

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 These Portfolios are 856 T.M., Subchapter J--Throwback Rules (which have been repealed for most domestic trusts); 858 T.M., Grantor Trusts: Sections 671-679; and 862 T.M., Income in Respect of a Decedent.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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trusts for federal income tax purposes and not aggregated into one even though the trusts have the same remainder beneficiary. [FN188]

This statutory multiple trust rule applies for taxable years beginning after March 1, 1984, with respect to trusts created after that date. This rule also applies to irrevocable trusts created on or before March 1, 1984, but only to that portion attributable to contributions to principal after March 1, 1984. [FN189]

The income tax rates for trusts and the limited personal exemption make it hard to save significant amounts of tax by using a trust. A trust might save \$800 to \$900 per year in federal income taxes. The use of multiple trusts could save more tax, but not a significantly large amount. In most cases, the cost of creating and administering separate trusts and the cost of preparing separate income tax returns will eliminate the incentive to create multiple trusts for this purpose. If multiple trusts are created, they should be created for purposes other than to avoid federal income taxes.

If an inter vivos trust exists, and a person desires to create another trust, one should consider whether the additional property should be added to the existing trust or used to fund a new trust. Income tax considerations should be only one factor; other factors include projected costs of administration and other tax consequences, such as estate, gift, or generation-skipping transfer tax consequences. If a will is to be executed with a testamentary trust, one should consider whether the bequest or devise should be poured over into the existing trust or whether the will should create a separate testamentary trust. If a new inter vivos trust or testamentary trust is to be used in addition to the existing trust, one may want the document to reflect why an additional trust was created. Such intent may be reflected in the selection of primary beneficiaries and the distribution provisions as well as in the general intent provisions of the will or the trust.

G. Election to Treat Revocable Trust as Part of the Estate

New Section 645, enacted by the Taxpayer Relief Act of 1997, [FN190] allows the trustee of a decedent's "qualified revocable trust" and the executor of the decedent's estate to make an irrevocable election to treat the trust as part of the decedent's estate (and not as a separate trust) for federal income tax purposes.

According to the House Report, the use of revocable trusts may offer nontax advantages for estate planning as compared to a traditional estate plan. But differences in the federal tax treatment of revocable trusts and estates (e.g., estates are allowed a charitable deduction for amounts permanently set aside for charitable purposes but post-death revocable

trusts are allowed deductions only for amounts actually paid to charities) may discourage individuals from using trusts where they might otherwise be appropriate or efficient. The amendment is intended to minimize the tax differences between estates and trusts that essentially serve the same estate administration function during a reasonable period of administration.

Section 645(a) requires both the trustee and the executor (if one is appointed) to join in the [election. Rev. Proc. 98-13](#), [FN191] which is reproduced in the Worksheets, below, provides guidance as to how the election is made and what the election must include. With respect to who must sign the election, the revenue procedure provides that if there is more than one trustee, only one must sign the required statement, unless otherwise required by the governing instrument or by local law. Similarly, if there is more than one executor, only one need sign the required statement, unless otherwise required by the governing instrument or by local law. If there is no probate estate and, hence, no executor or administrator, the election may still be made. In that case, a tax-identification number must still be obtained for the estate and only a trustee of the qualified revocable trust must sign the required statement; however, the required statement must then include a representation that there is no executor or administrator and that neither an executor nor an administrator will be appointed.

This elective treatment is available for any trust (or portion thereof) that was treated under Section 676 as owned by the decedent because of the decedent's power to revoke the trust (without applying the Section 672(e) rule attributing the powers of the grantor's spouse to the grantor), as defined in Section 645(b)(1). Thus, a trust that is treated as owned by the decedent solely by reason of a power in a nonadverse party would not qualify. Once made, the election is irrevocable and is effective from the date of the decedent's death until two years after his or her death (if no estate tax return is required) or until six months after the final determination of estate tax liability (if an estate tax return is required). [FN192]

The election is made by attaching a statement to the Form 1041 filed for the estate for its first taxable year and to the Form 1041 for the trust for the taxable year ending after the decedent's death. It is not necessary to file a return for the trust if the trust was not required to file a return by reason of Regs. Section 1.671-4(b)(2)(i)(A) or (B), which allow the grantor to report the trust income directly on his or her individual return. The election is considered made when the first of these two Forms 1041 is filed.

The revenue procedure does not provide guidance or answer questions on the potential effect of the Section 645 election.

Query: If the election is made and the estate makes a distribution of a portion of the residuary estate to the trust, does the distribution carry out distributable net income or is it deemed that no distribution occurred for tax purposes because the trust is treated as a part of the estate and, thus, the estate cannot make a distribution to itself?

The answer ought to be that a distribution occurs and that the tax consequences to the estate and trust ought to be determined in accordance with the rules of Subchapter J. This conclusion is based on the apparent intent of Section 645 as permitting an electing trust to be treated as an estate for income tax purposes, but which trust has the same fiscal year as the estate to which it is connected.

The legislative history states that the separate share rule, which was made applicable to estates of decedents dying after August 5, 1997 by amendment to Section 663(c), may apply when a qualified revocable trust is treated as part of the decedent's estate. [FN193] See Prop. Regs. Section 1.663(c)-4(b)(2). [FN194] The Preamble to the proposed regulations says that the IRS will provide further guidance in a separate regulations project on revocable trusts treated as part of an estate. The separate share regulations were made final on December 28, 1999. [FN195]

The election can be made for estates of decedents dying after August 5, 1997. [FN196] Section 645(c) requires the election to be made no later than the time required for filing the income tax return of the estate for its first taxable year, taking into account any extensions.

The Taxpayer Relief Act of 1997 also amended Section 2652(b)(1) to provide comparable treatment for a trust treated as part of the estate for generation-skipping transfer tax purposes. [FN197] This provision was subsequently deleted from Section 2652(b)(1) and added to Section 2654(b) which describes when a trust will be treated as two or more trusts. [FN198]

In [REG-106542-98, 65 Fed. Reg. 79015 \(12/18/00\)](#), the IRS issued Regs. Section 1.645-1 relating to the Section 645 election. Under the proposed regulations, if a personal representative is appointed for the decedent's estate, the personal representative and the trustee of the qualified revocable trust (QRT) make the Section 645 election by attaching a statement to the Form 1041, U.S. Income Tax Return for Estates and Trusts, filed for the first taxable year of the decedent's estate. If a personal representative is not appointed for the decedent's estate, the trustee makes a Section 645 election for the QRT by attaching a statement to the Form 1041 filed for the first taxable year of the trust treating the trust as an estate.

In some instances, the proposed regulations contain different procedures than those provided in [Rev. Proc. 98-13](#), and, when finalized, will replace [Rev. Proc. 98-13](#). [Rev. Proc. 98-13](#), in most situations, requires a trust that will make a Section 645 election to obtain a taxpayer identification number (TIN) and file a Form 1041 for the trust's short taxable year beginning with the decedent's death and ending December 31 of that year. In these situations, [Rev. Proc. 98-13](#) provides that the Section 645 election is made at the time the Form 1041 is filed for the trust. If a Form 1041 is not required to be filed for the trust, the election is considered made when the Form 1041 is filed for the estate. The proposed regulations, however, would provide that if a Section 645 election will be made for a trust, the trustee and the personal representative, if any, may choose not to obtain a TIN for the trust or file a Form 1041 for the trust's short taxable year. The proposed regulations would consider the Section 645 election made only upon the filing of a Form 1041, with the required election statement attached, for the first taxable year of the decedent's estate, or, if there is no personal representative, the first taxable year of the trust filing as an estate.

Further, Prop. Regs. Section 1.645-1 addresses: (1) the general Form 1041 filing requirements and TINs for the decedent's estate and electing trust during the election period; (2) the tax treatment of the electing trust and decedent's estate during the election period; (3) the duration of the election period; and (4) the tax treatment of the decedent's estate and electing trust upon termination of the election period. There are also proposed revisions in Prop. Regs. Section 1.671-4(d) to the reporting rules for grantor trusts. These regulations are proposed to apply on or after the date that the final regulations appear in the Federal Register.

In [Notice 2001-26, 2001-13 I.R.B. 942](#), the IRS announced that estates and qualifying revocable trusts of decedents who die after December 31, 1999, and before the effective date of the final Section 645 regulations may use either the election and reporting procedures set forth in [Rev. Proc. 98-13](#) or the election and reporting procedures set forth in the proposed regulations.

FN29 Section 641(a)(3), (1), and (4).

FN30 Section 641(a)(2). Thus, a custodial account under a state Uniform Transfers to Minors Act would not be a trust and would not be subject to Subchapter J. [Anastasio v. Comr., 67 T.C. 814](#), aff'd mem., [573 F.2d 1287 \(2d Cir. 1977\)](#); [Rev. Rul. 59-357, 1959-2 C.B. 161](#).

FN31 Section 641(a)(2), (4), and (1).

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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FN44 Section 7517.

FN45 Regs. Section 301.7517-1.

IV. OPTION TO TREAT REVOCABLE TRUST AS PART OF ESTATE

A. General

For decedents dying after August 5, 1997, an election may be made to treat any trust revocable by the decedent as part of the decedent's estate for federal tax purposes. [FN46]

The election must be made by the executor and the trustee no later than the due date of the fiduciary income tax return for the estate, with regard to extensions. The election is irrevocable. [FN47]

The election is effective for all taxable years of the estate until six months after the final determination of the federal estate tax liability. If no federal estate tax return is required, the election is effective for two years from the date of death. [FN48]

There are two methods for making the election. The first method, described in [Rev. Proc. 98-13, 1998-4 I.R.B. 21](#), is mandatory for elections made for trusts of decedents dying before January 1, 2000, and may also be used by trusts of decedents dying on or after that date. The second method, described in Prop. Regs. Section 1.645-1, may be used by trusts of decedents dying after December 31, 1999. Although the proposed regulations state that they will not be effective until published as final regulations, in [Notice 2001-26, 2001- 13 I.R.B. 942](#), the IRS stated that the election procedure in the proposed regulations may be used by trusts of decedents dying after December 31, 1999.

The election method under Prop. Regs. Section 1.645-1 is generally preferable to that under [Rev. Proc. 98-13](#). Under the proposed regulations, the election may be made on the first income tax return of the estate, which eliminates the need to file any separate return for the trust during the period subject to the election. The procedure under [Rev. Proc. 98-13](#), however, requires that the election be made on a separate income tax return of the trust, if the due date of that return would be earlier than the due date of the first income tax return of the estate. Since estates often use a fiscal year that ends after the calendar year of the decedent's death, in most cases it would be necessary to file a trust return for the calendar year of the decedent's death in order to make the election.

B. Observations

1. Potential Benefits

This election allows a trust to be treated as an estate for a limited period and take advantage of those tax rules that apply to estates. These would include:

- being entitled to the charitable set aside deduction under Section 642(c);
- recognizing loss upon the satisfaction of a pecuniary bequest with assets that have a fair market value less than basis pursuant to Section 267(b)(13);
- having the active participation requirements under the passive loss rules waived for tax years ending less than two years after the decedent's death pursuant to Section 469(i)(4);
- getting deductions for amortization of reforestation expenditures specifically disallowed to trusts under Section 194(b)(3), but allowed to estates under Section 194(b)(4); and
- using the estate's fiscal year for income tax purposes.

In [T.D. 8849, 64 Fed. Reg. 72540 \(12/28/99\)](#), the IRS issued Regs. § § 1.663(c)-2, -4, and -5. The regulations state that a qualified revocable trust for which an election is made under Section 645 will always be considered a separate share of the estate and may itself contain two or more separate shares. The preamble to the final regulations indicates that qualified revocable trusts are governed by the separate share rules for estates, rather than trusts, regardless of whether the trust elects to be treated as part of the estate.

The final regulations are generally effective for estates and qualified revocable trusts regarding decedents who die after December 28, 1999. For estates and qualified revocable trusts of decedents who died after August 5, 1997, but before December 28, 1999, the IRS stated that it will accept any reasonable interpretation of the separate share provisions, including those based on the proposed regulations. Regs. Section 1.663(c)-6.

2. Potential Detriments

An executor is defined as the executor or administrator of the decedent,

or, if there is no executor or administrator, any person in actual or constructive possession of any property of the decedent. [FN49] This provision states that it is in connection with the estate tax. The election to treat a revocable trust as part of the estate is an income tax section and, thus, does the definition of an executor under Section 2203 apply to the Section 645 election?

If the Section 2203 definition does apply to Section 645 and if no executor or administrator has been appointed, may any person who has possession of any property of the decedent make the election with the trustee, or must all such persons make the election?

If the Section 2203 definition does not apply to Section 645, must an executor be appointed to make the election when an executor otherwise would not have been appointed?

Other questions are raised by the Section 645 election. Because the trust is treated as part of the estate and not as a separate trust, are transfers from the estate to the trust disregarded for income tax purposes?

Example: A Section 645 election is made. During the taxable year, the estate distributes property to the trust which, normally, would have carried out DNI to the trust. If no DNI is deemed distributed because the estate is considered to have distributed property to itself, is the estate primarily liable for the income taxes? If the beneficiaries of the estate and the trust are not the same, should some equitable adjustment be made?

May the estate and trust exchange assets without tax consequence because the trust is considered a part of the estate?

These issues should ideally be addressed by regulations. Observation: If Congress wanted to allow revocable trusts to be taxed under rules applicable to estates, instead of stating that such trusts are a part of the decedent's estate, it could have stated that such trusts will be treated as if they were estates for all tax purposes, but not a part of the decedent's estate, but having a fiscal year the same as the decedent's estate.

FN46 Section 645.

FN47 Section 645(c).

FN48 Section 645(b)(2). See [Rev. Proc. 98-13, 1998-4 I.R.B. 21](#), for the rules regarding how the election is made.