciary is acting

- A statement that the fiduciary is making an election under IRC §642(c)(1) in respect of contributions treated as paid during such taxable year
- The name and address of each organization to which a contribution is made
- The amount of each contribution and date of actual payment or, if applicable, the total amount of contributions paid to each organization during the succeeding taxable year, to be treated as paid in the preceding taxable year [Reg. §1.642(c)-1(b)(3)]

The fiduciary should complete Schedule A, Form 1041 to claim a charitable deduction for an estate or trust.

Professional Fees—Line 14

All such fees paid for probate, trust, and return preparation are deductible. In the proposed regulations, to implement the Knight decision noted previously the IRS has concluded that the fees for preparation of the trust return are fees not of a kind normally incurred by an individual. The same is true for most other deductible professional fees incurred by the trust or estate.

However, if the trust or estate has tax-exempt income, these expenses may be subject to limitation based on the amounts properly allocable to the tax-exempt income of the trust.

Other Deductions not Subject to 2% Limitation—Line 15a

Under IRC §67€(1), costs that are unique to the administration of an estate or trust are deductible in computing the trust's adjusted gross income. The concept of adjusted gross income for an estate or trust may be confusing to some practitioners. A quick glance at the Form 1041 does not reveal any line that calls itself *adjusted gross income*.

Similarly, there is no line labeled *itemized deductions*, nor is there anything equivalent to Schedule A that goes with Form 1040. Nevertheless, the tax law does treat the trust or estate as having an adjusted gross income and certain deductions as itemized deductions.

Any itemized deductions that are not specifically excluded from the category of miscellaneous itemized deductions are subject to the 2% limitation. For the most part, the specifically identified itemized deductions of the trust or estate are found on lines we are previously discussed.

Line 15a exists primarily to hold those special deductions that are saved from the 2% treatment by the special rule found at IRC §67(e). The fact that the expenses are allowed in computing the trust or estate adjusted gross income should mean they are not, by definition, itemized deductions and therefore cannot be subject to the 2% limit. But, as was noted earlier, some commentators have worried about whether this applies after 2017, when the TCJA disallows any deduction for 2% miscellaneous itemized deductions. As the IRS has clarified that such expenses will remain deductible, it is very important to properly identify expenses that fall into this category.

Expenses Not Subject to the Limit—Regulation §1.67-4

Regulation §1.67-4(b) details the general tests for costs commonly or customarily incurred by an individual as well as the treatment of certain specific expenses. Regulation §1.67-4(c) details how a trust is to deal with bundled fees.

Expenses Customarily or Ordinarily Incurred by an Individual

The general rule, found in regulation §1.67-4(b)(1), provides initially that the analysis of whether a cost is commonly or ordinarily incurred by an individual, the fiduciary must look at the type of product or service rendered to the trust or estate and not the label applied to the fee.

The regulation provides that normally costs incurred in defense of a claim against the trust or estate (or the grantor or decedent) would be a cost commonly and ordinarily incurred by an individual. However, it notes that this would not be true if the claim related to the trust's existence, validity, or administration.

While the regulation does not say so, it should be noted that such expenses would not automatically be deductible or, if deductible, subjected to the 2% limit. For instance, if the trust is involved in the conduct of a trade or business and paid legal fees directly related to a claim related to the business, such legal fees would, if they met the general rules for a deductible business expense, be deductible in computing the trust's adjusted gross income and not treated as a miscellaneous itemized deduction. Remember that not all deductions allowed to an individual are subject to the 2% haircut.

Specific costs

Regulation §1.67-4(b) goes on to give details regarding five specific costs the IRS believes may be especially an issue in this area.

Ownership Costs

Ownership costs are costs that are incurred simply by being the owner of a piece of property such as condominium fees, insurance premiums, maintenance and law services, automobile registration fees, and auto insurance costs. Such expenses are commonly or ordinarily incurred by individual owners of such property [Reg. §1.67-4(b)(2)].

Tax Preparation Fees

An item of special interest to most readers is the treatment of tax preparation fees incurred by a trust or estate.

The regulation provides that expenses incurred for the following tax returns will be treated as costs *not* subject to the 2% floor:

- Estate tax returns
- GST returns

- Fiduciary income tax returns
- Decedent's final individual income tax returns

The costs of preparing all other returns are specifically subject to the 2% floor. The most prominent type of return not excluded from the 2% limit are gift tax returns, the regulation noting that the cost of preparing such is a cost commonly and customarily incurred by individuals [Reg. §1.67-4(b)(3)].

Investment Advisory Fees

The regulation deals directly with the Knight issues at this point. While the court held that typically investment fees are customarily and ordinarily incurred by individuals, it found that in unique situations (not present in the Knight case), there could be investment fees triggered solely by unique facts of the matter.

The regulations deal with this issue by providing that investment advisory costs are generally subject to the 2% floor. However, in the special case situations discussed by the court, the regulation will allow the excess portion of the fee to be treated as not subject to the 2% floor.

The regulation limits this treatment to incremental costs of investment advice *beyond* those that would normally be charged to an individual investor.

Such advice is defined as *additional* charge added *solely* because of the following:

- The advice is being rendered to a trust or estate.
- This is due to either:
  - an unusual investment objective (presumably provided by the trust or estate documents); or
  - there is a need for a specialized balancing of the interests of the parties (beyond the usual balancing of the interest of current beneficiaries and remaindermen) such that a reasonable comparison with individual investors would be improper.

Even in those cases, only the amount of the fee in excess of what would normally be charged to an individual will escape the 2% haircut.

As this special rule was added to the final regulation primarily to deal with an unclear statement made by the Supreme Court regarding a theoretical special situation which, while not defined, was held not to be the case in Knight, it seems reasonable to expect the IRS will be unlikely to find many cases they will deem to reasonably allow this splitting of investment fees. More likely, the IRS will argue that the trust or estate in front of them is just like the Knight situation in this regard [Reg. §1.67-4(b)(4)].

Appraisal Fees

Like tax preparation fees, the IRS decided to provide a specific list of "not subject to the 2% limit" appraisal fees, with all other appraisal fees being considered of a type normally and customarily incurred by an individual.

Those fees specifically exempt from the 2% limit are the following:

- Fees incurred to determine the fair market value of assets at the decedent's date of death or alternate valuation date
- Fees incurred to determine value for purposes of making trust distributions
- Fees incurred to determine values required to prepare the trust or estate's tax return or GST return (such as might need to be done to prepare a split-interest trust return for a CRUT)

All other appraisal fees are deemed to be of a type ordinarily and customarily incurred by an individual, with the regulation specifically providing that appraisals incurred for insurance purposes are of this not excepted type [Reg. §1.67-4(b)(5)].

Other Specifically Excluded Costs

Regulation §1.67-4(b)(6) lists the following additional expenses that will not be treated as subject to the 2% limit:

- Probate court fees and costs
- Fiduciary bond premiums
- Legal publication costs of notices to creditors or heirs
- Cost of certified copies of the decedent's death certificate
- Costs related to fiduciary accounts

Bundled Fees

A key issue of the final regulation dealt with the sticky problem of bundled fees of the type often charged by corporate trustees (such as banks). Often, a corporate trustee's fee will cover both administering the trust and providing investment advice to the trust.

If the estate or trust pays a single fee or expense that covers both costs subject to the 2% limitation and those not subject to such a limit, the fee must be allocated between the costs subject to the limit and those that are not [Reg. §1.67-4(c)(1)].

Note that this does reach beyond just corporate trustee fees. The IRS specifically lists the following types of fees as examples that may end up with a mixed treatment:

- Fiduciary's fee
- Attorney's fee
- Accountant's fee

The regulation then goes on to explain specific situations.

Hourly vs. Non-Hourly Fees

The regulation technically only discusses non-hourly fees in regulation §1.67-4(c)(2), but, by implication, it also contains guidance for fees charged on an hourly basis.

Specifically, the regulation provides that if a fee is *not* charged on an hourly basis, only the portion of the expense attributable to investment advice is subject to the 2% floor.

Presumably, this means that if an hourly fee is charged, a more comprehensive split of the fee is required, and the issue is not limited to searching for investment advice.

Expenses Specifically Excluded from Allocation

Even though a fee may be paid to a party charging a bundled fee, specific items of that fee will not be subject to allocation.

Such fees not subject to allocation include the following:

- Any payments made to third parties out of the bundled fee that would have been subject to the 2% floor if paid directly by the estate or trust
- Any expenses separately assessed by payee of the bundled fee for services that are commonly or customarily incurred by an individual

So, for instance, it would appear that if a corporate trustee were to outsource the investment advice to a third party, that fee paid to the third party would be treated as subject to the 2% limit entirely, even though the trust may have just paid a single fee to the corporate entity.

Reasonable Method

The regulation concludes the discussion of bundled fees by providing that any reasonable method may be used to allocate the fees between those subject to the limit and those not subject to the limit [Reg. §1.67-4(c)(4)].

While giving that broad authority, the regulation then goes on to provide certain factors that can be considered in making the allocation. The regulation does provide that this is not an exclusive list of factors, though drawing from this list may eliminate having to give a detailed defense of the method used if an examination takes place.

- Percentage of the value of the corpus subject to investment advice
- What a third party adviser would have charged for similar advisory services
- Amount of fiduciary's time devoted to investment advice as opposed to dealing with beneficiaries and distribution decisions or other fiduciary matters

The provision goes on to remind readers who may somehow have missed the provision found in regulation §1.67-4(c)(3) described previously, that they cannot allocate those fees for which allocation is prohibited.

Miscellaneous Itemized Deductions Subject to 2% Limitation—Line 15b

IRC Section 67(g), as added by the TCJA, will deny any deduction for 2% itemized after 2017. As was noted in the last section, items subject to limitation on Form 1041 are similar to those subject to limitation in Form 1040 of an individual and include the following:

- Miscellaneous itemized deductions from a pass-through entity
- Fees and expenses in connection with property held for production of income
- Investment expenses, such as investment advice and management fees

Determining the amount of deduction ultimately allowed for these items requires the computation of the trust's or the estate's adjusted gross income. That computation is found in IRC §67(e).

A trust computes its adjusted gross income by starting with the same calculation as an individual. This means that items such as expenses related to rental income, capital losses, and ordinary losses that flow through from Form 4797 and other similar items will go into the calculation of adjusted gross income. But certain additional items are allowed as deductions in computing the adjusted gross income of a trust or estate.

The first category of these items are the items discussed previously. Those are costs for administration of the trust or estate that would not have been incurred except for the existence of the trust or estate. In addition to those costs, the trust or estate is allowed a deduction for each of the following special items related to trusts or estates:

- The personal exemption of the trust or estate
- The trust or estate's income distribution deduction

Deduction for Income Distribution—Line 18

The income distribution deduction for a trust or estate is reported on line 18 of Form 1041. Due to the complexity of this issue, this matter is covered in a separate Unit.

Deduction for Estate Tax—Line 19

Federal estate tax attributable to net value of IRD items are included in Form 1041 for the year. To determine this amount, the estate must determine whether it has net IRD to begin with. If the estate has net IRD, then it must compute the portion of the estate tax allocable to the IRD.

That ratio of estate tax to the IRD is then used by the entity reporting the IRD for income tax purposes in order to compute the IRD deduction for that entity (whether it be an individual or a trust).

If an item of IRD on which estate tax was paid is reported on a Form 1041, the related deduction is taken on line 19. A deduction for estate tax related to IRD is not subject to the 2% of adjusted gross income limitation on Form 1041. Thus, this deduction is available on trust and estate income tax returns.

In an unrelated aside, note that it is also not subject to that limitation on an individual's income tax return if the IRD is reported by the individual who received the IRD generating asset.

TRUST AND ESTATE ISSUES FOR §199A

The final regulations provide the following general description of issues related to trusts and estates:

> A trust or estate computes its section 199A deduction based on the QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income that are allocated to the trust or estate. An individual beneficiary of a trust or estate takes into account any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income allocated from a trust or estate in calculating the beneficiary's section 199A deduction, in the same manner as though the items had been allocated from an RPE. For purposes of this section and §§1.199A-1 through 1.199A-5, a trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains the QBI and other items.[10]

Grantor Trusts

Not surprisingly, if a trust is a grantor trust, the §199A items are computed by the grantor just as if the grantor directly owned the interest in the RPE and directly conducted any activities.

[10] Reg. §1.199A-6(d)(1)

Non-Grantor Trusts and Estates

A non-grantor trust and estate has attributes of both a fully taxable entity and a pass-through entity. Thus, the regulations provide for a calculation at the entity level and an allocation among trust or estate beneficiaries.

Calculation at Entity Level

The regulations provide first that the trust or estate must run the standard QBI calculations for items related to IRC §199A.

> A trust or estate must calculate its QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income.[11]

The items of income and deduction are to be to items of DNI in accordance with the Reg. §1.652(b)-3(a) and (b), per the proposed regulations:

> The QBI of a trust or estate must be computed by allocating qualified items of deduction described in section 199A(c)(3) in accordance with the classification of those deductions under §1.652(b)-3(a), and deductions not directly attributable within the meaning of §1.652(b)-3(b) (other deductions) are allocated in a manner consistent with the rules in §1.652(b)-3(b).[12]

Reg. §1.652(b)-3(a)-(b) provides the following:

> § 1.652(b)-3 Allocation of deductions.
>
> Items of deduction of a trust that enter into the computation of distributable net income are to be allocated among the items of income in accordance with the following principles:
>
> (a) All deductible items directly attributable to one class of income (except dividends excluded under section 116) are allocated thereto. For example, repairs to, taxes on, and other expenses directly attributable to the maintenance of rental property or the collection of rental income are allocated to rental income. See § 1.642(e)-1 for treatment of depreciation of rental property. Similarly, all expenditures directly attributable to a business carried on by a trust are allocated to the income from such business. If the deductions directly attributable to a particular class of income exceed that income, the excess is applied against other classes of income in the manner provided in paragraph (d) of this section.
>
> (b) The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to nontaxable

[11] Reg. §1.199A-6(d)(3)

[12] Reg. §1.199A-6(d)(3)

> income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to $3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instance, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

The regulations provide the following guidance regarding the allocation of amortization, depletion, and amortization:

> Any depletion and depreciation deductions described in section 642(e) and any amortization deductions described in section 642(f) that otherwise are properly included in the computation of QBI are included in the computation of QBI of the trust or estate, regardless of how those deductions may otherwise be allocated between the trust or estate and its beneficiaries for other purposes of the Code.[13]

Allocation Among Beneficiaries

As with other items involved in beneficiary distribution deduction, the items related to the §199A deduction are allocated based on the relative portion of DNI. The regulation provides:

> The QBI (including any amounts that may be less than zero as calculated at the trust or estate level), W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI), as defined by section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. For this purpose, the trust's or estate's DNI is determined with regard to the separate share rule of section 663(c), but without regard to section 199A. If the trust or estate has no DNI for the taxable year, any QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income are allocated entirely to the trust or estate.[14]

[13] Reg. §1.199A-6(d)(3)(i)

[14] Reg. §1.199A-6(d)(3)(ii)

Threshold Amounts for Trusts and Estates

As trusts and estates are taxpayers filing with a status other than married filing joint, the threshold amount for 2019 is $163,300[15] and will be adjusted for inflation in future years.[16]

The regulations provide that distributions are added back to the trust or estate's taxable income in order to determining whether the income exceeds the threshold amount:

> For purposes of determining whether a trust or estate has taxable income that exceeds the threshold amount, the taxable income of a trust or estate is determined before taking into account any distribution deduction under sections 651 or 661.[17]

Electing Small Business Trusts (ESBTs)

Electing small business trusts are eligible to claim a §199A deduction on the ESBT income to the extent the income passed out qualifies for a §199A deduction. As is normally true with ESBTs, a separate calculation must be made for the ESBT and other portion of the trust.

The regulations provide:

> An electing small business trust (ESBT) is entitled to the deduction under section 199A. The S portion of the ESBT must take into account the QBI and other items from any S corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets treated as owned by a grantor or another person (owned portion) of a trust under sections 671 through 679, and the non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT. See §1.641(c)-1.[18]

Multiple Trusts Anti-Abuse Rule

Another of the planning structures suggested by some advisers when TCJA was passed involved using multiple trusts as equity holders to reduce each trust's income below the threshold amount to avoid the SSBT and/or W-2 wages/qualified property reduction or elimination of the §199A deduction.

These anti-abuse rules apply to taxable years ending after December 22, 2017. The IRS has provided anti-abuse regulations to attempt to eliminate this sort of planning by forcing a combination of all trusts interests into a single. The regulations provide:

> Trusts formed or funded with a significant purpose of receiving a deduction under section 199A will not be respected for purposes of section 199A. See also §1.643(f)-1 of the regulations.[19]

---

[15] Revenue Procedure 2019-44

[16] Reg. §1.199A-6(d)(3)(iii)

[17] Reg. §1.199A-6(d)(3)(iii)

[18] Reg. §1.199A-6(d)(3)(iv)

[19] Reg. §1.199A-6(d)(3)(v)

Comprehensive Example of Trust and Estate §199A Calculations

The interaction of the §199A rules with trusts and estates produce what many will find are surprising results. The key thing to remember is that all of the §199A items (such as QBI, UBIA and W-2 wages) follow distributable net income (an aggregate concept). So the mere fact the business lost money and no "business loss" shows up on the K-1 does not mean the beneficiary will not be hit with negative QBI when he/she starts to calculate his/her own personal §199A deduction on his/her Form 1040.

The IRS provides the following comprehensive calculation of trust and estate §199A amounts.

Example, Reg. §1.199A-6(d)(3)(viii)

Computation of DNI and Inclusion and Deduction Amounts

> (A) Example 1 to paragraph (d)(3)(viii) of this section. (1) Computation of DNI and inclusion and deduction amounts. (i) Trust's distributive share of partnership items. Trust, an irrevocable testamentary complex trust, is a 25% partner in PRS, a family partnership that operates a restaurant that generates QBI and W-2 wages. A and B, Trust's beneficiaries, own the remaining 75% of PRS directly. In 2018, PRS properly allocates gross income from the restaurant of $55,000, and expenses directly allocable to the restaurant of $45,000 (including W-2 wages of $25,000, and miscellaneous expenses of $20,000) to Trust. These items are properly included in Trust's DNI. PRS distributes $10,000 of cash to Trust in 2018.
>
> (ii) Trust's activities. In addition to its interest in PRS, Trust also operates a family bakery conducted through an LLC wholly-owned by the Trust that is treated as a disregarded entity. In 2018, the bakery produces $100,000 of gross income and $155,000 of expenses directly allocable to operation of the bakery (including W-2 wages of $50,000, rental expense of $75,000, miscellaneous expenses of $25,000, and depreciation deductions of $5,000). (The net loss from the bakery operations is not subject to any loss disallowance provisions outside of section 199A.) Trust maintains a reserve of $5,000 for depreciation. Trust also has $125,000 of UBIA of qualified property in the bakery. For purposes of computing its section 199A deduction, Trust and its beneficiaries have properly chosen to aggregate the family restaurant conducted through PRS with the bakery conducted directly by Trust under §1.199A-4. Trust also owns various investment assets that produce portfolio-type income consisting of dividends ($25,000), interest ($15,000), and tax-exempt interest ($15,000).

Accordingly, Trust has the following items which are properly included in Trust's DNI:

Interest income 15,000

Dividends 25,000

Tax-exempt interest 15,000

Net business loss from PRS and bakery ....(45,000)

Trustee commissions... 3,000

State and local taxes 5,000

(iii) Allocation of deductions under §1.652(b)-3. (A) Directly attributable expenses. In computing Trust's DNI for the taxable year, the distributive share of expenses of PRS are directly attributable under §1.652(b)-3(a) to the distributive share of income of PRS. Accordingly, Trust has gross business income of $155,000 ($55,000 from PRS and $100,000 from the bakery) and direct business expenses of $200,000 ($45,000 from PRS and $155,000 from the bakery). In addition, $1,000 of the trustee commissions and $1,000 of state and local taxes are directly attributable under §1.652(b)-3(a) to Trust's business income. Accordingly, Trust has excess business deductions of $47,000. Pursuant to its authority recognized under §1.652(b)-3(d), Trust allocates the $47,000 excess business deductions as follows: $15,000 to the interest income, resulting in $0 interest income, $25,000 to the dividends, resulting in $0 dividend income, and $7,000 to the tax exempt interest.(B) Non-directly attributable expenses. The trustee must allocate the sum of the balance of the trustee commissions ($2,000) and state and local taxes ($4,000) to Trust's remaining tax-exempt interest income, resulting in $2,000 of tax exempt interest.

(iv) Amounts included in taxable income. For 2018, Trust has DNI of $2,000. Pursuant to Trust's governing instrument, Trustee distributes 50%, or $1,000, of that DNI to A, an individual who is a discretionary beneficiary of Trust. In addition, Trustee is required to distribute 25%, or $500, of that DNI to B, a current income beneficiary of Trust. Trust retains the remaining 25% of DNI. Consequently, with respect to the $1,000 distribution A receives from Trust, A properly excludes $1,000 of tax-exempt interest income under section 662(b). With respect to the $500 distribution B receives from Trust, B properly excludes $500 of tax-exempt interest income under section 662(b). Because the DNI consists entirely of tax-exempt income, Trust deducts $0 under section 661 with respect to the distributions to A and B.

(2) Section 199A deduction. (i) Trust's W-2 wages and QBI. For the 2018 taxable year, prior to allocating the beneficiaries' shares of the section 199A items, Trust has $75,000 ($25,000 from PRS + $50,000 of Trust) of W-2 wages. Trust also has

$125,000 of UBIA of qualified property. Trust has negative QBI of ($47,000) ($155,000 gross income from aggregated businesses less the sum of $200,000 direct expenses from aggregated businesses and $2,000 directly attributable business expenses from Trust under the rules of §1.652(b)-3(a)).

(ii) Section 199A deduction computation. (A) A's computation. Because the $1,000 Trust distribution to A equals one-half of Trust's DNI, A has W-2 wages from Trust of $37,500. A also has W-2 wages of $2,500 from a trade or business outside of Trust (computed without regard to A's interest in Trust), which A has properly aggregated under §1.199A-4 with the Trust's trade or businesses (the family's restaurant and bakery), for a total of $40,000 of W-2 wages from the aggregate trade or businesses. A also has $62,500 of UBIA from Trust and $25,000 of UBIA of qualified property from the trade or business outside of Trust for $87,500 of total UBIA of qualified property. A has $100,000 of QBI from the non-Trust trade or businesses in which A owns an interest. Because the $1,000 Trust distribution to A equals one-half of Trust's DNI, A has (negative) QBI from Trust of ($23,500). A's total QBI is determined by combining the $100,000 QBI from non-Trust sources with the ($23,500) QBI from Trust for a total of $76,500 of QBI. Assume that A's taxable income is $357,500, which exceeds A's applicable threshold amount for 2018 by $200,000. A's tentative deductible amount is $15,300 (20% x $76,500 of QBI), limited to the greater of (i) $20,000 (50% x $40,000 of W-2 wages), or (ii) $12,187.50 ($10,000, 25% x $40,000 of W-2 wages, plus $2,187.50, 2.5% x $87,500 of UBIA of qualified property). A's section 199A deduction is equal to the lesser of (i) $15,300, or (ii) $71,500 (20% x $357,500 of taxable income). Accordingly, A's section 199A deduction for 2018 is $15,300.

(B) B's computation. For 2018, B's taxable income is below the threshold amount so B is not subject to the W-2 wage limitation. Because the $500 Trust distribution to B equals one-quarter of Trust's DNI, B has a total of ($11,750) of QBI. B also has no QBI from non-Trust trades or businesses, so B has a total of ($11,750) of QBI. Accordingly, B's section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of B pursuant to section 199A(c)(2).

(C) Trust's computation. For 2018, Trust's taxable income is below the threshold amount so it is not subject to the W-2 wage limitation. Because Trust retained 25% of Trust's DNI, Trust is allocated 25% of its QBI, which is ($11,750). Trust's section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of Trust pursuant to section 199A(c)(2).

TREATMENT OF MULTIPLE TRUSTS ANTI-ABUSE RULE

The IRS included with the §199A regulations an additional broader anti-abuse rule directed at the use of multiple trusts to obtain various benefits under the TCJA that had been proposed by some advisers.

One of the benefits sought related to the §199A deduction by dividing ownership of a RPE between multiple trusts so that each trust had taxable income below the threshold amount. Such trusts would be used to hold businesses, which had issues with either of the reduction calculations for taxpayers with income in excess of the threshold amounts.

The other most often cited reason to create multiple trusts was to obtain multiple $10,000 maximum state and local tax deduction amounts under IRC §164(b)(6). Taxpayers would transfer investment or personal real estate into the trusts, often with fractional interests in a piece of property distributed among multiple trusts to be able to obtain a deduction for property taxes in the trust by also contributing property to each trust that would generate sufficient income to use up the $10,000 state and local tax deductions.

The IRS had a tool to combat the use of multiple trusts that they had never used, since prior to TCJA the narrow tax brackets of a trust argued against using them for income tax savings in most cases. But because it was now possible to generate an income tax savings by using multiple trusts, the IRS finally issued regulations under IRC §643(f).

In the preamble to the proposed regulations, the IRS explains the justification for issuing this regulation.

> To address this and other concerns regarding the abusive use of multiple trusts, proposed §1.643(f)-1 confirms the applicability of section 643(f). As noted in part II of the Background, section 643(f) permits the Secretary to prescribe regulations to prevent taxpayers from establishing multiple non-grantor trusts or contributing additional capital to multiple existing non-grantor trusts in order to avoid federal income tax. Proposed §1.643(f)-1 provides that, in the case in which two or more trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and a principal purpose for establishing such trusts or contributing additional cash or other property to such trusts is the avoidance of federal income tax, then such trusts will be treated as a single trust for federal income tax purposes. For purposes of applying this rule, spouses are treated as only one person and, accordingly, multiple trusts established for a principal purpose of avoiding federal income tax may be treated as a single trust even in cases where separate trusts are established or funded independently by each spouse. Proposed §1.643(f)-1 further provides examples to illustrate specific situations in which multiple trusts will or will not be treated as a single trust under this rule, including a situation where multiple trusts are created with a principal purpose of avoiding the limitations of section 199A. The application of proposed §1.643(f)-1, however, is not limited to avoidance of the limitations under section 199A and §§1.199A-1 through 1.199A-6.

The regulation contains the following general rule:

> For purposes of subchapter J of chapter 1 of Title 26 of the United States Code, two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing such trusts or

for contributing additional cash or other property to such trusts is the avoidance of federal income tax. For purposes of applying this rule, spouses will be treated as one person.[20]

The regulation continues to define a principal purpose presumption for this rule:

A principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts.

Example 1, Proposed Reg. §1.643(f)-1(c)

A owns and operates a pizzeria and several gas stations. A's annual income from these businesses and other sources exceeds the threshold amount in section 199A(e)(2), and the W-2 wages properly allocable to these businesses are not sufficient for A to maximize the deduction allowable under section 199A.

A reads an article in a magazine that suggests that taxpayers can avoid the W-2 wage limitation of section 199A by contributing portions of their family businesses to multiple identical trusts established for family members. Based on this advice, in 2018, A establishes three irrevocable, non-grantor trusts: Trust 1 for the benefit of A's sister, B, and A's brothers, C and D; Trust 2 for the benefit of A's second sister, E, and for C and D; and Trust 3 for the benefit of E.

Under each trust instrument, the trustee is given discretion to pay any current or accumulated income to any one or more of the beneficiaries. The trust agreements otherwise have nearly identical terms.

But for the enactment of section 199A and A's desire to avoid the W-2 wage limitation of that provision, A would not have created or funded such trusts. A names A's oldest son, F, as the trustee for each trust.

A forms a family limited partnership, and contributes the ownership interests in the pizzeria and gas stations to the partnership in exchange for a 50-percent general partner interest and a 50-percent limited partner interest. A later contributes to each trust a 15% limited partner interest.

Under the partnership agreement, the trustee does not have any power or discretion to manage the partnership or any of its businesses on behalf of the trusts, or to dispose of the limited partnership interests without the approval of the general partner.

Each of the trusts claims the section 199A deduction on its Form 1041 in full based on the amount of qualified business income (QBI) allocable to that trust from the

[20] Proposed Reg. §1.643(f)-1(a)

limited partnership, as if such trust was not subject to the wage limitation in section 199A(b)(2)(B).

Under these facts, for Federal income tax purposes under this section, Trust 1, Trust 2, and Trust 3 would be aggregated and treated as a single trust.

Example 2, Proposed Reg. §1.643(f)-1(c) Substantial Non-Tax Differences

X establishes two irrevocable trusts: one for the benefit of X's son, G, and the other for X's daughter, H. G is the income beneficiary of the first trust and the trustee is required to apply all income currently to G for G's life. H is the remainder beneficiary of the first trust.

H is an income beneficiary of the second trust and the trust instrument permits the trustee to accumulate or to pay income, in its discretion, to H for H's education, support, and maintenance. The trustee also may pay income or corpus for G's medical expenses. H is the remainder beneficiary of the second trust and will receive the trust corpus upon G's death.

Under these facts, there are significant non-tax differences between the substantive terms of the two trusts, so tax avoidance will not be presumed to be a principal purpose for the establishment or funding of the separate trusts. Accordingly, in the absence of other facts or circumstances that would indicate that a principal purpose for creating the two separate trusts was income tax avoidance, the two trusts will not be aggregated and treated as a single trust for federal income tax purposes under this section.

Expenses Related to Tax-Exempt Income

Under IRC § 265(a)(1) no deduction is allowed for expenses related to tax-exempt income. If expenses are directly related to tax-exempt income, then it's fairly simple to determine that none of that expense would be allowed as a deduction. Similarly, if the expense only benefits assets generating taxable income, then no reduction is required and the entire expense can be deducted.

For instance, a payment made to a plumber to repair a leaky pipe in a rental property owned by the trust would relate totally to taxable income of the trust, and no special allocation of the expense to determine a disallowance relating to tax-exempt income would be required.

The first step any fiduciary should take, therefore, is to attempt to identify those expenses that are directly related to either taxable or nontaxable income. Expenses directly related to taxable income, if otherwise a lot of deduction, can be taken straight to the tax return. Similarly, expenses related to tax-exempt income will not be deductible on the Form 1041.

However, in the real world, the situation is often not so simple. Investment advisors will collect a fee but give advice related to both taxable and nontaxable investments held by the taxpayer, in this case, the trust or estate. Similarly, other expenses incurred may benefit both the taxable and nontaxable holdings of the trust or estate.

In such a case, an allocation of the expense or expenses must be made. Generally, any reasonable method may be used to calculate the allocation of such expenses.

Such potentially allowable methods include:

- the net income method;
- the gross income method;
- the DNI method; and
- any other reasonable method.

A CPA must be aware of how to properly report these items of expense through tax software in order to come up with a proper computation of allowable and non-allowable expenses. Most software uses the same terms that the tax law does, referring to expenses as either *direct* or *indirect expenses* as related to this area.

Individuals doing the initial preparation of the return through tax software need to take care that all expenses are entered with the proper designation on the return. In addition, the CPA should carefully review any worksheets produced by the tax software that it uses to calculate allowable and non-allowable portions of indirect expenses. Because the law allows any reasonable method to be used in these calculations, it is possible the CPA may decide that a method other than the default method used by the tax software would be more appropriate. With the disallowance of any deduction for 2% miscellaneous deductions under the TCJA, advisors will find fewer expenses that will need to be divided up between taxable and nontaxable income. Investment advisory fees, regardless of the type of income they relate to, simply won't be deductible.

DEPRECIATION, DEPLETION, AND AMORTIZATION

A number of special issues arise when dealing with depletion, depreciation, and amortization in a trust or estate.

In the case of a decedent's estate for the year of death, the amounts of these items should be prorated between the period of the year before the date of death (allocable to the decedent and reported on her final return) and the period after the date of death (when the item will be reported on the Form 1041).

An estate or trust is allowed a deduction for depreciation only to the extent that the depreciation is not allowable to beneficiaries of the estate or trust [Reg. §1.642(e)-1]. The rules however are somewhat different for trusts and estates.

For a trust, if local law requires or allows a trustee to maintain a reserve and the trustee does so, depreciation is first allocated to the trustee. This allocation is limited to the amount of the reserve [Reg. §1.167(h)-1(b)].

Any depreciation that is left over after this allocation is allocated between the trustee and the beneficiary based on their allocable shares of the trust's accounting income, not the trust DNI [Reg. §1.167(h)-1(b)]. Therefore, if the trust requires all income to be distributed to the trust beneficiaries on annual basis, all of the depreciation will be allocated to the beneficiaries.

Alternatively, if the trust does not require a current distribution of income, and the trustee distributes only half of the accounting income to the beneficiary, then half of the depreciation (after reducing it for the reserve if any) would be allocated to the beneficiary and the other half would be allocated back to the trust and reported on the Form 1041.

For an estate, only a single level of allocation takes place. The allocation is based on accounting income allocable to each for the year in question [Reg. §1.167(h)-1(c)]. If the estate makes no distributions for this year, then the entire amount of depreciation would be allocated to the estate.

Depreciation, depletion, and amortization are allocated to beneficiaries in proportion to the income allocated to each by an estate [Reg. §1.167(h) 1(c)].

The allocation by a trust is on the same basis unless otherwise determined by the trust instrument or state law [Reg. §1.167(h) 1(b)].

Expensing under IRC §179 is not available to a trust or estate for any property the trust or estate may purchase for use in a trade or business because IRC §179(d)(4) specifically prohibits it. With 100% bonus depreciation expanded to cover many more assets under the TCJA, the bar on §179 expensing is less of an issue. But issues may still arise if the trust or estate holds an interest in a pass-through entity, where a §179 election is made by the pass-through entity.

Furthermore, beneficiaries cannot take a §179 deduction on any inherited property because §179 requires that property be acquired by purchase in order to claim a deduction under §179 [IRC §179(d)(1)(C)].

Depreciation is recaptured by an estate limited to depreciation claimed by the entity, as the property receives a stepped-up basis when it passes to the estate.

OTHER ESTATE/TRUST INCOME TAX ISSUE

Deductions in Respect of a Decedent

Deductions in respect of the decedent may be deducted for both federal estate tax and income tax purposes. These items are simply the flip side of the concept of IRD.

Deductions in respect of a decedent are expenses the decedent incurred prior to death but which have not been allowed as a deduction on the decedent's individual income tax return. Most often, these are expenses that are unpaid as of the decedent's date of death for a decedent on the cash basis of accounting, as are most individuals.

Because of the double benefit allowed for the expenses, it is important to recognize these expenses and properly report them on both returns.

Election to Claim Administrative Expenses as Income Tax Deductions

An estate may claim administrative expenses as either an estate tax deduction or an income tax deduction, but cannot claim them in both places [IRC §642]. Expenses are to be claimed on the estate tax return when, no election is required. Rather the expenses are simply claimed on the Form 706.

However, if the estate wishes to claim these expenses on the fiduciary income tax returns, an election is necessary. The election can be filed either with the Form 1041 or directly with the IRS. Currently, on its website the IRS indicates that such an election, if not filed with the Form 1041, should be mailed to the following address:

Department of the Treasury
Internal Revenue Service
Cincinnati, OH 45999

The regulation provides that the election must be filed in duplicate.

The statement must provide that, "the items have not been allowed as deductions from the gross estate of the decedent under section 2053 or 2054 and that all rights to have such items allowed at any time as deductions under section 2053 or 2054 are waived." [Reg. §1.642(g)-1]

The statement can be filed at any time while the statute of limitations on the Form 1041 is open. However, once the statement is filed the estate is prohibited from claiming the deduction on the estate tax return.

The regulation even provides, "allowance of a deduction in computing an estate's taxable income is not precluded by claiming a deduction in the estate tax return, so long as the estate tax deduction is not finally allowed and the statement is filed." Thus, the fiduciary may wish to delay the final statement until the estate tax return has been examined or is closed, if it is not clear whether the deduction will be necessary on the estate tax return. Until the statement is filed, the estate retains full flexibility on where to claim the deduction.

In most cases, due to the higher estate tax rates if an estate tax is due, it will normally be more beneficial to claim the expenses on the Form 706. However, if there is no taxable estate or the entire estate is passing to the surviving spouse, then claiming expenses on the Form 1041 is generally going to be preferable.

Excess Deductions on Termination

If administrative expenses exceed income in a final trust or estate return, they are distributed to the beneficiaries who report them as miscellaneous itemized deductions in their personal returns. These items are referred to as excess deductions on termination [IRC §642(h)].

A key point to note is that expenses must be properly deductible in that final year to be passed out to the beneficiaries. Advisers may want to take this into consideration in determining when to pay certain expenses, considering the vast majority of trusts and estates will be reporting on the cash basis of accounting.

The deductions for charitable contributions and the exemption are not counted in determining the existence of excess deductions on termination [IRC §167(d)]. Moreover, a NOL is also excluded from this calculation unless the loss is one for which the final year for deduction of loss is the year of termination of the estate or trust. In that rare case, the NOL becomes part of excess deductions on termination [Reg. §1.642(h)-2(b)].

Net capital losses in excess of the $3,000 limit in the year of termination pass to the beneficiaries as capital loss carryovers. The same is true of NOL carryovers that survive the year of termination of the trust or estate [IRC §642(h)(1)].

If a portion of a trust is an electing small business trust (ESBT), the rules for excess deductions on termination are applied separately to the ESBT portion of the trust and the other portion of the trust [IRC §641(c)(4)].

Notice 2018-61 discusses one deduction that goes from a trust or estate to beneficiaries that has been left in an odd state of limbo under the new law. In particular, what happens to the beneficiaries' deduction for excess deductions on termination of a trust or estate under IRC §642(h)(2)?

The Notice points out:

> …§1.642(h)-2(a) provides that if, on the termination of an estate or trust, the estate or trust has for its last taxable year deductions (other than the deductions allowed under section 642(b) (relating to personal exemption) or section 642(c) (relating to charitable contributions) in excess of gross income, the excess is allowed under section 642(h)(2) as a deduction (section 642(h)(1) excess deduction) to the beneficiaries. However, the section 642(h)(2) excess deduction is allowed only in computing the taxable income of the beneficiaries and must be taken into account in computing the items of tax preference of the beneficiaries. Therefore, a section 642(h)(2) excess deduction is not used in computing the beneficiaries' adjusted gross income and is treated as a miscellaneous itemized deduction of the beneficiaries. See sections 63(d) and 67(b).

What makes this quirky is that, under the new law, the §642(h)(2) amount only contains items that were deductible to the trust or estate on the final year return—and, thus, do not contain miscellaneous itemized deductions. But because the §642(h)(2) deduction itself is an itemized deduction to the individual beneficiary, is this deduction now lost to beneficiaries?

The Notice discusses this issue as follows:

> The section 642(h)(2) excess deduction may include expenses described in section 67(e). As previously discussed, prior to enactment of section 67(g), miscellaneous itemized deductions were allowed subject to the restrictions contained in section 67(a). For the years in which section 67(g) is effective, miscellaneous itemized deductions are not permitted, and that appears to include the section 642(h)(2)

> excess deduction. The Treasury Department and the IRS are studying whether section 67(e) deductions, as well as other deductions that would not be subject to the limitations imposed by sections 67(a) and (g) in the hands of the trust or estate, should continue to be treated as miscellaneous itemized deductions when they are included as a section 642(h)(2) excess deduction. Taxpayers should note that section 67(e) provides that appropriate adjustments shall be made in the application of part I of subchapter J of chapter 1 of the Code to take into account the provisions of section 67.

The Notice asks for comments to be submitted on how deductions described in IRC §67(e) that make their way into the §642(h)(2) amount should be dealt with in the post-TCJA era.

DNI AND INCOME DISTRIBUTION RULES

In general, DNI is computed on Schedule B, Form 1041. The computation of DNI is important because it dictates how much of a distribution deduction may be taken by the trust or estate. It also dictates how much income from the trust or estate must be reported as taxable income by the beneficiaries on their respective income tax returns.

DNI is defined by IRC §643(a) as the taxable income of the estate or trust without the following items:

- Deduction for distributions to beneficiaries
- Deduction for personal exemption
- Excluding municipal bond interest
- Capital gains allocable to trust corpus
- Not paid, credited or required to be distributed to any beneficiary during the tax year
- Not set aside permanently to be used for a charitable purpose
- Capital losses

DNI operates principally as one limitation on the amount of income to be reported by beneficiaries and on the trust's ability to claim an income distribution deduction. The other limitation looks to the cash and property distributions made, or required to be made, during the year or, if elected by the trust or estate under IRC §663(b), during the first 65 days of the following year and treated as if paid in the prior year.

Beneficiaries must report as taxable income the lesser of the amounts distributed, or required to be distributed by the trust or, if less, the DNI of the trust available for distribution.

The nature of income to be reported by beneficiary is determined by type of income making up the trust's DNI.

Generally, whether an item is charged to corpus or income does not have an impact on the computation of DNI. The one major exception to this is the treatment of capital gains. If capital gains are properly chargeable to income, they will be included in the computation of DNI. That will include situations where the trustee has the discretion to allocate capital gains to either principal or income under the terms of the trust were such a term is not in violation of state law.

EFFECT OF LOSSES

Unlike pure pass-throughs such as S Corporations and partnerships, trust, and estate losses are not distributed to beneficiaries until termination of the entity. That final year distribution was described in the unit on expenses in the area discussing the excess deductions on termination, NOLs, and capital losses.

Among the losses retained within the entity until termination include such items as:

- NOL carryovers;
- capital loss carryovers;
- suspended passive losses (added to basis on termination);
- minimum tax credit (lost on termination);
- excess investment interest; and
- excess deductions.

Due to the fact that excess deductions do not pass out until the final year, it may be important to carefully plan when expenses will be triggered for tax purposes when approaching the termination of a trust or estate. For instance, if the trustee expects to be able to wrap up the estate a month or two after an upcoming fiscal year end, and the estate does not expect to have taxable income, the fiduciary should consider delaying the payment of expenses to the extent possible until after the end of the year in order to make them available to the beneficiaries upon termination.

One significant exception, discussed earlier, is that negative QBI may pass through the trust to beneficiaries to the extent the beneficiaries received a distribution deemed to be made up of DNI.

INCOME DISTRIBUTION DEDUCTION

The trust or estate can take an income distribution deduction for amounts of trust income distributed during the year. This deduction is limited both by the amounts of distributions made (or required to be made) and the DNI of the trust or estate. The deduction will serve to reduce the taxable income of the estate or trust. That in turn will affect the tax due from the estate or trust on Form 1041.

A similar calculation discussed in a later unit is used to determine the portion of the estate or trust net investment income that is deemed distributed for purposes of the tax on net investment income under IRC §1411.

Schedule B—In general

The purpose of Schedule B is to calculate the portion of the entity's taxable income to be reported by the beneficiaries and to determine the amount of deduction allowed on the Form 1041 to the trust or estate to be used in computing its taxable income.

The income distribution deduction will be the lesser of:

- the DNI, computed on the income tax basis minus distributable net tax-exempt income, or
- the amounts actually distributed, credited, or required to be distributed, computed using fiduciary accounting principles minus net tax-exempt income.

There are two ways to view the computation of DNI:

- Taxable income as modified
- Adjusted total income

The tax law takes the first approach. The law starts under IRC §643 with the taxable income of the trust or the estate and makes specific modifications to that income in order to arrive at the trivial net income.

Form 1041 starts with the other calculation, beginning with picking up a modified amount of the trust income and then making a lesser number of adjustments.

Schedule B—Line-by-line explanation

Schedule B	Income Distribution Deduction			
1	Adjusted total income. See instructions		1	
2	Adjusted tax-exempt interest		2	
3	Total net gain from Schedule D (Form 1041), line 19, column (1). See instructions		3	
4	Enter amount from Schedule A, line 4 (minus any allocable section 1202 exclusion)		4	
5	Capital gains for the tax year included on Schedule A, line 1. See instructions		5	
6	Enter any gain from page 1, line 4, as a negative number. If page 1, line 4, is a loss, enter the loss as a positive number		6	
7	**Distributable net income.** Combine lines 1 through 6. If zero or less, enter -0-		7	
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law	8		
9	Income required to be distributed currently		9	
10	Other amounts paid, credited, or otherwise required to be distributed		10	
11	Total distributions. Add lines 9 and 10. If greater than line 8, see instructions		11	
12	Enter the amount of tax-exempt income included on line 11		12	
13	Tentative income distribution deduction. Subtract line 12 from line 11		13	
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-		14	
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18		15	

Line 1—Adjusted Total Income (From Form 1041, Page 1)

On page one, line 17 (referred to as *adjusted income or loss*) is a positive number, the CPA will enter that amount on line 1 of Schedule B. However, if line 17 is negative, and the trust is reporting a net capital loss on line 4a, modification is necessary.

In that case, the CPA enters a negative number on line 1, the lesser (amount nearest zero) of the following:

- Adjusted total income, line 17, page 1
- Capital loss, line 4, page 1

Line 2—Adjusted Tax-Exempt Interest

On line 2 of Schedule B, the CPA enters gross tax-exempt interest minus all expenses, including interest paid to purchase tax-exempt securities that have been allocated to tax-exempt income. The CPA includes in the calculation tax-exempt interest allocated to charitable contributions.

Lines 3 through 6—Capital Gains

As was noted earlier, capital gains is the one area where the treatment for trust accounting purposes will impact the computation of DNI.

Schedule B adds capital gains allocated to beneficiaries to DNI and eliminates capital gains and losses reported on line 4, resulting in only the gains allocated to beneficiaries remaining as part of DNI.

Line 7—Distributable Net Income

DNI is computed by adding lines 1 through 6. This figure is reported on line 7 and serves as one of the factors to be considered in the income distribution deduction.

Line 8—Fiduciary Accounting Income for the Tax Year

Line 8 exists principally for complex trusts. Estates and simple trusts should skip line 8.

As was mentioned earlier, the term *accounting income* in this context refers to income computed under the applicable UPAIA and the trust terms.

Line 9—Income Required to be Distributed Currently

All simple trusts must complete this line because in order to be a simple trust the trust document must require income (i.e., accounting income) be distributed currently. This line simply reports that number. Remember that the number in question generally is going to be the accounting income of the trust not the taxable income.

Estates and complex trusts required to distribute accounting income currently complete this line.

In all cases, the governing document must be consulted to uncover the mandate to make this distribution. In the absence of a mandate, there will be no amount listed on this line and the trust will automatically be a complex trust.

The amount represents the first tier distribution and is deductible by the estate or trust. This is also the level that first absorbs DNI. If DNI is less than this number, then there will be no DNI left to be allocated to the second tier distributions that are shown on line 9.

All discretionary amounts actually distributed or credited are required to be distributed, including in the first 65 days of the following year under a §663(b) election. This amount represents the second tier distribution.

Line 11—Total Distributions

This line just reports the total of the first and second tier distributions for the year. This amount must be adjusted to reflect the portion of the distribution that arose from tax-exempt income. As should be obvious, the law is not going to allow a deduction based on a distribution of income that was not itself subject to tax.

Line 12—Amount of Net Tax-Exempt Income Included on line 11

The purpose of line 12 is to eliminate net tax-exempt income included in total distributions on line 11. This brings us down to the portion of the distribution that represents other than tax-exempt income available to fund the distribution.

Line 13 and 14—Tentative Income Distribution Deduction

Line 13 takes line 11 minus line 12, producing a tentative income distribution deduction based on taxable distributions.

Line 14 takes line 7 minus line 2 and produces a second tentative income distribution based on distributable net taxable income and eliminates adjusted tax-exempt interest.

Line 15—Income Distribution Deduction

The lesser of the two tentative income distribution deductions computed on line 13 and 14 becomes the final income distribution deduction. This amount is carried to line 18 on the front page of Form 1041.

65-day Rule for Complex Trusts

The trustee of a complex trust or the executor of an estate may elect to treat amounts paid or credited to the beneficiary within the first 65 days of the entity's current year as distributed on the last day of the preceding year [IRC §663(b)].

The amount treated as a distribution in the prior year under this rule cannot exceed the following:

- The DNI for the trust for the year in question reduced by:

  – any amounts paid, credited, or required to be distributed during the tax year, reduced by any amounts subject to this election under §663(b) for the prior year (that is, amounts paid in 2017 that were treated as paid in 2016 would not also serve to reduce the amount available for election for amounts paid in 2018) [Reg. §1.663(b)-1].

The election must be made by the due date (including extensions) for the year in which the election is to apply (so by the due date of the 2018 return to have 2019 distributions treated as if made during 2018).

Whether or not this election should be made often depends on tax and non-tax considerations. Given the relatively narrow brackets for trusts and estates, and the addition of the new tax on net investment income that applies at a very low level of income to trust estates, often substantially less tax would be paid if income were distributed to the beneficiaries.

However, paying those funds out to the beneficiaries may defeat some of the non-tax reasons why the trust was established. For instance, if there was a concern about the beneficiary's ability to manage funds, turning the funds over to the beneficiary may defeat the purpose of the trust even if it results in a savings of tax.

Regardless, the CPA should discuss this option with the trustee, potentially in consultation with counsel that may have some insight into the non-tax reasons for the structure. Ultimately, the decision will be made by the trustee, so the CPA needs to ensure the trustee has the information available to make a prudent decision.

TIERED DISTRIBUTION STRUCTURE—ESTATES AND COMPLEX TRUSTS

Payments required to be paid from current fiduciary accounting income are tier 1 distributions. Remember that if distributions are only made from producer accounting income, and the distributions are required to be made from that income, the trust will be a simple trust. A simple trust has only tier 1 distributions.

Payments required by the terms of the trust document to be paid from principal will automatically be part of tier 2. Similarly, payments not required to be made currently out of income but which may be allowed to be made out of income will become part of tier 2 as well.

First tier distributions carry DNI in full before allocation to the second tier. Conceptually, this makes sense because the trust document requires income, at least in the accounting sense, to be distributed to the tier 1 individuals. The last income is deemed to first come out in the tier 1 distributions.

If the first tier distributions exceed DNI, then each first tier beneficiary reports only her proportionate share of DNI. The excess, if any, paid to the first tier beneficiaries is a tax-free distribution of principal.

If first tier distributions are less than DNI, then second tier distributions will include a proportionate share of remaining DNI. As with the first tier beneficiaries, if the distribution exceeds the remaining DNI, the beneficiary reports her proportionate share of the DNI remaining after the first tier distribution.

ALLOCATION OF DNI TO CLASSES OF INCOME

For purposes of determining the nature of the remaining taxable income of the estate or trust, any amounts deductible for distributions are treated as consisting of a proportionate amount of each class of income equal to the ratio of each class of income to total DNI.

TRUSTS AND THE DECEDENT'S ESTATE

Some special rules apply to trusts that are created due to the decedent's estate.

Administrative Trust as Successor to Revocable Living Trust

A merged estate can be created if both the executor of a decedent's estate and the trustee of a qualified revocable trust (a grantor trust established by the decedent during his lifetime) elect to merge the entities for purposes of administration. Such a merger is permitted by IRC §645 and the election is made by filing Form 8855, Election To Treat a Qualified Revocable Trust as Part of an Estate not later than the time prescribed for filing Form 1041 for the first taxable year of the related estate. The current version of Form 8855 follows:

Form **8855**

(Rev. January 2009)

Department of the Treasury
Internal Revenue Service

Election To Treat a Qualified Revocable Trust as Part of an Estate

OMB No. 1545-1881

Part I Estate (or Filing Trust) Information

Name of estate (or the filing trust, if applicable (see instructions))	**Employer identification number** (see instructions)
Name of executor (or the filing trustee, if applicable)	Type of entity prior to the election: ☐ Domestic estate ☐ Foreign estate ☐ Domestic trust ☐ Foreign trust
Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)	
City or town, state, and ZIP code (if a foreign address, see instructions)	Date of executor's appointment

Under penalties of perjury, I, as executor (or filing trustee):

- Confirm that under applicable local law or the governing document, I have the authority to make this election for the estate (if executor) or trust (if filing trustee) and to agree to the conditions of the election;
- Elect the treatment provided under section 645 for the above-named estate (or filing trust, if applicable);
- Confirm that an agreement has been reached with the trustees of each qualified revocable trust (QRT) joining in the election to allocate the tax burden of the combined electing trusts and related estate, if any, for each tax year during the election period in a manner that reasonably reflects each entity's tax obligation;
- Agree to ensure that the related estate's (or filing trust's, if applicable) share of the tax obligations of the combined electing trust(s) and related estate, if any, is timely paid to the United States Treasury;
- Agree to accept responsibility for filing a complete, accurate, and timely income tax return, when required by law, for the combined electing trust(s) and related estate, if any, for each tax year during the election period;
- (If I am the filing trustee) confirm that if there is more than one QRT making this election, that I have been appointed by the trustees of each QRT making this election to be the filing trustee and I agree to accept the responsibility of filing the appropriate income tax return for the combined electing trust(s) for each tax year during the election period and all other responsibilities of the filing trustee;
- (If I am the filing trustee) represent that no executor has been appointed for a related estate and to the best of my knowledge and belief, one will not be appointed;
- (If I am the filing trustee) agree that, if an executor is appointed for the related estate after this Form 8855 is filed, that I will complete and file an amended Form 8855 if the late appointed executor agrees to the election, and I agree to cooperate with the executor in filing any amended returns required to be filed as a result of the executor's appointment; and
- Confirm to the best of my knowledge and belief, that all information contained in this election and any accompanying statements or schedules is true, correct, and complete.

Signature of executor (or filing trustee)	Date

Part II Decedent Information

Name of decedent	SSN of the decedent	Date of death

For Paperwork Reduction Act Notice, see page 4. Cat. No. 24542R Form **8855** (1-2009)

Form 8855 (1-2009) Page **2**

Part III **Qualified Revocable Trust Information**

Name of trust	Employer identification number (see instructions)
Name of trustee	
Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)	
City or town, state, and ZIP code (if a foreign address, see instructions)	

Under penalties of perjury, I, as trustee of the above-named trust:

- Confirm that under applicable local law or the governing instrument, I have the authority to make this election for the trust and to agree to the conditions of the election;
- Elect the treatment provided under section 645 for this trust;
- Agree to timely provide the executor (or filing trustee if there is no executor) with all the trust information necessary to permit the executor (or filing trustee, if applicable) to file a complete, accurate, and timely Form 1041 (or Form 1040-NR for a foreign estate) for the combined electing trust(s) and the related estate, if any, for each tax year during the election period;
- Confirm that an agreement has been reached with the trustees of each QRT joining in the election, and the executor of the related estate, if any, to allocate the tax burden of the combined electing trust(s) and related estate, if any, for each tax year during the election period in a manner that reasonably reflects each entity's tax obligation;
- Agree to ensure that this trust's share of the tax obligations of the combined electing trust(s) and related estate, if any, is timely paid to the United States Treasury;
- Confirm that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855, the trustee that completed Part I has been appointed the filing trustee, and to the best of my knowledge and belief, an executor has not been appointed to administer a related estate and one will not be appointed;
- Agree that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855 and an executor is appointed for the related estate after this Form 8855 is filed, that I will complete and file an amended Form 8855 if the later appointed executor agrees to the election, and I agree to cooperate with the executor in filing any amended returns required to be filed as a result of the executor's appointment; and
- Confirm to the best of my knowledge and belief, that all information of the electing trust contained in this election and any accompanying statements or schedules is true, correct, and complete.

Signature of trustee	Date

Name of trust	Employer identification number (see instructions)
Name of trustee	
Number, street, and room or suite no. (or P.O. box number if mail is not delivered to street address)	
City or town, state, and ZIP code (if a foreign address, see instructions)	

Under penalties of perjury, I, as trustee of the above-named trust:

- Confirm that under applicable local law or the governing instrument, I have the authority to make this election for the trust and to agree to the conditions of the election;
- Elect the treatment provided under section 645 for this trust;
- Agree to timely provide the executor (or filing trustee if there is no executor) with all the trust information necessary to permit the executor (or filing trustee, if applicable) to file a complete, accurate, and timely Form 1041 (or Form 1040-NR for a foreign estate) for the combined electing trust(s) and the related estate, if any, for each tax year during the election period;
- Confirm that an agreement has been reached with the trustees of each QRT joining in the election, and the executor of the related estate, if any, to allocate the tax burden of the combined electing trust(s) and related estate, if any, for each tax year during the election period in a manner that reasonably reflects each entity's tax obligation;
- Agree to ensure that this trust's share of the tax obligations of the combined electing trust(s) and related estate, if any, is timely paid to the United States Treasury;
- Confirm that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855, the trustee that completed Part I has been appointed the filing trustee, and to the best of my knowledge and belief, an executor has not been appointed to administer a related estate and one will not be appointed;
- Agree that if a filing trustee (and not an executor for a related estate) has completed Part I of this Form 8855 and an executor is appointed for the related estate after this Form 8855 is filed, that I will complete and file an amended Form 8855 if the later appointed executor agrees to the election, and I agree to cooperate with the executor in filing any amended returns required to be filed as a result of the executor's appointment; and
- Confirm to the best of my knowledge and belief, that all information of the electing trust contained in this election and any accompanying statements or schedules is true, correct, and complete.

Signature of trustee	Date

Form **8855** (1-2009)

The separate share rule of code section 663(c) requires the electing trust and related estate to be treated as separate shares for purposes of computing DNI.

It is possible that those separate shares could each contain two or more separate shares. That can add complexity to the calculation of DNI.

Merging the estate and a revocable trust may not be a good idea unless all income will be distributed to beneficiaries. Otherwise, the combined income might be taxed at higher rates than if each entity had been administered separately.

Note, however, that in many cases where revocable living trusts are used as the principal estate planning agreement that was drafted in consultation with an experienced estate planning attorney little or nothing will end up actually being part of the probate estate. And, due to the pour over will that most often accompanies such trusts, any assets that do leak out to the probate estate will make their way rapidly into the trust.

Testamentary Trusts

Testamentary trusts are those created upon the death of the decedent by the decedent's will or other estate planning documents.

REQUEST FOR PROMPT ASSESSMENT

IRC §6501(d) provides that a fiduciary representing an estate may request prompt assessment for income tax returns of the decedent, the estate, and a trust by filing Form 4810. Filing Form 4810 reduces the period that income tax returns of the decedent or the decedent's estate are open to examination from 3 years to 18 months. This rule exists because the fiduciary is liable for the taxes if the fiduciary has allowed assets to leave the estate that could have been used to pay the tax and the fiduciary is not able to recover those assets.

Some personal representatives and executors tend to express concern that filing this form might raise a red flag to the IRS indicating that they believe there are problems in the estate. The concern is that by filing the form, the returns may be subject to an exam that otherwise would not occur had the normal three-year statute remained open.

However, most advisors have not found in their experience that filing Form 4810 (most current version follows) has resulted in a generally higher level of examination of the affected returns. Nevertheless, the concerns of the fiduciary do need to be respected.

Arguably, there may not be a huge advantage to filing the form if the fiduciary is also the residual beneficiary of the estate. That is, if the IRS later determines taxes are due, the fiduciary will not need to recover assets from other beneficiaries.

But in cases where most or all of the assets left over in the estate go to parties other than the executor or personal representative, the filing of this form is often highly recommended.

Form **4810** (Rev. February 2009) Department of the Treasury Internal Revenue Service

Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)

► See instructions on back.

OMB No. 1545-0430

For IRS Use Only

Requester's name

Title

Kind of tax

- ☐ Income
- ☐ Gift
- ☐ Employment
- ☐ Excise

Number, street, and room or suite no. (If a P.O. box, see instructions.)

City, town, or post office, state, and ZIP code | Daytime phone number

Tax Returns for Which Prompt Assessment of Any Additional Tax is Requested

Form Number	Tax Period Ended	SSN/EIN on Return	Name and Address Shown on Return	Service Center Where Filed	Date Filed

If applicable, provide the name of decedent's spouse (surviving or deceased) | **Spouse's social security number**

If corporate income tax returns are included, check the applicable box below:

- ☐ Dissolution has been completed.
- ☐ Dissolution has begun and will be completed either before or after the 18-month period of limitation.
- ☐ Dissolution has not begun but will begin before the 18-month period of limitation expires and will be completed either before or after that period expires.

Attached are copies of:

- ☐ The returns listed above.
- ☐ Letters of administration or letters testamentary.
- ☐ Other (describe):

I request a prompt assessment of any additional tax for the kind of tax and periods shown above, as provided by Internal Revenue Code section 6501(d).

Sign Here

Under penalties of perjury, I declare that I have examined this request, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

☐ **I certify that I have never been assessed any penalties for civil fraud for any federal or state tax matter nor have I been charged with, indicted for, or convicted of fraud. If you cannot certify this statement, attach a detailed statement explaining the circumstances under which you were assessed a penalty, charged with, indicted for, or convicted of fraud.**

► Signature of requester | Date | ► Identifying number

For Privacy Act and Paperwork Reduction Act Notice, see back of form. Cat. No. 42022S Form **4810** (Rev. 2-2009)

Take Advantage of Diversified Learning Solutions

We are a leading provider of continuing professional education (CPE) courses to Fortune 500 companies across the globe, CPA firms of all sizes, and state CPA societies across the country, as well as CPA associations and other financial organizations. Our efficient and flexible approach offers an array of customized cutting-edge content to meet your needs and satisfy the priorities of your business. Select from live classes, live webinars, conferences, or online training, including Nano courses, based on your preferred method of learning.

Meet your CPE requirements, increase productivity, and stay up-to-date with relevant industry trends and mandatory regulations with collaborative live or online learning.

Live Training Topics	Online Training Topics
Accounting and Auditing	**Accounting and Auditing**
Employee Benefit Plans	**Business Law**
Ethics	**Business Management and Organization**
Information Technology	**Economics**
Governmental and Not-For-Profit	**Ethics**
Non-Technical (including Professional Development)	**Finance**
Tax	**Information Technology**
	Management Services and Decision Making
	Personal and Professional Development
	Tax

"We have enjoyed [your] programs and have found the content to be an excellent learning tool, not only for current accounting and management issues, but also how these issues apply to our company and affect how our business is managed."

—Debbie Y.

KAPLAN

ISBN: 978-1-07-880228-4

www.kaplanfinancial.com | 332 Front Street South, Suite 501, La Crosse, WI 54601 | 800.824.8742