Chapter 6: Death of a Taxpayer

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Corrections were made to this workbook through January of 2008. No subsequent modifications were made.

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Tax professionals are frequently called on to guide fiduciaries through income tax complications resulting from the death of a taxpayer. While a tax preparer should never try to replace the estate attorney, there are services she can provide. This chapter gives an overview of what might be expected.

When a taxpayer dies, the court appoints someone (a fiduciary) to handle the taxpayer's estate. This fiduciary's title can be executor, executrix, administrator, administratrix, or personal representative. The fiduciary has a responsibility to the decedent's estate. Primarily, the fiduciary has the responsibility to follow the guidelines of the will and handle the assets of the estate for the best interests of the beneficiaries. Consequently, it is important for the fiduciary to have a basic understanding of various issues that arise when a taxpayer dies.

The fiduciary completes a Form 56, *Notice Concerning Fiduciary Relationship*, and submits it to the IRS. This informs the IRS who to contact regarding income taxes and estate taxes for the decedent and the estate. When the fiduciary's work is completed, he files another Form 56 to revoke the position.

FEDERAL TAX FORMS

The tax practitioner must know which tax returns are due for the decedent. The following forms may be required.

FINAL FORM 1040 — *U.S. INDIVIDUAL INCOME TAX RETURN*

A taxpayer's year ends upon his death. The income and expenses to report on the taxpayer's final tax return are determined using the taxpayer's accounting method. If the accounting method is cash, all income received and expenses paid up to the date of death are reported on the final return. If the accounting method is accrual, all income earned and expenses incurred up to the date of death are reported on the final return. Income and expenses for periods after the date of death are reported by either the decedent's estate or beneficiary.

A Form 1040 is normally due by the 15th day of the 4th month after the last day of the year (April 15 for a calendar-year individual). Although a decedent's tax year ends on the date of death, the IRS has set the due date of the final return to be the same as if the taxpayer lived the entire year. Thus, a calendar-year-basis decedent's final return is due by April 15 of the following calendar year.

A decedent who was married as of the date of death is married on the final return. The decedent's final return can use the normal filing statuses available for married taxpayers, typically married filing separately (MFS), married filing jointly (MFJ), or head of household (HOH) if qualifying conditions are met.

In order for the decedent to use the MFJ filing status, the decedent's spouse must not have remarried prior to the end of the year. If the spouse remarried by the end of the year, the decedent's only filing status option is MFS, and the spouse files MFJ or MFS with the spouse's new spouse.

Example 1. Dan is married to Mindy on August 2, the date of Dan's death. Dan's fiduciary can file MFJ with Mindy, or MFS alone.

Example 2. Dan is married to Mindy on August 2, the date of Dan's death. Mindy marries Homer on December 15. Dan's fiduciary can only file MFS. Mindy files either MFS, or MFJ with Homer.

The representative of the decedent's estate determines the filing status for the decedent's returns.

The final return includes income and expenses reportable by the decedent based on the decedent's accounting method. It also includes medical bills paid within one year of the decedent's death if the representative waives the right to claim the medical bills on Form 706, *U.S. Estate (and Generation-Skipping Transfer) Tax Return.*

Note. Information about Form 706 is covered later in this section.

FORM 1041 — *U.S. INCOME TAX RETURN FOR ESTATES AND TRUSTS*

While individuals use Form 1040 to report income and expenses, estates and trusts use Form 1041. This form shows all income and expenses received or incurred by the estate from the date of death through the end of the estate's tax year.

An estate can elect the calendar year-end for its income tax year. Alternatively, **an estate can use the last day of any month to close its tax year.** While an estate may have a first tax year of less than 12 months, it may never be longer than 12 months. Filing the first return or extension allows for the election of the tax year. The due date for the estate's Form 1041 income tax return is the 15th day of the 4th month after the month the tax year ends.

Example 3. Wally dies October 3, 2007. The estate can choose a tax year that ends on the last day of any month prior to October 2008. Therefore, the last date to close the first year is September 30, 2008.

An estate's final income tax return ends on the date the estate is settled, and it no longer has assets other than funds necessary to cover any unexpected expenses. The final estate return does not have to end on the last day of a month. The due date for the estate's final income tax return is the 15th day of the 4th month after the month that contains the final date of the estate's year. Settlement of the estate within a short time span allows the estate to file only one Form 1041. The return would be marked both "Initial Return" and "Final Return."

Example 4. Lucy died on May 12, 2007. The estate is settled and all assets distributed by November 23, 2007. The representative does not elect a tax year that ends between May 13, 2007, and November 23, 2007, but chooses to file a first and final return for the year from May 12, 2007, to November 23, 2007. This income tax return is due March 15, 2008 (15th day after the 4th month after November 2007).

The Form 1041 includes all income and expenses reportable by the estate. It also includes a deduction for administration expenses if the representative waives the right to claim the expenses on Form 706.

The Estate as a Pass-Through Entity

Estates have a special tax provision regarding who pays tax on the estate income. The net income of the estate is taxable to the beneficiaries to the extent the beneficiaries received assets from the estate. Calculation of estate net income is different from calculations for individuals, although there are similarities. Beneficiaries receive Form 1041, Schedule K-1 from the estate reporting their share of the income.

The income identified on the Schedules K-1 is reportable by the beneficiaries on their income tax return that includes the ending date of the estate's tax year shown on the Schedules K-1. For example, if the estate's tax year ends on March 31, 2007, the beneficiaries report the Schedule K-1 income on their tax return that includes March 31, 2007. This is their 2007 calendar income tax return if they are calendar-year taxpayers.

Estates are entitled to an income distribution deduction (IDD) for distributions made to the beneficiaries. Any net income of the estate that is not distributed to the beneficiaries and reported on the Schedules K-1 is taxable to the estate. The estate has income tax brackets similar to individuals, except an estate does not have a 10% tax bracket. However, the income level of the brackets is considerably lower than an individual, which means the estate pays much higher tax on the same income. An estate reaches the 35% tax bracket once its taxable income exceeds $10,450. Because the beneficiaries' tax rates are often lower, it saves income taxes for the estate to make distributions to the beneficiaries.

As mentioned above, distributions from an estate or trust determine the IDD and the amounts passed through to the beneficiaries on Schedules K-1. When there are insufficient distributions during the year to pass through all the estate's income, the estate pays tax on the remaining income. **The estate can elect to treat distributions made within the first 65 days of the new year as if they happened in the prior year.** This is known as the "65-day Rule." To make this election, the estate checks box 6 on page 2, Form 1041 (2007 version) pertaining to an election under IRC §663(b).

Example 5. Garfield died February 12, 2007. His estate elects to use the calendar year for its tax year. The estate's Form 1041 shows taxable income of $10,000 for the year. The estate did not incur any capital gains or losses during the year. The beneficiaries received $150,000 of assets from the estate during the year. Therefore, the beneficiaries report the entire $10,000 of net income on their respective Schedules K-1.

Example 6. Arlene died June 15, 2007. Her estate elects to use a tax year ending May 31, 2008. The estate's Form 1041 shows taxable income of $8,000 for the year. The estate did not incur any capital gains or losses during the year. The beneficiaries received $3,000 of assets from the estate during the tax year. Therefore, the beneficiaries' Schedules K-1 show the $3,000, and the estate pays tax on the remaining $5,000.

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Losses

When calculating net income available to distribute to the beneficiaries, all capital losses are added back. These capital losses remain at the estate level until the estate's final year. In the estate's final year, the estate passes through any unused capital losses on the beneficiaries' Schedules K-1, box 11, as long- or short-term capital losses depending on their status.

An estate that has a net loss from the year's activity may carry a net operating loss (NOL) backwards or forward. The calculation of an NOL is similar to the calculation for an individual's NOL. Any part of the net loss that is not part of an NOL is lost, except in the estate's final tax year. If there is an NOL in the estate's final year, and it is not utilized in that year, the unused NOL passes to the beneficiaries on their Schedules K-1 in box 11 as an unused NOL. Final year losses, other than NOLs and capital losses, pass to the beneficiaries on their Schedules K-1 in box 11 as excess deductions on termination.

FORM 709 — *UNITED STATES GIFT (AND GENERATION-SKIPPING TRANSFER) TAX RETURN*

There are many taxes imposed on taxpayers. The tax on income is just one. There is also a tax on the right to transfer assets to another taxpayer. This tax is a transfer tax.

Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return,* is used to report taxable gifts. The due date for filing Form 709 is the same as the due date of the individual's personal income tax return. For a calendar-year individual, this is April 15 of the year following the year of the taxable gift, plus extensions.

Decedents only file Form 709 if they made taxable gifts between January 1 and the date of death. Form 709 includes all taxable gifts made during the year, and calculates the gift tax, if applicable. Information from previously filed Forms 709 is important for current year Form 709 and Form 706.

Taxpayers may need to report taxable gifts to anyone other than a spouse, a charity, and certain educational and medical gifts. Taxpayers must report a gift of a future interest[1] and present interest gifts of over $12,000 made in 2007.

> **Example 7.** Nick gives his daughter Nycole a 15% interest in a rental property he owns. The gift has a value of $15,000. However, Nycole does not receive any rental payments from the property until Nick dies. Therefore, this is a future interest, and is not eligible for the annual exclusion. The gift tax return is required.

> **Example 8.** Nick, in **Example 7,** gives his son Edwin his prize Model A Ford, valued at $15,000. Because Edwin receives title and full ownership of the car, and the value of the gift is over $12,000, Nick must report the gift on Form 709.

Each individual has a federal lifetime gift tax exemption of $1 million. An individual does not pay federal gift tax until the taxable gifts made by the individual exceed $1 million. **Taxable gifts are any gifts of a present interest to the extent they exceed $12,000, plus all gifts of a future interest.**

> **Example 9.** Nick, in **Example 7** and **Example 8,** must report the two gifts made in 2007. The amount of the taxable gift to Edwin is $3,000 ($15,000 – $12,000). The entire $15,000 gift amount to Nycole is a taxable gift. Therefore, Nick has utilized $18,000 of his lifetime gift tax exemption.

Taxpayers also report taxable gifts made in a prior year on the current year's gift tax return. The $1 million lifetime exemption is applicable to cumulative gifts. All taxable gifts in excess of the $1 million lifetime exemption require payment of gift tax. There are many tax rate brackets as the total cumulative taxable gifts increase. The rate applicable at $1 million is 41%.

Taxpayers should keep gift tax return information and the completed gift tax returns permanently. They should also keep all records showing the costs and valuations of the items reported on the gift tax return. The information on the gift tax returns is necessary to determine the requirement to file an estate tax return when the taxpayer dies, and the calculation of the estate tax, if applicable.

The recipient's basis in property received as a gift is often the taxpayer's adjusted basis. The taxpayer's holding period and prior depreciation, if any, also carry over to the recipient. If the property has an FMV lower than the taxpayer's adjusted basis, the recipient uses the FMV as the new basis for purposes of calculating depreciation and any loss upon the asset's disposition. If the taxpayer has to pay a gift tax on the gift, the recipient's basis is the taxpayer's adjusted basis **plus** the amount of gift tax paid that relates to the **appreciation** on the property.

> **Example 10.** Victoria has an adjusted basis of $10,000 in property. She gives it to Rita. At the time of the gift, the property was worth $15,000. Victoria paid $900 of gift tax on the transfer. Rita's basis in the property is Victoria's adjusted basis of $10,000 plus $300 of gift tax (($5,000 of appreciation ÷ $15,000 FMV) × $900 gift tax paid) for a total of $10,300.

Ideally, every time a taxpayer makes a gift, the taxpayer should also give the recipient verification of the taxpayer's cost and prior depreciation. The recipient will need these for future income tax reporting if the recipient places the gifted property into business usage or sells it. This documentation should include copies of purchase papers, receipts showing improvements made to the property, and depreciation schedules showing the amount claimed.

FORM 706 — *UNITED STATES ESTATE (AND GENERATION-SKIPPING TRANSFER) TAX RETURN*

Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return,* includes the assets and liabilities of the decedent's estate as of the date of death, as well as administration expenses. It calculates the estate tax due, if any. The estate can waive the right to claim medical expenses and administration expenses.

1. This means there is a right to property, but the recipient does not have total control until some time in the future.

When a taxpayer dies, the net value of his estate determines the amount of estate tax. Briefly, the net value calculation is:

- The FMV of all property the decedent owned, or had control over, **plus**
- All taxable gifts made since 1976 (plus some gifts after September 8, 1976), **less**
- The decedent's debts, **less**
- Bequests to charities and the decedent's spouse, **less**
- Administration expenses incurred to settle the estate.

Because all taxable gifts made since 1976 are required in order to calculate the net value of the estate, it is necessary for taxpayers to keep all Forms 709.

When this gross estate exceeds $2 million for deaths occurring in 2007, a Form 706 must be filed and an estate tax paid. At the $2 million level, the estate tax rate is currently 45%.

The estate tax return includes a deduction for the expenses incurred during the estate's administration. The representative can waive the right to claim these expenses in favor of deducting them on the estate income tax return. This waiver is normally beneficial when the estate does not have an estate tax. Common expenses that fall into this area are attorney fees, accounting and tax return preparation fees, representative fees, and probate costs. A listing of the description and amounts should be made part of the election. Below is sample wording for this election.

> Taxpayer hereby elects under IRC §642(g) and Treasury Regulation §1.642(g)-1 to deduct the following expenses on Form 1041 for the year ending _______. Such expenses have not been claimed under IRC §§2053 & 2054 on Form 706, and the taxpayer hereby waives the right to deduct the expenses at any time for estate tax purposes under IRC §§2053 & 2054.
>
> Description ______________________ Amount ____________

Form 706 may also include a deduction for medical bills the taxpayer owed at the time of death. The representative can waive the right to claim these medical bills in favor of claiming them on the decedent's final Form 1040. **Only medical expenses paid within one year of the date of death qualify for inclusion on the final Form 1040.** Therefore, the estate only waives these expenses if there is no estate tax, and then only waives expenses paid within one year of the date of death.

Form 706 is the only place to claim funeral-related expenses. Funeral expenses are **not** deductible on either Form 1040 or Form 1041.

Although all assets the decedent owned or had control over are included on the estate tax return, not all assets are part of the estate for distribution purposes. This includes any assets with a listed beneficiary, such as life insurance policies, or a pay on death (POD) or transfer on death (TOD). The asset-holding institution transfers any such assets directly to such beneficiary.

The representative is responsible for finding all assets, paying all bills, and distributing the remainder of the decedent's assets according to the decedent's will. In the case of a decedent who does not have a will, state law dictates who receives the assets. The representative should take care when performing these functions because unpaid bills may become a personal liability. For example, if taxes are due by the decedent and the estate distributed all assets, the IRS can go after the representative for the amount due. The representative can ask the beneficiaries to return assets in order to pay these taxes, but depletion of value may make this pointless. In the case where all assets had a listed beneficiary, the IRS can assess the beneficiaries for the unpaid taxes to the extent of the assets received.

The representative should also give all beneficiaries information showing the FMV of the properties received. The beneficiaries need this information for purposes of claiming depreciation, as well as the gain or loss from the future sale of the asset. Copies of appraisals are very important. Copies of the applicable parts of the estate tax return are also useful. If the beneficiary is receiving income in respect of decedent (IRD) property, the representative should give the beneficiary a statement showing the calculation of the estate tax deduction related to the IRD. A complete copy of the Form 706 may be useful to help substantiate the calculation.

Note. IRD is defined in the next section.

The estate tax return calculates the estate tax due by the decedent's estate. This is a tax on the right to transfer property. The net estate valuation, which is the FMV of the estate's assets less various expenses and bequests, determines the tax amount. IRD items are part of this net estate valuation. IRC §691(c) permits beneficiaries to claim a deduction for the estate taxes paid in connection with IRD items. To the extent a beneficiary has taxable IRD, the beneficiary also has an estate tax deduction.

Calculating the difference between the estate tax assessed on the entire estate and the estate tax assessed on the entire estate as if it did not include the IRD items reveals the total estate tax related to IRD. These calculations are made after all deductions and credits.

Example 11. The net value of Albert's estate is $3 million. This amount includes $250,000 of IRD items. The net estate tax on the $3 million of net valuation is $400,000 after all deductions and credits. Recalculating Albert's net estate tax on $2,750,000 ($3 million – $250,000 of IRD) results in a net estate tax of $300,000.

Based on these amounts, the difference of $100,000 ($400,000 – $300,000) is the amount of the estate tax related to the $250,000 IRD. This $100,000 of estate tax deduction is allocated pro rata to the $250,000 of IRD.

If one beneficiary reports $25,000 of IRD as income, the beneficiary also has a $10,000 estate tax deduction (($25,000 ÷ $250,000) × $100,000) reported on his Form 1040, Schedule A, miscellaneous itemized deductions not subject to 2%. The executor of Albert's estate should provide each beneficiary with the necessary information regarding the IRD they receive. This can be used as verification to support the deduction for the IRD items on the estate return.

INCOME IN RESPECT OF A DECEDENT (IRD)

IRD is defined as "those amounts to which a decedent was entitled as gross income but which were not properly includable in computing his taxable income for the tax year ending with the date of his death."[2] These items would have been included on the decedent's final tax return were he an accrual-method taxpayer, but are not because the decedent is a cash-method taxpayer. Stocks that have gone up in value are not IRD. Wages earned but not paid are IRD.

Common items that fall into the IRD classification include:

- Wages, vacation pay, and other compensation;
- Self-employment income, if the taxpayer's accounting method does not treat the income as received/earned prior to death;
- Installment sales reported on the installment method;
- Nonmaterial participation crop or livestock share lease;
- Interest income earned on U.S. savings bonds such as Series E, EE, and I; and
- Retirement plan monies, including employer plans and IRAs (both traditional and Roth).

2. Treas. Reg. §1.691(a)-2(a)(1)

The recipient (estate or beneficiary) of IRD items reports the income in the same manner and same location as the decedent would have if he was still living and had received the items directly. IRD items are usually fully taxable. However, IRAs and installment sales proceeds are two IRD items that are often only partially taxable. The character of IRD items is the same to the taxpayer receiving the IRD as it was in the hands of the decedent. However, **receipts that would have been self-employment income to the deceased are not self-employment income when received as IRD.**

Example 12. Before his death, John made $10,000 of **nondeductible** contributions to a traditional IRA. There were no distributions. After his death, John's estate withdrew half of the IRA, when it was worth $100,000.

The estate has a basis of $5,000 (($10,000 ÷ $100,000) × $50,000). Therefore, it reports $45,000 of income ($50,000 – $5,000) on Form 8606, *Nondeductible IRAs and Coverdell ESAs*. A year later the estate withdraws another $10,000 of the IRA, when it is worth $40,000 (lost value). The estate's basis is $1,250 (($5,000 ÷ $40,000) × $10,000). The estate reports $8,750 of income ($10,000 – $1,250).

Example 13. Karen sold land used in a business on installment last year, and used the installment method of reporting the gain on Form 4797, *Sale of Business Property*, Part I. The gross profit ratio is 70%. After Karen's death, her estate distributed the installment contract to Ben, her beneficiary. Ben received $20,000 in principal payments from the installment contract. He files Form 6252, *Installment Sale Income*, with his Form 1040, and includes $14,000 ($20,000 × 70%) of income. Because the sold property has the same character to the decedent, the taxable gain carries over from Form 6252 to Form 4797, Part I.

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Example 14. Mitchell was self-employed and used the cash method of accounting. Prior to his death, he performed services worth $3,000. Mitchell died shortly after billing his customer. The estate received the paid invoice. This $3,000 is IRD and is taxable to the estate, although it is not subject to SE taxes.

WAGES, SALARIES, VACATION PAY, AND OTHER COMPENSATION

Wages, salaries, vacation pay, and other compensation owed to a decedent have special rules for reporting by the employer. For simplification purposes, "wages" refers to all compensation items.

Frequently, an employer does not report the decedent's wages correctly. If this occurs, the decedent's representative should contact the employer and ask for a correction.

Wages paid after the decedent's death are reported to the recipient (estate or beneficiary) on Form 1099-MISC, *Miscellaneous Income,* in box 3 as "Other Income." Form 1099-MISC should include the name, and EIN of the estate or beneficiary, **not** the decedent's social security number.

Social security and Medicare (FICA) withholding confuse many employers. Wages paid in the year of the decedent's death are subject to FICA tax withholding. Boxes 3 and 5 of Form W-2 report the decedent's social security wages (up to the year's maximum) and Medicare wages, respectively. Boxes 4 and 6 report FICA withholding. No other sections of Form W-2 report these wages.

Wages paid in a year after the decedent's death are not subject to FICA withholding. There is no reporting other than the Form 1099-MISC, box 3, as mentioned previously.

Example 15. Gracie **received wages of $50,000** prior to her death on August 3, 2007. As of her date of death, she was due **$5,000 of unpaid wages.** Her estate receives the unpaid wages on August 15, 2007.

To report her wages correctly, her employer completes a Form W-2 for Gracie showing $50,000 in boxes 1 and 16, $55,000 in boxes 3 and 5, and $3,410 (social security tax) and $798 (Medicare tax) in boxes 4 and 6, respectively. The employer also completes a Form 1099-MISC showing $5,000 in box 3.

For Example 15

Form W-2 Wage and Tax Statement 2007

OMB No. 1545-0008 · Safe, accurate, FAST! Use IRS e-file · Visit the IRS website at www.irs.gov/efile.

- a Employee's social security number: 333-33-3333
- b Employer identification number (EIN): 11-1111111
- c Employer's name, address, and ZIP code: EMPLOYER, MAIN STREET, CITY, ST 11111
- d Control number:
- e Employee's first name and initial: GRACIE; Last name: DECEDENT; Suff.:
- f Employee's address and ZIP code:
- 1 Wages, tips, other compensation: 50000.00
- 2 Federal income tax withheld:
- 3 Social security wages: 55000.00
- 4 Social security tax withheld: 3410.00
- 5 Medicare wages and tips: 55000.00
- 6 Medicare tax withheld: 797.50
- 7 Social security tips:
- 8 Allocated tips:
- 9 Advance EIC payment:
- 10 Dependent care benefits:
- 11 Nonqualified plans:
- 12a See instructions for box 12:
- 12b:
- 12c:
- 12d:
- 13 Statutory employee / Retirement plan / Third-party sick pay:
- 14 Other:

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
ST		50000.00				

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

☐ CORRECTED (if checked)

Form 1099-MISC 2007 Miscellaneous Income · OMB No. 1545-0115

Copy B For Recipient

- PAYER'S name, street address, city, state, ZIP code, and telephone no.: EMPLOYER, MAIN ST, CITY, ST 11111
- PAYER'S federal identification number: 11-1111111
- RECIPIENT'S identification number: 22-2222222
- RECIPIENT'S name: ESTATE OF GRACIE DECEDENT
- Street address (including apt. no.):
- City, state, and ZIP code:
- Account number (see instructions):
- 1 Rents: $
- 2 Royalties: $
- 3 Other income: $ 5000.00
- 4 Federal income tax withheld: $
- 5 Fishing boat proceeds: $
- 6 Medical and health care payments: $
- 7 Nonemployee compensation: $
- 8 Substitute payments in lieu of dividends or interest: $
- 9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ▶ ☐
- 10 Crop insurance proceeds: $
- 11
- 12
- 13 Excess golden parachute payments: $
- 14 Gross proceeds paid to an attorney: $
- 15a Section 409A deferrals: $
- 15b Section 409A income: $
- 16 State tax withheld: $ / $
- 17 State/Payer's state no.:
- 18 State income: $ / $

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form 1099-MISC (keep for your records) Department of the Treasury - Internal Revenue Service

Example 16. Barney was an employee who received wages of $75,000 prior to his death on December 23, 2006. Barney was due $2,000 of unpaid wages as of his date of death. His estate receives this $2,000 on January 15, 2007. Because payment occurs in a year after the year of Barney's death, it is not subject to FICA withholding and is not reportable on a Form W-2. The employer should complete a Form 1099-MISC showing $2,000 in box 3. This is the employer's only reporting.

ROTH IRAs

Roth IRAs are unique in their taxability to both the original owner and the individual who inherits the Roth. Normally, the code excludes Roth IRA distributions from gross income after the owner reaches age 59½. However, they may not take distributions less than five years after the first contribution made to the Roth IRA.[3] The exception to the age 59½ rule applies to distributions because of:

1. Death
2. Disability
3. First-time home buyer, subject to the $10,000 limitation[4]

Example 17. For tax years 1998 through 2006, Angela contributed a total of $20,000 to a Roth IRA and did not take any distributions. Upon her death, her daughter, Margaret, inherited the IRA. Margaret withdrew the Roth IRA when it was worth $45,000. Since the Roth IRA started in tax year 1998, it met the first condition of being in existence for more than five tax years. Because Angela's death caused the Roth IRA to be distributed, the distribution met one of the second conditions. The entire $45,000 is nontaxable to Margaret.

The five tax years are determined by starting January 1 of the first year the Roth IRA contribution was made, and ending with the year of distribution. The decedent is not required to have contributed for five separate tax years. It is only required that more than five tax years have passed. The decedent's Roth IRA holding time includes the time following the decedent's death in order to determine if more than five tax years have passed since the initial contribution.

Note. A beneficiary may want to leave funds in the Roth IRA until the "more than five tax years" condition is met.

Example 18. For tax years 2005 and 2006, Louise contributed $8,000 to a Roth IRA and did not take any distributions. Jenny, her beneficiary, withdrew the Roth IRA in 2007 when it was worth $10,000. Although the distribution took place because of Louise's death, the Roth IRA did not exist for more than five tax years. Therefore, the normal distribution rules apply and Jenny must report $2,000 of income ($10,000 less Louise's basis of $8,000). If Jenny waits until 2010 to withdraw the Roth IRA, the entire amount is nontaxable since more than five tax years will have passed, in addition to the death of the owner.

U.S. SAVINGS BONDS

When cashed, interest on U.S. savings bonds is taxed as ordinary interest income. There is an option under IRC §454 for a taxpayer to report the interest from Series E, EE, and I bonds each year instead of waiting until the bonds are cashed. This election makes all accrued interest from prior years as well as the year of the election taxable in the year of the election. If a taxpayer dies without this election, the representative of the taxpayer's estate can make the election on behalf of the decedent. When the decedent's income is low in the year of death, this election may be valuable and reduce overall tax. By making this election, the estate or beneficiaries only report the remaining interest earned after the decedent's date of death. This election applies to all interest from U.S. savings bonds, including any interest deferred into Series H and HH bonds. Without the §454 election, all interest earned from the bonds' purchase date is taxable when they are cashed.

3. IRC §408A
4. IRC §408A(d)(5)

Note. This election normally saves tax dollars if the decedent's income for the year of death is in a tax bracket lower than the taxpayer who eventually cashes in the bonds. This also applies if the decedent has income and large deductible medical expenses. Typically, the earlier the decedent dies within the year, the more likely the election will save money.

Example 19. Annabell, a single individual, owns $10,000 of U.S. Series EE savings bonds on the date of her death in early April. The interest earned by these bonds is $3,000. Annabell did not previously make the §454 election, and only reported the interest when the bonds were cashed. She had only $4,000 of income in the year of death (not including the interest from these bonds). If the §454 election is made by the estate's representative, Annabell's income for the year of death is $7,000 ($4,000 + $3,000 interest income). After subtracting the standard deduction and personal exemption, her taxable income and income tax are $0. Because of the election, the party that cashes the bonds only has income to the extent the interest income exceeds the $3,000 reported on Annabell's return.

INTEREST AND DIVIDENDS

Amounts paid over the course of the entire year, such as interest and dividends, are often misreported by the payors. This adds some complexity to the income tax returns for the decedent and the estate, or beneficiaries. The decedent's fiduciary should notify financial institutions of the decedent's death as soon as possible. The fiduciary should provide them with the name of the estate and its taxpayer identification number (TIN). Institutions with accounts going to a beneficiary need the beneficiary's name and social security number (SSN). The institution should report the interest, dividends, and other transactions up to the date of death on the decedent's Form 1099. The estate's Form 1099 reports transactions after the date of death, but before distribution of the assets. The beneficiary's Form 1099 reports transactions after distribution of the assets to the beneficiary.

Frequently, the financial institution fails to get notice of the decedent's death, and therefore issues Form 1099 for the entire year in the decedent's name and SSN. In these cases, the institution should be:

- Advised of the date of death,
- Given the proper names and ID numbers of the new owners (estate or beneficiary), and
- Requested to issue new Forms 1099 for each proper owner.

If the institution does not issue new Forms 1099, the decedent's fiduciary reports the amounts shown on the Forms 1099 for the decedent. The incorrect amount is subtracted out as nominee income (income received for another taxpayer). The decedent's fiduciary must issue Forms 1099 to the true owner of the funds (estate or beneficiary) according to the Form 1099 instructions.

Example 20. John died during 2006. First Bank reported $2,500 of interest income for 2006 on a Form 1099-INT to John. He had earned $1,500 of interest income from a savings account before his death. The savings account also earned $1,000 of interest income after John's death. First Bank did not prepare corrected forms. His Schedule B follows. John's representative must issue a Form 1099-INT from John to the new owner of the account (estate or beneficiary).

For Example 20

Schedules A&B (Form 1040) 2007 OMB No. 1545-0074 Page **2**

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side.	Your social security number
John Decedent	333 : 33 : 3333

Schedule B—Interest and Ordinary Dividends Attachment Sequence No. **08**

Part I Interest

(See page B-1 and the instructions for Form 1040, line 8a.)

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

			Line	Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶			
	First Bank			2,500
			1	
	Interest subtotal	2,500		(1,000)
	Nominee Distribution	(1,000)		
	to Estate of John Decedent			
	EIN 37-6800000			
2	Add the amounts on line 1		2	1,500
3	Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815		3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶		4	1,500

Note. If line 4 is over $1,500, you must complete Part III. **Amount**

INSTALLMENT SALES

The uncollected proceeds of an installment sale, held by the decedent at the time of his death, are included in the estate of the decedent. The difference between the value of the installment obligation and its basis is a part of IRD.[5] The estate or beneficiary who receives payments on the installment sale must report in income the same amount that would have been reported by the decedent.

Example 21. Marissa sold her rental property using the installment sale method. At the time of her death, the buyer still owed 15 annual payments of $10,000. Marissa had a basis in the property that created a gross profit percentage of 70%. Therefore, for each $10,000 payment, Marissa paid tax on a gain of $7,000.

Robert inherited the installment obligation from Marissa. He will continue to report $7,000 of income from each $10,000 payment received.

An installment obligation transferred to the obligor by bequest, devise, or inheritance requires the estate to recognize the entire difference between the face value of the obligation and its basis in income at the time of transfer.[6]

Example 22. Assume that in **Example 21,** Robert was the purchaser of the rental property. At the time the installment obligation is transferred to Robert, the entire taxable gain on the obligation becomes taxable to the estate. In this case, the estate recognizes $105,000 ((15 × $10,000) × 70%) of gain at the time of transfer.

If the decedent and the obligor/recipient of the obligation are related, the FMV of the obligation cannot be less than the face amount. Related parties are defined in §453(f)(1).

5. Treas. Reg. §1.691(a)-5(a)

6. IRC §691(a)(5)

PASS-THROUGH ENTITIES

A pass-through entity, such as an S corporation or partnership, passes the prorated share of the entity's income to each owner (the decedent and estate). The proration is a simple ownership per day proration. Four steps are followed to arrive at the year's income.

1. Income for the year is divided by the number of days in the year (365 in most years) to arrive at income per day.
2. Income per day is divided by outstanding ownership units (shares, partnership interests, etc.) for that day to arrive at an ownership per day amount.
3. The ownership per day amount is multiplied by the ownership units each taxpayer held on that particular day to arrive at the taxpayer's share of that day's income.
4. The ownership per day amounts are multiplied by the days each owner owned the units. The total for the decedent's ownership days produces the decedent's share of the income to be reported on the decedent's Schedule K-1. Adding all the particular day results together for the days in the estate's ownership period produces the income for the estate's Schedule K-1. If the ownership units were distributed from the estate to a beneficiary during the year, the income to show on the beneficiary's Schedule K-1 is calculated in the same manner.

If the number of outstanding ownership units for the entire year is constant, the decedent's units can be divided into the total outstanding units to arrive at the decedent's ownership percentage. This percentage multiplied by the pass-through entity's profits/losses for the year results in the total income to report among the Schedules K-1 for the decedent, estate, and beneficiaries. Prorating this amount by the number of days in the year each entity owned the units produces the amounts reported on the individual Schedules K-1. Normally, this calculation is performed by the pass-through entity. However, if it is improperly reported, the entity should be notified and asked to correct the amounts. If the entity refuses to do so, the amounts must be adjusted on the separate owners' tax returns. A Form 8082, *Notice of Inconsistent Treatment or Amended Return*, should be filed with each separate owner's tax return explaining the discrepancy.

The fiduciary reports the decedent's K-1 income on the decedent's final Form 1040. The estate or successor reports K-1 information on Form 1041 of the estate, or the return of the successor.[7] To the extent any part of a distributive share of partnership income of the estate or successor in interest is attributable to the decedent, the income is IRD.[8]

Example 23. Zoe died April 3 owning 30% of an S corporation. The estate received ownership to the stock, and distributed the stock to the ultimate beneficiary on October 9. The ownership percentage did not change for the entire year. The S corporation's income for the year was $100,000. This results in $30,000 of income to prorate among the various owners. There are 93 days from January 1 through April 3 (except in leap years), so Zoe's Schedule K-1 reflects $7,644 (($30,000 ÷ 365) × 93). The estate's Schedule K-1 reflects $15,616 (($30,000 ÷ 365) × 190). The beneficiary's Schedule K-1 reflects $6,740 (($30,000 ÷ 365) × 82).

SPECIAL ITEMS

Some items are worthy of special mention.

Incomplete sales can result in IRD. If a sale progressed to a point beyond the control of the decedent without money being collected, it is included in IRD.

Example 24. Dan, a sole proprietor auto dealer, just negotiated a binding contract with the State of Illinois for 50 dump trucks that will result in a $250,000 profit. The trucks were part of Dan's inventory for 18 months. Payment and delivery will be on July 1, 2007. Unfortunately, Dan dies in an auto accident on June 30, 2007, after attending a party to celebrate the sale. The profit must be included in IRD.

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7. Treas. Reg. §1.706-1(c)(3)(ii)
8. Treas. Reg. §1.706-1(c)(3)(v)

If the sale is subject to outstanding conditions, or requires substantial economic activity on the part of the estate in order to consummate the sale, the proceeds are not IRD.

> **Example 25.** Assume the same facts as **Example 24,** but the trucks require a special bed. The estate must purchase and install the beds before delivery can take place. The sale is not IRD, and the trucks receive a step-up in basis to their FMV on the date of Dan's death.

Livestock and crops raised by a cash basis decedent**,** whether harvested or unharvested, are considered property of the estate, and are not IRD if they are not sold or pledged before the decedent's death.[9]

> **Observation.** Unharvested crops should be appraised separately from the land in order to receive a stepped-up basis.

Crop shares are different from personally-owned crops. A taxpayer receives crop shares as rent income for use of the decedent's property. Any amount of crops or livestock received as rent or due as rent for the period prior to the decedent's death is considered IRD when sold. Crop and livestock shares are only IRD if they are from a "non-materially participating" lease. Amounts received for the rest of the year are ordinary rental income, but are not IRD.[10]

Insurance commissions paid to the decedent's spouse are taxable as ordinary income, but are not subject to SE tax.[11] Frequently, these amounts are incorrectly reported to the spouse on a Form 1099-MISC in box 7. They are correctly reported in box 3.

MSAs and HSAs lose their character when the decedent dies. If listed as the beneficiary, the spouse becomes the owner of the decedent's MSA and HSA accounts. If the estate is the receiver of the funds, the FMV of the funds on the decedent's date of the death is reportable as other income on the decedent's final return. If anyone other than the spouse and estate is the beneficiary, the beneficiary reports the FMV of the funds on the date of the decedent's death as income.[12]

Life insurance proceeds paid to a beneficiary are not taxable for income tax purposes if the decedent owned the policy.[13] This includes policies owned by the decedent's employers. Interest earned between the time of death and the date the policy proceeds are distributed is taxable income to the beneficiaries.

DEDUCTIONS IN RESPECT OF A DECEDENT

Similar to IRD, a decedent's estate can have deductions in respect of a decedent (DRD). These are deductible expenses not taken by the decedent. They include, but are not limited to:

- Real estate taxes,
- Qualified mortgage interest expense, and
- Expenses relating to the decedent's business or rental activities.

As these expenses are paid, they are deductible by the payer. Payment of these expenses during the decedent's lifetime would reduce the amount of cash in the estate.

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9. Rev. Rul. 58-436, 1958-2 CB 366
10. Rev. Rul. 64-289, 1964-2 CB 173
11. Treas. Reg. §1.691(a)-2(b), Example 2
12. IRC §220(f)(8)
13. IRC §101(a)(1)

DRD does not include:

- Medical expenses,
- Alimony,
- Capital and net operating losses, and
- Charitable contributions.

> **Note.** Although IRD items retain their character,[14] there does not appear to be a code section addressing the character of DRD items. However, it is reasonable to expect they also retain their character.

SUSPENDED PASSIVE LOSSES

Transferring property that has a suspended passive loss at death incurs special treatment. The loss is limited to the amount in excess of the property's basis in the estate minus the property's basis in the hands of the decedent.[15]

> **Example 26.** Erick dies owning an interest in a passive activity with a suspended loss of $28,000. After his death, the beneficiaries' step up in basis for the interest (which is equal to FMV) is $24,000 greater than Erick's basis. This creates a $4,000 suspended loss that is deductible on Erick's final return.

INHERITED PROPERTY

> **Note.** Cash and other property of the decedent received by the beneficiary are not included in the gross income of the beneficiary. The exception is for IRD received.

Normally, when a taxpayer dies, the assets of the deceased receive a new basis. The new basis is the FMV on the date of the decedent's death.[16] Commonly called a step-up in basis, this new basis can be higher or lower than the decedent's adjusted basis. If a Form 706 is to be filed, the estate's representative may elect to use the FMV on the alternate valuation date, which is six months after the date of death.[17] However, a higher valuation cannot result from the use of that date. Certain types of property, such as farmland, can be valued using special rules.[18]

Items that receive this new basis include, but are not limited to, real estate, stocks (including solely held corporations), bonds (other than U.S. savings bonds), personal property, and partnership interests. A decedent's unsold inventory also receives a new basis equal to its FMV.

VALUATION

The normal definition of FMV is what a willing buyer would pay a willing seller in an arm's length transaction. However, this is not the case for an estate. For estate valuation purposes, FMV of items commonly sold at retail is the retail value of the item, not what it would cost in a wholesale purchase.[19] While this value is very advantageous for income tax purposes, it increases the value of the decedent's estate.

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14. IRC §691(a)(3)
15. IRC §469(g)(2)(A)
16. IRC §1014
17. IRC §2032
18. IRC §2032A
19. Treas. Reg. §20.2031-1(b)

Farmland and real property used in closely-held business interests can be valued using a special method if the executor so elects. IRC §2032A may be used to value farmland if:

1. The decedent was a U.S. citizen or resident at the time of his death, **and**
2. The executor elects to value the farmland using the requirements of §2032A.

To qualify for the special valuation, 50% or more of the gross estate must consist of qualified real property that is:

1. Located in the U.S.,
2. Passed to a qualified heir, and
3. Used for a qualified farm or business purpose by a decedent's family member on the date of death.

In addition, 25% or more of the adjusted value of the gross estate must consist of the adjusted value of real property specified in the election. During the 8-year period ending on the decedent's date of death, there must have been five or more years during which the decedent or a member of his family:

1. Owned the farmland and used it for farming, and
2. Materially participated in the business for which the real property was used.

If the decedent was receiving social security benefits or was disabled at the time of death, the "five out of the last eight year" rule is applied for the continuous periods the decedent used the property rather than from the date of death. If property, which qualifies for the §2032A election is inherited by a surviving spouse, the property retains its eligibility in the estate of the surviving spouse.[20]

If property which is valued under §2032A ceases to be qualified property within 10 years, or after the decedent's date of death and before the death of the qualified heir, any estate tax savings must be recaptured.

For deaths in 2007, the estate value reduction for §2032A property is limited to $940,000.[21]

For farmland, the §2032A computation uses the cash rent value of comparable land minus state and local real estate taxes on the actual comparable land, divided by the annual effective rate of new Federal Land Bank loans. Finding cash rental value of comparable land is sometimes difficult. However, Chapter 16, "Useful Rates and Tables" provides the annual Federal Land Bank rates. Using the required formula, the higher the comparable cash rent, the higher the land is valued.

Decedent's Former Residence

As stated previously, the beneficiary receives a step up in basis equal to the FMV of the decedent's property at the time of death. This FMV is typically what a willing buyer would pay a willing seller.

BASIS

The basis of inherited property is normally equal to the property's FMV on the date of the decedent's death. This is the same value reported on Form 706.

> **Example 27.** Diane died September 12, 2004. Her son Matthew inherited DM Stock worth $100,000 on the date Diane died. Matthew's basis in the DM Stock is $100,000.

A different value can be used only if the estate's total value decreases **and** the estate tax decreases. This value is determined using the value of the assets six months after the date of death. This is called the alternate valuation date. This only applies if there is an estate tax and if the representative makes an election to use such.

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20. IRC §2032A(b)(5)

21. Rev. Proc. 2006-53, 2006-48 IRB 996

Pass-Through Entities

The valuation of the S corporation and partnership includes the IRD for purposes of the Form 706. The estate's basis in the S corporation stock or partnership interest is the FMV as shown on Form 706, less the amount of IRD. The S corporation or partnership reports the IRD amount to the estate.

Example 28. Glyn is a 40% partner in Hill Partnership. Glyn's distributive share of partnership income for the year is $120,000, which is earned ratably over the year at $10,000 per month. Glyn received a $9,000 distribution each month up until his death on July 31. The partnership issues two Schedules K-1 for Glyn's partnership interest. One shows Glyn's name and SSN and reports income of $70,000. The other reports income of $50,000 in the estate's name and TIN.

For estate tax purposes, the appraised value of Glyn's partnership interest is $100,000 that includes the $7,000 of undistributed earnings (($10,000 – $9,000) × 7). The estate's basis in the partnership interest is $100,000.

Other Valuation Issues

Sometimes the tax preparer must determine basis when a federal estate tax return was not required, and without a formal appraisal of the estate assets. In order to determine the basis of inherited assets, it is necessary to make an appraisal. There are no formal rules for this process. However, the IRS looks for justification of the FMVs used to determine depreciation and gain or loss on disposed assets.

Discounts

The estate value of a closely-held business interest is not necessarily the FMV of the underlying assets. If the decedent owns less than 50% of the business, the courts consider this a minority interest. Because the holder of a minority interest is limited in what he can do, a buyer will not pay "full price" for the interest. For example, a minority shareholder cannot elect or remove board members. He can only participate in management to the extent agreed on by the majority shareholders. Therefore, the courts often allow a marketability discount for the decedent's value of the business. However, an estate can claim both a minority and a marketability discount. Facts and circumstances solely determine the amount of the discount.

HOLDING PERIOD

The holding period for inherited property, other than IRD, is the actual period beginning on the date of the decedent's death. However, **inherited property is always considered held a minimum of more than one year.** This holding period applies no matter how long the decedent held the property. Livestock is an exception as they do not receive a more than one year holding period at death.

Example 29. Diane died September 12, 2006. She purchased DM Stock in 2002. Her son Matthew inherited the DM Stock. It was worth $100,000 on the date Diane died. Matthew's basis in the DM Stock is $100,000. Matthew sells the stock on January 16, 2007 for $120,000. Matthew's holding period is just a little over four months, but because the property was inherited, Matthew is considered to have held the property for **more than one year.** He receives long-term capital gains treatment.

Example 30. Louise purchased KH Stock on September 3, 2006, and died on September 12, 2006. Her son Joshua inherited the KH Stock worth $100,000 on the date Diane died. Joshua's basis in the KH Stock is $100,000. He sells the stock on January 16, 2007 for $120,000. Joshua's holding period is just a little over four months, but because the property was inherited, he is considered to have held the property for **more than one year.** Even though Louise only owned the stock nine days, the holding period is still considered more than one year. Joshua receives long-term capital gains treatment.

The holding period of IRD property does not change the treatment of the income. It retains the same character it would have been to the decedent, as discussed earlier. The length of time IRD property is held by the estate or beneficiary does not change its character.

TRUSTS

The decedent may have formed a trust during his lifetime. The type of trust and its terms determines whether the trust is a part of the estate. A brief discussion of trusts follows.

Note. More in-depth information about trusts is found in the 2005 *University of Illinois Federal Tax Workbook.*

DEFINITIONS

Trust. A trust is a separate entity created by a trust document. A grantor can create a trust while alive or under the direction of the grantor's will.

Decedent's Estate. The decedent's estate is an entity created upon his death. It exists until the decedent's assets are distributed to beneficiaries according to the decedent's will, or state law if there is no will.

Trust Document. The trust document creates the trust. It gives details of the creation, operation, and termination of the trust. The fiduciary should have a copy of this document. A tax professional should always obtain a copy of the document due to possible tax consequences.

Will. The will is a document created by the deceased prior to death. It gives directions to the personal representative on how to distribute assets the deceased owned or had control of at the time of death. A tax professional should obtain a copy of the document in order to prepare the income tax return.

Grantor. The grantor is the person who creates a trust and contributes assets to the trust.

Beneficiary. The beneficiary is the person or entity that inherits a portion or all of a decedent's estate. A beneficiary receives benefits from a trust.

Fiduciary. The fiduciary is the person in charge of a trust or estate. In the case of an estate, the person can also be known as an executor, executrix, administrator, administratrix, or personal representative.

Corpus. The corpus of an estate is the amount of property left when an individual dies. The corpus of a trust is the sum of money or property that is set aside to produce income for a named beneficiary.

Fiduciary Responsibility. The fiduciary responsibility is the name given to the responsibility the fiduciary has in regard to the trust or estate. The fiduciary has the responsibility to take and handle the assets of the estate to the best interests of the beneficiaries, within the guidelines of the will or trust document.

Distributable Net Income (DNI). DNI is the amount of the net income of the trust or estate that is available to be distributed. It is typically the adjusted total income before the exemption, adjusted by capital gains and losses. It is calculated on the top half of Form 1041, Schedule B.

Income Distribution Deduction (IDD). IDD is the deduction provided to a trust or estate for making distributions of its income. This is also the amount reported on Form 1041, Schedule K-1, to the beneficiaries. Calculations are made on Form 1041, Schedule B.

TYPES OF TRUSTS

During an individual's lifetime, there are generally two specific types of trusts that can be created. They are a **revocable trust** and an **irrevocable trust.** Tax treatment differs depending on the type of trust created.

Revocable Trusts

In general, a revocable trust is ignored for tax purposes. All income and expenses of the trust are reported by the grantor on his personal tax return. Institutions dealing with the trust assets should be notified of the grantor's social security number. The institutions should report all interest income, dividend income, and sales of stocks in the grantor's social security number.

If an institution issues a Form 1099 in the revocable trust's TIN, the trust should file a Form 1041 trust income tax return and include the income on a statement, along with the name of the grantor who is reporting the income. The trust should notify the institution of the grantor's social security number.

A taxpayer who contributes assets to a revocable trust is not considered to have transferred any assets. The revocable nature of the trust means the taxpayer is merely changing the property's title. He is not relinquishing control, as opposed to contributions to an irrevocable trust.

Living trusts are a type of revocable trust, often set up to give directions for the transfer of the grantor's assets in the event of death. The trust, rather than the will, achieves this purpose, and it may avoid probate of the assets.

A revocable trust becomes irrevocable at the time of the grantor's death. At death, the trust becomes a separate taxable entity, and follows the same rules applicable to an irrevocable trust.

Because the revocable trust is ignored for tax purposes, contributed assets are considered owned by the grantor. When the grantor dies, the trust's assets are considered inherited at that time. Their basis is the FMV on the date of the grantor's death.

Irrevocable Trusts

An irrevocable trust is a separate legal entity for tax purposes. As such, the trust must have its own taxpayer identification number (TIN). All institutions should be notified of the trust's TIN. All income and expenses of the trust are reported on the trust's Form 1041.

A trust is required to file its Form 1041 using a calendar year-end. The Form 1041 has an unextended due date of the 15th day of the 4th month after the end of the trust's tax year. Interest charges apply to any balance due if the tax is not timely paid. There are also two penalties that normally exist for failing to timely file a trust return. One is a "failure to file" penalty of 5% per month for a maximum of five months. The other is a "failure to pay" penalty of 0.5% per month for a maximum of 50 months. Both of these penalties are based on a percentage of the balance owed on the trust's income tax return. If there is no balance due, no penalties are assessed.

Contributions to an irrevocable trust are considered gifts to the beneficiaries of the trust. As such, the grantor may be required to file a gift tax return, as discussed earlier. Because the contributed assets are gifts, their basis inside the trust is the gift's basis, normally the transferor's adjusted basis. **The basis does not change when the grantor dies.**

The income beneficiary receives a Schedule K-1, which reports the income the beneficiary has received or is deemed to have received.

SIMPLE TRUSTS VERSUS COMPLEX TRUSTS

Simple Trust

A simple trust is not a grantor trust and meets all three of the following requirements:

1. The trust document must require that all income be distributed currently.
2. The trust document must not allow amounts paid or set aside in the tax year to be used for charitable purposes.
3. The trust does not make distributions of principal (corpus) during the year.

A simple trust is deemed to have distributed all current year income in the current year **regardless of whether it actually made the distributions or not.** The deemed distributions result in the income from the trust being passed through to the beneficiaries on the Form 1041, Schedule K-1.

Complex Trust

A complex trust is a trust that does not qualify as a simple or grantor trust. A simple trust is a complex trust in its final year because of the distribution of the entire corpus. It has therefore violated the third requirement above.

Grantor Trust

The grantor is the individual who funds the trust by contributing assets. A grantor trust is a trust in which the grantor either retains control over the assets, and/or benefits from the assets.

A grantor trust may be either revocable or irrevocable. If it is **revocable,** the grantor normally maintains control over it. Therefore, it follows the rules of a revocable trust.

A grantor trust may also be an **irrevocable** trust that allows the grantor to receive income from the trust or to invade the corpus of the trust. To the extent the grantor benefits, the grantor is deemed to receive the income from the trust.

The income from an irrevocable grantor trust passes to the grantor in a manner similar to a beneficiary, yet no Schedule K-1 is required. The grantor is issued a statement from the trust showing the grantor's share of income, and the name, identifying number, and address of the person (grantor) to whom the income is taxable. This statement is included with the Form 1041 when filed. The income passed to the grantor is not shown on the face of the Form 1041. It is reported directly on the accompanying statement. The income of the trust that is taxable to the grantor has the same character to the grantor as it does to the trust.[22]

A trust may be a combination of a grantor trust and a trust that has distributions to beneficiaries. This trust reports income on the front of the return and income on the grantor statement. The total of the two income entries equals the total income of the trust. A trust that contains an insurance policy on the life of the grantor, pays the premiums from the trust, and is controlled by the grantor is considered a grantor trust to the extent of the life insurance premiums. If the grantor does not control the trust, the trust is normally a complex trust, otherwise it is a grantor trust.

If the grantor trust has an ID number, and has been filing a trust return unnecessarily, the trust can file a final return and report the income by passing the information through to the grantor. The trustee may change to one of the reporting methods listed below. In the year prior to the change, the trustee files a final return reporting the income. The top of the return contains the statement "Pursuant to Treas. Reg. §1.671-4(g), this is the final Form 1041 for this grantor trust." The "final" box must also be checked.

22. IRC §§671–678

The instructions to Form 1041 list three alternative methods of reporting income of a grantor trust. Methods 1 and 2 are only available to grantor trusts owned by one grantor, or one person treated as the owner of the trust. Method 3 is available for a trust treated as owned by two or more grantors.

- **Method 1.** The trustee, who may be the grantor, reports all income and expenses to the grantor. The trustee may also give the grantor's name and identification number to the payers of income. In this way, payers issue income to the recipient rather than the trust.
- **Method 2.** The trustee issues Forms 1099 to the grantor after receiving Forms 1099 from the payers.
- **Method 3.** The payers need the name of the trust for Form 1099 purposes. The trust must file Forms 1099 with the IRS for the income received by the trust that is treated as received by the grantors. The grantors must be given a copy of Form 1099 along with a statement containing income and expense information necessary to properly complete their own returns.

Tax-Exempt Income and Deductions. A trust that receives tax-exempt income, such as municipal interest, cannot claim deductions related to this income. Expenses directly related to the tax-exempt income are not deductible against taxable income. Expenses not directly related to any specific type of income are prorated to the tax-exempt income. When completing the IDD on Form 1041, Schedule B, the tax-exempt income entries take into account the tax-exempt income, less the direct and allocated indirect expenses.

INCOME DISTRIBUTION DEDUCTION

Estates and trusts report all their income and expenses on Form 1041, similar to the way an individual uses Form 1040. The income tax calculation is the same for both estates and trusts. The income distribution deduction (IDD) is calculated on Form 1041, Schedule B. The IDD reduces the trust's income before the calculation of the tax at the entity level.

The IDD is also the amount reported on the trust beneficiaries' Schedules K-1 for the year. Because simple trusts must distribute all current year income, the IDD for a simple trust always equals its income. The IDD for a complex trust depends on the trust interest. Any income requiring distribution in the current year is so deemed. Any additional distributions made to the beneficiary are also deemed from the IDD. The total of the required distributions and the additional distributions cannot exceed the beneficiary's share of the total IDD. The IDD for an estate is determined in the same manner as a complex trust. Often an estate's creation document does not mention required distributions. Therefore, an estate's IDD is normally limited to the distributions actually made.

Depreciation and depletion are two items that the trust can allocate to income beneficiaries. This allocation normally must be a condition of the will or trust document. Because of this allocation, it is possible for a trust to effectively distribute a loss to the beneficiary.

The income from the trust activity passes through to the extent of the IDD. This income is determined without regard to the depreciation/depletion allocated to the beneficiary. When the beneficiary reports both the income from the Schedule K-1 and the depreciation/depletion, the net result could be a loss. Beneficiaries are passive when they have a loss from a Form 1041, Schedule K-1, so the loss may not produce immediate benefits.

Each beneficiary's share of the income interest of the trust determines his allocation of the IDD. A beneficiary that receives a specific amount and does not share in the residual of the trust does not normally receive any portion of the income, and therefore does not normally receive a Schedule K-1. Remainder beneficiaries are those that share in the assets remaining after specific bequests.

Calculating the breakdown of the IDD involves allocating the expenses of the trust to the various types of income. Direct expenses are allocated to the income to which they pertain. A pro rata allocation of the indirect expenses to items that have special tax treatment prevents a distortion of the different types of income. For example, indirect expenses are allocated to:

- Tax-exempt income, because it is not taxed;
- Qualifying dividends, because they have the special capital gains tax rate; and
- Capital gains, because they have a special tax rate.

Many tax software programs break the IDD down into a simple pro rata share of each income item. For example, if interest income represents 60% of the gross income of the estate or trust, the programs allocates 60% of the IDD to interest income. This allocation is acceptable.

Caution. Reading the trust document is important because it determines the allocation of certain expenses to the principal or income of the trust. Failure to allocate properly results in either the income beneficiary or the principal beneficiary receiving an incorrect amount of income or deduction.

Beneficiary Not Found. The trust becomes more complex when there is more than one remainder beneficiary, and when one or more of the remainder beneficiaries did not receive his distribution during the year. In this case, the trust is deemed to be more than one trust. The IDD is calculated separately for each beneficiary. The trust pays tax on any amount of IDD belonging to the missing beneficiary. The missing beneficiary receives his share of the trust income less this tax. Two trust returns are not required.

Because the known beneficiaries may have received enough in distributions to offset the entire DNI, the amount of distributions on Form 1041, Schedule B, may have to be adjusted to make sure the correct amount of IDD is computed. An attached statement to the return should explain the discrepancy.

CHARITABLE CONTRIBUTIONS

A charitable contribution deduction is available to trusts only if the underlying trust document requires the fiduciary to give part of the trust's income to charities. A codicil in a will bequeathing an amount to a charity does not create a charitable contribution deduction. It is probably rare for a trust to have such a provision, and rarer for an estate to contain such.

SPECIAL ISSUES

LIFE ESTATES

Sometimes a taxpayer gives property to one or more of his children, yet keeps a partial ownership in the property. Often this ownership is a life estate. A life estate is the right to control certain aspects of the gifted property for the remainder of the donor's life. A life estate can include items such as the dividends from gifted stock, the right to rents from a gifted rental property, or the right to live in the gifted property until the donor's death. Ownership rights terminate upon the death of the life estate donor.

The gift of property, with the taxpayer keeping a life estate, is a gift of a future interest. These gifts are not eligible for the annual gift tax exclusion discussed previously.

When the taxpayer gifts the property but keeps a life estate, he gifts only the remainder interest in the property. This requires a special calculation in order to determine the value of the gifted portion of the overall property. When the taxpayer gifts the property, but keeps a life estate only for the donor's life, the property's FMV is determined by using Table S to find the present value of a single-life remainder interest and the IRC §7520 rate is used to determine the remainder ownership percentage. When the life estate is for two or more lives, the IRS uses other tables to calculate the remainder ownership percentage.

> **Example 31.** Wendy, age 70, makes a gift to Ronald of a remainder interest in her personal residence in February 2007. The residence's FMV on the date of the gift is $100,000. The IRC §7520 rate is 5.6. Finding the 5.6% rate on the S table shows a remainder factor for age 70 of .51034. Therefore, Wendy is deemed to have made a gift to Ronald of a future interest of $51,034 ($100,000 × .51034). The taxpayer's adjusted basis in the gifted portion of the property is 51.034% of the total adjusted basis in the property.

The IRC §7520 rate is the rate in effect for the month of the gift. The IRS posts these rates on its website (**www.irs.gov**). Below are the IRC §7520 rates and Table S for 5.6%.

IRC §7520 Interest Rates

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2007	5.6	5.6	5.8	5.6	5.6	5.6	6.0	6.2				
2006	5.4	5.2	5.4	5.6	5.8	6.0	6.0	6.2	6.0	5.8	5.6	5.8
2005	4.2	4.6	4.6	5.0	5.2	4.8	4.6	4.8	5.0	5.0	5.0	5.4
2004	4.2	4.2	4.0	3.8	3.8	4.6	5.0	4.8	4.6	4.4	4.2	4.2
2003	4.2	4.0	3.8	3.6	3.8	3.6	3.0	3.2	4.2	4.4	4.0	4.2
2002	5.4	5.6	5.4	5.6	6.0	5.8	5.6	5.2	4.6	4.2	3.6	4.0
2001	6.8	6.2	6.2	6.0	5.8	6.0	6.2	6.0	5.8	5.6	5.0	4.8
2000	7.4	8.0	8.2	8.0	7.8	8.0	8.0	7.6	7.6	7.4	7.2	7.0

Table S (5.6)
Single Life Factors Based on Life Table 90CM
Interest at 5.6 Percent

Age	Annuity	Life Estate	Remainder	Age	Annuity	Life Estate	Remainder
0	17.1944	.96289	.03711	55	12.3284	.69039	.30961
1	17.3242	.97015	.02985	56	12.1163	.67851	.32149
2	17.3073	.96921	.03079	57	11.8995	.66637	.33363
3	17.2851	.96797	.03203	58	11.6787	.65400	.34600
4	17.2597	.96654	.03346	59	11.4545	.64145	.35855
5	17.2316	.96497	.03503	60	11.2273	.62873	.37127
6	17.2014	.96328	.03672	61	10.9968	.61582	.38418
7	17.1690	.96146	.03854	62	10.7622	.60268	.39732
8	17.1346	.95954	.04046	63	10.5234	.58931	.41069
9	17.0977	.95747	.04253	64	10.2809	.57573	.42427
10	17.0582	.95526	.04474	65	10.0348	.56195	.43805
11	17.0162	.95291	.04709	66	9.7847	.54794	.45206
12	16.9720	.95043	.04957	67	9.5299	.53367	.46633
13	16.9261	.94786	.05214	68	9.2709	.51917	.48083
14	16.8796	.94526	.05474	69	9.0085	.50448	.49552
15	16.8330	.94265	.05735	70	8.7440	.48966	.51034
16	16.7865	.94004	.05996	71	8.4785	.47480	.52520
17	16.7398	.93743	.06257	72	8.2128	.45991	.54009
18	16.6926	.93479	.06521	73	7.9474	.44505	.55495
19	16.6439	.93206	.06794	74	7.6815	.43016	.56984
20	16.5932	.92922	.07078	75	7.4142	.41520	.58480
21	16.5401	.92625	.07375	76	7.1449	.40011	.59989
22	16.4849	.92315	.07685	77	6.8735	.38491	.61509
23	16.4270	.91991	.08009	78	6.6006	.36964	.63036
24	16.3663	.91651	.08349	79	6.3280	.35437	.64563
25	16.3022	.91292	.08708	80	6.0577	.33923	.66077
26	16.2348	.90915	.09085	81	5.7918	.32434	.67566
27	16.1636	.90516	.09484	82	5.5314	.30976	.69024
28	16.0890	.90099	.09901	83	5.2765	.29549	.70451
29	16.0109	.89661	.10339	84	5.0255	.28143	.71857
30	15.9293	.89204	.10796	85	4.7769	.26750	.73250
31	15.8442	.88728	.11272	86	4.5327	.25383	.74617
32	15.7555	.88231	.11769	87	4.2964	.24060	.75940
33	15.6627	.87711	.12289	88	4.0679	.22780	.77220
34	15.5659	.87169	.12831	89	3.8473	.21545	.78455
35	15.4645	.86601	.13399	90	3.6348	.20355	.79645
36	15.3589	.86010	.13990	91	3.4338	.19229	.80771
37	15.2486	.85392	.14608	92	3.2479	.18188	.81812
38	15.1333	.84747	.15253	93	3.0765	.17229	.82771
39	15.0130	.84073	.15927	94	2.9171	.16336	.83664
40	14.8872	.83369	.16631	95	2.7660	.15490	.84510
41	14.7556	.82632	.17368	96	2.6241	.14695	.85305
42	14.6182	.81862	.18138	97	2.4928	.13960	.86040
43	14.4748	.81059	.18941	98	2.3696	.13270	.86730
44	14.3255	.80223	.19777	99	2.2496	.12598	.87402
45	14.1707	.79356	.20644	100	2.1329	.11944	.88056
46	14.0104	.78458	.21542	101	2.0180	.11301	.88699
47	13.8449	.77532	.22468	102	1.9052	.10669	.89331
48	13.6741	.76575	.23425	103	1.7935	.10043	.89957
49	13.4978	.75588	.24412	104	1.6743	.09376	.90624
50	13.3158	.74568	.25432	105	1.5578	.08724	.91276
51	13.1281	.73518	.26482	106	1.4085	.07887	.92113
52	12.9355	.72439	.27561	107	1.2279	.06876	.93124
53	12.7380	.71333	.28667	108	.9484	.05311	.94689
54	12.5356	.70199	.29801	109	.4735	.02652	.97348

Example 31

Example 32

6

The value of the remainder interest, for gift tax purposes, is the FMV of the property multiplied by the remainder factor as found in Table S, matching the IRC §7520 rate in effect for the month of the gift, and the taxpayer's age at the time of the gift.

As the taxpayer ages, the remainder factor increases and the life estate factor decreases. These are important only if the taxpayer sells the property prior to death. When a sale takes place before the taxpayer's death, the percentage of the sale belonging to each owner (life estate owner and remainder owner) is calculated by revisiting the S table for the rate applicable at the time of the **gift.** The factors for each ownership changes because the age of the life estate owner changes.

Example 32. Using the same information as in **Example 31,** Wendy sells the property at age 75. The IRC §7520 rate when the gift was made was 5.6, therefore the S table for the 5.6% rate is still used. However, Wendy's age 75 remainder factor is .58480. Therefore, Ronald is deemed to own 58.480% of the property upon its sale, and Wendy is deemed to own the other 41.520%. Wendy reports 41.520% of the sales price, selling expenses, and adjusted basis. Ronald reports 58.480% of the sales price, selling expenses, and adjusted basis.

It is unlikely for the taxpayer to sell the life estate interest to anyone without the remainderman selling the remainder interest at the same time. A potential buyer of the life estate interest knows the interest ends when the life estate owner dies. Therefore, the buyer has no idea of how long the ownership rights will exist. As such, the buyer normally only purchases the property if both owners of the life estate are selling their respective ownership.

When a taxpayer retains a life estate ownership in property and dies prior to the property's disposition, the taxpayer may be considered to still have enough control over the property to require its inclusion in the taxpayer's estate. Such an inclusion requires the full FMV of the property to go into the taxpayer's estate for estate tax purposes. In some states, this ownership does not apply unless the ownership is held in a trust. In other states the wording "retained life estate" is sufficient to show the life estate ownership. When the property is included in the taxpayer's estate, the property is considered to be inherited by the remainder owner(s). As inherited property, the basis to the remainder owner(s) is the property's FMV on the date of the decedent's death.

Example 33. Use the same information as in **Example 31.** Wendy dies years later when the property has an FMV of $130,000. The entire $130,000 is included in Wendy's estate and Ronald's basis in the property is $130,000.

A life estate ownership can also be **implied** and demonstrated by the actions of the owner of record (recipient) and the taxpayer who transferred the property. For example, a life estate owner of real estate is normally responsible for the real estate taxes, insurance, and general upkeep of the property.

Sometimes a taxpayer with sole ownership of a property creates a life estate covering someone else's life. This may occur in a second marriage when a taxpayer puts a clause into his will giving the new spouse the right to live in the property until the new spouse's death. Because the new spouse is not the owner of the property at the creation of the life estate, the property's FMV on the date of the **spouse's** death is not an asset of the new spouse for estate tax purposes.

There is a uniform basis in the property that applies in this situation. **The uniform basis is the FMV at the time of the taxpayer's death** and does not change except by normal annual adjustments, such as improvements, and depreciation. The FMV at the time of the taxpayer's death is the basis used for both the life estate owner (spouse) and the remainder owners. The percentage belonging to each changes as the life estate owner gets older, but the uniform basis does not change. Because the value is not included in the spouse's estate upon the spouse's death, the property does **not** receive a new basis upon the spouse's death.

Example 34. Zach died on January 19, 2007. His will left his principal residence to Ryan, but it also granted his spouse, Cheryl, a life estate in the property. The property had an FMV of $150,000 on the date of Zach's death. The IRC §7520 rate for January 2007 is 5.6%. Cheryl and Ryan jointly sell the property when Cheryl is age 75. The life estate ownership is 41.520% and the remainder ownership is 58.480%. As such, Cheryl reports 41.520% of the sales price and selling expenses, and Ryan reports the remaining 58.480%.

Example 35. Use the same fact as **Example 34,** except Cheryl dies prior to a sale of the property. In this case, Ryan is now the 100% owner of the property. Ryan has a basis in the property of $150,000. This is the FMV of the property on Zach's (not Cheryl's) date of death, plus improvements, and less depreciation.

CREATION OF TRUSTS TO SAVE MONEY

Clients also seek advice regarding how to reduce estate taxes, one of the highest taxes. Therefore, it is beneficial for wealthy taxpayers to structure their financial affairs in a way that minimizes the estate tax. One way taxpayers often try to save money is by creating trusts.

Assets placed inside a trust commonly bypass probate upon the taxpayer's death. If probate is not required, the estate may save legal fees and other probate costs.

A taxpayer's probate paperwork is often open to public inspection. A trust shields assets from public view. The taxpayer's estate tax return shows the trust as an asset, and its valuation. However, the estate tax return does not show the contents of the trust.

Assets transferred to the taxpayer's spouse are **not** subject to estate tax. On the surface, it would appear a taxpayer should transfer all of his assets to the spouse. However, this is not always the best decision when it comes to overall estate tax. It can easily cost more in overall estate taxes if the second to die has an estate tax. Putting assets into a trust or willing them to someone other than the spouse may save estate tax dollars.

Example 36. Don and Janice jointly own $2 million of assets. When Don died in 2004, the estate tax exemption was $1,500,000. Don left $1 million of property to his spouse, Janice. Because Don's net estate is zero, which is below the $1,500,000 exemption, he does not have an estate tax. When Janice died in 2007, the assets she received from Don had increased in value to $1,250,000. Janice also owned $1,500,000 of assets in her own right giving her a gross estate of $2,750,000. In 2007, the estate tax exemption is $2 million. Therefore, Janice's estate is taxed on the excess $750,000 at the estate tax rate of 45% or $337,500.

If Don had put his $1 million of assets into a trust giving Janice the income for life, but not permitting her to invade the corpus, Don would have a net estate of $1 million, but still have no estate tax because he was below the $1,500,000. When Janice died in 2007, she would not include any of the trust assets in her estate because she only owned a life estate interest created by Don. Her net estate is $1,500,000, which is lower than the $2 million estate tax exemption. Therefore, her estate tax is $0. This results in a savings in estate tax of $337,500 between Don and Janice.

Often a taxpayer establishes a trust to reduce estate taxes while still giving the surviving spouse the income from the assets. The most common names for these are the credit shelter trust and the unified credit trust. Basically, the taxpayer's will requires a contribution to the trust of an amount equal to the estate tax exemption ($2 million for 2007) and it gives the rest of the assets to the surviving spouse. The trust document requires a distribution to the surviving spouse of the trust's income for the remainder of the spouse's life. Distributions of the trust's corpus may occur to the extent the trustee believes it is necessary for the safety and welfare of the spouse. This can occur when the spouse depletes all of the individually-owned assets.

The above discussion focuses on the estate tax savings by setting up the trust. It does not address other issues the taxpayer may want investigate, such as:

- Who controls the trust assets during the spouse's life, and what fees will be charged for their services?
- Can the spouse live the desired lifestyle with only the spouse's assets and the trust's income?
- What other costs are there associated with the existence of the trust, such as legal fees to create the trust and accounting and tax return preparation fees?
- Do the taxpayers want the surviving spouse to be able to determine who gets the assets upon the surviving spouse's death? The surviving spouse cannot determine who receives the assets of the trust.
- If the will dictates that the trust be funded with assets equal to the estate tax exemption, will any assets be left for the surviving spouse?

Example 37. Simple Trust Example. Richard created the Richard Trust in 2004. The trust has two 50% beneficiaries. During 2007, Richard Trust had the following income and expenses:

Interest income	$5,500
Dividend income (all qualifying)	950
Tax preparation fees	250
Fiduciary fees	200

Note. This is a very simple example. The Form 1041 return is discussed in much greater detail in Chapter 8 of the 2006 *University of Illinois Federal Tax Workbook.*

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts **2007** OMB No. 1545-0092

A Type of entity (see instr.): For calendar year 2007 or fiscal year beginning , 2007, and ending , 20

- ☐ 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

Name of estate or trust (If a grantor type trust, see page 12 of the instructions.): Richard Trust

C Employer identification number: 44 4444444

Name and title of fiduciary

D Date entity created: 04/01/2004

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)
- ☐ Not a private foundation
- ☐ Described in section 4947(a)(2)

City or town, state, and ZIP code

B Number of Schedules K-1 attached (see instructions) ▶ 2

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 Check here if the estate or filing trust made a section 645 election ▶ ☐

Income	1	Interest income	1	5,500
	2a	Total ordinary dividends	2a	950
	b	Qualified dividends allocable to: **(1)** Beneficiaries 950 **(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	6,450
Deductions	10	Interest. Check if Form 4952 is attached ▶ ☐	10	
	11	Taxes	11	
	12	Fiduciary fees	12	200
	13	Charitable deduction (from Schedule A, line 7)	13	
	14	Attorney, accountant, and return preparer fees	14	250
	15a	Other deductions **not** subject to the 2% floor (attach schedule)	15a	
	b	Allowable miscellaneous itemized deductions subject to the 2% floor	15b	
	16	Add lines 10 through 15b ▶	16	450
	17	Adjusted total income or (loss). Subtract line 16 from line 9 — 17: 6,000		
	18	Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)	18	6,000
	19	Estate tax deduction including certain generation-skipping taxes (attach computation)	19	
	20	Exemption	20	300
	21	Add lines 18 through 20 ▶	21	6,300
	22	Taxable income. Subtract line 21 from line 17. If a loss, see page 20 of the instructions	22	(300)
	23	**Total tax** (from Schedule G, line 7)	23	

For Example 37

7	Charitab... Enter here a... 13 . . .	7	
Schedule B	**Income Distribution Deduction**		
1	Adjusted total income (see page 22 of the instructions)	1	6,000
2	Adjusted tax-exempt interest	2	
3	Total net gain from Schedule D (Form 1041), line 15, column (1) (see page 22 of the instructions)	3	
4	Enter amount from Schedule A, line 4 (minus any allocable section 1202 exclusion)	4	
5	Capital gains for the tax year included on Schedule A, line 1 (see page 22 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.** Combine lines 1 through 6. If zero or less, enter -0-	7	6,000
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	6,000
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	6,000
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	6,000
14	Tentative income distribution deduction. Subtract line 2 from line 7. If zero or less, enter -0-	14	6,000
15	**Income distribution deduction.** Enter the smaller of line 13 or line 14 here and on page 1, line 18	15	6,000
Schedule G	**Tax Computation** (see page 23 of the instructions)		
	...page 23	1a	

For Example 37

661106

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0092

Schedule K-1 (Form 1041) **2007**
Department of the Treasury
Internal Revenue Service

For calendar year 2007,
or tax year beginning ____________, 2007
and ending ____________, 20____

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

► See back of form and instructions.

Part I Information About the Estate or Trust

A Estate's or trust's employer identification number

44-4444444

B Estate's or trust's name

Richard Trust

C Fiduciary's name, address, city, state, and ZIP code

D ☐ Check if Form 1041-T was filed and enter the date it was filed ____/____/____

E ☐ Check if this is the final Form 1041 for the estate or trust

F ☐ Tax shelter registration number, if any ____________

G ☐ Check if Form 8271 is attached

Part II Information About the Beneficiary

H Beneficiary's identifying number

I Beneficiary's name, address, city, state, and ZIP code

Beneficiary #1
Chicago, IL 60601

J ☒ Domestic beneficiary ☐ Foreign beneficiary

Draft

Part III Beneficiary's Share of Current Year Income, Deductions, Credits, and Other Items

1	Interest income	**2,558**
2a	Ordinary dividends	**442**
2b	Qualified dividends	**442**
3	Net short-term capital gain	
4a	Net long-term capital gain	
4b	28% rate gain	
4c	Unrecaptured section 1250 gain	
5	Other portfolio and nonbusiness income	
6	Ordinary business income	
7	Net rental real estate income	
8	Other rental income	
9	Directly apportioned deductions	
10	Estate tax deduction	
11	Final year deductions	
12	Alternative minimum tax adjustment	
13	Credits and credit recapture	
14	Other information	

*See attached statement for additional information.

Note: A statement must be attached showing the beneficiary's share of income and directly apportioned deductions from each business, rental real estate, and other rental activity.

For IRS Use Only

For Paperwork Reduction Act Notice, see the Instructions for Form 1041. Cat. No. 11380D **Schedule K-1 (Form 1041) 2007**

Example 38. Estate Income Tax Return Example. Dwayne died March 2, 2007. The estate was settled and all assets distributed by July 28, 2007. Gary, his personal representative chose to file a first and final return, so both options are checked in box F.

The estate has one 100% beneficiary. During the short year, the decedent's estate had the following income and expenses:

Interest income	$2,000
Tax preparation fees	300
Fiduciary fees	500
Attorney fees	5,000
Miscellaneous administration expenses (postage, mileage reimbursement, filing fees, etc.)	750

Gary waived the right to deduct the administration expenses of attorney, fiduciary, tax preparation, and miscellaneous fees on Form 706.

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts **2007** OMB No. 1545-0092

A Type of entity (see instr.):
- [X] 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 2007 or fiscal year beginning 03/02, 2007, and ending 07/28, 20 07

Name of estate or trust (If a grantor type trust, see page 12 of the instructions.) **Dwayne Estate**

C Employer identification number **55 5555555**

Name and title of fiduciary **Gary, personal representative**

D Date entity created **03/02/2007**

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

City or town, state, and ZIP code

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)

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

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

G Check here if the estate or filing trust made a section 645 election ▶ [ ]

Income	1	Interest income	1	2,000
	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	2,000
Deductions	10	Interest. Check if Form 4952 is attached ▶ [ ]	10	
	11	Taxes	11	
	12	Fiduciary fees	12	500
	13	Charitable deduction (from Schedule A, line 7)	13	
	14	Attorney, accountant, and return preparer fees	14	5,300
	15a	Other deductions **not** subject to the 2% floor (attach schedule)	15a	750
	b	Allowable miscellaneous itemized deductions subject to the 2% floor	15b	
	16	Add lines 10 through 15b ▶	16	6,550
	17	Adjusted total income or (loss). Subtract line 16 from line 9 . . 17		