PLANNING AND ADMINISTERING ESTATES AND TRUSTS: THE INCOME TAX CONSEQUENCES YOU NEED TO CONSIDER

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ACTEC-ALI CLE PHONE SEMINAR

MAY 9, 2013

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PLANNING AND ADMINISTERING ESTATES AND TRUSTS: THE INCOME TAX CONSEQUENCES YOU NEED TO CONSIDER

I. INTRODUCTION

It is essential for estate planners to have a fundamental understanding of the income taxation of trusts and estates, and of the income tax issues that arise in relation to related-party transactions. 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. The goal of this outline is to focus essential income tax planning issues that arise (i) as a result of intra-family transactions; (ii) immediately before death; and (iii) when administering the estate of a decedent. The outline addresses critical income tax reporting issues that arise for estates and trusts. An exhaustive examination of the issues would result in a book-length outline (or a semester-long course in law school). This outline is intended to hit some of the highlights in the area of income tax planning and reporting for family members, trusts and estates.

II. INCOME TAX CONSEQUENCES OF NON-CHARITABLE GIFTS AND LOANS

A. Income Shifting.

1. Benefits are Limited. Income shifting will save only small amounts of income taxes today, which is a huge change from the estate planning practice in the 1970's and '80's, due to rate reduction, bracket compression, expanded kiddie tax rules, prohibitions against multiple trusts, and the elimination of many income shifting devices (*Clifford* trusts, *Rushing* trusts, spousal remainder trusts, etc.).

2. Relevant Factors. Many factors besides bracket differential may impact the amount of tax savings achieved through income shifting, including the kiddie tax rules, the percentage limitations on various deductions (medical expenses, charitable deductions, casualty losses, miscellaneous itemized deductions, etc.), the partial disallowance of itemized deductions impacting high income taxpayers, capital and net operating loss carry-forwards, phase out of the $25,000 real estate exception to the passive activity loss rules, alternative minimum tax consequences, etc.

3. Shifting Income to Trust. Income taxed to a trust in excess of $11,950 for tax years beginning after December 31, 2012 will be taxed at the highest marginal income tax bracket (i.e., 39.6%), and trusts get only a $100 or $300 allowance in lieu of personal exemption, so little federal income tax savings will result from shifting taxable income from even a highest bracket individual taxpayer to a trust with no other income.

4. Kiddie Tax Rules. The kiddie tax rules have been expanded and now apply to children who are under 19 and dependent full-time students who are under age 24. For 2013, a child having only investment income will not pay income tax on the first $1,000 of such income and will pay income tax at the child's rate on the next $1,000 of investment income, with any excess taxes at the parents' rate. IRC § 1(g).

5. Section 529 Plans. Income earned in a Section 529 Plan that is subsequently spent on qualifying educational expenses will never be taxed to anyone. IRC § 529.

B. Income Tax Consequences of Gifts To The Donor.

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) 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).

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.

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).

Example: Assume that a donor has no remaining exclusions or unified credit, 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 was 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 Assumption of Non-Recourse Debt. Where a gift is made of property subject to non-recourse indebtedness, the donor will realize gain to the extent that 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).

6. Gift of Installment Obligation. The transfer of an installment obligation by lifetime gift 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 suspended passive activity losses. IRC § 469(j)(6).

C. 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 Internal Revenue 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 U.S. 322 (1943).

D. Adjusted Basis Of Gifted Property.

1. Carry-Over Basis. The donee of property which is received in a lifetime gift transaction where no gain is recognized receives such property with a carryover of the donor's cost basis and acquisition date. IRC §1015.

2. Basis for Gift Tax Paid. The basis of gifted property is increased for pre-1977 gifts by the gift tax paid. For gifts made after 1976, the basis of gifted property is increased by that portion of the gift tax paid attributable to the donor's net appreciation in the gifted assets. IRC § 1015.

Example: Assume that the donor gives stock having a basis of $200 and a fair market value of $1,000 to child, and pays $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.

3. Basis for GST Tax Paid. The basis of gifted property is increased (but not to above fair market value) by generation-skipping taxes paid. IRC § 2654. This basis adjustment for GST taxes paid is applied after the basis adjustment for gift taxes paid pursuant to Code Section 1015.

4. 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: 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, the donee will have a $100 basis for loss purposes and a $110 basis for gain purposes.

5. Limitation on Basis for Loss Purposes. For purposes of determining loss in a subsequent sale of a gifted asset by the donee, the donee's basis cannot exceed the fair market value of the gifted property at the time of its receipt by the donee. IRC § 1015. This can result in the gifted asset having one basis for gain purposes and a different basis for loss purposes (i.e., dual basis).

Example: Assume that a donor has an asset with a fair market value of $100 and an adjusted cost basis of $150. If such asset is gifted during life, and if no gift tax is due on such gift, then the donee will have a $100 basis for loss purposes and a $150 basis for gain purposes. No gain or loss would be recognized by the donee if the property is subsequently sold for more than $100 and less than $150.

E. 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 Section 7872 of the Code.

2. Loans Under $10,000. No interest is imputed if the loan is $10,000 or less, and the loan proceeds are not used by the borrower for income producing investments.

3. Loans Under $100,000. No interest is imputed if the loan is $100,000 or less, provided that the borrower has no more than $1,000 of total net investment income.

4. Investment Income Limitation. If the loan is $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.

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 (3-9 years) and long-term (9+ years) loans.

III. INCOME TAX CONSEQUENCES OF RELATED PARTY TRANSACTIONS

A. Who is a Related Party? Although the Internal Revenue Code has many different provisions dealing with related parties, Section 267 is the key section defining related parties which 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. 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. Code Section 1239, which applies to the sale of depreciable property between related parties, does not appear to apply to depletable property. PLR 8139052 (June 30, 1981).

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 inheritance within a year. IRC § 1014(e).

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 if the funding 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 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 a business bad debt or nonbusiness bad debt because Treasury Regulation Section 1.166-9(e) allows bad debt deductions only where 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), then any proceeds realized in excess of basis will be income to the recipient. IRC § 101(a)(2).

IV. 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 then 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. 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 beginning at page 21, assets the basis of which exceed their fair market value receive a reduced basis at death, 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 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 C.B. 52.

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 exemption. 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, receiving it back with a new basis upon that person's death. As a result, the Internal Revenue 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.[1]

2. Granting a General Power. 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 Section 2041(a)(2) of the Code. In that event, the property should receive a new cost basis upon W's death. IRC § 1014(b)(9). The IRS takes the position that the principles of

[1] 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 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. 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. IRC § 1022(d)(1)(C)(ii).

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.[2]

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. 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 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 Section 1014(e) of the Code 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 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 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).[3] 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, the couple 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).[4]

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

[2] 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 Section 1022 of the Code. As a result, no part of the decedent's basis allocation could be used to increase the basis of these assets. IRC § 1022(d)(1)(B)(iii).

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

[4] 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 Section 1022(d)(1)(B)(iv) of the Code, and as a result, was eligible for the $3 million spousal property basis increase. IRC § 1022(c); Rev. Proc. 2011-41. 2011-35 IRB 188, § 4.01.

the activity after the client's death. See the discussion of this issue at page 13 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 the donee, although 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. 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. <u>Pay Medical Expenses</u>. It is not unusual for persons with a terminal condition to incur substantial medical expenses in the year of their demise. These medical expenses may be deductible for federal income tax purposes if they exceed 7.5% of the taxpayer's adjusted gross income. IRC § 213(a). This 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 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. <u>Accelerate Death Benefits</u>. If a taxpayer is covered by a policy of life insurance, 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. <u>Payments to Terminally Ill Taxpayers</u>. If the insured is terminally ill, payments are tax-free. This exclusion from income 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. <u>Payments to Chronically Ill Taxpayers</u>. If the insured is chronically ill, payments 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. See IRC §§ 101(g)(4)(B); 7702(c)(2)(A). The exclusion for chronically ill taxpayers is subject to a per-diem cap ($300 per day, or $109,500 per year for 2011). IRC §§ 101(g)(3)(D); 7702B(d); Rev. Proc. 2010-40, 2010-46 IRB 663 § 3.29.

V. INCOME TAXATION OF DECEDENTS AND ESTATES

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 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 whicht tax returns have been filed by the decedent. The executor should make a written request for a "Record of Account" from the appropriate region. 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 be supplied free of charge. Call 1-800-829-1040 for details.

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 in writing "All Information Returns" (you should be as specific as possible) in writing from the appropriate region. Information is available after August 1st relating to the prior year, and six years' worth of information is kept in the IRS computers. Again, 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 be supplied free of charge. The executor can call 1-800-829-1040 for details.

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. Consider requesting at the same time copies of gift tax returns filed by the decedent. Be sure to make your request to the proper region or district, based upon 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 ($57 per return the last time the authors checked).

4. Contact Area Disclosure Officer. 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 Officer. 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. Treas. Reg. § 1.6012(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. 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); IRC § 6012(b)(1).

2. "Fiduciary Liability". Pursuant to the concept of "fiduciary liability," the executor is personally liable for the income and gift tax liability of the decedent, at least to the extent that assets of the decedent come within the reach of such executor. 31 U.S.C. § 3713(b). Fiduciary liability may be personally imposed on every executor, administrator, assignee or "other person" who distributes the living or deceased debtor's property to other creditors before he satisfies a debt due to the United States.

a. 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.

b. 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.

c. Knowledge Required. The fiduciary must know or have reason to know of the government's tax claim.

d. Deferring Distributions. Fiduciaries will frequently delay making distributions until 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 require that the beneficiary still have the funds to refund to the estate.

3. 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. Transferee Liability at Law. Transferee liability at law exists under Section 6901 of the Code if the government can prove: (1) the taxpayer transferred property to another person; (2) at the time of the transfer and at the time transferee liability is asserted, the taxpayer was liable for a tax; (3) there is a valid contract between the taxpayer who is the transferor and the transferee; and (4) under the terms of that contract, the transferee assumed the liabilities of the taxpayer, including the obligation to pay the tax or specifically the obligation to pay the taxes of the transferor.

b. Transferee Liability in Equity. Transferee liability at equity exists under Code Section 6901 if the government can prove: (1) the taxpayer transferred property to another person; (2) at the time of the transfer and at the time transferee liability is asserted, the taxpayer was liable for the tax; (3) the transfer was made after liability for the tax accrued, whether or not the tax was actually assessed at the time of the transfer; (4) the transfer was made for less than full or adequate consideration; (5) the transferor was insolvent at the time of the transfer or the transfer left the transferor insolvent; and (6) the government has exhausted all reasonable efforts to collect the tax from the taxpayer transferor before proceeding against the transferee.

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). 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) of the Revised Statutes for the payment of administration expenses, the IRS nevertheless appears to recognize exceptions for administration expenses, funeral expenses, and widow's allowance. GCM 22499, 1941-1 CB-272; Rev. Rul. 80-112. 1980-1 CB 306.

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 and in other 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. The final Form 1040 should normally be filed in the Internal Revenue District 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 at the service center serving such internal revenue district. IRC § 6091(b)(1)(A); Treas. Reg. § 1.6091-1(a). If the person filing the return has no legal residence or principal place of business in any Internal Revenue District, the return should be filed with the District Director, Internal Revenue Service, Baltimore, Maryland, 21202, except as provided in the case of returns of taxpayers outside the United States. Treas. Reg. § 1.6091-2(a). The return made by a person outside the United States having no legal residence or principal place of business in any Internal Revenue District should be filed with the Director of International Operations, Internal Revenue Service, Washington, D.C. 20225, unless the legal residence or principal place of business of that person, or the principal place of business or principal office or agency of such corporation, is located in the Virgin Islands or Puerto Rico, in which case the return shall be filed with the Director of International Operations, U.S. Internal Revenue Service, Hato Rey, Puerto Rico 00917. Treas. Reg. § 31.6091-1(c).

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 tax (but not estate tax) statute of limitations prior to the expiration of the statute. IRC § 6501(c)(4).

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 Form 4810. Treas. Reg. § 301.6501(d)-1(b). 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 collect such taxes from the executor) by making a request for such a discharge (Form 5495) pursuant to Code Sections 2204 (as to estate tax), or 6905 (as to income and gift tax). This request does 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 this increases the audit exposure on such returns.

8. Filing Joint Returns. 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's estate 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. 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 the year of the decedent's death and the succeeding two tax years, a "surviving spouse," as defined in Section 2(a) of the Code, is entitled to an AMT exemption of $78,750, reduced by 25% of any excess of AM1 over $150,000 (rather than the normal AMT exemption applicable to single persons of $50,600, reduced by 25% of any excess AM1 over $112,500). IRC §§ 55(d); 55(d)(3).

9. Planning Opportunities on the Final Return. Prior to the end of the tax year of the surviving spouse, several planning opportunities are presented.

a. Using Expiring Losses. The decedent's portion of net operating losses and capital losses can offset income and capital gains of the surviving spouse arising after death. The surviving spouse should be advised to examine opportunities to accelerate recognition of income sheltered by these losses. If not used prior to the end of the year in which the decedent dies, the net operating losses and capital losses are lost. If an NOL arises from a net business loss appearing on the decedent's final return, the NOL may be carried back to previous years. IRC § 172(b)(1)(A)(i). Since the estate is a separate taxpayer, however, the decedent's estate cannot carry over the decedent's net operating losses and capital losses. Rev. Rul. 74-175, 1974-1 C.B. 52.

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. 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 C.B. 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 C.B. 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 C.B. 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. Ltr. Rul. 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 partnership or 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 partnership 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 partnership or 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. The allocation of partnership income for a short year is made by an interim closing of the partnership's books unless the partners agree to allocate income on per diem or other reasonable basis. *See* Treas. Reg. § 1.706-1(c)(2)(ii). 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 the shareholders agree, the allocation for the short year is made by an interim closing of the books. IRC § 1377(a)(2). For a more complete discussion of issues that arise when estates hold interests in flow-through entities, see the material beginning at page 42 below.

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 the step-up in basis allocated to 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.[5]

C. The Estate's Income Tax Return.

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

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 a Notice Concerning Fiduciary Relationship (Form 56). This form puts the IRS on notice that the executor has been appointed to handle the decedent's affairs, and apprizes the IRS of the proper address to which correspondence regarding the decedent's tax matters may be directed. IRC § 6903; Treas. Reg. §§ 601.503; 301.6903.

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

[5] 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 Section 1022.

address of any substitute fiduciary and be accompanied by satisfactory evidence of termination of fiduciary relationship. *Id*.

3. Electing a Fiscal Year End. Unlike an individual or a trust, an estate may elect to adopt a year end other than December 31. The only requirements 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).

a. Available to Estates and Electing Trusts. Although the option to elect a fiscal year end does not generally apply to trusts, a revocable trust may elect to be treated as part of the estate and not as a separate trust. If the election is duly made, it applies for all taxable years of the estate beginning the day after the date of decedent's death and ending (1) two years after the date of death if no estate tax return is required, or (2) six months after the date of final determination of estate tax liability if an estate tax return is required. IRC § 645.

b. Method of Election. The election is made on the first income tax return filed by the estate Although IRS Form SS-4 asks for the taxpayer's fiscal year end, as does an Application for Extension of Time to File, the filing of those forms does not establish the fiscal year end for the entity. The election must be made by the due date of the return. 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-(c)(1).

c. Reasons for Adopting Fiscal Year Ends. By adopting a non-calendar year end, an estate (or electing trust) can accomplish a number of objectives.

(1) Deferral, Income Splitting and Expense Matching. For example, adoption of a fiscal year end for the estate of a decedent who dies in November 2012 would permit deferral of any income tax due from April 15, 2013 until February 15, 2014 (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. As discussed in the next section, when an estate makes a distribution, that distribution will generally carry out the estate's distributable net income to the distributee, causing the estate beneficiary to pay tax on any taxable income earned by the estate, to the extent of the distribution. If the tax year of the 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's tax year. IRC § 662(c). Therefore, if an estate selects 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 2013 through January 31, 2014 will be treated as being received by the beneficiary on January 31, 2014. Thus, a beneficiary who actually receives a distribution in February 2013 could defer paying the tax thereon until April 15, 2015 (the due date of the beneficiary's 2014 tax return), more than two years after receipt. Deferral in the first year 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, 2014, the beneficiary would include 23 months worth of estate income (February 2013 through December 2014) on the beneficiary's tax return for 2014. 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 Section 642(h)(2) of the Code.

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 IRS 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. U.S.*, 91 AFTR 2d 2003-1946 (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).

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. 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. 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, allocated 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 Goren 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 this 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. 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.

D. Ten Things Estate Planners Need to Know About Subchapter J. With apologies to David Letterman, here is our own personal list of the top ten income tax issues that every estate planner should know. We don't pretend to present them in order of importance (or, for that matter, in any particular order). There are certainly other income tax issues that merit consideration. Mastery of these ten, however, should give an estate planner a good background in fundamental income tax issues that arise in the estate planning and administration context. Most estate planners think of an inheritance as being free from income tax. IRC § 102(a). Nevertheless, We start our "top ten list" with four important income tax issues that arise when estate assets are distributed. These areas are the carry-out of estate income; the recognition of gain by the estate at the time of funding certain gifts; the impact upon beneficiaries of making unauthorized non-pro rata distributions of assets in kind; and the impact of distributing IRD assets. The income tax effect of estate distributions is an important area both in terms of language included in the governing instrument and the steps taken and elections made by the executor in the administration of the estate.

1. Estate Distributions Carry Out Distributable Net Income. The general rule is that any distribution from an estate will carry with it a portion of the estate's distributable net income ("DNI"). Estate distributions are generally treated as coming first from the estate's current income, with tax free distributions of "corpus" arising only if distributions exceed DNI. If distributions are made to multiple beneficiaries, DNI is generally allocated to them pro rata.

> **Example 1:** Assume that A and B are beneficiaries of an estate worth $1,000,000. During the year, the executor distributes $200,000 to A and $50,000 to B. During the same year, the estate earns income of $100,000. Unless the separate share rule discussed at page 16 below applies, the distributions are treated as coming first from estate income, and are treated as passing to the beneficiaries pro rata. Therefore, A will report income of $80,000 ($100,000 x ($200,000/$250,000)); B will report income of $20,000 ($100,000 x ($50,000/$250,000)). The estate will be entitled to a distribution deduction of $100,000. If the estate had instead distributed only $50,000 to A and $25,000 to B, each would have included the full amount received in income, the estate would have received a $75,000 distribution deduction, and would have reported the remaining $25,000 as income on the estate's income tax return.

If the tax year of the 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's tax year. IRC § 662(c). Section 663(b) of the Code permits complex trusts to treat distributions made during the first 65 days of the trust's tax year as though they were made on the last day of the preceding tax year. This election enables trustees to take a second look at DNI after the trust's books have been closed for the year, to shift income out to beneficiaries. The Taxpayer Relief Act of 1997 extended the application of the 65 day rule to estates for tax years beginning after August 5, 1997. As a result, for example, the executor of an estate can make distributions during the first 65 days of Year 2, and elect to treat them as though they were made on the last day of the estate’s fiscal Year 1. If the executor makes this election, the distributions carry out the estate's Year 1 DNI, and the beneficiaries include the distributions in income as though they were received on the last day of the estate's Year 1 fiscal year.

The general rule regarding DNI carry-out is subject to some important exceptions.

a. Specific Sums of Money and Specific Property. Section 663(a)(1) of the Code contains a special provision relating to gifts or bequests of "a specific sum of money" or "specific property." If the executor pays these gifts or bequests all at once, or in not more than three installments, the distributions will effectively be treated as coming from the "corpus" of the estate. As a result, the estate will not receive a distribution deduction for these distributions. By the same token, the estate's beneficiaries will not be taxed on the estate's DNI as a result of the distribution.

(1) Requirement of Ascertainability. In order to qualify as a gift or bequest of "a specific sum of money" under the Treasury Regulations, the amount of the bequest of money or the identity of the specific property must be ascertainable under the terms of the governing instrument as of the date of the

decedent's death. In the case of the decedent's estate, the governing instrument is typically the decedent's Will or revocable trust agreement.

(2) Formula Bequests. Under the Treasury Regulations, a marital deduction or credit shelter formula bequest *does not* usually qualify as a gift of "a specific sum of money." The identity of the property and the exact sum of money specified are both dependent upon the exercise of the executor's discretion. For example, if the executor elects to deduct administration expenses on the estate's income tax return, the amount of the formula marital gift will be higher than if those expenses are deducted on the estate tax return. Since the issues relating to the final computation of the marital deduction or credit shelter bequest cannot be resolved on the date of the decedent's death, the IRS takes the position that these types of bequests will not be considered "a specific sum of money." Treas. Reg. § 1.663(a)-1(b)(1); Rev. Rul. 60-87, 1960-1 C.B. 286. Thus, funding of formula bequests whose amounts cannot be ascertained at the date of death *does* carry out distributable net income from the estate.

(3) Payments from Current Income. In addition, amounts that an executor can pay, under the express terms of the Will, only from current or accumulated income of the estate will carry out the estate's distributable net income. Treas. Reg. § 1.663(a)-1(b)(2)(i).

(4) Distributions of Real Estate Where Title has Vested. The transfer of real estate does not carry out DNI when conveyed to the devisee thereof if, under local law, title vests immediately in the distributee, even if subject to administration. Treas. Reg. § 1.661(a)-2(e); Rev. Rul. 68-49, 1968-1 C.B. 304. State law may provide for immediate vesting either by statute or by common law. *See, e.g,* Tex. Prob. Code Ann. § 27; *Welder v. Hitchcock*, 617 S.W.2d 294, 297 (Tex. Civ. App.– Corpus Christi 1981, writ ref'd n.r.e.). Therefore, a transfer by an executor of real property to the person or entity entitled thereto should not carry with it any of the estate's distributable net income. Presumably, this rule applies both to specific devisees of real estate and to devisees of the residue of the estate. Otherwise, the no-carry-out rule would be subsumed within the more general rule that specific bequests do not carry out DNI. Rev. Rul. 68-49, 1968-1 C.B. 304. Note, however, that the IRS Office of the Chief Counsel has released an IRS Service Center Advice Memorandum (SCA 1998-012) which purports to limit this rule to specifically devised real estate (not real estate passing as part of the residuary estate) if the executor has substantial power and control over the real property (including a power of sale).

b. The Separate Share Rule. Generally, in the context of estate distributions made to multiple beneficiaries, DNI is carried out pro rata among the distributees of the estate. For example, in a year in which the estate has $10,000 of DNI, if the executor distributes $15,000 to A and $5,000 to B, A will include $7,500 of DNI in his income, and B will include $2,500 in his income, since the distributions were made 75% to A and 25% to B. The Taxpayer Relief Act of 1997 has made a substantial modification to the pro rata rule by applying the "separate share rule" to estates. Under this rule, DNI is allocated among estate beneficiaries based upon distributions of their respective "share" of the estate's DNI. IRC § 663(c). The Committee Report describing this change provides that there are separate shares of an estate "when the governing instrument of the estate (e.g., the will and applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specific items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries." The IRS has issued final regulations applying the separate share rules to estates. See T.D. 8849, 2000-2 IRB 245; Treas. Reg. § 1.663(c)-4. As a result of this change, the executor will have to determine whether the Will, revocable trust, or the intestate succession law creates separate economic interests in one beneficiary or class of beneficiaries.

> **Example 2:** A Will bequeaths all of the decedent's IBM stock to X and the balance of the estate to Y. During the year, the IBM stock pays $20,000 of post-death dividends to which X is entitled under local law. No other income is earned. The executor distributes $20,000 to X and $20,000 to Y. Prior to the adoption of the separate share rule, the total distributions to X and Y would have simply been aggregated and the total DNI of the estate in the year of distribution would have been carried out pro rata (i.e., $10,000 to X

> and $10,000 to Y). But X has an economic interest in all of the dividends; the distribution to Y must be from corpus. Under the separate share rules, the distribution of $20,000 to X carries out all of the DNI to X. No DNI is carried out to Y. Thus, application of the separate share rule more accurately reflects the economic interests of the beneficiaries resulting from estate distributions.

Distributions to beneficiaries who don't have "separate shares" continue to be subject to the former pro-rata rules. Application of the separate share rule is mandatory. The executor doesn't elect separate share treatment, nor may it be elected out of. Application of the separate share rules to estates was one of a host of small statutory changes enacted in 1997 that sought to bring the taxation rules for trusts and estates in line with one another. In practice, application of the separate share rules to estates is often quite complex. Unlike separate share trusts, which are typically divided on simple fractional lines (e.g., "one-third for each of my children") the "shares" of estates may be hard to identify, let alone account for. Under the final Regulations, a revocable trust that elects to be treated as part of the decedent's estate is a separate share. The residuary estate (and each portion of a residuary estate) is a separate share. A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is economically separate and independent from another share in which one or more beneficiaries have an interest. Moreover, the same person may be a beneficiary of more than one separate share. A bequests of a specific sum of money paid in more than three installments (or otherwise not qualifying as a specific bequest under Section 663(a)(1) of the Code) is a separate share. If the residuary estate is a separate share, than presumably pre-residuary pecuniary bequests (such as marital deduction formula bequests) are also separate shares. For a good discussion of some of the complexities associated with the application of the separate share rules to estates, see Cantrell, "Separate Share Regulations Propose Surprising Changes," TRUSTS & ESTATES, March 1999, p. 56.

c. Income From Property Specifically Bequeathed. Under the statutes or common law of most states, a beneficiary of an asset under a Will is entitled not only to the asset bequeathed, but also to the net income earned by that asset during the period of the administration of the estate. *See, e.g.,* Tex. Prob. Code § 378B(c). Until the adoption of the separate share rules, DNI was distributed on a pro rata basis among all beneficiaries receiving distributions. The items of income were not specifically identified and traced. As a result, the beneficiary may well have been taxed not on the income item actually received, but on his or her pro rata share of all income distributed to beneficiaries. However, since the income earned on property specifically bequeathed appears to be a "separate economic interest . . .", the separate share rules should change this result. This change means that if an estate makes a current distribution of income from specifically bequeathed property to the devisee of the property, the distribution will carry the DNI associated with it out to that beneficiary, regardless of the amount of the estate's other DNI or distributions. If the estate accumulates the income past the end of its fiscal year, the estate itself will pay tax on the income. When the income is ultimately distributed in some later year, the beneficiary will be entitled to only the net (after tax) income. In addition, the later distribution should not carry out DNI under the separate share rules, since it is not a distribution of current income, and since the accumulation distribution throwback rules (which still apply to certain pre-1985 trusts) do not apply to estates. The separate share rules, while complex to administer, have the advantage of making the income tax treatment of estate distributions more closely follow economic reality.

d. Interest on Pecuniary Bequests. State law or the governing instrument may require that a devisee of a pecuniary bequest (that is, a gift of a fixed dollar amount) is entitled to interest on the bequest, beginning one year after the date of death. The provision for paying interest on pecuniary bequests does not limit itself to payments from estate income. Under UPIA, the executor must charge this "interest" expense to income in determining the estate's "net" income to be allocated to other beneficiaries. Unif. Prin. & Inc. Act § 201(3) (1997). Interest payments are not treated as distributions for the estate for DNI purposes, so they do not carry out estate income. Instead, they are treated as an interest expense to the estate. Rev. Rul. 73-322, 1973-2 CB 44. For a discussion of the income tax issues associated with the deductibility of this interest payment by the estate, see page 31 below.

2. An Estate May Recognize Gains and Losses When It Makes Distributions In Kind. Unless a specific exception applies, all estate distributions, whether in cash or in kind, carry out the estate's DNI. Generally, the amount of DNI carried out by an in-kind distribution to a beneficiary is the *lesser* of the adjusted basis of the property prior to distribution, or the fair market value of the property at the time of the distribution. IRC § 643(e). The estate does not generally recognize gain or loss as a result of making a distribution to a beneficiary. This general rule is subject to some important exceptions.

a. Distributions Satisfying the Estate's Obligations. Distributions which satisfy an obligation of the estate are recognition events for the estate. The fair market value of the property is treated as being received by the estate as a result of the distribution, and the estate will recognize any gain or loss if the estate's basis in the property is different from its fair market value at the time of distribution. Rev. Rul. 74-178, 1974-1 C.B. 196. Thus, for example, if the estate owes a debt of $10,000, and transfers an asset worth $10,000 with a basis of $8,000 in satisfaction of the debt, the estate will recognize a $2,000 gain.

b. Distributions of Assets to Fund Pecuniary Gifts. A concept related to the "discharge of obligation" notion is a distribution of assets to fund a bequest of "a specific dollar amount," including a formula pecuniary bequest.

> **Example 3.** A formula gift requires an executor to distribute $400,000 worth of property. If the executor properly funds this bequest with assets worth $400,000 at the time of distribution, but with an adjusted cost basis of only $380,000 at the date of death, the estate will recognize a $20,000 gain.

The rules that apply this concept to formula bequests should not be confused with the "specific sum of money" rules which govern DNI carry outs. As noted above, unless the formula language is drawn very narrowly, most formula gifts do not constitute gifts of a "*specific sum of money*," exempt from DNI carryout, because they usually cannot be fixed exactly at the date of death (for example, most formula marital bequests must await the executor's determination of whether administration expenses will be deducted on the estate tax return or the estate's income tax return before they can be computed). Such gifts are nevertheless treated as bequests of "*a specific dollar amount*" for gain recognition purposes, regardless of whether they can be precisely computed at the date of death. As a result, gains or losses will be recognized by the estate if the formula gift describes a pecuniary amount to be satisfied with date-of-distribution values, as opposed to a fractional share of the residue of the estate. *Compare* Treas. Reg. § 1.663(a)-1(b) (to qualify as bequest of specific sum of money or specific bequest of property, and thereby avoid DNI carry-out, the amount of money or the identity of property must be ascertainable under the will as of the date of death) *with* Treas. Reg. § 1.661(a)-2(f)(1) (no gain or loss recognized unless distribution is in satisfaction of a right to receive a specific dollar amount or specific property other than that distributed). *See also* Treas. Reg. § 1.1014-4(a)(3); Rev. Rul. 60-87, 1960-1 C.B. 286. For fiscal years beginning on or before August 1, 1997, estates could recognize losses in transactions with beneficiaries. Although the Taxpayer Relief Act of 1997 repealed this rule for most purposes, an estate may still recognize a loss if it distributes an asset that has a basis in excess of its fair market value in satisfaction of a pecuniary bequest. IRC § 267(b)(13). Note, however, that loss recognition is denied to trusts used as estate surrogates by application of the related party rules of Section 267(b)(6) of the Code, except for qualified revocable trusts electing to be treated as estates under Section 645 of the Code.[6]

c. Pension and IRA Accounts Used to Fund Pecuniary Bequests. Some commentators have argued that if a pension asset is used to satisfy a pecuniary legacy, the use of that asset will be treated as a taxable

[6] For decedents dying in 2010 whose executors elected out of the federal estate tax and into the modified carry-over basis rules of Section 1022, recognition of gain on the funding of a pecuniary bequest was limited to post-death appreciation. IRC § 1040. Note, however, that if the modified carryover basis rules were applicable, any transfer of property by a United States person (including a trust or estate) to a non-resident alien resulted in the recognition of all built-in gains. IRC § 684(a).

sale or exchange, and this treatment will accelerate the income tax due. This analysis is based upon Treasury Regulation 1.661(a)-2(f)(1), which requires an estate to recognize gain when funding a pecuniary bequest with an asset whose fair market value exceeds its basis, as though the asset is sold for its fair market value at the date of funding. *See* Rev. Rul. 60-87, 1960-1 C.B. 286. If an estate uses an asset constituting income in respect of a decedent to satisfy a pecuniary bequest, application of this principle would cause the gain to be accelerated. In this author's opinion, however, it can be persuasively argued that this acceleration will not occur if the beneficiary is not the estate, but the trustee named in the participant's Will. Three lines of analysis confirm this result:

(1) <u>No Receipt By Estate</u>. The recognition rules under Treasury Regulation Section 1.661(a)-2(f)(1) apply only in the context of a distribution *by the estate* in satisfaction of a right to receive a specific dollar amount. When a "testamentary trustee" is named as the beneficiary of a pension plan or IRA, there is clearly no distribution by the estate, and no acceleration event should occur to the estate. The estate, after all, is subjected to taxation only on income *received by the estate* during the period of administration or settlement of the estate. IRC § 641(a)(3). Pension benefits payable directly to the trustee of the trust established under the Will of the plan participant are never "received by the estate." This fact remains true even if the Will contains instructions directing the testamentary trustee to use these funds in whole or in part to compute the amount of a pecuniary bequest. The fact that the executor takes these non-testamentary transfers into account in measuring the amount of *other* amounts needed to fund the pecuniary bequest should not change this result. Since the non-probate pension assets are not subject to administration, the estate cannot properly be said to be the taxpayer with respect to any transaction involving these benefits.

(2) <u>No IRD Transfer by Estate</u>. Separate and apart from the gain recognition rules of Treasury Regulation Section 1.661(a)-2(f)(1) is the IRD recognition rule of Section 691 of the Code. However, the recognition rules of Section 691(a)(2) of the Code, by their terms, apply only if the right to receive income in respect of a decedent is transferred "*by the estate of the decedent* or a person who receives such right by reason of the death of the decedent . . ." (emphasis added). If the testamentary trustee is the beneficiary, there is simply no transfer *by* the estate. Moreover, there is no transfer *by* any "person" who receives such right by reason of the decedent's death. The Code expressly excludes from the definition of "transfer" requiring IRD acceleration any "transmission at death . . . *to* a person pursuant to the right of such person to receive such amount by reason of the death of the decedent . . .". IRC § 691(a)(2) (emphasis added). In that event, the recipient (here, the trust) includes these amounts in gross income not when the right to the payment is received, but only when the payments themselves (i.e., the distributions from the retirement plan) are actually received. IRC § 691(a)(1)(B).

(3) <u>Constructive Receipt Rules</u>. The general rules which describe the timing of recognition for income attributable to an IRD asset are reinforced by the statutes expressly governing pension distributions. Amounts held in qualified plans and IRA's are taxable to the recipient only when actually distributed. IRC §§ 72, 402(a). The mere fact that benefits under the plan or IRA are made available, or that the participant or beneficiary has access to them, is not determinative, since the constructive receipt rules do not apply to these assets. IRC §§ 402(a)(1), 408.

(4) <u>Proper Tax Treatment</u>. Therefore, if the testamentary trustee receives, whether by a spouse's disclaimer or by direct designation by the participant, the right to receive plan distributions, no income tax should be payable until such time as distributions are actually made from the plan or IRA to the trust, even if the assignment of the right to receive plan assets otherwise reduces (or eliminates) the amount that the estate needs to distribute in satisfaction of a pecuniary bequest. Instead, the testamentary trust should be able to defer taxation on pension and IRA proceeds until such time as those accounts are distributed (which may be until they are required to be distributed in accordance with the minimum required distribution rules). See PLR 9630034 (pecuniary disclaimer by spouse of one-half interest in decedent's IRA does not cause recognition to spouse or estate).

d. Section 643(e)(3) Election. The executor may elect under Section 643(e)(3) of the Code to recognize gain and loss on the distribution of appreciated and depreciated property. If this election is made, the amount of the distribution for income tax purposes will be the fair market value of the property at the time of the distribution. The Section 643(e) election must be made on an "all or nothing" basis, so that the executor may not select certain assets and elect to recognize gain or loss on only those assets. Of course, if the executor wants to obtain the effect of having selected certain assets, he or she may actually "sell" the selected assets to the beneficiary for the fair market value of those assets, recognizing gain in the estate. The executor can thereafter distribute the sales proceeds received to the beneficiary who purchased the assets. Note that if an executor makes a Section 643(e)(3) election in a year that an IRD asset is distributed by the estate, gain would be accelerated, even if the distribution is otherwise subject to a Section 691(a)(2) exception, since the asset representing the IRD will be treated as having been sold by the estate in that year. For fiscal years beginning after August 1, 1997, the Section 643(e)(3) election (or an actual sale to a beneficiary) can cause the estate to recognize gains, but not losses, since under the principles of Section 267 of the Code, the estate and its beneficiary are now treated as related taxpayers. IRC § 267(b)(13).

3. Estate Beneficiaries May Recognize Gains and Losses If the Estate Makes Unauthorized Non Pro Rata Distributions In Kind. If an estate makes unauthorized non-pro rata distributions of property to its beneficiaries, the IRS has ruled that the distributions are equivalent to a pro rata distribution of undivided interests in the property, followed by an exchange of interests by the beneficiaries. This deemed exchange will presumably be taxable to both beneficiaries to the extent that values differ from basis. Rev. Rul. 69-486, 1969-2 C.B. 159.

> **Example 4:** A decedent's estate passes equally to A and B, and contains two assets, stock and a farm. At the date of death, the stock was worth $100,000 and the farm worth $110,000. At the date of distribution, each are worth $120,000. If the executor gives the stock to A and the farm to B *and if the will or local law fails to authorize non-pro rata distributions,* the IRS takes the view that A and B each received one-half of each asset from the estate. A then "sold" his interest in the farm (with a basis of $55,000) for stock worth $60,000, resulting in a $5,000 gain to A. Likewise, B "sold" his interest in the stock (with a basis of $50,000) for a one-half interest in the farm worth $60,000, resulting in a $10,000 gain to B. To avoid this result, the governing instrument should expressly authorize non-pro rata distributions.

See page 32 for a discussion of an analogous issue in the context of non-pro rata divisions of community property between the estate and the surviving spouse.

4. Income in Respect of a Decedent is Taxed to the Recipient. A major exception to the rule that an inheritance is income tax free applies to beneficiaries who receive payments that constitute income in respect of a decedent. IRC § 691.

a. IRD Defined. Income in respect of a decedent ("IRD") is not defined by statute, and the definition in the Treasury Regulations is not particularly helpful. Generally, however, IRD is comprised of items which would have been taxable income to the decedent if he or she had lived, but because of the decedent's death and tax reporting method, is not includible in the decedent's final Form 1040. 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 amounts in IRAs and qualified benefit plans upon which the decedent has not been taxed. A helpful test for determining whether an estate must treat an asset as IRD is set forth in *Estate of Peterson v. Comm'r*, 667 F.2d 675 (8th Cir. 1981). The estate's basis in an IRD asset is equal to its basis in the hands of the decedent. No step-up is provided. IRC § 1014(c).

b. Recognizing IRD. If the executor distributes an IRD asset in a manner which will cause the estate to recognize gain on the distribution, or if a Section 643(e)(3) election is made and the asset is distributed in the year of the election, the result will be to tax the income inherent in the item to the decedent's estate. Absent one of these recognition events, if the estate of the decedent transmits the right to an IRD asset to another person who would be entitled to report that income when received, the transferee, and not the estate, will recognize the income. Thus, if a right to IRD is transferred by an estate to a specific or residuary legatee, only the legatee must include the amounts in income when received. Treas. Reg. § 1.691(a)-4(b)(2). If IRD is to be recognized by the estate, the tax costs may be substantial. In a setting where a substantial IRD asset is distributed from the estate in a manner causing recognition, a material decrease in the amount passing to other heirs might result.

> **Example 5:** In 2013, X dies with an $8.25 million estate. The Will makes a formula marital gift of $3,000,000 to the spouse, leaving the rest of the estate to a bypass trust. If an IRD asset worth $3,000,000 but with a basis of $0 is used to fund this marital gift, the estate will recognize a $3,000,000 gain. The spouse will receive the $3,000,000 worth of property, but the estate will owe income tax of some $1,186,000, presumably paid from the residue of the estate passing to the bypass trust. Payment of this tax would leave only $4,064,000 to fund the bypass trust.

Under these circumstances, the testator may wish to consider making a specific bequest of the IRD asset to insure that the income will be taxed to the ultimate beneficiary as received, and will not be accelerated to the estate.

c. <u>Deductions in Respect of a Decedent</u>. A concept analogous to income in respect of a decedent is applied to certain deductible expenses accrued at the date of the decedent's death but paid after death. These "deductions in respect of a decedent" ("DRD") are allowable under Code Section 2053(a)(3) for estate tax purposes as claims against the estate, and are also allowed as deductions in respect of a decedent for income tax purposes to the person or entity paying those expenses. IRC § 691(b). The general rule disallowing both income and estate tax deductions for administration expenses, discussed below at page 23 does not apply to DRD. The theory behind allowing this "double" deduction is that had the decedent actually paid this accrued expense prior to death, he could have claimed an income tax deduction, and the cash on hand in his estate would be reduced, thereby effecting an estate tax savings as well. Of course, interest, administration expenses, and other items not accrued at the date of the decedent's death are subject to the normal election rules of Section 642(g) of the Code discussed below.

5. <u>Impact of Death Upon Basis</u>. Most practitioners describing the impact of death upon basis have traditionally used a kind of short-hand by saying that assets get a "step-up" in basis at death. In inflationary times, this oversimplification is often accurate. However, it is important to remember that the basis of an asset may step up or down. For most assets, the original cost basis in the hands of the decedent is simply irrelevant. It is equally important to remember that the basis adjustment rule is subject to some important exceptions. In addition, for estates of persons dying in 2010 whose executors elected not to have the federal estate tax apply, the basis adjustment rules of Section 1014 did not apply. Instead, the "modified carry-over basis" rules of Section 1022, were used.

a. <u>General Rule</u>. In general, the estate of a decedent receives a new cost basis in its assets equal to the fair market value of the property at the appropriate valuation date. IRC § 1014. In most cases, the basis is the date-of-death value of the property. However, if the alternate valuation date for estate property has been validly elected, that value fixes the cost basis of the estate's assets. IRC § 1014(a)(3). The basis adjustment rule also applies to a decedent's assets held by a revocable trust used as an estate surrogate, since they are deemed to pass from the decedent pursuant to Sections 2036 and 2038 of the Code. Although often called a "step up" in basis, various assets may be stepped up *or down* as of the date of death. The adjustment to the basis of a decedent's assets occurs regardless of whether the estate is large enough to be subject to federal estate tax. Original basis is simply ignored and federal estate tax values are substituted. Note that the new cost basis applies not only to the decedent's separate property but also to *both halves* of the community property owned by a married decedent. IRC § 1014(b)(6).

b. <u>Exceptions</u>. There are two important exceptions to the basis adjustment rules of Section 1014.

(1) No New Basis for IRD. Items which constitute IRD receive a carryover basis. IRC § 1014(c). This rule is necessary to prevent recipients of income in respect of a decedent from avoiding federal income tax with respect to items in which the income receivable by a decedent was being measured against his basis in the asset (such as gain being reported on the installment basis).

(2) No New Basis for Deathbed Transfers to Decedent. Section 1014(e) of the Code provides a special exception 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. As noted earlier, this rule is presumably designed to prevent avaricious taxpayers from transferring property to dying individuals, only to have the property bequeathed back to them with a new cost basis.

c. Holding Period. A person acquiring property from a decedent whose basis is determined under Section 1014 is considered as being held by the person for more than one year. IRS § 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.

d. 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. IRC § 1022(a). There were two important adjustments to this basis.

(1) 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." 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. 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. In the case of a decedent nonresident not a citizen of the United States, the general basis increase was limited to $60,000.

(2) The $3 Million Adjustment for Qualified Spousal Property. Second, there was a spousal basis adjustment equal to $3 million for "qualified spousal property." 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").

(3) The "Owned-by-the-Decedent" Requirement. Basis increases were available only for property that was "owned" by the decedent at the time of death. 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. 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 a decedent's estate (essentially, a trust that was revocable by the decedent immediately before death). 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. 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. IRC § 1022(d)(1)(B)(iii). In addition, property acquired by the decedent from any one 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. 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*.

(4) "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. IRC § 1022(e).

(5) 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. 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). IRC § 1022(d)(1)(D).

(6) 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. 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. IRC § 1022(d)(3). Notice 2011-66, § I.D.2, Notice 2011-76.

(7) 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. IRC § 1022(g).

(8) 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 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).

6. The Executor Can Elect to Deduct Many Expenses for Either Income or Estate Tax Purposes (but not Both). An executor is often confronted with a choice of deducting estate administration expenses on the estate tax return, or the estate's income tax return. In most instances, double deductions are disallowed. IRC § 642(g). Between 1986 and 1992, the decision about where to deduct an expense was simplified by the fact that the lowest effective federal estate tax bracket (37%) was always higher than the highest marginal income tax bracket applied to estates (typically 31%). If estate tax was due, a greater tax benefit was always obtained by deducting expenses on the estate tax return. Between 1993 and 2001, the analysis was more difficult since income tax rates might or might not exceed effective estate tax rates in those years. For decedents dying between 2002 and 2009, the decision about where to deduct an expense was simplified by the fact that the lowest effective federal estate tax bracket (45%) was always higher than the highest marginal income tax bracket applied to estates (35%). In 2013, with a top income tax rate of 39.6% and a possible Medicare surtax of 3.8%, executors are once again faced with deciding whether the deduction on the estate's income tax return (with a top combined tax bracket of 43.4%) may

be of greater benefit than deducting expenses on the estate tax return, where the top bracket is effectively 40%.

a. Section 642(g) Expenses. The executor must make an election to take administration expenses as a deduction for income tax purposes by virtue of Section 212 of the Code, or to deduct those same expenses as an estate tax deduction under Section 2053 of the Code. No double deduction is permitted. Expenses to which this election applies include executors' fees, attorneys' fees, accountants' fees, appraisal fees, court costs, and other administration expenses, provided that they are ordinary and necessary in collection, preservation, and management of the estate. There is no requirement that the estate be engaged in a trade or business or that the expenses be applicable to the production of income. Treas. Reg. § 1.212-1(i). Note, however, that expenses attributable to the production of tax-exempt income are denied as an income-tax deduction to estates, just as they are to individuals, under Section 265(1) of the Code. Interest on estate taxes deferred under Section 6166 of the Code, which now accrues at only 45% of the regular rate for interest on under payments, is no longer allowed as an estate tax or on income tax deduction. IRC §§ 2053(c)(1)(D); 163(k).

b. Method of Election. Technically, the Code and Treasury Regulations require the executor to file with the estate's income tax return a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under Section 2053 or 2054 and that all rights to have such items allowed at any time as deductions under Section 2053 or 2054 are waived. Treas. Reg. § 1.642(g)-1. Some executors tentatively claim expenses on both returns, filing the income tax return waiver statement only after the estate has received a closing letter and deductions on the estate tax return have proven unnecessary. This approach can be dangerous, however, if deductions are taken on the estate tax return, and the estate receives a closing letter without examination of or adjustment to the return. Under these circumstances, presumably, the income tax waiver statement could not lawfully be filed, since the deductions in question will have been "allowed" as deductions from the gross estate.

c. Payments From Income. Increased attention has been focused on the interaction of state law and tax rules in determining whether estate administration expenses are chargeable to principal or income, particularly in estates seeking an estate tax marital or charitable deduction. The importance of this issue is illustrated by *Commissioner v. Estate of Hubert*, 117 S. Ct. 1124 (1997) where the executor charged administration expense to estate income for both state law and tax law purposes. The IRS held that such an allocation constituted a "material limitation" on the rights to income otherwise afforded recipients of marital and charitable gifts, and denied estate tax deductions for the gifts to which these expenses were allocated. The Supreme Court disagreed, holding that the Treasury Regulations in place at the time justified the tax court's finding that the marital deduction was not jeopardized.

(1) Regulatory Guidance. In response to the *Hubert* decision, the IRS announced new regulations providing guidance on this issue. Treas. Reg. §§ 20.2013-4(b)(3), 20.2055-3; 20.2056(b)-4(d). Unlike the "material limitation" rules under the prior regulations, the new regulations permit deductions depending upon the nature of the expenses in question. The regulation provides that "estate management expenses" may be deducted as an income tax deduction (but not as an administrative expense for estate tax purposes) without reducing the marital or charitable deduction. Expenses that constitute "estate transmission expenses" will require a dollar for dollar reduction in the amount of marital or charitable deduction.

(2) Estate Management Expenses. Estate management expenses are "expenses incurred in connection with the investment of the estate assets and their preservation and maintenance during a reasonable period of administration. Examples of these expenses include investment advisory fees, stock brokerage commissions, custodial fees and interest." Treas. Reg. §§ 20.2055-3(b)(1)(i); 20.2056(b)-4(d)(1)(i).

(3) Estate Transmission Expenses. Estate transmission expenses are all estate administration expenses that are not estate management expenses. These expenses reduce the amount of the marital or charitable deduction if they are paid out of assets that would otherwise pass to the surviving spouse or to charity. Estate transmission expenses include expenses incurred as a result of the "consequent necessity

of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it." Examples of these expenses could include executor commissions and attorney fees (except to the extent of commissions or fees specifically related to investment, preservation, and maintenance of assets), probate fees, expenses incurred in construction proceedings and defending against Will contests, and appraisal fees. Treas. Reg. §§ 20.2055-3(b)(1)(ii); 20.2056(b)-4(d)(1)(ii).

(4) Reduction for Unrelated Estate Management Expenses. In addition to reductions for estate transmission expenses, the final regulations require that the marital deduction be reduced by the amount of any estate management expenses that are "paid from the marital share but attributable to a property interest not included in the marital share." Treas. Reg. § 20.2056(b)-4(d)(1)(iii)(4). Similar language is applied to charitable gifts. Treas. Reg. § 20.2055-3(b)(4).

(5) Special Rule for Estate Management Expenses Deducted on Estate Tax Return. If estate management expenses are deducted on the estate tax return, the marital or charitable deduction must be reduced by the amount of any estate management expenses "that are deducted under section 2053 on the decedent's Federal estate tax return." Treas. Reg. §§ 20.2055-3(b)(3); 20.2056(b)-4(d)(3). The justification for this position is the language in Section 2056(b)(9) of the Code, which provides that nothing in section 2056 or any other estate tax provision shall allow the value of any interest in property to be deducted for federal estate tax purposes more than once with respect to the same decedent.

> **Example 6:** $150,000 of life insurance proceeds pass to the decedent's child, and the balance of the estate passes to the surviving spouse. The decedent's applicable credit amount had been fully utilized prior to death. If estate management expenses of $150,000 were deducted for estate tax purposes, the marital deduction would have to be reduced by $150,000. Otherwise, the estate "would be taking a deduction for the same $150,000 in property under both sections 2053 and 2056." As a result, the deduction would have the effect of sheltering from estate tax $150,000 of the insurance proceeds passing to the decedent's child. Treas. Reg. § 20.2056(b)-4(d)(5), Ex.4.

(6) Effective Date. The regulations apply to estates of decedents dying on or after December 3, 1999. Treas. Reg. §§ 20.2055-3(b)(7); 20.2056(b)-4(d)(6).

d. Summary of Deductible Expenses.

(1) Deductible ONLY on the Decedent's Final Income Tax Return:

(a) Iitemized deductions paid prior to date of death. IRC §§ 161-223.

(b) Capital loss carry-forward of the decedent. IRC § 212(b).

(c) Charitable contributions carry-forward of the decedent. IRC § 170(d)(1).

(d) Net operating loss carry-forward of the decedent. IRC § 172(b).

(e) Disallowed investment interest carry-forward of the decedent. IRC § 163(d)(2).

(f) Disallowed S Corporation carry-forward of the decedent. IRC § 1366(d)(2).

(g) Investment tax credit carry-forward of the decedent. IRC § 46(b).

(2) Deductible on EITHER the Decedent's Final Income Tax Return or the Estate Tax Return:

(a) Medical expenses of the decedent paid out of his estate within one year after date of death. IRC § 213(c).

(3) Items Deductible ONLY on the Estate Tax Return:

(a) Funeral expenses. IRC § 2053(a)(1); Treas. Reg. § 20.2053-2.

(b) Claims against the estate of a personal non-deductible nature (e.g., federal income and gift taxes unpaid at date of death). IRC § 2053(a)(3).

(c) Administration expenses attributable to tax-exempt income. Rev. Rul. 59-32, 1959-1 CB 245.

(4) Items Deductible ONLY on the Estate's Income Tax Return:

(a) State, local and windfall profit taxes on estate income. IRC §§ 164(a); 2053(c)(1)(B).

(b) Real estate taxes not accrued prior to death. IRC §§ 164(a); 2053(c)(1)(B).

(c) Interest accruing after date of death on indebtedness incurred by the decedent or the estate which are not allowable as expenses of administration under local law. IRC §§ 163(a); 2053(c)(1)(B).

(5) Items Deductible on EITHER the Estate's Income Tax Return or the Estate Tax Return:

(a) Administration expenses, except administration expenses attributable to tax-exempt income, may be taken on the Form 1041 or the Form 706. Any administration expenses, including those attributable to tax-exempt income, not claimed on the Form 1041 can be claimed on the Form 706. IRC §§ 212; 642(g); 2053(a). *See* Rev. Rul. 59-32, 1959-1 CB 245.

(b) Casualty and theft losses. IRC §§ 165; 642(g); 2054.

(6) Items (called "Deductions in Respect of a Decedent") Deductible BOTH on the Estate's Income Tax Return and on the Estate's Death Tax Return:

(a) Business expenses accrued prior to death. IRC §§ 163; 2053(a).

(b) Interest expenses accrued prior to death. IRC §§ 163; 2053(a).

(c) Taxes accrued prior to death. IRC §§ 164, 2053(a); 2053(c)(1)(B).

(d) Expenses incurred for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection or refund of any tax accrued prior to death. IRC §§ 212; 2053(a).

(e) Alimony or separate maintenance payments accrued prior to death. §§ 215; 2053(a). *See* Rev. Rul. 67-304. 1967-2 CB 224.

7. Post-Death Revocable Trusts May Be Separate Taxpayers or Part of the Estate. Revocable trusts typically provide for the creation of sub-trusts (i.e., marital trusts, 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, and that it is a separate taxpayer from the sub-trusts that will later be funded by 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 paragraph (b) of Treasury Regulation Section 1.641(b)-3, as opposed to paragraph (a). The rules, however, are similar and should give rise to no real substantive difference in timing or treatment.

a. Effect of Grantor's Death. 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. A revocable living trust becomes a different taxpayer after the grantor dies. Rev. Rul. 57-51, 1957-1 C.B. 171. It must obtain a new taxpayer identification number and start filing Form 1041 trust income tax returns under such new number 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 obtaining a taxpayer identification number during the grantor's lifetime, then such trust should file a final grantor-type trust income tax return under its old taxpayer identification number relating to items of income, deductions, and credits attributable to such trust for the period ending on the grantor's date of death.

b. Post-Differences Between Trusts and Estates. Post-death revocable trusts suffer several minor disadvantages when contrasted with an estate for income tax purposes. These included, for example:

(1) The revocable living trust becomes a separate taxpaying entity after the grantor's death; if no 645 election (described below) is made to treat it 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). xxx

(2) After TRA '97, 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).

(3) An estate is allowed to choose a fiscal year for income tax reporting purposes, but 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 post-TRA '97, some domestic trusts and all foreign trusts are still subject to throwback rules. IRC §§ 665-669.

(5) Estates and (since TAMRA) revocable trusts are not required to make estimated income tax payments during their first two taxable years. IRC §6654(k). However, estates 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).

(6) Estates having a charitable residuary beneficiary can deduct amounts which are set aside for ultimate distribution to charity. IRC § 642(c). Post 1969-Act trusts are not entitled to the IRC §642(c) 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). But 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 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 personal representative) and a trustee may have personal liability for a decedent's income and gift tax returns, but only an "executor" (as specially defined in IRC § 6905(b), which 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).

(12) Estates qualify for IRC § 194 amortization of reforestation expenditures, but trusts do not.

c. Election to Unify. For decedents dying after August 5, 1997, the trustee and the 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 Section 676 of the Code. IRC § 645(b). The election must be made on the estate's first timely income tax return (including extensions), and, once made, is irrevocable. IRC § 645(c); Treas. Reg. § 1.645-1(e)(1). The election applies until "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, two years after the date of death. 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 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 their assets. 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 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).

d. Advantages of the Election. 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 under Section 644. Treas. Reg. § 1.645-1(e)(3)(i).

(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 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 C.B. 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 Section 469 of the Code 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 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).

8. When An Estate or Trust Allocates "Income," That Means Fiduciary Accounting Income, Not Taxable Income. Estate planning attorneys that spend too much of their time studying tax rules sometimes forget that not every situation is governed by the Internal Revenue 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). In measuring

fiduciary accounting income, the governing instrument and local law, not the Internal Revenue 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-two states and the District of Columbia have adopted the 1997 Uniform Principal and Income Act ("UPIA"). Most other jurisdictions utilize a version of the prior Uniform Principal and Income Act, primarily the 1962 version of that Act ("RUPIA 62"). Despite the benefits of "uniform" acts, many states have chosen to modify specific sections to their principal and income rules. (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. Allocation of Income.

(1) General Rules. UPIA provides that a trustee must make allocations 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) (1997). Provisions in the Will or trust agreement should therefore control allocations of estate and trust income and expense, so long as they 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 control allocations between income and principal.

(2) Allocations Under UPIA. Under UPIA, a more uniform approach is directed for distributions from entities than was applied under prior law. The cash basis is expressly used to characterize income from entities.

(a) Distributions from "Entities". Section 401(d) of the 1997 UPIA provides a direct answer to the question of how to characterize distributions from "entities," which the Act defines to include corporations, partnerships, 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 as principal. Second, 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). Third, distributions in kind (as opposed to distributions of money) from partnerships and S corporations are treated as principal. Finally, distributions of money are income unless (i) they are designated by the entity as a liquidating distribution; or (ii) to the extent they exceed 20% of the entity's gross assets prior to distribution (ignoring money that does not exceed the income tax that the trustee or beneficiary must pay on the entity's income).

(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) (1997). 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 § 402(b) (1997).

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 make allocations against income and principal similar to those made under prior law.

(a) Charges Against Income. Under the statute, charges against income include one-half of all trustee fees and commission, (including investment advisor 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 (1997).

(b) Charges Against Principal. Charges against principal are all those not charged to income, including one-half of trustee fees, accountings and judicial proceedings not charged to income, trustee compensation based on acceptance, distribution or termination, of for making property ready 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 (1997).

(c) Income Taxes. UPIA Section 505 general charges taxes based upon income receipts to income, and charging 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 allocate to principal; or (2) the entity's taxable income exceeds the total receipts from the entity. Unif. Prin. & Inc. Act § 505(c) (1997). These allocations may be reduced by the amount distributed to a beneficiary for which a distribution deduction is allowed. Unif. Prin. & Inc. Act § 505(d) (1997). In 2008, the Uniform Laws Commission made important changes to Section 505 of UPIA to deal with income tax issues associated with pass-though entities owned by trusts and estates. These changes are discussed below beginning at page 45.

c. "Power to Adjust".

(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 (1997). The power to adjust includes the power to allocate all or part of a capital gain to trust income. This power is seen as 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) (1997). 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. <u>Equitable Adjustments</u>. 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 7:** Equitable adjustments can be illustrated by *Estate of Bixby*, 140 Cal. App. 2d 326, 295 P.2d 68 (1956). There, the executor elected under Section 642(g) to take deductions for income tax purposes, which reduced income taxes by $100,000.00, at the cost of $60,000.00 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 court required the benefitted estate to pay $60,000.00 in damages to the remainder beneficiaries as an "equitable adjustment." As a result, the remainder beneficiaries were unharmed, and the income beneficiaries received the net $40,000.00 tax savings.

9. <u>Deduction of Interest Paid on Pecuniary Bequests</u>. State law or the governing instrument may provide that at some point in time, the devisee of a pecuniary bequest is entitled to interest on the bequest. Many jurisdictions provide that interest begins to accrue one year after the date of death. See, e.g., Tex. Prop. Code § 116.051(3). UPIA provides that this interest is charges against income to the extent that it is sufficient, and thereafter from principal. Unif. Prin. & Inc. Act § 201(3) (1997). For tax purposes, however, payment of this interest is treated not as a distribution of income, but as an interest expense to the estate and interest income to the beneficiary. Rev. Rul. 73-322, 1973-2 C.B. 44. Under Section 163(h) of the Code, interest is non-deductible "personal interest" unless it comes within an exception, none of which expressly relates to interest on a pecuniary bequest. Some practitioners have sought to characterize this interest as deductible "investment interest." Section 163(d)(3) of the Code defines "investment interest" as interest paid or accrued on indebtedness properly allocable to property held for investment, and capital gains attributable to that property. Property held for investment is described by reference to Section 469(e)(1) of the Code, and includes property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. IRS Notice 89-35, 1989-13 IRB 4, provides temporary guidance on allocating interest expense on a debt incurred with respect to certain pass-through entities. Under the Notice, the debt and associated interest expense must be allocated among the assets of the entity using a reasonable method. Reasonable methods of allocating debt among assets ordinarily include pro rata allocation based upon fair market value, book value, or adjusted basis of the assets. Although this Notice does not apply by its terms to indebtedness incurred by

an estate in funding a bequest, perhaps these principles can be applied by analogy to estates. This analysis would probably require the executor to examine the activities of the estate. One could argue that a "debt" to the beneficiary was incurred because the estate failed to distribute its assets to fund the pecuniary bequest promptly. As a result, the estate was able to retain assets, including assets that generate portfolio income, as a result of its delay in funding the bequest. In effect, the estate could be said to have "borrowed" these assets from the beneficiary during the period that the distribution was delayed, and it is as a result of this borrowing that the interest is owed under the provisions of the Will or local law. This analysis would mean that to the extent that the assets ultimately distributed to the beneficiary (or sold to pay the beneficiary) were assets of a nature that produced interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business, the interest expense would be deductible to the estate as "investment interest." It should be noted, however, that in an example contained in the Treasury Regulations relating to the separate share rules, the IRS states (without explanation) that interest paid on a spouse's elective share that is entitled to no estate income, but only statutory interest, is income to the spouse under Section 61 of the Code, but non-deductible to the estate under Section 163(h). Treas. Reg. § 1.663(c)-5, Ex. 7. The focus of this regulation is on the amount of DNI that will be carried out by the distribution; it properly rules that no DNI is carried out. Its characterization of the interest expense as nondeductible under Section 163(h) is gratuitous, and in this author's view, erroneous. It appears that the only case to consider this matter is *Schwan v. United States*, 264 F. Supp. 887 (DSD 2003). In *Schwan*, the court rejected the executors' argument that the interest was incurred to prevent the forced liquidation of stock held by the estate, noting that the stock had already been transferred to the estate's beneficiary when the interest obligation began to run. The estate, therefore, did not even own the stock when the interest was imposed, and had no interest in preventing its forced liquidation. On these facts, the investment interest question was not squarely before the court.

10. <u>Non-Pro Rata Divisions of Community Property</u>. Can an executor and the surviving spouse make tax free non-pro rata divisions of community property, so that the beneficiaries of the estate own 100% of a community property asset while the surviving spouse succeeds to 100% of other community property assets of equal value? Two 1980 technical advice memoranda suggest that such a tax-free division is permissible. Both rely on Revenue Ruling 76-83, 1976-1 C.B. 213, a ruling involving similar issues in the divorce context, which has since been rendered obsolete by the enactment of Section 1041 of the Code (which expressly provides for non-recognition in the divorce context). Tech. Adv. Mem. 8016050; Tech. Adv. Mem. 8037124. A more recent ruling seems to confirm this analysis, so long as the division is permitted by the governing instrument or by local law. Tech. Adv. Mem. 9422052. Does local law permit such a non-pro rata division? In Texas, at least, there is no direct authority on point. One can construct a reasonable, if complex, argument. Under Section 177(b) of the Texas Probate Code, the executor of an estate takes possession of both halves of the community property of the decedent and the decedent's spouse. Section 385 of the Texas Probate Code provides that when a husband or wife die leaving community property, the surviving spouse may, at any time after the grant of letters testamentary and the filing of an inventory, make application to the court for a "partition" of the community property into "two equal moieties, one to be delivered to the survivor and the other to the executor or administrator id the deceased. The provisions of this Code respecting the partition and distribution of estates shall apply to such partition so far as the same are applicable." Tex. Prob Code § 385. At least one court has described equal moieties in this circumstance to be either two groups alike in magnitude, quantity, number or degree, or two groups alike in value or quality. *Estate of Furr*, 553 S.W.2d 676, 679 (Tex. Civ. App.–Amarillo, 1977, writ ref'd n.r.e.). Section 373 of the Probate Code deals with partitions and distributions of estate assets generally. This section does not require the court to make a pro rata partition of each and every asset of the estate, but permits the court to allocate assets among beneficiaries to achieve a "fair, just and impartial" distribution of estate assets. Similar powers perhaps apply to independent executors acting without court supervision. For example, in the context of a community administrator, there appears to be no requirement to account for specific assets upon the conclusion of the administration. Rather, the responsibility of the survivor is only in the aggregate. *See Leatherwood v. Arnold*, 66 Tex. 414, 416, 1 S.W. 173, 174 (1886). *Cf. Gonzalez v. Gonzalez*, 469 S.W.2d 624, 630 (Tex. Civ. App.–Corpus Christi 1971, writ ref'd n.r.e.) (power of an executor to distribute an estate does not

include the right to partition undivided interests, absent express grant of authority in the Will). As to partitions generally, Texas courts in establishing the rights of co-owners of property subject to partition have adopted the concept of "owelty." The classic definition of "owelty" is an amount paid or secured by one co-tenant to another for the purpose of equalizing a partition. Although originally designed to address minor variations in value, the concept has been expanded to the situation where one co-tenant acquires all of the commonly owned property, and the other takes only cash. *See, e.g.*, *McGoodwin v. McGoodwin*, 671 S.W. 2d 880 (Tex. 1984).

VI. ADDITIONAL INCOME TAX ON ESTATES AND TRUSTS

A. Health Care and Education Reconciliation Act of 2010, P.L. 111-152. The year 2013 brings a new income tax to estates and trusts. The Health Care and Education Reconciliation Act of 2010 ("HCA 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. For individuals, the 3.8% tax will apply 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 will apply to the lesser of undistributed net investment income or the excess of adjusted gross income over a threshold determined based on the highest tax bracket for estates and trusts ($11,950 for 2013). 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.

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.

1. Net Investment Income vs. Undistributed Net Investment Income. Net investment income consists of the sum of three categories of income. IRC § 1411(c)(1). The first category includes gross income from interest, dividends, annuities, royalties, and rents, other than that which is derived in the ordinary course of a trade or business. The second category includes other gross income derived from a trade or business. The third category includes net gain from the disposition of property held in a trade or business. In each of these cases, when the term "trade or business" is used, it is in reference to that term as defined in Code Section 1411(c)(2). From the total of these categories, deductions that are properly allowed are taken. IRC § 1411(c)(1)(B). 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 proposed regulations apply rules similar to those in Code Sections 651 and 661 regarding the carry out of distributable net income ("DNI") to beneficiaries. Prop. Treas. Reg. § 1.1411-3(e). Whereas for other income, DNI carries out to beneficiaries to the extent of 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.

2. Trade or Business. "Trade or business" is defined as a passive activity or a trade or business of trading in financial instruments or commodities. IRC § 1411(c)(2).

C. Proposed Regulations. On December 5, 2012, the IRS issued a Notice of Proposed Rulemaking ("Notice") seeking comments to proposed regulations related to Section 1411 (77 FR 72611) which are expectd to be finalized in 2013. 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 Internal Revenue 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 Internal Revenue 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."

D. Trusts. Although the statute indicates that the tax applies to "trusts," it does not specify which trusts are included. Proposed 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 Internal Revenue 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 charitable trusts, tax exempt trusts, grantor trusts, foreign trusts, and business trusts. In addition, because subtitle A does not include tax exempt trusts, the statute does not apply to tax exempt trusts.

E. 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 net investment income. Prop. Treas. Reg. § 1.1411-3(b)(5).

F. 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 Internal Revenue Code. Following is a discussion of some net investment income problem areas but it is in no way meant to be an exhaustive list. The Notice also asked for comments related to foreign estates and foreign trusts but a discussion of those issues is beyond the scope of this paper.

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 Code 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. 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 this condition. 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) will have this component of net investment income trapped as undistributed net investment income, taxable to the trust or estate. Section 1411 and the related proposed Treasury regulations do 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. It seems that it would be fair to allow existing trusts and estates that incur capital gains after December 31, 2012 the option to reconsider how capital gains are to be allocated since it is possible that if the tax imposed by Section 1411 had existed in the year that an existing trust or estate had first incurred capital gains, the election may have been different. The Tax Section of the State Bar of Texas, in their comments on the proposed regulations, has asked for just such a fresh look. We will have to wait for the final regulations to see whether this option will be granted.

2. <u>Qualified Subchapter S Trusts ("QSSTs")</u>. In most cases, when a trust owns stock in an S corporation and the 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. 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 proposed regulations provide any special rules. In the Notice, the IRS has asked for comments to determine if any special rules are needed. However, as things currently stand, presumably, 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.

3. <u>Passive Loss Rules</u>. The statute does not define to what extent the passive loss rules for "ordinary" income taxes will apply. According to the proposed regulations, 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 master these exceptions when computing net investment income.

4. <u>Charitable Remainder Trusts</u>. Although charitable remainder trusts are not themselves subject to Section 1411, distributions that are made to non-charitable beneficiaries may be. The proposed regulations impose certain character and ordering rules in order to first distribute net investment income proportionately among the non-charitable beneficiaries. Prop. Treas. Reg. § 1.1411-3(c)(2). It appears at this point that for non-charitable beneficiaries of charitable remainder trusts, there is a WIFO ("worst in – first out") approach, thereby imposing another layer of tax on these beneficiaries.

5. <u>Properly Allowable Deductions</u>. The only deductions allowed in computing net investment income are those that are allowed by subtitle A of the Internal Revenue Code and are properly allocated to the gross income or net gain which is part of net investment income. IRC § 1411(c)(1)(B). The key is that the deductions must be allocated to the related gross income or net gain. Proposed Treasury Regulation Section 1.1411-4(f) places further limitations on the amount and timing of these deductions. In the Notice, the IRS asked for comments regarding the treatment of certain deductions, such as suspended passive losses and net operating losses.

G. <u>Special Notes</u>. A few additional items of note:

1. <u>Estates of Decedents Dying in 2012</u>. Section 1411 is effective for taxable years beginning after December 31, 2012. The consensus among commentators is that for estates of decedent’s dying in 2012 before December 31, 2012, Section 1411 will not apply until the second year of the estate since the first taxable year of the estate began in 2012.

2. 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 Section 67(e) of the Code 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.

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

H. 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 will 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.
- There may be even more reason for clients to take a team approach with the attorney, accountant and financial planner to minimize the additional tax burden.
- Fiduciaries have a greater burden with the additional recordkeeping necessary 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 will 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. the 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.

VII. STATE INCOME TAXATION OF TRUSTS

In considering income tax consequences of trust administration, it is important to consider not only federal income tax issues, but also issues relating to state income taxes. Trusts can present unique multi-jurisdictional problems when the trust is established by a grantor in one state, administered by a trustee residing in another state, for the benefit of beneficiaries in one or more other states. Moreover, the trust may hold income-producing property situated in yet another state. Although many states have statutes designed to limit the taxation of trust income in multiple states, no state imposing an income tax wishes to lose tax revenue to another state. Therefore, these double-tax prevention measures are imperfect at best. A detailed, if somewhat dated, discussion of the state tax regime attributable to trusts, together with a helpful summary of state tax rules and rates in each state, is set forth in Gutierrez and Keydel, "Study 6: State Taxation on Income of Trusts with Multi-State Contacts," ACTEC STUDIES (2001). An updated table is found in the current ACTEC State Survey (formerly ACTEC STUDIES) Neno, "Bases of State Income Taxation of Nongrantor Trusts".

A. Constitutional Issues. In order to pass constitutional muster, a state seeking to impose tax on a trust's income must establish some nexus to the trust. In the words of the Supreme Court, "due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Bros. V. Maryland*, 347 U.S. 340, 344-45 (1953). In general, states may impose a tax on nonresidents with respect to income derived within the state, so long as the tax is no more onerous than the tax imposed under like circumstances on residents of the taxing state. *Shaffer v. Carter*, 252 U.S. 37, 50 (1919).

1. The Nexus Requirement. For most states, "contacts" with the state are described in terms of "residency." A state may constitutionally tax all of the income of its residents, regardless of the source of that income. *Oklahoma Tax Comm'n v. Chickasaw Nation*, 515 U.S. 450, 462-63 (1995). If a trust is determined to be a resident of a state, the state may tax the trust's undistributed income. *New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937). The due process clause of the United States Constitution required that residency be based upon a sufficient nexus between the trust and the taxing state.

2. Contacts Supporting State Taxation. The seminal case in the area of establishing a trust's "residency" for income tax purposes points to six factors to consider in fixing this nexus. *Swift Trust v. Director of Revenue*, 727 S.W.2d 880 (Mo. 1987). These factors are (1) the domicile of the grantor; (2) the state in which the trust is created; (3) the location of the trust property; (4) the domicile of the beneficiaries; (5) the domicile of the trustee; and (6) the location of the administration of the trust. Moreover, the nexus must be tested not at the inception of the trust, but at the time that the tax is being imposed. The *Swift Trust* court held that of these six factors, the first two are irrelevant for years following the inception of the trust, and the domicile of the beneficiaries was not a sufficiently important nexus. Therefore, the other three factors (location of trust property, domicile of the trustee and location of administration) were determinative.

3. Broader Views of Contacts. Some states take a much broader view of which contacts support taxation than did the *Swift Trust* court. For example, the Connecticut Supreme Court found that the domicile of the grantor at the time of death is sufficient to establish the residence of the trust for state income tax purposes. *Chase Manhattan Bank v. Gavin*, 733 A.2d 780, 782 (Conn. 1999). The court in *Chase* distinguished the much earlier United States Supreme Court case of *Safe Deposit & Trust Co. v. Virginia*, 280 U.S. 83 (1929) on the somewhat dubious basis that the court there applied the due process clause to avoid the taxation of intangibles in multiple jurisdictions, noting that this tax issue was not now a part of the due process jurisprudence. The *Swift Trust* line of cases has also been called into question by the U.S. Supreme Court's decision in *Quill v. North Dakota*, 504 U.S. 298, 307-08 (1992), which extended the nexus test to cases in which an entity has an "economic presence" in a state, even though it does not have a physical presence there.

4. Interstate Commerce Issues. While the *Quill* decision extended the notion of nexus for due process purposes, it added new requirements for state taxation to pass muster under the Constitution's commerce clause. First, the tax must be fairly apportioned among all jurisdictions with which the entity has a nexus. Second, the tax must not discriminate against interstate commerce. Finally, the tax must be fair relative to the benefits provided to the entity by the state. 504 U.S. 298, 311. Application of these principles to the multi-state income taxation of trusts awaits further analysis by the courts.

B. State Tax Regimes.

1. Resident vs. Non-Resident Trusts. Most states implement their tax regimes by differentiating between "resident" and "nonresident" trusts. Therefore, a preliminary matter in determining state income tax issues is to identify the "residence" of the trust. States do not, however, apply a uniform test in determining which trust is classified as a "resident" trust. *See* Gutierrez, "Oops! The State Income Taxation of Multi-jurisdictional Trusts," 25 U. MIAMI HECKERLING INST ON EST. PL. 12 (1991). States typically impose an income tax on all income of resident trusts, regardless of where it is earned. On the other hand, for nonresident trusts, states generally impose tax only on income derived from sources located within the taxing state. For most states, in-state revenue sources are limited to income derived from real estate located within the state, or from closely held businesses situated within the state.

2. Determining Trust Residency.

a. Residence of the Grantor. Most states use the residency of the grantor as the starting point for fixing the residency of the trust. For example, Missouri, New York, Virginia, and the District of Columbia impose an income tax on the trust where the only contact with the state is the residency of the grantor at the time the trust is created (or in the case of an revocable trust, the time that the trust becomes irrevocable). Other states add a requirement that at least some trust property is situated in the state.

b. Residence of the Trustee. The trustee is the legal owner of the assets of the trust. As a result, many states (e.g., Arkansas and California) use the residence of the trustee as the main criterion for fixing the trust's residence. Some states take other factors into consideration. For example, Indiana does not treat a trust as a resident trust if half or less of the trustees are resident there and the trust situs is in another state.

c. Place of Administration. Some states, such as Colorado, Utah and West Virginia, look primarily or exclusively to the place of administration as the basis of determining a trust's residence. Other states have found that the place of administration alone is not a sufficient nexus to a state to support state income taxation. See *Bayfield County v. Pishon*, 162 Wis. 466, 156 N.W. 463 (1916).

d. Residency of the Beneficiary. Most states do not look to the residence of the beneficiary to determine trust residence. A beneficiary resident in the state may be taxed on income distributed to that beneficiary, but the trust is generally not taxed by virtue of the beneficiary's residence alone. *Mauire v. Tefery*, 253 U.S. 12 (1938); *Guaranty Trust Co. v. Virginia*, 305 U.S. 19 (1938). Eight states, however, do look to the residence of the beneficiary. For example, Georgia imposes a tax on trusts with beneficiaries residing in Georgia, or more precisely, a resident trustee may avoid taxation on income that is distributed to, or accumulated for later distribution to, a non-resident of Georgia, if the income is received from business done outside of Georgia or from property outside of Georgia. O.C.G.A. § 48-7-22(a)(3)(A).

3. Income Derived from Within the State. Almost all states imposing an income tax do so on income derived from sources derived within the state, regardless of the residency of the trust. The benefit that the state provides to enable the production of income generally provides a sufficient nexus to permit the state to tax locally derived income of nonresident trusts. *Shaffer v. Carter*, 252 U.S. 37 (1920). Domestic income typically includes income from real or tangible property located within the state, the conduct of a business located within the state, or to intangible property which has acquired a business situs within the state.

C. Selecting a Trust Situs to Avoid State Tax. State income taxation is one of several factors that a grantor may consider in selecting the situs to establish a trust. Moreover, if permitted, a trustee may seek to move the situs of a trust to a state that offers a favorable state income tax environment. For a discussion of these issue, see Warnick and Pareja, "Selecting a Trust Situs in the 21st Century," PROB. & PROP. 53 (Mar/Apr 2002); Sligar, "Changing Trust Situs: The Legal Considerations of 'Forum Shopping'," TR. & EST., July 1996 at 40.

VIII. OVERVIEW OF INCOME TAXATION OF FLOW-THROUGH ENTITIES

A. Partnerships.

1. Entity Not Taxed. Partnerships are subject to a unique set of rules under the Internal Revenue Code. On the one hand, a partnership may be viewed for some purposes as entity. In other contexts, a partnership is viewed as an aggregate of individual partners. Congress chose the latter approach in taxing income derived through a partnership. In other words, unlike an individual, trust or corporation, a partnership itself is not subject to income tax. Instead, the partnership serves only as a reporting vehicle for the partners. The partners themselves must pay tax on the income generated by partnership operations. This conduit theory of taxation is sometimes difficult to apply. Most taxpayers operate on a cash basis, and pay tax based upon their own realization events (and cash flow). The partnership,

however, does not pay tax. It simply records realization events at the partnership level and reports them to the partners (and the IRS). The cash flow between the partnership and its partners is largely irrelevant.

2. Taxation of Partners. The partners in a partnership are the taxpayers with respect to partnership income, losses, deductions and credits. These items, as they arise at the partnership level, are treated as having occurred at the partner level, and are allocated among the partners in accordance with the terms of the partnership agreement. Note that the partners are taxed on partnership activities, regardless of whether the partnership makes distributions to the partners. In that regard, a partner in a partnership is not taxed based upon the cash flow rules that most individual taxpayers are otherwise accustomed. Partners need not apportion individual items of income, loss, deduction or credit among them equally or in the ratio of their contributions. They may agree to any form of allocation. In order to ensure that the allocation of these items is not manipulated by the partners to artificially minimize taxation, the allocations are given effect only if they have a substantial basis in economic reality as among the partners themselves. IRC § 704.

3. Basis Issues. As with other taxpayers, partnership basis plays a key role in measuring gains and losses. Partnerships present an unusual layering of these rules, however, since a partner may sell not only his or her interest in the partnership's assets, but also his or her partnership interest itself. Thus, separate measures must be made of the partnership's basis in its assets, and the partners' respective bases in their partnership interests.

a. Inside Basis. The partnership's basis in the assets held by the partnership is figured much like a corporation's basis in its assets. Thus, for example, assets contributed by the partners to the partnership generally have a carry-over of the contributing partner's basis. Assets acquired by the partnership have a basis equal to cost. Depreciation may be taken at the partnership level (and passed through to the partners), thereby decreasing the partnership's basis in the depreciated assets.

b. Outside Basis. The partners themselves also have a basis in their partnership interest. Partners who enter the partnership by contributing assets generally begin with a basis equal to the basis of the assets contributed. Partners who acquire their interest by purchase from another partner begin with a basis equal to the purchase price. In either event, each partner's basis in the partnership is thereafter increased by his or her share of partnership income, and the basis of assets later contributed to the partnership, and is decreased by his or her share of partnership losses, and the basis of property distributed to him or her by the partnership. If a partnership makes distributions to its partners in excess of their unrecovered basis in the partnership, those distributions are generally taxed to the partners.

B. S Corporations. Most corporations are taxed upon the income earned by the corporation. If income is later distributed to the corporation's shareholders, that income is again taxed at the shareholder level as a dividend. This regime of double taxation can make operation as a corporation unattractive for many businesses. At the same time, however, the limited liability afforded to corporate operations under state law makes operating as a corporation extremely attractive for businesses. To address this dilemma, Congress permits certain qualified corporations and their shareholders to opt out of the usual tax system for corporations (described in Subchapter C of the Internal Revenue Code) and instead elect to be taxed much as a partnership (under Subchapter S of the Code).

1. Qualification. Only eligible small business corporations may elect to avoid the double tax regime applied to most corporate taxpayers. An eligible small business is one which does not have more than 100 shareholders, all of whom are individuals (or estates or certain eligible trusts), and none of whom are nonresident aliens. In addition, the corporation must not have more than one class of stock. If the corporation meets these threshold requirements, and if the corporation and each shareholder makes an election to be taxed as an "S Corporation," then the corporation itself is generally not taxed.

2. Entity Not Taxed. An S corporation is not itself subject to tax (except in very rare instances which are beyond the scope of this overview). Instead, the entity is treated for most purposes like a partnership. The shareholders are subjected to tax on the S corporation's items of income, losses, deductions and

credits, much like the partners of a partnership. Since S corporations must have only one class of stock, these items cannot be specially allocated among the shareholders. Instead, they are generally passed out to the shareholders pro rata, based upon their respective shareholdings.

3. Basis Issues. S corporation basis issues are similar to those arising with partnerships. The corporation must keep track of its basis in the assets owned by the corporation. At the same time, the shareholders themselves must keep track of their "outside" basis in their stock, which is adjusted to reflect income and losses of the corporation, as well as contributions by and distributions to shareholders.

4. Ownership By Trusts and Estates. In adopting the S corporation rules, Congress sought to limit their application to those entities that have identifiable domestic individuals as shareholders. Since an individual is mortal, the rule was extended to permit estates of decedents to remain as shareholders of S corporations during a reasonable period of administration. Congress apparently viewed trusts with somewhat more suspicion, as potential vehicles to shift income away from domestic individuals, or at least to complicate identification of the appropriate taxpayers. As a result, only a limited class of trusts are permitted to be S corporation shareholders. Ownership of S corporation stock by prohibited trusts terminates the S corporation election. Code Section 1361(c)(2)(A) limits trust ownership of S corporation stock to:

- Trusts that qualify as grantor trusts (the grantor is treated as the taxpayer);
- Trusts receiving stock pursuant to the terms of a Will, for a period of two years, beginning on the date that the stock is transferred to the trust, not the date of death (the trust is treated as the taxpayer);
- A Qualified Subchapter S Trust ("QSST"), which is a trust with a single income beneficiary who is entitled to receive all income annually, and which requires that any principal distributions during the beneficiary's lifetime be made only to that beneficiary (the electing beneficiary is treated as the taxpayer);
- An Electing Small Business Trust ("ESBT"), which is a trust which has only eligible individuals, estates or certain charities as beneficiaries, and for which the trustee makes an election to have the S stock treated as a separate trust, (the trust is treated as the taxpayer, taxed at the highest marginal federal income tax rate, regardless of whether its income is distributed).

C. Limited Liability Companies. A limited liability company is in large measure a hybrid entity under state law. It typically operates much as partnership under applicable state statutes, but has the uniquely corporate characteristic of limited liability. That is, unlike a general partnership (or the general partners of a limited partnership) the owners of a limited liability company have no personal liability to the creditors of the entity. Members of an LLC are in that respect very much like the shareholders of a corporation. The Internal Revenue Code does not set forth separate treatment for limited liability companies. Instead, unless the entity elects otherwise, it is taxed as a partnership for federal income tax purposes. Theoretically, the LLC could elect to be taxed as a corporation, and then if it met the eligibility requirements, it could make an S election. Most LLCs, however, simply accept partnership tax treatment. In that regard, they may adopt special allocation rules to apportion profits and losses among members and obtain flow-through tax treatment (like a partnership), while retaining limited liability under state law (like a corporation).

IX. INCOME TAX ISSUES ASSOCIATED WITH FLOW-THROUGH ASSETS

A. Issues Unique to Estates.

1. Basis and the Section 754 Election.

a. Rationale for the Election. Upon the death of a partner, the partner's partnership interest is revalued based on date of death value or the value on the alternate valuation date. IRC § 1014(a). Unfortunately, however, this step-up affects only the partner's "outside" basis in the partnership interest. It has no direct effect on the partnership's "inside" basis in its assets. If the partnership sells an appreciated asset after the death of the deceased partner, the successor partner generally must report gain as if no step-up in basis of the asset had occurred. To alleviate this harsh result, the Code offers a unique tax advantage to a successor of a decedent's partnership interest. If the partnership makes a Section 754 election, the successor partner (but not the other partners) can increase his or her share of the "inside" basis of partnership assets by the difference between the stepped-up "outside basis" and the decedent's old inside share of the partnership assets. This increase in inside basis allows the inheriting partner to recognize less gain or more loss when assets are later sold by the partnership. If there is depreciable property, the inheriting partner can claim higher depreciation deductions than the other partners based on the higher inside depreciable basis. Conventional wisdom usually suggests making the Section 754 election on the death of a partner. However, a Section 754 can be a two-edged sword. It has several disadvantages. As one might imagine, a Section 754 election can dramatically increase the partnership's record keeping requirements, especially if several partners die (or sell their interests). Second, the election may cause a *step-down* as well as a step-up in basis if the fair market value of the deceased partner's interest is less than the partnership's inside basis of its assets. Unfortunately, once made, the Section 754 election is irrevocable without the consent of the IRS and forevermore affects all the other partners when any other partner dies, or a distribution of property to any partner is made in later years. Finally, changes made by The Taxpayer Relief Act of 1997 to the basis allocation rules on liquidation of a partner's interest in a partnership and new proposed regulations under Sections 754, 755, 743, 734, and 732 have caused advisors to reconsider the benefits of a Section 754 election. In some cases, a liquidation might offer preferential tax treatment over a Section 754 election. For a detailed discussion of these issues, see Cantrell, "Practical Income Tax Guidance on Forming, Operating, and Liquidating Your Family Limited Partnership," State Bar of Texas 22nd Annual Advanced Estate Planning and Probate Course (1998).

b. Manner and Timing of Election. A Section 754 election is made by the partnership by attaching a written statement, signed by any one of the partners, to the partnership's timely filed (including extensions) tax return for the year in which the death of the partner occurred. Once made, the election is effective until revoked with the approval of the district director for the district in which the partnership return is required to be filed. Treas. Reg. §§ 1.754-1(b) and (c). If the partnership determines that a Section 754 election is desirable after the due date has passed, an automatic extension of twelve months from the original due date may be granted provided the partnership files an original or amended partnership tax return attaching the required election statement and prints: "FILED PURSUANT TO TREAS. REG. 301.9100-2T" at the top of Form 1065 or the attached election statement. No user fees apply. If a partnership has other partnership interests as part of its portfolio, each partnership must make a separate election. Rev. Rul. 87-115, 1987-2 CB 163.

c. Application to Both Halves of the Community. Section 743(b) of the Code permits an adjustment to the basis of partnership property "in the case of a transfer of an interest in a partnership . . . upon the death of a partner." However, in community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington), the surviving spouse's interest in the partnership is not "transferred" upon the death of the decedent. Nevertheless, the IRS has ruled that the Section 754 optional basis adjustment applies to the entire partnership interest owned as community property, including the surviving spouse's share. The ruling also states that the same result would apply if the non-partner spouse predeceased the partner spouse. Rev. Rul. 79-124, 1979-1 CB 224.

d. Tax Effects of Election. A step-up (or step-down) in the partner's "outside" basis of the partnership interest may occur when a partner dies, regardless of whether a Section 754 election is made. A step-up eventually provides a tax savings for the successor-in-interest when the partnership interest is sold or liquidated. The effect of the Section 754 election is to accelerate the benefit of the step-up by immediately passing it through to the "inside basis" of the individual assets as to the decedent partner's interest only. As a result, if partnership assets are sold or depreciated after death, the successor partner will benefit immediately, due to the higher basis of the decedent's share of assets inside the partnership. The method by which the partner's increased (or decreased) basis is allocated among specific partnership assets is complex, involving first a separation of the partnership's ordinary income from its capital assets, followed by an allocation among specific assets within each class. This system yields rough justice, but does not truly put the transferee in the position of a purchaser of an undivided interest in partnership assets if some of the partnership's assets have appreciated and others depreciated.

2. Fiscal Year End Issues. As indicated above, an estate may select a fiscal year end. If the fiscal-year-end estate holds a majority interest in a partnership, the partnership must convert to the estate's fiscal year end. A partnership's tax year is not dictated by the terms of the partnership agreement. Instead, a Section 706(a) of the Code requires that the partnership's tax year be determined by reference to the partners. IRC § 706(b)(1)(B). Once a partnership's tax year is selected, it ordinarily does not change. However, there are some exceptions to that rule.

a. Mandatory Change in Partnership Year Based on Majority Partner. A partnership's tax year must conform to that of the majority interest partners. A majority interest partner is any one or more partners with the same tax year whose interest(s) in the capital and profits of the partnership constitute more than 50% on the first day of the partnership taxable year (the "testing date"). IRC § 706(b)(4)(A)(ii). When a partner of a calendar year partnership dies and his or her estate owns a majority interest and selects a tax year other than the calendar year, the partnership will be required to change its tax year to conform to the majority partner in the partnership's next tax year. The partnership does not "annualize" its income for the short period. Treas. Reg. § 1.706-1(b)(5)(ii)(a). If a change is required under the provisions of Section 706(b)(1)(B)(i) due to a change in the majority interest partner's tax year, no further change will be required of the partnership for the two years following the year of change. IRC § 706(b)(4)(B). This required tax year change can result in some rather interesting planning opportunities for the executor in selecting the estate's tax year. Invariably, one or more beneficiaries of the estate's partnership interest will be a trust or an individual required to use a calendar year. If the beneficiary receives the partnership interest following the "testing date," then the recipient partner may obtain a deferral on reporting his or her share of partnership income for as many as two tax years before the partnership is again required to change tax years.

b. Selection of Estate's Tax Year for Maximum Deferral. An estate or electing trust with partnership interests should carefully examine the effects of its chosen tax year on the deferral opportunities afforded by virtue of the ownership of calendar year partnership interests. If the estate is a majority partner, the partnership will be required to change to the estate's tax year. If the estate chooses a November 30 tax year, the estate's beneficiaries may obtain up to an eleven month deferral of income each year for two years following the partner's death. If the estate is not a majority partner, so the partnership stays on the calendar year, and the estate chooses a November 30 tax year, the estate may obtain this eleven month deferral for as long as it holds the partnership interest.

3. Requirement to Close Partnership and S Corporation Tax Years. When a partner or S corporation shareholder dies, the decedent must report his or her share of the entity's income for the year of death. The allocation of partnership income for a short year is made by an interim closing of the partnership's books unless the partners agree to allocate income on per diem or other reasonable basis. *See* Treas. Reg. § 1.706 1(c)(2)(ii). 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 the shareholders agree, the allocation for the short year is made by an interim closing of the books. IRC § 1377(a)(2).

4. Special Problems for Estates Holding Interests in S Corporations.

a. Eligibility Issues. A decedent's estate qualifies as an S corporation shareholder for the entire period of administration. IRC § 1361(b)(1)(B). For purposes of ensuring that the corporation has no more than 100 shareholders, the estate counts as only one shareholder. Treas. Reg. § 1.1361-1(e)(1). In addition, the fact that an estate has one or more beneficiaries who are not eligible to be S corporation shareholders does not disqualify the S election so long as the estate retains the stock and does not distribute it to the ineligible shareholder. These rules give an executor time to analyze the consequences of a distribution of stock, and to take necessary actions to ensure that the beneficiaries who receive the stock are eligible shareholders. These actions might include reforming a recipient trust to ensure that it is eligible to hold S corporation stock. Note, however, that the administration of an estate for tax purposes cannot be prolonged beyond the period necessary for its administration under state law. If an estate is unduly prolonged, the IRS might assert that the estate has in effect become a trust, and therefore is no longer an eligible shareholder. *See Old Virginia Brick Co.*, 367 F2d 276, 66-2 USTC ¶ 9708 (4th Cir. 1966); *see also* Tenney and Belkap, "Postmortem Planning for Interests in Pass-Through Entities," 27 EST. PLAN. J.,No. 6, p. 250 (July 2000).

b. Avoiding Mismatches on Sale of S Corporation Assets. If the business of the S corporation will be discontinued after the death of the decedent, the executor (or remaining officers) may choose to sell the company. Most buyers of operating concerns prefer to purchase assets, and not stock (to avoid liability for past actions of the business and to facilitate an increased basis for acquired assets). Note, however, that the assets of the corporation do not receive a new cost basis at death. Only the stock held by the decedent receives a new basis. Unlike a partnership no Section 754 election is permitted for S corporations to transfer their shareholders' stepped up basis through to the corporation's underlying assets. As a result, any gain realized by the corporation will be passed through to its shareholders, further increasing basis, which can then enable an offset upon liquidation. Timing here, however, is critical. For example, suppose the estate holds all of the stock of an S corporation, whose fair market value on the date of death is $1,000,000. The executor thus has a basis in the stock of $1,000,000. The corporation holds assets with a fair market value of $1,000,000, and a basis of $100,000. If the corporation sells its assets, the corporation recognizes a gain of $900,000, which is passed through to the estate. The estate reports a capital gain of $900,000, and adds $900,000 to the basis of its stock, for a total basis of $1,900,000. If the corporation liquidates, transferring the $1,000,000 sales proceeds to the estate, it will apply its basis of $1,900,000, resulting in a $900,000 loss (which exactly offsets its gain). Note, however, that if the sale takes place in the estate's first fiscal year, and the liquidation occurs in the second, the estate will have to report, and pay tax on, the $900,000 gain in year one. The $900,000 loss in year two can be carried forward, but cannot be carried back to offset the prior year's gain.

5. Income Tax Consequences of Funding Bequests with Partnership Interests and S Corporation Stock.

a. Satisfactions of Specific Bequests. If an estate make a distribution of property in kind, including a distribution of a partnership interest or S corporation stock, to satisfy a gift of a "specific dollar amount" or a gift of specific property with property other than that specified in the governing instrument, then the estate will recognize gain or loss, based on the difference between the fair market value of the asset on the date of the distribution and the date of death basis of the property. Treas. Reg. § 1.661(a)-2(f)(1). This rule applies whether the gift is fixed dollar amount or a formula fixed dollar amount. *See* Rev Rul. 60-87, 1960-1 CB 286. Thus, if an appreciated partnership interest is used to fund a pecuniary bequest, gain may be required to be recognized by the estate upon the funding of the bequest. Of course, a partnership interest or S corporation stock can decline in value as well as appreciate between date of death and date of funding. Generally, any losses realized from date of death values will be subject to the related party rules and be denied to non-electing trusts. However, an estate may recognize losses incurred in funding pecuniary bequests. IRC § 267(b)(13).

b. Basis Issues. Except for estates of decedents dying in 2010 whose executors opt out of the federal estate tax, the basis to the decedent's estate of a partnership interest or S corporation stock will be its fair market value on the decedent's date of death (or on the alternate valuation date, if the decedent's executor so elects). Treas. Reg. § 1.1014-1(a). When the estate distributes an asset to an individual or a trust, the basis is generally a carryover basis of the adjusted basis in the hands of the estate prior to distribution, adjusted by the income or losses recognized by the estate during the administration, and any gain or loss triggered on the distribution. IRC § 643(e)(1). If the distribution does not trigger gain or loss to the estate, then the beneficiary would expect to receive a carryover basis in the interest distributed. If, however, the distribution occurs pursuant to a will clause or other situation that triggers gain or loss recognition, the beneficiary will obtain an additional step-up or step-down in basis equal to the gain or loss recognized upon the distribution. In addition, since the distribution constitutes a sale or exchange, the beneficiary will be afforded the opportunity to adjust the inside basis of assets as to the beneficiary if the partnership has made a Section 754 election. IRC § 743(b). In situations where the discounts and potential step-down indicate that a Section 754 election might not have been desirable in the year of death, the potential benefit of a Section 754 election should be revisited in the year of distribution.

B. Trust Issues.

1. Distribution of "All Income". As noted above, a simple trust is one which must distribute all of its "income" annually. "Income" for this purpose means *fiduciary accounting income* determined under local law–not taxable income. IRC § 643(b). In most states, "fiduciary accounting income" is determined under some version of the Uniform Principal and Income Act or the Revised Uniform Principal and Income Act and the relevant provisions of the governing instrument. The trust need not distribute all of its taxable or distributable net income. Naturally, in the context of stocks, bonds and most other assets, the trustee can look to the governing instrument or local law to determine which items constitute principal or income.

2. Trapping Distributions.

a. Description of 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 43.4% at only $11,950.00 in income (applying 2013 rules), the tax savings generated by this technique are limited. A simple trust with $12,250.00 in income ($300.00 of which would be excluded by the trust's allowance in lieu of personal exemption) would pay a tax of $3,090.00 instead of $4,851 if the entire $12,250.00 were taxed to a beneficiary in the 39.6% bracket–a savings of only $1,761. If the beneficiary were subject to the 3..8% tax on net investment income, the savings would be $2,226.50. Under 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." Although trapping distributions may arise without regard to whether the estate owns an interest in a pass-through entity, their application in this context can be more insidious.

Assume, for example, that the estate of a decedent who dies in 2011 holds as its only asset a limited partnership interest worth $6,000,000 at the date of death. The will makes a formula bequest of $1,000,000 (one-sixth of the estate) to a QTIP trust, with the residue (five-sixths of the estate) passing to a bypass trust. Suppose the estate funds these bequests on November 30, 2011. Upon funding, the partnership closes its books and determines that the estate's share of partnership taxable income is $180,000. No distributions are made by the partnership to the estate. The estate would report taxable income and DNI of $180,000, and increase its basis in the partnership by this amount. The estate would then distribute one-sixth of its limited partnership interest to the marital trust, and five-sixths of its interest to the bypass trust. These distributions would entitle the estate to a distribution deduction of $180,000 (since all of the estate's taxable DNI was distributed) and the estate's taxable income would be zero. The estate would issue K-1s to the QTIP trust showing $30,000 of income, and to the bypass trust showing $150,000 of income. The trusts would also receive a K-1 from the partnership for income earned by the partnership from December 1 to December 31, 2011. Assume for this example that partnership expenses offset income for the month of December and so no amounts are reportable on the K-1s issued by the partnership to the trusts. The QTIP trust, which has a mandatory income distribution requirement, calculates its fiduciary accounting income to be zero. (Even though post-death taxable income has been attributed to the estate, presumably no post-death fiduciary accounting income has been received by the estate or distributed to the trust.) The trust's only asset is a limited partnership interest which it held for one month during 2011. The partnership made no distributions to the trust in 2011. Therefore, the QTIP trust is not required to make any income distributions to the surviving spouse beneficiary in 2011. However, the marital trust has taxable income of $30,000 on which it must pay tax at fiduciary rates. The income is "trapped" in the trust (unless the trust agreement allows for, and the fiduciary actually makes, corpus distributions during December 2011 or within 65 days after the QTIP trust's year end under the 65 day rule).

3. Cash Flow Difficulties.

a. If the Entity Makes No Distributions. Note that in the above example, the QTIP trust and bypass trust both have serious liquidity problems. Their only assets are limited partnership interests from which they cannot demand a cash distribution. Perhaps the trusts could carve out and distribute partnership interests with a basis or value equal to their DNI (if the distributions are deemed to be necessary under the standards set forth in the trusts, and if the partnership agreement permits such an assignment). The effect of those distributions would be to shift the tax liability (and the liquidity problem) to the beneficiaries receiving the distributions. Query whether the trustee's fiduciary duty to the beneficiaries is violated by making in-kind distributions which carry out taxable income, without distributing sufficient cash to pay the resulting tax. If the trusts do not make any distributions, they are each faced with a significant federal income tax liability and no cash with which to pay it. Although the IRS now accepts credit cards payments, it has not yet approved payment by way of partnership interests. Presumably, the trustees will be required to sell sufficient limited partnership interests to raise the required cash, or to borrow funds to pay taxes.

b. If the Entity Distributes "Enough to Pay Taxes".

(1) Partnerships. If a partnership owned by a simple trust makes a distribution during the year, but doesn't distribute all of its taxable income, a new cash flow problem arises. Suppose that a QTIP trust owns a 25% interest in a partnership which earns $1,000,000 in income $250,000 of which is allocated to the trust. The managing partner decides to distribute $400,000 ($100,000 of which passes to the trust) to the partners so that they have funds with which to pay any resulting tax liability. The partnership sends the trust a K-1 for $250,000. For fiduciary accounting purposes, though, the income of the trust (if income is based upon receipts) is only $100,000. UPIA § 401(b). As a result, the trust distributes $100,000, leaving taxable income of $150,000 in the trust. The trust owes tax on that income of about $51,464.50 (using 2011 rates). Under Section 505 of UPIA as originally enacted, a tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid proportionally (i) from income to the extent that receipts from the entity are allocated to income; and (ii) from principal to the extent that receipts from the entity are allocated to principal, *or to the extent that the trust's share of the entity's taxable income exceeds receipts from the entity*. For this purpose receipts must be reduced by the amount distributed to a beneficiary which generates a distribution deduction. Since the trust's share of taxable income exceeds the receipts from the entity, this tax is charged to principal. UPIA § 505(c) (1997). Applying this rule, the trust owes tax not on proceeds, but on phantom income from the partnership, all of which is charged to principal on the trust's books. As a result, the trust may have a $51,464.50 cash shortfall. If the trustee ignores the statute and reduces fiduciary accounting income by *all* income taxes (or if the governing instrument permits or requires all taxes to be allocated to income), a rather curious set of inter-related computations arise: the distributable amount is reduced by taxes, which reduces that distribution (and the distribution deduction). This reduced deduction further increases taxes, etc. until the tax bill on almost the entire $250,000 is owed by the trust, generating a tax of about $80,769, leaving $19,231 of income to be distributed by the trust (using a flat 35% income tax rate). In other words, for tax purposes, the trust would have $250,000 of K-1 income, less a distribution deduction of $19,231, leaving taxable income of $230,769, yielding a tax of $80,769. From a fiduciary accounting income point of view (ignoring UPIA), the trust would have $100,000 of gross accounting income, less $80,769 in taxes, for net accounting income of $19,231 (equal to the imputed distribution deduction). As noted below, this is exactly the result in those jurisdictions that have adopted the 2008 changes to UPIA

or have comparably amended their principal and income rules. The same result occurs if the governing instrument charges these income taxes to income.

(2) ESBTs. A similar problem arises if the entity involved is an S corporation and the trust has made an ESBT election. The trust will receive a K-1 from the S corporation showing taxable income of $250,000. The trust will owe tax of $87,500 ($250,000 x 35%). As with the preceding example, actual *proceeds* have been received by the trust, which should be characterized as income. UPIA Section 505 allocates taxes to the income account to the extent receipts are treated as income. Subsection 505(d) provides that receipts allocated to income are reduced only for distributions yielding a distribution deduction, but an ESBT receives no distribution deduction. Therefore, the tax, to the extent it relates to income, should reduce fiduciary accounting income. If the trustee reduces fiduciary accounting income by the taxes attributable to income, the fiduciary accounting income will be $100,000, less the tax on that income ($35,000) or $65,000. The trust has only $100,000 of cash, but must write a check for $87,500 in tax, and make a distribution of $65,000. Thus, the trust will have a cash shortfall of $52,500 ($100,000-$87,500-$65,000) when it comes time to make its required distribution.

(3) QSSTs. If S corporation stock is held in a QSST, the S corporation should send the K-1 to the trust beneficiary, and not the trust. IRC § 1361(d)(1)(B); Treas. Reg. § 1.1361-1(j)(7). In that event, the $100,000 received by the trust is all fiduciary accounting income distributable to the beneficiary, who then has the cash flow with which to pay the tax.

(4) UPIA Power to Adjust Taxes. Section 506 of UPIA grants a fiduciary a power to adjust between principal and income to offset the shifting of economic interests or tax benefits between income and remainder beneficiaries which arise from tax elections, distributions or ownership of interests in flow-through entities. This section is essentially a codification of the doctrine of equitable adjustment. The commentary on Section 505 of UPIA notes that the power to adjust, together with the more general power to adjust between principal and income in Section 104 of UPIA (when available) "are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems." This Pollyannaish view of the complex issues presented does little to solve the cash flow problems encountered by the trust. For example, for an ESBT to pay its taxes when the S corporation distributes only enough to pay taxes, the commissioners must expect the trustee to ignore UPIA Section 401, allocate all ESBT distributions to principal, and make no distributions to the income beneficiary, so that corporate dividends may be used to pay the trust's tax. Perhaps this is the best result one can hope for under the current state of the law, but it is probably contrary to the expectation of most income beneficiaries.

(5) 2008 UPIA Changes. In 2008, the Uniform Laws Commission finalized an amendment to Section 505 of UPIA to address the problem associated with trusts and estates holding interests in pass-through entities. 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 a source of cash to pay some or all of the taxes on its share of the entity's taxable income. Subsection 505(d) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection 505(d) requires the trust to increase receipts payable to a beneficiary as determined under subsection (c) to the extent the trust's taxes are reduced by distributing those receipts to the beneficiary. Because the trust's taxes and amounts distributed to a beneficiary are interrelated, the rewritten rule effectively requires the trustee to apply the formula approach outlined below to determine the correct amount payable to a beneficiary. This formula must take into account that each time a distribution is made to a beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity's taxable income as reduced by distributions to beneficiaries. The comments to the revised statute provide two examples to illustrate these tax allocations. In the first example, Trust T receives a Schedule K-1 from

Partnership P reflecting taxable income of $1 million. Partnership P distributes $100,000 to T. The trustee allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket. Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c) T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire $100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing. In the second example, Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $500,000 to T. Again, the trustee allocates the receipts to income. As in the first example, Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses $350,000 of the $500,000 to pay its taxes and distributes the remaining $150,000 to B. However, the $150,000 payment to B reduces T's taxes by $52,500, which it must pay to B. But the $52,500 further reduces T's taxes by $18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B. The total amount due to B could be solved by multiple iterations. Alternatively, the trustee can apply the following algebraic formula to determine the amount payable to B:

> D = (C-(R*K))/(1-R), where D = Distribution to income beneficiary; C = Cash paid by the entity to the trust; R = tax rate on income; and K = entity's K-1 taxable income

Applying this formula (still using 2011 income tax rates), the distribution (D) would equal ($500,000-(.35*1,000,000))/(1-.35)= 230,769. The trust would thus report $1,000,000 of K-1 income less a $230,769 distribution deduction for a taxable income of $769,231. The tax on that income would be $269,231 (at a flat 35%). As a result, the $500,000 distributed to the trust would pass $230,769 to the beneficiary and $269,231 to the IRS. As of the date of this writing, the amended version of Section 505 has been adopted in the District of Columbia and 27 states: Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Idaho, Kansas, Kentucky, Maine, Missouri, Montana, Nebraska, Nevada, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, and West Virginia.

X. CONCLUSION

The income taxation of trusts and estates involves a myriad of sophisticated tax issues. Armed with a working knowledge of these issues, however, professionals who advise executors and trustees, and those that prepare their tax returns, can feel comfortable in administering and reporting these esoteric events. With proper attention and planning, the family can often recognize significant tax savings.