

Post Mortem Estate Planning Class 8

*Christopher M. Harvey, Esquire
Harvey & Mortensen
800 Lancaster Ave. Suite T-2
Berwyn, PA 19312
www.harveymortensen.com
(610) 408-8388 (610) 408-8378 fax*

Taxable Income of Trusts/Estates

- Section 641(b): TI shall be computed in the same manner as an individual except as otherwise provided in Subchapter J.
- Gross Income: Section 61: income from whatever source derived.
 - Estates: Income from Probate Assets
 - Trusts: Income from Trust Assets

81

Deductions

- Deductions: All allowable deductions plus:
 - Charitable Deductions: 642(c)
 - Net Operating Loss: 642(d)
 - Depreciation: 642(e)
 - Amortization: 642(f)
 - Disallowance of Double Deduction: 642(g)
- Income Distribution Deduction: 651 & 661

82

Personal Exemption

- Section 151: personal exemption for individuals. Does not apply to trusts and estates.
- Section 642(b):
 - Estates: \$600
 - Trusts with required income distribution: \$300
 - All other trusts: \$100

83

Complex Trusts & Estates

- Amount of Deduction: Section 661(a)(1)-(2)
 - Section 661(a)(1)-(2): "... there shall be allowed a deduction in computing TI of an estate or trust [other than a simple trust], the sum of
 - (1) any amount of income ... required to be distributed currently (TIER 1); and
 - (2) any other amounts properly paid or credited or required to be distributed ... (TIER 2);
 - but such deduction shall not exceed the DNI of the estate or trust.

84

Complex Trusts: Limitation

- Section 661(c):
 - Limitation on Deduction: No deduction shall be allowed ... in respect of any portion of the amount allowed as a deduction ... consisting of any item of DNI which is not included in gross income of the trust or estate.

85

DNI

- Section 643(a): TI with modifications
 - (1) Deduction for distribution
 - (2) Deduction for personal exemption

86

DNI cont.

- (3) Capital Gains and Losses: Excluded to the extent allocated to principal and not (a) paid, credited or required to be distributed to any beneficiary, or (b) paid, permanently set aside or used for charitable purposes under 642(c).

87

DNI cont.

- (4) Extraordinary dividends and stock dividends for simple trusts
- (5) Tax-exempt interest: Include tax-exempt interest under Section 103, reduced by any amount which would be deductible under Section 265.

88

Character of Income

- 662(a): Inclusion
 - **(1) Tier 1:** The amount of income required to be distributed, whether distributed or not.
 - **(2) Tier 2:** All other amounts properly paid, credited or required to be distributed.
 - Treas. Reg. Section 1.662(a)(3).
 - If the sum of amount required to be distributed plus all other amounts properly paid, credited or required to be distributed exceeds the DNI, then include in gross income a pro rata portion.

89

Character of Income (continued)

- 662(b): Character of Amounts
 - Character to the beneficiary is the same as the character to the estate or trust.
 - Unless the will or trust specifically allocates classes of income to specific beneficiaries, then amounts from 661(a) shall consist of the same proportion of each class of item entering into DNI as the total bears to total DNI.
 - Each Beneficiary receives the same proportion of each class. Treas. Reg. Section 1.662(b)(1).

90

Estates: How Does DNI Get Out?

- **Function:** an estate is created to collect the assets of the decedent, pay the debts, and distribute the assets to the heirs.
- The distributions of estate assets to the beneficiaries is the mechanism to carry out DNI to the beneficiaries.

91

Types of Distributions

- Specific Gifts of Money or Property
 - “I give Bob \$10,000”
 - “I give Bob my 1979 Green Gremlin”
- Formula Bequests
 - “I give my wife . . . (see handout)”
- Residuary Bequests
 - “All the rest and residue . . . I give to Sally.”

92

Estate Distribution Diagram

ESTATE

First SPECIFIC BEQUESTS

Second RESIDUE

Note: if the estate is insufficient to pay all of the specific bequests and the residue, then the residue loses.

93

Distributions that Carry Out DNI

- Once we have determined the type of distributions, the next step is to identify distributions that carry out DNI.
- Section 661(a)(1)-(2): distributions are income required to be distributed plus any other amounts actually distributed.
- Section 663(a): defines distributions that are excluded (do not carry out DNI).

94

Section 663(a): Specific Bequests

- (1) Any amount properly paid as a gift of a specific sum of money or specific property and paid in not more than 3 installments.
- Treas. Regs. Section 1.663(a)-1(b).
 - Must be ascertainable under terms of will.
 - Executor’s discretion as to which assets and payment of post-death expenses will disqualify most “formula clauses.”

95

Examples:

- (1) Estate to be given \$5,000 to A, 1,000 shares of stock to B, and balance distributed evenly to C and D.
 - Does your answer change if A received stock worth \$5,000 instead of cash.
- (2) Estate to be given to A and B evenly. A decides to take \$40,000 of stock.
- (3) See. 1.663(a)-1(b)(3), Example 3

96

Installments

- **663(a)(1) and 1.663(a)-1(c):** not more than 3 installments, but apply these rules
 - (1) Gifts of personal property are disregarded
 - (2) Specific bequests of real estate are excluded
 - (3) All bequests where no time is specified for payment are considered paid in 1 installment.
 - (4) All gifts payable at any one specified time are treated as one installment.
- Decedent’s estate and testamentary trust are treated separately.

97

Valuing the Property for DNI

- After identifying the distributions that count for purposes of carrying out DNI, the next step is to determine the value of property distributed.
- Section 643(e)(2) states that distributions other than cash carry out DNI at the lesser of adjusted basis (in the hands of the beneficiary) or FMV.

98

Hypo: Estate w/Property Distributions

- Assume the decedent left her entire estate to A and B. The estate has DNI of \$20,000 and the executor distributes stock worth \$20,000 with an adjusted basis of \$10,000 to A.
- How much DNI does A receive?
A would pull out \$10,000 of DNI; the lesser of AB or FMV.

99

Beneficiary's Adjusted Basis

- **643(e)(1):** the beneficiary who takes a property distribution from an estate or trust will have an adjusted basis equal to
 - (1) the adjusted basis of the property to the estate or trust; plus
 - (2) any gain or loss recognized to the estate or trust on the distribution.

100

Gain/Loss on Distributions

- Assume Bob is entitled to a \$10,000 cash bequest from an estate, and the executor distributes stock worth \$10,000 with a basis of \$8,000.
- Is Bob in the same economic position?
- Who should recognize the \$2,000 capital gain on the stock?
- What is Bob's basis in the stock?

101

Distributions in Satisfaction of Pecuniary Bequests

- **General Rule:** any distribution of property in satisfaction of a pecuniary amount will cause gain recognition to the trust/estate.
- **What is a pecuniary amount?**
 - Specific Bequests of Money
 - Pecuniary Formula Bequests
- **What is not a pecuniary amount?**
 - Residuary Bequests
 - Specific Bequests of Property

102

Distributions Not in Satisfaction of A Pecuniary Amount

- **643(e)(3): Election to Recognize Gain:** the executor or trustee has the discretion to elect to recognize gain on the distribution of property not in satisfaction of a pecuniary amount.
- **Basis Effect:** if the election to recognize gain is made, the beneficiary's adjusted basis in the asset is increased by the gain.

103