

Tax Management Portfolios
Estates, Gifts and Trusts Series
852-2nd : Income Taxation of Trusts and Estates

TITLE PAGE

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This portfolio revises and supersedes 852 T.M., Income Taxation of Trusts and Estates. Portfolio 852 T.M. should be discarded.

PORTFOLIO DESCRIPTION SHEET

Portfolio Description Sheet

Tax Management Portfolio, Income Taxation of Trusts and Estates, No. 852-2nd, provides detailed coverage of the rules governing the income taxation of estates, trusts, and their beneficiaries.

The Portfolio discusses the types of entities covered by the rules of Subchapter J of the Code, including the practical problems which can occur if an entity is classified as a business entity instead of a trust or the administration of an estate is unduly prolonged.

The Detailed Analysis provides comprehensive coverage of the rules governing the gross income and exclusions of an estate or trust, allowable deductions, and credits. The Portfolio includes a detailed discussion of the rules concerning the interrelationship of the taxation of estates and trusts and their beneficiaries. The concept of distributable net income and its applicability in determining the taxation of simple trusts, complex trusts, and estates and their respective beneficiaries are analyzed in depth. This analysis includes the appropriate methods to determine the distribution deduction

resulting from distributions to beneficiaries of simple trusts, complex trusts, and estates. The rules regarding the manner of determining the income taxable to beneficiaries, whether it be cash or distributions in kind, also are explained. It also addresses significant changes made by the Taxpayer Relief Act of 1997, including the repeal of the throwback rules, the election to treat the decedent's revocable trust as part of the decedent's estate, and the simplified taxation available for pre-need funeral trusts, as well as the impact of related IRS regulations.

Throughout the Portfolio, practical applications of these rules are included.

The Portfolio gives a comprehensive analysis of the tax issues that arise in the application of Subchapter J to estates, trusts and their beneficiaries. But, certain areas of Subchapter J have been considered in separate Tax Management Portfolios. These Portfolios are 856 T.M., Subchapter J--Throwback Rules (which have been repealed for most domestic trusts); 858 T.M., Grantor Trusts: Sections 671-679; and 862 T.M., Income in Respect of a Decedent.

This Portfolio may be cited as Acker, 852-2nd T.M., Income Taxation of Trusts and Estates.

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of the beneficiary. [FN689]

Example : An estate uses a fiscal year ending June 30. The personal representative made a distribution of DNI to B on June 30, 1999. B uses the calendar year. B will report the gross income from the distribution in 1999, reflecting the trust's taxable DNI from July 1, 1998, to June 30, 1999. Therefore, taxation of the last six months of the trust's DNI in 1998 is deferred until 1999.

Example : If the estate in the above example terminates on November 30, 1999, and distributes five months of DNI to B, B will have DNI from two taxable years of the estate. In 1999, B will include in gross income (subject to characterization) the estate's DNI from July 1, 1998, to June 30, 1999, and from July 1, 1999, to Nov. 30, 1999 (17 months of taxable DNI).

In another rare exception to the symmetry of §§ 661 and 662, a trust will be allowed a distribution deduction under Section 661, but the beneficiary will report income not because of Section 662, but because of another Code provision. For example, an employees' trust established pursuant to a nonqualified deferred compensation plan is taxed as a trust and can take a distribution deduction, but the employee/beneficiary will be taxed under the rules relating to nonexempt employees' trusts. [FN690]

G. Distributions in Kind

An estate or trust may make distributions in cash and in kind. If the distribution is in kind, several issues arise:

- (1) Does the estate or trust realize gain or loss as a result of the disposition, and if a loss is realized, is it deductible;
- (2) If gain or loss is realized, but not recognized, may the estate or trust elect to recognize such gain or loss;
- (3) Is any gain or loss is taken into account in computing DNI;
- (4) What is the value of the property that the estate or trust must use to compute its distribution deduction; and
- (5) What is the basis to the beneficiary who receives the distribution in kind.

1. First Issue: Realization of Gain or Loss on Distribution in Kind

If a personal representative or trustee distributes property other than cash to a beneficiary, the distribution may be treated as a taxable disposition, depending upon the facts and the rights of the beneficiary. Distributions in kind arise in various contexts. For example:

A beneficiary may be entitled to receive a distribution of income, but instead may consent to a distribution of other property.

A beneficiary may be entitled to receive a distribution of specific property and receive a distribution of that specific property.

A specific devisee may agree to receive different property in lieu of the specifically devised property.

A beneficiary may be entitled to receive a certain amount of cash, payable out of income or principal, and may receive a distribution in kind.

A beneficiary may be entitled to receive a distribution of a percentage of the trust assets and may receive a distribution in kind.

A trustee may have discretion to distribute principal and may exercise the discretion and make a distribution in kind.

Not all of these distributions result in gain or loss to the estate or trust. One must ask: is a beneficiary who is entitled to a pecuniary amount instead receiving property in kind; is a beneficiary who is entitled to one type of property, such as income or specific property, instead receiving other property? In other words, is the fiduciary using appreciated or depreciated property to satisfy an obligation to distribute money, income, or other specific property? [FN691] These issues and their answers originate from two trust cases: *Suisman v. Eaton* [FN692] and *Kenan v. Comr.* [FN693]

In *Suisman*, a father created a testamentary trust for the benefit of his children and wife. The trustee was required to "pay to each of my children at their arriving at the age of twenty-five years, the sum of Fifty Thousand Dollars (\$50,000)." The court construed this as granting each child the "equitable right to receive the sum of \$50,000 in cash from the general assets of the trust principal, upon attaining the age of 25 years." No child had the right to receive any specific trust property. In 1924, when the eldest child reached 25, the trustee, with the consent of the other beneficiaries, transferred 92 shares of life insurance company stock in satisfaction of her right to receive \$50,000. The court held that the trustee's transfer of stock was a sale or other disposition, resulting in gain to the trust.

In *Kenan*, an aunt created a residuary trust for her niece and provided that when the niece reached 40 "or as soon thereafter as compatible with the interests of my estate [the trustees] shall pay to her the sum of Five Million

(\$5,000,000.00) Dollars." The trustees also had the right "to substitute for the payment in money, payment in marketable securities of a value equal to the sum to be paid, the selection of the securities to be substituted in any instance, and the valuation of such securities to be done by the Trustees and their selection and valuation to be final." The Second Circuit held that the niece had no right to any specific trust assets; she was entitled to \$5,000,000 in cash or other property, no more, no less. Thus, she was not affected by the appreciation or depreciation of any specific trust assets. In 1935, when the niece reached 40, the trustee decided to pay her \$5,000,000, partly in cash and partly in securities. The court held that the trust realized a gain when it transferred appreciated securities to the niece, even though it did so at the trustee's discretion.

In Suisman, the trust made the distribution in kind with the beneficiaries' consent. In Kenan, the fact that the trustees could do so without the consent of the beneficiary was considered irrelevant. In addition, the distribution qualified as "a sale or exchange" for purposes of obtaining capital gains treatment for the trust.

These two cases have been applied to distributions in kind when made to satisfy a beneficiary's right to receive income in cash, [FN694] to satisfy a beneficiary's right to receive an annuity; [FN695] to satisfy a beneficiary's right to receive a pecuniary legacy of money; [FN696] and to satisfy a marital deduction pecuniary amount formula clause. [FN697] Gain is recognized whether the distribution to the beneficiary qualifies as a "specific sum of money" under Section 663(a)(1) or results in a distribution deduction to the estate or trust. [FN698]

The IRS also has applied the principle of these cases to an equalization provision of a residuary clause. In [Rev. Rul. 82-4](#), [FN699] a father gave stock to one of his sons. His will provided for his residuary estate to be distributed equally between his two sons, except that the executor was required to take into account the date of death value of the stock transferred to the first son. This equalization provision required the executor to pay out of the residue a specific sum of money to the second son based on the date of death value of the gifted stock. Thus, any appreciated property transferred to satisfy that amount resulted in gain to the estate.

By contrast, the [IRS ruled in Rev. Rul. 72-295](#) that a bequest of \$8x worth of Y stock, valued at the date of distribution, was not a bequest of a specific dollar amount. [FN700] Under the facts, 64 shares of Y stock were distributed to satisfy the executor's obligation to distribute \$8x worth of stock. Because the number of shares to be distributed was not ascertainable at the date of death, it was not a bequest of specific property under Section 663(a). Furthermore, the distribution did not result in gain or loss to the estate. The difference between the rulings is that in [Rev. Rul. 82-4](#), a specific sum of money, measured by the value of stock at the date of death, was bequeathed to

the beneficiary, while in [Rev. Rul. 72-295](#), the beneficiary, though entitled to specific property (stock), was not entitled to a specific number of shares determined as of the date of death.

The circumstances in which gain (or loss) may occur are described further in the following paragraphs and examples.

A disposition may occur if a beneficiary of an estate or trust has the right to receive a dollar or pecuniary amount -- a general legacy or bequest under state law. If the executor is authorized to satisfy the pecuniary amount with property in kind and elects to do so, the estate is treated as selling the property, and will realize a gain or loss, depending on the adjusted basis of the property distributed. [FN701]

Example : D bequeaths \$100,000 to B. The personal representative has the right to satisfy this bequest by distributing cash or property in kind. The personal representative distributes real estate with a fair market value of \$100,000. The adjusted basis of the real estate is \$75,000. The estate realizes a gain of \$25,000 on the transfer (\$100,000 - \$75,000). [FN702]

A disposition may occur when a marital deduction devise is funded, whether outright or in trust. If the will uses a pecuniary amount formula clause, the surviving spouse or the marital trust will be entitled to receive a pecuniary amount. If the personal representative satisfies that amount by making distributions of non-cash property, the personal representative will be treated as having disposed of the property in a taxable transaction. [FN703] Thus, gain or loss will be realized, depending upon the fair market value and the adjusted basis of the property distributed.

Example : D's will used a pecuniary formula marital deduction clause. His wife is to receive "an amount equal to the smallest amount which will result in the least possible federal estate tax." The personal representative may satisfy the devise in cash or in kind, or both. The marital devise is calculated to be \$250,000. The personal representative distributes to the wife \$200,000 cash plus \$50,000 worth of stock. The adjusted basis of the stock is \$35,000. The estate realizes \$15,000 of gain on the transfer (\$50,000 - \$35,000). If the adjusted basis of the property had been \$60,000, the estate would have realized a loss of \$10,000 (\$60,000 - \$50,000). If the adjusted basis had been \$50,000, no gain or loss would have been realized.

Example : G's will also used a similar pecuniary formula marital deduction clause. At G's death, he had \$500,000 of accounts receivable which are IRD. G's personal representative assigns these accounts to the marital deduction trust in partial satisfaction of the amount due the trust. The distribution triggers recognition of the IRD to the estate. [FN704] Because the gain is ordinary income, it is included in DNI, and the distribution will give rise to a tier two distribution deduction. Thus, the distribution should carry out DNI to the

marital deduction trust, which will have income for tax purposes, but no money with which to pay the tax.

By contrast, the pro rata funding of a fractional share marital deduction clause will not result in gain or loss to an estate because a fractional share is not a pecuniary amount. [FN705] In addition, if a residuary devise to a surviving spouse qualifies for the marital deduction, the distribution of the residue in kind to the surviving spouse should not result in any gain or loss to the estate.

A disposition may occur when a beneficiary has a right to receive income, but agrees to receive other property instead. A beneficiary who is entitled to receive all of the current income of a trust expects and has a right to receive a distribution of that income. If that income is in the form of cash, but the beneficiary receives other property, the trust is treated as having sold the property to the income beneficiary. [FN706] If the trust received income in a form other than cash, then it is unclear whether a distribution of that specific non-cash income would be treated as a sale or exchange. It should not; but if it were, the trust's basis in the asset should equal the amount of the income received. Thus, any gain or loss would result only from short-term appreciation or depreciation.

Example : B has the right to receive all of the income of a trust created by his grandfather. The income for 1998 is \$50,000. Instead of distributing \$50,000 to B, the trustee and B agree to distribute to B \$40,000 in cash plus a bond worth \$10,000. The bond was purchased by the trustee for \$8,000, which is its adjusted basis. The trust realizes a \$2,000 gain on the distribution (\$10,000 - \$8,000), [FN707] the same gain the trust would have if it had distributed \$8,000 to B and then sold the bond to B. [FN708] The trust is entitled to a distribution deduction. But if the gain recognized on the disposition of the bond is capital gain and is not a part of DNI, the gain will be taxed to the trust.

A disposition may occur when a trustee is required to distribute an annuity to a beneficiary and distributes property in kind to the annuity beneficiary. To the extent the annuity was paid out of income, no taxable disposition should occur. To the extent the annuity was paid out of principal, a taxable disposition will occur. In [Rev. Rul. 83-75](#), [FN709] the trustee of an irrevocable trust was required to pay qualified charities an annuity equal to 8% of the initial fair market value of the stock transferred to the trust. The annuity was to be paid out of income, then capital gains, then principal. In 1983, there was insufficient income and capital gains, so the trustee distributed \$48x worth of stock. The basis of the stock was \$38x. The IRS ruled that the trust had gain of \$10x (\$48 - \$38x) because it transferred appreciated stock to satisfy its obligation to pay a fixed annuity amount.

2. Subsidiary Issue: Disallowance of Losses Between Related Parties -- Section 267

Section 267 prevents the recognition of losses that arise from transactions between certain parties. Section 267 is intended to prevent related parties from agreeing to create losses for income tax purposes. For purposes of Section 267, related parties include a fiduciary of a trust and a beneficiary of the same trust; [FN710] a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts; [FN711] and, for tax years beginning after August 5, 1997, an executor of an estate and a beneficiary of the estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest. [FN712]

The legislative history of Section 267(b)(13) states that the Section 267 loss disallowance rule should apply to estates and their beneficiaries for the same reasons it applies to trusts and their beneficiaries. [FN713] Section 267(b)(13), however, does not totally conform the treatment of estates to the treatment of trusts because it continues to allow losses to be deducted for in-kind distributions made to satisfy a pecuniary bequest.

If a trust realizes a loss on the distribution of depreciated property to a beneficiary in satisfaction of a pecuniary amount or other specific property, Section 267 prevents the trust from deducting the loss. The deduction is not lost forever -- it is merely suspended until further disposition. If the beneficiary sells or exchanges the property thereafter, any gain realized on the sale will be offset by the disallowed loss.

Example : B is entitled to receive a distribution of \$10,000 from the trust on her 21st birthday. The trustee distributes a bond worth \$10,000, with an adjusted basis of \$13,000, to satisfy her right to the \$10,000 distribution. The trust realizes a loss of \$3,000 but is not entitled to deduct the loss. B's basis in the bond is \$10,000. If she sells the bond for \$11,000, she will realize a gain of \$1,000. The gain, however, will not be recognized because of the \$3,000 loss disallowed to the trust. The remainder of the \$2,000 loss does not benefit her, because she sold the bond for less than a \$3,000 gain. If she sold the bond for \$15,000, she would realize a gain of \$5,000, but she would only have to recognize \$2,000 of the gain.

3. Second Issue: Election to Recognize Gain or Loss

When an estate or trust distributes property other than cash to a second-tier beneficiary, the estate or trust can elect to treat the distribution as a sale to the beneficiary and recognize gain or loss on the distribution. [FN714] Section 643(e)(3) implies that a fiduciary may elect to recognize a loss from a distribution to a beneficiary; however, if the election is made, the loss will

be disallowed under Section 267. [FN715]

Generally, as shown above, beneficiaries are taxed on amounts distributed from a trust or estate to the extent of the taxable portion of DNI, and the trust or estate is allowed a deduction for amounts taxed to its beneficiaries. Prior to the enactment of Section 643(e), if property (instead of cash) was distributed, the regulations under Section 661 allowed a possible tax-free step up in basis in the assets distributed. The regulations provide that:

- no gain or loss is realized by the trust, estate or beneficiaries;
- the fair market value of the property at the time of distribution determines the amount deductible by the trust or estate and includible in the gross income of the beneficiary; and
- the basis of the property in the hands of the beneficiary is its fair market value at the time it was distributed, to the extent that value is included in the gross income of the beneficiary. [FN716]

Therefore, if a trust or estate has DNI, a distribution of appreciated property to a beneficiary would result in a step-up in the basis of the property, and the gain that otherwise would have been recognized upon a sale or exchange of the property is avoided.

To end this unwarranted benefit, the Tax Reform Act of 1984 added Section 643(e), which provides that whenever property (other than cash) is distributed

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- the estate or the trust may elect to recognize gain or loss in the same manner as if the property had been sold to the distributee at its fair market value;
- if the election is made, the amount treated as a distribution deduction under Section 661(a)(2) and as distributed to the beneficiary under Section 662(a)(2) is equal to the fair market value of the property distributed;
- if no election is made, the amount used for purposes of §§ 661(a)(2) and 662(a)(2) is either (i) the adjusted basis of the property to the estate or trust immediately before the distribution, or (ii) the fair market value of the property, whichever is less;
- the basis of any property received by a beneficiary will be the adjusted basis of the property to the estate or trust immediately before the distribution (that is, a carryover basis), adjusted for any gain or loss recognized by the estate or trust.

Note : If property has declined in value, the amount taken into account

under § § 661(a)(2) and 662(a)(2) will be the property's fair market value, whether or not an election is made.

Whether an election should be made requires careful analysis by the fiduciary, because the decision to recognize or not to recognize gain or loss shifts tax consequences between the estate or trust and the beneficiaries. This is especially true when the fiduciary contemplates a distribution of appreciated property.

When appreciated property is distributed to a beneficiary and no election is made under Section 643(e), the beneficiary takes the property with the same basis that the estate or trust had in the property. The recognition of any unrealized gain will either be deferred until the property is sold or exchanged in a taxable transaction, or will be eliminated if the property is held by the beneficiary until his death and the general basis rules of Section 1014 apply. Therefore, this ability to defer, and possibly eliminate, recognition of gain is a reason for the fiduciary not to elect to recognize the gain in the estate or trust when distributing appreciated property, unless the estate or trust has losses or deductions that can be used to significantly reduce or eliminate the gain.

Potential recognition of gain is not the only concern of the fiduciary; the amount and character of the income taxable to the estate or trust and the beneficiaries may be affected by the fiduciary's decision whether or not to elect to recognize gain.

Example : Trust X has DNI of \$3,000 and the trustee distributes appreciated capital gain property that has an adjusted basis of \$1,000 and a fair market value of \$2,500 to its beneficiary. If a Section 643(e) election is made, the beneficiary will have a basis of \$2,500 in the property and, pursuant to Section 662(a)(2), will recognize ordinary income of \$2,500. But if no election is made, the beneficiary will have a basis of \$1,000 in the property and will recognize ordinary income of \$1,000. Therefore, if no election is made, the beneficiary benefits by having \$1,500 of ordinary income converted into potential capital gain. On the other hand, if the Section 643(e) election is not made, the trust suffers by converting \$1,500 of capital gain into \$1,500 of ordinary income, the cost of which may be borne by the remaindermen.

Similarly, the impact of the Section 643(e) election must be analyzed when there are multiple beneficiaries.

Example : Trust Y has DNI of \$3,000 and the trustee, exercising its discretion, distributes \$5,000 in cash to beneficiary C and property with a basis of \$2,500 and a fair market value of \$5,000 to beneficiary D. If no election is made, then, for purposes of Section 662(a)(2), D is treated as receiving \$2,500 and, therefore, will recognize only \$1,000 of ordinary income,

while C will recognize \$2,000 of ordinary income. If an election is made to recognize gain in the trust, both C and D are treated as receiving equal amounts under Section 662 and, hence, both will recognize ordinary income of \$1,500. Note : If the fiduciary elects to recognize the capital gain, but distributes the capital gain property (as would occur in the final year of the estate or trust), any capital gain thus recognized by the estate or trust would be distributed among and taxable to the beneficiaries.

Example : A trustee distributes property with a basis of \$10,000 and a fair market value of \$15,000, and the trust has DNI of \$12,000. If no election to recognize gain is made, the trust will have \$2,000 of ordinary income. If the trustee elects to recognize gain, the trust will have \$5,000 of capital gain. [FN717]

If a trustee distributes appreciated property to a beneficiary and the property is depreciable by the beneficiary, any gain recognized by the trustee will be ordinary income. [FN718] The same is true for estates, for tax years beginning after August 5, 1997, except in the case of a sale or exchange in satisfaction of a pecuniary bequest. [FN719]

Where property has declined in value, the analysis for the fiduciary is simpler. In the case of a trust and, after 1997, an estate, regardless of whether the fiduciary elects to recognize loss upon a distribution of property, the tax results under Section 643(e) to the trust or estate and to beneficiaries will be the same. Although gain or loss is recognized as though the property had been sold to the distributee at its fair market value, Section 267 disallows the deduction for losses from a sale or exchange of property between a fiduciary and a beneficiary of the same trust or estate. Therefore, whether or not the election is made, no loss will be recognized by the trust or estate. [FN720]

Further, under either event, the amount taken into account under §§ 661(a)(2) and 662(a)(2) will be the fair market value of the property, and the basis of the property in the hands of the beneficiary will be the same as the trust's or estate's basis in the property immediately before the distribution.

An election under Section 643(e) should be made by the estate or trust on its return for the taxable year for which the distribution was made. The election applies to all distributions made during the year, other than distributions described in Section 663(a). [FN721] Once made, the election may be revoked only with the consent of the Secretary. [FN722] The election can, however, be made on a year-by-year basis.

The election will not affect the recognition of gain or loss on distributions that satisfy pecuniary amounts, or on distributions of property other than the specific property required to be distributed, because recognition of such gains and deductible losses is mandatory. Thus, the gains

or losses mandated by Kenan and discussed in V, G, 1, above, are mandatory and not subject to this election.

4. Third Issue: Is the Gain or Loss Included in DNI?

If an estate or trust recognizes gain or loss on a distribution, by election or otherwise, the gain or loss may or may not be included in DNI. If the gain or loss is ordinary (not from the sale of a capital asset), it should be included in DNI. If the gain or loss is from the sale or exchange of a capital asset in the year of termination, the resulting gains (and losses up to gains) also will be in DNI. [FN723]

If an estate or trust recognizes a capital gain or loss on a distribution by election or by satisfaction of an obligation, one issue is whether the gain or loss would be included in DNI if the fiduciary had sold the asset and distributed the proceeds. Inclusion of the capital gains (and losses) in DNI will affect the character of distributions to beneficiaries. In addition, it will increase the distribution deduction and gross income of the beneficiaries if distributions exceed the amount of DNI computed without including the gain, so that the gain is effectively taxed to the beneficiaries rather than the estate or trust.

The test under Section 643(a)(3) is whether the capital gains are allocated to income, or are allocated to principal and actually paid, credited, or required to be distributed. The test under the regulations when capital gains are allocated to principal is whether they are actually distributed to beneficiaries, used in determining the amount distributed, or required to be distributed. [FN724] Under the examples in the regulations, this turns on whether capital gains that are allocated to principal also are allocated by the fiduciary under the governing instrument or state law to a beneficiary receiving a distribution. This is shown in the examples when the fiduciary has sold an asset for a gain, and has established a regular practice of distributing the exact net proceeds. [FN725]

It also is shown when the fiduciary is required to distribute a percentage of principal, sells assets, distributes the proceeds, and allocates the gain to such beneficiary under the governing instrument and state law. [FN726] One example provides that if the trustee is required to distribute one-half of the principal, sells one-half of the principal, distributes all of the proceeds, and allocates all of the gain to a beneficiary, it will be included in DNI. Alternatively, if the trustee sells all of the assets, distributes one-half of the proceeds, and allocates one-half of the gain to the beneficiary, then only half of the gain will be in DNI. [FN727] It is difficult to predict how these tests and examples relate to capital gains resulting from distributions, but some generalizations are possible.

Tax Management Portfolios
Estates, Gifts and Trusts Series
855-1st : Estate and Trust Administration -- Tax Planning

TITLE PAGE

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PORTFOLIO DESCRIPTION SHEET

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Tax Management Portfolio, Estate and Trust Administration -- Tax Planning, No. 855, discusses aspects of tax planning in connection with the administration of an estate or trust. This Portfolio includes, but is not limited to, the subject of after-death tax planning.

In administering an estate or trust, the fiduciary has numerous options available to minimize taxes. These options are analyzed from the standpoint of the income, estate, gift, and generation-skipping tax laws. Options that must be considered by a fiduciary include: (1) splitting gifts, (2) claiming administration expenses as income expenses, (3) using the entity as a separate taxpayer, (4) disclaimers, and (5) options relating to interests in partnerships and corporations.

The timing and type of distributions from an estate or trust can affect the income tax consequences of both the estate or trust and its beneficiaries. The fiduciary can distribute income currently or retain it, thereby using the estate or trust as a separate taxpayer. The fiduciary can also time distributions to make use of deductions. In distributing property in kind, the estate or trust can elect to recognize the gain or loss.

Many of the post-mortem estate planning options discussed in this Portfolio cannot be utilized by unilateral action of the executor; the

cooperation (or at least the consent) of others is required. In addition, the executor must often take timely action to take advantage of a given option. On the other hand, many elections, once made, are irrevocable or difficult to revoke. Thus, the task of post-mortem tax planning is one of the most challenging areas of tax practice.

This Portfolio may be cited as Acker, 855 T.M., Estate and Trust Administration -- Tax Planning.

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represent most of the estate income, that 50% of the receivables will be collected by October 31, and the balance collected over the subsequent six months. As a result, the executor may wish to elect October 31 as the fiscal year to spread roughly equal amounts of income over two tax years. [FN256]

B. Distributions of Property in Kind

Generally, beneficiaries are taxed on amounts distributed from a trust or estate to the extent of the trust's or estate's distributable net income (DNI), and the trust or estate is allowed a deduction for amounts distributed to its beneficiaries. If property, other than cash is distributed, and if Section 643(e) applies, the amount of DNI deemed distributed to the beneficiaries and the distribution deduction allowed to the estate or trust will depend on whether or not the fiduciary has made a Section 643(e) election.

1. When Section 643(e) Election Is Available

Section 643(e) will apply whenever a distribution would carry out distributable net income (DNI) pursuant to Section 661. Or, to state it in the negative, Section 643(e) will not apply to any distribution covered by Section 663(a). [FN257]

Example: John's will bequeaths \$50,000 to Mary. John's executor distributes property to Mary in satisfaction of the bequest. Satisfying the bequest with property is treated as a taxable exchange and there is no election on this point because Section 643(e) does not apply. [FN258]

2. Effect of Section 643(e) Election

Whenever property, instead of cash, is distributed and Section 643(e) applies to the distribution, the estate or trust may elect to recognize gain or loss in the same manner as if such property had been sold to the distributee at its fair market value.

If the election is made, the amount treated as a distribution deduction under Section 661(a)(2) and as distributed to the beneficiary under Section 662(a)(2) is equal to the fair market value of the property distributed. [FN259]

If no election is made, then the amount to be used for purposes of §§ 661(a)(2) and 662(a)(2) is the lesser of (1) the adjusted basis of the property distributed in the hands of the estate or trust immediately before the

distribution, or (2) the fair market value of such property. [FN260] Note: If distributed property has a fair market value less than its adjusted basis, the amount to be used under § 661(a)(2) and 662(a)(2) will be the property's fair market value whether or not the election is made.

The basis of any property received by a beneficiary will be the adjusted basis of such property in the hands of the estate or trust immediately before the distribution, adjusted for any gain or loss recognized by the estate or trust. [FN261]

3. Planning Considerations

Whether or not a Section 643(e) election should be made requires analysis by the fiduciary because the decision to recognize or not to recognize gain or loss can shift tax consequences among the estate or trust and its beneficiaries.

When appreciated property is distributed to a beneficiary and no Section 643(e) election is made, the beneficiary takes the property with the same basis that the estate or trust had in such property and the recognition by the beneficiary of any unrealized gain will either be deferred until such property is sold or exchanged in a taxable transaction, or eliminated if the beneficiary dies with such property and the general basis step-up rules of Section 1014 apply.

Example: A trust distributes securities worth \$10,000 but with a basis of \$6,000 to a beneficiary. No Section 643(e) election is made and, as a result, the beneficiary takes the same basis as the trust, that is, \$6,000. The potential \$4,000 of gain remains unrecognized. The beneficiary holds such securities until his death when the securities are worth \$20,000, and, because of Section 1014, the beneficiary's estate gets a step-up in basis in the securities to \$20,000. The potential gain of \$4,000 existing when the beneficiary received the securities is never recognized.

This ability to defer, and possibly eliminate, recognition of gain is one reason for the fiduciary not to make a Section 643(e) election, unless the estate or trust has losses or deductions that can be used to significantly reduce or eliminate such gains.

Potential recognition of gain is not the only concern of the fiduciary; the amount and character of the income taxable to the estate or trust and the beneficiaries may be affected by the fiduciary's decision whether or not to elect to recognize gain under Section 643(e).

Example: A trust has DNI of \$3,000, comprised of ordinary income. The

trustee distributes to a beneficiary appreciated capital property that has an adjusted basis of \$1,000 and a fair market value of \$2,500. If a Section 643(e) election is made, the beneficiary will have a basis of \$2,500 in the property and, pursuant to Section 662(a)(2), will be treated as receiving \$2,500 of DNI, thereby recognizing ordinary income of \$2,500. The trust will have a distribution deduction of \$2,500, but will now recognize \$1,500 of capital gain.

If no Section 643(e) election is made, the beneficiary will have a basis of \$1,000 in the property, but will recognize ordinary income of only \$1,000 (the DNI deemed distributed to him). Due to the trustee's not making the election, the beneficiary benefits by having \$1,500 of ordinary income converted into potential capital gain. On the other hand, the trust will have a distribution deduction of only \$1,000, thereby converting the \$1,500 of capital gain which would have been recognized if the election had been made into \$1,500 of ordinary income, the cost of which may be borne by the remaindermen.

The impact of a Section 643(e) election also must be analyzed when there are multiple distributees.

Example: Trust Y has DNI of \$3,000 comprised of ordinary income. The trustee, exercising its discretion, distributes \$5,000 in cash to beneficiary J and distributes property with a basis of \$2,500 and a fair market value of \$5,000 to beneficiary B. If no Section 643(e) election is made, then, for purposes of §§ 661(a)(2) and 662(a)(2), B is treated as receiving \$2,500, the basis of the property distributed to him. As a result, B is treated as receiving one-third of the DNI, or \$1,000, while J is treated as receiving two-thirds of the DNI, or \$2,000.

If a Section 643(e) election is made to recognize gain in the trust, both J and B are treated as receiving equal amounts under Section 662(a)(2) and, hence, both will recognize ordinary income of \$1,500. Note: If the fiduciary elects to recognize the capital gain but distributes such capital gain (as would occur in the final year of the estate or trust), any capital gain so recognized would be distributed among and taxable to the beneficiaries.

Further, in the case of a trust, the trustee's decision can affect whether or not the trust will have undistributed net income or an accumulation distribution in the year the property is distributed.

Example: A trustee distributes property with a basis of \$10,000 and a fair market value of \$15,000. The trust has DNI of \$12,000 comprised of ordinary income. If no Section 643(e) election to recognize gain is made by the trustee, the trust will have undistributed net income of \$2,000 (less the amount of taxes imposed on the trust). If the trustee elects to recognize gain, the trust will have made an accumulation distribution and, to the extent the trust has undistributed net income from preceding taxable years, the throwback

rules found in §§ 665-667 will apply to such distribution. Note: The throwback rules have been repealed for domestic trusts created after February 29, 1984 for distributions in trust in taxable years beginning after August 5, 1997.

If a trustee distributes appreciated property to a beneficiary and such property in the hands of the beneficiary will be subject to depreciation, any gain recognized by the trustee will be treated as ordinary income under Section 1239.

Where property has declined in value, the analysis for the fiduciary may be simpler. In the case of an estate or trust, whether or not the fiduciary elects to recognize loss upon a distribution of property, the tax results under Section 643(e) to the trust and beneficiaries will be the same. This is because gain or loss is recognized in the same manner as if such property had been sold to the distributee at its fair market value, and Section 267 provides that no deduction is allowed for losses from sales or exchanges of property between a fiduciary and a beneficiary of the estate or trust. [FN262] Therefore, whether or not the election is made, no loss will be recognized by the trustee. Further, under either event, the amount under §§ 661(a)(2) and 662(a)(2) will be the fair market value of the property, and the basis of the property in the hands of the beneficiary will be the same as the trust's basis in the property immediately before the distribution.

Any election made under Section 643(e) is to be made by the estate or trust on its return for the taxable year for which the distribution was made, and applies to all distributions made during the year other than distributions described under Section 663(a). Once made, the election may be revoked only with the consent of the IRS.

C. 65 Day Election -- Section 663(b)

If within the first 65 days of the taxable year of a trust or an estate [FN263] an amount is properly paid or credited, and if the trustee makes a proper election, the distribution is treated as having been made on the last day of the preceding taxable year for all purposes. [FN264] The election is made on the back page of Form 1041. If no return is required, a statement making the election must be filed with the Internal Revenue office where a return would have been filed. The trustee need not make the 65 day election for all distributions made in the first 65 days, but may designate particular distributions.

Regs. Section 1.663(b)-1(a)(2), although not the statute, restrict the amount that may be elected under the 65 day rule. The amount cannot exceed the accounting income for the prior year, or DNI, if greater, reduced by payments