Chapter 8: Estate and Trust Basics

Corrections were made to this workbook through January of 2006. No subsequent modifications were made.

Note. This chapter is meant to be a basic discussion on estates and trusts. In future years, more advanced estate and trust topics are planned.

The purpose of this chapter is to educate tax preparers on when **estate income tax** returns must be filed. This chapter focuses on the income tax aspects of estates and trusts. Local law governs the proceedings of dispensing with the estate and handling assets inside a trust. Many taxpayers mistakenly believe that there is no need for an estate **income** tax return unless there is an estate tax return filed. Certainly, if there is an estate tax return filed, then there would be a need for an estate income tax return. However, in the majority of cases there are income tax returns filed for these entities when there is no need for an estate tax return. In fact, in many instances, the taxpayer will **want** to file a Form 1041 to allow deductions to be taken on either the estate income tax return or the beneficiary's income tax return.

8

DEFINITIONS

COMMON TERMS

Before beginning the chapter, the tax preparer must understand a few definitions for terms used in this chapter.

Beneficiary — The person who inherits the decedent's property.

Decedent — The person who died.

Fiduciary — The person charged with wrapping up the affairs of the decedent.

Heir — The person who inherits the decedent's property.

Personal Representative — Normally, the fiduciary.

Probate — The legal process for finalizing the affairs of the decedent.

Trustee —The person charged with wrapping up the affairs of the decedent.

OVERVIEW

It has been said that death and taxes are the only things certain in life. Unfortunately, taxes are often due after someone dies and a number of new filing requirements are triggered. The representative may have to file a:

- Final Form 1040, *U.S. Individual Income Tax Return,* for the decedent, as well as any previously unfiled Forms 1040;
- Form 1041, *U.S, Income Tax Return for Estates and Trusts,* for any federal estate income taxes;
- Form 1041 for any existing trusts or testamentary trusts; and
- Form 706, *United States Estate (and Generation Skipping Transfer) Tax Return.*

The personal representative may also be responsible for any related state forms for the state in which the decedent lived. In addition, the representative may need to file various forms associated with extensions, estimated tax payments, establishing fiduciary relationships, payments to beneficiaries, and acquiring taxpayer identification numbers (EINs).

Note. A detailed listing of the duties of the personal representative is located on pages 375–376 of the *2003 University of Illinois Federal Tax Workbook.*

The domestic federal income tax filing requirements of the fiduciary, upon the death of the decedent, are discussed in this chapter. It is important for tax preparers to understand the concepts of:

- Income in respect of a decedent (IRD),
- Fiduciary accounting income (FAI),
- Distributable net income (DNI), and
- Income distribution deduction (IDD).

The fiduciary must determine whether to allocate an item to income or principal according to the Uniform Income and Principal Act and understand why this is important. He must also understand the differences between the preparation of Form 1041 for an estate and a trust. This chapter also discusses the origination and benefits of the "Total Return Trust."

ESTATE

When an individual dies, all real and personal property owned by that individual that was not passed directly to a joint owner or beneficiary usually becomes part of a probate estate. The estate is created in order to settle the affairs of a decedent, pay debts, pay taxes, and distribute any remaining property.

The fiduciary who manages the decedent's assets may be called a personal representative, executor, executrix, or administrator. The estate is often supervised by a probate court, which is authorized to legally remove the name of the decedent from the title of the assets and place the assets in the name of the beneficiary(s).

The document designating the beneficiaries and listing the administrative powers is the Last Will and Testament (will). If the decedent held title to assets and did not have a formal will, the assets are distributed according to the "intestate succession" statutes of the state where the assets were held.

There are both advantages and disadvantages to settling a decedent's affairs through probate. Some of the advantages include:

- Handling disputes through probate court.
- Establishing a will is usually less expensive than establishing a trust.
- Selecting a fiscal year for income tax purposes.
- Avoiding probate may be possible for small estates.

Some the disadvantages of probate include:

- Lack of privacy.
- Probated assets cannot be quickly distributed.
- Probate proceedings may be necessary in multiple states.
- Legal fees can be significant.

For the purpose of federal estate taxes, the values of both probate and nonprobate property are included on Form 706.[1] Generally, nonprobate property is not included in the decedent's estate for income tax purposes.

TRUST

A "trust" is not defined in the Internal Revenue Code; however, the following excerpt is taken from Treas. Reg. §301.7701-4(a):

Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries.

A trust is a form of ownership, created and governed under state law, where one party holds assets for the benefit of another. Trusts may be established for any legal purpose including, but not limited to, asset protection, estate planning, and for the benefit of charities. Generally, a trust is established when the creator (grantor) transfers property to a trustee (fiduciary) for the benefit of the beneficiaries. A trust may be created during an individual's life (inter vivos) or at the time of his death under the provisions of his will (testamentary).

When a trust is created during the life of the grantor, it is commonly referred to as a living trust or family trust. Generally, these types of trusts are considered to be grantor trusts while the grantor(s) is alive and retains control. They become irrevocable trusts upon the death of the last surviving grantor. Any assets that are already in the name of the trust avoid probate upon the death of the grantor. Any assets that are not titled to the trust become part of the probate estate. Normally, a pour-over will is created at the same time as the living trust to account for all of the assets remaining in the grantor's name.

Note. A pour-over will is a will with a clause that says any assets owned by the decedent which are not in the trust are placed into the trust at the time of death.

Note. For more information on living trusts, see pages 82–84 in the *2004 University of Illinois Federal Tax Workbook*.

If the trust is established by a will after the decedent's death (testamentary), the assets do not avoid probate and become part of the estate.

1. IRC §§2033, 2035–2044

TAXATION OF ESTATES AND TRUSTS

Generally, the taxation of estates and trusts is covered in Subchapter J of the Internal Revenue Code. State law generally governs the legal standing of a trust and is important in some definitions included in the Internal Revenue Code.

> **Note.** The following discussion does not relate to bankruptcy estates.

Division of Subchapter J	Description	Code Sections
Part 1	Estates, trusts, and beneficiaries	§§641–683
Subpart A	General rules for taxation of estates and trusts	§§641–645
Subpart B	Trusts which distribute current income only	§§651–652
Subpart C	Estates and trusts which may accumulate income or distribute corpus	§§661–664
Subpart D	Treatment of excess distributions by trusts	§§665–668
Subpart E	Grantors and others treated as substantial owners	§§671–679
Subpart F	Miscellaneous	§§681–683
Part 2	Income in respect of a decedent	§§691–692

The computation of taxable income for trusts and estates is similar to that of an individual, with a few differences. These differences are covered in Subchapter J and include:

- Estates and trusts are eligible for an income distribution deduction (IDD) for payments made or required to be made to beneficiaries under §§651 and 661. The deduction is computed on Form 1041, Schedule B, and deducted on line 18 in the deduction section of Form 1041. A more detailed discussion of IDD follows later in this chapter.

- If provided for in the governing instrument, estates and trusts may reduce the entity income by a charitable deduction.[2] The charitable deduction is computed on Form 1041, Schedule A, and deducted on line 13 in the deduction section of Form 1041.

- The estate or trust is allowed a personal exemption on line 20 of Form 1041.[3] Domestic estates are entitled to a $600 exemption. Simple trusts are entitled to an exemption of $300. The exemption is limited to $100 for all other trusts.

BASIC TRUSTS AND ESTATES

There are four basic elements of a trust and estate which must exist in some capacity. Each trust must have a creator, fiduciary, beneficiary, and corpus. The elements of an estate are similar to that of a trust.

1. Creator

Each trust and estate is established by the transfer of property into the entity by the creator. The creator of a **trust** is also known as the grantor, settlor, or trustor. The creator of an **estate** is the decedent.

The transfer to establish a trust may take place during the life of the creator (inter vivos transfer) or at death (testamentary transfer). Transfers made to the trust during the life of the creator can be revocable or irrevocable, depending on the terms of the trust document and the powers granted to the creator. For estates, the transfer only occurs at death.

2. IRC §642(c)

3. IRC §642(b)

2. Fiduciary

The fiduciary is the person who has control of the corpus (assets placed in the trust or estate) and who manages or controls it on behalf of the beneficiaries. The fiduciary distributes income and principal in accordance with the terms of the trust document, will, or state law. The fiduciary of a trust is also known as the trustee, executor, executrix, administrator, or personal representative.

The fiduciary is generally named in the trust instrument or will. When a will or trust does not exist, the court appoints an administrator to oversee the decedent's estate.

3. Beneficiary

The beneficiary is the person or entity that receives the benefits of the trust or estate. Other names for the beneficiary include heir and legatee. Beneficiaries can be current income beneficiaries or remainder beneficiaries. The current **income beneficiary(s)** is entitled to all or a portion of the income of the trust or estate. The **remainder beneficiary(s)** is entitled to the corpus according to the terms of the governing instrument.

4. Corpus

The corpus consists of the assets placed in the trust or estate. Corpus or principal consists of assets that are definite and have a determinable market value.

> **Example 1.** Brian, a wealthy hermit, only has one asset, a $1 million CD. His will provides that at his death, a trust is established and managed by the Uptown Bank of Marlboro. The trust provides all income from the CD go to his niece, Rhonda for her lifetime. At Rhonda's death, the CD goes to the Society for the Benefit of Hermits.
>
> Brian is the **creator** of the trust. The Uptown Bank of Marlboro is the **fiduciary** of the trust. Rhonda is the **income beneficiary** and the Society for the Benefit of Hermits is the **remainder beneficiary.** The **corpus** of the trust is the $1 million CD.

ENTITY CREATION

The death of a taxpayer usually creates an estate and may create a trust.

CREATION OF AN ESTATE

When an estate is created, a separate taxable entity is formed. The estate or its beneficiaries are now liable for any income tax owed on the income produced by the estate's assets. The estate begins on the date of death[4] and continues through the period of administration. Any income generated by the estate's assets is reported on Form 1041 for each taxable year. The income is taxed either at the estate tax rates, or passed through to the beneficiaries by way of a Schedule K-1 and taxed directly to them at their individual rate.

The executor of an estate can choose either a **calendar or fiscal tax year:**

- A calendar tax year must end on December 31.
- A fiscal tax year must end on the last day of a month and cannot exceed 12 months.

The personal representative is responsible for finalizing the decedent's affairs and possibly filing a:

- Final Form 1040 for the decedent,
- Form 1041 for the income taxes of the estate, and
- Form 706 for any estate taxes due.

4. *PPC's 1041 Deskbook,* Key Issue 2B, 2002

The representative may also be responsible for **filing these same returns at the state level.**

In addition to these filing requirements, the fiduciary should:

- Obtain an Employer Identification Number (EIN) for the estate, and
- Notify the IRS and possibly the state of fiduciary relationships that are established.

The estate **terminates** under two conditions:

1. All assets are distributed to the beneficiaries, except for a reasonable amount set aside, in good faith, for the payment of contingent or unexpected liabilities and expenses.
2. An unreasonably long period of time elapses.[5] If the settlement of the estate is unreasonably prolonged, the estate is considered terminated for federal income tax purposes. From that time forward, the income, deductions, and credits of the estate are considered to belong to the beneficiary(s) who inherits the property of the estate.

CREATION OF A TRUST

The creation of a trust begins with the drafting of a trust document. This document specifies the:

- Purpose of the trust,
- Trustee(s) name,
- Beneficiary(s) name, and
- Directions pertaining to the operation of the trust.

The trust can be created during the grantor's lifetime (inter vivos) or at the time of his death (testamentary). The trust begins operating once the trust is funded and it must comply with state law, because state law governs trusts.

Normally, each domestic trust is classified as a grantor trust, simple trust, or complex trust for federal tax purposes. Simple trusts and complex trusts are treated as separate legal entities and report their income and deductions on Form 1041. These trusts are typically required to use a calendar tax year ending on December 31. Generally, the income and deductions of a grantor trust are taxed directly to the creator on his individual tax return. It is also possible to treat a trust partially as a grantor trust and partially as a simple or complex trust.

Grantor Trust

"Grantor Trust" is a term used by the Internal Revenue Code to describe any trust over which the creator retains the power to control or direct the trust's income or assets. If a **creator** retains certain powers over benefits in a trust, the creator pays the income tax, rather than the trust.

All revocable trusts are by definition grantor trusts.[6] An irrevocable trust receives grantor trust treatment if it meets any of the definitions contained in IRC §§671, 673–677. If a trust is a grantor trust, for tax purposes, the creator is considered the owner of the assets. Therefore, the trust is not a separate taxable entity, and the creator pays tax on all income. However, the trust receives state recognition and exists under property transfer laws.

Example 2. Brian **(Example 1)** creates a grantor trust rather than having the trust created at his death. Brian receives all income from the CD for his lifetime. At his death, the income goes to Rhonda. At her death, the corpus goes to the Society for the Benefit of Hermits. Because Brian controls the CD and receives all income from the CD, he pays income tax on the interest and the CD is included in his estate for estate tax purposes only. If the CD is his only asset, a Form 1041 is not required for the estate upon Brian's death. However, a Form 1041 is used to report the interest for the trust created upon his death.

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5. Treas. Reg. §1.641(b)–3(a)
6. IRC §676

Simple Trust

A trust may qualify as a simple trust if it:

1. Requires that all income be distributed currently;
2. Does not specify that any amounts be paid, permanently set aside, or used for charitable purposes; and
3. Does not distribute amounts allocated to the principal of the trust.[7]

Complex Trust

A complex trust is any trust that does not qualify as a simple trust or grantor trust.

EMPLOYER IDENTIFICATION NUMBER (EIN)

One of the first duties of the fiduciary, when an estate or trust comes into existence upon the decedent's death, is to apply for an EIN. Form SS-4, *Application for Employer Identification Number*, is used for this purpose. The IRS accepts applications for an EIN online, by phone, fax, or mail.

Caution. For a grantor trust that becomes an irrevocable trust, line 10 of Form SS-4 must show the **date of death as the date the entity was created.** If the fiduciary inadvertently enters the date the trust was created (as a grantor trust) from the trust document, he may receive an IRS Notice 575 requesting delinquent Forms 1041 be filed for all years from the date of creation.

If this notice is received in error, the only way to correct the situation is to send correspondence to the address on the notice. The letter should include a copy of the notice, the name of the trust, EIN, and the reason why returns **are not** required for the years in question. The correspondence must be signed and dated by the fiduciary.

CREATION OF A FIDUCIARY RELATIONSHIP

The fiduciary must notify the IRS of his fiduciary relationship.[8] He should file the written notice as soon as all of necessary information (including the EIN) is available. This notifies the IRS that the fiduciary is assuming the powers, rights, duties, and privileges of that individual or entity. If the fiduciary fails to notify the IRS of his fiduciary relationship and a notice of deficiency is sent to the wrong address, the deficiency can be assessed after a 90-day period even though the fiduciary had no knowledge of the deficiency.

Form 56, *Notice Concerning Fiduciary Relationship*, can be used to report a change of fiduciary. If Form 56 is used, the fiduciary should complete Parts I, II, III, V, and VI. If more than one fiduciary exists, each fiduciary must complete a separate Form 56.

If the same fiduciary is responsible for filing the decedent's final Form 1040 and the trust/estate's Form 1041, he completes a Form 56 for each type of return. One Form 56 shows the name and SSN of the decedent as the person for whom he is acting and a second Form 56 shows the name and EIN of the trust/estate. The notice is mailed to the same IRS address as the Form 1040 and Form 1041.

The notice remains in effect until the fiduciary notifies the appropriate IRS office that his fiduciary relationship has terminated. Form 56, Part IV is used for the termination notice, in addition to the other applicable sections. If a successor is appointed as the personal representative, the fiduciary lists the name and address of the successor.

7. IRC §651
8. IRC §6903

FINAL FORM 1040 FOR THE DECEDENT

The personal representative (fiduciary) must file the final Form 1040 for the decedent. He must also file any unfiled returns for prior years for which the decedent has a filing requirement. Generally, the final return contains all income received by the decedent through the date of death, assuming that he was a cash basis taxpayer. If the decedent used the accrual method, any income earned prior to death is reported on the final Form 1040.

If the decedent's spouse is still living, the spouse may file as married filing jointly for the year of death, as long as the spouse does not remarry. The surviving spouse reports all income for the entire year and reports the deceased spouse's income as received through the date of death. However, if the surviving spouse elects to file a joint return, the court appointed personal representative may still file a separate return for the decedent by the return due date. This revokes the surviving spouse's previously made election to file jointly.

In order for the return to be processed correctly, the personal representative or surviving spouse should write across the top of the tax return: "DECEASED," the decedent's name, and the date of death. One of the following individuals must sign the return:

- The personal representative, if one has been appointed.
- The surviving spouse, if filing jointly.
- If no personal representative was appointed and the surviving spouse elects to file a joint return, the surviving spouse should write "Filing as a surviving spouse" in the signature area.
- If there was no surviving spouse and a personal representative hasn't been appointed, the person in charge of the decedent's property must file and sign the return as the "personal representative."

If the decedent is due a refund in the final year or for any prior years, the personal representative must file a Form 1310, *Statement of Person Claiming Refund Due a Deceased Taxpayer*, with the return in order to receive the refund. Form 1310 is **not required** if the refund is being **claimed by the surviving spouse** on a joint return or if a court appointed **representative for the decedent**[9] **is filing an original return** that has a copy of the court certificate attached.

FEDERAL ESTATE TAX RETURN, FORM 706

The personal representative may be responsible for filing Form 706 if the value of the decedent's estate is at least $1.5 million in 2005. For tax years 2006 through 2008, the exclusion amount increases from $1.5 million to $2 million. The estate tax is a wealth transfer tax, not an income tax. Generally, the gross estate includes the value of all assets from which the decedent was still benefiting or controlling. Therefore, the gross estate includes all assets passing through probate, assets funding a grantor trust, and any assets passing directly to joint owners and beneficiaries.

> **Note.** In determining a decedent's taxable estate, all prior taxable gifts are included in the computation at the value included on the gift tax return.

Generally, all assets included in the estate receive a step-up or step-down in basis to the assets' fair market value (FMV) on the date of death[10] or the alternate valuation date, if elected. The **alternate valuation date** is the earlier of (1) the date that the asset is disposed of, or (2) six months after the date of death.[11] Use of the alternate valuation date

9. 2004 IRS Pub. 559, *Survivors, Executors, and Administrators*

10. IRC §2031

11. IRC §2032

must result in lower estate taxes.[12] If the personal representative decides to use the alternate valuation date, it must be used to determine the value of all of the decedent's assets.

The personal representative may elect to value real estate using **special use valuation.** The real estate must be used in a family business or family farm, and certain requirements must be met.[13] Under special use valuation, the value is based on the activity for which the property is used rather than on its highest value. The **same value used for estate tax purposes must also be used for income tax purposes** when Form 1041 is filed for the related estate or trust income tax return.

If Form 706 is required, it is due within nine months after the date of the decedent's death unless an extension is approved. To apply for an extension, Form 4768, *Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes* is used.

FORM 1041 — INCOME TAX RETURN FOR ESTATES AND TRUSTS

The estate or trust **starts on the day of death** and contains all of the income that was not reportable by the decedent, heirs, or another trust. The fiduciary of a domestic estate is required to file Form 1041 if the estate has gross income during its taxable year of **$600 or more.** He must file Form 1041 if any of the **beneficiaries are nonresident aliens,** even if the estate does not have gross income of $600. In addition to the filing requirements of an estate, a **domestic trust must file Form 1041** if there is any **taxable income.**

Calendar Tax Year

The fiduciary of a domestic trust must use a calendar year, unless it is a qualified revocable trust (QRT) that elects to be treated as part of an estate.[14] A QRT is a trust that is treated as a grantor trust while the decedent is living since the grantor has the power to revoke the trust or remove any of the assets within the trust. The election to treat the trust as part of the estate is made by filing Form 8855, *Election To Treat a Qualified Revocable Trust as Part of an Estate*, by the due date, including extensions, with Form 1041 for the first taxable year of the estate.

Fiscal Tax Year

If a fiscal year end is elected, it must end on the last day of the month chosen and cannot extend past twelve months from the date of death. The election is made upon filing the first return for the estate. When a fiscal year is elected, any income distributed to the beneficiaries during the fiscal year is reported on the beneficiary's return. It is reported in the same tax year as the estate year end.

> **Example 3.** Kathleen dies September 30, 2004. Her representative elects to end the fiscal year on August 31, 2005. On December 6, 2004, the representative distributes income to Kathleen's beneficiary. The beneficiary reports this income on his 2005 individual return.

ENTITY INFORMATION

In the top space of the name and address area of Form 1041, the exact name of the estate or trust used on the EIN application is entered. In the remaining lines, the name and address of the fiduciary of the estate or trust is entered.

The fiduciary or preparer must:

- Check the box for Decedent's Estate, Simple Trust, or Complex Trust in Box A for the type of entity,
- Enter the EIN of the estate or trust in Box C, and
- Enter the date of the decedent's death in Box D (this is also true for a grantor trust that becomes a simple or complex trust).

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12. IRC §2032(c)
13. IRC §2032A
14. Treas. Reg. §1.645-1

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts **2004** OMB No. 1545-0092

A Type of entity (see instr.):	For calendar year 2004 or fiscal year beginning , 2004, and ending , 20	
☐ Decedent's estate ☐ Simple trust	Name of estate or trust (If a grantor type trust, see page 12 of the instructions.)	**C Employer identification number**
☐ Complex trust ☐ Qualified disability trust	Name and title of fiduciary	**D** Date entity created
☐ ESBT (S portion only) ☐ Grantor type trust ☐ Bankruptcy estate–Ch. 7	Number, street, and room or suite no. (If a P.O. box, see page 12 of the instructions.)	**E** Nonexempt charitable and split-interest trusts, check applicable boxes (see page 13 of the instr.): ☐ Described in section 4947(a)(1)
☐ Bankruptcy estate–Ch. 11 ☐ Pooled income fund	City or town, state, and ZIP code	☐ Not a private foundation ☐ Described in section 4947(a)(2)
B Number of Schedules K-1 attached (see instructions) ▶	**F** Check applicable boxes: ☐ Initial return ☐ Final return ☐ Amended return ☐ Change in fiduciary ☐ Change in fiduciary's name	☐ Change in trust's name ☐ Change in fiduciary's address
G Pooled mortgage account (see page 14 of the instructions): ☐ Bought ☐ Sold Date:		

If the estate or QRT (that made the §645 election) was on a fiscal year, the line above the name of the estate or trust must be completed. If any distributions are made to beneficiary(s) during the tax year, then a Schedule K-1 must be issued and Box B must indicate the number of Schedules K-1 issued. If any of the items in Box F occurred during the year, the appropriate box or boxes must be checked. These items are shown on the above Form 1041.

INCOME OF THE ESTATE OR TRUST

Generally, this section includes any income earned by the estate or trust's assets and IRD that belongs to the estate or trust. Therefore, it is important for the personal representative to notify all payors of income about the decedent's death and the estate's or trust's EIN as soon as possible.

The income section of Form 1041 is shown below. Any income or losses reported on lines 3 through 7 require additional supporting schedules and/or forms, as identified on the appropriate line. An additional itemized schedule may also be needed for line 8 if it consists of more than one item. Typically, line 8 is used to report IRD income.

Income	**1**	Interest income	**1**
	2a	Total ordinary dividends	**2a**
	b	Qualified dividends allocable to: **(1)** Beneficiaries **(2)** Estate or trust	
	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**
	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	**Total income.** Combine lines 1, 2a, and 3 through 8 ▶	**9**

Business Income or Loss

Business income and expenses from a decedent's sole proprietorship continue to be reported on Schedule C (Form 1040). However, the net profit or loss is carried to line 3 of Form 1041. The estate or trust is not liable for self-employment taxes.

Capital Gain or Loss

If the estate or trust sold any capital assets, a Schedule D (Form 1041) must be completed. Assets acquired by the estate from the decedent, receive a stepped-up or stepped-down basis.

The **asset value** used for estate tax purposes on Form 706 is also used as **basis** for income tax purposes on Form 1041. If a Form 706 was not required, the basis is the FMV on the date of death, plus or minus any adjustments since death.

The sale of **inherited assets** is always reported in Schedule D, Part II as a long-term sale. In column (b), the word "inherited" is written as the date acquired.

Schedule D, Part III is used to allocate **gains from the sales** between the beneficiary(s) and the estate. Losses cannot be allocated to the beneficiary(s) unless they are incurred in the **final year** of the estate. In years prior to the final year, $3,000 of capital losses in excess of capital gains can only be used by the estate.

If there is a **capital loss,** Schedule D, Part IV must be completed. The Capital Loss Carryover Worksheet in the instructions may need to be completed.

If any **long-term capital gains** are allocated to the estate, Schedule D, Part V must be completed to determine the tax liability. Any net gains (or net losses, not to exceed $3,000), are carried over to line 4 of Form 1041.

Rents, Royalties, Partnerships, Other Estates and Trusts

If the estate is the beneficiary of any rental properties, royalties, partnerships, estates, or trusts, a Schedule E (Form 1040) must be completed. The total income or loss from Schedule E, Part V is reported on line 5 of Form 1041. If a Schedule K-1 is received from another flow-through entity, any items such as interest, dividends, capital gains, and so on, retain their character and are reported on the appropriate lines of Form 1041.

Farm Income or Loss

If the estate continues the decedent's farming activities, the income and expenses are reported on Schedule F (Form 1040). The net profit or loss from Schedule F is reported on line 6 of Form 1041. If there is a net profit, the estate is not liable for self-employment taxes.

Other Income

IRD includes all income that the decedent would have received if death had not occurred. Assets considered IRD do not receive a step-up (step-down) in basis.[15] IRD includes:

- Accrued wages,
- Vacation pay,
- Pensions,
- Retirement plans,
- Individual retirement accounts (IRAs),
- Installment sales,
- Annuities, and
- Bond interest.

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15. IRC §1014(c)

IRD must be distributed to one of the following:

- The decedent's estate, if the estate receives the income
- The beneficiary's income, if the right to income is passed directly to the beneficiary and the beneficiary receives the income
- Any person to whom the estate properly distributes the right to receive the income.[16]

Generally, items of IRD are reported as "Other Income" on line 8 of Form 1041. A separate schedule listing the types and amounts of income on line 8 is attached to Form 1041.

DEDUCTIONS OF THE ESTATE

The estate is generally entitled to the same deductions as an individual. However, there are some differences including fiduciary fees (line 12), charitable deductions (line 13), administration expenses (line 15a), income distribution deduction (line 18), estate tax deduction (line 19), and the exemption (line 20).

	9	Total inc[illegible] . . . . . . ▶	9	
Deductions	10	Interest. Check if Form 4952 is attached ▶ ☐	10	
	11	Taxes	11	
	12	Fiduciary fees	12	
	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	
	b	Allowable miscellaneous itemized deductions subject to the 2% floor	15b	
	16	**Total.** Add lines 10 through 15b	16	
	17	Adjusted total income or (loss). Subtract line 16 from line 9. Enter here and on Schedule B, line 1 ▶	17	
	18	Income distribution deduction (from Schedule B, line 15) (attach Schedules K-1 (Form 1041))	18	
	19	Estate tax deduction (including certain generation-skipping taxes) (attach computation)	19	
	20	Exemption	20	
	21	**Total deductions.** Add lines 18 through 20 ▶	21	
	22	Taxable income. Subtract line 21 from line 17. If a loss, see page 19 of the instructions	22	

Fiduciary Fees

Ordinary and necessary expenses incurred by the fiduciary of an estate during the administration are deductible non-business expenses.[17] However, they can only be deducted for income tax purposes on line 12 of Form 1041 if they weren't claimed on the estate tax return (Form 706).[18] If there was tax-exempt income, a portion of the fees must be allocated to the tax-exempt income and that portion is not deductible.

Charitable Deductions

The charitable deduction on Form 1041, allowed to estates and complex trusts, differs from those allowed to individuals on Form 1040. A charitable deduction is only allowed to an estate or complex trust if the will or trust document **requires** the contribution be made from the estate's **income.**[19] If the will specifies a charitable contribution to a charitable entity allowed by §170, the deduction is calculated on Form 1041, Schedule A.

16. IRC §691(a)(1)
17. IRC §212
18. Treas. Reg. §1.212-1(i)
19. Treas. Reg. §1.642(c)-1

Some of the differences between the charitable deduction allowed to individuals and the charitable deduction allowed to estates or complex trusts include:

- Individual charitable deductions are limited to a maximum of 50% of AGI, while deductions for estates and complex trusts are unlimited.
- Individuals can only deduct contributions to domestic charities, while estates and trusts can also deduct contributions to foreign charities.[20]
- Individuals can deduct any type of donated property, but estates and complex trusts can only deduct distributions from gross income.
- Individuals must generally make the contribution during the tax year in which it is deducted, but estates and trusts can make the actual contribution in the following year if it was set aside during the year or if a special election was made.[21]

Administration Expenses

Expenses of administering an estate can be deducted either from the gross estate in determining the federal estate tax on Form 706, or from the estate's gross income in determining the estate's income tax on Form 1041. However, these expenses cannot be claimed for both estate tax and income tax purposes.[22] If the expenses are going to be deducted on Form 1041, the personal representative must sign and attach a statement to both Form 706 and Form 1041 listing the expenses and stating that the right to claim such expenses for federal estate tax purposes is being waived.[23] The statement must be completed and attached to Form 1041 even when there is no filing requirement for a Form 706.

In general, administration expenses deductible in calculating the estate tax include:

- Fees paid to the **fiduciary** for administering the estate;
- Attorney, accountant, and return preparer fees;
- Expenses incurred for the management, conservation, or maintenance of property; and
- Expenses in connection with the determination, collection, or refund of the estate's tax liability.

If these expenses are only incurred because the property is held by the estate, then they are not subject to the 2% AGI limitation and can be deducted on lines 12, 14, and 15a of Form 1041.[24]

Income Distribution Deduction (IDD)

The income distribution deduction is allowed to the estate or trust for any distributions made or required to be made to beneficiaries during the tax year. To determine the amount of the IDD, the fiduciary needs to determine the fiduciary accounting income (FAI) and the distributable net income (DNI).

Fiduciary Accounting Income (FAI). Fiduciary accounting is not financial accounting. Fiduciary accounting is determined by the fiduciary accounting rules, which allocate yearly receipts and payments between a principal account and an income account.

FAI has no relevance when preparing the financial records of the fiduciary entity. Allocations to the income account and principal account affect the income beneficiary(s) and remainder beneficiary(s). Allocations between the two

20. Rev. Rul. 74-523, January 1, 1974
21. Treas. Reg. §1.642(c)-1(a)
22. IRS Pub. 559, *Survivors, Executors, and Administrators* (2004), p. 17
23. IRC §642(g)
24. IRC §67(e)(1)

accounts are determined by the governing instrument (will or trust document).[25] If the governing document is silent, the fiduciary must comply with state law regarding the allocation of receipts and payments.[26] Most states have adopted one of the Principal and Income Acts with modifications. Therefore, if the governing document is silent, the fiduciary must be familiar with the laws of the state in which the estate or trust is located.

The following items **are** and **are not** included in FAI according to IRC §643(b). FAI:

- Includes tax-exempt interest
- Does **not** include capital gains
- Does **not** include IRD

Depreciation may also affect the computation of FAI. If the fiduciary establishes a depreciation reserve and makes annual payments to the reserve fund, the payments reduce FAI. If no payments are made to a depreciation reserve fund, FAI is not affected even though a depreciation deduction is allowed.[27]

Example 4. The Oliver Trust only has rental properties and has net rental income of $10,000 before depreciation. It also has an allowable depreciation deduction of $3,000.

- **Depreciation reserve:** If $2,000 is paid into a depreciation reserve (based on the trust document), the FAI is $8,000 ($10,000 – $2,000).
- **No depreciation reserve:** If there are no required payments to a depreciation reserve, the FAI is $10,000.

Using tax accounting rules, the net rental income is $7,000 ($10,000 – $3,000).

The FAI is **not** calculated on Form 1041, but can be included on line 8 of Form 1041, Schedule B.

Distributable Net Income (DNI). DNI limits the amount of the IDD that can be deducted by the estate or trust, and the amount that is taxable to the beneficiary(s). DNI also determines the character of the income that is reported by the beneficiary(s). There are three methods for computing DNI:

1. Code method,
2. Short-cut method, and
3. Form method.

The **form method** is probably the most common and uses lines 1 through 7 of Form 1041, Schedule B.

25. IRC §643(b)

26. Ibid

27. Treas. Reg. §1.167(h)

7 Charitable de

Schedule B	Income Distribution Deduction		
1	Adjusted total income (see page 21 of the instructions)	1	
2	Adjusted tax-exempt interest	2	
3	Total net gain from Schedule D (Form 1041), line 15, column (1) (see page 21 of the instructions)	3	
4	Enter amount from Schedule A, line 4 (reduced by any allocable section 1202 exclusion)	4	
5	Capital gains for the tax year included on Schedule A, line 1 (see page 21 of the instructions)	5	
6	Enter any gain from page 1, line 4, as a negative number. If page 1, line 4, is a loss, enter the loss as a positive number	6	
7	**Distributable net income (DNI).** Combine lines 1 through 6. If zero or less, enter -0-	7	
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law — 8		
9	Income required to be distributed currently	9	
10	Other amounts paid, credited, or otherwise required to be distributed	10	
11	Total distributions. Add lines 9 and 10. If greater than line 8, see page 22 of the instructions	11	
12	Enter the amount of tax-exempt income included on line 11	12	
13	Tentative income distribution deduction. Subtract line 12 from line 11	13	
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-	14	
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18	15	

Tax Computation (see page 22 of the instructions)

The amount entered on line 1 of Schedule B is the adjusted total income (or loss) from line 17 of Form 1041. This amount is:

- **Increased** by net tax-exempt income (gross amount less any allocable expenses), line 2
- **Increased** by capital gains allocated to beneficiaries
- **Decreased** by the amount of ordinary income and capital gains that are allocated to a charity on Schedule A, lines 4 and 5
- **Decreased** by all capital gains including those added in lines 3 through 6

Capital gains generally are **not** included in the calculation of DNI, unless they are:[28]

- Allocated to FAI by the governing document or state law,
- Allocated to corpus and actually distributed to the beneficiary(s) during the taxable year.
- Used to determine the amount required to be distributed to beneficiaries,
- Included in DNI if it is the termination year of the trust or estate, or
- Included in DNI if a reasonable apportionment of the trust's total return is made under state law.

Capital losses are **not** included in DNI unless it is the final distribution in the termination year and they are being used to offset capital gains.[29]

Ordinary losses allowed as deductions for income tax purposes generally reduce DNI.

Depreciation that is allocable to the beneficiary(s) passes directly to the beneficiary(s) and does **not** affect DNI. The depreciation allocated to the beneficiary(s) is **not** deducted on Form 1041. Instead, it is reported directly on Schedule K-1.

8

28. Treas. Reg. §§1.643(a)-6 and (b)

29. Treas. Reg. §1.643(a)-3(c)

The net character of income included in DNI is affected by all deductible expenses, since these expenses must be netted against the income. There are two types of expenses that must be considered:

- **Direct expenses** are directly related to a particular class of income.
- **Indirect expenses** are **not** directly related to a particular class of income.

In addition, IRC §212 expenses[30] must be allocated between tax-exempt and taxable income.[31] This requirement has a significant effect on taxes since the portion allocated to tax-exempt income is disallowed for income tax purposes. This is the reason that line 1 in the "Other Information" section of Form 1041 asks whether the trust or estate received tax-exempt income and requires the fiduciary to attach a computation of the allocation of expenses to the tax-exempt income.

7	Total ta... on page 1, ... ▶ 7		
	Other Information	**Yes**	**No**
1	Did the estate or trust receive tax-exempt income? If "Yes," attach a computation of the allocation of expenses Enter the amount of tax-exempt interest income and exempt-interest dividends ▶ $		
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?		
3	At any time during calendar year 2004, 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 24 of the instructions for exceptions and filing requirements for Form TD F 90-22.1. If "Yes," enter the name of the foreign country ▶		
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 24 of the instructions		
5	Did the estate or trust receive, or pay, any qualified residence interest on seller-provided financing? If "Yes," see page 24 for required attachment		
6	If this is an estate or a complex trust making the section 663(b) election, check here (see page 24) ▶ ☐		
7	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here (see page 24) ▶ ☐		
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 ▶ ☐		
9	Are any present or future trust beneficiaries skip persons? See page 24 of the instructions		

Form **1041** (2004)

If the estate or trust is required to distribute income currently, it will have a **Tier 1 distribution** that is reported on line 9 of Schedule B. Any other amounts paid or credited, and property distributions, are considered **Tier 2 distributions** and are reported on line 10 of Schedule B.

The fiduciary of an estate or complex trust can treat distributions made within the first 65 days of the subsequent tax year as if they were made in the current year by checking the box on line 6 in the "Other Information" section.[32]

The total distributions on lines 9 and 10 of Schedule B, less net tax-exempt income, are compared to the DNI amount on line 7. The IDD amount computed on line 15 of Schedule B (Form 1041) is the lesser of the two amounts. The amount from line 15 of Schedule B is carried over to line 18 in the deduction section of Form 1041.

30. Expenses for production of income

31. IRC §265

32. IRC §663(b)

Income	1	Interest income	1	5,000
	2a	Total ordinary dividends	2a	30,000
	b	Qualified dividends allocable to: (1) Beneficiaries (2) Estate or trust		
	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	25,000
	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	**Total income.** Combine lines 1, 2a, and 3 through 8 ▶	9	60,000
Deductions	10	Interest. Check if Form 4952 is attached ▶ ☐	10	
	11	Taxes	11	
	12	Fiduciary fees	12	3,000
	13	Charitable deduction (from Schedule A, line 7)	13	2,000
	14	Attorney, accountant, and return preparer fees	14	
	15a	Other deductions **not** subject to the 2% floor (attach schedule)	15a	
	b	Allowable miscellaneous itemized deductions subject to the 2% floor	15b	
	16	**Total.** Add lines 10 through 15b	16	5,000
	17	Adjusted total income or (loss). Subtract line 16 from line 9. Enter here and on Schedule B, line 1 ▶	17	55,000
	18	Income distribution deduction (from Schedule B, line 15) (attach Schedules K-1 (Form 1041))	18	30,000

Schedule B **Income Distribution Deduction**

1	Adjusted total income (see page 21 of the instructions)	1	55,000
2	Adjusted tax-exempt interest	2	
3	Total net gain from Schedule D (Form 1041), line 15, column (1) (see page 21 of the instructions)	3	
4	Enter amount from Schedule A, line 4 (reduced by any allocable section 1202 exclusion)	4	
5	Capital gains for the tax year included on Schedule A, line 1 (see page 21 of the instructions)	5	
6	Enter any gain from page 1, line 4, as a negative number. If page 1, line 4, is a loss, enter the loss as a positive number	6	(25,000)
7	**Distributable net income (DNI).** Combine lines 1 through 6. If zero or less, enter -0-	7	30,000
8	If a complex trust, enter accounting income for the tax year as determined under the governing instrument and applicable local law (8)		
9	Income required to be distributed currently	9	
10	Other amounts paid, credited, or otherwise required to be distributed	10	45,000
11	Total distributions. Add lines 9 and 10. If greater than line 8, see page 22 of the instructions	11	45,000
12	Enter the amount of tax-exempt income included on line 11	12	
13	Tentative income distribution deduction. Subtract line 12 from line 11	13	45,000
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-	14	30,000
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18	15	30,000

Note. Whenever a beneficiary receives or is required to receive a distribution from an estate or trust during the taxable year, the fiduciary must complete:

- Schedule B, to compute the IDD;
- Schedule I, Parts I and II, to recalculate the deduction on a minimum tax basis; and
- Schedule K-1 (Form 1041) for each beneficiary.

In addition, the fiduciary must enter the number of Schedules K-1 attached to Form 1041 in box B of the entity section.

Pecuniary or Specific Bequest. When an estate or trust distributes property in satisfaction of a specific bequest, the entity must recognize gain or loss on the distribution of the property. The **related party rules do not apply** in these situations.

Property Distributed When FMV Is Greater than Basis. When an estate or trust distributes property to the beneficiaries (other than specific bequests), they generally do not recognize gain upon the transfer. However, the trustee may make an election to recognize the gain at the entity level.[33] If this election is made, it is irrevocable and the basis of the property in the hands of the transferee is the FMV on the date of distribution. The gain is the excess of the property's FMV over its adjusted basis on the distribution date. If the election to recognize the gain is made, the IDD equals the FMV.

Property Distributed When FMV Is Less than Basis. When an estate or trust distributes property to the beneficiaries (other than specific bequests), they may **not** recognize a loss on the distribution due to the related party rules of §267(a)(1). The IDD is the basis of the assets of the trust or estate. The basis in the hands of beneficiary is generally the same as the basis of the trust's or estate's assets. However, this depends upon whether the beneficiary sells the asset at a gain or loss in the future. The loss that was disallowed at the entity level may be used to reduce gain on the beneficiary's tax return — but may not be used to increase a loss by the beneficiary.

Estate Tax Deduction

The estate tax deduction does not exist unless estate taxes were paid on the IRD on Form 706. IRD is taxed on both Form 1041 and Form 706. Consequently, a deduction equivalent to any additional estate taxes paid as a result of the IRD, less any deductions in respect of a decedent (DRD) is allowed on either line 19 of Form 1041,[34] or on line 10 of Schedule K-1.

Exemption. The $600 exemption amount is applicable to an estate. In the final year of the estate or trust, no benefit is received by the exemption.

> **Note.** The exemption amount is $300 for a simple trust. For all other trusts the exemption is limited to $100.[35]

Funeral and Medical Expenses. Funeral and medical expenses of the decedent are never deductible on Form 1041. Funeral expenses paid by the estate are only allowed as a deduction on Form 706.

The decedent's medical and dental expenses that are not paid before death are liabilities of the estate and are deducted on Form 706. However, if the decedent's medical expenses are paid by the estate during the one-year period beginning with the day after death, the fiduciary can elect to treat all or part of the expenses as paid by the decedent and claim all or part of the expenses on the decedent's final Form 1040, Schedule A.[36] The amount the fiduciary can deduct on the income tax return is the amount in excess of 7.5% of AGI. The amounts not deductible because of this percentage cannot be claimed on the federal estate tax return. The election to deduct the medical expenses on the final Form 1040 is made by attaching a statement to the return stating that the estate has waived the right to claim the expenses on Form 706.

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33. IRC §643(e)(3)

34. IRC §691(c)(1)

35. IRC §642(b)

36. Treas. Reg. §1.213-1(d)

TAXABLE INCOME

If line 22 results in taxable income, Schedule G must be completed to determine the total tax liability for the estate or trust. The amount on line 1a of Schedule G is the result of one of the following:

1. Tax Rate Schedules,
2. Form 1041, Schedule D, or
3. The Qualified Dividend Tax Worksheet in the Form 1041 instructions.

Schedule G also takes into consideration:

- Taxes on lump-sum distributions, line 1b, and
- Additional alternative minimum taxes, line 1c, from Schedule I.

Schedule G **Tax Computation** (see page 22 of the instructions)

1 Tax: a Tax on taxable income (see page 22 of the instructions)	1a		
b Tax on lump-sum distributions (attach Form 4972)	1b		
c Alternative minimum tax (from Schedule I, line 56)	1c		
d Total. Add lines 1a through 1c ▶		1d	
2a Foreign tax credit (attach Form 1116)	2a		
b Other nonbusiness credits (attach schedule)	2b		
c General business credit. Enter here and check which forms are attached: ☐ Form 3800 ☐ Forms (specify) ▶	2c		
d Credit for prior year minimum tax (attach Form 8801)	2d		
3 Total credits. Add lines 2a through 2d ▶		3	
4 Subtract line 3 from line 1d. If zero or less, enter -0-		4	
5 Recapture taxes. Check if from: ☐ Form 4255 ☐ Form 8611		5	
6 Household employment taxes. Attach Schedule H (Form 1040)		6	
7 Total tax. Add lines 4 through 6. Enter here and on page 1, line 23 ▶		7	

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Generally, there is no tax advantage when income is taxable to the estate. The tax rates for a fiduciary return are the same as those for an individual, except there is no 10% bracket. However, the income brackets for the other rates are compressed.

The table below compares the 2005 tax rate tables for a fiduciary return and single individual.

2005 Tax Rate Schedule for Fiduciary Returns

If Taxable Income Is:	The Tax Is:
Not over $2,000	15% of taxable income
Over $2,000 but not over $4,700	$300 plus 25% of the excess over $2,000
Over $4,700 but not over $7,150	$975 plus 28% of the excess over $4,700
Over $7,150 but not over $9,750	$1,661 plus 33% of the excess over $7,150
Over $9,750	$2,519 plus 35% of the excess over $9,750

2005 Tax Rate Schedule for Single Individuals

If Taxable Income Is:	The Tax Is:
Not over $7,300	10% of taxable income
Over $7,300 but not over $29,700	$730 plus 15% of the excess over $7,300
Over $29,700 but not over $71,950	$4,090 plus 25% of the excess over $29,700
Over $71,950 but not over $150,150	$14,652.50 plus 28% of the excess over $71,950
Over $150,150 but not over $326,450	$36,548.50 plus 33% of the excess over $150,150
Over $326,450	$94,727.50 plus 35% of the excess over $326,450

Net Operating Loss (NOL)

If the amount on line 22 of Form 1041 is negative, the estate may have a net operating loss (NOL). However, the loss must be created by one of the following:

- Trade or business,
- Casualty and theft loss, or
- Rental property.

The NOL is computed by completing Form 1045, Schedule A without including capital losses, charitable deductions, income distribution deduction, and exemption amount. The NOL may be carried back to offset income on prior income tax returns or, if elected, it can be carried forward instead of being carried back. In the termination year, unused NOL is passed through to the beneficiaries. Any NOL carried forward to the beneficiaries upon termination of the estate or trust is reported on lines 13d and 13e of Form 1041, Schedule K-1.

Excess Deductions

If the loss on line 22 is not created by an NOL, it is considered an excess deduction. Excess deductions are lost except in the final year of the estate. Excess deductions in the final year, not including charitable deductions and the exemption amount, are allowed as an itemized deduction (subject to the 2% AGI limitation) to the beneficiary(s). Excess deductions upon termination are reported on line 13a of Form 1041, Schedule K-1.

Note. The 2005 version of Form 1041, Schedule K-1 is being revised to look more like a Form W-2. The improved layout has streamlined instructions and is scannable to help reduce transcription errors. The IRS plans to make the new line numbers correspond with the lines on the previous version of Schedule K-1.

Estimated Taxes

Estates and certain grantor trusts[37] of a decedent are **not** required to make estimated tax payments for tax years ending within the first two tax years of the decedent's death.[38] Estates and trusts with tax years ending two or more years after the date of the decedent's death must pay estimated tax in the same manner as individuals. In general, the estate is liable for paying estimated taxes if the estate is expected to owe at least $1,000 in taxes for 2006. The same exceptions that apply to individuals also apply to estates.[39]

To determine whether estimated tax payments are required for 2006, Form 1041-ES, *Estimated Income Tax for Estates and Trusts,* is used. Generally, estimated taxes are due in four equal amounts and are due by the 15th day of the fourth, sixth, and ninth months of the tax year and the 15th day of the first month of the following tax year. If any of these dates fall on a weekend or legal holiday, the payment is due the next business day.

Note. Illinois does not require state estimated payments for estates and trusts.

The fiduciary may allocate the estimated tax payments to the beneficiary(s) by filing Form 1041-T, *Allocation of Estimated Tax Payments to Beneficiaries*, by the 65th day after the close of the tax year.[40] The estimated payments are then shown on the beneficiary's Schedule K-1 on line 14(a).

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37. IRC §6654(l)
38. Ibid
39. IRC §6654(d)
40. IRC §643(g)

Withheld Income Tax

Except for backup withholding, taxes withheld on income of the estate **cannot** be allocated to the beneficiaries. Even if all of the income is allocated to the beneficiaries, the estate must file a claim for refund.

Extensions

The personal representative of an **estate** can request a three-month extension to file Form 1041 by filing Form 2758, *Application for Extension of Time To File Certain Excise, Income, Information, and Other Returns*. Because the extension is not automatic, the personal representative must clearly state the reasons for the delay and should submit the request several weeks before Form 1041 is due. Normally, if an extension is not approved, the IRS allows a 10-day grace period. However, the grace period is not automatic. Therefore, early filing of the extension may prevent late filing penalties. Form 2758 should be filed in duplicate with the same IRS office where Form 1041 is filed. The extension to file does not extend the payment date or taxes due. If additional time is needed, a second Form 2758 must be filed before the original extension expires.[41]

The fiduciary of a **trust** can request an automatic three-month extension to file Form 1041 by filing a Form 8736, *Application for Automatic Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts.* Form 8736 must be filed by the due date of Form 1041. If additional time is needed, the fiduciary can request an additional three-months by filing Form 8800, *Application for Additional Extension of Time to File U.S. Return for a Partnership, REMIC, or for Certain Trusts*. Since the additional extension is not automatic, the fiduciary must explain why the additional time is needed.[42]

GRANTOR TRUSTS

Because grantor trusts are disregarded as a separate **taxable** entity for federal income tax purposes, the income is taxed directly to the creator. However, the trust is still recognized under state law as a separate **legal** entity.

The Internal Revenue Code describes a grantor trust as any trust over which the creator retains the power to control or direct the trust's income or assets. All revocable trusts are automatically classified as grantor trusts.[43] Irrevocable trusts can also be classified as grantor trusts if any of the definitions contained within IRC §§671, or 673–677 are met.

One of the primary reasons that grantor trusts are created is to avoid probate, which is the main disadvantage of a will. Since all the assets transferred to a trust are no longer in the name of the grantor, they do not pass through probate. However, the decedent may have some assets still in his name that were never transferred to the trust. These assets may be subject to probate, hence the need for a pour-over will.

Generally, the assets within a grantor trust become part of an irrevocable trust upon the death of the grantor and the successor trustee is required to obtain an EIN for the trust, if the trust does not have an EIN. The trustee is required to file Form 1041 for the trust and follow the terms of the governing instrument.

If a trust does not have an EIN and the trustee furnishes the name and taxpayer identification number of the grantor or other person treated as the owner of the trust and the trust's address to all payors pursuant to Treas. Reg. §1.671-4(b)2), the trustee need not obtain an EIN for the trust until either the first taxable year of the trust in which all of the trust is no longer owned by the grantor or another person, or until the trust's first taxable year for which the trustee no longer reports pursuant to Treas. Reg. §1.671-4(b)(2).[44]

41. 2004 Instructions for Form 1041 and Schedules A, B, D, G, I, J, and K-1

42. Ibid

43. IRC §676

44. Treas. Reg. 301.6109-1(a)(2)

If the trustee has not already obtained an EIN for the trust, the trustee must obtain one for the trust.[45] The trustee should complete Form SS-4, *Application for Employee Identification Number,* and then apply by fax, mail, telephone, or online.

If a grantor trust is treated as owned by one grantor or one other person, the trustee may choose between two alternative methods of reporting. Under the first alternative, the trustee must furnish to all payors of income the name and tax ID number of the grantor, and the address of the trust. Unless the grantor or other person treated as the owner of the trust is the trustee or co-trustee, the trustee must also furnish the grantor with a statement that identifies the payor of each income item, and that:

1. Shows all items of income, deduction, and credit of the trust for the tax year;
2. Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's income; and
3. Informs the grantor or other person treated as the owner of the trust that the items of income, deduction, credit and other information shown on the statement must be included in computing the grantor's or other person's income on their tax return.

A trustee who follows the first alternative method does not have to file any return with the IRS. Under the second alternative, the trustee must furnish to all payors during the tax year the name, EIN and address of the trust.

45. Treas. Reg. §1.671-4(a).

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts **2004** OMB No. 1545-0092

A Type of entity (see instr.):
- ☐ Decedent's estate
- ☐ Simple trust
- ☐ Complex trust
- ☐ Qualified disability trust
- ☐ ESBT (S portion only)
- ☒ Grantor type trust
- ☐ Bankruptcy estate–Ch. 7
- ☐ Bankruptcy estate–Ch. 11
- ☐ Pooled income fund

For calendar year 2004 or fiscal year beginning , 2004, and ending , 20

Name of estate or trust (If a grantor type trust, see page 12 of the instructions.)
The Living Trust of George Oliver

C Employer identification number: **37 : 0000001**

Name and title of fiduciary
George Oliver, Trustee

D Date entity created: **6/10/2003**

Number, street, and room or suite no. (If a P.O. box, see page 12 of the instructions.)
111555 S Homan Ave.

E Nonexempt charitable and split-interest trusts, check applicable boxes (see page 13 of the instr.):
- ☐ Described in section 4947(a)(1)
- ☐ Not a private foundation
- ☐ Described in section 4947(a)(2)

City or town, state, and ZIP code
Chicago, IL 60655

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

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

G Pooled mortgage account (see page 14 of the instructions): ☐ Bought ☐ Sold Date:

Income

1 Interest income — 1
2a Total ordinary dividends — 2a
b Qualified dividends allocable to: **(1)** Beneficiaries .... **(2)** Estate or trust
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
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 **Total income.** Combine lines 1, 2a, and 3 through 8

Under the terms of the trust instrument, this is a grantor trust. All income is taxable to the grantor as set forth under IRC §§671–678.

A statement of income, deductions and credits is attached.

Deductions

10 Interest. Check if Form 4952 is attached ▶ ☐
11 Taxes
12 Fiduciary fees
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
b Allowable miscellaneous itemized deductions subject to the 2% floor — 15b
16 **Total.** Add lines 10 through 15b — 16
17 Adjusted total income or (loss). Subtract line 16 from line 9. Enter here and on Schedule B, line 1 ▶ — 17
18 Income distribution deduction (from Schedule B, line 15) (attach Schedules K-1 (Form 1041)) — 18
19 Estate tax deduction (including certain generation-skipping taxes) (attach computation) — 19
20 Exemption — 20
21 **Total deductions.** Add lines 18 through 20 ▶ — 21

Tax and Payments

22 Taxable income. Subtract line 21 from line 17. If a loss, see page 19 of the instructions — 22
23 **Total tax** (from Schedule G, line 7) — 23
24 **Payments: a** 2004 estimated tax payments and amount applied from 2003 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: ☐ Form 2758 ☐ Form 8736 ☐ Form 8800 — 24d
e Federal income tax withheld. If any is from Form(s) 1099, check ▶ ☐ — 24e
Other payments: **f** Form 2439 .... ; **g** Form 4136 .... ; Total ▶ — 24h
25 **Total payments.** Add lines 24c through 24e, and 24h ▶ — 25
26 Estimated tax penalty (see page 20 of the instructions) — 26
27 **Tax due.** If line 25 is smaller than the total of lines 23 and 26, enter amount owed — 27
28 **Overpayment.** 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 2005 estimated tax** ▶ ; **b Refunded** ▶ — 29

Sign Here

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

Signature of fiduciary or officer representing fiduciary | Date | EIN of fiduciary if a financial institution

May the IRS discuss this return with the preparer shown below (see instr.)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no. ( )

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11370H Form **1041** (2004)

8

INCOME IN RESPECT OF A DECEDENT (IRD)

The Revenue Code defines income in respect of a decedent as:

In general, the term income in respect of a decedent refers to those amounts to which a decedent was entitled as gross income but which were not properly includable in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent. Thus, the term includes: (1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method; (2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and (3) Income to which the decedent had a contingent claim at the time of his death.[46]

Therefore, IRD consists of accrued wages, interest, dividends, annuities, interest from savings bonds, income from pensions or retirement plans, installment sales, and so on.

Inherited items of IRD are not entitled to a step-up in basis.[47] Instead, the IRD is included on the recipient's income tax return.

> **Example 5.** John owned stock in XYZ Corporation, which declared a $2,500 dividend on June 2, 2005. John died on June 15, 2005 prior to the dividend payment. When the dividend is paid to John's estate on July 1, 2005, it is reported on line 2a of Form 1041.

SPECIAL RULES FOR DISCOUNT SAVINGS BONDS

Special rules apply to U.S. Series E, EE, H, and I Savings Bonds. These bonds are purchased at a discount and the owner has the choice of paying tax on all of the interest when the bonds are cashed or he can pay taxes on the annual interest accrual.

If the decedent was an accrual basis taxpayer or a cash basis taxpayer that elected under §454(a) to report the interest on the annual accrual, the interest that accrued from January 1 up to the date of death is reported on the decedent's final Form 1040. Any interest earned on the bonds after the date of death is reported on the beneficiary's return.

If a cash-basis decedent chose not to report the interest each year and the bonds were purchased from the decedent's personal funds, the interest is reported in one of two ways:

1. The personal representative elects to report all interest accrued through the date of death on the decedent's final Form 1040.[48] The estate or beneficiary then reports all interest earned after the decedent's death.[49]
2. If the IRC §454(a) election is not made, the estate or beneficiary reports all interest on his return. The interest that accrued prior to the decedent's death is reported as IRD and the interest that accrues after the date of death is reported as interest income by the recipient. If the beneficiary is also on the cash method, he can wait to report all interest until the earlier of the bonds being cashed or maturing.[50] In the year the interest is reported, the estate (or beneficiary) can claim a deduction on its respective return.

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46. Treas. Reg. §§1.691(a)-1 and 1.691(b)
47. IRC §1014
48. IRC §454(a)
49. Rev. Rul. 68-145, January 1, 1968
50. Rev. Rul. 64-104, January 1, 1964

Example 6. Uncle Ronny, a cash basis taxpayer, died in October and left his nephew, Gipper, a $1,000 Series EE bond. Uncle Ronny had purchased the bond for $500 and had not elected to report the increase in value each year on his individual income tax returns. On the date of Uncle Ronny's death, interest of $147 had accrued on the bond, and the bond's value of $647 was included in Uncle Ronny's gross estate. The executor decided not to elect under §454(a) to include the $147 accrued interest in Ronny's final income tax return.

Gipper is a cash basis taxpayer and does not elect to report the increase in value each year as it is earned. Gipper waits and cashes the bond when it reaches maturity value of $1,000. Gipper reports interest income of $500 (the difference between maturity value of $1,000 and the original cost, $500) in the year he cashes in the bond. Gipper is also entitled to an itemized deduction for any estate tax attributable to the inclusion in Uncle Ronny's estate of the $147 increase in value.

Example 7. Use the same facts as **Example 6,** except Ronny's executor elects under §454(a) to include interest on the bond earned before death on Ronny's final income tax return. Gipper reports only $353 ($500 – $147) as interest income when he cashes the bond at maturity. Because the $353 is interest earned after Uncle Ronny's death, it is **not** IRD. This interest is not included in Ronny's estate. Gipper is not entitled to a deduction for estate tax.

TRADITIONAL IRAs INHERITED FROM A DECEDENT

If an estate is the beneficiary of a traditional IRA and receives a lump-sum distribution, the distribution is considered IRD. The taxable portion of the distribution is reported on line 8 of Form 1041.

If a beneficiary receives a lump-sum distribution from an inherited traditional IRA, all or some of the proceeds may be taxable. The distribution is taxable in the year received as IRD up to the decedent's taxable balance.

If the beneficiary of a traditional IRA is the decedent's surviving spouse who properly rolls over the distribution into another traditional IRA, the distribution is not currently taxed. A surviving spouse also can roll over tax free the taxable part of the distribution into a qualified plan, a §403(b) annuity, or a §457 plan.

ROTH IRAs INHERITED FROM A DECEDENT

Qualified distributions from a Roth IRA are not subject to income tax. A distribution made to a beneficiary or to the Roth IRA owner's estate on or after the date of death is often a qualified distribution. To be qualified, it must be made after the 5-year tax period beginning with the first tax year in which the decedent made a contribution to any Roth IRA.

Part of a distribution to a beneficiary that is not a qualified distribution may be includable in the beneficiary's income. Generally, the earnings in the Roth IRA are includable. Earnings attributable to the period ending with the decedent's date of death are IRD. Additional earnings are the income of the beneficiary(s).

> **Note.** A discussion of spousal rollovers is included in Chapter 4, "Retirement Issues."

DEDUCTIONS IN RESPECT OF A DECEDENT (DRD)

Certain accrued expenses that would have been deductible by the decedent had he lived are allowed as a deduction by the estate, or by beneficiary(s) who pay the expense.[51] These expenses typically include accrued:

- Interest expenses deductible under IRC §163,
- Business expenses deductible under IRC §162,
- Taxes deductible under IRC §164, and
- Miscellaneous expenses deductible under IRC §212.

51. IRC §691(b)

ESTATE TAX DEDUCTION

Items of IRD are subject to both estate and income taxation when the value of the decedent's estate requires filing Form 706, and estate taxes are paid. Because of the estate tax deduction that is allowed to the recipient of the IRD, income tax may be reduced.[52]

The IRD deduction is computed by recalculating the estate tax without the net IRD value (IRD less DRD) of all assets reported on Form 706. The estate tax deduction is the difference between the actual estate tax and the recalculated estate tax amount without the net IRD items.

If an estate or trust is the beneficiary, the deduction is allowed on line 19 of Form 1041. The computation must be attached to Form 1041.

17	Adjusted total income or (loss). Subtract line 16 from line 9. Enter here and on Schedule B, line 1 ▶	17	
18	Income distribution deduction (from Schedule B, line 15) (attach Schedules K-1 (Form 1041))	18	
19	Estate tax deduction (including certain generation-skipping taxes) (attach computation) . .	19	
20	Exemption	20	
21	**Total deductions.** Add lines 18 through 20 . . . . ▶	21	

If an individual is the recipient, the location of the deduction depends on whether the income is the result of ordinary income or capital gain income:

- If it is the result of **ordinary income,** the deduction is claimed as an "other miscellaneous deduction" on Schedule A, not reduced by 2% of AGI.

If the estate or trust makes a distribution, the §691(c) deduction is handled in the same way as a depreciation deduction:

- If a distribution is made or is required to be made, the deduction is allocated between the estate and the beneficiary(s) based on the income allocated to each.
- If a portion of the deduction is allocated to a beneficiary(s), the deduction is excluded from DNI and is not listed as a deduction on Form 1041. Instead, the deduction is listed directly on the Schedule K-1 on line 10.

8	Income for regular tax purposes (add lines 1, 2b, 3, 4a, 5a, and 6a)	8		
9	Adjustment for minimum tax purposes (subtract line 8 from line 7)	9		Form 6251, line 14
10	Estate tax deduction (including certain generation-skipping transfer taxes)	10		Schedule A, line 27
11	Foreign taxes	11		Form 1040, line 46 or Schedule A, line 8

52. IRC §691(c)

Example 8. John died at age 73. The total value of his IRA was $150,000. The beneficiaries of his IRA were his three daughters. After his death, the daughters created three equal sub-accounts of $50,000 each. During his lifetime, John made no nondeductible contributions and the IRA was the only IRD in his estate. If John's estate had not included the IRA, the estate tax bill on Form 706 would have been $60,000 less.

Daughter 1 is building a new house and she wants to take her distribution in one lump sum of $50,000. On the date of distribution, there was a decline in the stock market and the account balance was only $49,000. She includes $49,000 of IRD in income she received. She may also deduct $19,600 as an itemized deduction (($49,000 ÷ $50,000) × $20,000). She deducts the estate tax attributable to the IRD amount included in her gross income.

Daughter 2 has two children in college and she decided to withdraw $10,000 per year from her inherited IRA and distribute the balance in year six. She includes $10,000 in income each year for five years and receives an itemized deduction of $4,000 (($10,000 ÷ $50,000) × $20,000) each year for five years. In the sixth year, she includes the distributed balance of the IRA in income. However, there is no §691(c) IRD deduction available in excess of the $20,000 previously claimed.

Daughter 3 wants to take the minimum distribution allowable and spread the inherited IRA out as long as possible. She is age 40 the year after her father died. This is the same year she took her first distribution. Her required minimum distribution in that first year was only $1,147 ($50,000 account balance at December 31 of the year prior to distribution ÷ 43.6 from the single life expectancy table for inherited IRAs). Her itemized deduction would be $459 (($1,147 ÷ $50,000) × $20,000). She will hopefully withdraw more than $50,000 over her lifetime from her inherited IRA, however, her accumulated IRD deduction can't exceed $20,000.

PROPERTY BASIS AND HOLDING PERIODS

There is confusion regarding the tax effect of an inherited asset:

- Is the property a tax-free inheritance? If not, what is the basis of the property?
- What happens if the property was held in trust?
- Can the property be depreciated?
- Is the property treated as a short-term or long-term disposition when sold?

To answer these questions, the terms **cost basis** and **adjusted cost basis** must be defined.

Generally, the **cost basis** of an asset is the amount someone paid for the asset in an arms-length transaction.[53] Basis is the starting point for determining deductions for depreciation, depletion, and amortization.

The **adjusted cost basis** is the cost basis plus or minus various adjustments made during the years the asset is held. These adjustments include depreciation, depletion, amortization, stock-splits, and overall improvements to property.[54] The adjusted cost basis is used to determine whether there is a gain or loss when the asset is disposed of or sold.

53. IRC §1012

54. IRC §1016

GENERAL RULE: STEP-UP (STEP-DOWN) TO FMV

When a decedent dies, his assets are transferred to his heirs. Generally, the assets receive a step-up (step-down) in basis to FMV on the decedent's date of death.[55]

> **Example 9.** When Jack died on March 13, 2005, he owned 100 shares of ABC stock. The stock had an adjusted cost basis of $35 per share. The FMV of the shares was $75 per share on March 13, 2005. If the estate sold the stock on April 1, 2005 at $78 per share, it would only report a taxable capital gain of $300 (100 shares × ($78 per share – $75 per share)). If the estate did not receive the step-up in basis, the reportable capital gain would have been $4,300 (100 shares × ($78 per share – $35 per share)). The step-up in basis saved the estate from paying taxes on $4,000 ($4,300 – $300) of the capital gain.

EXCEPTIONS TO GENERAL RULE

The step-up (step-down) to FMV does not apply when:

1. The asset is classified as an item of IRD.[56]
2. An appreciated asset was given to the decedent within one year of death and then bequeathed back to either the person who transferred the property to the decedent or the decedent's spouse.[57]

If either of these exceptions apply, the adjusted basis rule rather than the stepped-up basis rule applies. An owner of appreciated property cannot make a gift of the property to a terminally ill person and then reacquire the same property from the donee-decedent with a stepped-up basis if the donee dies within one year of receiving the gift.

SPECIAL ASSET VALUATION RULES

If the decedent's estate is required to file Form 706, the personal representative of the estate can elect to value the assets using either the alternate valuation date or the special-use valuation rules:

- If the personal representative makes the proper election on Form 706, the alternate valuation date is used to value the assets rather than using FMV on date of death.[58] The alternate valuation date is the FMV six months after the date of death or the date that the asset is disposed of, whichever is earlier. If the alternate valuation date is elected, all of the decedent's assets must be valued using this method. The alternate valuation date is used only if it reduces the value of the entire estate and estate taxes due.[59] If the alternate valuation date is used for estate tax purposes, that basis must also be used by the recipient of the asset when determining their gain or loss.
- If the decedent owned a small family business or farm, the personal representative may be able to value the real property using the special-use valuation rules.[60] Using these rules, the real property used in a trade or business can be valued based on its actual use rather than its highest value. To be eligible, the property must have been owned and used in the same activity for at least five of the eight years preceding death. In addition, the property cannot be sold by the heirs within 10 years and must be used during that time for the same activity. The property must be located within the United States, the decedent must have been a U.S. citizen or resident, the net FMV of the realty must be at least 25% of the adjusted gross estate, the total real estate and business personal property in use on the date of death must be at least 50% of the gross estate, and the property must pass to a qualifying heir.[61]

> **Note.** Although federal law allows special valuation, it is not reconized in some states.

55. IRC §1014
56. IRC §1014(c)
57. IRC §1014(e)
58. IRC §2032
59. IRC §2032(c)
60. IRC §2032(A)
61. IRC §2032A

INHERITED PROPERTY HOLDING PERIOD

If the beneficiary sells or disposes of inherited property, he is considered to have held that property for more than one year regardless of how long he actually held the property.[62]

If the property is transferred prior to death as the result of a completed gift, the holding period includes the holding period of the transferor.[63]

PROPERTY PLACED IN JOINT TENANCY AFTER 1976

The step-up in basis becomes more complicated when the property is jointly held and one of the joint owners dies. The general rule for property placed in joint tenancy after 1976 is that one-half of the property receives a step-up in basis.

Example 10. When Jack died on March 13, 2005, he owned rental real estate with his wife, Mary. The value of the rental property on March 13, 2005 was $300,000. His wife originally acquired the property in 1970 for $50,000. When they were married in 1980, she transferred it into joint tenancy. Mary sold the property on June 1, 2005 for $300,000. There was no depreciation.

If the property is held in joint tenancy on the date of death and the qualified joint interest rules of §2040(b) apply, one-half of the value is included in Jack's gross estate and the basis for purposes of the sale is computed as follows:

	Jack's Interest	Mary's Interest	Total
Amount realized	$150,000	$150,000	$300,000
Less: basis	(150,000)	(25,000)	(175,000)
Gain or loss	$ 0	$125,000	$125,000

Property Placed in Joint Tenancy before 1977

For property placed in joint tenancy before 1977, the qualified joint interest rules of §2040(b) do not apply. Instead, the normal contribution rules of §2040(a) apply. This is commonly referred to as the **consideration furnished test.**[64]

Example 11. Use the same facts as **Example 10,** except Mary transferred the property into joint tenancy in 1975.

	Jack's Interest	Mary's Interest	Total
Amount realized	$0	$300,000	$300,000
Less: basis	(0)	(50,000)	(50,000)
Gain or loss	$0	$250,000	$250,000

62. IRC §1223(11)

63. IRC §1223(2)

64. *Hahn v. Commr.,* 110 TC 140, March 4, 1998

Community Property

For joint property owned in a community property state, both spouses' portions of the property receive a step-up (step-down) in basis to FMV. In addition, only the portion of the property that belongs to the decedent becomes part of the gross estate. The holding period of the surviving spouse's interest is considered long-term, regardless of whether the interest was held over 12 months.[65]

Example 12. Use the same facts as **Example 10,** except the property is jointly owned in a community property state and results in the following:

	Jack's Interest	Mary's Interest	Total
Amount realized	$150,000	$150,000	$300,000
Less: basis	(150,000)	(150,000)	(300,000)
Gain or loss	$ 0	$ 0	$ 0

Note. Community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Basis Questions

Question A. What is the basis of an asset originally transferred to a grantor trust upon the grantor's death?

Answer A. Generally, since a grantor trust is not recognized as a separate entity for federal income tax purposes, any assets that are in the name of the trust retain the adjusted cost basis of the grantor. Therefore, the assets receive a step-up (step-down) in basis to FMV upon the grantor's date of death, unless one of the exceptions applies.

Question B. Is the grantor entitled to the §121 exclusion if the residence is transferred to a grantor trust?

Answer B. If a residence is owned by a trust, for the period that a taxpayer is treated under §§671–679 as the owner of the trust (grantor-type trust) or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the two-year ownership requirement of §121. The sale or exchange by the trust is treated as if made by the taxpayer. Therefore, the sale may qualify for the exclusion of gain from the sale or exchange of a principal residence if the grantor meets the requirements of §121.

Question C. What is the basis of a personal residence that is transferred to an irrevocable trust? Will the sale of the home qualify for the §121 exclusion?

Answer C. If the residence is transferred to an irrevocable trust and then sold, the sale is reported on Form 1041, Schedule D as a short-term or long-term sale, depending on the holding period. Generally, the basis of property acquired by gift is the same as the adjusted basis of the donor. If the FMV of the property at the time it is transferred to the trust is less than the transferor's basis, the FMV is used for determining any loss on disposition. If the property is transferred to the trust after 1976, and a gift tax is paid, the adjusted basis is increased. The trust does not qualify for the exclusion of gain ($250,000/$500,000) from the sale of a principal residence under §121.

Question D. How does an estate treat the sale of a decedent's residence?

Answer D. The sale of a decedent's personal residence by the estate is reported on Form 1041, Schedule D as a long-term sale. The basis of the home is stepped up to FMV at the date of death, unless a Form 706 is filed and the alternate valuation date is used. Usually, there is a loss due to the cost of selling the house. Since the loss is considered personal, the loss is generally not allowed. Therefore, the estate lists the sale's price and basis, and notes on Schedule D that the loss is personal and not deductible or lists the sales price and the basis as the same. If the house is sold at a gain, the estate or the beneficiary(s) is responsible for the taxes on the long-term capital gain. The estate does not qualify for the exclusion of gain ($250,000/$500,000) from the sale of a principal residence under §121.

65. Treas. Reg. §1.1223-1(j)

> **Note.** Selling expenses may qualify as administrative expenses and are not considered part of a capital loss. When selling expenses qualify as administrative expenses, they are deductible on Form 706 unless the executor elects to deduct them on Form 1041. Expenses of selling estate property are deductible as administrative expenses if the sale is necessary to pay the decedent's debts, expenses of administration, or taxes; to preserve the estate; or to effect the distribution of assets.

Question E. What is the basis of an asset that is transferred to an inter vivos irrevocable trust by the grantor?

Answer E. The basis is the adjusted cost basis of the grantor on the date of the death plus any gift taxes paid.[66] The assets do not receive a step-up (step-down) in basis when the grantor dies.

Question F. How does depreciation effect inherited assets?

Answer F. When depreciable assets are inherited from a decedent and the estate or beneficiary(s) continue to use the asset for the same purpose, the asset receives the step-up (step-down) to FMV and the depreciation starts over at the date of death using the method applicable at that time.

Example 13. When Jack died on March 13, 2005, he owned residential rental real estate with an FMV of $300,000. Jack originally purchased the rental property in 1990 for $150,000 and the accumulated depreciation through March 13, 2005 was $70,000.

When Jack's estate inherited the property, it received a step-up in basis to the FMV of $300,000, even though Jack's adjusted cost basis was $80,000. The estate continues to use the property as a rental property and is therefore able to restart the depreciation under the MACRS method for an additional 27.5 years.

TOTAL RETURN TRUST

Most trusts are created with both income and remainder beneficiaries. Typically, these are different individuals or entities.

Because **income beneficiaries** are usually entitled to any income earned by the trust during the life of the trust on its investments and **remainder beneficiaries** are entitled to the remaining assets when the trust is terminated, disagreements can occur. The allocation of income and assets between the two types of beneficiaries may not always seem fair to all parties. Since the trustee is ultimately responsible for the investment decisions, he is in the middle of the disagreement and is sometimes held liable for any inequities.

Generally, the manner in which the income of a trust is determined depends on the Principal and Income Act of the State where the trust was created, unless specific items of income and principal are defined within the trust instrument. The majority of the Principal and Income Acts established by the various states treat interest and dividend payments as income. Capital gains and losses are often charged to principal and taxed directly to the trust for the benefit of the remainder beneficiaries. Therefore, the investment interests between the income and remainder beneficiaries are often in conflict.

Final regulations now approve of state statutes that provide for a unitrust payment of income to the income beneficiary(s) of between 3% and 5% of the FMV of trust assets.[67] Since many states have adopted the Prudent Investor Act and incorporated it into their state Principal and Income Act, the trustee can now make investment decisions based solely on obtaining the best returns over the life of the trust. The income is recalculated each year as a fixed percentage of the value of the trust. Therefore, if the value of the trust goes up during the year, the income beneficiary(s) receives a greater distribution. If the value of the trust goes down, the distributions to the income beneficiary(s) likewise decrease.

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66. IRC §1015

67. Treas. Reg. §1.643(b)-(1)

The remainder beneficiary(s) also benefit because the trustee no longer tries to split the investments between those investments generating current income and those investments offering the greatest return on capital.

Example 14. Under the state unitrust statute, a trustee may make an election to pay 4% of the FMV of the trust's assets to an income beneficiary in full satisfaction of that beneficiary's right to income. If the trustee makes the election, the 4% is taken first from ordinary income, next from capital gains, and finally from return of principal. The trust's assets have an FMV of $1 million. The trust receives $25,000 of ordinary income and $60,000 of capital gain. Under the unitrust method, the trustee distributes $40,000 (4% of $1 million) to the income beneficiary. Therefore, $15,000 ($40,000 – $25,000) of the capital gain is allocated to income following the ordering rule of the state statute, and is included in DNI.