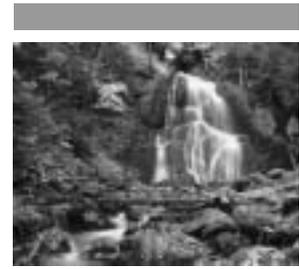




1999 Income Tax School

## TRUSTS AND ESTATES

43 Basic Trusts . . . . .	210	QTIP Summary: Advantages and Disadvantages . . . . .	223
Reasons for Using Trusts . . . . .	214	Other Exceptions to Terminable Interest Rules . . . . .	223
Functional Use of Trusts . . . . .	214	Noncitizen Spouses and the Qualified Domestic Trust (QDOT) . . . . .	224
Income Tax Rates . . . . .	215	Federal Income Tax Summary . . . . .	225
Revocable Living Trusts . . . . .	215	Federal Statements . . . . .	234
Ten Key Points in Considering a Living Trust . . . . .	217	Terminations . . . . .	235
What Types of Property Can a Grantor Put Into a Revocable Trust . . . . .	218	Termination of Estates and Trusts: The Rules . . . . .	235
Qualified Terminable Interest Property (QTIP) Trusts . . . . .	220	What Happens When a Trust Terminates . . . . .	235
Common Interests/Uncommon Beneficiaries . . . . .	220	Passive Losses . . . . .	237
The Election . . . . .	220	Trusts and Subchapter S Corporations . . . . .	239
Overview of QTIP . . . . .	221		
Postmortem Planning . . . . .	222		
Invasion Provisions . . . . .	222		



1999 Income Tax School

## TRUSTS AND ESTATES

Since the early 1980s, the use of trusts has increased as taxpayers have attempted to nurture and preserve financial wealth for their spouses, children, and grandchildren.

Approximately 43 basic trusts have come into use over the last 25 years. The following list illustrates the variety of trusts that are being used. It also helps practitioners understand the names that are used to label the various trusts:

- 1. A-B Trusts.** Before the adoption of the unlimited marital deduction, when the marital deduction was limited to 50% of an individual's adjusted gross estate, it was common to create two trusts for the benefit of an individual's spouse—one that qualified for the marital deduction and one that did not. These were frequently referred to as A-B Trusts. Many practitioners use this term today in reverse with the intent first to trap the estate exemption amount (\$650,000 in 1999) and then, with trust B crafted to take the excess as a Marital Deduction Trust. (See below.)
- 2. Alaska Trust.** This trust, available in certain states, combines the benefits of multigenerational planning (see Generation-Skipping Trust and Dynasty Trust) with an attempt at protection from the grantor's creditors. It has risks that must be carefully considered. Alaska Trusts can also last into perpetuity and pay no state taxes. They also are intended to compete with many of the "off-shore" trust havens.
- 3. Applicable Credit Amount Trust.** See Credit Shelter Trust (below).
- 4. Blind Trust.** This is a trust, often created by a politician after election to office, in which certain assets of the grantor are managed by one or more trustees without the grantor being advised of what is in the trust. The assets, however, are managed for the benefit of the grantor of the trust.
- 5. Cemetery Trust.** This is typically a trust for the purpose of maintaining one or more graves or gravesites in a cemetery.
- 6. Charitable Lead Trust.** This is a trust that provides a specified sum to a charity at least annually, for a specified period, with the remainder passing to one or more individuals. The sum is expressed as a fixed percentage of the value of the trust at inception (in effect, an annuity) or a fixed percentage of the value of the net assets of the trust, calculated annually. If an annuity is utilized, it is a Charitable Lead Annuity Trust (CLAT); if a percentage of the net assets valued annually is utilized, the trust is a Charitable Lead Unitrust (CLUT). Such trusts may save estate, gift, and income taxes.
- 7. Charitable Remainder Trust.** This is a trust that provides one or more individuals, at least annually, either a sum equal to a fixed percentage of the assets valued at the trust's inception (in effect, an annuity) or a sum equal to a fixed percentage of the net assets of the trust valued annually, either for a set number of years or for one or more lifetimes. If an annuity is utilized, the trust is a Charitable Remainder Annuity Trust (CRAT); if a percentage of net assets valued annually is utilized, the trust is a Charitable Remainder Unitrust (CRUT). Such trusts may save estate, gift, income, and/or capital gains taxes.

8. **Credit Shelter Trust.** This trust is customarily designed to receive the maximum amount that can pass free of federal estate tax upon the death of the first spouse. It has numerous variations. Frequently, the terms of the trust provide that all of its income will be provided to the surviving spouse for life, with the assets passing to others upon the surviving spouse's death. Another variation involves a Sprinkling Trust (see below).
9. **Contingent Trust.** This trust comes into being only in the event that a contingency occurs. For example, a document may provide that if any assets are distributable to a person under the age of 21 years, those assets are held in a Contingent Trust for the benefit of that person until he or she attains 21 years of age.
10. **Crummey Trust.** Named after a famous court decision, this trust permits one or more individuals to withdraw a limited amount from the assets added to the trust in a specified manner during a specified period. Its purpose is to avoid gift taxes on assets placed in the trust by qualifying the transfer for the annual gift tax exclusion. Insurance Trusts (see below) are often designed as Crummey Trusts.
11. **Defective Grantor Trust.** This is a type of trust purposely made "defective" so as to be a Grantor Trust for income tax purposes but an Irrevocable Trust (see below) for estate and gift tax purposes. It may result in increased tax savings.
12. **Delaware Business Trust.** Similar to a family limited partnership or limited liability company, as opposed to a traditional trust, a Delaware Business Trust is a way to hold and invest assets, possibly including life insurance, with greater flexibility than most trusts allow. The grantor of the trust retains far more control than the tax laws permit for traditional trusts. They can provide limited liability, creditor protection, and valuation discounts.
13. **Disclaimer Trust.** This trust is designed to receive property that is disclaimed (renounced) by a beneficiary. For example, it can be used to fund a Credit Shelter Trust. It allows the surviving spouse to determine how much goes into the Credit Shelter Trust after the death of the first to die.
14. **Discretionary Trust.** This is any trust in which the trustees have discretion to distribute (or not distribute) income and/or principal among one or more beneficiaries. The discretion may apply to income, principal, or both. The trustees may have the right to give or not give income or principal to a single beneficiary, or to distribute some or all of the income or principal among members of a group, excluding one or more members of a group.
15. **Dry Trust.** This trust has no assets. A Dry Trust is usually created either to receive assets upon the death of an individual, such as a pour-over under the individual's will, or to receive assets transferred to the trust via a power of attorney in the event of an individual's incapacity.
16. **Dynasty Trust.** This is a name customarily used for a Generation-Skipping Trust that continues for an extended period of time, such as for multiple generations, limited only by the applicable Rule Against Perpetuities, if any. In certain states such a trust may run for a very extended period of time. Its purpose is to avoid estate taxation for several generations and to provide for an individual's descendants (or the equivalent) for a very long period.
17. **Educational Trust (§2503(c) trust).** This is a trust for a minor (a person under the age of 18 or 21 years, depending on state law) designed to use the annual gift tax exclusion for gifts on behalf of the minor. Section 2503(c) trusts are an alternative to the use of the Uniform Gifts (or Transfers) to Minors Act and are often a better way of planning with respect to gifts to children (particularly if they are under the age of 14 years) whose parents are in a high income tax bracket. A §2503(c) trust can have provisions allowing more flexibility than is available under the Uniform Gifts (or Transfers) to Minors Act. Variations of this trust permit it to continue beyond the date on which the beneficiary attains the age of 21 years.
18. **Estate Trust.** This type of Marital Deduction Trust (see below) provides that upon the death of the surviving spouse, the assets in the trust, or at least the accumulated income of the trust, are payable to his or her estate.
19. **Foreign Situs Trust (Offshore Trust).** An individual who believes that assets cannot be fully secure while they remain under the jurisdiction of U.S. courts will seek havens outside U.S. boundaries where they can be safe from creditors (Switzerland, Liechtenstein, Isle of Man). This

does not necessarily mean that assets can be hidden. There is in fact a high degree of economic intelligence data and disclosure to the IRS upon the formation or transfer to such offshore trusts. In the new global economic order, such trusts will continue to grow.

20. **Generation-Skipping Trust.** This trust either skips over an entire generation or provides for members of more than one generation, and is normally geared to utilize the exemption from the tax on generation-skipping transfers. Under federal law this exemption may be as much as \$1,010,000 per grantor (not per trust and not per grandchild). The 55% generation-skipping tax applies to amounts in excess of \$1,010,000. (See pages 490–491 of the 1995 *Income Tax Workbook*.)
21. **Grantor Retained Annuity Trust (GRAT).** This is an irrevocable trust created by an individual (the grantor) that provides the grantor, at least annually, a sum equal to a fixed percentage of the value of the assets placed in the trust (in effect, an annuity) for a fixed period of time, or until the grantor's death. Upon termination, the balance in the trust usually passes to the grantor's estate if the grantor does not survive the term of the trust, or to other individuals if the grantor survives the term of the trust. Its purpose is to reduce gift and estate taxes. It serves little if any tax purpose if the grantor dies during the term of the trust. Note that it does not yield a step-up in basis of the assets in the trust if the trust terminates during the grantor's lifetime, and it is possible for the gift tax and resulting capital gains tax (assuming the assets are sold) to exceed the tax savings resulting from the creation of the trust. Note also that for income tax purposes it is a Grantor Trust (see below)
22. **Grantor Retained Income Trust (GRIT).** This trust, now only used in limited situations, is an irrevocable trust in which the grantor retains the right to income for a fixed period of years geared to end before the grantor's death. Upon termination of the trust, the assets in the trust pass to the final beneficiary. The main purpose of such a trust is to reduce the gift tax value of the transfer. The value of a promise to transfer an asset in the future is less than the current value of that asset. Grantor Retained Income Trusts are now used for gifts to nonimmediate family members (e.g., nieces or nephews). Such a trust serves little or no tax purpose if the grantor dies before it terminates.
23. **Grantor Retained Unitrust (GRUT).** This trust is very similar to a Grantor Retained Annuity Trust (see above), except that, rather than a fixed sum (a percentage of the assets of the trust valued at the creation of the trust), the grantor is to receive an annual (or more frequent) payment equal to a fixed percentage of the value of the net assets of the trust valued annually during the term of the trust.
24. **Grantor Trust.** A grantor trust is any trust in which the grantor retains enough control to cause the income and capital gains to be taxed to the grantor even if not payable to him or her.
25. **Insurance Trust.** This is generally an irrevocable trust, designed to own insurance on the life or lives of one or more individuals and to provide for the disposition of the proceeds of such insurance. Unless irrevocable, an insurance trust serves no tax purpose whatsoever.
26. **Inter Vivos Trust.** This is another name for a living trust. It includes any trust that is set up during the grantor's lifetime. By contrast, a trust set up at the grantor's death is a testamentary trust.
27. **IRA QTIP.** This is a type of QTIP Trust specifically designed to receive the proceeds from an IRA. It requires specific provisions in the IRA agreement, the IRA beneficiary designation, and in the IRA QTIP Trust to qualify for the marital deduction and to avoid adverse income tax consequences.
28. **Irrevocable Trust.** This is any trust that may not be amended or revoked by the grantor. Transfers to such a trust may be subject to gift tax.
29. **Marital Deduction Trust.** This is any trust that qualifies for the estate tax (or gift tax) marital deduction. A Marital Deduction Trust may provide, for example, that the spouse receive all of the net income for life, with the assets remaining in the trust passing to other individuals upon the spouse's death. It may also provide that the net income is payable to the spouse for life and give the spouse the right, either by will or by another specified instrument, to determine who receives the assets remaining in the trust upon that spouse's death.

30. **Medicaid Trust.** This is typically an Inter Vivos Trust (see above) for the benefit of the grantor or the grantor's spouse. Its purpose is to protect assets from creditors and to permit eligibility for Medicaid benefits. See also Supplemental Needs Trust (below).
31. **Minority Trust.** This is a trust geared to hold assets during an individual's minority or age specified in the trust.
32. **Pour-Over Trust.** This trust is funded from another instrument. For example, in a person's will the executor may be instructed to transfer (pour over) all or a portion of the assets of the estate to a trust created under another instrument.
33. **Power-of-Appointment Trust.** This is a trust over which an individual has a power of appointment—the right to designate who will receive some or all of the assets of the trust at a specified time or times. A power of appointment may be exercisable either during life (an “inter vivos power”) or by will (a “testamentary power”). A general power of appointment (one exercisable by the holder in favor of himself/herself, his or her estate, his or her creditors, or the creditors of his or her estate) will cause the trust property to be included in the holder's taxable estate. A “limited” or “special” power of appointment will avoid this tax trap while enhancing future flexibility.
34. **QTIP Trust (Qualified Terminable Interest Property Trust).** A Qualified Terminable Interest Property Trust is one of several types of trusts designed to qualify for the estate or gift tax marital deduction (see Marital Deduction Trust, above). It provides that the grantor's spouse receive all of the net income for life, and no one other than the surviving spouse has access to the principal during the spouse's life. It may (but need not) provide for invasion of principal for the benefit of that spouse. Upon the death of the spouse for whose benefit the trust was created, the portion of the assets in the trust equivalent to the amount (or percentage) subject to the QTIP election includable in that spouse's estate for estate tax purposes and is distributed in accordance with the provisions of the trust.
35. **Qualified Domestic Trust.** This trust is very similar to a QTIP trust (see above) but is meant for a surviving spouse who is not a citizen of the United States. A qualified Domestic Trust must have specific provisions regarding the distribution of income and principal, dealing with who may be trustees, and, unless an appropriate bank or trust company is a trustee, securing the IRS with respect to future taxes. It is subject to special tax rules applicable only to such trusts.
36. **Qualified Personal Residence Trust.** This is a variation of a Grantor Retained Annuity Trust (see above). It is a trust funded with the grantor's residence or vacation home. It provides that the grantor may reside in the residence (or in another purchased with the proceeds of the sale of the residence) for a specified number of years, at the end of which the property passes to other persons. Its purpose is to reduce the value of the property for transfer tax purposes.
37. **Rabbi Trust.** This is not a typical trust arrangement but, in fact, a type of retirement plan or deferred compensation arrangement. The first was created for a rabbi (thus its name).
38. **Revocable Living Trust.** This is a trust created during the grantor's life that may be revoked by the grantor. It is used to avoid probate; to provide management during the grantor's lifetime; to permit the administration, without additional (“ancillary”) probate proceeds, of assets (e.g., real estate) located in a jurisdiction other than the one on which the grantor resides; and sometimes for other purposes. Such trusts have the same income, gift, and estate tax consequences as wills, and may or may not reduce administration expenses and legal and accounting fees. Revocable Living Trusts must be executed in accordance with applicable state law.
39. **Second-to-Die Insurance Trust.** This is a type of Insurance Trust (see above) geared to one or more second-to-die insurance policies (also called Survivorship or Last-to-Die Trust).
40. **Spray/Sprinkling Trust.** This is a discretionary trust for the benefit of a specified group, such as the grantor's spouse and descendants.
41. **Supplemental Needs Trust.** This is a trust for the benefit of an incapacitated person. It typically provides that its assets be available to be used for the benefit of that person, but the trustees are not to use trust assets to the extent that the incapacitated person would otherwise be receiving governmental benefits. Accordingly, it is possible, for example, for a parent to create a Supplemental Needs Trust for an incapacitated child without interfering with the child's Medicaid

# 1999 Workbook

benefits. Supplemental Needs Trusts often provide care for the beneficiary in addition to what Medicaid provides and deal with a beneficiary's nonessentials, such as paying for a vacation, travel, transportation, entertainment, supplemental dental care, paid companions, miscellaneous comfort items, and other desirables not covered by public funds. The use of Supplemental Needs Trusts was expanded under provisions of the tax law enacted by Congress in 1993.

42. **Unified Credit Trust.** See Credit Shelter Trust (above).
43. **Wealth Replacement Trust.** This is the name given to a type of insurance trust designed to hold insurance on the life of an individual, or an individual and spouse, and to utilize the proceeds of that insurance to replace assets passing to charity, such as upon the termination of a Charitable Remainder Trust.

## REASONS FOR USING TRUSTS

While grantors set up trusts for many reasons, the six major reasons are as follows:

1. **Second marriage.** The grantor wishes to leave his or her spouse an annual income, but upon that spouse's death, the principal usually goes to the children of a prior marriage.
2. **Professional management.** A trust may be advisable where beneficiaries may be deemed not to have the skills or the inclination to financially manage and control large sums of money.
3. **Creditor protection.** A trust can protect a beneficiary from unethical people who might seek to take advantage of his or her naiveté, or a beneficiary who already has creditor problems.
4. **Minor as a beneficiary.** Because of the highly technical, sophisticated nature of planning and tax decisions, minors deserve and must have substantial oversight in the operations of their affairs.
5. **Estate taxes.** A trust can be used to hold funds where there may be a risk that a direct beneficiary, by circumstances unforeseen, will take funds without paying the appropriate share of estate taxes.
6. **Alternative to the probate process.** Trusts offer confidentiality, ease of transfer, and ease in marshaling assets that are located in more than one state.

## FUNCTIONAL USE OF TRUSTS

The use of trusts in the United States generally falls into five categories:

1. The great majority of trusts are testamentary—created by a decedent's will or by a revocable trust that is a will substitute. Testamentary trusts allow taxpayers who acquired specific kinds of assets to direct the management and use of the assets after their death.
2. Taxpayers are increasingly setting up trusts during their lives that provide them an income for life and transfer the balance in the trust to a charity upon death.
3. The next most popular group of trusts are the split trusts (GRATs, GRITs, and GRUTs), which integrate a series of income, gift, and estate tax planning strategies for the benefit for both the grantor and his or her beneficiaries.
4. Grantor trusts have become extremely popular because they can simplify the efficiency and the cost of probate. In addition, they will become increasingly useful in eldercare—the integrated system of living, financial planning, and care for the aged.
5. Alaska and Foreign Situs Trusts are used for secrecy, credit protection, perpetuity, and other reasons for sequestering property from prying eyes.

## INCOME TAX RATES

The income tax rates for estates and trusts are the most progressively escalating rates in the Internal Revenue Code and permeate all estate planning and fiduciary income tax planning.

### 1999 Income Tax Rates for Estates and Trusts

*Taxable Income*

<u>Over</u>	<u>But Not Over</u>	<u>Pay</u>	<u>+ % on Excess</u>	<u>of the Amount Over</u>
\$ 0	\$1,750	\$ 0	15	\$ 0
1,750	4,050	262.50	28	1,750
4,050	6,200	906.50	31	4,050
6,200	8,450	1,573.00	36	6,200
8,450	—	2,383.00	39.6	8,450

Prior to 1993, many taxpayers took advantage of the low trust and estate income tax rates to accumulate family wealth for long periods of time. In 1993 Congress closed that loophole. However, trusts and estates can utilize the 20% capital gains rate to accumulate wealth for future beneficiaries.

**Observation.** There has been a subtle change in U.S. corporation policy away from paying ordinary dividends, thereby increasing the market value of shares, which then can be transferred with the much lower capital gains rates. Many U.S. companies do not pay dividends for this very reason.

## REVOCABLE LIVING TRUSTS

The Revocable Living Trust is becoming more popular as a will substitute. It is important to note that while a living trust can serve as a will substitute, a taxpayer still needs a will to transfer assets that leak out of the trust. Furthermore, the assets in a revocable trust are included in the grantor's estate.

Some of the advantages of a living trust are as follows:

- Confidentiality/privacy at time of estate settlement
- Reduction of estate delays and expenses, including avoidance of obtaining releases from potential estate beneficiaries and multistate administration
- Control of asset transfer to minors and other beneficiaries
- Continuity of asset ownership
- A contingency plan upon the incapacity of the creator, avoiding guardianship or conservatorship

Some of the tax consequences of a trust are:

- Contribution of property to a trust is not a taxable event for income tax purposes.
- Contribution of property to a trust is not a taxable event for gift tax purposes.
- The trust has a carry-over basis in contributed property.
- The tax basis of property distributed outright to beneficiaries on death of grantor is adjusted to the date-of-death value.

# 1999 Workbook

A Form 1041 is required for a grantor trust unless the same individual is serving as both grantor and trustee.

**Example.** Following is the Form 1041 (first page) and income and expense schedule to be included in Milton F. Sloan's Form 1040 tax return.

Form <b>1041</b> Department of the Treasury—Internal Revenue Service		1999
<b>U.S. Income Tax Return for Estates and Trusts</b>		OMB No. 1545-0092
For calendar year 1999 or fiscal year beginning _____, 1999, and ending _____		
<b>A</b> Type of entity: <input type="checkbox"/> Decedent's estate <input type="checkbox"/> Simple trust <input type="checkbox"/> Complex trust <input type="checkbox"/> Grantor type trust <input type="checkbox"/> Bankruptcy estate—Ch. 7 <input type="checkbox"/> Bankruptcy estate—Ch. 11 <input type="checkbox"/> Pooled income fund	Name of estate or trust (If a grantor type trust, see page 8 of the instructions.)  <p style="text-align: center;"><b>Living Trust/Milton F. Sloan</b></p> <hr/> Name and title of fiduciary <p style="text-align: center;"><b>Allen M. Sloan, TTEE</b></p> <hr/> Number, street, and room or suite no. (If a P.O. box, see page 8 of the instructions.) <p style="text-align: center;"><b>13 Fitzhugh St. So. S-100</b></p> <hr/> City or town, state, and ZIP code <p style="text-align: center;"><b>Rochester, NY 14614-1497</b></p>	<b>C</b> Employer identification number <p style="text-align: center;"><b>16 : 6402551</b></p> <hr/> <b>D</b> Date entity created <p style="text-align: center;"><b>4/07/94</b></p> <hr/> <b>E</b> Nonexempt charitable and split-interest trusts, check applicable boxes (see page 10 of the instructions): <input type="checkbox"/> Described in section 4947(a)(1) <input type="checkbox"/> Not a private foundation <input checked="" type="checkbox"/> Described in section 4947(a)(2)
<b>B</b> Number of Schedules K-1 attached (see instructions) ▶	City or town, state, and ZIP code <p style="text-align: center;"><b>Rochester, NY 14614-1497</b></p>	
<b>F</b> Check applicable boxes: <input type="checkbox"/> Initial return <input type="checkbox"/> Final return <input type="checkbox"/> Amended return <input type="checkbox"/> Change in fiduciary's name <input type="checkbox"/> Change in fiduciary's address	<b>G</b> Pooled mortgage account (see page 10 of the instructions): <input type="checkbox"/> Bought <input type="checkbox"/> Sold    Date: _____	
<b>Income</b>	1 Interest income . . . . . 2 Ordinary dividends . . . . . 3 Business income or (loss) (attach Schedule C or C-EZ (Form 1040)) . . . . . 4 Capital gain or (loss) (attach Schedule D (Form 1041)) . . . . . 5 Rents, royalties, partnerships, other estates and trusts, etc. (attach Schedule E (Form 1040)) . . . . . 6 Farm income or (loss) (attach Schedule F (Form 1040)) . . . . . 7 Ordinary gain or (loss) (attach Form 4797) . . . . . 8 Other income. List type and amount . . . . . 9 <b>Total income.</b> Combine lines 1 through 8 ▶	1 2 3 4 5 6 7 8 9 <p style="text-align: center;"><b>Under the terms of the trust instrument, this is a grantor trust. All income is taxable to the grantor as set forth under sections 671-678 I.R.C. A statement of income, deductions and credits is attached.</b></p>
<b>ns</b>	10 Interest. Check if Form 4952 is attached ▶ <input type="checkbox"/> . . . . . 11 Taxes . . . . . 12 Fiduciary fees . . . . . 13 Charitable deduction (from Schedule A, line 7) . . . . . 14 Attorney, accountant, and return preparer fees . . . . .	10 11 12 13 14

## *Income*

Gross dividends (see statement 1) (enter on line 5, schedule B, Form 1040)	\$12,322
Capital gain dividends (included above) (see statement 2) (enter on schedule B, line 7, and schedule D, line 13F, Form 1040)	1,504
Net 28% rate gain distributions (included above) (enter on schedule D, line 13G, Form 1040)	491
Nontaxable dividends (see statement 3) (enter on line 8, schedule B and if applicable schedule D, 1040)	1,539
Interest (see statement 4) (enter on line 1, schedule B, Form 1040)	907
Net short-term capital gain or (loss) (see schedule D) (enter on line 5, schedule D, Form 1040)	-114
Net long-term capital gain or (loss) (see schedule D) (enter on line 12F, schedule D, Form 1040)	12,563
Net 28% rate gain or (loss) (see schedule D) (enter on line 12 G, schedule D, form 1040)	16

## *Deductions*

Other deductions (see statement 5) (enter on line 22 or 27, schedule 1, form 1040)	16
--	----

## *Foreign Taxes*

Name of country - VARIOUS	
Type of income - passive income	
Foreign taxes	20
Gross income	500



## TEN KEY POINTS IN CONSIDERING A LIVING TRUST

1. A living trust should not be created without the assistance and advice of an attorney.
2. 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 the grantor's assets. This is sometimes a complicated procedure and requires the assistance of an attorney.
3. Since disposition of the grantor's property will ultimately be governed by the trust provisions and not by the provisions of the person's will, the trust must be drafted as carefully as a will.
4. 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.
5. 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.
6. 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 the property is being used in an active trade or business.
7. In order to avoid probate, all property that would be subject to probate must 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 a long, costly process.

# 1999 Workbook

8. A properly drafted living trust, combined with properly executed powers of attorney for financial matters and health care power of attorney, can eliminate 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 or her property.
9. The cost of having a living trust drafted, the property transferred, and the accompanying will drafted can be expensive. 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.
10. 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.

## WHAT TYPES OF PROPERTY CAN A GRANTOR PUT INTO A REVOCABLE TRUST?

Any property a grantor can own in his or her own name can be placed into a revocable living trust. Cash, stocks, mutual funds, bonds, real estate, or any other assets can be put into a trust. Life insurance can be put into a trust, or the trust can be named as beneficiary of life insurance. A trust can also be named as the beneficiary of pension or profit-sharing plans or an individual retirement account, but the actual assets of the retirement plan or IRA cannot be transferred into the trust without leading to the realization of taxable income and perhaps the incurring of penalties for premature withdrawals.

It is advisable that at the time the trust documents are signed, at least a small amount of cash be put into the trust so there is no question that the trust has been funded. (Some lawyers will staple a \$10 bill into the trust, so that it is clear that the trust has a valid "corpus.")

Assets can be transferred at the time the trust is set up and can be added at any time. Assets can be added at the time of death by a pour-over will. The pour-over will ensures that any assets that were not in the trust during the grantor's life are added to the trust at the grantor's death and are distributed according to the terms of the revocable trust.

The Taxpayer Relief Act of 1997 added a provision under I.R.C. §645 that allows a qualified revocable trust to be treated and taxed for income tax purposes as part of the estate and not as a separate trust, if both the executor of the estate and the trustee elect this treatment. The advantage is that only one tax return has to be filed. A disadvantage is that the estate will be forced to use the same calendar tax year that is required for all trusts. This election must be made by December 1, and once made is irrevocable. The election is illustrated in the following example.

**Example.** Jack Gilbert is a 70-year-old widower who lives in Buffalo, New York. He is a retired stockbroker. Both of his grown children live and work in California.

In 1990 Jack was concerned about his health and wanted to make sure his assets were properly managed if he became incompetent. On the advice of his attorney, accountant, and family, he set up a revocable living trust naming his son and accountant as co-trustees.

Upon Jack's death, the trust is to distribute one-half of the assets in the trust to his son, Thomas, and the other half of the assets to Jack's daughter, Sara.

Jack passed away on January 4, 1999. Jack's attorney, his son (who is the executor), and you have decided that it is in everybody's interest to elect under I.R.C. §645 to merge the estate and the grantor trust.

Following is a summary of the Forms 1099 received as of 12/31/99. Prepare the Form 1041 for the merged estate and trust.

	<u>Total</u>	<u>Trust Income</u>	<u>Estate Income</u>
Trust dividends	\$35,000	\$35,000	
Interest	14,500	10,000	\$4,500

# 1999 Workbook

For calendar year 1999 or fiscal year beginning \_\_\_\_\_, 1999, and ending \_\_\_\_\_, OMB No. 1545-0092

<b>A</b> Type of entity: <input checked="" type="checkbox"/> Decedent's estate <input type="checkbox"/> Simple trust <input type="checkbox"/> Complex trust <input type="checkbox"/> Grantor type trust <input type="checkbox"/> Bankruptcy estate—Ch. 7 <input type="checkbox"/> Bankruptcy estate—Ch. 11 <input type="checkbox"/> Pooled income fund	Name of estate or trust (If a grantor type trust, see page 8 of the instructions.) <p style="text-align: center;"><b>Estate of Jack Gilbert</b></p> <hr/> Name and title of fiduciary <p style="text-align: center;"><b>Thomas J. Gilbert</b></p> <hr/> Number, street, and room or suite no. (If a P.O. box, see page 8 of the instructions.) <p style="text-align: center;"><b>100 North Metro Way</b></p> <hr/> City or town, state, and ZIP code <p style="text-align: center;"><b>Buffalo, NY 14240</b></p>	<b>C</b> Employer identification number <p style="text-align: center;"><b>16 : 1279476</b></p> <hr/> <b>D</b> Date entity created <p style="text-align: center;"><b>1/04/99</b></p> <hr/> <b>E</b> Nonexempt charitable and split-interest trusts, check applicable boxes (see page 10 of the instructions): <input type="checkbox"/> Described in section 4947(a)(1) <input type="checkbox"/> Not a private foundation <input type="checkbox"/> Described in section 4947(a)(2)								
<b>B</b> Number of Schedules K-1 attached (see instructions) ▶ <b>2</b>										
<b>F</b> Check applicable boxes: <table style="width: 100%; border: none;"> <tr> <td><input type="checkbox"/> Initial return</td> <td><input type="checkbox"/> Final return</td> <td><input type="checkbox"/> Amended return</td> <td><b>G</b> Pooled mortgage account (see page 10 of the instructions):</td> </tr> <tr> <td><input type="checkbox"/> Change in fiduciary's name</td> <td><input type="checkbox"/> Change in fiduciary's address</td> <td><input type="checkbox"/> Bought</td> <td><input type="checkbox"/> Sold</td> </tr> </table>			<input type="checkbox"/> Initial return	<input type="checkbox"/> Final return	<input type="checkbox"/> Amended return	<b>G</b> Pooled mortgage account (see page 10 of the instructions):	<input type="checkbox"/> Change in fiduciary's name	<input type="checkbox"/> Change in fiduciary's address	<input type="checkbox"/> Bought	<input type="checkbox"/> Sold
<input type="checkbox"/> Initial return	<input type="checkbox"/> Final return	<input type="checkbox"/> Amended return	<b>G</b> Pooled mortgage account (see page 10 of the instructions):							
<input type="checkbox"/> Change in fiduciary's name	<input type="checkbox"/> Change in fiduciary's address	<input type="checkbox"/> Bought	<input type="checkbox"/> Sold							

<b>Income</b>	1 Interest income . . . . . <b>see statement 1</b> 2 Ordinary dividends . . . . . <b>see statement 2</b> 3 Business income or (loss) (attach Schedule C or C-EZ (Form 1040)) . . . . . 4 Capital gain or (loss) (attach Schedule D (Form 1041)) . . . . . 5 Rents, royalties, partnerships, other estates and trusts, etc. (attach Schedule E (Form 1040)) . . . . . 6 Farm income or (loss) (attach Schedule F (Form 1040)) . . . . . 7 Ordinary gain or (loss) (attach Form 4797) . . . . . 8 Other income. List type and amount . . . . . 9 <b>Total income.</b> Combine lines 1 through 8 . . . . . ▶	1 <b>14,500</b> 2 <b>35,000</b> 3 4 5 6 7 8 9 <b>49,500</b>	
<b>Deductions</b>	10 Interest. Check if Form 4952 is attached ▶ <input type="checkbox"/> . . . . . 11 Taxes . . . . . 12 Fiduciary fees . . . . . 13 Charitable deduction (from Schedule A, line 7) . . . . . 14 Attorney, accountant, and return preparer fees . . . . . 15a Other deductions NOT subject to the 2% floor (attach schedule) . . . . . 15b Allowable miscellaneous itemized deductions subject to the 2% floor. . . . . 16 <b>Total.</b> Add lines 10 through 15b . . . . . 17 Adjusted total income or (loss). Subtract line 16 from line 9. Enter here and on Schedule B, line 1 ▶ 18 Income distribution deduction (from Schedule B, line 15) (attach Schedules K-1 (Form 1041)) . . . . . 19 Estate tax deduction (including certain generation-skipping taxes) (attach computation) . . . . . 20 Exemption . . . . . 21 <b>Total deductions.</b> Add lines 18 through 20 . . . . . ▶	10 11 12 13 14 15a 15b 16 17 <b>49,500</b> 18 <b>49,500</b> 19 20 <b>600</b> 21 <b>50,100</b>	
<b>Tax and Payments</b>	22 Taxable income. Subtract line 21 from line 17. If a loss, see page 14 of the instructions . . . . . 23 <b>Total tax</b> (from Schedule G, line 8) . . . . . 24 <b>Payments:</b> a 1999 estimated tax payments and amount applied from 1998 return . . . . . b Estimated tax payments allocated to beneficiaries (from Form 1041-T) . . . . . c Subtract line 24b from line 24a . . . . . d Tax paid with extension of time to file: <input type="checkbox"/> Form 2758 <input type="checkbox"/> Form 8736 <input type="checkbox"/> Form 8800 . . . . . e Federal income tax withheld. If any is from Form(s) 1099, check <input type="checkbox"/> . . . . . Other payments: f Form 2439 . . . . . ; g Form 4136 . . . . . ; Total ▶ 25 <b>Total payments.</b> Add lines 24c through 24e, and 24h . . . . . ▶ 26 Estimated tax penalty (see page 15 of the instructions) . . . . . 27 <b>Tax due.</b> If line 25 is smaller than the total of lines 23 and 26, enter amount owed . . . . . 28 <b>Overpayment.</b> If line 25 is larger than the total of lines 23 and 26, enter amount overpaid . . . . . 29 Amount of line 28 to be: a Credited to 2000 estimated tax ▶ ; b Refunded ▶	22 <b>-600</b> 23 <b>0</b> 24a 24b 24c 24d 24e 24h 25 26 27 28 29	



# 1999 Workbook

## Section 645 Election (Attach to Form 1041)

Name of decedent	Jack Gilbert
Address	2 Rotain Place Buffalo, NY 14202
Date of death	January 4, 1999
Decedent's S.S. #	050-50-1001
Revocable trust name	Gilbert Revocable Trust 2 Rotain Place Buffalo, NY 14202
TIN of Trust	16-1001414
TIN of Estate	16-1279476
Estate of	Jack M. Gilbert 2 Rotain Place Buffalo, NY 14202
Executor	Thomas B. Gilbert
Trustee	Thomas B. Gilbert

Section 645 election is hereby made by the Estate of Jack M. Gilbert as of date of death, January 4, 1999. The above trust was treated under I.R.C. §645 as owned by the decedent by reason of the power of the decedent to revoke.

---

Thomas B. Gilbert, Executor

---

Thomas B. Gilbert, Trustee

## QUALIFIED TERMINABLE INTEREST PROPERTY (QTIP) TRUSTS

### COMMON INTERESTS/UNCOMMON BENEFICIARIES

It is increasingly common for married couples to want the surviving spouse to enjoy the same lifestyle after the death of the first to die as the couple enjoyed while they were both alive. However, each of the spouses wants to ensure that his or her share of the wealth passes to specific beneficiaries upon the death of the surviving spouse.

This distribution pattern is particularly important to the individual who is married and has children from a previous relationship. It is also important to the individual who wants professional management of his or her assets while the surviving spouse is receiving the income from the assets.

### THE ELECTION

A Qualified Terminable Interest Property (QTIP) provision in a will or revocable trust gives the executor or trustee the obligation and power to accomplish the above objectives by making the QTIP election.

**Practitioner Note.** An IRA trust is very similar to a QTIP trust but is more specialized. See the Retirement chapter for more information on this subject.

## OVERVIEW OF QTIP

The QTIP election allows the estate to qualify for the marital deduction without giving the surviving spouse control of the trust principal. The QTIP provisions are effective for estates of decedents dying after 1981. The two major differences between the QTIP trust and its predecessor, the power of appointment trust [I.R.C. §2056(b)(5)], are:

1. The executor may elect to deduct only a part of the QTIP qualifying property to make optimal use of the applicable exclusion and marital deduction amounts.
2. With the QTIP trust the testator can control the ultimate disposition of the property— a provision commonly referred to as “ruling from the grave.”

Property subject to a QTIP election becomes “2044 property” and is includable in the estate of the surviving (donee) spouse (I.R.C. §2044). **The estate of the surviving spouse may recover estate taxes (including interest and penalties) attributable to the §2044 property from the person receiving the property, subject to the terms of the will (I.R.C. §2207A).**

**Example.** Mary Lou Smith is 80 years old. Her husband, George, made her the beneficiary of a QTIP trust in 1985. At the time of George’s death, the QTIP trust was worth \$600,000. In 1999, it is worth \$1,200,000. When Mrs. Smith died in 1999, she had \$500,000 of her own assets other than the QTIP trust. Without the QTIP trust assets, Mrs. Smith’s estate would not have to pay any federal estate tax. Since the trust assets are included in her estate, it owes approximately \$388,000 of estate tax on the combined assets of \$1,700,000. The estate can recover that \$388,000 from the beneficiaries of the trust.

## QTIP REQUIREMENTS

To qualify for the marital deduction the QTIP trust is subject to the following conditions:

**Lifetime Income.** The QTIP must provide the surviving spouse a lifetime income interest in the property passing from the decedent spouse. An income interest for a specific number of years or an income interest that terminates upon remarriage or another event will not qualify. The income must be payable at least annually for life.

**Practitioner Note.** The property must be income-producing property to qualify for QTIP purposes unless the surviving spouse has a right to convert the non-income-producing property into income-producing property.

**No Lifetime Power to Appoint.** No person (including the surviving spouse) may have the power to appoint any part of the subject property to anyone except the surviving spouse during his or her life. However, a testamentary special power of appointment may be used for heightened flexibility. The surviving spouse or trustee may possess a limited power of appointment to invade the trust corpus and distribute it to the surviving spouse for support of minor children for whom the surviving spouse has a legal obligation of support. The QTIP will not be disqualified if the distribution is made directly to the surviving spouse. A payment directly to the minor children will disqualify the QTIP (Ltr. Rul. 9005002). Any provision permitting invasion for “any child of mine who is dependent upon my spouse for his or her support” would not qualify since recipients could possibly include adult children whom the surviving spouse is not legally obligated to support (Ltr. Rul. 8913003).

# 1999 Workbook

**QTIP Election.** The executor must elect QTIP on Schedule M of Form 706. Property interests that are subject to a QTIP election must be individually listed on Schedule M. Any property not listed will be disqualified for the marital deduction.

The election must be timely made on either the last estate tax return filed before the due date (including extensions) or, if no return is filed by the due date, on the first return after the due date. The election, once made, is irrevocable.

## POSTMORTEM PLANNING

### MAKING THE QTIP ELECTION

The QTIP election may provide the executor with great postmortem flexibility depending upon the will. The executor, if given proper discretion in the will, may or may not elect QTIP treatment.

The QTIP election may be made in several ways.

**Partial QTIP.** The testator may make a bequest of all intangible property in trust to the surviving spouse, leaving the decision of partial election to the executor.

**Formula Marital Deduction.** If both a nonmarital unified (credit shelter) trust and marital trust are set up by the testator, the executor's QTIP election is available only on the marital trust portion, upon which the executor may make a partial election.

**Pecuniary (Dollar Amount) Marital Deduction.** In many second-marriage situations, the testator makes a bequest of a specified amount, percentage, or fraction of the residuary estate in trust for the surviving spouse. The testator thereby controls the ultimate disposition of an exact amount. In this case the executor will probably want to elect QTIP treatment for the entire trust.

## DISCLAIMERS

Qualified disclaimers are effective postmortem estate planning tools, especially in the QTIP area. A qualified disclaimer pursuant to I.R.C. §2518 is a person's irrevocable refusal in writing to accept an interest in property. The disclaimer must be made by the later of nine (9) months after the date of transfer or upon the disclaimant attaining the age of twenty-one (21). The property must pass "without any direction on the part of the person making the disclaimer."

**Disclaimer by Surviving Spouse after QTIP Election.** A surviving spouse may disclaim his or her interest in an elected QTIP trust to pass the income interest to the next beneficiary. However, the QTIP trust will not qualify for the marital deduction if the income interest is disclaimed. A qualified disclaimer could also prevent double estate taxation where property did not qualify for the marital deduction.

**Disclaimer by Other Beneficiaries.** Other beneficiaries may also disclaim in favor of the surviving spouse, to increase the marital deduction and reduce the decedent's estate tax. The disclaimer may also be used to qualify property as QTIP where the other beneficiary disclaims his or her share of qualifying life interest in property passed to both the beneficiary and the surviving spouse.

## INVASION PROVISIONS

From an estate tax standpoint, the surviving spouse can be given broad powers to invade the principal in the trust. This is because the QTIP property, by law (I.R.C. §2044), is automatically includable in the estate of the surviving spouse. Even if the QTIP invasion provisions are so broad as to be deemed a general power of appointment, there is no additional estate tax cost for the surviving spouse.

The only problem with invasion provisions of a QTIP trust is that if they are too broad, the trust property may be consumed before it can pass to the intended beneficiary. This could be especially harmful in second-marriage situations, where the decedent spouse's ultimate beneficiary may lose his or her inheritance.

**Practitioner Note.** If the QTIP election is to apply to only part of the trust, the power to invade should be limited to an ascertainable standard of health, education, and maintenance support.

## QTIP SUMMARY: ADVANTAGES AND DISADVANTAGES

### ADVANTAGES OF QTIPS

1. QTIP provides estate liquidity with deferral of estate tax until the death of the surviving spouse.
2. The testator (decedent spouse) can control the ultimate disposition of the QTIP property.
3. Probate is avoided at the death of the surviving spouse.
4. QTIP is very flexible with regard to invasion provisions.
5. QTIP provides professional trust fund management for the surviving spouse and other beneficiaries.
6. QTIP can protect trust principal from creditors of the surviving spouse both during lifetime and upon his or her death.
7. QTIP provides postmortem flexibility and a second chance to make changes in response to subsequent events or poor planning. The executor can decide not to elect QTIP if necessary.
8. QTIP is an excellent control mechanism for second marriages.
9. QTIP can be used to satisfy minimum distribution amounts (right of election as required by state law) to the surviving spouse.

### DISADVANTAGES OF QTIPS

1. QTIP regulations are restrictive as to qualifying property.
2. Executor could make inappropriate postmortem decisions.
3. Flexible invasion provisions may lead to early consumption or squandering of trust property.
4. QTIP is subject to estate tax at the death of the surviving spouse.
5. Trustee fees may be incurred.
6. QTIP trust provisions can be made too restrictive and not provide for invasions based on need.
7. QTIP trust income must be distributed at least annually, even if not needed by the surviving spouse.

### OTHER EXCEPTIONS TO TERMINABLE INTEREST RULES

In addition to the QTIP rules, there are other exceptions to the general rule that a terminable interest does not qualify for the marital deduction.

### LIFE ESTATES COUPLED WITH A GENERAL POWER OF APPOINTMENT

A life estate that would otherwise be considered a terminable interest and not qualify for the marital deduction may qualify under I.R.C. §2056(b)(5) if the surviving spouse:

1. Is entitled to all income of the entire interest (or specific portion thereof) payable at least annually, and
2. May appoint the entire property (or specific portion thereof) to him or herself or his or her estate, and no other person has the power to appoint the property to anyone other than the surviving spouse.

# 1999 Workbook

Any conditions or limits placed on the power of appointment (causing a limited or special power of appointment) will negate the general power of appointment and create a terminable interest that does not qualify for the marital deduction. Local (state) law may also have to be considered in cases where there are doubts as to the extent of the surviving spouse's interest in the property.

## **SURVIVORSHIP CONDITIONS**

Code §2056(b)(3) allows a marital deduction if the only condition of a bequest is that the surviving spouse live up to six months after the death of the decedent-testator.

## **ANNUITIES**

Code §2056(b)(6) allows annuities coupled with a general power of appointment in favor of the surviving spouse to qualify for the marital deduction. In general, annuities that pass from a decedent to a surviving spouse with interests or refunds passing beyond the surviving spouse's lifetime are considered a terminable interest and do not qualify for the marital deduction. However, if the surviving spouse has power to appoint the entire interest in the annuity contract or the annuity qualifies as QTIP under I.R.C. §2056(b)(7)(B), the annuity will be deemed a nonterminable interest and qualify for the marital deduction.

## **CHARITABLE REMAINDER TRUSTS**

Code §§2056(b)(8) and 2523(g) allow the marital deduction to be claimed for the value of the surviving spouse's interest in a charitable remainder trust as long as the surviving spouse is the only noncharitable beneficiary of the trust. Similar to the QTIP trust, the ultimate beneficiary of the subject property is predetermined by the testator-decedent spouse and not the surviving spouse.

## **CONDITIONS UPON IRS APPROVAL**

A terminable interest is not created if the surviving spouse's interest in the property is conditional only upon IRS approval of the property to qualify for the marital deduction (Rev. Rul. 76-199).

## **NONCITIZEN SPOUSES AND THE QUALIFIED DOMESTIC TRUST (QDOT) (I.R.C. §2056A)**

### **OVERVIEW OF THE QDOT**

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) disqualifies the marital deduction to estates of decedents whose surviving spouse is not a U.S. citizen [I.R.C §2056(d)]. The reason for this position is to make sure that a noncitizen surviving spouse cannot escape estate tax on his or her death by residing outside the United States.

An exception to the rule is the qualified domestic trust (QDOT). The QDOT rules are effective for estates of decedents dying after November 19, 1988. The marital deduction will be allowed if the non-citizen surviving spouse:

1. Becomes a U.S. citizen before the estate tax return is filed and
2. Resides in the United States at all times after the death of the decedent and before the surviving spouse becomes a citizen of the United States.

**Example.** Phyllis M. Warren is a 56-year-old Xerox Corporation sales executive residing in Chicago, Illinois. She has been married before and now resides with her second husband, Charles, who is 65 years old. She has two grown children from her previous marriage. In consultation with her attorney, and you as her accountant, she has named you as the trustee in her will to manage her QTIP trust for the benefit of Charles, but with the imperative command not only to support Charles during his life but to make sure that the principal grows and passes to her children upon Charles's demise.

One of the key determining points in this case is that Charles has not accumulated a large estate and lives off his modest Air Force retirement.

# 1999 Workbook

On August 25, 1998, Phyllis Warren dies. Her executor has informed you that they will fund the QTIP trust with 15,000 shares of Xerox stock valued for federal estate tax purposes at \$47.50 per share. Now you will have to reallocate the portfolio with an appropriate asset allocation. In October 1998, the trust is funded with the 15,000 shares of Xerox.

In 1999 Xerox is selling for \$80 per share. You sell 10,000 shares on April 30, 1999, and immediately invest the \$800,000 proceeds in the following allocations:

5%	Money market funds
15%	Bonds
10%	Tax-exempt bonds
20%	Income equities
10%	Real estate investment trusts
15%	Growth and income equities
15%	International growth and income equities
10%	Aggressive growth equities

In early 2000 you receive the following information on 1999 Forms 1099:

Money market dividends	\$ 3,200
Bonds	10,200
Tax-exempt bonds	4,000
Regular dividends	22,000

Your trustee fee of \$15,000 was paid in December 1999. Prepare the 1999 Form 1041.

## FEDERAL INCOME TAX SUMMARY

### TRUST U/W/O PHYLLIS M. WARREN

Income	
Interest income	\$ 10,200
Dividend income	25,200
Capital gain (loss) (1041 & 1041-A only)	325,000
Total income	360,400
Deductions	
Fiduciary fees	13,477
Total	13,477
Adjusted total income	
Adjusted total income	346,923
Income distribution deduction	
Adjusted total income	346,923
Adjusted tax-exempt interest	2,477
Subtract capital gain included in income	-325,000
Distributable net income	24,400
Accounting income	31,900
Income required to be distributed	24,400
Other amounts distributed	0
Total distributions	24,400
Tax-exempt included in distributions	2,477
Distributions less tax-exempt income	21,923
DNI less tax-exempt income	21,923
Income distribution deduction	21,923

# 1999 Workbook

## FEDERAL INCOME TAX SUMMARY

Other deductions	
Income distribution deduction	21,923
Exemption	100
Total other deductions	22,023
Tax computation	
Taxable income	324,900
Tax from rate schedule or schedule D	64,810
Alternative minimum tax	20
Total tax from schedule G	64,810
Refund or amount due	
Amount of tax due	64,810
Tax rates	
Marginal tax rate	39.6%
Effective tax rate	20.0%

# 1999 Workbook

For calendar year 1999 or fiscal year beginning \_\_\_\_\_, 1999, and ending \_\_\_\_\_, OMB No. 1545-0092

<b>A</b> Type of entity: <input type="checkbox"/> Decedent's estate <input type="checkbox"/> Simple trust <input type="checkbox"/> Complex trust <input type="checkbox"/> Grantor type trust <input type="checkbox"/> Bankruptcy estate—Ch. 7 <input type="checkbox"/> Bankruptcy estate—Ch. 11 <input type="checkbox"/> Pooled income fund	Name of estate or trust (If a grantor type trust, see page 8 of the instructions.) <p style="text-align: center;"><b>Trust U/W/O Phyllis M. Warren</b></p> Name and title of fiduciary <p style="text-align: center;"><b>Carl F. Schaeffer</b></p> Number, street, and room or suite no. (If a P.O. box, see page 8 of the instructions.) <p style="text-align: center;"><b>3000 Michigan Avenue</b></p> City or town, state, and ZIP code <p style="text-align: center;"><b>Chicago, IL 12054</b></p>	<b>C</b> Employer identification number <p style="text-align: center;"><b>16 : 1400914</b></p> <b>D</b> Date entity created <p style="text-align: center;"><b>8/25/98</b></p> <b>E</b> Nonexempt charitable and split-interest trusts, check applicable boxes (see page 10 of the instructions): <input type="checkbox"/> Described in section 4947(a)(1) <input type="checkbox"/> Not a private foundation <input type="checkbox"/> Described in section 4947(a)(2)
<b>B</b> Number of Schedules K-1 attached (see instructions) ▶ <b>1</b>	<b>F</b> Check applicable boxes: <input type="checkbox"/> Initial return <input type="checkbox"/> Final return <input type="checkbox"/> Amended return <input type="checkbox"/> Change in fiduciary's name <input type="checkbox"/> Change in fiduciary's address	
<b>G</b> Pooled mortgage account (see page 10 of the instructions): <input type="checkbox"/> Bought <input type="checkbox"/> Sold    Date: _____		

	Description	Amount	Total
<b>Income</b>	1 Interest income . . . . .	<i>see statement</i>	1 <b>10,200</b>
	2 Ordinary dividends . . . . .	<i>see statement</i>	2 <b>25,200</b>
	3 Business income or (loss) (attach Schedule C or C-EZ (Form 1040)) . . . . .		3
	4 Capital gain or (loss) (attach Schedule D (Form 1041)) . . . . .		4 <b>325,000</b>
	5 Rents, royalties, partnerships, other estates and trusts, etc. (attach Schedule E (Form 1040)) . . . . .		5
	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 <b>Total income.</b> Combine lines 1 through 8 . . . . . ▶		9 <b>360,400</b>
<b>Deductions</b>	10 Interest. Check if Form 4952 is attached ▶ <input type="checkbox"/> . . . . .		10
	11 Taxes . . . . .		11
	12 Fiduciary fees . . . . .	<i>see statement</i>	12 <b>13,477</b>
	13 Charitable deduction (from Schedule A, line 7) . . . . .		13
	14 Attorney, accountant, and return preparer fees . . . . .		14
	15a Other deductions NOT subject to the 2% floor (attach schedule) . . . . .		15a
	15b Allowable miscellaneous itemized deductions subject to the 2% floor. . . . .		15b
	16 <b>Total.</b> Add lines 10 through 15b . . . . .		16 <b>13,477</b>
	17 Adjusted total income or (loss). Subtract line 16 from line 9. Enter here and on Schedule B, line 1 ▶		17 <b>346,923</b>
	18 Income distribution deduction (from Schedule B, line 15) (attach Schedules K-1 (Form 1041)) . . . . .		18 <b>21,923</b>
	19 Estate tax deduction (including certain generation-skipping taxes) (attach computation) . . . . .		19
20 Exemption . . . . .		20 <b>100</b>	
21 <b>Total deductions.</b> Add lines 18 through 20 . . . . . ▶		21 <b>22,900</b>	
<b>Tax and Payments</b>	22 Taxable income. Subtract line 21 from line 17. If a loss, see page 14 of the instructions . . . . .		22 <b>324,900</b>
	23 <b>Total tax</b> (from Schedule G, line 8) . . . . .		23 <b>64,830</b>
	24 <b>Payments:</b> a 1999 estimated tax payments and amount applied from 1998 return . . . . .		24a
	b Estimated tax payments allocated to beneficiaries (from Form 1041-T) . . . . .		24b
	c Subtract line 24b from line 24a . . . . .		24c
	d Tax paid with extension of time to file: <input type="checkbox"/> Form 2758 <input type="checkbox"/> Form 8736 <input type="checkbox"/> Form 8800 . . . . .		24d
	e Federal income tax withheld. If any is from Form(s) 1099, check ▶ <input type="checkbox"/> . . . . .		24e
	Other payments: f Form 2439 . . . . . ; g Form 4136 . . . . . ; Total ▶		24h
	25 <b>Total payments.</b> Add lines 24c through 24e, and 24h . . . . . ▶		25
	26 Estimated tax penalty (see page 15 of the instructions) . . . . .		26
27 <b>Tax due.</b> If line 25 is smaller than the total of lines 23 and 26, enter amount owed . . . . .		27 <b>64,830</b>	
28 <b>Overpayment.</b> If line 25 is larger than the total of lines 23 and 26, enter amount overpaid . . . . .		28	
29 Amount of line 28 to be: a Credited to 2000 estimated tax ▶ . . . . . ; b Refunded ▶ . . . . .		29	

7

# 1999 Workbook

Form 1041 (1999)

**Trust U/W/O Phyllis M. Warren**

**16 1400914**

Page **2**

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

<b>Schedule B Income Distribution Deduction</b>			
1	Adjusted total income (from page 1, line 17) (see page 16 of the instructions)		<b>346,923</b>
2	Adjusted tax-exempt interest		<b>2,477</b>
3	Total net gain from Schedule D (Form 1041), line 16, column (1) (see page 16 of the instructions)		
4	Enter amount from Schedule A, line 4 (reduced by any allocable section 1202 exclusion)		
5	Capital gains for the tax year included on Schedule A, line 1 (see page 16 of the instructions)		
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		<b>-325,000</b>
7	<b>Distributable net income (DNI).</b> Combine lines 1 through 6. If zero or less, enter -0-		<b>24,400</b>
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law	8	<b>31,900</b>
9	Income required to be distributed currently		<b>24,400</b>
10	Other amounts paid, credited, or otherwise required to be distributed		
11	Total distributions. Add lines 9 and 10. If greater than line 8, see page 17 of the instructions		<b>24,400</b>
12	Enter the amount of tax-exempt income included on line 11		<b>2,477</b>
13	Tentative income distribution deduction. Subtract line 12 from line 11		<b>21,923</b>
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-		<b>21,923</b>
15	<b>Income distribution deduction.</b> Enter the smaller of line 13 or line 14 here and on page 1, line 18		<b>21,923</b>

<b>Schedule G Tax Computation</b> (see page 17 of the instructions)					
1	Tax: <input type="checkbox"/> Tax rate schedule or <input type="checkbox"/> Schedule D (Form 1041)	1a	<b>64,810</b>		
	b Tax on lump-sum distributions (attach Form 4972)	1b			
	c Total. Add lines 1a and 1b			1c	<b>64,810</b>
2a	Foreign tax credit (attach Form 1116)	2a			
b	Check: <input type="checkbox"/> Nonconventional source fuel credit <input type="checkbox"/> Form 8834	2b			
c	General business credit. Enter here and check which forms are attached: <input type="checkbox"/> Form 3800 or <input type="checkbox"/> Forms (specify) ▶	2c			
d	Credit for prior year minimum tax (attach Form 8801)	2d			
3	<b>Total credits.</b> Add lines 2a through 2d	3		0	
4	Subtract line 3 from line 1c	4		<b>64,810</b>	
5	Recapture taxes. Check if from: <input type="checkbox"/> Form 4255 <input type="checkbox"/> Form 8611	5			
6	Alternative minimum tax (from Schedule I, line 39)	6		<b>20</b>	
7	Household employment taxes. Attach Schedule H (Form 1040)	7			
8	<b>Total tax.</b> Add lines 4 through 7. Enter here and on page 1, line 23	8		<b>64,830</b>	

<b>Other Information</b>			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 ▶ \$ <b>4,000 stmt 4</b>	<b>X</b>		
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?			<b>X</b>
3	At any time during calendar year 1999, 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 ▶			<b>X</b>
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. See page 19 of the instructions			<b>X</b>
5	Did the estate or trust receive, or pay, any qualified residence interest on seller-provided financing? If "Yes," see page 19 for required attachment			<b>X</b>
6	If this is an estate or a complex trust making the section 663(b) election, check here (see page 19) ▶ <input type="checkbox"/>			
7	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here (see page 19) ▶ <input type="checkbox"/>			
8	If the decedent's estate has been open for more than 2 years, attach an explanation for the delay in closing the estate, and check here ▶ <input type="checkbox"/>			
9	Are any present or future trust beneficiaries skip persons? See page 19 of the instructions			

# 1999 Workbook

**Schedule I Alternative Minimum Tax** (see pages 19 through 24 of the instructions) **16 1400914**

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

1	Adjusted total income or (loss) (from page 1, line 17)		<b>346,923</b>
2	Net operating loss deduction. Enter as a positive amount		
3	Add lines 1 and 2		<b>346,923</b>
4	<b>Adjustments and tax preference items:</b>		
a	Interest	4a	
b	Taxes	4b	
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	
6	Add lines 3 and 5	6	<b>346,923</b>
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 13 <i>Note: Complete Part II below before going to line 9.</i>	8	<b>346,923</b>
9	Income distribution deduction from line 27 below	9	<b>21,923</b>
10	Estate tax deduction (from page 1, line 19)	10	
11	Add lines 9 and 10	11	<b>21,923</b>
12	Estate's or trust's share of alternative minimum taxable income. Subtract line 11 from line 8 If line 12 is:	12	<b>325,000</b>

- \$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 28.
- \$165,000 or more, enter the amount from line 12 on line 34 and go to line 35.

**Part II—Income Distribution Deduction on a Minimum Tax Basis**

13	Adjusted alternative minimum taxable income (from line 8)		<b>346,923</b>
14	Adjusted tax-exempt interest (other than amounts included on line 4p)		<b>2,477</b>
15	Total net gain from Schedule D (Form 1041), line 16, column (1). If a loss, enter -0-		<b>0</b>
16	Capital gains for the tax year allocated to corpus and paid or permanently set aside for charitable purposes (from Schedule A, line 4)		
17	Capital gains paid or permanently set aside for charitable purposes from gross income (see page 23 of the instructions)		
18	Capital gains computed on a minimum tax basis included on line 8		<b>( 325,000 )</b>
19	Capital losses computed on a minimum tax basis included on line 8. Enter as a positive amount		
20	Distributable net alternative minimum taxable income (DNAMTI). Combine lines 13 through 19. If zero or less, enter -0-		<b>24,400</b>
21	Income required to be distributed currently (from Schedule B, line 9)		<b>24,400</b>
22	Other amounts paid, credited, or otherwise required to be distributed (from Schedule B, line 10)		
23	Total distributions. Add lines 21 and 22		<b>24,400</b>
24	Tax-exempt income included on line 23 (other than amounts included on line 4p)		<b>2,477</b>
25	Tentative income distribution deduction on a minimum tax basis. Subtract line 24 from line 23		<b>21,923</b>
26	Tentative income distribution deduction on a minimum tax basis. Subtract line 14 from line 20. If zero or less, enter -0-		<b>21,923</b>
27	<b>Income distribution deduction on a minimum tax basis.</b> Enter the smaller of line 25 or line 26. Enter here and on line 9		<b>21,923</b>



# 1999 Workbook

**Part III—Alternative Minimum Tax**

28	Exemption amount . . . . .				\$22,500
29	Enter the amount from line 12 . . . . .	29			
30	Phase-out of exemption amount . . . . .	30	\$75,000		
31	Subtract line 30 from line 29. If zero or less, enter -0- . . . . .	31	0		
32	Multiply line 31 by 25% (.25) . . . . .			32	
33	Subtract line 32 from line 28. If zero or less, enter -0- . . . . .			33	0
34	Subtract line 33 from line 29 . . . . .			34	325,000
35	If the estate or trust completed Schedule D (Form 1041) and has an amount on line 24 or 26 (or would have had an amount on either line if Part V had been completed) (as refigured for the AMT, if necessary), go to Part IV below to figure line 35. <b>All others:</b> If line 34 is— <ul style="list-style-type: none"> <li>• \$175,000 or less, multiply line 34 by 26% (.26).</li> <li>• Over \$175,000, multiply line 34 by 28% (.28) and subtract \$3,500 from the result</li> </ul>			35	64,830
36	Alternative minimum foreign tax credit (see page 23 of instructions) . . . . .			36	
37	Tentative minimum tax. Subtract line 36 from line 35 . . . . .			37	64,830
38	Enter the tax from Schedule G, line 1a (minus any foreign tax credit from Schedule G, line 2a) . . . . .			38	64,810
39	<b>Alternative minimum tax.</b> Subtract line 38 from line 37. If zero or less, enter -0-. Enter here and on Schedule G, line 6 . . . . .			39	20

**Part IV—Line 35 Computation Using Maximum Capital Gains Rates**

**Caution:** If the estate or trust did not complete Part V of Schedule D (Form 1041), complete lines 19 through 26 of Schedule D (as refigured for the AMT, if necessary) before completing this part.

					325,000
40	Enter the amount from line 34 . . . . .			40	
41	Enter the amount from Schedule D (Form 1041), line 26 (as refigured for AMT, if necessary) . . . . .	41	325,000		
42	Enter the amount from Schedule D (Form 1041), line 24 (as refigured for AMT, if necessary) . . . . .	42			
43	Add lines 41 and 42. If zero or less, enter -0- . . . . .	43	325,000		
44	Enter the amount from Schedule D (Form 1041), line 21 (as refigured for AMT, if necessary) . . . . .	44	325,000		
45	Enter the <b>smaller</b> of line 43 or line 44 . . . . .			45	325,000
46	Subtract line 45 from line 40. If zero or less, enter -0- . . . . .			46	0
47	If line 46 is \$175,000 or less, multiply line 46 by 26% (.26). Otherwise, multiply line 46 by 28% (.28) and subtract \$3,500 from the result . . . . . ▶			47	
48	Enter the amount from Schedule D (Form 1041), line 35 (as figured for the regular tax) . . . . .			48	1,700
49	Enter the <b>smallest</b> of line 40, line 41, or line 48 . . . . .			49	1,700
50	Multiply line 49 by 10% (.10) . . . . . ▶			50	170
51	Enter the <b>smaller</b> of line 40 or line 41 . . . . .			51	325,000
52	Enter the amount from line 49 . . . . .			52	1,700
53	Subtract line 52 from line 51. If zero or less, enter -0- . . . . .			53	323,000
54	Multiply line 53 by 20% (.20) . . . . . ▶			54	64,660
55	Enter the amount from line 40 . . . . .			55	325,000
56	Add lines 46, 49, and 53 . . . . .			56	325,000
57	Subtract line 56 from line 55 . . . . .			57	
58	Multiply line 57 by 25% (.25) . . . . . ▶			58	
59	Add lines 47, 50, 54, and 58 . . . . .			59	64,830
60	If line 40 is \$175,000 or less, multiply line 40 by 26% (.26). Otherwise, multiply line 40 by 28% (.28) and subtract \$3,500 from the result . . . . .			60	87,500
61	Enter the <b>smaller</b> of line 59 or line 60 here and on line 35 . . . . . ▶			61	64,830

# 1999 Workbook

**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

# 1999

Name of estate or trust

**Trust U/W/O Phyllis M. Warren**

Employer identification number

**16 : 1400914**

**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) (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. Enter the amount, if any, from line 9 of the 1998 Capital Loss Carryover Worksheet . . . . .				4	(      )
5	<b>Net short-term gain or (loss).</b> 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) (col. (d) less col. (e))	(g) 28% RATE GAIN or (LOSS) *(see instr. below)
6	<b>10,000 shares</b>	<b>8/25/98</b>	<b>800,000</b>	<b>475,000</b>	<b>325,000</b>	
	<b>Xerox Corp</b>					
7	Long-term capital gain or (loss) from Forms 2439, 4684, 6252, 6781, and 8824 . . . . .				7	
8	Net long-term gain or (loss) from partnerships, S corporations, and other estates or trusts . . . . .				8	
9	Capital gain distributions . . . . .				9	
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 line 14, of the 1998 Capital Loss Carryover Worksheet . . . . .				11	(      ) (      )
12	Combine lines 6 through 11 in column (g). . . . .				12	
13	<b>Net long-term gain or (loss).</b> Combine lines 6 through 11 in column (f). Enter here and on line 15 below . . . . . ▶				13	<b>325,000</b>

\*28% Rate Gain or (Loss) includes all "collectibles gains and losses" (as defined on page 27 of the instructions) and up to 50% of the eligible gain on qualified small business stock (see page 25 of the instructions).

Part III Summary of Parts I and II	(1) Beneficiaries' (see page 27)	(2) Estate's or trust's	(3) Total
14 <b>Net short-term gain or (loss)</b> (from line 5 above) . . . . .	14		
15 <b>Net long-term gain or (loss):</b>			
a 28% rate gain or (loss) (from line 12 above) . . . . .	15a		
b Unrecaptured section 1250 gain (see worksheet on page 26). . . . .	15b		
c Total for year (from line 13 above) . . . . .	15c	<b>325,000</b>	<b>325,000</b>
16 <b>Total net gain or (loss).</b> Combine lines 14 and 15c . . . . . ▶	16	<b>325,000</b>	<b>325,000</b>

**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.

7

# 1999 Workbook

**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 22, 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 22 is more than zero.)

18 Enter taxable income from Form 1041, line 22. . . . .				<b>18</b>	<b>324,900</b>
19 Enter the <b>smaller</b> of line 15c or 16 in column (2). . . . .	<b>19</b>	<b>325,000</b>			
20 If you are filing Form 4952, enter the amount from Form 4952, line 4e . . . . .	<b>20</b>				
21 Subtract line 20 from line 19. If zero or less, enter -0- . . . . .	<b>21</b>	<b>325,000</b>			
22 Combine lines 14 and 15a, column (2). If zero or less, enter -0- . . . . .	<b>22</b>	<b>0</b>			
23 Enter the <b>smaller</b> of line 15a, column (2), or line 22, but not less than zero . . . . .	<b>23</b>				
24 Enter the amount from line 15b, column (2). . . . .	<b>24</b>				
25 Add lines 23 and 24 . . . . .	<b>25</b>				
26 Subtract line 25 from line 21. If zero or less, enter -0- . . . . .	<b>26</b>			<b>325,000</b>	
27 Subtract line 26 from line 18. If zero or less, enter -0- . . . . .	<b>27</b>			<b>0</b>	
28 Enter the <b>smaller</b> of line 18 or \$1,750 . . . . .	<b>28</b>	<b>1,700</b>			
29 Enter the <b>smaller</b> of line 27 or line 28 . . . . .	<b>29</b>				
30 Subtract line 29 from line 27. If zero or less, enter -0- . . . . .	<b>30</b>	<b>0</b>			
31 Enter the <b>larger</b> of line 29 or line 30 . . . . .	<b>31</b>				
32 Tax on amount on line 31 from the 1999 Tax Rate Schedule . . . . . ▶				<b>32</b>	
<b>Note:</b> If line 27 is equal to or greater than line 28, go to line 37.					
33 Enter the amount from line 28 . . . . .	<b>33</b>	<b>1,700</b>			
34 Enter the amount from line 27 . . . . .	<b>34</b>				
35 Subtract line 34 from line 33. If zero or less, enter -0- . . . . .	<b>35</b>	<b>1,700</b>			
36 Multiply line 35 by 10% (.10) . . . . . ▶				<b>36</b>	<b>170</b>
37 Enter the <b>smaller</b> of line 18 or line 26 . . . . .	<b>37</b>	<b>324,900</b>			
38 Enter the amount from line 35 . . . . .	<b>38</b>	<b>1,700</b>			
39 Subtract line 38 from line 37. If zero or less, enter -0- . . . . .	<b>39</b>	<b>323,200</b>			
40 Multiply line 39 by 20% (.20) . . . . . ▶				<b>40</b>	<b>64,640</b>
<b>Note:</b> If line 24 is zero or blank, skip lines 41 through 46 and read the Note before line 47.					
41 Enter the <b>smaller</b> of line 21 or line 24 . . . . .	<b>41</b>				
42 Add lines 21 and 31 . . . . .	<b>42</b>	<b>325,000</b>			
43 Enter the amount from line 18 . . . . .	<b>43</b>	<b>324,900</b>			
44 Subtract line 43 from line 42. If zero or less, enter -0- . . . . .	<b>44</b>	<b>100</b>			
45 Subtract line 44 from line 41. If zero or less, enter -0- . . . . .	<b>45</b>	<b>0</b>			
46 Multiply line 45 by 25% (.25) . . . . . ▶				<b>46</b>	
<b>Note:</b> If line 23 is zero or blank, go to line 51.					
47 Enter the amount from line 18 . . . . .	<b>47</b>	<b>324,900</b>			
48 Add lines 31, 35, 39, and 45 . . . . .	<b>48</b>	<b>324,900</b>			
49 Subtract line 48 from line 47 . . . . .	<b>49</b>				
50 Multiply line 49 by 28% (.28) . . . . . ▶				<b>50</b>	
51 Add lines 32, 36, 40, 46, and 50 . . . . .	<b>51</b>			<b>64,810</b>	
52 Tax on the amount on line 18 from the 1999 Tax Rate Schedule . . . . .	<b>52</b>			<b>127,714</b>	
53 <b>Tax on taxable income (including capital gains).</b> Enter the <b>smaller</b> of line 51 or line 52 here and on line 1a of Schedule G, Form 1041. . . . . ▶	<b>53</b>			<b>64,810</b>	

# 1999 Workbook

**SCHEDULE K-1**  
**(Form 1041)**

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

**Beneficiary 1**

OMB No. 1545-0092

Department of the Treasury  
Internal Revenue Service

for the calendar year 1999, or fiscal year  
beginning \_\_\_\_\_, 1999, ending \_\_\_\_\_  
▶ Complete a separate Schedule K-1 for each beneficiary.

**1999**

Name of trust or decedent's estate

**Trust U/W/O Phyllis M. Warren**

Amended K-1  
 Final K-1

Beneficiary's identifying number ▶ **050 20 4444**

Estate's or trust's EIN ▶ **16 1400914**

Beneficiary's name, address, and ZIP code

**Charles G. Warren**  
**1500 Esplande Blvd**  
**North Chicago, IL 12099**

Fiduciary's name, address, and ZIP code

**Carl F. Schaeffer**  
**3000 Michigan Ave**  
**Chicago, IL 12054**

(a) Allocable share item	(b) Amount	(c) Calendar year 1999 Form 1040 filers enter the amounts in column (b) on:
1 Interest . . . . .	<b>1</b>	Schedule B, Part I, line 1
2 Ordinary dividends . . . . .	<b>2</b> <span style="float: right;"><b>21,923</b></span>	Schedule B, Part II, line 5
3 Net short-term capital gain . . . . .	<b>3</b>	Schedule D, line 5
4 Net long-term capital gain: a 28% rate gain . . . . .	<b>4a</b>	Schedule D, line 12, column (g)
b Unrecaptured section 1250 gain . . . . .	<b>4b</b>	Line 11 of the worksheet for Schedule D, line 25
c Total for year . . . . .	<b>4c</b>	Schedule D, line 12, column (f)
5a Annuities, royalties, and other nonpassive income before directly apportioned deductions . . . . .	<b>5a</b>	Schedule E, Part III, column (f)
b Depreciation . . . . .	<b>5b</b>	} Include on the applicable line of the appropriate tax form
c Depletion . . . . .	<b>5c</b>	
d Amortization . . . . .	<b>5d</b>	
6a Trade or business, rental real estate, and other rental income before directly apportioned deductions (see instructions) . . . . .	<b>6a</b>	Schedule E, Part III
b Depreciation . . . . .	<b>6b</b>	} Include on the applicable line of the appropriate tax form
c Depletion . . . . .	<b>6c</b>	
d Amortization . . . . .	<b>6d</b>	
7 Income for minimum tax purposes . . . . .	<b>7</b> <span style="float: right;"><b>21,923</b></span>	
8 Income for regular tax purposes (add lines 1, 2, 3, 4c, 5a, and 6a) . . . . .	<b>8</b> <span style="float: right;"><b>21,923</b></span>	
9 Adjustment for minimum tax purposes (subtract line 8 from line 7) . . . . .	<b>9</b>	Form 6251, line 12
10 Estate tax deduction (including certain generation-skipping transfer taxes) . . . . .	<b>10</b>	Schedule A, line 27
11 Foreign taxes . . . . .	<b>11</b>	Form 1116 or Schedule A (Form 1040), line 8
12 Adjustments and tax preference items (itemize):		
a Accelerated depreciation . . . . .	<b>12a</b>	} Include on the applicable line of Form 6251
b Depletion . . . . .	<b>12b</b>	
c Amortization . . . . .	<b>12c</b>	
d Exclusion items . . . . .	<b>12d</b>	2000 Form 8801
13 Deductions in the final year of trust or decedent's estate:		
a Excess deductions on termination (see instructions) . . . . .	<b>13a</b>	Schedule A, line 22
b Short-term capital loss carryover . . . . .	<b>13b</b> (            )	Schedule D, line 5
c Long-term capital loss carryover . . . . .	<b>13c</b> (            )	Schedule D, line 12, columns (f) and (g)
d Net operating loss (NOL) carryover for regular tax purposes . . . . .	<b>13d</b> (            )	Form 1040, line 21
e NOL carryover for minimum tax purposes . . . . .	<b>13e</b>	See the instructions for Form 6251, line 20
f . . . . .	<b>13f</b>	} Include on the applicable line of the appropriate tax form
g . . . . .	<b>13g</b>	
14 Other (itemize):		
a Payments of estimated taxes credited to you . . . . .	<b>14a</b>	Form 1040, line 58
b Tax-exempt interest . . . . .	<b>14b</b> <span style="float: right;"><b>2,477</b></span>	Form 1040, line 8b
c . . . . .	<b>14c</b>	} Include on the applicable line of the appropriate tax form
d . . . . .	<b>14d</b>	
e . . . . .	<b>14e</b>	
f . . . . .	<b>14f</b>	
g . . . . .	<b>14g</b>	

7

# 1999 Workbook

## FEDERAL STATEMENTS

### TRUST U/W/O PHYLLIS M. WARDEN

#### STATEMENT 1 FORM 1041, LINE 1 INTEREST INCOME

Smith Barney bonds	\$10,200
Total	\$10,200

#### STATEMENT 2 FORM 1041, LINE 12 DIVIDEND INCOME

Smith Barney	\$22,000
Smith Barney MM	3,200
Total	25,200

#### STATEMENT 3 FORM 1041, LINE 12 FIDUCIARY FEES

Fees:	15,000
Less 10.15% allocated to tax-exempt income	-1,523
Plus fees not allocable to tax-exempt income	0
Total	\$13,477

#### STATEMENT 4 ALLOC. OF EXPENSES TO TAX-EXEMPT INCOME

Tax-exempt interest	\$4,000
Total tax-exempt income	\$4,000
Taxable interest	10,200
Taxable dividends	25,200
Tax-exempt income	4,000
Total gross income	39,400
Tax-exempt income 4,000	
$\times 100 = 10.15\%$	
Total gross income 39,400	
Total indirect deductions - allocable	15,000
Percentage allocable to tax-exempt income	10.15%
Amount allocable to tax-exempt income	1,523
Tax-exempt interest and dividends	4,000
Less: allocated indirect deductions	1,523
Net tax-exempt interest and dividends	\$2,477

## TERMINATIONS

Planning is important upon the termination of a trust or estate since the final beneficiary may want to invest in assets different from the assets held by the trust.

### TERMINATION OF ESTATES AND TRUSTS: THE RULES

#### A. In the final year of an estate or trust:

1. No income is taxed to the fiduciary; all income (including capital gains) is taxed to the beneficiaries.
2. No personal exemption is allowed to the estate or trust.
3. Net capital losses in excess of \$3,000 cannot be deducted on the final return against other income; any balance of losses over \$3,000 is transferred in a capital loss carryover to the beneficiaries.

#### B. Excess deductions

1. Only in the year of termination of an estate or trust can the beneficiary receive the benefit of excess deductions (other than the personal exemption and charitable contribution deductions) for that year over income [I.R.C. §642(h)].
2. However, the §642(h) deduction constitutes a “miscellaneous itemized deduction” and is subject to the 2% of AGI floor (I.R.C. §67).
3. The fiduciary should consider paying administration expenses currently, if possible under local law, rather than waiting until termination of the trust or estate. The fiduciary may also wish to keep an estate or trust open long enough in its final year to generate sufficient income to offset more deductions.

#### C. The beneficiary will also be able to “carry over” in the year of termination:

1. Any unused NOL carryforward of the estate or trust, and
2. Any unused capital loss carryforward [I.R.C. §642(h)]

#### D. Unused suspended passive activity losses of estates and trusts

1. Code §469(j)(12) provides that if a trust or an estate distributes its entire interest in a passive activity to a beneficiary, the basis of the property is increased (no deduction is allowed) by the amount of any suspended unallowed losses of such passive activity.
2. This provision, however, completely ignores I.R.C. §469(g)(1), which provides that when a taxpayer disposes of his or her entire interest in any passive activity in a “fully taxable transaction,” any unused suspended passive activity losses (PALs) applicable to such interest will come out of suspension and constitute an allowable business loss deduction against any other type of gross income (e.g., active business income, portfolio income). If the loss deduction exceeds other income, the result will be a net operating loss that may be carried back or forward [see §172(b)(2) and (3)].

## WHAT HAPPENS WHEN A TRUST TERMINATES

### BASIS PREVAILS

**Example.** Gustave A. Katus died January 19, 1995. Besides joint property and specific bequests, he left \$600,000 of securities in a credit shelter trust, with the income to be distributed to either his wife or his two daughters in any manner the trustees should choose. Upon the death of his wife, Marion, the

# 1999 Workbook

trust terminates and the corpus is to be distributed 50% to each daughter. On April 29, 1998, Marion died.

Following is a list of securities with the basis of each item on the date of Gustave's death or the date of purchase, and the current market value:

	<u>Basis</u>	<u>Current FMV</u>
500 shares of Exxon	\$ 17,500	\$ 39,000
6,000 shares of General Electric	321,500	605,000
\$80,000 Treasury notes	80,000	95,000
300 shares of AT&T	30,000	90,000
100 shares of Triborough Bridge	101,000	90,000

The trustee and beneficiaries come into your office and ask:

1. What is it going to take to terminate this trust?
2. Should they sell all the assets or distribute them?

In addition, they ask you to prepare the final tax return.

In the final analysis, we advise that the assets be distributed in kind. That will allow each beneficiary to decide whether to hold his or her share of the trust assets or sell them and recognize gain or loss. If the trust sold any assets, the gain or loss would have to be recognized by the trust or distributed pro-rata to the beneficiaries.

**Example.** Prior to his death in 1986, Leo V. States made many gifts to his children to carry out his estate plan. At that time, his daughter, Ellen, was married (and still is) to a man who Leo greatly mistrusted when it came to financial affairs. As a consequence, over the years he made gifts to a trust on Ellen's behalf. The trustee in this case was Ellen's brother, a banker by profession. The terms of the trust were extremely broad as to income distribution. Principal was to be distributed as follows:

- 33% at Ellen's 35th birthday
- 33% at her 45th birthday
- The remainder upon her 55th birthday

For various reasons, with the acquiescence of Ellen, no principal distributions have been made. However, Ellen, now 55, has informed her brother, the trustee, that she wants him to comply with the terms of the trust. The trust balance sheet is as follows:

	<u>Basis</u>	<u>FMV</u>
Certificates of deposit	\$55,000	\$ 55,000
5,000 shares Paychex stock	5,000	155,000
	<u>\$60,000</u>	<u>\$210,000</u>

The certificate of deposit and Paychex stock is distributed to Ellen, and the trust is terminated.

You have to prepare the final trust return and advise her on what to do with her 5,000 shares of Paychex stock, as she and her husband have retired and are looking to increase their income.

**Observation.** If Ellen sells all of the Paychex stock immediately, she must recognize \$150,000 of long-term capital gain and pay \$30,000 of tax on that gain. If Ellen sells 500 shares in each of the next 10 years, she would postpone some of the tax, but the tax rate (assuming no change in the law) would still be 20%.

## PASSIVE LOSSES

One of the most complex areas in the Internal Revenue Code is §469, on passive losses. It is especially so when real estate projects and tax shelters are left in a person's estate.

The following is a very brief description of the passive loss rules. There are eight general rules, one of which is particularly relevant to trusts and estates.

**General Rule.** Generally, losses from passive activities may not be deducted from other types of income.

**Who Is Covered?** The passive activity rules apply to: (1) individuals, (2) estates, (3) trusts (other than grantor trusts), (4) personal service corporations, and (5) closely held corporations.

**"Activity" Defined.** In applying the passive loss rules, taxpayers must determine which of their operations constitute activities through a series of complex rules. Once those activities are grouped or kept separate, they may not be regrouped in future years.

**"Passive Activities" Defined.** A passive activity is one that involves the conduct of any trade or business in which the taxpayer does not materially participate. Any rental activity is passive, whether or not the taxpayer materially participates.

**Special Rules for Rental Activities.** Here are the definitions specifically characterizing all the different kinds of rental activities other than real estate (i.e., tangible personal property, etc.).

**Active Participation in Rental Activity [(I.R.C. §469(i)).** A special rule allows individuals to deduct \$25,000 in losses from rental real estate activities in which:

1. Taxpayers "actively" participate both in the year that the deduction or credit arose and the year the deduction or credit was taken, and
2. They have at least a 10% interest at any time during the year.

This \$25,000 allowance is zero for married persons filing separately but who live together. The \$25,000 allowance is phased out ratably as adjusted gross income increases from \$100,000 to \$150,000. Minimal involvement in management is sufficient to meet the active participation requirement.

This exception is available only to individual taxpayers or their estates for the tax years ending less than two years after the date of death. This exception is not available to trusts, but see the discussion of real estate professionals below.

**The Real Estate Professional.** Real estate professionals are allowed to treat rental real estate activities as nonpassive if they (1) materially participate in the activities for more than half the time spent performing all personal services during the tax year, and (2) perform more than 750 hours of service.

There is nothing in the language of I.R.C. §469(c)(7) that explicitly excludes estates, trusts, and personal service corporations from the benefit of the rule. Therefore, there are major planning opportunities for real estate entrepreneurs to utilize long-term rental arrangements in testamentary trusts.

**Example.** The estate of Gerald R. Earl held 12 commercial and residential real estate properties. At the time of his death in July 1994, his will provided that all of his properties were to be left in trust to his then-minor son until he reached the age of majority. The estate and trust can use the real estate professional rules to deduct the losses from the activities.

**The Tax Treatment of Suspended Losses and Credits.** The last major treatment of passive activity losses has to do with the rules of various dispositions as follows:

- Entire interests.
- The taxable nature of such dispositions.
- Installment sales.

# 1999 Workbook

- Death. Transfer by reason of the taxpayer's death causes suspended losses to be allowed in the year of death to the extent that they exceed the amount by which the basis of the interest is increased to its fair market value at the date of death.

**Example.** In 1982 Mr. Rhine purchased a \$25,000 syndicated real estate partnership from his stockbroker. By October 1998, when the taxpayer died, Mr. Rhine had claimed \$25,000 of depreciation and accumulated \$15,000 of suspended losses. The estate has asked you to prepare his final return, the fiduciary return, and to make inquiries as to the fair market value for Form 706, U.S. Federal Estate Return.

In correspondence with the Chicago partnership board, you have ascertained Mr. Rhine's limited partnership to be worth \$9,000. Therefore, on Mr. Rhine's final Form 1040, the amount of his deductible suspended losses is  $\$15,000 - \$9,000 = \$6,000$ . His daughter, Sue, has inherited the property, and her basis is \$9,000. If she sells it the next day for \$8,000, she would have a long-term capital loss of \$1,000.

- Gifts. Disposition of passive activities by gift does not trigger the suspended losses. Instead, the basis of the interest is increased by the amount of such losses.

The remaining treatment of suspended loss deals with:

- Exchanges
- Casualty and theft
- Activities no longer passive
- Treatment of losses on a disposition

Passive losses incurred by estates and trusts are suspended within that entity and do not pass through to beneficiaries.

## STRATEGY: PRE- AND POSTMORTEM PLANNING

As the owner of a shelter nears death, several tax rules must be kept in mind:

1. Assets passing at death receive a date-of-death basis.
2. At the death of an owner, suspended losses are added to basis to the extent that the suspended losses exceed the increase in basis.
3. On the death of an individual, capital loss carryforwards die with that individual.

Many taxpayers own shelters with basis below fair market value. If those shelters are sold before the owner's death, the owner must recognize the capital gain.

- If the shelter has suspended losses, those losses will offset the gain.
- If the shelter has no suspended losses, the owner must pay tax on the gain. By contrast, if the shelter is passed through the owner's estate, it will get a stepped-up basis and no one will have to recognize the gain.

**Example.** Joseph A. Plat, a 68-year-old widower, died on February 1, 1998. A review of his prior year's tax return and his estate tax return reveal the following information:

## ASSET ANALYSIS

Asset	January 1, 1998, Fair Market Value	Depreciation	(Cost) Tax Basis	Suspended Losses at Date of Death
Ten-unit apartment house acquired 01/15/90	\$600,000	\$86,000	\$314,000	\$35,000 prior to retirement
Argosey Limited Rental Real Estate Ltd. Ptr.	15,000		-0-	15,000
Olympic Senior Apts. Assoc. Low-income housing partnership suspended credits	3,000		10,000	5,000 (and \$1,000 in suspended credits)

Unfortunately, by dying very early in the year, Mr. Plat did not generate much income to use up the suspended losses or low-income housing credits on his final Form 1040.

## TRUSTS AND SUBCHAPTER S CORPORATIONS

### CORPORATIONS ELIGIBLE TO ELECT S CORPORATION STATUS

To become an S corporation, an organization must be a “small business corporation.” Thus, all the following requirements must be met [I.R.C. §1361(b); Treas. Reg. §1.1361-1(b)]:

1. The entity must be a domestic corporation that is organized under the laws of any state or U.S. territory. An unincorporated association that is treated as a corporation for Code purposes (I.R.C. §7701) may elect S corporation status [Treas. Reg. §1.1361-1(c)(6)].
2. The corporation may have as shareholders only individuals, estates, or certain trusts. Partnerships and corporations cannot be shareholders.
3. Only citizens or residents of the United States can be shareholders.
4. The corporation can have only one class of stock. All stock must be identical with regard to rights to profits and assets of the corporation but may have different voting rights.

A few limited types of corporations are ineligible to be “small business corporations” [I.R.C. §1361(b)(2)].

**Shareholder Limitations.** A qualifying S corporation can have no more than 75 shareholders. For purposes of this limitation, a husband and wife (and their estates) are counted as a single shareholder without regard to how they hold their shares. All “eligible” shareholders must be individuals, estates, certain defined trusts, or certain tax-exempt organizations.

The term “eligible shareholders” includes a grantor trust (where the grantor is regarded as the shareholder), a voting trust (where each beneficiary is treated as a shareholder), and any testamentary trust that receives S corporation stock. However, the trust is treated as an eligible shareholder only for two years after the deemed owner’s death [I.R.C. §1361(c)(2)(A); Treas. Reg. §1.1361-1(h)].

# 1999 Workbook

**Electing Small Business Trusts.** An “electing small business trust” (ESBT) can be an S corporation shareholder [I.R.C. §1361(e)]. An electing trust is one that does not have as a beneficiary any person other than

1. An individual,
2. An estate, or
3. An organization eligible to accept charitable contributions under I.R.C. §170 (other than political entities) and that has only a contingent remainder interest. An electing small business trust is different from a qualified subchapter S trust. (See Qualified Subchapter S Trusts below.)

A trust must elect to be treated as an electing small business trust. An election applies to the taxable year for which it is made and can be revoked only with the consent of the Secretary of Treasury or his delegate (see the S Corporations chapter for relief provisions for late ESBT elections).

Each potential current beneficiary of the trust is counted as a shareholder for purposes of the 75-shareholder limitation (if there were no potential current beneficiaries, the trust is treated as the shareholder) [I.R.C. §1361(e)(6)]. The beneficiary is treated as the owner of the portion of the trust consisting of the stock in the S corporation. All the income (as defined for local law purposes) must be currently distributed to that beneficiary.

The portion of the trust that consists of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust is taxed at the highest individual rate (currently, 39.6% on ordinary income and 20%, 25%, or 28% on net capital gain) on this portion of the trust’s income. In computing the trust’s income tax on this portion of the trust, no deduction is allowed for amounts distributed to beneficiaries, and no deduction or credit is allowed for any item other than the items described above. This income is not included in the distributable net income of the trust, and thus is not included in the beneficiaries’ income. No item relating to the S corporation stock can be apportioned to any beneficiary.

An electing small business trust cannot have any interest acquired by purchase. A purchase is defined as an acquisition in which the basis of the property is determined under I.R.C. §1012 (the cost basis rules). Therefore an acquisition by gift, inheritance, or bequest is not a purchase.

Neither a charitable remainder trust nor a trust that qualifies as an individual retirement account is an eligible S corporation shareholder (Rev. Ruls. 92-48, 92-73).

**Qualified Subchapter S Trusts.** In addition to the electing small business trust, a qualified subchapter S trust (QSST) may also be a shareholder of an S corporation if the individual beneficiary of the trust, or his legal representative, elects to be treated as the owner of the portion of the trust that consists of the S corporation stock for purposes of I.R.C. §678 (person other than grantor treated as substantial owner). This election may be revoked only with the consent of the IRS [I.R.C. §1361(d); Treas. Reg. §1.1361-1(j)]. See the S Corporations chapter for relief provisions for late QSST elections.

A “qualified Subchapter S trust” is subject to the following terms:

1. It is required to have only one current income beneficiary (for life).
2. Any corpus distributed during the life of the beneficiary must be distributed to the beneficiary.
3. The beneficiary’s income interest must terminate at the earlier of the beneficiary’s death or the termination of the trust.
4. If the trust terminates during the beneficiary’s life, the trust assets must be distributed to the beneficiary.