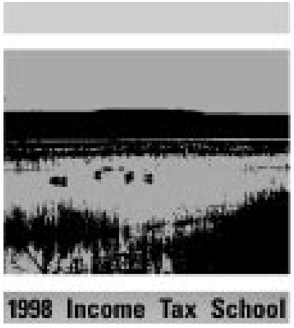


THE INCOME TAXATION OF TRUSTS AND ESTATES—III

Review of Taxation of Income and Distributions of an Estate or Trust **161**

A. Introduction **161**
A decedent's estate is a taxpaying entity.

B. Income vs. Inheritance **161**
Distributions from estates must be allocaed between income and inheritance.

C. Nonprobate Assets [I.R.C. §641] **161**
Assets that are not part of the probate estate do not carry out DNI to the beneficiary.

D. Effect of State Law on Classification of Income **162**
Federal tax law preempts state-law rules on taxation of interest and dividends, but state law controls the taxation of income from real estate.

E. Taxable Year of Estate **162**
Flexibility in defining the estate's tax year allows the executor to minimize income taxes.

F. Tax Rates for Estates or Trusts **162**
The first $1,700 for tax years beginning in 1998 of taxable income of an estate or trust is taxed at the 15% rate. Successive rates are highly progressive.

G. Distribution Tax Trap **163**
I.R.C. §663(b) allows a trustee or an estate to treat certain distributions made within 65 days of the end of the trust's or estate's tax year as if made on the last day of that tax year.

H. Estimated Taxes **163**
Estates and most trusts that are will substitutes are not required to make estimated tax payments for any tax year ending within two years of the death of the decedent.

I. Depreciation and Depletion **164**
Beneficiaries can claim the excess of depreciation over income.

J. Estate Administration Expenses **164**
Administration expenses can be claimed as deductions for either income tax or estate tax purposes, but not both.

K. Double Deductions Allowed for Accrued Expenses **165**
The rules preventing double deductions do not apply to deductions for expenses accrued at the date of death.

L. Expenses Allocable to Tax-Exempt Income **165**
These expenses are **not** to be claimed as deductions on Form 1041.

M. Filing Requirements **165**
Every domestic estate with gross income of $600 or more must file a Form 1041.

N. Distributable Net Income **165**
This is important for both the estate's income tax return and the beneficiaries' returns.

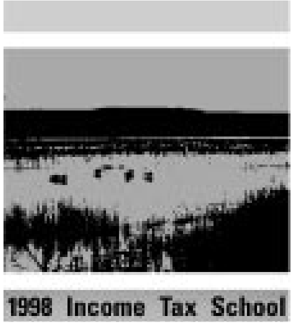
O. Allocation of Interest and Dividend Income **168**
Interest and dividend income must be allocated between the estate and the beneficiaries.

P. Distributions to Beneficiaries—Special Rules **169**
Special rules apply for determining the deduction allowable for these distributions and the amount includable in the beneficiaries' gross income.

Q. Determination of Whether a Gift or Bequest Is Included in Gross Income or Beneficiary—Regulation Examples **172**
Treas. Reg. §1.663(a)-1 provides clear interpretive rules for making this determination.

R. Capital Gains and Losses—Taxable to Fiduciary or Beneficiary **173**
Capital gains and losses are sometimes treated as part of DNI, but they are usually taxable to the estate or trust.

S. Holding Period **175**
Whatever the holding period, a revocable trust gets long-term capital gain or loss treatment on distribution of the assets.



THE INCOME TAXATION OF TRUSTS AND ESTATES– PART THREE

REVIEW OF TAXATION OF INCOME AND DISTRIBUTIONS OF AN ESTATE OR TRUST

A. INTRODUCTION

A decedent’s estate is a vehicle for gathering up the assets owned by the decedent that are subject to probate and distributing them to the decedent’s beneficiaries. For income tax purposes, the estate is a taxpaying entity. It must pay taxes on any income that it earns—unless that income is distributed to beneficiaries within 65 days from the **end of the trust’s or estate’s taxable year. Note:** It is usually very important to distribute because of the tax rates for estates and trusts [I.R.C. §663].

B. INCOME VS. INHERITANCE

An inheritance is not subject to income tax [I.R.C. §102], but income that is earned on the inheritance is subject to income tax. Therefore, a distribution from an estate must be allocated between the income and the inheritance so that the beneficiary can properly include the income on his or her tax return.

In general, a distribution from an estate will first be allocated to income. Therefore, a distribution is generally treated as income to the extent the estate has realized income during its taxable year.

Example 1. Jo Ann’s estate includes only $100,000 of cash. During the estate’s current tax year, the estate received $5,000 in interest and distributed $7,000 of cash to George, the only heir. The distribution to George will be treated as $5,000 of income and $2,000 of nontaxable inheritance.

C. NONPROBATE ASSETS [I.R.C. §641]

The estate **does not,** for example, include in its calculations of gross income the income from:

- Property passing automatically by operation of the community property laws of a state
- Property owned in joint tenancy, which passes automatically to the surviving joint tenant(s)
- Life insurance, if there is a named beneficiary other than the estate

- Death benefit plan proceeds and any retirement plan benefit amounts, if there is a named beneficiary other than the estate
- Interests in trusts if the estate is not a beneficiary
- Payable-on-death accounts or bonds naming someone other than the estate as the successor owner

D. EFFECT OF STATE LAW ON CLASSIFICATION OF INCOME

- **All interest and dividends** are taxable income unless exempt under federal law. Federal tax law **preempts** any state-law rules.
- The taxation of income from **real estate** depends on state law. Generally, real estate is subject to administration by the estate, and therefore the income from the real estate is estate income during that period [Rev. Rul. 57-133]. However, not all states treat the administration of real estate the same. In addition, real estate can sometimes be distributed to heirs prior to the end of the estate administration. Specific will provisions can also sometimes change the application of state law in regard to real estate administration.

E. TAXABLE YEAR OF ESTATE

The executor for the estate may choose a tax year that ends on the last day of any month that does not make the first tax year longer than 12 months. This flexibility gives the executor the opportunity to control the amount of income that falls into the estate's first tax year. It can also provide a longer period to make distributions to beneficiaries, thus reducing the taxable income of the estate [An estate is on an effective cash basis]. **A trust must use a calendar year** [I.R.C. §645].

F. TAX RATES FOR ESTATES OR TRUSTS

Only the first $1700 (for tax years beginning in 1998) of taxable income of an estate or trust receives the benefit of the 15% tax rate. The successive rates are highly progressive.

Estate and Trust Income Tax Rates

Estates and Trusts for Tax Years Beginning in 1998

If taxable income is:		*The tax is:*	
Over—	*but not over—*		*of the amount over—*
$ 0	1,700	15 %	$ 0
1,700	4,000	$ 255.00 + 28	1,700
4,000	6,100	899.00 + 31	4,000
6,100	8,350	1550.00 + 36	6,100
8,350	.....	2360.00 + 39.6	8,350

Estates and Trusts for Tax Years Beginning in 1997
1997 Tax Rate Schedule

If taxable income is:			
Over—	but not over—	Its tax is:	Of the amount over—
$0	$1,650	15%	$0
1,650	3,900	$247.50 + 28%	1,650
3,900	5,950	877.50 + 31%	3,900
5,950	8,100	1,513.00 + 36%	5,950
8,100	- - -	2,287.00 + 39.6%	8,100

Observation. Because the tax rates for trusts and estates allow only $1,700 of taxable income (1998) to be taxed in the 15% bracket and another $2,300 to be taxed in the 28% bracket, it is important to distribute almost all of the estate's income to prevent it from being taxed at a rate higher than the beneficiaries' marginal tax rate.

G. DISTRIBUTION TAX TRAP ESTATES AND TRUSTS

Practitioner Note. A trustee or an estate can elect to have certain distributions not otherwise deductible made within 65 days of the end of the trust's or estate's tax year treated as if they were made on the last day of the trust's or estate's tax year [I.R.C. §663(b)].

Example 2. Assume there is no requirement to distribute income currently, the estate is on a calendar-year basis, and distributes $100,000 to beneficiaries on April 1, 1998, instead of on or before 65 days after the end of the estate's tax tear. **The $100,000 is taxable to the estate,** not the beneficiaries. [Also see Section **P,** later in this chapter.]

H. ESTIMATED TAXES

An estate is **not required** to make estimated tax payments for any tax year ending within two years of the death of the decedent [I.R.C. §6654(1)(2)(A)]. **Most trusts that are will substitutes (e.g., grantor trusts and revocable living trusts) will qualify for the same exception from making estimated payments.** I.R.C. §6654(k)(1)(2)(B) states that the estimated tax rules **do not apply** for tax years ending within two years of the decedent's death of **any trust:**

- **(i)** All of which was treated as owned by the decedent, and
- **(ii)** To which the residue of the decedent's estate will pass under his will (or, if no will is admitted to probate, to the trust primarily responsible for paying debts, taxes, and expenses of administration).

Practitioner Note. If the trust pays estimated taxes, the trustee can elect to have any portion of them treated as an estimated payment of a beneficiary or beneficiaries [I.R.C. §643(g)]. The election is made by filing Form 1041-T **within** 65 days of the end of the trust's tax year. The payment is treated as being made by the beneficiary on January 15 following the trust's taxable year and as being received from the trust on the last day of the trust's tax year.

I. DEPRECIATION AND DEPLETION ESTATES AND TRUSTS

The allowable deductions for depreciation and depletion that accrue after the decedent's death must be apportioned between the estate and the beneficiaries, depending on the income of the estate that is allocable to each, and reported as a separate item on Schedule K-1.

Example 3. In 1998 the decedent's estate realized $3,000 of business income during the administration of the estate. The personal representative distributed $1,000 of the income to the decedent's son, Ned, and $2,000 to another son, Bill. The allowable depreciation on the business property is $300. Ned can take a deduction of $100 (($1,000 ÷ $3,000) × $300), and Bill can take a deduction of $200 (($2,000 ÷ $3,000) × $300). Depreciation is allocated on the K-1.

Example 4. Assume that a business building was owned by the decedent and his wife as tenants in common, and that the decedent's estate administered his share of the property. The estate will calculate depreciation on its portion and the wife on hers. **Note:** The estate will have a tax basis for its one-half share that will be different from the wife's basis for her one-half because of the step-up-in-basis rules. [see I.R.C. §1014]

J. ESTATE ADMINISTRATION EXPENSES

- Expenses of administering an estate can be deducted either from the **gross estate** in figuring the federal estate tax on Form 706 or from the estate's **gross income** in figuring the estate's income tax on Form 1041.

However, these expenses cannot be claimed for ***both*** estate tax and income tax purposes. In most cases, this rule also applies to expenses incurred in the sale of property by an estate (not as a dealer).

- To prevent a double deduction, amounts otherwise allowable in figuring the decedent's taxable estate for federal estate tax on Form 706 **will not** be allowed as a deduction in figuring the income tax of the estate or of any other person **unless** the personal representative files a statement, in duplicate, that the items of expense, as listed in the statement, **have not** been claimed as deductions for federal estate tax purposes and that all rights to claim such deductions are ***waived.***
- One deduction or part of a deduction can be claimed for income tax purposes if the appropriate statement is filed, while another deduction or part is claimed for estate tax purposes.

  [IRS Pub. 559.]

Estate and Trust Administration Expenses—2% Floor

Generally, under I.R.C. §67(e), costs paid in connection with the administration of an estate or trust, such as trustee commissions, accounting costs, legal fees, and investment counseling fees, are deductible as administration fees not subject to the 2% floor for miscellaneous itemized deductions. However, these expenses should be unique to the trust or estate in order to be fully deductible [see *O'Neill Jr., Irrevocable Trust v. Commissioner,* 98 T.C. 227, *rev'd,* 994 F.2d 302 (6th Cir. 1992)].

> **Note:** Unique means expenses that would **not have been** incurred if the property were not held in the trust or estate.

K. DOUBLE DEDUCTIONS ALLOWED FOR ACCRUED EXPENSES

- The rules preventing double deductions **do not apply** to deductions for taxes, interest, business expenses, and other items **accrued** at the date of death.
- These expenses are allowable as a deduction for estate tax purposes as **claims** against the estate and also are allowable as **deductions** in respect of a decedent for income tax purposes.
- Deductions for interest, business expenses, and other items **not accrued** at the date of the decedent's death are allowable **only** as a deduction for administration expenses for both estate and income tax purposes and **do not** qualify for a double deduction.

  [IRS Pub. 559.]

L. EXPENSES ALLOCABLE TO TAX-EXEMPT INCOME

- When figuring the estate's taxable income on Form 1041, **do not** deduct administration expenses allocable to any of the estate's tax-exempt income.

M. FILING REQUIREMENTS

Every domestic estate with gross income of $600 or more during a tax year must file a Form 1041. If one or more of the beneficiaries of the domestic estate are nonresident alien individuals, the personal representative must file Form 1041, even if the gross income of the estate is less than $600.

N. DISTRIBUTABLE NET INCOME ESTATES AND TRUSTS

The income tax concept used to sort out the amount of a distribution that is treated as income is "distributable net income" (DNI).

DNI is important for both the estate's income tax return and the beneficiaries' returns. **It sets the limit for the estate's distribution deduction** [I.R.C. §651(b)] **and the limit for the income that must be reported by the beneficiaries** [I.R.C. §652(a)]. The purpose of this concept is to put estates on an equitable footing regarding income and deductions, rather than relying on local law or the will to allocate income and deductions between the estate and the beneficiaries.

DNI is defined in I.R.C. §643(a) as the taxable income of the estate **modified** as follows:

1. No deduction is allowed for distributions to beneficiaries.
2. The $600 personal exemption deduction under I.R.C. §642(b) is not allowed.
3. Capital gains and losses are not included to the extent they are allocated to the corpus and **are not distributed** to a beneficiary or set aside for charitable purposes.
4. Tax-exempt interest, reduced by the deductions that are allocated to it that are disallowed, **is included.**

Distributable Net Income—Distribution Deductions

The basic rules for calculating DNI are included in I.R.C. §643. See I.R.C. §651 for simple trust rules and I.R.C. §§661–663 for the rules applying to complex trusts. Fortunately, Schedule B of Form 1041 is very helpful in driving the practitioner to a final number for DNI.

The following trust example is taken from *Trust Administration* **(Illinois Institute for Continuing Legal Education, 1992, Supp. 1995, 2395 West Jefferson St., Springfield, IL. 62702.)**

> The following example illustrates the general rule for determining the amount of DNI. A trust that is required to distribute all of its income currently has the following items of income and expenses for trust accounting purposes in the current taxable year. Capital gains and half of the trustee's fee are assumed allocable to corpus under local law.

Dividends	$25,000
Tax-exempt interest	15,000
Net long-term capital gains	10,000
Trustee Fee	
Allocable to income	(2,200)
Allocable to principal	(2,200)

Trust income for fiduciary accounting purposes is determined by the trustee to be

Dividend	$25,000
Tax-exempt interest	15,000
	$40,000
Trustee fees allocable to income	(2,200)
Trust income	$37,800

The amount required to be distributed currently by the trustee to the beneficiary for fiduciary accounting purposes is $37,800. This distribution will discharge the trustee's obligations under the trust instrument to distribute all income. However, how much of this distribution will be deductible by the trustee? And how will this distribution be characterized in the hands of the beneficiary—as income or principal, and, if income, as what type of income? In other words, how much of this distribution carries out DNI?

The DNI is computed as follows:

Dividends		$25,000
Tax-exempt interest	$15,000	
Less: Expenses allocable thereto	(1,650)	13,350
		$38,350
Deductions: Trustee fee ($4,400 − 1,650)		(2,750)
Distributable net income		$35,600

Note that for purposes of computing DNI the trustee has allocated $1,650 (15,000/40,000 × 4,400) of the total trustee's fee to the production of tax-exempt income. **Treas. Reg.** §1.652(b)-3(b). See also Rev. Rul. 77-355, 1977-2 C.B.82. **This Revenue Ruling holds that while the total trustee fee must be taken into account, amounts not actually distributable to the beneficiary—such as capital gains—may not be included in the formula for determining the proportion of the trustee's fee to be allocated to tax-exempt income.**

DNI now becomes a reference point for (a) measuring the amount of taxable income deductible by the trust or retained by the trust and taxable to it; (b) measuring the amount of taxable income distributed to the beneficiaries and taxable to them; and (c) determining the character of amounts distributed to the beneficiaries or retained by the trust. **Treas. Reg.** §1.643(a)-0.

Simple Trust

In computing its taxable income, a simple trust is allowed a deduction for the amount of income required to be distributed currently to beneficiaries under the terms of the trust agreement. **If the amount of income required to be distributed currently exceeds the DNI, the amount of deduction is limited to the DNI.** For this purpose, however, DNI does not include items (such as tax-exempt interest) not included in the gross income of the trust. Code §651(b).

Deduction for Distributions to Beneficiaries

The computation of the distributions deduction for a simple trust may be illustrated by reference to the foregoing example in which DNI, which included tax-exempt interest, was determined to be $35,600. Therefore, DNI must be further adjusted to exclude tax-exempt interest, as follows:

DNI	$35,600
Less: Tax-exempt interest less expenses	13,350
Distributions deduction	$22,250

Since the income required to be distributed currently ($37,800) exceeds DNI as adjusted ($22,250), the trustee deducts $22,250 as the distribution deduction allowable for this trust. Code §651(a). **Under these facts, the beneficiary receives a distribution of $37,800 but is taxable on only $22,500 of income from the trust.**

Example 5. Pedro died on March 15, 1998. His estate received $4,200 of interest income on July 17, 1998. On September 13, 1998, his estate received a $10,000 dividend. The estate has no deductions other than the personal exemption deduction.

If the beneficiaries of Pedro's estate are in the 28% income tax bracket, income taxes can be minimized by leaving $4,600 of the income in the estate and distributing the remainder of the income to the beneficiaries. The first $600 of the $4,600 left in the estate is exempt due to the $600 personal exemption deduction allowed to an estate [I.R.C. §642(b)]. The next $1,700 is taxed at the rate of 15%, and the remaining $2,300 is taxed at the rate of 28% [I.R.C. §1(e)].

One method of leaving $4,600 in the estate's first tax year is to choose a year end that falls between the distribution of interest and dividends. For example, Pedro's executor could choose a year ending on August 31, 1998.

Another method of leaving $4,600 in the estate's first tax year is to make a $10,000 distribution to beneficiaries that carries out income before ending the first tax year. For example, if the will permits, Pedro's executor could distribute $10,000 of income to beneficiaries in January of 1999 and choose January 31, 1999, as the end of the first tax year. That will allow the estate to claim a $10,000 distribution deduction in addition to the $600 personal exemption deduction, and therefore reduce its taxable income to $4,000—which will be taxed at no more than the 28% marginal rate. The 1999 distribution to the beneficiaries will allow them to delay reporting this income from the distribution until April 2000 if they are calendar-year taxpayers.

O. ALLOCATION OF INTEREST AND DIVIDEND INCOME ESTATES AND TRUSTS

If the estate receives interest and / or dividend income, that income must be allocated between the estate and the beneficiaries, and the beneficiaries' portion must be allocated among them.

Expenses must be allocated between taxable and tax-exempt income. These allocations are made by first calculating DNI for each type of income and then allocating the **lesser** of DNI or the amount distributed among the beneficiaries.

Example 6. The Estate of John R. Smith received $1,000 of dividends, $9,000 of taxable interest, and $5,000 of tax-exempt interest during its taxable year, which ended October 31, 1998. The estate paid $100 of income taxes, $1,500 of other expenses not directly related to any of the income, and $400 of expenses attributable to the tax-exempt interest. The estate distributed $2,500 to each of the beneficiaries, Sally and Billy. The following table shows the calculation of each beneficiary's taxable distribution:

	Dividends	Taxable Interest	Tax-Exempt Interest	Total
Income	$1,000	$9,000	$5,000	$15,000
Less deductions				
Not attributable				
Taxes[1]		100		100
Fiduciary fees[2]	1,000		500	1,500
Attributable[3]			400	400
Total deductions	1,000	100	900	2,000
DNI	-0-	8,900	4,100	13,000
Distributions				
Sally[4]	-0-	1,712	788	2,500
Billy[4]	-0-	1,712	788	2,500
Total Distributions	-0-	3,424	1,576	5,000

[1] Expenses that are not attributable to tax-exempt income and are not directly attributable to a class of taxable income can be allocated among the classes in any manner [Treas. Reg. §1.652(b)-3(b)]. For simplicity, all of the taxes are allocated to interest income in this example.

[2] Expenses that are not directly attributable to any class of income but are indirectly attributable to tax-exempt income must be allocated pro rata to tax-exempt income. The amount not allocated to tax-exempt income can be allocated in any manner to taxable income [Treas. Reg. §1.652(b)-3(b)]. Therefore, since tax-exempt interest is one-third of all income ($5,000/$15,000), one-third of the fiduciary fees are allocated to the tax-exempt interest. The remaining $1,000 of fees can be allocated in any manner between the two classes of taxable income. For simplicity, the remaining $1,000 is allocated to dividend income in this example.

[3] The $400 of expenses attributable to the tax-exempt income must be allocated to that class.

[4] Since the amount that was distributed is less than the DNI, the taxable income that Sally and Billy must report **is limited** to the portion of the distributions allocable to taxable income [I.R.C. §662(a)]. That amount is calculated by multiplying the amount distributed to a beneficiary ($2,500) by a fraction in which the numerator is the DNI allocated to taxable interest ($8,900) and the denominator is the total DNI ($13,000): $2,500 × $8,900/$13,000 = $1,712.

P. DISTRIBUTIONS TO BENEFICIARIES—SPECIAL RULES ESTATES AND TRUSTS

Some special rules apply for determining the deduction allowable to the estate for distributions to beneficiaries and the amount includible in the beneficiary's gross income.

Bequest

A bequest is the act of giving or leaving property to another through the last will and testament. Generally, any distribution of income (or property in kind) to a beneficiary **is an allowable deduction to the estate and is includible in the beneficiary's gross income to the extent of the estate's distributable net income.**

However, **it will not be an allowable deduction to the estate** and **will not be includible in the beneficiary's gross income if the distribution meets three tests:**

1. It is required by the terms of the will,
2. It is a gift or bequest of a **specific sum of money or property,** and
3. It is paid out in three or fewer installments under the terms of the will.

Specific sum of money or property. To meet this test, the amount of money or the identity of the specific property must be determined by the decedent's will. To qualify as specific property, the property must be identifiable both as to its kind and as to its amount.

Example 7. Dave Rogers's will provided that his son, Ed, receive Dave's interest in the Rogers-Jones partnership. Dave's daughter, Marie, would receive a sum of money equal to the value of the partnership interest given to Ed. The bequest to Ed is a gift of a specific property ascertainable at the date of Dave Rogers's death. The bequest of a specific sum of money to Marie is determinable by the same will on the same date.

The following distributions **are not bequests** that meet all of the three tests listed earlier that allow a distribution to be **excluded** from the beneficiary's income:

- **Paid only from income.** An amount that can be paid only from current or prior income of the estate **does not qualify** even if it is specific in amount and there is no provision for installment payments.
- **An annuity.** An annuity or a payment of money or of specific property in lieu of, or having the effect of, an annuity is **not the payment** of a specific property or sum of money.
- **Residuary estate.** If the will provides for the payment of the balance or residue of the estate to a beneficiary of the estate after all expenses and other specific legacies or bequests, that residuary bequest is **not a payment** of a specific property or sum of money.
- **Gifts made in installments.** Even if the gift or bequest is made in a lump sum or in three or fewer installments, it will not qualify as a specific property or sum of money if the will provides that the amount must be paid in more than three installments.

[IRS Pub. 559.]

The regulations provide guidance in determining which distributions are deductible.

Summary of Treas. Reg. §1.661(a)-2. **Deduction for distributions to beneficiaries.**

(a) In computing the taxable income of an **estate or trust** there is allowed as a deduction for distributions to beneficiaries the **sum of:**

(1) The amount of income for the taxable year which is required to be distributed **currently,** and

(2) Any other amounts properly **paid** or **credited** or **required** to be distributed for such taxable year.

However, the total amount deductible cannot exceed the **distributable net income.**

(b) The term "income required to be distributed currently" includes any amount required to be distributed which may be paid out of income or corpus (such as an annuity), to the extent it is paid out of income for the taxable year. [**See** §**1.651(a)-2** (below) which sets forth additional rules which are applicable in determining whether income of an estate or trust is required to be distributed currently.]

(c) The term “any other amounts properly paid or credited or required to be distributed” includes all amounts properly paid, credited, or required to be distributed by an estate or trust during the taxable year other than income required to be distributed currently. Thus, the term includes the payment of an annuity to the extent it is not paid out of income for the taxable year, and a distribution of property in kind [see paragraph (f)].

(d) The terms “income required to be distributed currently” and “any other amounts properly paid or credited or required to be distributed” also include any amount used to discharge or satisfy any person’s legal obligation as that term is used in §1.662(a)-4.

(e) The terms “income required to be distributed currently” and “any other amounts properly paid or credited or required to be distributed” include amounts paid, or required to be paid, during the taxable year pursuant to a court order or decree or under local law, by a decedent’s estate as an allowance or award for the support of the decedent’s widow or other dependent for a limited period during the administration of the estate. [The term “any other amounts properly paid or credited or required to be distributed” **does not include** the value of any interest in real estate owned by a decedent, title to which under local law passes directly from the decedent to his heirs or devisees.]

(f) If property is paid, credited, or required to be distributed in kind:

(1) No gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of the distribution, unless the distribution is in satisfaction of a right to receive a distribution in a **specific dollar amount or in specific property other than that distributed.**

(2) In determining the amount deductible by the trust or estate and includable in the gross income of the beneficiary the property distributed in kind is taken into account at its **fair market value at the time** it was distributed, credited, or required to be distributed.

(3) The basis of the property in the hands of the beneficiary is its fair market value at the time it was paid, credited, or required to be distributed, to the extent such value is included in the gross income of the beneficiary.

To the extent that the value of property distributed in kind **is not included** in the gross income of the beneficiary, its basis in the hands of the beneficiary is governed by the rules in sections 1014 and 1015 and the regulations thereunder.

Summary of Treas. Reg. §1.651(a)-2. Income required to be distributed currently.

- (a) The determination of whether trust income is required to be distributed currently depends upon the terms of the trust instrument and the applicable local law.
- For this purpose, if the trust instrument provides that the trustee in determining the distributable income shall first retain a reserve for depreciation or otherwise make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the retention of current income for that purpose will not disqualify the trust from being a “simple” trust.
- The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust’s taxable year.
- **For example:** Under the terms of the trust instrument, all of the income is currently distributable to A. The trust reports on the calendar year basis and as a matter of practical necessity makes distribution to A of each quarter’s income on the fifteenth day of the month following the close of the quarter.
- The distribution made by the trust on January 15, 1955, of the income for the fourth quarter of 1954 does not disqualify the trust for treatment in 1955 under section 651, since the income is required to be distributed currently.

- However, if the terms of a trust require that none of the income be distributed until after the year of its receipt by the trust, the income of the trust is not required to be distributed currently and the trust is not a simple trust [For definition of the term "income" see I.R.C. §643(b) and **Treas. Reg.** §1.643(b)-1].
- (b) It is immaterial, for purposes of determining whether all the income is required to be distributed currently, that the amount of income allocated to a particular beneficiary is not specified in the instrument.
- **For example,** if the fiduciary is required to distribute all the income currently, but has discretion to "sprinkle" the income among a class of beneficiaries, or among named beneficiaries in such amount as he may see fit, all the income is required to be distributed currently, even though the amount distributable to a particular beneficiary is unknown until the fiduciary has exercised his discretion.

Q. DETERMINATION OF WHETHER A GIFT OR BEQUEST IS INCLUDED IN GROSS INCOME OF BENEFICIARY—REGULATION EXAMPLES ESTATES AND TRUSTS

The regulations provide rather clear interpretive rules. **Treas. Reg.** §1.663(a)-1.

Example (1). Under the terms of a will, a legacy of $5,000 was left to A, 1,000 share of X company stock was left to W, and the balance of the estate was to be divided equally between W and X. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of $25,000 during the taxable year 1954, which was accumulated and added to corpus for estate accounting purposes. During the taxable year, the executor paid the legacy of $5,000 in a lump sum to A and transferred the X company stock to W. No other distributions to beneficiaries were made during the taxable year. The distributions to A and W will qualify as exclusions.

Example (2). Under the terms of a will, the testator's estate was to be divided equally between A and B. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of $50,000 for the taxable year 1954. In accordance with an agreement among the beneficiaries that part of the assets of the estate would be distributed in kind to the beneficiaries, stock in corporation X was distributed to A during 1954. The fair market value of the stock was $40,000 on the date of distribution. No other distribution was made during the year. The distribution **does not qualify** as an exclusion, since it is not a specific gift to A required by the terms of the will. Accordingly, the fair market value of the property ($40,000) represents a deductible distribution [Section 661(a) and section 662(a)].

Example (3). Under the terms of a trust instrument, income is to be accumulated during the minority of A. Upon A's reaching the age of 21, $10,000 is to be distributed to B out of the income or corpus. Also at that time, $10,000 is to be distributed to C out of the accumulated income and the remainder of the accumulations are to be paid to A. A is then to receive all the income until he is 25, when the trust is to terminate. Only the distribution to B would qualify for exclusion.

- A gift or bequest of a specific sum of money or of specific property is not disqualified solely because its payment is subject to a condition. For example, provision for a payment by a trust to beneficiary A of $10,000 when he reaches age 25, and $10,000 when he reaches age 30, with payment over to B of any amount not paid to A because of his death, is a gift to A of a specific sum of money payable in two installments, even though the exact amount payable to A cannot be ascertained with certainty under the terms of the trust instrument.

(c) *Installment payments.* (1) In determining whether a gift or bequest of a specific sum of money or of specific property is required to be paid or credited to a particular beneficiary in more than three installments—

(i) Gifts or bequests of articles for personal use (such as personal and household effects, automobiles, and the like) are disregarded.

(ii) Specifically devised real property, the title to which passes directly from the decedent to the devisee under local law, is not taken into account, since it would not constitute an amount paid, credited, or required to be distributed.

(iii) All gifts and bequests under a decedent's will (which are not disregarded under (i) and (ii) above) for which no time of payment or crediting is specified, and which are to be paid or credited in the ordinary course of administration of the decedent's estate, are considered as required to be paid or credited in a single installment.

(iv) All gifts and bequests (which are not disregarded under (i) end (ii) of above) payable at any one specified time under the terms of the governing instrument are taken into account as a single installment.

For purposes of determining the number of installments paid or credited to a particular beneficiary, a decedent's estate and a testamentary trust is each treated as a separate entity.

R. CAPITAL GAINS AND LOSSES—TAXABLE TO FIDUCIARY OR BENEFICIARY

ESTATES AND TRUSTS

Capital gains and losses are occasionally considered as paid to the beneficiary (and are therefore treated as a part of DNI). **However, they are usually taxable to the estate or trust.** The regulations are helpful in making the determination:

Treas. Reg. §1.643(a)-3. **Capital gains and losses.**

(a) Except as provided in §1.643(a)-6, gains from the sale or exchange of capital assets **are ordinarily excluded** from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary **unless** they are:

(1) Allocated to income under the terms of the governing instrument or local law by the fiduciary on its books or by notice to the beneficiary,

(2) Allocated to corpus and actually distributed to beneficiaries during the taxable year, or

(3) Utilized (pursuant to the terms or the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed.

However, if capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

(b) Losses from the sale or exchange of capital assets are excluded in computing distributable net income except to the extent that they enter into the determination of any capital gains that are paid, credited, or required to be distributed to any beneficiary during the taxable year (but see §1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust).

* * *

Examples

(d) The application of this section may be illustrated by the following examples:

Example (1). A trust is created to pay the income to A for life, with a discretionary power in the trustee to invade principal for A's benefit. In the taxable year, $10,000 is realized from the sale of securities at a profit, and $10,000 in excess of income is distributed to A. The capital gain is not allocated to A by the trustee. During the taxable year the trustee received and paid out $5,000 of dividends. No other cash was received or on hand during the taxable year. **The capital gain will not ordinarily be included in distributable net income.** However, if the trustee follows a regular practice of distributing the exact net proceeds of the sale of trust property, capital gains will be included in distributable net income.

Example (2). The result in example (1) would have been the same if the trustee had been directed to pay an annuity of $15,000 a year to A (instead of being directed to pay the income to A with a discretionary power to distribute principal).

Example (3). The trustee of a trust containing Blackacre and other property is directed to hold Blackacre for ten years, and then sell it and distribute its proceeds to A. Any capital gain realized from the sale of Blackacre **will be included in distributable net income.**

Example (4). A trust instrument directs that the income shall be paid to A, and that the principal shall be distributed to A when he reaches age 35. All capital gains realized in the year of termination will be included in distributable net income. (See §1.641(b)-3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.)

Example (5). If in example (4) the trustee had been directed to distribute half of the principal to A when he reached 35, the capital gain would be included in distributable net income (and in the distribution to A) to the extent the capital gain is allocable to A under the governing instrument and local law. Thus, if the trust assets consisted entirely of 100 shares of corporation M stock and the trustee sold half the shares and distributed half the proceeds to A, the entire capital gain would normally be considered as allocated to A. On the other hand, if the trustee sold all the shares and distributed half the proceeds to A, half the capital gain would be considered as allocable to A.

Example (6). If in example (4) the trustee had been directed to pay $10,000 to B before making distribution to A, no portion of the capital gains would be allocable to B since the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1) [**Reg.** §1.643(a)-3].

[Also see **Rev. Rul.** 68-392.]

Allocation of Principal and Income

This allocation is sometimes perplexing to the executor or trustee. Sometimes the will or trust instrument provides guidance. If not, state law will control. Generally, state law is found in the state's Principal and Income Act. Most states have adopted the Uniform Principal and Income Act. As a result, the provisions governing allocations are similar from state to state. However, the appropriate state statute should be carefully reviewed.

- **The Illinois Principal and Income Act** defines receipts that are generally allocated to principal as follows:

(b) . . . Principal includes:

(1) consideration received by the trustee on the sale or other transfer of principal or on repayment of a loan or as a refund or replacement or change in the form of principal;

(2) proceeds of property taken on eminent domain proceedings;

(3) proceeds of insurance upon property forming part of the principal except proceeds of insurance upon a separate interest of an income beneficiary;

(4) stock dividends, receipts on liquidation of a corporation and other corporate distributions, as provided in Section 7;

(5) receipts from the disposition of bonds or other obligations, as provided in Section 8;

(6) receipts from disposition of natural resources, as provided in Sections 10 and 11;

(7) receipts from other principal subject to depletion, as provided in Section 12;

(8) any profit resulting from change in the form of principal;

(9) any allowances for depreciation established under Section 9 and paragraph (2) of subsection (a) of Section 14;

(10) receipts from the granting of options.

- Income in respect of a decedent (I.R.C. §691) is allocated to principal as follows:

> (b) In the administration of a decedent's estate or of an asset becoming subject to a trust by reason of a will or by reason of the death of a decedent, income which is earned or accrued to the date of death of the decedent but not yet payable, including, but not limited to, income in respect of a decedent, or which is due but not yet paid, shall be added to *principal* when received. [§5(b) of the Illinois Act]

S. HOLDING PERIOD

An estate (or other recipient) that acquires a capital asset from a decedent and sells or otherwise disposes of it within one year of the decedent's death is considered to have held that asset for the required long-term holding period of more than one year.

T. BASIS OF ASSET

The basis used to figure gain or loss for property the estate receives from the decedent usually is its fair market value at the date of death, or at the alternate valuation date. The exception is for items that are considered to be I.R.C §691 property—Income in respect of a decendent.

FIDUCIARY TAX PROBLEM

The following facts are used in all of the following scenarios to illustrate the preparation of the decedent's final income tax return and the income tax return of the estate. In all of the scenarios, the estate elects the calendar year.

- Ace Retired was born on January 28, 1925. He was married to Alice Retired, who was born on February 10, 1928. They have a son, Robert, who is an adult. Ace died on May 1, 1998. The following tables analyze the assets Ace owned at the time of death.
- Assume that the estate has waived the right to deduct (on Form 706) any expenses that qualify as both an estate tax deduction and as an income tax deduction.

Asset Analysis

Asset	May 1, 1998 Fair Market Value	Depreciation	(Cost) Tax Basis	Ownership at Death
1. 100 shares of Go Go stock	$ 40,000	N/A	$ 4,000	Ace
2. 1,000 shares of High Flyer Mutual Fund	$100,000	N/A	$ 50,000	Ace
3. Four vacant lots	$ 10,000	N/A	$ 5,000	Ace
4. Little Bank CD	$ 10,000	N/A	$ 10,000	Ace
5. Rental home	(all) $ 50,000	(all) $ 31,050 18-yr ACRS	(all) $ 13,950	Ace and Alice (joint tenancy)—acquired April 28, 1985
6. 300 acres farmland (unimproved)	(all) $900,000	(all) $ 10,000	(all) $100,000	Ace and Alice as tenants in common
7. Installment obligation received on sale of property to son; contract amount $200,000, basis $100,000; of 20 payments 5 have been made (GPP—50%)	$150,000	N/A	$ 75,000	Ace
8. Keogh plan	$120,000	N/A	$ 0	Ace—[Alice beneficiary]
9. Personal residence	$200,000	N/A	$ 50,000	Acquired 1980 (joint tenancy) with Alice
10. Auto	$ 15,000	N/A	$ 20,000	Joint tenancy with Alice
Taxable estate [Assumes no deduction other than joint tenancy and Keogh plan marital deductions]	$760,000			

Income and Expenses Analysis 1998

Asset	Prior to Date of Death	After Date of Death	Ownership after Date of Death
1. 100 shares of Go Go stock	$100 dividends received	$200 dividends received	Estate
2. 1,000 shares of High Flyer Mutual Fund	$1,000 tax-exempt dividend received $1,000 long-term capital gain received	$3,000 tax-exempt dividend received $1,000 long-term capital gain received	Estate
3. Four vacant lots	No expenses No income	$2,000 property tax $12,000 received on sale by estate on 12/20/98	Estate
4. Little Bank CD	$250 interest received	$350 interest received	Estate
5. Rental home	$2,500 rent received $200 legal fee paid $500 repairs paid $750 depreciation[1]	$3,500 rent received $2,000 property taxes paid $500 insurance paid $500 repairs paid $1,394 depreciation[2]	Alice
6. 300 acres of farmland (unimproved) (Ace did not materially participate.)	$6,000 received from sale of corn $1,000 paid for seed $2,000 paid for fertilizer	$4,000 received from sale of soybeans $20,000 received from sale of feeder calves $8,400 paid for property taxes $1,600 paid for chemicals $1,000 paid for repairs $1,000 paid for insurance [Total—100% of expenses and income]	Alice—one-half Estate—one-half
7. Installment obligation received on sale of unimproved property to son; contract amount $200,000, basis $100,000; 5 of 20 payments have been made; GPR is 50%	Nothing received	$10,000 principal received $9,000 interest received	Estate
8. Keogh plan	$5,000 distribution received		Alice
9. Personal residence	No expenses	$4,000 property taxes paid	Alice
10. Auto	No deductible expenses	No deductible expenses	Alice

[1] One-third of the 1998 depreciation is claimed for the period before death since death occurred one-third of the way through the year ($45,000 × 5% × 1/3 = $750).

[2] Two-thirds of the 1998 depreciation is claimed for the half that Alice owned before Ace's death ($22,500 × 5% × 2/3 = $750). The half that Alice received upon Ace's death is depreciated using a date-of-death value basis and a new life as if it were placed in service on the date of death ($25,000 × 2.576% = $644.) ($750 + $644 = $1,394).

Other Estate Expenses during 1998

Attorney fees	$3,000
Accounting fees	1,000
Burial expenses	3,000
Appraisal fees	500

Alice received $6,894 in wages from her employment as a teacher's aide.

SCENARIO #1

Ace's will leaves all assets to Alice. Under state law, the executor of the estate is to take possession of and administer both personal and real property. The executor has discretion to distribute or not distribute income. On December 1, 1998, the executor distributed $15,000 to Alice.

Step One—Prepare the Estate 1041—Alice received an estate distribution so we need the K-1 before doing the decedents final return.

1998 Income Tax Return for the Estate—Form 1041

Income earned after the date of death and before January 1, 1999, on assets that are owned by the estate are reported on lines 1 through 9 of Form 1041. Notice that only one-half of the income from the sale of soybeans and feeder calves and one-half of the farm expenses after the date of death are reported on the estate's Form 4835, since the farm was owned as **tenants in common** by Ace and Alice before his death, and therefore it is owned by the estate and Alice after his death. The soybeans and feeder calves **do not** get a basis adjusted to the date-of-death value because Ace was a **nonmaterially participating landowner** when he received the beans and calves as his share of the crop and livestock under a share lease. [This is I.R.C. §691, Income in Respect of a Decedent.]

Deductions for expenses that are paid by the estate after the date of death are reported on lines 10 through 21 of Form 1041. The $2,000 of taxes reported on line 11 are the property taxes paid on the vacant lots. Taxes paid on the farmland are reported on Form 4835.

The total tax reported on line 24 is calculated on Schedule D.

Schedule B (Form 1041)—Income Distribution Deduction. The tax-exempt income (asset #2) that is reported on line 12 is calculated by multiplying the $3,000 of tax-exempt income by a fraction. The numerator of the fraction is the income required to be distributed currently, and the denominator is the distributable net income ($3,000 × $15,000/$12,050 = $**3,734**(**limited to 3,000**)).

Schedule 1 (Form 1041)—Alternative Minimum Tax. The $2,000 adjustment for real property taxes results in a different income distribution deduction on a minimum tax basis (line 28) compared to the income distribution deduction for regular tax purposes (line 15 of Schedule B), because it increases the denominator of the fraction used to calculate the tax-exempt income reported on line 28 ($3,000 × $15,000/$15,050 = $**2,990**).

The estate's share of the alternative minimum taxable income is less than the $22,500 exemption. Therefore, the estate **does not owe** any alternative minimum tax.

Form 4835. The estate uses Form 4835 to report income and expenses from the farm lease. Note that the soybeans and feeder calves have a zero basis. They did not get a date-of-death value basis since Ace was a **nonmaterially participating landowner** when he received them as his share of the crop and livestock. If Ace had been materially participating, the basis of the beans and calves would have been adjusted to their date-of-death value, and the sale would have been reported on lines 1 of form 4835.

Form 6252. The estate uses the same gross profit ratio that [50%] Ace used to report gain from payments on the installment contract. [This is also I.R.C. §691 income.]

Schedule K-1 (Form 1041). The $15,000 that Alice received from the estate is allocated among the types of income received by the trust on a pro rata basis. That allocation is done by multiplying the net income received by the estate in each category by a fraction.

> Alice only pays tax on the amount shown on the K-1. The rest of the $15,000 distribution is a nontaxable inheritance.

> The numerator of the fraction is the $15,000 Alice received, and the denominator is the $12,050 of distributable net income.

The net income received in each category is the gross income for that category reduced by deductions that are attributable to that category. If the deductions for a given category exceed income from that category, the excess can be deducted from **any category the taxpayer chooses,** except that excess expenses allocable to tax-exempt income **cannot** be deducted from another category [**Treas. Reg.** §§1.652(b)-3(a) and (d)].

> Deductions that are not attributable to any one category can be allocated to any category the taxpayer chooses, except that a pro rata share must be allocated to tax-exempt income [**Treas. Reg.** §1.652(b)-3(b)].

In this example, **all of the expenses are attributable to the four vacant lots.** Since they did not generate income, the taxpayer chose to allocate those expenses to the interest income.

The $15,000 that was distributed to Alice is allocated as follows:

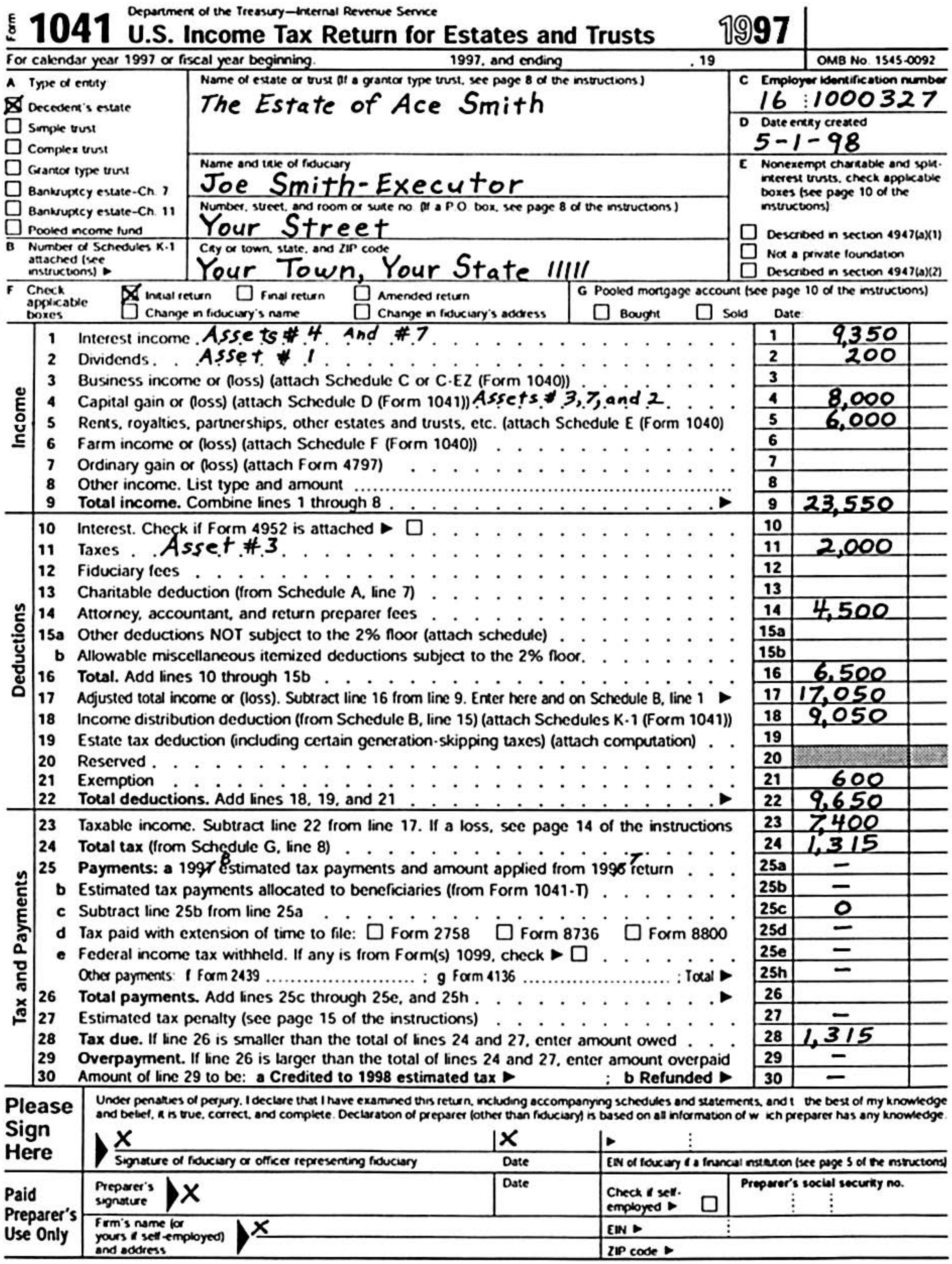
Interest		
Amount received by estate	$9,350	
Minus deductions allocated	$6,500	
Total distributable	$2,850	
Times allocated fraction (1) (2)		
Interest distributed to Alice		$2850.00
Dividends		
Amount received by estate	$200	
Times allocation fraction (1)		
Dividends distributed to Alice		$200
Farm Rental Income		
Amount received by estate	$6,000	
Times allocation fraction (1)		
Farm rental income distributed to Alice		$6,000
Tax-Exempt Income		
Amount received by estate	$3,000	
Times allocation fraction (1)		
Tax-exempt income distributed to Alice		$3,000
Total		$12,050

(1) Doesn't apply because the distribution to Alice was greater (15,000) than the DNI (12,050).

(2) If for example the DNI was $30,000 then the "times allocated fraction would be 15,000/30,000 or .50 and interest allocated to Alice would be 2850 × .50 or $1425

On line 13c of Schedule K-1, Alice's share of gross farm income is reported for purposes of calculating her gross income from farming for provisions such as the exception to the estimated tax penalty under I.R.C. §6654(i). It is calculated by using the same fraction that was used to allocate net income ($6,000 × $15,000/$12,050 = $7, 469).

Note: Not all required schedules and attachments are included in the following pages.



Form **1041** Department of the Treasury—Internal Revenue Service

U.S. Income Tax Return for Estates and Trusts 1997

For calendar year 1997 or fiscal year beginning , 1997, and ending , 19 OMB No. 1545-0092

A Type of entity
☒ Decedent's estate
☐ Simple trust
☐ Complex trust
☐ Grantor type trust
☐ Bankruptcy estate-Ch. 7
☐ Bankruptcy estate-Ch. 11
☐ Pooled income fund

B Number of Schedules K-1 attached (see instructions) ▶

Name of estate or trust (If a grantor type trust, see page 8 of the instructions.)
The Estate of Ace Smith

Name and title of fiduciary
Joe Smith-Executor

Number, street, and room or suite no. (If a P.O. box, see page 8 of the instructions.)
Your Street

City or town, state, and ZIP code
Your Town, Your State 11111

C Employer identification number
16 : 1000327

D Date entity created
5-1-98

E Nonexempt charitable and split-interest trusts, check applicable boxes (see page 10 of the instructions)
☐ Described in section 4947(a)(1)
☐ Not a private foundation
☐ Described in section 4947(a)(2)

F Check applicable boxes: ☒ Initial return ☐ Final return ☐ Amended return ☐ Change in fiduciary's name ☐ Change in fiduciary's address

G Pooled mortgage account (see page 10 of the instructions): ☐ Bought ☐ Sold Date:

Income	1	Interest income Assets #4 And #7	1	9,350
	2	Dividends Asset #1	2	200
	3	Business income or (loss) (attach Schedule C or C-EZ (Form 1040))	3	
	4	Capital gain or (loss) (attach Schedule D (Form 1041)) Assets #3,7, and 2	4	8,000
	5	Rents, royalties, partnerships, other estates and trusts, etc. (attach Schedule E (Form 1040))	5	6,000
	6	Farm income or (loss) (attach Schedule F (Form 1040))	6	
	7	Ordinary gain or (loss) (attach Form 4797)	7	
	8	Other income. List type and amount	8	
	9	**Total income.** Combine lines 1 through 8 ▶	9	23,550
Deductions	10	Interest. Check if Form 4952 is attached ▶ ☐	10	
	11	Taxes Asset #3	11	2,000
	12	Fiduciary fees	12	
	13	Charitable deduction (from Schedule A, line 7)	13	
	14	Attorney, accountant, and return preparer fees	14	4,500
	15a	Other deductions NOT subject to the 2% floor (attach schedule)	15a	
	b	Allowable miscellaneous itemized deductions subject to the 2% floor	15b	
	16	**Total.** Add lines 10 through 15b	16	6,500
	17	Adjusted total income or (loss). Subtract line 16 from line 9. Enter here and on Schedule B, line 1 ▶	17	17,050
	18	Income distribution deduction (from Schedule B, line 15) (attach Schedules K-1 (Form 1041))	18	9,050
	19	Estate tax deduction (including certain generation-skipping taxes) (attach computation)	19	
	20	Reserved	20	▨
	21	Exemption	21	600
	22	**Total deductions.** Add lines 18, 19, and 21 ▶	22	9,650
Tax and Payments	23	Taxable income. Subtract line 22 from line 17. If a loss, see page 14 of the instructions	23	7,400
	24	**Total tax** (from Schedule G, line 8)	24	1,315
	25	**Payments: a** 199~~7~~8 estimated tax payments and amount applied from 199~~6~~7 return	25a	—
	b	Estimated tax payments allocated to beneficiaries (from Form 1041-T)	25b	—
	c	Subtract line 25b from line 25a	25c	0
	d	Tax paid with extension of time to file: ☐ Form 2758 ☐ Form 8736 ☐ Form 8800	25d	—
	e	Federal income tax withheld. If any is from Form(s) 1099, check ▶ ☐	25e	—
		Other payments: f Form 2439 ; g Form 4136 ; Total ▶	25h	—
	26	**Total payments.** Add lines 25c through 25e, and 25h ▶	26	
	27	Estimated tax penalty (see page 15 of the instructions)	27	—
	28	**Tax due.** If line 26 is smaller than the total of lines 24 and 27, enter amount owed	28	1,315
	29	**Overpayment.** If line 26 is larger than the total of lines 24 and 27, enter amount overpaid	29	—
	30	Amount of line 29 to be: **a Credited to 1998 estimated tax ▶** ; **b Refunded ▶**	30	—

Please Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and t the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than fiduciary) is based on all information of w ich preparer has any knowledge.

▶ X
Signature of fiduciary or officer representing fiduciary

X
Date

▶
EIN of fiduciary if a financial institution (see page 5 of the instructions)

Paid Preparer's Use Only

Preparer's signature ▶ X

Date

Check if self-employed ▶ ☐

Preparer's social security no.

Firm's name (or yours if self-employed) and address ▶ X

EIN ▶

ZIP code ▶

Schedule A Charitable Deduction. Do not complete for a simple trust or a pooled income fund.

1	Amounts paid or permanently set aside for charitable purposes from gross income (see page 15)	1	
2	Tax-exempt income allocable to charitable contributions (see page 16 of the instructions)	2	
3	Subtract line 2 from line 1	3	
4	Capital gains for the tax year allocated to corpus and paid or permanently set aside for charitable purposes	4	
5	Add lines 3 and 4	5	
6	Section 1202 exclusion allocable to capital gains paid or permanently set aside for charitable purposes (see page 16 of the instructions)	6	
7	**Charitable deduction.** Subtract line 6 from 5. Enter here and on page 1, line 13	7	

Schedule B Income Distribution Deduction

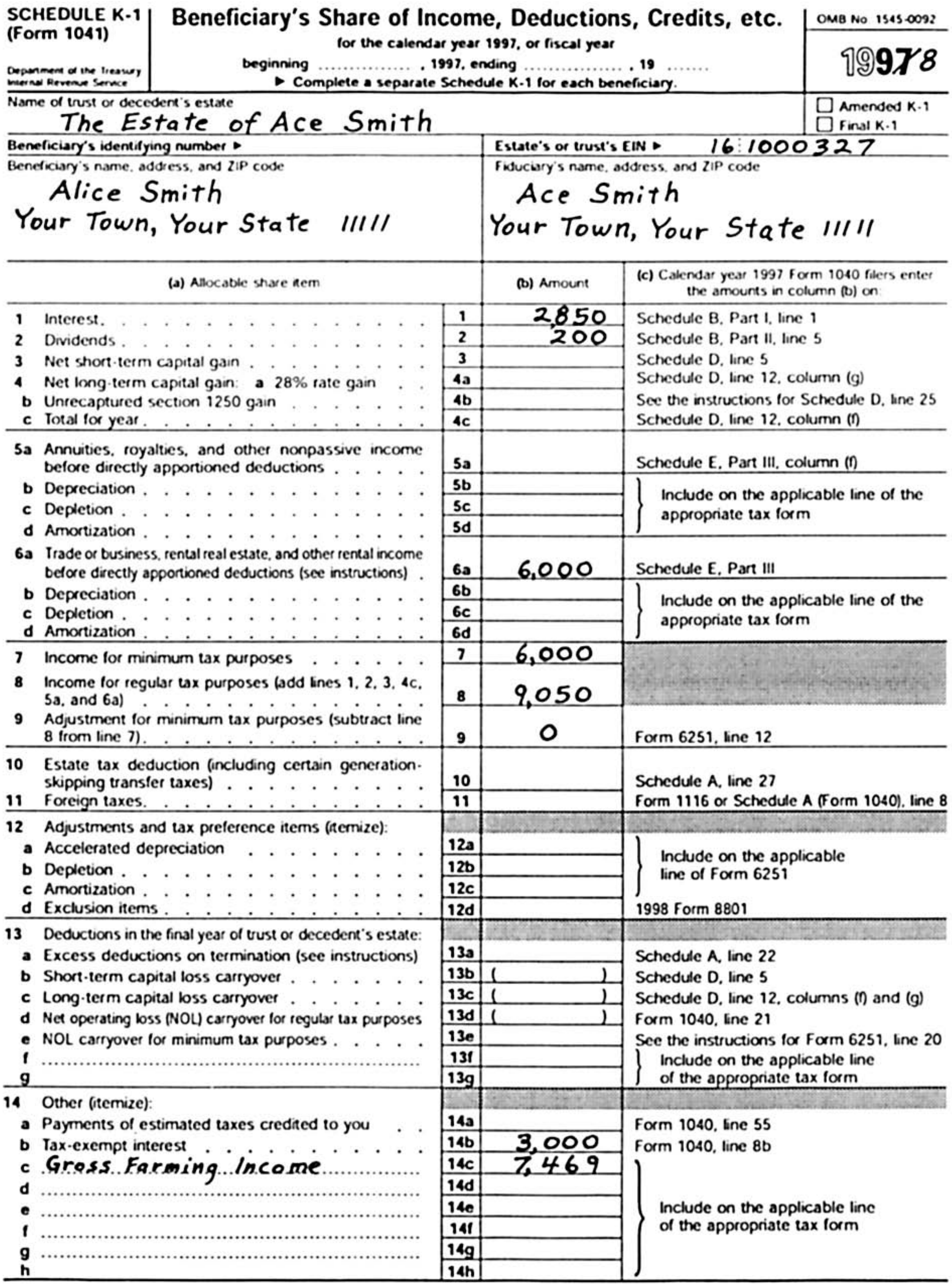
1	Adjusted total income (from page 1, line 17) (see page 16 of the instructions)			1	17,050
2	Adjusted tax-exempt interest			2	3,000
3	Total net gain from Schedule D (Form 1041), line 16, column (1) (see page 16 of the instructions)			3	
4	Enter amount from Schedule A, line 4 (reduced by any allocable section 1202 exclusion)			4	
5	Capital gains for the tax year included on Schedule A, line 1 (see page 16 of the instructions)			5	
6	Enter any gain from page 1, line 4, as a negative number. If page 1, line 4, is a loss, enter the loss as a positive number			6	(8000)
7	**Distributable net income (DNI).** Combine lines 1 through 6. If zero or less, enter -0-			7	12,050
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law	8			
9	Income required to be distributed currently			9	0
10	Other amounts paid, credited, or otherwise required to be distributed			10	15000
11	Total distributions. Add lines 9 and 10. If greater than line 8, see page 17 of the instructions			11	15000
12	Enter the amount of tax-exempt income included on line 11			12	3000
13	Tentative income distribution deduction. Subtract line 12 from line 11			13	12000
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-			14	9050
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18			15	9050

Schedule G Tax Computation (see page 17 of the instructions)

1	**Tax:** a ☐ Tax rate schedule or ☒ Schedule D (Form 1041)	1a	1315		
	b Other taxes	1b	—		
	c Total. Add lines 1a and 1b ▶			1c	1315
2a	Foreign tax credit (attach Form 1116)	2a	—		
b	Check: ☐ Nonconventional source fuel credit ☐ Form 8834	2b	—		
c	General business credit. Enter here and check which forms are attached: ☐ Form 3800 or ☐ Forms (specify) ▶	2c	—		
d	Credit for prior year minimum tax (attach Form 8801)	2d	—		
3	**Total credits.** Add lines 2a through 2d ▶			3	0
4	Subtract line 3 from line 1c			4	1315
5	Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611			5	—
6	Alternative minimum tax (from Schedule I, line 42)			6	—
7	Household employment taxes. Attach Schedule H (Form 1040)			7	—
8	**Total tax.** Add lines 4 through 7. Enter here and on page 1, line 24 ▶			8	1315

Other Information

		Yes	No
1	Did the estate or trust receive tax-exempt income? If "Yes," attach a computation of the allocation of expenses. Enter the amount of tax-exempt interest income and exempt-interest dividends ▶ $ 3000	X	
2	Did the estate or trust receive all or any part of the earnings (salary, wages, and other compensation) of any individual by reason of a contract assignment or similar arrangement?		X
3	At any time during calendar year 199~~7~~8, did the estate or trust have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country? See page 19 of the instructions for exceptions and filing requirements for Form TD F 90-22.1. If "Yes," enter the name of the foreign country ▶		X
4	During the tax year, did the estate or trust receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the estate or trust may have to file Form 3520 or 926. See page 19 of the instructions		X
5	Did the estate or trust receive, or pay, any seller-financed mortgage interest? If "Yes," see page 19 for required attachment		X
6	If this is an estate or a complex trust making the section 663(b) election, check here (see page 19) ▶ ☐		
7	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here (see page 19) ▶ ☐		
8	If the decedent's estate has been open for more than 2 years, check here ▶ ☐		
9	Are any trust beneficiaries skip persons? See page 19 of the instructions		X



SCHEDULE K-1 (Form 1041)

Department of the Treasury
Internal Revenue Service

Beneficiary's Share of Income, Deductions, Credits, etc.

for the calendar year 1997, or fiscal year

beginning .... , 1997, ending .... , 19 ....

▶ Complete a separate Schedule K-1 for each beneficiary.

OMB No. 1545-0092

199~~7~~8

☐ Amended K-1
☐ Final K-1

Name of trust or decedent's estate: The Estate of Ace Smith

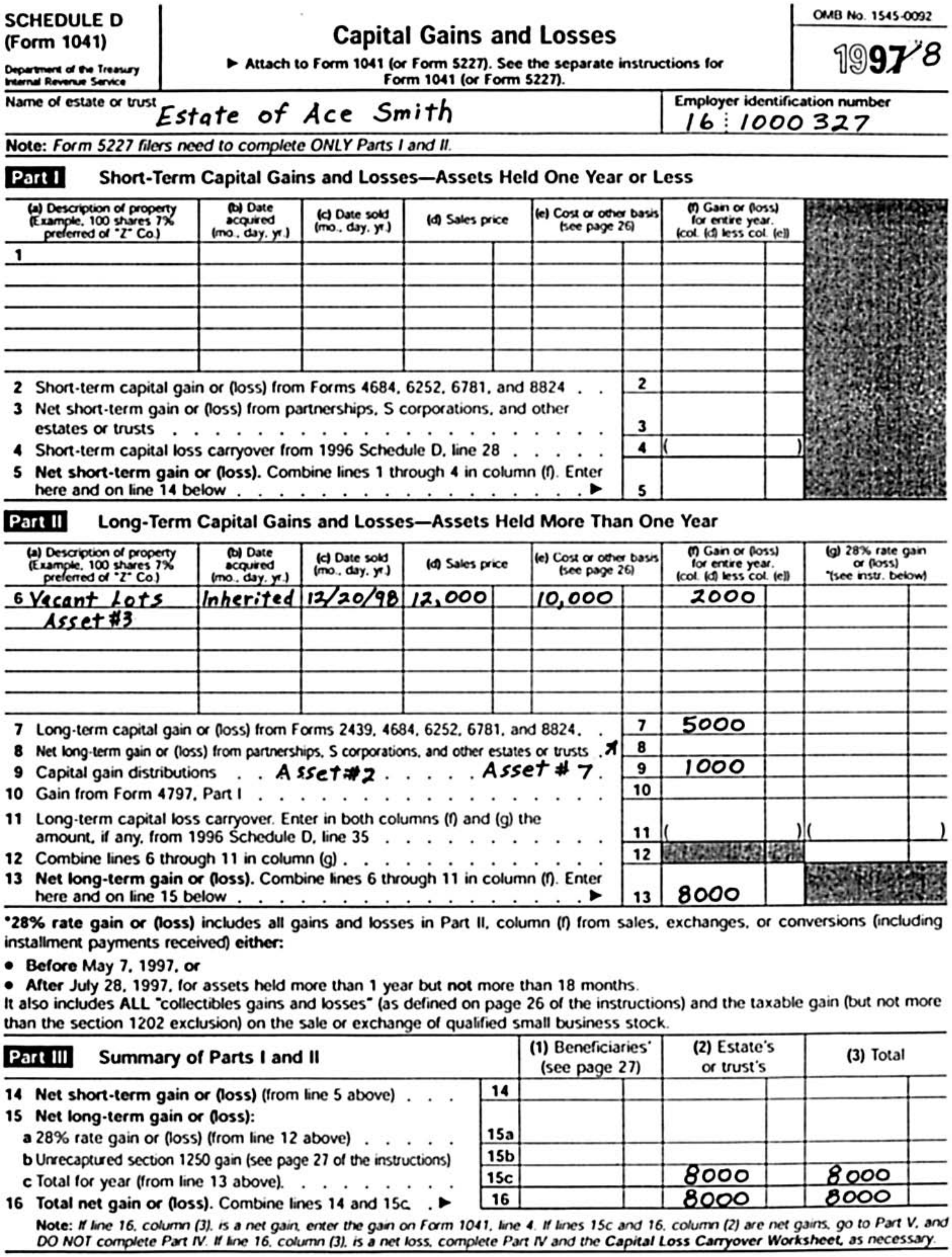
Beneficiary's identifying number ▶

Estate's or trust's EIN ▶ 16:1000327

Beneficiary's name, address, and ZIP code:
Alice Smith
Your Town, Your State 11111

Fiduciary's name, address, and ZIP code:
Ace Smith
Your Town, Your State 11111

(a) Allocable share item		(b) Amount	(c) Calendar year 1997 Form 1040 filers enter the amounts in column (b) on:
1 Interest	1	2,850	Schedule B, Part I, line 1
2 Dividends	2	200	Schedule B, Part II, line 5
3 Net short-term capital gain	3		Schedule D, line 5
4 Net long-term capital gain: a 28% rate gain	4a		Schedule D, line 12, column (g)
b Unrecaptured section 1250 gain	4b		See the instructions for Schedule D, line 25
c Total for year	4c		Schedule D, line 12, column (f)
5a Annuities, royalties, and other nonpassive income before directly apportioned deductions	5a		Schedule E, Part III, column (f)
b Depreciation	5b		Include on the applicable line of the appropriate tax form
c Depletion	5c		
d Amortization	5d		
6a Trade or business, rental real estate, and other rental income before directly apportioned deductions (see instructions)	6a	6,000	Schedule E, Part III
b Depreciation	6b		Include on the applicable line of the appropriate tax form
c Depletion	6c		
d Amortization	6d		
7 Income for minimum tax purposes	7	6,000	
8 Income for regular tax purposes (add lines 1, 2, 3, 4c, 5a, and 6a)	8	9,050	
9 Adjustment for minimum tax purposes (subtract line 8 from line 7)	9	0	Form 6251, line 12
10 Estate tax deduction (including certain generation-skipping transfer taxes)	10		Schedule A, line 27
11 Foreign taxes	11		Form 1116 or Schedule A (Form 1040), line 8
12 Adjustments and tax preference items (itemize):			
a Accelerated depreciation	12a		Include on the applicable line of Form 6251
b Depletion	12b		
c Amortization	12c		
d Exclusion items	12d		1998 Form 8801
13 Deductions in the final year of trust or decedent's estate:			
a Excess deductions on termination (see instructions)	13a		Schedule A, line 22
b Short-term capital loss carryover	13b	( )	Schedule D, line 5
c Long-term capital loss carryover	13c	( )	Schedule D, line 12, columns (f) and (g)
d Net operating loss (NOL) carryover for regular tax purposes	13d	( )	Form 1040, line 21
e NOL carryover for minimum tax purposes	13e		See the instructions for Form 6251, line 20
f	13f		Include on the applicable line of the appropriate tax form
g	13g		
14 Other (itemize):			
a Payments of estimated taxes credited to you	14a		Form 1040, line 55
b Tax-exempt interest	14b	3,000	Form 1040, line 8b
c Gross Farming Income	14c	7,469	Include on the applicable line of the appropriate tax form
d	14d		
e	14e		
f	14f		
g	14g		
h	14h		



SCHEDULE D (Form 1041)
Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

▶ Attach to Form 1041 (or Form 5227). See the separate instructions for Form 1041 (or Form 5227).

OMB No. 1545-0092

199~~7~~8

Name of estate or trust: Estate of Ace Smith

Employer identification number: 16 : 1000327

Note: *Form 5227 filers need to complete ONLY Parts I and II.*

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

(a) Description of property (Example, 100 shares 7% preferred of "Z" Co.)	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Sales price	(e) Cost or other basis (see page 26)		(f) Gain or (loss) for entire year. (col. (d) less col. (e))
1						
2 Short-term capital gain or (loss) from Forms 4684, 6252, 6781, and 8824					2	
3 Net short-term gain or (loss) from partnerships, S corporations, and other estates or trusts					3	
4 Short-term capital loss carryover from 1996 Schedule D, line 28					4	( )
5 **Net short-term gain or (loss).** Combine lines 1 through 4 in column (f). Enter here and on line 14 below ▶					5	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

(a) Description of property (Example, 100 shares 7% preferred of "Z" Co.)	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Sales price	(e) Cost or other basis (see page 26)		(f) Gain or (loss) for entire year. (col. (d) less col. (e))	(g) 28% rate gain or (loss) *(see instr. below)
6 Vacant Lots Asset #3	Inherited	12/20/98	12,000	10,000		2000	
7 Long-term capital gain or (loss) from Forms 2439, 4684, 6252, 6781, and 8824					7	5000	
8 Net long-term gain or (loss) from partnerships, S corporations, and other estates or trusts					8		
9 Capital gain distributions Asset #2 Asset #7					9	1000	
10 Gain from Form 4797, Part I					10		
11 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from 1996 Schedule D, line 35					11	( )	( )
12 Combine lines 6 through 11 in column (g)					12		
13 **Net long-term gain or (loss).** Combine lines 6 through 11 in column (f). Enter here and on line 15 below ▶					13	8000	

***28% rate gain or (loss)** includes all gains and losses in Part II, column (f) from sales, exchanges, or conversions (including installment payments received) **either:**

- **Before** May 7, 1997, **or**
- **After** July 28, 1997, for assets held more than 1 year but **not** more than 18 months.

It also includes **ALL** "collectibles gains and losses" (as defined on page 26 of the instructions) and the taxable gain (but not more than the section 1202 exclusion) on the sale or exchange of qualified small business stock.

Part III Summary of Parts I and II

		(1) Beneficiaries' (see page 27)	(2) Estate's or trust's	(3) Total
14 **Net short-term gain or (loss)** (from line 5 above)	14			
15 **Net long-term gain or (loss):**				
a 28% rate gain or (loss) (from line 12 above)	15a			
b Unrecaptured section 1250 gain (see page 27 of the instructions)	15b			
c Total for year (from line 13 above)	15c		8000	8000
16 **Total net gain or (loss).** Combine lines 14 and 15c ▶	16		8000	8000

Note: *If line 16, column (3), is a net gain, enter the gain on Form 1041, line 4. If lines 15c and 16, column (2) are net gains, go to Part V, and DO NOT complete Part IV. If line 16, column (3), is a net loss, complete Part IV and the* **Capital Loss Carryover Worksheet,** *as necessary.*

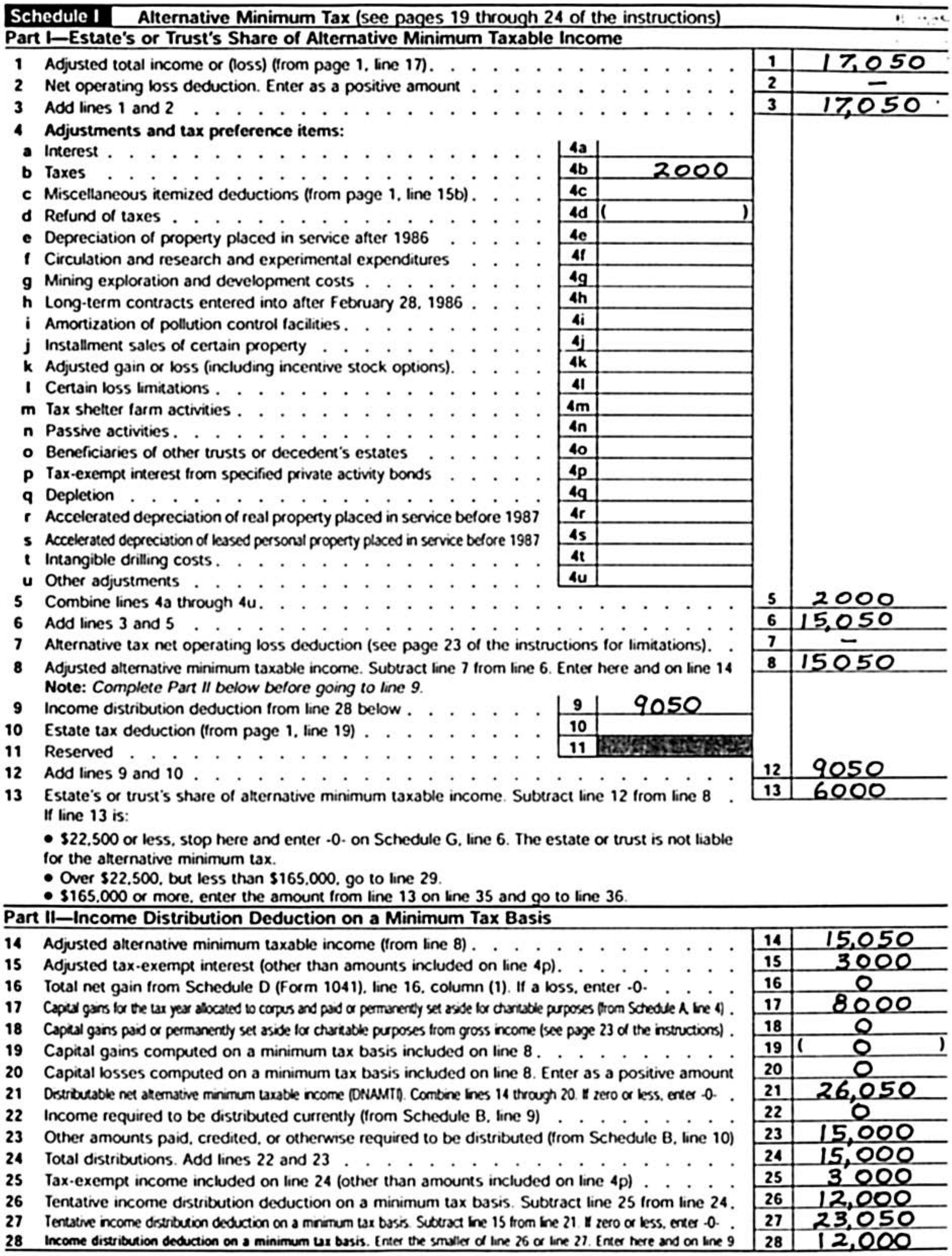
Part IV Capital Loss Limitation

17	Enter here and enter as a (loss) on Form 1041, line 4, the **smaller** of: **a** The loss on line 16, column (3); **or** **b** $3,000	17	( )

*If the loss on line 16, column (3) is more than $3,000, OR if Form 1041, page 1, line 23, is a loss, complete the **Capital Loss Carryover Worksheet** on page 27 of the instructions to determine your capital loss carryover.*

Part V Tax Computation Using Maximum Capital Gains Rates (Complete this part **only** if both lines 15c and 16 in column (2) are gains, and Form 1041, line 23 is more than zero.)

18	Enter taxable income from Form 1041, line 23			18	7400
19	Enter the **smaller** of line 15c or 16 in column (2)	19	8000		
20	If you are filing Form 4952, enter the amount from Form 4952, line 4e	20	—		
21	Subtract line 20 from line 19. If zero or less, enter -0-	21	8000		
22	Combine lines 14 and 15a, column (2). If zero or less, enter -0-	22	0		
23	Enter the **smaller** of line 15a, column (2), or line 22, but not less than zero	23	0		
24	Enter the amount from line 15b, column (2)	24	0		
25	Reserved	25			
26	Add lines 23 and 24	26	0		
27	Subtract line 26 from line 21. If zero or less, enter -0-			27	8000
28	Subtract line 27 from line 18. If zero or less, enter -0-			28	0
29	Enter the **smaller** of line 18 or $1,650			29	1650
30	Enter the **smaller** of line 28 or line 29			30	0
31	Subtract line 21 from line 18. If zero or less, enter -0-			31	0
32	Enter the **larger** of line 30 or line 31			32	0
33	Tax on amount on line 32 from the 199~~7~~8 Tax Rate Schedule ▶			33	0
34	Enter the amount from line 29			34	1650
35	Enter the amount from line 28			35	0
36	Subtract line 35 from line 34. If zero or less, enter -0-			36	1650
37	Multiply line 36 by 10% (.10) ▶			37	165
38	Enter the **smaller** of line 18 or line 27			38	7400
39	Enter the amount from line 36			39	1650
40	Subtract line 39 from line 38. If zero or less, enter -0-			40	5750
41	Multiply line 40 by 20% (.20) ▶			41	1150
42	Enter the **smaller** of line 21 or line 24			42	0
43	Add lines 21 and 32	43	8000		
44	Enter the amount from line 18	44	7400		
45	Subtract line 44 from line 43. If zero or less, enter -0-			45	600
46	Subtract line 45 from line 42. If zero or less, enter -0-			46	0
47	Multiply line 46 by 25% (.25) ▶			47	0
48	Enter the amount from line 18			48	7400
49	Add lines 32, 36, 40, and 46			49	7400
50	Subtract line 49 from line 48			50	0
51	Multiply line 50 by 28% (.28) ▶			51	0
52	Add lines 33, 37, 41, 47, and 51			52	1315
53	Tax on the amount on line 18 from the 199~~7~~8 Tax Rate Schedule			53	2018
54	**Tax.** Enter the **smaller** of line 52 or line 53 here and on line 1a of Schedule G, Form 1041 ▶			54	1315



Schedule I Alternative Minimum Tax (see pages 19 through 24 of the instructions)

Part I—Estate's or Trust's Share of Alternative Minimum Taxable Income

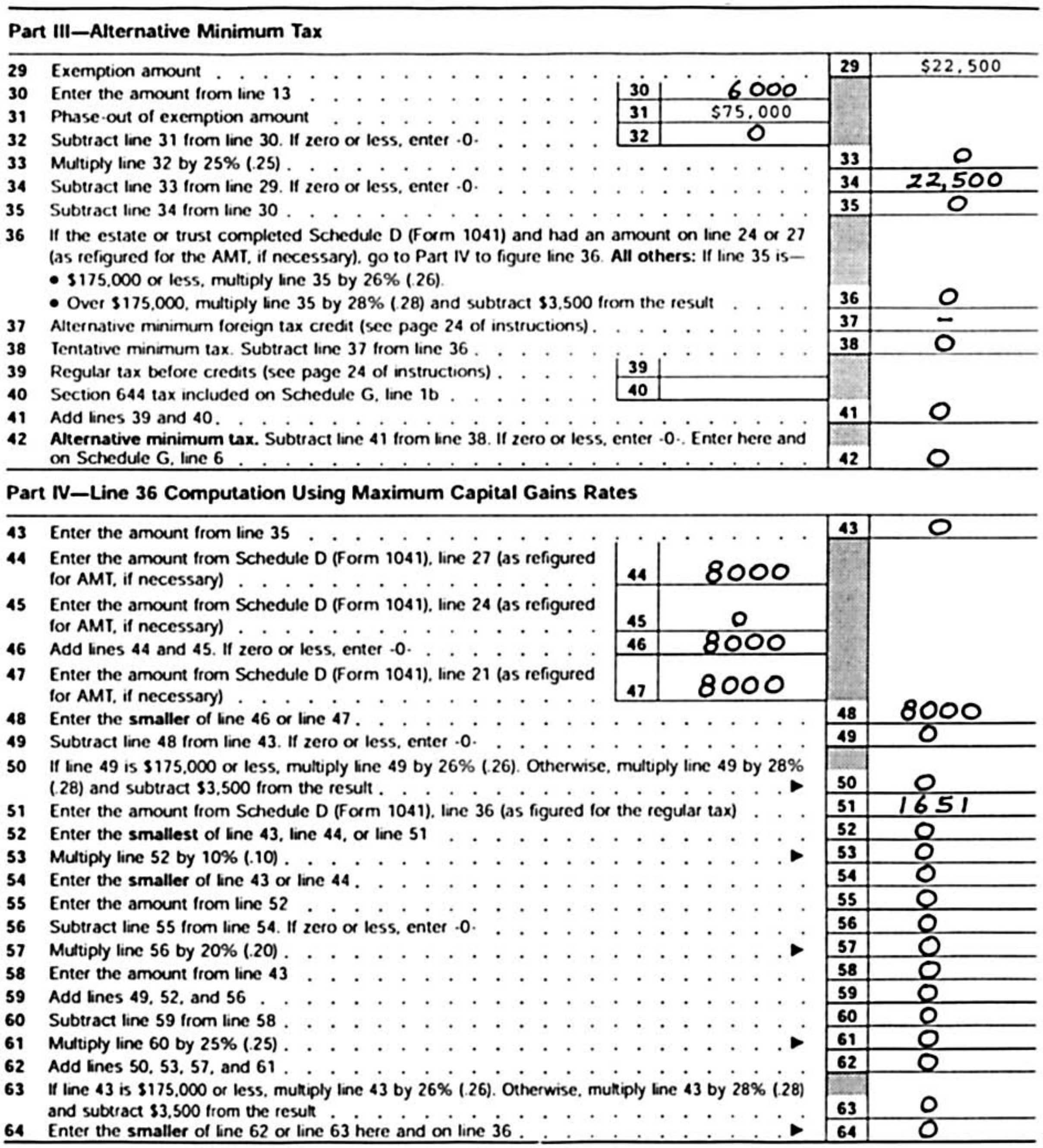
1		Adjusted total income or (loss) (from page 1, line 17)			1	17,050
2		Net operating loss deduction. Enter as a positive amount			2	—
3		Add lines 1 and 2			3	17,050
4		**Adjustments and tax preference items:**				
	a	Interest	4a			
	b	Taxes	4b	2000		
	c	Miscellaneous itemized deductions (from page 1, line 15b)	4c			
	d	Refund of taxes	4d	( )		
	e	Depreciation of property placed in service after 1986	4e			
	f	Circulation and research and experimental expenditures	4f			
	g	Mining exploration and development costs	4g			
	h	Long-term contracts entered into after February 28, 1986	4h			
	i	Amortization of pollution control facilities	4i			
	j	Installment sales of certain property	4j			
	k	Adjusted gain or loss (including incentive stock options)	4k			
	l	Certain loss limitations	4l			
	m	Tax shelter farm activities	4m			
	n	Passive activities	4n			
	o	Beneficiaries of other trusts or decedent's estates	4o			
	p	Tax-exempt interest from specified private activity bonds	4p			
	q	Depletion	4q			
	r	Accelerated depreciation of real property placed in service before 1987	4r			
	s	Accelerated depreciation of leased personal property placed in service before 1987	4s			
	t	Intangible drilling costs	4t			
	u	Other adjustments	4u			
5		Combine lines 4a through 4u			5	2000
6		Add lines 3 and 5			6	15,050
7		Alternative tax net operating loss deduction (see page 23 of the instructions for limitations)			7	—
8		Adjusted alternative minimum taxable income. Subtract line 7 from line 6. Enter here and on line 14 **Note:** *Complete Part II below before going to line 9.*			8	15050
9		Income distribution deduction from line 28 below	9	9050		
10		Estate tax deduction (from page 1, line 19)	10			
11		Reserved	11			
12		Add lines 9 and 10			12	9050
13		Estate's or trust's share of alternative minimum taxable income. Subtract line 12 from line 8			13	6000

If line 13 is:

- $22,500 or less, stop here and enter -0- on Schedule G, line 6. The estate or trust is not liable for the alternative minimum tax.
- Over $22,500, but less than $165,000, go to line 29.
- $165,000 or more, enter the amount from line 13 on line 35 and go to line 36.

Part II—Income Distribution Deduction on a Minimum Tax Basis

14	Adjusted alternative minimum taxable income (from line 8)	14	15,050
15	Adjusted tax-exempt interest (other than amounts included on line 4p)	15	3000
16	Total net gain from Schedule D (Form 1041), line 16, column (1). If a loss, enter -0-	16	0
17	Capital gains for the tax year allocated to corpus and paid or permanently set aside for charitable purposes (from Schedule A, line 4)	17	8000
18	Capital gains paid or permanently set aside for charitable purposes from gross income (see page 23 of the instructions)	18	0
19	Capital gains computed on a minimum tax basis included on line 8	19	(0)
20	Capital losses computed on a minimum tax basis included on line 8. Enter as a positive amount	20	0
21	Distributable net alternative minimum taxable income (DNAMTI). Combine lines 14 through 20. If zero or less, enter -0-	21	26,050
22	Income required to be distributed currently (from Schedule B, line 9)	22	0
23	Other amounts paid, credited, or otherwise required to be distributed (from Schedule B, line 10)	23	15,000
24	Total distributions. Add lines 22 and 23	24	15,000
25	Tax-exempt income included on line 24 (other than amounts included on line 4p)	25	3 000
26	Tentative income distribution deduction on a minimum tax basis. Subtract line 25 from line 24	26	12,000
27	Tentative income distribution deduction on a minimum tax basis. Subtract line 15 from line 21. If zero or less, enter -0-	27	23,050
28	**Income distribution deduction on a minimum tax basis.** Enter the smaller of line 26 or line 27. Enter here and on line 9	28	12,000



Part III—Alternative Minimum Tax

29	Exemption amount			29	$22,500
30	Enter the amount from line 13	30	6 000		
31	Phase-out of exemption amount	31	$75,000		
32	Subtract line 31 from line 30. If zero or less, enter -0-	32	0		
33	Multiply line 32 by 25% (.25)			33	0
34	Subtract line 33 from line 29. If zero or less, enter -0-			34	22,500
35	Subtract line 34 from line 30			35	0
36	If the estate or trust completed Schedule D (Form 1041) and had an amount on line 24 or 27 (as refigured for the AMT, if necessary), go to Part IV to figure line 36. **All others:** If line 35 is— • $175,000 or less, multiply line 35 by 26% (.26). • Over $175,000, multiply line 35 by 28% (.28) and subtract $3,500 from the result			36	0
37	Alternative minimum foreign tax credit (see page 24 of instructions)			37	–
38	Tentative minimum tax. Subtract line 37 from line 36			38	0
39	Regular tax before credits (see page 24 of instructions)	39			
40	Section 644 tax included on Schedule G, line 1b	40			
41	Add lines 39 and 40			41	0
42	**Alternative minimum tax.** Subtract line 41 from line 38. If zero or less, enter -0-. Enter here and on Schedule G, line 6			42	0

Part IV—Line 36 Computation Using Maximum Capital Gains Rates

43	Enter the amount from line 35			43	0
44	Enter the amount from Schedule D (Form 1041), line 27 (as refigured for AMT, if necessary)	44	8000		
45	Enter the amount from Schedule D (Form 1041), line 24 (as refigured for AMT, if necessary)	45	0		
46	Add lines 44 and 45. If zero or less, enter -0-	46	8000		
47	Enter the amount from Schedule D (Form 1041), line 21 (as refigured for AMT, if necessary)	47	8000		
48	Enter the **smaller** of line 46 or line 47			48	8000
49	Subtract line 48 from line 43. If zero or less, enter -0-			49	0
50	If line 49 is $175,000 or less, multiply line 49 by 26% (.26). Otherwise, multiply line 49 by 28% (.28) and subtract $3,500 from the result ▶			50	0
51	Enter the amount from Schedule D (Form 1041), line 36 (as figured for the regular tax)			51	1651
52	Enter the **smallest** of line 43, line 44, or line 51			52	0
53	Multiply line 52 by 10% (.10) ▶			53	0
54	Enter the **smaller** of line 43 or line 44			54	0
55	Enter the amount from line 52			55	0
56	Subtract line 55 from line 54. If zero or less, enter -0-			56	0
57	Multiply line 56 by 20% (.20) ▶			57	0
58	Enter the amount from line 43			58	0
59	Add lines 49, 52, and 56			59	0
60	Subtract line 59 from line 58			60	0
61	Multiply line 60 by 25% (.25) ▶			61	0
62	Add lines 50, 53, 57, and 61			62	0
63	If line 43 is $175,000 or less, multiply line 43 by 26% (.26). Otherwise, multiply line 43 by 28% (.28) and subtract $3,500 from the result			63	0
64	Enter the **smaller** of line 62 or line 63 here and on line 36 ▶			64	0

Name(s) shown on return. Do not enter name and social security number if shown on other side.	Your social security number
Estate of Ace Smith 16-1000327	

Note: *If you report amounts from farming or fishing on Schedule E, you must enter your gross income from those activities on line 41 below. Real estate professionals must complete line 42 below.*

Part II Income or Loss From Partnerships and S Corporations

Note: *If you report a loss from an at-risk activity, you MUST check either column* **(e)** *or* **(f)** *on line 27 to describe your investment in the activity. See page E-4. If you check column* **(f)**, *you must attach* **Form 6198.**

27	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	Investment At Risk? (e) All is at risk	Investment At Risk? (f) Some is not at risk
A						
B						
C						
D						
E						

	Passive Income and Loss		Nonpassive Income and Loss		
	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss from Schedule K-1	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
A					
B					
C					
D					
E					
28a Totals					
b Totals					

29	Add columns (h) and (k) of line 28a	29	
30	Add columns (g), (i), and (j) of line 28b	30	( )
31	Total partnership and S corporation income or (loss). Combine lines 29 and 30. Enter the result here and include in the total on line 40 below	31	

Part III Income or Loss From Estates and Trusts

32	(a) Name	(b) Employer identification number
A		
B		

	Passive Income and Loss		Nonpassive Income and Loss	
	(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1
A				
B				
33a Totals				
b Totals				

34	Add columns (d) and (f) of line 33a	34	
35	Add columns (c) and (e) of line 33b	35	( )
36	Total estate and trust income or (loss). Combine lines 34 and 35. Enter the result here and include in the total on line 40 below	36	

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

37 (a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see page E-5)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b

38	Combine columns (d) and (e) only. Enter the result here and include in the total on line 40 below	38	

Part V Summary

39	Net farm rental income or (loss) from **Form 4835.** Also, complete line 41 below	39	6,000
40	TOTAL income or (loss). Combine lines 26, 31, 36, 38, and 39. Enter the result here and on Form 1040, line 17 ▶	40	6,000
41	**Reconciliation of Farming and Fishing Income.** Enter your gross farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), line 15b; Schedule K-1 (Form 1120S), line 23; and Schedule K-1 (Form 1041), line 14 (see page E-5)	41	12,000
42	**Reconciliation for Real Estate Professionals.** If you were a real estate professional (see page E-4), enter the net income or (loss) you reported anywhere on Form 1040 from all rental real estate activities in which you materially participated under the passive activity loss rules . . .	42	

Asset #6

Form **4835**

Department of the Treasury
Internal Revenue Service

Farm Rental Income and Expenses

(Crop and Livestock Shares (Not Cash) Received by Landowner (or Sub-Lessor))

(Income not subject to self-employment tax)

▶ Attach to Form 1040. ▶ See instructions on back.

OMB No. 1545-0187

199~~7~~8

Attachment Sequence No. **37**

Name(s) shown on Form 1040: Estate of Ace Smith

Your social security number:

Employer ID number (EIN), if any: 161000327

A Did you actively participate in the operation of this farm during 1997? See instructions . . . . ☒ Yes ☐ No

Part I **Gross Farm Rental Income—Based on Production.** Include amounts converted to cash or the equivalent.

1	Income from production of livestock, produce, grains, and other crops	**1**	12,000
2a	Total cooperative distributions (Form(s) 1099-PATR) **2a** ______ **2b** Taxable amount	**2b**	
3a	Agricultural program payments. See instructions **3a** ______ **3b** Taxable amount	**3b**	
4	Commodity Credit Corporation (CCC) loans. See instructions:		
a	CCC loans reported under election	**4a**	
b	CCC loans forfeited **4b** ______ **4c** Taxable amount	**4c**	
5	Crop insurance proceeds and certain disaster payments. See instructions:		
a	Amount received in 1997 **5a** ______ **5b** Taxable amount	**5b**	
c	If election to defer to 1998 is attached, check here ▶ ☐ **5d** Amount deferred from 1996	**5d**	
6	Other income, including Federal and state gasoline or fuel tax credit or refund. See instructions	**6**	
7	**Gross farm rents.** Add amounts in the right column for lines 1 through 6. Enter the total here and on Schedule E (Form 1040), line 41 ▶	**7**	12,000

Part II **Expenses—Farm Rental Property.** Do not include personal or living expenses.

8	Car and truck expenses. See Schedule F instructions—also attach **Form 4562**	**8**	
9	Chemicals	**9**	800
10	Conservation expenses (see instructions)	**10**	
11	Custom hire (machine work)	**11**	
12	Depreciation and section 179 expense deduction not claimed elsewhere	**12**	
13	Employee benefit programs other than on line 21. See Schedule F instructions	**13**	
14	Feed purchased	**14**	
15	Fertilizers and lime	**15**	
16	Freight and trucking	**16**	
17	Gasoline, fuel, and oil	**17**	
18	Insurance (other than health)	**18**	500
19	Interest:		
a	Mortgage (paid to banks, etc.)	**19a**	
b	Other	**19b**	
20	Labor hired (less employment credits). See Schedule F instructions	**20**	
21	Pension and profit-sharing plans	**21**	
22	Rent or lease. See instructions:		
a	Vehicles, machinery, and equipment	**22a**	
b	Other (land, animals, etc.)	**22b**	
23	Repairs and maintenance	**23**	500
24	Seeds and plants purchased	**24**	
25	Storage and warehousing	**25**	
26	Supplies purchased	**26**	
27	Taxes	**27**	4,200
28	Utilities	**28**	
29	Veterinary, breeding, and medicine	**29**	
30	Other expenses (specify):		
	a	**30a**	
	b	**30b**	
	c	**30c**	
	d	**30d**	
	e	**30e**	
	f	**30f**	
	g	**30g**	
31	**Total expenses.** Add lines 8 through 30g ▶	**31**	6,000
32	**Net farm rental income or (loss).** Subtract line 31 from line 7. If the result is income, enter it here and on Schedule E, line 39. If the result is a loss, you MUST go on to line 33	**32**	6,000
33	If line 32 is a loss, you MUST check the box that describes your investment in this activity. See instructions	**33a** ☒ All investment is at risk. **33b** ☐ Some investment is not at risk.	
	You may need to complete **Form 8582** to determine your deductible loss, regardless of which box you check (see instructions). However, if you checked 33b, you MUST complete **Form 6198** before going to Form 8582. In either case, enter the deductible loss here and on Schedule E, line 39	**33c**	

Asset # 7

Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ See separate instructions. ▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.

OMB No. 1545-0228
1998
Attachment Sequence No. **79**

Name(s) shown on return: Estate of Ace Smith

Identifying number: 16-1000327

1 Description of property ▶ Farmland

2a Date acquired (month, day, year) ▶ Inherited **b** Date sold (month, day, year) ▶ 12 / 20 / 98

3 Was the property sold to a related party after May 14, 1980? See instructions. If "No," skip line 4 ☒ Yes ☐ No

4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale ☐ Yes ☒ No

Part I **Gross Profit and Contract Price.** Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest whether stated or unstated		5	
6	Mortgages and other debts the buyer assumed or took the property subject to, but not new mortgages the buyer got from a bank or other source	6		
7	Subtract line 6 from line 5	7		
8	Cost or other basis of property sold	8		
9	Depreciation allowed or allowable	9		
10	Adjusted basis. Subtract line 9 from line 8	10		
11	Commissions and other expenses of sale	11		
12	Income recapture from Form 4797, Part III. See instructions	12		
13	Add lines 10, 11, and 12		13	
14	Subtract line 13 from line 5. If zero or less, **stop here. Do not** complete the rest of this form		14	
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain. Otherwise, enter -0-. See instructions		15	
16	**Gross profit.** Subtract line 15 from line 14		16	
17	Subtract line 13 from line 6. If zero or less, enter -0-		17	
18	**Contract price.** Add line 7 and line 17		18	

Part II **Installment Sale Income.** Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage. Divide line 16 by line 18. For years after the year of sale, see instructions		19	0.5000
20	**For year of sale only:** Enter amount from line 17 above; otherwise, enter -0-		20	
21	Payments received during year. See instructions. **Do not** include interest whether stated or unstated		21	10,000
22	Add lines 20 and 21		22	10,000
23	Payments received in prior years. See instructions. **Do not** include interest whether stated or unstated	23	50,000	
24	**Installment sale income.** Multiply line 22 by line 19		24	5,000
25	Part of line 24 that is ordinary income under recapture rules. See instructions		25	—
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions		26	5,000

Part III **Related Party Installment Sale Income. Do not** complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party
Bob Smith, Your town, Your State 333-33-3333

28 Did the related party, during this tax year, resell or dispose of the property ("second disposition")? ☐ Yes ☒ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check only the box that applies.**

- **a** ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (month, day, year) ▶ / /
- **b** ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
- **c** ☐ The second disposition was an involuntary conversion where the threat of conversion occurred after the first disposition.
- **d** ☐ The second disposition occurred after the death of the original seller or buyer.
- **e** ☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See instructions.

30	Selling price of property sold by related party	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 1998 tax year. See instructions	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Part of line 35 that is ordinary income under recapture rules. See instructions	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797. See instructions	37	

Final Return—Filed Jointly
Decedent Ace E. Smith Died 5-1-1998

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 1998

IRS Use Only—Do not write or staple in this space

For the year Jan. 1–Dec. 31, 1998, or other tax year beginning , 1998, ending , 19 OMB No. 1545-0074

Label (See instructions on page 12.) **Use the IRS label.** Otherwise, please print or type.

Your first name and initial Ace E.	Last name Smith		**Your social security number** 111 11 1111
If a joint return, spouse's first name and initial Alice W.	Last name Smith		**Spouse's social security number** 222 22 2222
Home address (number and street). If you have a P.O. box, see page 12. Your Street		Apt. no.	▲ **IMPORTANT!** ▲ You must enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 12. Your Town, Your State 11111			

Presidential Election Campaign (See page 12.)
Do you want $3 to go to this fund? Yes ☐ No ☐
If a joint return, does your spouse want $3 to go to this fund? Yes ☐ No ☐
Note: *Checking "Yes" will not change your tax or reduce your refund.*

Filing Status

Check only one box.

1 ☐ Single
2 ☒ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. Enter spouse's social security no. above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 12.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶ 19). (See page 12.)

Exemptions

6a ☒ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a.
b ☒ **Spouse**
No. of boxes checked on 6a and 6b: 2

c **Dependents:**

If more than six dependents, see page 13.

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 13)
			☐
			☐
			☐
			☐
			☐
			☐

No. of your children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see page 13)

Dependents on 6c not entered above

d Total number of exemptions claimed

Add numbers entered on lines above ▶ 2

Income

Attach Copy B of your Forms W-2, W-2G, and 1099-R here.

If you did not get a W-2, see page 14.

Enclose, but do not staple, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	6,894
8a	**Taxable** interest. Attach Schedule B if required		8a	3,100
b	**Tax-exempt** interest. DO NOT include on line 8a	8b 3,000		
9	Ordinary dividends. Attach Schedule B if required		9	300
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 15)		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). Attach Schedule D		13	1,000
14	Other gains or (losses). Attach Form 4797		14	
15a	Total IRA distributions 15a	b Taxable amount (see page 16)	15b	
16a	Total pensions and annuities 16a 5,000	b Taxable amount (see page 16)	16b	5,000
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	15,156
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation		19	
20a	Social security benefits 20a	b Taxable amount (see page 18)	20b	
21	Other income. List type and amount—see page 18		21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	31,450

Adjusted Gross Income

If line 33 is under $30,095 (under $10,030 if a child did not live with you), see EIC inst. on page 30.

23	IRA deduction (see page 19)	23		
24	Student loan interest deduction (see page 21)	24		
25	Medical savings account deduction. Attach Form 8853	25		
26	Moving expenses. Attach Form 3903	26		
27	One-half of self-employment tax. Attach Schedule SE	27		
28	Self-employed health insurance deduction (see page 22)	28		
29	Keogh and self-employed SEP and SIMPLE plans	29		
30	Penalty on early withdrawal of savings	30		
31a	Alimony paid b Recipient's SSN ▶	31a		
32	Add lines 23 through 31a		32	–
33	Subtract line 32 from line 22. This is your **adjusted gross income** ▶		33	31,450

Tax and Credits	34	Amount from line 33 (adjusted gross income)			34	31,450
	35a	Check if: ☒ **You** were 65 or older, ☐ Blind; ☒ **Spouse** was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 35a	2			
	b	If you are married filing separately and your spouse itemizes deductions or you were a dual-status alien, see page 23 and check here ▶ 35b ☐				
Standard Deduction for Most People Single: $4,250 Head of household: $6,250 Married filing jointly or Qualifying widow(er): $7,100 Married filing separately: $3,550	36	Enter the **larger** of your **itemized deductions** from Schedule A, line 28, **OR standard deduction** shown on the left. **But** see page 23 to find your standard deduction if you checked any box on line 35a or 35b **or** if someone can claim you as a dependent			36	8800
	37	Subtract line 36 from line 34			37	22,650
	38	If line 34 is $93,400 or less, multiply $2,700 by the total number of exemptions claimed on line 6d. If line 34 is over $93,400, see the worksheet on page 24 for the amount to enter			38	3400
	39	**Taxable income.** Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-			39	19,250
	40	**Tax.** See page 24. Check if any tax from a ☐ Form(s) 8814 b ☐ Form 4972 ▶			40	2850
	41	Credit for child and dependent care expenses. Attach Form 2441	41			
	42	Credit for the elderly or the disabled. Attach Schedule R	42			
	43	Child tax credit (see page 25)	43			
	44	Education credits. Attach Form 8863	44			
	45	Adoption credit. Attach Form 8839	45			
	46	Foreign tax credit. Attach Form 1116 if required	46			
	47	Other. Check if from a ☐ Form 3800 b ☐ Form 8396 c ☐ Form 8801 d ☐ Form (specify)	47			
	48	Add lines 41 through 47. These are your **total credits**			48	–
	49	Subtract line 48 from line 40. If line 48 is more than line 40, enter -0- ▶			49	2850
Other Taxes	50	Self-employment tax. Attach Schedule SE			50	
	51	Alternative minimum tax. Attach Form 6251			51	
	52	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137			52	
	53	Tax on IRAs, other retirement plans, and MSAs. Attach Form 5329 if required			53	
	54	Advance earned income credit payments from Form(s) W-2			54	
	55	Household employment taxes. Attach Schedule H			55	
	56	Add lines 49 through 55. This is your **total tax** ▶			56	2850
Payments Attach Forms W-2 and W-2G on the front. Also attach Form 1099-R if tax was withheld.	57	Federal income tax withheld from Forms W-2 and 1099	57	2500		
	58	1998 estimated tax payments and amount applied from 1997 return	58			
	59a	**Earned income credit.** Attach Schedule EIC if you have a qualifying child **b** Nontaxable earned income: amount ▶ and type ▶	59a			
	60	Additional child tax credit. Attach Form 8812	60			
	61	Amount paid with Form 4868 (request for extension)	61			
	62	Excess social security and RRTA tax withheld (see page 37)	62			
	63	Other payments. Check if from a ☐ Form 2439 b ☐ Form 4136	63			
	64	Add lines 57, 58, 59a, and 60 through 63. These are your **total payments** ▶			64	2500
Refund Have it directly deposited! See page 37 and fill in 66b, 66c, and 66d.	65	If line 64 is more than line 56, subtract line 56 from line 64. This is the amount you **OVERPAID**			65	
	66a	Amount of line 65 you want **REFUNDED TO YOU** ▶			66a	
	▶ b	Routing number ☐☐☐☐☐☐☐☐☐ ▶ c Type: ☐ Checking ☐ Savings				
	▶ d	Account number ☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐				
	67	Amount of line 65 you want **APPLIED TO YOUR 1999 ESTIMATED TAX** ▶	67			
Amount You Owe	68	If line 56 is more than line 64, subtract line 64 from line 56. This is the **AMOUNT YOU OWE**. For details on how to pay, see page 38 ▶			68	350
	69	Estimated tax penalty. Also include on line 68	69			

Sign Here

Joint return? See page 38.

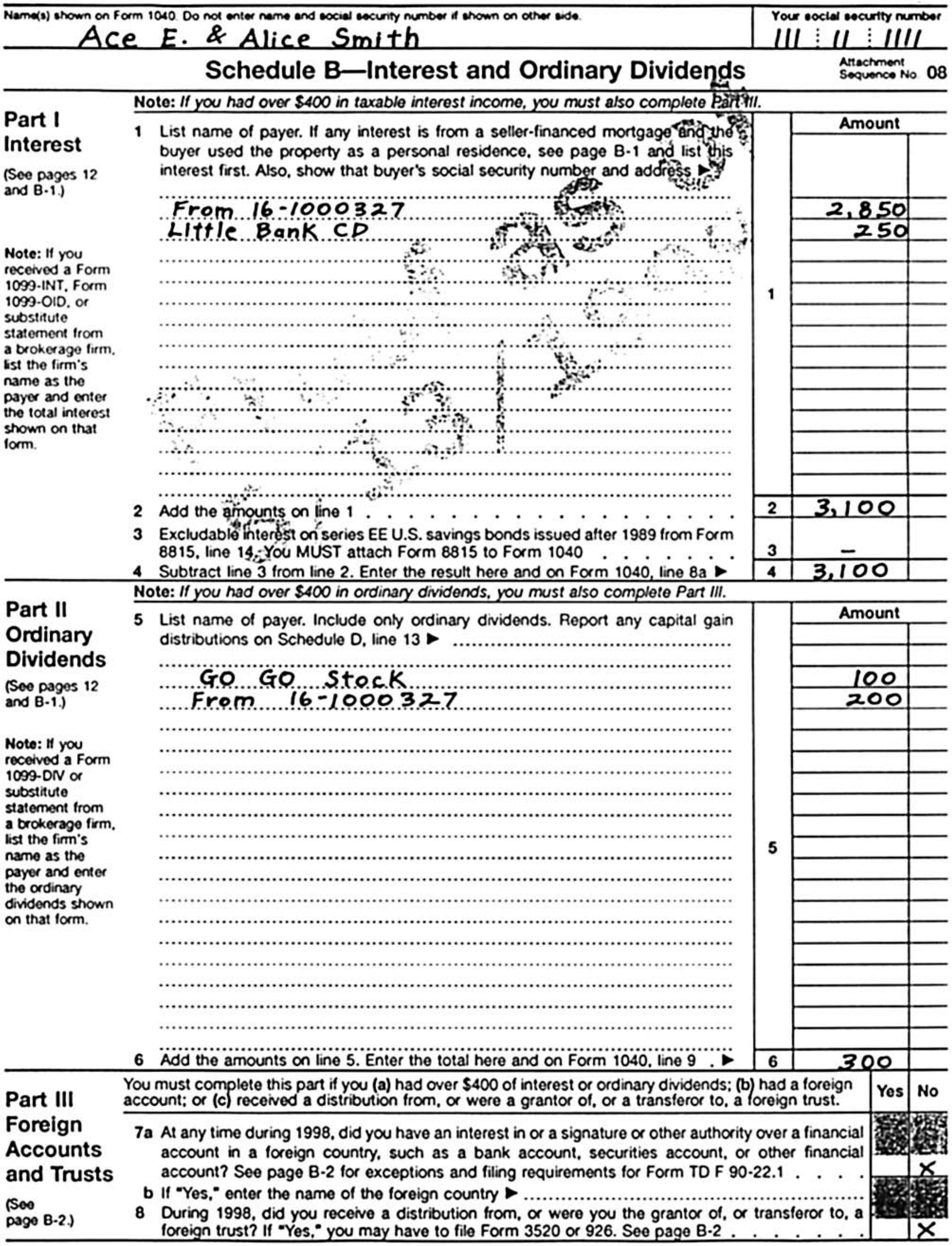
Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature X	Date X	Your occupation	Daytime telephone number (optional) ( )
Spouse's signature. If a joint return, BOTH must sign. X	Date X	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature ▶ X	Date	Check if self-employed ☐	Preparer's social security no.
Firm's name (or yours if self-employed) and address ▶			EIN
			ZIP code



Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side.
Ace E. & Alice Smith

Your social security number
111 : 11 : 1111

Schedule B—Interest and Ordinary Dividends

Attachment Sequence No. 08

Part I Interest

(See pages 12 and B-1.)

Note: If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

Note: *If you had over $400 in taxable interest income, you must also complete Part III.*

		Amount
1 List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶		
From 16-1000327	1	2,850
Little Bank CD		250
2 Add the amounts on line 1	2	3,100
3 Excludable interest on series EE U.S. savings bonds issued after 1989 from Form 8815, line 14. You MUST attach Form 8815 to Form 1040	3	—
4 Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	4	3,100

Part II Ordinary Dividends

(See pages 12 and B-1.)

Note: If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

Note: *If you had over $400 in ordinary dividends, you must also complete Part III.*

		Amount
5 List name of payer. Include only ordinary dividends. Report any capital gain distributions on Schedule D, line 13 ▶		
GO GO Stock	5	100
From 16-1000327		200
6 Add the amounts on line 5. Enter the total here and on Form 1040, line 9 ▶	6	300

Part III Foreign Accounts and Trusts

(See page B-2.)

You must complete this part if you (a) had over $400 of interest or ordinary dividends; (b) had a foreign account; or (c) received a distribution from, or were a grantor of, or a transferor to, a foreign trust.	Yes	No
7a At any time during 1998, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-2 for exceptions and filing requirements for Form TD F 90-22.1		X
b If "Yes," enter the name of the foreign country ▶		
8 During 1998, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520 or 926. See page B-2		X

SCHEDULE E
(Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Supplemental Income and Loss

(From rental real estate, royalties, partnerships,
S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040 or Form 1041. ▶ See Instructions for Schedule E (Form 1040).

OMB No. 1545-0074
1998
Attachment Sequence No. **13**

Name(s) shown on return: Ace & Alice Smith

Your social security number: 111 11 1111

Part I **Income or Loss From Rental Real Estate and Royalties** **Note:** *Report income and expenses from your business of renting personal property on* ***Schedule C*** *or* ***C-EZ*** *(see page E-1). Report farm rental income or loss from* ***Form 4835*** *on page 2, line 39.*

				Yes	No
1	Show the kind and location of each **rental real estate property:**	2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of: • 14 days, or • 10% of the total days rented at fair rental value? (See page E-3.)			
A	Rental Home #1 South Artumm		A		
B			B		
C			C		

		Properties A	Properties B	Properties C		Totals (Add columns A, B, and C.)
Income:						
3 Rents received	3	6000			3	6000
4 Royalties received	4				4	
Expenses:						
5 Advertising	5					
6 Auto and travel (see page E-2)	6					
7 Cleaning and maintenance	7					
8 Commissions	8					
9 Insurance	9	500				
10 Legal and other professional fees	10	200				
11 Management fees	11					
12 Mortgage interest paid to banks, etc. (see page E-2)	12				12	
13 Other interest	13					
14 Repairs	14	1000				
15 Supplies	15					
16 Taxes	16	2000				
17 Utilities	17					
18 Other (list) ▶	18					
19 Add lines 5 through 18	19	3700			19	3700
20 Depreciation expense or depletion (see page E-2)	20	2144			20	2144
21 Total expenses. Add lines 19 and 20	21	5844				
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-3 to find out if you must file **Form 6198**	22	156				
23 Deductible rental real estate loss. **Caution:** *Your rental real estate loss on line 22 may be limited. See page E-3 to find out if you must file* ***Form 8582****. Real estate professionals must complete line 42 on page 2*	23	( )	( )	( )		
24 **Income.** Add positive amounts shown on line 22. **Do not** include any losses					24	156
25 **Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here					25	( )
26 Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 39 on page 2 do not apply to you, also enter this amount on Form 1040, line 17. Otherwise, include this amount in the total on line 40 on page 2					26	156

Name(s) shown on return. Do not enter name and social security number if shown on other side
Ace & Alice Smith

Your social security number
111 : 11 : 1111

Note: *If you report amounts from farming or fishing on Schedule E, you must enter your gross income from those activities on line 41 below. Real estate professionals must complete line 42 below.*

Part II Income or Loss From Partnerships and S Corporations

Note: *If you report a loss from an at-risk activity, you MUST check either column **(e)** or **(f)** on line 27 to describe your investment in the activity. See page E-4. If you check column **(f)**, you must attach **Form 6198**.*

27	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	Investment At Risk? (e) All is at risk	(f) Some is not at risk
A						
B						
C						
D						
E						

	Passive Income and Loss		Nonpassive Income and Loss		
	(g) Passive loss allowed (attach **Form 8582** if required)	(h) Passive income from **Schedule K-1**	(i) Nonpassive loss from **Schedule K-1**	(j) Section 179 expense deduction from **Form 4562**	(k) Nonpassive income from **Schedule K-1**
A					
B					
C					
D					
E					
28a Totals					
b Totals					

29 Add columns (h) and (k) of line 28a 29

30 Add columns (g), (i), and (j) of line 28b . . . . 30 ( )

31 Total partnership and S corporation income or (loss). Combine lines 29 and 30. Enter the result here and include in the total on line 40 below 31

Part III Income or Loss From Estates and Trusts

32	(a) Name	(b) Employer identification number
A	Estate of Ace Smith	16-1000327
B		

	Passive Income and Loss		Nonpassive Income and Loss	
	(c) Passive deduction or loss allowed (attach **Form 8582** if required)	(d) Passive income from **Schedule K-1**	(e) Deduction or loss from **Schedule K-1**	(f) Other income from **Schedule K-1**
A		6,000		
B				
33a Totals		6,000		
b Totals				

34 Add columns (d) and (f) of line 33a 34 6,000

35 Add columns (c) and (e) of line 33b . . . . 35 ( )

36 Total estate and trust income or (loss). Combine lines 34 and 35. Enter the result here and include in the total on line 40 below 36 6,000

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

37 (a) Name	(b) Employer identification number	(c) Excess inclusion from **Schedules Q**, line 2c (see page E-5)	(d) Taxable income (net loss) from **Schedules Q**, line 1b	(e) Income from **Schedules Q**, line 3b

38 Combine columns (d) and (e) only. Enter the result here and include in the total on line 40 below 38

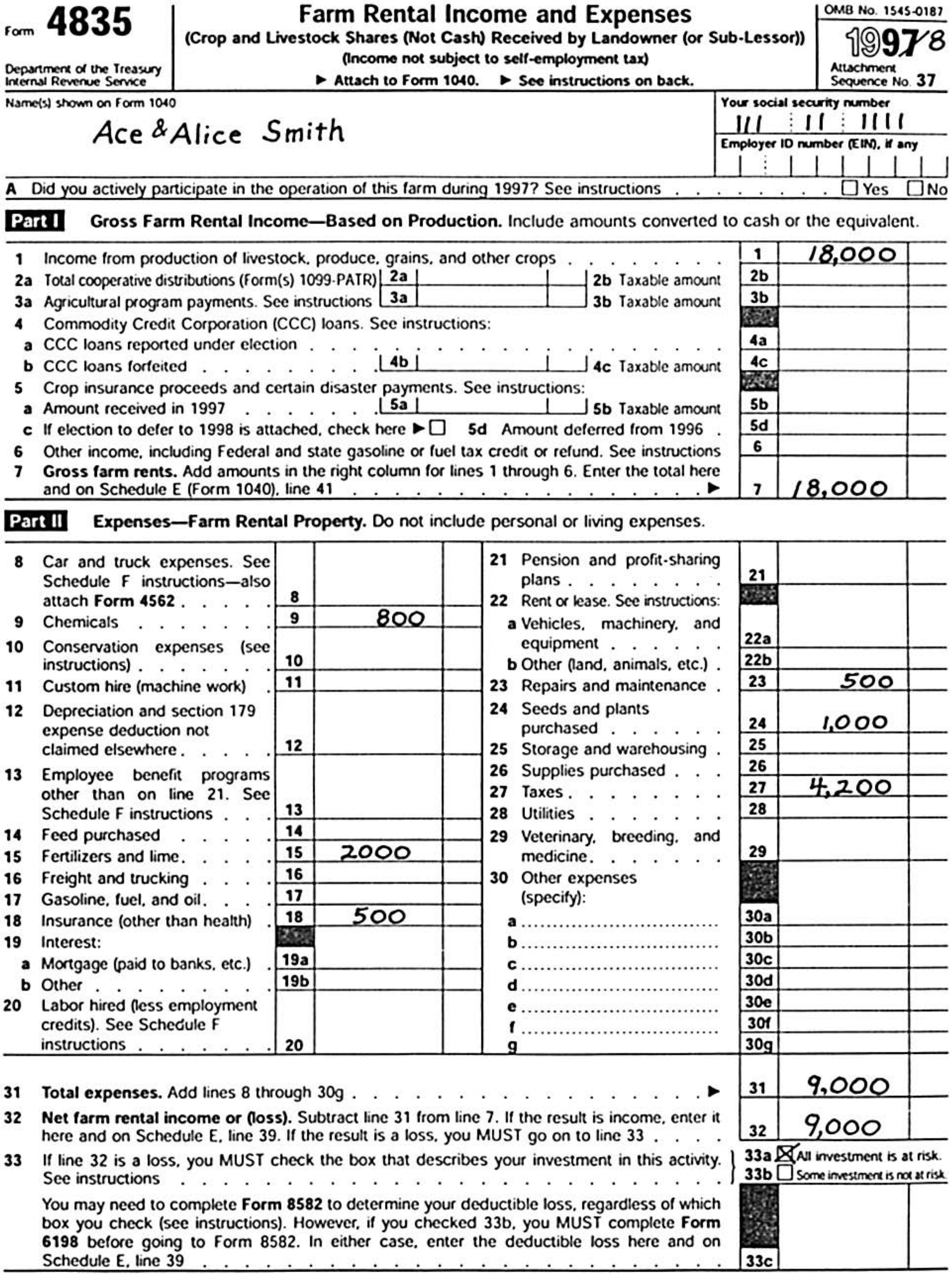
Part V Summary

39 Net farm rental income or (loss) from **Form 4835**. Also, complete line 41 below 39 9,000

40 TOTAL income or (loss). Combine lines 26, 31, 36, 38, and 39. Enter the result here and on Form 1040, line 17 ▶ 40 15,156

41 **Reconciliation of Farming and Fishing Income.** Enter your **gross** farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), line 15b; Schedule K-1 (Form 1120S), line 23; and Schedule K-1 (Form 1041), line 14 (see page E-5) 41 25,469

42 **Reconciliation for Real Estate Professionals.** If you were a real estate professional (see page E-4), enter the net income or (loss) you reported anywhere on Form 1040 from all rental real estate activities in which you materially participated under the passive activity loss rules . . . 42



Form **4835**

Department of the Treasury
Internal Revenue Service

Farm Rental Income and Expenses

(Crop and Livestock Shares (Not Cash) Received by Landowner (or Sub-Lessor))

(Income not subject to self-employment tax)

▶ Attach to Form 1040. ▶ See instructions on back.

OMB No. 1545-0187

199~~7~~8

Attachment Sequence No. **37**

Name(s) shown on Form 1040: Ace & Alice Smith

Your social security number: 111 11 1111

Employer ID number (EIN), if any:

A Did you actively participate in the operation of this farm during 1997? See instructions . . . . ☐ Yes ☐ No

Part I **Gross Farm Rental Income—Based on Production.** Include amounts converted to cash or the equivalent.

1	Income from production of livestock, produce, grains, and other crops	1	18,000
2a	Total cooperative distributions (Form(s) 1099-PATR) 2a ____ 2b Taxable amount	2b	
3a	Agricultural program payments. See instructions 3a ____ 3b Taxable amount	3b	
4	Commodity Credit Corporation (CCC) loans. See instructions:		
a	CCC loans reported under election	4a	
b	CCC loans forfeited 4b ____ 4c Taxable amount	4c	
5	Crop insurance proceeds and certain disaster payments. See instructions:		
a	Amount received in 1997 5a ____ 5b Taxable amount	5b	
c	If election to defer to 1998 is attached, check here ▶ ☐ **5d** Amount deferred from 1996	5d	
6	Other income, including Federal and state gasoline or fuel tax credit or refund. See instructions	6	
7	**Gross farm rents.** Add amounts in the right column for lines 1 through 6. Enter the total here and on Schedule E (Form 1040), line 41 ▶	7	18,000

Part II **Expenses—Farm Rental Property.** Do not include personal or living expenses.

8	Car and truck expenses. See Schedule F instructions—also attach **Form 4562**	8		21	Pension and profit-sharing plans	21	
9	Chemicals	9	800	22	Rent or lease. See instructions:		
10	Conservation expenses (see instructions)	10		a	Vehicles, machinery, and equipment	22a	
11	Custom hire (machine work)	11		b	Other (land, animals, etc.)	22b	
12	Depreciation and section 179 expense deduction not claimed elsewhere	12		23	Repairs and maintenance	23	500
13	Employee benefit programs other than on line 21. See Schedule F instructions	13		24	Seeds and plants purchased	24	1,000
14	Feed purchased	14		25	Storage and warehousing	25	
15	Fertilizers and lime	15	2000	26	Supplies purchased	26	
16	Freight and trucking	16		27	Taxes	27	4,200
17	Gasoline, fuel, and oil	17		28	Utilities	28	
18	Insurance (other than health)	18	500	29	Veterinary, breeding, and medicine	29	
19	Interest:			30	Other expenses (specify):		
a	Mortgage (paid to banks, etc.)	19a		a		30a	
b	Other	19b		b		30b	
20	Labor hired (less employment credits). See Schedule F instructions	20		c		30c	
				d		30d	
				e		30e	
				f		30f	
				g		30g	

31	**Total expenses.** Add lines 8 through 30g ▶	31	9,000
32	**Net farm rental income or (loss).** Subtract line 31 from line 7. If the result is income, enter it here and on Schedule E, line 39. If the result is a loss, you MUST go on to line 33	32	9,000
33	If line 32 is a loss, you MUST check the box that describes your investment in this activity. See instructions	33a ☒ All investment is at risk. 33b ☐ Some investment is not at risk.	
	You may need to complete **Form 8582** to determine your deductible loss, regardless of which box you check (see instructions). However, if you checked 33b, you MUST complete **Form 6198** before going to Form 8582. In either case, enter the deductible loss here and on Schedule E, line 39	33c	

SCHEDULE D (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074
1998
Attachment Sequence No. **12**

Name(s) shown on Form 1040: Ace & Alice Smith

Your social security number: 111 11 1111

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-4)	(f) GAIN or (LOSS) Subtract (e) from (d)
1						
2	Enter your short-term totals, if any, from Schedule D-1, line 2		2			
3	**Total short-term sales price amounts.** Add column (d) of lines 1 and 2		3			
4	Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824				4	
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5	
6	Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 1997 Capital Loss Carryover Worksheet				6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f). ▶				7	

Proof as of
[illegible] 1998

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-3)	(e) Cost or other basis (see page D-4)	(f) GAIN or (LOSS) Subtract (e) from (d)	(g) 28% RATE GAIN or (LOSS) * (see instr. below)
8							
9	Enter your long-term totals, if any, from Schedule D-1, line 9		9				
10	**Total long-term sales price amounts.** Add column (d) of lines 8 and 9		10				
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11		
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12		
13	Capital gain distributions. See pages D-1 and D-6				13	1000	
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1997 Capital Loss Carryover Worksheet				14	( )	( )
15	Combine lines 8 through 14 in column (g)				15		
16	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). ▶				16	1000	

Next: Go to Part III on the back.

***28% Rate Gain or Loss** includes **all** "collectibles gains and losses" (as defined on page D-4) and part or all of the eligible gain on qualified small business stock (see page D-4).

Part III Summary of Parts I and II

17	Combine lines 7 and 16. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13 **Next:** Complete Form 1040 through line 39. Then, go to **Part IV** to figure your tax if: • Both lines 16 and 17 are gains, **and** • Form 1040, line 39, is more than zero.			17	1000
18	If line 17 is a loss, enter here and as a (loss) on Form 1040, line 13, the **smaller** of these losses: • The loss on line 17; **or** • ($3,000) or, if married filing separately, ($1,500) . . . . **Next:** Complete Form 1040 through line 37. Then, complete the **Capital Loss Carryover Worksheet** on page D-4 if: • The loss on line 17 exceeds the loss on line 18, **or** • Form 1040, line 37, is a loss.			18	( )

Part IV Tax Computation Using Maximum Capital Gains Rates

19	Enter your taxable income from Form 1040, line 39			19	19,250
20	Enter the **smaller** of line 16 or line 17 of Schedule D	20	1000		
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21	–		
22	Subtract line 21 from line 20. If zero or less, enter -0-	22	1000		
23	Combine lines 7 and 15. If zero or less, enter -0-	23	0		
24	Enter the **smaller** of line 15 or line 23, but not less than zero . . .	24	0		
25	Enter your unrecaptured section 1250 gain, if any (see page D-4) .	25	0		
26	Add lines 24 and 25	26	0		
27	Subtract line 26 from line 22. If zero or less, enter -0-			27	1000
28	Subtract line 27 from line 19. If zero or less, enter -0-			28	18,250
29	Enter the **smaller** of: • The amount on line 19, **or** • $25,350 if single; $42,350 if married filing jointly or qualifying widow(er); $21,175 if married filing separately; or $33,950 if head of household			29	19,250
30	Enter the **smaller** of line 28 or line 29			30	0
31	Subtract line 22 from line 19. If zero or less, enter -0-			31	18,250
32	Enter the **larger** of line 30 or line 31			32	18,250
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies . . . . ▶			33	2738
34	Enter the amount from line 29			34	19,250
35	Enter the amount from line 28			35	18,250
36	Subtract line 35 from line 34. If zero or less, enter -0-			36	1000
37	Multiply line 36 by 10% (.10) . . . . ▶			37	100
38	Enter the **smaller** of line 19 or line 27			38	1000
39	Enter the amount from line 36			39	1000
40	Subtract line 39 from line 38			40	0
41	Multiply line 40 by 20% (.20) . . . . ▶			41	0
42	Enter the **smaller** of line 22 or line 25			42	0
43	Add lines 22 and 32	43	19,250		
44	Enter the amount from line 19	44	19,250		
45	Subtract line 44 from line 43. If zero or less, enter -0-			45	0
46	Subtract line 45 from line 42. If zero or less, enter -0-			46	0
47	Multiply line 46 by 25% (.25) . . . . ▶			47	0
48	Enter the amount from line 19			48	19,250
49	Add lines 32, 36, 40, and 46			49	19,250
50	Subtract line 49 from line 48			50	0
51	Multiply line 50 by 28% (.28) . . . . ▶			51	0
52	Add lines 33, 37, 41, 47, and 51			52	2850
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies			53	2888
54	**Tax on taxable income including capital gains.** Enter the **smaller** of line 52 or line 53 here and on Form 1040, line 40 . . . . ▶			54	2850

SCENARIO #2

Scenario #2 has the same facts as Scenario #1, except that:

1. No distributions are made to Alice in 1998 nor during the following 65 days.
2. Ace's will creates two trusts. All property of the estate is to be divided between the two trusts. Assume that Alice is the sole income beneficiary of each trust for her lifetime.
3. Neither trust is funded in 1998 nor in the following 65 days.

1998 Income Tax Return for the Estate

Since no distributions are made in 1998, all of the income is taxed to the estate. The Schedules K-1 for Alice, Trust A, and Trust B show no reportable amounts.

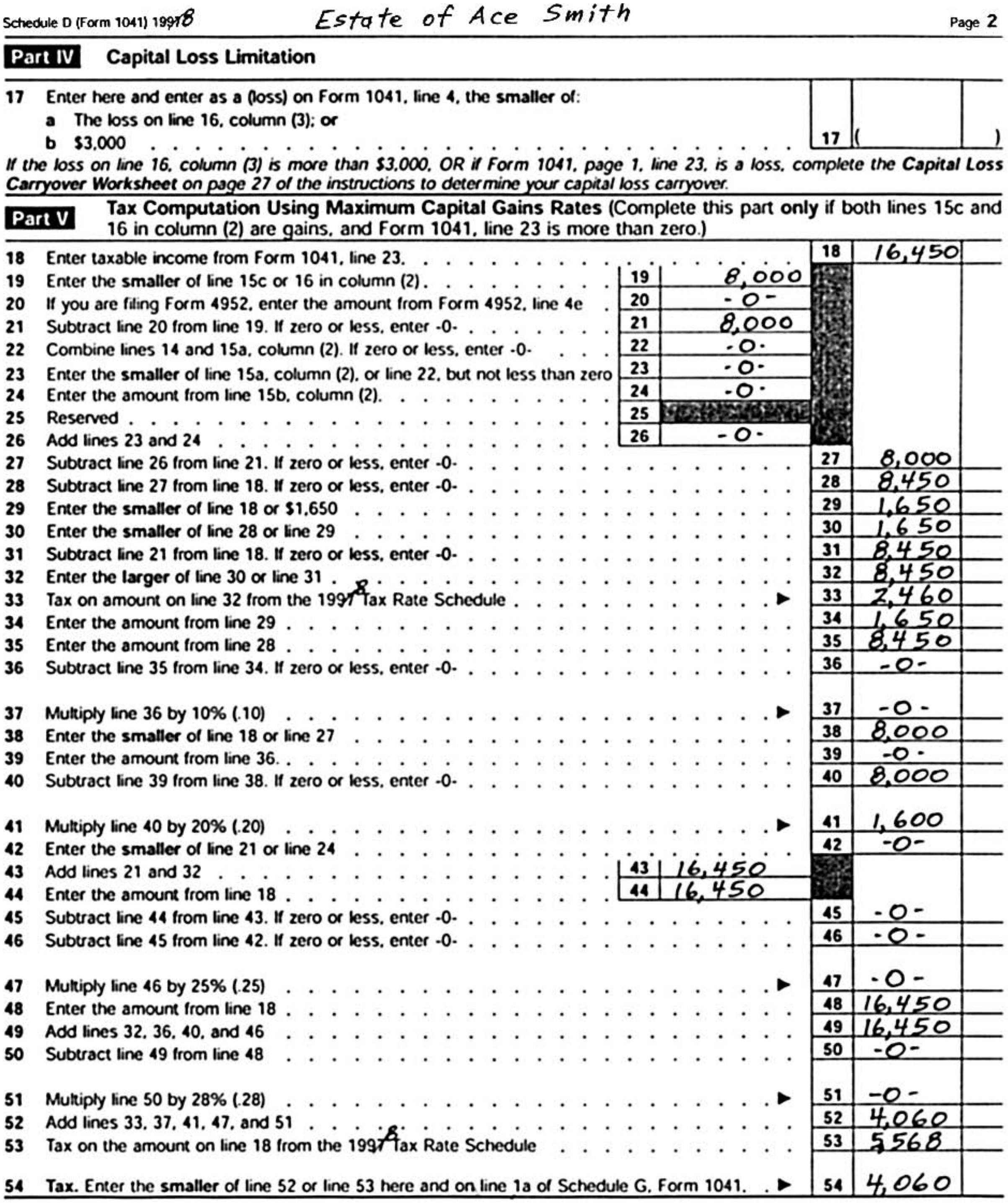
1998 Federal Income Tax Summary

The Estate of Ace Smith

Scenario #3

Income	
Interest income	9,350
Dividend income	200
Capital gain (loss) (1041 and 1041-A only)	8,000
Farm income (Form 4835)	6,000
Total income	23,550
Deductions	
Taxes	2,000
Attorney, accountant, and appraisal fees	4,500
Total	6,500
Adjusted total income	
Adjusted total income	17,050
Income distribution deduction	
Adjusted total income	17,050
Adjusted tax-exempt interest	3,000
Subtract capital gain incl. in income	−8,000
Distributable net income	12,050
Income required to be distributed	0
Other amounts distributed	0
Total distributions	0
DNI less tax-exempt income	9,050
Income distribution deduction	0
Other deductions	
Exemption	600
Total other deductions	600
Tax computation	
Taxable income	16,450
Tax from rate schedule or Schedule D	4,060
Total tax from Schedule G	4,060
Refund or amount due	
Amount of tax due	4,060(1)

(1) see the schedule D calculation on the next page.



Schedule D (Form 1041) 199~~7~~8 Estate of Ace Smith Page 2

Part IV **Capital Loss Limitation**

17	Enter here and enter as a (loss) on Form 1041, line 4, the smaller of: a The loss on line 16, column (3); or b $3,000			17	( )

If the loss on line 16, column (3) is more than $3,000, OR if Form 1041, page 1, line 23, is a loss, complete the **Capital Loss Carryover Worksheet** *on page 27 of the instructions to determine your capital loss carryover.*

Part V **Tax Computation Using Maximum Capital Gains Rates** (Complete this part **only** if both lines 15c and 16 in column (2) are gains, and Form 1041, line 23 is more than zero.)

18	Enter taxable income from Form 1041, line 23			18	16,450
19	Enter the **smaller** of line 15c or 16 in column (2)	19	8,000		
20	If you are filing Form 4952, enter the amount from Form 4952, line 4e	20	-0-		
21	Subtract line 20 from line 19. If zero or less, enter -0-	21	8,000		
22	Combine lines 14 and 15a, column (2). If zero or less, enter -0-	22	-0-		
23	Enter the **smaller** of line 15a, column (2), or line 22, but not less than zero	23	-0-		
24	Enter the amount from line 15b, column (2)	24	-0-		
25	Reserved	25			
26	Add lines 23 and 24	26	-0-		
27	Subtract line 26 from line 21. If zero or less, enter -0-			27	8,000
28	Subtract line 27 from line 18. If zero or less, enter -0-			28	8,450
29	Enter the **smaller** of line 18 or $1,650			29	1,650
30	Enter the **smaller** of line 28 or line 29			30	1,650
31	Subtract line 21 from line 18. If zero or less, enter -0-			31	8,450
32	Enter the **larger** of line 30 or line 31			32	8,450
33	Tax on amount on line 32 from the 199~~7~~8 Tax Rate Schedule ▶			33	2,460
34	Enter the amount from line 29			34	1,650
35	Enter the amount from line 28			35	8,450
36	Subtract line 35 from line 34. If zero or less, enter -0-			36	-0-
37	Multiply line 36 by 10% (.10) ▶			37	-0-
38	Enter the **smaller** of line 18 or line 27			38	8,000
39	Enter the amount from line 36			39	-0-
40	Subtract line 39 from line 38. If zero or less, enter -0-			40	8,000
41	Multiply line 40 by 20% (.20) ▶			41	1,600
42	Enter the **smaller** of line 21 or line 24			42	-0-
43	Add lines 21 and 32	43	16,450		
44	Enter the amount from line 18	44	16,450		
45	Subtract line 44 from line 43. If zero or less, enter -0-			45	-0-
46	Subtract line 45 from line 42. If zero or less, enter -0-			46	-0-
47	Multiply line 46 by 25% (.25) ▶			47	-0-
48	Enter the amount from line 18			48	16,450
49	Add lines 32, 36, 40, and 46			49	16,450
50	Subtract line 49 from line 48			50	-0-
51	Multiply line 50 by 28% (.28) ▶			51	-0-
52	Add lines 33, 37, 41, 47, and 51			52	4,060
53	Tax on the amount on line 18 from the 199~~7~~8 Tax Rate Schedule			53	5568
54	**Tax.** Enter the **smaller** of line 52 or line 53 here and on line 1a of Schedule G, Form 1041. ▶			54	4,060

SCENARIO #3

Scenario #3 is the same as Scenario #2, except that the two trusts are funded on December 28, 1998.

The 1,000 shares of High Flyer, Inc., are transferred to Trust A to satisfy a pecuniary formula bequest. The High Flyer shares were worth $110,000 when they were transferred to Trust A.

Half of the other assets are transferred to Trust B and the other half are retained by the estate until 1999.

1998 Income Tax Return for the Estate and Trusts

Transferring assets to satisfy a pecuniary formula bequest triggers the recognition of gain or loss on the asset transferred. Therefore, $10,000 of gain ($110,000 − $100,000) on the High Flyer stock must be recognized.

The **estate will** pay the taxes on the gain realized on the transfer of the High Flyer stock.

Note:

1. The estate of Ace Smith will file a Form 1041 for 1998, reporting all capital gain. Because the funding of the trust is not a qualifying bequest, the funding (it exceeds the estate's DNI) will carry out the other income of the estate and will be shown on K-1's for the trusts. A proportionate part of the income will be shown on separate K-1's for each trust. The proportion of each type of income each trust will report is based on the relative FMV of assets distributed to each trust.
2. Each trust can distribute the income allocated to the trust under **point 1, above,** to Alice, the only income beneficiary.
3. **Note** that if this was a total distribution by the estate to the two trusts, the capital gain would also flow through to the trusts and be taxable at the trust level.

REVOCABLE LIVING TRUSTS—INFORMATION AND EXAMPLES

1. IN GENERAL

- **Revocable living trusts to avoid probate are being extensively promoted.** Various kinds of do "it" yourself kits have been advertised, and other promotional efforts by certain groups are continuing. As a result, many questions have been raised about the advantages and disadvantages of living trusts.
- **A living trust is not a special kind of trust.** It is created and administered like any other kind of legal trust. A person (the grantor) transfers property to a trust, to be administered by a trustee for the benefit of the individuals named as beneficiaries. The trust is revocable (that is, its provisions can be changed or revoked by the grantor). All or some of the grantor's property can be conveyed or otherwise transferred to the trust and will be subject to the trust provisions.
- **Individuals who are creating the living trust generally try to transfer to the trust all of the property they own that will be subject to probate.** The grantor will name himself or herself as trustee and will give the trustee the power to pay all the income and any of the principal of the

trust to the grantor. On the date that the grantor (who is also the trustee in many instances) becomes incapacitated in a way that the grantor can no longer manage his or her financial affairs, a successor trustee will act for the benefit of the grantor. Upon the grantor's death, the trust will specify how and to whom the property owned by the trust will be distributed. Once the property is distributed, the trust is terminated.

2. IMPORTANT CONCERNS WHEN CONSIDERING A LIVING TRUST

- **A living trust should not be created without the assistance and advice of an attorney.**
- **A living trust is a separate legal entity.** To accomplish the objectives of the person creating the trust, it is necessary to legally transfer to the trust a variety of assets. This is sometimes a complicated procedure and requires the assistance of an attorney.
- Since the grantor's property will ultimately be transferred by the trust provisions and **not by the provisions of the person's will, the drafting of the provisions transferring the property on the death of the grantor of the trust must be done as carefully as when a will is drafted.**
- If an institution qualified to administer trusts is named as a trustee, a trust administration fee will be charged. The grantor should be aware of the amount of the fee and the basis for its calculation.
- At the time when the grantor **is no longer a trustee,** a separate fiduciary income tax return will have to be filed for the trust for the duration of the life of the trust.
- For the duration of the trust, property within the trust will be owned by the trust and must be transferred and accounted for differently than if the grantor owned the property. This is especially difficult if property being used in an active trade or business is a part of the trust.
- **In order to avoid probate, all property that would be subject to probate would have to be transferred to the trust.** Although avoidance of probate is one reason for creating a living trust, the probate process in many states has been streamlined in recent years and is not usually the timely, costly process that it once was.
- A properly drafted living trust, combined with properly executed Powers of Attorney and Health, **usually eliminates the necessity of having a court appoint a guardian for the person and property of an individual** who is mentally or physically incapacitated and unable to manage his property.
- The **cost** of having a living trust drafted, the property transferred, and the accompanying will drafted may run up to $3,500 (or more). The cost will depend on the kind and amount of the property transferred, the nature of the clauses that dispose of the property that is a part of the trust, and other special drafting or planning needs of the person creating the trust.
- **One attractive aspect of the revocable living trust is the right of the grantor to change the provisions or terminate the trust and take the assets back at any time.**
- The living trust, like many kinds of legal arrangements, **needs to be tailor-made to meet the objectives of the person who wants to create the trust.** Many attorneys, and this author, believe that the trust is most advantageous for certain classes of individuals. Its most common use is for older persons who are no longer involved in an active trade or business and who do not frequently shift the kind of assets they own. These people most frequently can utilize the advantages of the living trust without having to encounter some of the disadvantages. **In all cases, it is highly recommended that a lawyer be involved in the analysis of whether or not a living trust is beneficial, and in the drafting of this important legal document.**

3. PROBATE VS. REVOCABLE LIVING TRUST

- Compare the cost of creating, operating, and terminating the trust with probate cost.
- Probate is public; a revocable living trust is private and does not have to be filed.
- Consider the possible delay in distribution of property with probate. A trust **can** be quicker but **may not be.** It depends on the provisions of the trust.
- A **revocable living** trust can avoid ancillary probate. [Probate for real estate in another state.]
- These trusts allow management of assets during lifetime by someone other than the grantor. This may be a reason to create the trust.
- See the 1997 Act chapter for a new tax related code section.

4. TAX ISSUES

- These trusts save no income, estate, or gift taxes.
- There are 1041 filing requirements and identification number consequences if the **trustee is other than the settlor** (person transferring the assets to the trust) [I.R.C. §676(a), 671, **Regs.** 1.671-4(b)]. **Otherwise a 1041 is not filed, and the grantor pays income tax just as before the trust was created.**
- Upon the grantor's death, the revocable trust becomes an irrevocable trust—a new tax entity.

5. ASSETS TRANSFERRED TO REVOCABLE LIVING TRUST—OVERVIEW

- Taxpayer will lose §1244 loss benefits.
- Check carefully professional corporation stock for any disqualification.
- Sub. S. stock: OK, but some post-death problems are possible.
- E and H bonds: OK (see examples below).
- Principal residence: OK for §121 purposes [**Rev. Rul. 66-159,** P.L.R. 8006056, 8007050 and 8025027].
- Installment obligations: OK in and out [I.R.C. §453(e) and (f)(1); **Rev. Rul. 76-100**].
- §2032A property: OK as long as qualified heir retains full control over the trustees and right to revoke [P.L.R. 8109073].

6. GIFTS FROM REVOCABLE TRUSTS WITHIN THREE YEARS OF DEATH

[See the 1997 Act chapter.]

7. SOME POSSIBLE DISADVANTAGES OF REVOCABLE TRUSTS

- Title transfer costs and procedures
  - a. Deeds
  - b. Stock
  - c. Taxing authorities - assessed valuation
  - d. Permits, licenses, deed restrictions
- Costs

a. Attorney fees
b. Trustee fees
c. Conveyance costs
d. Administration costs

8. WHEN TO USE A REVOCABLE TRUST—OVERVIEW

- Need for asset management
- Privacy from public probate records
- People with age disabilities who need management assistance through a successor or co-trustee
- Probate avoidance

9. ALTERNATIVES TO REVOCABLE LIVING TRUST TO AVOID PROBATE

- Joint tenancy
- Payable on death clause
- Transfers with donor or seller retaining a life estate
- Powers of attorney
- Beneficiaries named for life insurance, pensions, annuities, etc.

10. TRANSFERS TO AND FROM THE REVOCABLE LIVING TRUST—SPECIFIC EXAMPLES

Sale of Principal Residence

If a taxpayer conveys his or her personal residence to a revocable living trust and the trust later sells the personal residence, the sale will qualify for the I.R.C. §121 exclusion of gain only if the taxpayer is considered the owner of the trust under the grantor trust rules (Rev. Rul. 66-159, 1966-1 C.B. 162; Rev. Rul. 85-45, 1985-1 C.B. 183).

Example 1. Garnet conveyed his personal residence which he bought in 1960 to a revocable living trust that is treated as a grantor trust under I.R.C. §§671 through 678. In 1998 the trust sold the personal residence and bought another house, which Garnet uses as his personal residence.

The **sale qualifies for I.R.C. §121** since Garnet is treated as the owner of the trust and meets all of the requirements.

Installment Obligations

Transferring an installment obligation to a trust or from a trust may trigger recognition of gain, but see (2) below.

(1) Amount of Gain. The amount of gain that will be recognized is the **difference between the fair market value of the obligation and the basis of the obligation.**

Example 2. George transferred an installment obligation to a trust and the transfer triggered recognition of gain. At the time of the transfer, George had received three of ten $10,000 payments of principal on the obligation. His gross profit ratio on the obligation is 40%.

George’s basis in the obligation at the time of the transfer is as follows:

Beginning basis	$ 60,000
Recovered basis: $30,000 × 60%	18,000
Basis in obligation	$ 42,000

Assuming that the obligation is valued at the face amount of the remaining balance to be paid, George's gain on the transfer is as follows:

Fair market value	$ 70,000
Basis	42,000
Gain	$ 28,000

Observation. If the fair market value of the obligation is the same as its face value, the gain on the transfer can be calculated by multiplying the gross profit ratio of the obligation by the remaining payments due. In Example 2, the calculation would be 40% × $70, 000 = $28, 000.

(2) Transfer to a Trust.

Grantor Trust. If a taxpayer is treated as the owner of a trust under the grantor trust rules, then the transfer of an installment obligation to the trust by the taxpayer is **not a taxable disposition** (Rev. Rul. 74-613, 1974-2 C.B. 153).

Example 3. Harriet transferred an installment obligation to a trust in which she retained the right to income for the rest of her life and the power to revoke the trust.

Since Harriet is treated as the owner of the trust, no gain is triggered on the transfer of the installment obligation and Harriet will continue to report the installment payments on her tax return as they are received by the trust.

Nongrantor Trust. If a taxpayer transfers an installment obligation to **a trust for which the taxpayer is not treated as the owner** under the grantor rules, then the transfer is treated as a taxable disposition.

Example 4. Ike transferred an installment obligation to a trust in which he retained no interest or powers. **The transfer will trigger recognition of gain on the obligation.**

(3) Transfers from a Trust. Generally, the distribution of an installment obligation from a trust to a beneficiary is **not a taxable disposition.** However, if the installment obligation is transferred to satisfy an obligation to distribute a specific dollar amount or other specific property, then the distribution will be treated as if the obligation were sold for its fair market value and the money were used to satisfy the distribution requirement. Therefore, **the transfer will be a taxable disposition** [Treas. Reg. §1.661(a)-2(f)(1)].

Example 5. Jack is the beneficiary of a trust set up by his mother's will. Under the terms of the trust, Jack is to receive all of the income from the trust. In 1998 the income is $50,000. **The trustee and Jack agree to distribute an installment obligation** that has a fair market value of $50,000 and an income tax basis of $30,000 instead of $50,000 in cash.

Since the obligation is distributed to satisfy a distribution of income, the trust must include the $20,000 ($50,000 — $30,000) gain realized on the obligation in its income.

Exception. If the trust distributes an installment obligation to **a beneficiary who is treated as the owner** of the trust under the grantor trust rules (revocable living trust), no gain has to be recognized (**Ltr. Rul.** 8001045).

Example 6. Katie is treated as the owner of a trust under the grantor trust rules. In 1998 the trust distributed an installment obligation to her to satisfy an income distribution requirement. The obligation had a fair market value of $40,000 and a $25,000 basis.

The trust does **not have** to report the $15,000 gain on the transfer of the trust. Katie will continue to report the gain as she receives payments on the obligation.

(4) Basis. The trust's basis in an obligation transferred to it is the **grantor's basis increased by any gain recognized by the grantor as** a result of the transfer to the trust. Similarly, the beneficiary's basis in an obligation distributed by the trust is the trust's basis increased by any gain recognized by the trust as a result of the distribution.

Example 7. Assume the same facts as in Example 6. Katie's basis in the obligation is still $25,000.

Series E and H U.S. Savings Bonds

(1) Series EE or Series E Bonds. If a taxpayer is considered the owner of a trust (as in a revocable living trust) and transfers Series EE or Series E Bonds to it, **the taxpayer continues to be taxable for the increase in value of the bonds.** Therefore, the transfer has **no effect** on the timing of the income.

If the taxpayer was not reporting the increase in value each year, he or she can continue to postpone reporting that increase in value until the bonds are cashed or finally mature, whichever is earlier.

Example 8. Lyle owned a Series EE U.S. Savings Bond. He was not reporting the increase in value each year. He transferred the bond to a revocable living trust. He is considered the owner of the trust.

Lyle can continue to postpone reporting the increase in value of the bond until the earlier of the date it matures or the trust cashes the bond.

If the taxpayer is reporting the increase in value each year, he or she must continue to report the increase in value each year after the bond has been transferred to the revocable trust.

Example 9. Martha owned a Series EE U.S. Savings bond. She was reporting the increase in value as income each year. She transferred the bond to a revocable living trust. She is considered the owner of the trust.

Martha must continue to report the increase in value of the bond as income each year.

Practitioner Note. If Series EE or Series E bonds are transferred to a trust of which the taxpayer is **not considered the owner,** the taxpayer must report any increase in value that has not previously been reported.