INCOME TAX BASICS FOR ESTATE PLANNERS

PRESENTED BY:

MELISSA J. WILLMS

WRITTEN BY:

MELISSA J. WILLMS AND MICKEY R. DAVIS
DAVIS & WILLMS, PLLC
3555 Timmons Lane, Suite 1250
Houston, Texas 77027
(281) 786-4500
melissa@daviswillms.com
mickey@daviswillms.com

AMERICAN BAR ASSOCIATION
SKILLS TRAINING FOR ESTATE PLANNERS - FUNDAMENTALS
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MELISSA J. WILLMS

Davis & Willms, PLLC

Board Certified - Estate Planning and Probate Law
Texas Board of Legal Specialization

Master of Laws (LL.M.) in Tax Law

3555 Timmons Lane, Suite 1250
Houston, Texas 77027

Phone (281) 786-4500
Fax (281) 742-2600
melissa@daviswillms.com

EDUCATION:

- LL.M., Tax Law, University of Houston Law Center, 1996
- J.D., Texas Tech University School of Law, 1992
- B.A., Psychology, B.A., Sociology, University of Texas at Austin, 1987

OTHER QUALIFICATIONS:

- Fellow, The American College of Trust and Estate Counsel (ACTEC) (Member, Estate & Gift Tax, Long Range Planning, and Program Committees)
- Board Certified, Estate Planning and Probate Law, Texas Board of Legal Specialization
- Best Lawyers in America, Trusts and Estates; Texas Super Lawyer, *Texas Monthly* and *Super Lawyers Magazine*
- Admitted to Practice: State Bar of Texas; Federal District Court for the Southern District of Texas; United States Tax Court

PROFESSIONAL ACTIVITIES:

- Real Estate, Probate and Trust Law Section, State Bar of Texas (Council Member, 2014-2018; Member, Decedents' Estates Committee, 2011-present; Chair, Decedents' Estates Committee, 2015-present)
- Member of the Board of Directors, ACTEC Foundation (Member, Grants Committee)
- Fellow, Texas Bar Foundation
- Tax Section, State Bar of Texas (Council Member, 2013-2016; Vice Chair, Estate and Gift Tax Committee, 2011-2014)
- Member, State Bar of Texas (Sections of Real Estate, Probate and Trust Law; Tax); Houston Bar Association (Section of Probate, Trusts and Estates); The College of the State Bar of Texas; Houston Estate and Financial Forum
- Awarded 2015 Standing Ovation Award by TexasBarCLE staff

RECENT SPEECHES AND PUBLICATIONS:

- Co-Author/Co-Presenter: *All About that Basis: How Income Taxes Have Reshaped Estate Planning*, 42nd Annual Notre Dame Tax and Estate Planning Institute, 2016; 36th, 37th, and 38th Annual ALI CLE Planning Techniques for Large Estates, 2016-2018
- Co-Author/Speaker: *Estate Planning for Married Couples in a World with Portability and the Marital Deduction*, 44th Annual Midwest/Midsouth Estate Planning Institute, 2017; 38th Annual ALI CLE Planning Techniques for Large Estates, 2018
- Co-Author/Panelist: *Hot Tax Topics*, State Bar of Texas 24th Annual Advanced Estate Planning Strategies Course, 2018
- Co-Author/Speaker: *Knowing the Ropes and Binding the IRS: Income and Transfer Tax Issues of Settlements and Modifications Every Fiduciary Should Know*, 10th Annual Texas Tech Estate Planning & Community Property Law Journal CLE & Expo, 2018; 39th Annual Duke University Estate Planning Conference, 2017
- Co-Author/Speaker: *Income Taxation of Trusts and Estates*, The Center for American and International Law 52nd Annual Short Course on Estate Planning, 2016, 2018
- Co-Author/Co-Presenter: *Income Taxation of Trusts and Estates: Ten Things Estate Planners Should Know*, National Association of Estate Planning Councils, 54th Annual NAEPC Advanced Estate Planning Strategies Conference, 2017
- Author/Speaker: *Income Tax Basics for Estate Planners*, American Bar Association Section of Real Property, Trust & Estate Law, Skills Training for Estate Planners – Fundamentals Course, 2015-2017
- Panelist: *Estate Planning in Light of the New Administration: What Do We Tell Our Clients Now?*, State Bar of Texas 41st Annual Advanced Estate Planning and Probate Course, 2017
- Co-Author/Panelist: *It's 1:45 p.m. in the Garden of Good and Evil: Now How Do We Deal with Value in Estate and Business Planning and Estate and Trust Administration?*, State Bar of Texas 23rd Annual Advanced Estate Planning Strategies Course, 2017
- Co-Author/Co-Presenter: *Planning for Married Clients: Charting a Path with Portability and the Marital Deduction*, 42nd Annual Notre Dame Tax and Estate Planning Institute, 2016; 36th and 37th Annual ALI CLE Planning Techniques for Large Estates, 2016, 2017
- Co-Author *All About That Basis: How Income Taxes Have Reshaped Estate Planning*, Estate Planning Council of Saint Louis, 2017; Philadelphia Estate Planning Council, 2016
- Co-Author/Speaker: *Knowing the Ropes and Binding the IRS When Fiduciaries are Involved in Settlements and Modifications: Income and Transfer Tax Issues Every Fiduciary Should Know*, 51st Annual Heckerling Institute on Estate Planning, 2017
- Co-Author/Panelist: *Distilling the Essence of Subchapter J: Fiduciary Income Tax Essentials for Estate Planners*, 51st Annual Heckerling Institute on Estate Planning, 2017
- Co-Author: *Planning and Drafting for the Married Couple in an Era of Portability, Mobility, and Liability*, ABA Real Property, Trust and Estate Law Section Webinar, 2016
- Co-Author/Speaker: *Practical Inter Vivos Inter Vivos and Testamentary Estate Planning: Helping Our Clients Plan in a High Exemption World*, 51st Annual Southern Federal Tax Institute, 2016

INCOME TAX BASICS FOR ESTATE PLANNERS

INCOME TAX BASICS FOR ESTATE PLANNERS[1]

I. INTRODUCTION

Income taxes are a pervasive part of our lives. With the passage of the American Taxpayer Relief Act of 2012, P.L. 112-240, 126 Stat. 2313 (2013) ("ATRA 2012"), estate planners and their clients began to see a new focus on the role of income taxes as part of estate planning. ATRA 2012 reunified and made "permanent" the estate, gift, and generation-skipping transfer ("GST") tax laws. As part of these new laws, the highest tax bracket for estate, gift, and GST tax purposes went from 35% to 40%, making the spread between these transfer tax rates and the highest income tax rate closer than they had been in years. Combining the large (and inflation-adjusted) estate tax exclusions, together with portability, higher income tax rates, and a new income tax, estate planners had to change their conversations with clients during the estate planning and the estate administration process.

Now, with the enactment of the Tax Cut and Jobs Act of 2017, P.L. 115-97, 131 Stat. 2054 (2018) ("TCJA 2017") on December 22, 2017,[2] additional significant changes have been made to the income and transfer tax laws. TCJA 2017 essentially doubled the estate and gift tax exclusions and GST tax exemption for persons dying and transfers made between 2018 and 2025. As a result, we have unified estate, gift and GST tax laws with an exclusion (or exemption) temporarily set at $10,000,000, but adjusted annually for inflation after 2011 (scheduled to return to $5,000,000 after 2025, as adjusted for inflation after 2011), and a top transfer tax bracket of 40%.[3] For 2018, after applying the inflation adjustment, the exclusion is $11,180,000.[4] Changes to the income tax rates maintain a spread between the tax rates that is virtually nil.

Accordingly, it is essential for estate planners to have a fundamental understanding of the income tax issues that are important to their clients. These issues relate not only to income taxation of individuals, but also income taxation of trusts and estates. The income tax arena presents a multitude of planning opportunities that arise, both during lifetime, and during the administration of a trust or a decedent's estate. Language contained in (or omitted from) the governing instrument as well as steps taken (or not taken) by the fiduciary in the course of administering a trust or estate can have important income tax implications. This paper is intended as a resource to highlight essential income tax planning issues that arise (i) when drafting wills and trust agreements; and (iii) when administering a trust or the estate of a decedent. It assumes that the reader has a passing familiarity with non-tax issues associated with the administration of trusts and estates. While not a complete treatise on the subject, the paper is intended to highlight areas of income tax planning and reporting for grantors, executors, trustees, and beneficiaries.

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[1] This paper was derived in part from Mickey R. Davis, *Planning for Basis at Death*, ABA Midyear Meeting—Fiduciary Income Tax Committee Meeting, 2015, Mickey R. Davis and Melissa J. Willms, *Income Taxation of Trusts and Estates—Ten Things Estate Planners Need to Know*, presented to the Southern Arizona Estate Planning Council, March 4, 2014, and from Theodore B. Atlass, Mickey R. Davis and Melissa J. Willms, *Planning and Administering Estates and Trusts: The Income Tax Consequences You Need to Consider*, presented as an ACTEC-ALI Telephone Seminar, May 9, 2013.

[2] The technical name of the Act is "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018", but "AAPRPTIIVCRBFY 2018" seems to be a remarkably unhelpful acronym. Some have suggested "the Act Formerly known as TCJA 2018," or perhaps its abbreviation, "AFKATCJA."

[3] Prior to TCJA 2017, inflation was measured by changes to the Consumer Price Index ("CPI"), published by the U.S. Bureau of Labor Statistics. TCJA 2017 modified the index to the "Chained Consumer Price Index," ("C-CPI-U" or "Chained CPI"), which generally grows more slowly than CPI. Using CPI, the 2018 figure would have been $11.20 million instead of the $11.18 million that results from using C-CPI-U. Although many of the provisions related to individuals in TCJA 2017 are only effective for years 2018-2025, Chained CPI as the method of inflation adjustment is "permanent."

[4] Rev. Proc 2018-18, 2018-10 IRB 392.

II. TYPES OF TAXPAYERS

A. General Rules. Estate planning attorneys will tell you that trusts and estates are not "juridical" entities, by which they mean that unlike individuals, partnerships, corporations, and the like, they do not exist apart from the fiduciaries that control them. You cannot sue a trust or an estate, nor can a trust or an estate technically own property, earn income, or pay tax. Rather, the executor or trustee is the proper party to litigation. The executor or trustee holds legal title to assets, but in short, trusts and estates are not technically legal entities. Nevertheless, for purposes of applying the income tax rules, Congress and the IRS generally treat trusts and estates themselves as though they were entities. In this paper, we follow the same approach. When computing the taxable income of a trust or estate, then, we treat it as though it were a legal entity, and speak of the income, expenses, deductions and credits of trusts and estates as taxpayers. Section 641(b) of the Internal Revenue Code (the "Code")[5] lays out the general rule that the taxable income of an estate or trust is computed in the same manner as in the case of an individual, except as set forth in Part I of Subchapter J of the Code. Therefore, when applying general tax principles (e.g., that rents and dividends are taxable income, that municipal bond interest is not, that capital gains and qualified dividends are taxed at special rates, etc.), the same rules that apply to individuals apply to estates and trusts.

Before delving into the world of income taxation of trusts and estates, it is important to understand some of the fundamentals regarding the general categories of various income taxpayers and the income tax rates. In addition to trusts[6] and estates, taxpayers can be individuals, corporations, or partnerships. (Note that although partnerships are termed "taxpayers," they are pass-through entities that never pay tax. Instead, partnerships report income and expenses on an IRS Form 1065, "U.S. Return of Partnership Income," and then provide a Schedule K-1 to each partner who then reports the information provided on the K-1 on the partner's income tax return. A corporation that elects to be taxed as an S corporation under Subchapter S of the Code reports its income and expenses similarly, instead filing an IRS Form 1120S, "U.S. Income Tax Return for an S Corporation," and then providing a Schedule K-1 to each shareholder.)

B. Taxable Income. For income tax imposed on taxable income, individuals and trusts and estates share most of the same income tax brackets, including the highest bracket which is currently 37%.[7] The main difference between these two categories is that the brackets are much more compressed for trusts and estates, such that in 2018 where individuals reach the highest bracket at $500,000 of income for a single person spread over seven tax brackets ($600,000 for married persons, filing jointly), trusts and estates reach the highest bracket at $12,500 of income. In addition, the income tax brackets for trusts and estates do not include a 12%, 22% or 32% tax rate.

C. Capital Gains[8]. A short-term capital gain, i.e. gain on the sale of a capital asset held for one year or less is taxed at the ordinary income tax rates. A long-term capital gain is a gain on the sale of a capital asset

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[5] References herein to "Section(s)" or to "Code" are to the Internal Revenue Code of 1986, as amended.

[6] Keep in mind that when discussing the taxation of trusts in this paper, revocable or other grantor trusts are excluded, at least while the grantor is alive. Revocable trusts are disregarded for income tax purposes and the rules applicable to individuals apply. *See* IRC §§ 671-679. In addition, another type of trust is a charitable trust which can be either a charitable lead or charitable remainder trust. Depending on the structure, at least a charitable lead trust may or may not be a taxpayer. The specifics regarding charitable trusts are beyond the scope of this paper, and this paper addresses trusts that are subject to tax, unless otherwise indicated.

[7] IRC § 1. In the last quarter of each year, the IRS issues a Revenue Procedure that provides the inflation-adjusted numbers for a variety of items. Revenue Procedure 2016-55, 2016-45 IRB 707 was issued on October 25, 2016 and provides the tax rate tables for taxpayers for the year 2017. Although a Revenue Procedure was issued on October 19, 2017 to provide the tax rate tables for 2018, the enactment of TCJA 2017 overrode that Revenue Procedure and published new tables as part of the Act. For years after 2018, income tax brackets will be adjusted by Chained CPI. Certain other inflation-adjusted numbers that require the application of Chained CPI, such as the exclusion amounts for transfer tax purposes, also required an official update by the IRS. On March 2, 2018, the IRS issued an updated Revenue Procedure establishing many 2018 inflation-adjusted figures using the Chained CPI method. Rev. Proc. 2018-18, 2018-10 IRB 392.

[8] This discussion addresses the more typical capital gains and does not address unrecaptured IRC § 1250 gain, collectibles gain, or IRC § 1202 gain.

that was held for greater than one year. A net capital gain is a gain that results when a taxpayer has excess long-term capital gains over short-term capital losses. For net capital gains, individuals, trusts, and estates are taxed the same. Prior to 2018, the bracket in which a net capital gain was taxed was determined based on how the gain would be taxed if it was ordinary income. Specifically, if the net capital gain would be taxed at 39.6% if it were ordinary income, then the gain was taxed at 20%; if it would be taxed at above 15% but less than 39.6% if it were ordinary income, then the gain was taxed at 15%; and if it would be taxed at or below 15% if it were ordinary income, then the gain was taxed at 0%. For capital gains arising between 2018 and 2025, the maximum rates for capital gains and qualified dividends are retained at the same breakpoints that existed under prior law, but indexed for inflation after 2017 using Chained CPI rather than CPI. Thus, the 15% breakpoint is $77,200 for joint returns and surviving spouses (half that amount for married taxpayers filing separately, $51,700 for heads of households, and $38,600 for unmarried individuals), and $2.600 for trusts and estates. The 20% breakpoint is $479,000 for joint returns and surviving spouses ($452,000 for heads of households and $425,800 for unmarried individuals), and $12,700 for trusts and estates. Note the disconnect for years 2018 through 2025 as to when the highest brackets are met for ordinary income tax purposes vs. the highest brackets for capital gains purposes. For corporations, there is no distinction between capital gains and ordinary income. Capital losses are simply netted against capital gains and the difference is added to or subtracted from gross income, as applicable.

D. Tax on Net Investment Income. Although a more detailed discussion is provided below, due to the Health Care and Education Reconciliation Act of 2010, P.L. 111-152, 124 Stat. 1029 (2010), beginning in 2013, individuals and trusts and estates became subject to a tax on net investment income. For individuals, the 3.8% tax applies to the lesser of net investment income or the excess of a taxpayer's modified adjusted gross income over certain defined thresholds. For estates and trusts, the 3.8% tax applies to the lesser of undistributed net investment income or the excess of adjusted gross income over a threshold determined based on the highest income tax bracket for estates and trusts ($12,500 for 2018). For taxpayers who are married filing jointly, the threshold is $250,000 (for married filing separately, $125,000 each) and for single persons, the filing threshold is $200,000. Because the threshold for trusts and estates is based on the highest income tax bracket for each, the threshold is indexed each year to some extent for these entities, whereas there is no indexing for individuals.

III. INCOME TAX CONSEQUENCES OF GIFTS AND LOANS

Two common techniques that may be used by clients during their life as part of their estate planning are giving outright gifts to a loved one or making a loan to a loved one. A review of the potential income tax issues related to such techniques follows.

A. Income Tax Consequences to the Donor and Donee for Outright Gifts.

1. Post-Gift Income. Any income generated on gifted property after the date of the gift is shifted from the donor's income tax return to the donee's income tax return.

2. Unrealized Gain. Any unrealized gain in appreciated gifted property becomes the donee's problem (as the donee receives a carryover basis for purposes of determining gain) unless the gift itself is characterized as a taxable disposition triggering gain to the donor (such as in the case of a gift of an installment obligation). IRC §§ 1015, 453B; Treas. Reg. § 1.1015-1. For gifts between spouses, the donee spouse receives a carryover basis for all purposes. IRC § 1041(b).

3. Below-Market Loans. Gift loans (i.e., those containing a below-market rate of interest) cause the lender to have imputed interest income for income tax purposes, subject to a *de minimis* rule. IRC § 7872. Below-market loans are those with an interest rate below the applicable federal rate as determined under Code Section 1274.

4. Gain from "Net Gift" Transactions. Where a "net gift" is made (i.e., the gift taxes on the transfer, which are the legal obligation of the donor, are instead assumed by the donee as a condition of the gift), the donor will realize gain to the extent the gift tax paid exceeds the donor's adjusted cost basis in the property. *Diedrich v. Comm'r*, 643 F.2d 499 (8th Cir. 1981). As a result, the gift is determined by dividing the value of the gifted assets by 1 + the gift tax rate.

Example 1: Assume that a donor has no remaining gift tax exclusion or applicable exclusion, and is in a flat 40% gift tax bracket. If a $1 million asset having no cost basis was given away in a net gift transaction (i.e., the donee is obligated to pay any gift tax due), then a net gift of $714,286 would be made by the donor. The donee would pay the donor's $285,714 gift tax liability, which would be "boot" to the donor. The donor would have $285,714 of gain (i.e., the amount of boot in excess of basis).

5. Gain from Gift of Property Subject to Debt. Where a gift is made of property subject to non-recourse indebtedness, the donor will realize gain to the extent that the indebtedness exceeds the basis of the property. *Winston F. C. Guest*, 77 T.C. 9 (1981). The "amount realized" is equal to the outstanding balance of the nonrecourse obligation, and the fair market value of the property is irrelevant to the computation. *Tufts v. Comm'r*, 103 S.Ct. 1826 (1983). In contrast, if the gifted property is subject to recourse debt, the donor will realize gain to the extent that indebtedness assumed by the donee exceeds the basis of the property. Treas. Reg. § 1.1001-2(a).

6. Gift of Installment Obligation. The transfer of an installment obligation by lifetime gift to an individual other than a spouse will constitute a disposition and cause an acceleration of the deferred gain for income tax purposes. IRC § 453B.

7. Gift of Passive Loss Assets. The transfer of a passive-activity asset by lifetime gift does not trigger the recognition of any suspended passive activity losses. IRC § 469(j)(6).

B. Income Tax Consequences of Gifts to the Donee.

1. No Income Tax on Gifts or Bequests. Gross income does not include the value of property acquired by gift, bequest, devise or inheritance. IRC § 102(a).

2. Taxation of Post-Gift Income. Gross income does include the income derived from any property acquired by gift, bequest, devise or inheritance. IRC § 102(b)(1).

3. Taxation of Post-Death Income. Gross income does include the amount of such income where the gift, bequest, devise or inheritance is of income from property. IRC § 102(b)(2).

4. Taxation of Forgiveness of Indebtedness. In the case of the gratuitous forgiveness of indebtedness, the Code contains conflicting provisions relating to whether the donee has received gross income. *See* IRC §§ 61(a)(2) and 102(a). It has been held that the forgiveness of indebtedness which is a true gift (i.e., made gratuitously and with donative intent) is not included in gross income. *Helvering v. American Dental*, 318 US 322 (1943).

C. Loans to Family Members.

1. Below-Market Loan Rules. In order to avoid the adverse rules relating to below-market loans, which impute interest income and gifts to the lender if inadequate interest is charged, it is necessary to comply with the rules contained in Code Section 7872.

2. Loans Under $10,000. No interest is imputed if at any time, the aggregated loan balances to an individual are $10,000 or less, and the loan proceeds are not used by the borrower for income producing investments. IRC § 7872(c)(2).

3. Loans Under $100,000. No interest is imputed if at any time, the aggregated loan balances to an individual are $100,000 or less, provided that the borrower has no more than $1,000 of total net investment income. IRC § 7872(d)(1).

4. Investment Income Limitation. If at any time, the aggregated loan balances to an individual are $100,000 or less, and the borrower does have investment income exceeding $1,000, then the imputed interest in any year will not exceed the borrower's net investment income for such year. IRC § 7872(d)(1).

5. Loans at "Applicable Federal Rate" of Interest. On other loans, interest at the applicable federal rate (the "AFR") must be charged if imputed interest problems are to be avoided. Such rates are published monthly for short-term (0-3 years), mid-term (greater than 3 years and up to 9 years) and long-term (greater than 9 years) loans. IRC §§ 1274(d), 7872(f).

IV. INCOME TAX CONSEQUENCES OF RELATED PARTY TRANSACTIONS

A. Who is a Related Party? Although the Code has many different provisions dealing with related parties, Section 267 is the key section defining related parties. Section 267 of the Code is used by most of the other sections which contain special tax rules for related party transactions. Complex attribution rules govern the determination of who is a related party. Pursuant to Section 267(b), related parties include: (1) members of a family as defined in subsection (c)(4) [i.e., brothers and sisters (half-blood and whole-blood), spouse, ancestors, and lineal descendants]; (2) an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual; (3) two corporations which are members of the same controlled group (as defined in subsection (f)); (4) a grantor and a fiduciary of any trust; (5) a fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts; (6) a fiduciary of a trust and a beneficiary of such trust; (7) a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts; (8) a fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust; (9) a person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual; (10) a corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock in the corporation, or more than 50 percent of the capital interest, or the profits interest, in the partnership; (11) an S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation; (12) an S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or (13) except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

B. Section 1031 Exchanges Between Related Parties. A Section 1031 exchange, or like-kind exchange, is an exchange of real property between parties with the goal of avoiding any gain or loss treatment as a result of the transfer. [9] Normally, taxpayers who do a Section 1031 exchange with each other don't care what the other party does with the exchange property after the deal is closed. However, if a taxpayer exchanges property with a related person in a Section 1031 tax-free exchange and within two years of the last transfer which was part of the exchange, either party disposes of the property received by that party in the exchange, then the original transaction does not qualify for the non-recognition of gain or loss under Section 1031 for either party. IRC §§ 267, 1031(f).

C. Sales of Depreciable Assets to Related Party. Gain on the sale of a capital asset is usually capital gain income (unless the recapture provisions contained in Code Sections 1245 and 1250 apply). However, in the sale or exchange, directly or indirectly, of property between related parties, any gain recognized by the transferor is treated as ordinary income if the property in the transferee's hands is depreciable property. IRC §§ 267, 1239.

D. Sale of Depletable Property to Related Party. Section 1239 of the Code, which applies to the sale of depreciable property between related parties, does not appear to apply to depletable property. PLR 8139052.

E. Appreciated Property Acquired by Decedent by Gift Within One Year of Death. In the case of a decedent dying after 1981, if appreciated property was acquired by the decedent within one year prior to the decedent's death, and if that property is subsequently reacquired from the decedent by (or passes from the decedent to) the donor of the property (or the spouse of the donor), then the original donor of the property will not receive a basis step-up at death. For example, a person owning highly appreciated assets could not give them to his or her terminally ill spouse and get a stepped-up basis if the assets were subsequently reacquired by the donee or the donee's spouse by inheritance within a year. IRC § 1014(e). A more detailed discussion of the effect death has on the basis of property is provided below.

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[9] Note that prior to the enactment of TCJA 2017, a 1031 exchange could involve any type of property, real or personal, but are now limited to exchanges of real property.

F. Disallowance of Losses on Sales Between Related Parties. A loss can normally be claimed when investment property is sold at a loss. However, no loss is recognized on the sale or exchange of property between related parties (including a trust and its beneficiaries). An estate and its beneficiaries are not deemed to be related parties for this purpose when the transaction at issue is the funding of a pecuniary bequest, so an estate (but not a trust, unless it had made a Section 645 election to be treated as a part of the estate) could recognize a loss if it funded a pecuniary bequest with loss property. Any disallowed loss is carried forward and can be applied to reduce the gain that would otherwise be recognized on the subsequent disposition of the property. IRC § 267.

G. Guarantee of Loans to Related Parties. Normally, a guarantor's payment on a debt will be deductible, either as a business bad debt or a non-business bad debt. A parent's payment as guarantor on a child's liability will usually not be deductible by the parent. It does not matter in this case whether the deduction was business bad debt or nonbusiness bad debt because Treasury Regulation Section 1.166-9(e) allows bad debt deductions only when the taxpayer received reasonable consideration for making the guarantee and provides that consideration received from a spouse or other defined family member must be direct consideration in the form of cash or property. *See Lair v. Comm'r*, 95 T.C. 35 (1990).

H. Installment Sale to Related Party. Normally, a taxpayer who sells property on an installment basis does not care how or when the buyer of the property subsequently disposes of it. However, if an installment sale is made to a related party who subsequently resells the property before the original seller has been fully paid (with a 2-year cutoff for property other than marketable securities), the sale by the related party accelerates the recognition of gain to the original seller. IRC § 453(e).

I. Non-Recognition of Gain or Loss Between Spouses. When one spouse enters into a sale transaction with the other spouse, the transaction is ignored for income tax purposes (i.e., no gain or loss occurs, so basis is unchanged). IRC § 1041.

J. Transfer for Value of Life Insurance. Life insurance proceeds are generally not taxed as income to the payee at the insured's death. However, if an existing life insurance policy is transferred for value to a non-excepted transferee (i.e., someone other than the insured, a partner of the insured, a partnership including the insured, or a corporation of which the insured was a shareholder or officer), or as part of a reportable policy sale, then any proceeds realized in excess of basis will be income to the recipient. IRC §§ 101(a)(2), (a)(3).

V. PRE-DEATH INCOME TAX PLANNING

Discussion of tax planning for an individual with a shortened life expectancy requires considerable diplomacy. Most people faced with their own imminent mortality have a number of issues that are more important to them than minimizing taxes. Nevertheless, under the right circumstances, there are a number of areas that might warrant consideration by persons who have a shortened life expectancy.

A. Capture Capital Losses and Use NOLs. If an individual has incurred capital gains during the year, he or she may consider disposing of high basis assets at a loss during his or her lifetime, in order to recognize capital losses to shelter any gains already incurred during the year. As discussed below in the discussion about what basis is, assets the basis of which exceed their fair market value receive a reduced basis at death (a step-down in basis), foreclosing recognition of these built-in capital losses after death. Moreover, losses recognized by the estate after death will not be available to shelter capital gains recognized by the individual before death. If, on the other hand, the individual has recognized net capital losses, he or she may sell appreciated assets before death with impunity. Net capital losses are not carried forward to the individual's estate after death, and as a result, they are simply lost. Rev. Rul. 74-175, 1974-1 CB 52. As discussed on page 15 below, a surviving spouse may be able to use these expiring losses but only in the year of the decedent's death.

B. Transfer Low Basis Assets to the Taxpayer. Since assets owned by an individual may receive a new cost basis at death, taxpayers may consider transferring low basis assets to a person with a shortened life expectancy, with the understanding that the person will return the property at death by will. This basis "gaming" may be easier in an environment with no estate tax or a substantial estate tax exclusion. If the person to whom the assets are initially transferred does not have a taxable estate, substantial additional assets may be transferred, and a new basis obtained thereby, without exposure to estate tax.

1. Gifts Received Prior to Death. Congress is aware that someone could acquire an artificial step-up in basis by giving property to a terminally ill person, and then receiving it back with a new basis upon that person's death. As a result, and as mentioned above, the Code prohibits a step-up in basis for appreciated property given to a decedent within one year of death, which passes from the decedent back to the donor (or to the spouse of the donor) as a result of the decedent's death. IRC § 1014(e). A new basis is achieved only if the taxpayer lives for at least one year after receipt of the property.[10] If the assets have depreciated in value, consideration should be given to gifting the property prior to the death of the donor in order to avoid a step-down in basis that would occur if the assets were in the donor's estate at death. Doing so would allow the donee to later sell the property and minimize gain recognition to the extent of the donor's basis since the carryover basis rules would apply to the gifted property.

2. Granting a General Power of Appointment. Rather than giving property to a terminally ill individual, suppose that you simply grant that person a general power of appointment over the property. For example, H could create a revocable trust, funded with low basis assets, and grant W a general power of appointment over the assets in the trust. The general power of appointment will cause the property in the trust to be included in W's estate under Code Section 2041(a)(2). In that event, the property should receive a new cost basis upon W's death. IRC § 1014(b)(9). The IRS, however, takes the position that the principles of Section 1014(e) apply in this circumstance if H reacquires the property, due either to the exercise or non-exercise of the power by W. *See* PLR 200101021 (". . . section 1014(e) will apply to any Trust property includible in the deceased Grantor's gross estate that is attributable to the surviving Grantor's contribution to Trust and that is acquired by the surviving Grantor, either directly or indirectly, pursuant to the deceased Grantor's exercise, or failure to exercise, the general power of appointment," citing H.R. Rept. 97-201, 97th Cong., 1st Sess. (July 24, 1981)). If W were to actually exercise the power in favor of (or the taker in default was) another taxpayer, such as a bypass-style trust for H and their descendants, the result should be different.[11]

C. Transfer High Basis Assets to Grantor Trust. An intentionally defective grantor trust is one in which the grantor of the trust is treated as the owner of the trust property for federal income tax purposes, but not for gift or estate tax purposes. *See* IRC §§ 671-679. If the taxpayer created an intentionally defective grantor trust during his or her lifetime, he or she may consider transferring high basis assets to that trust, in exchange for low basis assets of the same value owned by the trust. The grantor trust status should prevent the exchange of these assets during the grantor's lifetime from being treated as a sale or exchange. Rev. Rul. 85-13, 1985-1 CB 184. The effect of the exchange, however, will be to place low basis assets into the grantor's estate, providing an opportunity to receive a step-up in basis of those assets at death. But for the exchange of these assets, the low basis assets formerly held by the trust would not have acquired a step-up in basis as a result of the grantor's death. At the same time, if the grantor transfers assets with a basis in excess of fair market value to the trust, those assets will avoid being subject to a step-down in basis at death. Since the grantor is treated for income tax purposes as the owner of all of the assets prior to death, the one-year look-back of Code Section 1014(e) should not apply to limit the step-up in basis of the exchanged assets.

D. Change Marital Property Characteristics. For married clients living in community property jurisdictions, and for clients living in common law jurisdictions that have otherwise acquired community

[10] For the estate of a person dying in 2010 whose executor opted out of the federal estate tax, the modified carry-over basis rules of former Section 1022 extended this look-back period to three years. For those estates, the denial of step-up applied regardless of whether the donor re-inherited the property. Former IRC § 1022(d)(1)(C)(i). An exception to the three-year rule applied to gifts received from the decedent's spouse, unless the spouse acquired the property from another person by gift within the prior three years. Former IRC § 1022(d)(1)(C)(ii).

[11] For estates of persons dying in 2010 whose executors opted out of the federal estate tax, simply holding a general power of appointment over property would not be sufficient to cause the property to be treated as being "owned by the decedent" as required by the modified carry-over basis rules in former Code Section 1022. As a result, no part of the decedent's basis allocation could be used to increase the basis of these assets. Former IRC § 1022(d)(1)(B)(iii).

property, the clients may consider a modification of the marital property character of assets, if consistent with their dispositive scheme.

1. Partition Depreciated Community Property. If a married couple owns community property that at the death of one spouse is worth less than its basis, both halves of the community property will receive a step-down in basis upon the death of the first spouse to die. IRC § 1014(b)(6).[12] *See, e.g.,* TEX. FAM. CODE § 4.201 *et seq.* Partitioning these assets into separate property will limit the loss of basis to only the deceased spouse's half of the assets. Additional basis could be preserved by having the terminally ill spouse transfer loss assets to his or her spouse in exchange for low-basis assets. No gain or loss should be recognized from the exchange of those assets. IRC § 1041(a).

2. Transmute Appreciated Separate Property. If local law permits the creation of community property by agreement, a couple owning assets that have depreciated in value should consider transmuting the healthy spouse's low-basis separate property into community property so that both halves of the property may receive a step-up in basis at death. IRC § 1014(b)(6).[13] *See, e.g.,* TEX. FAM. CODE § 4.201 *et seq.*

E. Dispose of Passive Loss Assets. If an individual has assets that have generated passive loss carry-overs, he or she may wish to dispose of those assets prior to death, so that the losses can be deducted. The losses may otherwise be lost at death to the extent of any increase in the asset's basis. IRC § 469(g). In addition, the IRS may take the position that the decedent's estate or trust does not materially participate in the activity after the client's death. See the discussion of this issue at page 26 below. Note, however, that the transfer of a passive-activity asset by lifetime gift does not trigger recognition of suspended passive activity losses for the donor. IRC § 469(j)(6). Rather, any suspended passive activity losses attributable to a gifted asset are added to the donee's adjusted cost basis. This addition to basis provides some benefit to the donee, although to the extent it would cause basis to exceed the fair market value of the property at the time of the gift, it will not benefit the donee in a loss transaction, because for loss purposes, the increase in basis is limited to fair market value. To illustrate this limitation, assume that a donor has an asset with a fair market value of $100, an adjusted cost basis of $70, and a suspended passive activity loss of $40. When the asset is gifted, the donee will have a $100 basis for loss purposes and a $110 basis for gain purposes. IRC § 1015(a).

F. Pay Medical Expenses. It is not unusual for persons with a terminal condition to incur substantial medical expenses in the year of their death. For years between 2013 and 2016, these medical expenses may be deductible for federal income tax purposes if they exceed 7.5% of the taxpayer's adjusted gross income ("AGI") if the taxpayer or taxpayer's spouse reached age 65 before the end of the tax year, and for all other taxpayers, these expenses are deductible if they exceed 10% of AGI. For years 2017 and 2018, the threshold is 7.5% for all taxpayers. Beginning in 2019, the threshold will be 10% for all taxpayers. IRC §§ 213(a), (f). The threshold may be easier to meet in the year of the decedent's death, especially if the decedent dies early in the year before earning significant AGI, since there is no requirement to annualize income or make other adjustments to reflect a "short" year. Treas. Reg. § 1.443-1(a)(2). Expenses outstanding at the date of death, if paid within one year after the date of death, may be deducted on the decedent's final income tax return, or may be deducted as a debt on the decedent's estate tax return. IRC § 213(c)(1). A "double" deduction is disallowed. IRC § 213(c)(2). Note, however, that if the taxpayer actually pays outstanding medical expenses prior to death, they are eligible for deduction on his or her income tax return. At the same time, the individual's cash has decreased as a result of the payment, which has the same effect as deducting them on the estate tax return, since the decedent's estate is effectively decreased by the amount of the

[12] For estates of decedents dying in 2010 whose executors opted out of the federal estate tax, this same result arose under former Section 1022(a)(2)(B) because the decedent was deemed to own the surviving spouse's half of the community property. Former IRC § 1022(d)(1)(B)(iv); Rev. Proc. 2011-41. 2011-35 IRB 188, § 4.05.

[13] For estates of decedents dying in 2010 whose executors elected out of the federal estate tax, the surviving spouse's share of the community property was deemed to be owned by and acquired from the decedent pursuant to former Code Section 1022(d)(1)(B)(iv), and as a result, was eligible for the $3 million spousal property basis increase. Former IRC § 1022(c); Rev. Proc. 2011-41. 2011-35 IRB 188, § 4.01.

expenses paid. Even paying the medical expense by credit card prior to death should be sufficient to allow this double tax benefit. *See* Rev. Rul. 78-39, 1978-1 CB 73.

G. Accelerate Death Benefits. If a taxpayer owns life insurance on his or her life, the taxpayer may seek to obtain a pre-payment of the death benefits available under the policy. If the payments are received at a time when the taxpayer is terminally ill or chronically ill, the payments may be excluded from gross income. IRC § 101(g). The exclusion for prepayment of death benefits applies only to payments received from the insurance company that issued the policy, or from certain licensed "viatical settlement providers." A "viatical settlement" is a transaction in which a third party purchases the policy from the insured.

1. Payments to Terminally Ill Taxpayers. If the insured is terminally ill, the exclusion from income for payments of certain death benefits applies to both accelerated death benefits and to payments made by a viatical settlement provider (but only if the provider meets licensing or other requirements). IRC § 101(g). For this purpose, a "terminally ill" individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less. IRC § 101(g)(4)(A).

2. Payments to Chronically Ill Taxpayers. If the insured is chronically ill, payments of certain death benefits are tax-free only if detailed requirements are met. For example, the payment must be for costs incurred for qualified long-term care services. These costs include both medical services and maintenance or personal care services provided under a prescribed plan of care. Also, the payment must not be for expenses reimbursable under Medicare, other than as a secondary payor. IRC § 101(g)(3). A person is considered "chronically ill" if he or she is unable to perform, without "substantial assistance," at least two activities of daily living for at least 90 days due to a loss of functional capacity, or because of severe cognitive impairment, requires substantial supervision to protect him or her. *See* IRC §§ 101(g)(4)(B); 7702B(c)(2)(A). The exclusion for chronically ill taxpayers is subject to a per-diem cap ($360 per day, or $131,400 per year for 2017). IRC §§ 101(g)(3)(D), 7702B(d); Rev. Proc. 2016-55, 2015-45 IRB 707 § 3.55. Beginning in 2018, pursuant to TCJA 2017, the per-diem cap will be calculated using Chained CPI. The IRS published the 2018 figure ($360 per day) in Revenue Procedure 2017-58, 2017-45 IRB 489, § 3.55. As of this writing, this figure has not been updated to reflect any change resulting from the use of Chained CPI.

VI. INCOME TAXATION OF DECEDENTS

A. The Decedent's Prior Tax Returns. Upon the death of an individual, the personal representative should determine which income tax returns have or have not been filed by the decedent, and should examine those returns, in order to ascertain whether all required returns have been properly filed.

1. Ascertaining What Tax Returns Have Been Filed. The IRS can provide information about which tax returns have been filed by the decedent. Information about a current year plus the prior three years can be reviewed on an account transcript provided by the IRS. The executor can submit an IRS Form 4506-T, "Request for Transcript of Tax Return" to request various types of transcripts, including a detailed record of account. The executor's letters of appointment (and an IRS Form 2848, "Power of Attorney and Declaration of Representative" if the executor's attorney is to get the information) should be included with the request. The IRS response will be supplied free of charge. The executor can also call 1-800-908-9946 or 1-866-699-4083 for details. Note that the IRS is increasingly concerned about identity theft and may require personal contact (usually by telephone) with the taxpayer.

2. Ascertaining the Amount of the Decedent's Income. The executor may not be certain that he or she has information concerning all of the decedent's income relating to years for which the executor will file income tax returns on behalf of the decedent. It may be necessary to request a transcript of the various information returns, such as Forms W-2 and 1099. Form 4506-T, "Request for Transcript of Tax Return" may be used to make this request. Keep in mind that information may not be immediately available for the current year, but up to ten years' worth of information may be available. Again, the executor's letters of appointment (and an IRS Form 2848 if the executor's attorney is to get the information) should be included with the request.

3. Getting Copies of Prior Filed Tax Returns. The executor can obtain copies of prior income tax returns filed by the decedent from the IRS via Form 4506,"Request for Copy of Tax Return". The copy of the return will also include copies of all information returns that were filed. Consider requesting at the same time copies of gift tax returns filed by the decedent. Be sure to make your request to the proper IRS office as provided in the instructions, which is based on where the decedent filed the returns in question. The executor's letters of appointment (and a Form 2848 Power of Attorney if the executor's attorney is to get the information) should be included with the request. The IRS response will require a fee ($50 per return as of the date of this paper).

4. Contact Area Disclosure Office. Any questions concerning what information is available from the IRS, or procedurally how to get at that information, should be directed to the IRS Area Disclosure Office. Personnel in this office are generally very knowledgeable and helpful with regard to these matters.

B. The Decedent's Final Return. Upon the death of an individual, a final income tax return must be filed. In fact, depending upon the date of death, there may be two returns required for the decedent–one for the last full calendar year of the decedent's life, if that return was not yet filed as of the date of death, and one final return for the year of the decedent's death. Only this last return is the "final" return. The final return of the decedent includes items of income and deductions actually or constructively received or paid (assuming the decedent was on a cash basis) by the decedent prior to death. Treas. Reg. § 1.451-1(b). The responsibility for preparing and filing the decedent's final income tax return rests with the personal representative of the estate or other person charged with the decedent's property. IRC § 6012(b)(1); Treas. Reg. § 1.6012-3(b)(1).

1. Due Date, Filing Responsibilities, and "Short Year" Issues. A decedent's final return is due on the regular return date, typically April 15th of the year following the date of death. Treas. Reg. § 1.6072-1(b). The executor need not make adjustments to reflect a "short" year. Treas. Reg. § 1.443-1(a)(2). Apparently, the personal representative need not make further estimated tax payments on behalf of the decedent. Although Code Section 6153, which formerly dealt with estimated payments, has been repealed and replaced by Code Section 6654, the IRS has privately ruled that the principles set forth in Treasury Regulation Section 1.6153-1(a)(4) (which exempted estates from making estimated payments) continue to apply to Section 6654 (for which there are no relevant regulations). PLR 9102010. Estates (and certain post-death revocable trusts) are exempt from the requirement to make estimated tax payments for two years. IRC § 6654(l)(2). While the surviving spouse must generally continue to make estimated payments, there is no longer any requirement to file an amended declaration of payments. *See* former IRC § 6015. The executor of the estate is responsible for paying the decedent's income tax liability and may be liable for the payment of the tax. IRC §§ 641, 6012(b)(1), 6901(a)(1)(B); 31 USC § 3713; Treas. Reg. § 1.641(b)-2(b). The distributee may also be held liable. IRC § 6901. If no executor is appointed, the term "executor" means any person in actual or constructive possession of any property of the decedent. IRC § 2203. The executor faces personal liability if he distributes the estate prior to paying tax obligations of which he had notice, or with respect to which he failed to exercise due diligence. Treas. Reg. § 1.641(b)-2(a).

2. Rules for Imposing Fiduciary Liability. Federal taxing authorities, to a large extent, use executors as their collection agents. They do so primarily through the notion of "fiduciary liability." Pursuant to the concept of fiduciary liability, the executor is personally liable for tax liabilities of the decedent, at least to the extent that assets of the decedent come within the reach of the executor. 31 USC § 3713(b) (tax claim priority); see also IRC §§ 6321-6323 (federal tax liens), 6901(a)(1)(B) (transferee liability). Code Section 2002 expressly imposes upon an executor the obligation to pay estate taxes. If the IRS has recorded tax liens against a decedent, then the payment of the lien takes priority over other debts of the decedent as well as expenses for the administration of the decedent's estate. See IRC §§ 6321, 6323*; In re Est. of Simmons*, 120 AFTR 2d ¶ 2017-5368 (S.D. Ind. 2017). More broadly, fiduciary liability may be personally imposed on every executor, administrator, assignee or "other person" who distributes a living or deceased debtor's property to other creditors before he or she satisfies a debt due to the United States. 31 USC § 3713(b); Treas. Reg. § 20.2002-1; *U.S. v. Holmes*, 119 AFTR 2d ¶ 2017-2174 (S.D. Tex. 2016) (amended district court judgment finding (1) executor liable for unpaid estate tax; (2) beneficiaries, one of whom is the executor, personally liable for estate tax per 31 USC § 3713 and state law; and (3) estate property received

by the beneficiaries could be seized to satisfy the state law liens). The extent of the IRS's priority for satisfaction of its lien may come down to whether the lien is for a tax liability of the decedent for which a federal tax lien has been recorded. While liability is normally focused upon a court-appointed executor where one exists, where there is none, a wider net may be cast. *See, e.g., U.S. v. Paulson*, 118 AFTR2d ¶ 2016-5665 (D.C. Cal. 2016) (after removal of court-appointed executor, IRS could pursue claim against surviving spouse-distributee as "executor" under Code Section 2002).

a. Priority of Recorded Federal Tax Liens. If the IRS has recorded a tax lien against the property of the decedent prior to the decedent's death, that lien may take priority over all claims against the property except for choate claims of a purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor. IRC § 6323; *Sgro v. U.S.*, 609 F.2d 1259, 1261 (7th Cir. 1979); *In re Est. of Simmons*, 120 AFTR 2d ¶ 2017-5368 (S.D. Ind. 2017). Courts who have reached this conclusion interpret Code Section 6323 as giving the federal government super-priority for its claims over all other claims but for those of the creditors listed in the statute. *Id*. The federal government's super-priority may take precedence over such items as funeral and estate administration expenses, although the IRS "may in its discretion not assert priority of its federal tax lien over reasonable administrative expenses of the estate." IRM 5.5.2.4(3) (Apr. 5, 2012).

Note that if a decedent's property is subject to an existing income or other tax lien that had arisen before death, that property will remain subject to the lien as well as the IRS's power to seize the property to satisfy the lien. *U.S. v. Davis, Sr.*, 119 AFTR 2d ¶ 2017-1122 (5th Cir. 2017). In *United States v. Davis, Sr.*, the court recognized that state law will determine the property to which the tax lien will attach, and in so doing, found that what had been former community property of a decedent-spouse remained subject to a tax lien and subject to seizure, regardless of the fact that the property passed to beneficiaries other than the surviving spouse. *Id*.

b. Exceptions to Fiduciary Liability. For IRS claims, other than those that have been recorded as discussed above, 31 USC § 3713 establishes the IRS's priority in relation to other creditors for claims against a decedent's estate and its fiduciary. On its face, Section 3713(a) seems to impose absolute liability upon an executor. It essentially provides that debts due to the United States must be paid before the debts of any other creditor. No exceptions are made in the statute for the payment of administrative expenses or for the satisfaction of earlier liens out of the debtor's property or estate. However, courts and the IRS have held that this apparent absolute priority is subject to a number of exceptions. First, costs of administering an estate may be paid before a tax claim. *U.S. v. Weisburn*, 48 F. Supp. 393 (D.C. Pa. 1943) (priority given to expenses for administration, funeral, and headstone). These expenses include court costs and reasonable compensation for the fiduciary and attorney. *See Champlin v. Comm'r*, 6 TC 280, 285 (1946). The theory for permitting the payment of these items is that they were not incurred by the debtor but are for the benefit of all creditors, including the United States. *See Abrams v. U.S.*, 274 F.2d 8 (8th Cir. 1960). Second, funeral expenses and widow's allowances may be paid before the government's claim, as may doctor's bills from last illness and wages due household employees. Rev. Rul. 80-112, 1980-1 CB 306. The basis for allowing these payments is less clear than for administration expenses, but the rationale seems to be that because funeral expenses and the widow's allowance are considered charges against the estate, the executor, in effect, never actually had possession of this property. *Id*. However, payments of state income taxes, general creditors, and other claims constitute the payment of debts in derogation of the government's priority. Rev. Rul. 79-310, 1979-2 CB 404. Likewise, distributions to beneficiaries are not "charges" against the estate, but are treated as the payment of a "debt." In addition, a distribution to the executor-beneficiary cannot be treated as the payment of "administration expenses" unless the executor demonstrates that the expenses were used for that purpose. *U.S. v. McNicol*, 829 F.3d 77 (1st Cir. 2016). As a result, liability arises if the executor makes distributions to beneficiaries from an insolvent estate before payment of estate or gift taxes. Treas. Reg. §§ 20.2002-1 (estate tax), 25.2502-2 (gift tax). State law may impose an independent source of liability for an executor. *See, e.g.,* TEX. ESTS. CODE § 355.113 (liability if payment not made after court orders claim to be paid).

In recent Chief Counsel Advice 201723018, the IRS has been given instructions as to how it should approach its involvement in a state probate proceeding. Specifically, the IRS is advised that if it participates in a state action, such as by filing a claim in the probate proceeding, then by doing so, it will be bound by that state court's final decision as to the priority of its claim as against other creditors and with regard to potential fiduciary liability. The IRS is further advised that it may be bound to the state court's decision, even if that decision differs from what would apply under federal law, but if the IRS had not participated in the proceeding, it will preserve its right to seek remedy under either the federal priority statute of Code Section 6323 or to impose fiduciary liability pursuant to 31 USC § 3713(b). Therefore, the recommendation is made for the IRS to consider its options and make a conscious decision to either not participate at all, or to participate, but if the latter choice is made, then to participate fully so that all rights to remedies may be preserved.

c. Insolvency of Estate. Fiduciary liability is imposed only when, by virtue of the insolvency of a deceased debtor's estate (or of the insolvency and collective creditor proceeding involving a living debtor), the priority of 31 USC § 3713(a) is applicable. *See U.S. v. Coppola*, 85 F.3d 1015 (2d Cir. 1996).

d. Limited to Distributions. The fiduciary's liability is limited to debts (or distributions) actually paid before the debt due to the United States is paid, and then only to the extent of distributions made after the estate's insolvency but including if the distributions make the estate insolvent. 31 USC § 3713(b); *Schwartz v. Comm'r*, 560 F.2d 311 (8th Cir. 1977); *Singer v. Comm'r*, TC Memo 2016-48 (2016) (Tax Court emphasized the burden of proof lies with the IRS).

e. Knowledge Required. Although a literal reading of 31 USC Section 3713 seems to impose strict liability on a fiduciary when he makes a distribution which leaves the estate with insufficient funds from which to pay a debt owing to the United States, courts have long departed from such a rigid interpretation. *See Singer v. Comm'r*, TC Memo 2016-48 (2016) (non-probate assets and state law contribution requirements of beneficiaries to pay portion of taxes taken into account to find estate was solvent at time distributions were made from probate estate). In order to render a fiduciary personally liable, he or she must first be chargeable with knowledge or notice of the debt due to the United States at a time when the estate had sufficient assets from which to pay the debt. *U.S. v. Marshall*, 798 F.3d 296 (5th Cir. 2015); *Leigh v. Comm'r*, 72 TC 1105 (1979); *Want v. Comm'r*, 280 F.2d 777 (2d Cir. 1960).

f. Deferring Distributions. Fiduciaries will frequently delay making distributions until they are sufficiently sure they are no longer liable for the decedent's income tax and estate tax liabilities. Refunding agreements with beneficiaries and state law provisions allowing fiduciaries to get back prior distributions to settle estate liabilities are sometimes relied upon, but these solutions protect the fiduciary only to the extent that the beneficiaries still have the funds in their possession to refund to the estate.

3. Transferee Liability Contrasted. Fiduciary liability should be contrasted with transferee liability. Transferee liability may make the transferee: (1) of property of a taxpayer personally liable for income taxes, (2) of property of a decedent personally liable for estate taxes, and (3) of property of a donor personally liable for gift taxes. IRC § 6901(a)(1)(A).

a. Transferee Liability "at Law or Equity." Under Code Section 6901(a)(1)(A), the IRS can impose liability for unpaid income, gift, or estate taxes "at law or in equity" upon a transferee of the decedent's property. Code Section 6901(a)(1) is a procedural provision, which applies only when state or federal law imposes liability on the transferee for debts or taxes owed by the person from whom the transferee received property. *See Comm'r v. Stern*, 357 U.S. 39 (1958). Although Code Section 6324(a)(2) imposes personal liability for any estate tax on recipients of non-probate property included in the gross estate, it does not similarly burden distributees of the decedent's probate estate. The IRS can therefore collect from distributees of the probate estate only if it can point to some other source of personal liability. This finding is typically dependent upon a showing by the IRS that the distributions rendered the estate insolvent or otherwise created an obligation under local law to pay the estate's debts. Depending on the state or federal law on which its claim rests, the IRS may also have to establish that timely efforts to collect from the estate were (or would have been) unavailing.

b. Applicable Law. Generally, the liability of a transferee "at law or in equity" is a question of state, not federal, law. *Id*; *see also, e.g.*, TEX. ESTS. CODE § 101.051 (property vests at date of death in devisees, subject to debts of decedent), TEX. BUS. & COMM. CODE, Title 3, Ch. 24 (Texas Uniform Fraudulent Transfer Act). Even though state law governs whether a person is liable as a transferee (and if so, the extent of a transferee's liability), the principle is subject to important qualifications. First, when state law does not definitively answer a question relating to the transferee's liability in a particular case, federal courts consult judicial principles to protect private creditors as well as the body of federal transferee liability law in federal courts. *See Starnes v. Comm'r*, 680 F.3d 417 (4th Cir. 2012). Second, although state law controls, it is a federal court, not a state court, that independently determines the result under state law. *Id.; see also U.S. v. Kimball*, 117 AFTR 2d ¶ 2016-2234 (D.C. Me. 2016) *citing U.S. v. Kraft*, 535 US 274 (2002). Third, the supremacy of the federal government prevents state law from being applied to limit some transferee liability issues. Thus, for example, the IRS's claim may not be cut off by a state statute of limitations when the federal period of limitations is still open. Code Section 6901(c) establishes the statute of limitations for the assessment of transferee liability. *See, e.g., U.S. v. Summerlin*, 310 US 414, 416 (1940). In addition, claims for deductions that may be available to the fiduciary in determining the amount of the tax may not be available to the transferee. *U.S. v. Cowles-Reed*, 114 AFTR 2d 2014-5612 (9th Cir. 2014) (unpublished opinion). Moreover, a transferee cannot avoid liability by arguing that there are pending cross- or counter-claims against the estate's personal representative, or, apparently, by seeking to raise reasonable-cause defenses that might be available to the estate's personal representative. *See U.S. v. Whisenhunt*, 2014-2 USTC ¶ 60,681 (N.D. Tex. 2014). At least in the context of liability for gift taxes, transferee liability does not include liability for interest on the tax that exceeds the amount of the gift. *See U.S. v. Marshall*, 798 F.3d 296 (5th Cir. 2015); *Poinier v. Comm'r*, 858 F.2d 917, 920 (3d Cir. 1988); *cf. Baptiste v. Comm'r*, 29 F.3d 1533, (11th Cir. 1994) (holding that liability limitation of Code Section 6324(a)(2) applies only to underlying estate tax obligation and not to interest accruing after liability arose). Note that transferee liability may not extend to trust beneficiaries because it is the trustee who receives the property on the date of a decedent's death, not the trust beneficiaries. Thus, the trustee is considered the "transferee." *U.S. v. Paulson*, 118 AFTR2d ¶ 2016-5665 (D.C. Ca 2016); *U.S. v. Johnson*, 112 AFTR2d 2013-5474 (D.C. Ut. 2013). Nevertheless, property distributed to a trust beneficiary as a subsequent transferee may still be subject to the general tax lien of Code Section 6324.

4. Priority of Tax Claims. In a probate setting, the state law rules relating to the time and place for filing claims do not apply to the tax claims of the United States. *Board of Comm'rs of Jackson County v. U.S.*, 308 US 343 (1939); *U.S. v. Summerlin*, 310 US 414 (1940); *U.S. v. Weisburn*, 48 F. Supp. 393 (D.C. Pa. 1943). Federal law generally provides that a debt due to the United States be satisfied first whenever the estate of a deceased taxpayer/debtor is insufficient to pay all creditors. 31 USC § 3713(a). Although no exceptions are made in Section 3713(a) for the payment of administration expenses, as noted above, the IRS nevertheless appears to recognize exceptions for administration expenses, funeral expenses, and widow's allowance. As mentioned above, however, although no exception is made in Title 31, Section 3713(a) for the payment of administration expenses, the IRS nevertheless recognizes exceptions for administration expenses, funeral expenses, and widow's allowance. *U.S. v. Weisburn*, 48 F. Supp. 393 (D.C. Pa. 1943); Rev. Rul. 80-112, 1980-1 CB 306; GCMs 35849, 38159.

5. Claims for Refund.

a. Time for Filing. A tax refund claim must generally be filed within three years from the time the related return was filed or two years from the time the tax was paid, whichever of such periods expires later, or if no return was filed, within two years from the time the tax was paid. IRC § 6511(a). Special rules extend the time for filing a claim for refund in cases where the period for assessing tax has been extended by agreement and in other defined cases. IRC §§ 6511(c), 6511(d). Equitable mitigation provisions exist that may be useful in cases where a refund or credit would otherwise be barred by the applicable statute of limitations. *See* IRC §§ 1311-1314, 1341.

b. Informal Claims. In estates with no formal need for administration, a surviving spouse, heir, or another person agreeing to pay out the refund according to the laws of the state where the decedent was a legal resident may claim any refund owed to the decedent by filing IRS Form 1310, "Statement of Person Claiming Refund Due a Deceased Taxpayer."

6. Place for Filing Decedent's Final Return. A decedent's final Form 1040 should normally be filed in the local Internal Revenue Service office in which the legal residence or principal place of business of the person making the return is located (i.e., based upon where the executor is located, which is not necessarily

where the decedent filed his or her returns), or if the filing instructions provide that the return is to be filed at a service center, then the return is filed as the instructions provide. IRC § 6091(b)(1)(A); Treas. Reg. §§ 1.6091-2(a), (c). For a citizen whose principal place of abode is outside the United States because either the legal residence is outside of the United States or a foreign address is used on the return (and for an estate or trust that has a fiduciary who is outside of the United States or has no legal residence or principal place of business in the United States), then the return is filed as provided in the filing instructions. Treas. Reg. § 1.6091-3. Note that the instructions provide for a different address based on whether a payment is being made or not.

7. Applicable Statute of Limitations. Income tax must normally be assessed within three years after the related return was filed, whether or not such return was timely filed. IRC § 6501(a). The normal three-year income tax statute of limitations is extended to six years if the taxpayer makes a substantial omission (in excess of 25%) of the amount of gross income shown on the return. IRC § 6501(e)(1). There is no limit on the statute of limitations where a false return was filed, there is a willful attempt to evade tax, or no return was filed. IRC § 6501(c). The normally applicable statute of limitations is extended as to transferees–for one year in the case of the initial transferee, and as to transferees of transferees, for as much as three years after the expiration of the period of limitations for assessment against the initial transferor. IRC § 6901(c). The taxpayer and government can agree to indefinitely extend an income or gift tax (but not estate tax) statute of limitations prior to the expiration of the statute. IRC § 6501(c)(4). Note that the statute of limitations may work against the taxpayer for purposes of claiming a deduction such as for interest or other administration expenses. *See, e.g., La Sala v. Comm'r*, TC Memo 2016-42 (2016) where the statute of limitations had expired for claiming an estate tax deduction for interest owed on unpaid gift taxes determined through a settlement with the IRS.

a. Requests for Prompt Assessment. The executor may shorten to 18 months the period of time for the IRS to assess additional taxes on returns previously filed by the decedent or the executor by separately filing IRS Form 4810, "Request for Prompt Assessment Under Internal Revenue Code Section 6501(d)," or by submitting a written request containing the information required on the form. Treas. Reg. § 301.6501(d)-1(b). The request is to be filed with the same IRS center where the return is filed and should be filed after the return. It is not believed that this increases the audit exposure on such returns.

b. Requests for Discharge from Personal Liability. The executor may request a discharge from personal liability for estate, income and gift tax liabilities of the decedent (which gives the IRS nine months to notify the executor of the amount of the relevant tax) by making a request for such a discharge (IRS Form 5495, "Request for Discharge from Personal Liability Under Internal Revenue Code Section 2204 or 6905") pursuant to Code Section 2204 (as to estate tax), or 6905 (as to income and gift tax). If the notice is not provided within the time period, or if notice is provided and the executor pays the tax, the executor is discharged from personal liability for any deficiencies. IRC §§ 2204(a), 6905(a). Although Code Section 2204(b) provides that for must purposes, the term "executor" means any person in actual or constructive possession of any property of the decedent, in the case of a request for discharge from income and gift tax liabilities of a decedent, the request may only be made by a court-appointed personal representative. IRC §§ 2203, 6905(b). In the case of estate tax, the time period is shortened to six months for a fiduciary other than an executor (such as, for example, the trustee of a post-death revocable trust). IRC § 2204(b). These requests do not shorten the statute of limitations (i.e., the IRS could still assert the tax due by pursuing the assets, transferees, etc.), and it is not believed that the requests increase the audit exposure on such returns. A more limited, but nonetheless important, discharge from personal liability is afforded to executors who rely in good faith on the decedent's gift tax returns as furnished to the executor by the IRS in determining adjusted taxable gifts for computing the estate tax. The executor is relieved of personal liability for any estate tax deficiency attributable to gifts that were made more than three years before the decedent's death and are not shown on those returns. IRC § 2204(d).

8. Filing Joint Returns. For a decedent who was married on the date of death, the personal representative has the option to file a separate return for the decedent, or to file a joint return with the surviving spouse, provided that the surviving spouse has not remarried prior to the end of the survivor's tax year. IRC § 6013. A joint return may not be filed if either of the spouses is a nonresident alien at any time

during the taxable year. IRC § 6013(a)(1). If no executor has been appointed by the due date of the decedent's final return, the surviving spouse may file the joint return alone. If an executor is subsequently appointed, however, the executor may revoke the surviving spouse's election to file a joint return by filing a separate return for the decedent within one year from the due date of the return, including extensions. IRC § 6013(a)(3).

a. Apportionment of Tax. The joint return will report the decedent's income through the date of death, and the spouse's income for the entire year. IRC § 6013. The income tax liability between the executor and surviving spouse is apportioned as they agree, or if there is no agreement, as provided by local law. *See* Treas. Reg. § 20.2053-6(f).

b. Joint and Several Liability. The executor, when considering whether to file a joint return with a surviving spouse, must consider not only the possibility of saving income taxes, but also the liability associated with the election. By filing a joint return, the executor becomes jointly and severally liable with the surviving spouse for the taxes and penalties associated with the return. IRC § 6013(d)(3). The executor may thereby be adopting a significant risk of unknown tax liabilities. It is currently unsettled whether the "innocent spouse" rule applies in this context. Many wills expressly authorize the executor to file a joint return with the spouse on the theory that the benefits of any resulting tax reduction outweigh any detriment of joint and several liability.

c. Available AMT Exemption Amount. For a decedent dying in 2017, a "surviving spouse," as defined in Code Section 2(a), is entitled to an AMT exemption of $84,500, reduced by 25% of any excess of AMT over $160,900 (rather than the normal AMT exemption applicable to single persons of $54,300, reduced by 25% of any excess AMT over $120,700). IRC § 55(d); Rev. Proc. 2016-55, 2016-45 IRB 707 § 3.10. Historically, these amounts are adjusted for inflation each year; however, by statute, TCJA 2017 increased the exemption to $109,400, reduced by 25% of any excess of AMT over $1,000,000 (rather than the normal AMT exemption applicable to single persons of $70,300, reduced by 25% of any excess AMT over $500,000).

9. Planning Opportunities on the Final Return. For a surviving spouse, prior to the end of his or her tax year, several planning opportunities are presented.

a. Using Expiring Losses. The decedent's portion of net operating losses ("NOLs") and capital losses (including capital loss carryforwards) can offset income and capital gains of the surviving spouse arising after death. IRC §§ 172(a), 1211(b), 1212(b). TCJA 2017 now limits the amount of the NOL deduction to 80% of taxable income for tax years beginning after 2017. IRC § 172(a). The surviving spouse should be advised to examine opportunities to accelerate recognition of income sheltered by these losses, such as accelerating any installment gains if the decedent entered into an installment sale in the year of death. If not used prior to the end of the year in which the decedent dies, the NOLs and capital losses are lost. Prior to the enactment of TCJA 2017, if an NOL arose from a net business loss appearing on the decedent's final return, the NOL could be carried back to previous years; however, beginning in 2018, no carry back is allowed. IRC § 172(b)(1)(A). Since the estate is a separate taxpayer from the decedent, the decedent's NOLs and capital losses cannot carry forward to the estate, although excess NOLs and capital losses in the final year of an estate or trust will carry out to the beneficiaries. IRC § 642(h); Rev. Rul. 74-175, 1974-1 CB 52. Note that the changes made by TCJA with regard to NOLs do not expire in 2026.

b. Reporting Savings Bond Interest. A taxpayer may elect to report all previously unreported Series E or EE Bond interest and thereafter report all Series E or EE Bond interest as it is accrued in the future. IRC § 454(a). The executor may make this election on behalf of the decedent on the final Form 1040. Rev. Rul. 68-145, 1968-1 CB 203. The executor may also make this election for bonds held in the decedent's revocable trust at the time of death. Rev. Rul. 79-409, 1979-2 CB 208. If the Section 454(a) election is not made, interest will be taxable as income in respect of a decedent ("IRD") to the ultimate recipient. If the interest is IRD, a deduction is available under Section 691(c) for any estate tax attributable to the interest. Rev. Rul. 64-104, 1964-1 CB 223. If the Section 454(a) election is made, no Section 691(c) deduction will be applicable, but a deduction for federal estate tax purposes will be generated for the amount of the income tax created on the decedent's final return. PLR 9232006. If federal estate tax is due, making the Section 454(a) election will generally lower the overall tax liability.

c. Partnership and S Corporation Income. If the decedent was a partner or S corporation shareholder, the method of determining the decedent' share of the entity's income may have a substantial effect on the final return. For example, if a substantial portion of S corporation income is received in a month of the entity's taxable year after the date of death, a portion of the disproportionately high post-mortem income can be shifted to the decedent's final return by making an election to prorate the income on a daily basis. Conversely, if a disproportionately large portion of the S corporation income was received prior to the date of the decedent's death, more income can be bunched into the decedent's final return by using a "closing of the books" method to allocate the income between the pre-death and post-death periods. When a partner dies, the partnership's tax year for that partner closes. IRC § 706(c)(2)(A). The allocation of partnership income for that short year is made by an interim closing of the partnership's books. It may be possible for the partners to agree to allocate income on a per diem or some other reasonable basis. *See* Treas. Reg. § 1.706-1(c)(2)(ii).[14] Conversely, an S corporation shareholder's final return must include the decedent's pro rata share of the S corporation's income for the year on a per diem basis. IRC § 1377(a)(1). If all of the shareholders agree (including the executor or administrator of the deceased shareholder's estate), the allocation for the short year is made by an interim closing of the books. IRC § 1377(a)(2); Treas. Reg. § 1.1377-1(b)(5)(ii).

d. Accelerating Installment Gain. If the decedent participated in an installment sale in the year of death, the executor may decide to elect out of the installment method. IRC § 453(d). Electing out of the installment method would cause the gain to be taxed on the decedent's final return (thereby creating an estate tax deduction for the resulting income tax liability). The election would preclude IRD recognition after death as the note is collected (or if the installment note is later cancelled or forgiven).

e. Passive Activity Losses. Congress enacted the passive activity loss ("PAL") rules to limit a taxpayer's ability to offset non-passive sources of income (active income, such as salary, and portfolio income, such as dividends and interest) with losses from passive sources (such as rental real estate). Generally, if an activity generates passive losses, the taxpayer owning the activity can only deduct those losses against income from other passive activities, or upon the disposition of the activity. IRC §§ 469(d), (f). The death of the owner of a passive activity does constitute a "disposition" of that activity for purposes of the loss recognition rules. IRC § 469(g). However, a deduction is allowable on the decedent's final Form 1040 only to the extent that the suspended passive activity loss exceeds any step-up in basis allocated to the activity. IRC § 469(g)(2). To illustrate this rule, assume that the decedent had an asset having a fair market value at the death of $100, and adjusted basis before death of $60. Assume also that the decedent had a suspended passive activity loss of $50. The basis of the asset is stepped up by $40 to its $100 fair market value at the decedent's death. As a result, only a $10 loss (i.e., the $50 suspended loss, less the $40 basis step-up at death) is deductible on the decedent's final Form 1040.[15]

VII. WHAT IS BASIS?[16]

Basis is a fundamental concept in income tax planning. A taxpayer may incur a tax liability whenever he or she sells assets at a gain. Gain is measured by the excess of the amount realized from a disposition of property over the taxpayer's adjusted basis in that property. IRC § 1001. Basis also establishes the amount upon which depreciation deductions are based. IRC § 167(c). In general, a taxpayer's basis in an asset is

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[14] Use caution when reviewing these partnership regulations. The Treasury Regulations related to Code Section 706 have not been updated since Code Section 706 was amended in 1997. Therefore, Treasury Regulation Section 1.706-1(c)(2)(iii) does not reflect the current statutory rule, and the election described in Treasury Regulation Section 1.706-1(c)(2)(ii) may not be available.

[15] This initial basis adjustment would not apply to estates of decedents dying in 2010 whose executors opted out of the estate tax and who elected not to allocate $40 of basis to the asset under former Section 1022.

[16] For a more detailed discussion of the topic of basis and basis adjustment planning, see Davis and Willms, *All About that Basis: How Income Taxes Have Reshaped Estate Planning*, 38th ANN. ALI CLE PLANNING TECHNIQUES FOR LARGE ESTATES COURSE (2018).

measured by its cost, with certain adjustments. IRC §§ 1012, 1016. However, a special rule applies if the property in question is acquired from a decedent. IRC § 1014(a).

A. Basis in Property Acquired from a Decedent. With a few exceptions, the basis of property in the hands of a person acquiring the property from a decedent, or to whom the property passed from a decedent, is equal to: (i) the fair market value of the property at the date of the decedent's death; (ii) if an "alternate valuation date" election is validly made by the executor of the decedent's estate, its value at the applicable valuation date prescribed by Code Section 2032; and (iii) if a "special use valuation" election is validly made by the executor of the decedent's estate, its value for special use valuation purposes prescribed by Code Section 2032A. IRC § 1041(a). In short, then, in most cases, the basis in property inherited from a decedent is the value of that property for federal estate tax purposes. Although often called a "step-up" in basis, the basis in various assets may be stepped up or down. Therefore, it is more accurate to call it a basis adjustment. Original basis is simply ignored and federal estate tax values are substituted. The adjustment to the basis of a decedent's assets occurs regardless of whether an estate tax return is filed, and regardless of whether the estate is even large enough to be subject to federal estate tax.

1. Basis Consistency and Value Reporting Rules. Although the basis adjustment occurs regardless of whether an estate tax return is filed, Code Section 1014(f), enacted on July 31, 2015 as part of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (P.L. 114-41) ("Transportation Act"), provides that basis of certain property acquired from a decedent, as determined under Code Section 1014, may not exceed the value of that property as finally determined for federal estate tax purposes, or if not finally determined, the value of that property as reported on a statement made under Code Section 6035. Code Section 6035, also enacted as part of the Transportation Act, provides that the executor of any estate that is required to file an estate tax return under Code Section 6018 (i.e., an estate that exceeds the estate tax filing threshold) must furnish to the IRS and to each person acquiring any interest in property included in the decedent's gross estate for federal estate tax purposes a statement identifying (1) the value of each interest in that property as reported on the estate tax return, and (2) any other information that the IRS might require. IRC § 6035(a)(1). Note that the reporting requirement is limited to the value of the property as finally determined for estate tax purposes; it is not a requirement to report basis of the property in the hands of the distributee. In addition, each person required to file a return under Code Section 6018(b) (persons other than executors holding estate property) must furnish to the IRS and to each other person who holds a legal or beneficial interest in the property to which that return relates a statement identifying the information described above. IRC § 6035(a)(2). The IRS is required to prescribe any regulations that are necessary to carry out these rules, including rules applicable to estates for which no estate tax return is required to be filed, and for situations where a surviving joint tenant or other recipient might have better information than the executor regarding the basis or fair market value of the property. IRC § 6035(b).

In January 2016, the IRS issued Form 8971, "Information Regarding Beneficiaries Acquiring Property from a Decedent," to be used to provide the required information to the IRS, and Schedule A to Form 8971 to provide the required information to beneficiaries. Updated instructions to Form 8971 and Schedule A were released in September 2016. On March 4, 2016, the IRS issued proposed and Temporary Regulations under Code Sections 1014(f) and 6035. *See* TD 9757. Pursuant to the proposed regulations, Form 8971 is termed an Information Return, and Schedule A is termed a Statement. Prop. Treas. Reg. § 1.6035-1(g).

Suffice it to say, many questions remain unanswered by the proposed regulations. Comments to the proposed regulations were invited and groups, such as The American College of Trust and Estate Counsel ("ACTEC") and the American Institute of Certified Public Accountants ("AICPA") submitted comments.

We do know that if a federal estate tax return is required to be filed pursuant to Code Section 6018, the executor must report certain information to the IRS, and must provide certain information to each beneficiary of the property, including a description of the property and its value. Prop. Treas. Reg. § 1.6035-1(a), (b), (c). In identifying the beneficiaries to whom the information is to be provided, if a beneficiary is a trust, the information is furnished to the trustee. Prop. Treas. Reg. § 1.6035-1(c)(2). In the case of an estate where the property passing to a beneficiary has not been identified by the due date for reporting, such as when funding decisions have not been made, the executor must provide information regarding all property that may be used to fund the beneficiary's interest to each beneficiary that may be affected and must provide the information to all potential beneficiaries of the property. Prop. Treas. Reg. § 1.6035-1(c)(3). Once this information is given, no further reporting is required, regardless of which (if any) assets are ultimately distributed to each beneficiary. *Id*.

We also know that Form 8971 and Schedule A must be furnished no later than the earlier of (1) 30 days after the date on which the estate tax return is required to be filed (including extensions), or (2) 30 days after the date the estate tax return is filed. IRC § 6035(a)(3)(A); Prop. Treas. Reg. § 1.6035-1(d)(1). In addition, IRS Notice 2016-27, 2016-15 IRB 1, published on March 24, 2016, provides that for any reporting due before June 30, 2016, reporting was not required until June 30, 2016. Final Treasury Regulation § 1.6035-2 was used on December 2, 2016 confirming that the first required reporting was on June 30, 2016.[17] *See* TD 9757. The proposed regulations confirm that the value as finally determined for federal estate tax purposes serves as the beneficiary's *initial* basis in the property and the beneficiary's basis is capped by the estate tax value (i.e., basis consistency), although post-death events may cause adjustments to the property's basis. Prop. Treas. Reg. § 1.1014-10(a), (c).

Although property that qualifies for the marital or charitable deduction is excluded from the basis consistency rules of Code Section 1014(f), that property is *not* excluded from the reporting requirements of Code Section 6035. Prop. Treas. Reg. §§ 1.1014-10(b)(2), 1.6035-1(b). Certain property is excluded from the reporting requirements of Code Section 6035, however, including cash (other than collectible cash), income in respect of a decedent (IRD), certain tangible personal property, and property sold or otherwise disposed of (and thus not distributed to a beneficiary) by the estate in a manner in which capital gain or loss is recognized.[18] Prop. Treas. Reg. § 1.6035-1(b). In addition, if an estate is below the filing threshold for federal estate tax purposes but the return is filed for another reason, such as to make a portability election, the executor is not subject to the reporting requirements of Code Section 6035. Prop. Treas. Reg. § 1.6035-1(a)(2).

One of the more surprising (and shocking) provisions in the proposed regulations has to do with property that is later-discovered or was otherwise omitted from a federal estate tax return. If a federal estate tax return was never filed and after-discovered or omitted property is discovered that would generate or increase estate taxes, the basis in that property is zero until the federal estate tax value is determined. Prop. Treas. Reg. § 1.1014-10(c)(3)(ii). In contrast, if a federal estate tax return is filed and additional property is discovered, as long as the executor includes the property on an estate tax return prior to the expiration of the statute of limitations on assessment, the final value (and therefore, the beneficiary's initial basis) in the property will be the federal estate tax value of the property. However, if the limitations period has expired, the basis in the after-discovered or omitted property is deemed to be zero, with no recourse. Prop. Treas. Reg. § 1.1014-10(c)(3)(i).

If there is an adjustment to the information required to be filed with the IRS or reported to a beneficiary that would cause the reported information to be incorrect or incomplete, a supplemental statement must be filed no later than the date 30 days after the adjustment is made. IRC § 6035(a)(3)(B); Prop. Treas. Reg. § 1.6035-1(e)(1), (2), (4). An adjustment includes a situation in which a beneficiary different than one who previously received a Schedule A receives property identified on the Schedule A, such as because of a disclaimer or because of a value change as a result of audit. Supplemental reporting is not required, however, if reporting of the same asset was made to multiple beneficiaries because a funding decision had not been made at the time of the initial reporting. *Id*.

Another surprising provision in the proposed regulations is the requirement to report subsequent transfers. The proposed regulations provide that for property reported pursuant to Code Section 6035, if that property is subsequently transferred to a related transferee and the transferee determines its basis, in whole or part,

[17] This Notice was the third extension of the due date for the first reporting required pursuant to IRC § 6035. Although the first due date was August 30, 2015, Notice 2015-57 was issued on August 21, 2015, extending the due date for the first reporting to February 29, 2016, and then Temporary Treasury Regulation § 1.6035-2T was issued providing a transitional rule extending the due date for the first reporting to March 31, 2016. Twenty days after the regulation was published, Notice 2016-27 was issued.

[18] Many questions remain as to the nuances of these exclusions, but those questions go beyond the scope of this paper.

by reference to the transferor's basis, the transferor must file a supplemental Schedule A with the IRS and provide a copy to the transferee within 30 days of the transfer. A related transferee is defined to include a member of a transferor's family as defined in Code Section 2704(c)(2), an entity controlled by the transferor or the transferor's family as defined in Code Section 2701(b)(2)(A), and a trust of which the transferor is the deemed owner for income tax purposes. Prop. Treas. Reg. § 1.6035-1(f). Presumably, the requirement for reporting subsequent transfers extends indefinitely.

B. Holding Period. A person acquiring property from a decedent whose basis is determined under Code Section 1014 is considered as being held by the person for more than one year. IRC § 1223(9). Therefore, any post-death gains will be treated as long-term capital gain, even if the property is sold within one year of the decedent's death.

C. What Property is "Acquired from a Decedent"? Most people think of property "acquired from a decedent" as simply property passing to them under the will of a deceased person. For purposes of determining basis, however, the Code lists ten separate methods by which property can be acquired from a decedent. Some of the listed methods contain effective dates that have since passed, which make parsing the statute somewhat difficult. In summary, the current applicable list includes the following seven items:

1. Inherited Property. Property acquired by bequest, devise, or inheritance. The statute makes clear that the basis adjustment applies not only to beneficiaries, but also to the decedent's property held by his or her estate. IRC § 1014(b)(1).

2. Revocable Trust Property. Property transferred by the decedent during his lifetime and placed in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust. IRC § 1014(b)(2).

3. Property with Retained Right to Control Beneficial Enjoyment. Property transferred by the decedent during his lifetime and placed in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust. IRC § 1014(b)(3).

4. Property Subject to a General Power of Appointment. Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will. IRC § 1014(b)(4).

5. Both Halves of Community Property. Property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any state, or possession of the United States, or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate for federal estate tax purposes. Thus, unlike the surviving spouse's separate property, both halves of a couple's community property receive a new cost basis upon the death of either spouse. IRC § 1014(b)(6).

6. Other Property Includable in the Decedent's Gross Estate. Property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate for estate tax purposes. IRC § 1014(b)(9). Clearly, the provision applying a basis adjustment for property "included in determining the value of the decedent's gross estate" overlaps with several other provisions. Revocable trust property, property with a retained right to control beneficial enjoyment, property passing pursuant to the exercise of a power of appointment, and QTIP property are all included in determining the value of the decedent's gross estate. But this catch-all provision of Section 1014(b)(9) alone is subject to a curious limitation. As discussed below, any basis adjustment allowed solely by reason of Section 1014(b)(9) is reduced by "the amount allowed to the taxpayer as deductions . . . for exhaustion, wear and tear, obsolescence, amortization and depletion on such property before the death of the decedent."

7. QTIP Property. Property includible in the gross estate of the decedent under Code Section 2044 (relating to property for which a "QTIP" marital deduction was previously allowed). IRC § 1014(b)(10).

D. Exceptions. Not all property acquired from a decedent receives a new cost basis at death.

1. Assets Representing Income in Respect of a Decedent. Most notably, items which constitute a right to income in respect of a decedent ("IRD") under Code Section 691 do not receive a new cost basis. Instead, the basis in an IRD asset is equal to its basis in the hands of the decedent. The Code does not provide a specific definition of IRD, but generally, it is comprised of items that would have been taxable income to the decedent if he or she had lived, but because of the decedent's death and income tax reporting method, are not reportable as income on the decedent's final income tax return. IRD may be included in the gross income of the decedent's estate or by one or more of the estate beneficiaries at the time the estate or beneficiary, respectively, collects the item of income. The most common example of IRD is retirement assets such as IRAs and qualified benefit plans upon which the decedent has not been taxed (which excludes Roth IRAs and nonqualified contributions from IRD). Other examples of IRD include accrued interest, dividends declared but not payable, unrecognized gain on installment obligations, bonuses and other compensation or commissions paid or payable following the decedent's death, and interests in partnerships that hold unrealized receivables or inventory items. A helpful test for determining whether an estate must treat an asset as IRD is set forth in *Estate of Peterson v. Commissioner,* 667 F.2d 675 (8th Cir. 1981): (i) the decedent must have entered into a "legally significant transaction"—not just an expectancy; (ii) the decedent must have performed the substantive tasks required of him or her as a precondition to the transaction; (iii) there must not exist any economically material contingencies which might disrupt the transaction; and (iv) the decedent would have received the income resulting from the transaction if he or she had lived. The basis in an IRD asset is equal to its basis in the hands of the decedent. IRC § 1014(c). This rule is necessary to prevent recipients of IRD from avoiding federal income tax with respect to items in which the income receivable by a decedent was being measured against his or her basis in the asset (such as gain being reported on the installment basis).

2. Property "Re-Inherited" Within One Year of Gift. A special exception is provided for appreciated property given to a decedent within one year of death, which passes from the decedent back to the donor or the donor's spouse as a result of the decedent's death. IRC § 1014(e). This rule is designed to prevent taxpayers from transferring property to dying individuals, only to have the property bequeathed back to them with a new cost basis.

3. Depreciable Property Owned by Others**.** As noted above, if a basis adjustment arises solely from the application of Section 1014(b)(9), the basis adjustment is reduced by the amount allowed "to the taxpayer" for depreciation, amortization or depletion prior to the decedent's death. IRC § 1014(b)(9). This limitation apparently applies only when someone other than the decedent owns depreciable, amortizable or depletable property which is nevertheless includible in the decedent's taxable estate. The Treasury Regulation interpreting the provision is entitled, "Special rule for adjustment to basis when property is acquired from a decedent prior to his death." It appears to have originated at a time when assets given away within three years of death were taxed to the decedent under a prior version of Code Section 2035. *See* Treas. Reg. § 1.1014-6(a)(3), Ex. 1. Its application is not, however, limited to that situation. Thus, for example, the provision has been applied to depreciated property held by the decedent and another as joint tenants with rights of survivorship. *See* Treas. Reg. § 1.1014-6(a)(2). It has also been applied to property held by spouses as tenants by the entirety. Rev. Rul. 58-130, 1958-1 CB 121. If an owner of the property was able to claim a deduction for depreciation, amortization or depletion during the decedent's lifetime, this provision prevents the owner from recouping that deduction as a result of having the property included in another person's estate. Thus, for example, assume that A made a gift of depreciable property with a basis of $50,000 to B, and retained a life estate. Prior to A's death, B claimed depreciation deductions of $20,000. When A dies, the property, valued at $80,000, is included in determining the value of A's gross estate under Section 2036(a)(1). Pursuant to Section 1014(b)(9), B's adjusted basis in the property as of the date of the decedent's death is $60,000 ($80,000, the fair market value at the decedent's death, less $20,000, the total depreciation deduction actually allowed to B). *See* Treas. Reg. § 1.1014-6(c).

4. Property Subject to a Conservation Easement. Property that is the subject of a conservation easement is entitled to special treatment for estate tax purposes. In general, if the executor so elects, the value of certain conservation easement property may be excluded from the value of the decedent's estate under Code

Section 2031(c), subject to certain limitations. To the extent of the exclusion, the property retains its basis in the hands of the decedent. IRC § 1014(a)(4).

E. Persons Dying in 2010. For estates of decedents dying in 2010 whose executors elected not to have the federal estate tax apply, the foregoing basis adjustment rules did not apply. For those estates, property acquired from these decedents was treated as transferred by gift, with a special $1.3 million allowance for basis adjustments, plus an additional $3 million basis adjustment for property passing to a spouse (or qualified trust for a spouse). The 2010 basis adjustment rules are set forth in Exhibit A.

F. Contrast Basis in Property Acquired by Gift. Unlike property acquired from a decedent, property acquired by gift (whether the gift is made outright or in trust), generally receives a "carry-over" basis. There are, however, some special rules that apply.

1. Donee's Basis to Determine Gain. For purposes of determining gain (and for purposes of determining depreciation, depletion, or amortization), the basis of property acquired by gift is the same as it would be in the hands of the donor or, in the case of successive gifts, of the last preceding owner by whom it was not acquired by gift. IRC § 1015(a).

2. Donee's Basis to Determine Loss. Unrecognized losses incurred by the donor do not carry over to the donee. Solely for determining a donee's loss on a sale of a gifted asset by the donee, the donee's basis cannot exceed the fair market value of the property at the date of the gift. IRC § 1015(a). In other words, if the donor's basis in an asset exceeds its fair market value at the date of the gift, the donee's basis may be one number for purposes of determining depreciation or gain on a later sale, and another for purposes of determining loss (i.e. dual basis). Fair market value for this purpose is determined in the same manner as it is for purposes of determining the value of the property for gift tax purposes. Treas. Reg. § 1.1015-1(e). The "lower of fair market value or basis" rule does not apply to transfers to a spouse, whether made incident to a divorce or otherwise. IRC § 1015(e). Instead, the basis of the transferee spouse in the property is equal to the adjusted basis of the transferor spouse for all purposes. IRC § 1041(b)(2).

Example 2: X gives stock to Y with a fair market value of $100 and an adjusted basis of $270. The following year, Y sells the stock for $90. Since Y is selling the stock at a loss, Y must use the lesser of X's basis or the stock's fair market value ($100) as the basis, and may recognize a loss of only $10. The $170 loss in value suffered by X is forgone. If instead, Y sold the asset for $150, a paradox arises. If Y were permitted to utilize X's basis of $270, Y would incur a $120 loss on the sale. However, Code Section 1015 provides that if a loss would otherwise arise, Y's basis is the lesser of X's basis or the stock's fair market value ($100). But Y's basis cannot be the fair market value on the date of the gift ($100), because fair market value is used as the donee's basis only when a loss would be recognized, and no loss would be recognized if there were a $100 basis in the stock. Therefore, Y recognizes neither a gain nor a loss. If Y is X's spouse, the gain or loss determination would be the same as if X sold the stock.

3. Basis for Gift Tax Paid. The basis of gifted property is increased for pre-1977 gifts by any gift tax paid. IRC § 1015(d)(1). For gifts made after 1976, the basis of gifted property is increased (but not to above its fair market value) by that portion of the gift tax paid which is attributable to the donor's net appreciation in the gifted assets. IRC § 1015(d)(6).

Example 3: Assume that the donor has used all of his applicable exclusion amount (and annual exclusion amount for the year) and gives stock having a basis of $200 and a fair market value of $1,000 to child, thereby paying $400 of gift tax. The basis adjustment for the gift tax paid is [($1000 minus $200)/$1000] times $400, or $320. The donee's basis becomes $200 plus $320, for a total basis of $520.[19]

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[19] Note that if any part of the gift qualified for the annual exclusion, Treasury Regulation Section 1.1015-5(c) helpfully apportions the tax only to the taxable portion of the gift, which maximizes the basis adjustment. For example, assume that the donor gives stock with a basis of $5,000 and a fair market value of $31,000. Further assume the gift qualifies for the $15,000 annual exclusion and after taking it into account, the taxable gift is $16,000, resulting in gift tax of $6,400. The gift tax basis adjustment is [($16,000 minus $5,000)/$16,000] times $6,400, or $4,400. The key is that

4. Basis for GST Tax Paid. The basis of gifted property is also increased (but not to above its fair market value) by any generation-skipping transfer taxes paid and which are attributable to the donor's net appreciation in the gifted asset. IRC § 2654(a). This basis adjustment for GST taxes paid is applied after the basis adjustment for gift taxes paid pursuant to Code Section 1015.

5. Basis of Suspended Passive Losses. Any suspended passive activity losses attributable to a gifted asset are added to the donee's adjusted cost basis and benefit the donee (although a dual basis may exist, and such addition to basis, to the extent it causes basis to exceed the fair market value of the property at the time of the gift, will not benefit the donee in a loss transaction). IRC § 469(j)(6).

> **Example 4:** Assume that the donor has an asset with a fair market value of $100, an adjusted cost basis of $70, and a suspended passive activity loss of $40. When the asset is given to the donee, the donee will have a $100 basis for loss purposes and a $110 basis for gain purposes.

a. The Cost of Forgoing Basis. One of the main transfer-tax advantages of making a gift is that any post-gift appreciation is not subject to estate tax. But, as noted above, one cost of lifetime gifting is that there will be no basis adjustment for the gifted asset at death. As a result, the asset may need to appreciate significantly after the gift in order for the 40% estate tax savings on the appreciation to offset the loss of basis adjustment for the asset. For example, assume a gift is made of a $1 million asset with a zero basis. If the asset does not appreciate, the beneficiaries will lose the step-up in basis. At a 23.8% effective capital gain rate (if the beneficiaries are in the top tax bracket), this means the beneficiaries will receive a net value of $762,000 from the asset after it is sold. If the donor had retained the asset until death, and if the property does not appreciate, the transfer tax implications would be the same (since the adjusted taxable gift rules under Code Section 2001(b)(1)(B) effectively use up an equivalent exclusion at death). But if the asset was held until death, the basis adjustment would save $238,000 of capital gain taxes. In order for the estate tax savings on post-gift appreciation to offset the loss of basis adjustment, the asset would have to appreciate from $1,000,000 to $2,469,136 (nearly 147%) (appreciation of $1,469,135 x .40 estate tax rate = gain of $2,469,135 x .238 capital gain rate). *See* McCaffrey, *Tax Tuning the Estate Plan by Formula*, 33 U. MIAMI HECKERLING INST ON EST. PL. 4, ¶ 403.5 (1999); Mahon, *The 'TEA' Factor*, TR. & EST. (Aug. 2011). Keep in mind that the income tax is incurred only if the beneficiaries sell the asset. If the beneficiaries will retain the asset indefinitely, if the beneficiaries have their own capital losses that would offset any capital gains, or if real estate investment changes could be made with like-kind exchanges, basis step-up is not as important.

VIII. INCOME TAXATION OF TRUSTS AND ESTATES

A. General Rules. As noted above, although trusts and estates are technically not legal entities, for income tax purposes, they are treated as such. The balance of the paper focuses on the special rules applicable to trusts and estates.

B. The Estate's Income Tax Return.

1. Obtaining an Employer Identification Number. The executor must obtain an employer identification number ("EIN") for the estate. Payers of interests, dividends and other income items should be notified of the estate's EIN so that these items of income can be accurately attributed to the estate. An executor may obtain a number by filing IRS Form SS-4, "Application for Employer Identification Number." Alternatively, the number may be obtained online at: https://sa1.www4.irs.gov/modiein/individual/index.jsp. Note that the IRS has discontinued the ability to obtain an EIN by telephone.

2. Notifying the IRS of Fiduciary Status. The executor (or if none, the testamentary trustee, residuary legatee(s), or distributee(s)) should file with the IRS an IRS Form 56, "Notice Concerning Fiduciary Relationship." This form puts the IRS on notice that the executor has been appointed to handle the decedent's affairs, and apprises the IRS of the proper address to which correspondence regarding the decedent's tax matters may be directed. IRC § 6903; Treas. Reg. §§ 301.6903-1, 601.503.

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the divisor is equal to the taxable portion of the gift rather than the fair market value of the gifted property.

a. A short-form certificate or authenticated copy of letters testamentary or letters of administration showing that the executor's authority is still in effect at the time the Form 56 is filed, otherwise an appropriate statement by the trustee, legatee, or distributee, should accompany the Form 56. *Id*.

b. The Form 56 must be signed by the fiduciary and must be filed with the IRS office where the return(s) of the person for whom the fiduciary is acting must be filed. Treas. Reg. §§ 301.6903-1(b).

c. Written notice of the termination of such fiduciary relationship (on Form 56) should also be filed with the same office of the IRS where the initial Form 56 was filed. The notice must state the name and address of any substitute fiduciary and be accompanied by satisfactory evidence of termination of the fiduciary relationship. *Id*.

3. <u>Post-Death Revocable Trusts May Be Separate Taxpayers or Part of the Estate</u>. Often, revocable trusts typically provide for the creation of sub-trusts (i.e., marital trusts, bypass or credit shelter trusts, trusts for descendants, etc.) after the grantor's death. It is important to remember that the revocable trust becomes a separate taxpayer at the grantor's death. It is also a separate taxpayer from the sub-trusts that will later be funded from it. Trusts used as estate surrogates face issues similar to estates in the context of post-death income taxation. In the words of one author,

> A postmortem successor trust does not spring, Minerva-like, full-blown from the Jovian brow of the grantor trust *eo instante* upon the grantor's death. In most instances, and unless the governing instrument provides otherwise, the postmortem successor trusts (marital deduction, credit shelter or other) will be treated as separate trusts for income tax purposes only when funded. Funding occurs only when the trustee has assigned assets to the trust after careful exploration and prudent exercise of post-mortem tax options and elections available under the Internal Revenue Code of 1986. In the interim, the grantor trust normally functions like an estate pending distribution to its beneficiaries (including successor trusts) and, as such, in a separate taxable entity for income tax purposes.

Becker, *Wills vs. Revocable Trusts - Tax Inequality Persists*, 3 PROB. & PROP. No. 4 at 17, 18 (1989).

Trust termination rules are governed by subsection (b) of Treasury Regulation Section 1.641(b)-3, as opposed to estates which are governed by subsection (a). The rules, however, are similar and should give rise to no real substantive difference in timing or treatment.

a. <u>Effect of Grantor's Death</u>. A revocable living trust typically allows the grantor, but no one else, to revoke it and thus becomes irrevocable at the grantor's death. The income, deductions and credits attributable to such a grantor-type trust prior to the grantor's death will be reflected on the deceased grantor's final Form 1040 and the grantor's Social Security number is used for identification. A revocable living trust becomes a different taxpayer after the grantor dies. Rev. Rul. 57-51, 1957-1 CB 171. It must obtain a new EIN and start filing Form 1041, "U.S. Income Tax Return for Estates and Trusts" under the new EIN on income earned after the grantor's death. If a grantor-type revocable living trust was not exempt from filing trust income tax returns or had to obtain an EIN during the grantor's lifetime, then such trust should file a final grantor-type trust income tax return under its old EIN to report items of income, deductions, and credits attributable to such trust for the period ending on the grantor's date of death.

b. <u>Post-Death Differences Between Trusts and Estates</u>. For income tax purposes, post-death revocable trusts suffer several minor disadvantages when contrasted with estates. These include, for example:

(1) The revocable living trust becomes a separate taxpaying entity after the grantor's death. If no Section 645 election (described below) is made to treat the trust as part of the probate estate, it gets an added run up the tax bracket ladder (i.e., on the estate's return as well as the trust's tax return) and the advantage of separate exemptions ($600 for the estate, and either $100 or $300 for the trust). IRC §§ 1(e), 642(b).

(2) After 1997, an estate is still allowed to recognize some losses for income tax purposes (i.e., losses resulting from the funding of a pecuniary gift), but losses in other taxable transactions between an estate or trust and its beneficiaries are not allowed to be recognized for tax purposes. IRC § 267(b)(5), (b)(13).

(3) An estate is allowed to choose a fiscal year for income tax reporting purposes, but absent an election otherwise, a revocable living trust must utilize a calendar year for reporting its income after the grantor's death. IRC § 645(a).

(4) Estates are not subject to the throwback rules with respect to accumulated income from prior tax years, but after 1997, some domestic trusts and all foreign trusts are still subject to the throwback rules. IRC §§ 665-669.

(5) A decedent's estate does not need to make estimated income tax payments for the first two years after the decedent's death. IRC § 6654(l)(2)(A). Upon the death of a grantor, a revocable trust is required to pay estimated income taxes, unless the trust is wholly a grantor trust, and either the residue of the grantor's estate pours over to the trust or no will is admitted to probate and the trust is primarily responsible for paying the debts, taxes, and expenses of the estate. IRC § 6654(l)(2)(B). If the revocable trust meets these two conditions, no estimated taxes are due for any tax period before the date two years after the date of the grantor's death (the same rule applicable to estates). IRC § 6654(l)(2). Trusts created as a result of someone's death that do not fit the narrow requirements described above do not have the luxury of a two-year exemption from paying estimated taxes which become payable in the trust's first year. The methods for calculating the estimated taxes are set out in Code Section 6654 and IRS Notice 87-32, 1987-1 CB 477, and worksheets accompany IRS Form 1041-ES. Estates, however, have less flexibility than trusts, as trusts can elect to have estimated income tax payments deemed distributed to the beneficiary in any year, but estates can only do so in their last year. IRC § 643(g). The election must be made by the 65th day after the close of the taxable year for the trust or after the close of the last year of the estate and is made using IRS Form 1041-T, "Allocation of Estimated Tax Payments to Beneficiaries (Under Code section 643(g))." IRC § 643(g)(2).

(6) Estates having a charitable residuary beneficiary can deduct amounts which are permanently set aside for ultimate distribution to charity. IRC § 642(c)(2). Post 1969-Act trusts are not entitled to the IRC § 642(c)(2) deduction, which makes it difficult for trusts to avoid income tax on capital gains realized unless a current year distribution of such gains can be made to charity.

(7) Estates have a potentially unlimited charitable income tax deduction. IRC §642(c). In contrast, trusts having unrelated business income that is contributed to charity are subject to the percentage limitations on deductibility applicable to individuals. IRC § 681(a).

(8) An estate (but not a trust) in its first two taxable years after death may deduct up to $25,000 of losses with respect to rental real estate against other income if the decedent was an active participant with respect to such real estate at the time of death. IRC § 469(i)(4).

(9) An estate qualifies to hold S corporation stock for a reasonable period of time, but a revocable trust can continue as an S corporation shareholder for only two years after the grantor's death. IRC §§ 1361(b)(1)(B), 1361(c)(2)(A)(ii).

(10) The executor (or other personal representative) and a trustee may have personal liability for a decedent's income and gift tax returns, but only an appointed executor or administrator (as specially defined in IRC § 6905(b), and which includes a court-appointed executor but does not include a trustee) is entitled to a written discharge for personal liability for such taxes. IRC § 6905.

(11) Medical expenses of the decedent paid out of the estate within one year after date of death may be deducted if so elected. IRC §§ 213(c), 642(g).

c. Election to Unify. For decedents dying after August 5, 1997, the trustee and the appointed executor (if any) may irrevocably elect to treat a "qualified revocable trust" as part of the estate for income tax purposes. IRC § 645(a). A "qualified revocable trust" is a trust that, during the life of the grantor, was treated as a grantor trust because of his or her right of revocation under Code Section 676. IRC § 645(b). The election must be made on the estate's first timely filed income tax return (including extensions), and, once made, is irrevocable. IRC § 645(c); Treas. Reg. § 1.645-1(e)(1). Therefore, the decision may be made several months after the end of the month selected. IRC §§ 441, 443(a)(2), 6072(a); Treas. Reg. § 1.441-1(c)(1). The election applies until the day before "the date which is 6 months after the date of the final determination of the liability for tax imposed by chapter 11," or if no estate tax return is due, the day before two years after the date of death, although the regulations clarify that if a return is due, the election is until the day before the later of two years after death or six months after the date of final determination. IRC § 645; Treas. Reg. § 1.645-1(f)(2). The final regulations provide that the date of final determination of liability is the date that is six months after the date the closing letter is issued. Therefore, the section 645 election will terminate one day less than twelve months after issuance of the closing letter. The regulations further provide that the election period terminates earlier if both the electing trust and the related estate, if any, have distributed all of their assets, which is helpful for estates where a return is due since a closing letter will no longer be routinely issued. Treas. Reg. § 1.645-1(f)(1). The procedures for making the election for decedents who die on or after December 24, 2002 are governed by final Treasury Regulations. Treas. Reg. § 1.645-1(j). If an executor has been appointed, the executor and trustee of the trust make the election by signing and filing IRS Form 8855, "Election to Treat a Qualified Revocable Trust as Part of an Estate." If there is no executor, the trustee of the trust files the election form. Treas. Reg. § 1.645-1(c)(2). An EIN for the trust is required for making the election.

d. <u>Advantages of the Election</u>. If the estate (if any) and the revocable trust make the election, a number of tax benefits may result to the trust, including:

(1) availability of a fiscal year end under Code Section 644. Treas. Reg. § 1.645-1(e)(3)(i). Note that although Form SS-4 asks for the taxpayer's fiscal year end, the filing of the form does not establish the fiscal year end for the entity.

(2) avoiding the need to make estimated tax payments for two years after the decedent's death. Treas. Reg. § 1.645-1(e)(4).

(3) the ability to obtain a charitable deduction for amounts permanently set aside for charity under Code Section 642(c)(2). Treas. Reg. § 1.645-1(e)(2)(iv), (e)(3)(i).

(4) the ability to hold S corporation stock for the duration of the administration of the estate, without meeting special trust rules. Treas. Reg. § 1.645-1(e)(3)(i); *see* Rev. Rul. 76-23, 1976-1 CB 264 (estate exception applies for the reasonable period of estate administration and applies for entire section 6166 deferral period).

(5) avoidance of the passive loss active participation requirement under Code Section 469 for rental real estate for two years after death. Treas. Reg. § 1.645-1(e)(3)(i).

(6) use of the $600 personal exemption available to an estate rather than either a $300 or $100 exemption available to trusts (depending on whether the trust is required to distribute all of its income annually). Treas. Reg. § 1.645-1(e)(2)(ii)(A).

(7) allowing losses in funding pecuniary bequests under Code Section 267(b)(13).

(8) simplifying the number of tax returns.

(9) deferral of payment of income tax on income earned after the date of death until the due date of the estate's fiduciary return (which could result in up to eleven months of additional deferral).

e. <u>Electing a Fiscal Year End</u>. Trusts subject to income tax must have a calendar year end. IRC § 644(a). Unlike these trusts, an estate and tax-exempt trusts may elect to adopt a year end other than December 31. Although more about the specifics of making the Section 645 election is provided above, the only requirements regarding when the year must end are that the fiscal year must end on the last day of a month, and that the first year does not exceed 12 months. IRC § 441(e); Treas. Reg. § 1.441-1(a).

f. <u>Reasons for Adopting Fiscal Year End</u>. By adopting a non-calendar year end, an estate (or electing trust) can accomplish a number of objectives.

(1) <u>Deferral, Income Splitting and Expense Matching</u>. For example, adoption of a fiscal year end for the estate of a decedent who dies in November 2014 would permit deferral of any income tax due on April 15, 2015 until February 15, 2016 (if an October 31 fiscal year end were selected). By adopting a very short first fiscal year, the estate may be able to split substantial income arising immediately after death

(such as the collection of IRD) into two separate years, thereby taking advantage of two uses of the estate's lower marginal brackets (although the compression of rate brackets for estates substantially reduces the benefit of this strategy). Selecting a long first fiscal year may serve to permit enough time to pass for the estate to generate deductions (e.g., the payment of fees) to offset estate income. Alternatively, selection of a fiscal year end may allow substantial excess deductions taken in a last short year to be taken by the estate's beneficiaries. IRC § 642(h).

(2) Deferral for Recipients of DNI. When an estate or trust makes a distribution, that distribution will generally carry out the estate or trust's distributable net income ("DNI") to the distributee, causing the beneficiary to report and pay tax on any taxable income earned by the estate or trust, to the extent of the distribution. If the tax year of the estate or estate and the beneficiary differ, the beneficiary reports taxable DNI not when actually received, but as though it had been distributed on the last day of the estate or trust's tax year. IRC § 662(c). Therefore, if an estate or trust elects a fiscal year end other than December 31, its beneficiaries may defer reporting of income. For example, if an estate selects a January 31 year end, all distributions made from, say February 2016 through January 31, 2017 will be treated as being received by the beneficiary on January 31, 2017. Thus, a beneficiary who actually receives a distribution in February 2016 could defer paying the tax thereon until April 15, 2016 (the due date of the beneficiary's 2017 tax return), more than two years after receipt. Deferral in the first year, however, may result in a bunching of income in the final year of the estate. If the estate in the foregoing example terminated on December 31, 2016, the beneficiary would include 23 months' worth of estate income (February 2015 through December 2016) on the beneficiary's tax return for 2016. Bunching can be offset by deferring expenses into the last year of the estate, and by keeping the estate's last fiscal year as short as possible, to generate excess deductions for the beneficiary under Code Section 642(h)(2).

4. Passive Activity Losses. A passive activity involves the conduct of a trade or business in which the taxpayer does not materially participate. IRC § 469(c)(1). While Treasury regulations spell out seven ways in which an individual can materially participate, there are no regulations addressing how an estate or trust materially participates. The regulations suggest that the capacity in which one participates does not matter. Treas. Reg. § 1.469-5(a)(1). The legislative history, however, says that "an estate or trust is materially participating in any activity . . . if an executor or fiduciary, *in his capacity as such*, is so participating." S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986) (emphasis added). In *Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. 2003), a case of first impression that addresses what activities can qualify as material participation under the passive loss rules for trusts and estates, the IRS took the position that only the trustee's activities, in his capacity as trustee, could be used to test material participation. The taxpayer argued instead that because the trust (not the trustee) is the taxpayer, material participation in the ranch operations should be determined *by assessing the activities of the trust* through its fiduciaries, employees, and agents. The court agreed with the taxpayer's position, based on an interpretation of the statute itself. Section 469 states that a "taxpayer" is treated as materially participating in a business if "its" activities in pursuit of that business are regular, continuous, and substantial. IRC § 469(h)(1). Therefore, the court ruled that participation must be tested by the activities of the trust itself, which necessarily entails an assessment of the activities of those who labor on the ranch, or otherwise in furtherance of the ranch business, on behalf of the trust. Although the legislative history quoted above might have suggested otherwise, the court noted that legislative history has no application where the statutory language is clear. Furthermore, the court concluded that the activities of the trustee alone were also sufficient to constitute material participation. The IRS continues to advance its view that the actions of the trustee are controlling. For example, in Technical Advice Memorandum 200733023, the IRS, relying primarily on the legislative history, held that notwithstanding the decision in *Mattie K. Carter Trust*, the sole means for a trust to establish material participation was by its fiduciaries being involved in the operations. *See also* TAM 201317010 ("special" trustee of two trusts holding S corporation stock who also served as president of S corporation didn't materially participate on behalf of trust since trustee's non-fiduciary activities are excluded from consideration). More on these issues and the recent case of *Frank Aragona Trust v. Commissioner* is provided below.

5. Allocating Depreciation. Like an individual, a trust or an estate is entitled to an income tax deduction for depreciation, depletion, and amortization. However, there are special rules in allocating the deduction

between the estate (or trust) and the beneficiaries. IRC § 642(e). For an estate, the deductions for depreciation and depletion are apportioned between the estate and beneficiary based on the amount of state law accounting income allocable to each. IRC §§ 167(d), 611(b)(4). For a trust, the depreciation and depletion deductions are apportioned between the trust and beneficiaries in accordance with the terms of the trust agreement. IRC § 167(d). Therefore, if the trust agreement or state law requires or permits the trustee to maintain a reserve for depreciation or depletion, the deduction is allocated first to the trust to the extent that income is set aside for the reserve. *See, e.g.*, Tex. Prop. Code §§ 116.004, .173, .203, .204. If the trust agreement (or local law) is silent on this issue, the deduction is apportioned between the trust and beneficiaries on the basis of "income" allocable to each. IRC §§ 167(d), 611(b)(3). The fiduciary allocates the depreciation, depletion, and amortization deductions using the allocation procedures described above. After those calculations have been made, the fiduciary computes taxable income of the trust or estate by deducting only the portion of the depreciation, depletion and amortization deductions that have not been allocated to the beneficiaries. IRC §§ 642(e), 642(f), 167(d), 611(b). If authorized by local law or under the terms of the governing instrument, a fiduciary may establish a reserve for depreciation or depletion. Doing so effectively reduces receipts that would otherwise be treated as income of the estate or trust, allocating them instead to corpus. Section 179 of the Code allows businesses to expense depreciable personal property within certain limits, which limits have become much more generous in recent years. *See* Stevens, *Section 179's Special Pass-Through Entity Rules*, BUSINESS ENTITIES (July/August 2010). As Steve Gorin has noted, however, a trust cannot deduct this special Section 179 expense that flows through on its K-1 from a partnership or S corporation. IRC § 179(d)(4). The business entity does not reduce its basis in, and may depreciate, this depreciable property to the extent that the deduction is disallowed. Treas. Reg. § 1.179-1(f)(3). Because the regulation specifically refers to S corporations, presumably this regulation overrides the general rule that all S corporation shareholders are taxed the same; the only way to give effect to this regulation would appear to make a special allocation of depreciation expense to the trust or estate. *See* Gorin, *Structuring Ownership of Privately-Owned Business: Tax and Estate Planning Implications* (available by emailing the author at sgorin@thompsoncoburn.com to request a copy or request to subscribe to his newsletter *Gorin's Business Succession Solutions*). Presumably, this complexity would be avoided by using a grantor trust. Rev. Rul. 85-13, 1985-1 CB 184; *see also* Rev. Rul. 2007–13, 2007-11 IRB 684.

C. <u>State vs. Federal Law Notions of "Income"</u>

1. <u>When An Estate or Trust Allocates "Income," That Means Fiduciary Accounting Income, Not Taxable Income</u>. Estate planning attorneys that spend too much of their time studying tax rules sometimes forget that not every situation is governed by the Code. Nowhere is this failure more prevalent than in the area of allocating and distributing estate and trust "income." In general, when a trust (or the income tax rules applicable to estates and trusts) speaks of "income" without any modifier, it means fiduciary accounting income, and not taxable income. IRC § 643(b). The fiduciary accounting rules tell a fiduciary whether a receipt is principal or income, which in turn determines which beneficiary is entitled to it, i.e. an income or a principal beneficiary. In measuring fiduciary accounting income, the governing instrument and local law, not the Code, control. Therefore, estate planners should have a basic understanding of these state law rules. Allocations are generally made pursuant to directions set forth in the governing instrument, or in the absence of those directions, pursuant to the provisions of local law. As of this writing, forty-six states and the District of Columbia have adopted the Uniform Principal and Income Act ("UPIA"). Only Georgia, Illinois, Louisiana, and Rhode Island have not. Despite the benefits of "uniform" acts, many states have chosen to modify specific sections to their principal and income rules, including Texas. (For example, Section 116.174 of the Texas Trust Code effectively provides that income from mineral royalties for most trusts will be allocated 85% to income instead of the 10% specified in Section 411 of the Uniform Act.) Therefore, it is essential that the actual language of the applicable local law be reviewed.

a. <u>Allocation of Income</u>.

(1) <u>General Rules.</u> UPIA provides that a trustee must make allocations of receipts between trust income and principal in accordance with the specific provisions of the governing instrument, notwithstanding contrary provisions of the Act. UNIF. PRIN. & INC. ACT § 103(a)(1) (2000). Provisions in

the Will or trust agreement should therefore control allocations of estate and trust income and expenses, so long as the provisions are specific enough to show that the testator chose to define a specific method of apportionment. *See InterFirst Bank v. King*, 722 S.W.2d 18 (Tex. App.–Tyler 1986, no writ). In the absence of specific provisions in the instrument, the provisions of the Act (as provided in state law) control allocations of receipts between income and principal.

In Texas, for example, items accrued on the day before the date of death, such as rent, interest and annuities, are treated as principal under the Texas Trust Code, even if those items are considered income (presumably, income in respect of a decedent) under tax law. TEX. PROP. CODE § 116.102(a). However, if the income is derived from an asset that is specifically bequeathed, the income is distributable to the recipient of that asset. TEX. PROP. CODE § 116.051(l). Although income accrued before the date of death is principal, funds received by a trustee from an estate that constitute the estate's income under Section 310.004 of the Texas Estates Code is treated as trust income under Section 116.152 of the Texas Trust Code. TEX. ESTS. CODE § 310.004; TEX. PROP. CODE § 116.101(b)(2). Accordingly, this post-death income passing from the estate to the trust will not be "trapped."

(2) Allocations Under UPIA. UPIA applies a uniform approach in allocating receipts and disbursements between principal and income. In most cases, the cash basis is expressly used to characterize income and expenses.

(a) Distributions from "Entities." Section 401 of UPIA describes how to characterize distributions from "entities," which the Act defines to include corporations, partnerships, limited liability companies ("LLCs"), regulated investment companies (i.e., mutual funds), real estate investment trusts, and common trust funds. The general rule under UPIA is that all distributions received from these entities are income, subject to four exceptions. First, the Act treats long term capital gain distributions from mutual funds or real estate investment trusts as principal. Second, a distribution or series of distributions received in exchange for the trust's interest in the entity are principal. Third, distributions in kind (as opposed to distributions of money) from entities are treated as principal. Fourth, distributions of money received as a partial liquidation are principal. In this regard, a distributions of money is treated as a partial liquidation if (i) it is designated by the entity as a liquidating distribution; or (ii) if the distribution or a series of distributions exceed 20% of the entity's gross assets prior to distribution (ignoring an amount that does not exceed the income tax that the trustee or beneficiary must pay on the entity's income). Of note, reinvested corporate dividends are treated as principal (but presumably only if they are reinvested pursuant to the trustee's power under the Act to adjust between income and principal to comply with the duty of impartiality between income and remainder beneficiaries).

(b) Mutual Fund Distributions. Section 401(c)(4) of UPIA provides that principal includes money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes. The official comment to the Uniform Act states: "Under the Internal Revenue Code and the Income Tax Regulations, a 'capital gain dividend' from a mutual fund or real estate investment trust is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act."

(c) Business and Farming Operations. UPIA permits a trustee to aggregate assets used in a business or farming operation and to account separately for the business or activity (instead of accounting separately for its various components) if the trustee "determines that it is in the best interest of all of the beneficiaries" to do so. UNIF. PRIN. & INC. ACT § 403(a) (2000). The trustee is permitted to maintain a reserve from its net cash receipts to the extent needed for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business. UNIF. PRIN. & INC. ACT § 403(b) (2000).

b. Allocation of Expenses.

(1) General Rule. Like income, expenses may be allocated between fiduciary accounting income and principal based upon the terms of the governing instrument. If the instrument fails to specify how expenses are to be allocated, state law provides guidance.

(2) Allocations Under UPIA. Section 501 and 502 of UPIA describe allocations against income and principal.

(a) Charges Against Income. Under Section 501, charges against income include one-half of all regular trustee compensation (including investment advisory or custodial fees) and one-half of expenses for accountings and judicial proceedings that involve both the income and principal beneficiaries. All of the ordinary expenses of administration, management and preservation of property, and the distribution of income, including recurring taxes assessed against principal, insurance, interest and repairs are charged against income. Also charged to income are all court costs and attorney fees for other matters concerning income. UNIF. PRIN. & INC. ACT § 501 (2000).

(b) Charges Against Principal. Charges against principal are all those expenses not charged to income, including one-half of trustee fees; accountings and judicial proceedings not charged to income; trustee compensation calculated on principal as a fee for acceptance, distribution, or termination of the trust, and disbursements made to prepare property for sale; and payments on the principal portion of debt. Also charged to principal are estate, inheritance, and other transfer taxes. UNIF. PRIN. & INC. ACT § 502 (2000).

(c) Income Taxes. UPIA Section 505 generally charges taxes based upon income receipts to income, and charges taxes on principal receipts to principal, even if denominated as an "income" tax (such as capital gain taxes). The Section then goes on to allocate "tax required to be paid by a trustee on a trust's share of an entity's taxable income," which would presumably include income from partnerships, LLCs and S corporations. The Act requires that these taxes be paid proportionally from income, to the extent that receipts from the entity are allocated to income, and to principal to the extent (i) receipts are allocated to principal; or (2) the entity's taxable income exceeds the total receipts from the entity. UNIF. PRIN. & INC. ACT § 505(c) (2000). These allocations must be reduced by the amount distributed to a beneficiary for which a distribution deduction is allowed. UNIF. PRIN. & INC. ACT § 505(d) (2000). In 2008, the Uniform Laws Commission made important changes to Section 505 of UPIA to deal with income tax issues associated with pass-through entities owned by trusts and estates. The revised statute deletes the requirement that taxes be charged to principal to the extent that the trust's share of the entity's taxable income exceeds receipts from the entity. It then adds a provision requiring the trustee to adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary. The rewritten statute requires the trust to pay the taxes on its share of an entity's taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This treatment assures the trust is a source of cash to pay some or all of the taxes on its share of the entity's taxable income. Only thirty-six states and the District of Columbia have enacted this amendment.

c. "Power to Adjust". Separate from UPIA's directions as to the allocations of receipts and disbursements is UPIA's granting of the power to adjust to trustees of certain trusts. Once a trustee determines whether a receipt is allocated to principal or income, the trustee can shift the allocation somewhat by exercising the power to adjust in order to provide fairness among the beneficiaries.

(1) Breadth of the Power. The framers and advocates of UPIA make much of its provision granting the trustee the power to adjust between principal and income "to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines . . . that the trustee is unable to comply with" the general requirement to administer the trust "impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." UNIF. PRIN. & INC. ACT §§ 103(b), 104 (2000). The power to adjust includes the

power to allocate all or part of a capital gain to trust income. This power is seen by many as a panacea to cure all of the ills of trust administration. Unfortunately, however, its application is limited.

(2) Limitations on the Power to Adjust. The power to adjust is not available to all trustees. In particular, the power may not be used to make an adjustment: (1) that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment; (2) that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion; (3) that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets; (4) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside; (5) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment; (6) if possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment; (7) if the trustee is a beneficiary of the trust; or (8) if the trustee is not a beneficiary, but the adjustment would benefit the trustee directly or indirectly. UNIF. PRIN. & INC. ACT § 104(c) (2000). Many of the trusts with which estate planners struggle fall within category (1) (intended to qualify for the estate tax marital deduction) or (7) (the trustee is a beneficiary). As a result, the power to adjust is simply unavailable in many cases.

d. Equitable Adjustments. Separate from the power to adjust, UPIA Section 506 permits a fiduciary to make adjustments between principal and income to offset the shifting economic interests or tax benefits between income beneficiaries and remainder beneficiaries that arise from (i) elections that the fiduciary makes from time to time regarding tax matters; (ii) an income tax imposed upon the fiduciary or a beneficiary as a result of a distribution; or (iii) the ownership by an estate or trust of an entity whose taxable income, whether or not distributable, is includible in the taxable income of the estate, trust or a beneficiary. This sort of adjustment, often referred to as an "equitable adjustment," has been the subject of common law decisions in a variety of jurisdictions.

Example 5: In *Estate of Bixby*, 140 Cal. App. 2d 326, 295 P.2d 68 (1956), the executor elected under Code Section 642(g) to take deductions for income tax purposes, which reduced income taxes by $100,000, at the cost of $60,000 in estate tax savings. Based upon the terms of the Will, the income tax savings inured to the benefit of the income beneficiary, while the loss of estate tax savings came at the expense of the remainder beneficiaries. The net savings to the estate overall was $40,000, but as among its various beneficiaries, some gained at the expense of others. The court required the executor of the estate to allocate $60,000 to the remainder beneficiaries to compensate them for their damages as an "equitable adjustment." As a result, the remainder beneficiaries were unharmed, and the income beneficiaries received the net $40,000 tax savings.

e. Trapping Distributions. A "trapping distribution" may arise when one fiduciary (e.g., an estate) distributes property to a trust (e.g., a marital deduction trust), if the distribution carries with it taxable income in the form of the distributing entity's distributable net income. If the transferee fiduciary characterizes the receipt as corpus under principles of local law or the governing instrument, the recipient will not distribute that amount as "income" to the beneficiary. As a result, the DNI carried out by the distributing entity is "trapped" inside the transferee entity. This trapping of income presents an opportunity to use an otherwise simple trust as a taxpayer in the year it is funded. Naturally, since the trust's tax rates may be as high as 40.8% at only $12,500.00 in taxable income (applying 2018 rules), the tax savings generated by this technique are limited. A simple trust with $12,800.00 in income ($300.00 of which would be excluded by the trust's allowance in lieu of personal exemption) would pay a tax of $3,011.50 instead of $4,736.00 if the entire $12,800.00 were taxed to a beneficiary in the 37% bracket–a savings of only $1,724.50. If the beneficiary were subject to the 3.8% tax on net investment income, the savings would be $2,210.90. Under Section 302 of UPIA, income accrued at the date of death is principal, but funds received by a trustee from an estate that constitute the estate's income is treated as trust income. Accordingly, this post-death income passing from the estate to the trust will not be "trapped."

IX. NET INVESTMENT INCOME TAX ON ESTATES AND TRUSTS

A. Health Care and Education Reconciliation Act of 2010, P.L. 111-152, 124 Stat. 1029 (2010). The year 2013 brought a new income tax to estates and trusts. The Health Care and Education Reconciliation Act of 2010 imposes an additional 3.8% income tax on individuals, trusts, and estates. Although the tax is similar between individuals on the one hand and trusts and estates on the other, there are some differences.

B. IRC § 1411. The new income tax is found in new Chapter 2A of the Code entitled "Unearned Income Medicare Contribution." Chapter 2A is comprised only of Section 1411. Although commonly referred to as a Medicare tax (which is understandable based on the name of the Chapter), the funds will not be placed in the Medicare Fund but will go to the General Fund of the Treasury.

For individuals, the 3.8% tax applies to the lesser of net investment income or the excess of a taxpayer's modified adjusted gross income over certain defined thresholds. For estates and trusts, the 3.8% tax applies to the lesser of undistributed net investment income or the excess of adjusted gross income over a threshold determined based on the highest income tax bracket for estates and trusts ($12,500 for 2018 and 2017 and $12,400 for 2016). For ease of reference, for individuals who are married filing jointly, the threshold is $250,000 (for married filing separately, $125,000 each) and for single individuals, the filing threshold is $200,000. Because the threshold for trusts and estates is based on the highest income tax bracket for each, the threshold is indexed each year to some extent for these entities, whereas there is no indexing for individuals.

The statute as it applies to estates and trusts is as follows:

§ 1411(a) In general. Except as provided in (e) –

> (2) Application to estates and trusts. In the case of an estate or trust, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax of 3.8 percent of the lesser of –
>
> (A) the undistributed net investment income for such taxable year, or
>
> (B) the excess (if any) of –
>
> (i) the adjusted gross income (as defined in section 67(e)) for such taxable year, over
>
> (ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

C. Regulations.

1. Proposed Regulations. On December 5, 2012, the IRS issued a Notice of Proposed Rulemaking ("Notice") seeking comments to proposed Treasury regulations related to Section 1411 (77 FR 72611). As stated in the Notice, the purpose of Section 1411 is to impose a tax on "unearned income or investments." The Notice provides that for the most part, the principles of chapter 1 of subtitle A of the Code are to be applied in determining the tax to be imposed. In addition, the statute introduces terms that are not defined and makes cross references to various other sections of the Code; however, as pointed out in the Notice, nothing in the legislative history indicates that a term used in the statute is meant to have the same meaning as it would for other income tax purposes. The proposed regulations are intended to provide additional definitions of terms and guidance for the imposition of the tax. The proposed regulations are "designed to promote the fair administration of section 1411 while preventing circumvention of the purposes of the statute."

2. Final Regulations. On December 2, 2013, the IRS and Treasury Department issued final regulations under Section 1411 ("Final Regulations"). For the most part, the Final Regulations are effective for tax years beginning after December 31, 2013. Section 1.1411-3(d)(3), which applies to charitable remainder

trusts, is effective for tax years beginning after December 31, 2012. Interestingly, amendments to the Final Regulations should be issued at some point. Contemporaneously with the Final Regulations, the IRS and Treasury Department issued a new set of proposed regulations (78 FR 72451) to further study specific items under Section 1411.

D. Net Investment Income vs. Undistributed Net Investment Income**.** Individuals, trusts, and estates now have to calculate their "net investment income." Net investment income consists of the sum of three categories of income. IRC § 1411(c)(1). Keep in mind that in each of the three categories of income, when the term "trade or business" is used, it is in reference to that term as defined in Section 1411(c)(2) and as further defined in Treasury Regulation Section 1.1411-4(b).

The first category of income includes gross income from interest, dividends, annuities, royalties, and rents, other than those that are derived in the ordinary course of a trade or business. IRC § 1411(c)(1)(A)(i). Note that each of these types of income may be included in the first category even though they may be earned through an activity that may otherwise be thought of as a trade or business. In order to be excluded from this category, the income must meet the ordinary course of a trade or business exception as set out in Treasury Regulation Section 1.1411-4(b). To meet the exception, the trade or business must be one to which the tax will not apply. The second category of income includes other gross income derived from a trade or business. IRC § 1411(c)(1)(A)(ii). The third category of income includes net gain from the disposition of property held in a trade or business, as "trade or business" is defined for purposes of Section 1411 (discussed below). IRC § 1411(c)(1)(A)(iii); Treas. Reg. § 1.1411-4(a)(1)(iii). From the total of these three categories, deductions that are properly allocable are taken. IRC § 1411(c)(1)(B). Exhibit B sets forth a preliminary attempt to diagram the calculation of net investment income.

For estates and trusts, the first component of income taken into account is "undistributed" net investment income, a term that is unique to Section 1411. Although the statute does not define what is meant by "undistributed," the regulations apply rules similar to those in Sections 651 and 661 regarding the carry out of distributable net income ("DNI") to beneficiaries. Treas. Reg. § 1.1411-3(e).

Whereas for other income, DNI carries out to beneficiaries to the extent of a trust or estate's taxable income, for purposes of Section 1411, net investment income will carry out to beneficiaries (and the trust will receive a deduction) in an amount equal to the *lesser of* the trust's DNI or its net investment income. In other words, if a trust has both net investment income and other income, distributions will carry out each class of income pro rata to the beneficiaries. In turn, each beneficiary will pick up the respective classes of income for purposes of computing their income, including net investment income, and the trust will receive corresponding deductions. With the vast difference between the threshold for estates and trusts and individuals, the distribution of net investment income will frequently impact the overall amount of the tax paid.

As discussed above, the interrelation between taxable income, fiduciary accounting income, and DNI can be difficult to understand. When determining a trust's DNI, any amounts that the fiduciary allocates to principal or income for purposes of fiduciary accounting income are irrelevant. Rather, when determining a trust's DNI, the *taxable* income of the trust is what is important. DNI not only determines how much taxable income will be income taxed to a beneficiary, it also determines the amount that will be taxed to a trust or a beneficiary for purposes of Section 1411. Therefore, it is important that these concepts be understood.[20]

E. Trade or Business. The phrase "trade or business" is part of each of the categories of net investment income. Therefore, a fiduciary must evaluate this phrase to determine whether items of income or gain constitute net investment income. Although Treasury Regulation Section 1.1411-1(d)(12) clarifies that a trade or business is one that is defined in Section 162, the term is subject to further limitations of Section 1411. Section 1411(c)(2) limits the application of the tax to a trade or business that is (i) a passive activity

[20] The examples in Proposed Treasury Regulation Section 1.1411-3(f) proposed to illustrate the calculation of undistributed net investment income, but Examples 1 and 2 contained a fundamental mistake in excluding a distribution from an individual retirement account when calculating DNI. The calculations were corrected in the Final Regulations. *See* Treas. Reg. § 1.1411-3(e)(5), Exs. 1 and 2.

or (ii) a trade or business of trading in financial instruments or commodities. IRC § 1411(c)(2); Treas. Reg. § 1.1411-5. Note that trading in financial instruments or commodities is included regardless of whether or not it is a passive activity. Because income from passive activities comprise the largest portion of what constitutes net investment income, determining what activities are passive is key.

F. Trusts. Although the statute indicates that the tax applies to "trusts," it does not specify which trusts are included. Treasury Regulation Section 1.1411-3(a)(1)(i) specifies that the statute applies to trusts that are subject to part I of subchapter J of chapter 1 of subtitle A of the Code unless otherwise exempted – in other words, the statute applies to ordinary trusts as defined in Treasury Regulation Section 301.7701-4(a), but not to certain other trusts, including charitable trusts, grantor trusts, foreign trusts, and business trusts. *See* Treas. Reg. § 1.1411-3(b). Certain charitable estates and foreign estates were also included in the exceptions from the tax pursuant to the Final Regulations. Treas. Reg. §§ 1.1411-3((b)(i), (ix). In addition, because subtitle A does not include tax exempt trusts, the statute does not apply to these trusts. After receiving comments to the proposed regulations, the Final Regulations also provide that the tax does not apply to certain Alaska Native Settlement Trusts and Cemetery Perpetual Care Funds. Treas. Reg. §§ 1.1411-3((b)(vi), (vii).

G. Grantor Trusts. The grantor trust rules for income tax purposes are to be applied for purposes of Section 1411. Therefore, the 3.8% tax is not imposed on a grantor trust, but items of income or deductions that are attributable to the grantor (or to someone treated as the grantor) are to be treated as if the items had been paid or received by the grantor for calculating his or her own net investment income. Treas. Reg. § 1.1411-3(b)(1)(v).

H. Special Problem Areas. Although the statute uses terms such as "net investment income," "adjusted gross income," "ordinary course of a trade or business," "passive activity," and "disposition," the terms do not necessarily correspond to the same terms as used in other parts of the Code. Following is a discussion of some net investment income problem areas, but this is in no way meant to be an exhaustive list.

1. Capital Gains. A review of the statute and proposed regulations raises a concern for existing trusts and estates with regard to the treatment of capital gains. As mentioned above, trust and estate income is taxed to the trust or estate unless the income (or more specifically unless the trust's or estate's DNI) is carried out to the beneficiaries. As a general rule, capital gains are not treated as part of DNI. This general rule applies as long as those gains are allocated to corpus and are not "paid, credited, or required to be distributed to any beneficiary during the taxable year." IRC § 643(a)(3). However, pursuant to Section 643 and the related Treasury regulations, capital gains may be included in DNI under certain conditions and if done pursuant to local law, the trust agreement, or "a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)." Treas. Reg. § 1.643(a)-3(b).

Two of the three conditions which allow a fiduciary to allocate capital gains to DNI can invoke a consistency requirement by the fiduciary for all future years. *Id*. Most commentators and practitioners believe that in the first year that a trust or estate incurs capital gains, once a fiduciary decides to allocate the capital gains to DNI or not to do so, the fiduciary has in effect made an election that remains in place for all future years of the trust or estate. Unfortunately, there is no authority or guidance in this area to suggest otherwise. A trust or an estate may have the ability to allocate capital gains to corpus on a case-by-case basis under a narrow condition provided by Treasury Regulation Section 1.643(a)-3(b)(3), but there is no clear guidance for fiduciaries as to how to meet the condition under this so-called "deeming rule." Since many capital gains are included in net investment income under Section 1411, trusts and estates that do not include capital gains in DNI (which are most trusts and estates), or cannot "deem" capital gains to be part of DNI under the narrow condition provided in the regulations, will have this component of net investment income trapped as undistributed net investment income, taxable to the trust or estate. Section 1411 does not (and the related proposed Treasury regulations did not) address this issue for existing trusts or estates, although for other similar elections, an entity is given a fresh start to make a new election. The IRS and Treasury received comments requesting that existing trusts and estates that incur capital gains after December 31, 2012 be given the option to reconsider how capital gains are to be allocated. The Final Regulations, however, did not adopt the request, reasoning that a fiduciary's decision in this regard is similar to other elections "that only indirectly impact the computation of net investment income" and that potential changes in the capital gains rate is something foreseeable to a fiduciary when making the election. *See* Final Regulations, Summary of Comments and Explanation of Provisions, § 4.E.

2. Passive Activities, Passive Income, and the Passive Loss Rules. The statute does not define to what extent the passive loss rules for "ordinary" income taxes will apply. For purposes of Section 1411, however, passive activities are those that are included within the meaning of Section 469. IRC § 1411(c)(2)(A). To determine if an activity is a passive activity, a two-step determination is needed. First, the activity must be a trade or business within Section 162. Second, the activity must be passive within the meaning of Section 469, which means the taxpayer must not materially participate in the trade or business. Treas. Reg. §§ 1.1411-1(d)(12), 1.1411-5(b). Section 469 further provides that in order for a taxpayer to materially participate in an activity, the taxpayer must be involved in the operations of the activity on a *regular, continuous and substantial* basis. IRC § 469(h)(1). It appears that for the most part, the majority of passive income will be included in the calculation of the tax under Section 1411. However, there are certain exceptions where items that are generally thought of as passive are not included and vice versa, such as in the case of actively managed real estate investments. As a result, practitioners will need to not only have a good understanding of Section 469 and its related Treasury regulations to know what constitutes a passive activity but will also need to master the exceptions under Section 1411 when computing net investment income.

a. Material Participation. Because Section 1411 defers to Section 469 to define a passive activity, we must look to Section 469. For determining the disallowance of passive activity losses and credits, Section 469 applies to individuals, trusts[21], estates, closely held C corporations, and personal service corporations. IRC § 469(a). Although Section 469 applies to trusts and estates, what amounts to material participation by a trust or estate has not been defined beyond the requirement that the taxpayer's involvement in the operations of the business must be regular, continuous, and substantial. The temporary regulations outline seven separate tests that an individual may satisfy in order to meet the definition of material participation and avoid the passive loss disallowance rules. Since the statute was enacted in 1986, however, no such regulations have been issued for trusts and estates. Temp. Treas. Reg. § 1.469-5T(a), 1.469-5T(g), 1.469-8.

From Section 469 we can glean that the taxpayer's involvement in the operations is what is important. However, for trusts and estates, who the taxpayer is continues to be an issue. Until March of 2014, only one federal case had addressed this issue. In *Mattie K. Carter Trust v. United States,* 256 F. Supp. 2d 536 (N.D. Tex. 2003), a testamentary trust owned a cattle ranching operation as a proprietorship rather than through an LLC or other entity. In addition to work done by the trustee himself, the trust employed a ranch manager and other employees. The work done by the trustee, the ranch manager, and the other employees was performed on behalf of the trust. The IRS argued that the trustee is the taxpayer and only his activities should be considered to determine whether the trustee materially participated in the operations. The trust argued that the trust, as a legal entity, is the taxpayer and the activities of the fiduciaries, employees, and agents of the trust should be considered. The court looked to the plain language of Section 469 which states that a trust is the taxpayer, and in agreeing with the trust, held that the material participation of the trust should be determined by looking at the activities of all persons acting on behalf of the trust, not solely the trustee. The court noted that common sense says that in order to determine material participation by a trust, one must look to the activities of all of those who work on behalf of the trust.[22]

In the decade since the holding in the *Mattie K. Carter Trust* case, and with no regulations having being issued, the IRS has continued to maintain its position that only the activities of the trustee should be considered. *See* PLR 201029014; TAMs 201317010, 200733023. The only source that the IRS cites for its position is language in the legislative history of Section 469 that states that "an estate or trust is treated

[21] Like with Section 469, the trusts at issue are non grantor trusts because the passive activity loss rules do not apply to grantor trusts and instead are applied at the grantor level. Temp. Treas. Reg. § 1.469-1T(b)(2).

[22] In criticizing the IRS, the court went as far as to say that the IRS's position that only the activities of the trustee himself should be considered is "arbitrary, subverts common sense, and attempts to create an ambiguity where there is none." *Id*. Zowie!

as materially participating in an activity . . . if an executor or fiduciary, in his capacity as such, is so participating." S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986). It is important to note, however, that nothing in the legislative history indicates that looking to the actions of an executor or trustee is the exclusive way to determine material participation by a trust or an estate. In the most recent Technical Advice Memorandum, the IRS again found that the language in the legislative history is the standard to apply to trusts for determining material participation. In so finding, the IRS inexplicably comes to the conclusion that the *sole* means for making such determination is to find that in the operation of the activity, the activities of fiduciaries, in their capacities as fiduciaries, are conducted on a regular, continuous, and substantial basis. TAM 201317010.

In relying on limited language in legislative history for its reasoning in these decisions, the IRS appears to ignore the ability to consider activities of employees when determining material participation by other categories of taxpayers in Section 469. *See* Temp. Treas. Reg. § 1.469-1T(g) (allowing activities of employees of corporation to be taken into account by virtue of the rules of Section 465(c)(7)) and Temp. Treas. Reg. § 1.469-5T(k) (Examples 1 and 2 where activity as employee of owner of entity counts toward whether entity materially participates in a business). Although it may be understandable to disregard the activities of employees of the underlying operation who are not trustees, employees of the trust itself are not the same, and their activities should be taken into account. Unless and until the IRS reverses its narrow view of these rules, commentators suggest for trusts that own an interest in an entity such as a limited liability company, the entity might be structured to be member-managed so that the activities of the trustee (owner) count toward material participation. Of course, in this case, the trustee would owe fiduciary obligations to the company as well as to the trust beneficiaries and would need to explore how best to deal with any potential division of loyalties in exercising its fiduciary duties. For other thoughts and potential planning alternatives when a trust owns an interest in a business entity, *see* Gorin, *Structuring Ownership of Privately-Owned Business: Tax and Estate Planning Implications*.

The recent Tax Court decision in *Frank Aragona Trust v. Commissioner*, 142 TC 165 (2014), may give some comfort for individual trustees. Although the case is very fact-specific, it does give some guidance as to the attitude of the Tax Court. The case involved the issues of whether a trustee can qualify for a certain exception under Section 469 for real estate activities for real estate professionals and whether a trust can materially participate in a rental real estate business. The issues arose because the trust had claimed losses from rental activities as non-passive activity losses. Because the Section 469 exception involves a determination of material participation by a taxpayer, the court's ruling may have an impact on interpreting a trustee's material participation for other purposes of Section 469. In *Frank Aragona Trust*, five siblings served as co-trustees together with one independent trustee of a trust that was the sole owner of a limited liability company that was in the rental real estate business. Three of the siblings were also employed by the LLC. Disregarding the IRS's arguments that a trust can never satisfy the real estate professional exception and that activities of a trustee-employee should not be considered in determining material participation, the court held that (1) if a trustee is an individual and works in a trade or business as part of its trustee duties, the trustee's work may be considered personal services of an individual in order to determine if the real estate professional exception under Section 469(c)(7) is met, and (2) because of duties set out in applicable state law (which seem to be the duties arising under the common law of every state), the activities of a trustee, both in its capacity as a trustee and as an employee, are to be considered in determining whether the trust materially participates in the business.

Section 1411 and the Final Regulations require taxpayers to look to Section 469 for the passive activity loss rules. It seems evident that the IRS and Treasury Department did not want to add anything new to the passive activity loss rules through Section 1411. With no regulations being issued for Section 469 to deal with passive activities and material participation for trust and estates, as expected the Final Regulations declined to address the issue and practitioners continue to struggle in giving guidance to give their clients. Although recognizing that commentators to the proposed regulations raised valid concerns regarding this issue, the IRS and Treasury Department deferred to Section 469 and a separate study of the issue being conducted from which separate guidance may come. Comments were welcomed for consideration and several groups submitted comments, including the Real Property, Trust and Estate Law Section of the

American Bar Association, AICPA, and ACTEC. *See* Final Regulations, Summary of Comments and Explanation of Provisions, § 4.F.

3. Qualified Subchapter S Trusts ("QSSTs"). When shares of an S corporation pass to or are held by a trust (other than certain trusts such as grantor trusts), unless one of two elections is made, the corporation will lose its S corporation status. IRC § 1361(b)(1), (c)(2), (d), (e). The first of these elections is for the trust to be treated as a qualified Subchapter S corporation, or QSST. For a trust o be treated as a QSST, there are three basic requirements: (1) an election must be made, (2) the trust must have only one income beneficiary, and (3) all fiduciary accounting income of the trust must be distributed or be required to be distributed to the income beneficiary at least annually. IRC § 1361(d). The election is made by the current income beneficiary of the trust by filing IRS Form 2553, "Election by a Small Business Corporation", and providing the information outlined in Treasury Regulation Section 1.1361-1(j)(6). The election is to be made within two months and 15 days after the transfer of the stock to the trust, although late election relief is available. IRC § 1361(d)(2); *see also*, Rev. Proc. 2013-30, 2013-36 IRB 173.

In most cases, when a trust owns stock in an S corporation and the income beneficiary makes an election to have the trust treated as a QSST, because the beneficiary is treated as the owner of the stock for income tax purposes, all income from the S corporation which is attributable to the QSST will be taxed to the beneficiary.[23] Treas. Reg. § 1.1361-1(j)(7). An exception to this rule is when a disposition of the S stock occurs. In that case, the beneficiary is not treated as the owner and any resulting gain or loss that is recognized will be reported by the trust. Treas. Reg. § 1.1361-1(j)(8). For Section 1411 purposes, neither the statute nor the original proposed regulations provide any special rules that would change these results. Rather than issuing final regulations regarding QSSTs, the IRS and Treasury Department issued a new set of proposed regulations under Code Section 1411 at the same time as the Final Regulations. Under the new proposed regulations, these same rules will apply with regard to allocating income and gain for QSSTs. As a result, a QSST's share of an S corporation's net investment income will be taxed to the beneficiary, but net investment income arising from a sale of S corporation stock will be taxed to the trust. Prop. Treas. Reg. § 1.1411-7(a)(4)(iii)(C). Moreover, the passive nature of any gains or loss on the disposition will be determined at the trust level, and will not be based on the material participation of the beneficiary. *Id*. In determining the amount of net investment income that results from a sale of S corporation stock, the new proposed regulations set out complex rules for entities that have activities that are passive only in part as to the transferor. *See* Prop. Treas. Reg. §§ 1.1411-7(b)-(c).

As a reminder, income for trust and estate purposes is not always the same as income for income tax purposes. Section 643(b) provides that for trusts and estates, if the general term "income" is used, it means fiduciary accounting income as determined pursuant to the governing instrument and local law, and *not* taxable income. IRC § 643(b). Because a beneficiary will have to report taxable income as part of DNI but will receive only a distribution of fiduciary accounting income (if any), the distinction between fiduciary accounting income and taxable income is important when considering a QSST election. Accordingly, it raises the question as to whether a beneficiary should try to obtain some assurance or guarantee from the trustee regarding sufficient cash distributions, whether of income or principal, in order to pay any income tax liability that arises from the QSST election. For additional discussion regarding the income characterization issues, see Davis, *Funding Testamentary Trusts: Tax and Non-Tax Issues*, State Bar of Texas Adv. Est. Pl. Strat. Course (2013).

4. Electing Small Business Trusts ("ESBTs"). The second type of election that can be made in order for an S corporation to maintain its status when any shareholder is what would otherwise be a disqualifying trust, is for an election to be made for the trust to be treated as an electing small business trust, or ESBT. With an ESBT, there can be multiple beneficiaries of the trust, so the limit of one income beneficiary does not apply. A grantor trust may also make the election. The election for ESBT treatment is made by the trustee of the trust by submitting a letter to the IRS center where the corporation files its income tax return and providing the information outlined in Treasury Regulation Section 1.1361-1(m)(2). The election is to

[23] Remember that because a QSST is treated as a grantor trust that is deemed to be owned by the beneficiary, the character of income is determined and the test for material participation occurs at the deemed owner level instead of at the trust level.

be made within two months and 15 days after the transfer of the stock to the trust or the expiration of the 2-year allowed holding period for shares transferred as a result of death, although late election relief is available. IRC § 1361(c)(2); Treas. Reg. 1.1361-1(m)(2); *see also,* Rev. Proc. 2013-30, 2013-36 IRB 173.

For income tax purposes, in contrast to a QSST, when a trust that is not a grantor trust holds S corporation stock and the trustee makes an election to have the trust treated as an ESBT, all income from the S corporation is taxed to the trust at the highest income tax bracket, regardless of whether any income is distributed to a beneficiary and without regard to any threshold. IRC § 641(c). The portion of the trust that holds the S corporation stock is treated as if it were a separate trust. *Id*. If all or any portion of an ESBT is a grantor trust, the income attributable to such portion is taxable to the grantor. Treas. Reg. § 1.641(c)-1(c).

As with other S corporation shareholders, in making an ESBT election, a trustee would want some assurance from the S corporation that sufficient cash distributions will be made from the corporation to allow the trustee to pay any income tax liability. An ESBT will have to pay income tax on its share of S corporation income at the highest marginal rate. The trustee of an ESBT, therefore, must make careful consideration before making any distributions to beneficiaries, since the trust will need to retain sufficient funds to pay any income tax liability and will not have the advantage of reducing the trust's taxable income since it will not receive a distribution deduction for these distributions.

Also in contrast to QSSTs, Section 1411 provides special rules for ESBTs. In Treasury Regulation Section 1.1411-3(c), two separate computations are made to determine whether income of an ESBT is subject to the net investment income tax. In line with the stated attempt to preserve as much Chapter 1 treatment as possible, the first calculation requires that the amount of the undistributed net investment income be calculated for each of the separate S and non S portions of the trust. The separate treatment is disregarded, however, for the second calculation because the Final Regulations require the ESBT to then calculate its adjusted gross income by combining the adjusted gross income of the non S portion of the trust with the net income or net loss of the S portion of the trust. *Id*. In other words, the trust is treated as a single trust for determining whether the trust's adjusted gross income exceeds the Section 1411 threshold. The trust is then to pay tax on the lesser of the trust's total undistributed net investment income or the excess of the trust's adjusted gross income over the trust's threshold. Treas. Reg. § 1.1411-3(c)(2)(iii). Treasury Regulation Section 1.1411-3(c)(3) provides a detailed example of the calculation. Again, as discussed above, these calculations can be avoided if the trustee's involvement in the S corporation constitutes material participation which would prevent treatment as a passive activity and imposition of the net investment income tax.

5. Charitable Remainder Trusts. Although charitable remainder trusts are not themselves subject to Section 1411, distributions that are made to non-charitable beneficiaries may be. The first set of proposed regulations provided what was termed by the IRS and Treasury Department to be a simplified method of reporting for charitable remainder trusts. After receiving comments requesting that net investment income of a charitable remainder trust be treated as a subset of the income earned by the trust, the Final Regulations adopted this approach. Therefore, for a charitable remainder trust, net investment income is assigned to the related tier or class of income set forth in Code Section 664 and is distributed to a beneficiary as that class of income is distributed. Treas. Reg. § 1.1411-3(d). The Final Regulations require that the trustee keep track of accumulated net investment income (i.e., net investment income accrued but not distributed after December 31, 2012). Treas. Reg. § 1.1411-3(d)(1)(iii). Any non-accumulated net investment income is also to be tracked but will be treated as excluded income for purposes of Code Section 1411. Treas. Reg. § 1.1411-3(d)(2). In issuing the new set of proposed regulations, the IRS and Treasury Department requested comments as to whether the alternate simplified approach should be retained and a section of the Final Regulations was reserved for this purpose, just in case. Pursuant to the alternative method, the net investment income of a non-charitable beneficiary would include an amount equal to the lesser of the distributions made for the year or the trust's current and accumulated net investment income. Prop. Treas. Reg. § 1.1411-3(d)(2)(ii). In addition, certain character and ordering rules would be imposed in order to first distribute net investment income proportionately among the non-charitable beneficiaries before any amounts of non-net investment income. *Id*. For many non-charitable beneficiaries of charitable remainder trusts, the alternative method appears to be a WIFO ("worst in – first out") approach, thereby imposing

another layer of tax on these beneficiaries. However, for some charitable remainder trusts, such as those that never accumulate net investment income, the simplified approach may be preferred. Availability of the simplified approach will not be known until the IRS and Treasury Department review requested comments and determines whether to amend the Final Regulations.

6. Allowable Losses and Properly Allocable Deductions. The only deductions allowed in computing net investment income are those that are allowed by subtitle A of Chapter 1 of the Code and that are properly allocated to the gross income or net gain that is part of net investment income. IRC § 1411(c)(1)(B). The key is that the deductions must be allocable to the related gross income or net gain. In addition, in general, allowable losses may not exceed net gain such that net gain will be less than zero.[24] Treas. Reg. § 1.1411-4(d)(2). Treasury Regulation Section 1.1411-4 places further limitations on the amount and timing of deductions.

In the Notice, the IRS asked for comments regarding the treatment of certain deductions, such as suspended passive losses and net operating losses. Of particular note, the Final Regulations specify deductions that are considered property allocable. Some of these deductions are: a deduction for unrecovered basis in an annuity in a decedent's final year; a deduction to beneficiaries of a trust or estate for any net operating losses, capital loss carryovers, and other excess deductions passing to them in the final year of the trust or estate as provided in Code Section 642(h); deductions in respect of a decedent as provided in Code Section 691(b); a deduction for estate taxes paid on IRD items as provided in Code Section 691(c); and a deduction for ordinary and necessary expenses related to the determination, refund, or collection of tax, to be allocated to net investment income using any reasonable method. Treas. Reg. §§ 1.1411-4(f)(3)(iv), (f)(3) (v), (f)(3) (vi), (g)(3), (g)(4). If an IRD item is an ordinary income item, the deduction for the related estate tax pursuant to Code Section 691(c) is treated as an itemized deduction not subject to the 2% floor, whereas if the IRD item is a capital gain, the deduction is used in calculating net gain. Treas. Reg. §§ 1.1411-4(f)(3)(v), (7). Because the IRD deduction is not treated as a miscellaneous itemized deduction, TCJA 2017's suspension of those deductions between 2018 and 2025 does not apply to the IRD deduction under Section 691(c).

I. Special Notes. A few additional items of note:

1. Tax Does Not Apply to Distributions from Qualified Plans. You will recall that there are two components of income used to measure whether the tax will apply. One type of income is net investment income and the other is adjusted gross income (modified adjusted gross income for individuals and adjusted gross income as defined in Code Section 67(e) for trusts and estates). Section 1411(c)(5) provides that net investment income does not include distributions from qualified plans. However, there is no exception for distributions from qualified plans for purposes of computing adjusted gross income. As a result, distributions from qualified plans may push the trust or estate into the top income tax bracket, exposing its net investment income to the 3.8% tax.

2. Nonresident Aliens. The tax does not apply to nonresident aliens. IRC § 1411(e)(1).

J. Planning for the Tax. The additional 3.8% income tax on trusts and estates can be considered an additional cost of forming a trust or administering an estate. Items to consider include:

- Planners need to advise clients that certain investments may subject estates and trusts to additional income tax. For example, when funding testamentary trusts, it may be more desirable to transfer the homestead to the surviving spouse and make a non pro rata distribution of other assets to fund the trust so that if the homestead is later sold, any appreciation will not be subject to the tax imposed under Section 1411.

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[24] An exception to this general rule is found in Treasury Regulation Section 1.1411-4(f)(4). If a loss is described in Code Section 165, any excess loss may be deducted against unrelated net investment income if it is not used in computing net gain under Section 1.1411-4(d). In other words, a loss will first offset a related net gain down to zero, and if any excess loss remains, the loss can offset any unrelated net investment income.

- There may be even more reason for clients to take a team approach with the attorney, accountant and financial planner to adequately plan to minimize the additional tax burden.
- Fiduciaries have a greater burden to track assets that may be subject to the 3.8% tax, and most likely will need even more assistance than before from accountants.
- When evaluating whether to make a distribution, fiduciaries may desire additional cooperation between themselves and beneficiaries in order to better evaluate the tax brackets of each as they relate not only to income taxes, but also the tax on net investment income.
- There may be more incentive to speed up the administration of estates to minimize the potential of the additional tax that may not apply once the assets which produce net investment income are transferred to beneficiaries.
- Fiduciaries need to weigh whether it is better to invest more in assets that are not subject to the tax, such as those that produce tax-exempt income vs. those assets that may produce a higher after-tax return regardless of this additional tax.
- There may be more incentive to take a buy-and-hold approach to investing in order to put off the additional tax burden that may arise from recognizing capital gains.

X. CONCLUSION

Estate planners need to have a working knowledge of income taxes and how they affect their clients, whether individuals or fiduciaries. Armed with this information, professionals can better advise their individual clients how income taxes fit into the plan and can better advise trustees and executors how income taxes impact the administration of a trust or a decedent's estate. With proper attention and planning, clients can be better prepared and can often recognize significant tax savings, or at least properly plan for any potential income tax consequences.

EXHIBIT A

Basis Rules for Persons Dying in 2010

I. Persons Dying in 2010. For estates of decedents dying in 2010 whose executors elected not to have the federal estate tax apply, property acquired from these decedents was treated as transferred by gift. As a result, the basis of that property was the lesser of (i) the adjusted basis of the decedent; or (ii) the fair market value of the property as of the date of the decedent's death. Former IRC § 1022(a). There were two important adjustments to this basis.

A. The $1.3 Million Adjustment. First, a general basis adjustment equal to $1.3 million was available for property that was "owned by the decedent" and "acquired from a decedent." Former IRC § 1022(b). The $1.3 million amount was increased by the sum of (i) any capital loss carryover determined under Section 1212(b); and (ii) the amount of any net operating loss carryover determined under Section 172, which would (but for the decedent's death) be carried from the decedent's last taxable year to a later taxable year of the decedent. Former IRC § 1022(b)(2)(C). The $1.3 million amount was further increased by the sum of the amount of any losses that would have been allowable under Code Section 165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death. *Id*. In the case of a decedent nonresident not a citizen of the United States, the general basis increase was limited to $60,000. Former IRC § 1022(b)(3).

B. The $3 Million Adjustment for Qualified Spousal Property. Second, there was a spousal basis adjustment equal to $3 million for "qualified spousal property." Former IRC § 1022(c). Qualified spousal property means either: (i) property that would not be treated as nonqualified terminable interest property under the federal estate tax marital deductions rules ("Outright transfer property"); or (ii) property that would be treated as qualified terminable interest property (QTIP) under those rules ("Qualified terminable interest property"). *Id*.

C. The "Owned-by-the-Decedent" Requirement. Basis increases were available only for property that was "owned" by the decedent at the time of death. Former IRC § 1022(d)(1). For purposes of this rule, property that was owned with the surviving spouse either jointly with right of survivorship or as tenants by the entirety, was treated as being owned 50% by the decedent. Former IRC § 1022(d)(1)(B(i). Other survivorship property was treated as being owned in the proportion that the decedent furnished consideration, unless acquired by gift, bequest, or inheritance, in which case the decedent was treated as owning a fractional part of the property determined by dividing the value of the property by the number of joint tenants with rights of survivorship. *Id.* In addition, the decedent was treated as owning property in a revocable trust for which the election under Section 645(b)(1) was available to treat the trust as part of the decedent's estate (essentially, a trust that was revocable by the decedent immediately before death). Former IRC § 1022(d)(1)(B)(ii). Finally, a surviving spouse's interest in community property was treated as owned by, and acquired from, the decedent if at least one-half of the whole of the community interest in that property was treated as owned by, and acquired from, the decedent. Former IRC § 1022(d)(1)(B(iv). A decedent was not treated as owning any property by reason of having a limited or general power of appointment with respect to such property. Former IRC § 1022(d)(1)(B)(iii). In addition, property acquired by the decedent from anyone except the surviving spouse during the three-year period ending on the decedent's death for less than adequate and full consideration in money or money's worth was not treated as owned by the decedent. Former IRC § 1022(d)(1)(C). Property acquired from the surviving spouse during such period was, however, treated as owned by the decedent unless the spouse acquired the property by gift or inter vivos transfer for less than adequate and full consideration in money or money's worth. *Id*.

D. "Property Acquired from the Decedent". For purposes of the modified carryover basis rules, property acquired from the decedent included: (i) property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent; (ii) property transferred by the decedent during his lifetime to a qualified revocable trust as defined in Code Section 645; (iii) property transferred by the decedent to any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust; and (iv) any other property passing from the decedent by reason of death to the extent that such property passed without consideration. Former IRC § 1022(e).

E. Ineligible Property. Certain property was not eligible for any basis adjustment. The carryover basis rules did not apply to items of income in respect of a decedent. Former IRC § 1022(f). In addition, no basis adjustment was permitted for stock or securities in a foreign personal holding company; a DISC (domestic international sales company); a foreign investment company; and a passive foreign investment company (unless it is a qualified electing fund as described in Section 1295 with respect to the decedent). Former IRC § 1022(d)(1)(D).

F. Limited to Fair Market Value. The basis adjustments did not increase the basis of any asset above its fair market value as of the date of the decedent's death. Former IRC § 1022(d)(2). The executor must have made the allocation of the basis adjustments on the return required by Section 6018 (IRS Form 8939, due January 17, 2012). Once basis was allocated, changes in the allocation could be made only as provided by the Secretary of Treasury. Former IRC § 1022(d)(3); Notice 2011-66, 2011-35 IRB 179 § I.D.2; Notice 2011-76, 2011-40 IRB 479.

G. Certain Liabilities in Excess of Basis. In determining whether gain was recognized on the acquisition of property (i) from a decedent by a decedent's estate or any beneficiary other than a tax exempt organization; and (ii) from the decedent's estate by any beneficiary other than a tax exempt organization, and in determining the basis of such property, liabilities in excess of basis were disregarded. Former IRC § 1022(g).

H. Holding Period. The automatic one-year holding period of Section 1223(9) did not apply to estates of persons dying in 2010 whose executors opted out of the federal estate tax and into the modified carryover basis rules. Instead, the holding period of inherited property was likely determined under Section 1223(2), which is the rule generally applicable to property acquired by gift. The IRS has ruled that to the extent the recipient's basis in property acquired from the decedent is determined under Former Section 1022, the recipient's holding period of that property will include the period during which the decedent held the property, whether or not the executor allocates any Basis Increase to that property. Rev. Proc. 2011-41, 2011-35 IRB 188, § 4.06(1).

EXHIBIT B

IRC 1411 Net Investment Income (Preliminary)