Chapter 3: Trust and Estate Taxation

Please note. Corrections were made to this workbook through January of 2017. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

Note. See the 2015 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Trust Accounting and Taxation, for the basics of trust taxation, including key definitions.

It is vital to understand the concept of a **completed gift** when working with trusts and estates. In general, a gift is only considered complete when the donor has given up enough "dominion and control" so that they have no power to change its disposition or change who currently benefits from the asset.[1]

Whether or not a gift to a trust is complete determines who should pay the income taxes on the revenue generated by assets that were transferred into a trust. It also determines which assets must be included in a decedent's estate.

Regardless of who is the nominal owner of an asset, the facts and circumstances dictate who bears the tax consequences related to the asset. This caveat should be kept in mind as an exception to each general rule covered in this chapter.

In this chapter, the term **beneficiary** refers to all individuals and organizations who receive benefits from a trust. The term also includes anyone who receives property from a deceased person, including heirs and legatees. The term **executor** includes anyone who is handling the affairs of a deceased person, whether the person is legally designated as a personal representative, administrator, or trustee.

Note. Often, the person handling the affairs of a deceased person is not experienced in such matters, and tax practitioners must exercise additional diligence to properly prepare the necessary tax documents.

1. Treas. Reg. §25.2511-2(b).

GRANTORS AS OWNERS

A grantor trust is generally a trust created by an individual who transfers property into the trust and who subsequently retains powers and rights in the trust. The grantor is considered the owner of the trust property for federal tax purposes. Therefore, transactions between the grantor trust and the individual grantor are disregarded for tax purposes.[2]

The grantor trust rules of IRC §§671–679 were originally enacted in 1954 to address tax abuses resulting from using trusts to shift income from high-income taxpayers to low-income taxpayers. The grantor trust rules required the grantor to recognize the income from the trust if certain rights and powers were retained in the trust.

Most attributes that make a trust a grantor trust also result in trust assets being included as part of the grantor's estate at death. For example, a common estate planning technique is to use a revocable trust. The grantor's retention of the right to revoke the trust causes all income of the trust to be taxed to the grantor. The power to revoke also causes all assets in the trust to be includable in the grantor's taxable estate. The assets in the trust receive a stepped-up basis on the death of the grantor.

There are, however, some powers that cause income of a trust to be taxed to the grantor without causing the trust assets to be included in the grantor's taxable estate. For example, a power to reacquire trust corpus by substituting other property of an equivalent value under IRC §675(4)(c) causes the trust to be treated as a grantor trust for income tax purposes. This power does not, however, cause the trust assets to be part of the grantor's estate.[3]

A grantor may want to pay income taxes on the trust income personally because the tax brackets applicable to nongrantor trusts are highly progressive. For 2016, the highest income tax rate of 39.6% is reached after only $12,400 of taxable income when a trust has no long-term capital gains.[4]

Note. Some examples in this chapter are drawn from IRS regulations and use the term "ordinary income" to distinguish trust income distributable to beneficiaries from income allocable to corpus. Under IRC §642(b) this should properly be called "fiduciary accounting income" as determined under the trust instrument and applicable state law.

Note. For additional information on grantor trusts, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Wealth Accumulation and Preservation.

2. Rev. Rul. 85-13, 1985-1 CB 184.
3. Rev. Rul. 2008-22, 2008-16 IRB 796.
4. Rev. Proc. 2015-53, 2015-44 IRB 615.

GENERAL RULES FOR INCOME TAX PURPOSES

Under the general rules for grantor trusts, when the grantor is regarded as the owner of any portion of a trust, the income, deductions, and credits attributable to that portion of the trust are included in calculating the grantor's taxable income and credits.[5] The following **situations** cause the IRS to view the grantor as an owner for income tax purposes despite any legal language in the trust that suggests the trust is not a grantor trust.

1. The grantor has retained a **reversionary interest** in the trust (as discussed in the next section).[6]
2. The grantor or a nonadverse party has certain powers over **the beneficial interests** under the trust.[7]
3. Certain **administrative powers** over the trust exist under which the grantor can or does benefit.[8]
4. The grantor or a nonadverse party has the power to **revoke the trust** or return the corpus to the grantor.[9]
5. The grantor or a nonadverse party has the power to **distribute income to or for the benefit of the grantor or the grantor's spouse.**[10]

KEY DEFINITIONS AND PROVISIONS

This section provides the legal definitions of terms that are used pervasively throughout those Code provisions that **mandate a trust be taxed in whole or in part as a grantor trust** under certain conditions.

> **Note.** Ideally, it is not the tax practitioner's responsibility to decode the trust's legal language and parse that understanding in light of relevant Code provisions. However, the practitioner must have enough understanding of the applicable Code provisions to be aware of questions to ask the taxpayer and their legal advisor. The key definitions and provisions in this section are relevant when a trust has the appearance of an irrevocable trust but, under the Code, must be treated as a grantor trust.

Present and Remainder Interest

Present interest is defined as the right to the immediate use, possession, or enjoyment of the trust property or income subject to the terms of the trust. A remainder interest includes all beneficial rights in a trust other than present interests.

Reversionary Interest[11]

A **reversionary interest** is something that occurs in the **future** that causes the trust's principal or interest to revert to the grantor,[12] usually based on a contingency and/or a period of time. Once the trust is established, the grantor typically has **no control** over the reversionary event. For example, the grantor has no control over time passing; consequently, if the assets revert to them after a certain period of time, they have a reversionary interest.

A reversionary interest should not be confused with a **revesting power** (discussed in detail later). A revesting power is typically **under the grantor's control** even if it is subject to certain conditions.

---

5. IRC §671.
6. IRC §673.
7. IRC §674.
8. IRC §675.
9. IRC §676.
10. IRC §677.
11. IRC §673.
12. *What's Yours Is Mine and What's Mine Is Mine: Grantor Trust Sections 673 and 676.* Jan. 22, 2011. ABA Section of Taxation Fiduciary Income Tax Committee. [www.americanbar.org/content/dam/aba/events/taxation/taxiq-11mid-022.authcheckdam.pdf] Accessed on Jun. 6, 2016.

The **general rule** is that the grantor is treated as the owner of any portion of a trust in which they have a reversionary interest, if, as of the trust's inception, the value of the reversionary interest exceeds 5% of the trust's value. This also applies to portions of the trusts when the grantor's reversionary interest does not apply uniformly to the trust. IRC §673(c) requires that the reversionary interest's value be determined by assuming the "maximum exercise of discretion in favor of the grantor."

However, this rule does **not apply** if the beneficiary is the grantor's lineal descendant and the lineal descendant holds all of the present interests in the trust. In addition, for the rule to **not apply,** the reversionary interest must be contingent upon the beneficiary's death before the beneficiary reaches age 21.

Adverse and Nonadverse Parties

For a trust **not** to be taxed as a grantor trust, the grantor must **avoid all five of the situations mentioned earlier.** In addition, the power over these benefits must be held by parties who are truly independent from the grantor. It is critical to understand who qualifies as an adverse party and who qualifies as a nonadverse party. It is assumed that an adverse party is **not** swayed by the grantor's needs and desires, and a nonadverse party can be. As the examples in this section illustrate, a person's status as an adverse or nonadverse party may be specific to one or more provisions of the trust.

The term **adverse party** refers to any person having a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power that they possess for the trust. A person having a general power of appointment over the trust property is deemed to have a beneficial interest in the trust.[13] The person with a power of appointment is the one with the authority to decide who receives the property in question.

Ordinarily, a beneficiary is an adverse party, but if their right to share in the trust's income or corpus (i.e., trust principal) is limited to only a part, they may be an adverse party only for that part.[14]

> **Example 1.** Ronald MacDonald created a trust for the benefit of his son, Donnie, on January 15, 2015. The trust's income is payable to Donnie for life. Donnie also has the power to assign the trust corpus to Ronald either during his life or by will. Donnie's interest is adverse to the return of the corpus during his life, but it is not adverse to the corpus after his death. This means that his interest is adverse as to ordinary income but is not adverse as to the income allocable to corpus. Therefore, assuming no other relevant facts exist, Ronald is not taxed on the trust's ordinary income but **is** taxed on income allocable to corpus (such as capital gains) under IRC §677. This is because the capital gain income is accumulated for future distribution to Ronald at the discretion of Donnie, a nonadverse party.[15]

Similarly, the interest of a contingent income beneficiary is adverse to a return of corpus to the grantor before the termination of their interest but not to a return of corpus after the termination of their interest.[16] The interest of a person with a remainder interest is adverse to the exercise of any power over the trust's corpus but not to the exercise of a power over any income interest preceding their remainder.[17]

The term **nonadverse party** refers to any person who is not an adverse party. **If a nonadverse party has any of the powers that would cause the trust to be taxed as a grantor trust, then the grantor is taxed as if the grantor had retained those powers.**

13. IRC §672.
14. Treas. Reg. §1.672(a)-1(b).
15. Treas. Reg. §1.672(a)-1(c).
16. Ibid.
17. Treas. Reg. §1.672(a)-1(d).

Example 2. Wendall Kingston created a trust for the benefit of his son, Angus, on January 15, 2015. The trust's income is to be distributed to Angus for 10 years subject to certain powers held by Birdie, Wendall's daughter. After 10 years, the corpus goes to Birdie if she is living at that time.

Birdie's powers include distributing the income to Wendall instead of Angus. This power to distribute part or all of the ordinary income to Wendall is a power exercisable by a **nonadverse** party. Because the corpus that goes to Birdie will ultimately be the same regardless of whether Wendall or Angus receives the income, her authority to give Wendall income from the trust causes the ordinary income to be taxable income for the grantor, Wendall.

The trust also allows Birdie to give the corpus back to Wendall instead of keeping it for herself. This is a power exercisable by an adverse party because Birdie experiences a real forfeiture of her own fortunes if she gives the property back to Wendall.[18]

Related or Subordinate Party. A trust that gives certain powers to someone who is "related or subordinate" **and** "subservient" to the grantor is treated as a grantor trust despite the stated powers of the appointed person.[19] Unlike most Code provisions that apply to related parties, for trust purposes, the term "related" does **not** necessarily include all members of the taxpayer's family. The person must be both related and subservient. Therefore, if a bona fide family member has an adverse interest in the trust, the Code assumes that the adverse party will not give deferential treatment to the grantor despite any relationship between them.

In general, a related or subordinate party is presumed to be subservient to the grantor unless meaningful evidence proves they are not.[20] Thus, the burden of proof is on the parties to prove that a related party acts independently of the grantor.

The term **related or subordinate party** refers to **any nonadverse** party who is any of the following.[21]

1. The grantor's spouse, if living with the grantor
2. The grantor's father, mother, child, brother, or sister
3. An employee of the grantor
4. A corporation or any employee of a corporation in which the grantor's stock holdings and the trust are significant from the viewpoint of voting control
5. A subordinate employee of a corporation in which the grantor is an executive

Power

Trust taxation rules frequently refer to "powers" that determine whether a trust is taxed as a grantor trust. It is important to understand what **power** is in general, when a power is considered effective, and how the existence of certain powers or the relationship of the power-holder to the grantor can cause a trust to be treated as a grantor trust for tax purposes.

Power includes the right, ability, or authority to perform acts[22] that affect the ownership of the trust's assets or who benefits from its income.

18. Ibid.
19. IRC §672(c).
20. Ibid.
21. Ibid.
22. *Power*. The Free Dictionary by Farlex. Inc. [legal-dictionary.thefreedictionary.com/power] Accessed on Jul. 5, 2016.

A person is considered to have a power even though the exercise of the power is:[23]

1. Subject to giving of notice, or
2. Takes effect only on the expiration of a certain period **after the exercise of the power.**

Example 3. Darrell McQueen created a trust for the benefit of his son, Lonny, on January 15, 2015. Darrell retained the power to revoke the trust with certain conditions.

On July 1, 2016, Darrell gave notice that he intended to revoke the trust. Under the trust's terms, the revocation takes effect two years after notice is given; consequently, the revocation will occur on July 1, 2018. Darrell is treated as an owner **from the trust's inception.**

A person is **not** considered to have a power if the power is not effective until a period of time **after the trust is created.**[24]

Example 4. Joseph created a trust for the benefit of his daughter, Ronnette, on January 15, 2015. Under the trust's terms, Ronnette receives the income from the trust until she dies. However, Joseph retained a power to revoke the trust, which is exercisable at any time but subject to certain restrictions. One restriction is that a revocation cannot take effect until 10 years after the date the trust was originally funded or after the income beneficiary's death, whichever comes first.

This power does not cause Joseph to be treated as an owner with respect to the ordinary income in the trust during the first 10 years of the trust or during the income beneficiary's life, as the case may be.[25]

Power or Interest of Grantor's Spouse. A grantor is treated as holding any power or interest held by:[26]

1. The grantor's spouse **at the time of the creation** of such power or interest, or
2. The grantor's spouse after the creation of such power or interest, but only with respect to periods after the individual became the grantor's spouse.

An individual legally separated from their spouse under a decree of divorce or separate maintenance is not considered married.[27]

Example 5. David Sanders created a trust for the benefit of his girlfriend, Wendy Thomas, on January 15, 2012. Under the trust's terms, Wendy has the power to name any other person as the income beneficiary. Wendy is treated as the owner for income tax purposes.

In July 2014, David and Wendy were married. After their marriage, both David and Wendy are treated as trust owners for income tax purposes.

On January 15, 2016, Wendy and David were separated under a court decree of separate maintenance. David is no longer treated as an owner, but Wendy still is.

Power to Revest[28]

Trust taxation rules frequently refer to the power to revest as a reason for a trust to be taxed to the grantor. Having the right to **take back** the assets given to the trust is a clear indication that the grantor did not really make a gift of the assets to the trust.

---

23. IRC §672(d).
24. Treas. Reg. §1.672(d)-1.
25. Ibid.
26. IRC §672(e).
27. Ibid.
28. IRC §676.

The power to **revest** is a provision in the trust document that allows the grantor (or a nonadverse party) to take back the assets, income, or "enjoyment" of the assets within the trust. The powers to revoke, terminate, alter, amend, or to appoint fall under the revesting powers.[29] The grantor **is typically in control** of the revesting event even if they are not in control of all provisions applicable to the power.

Example 6. Denny created a trust for the benefit of his grandson, Red. Under the trust's terms, Denny has the power to terminate the trust by giving two weeks' notice. This is a revesting power. The revesting event is his demand that the trust be terminated. The two weeks' notice is merely an administrative waiting period that begins after an event under Denny's control.

Revesting powers retained by the grantor (or given to a nonadverse party) can cause the trust or a portion of the trust to be treated as a grantor trust for income tax purposes. This occurs when the power to revest is exercisable by the grantor or a nonadverse party, or both.

If a revesting power is only exercisable after the occurrence of a specific event, the power does not cause the trust to be treated as a grantor trust prior to that event. Once the event occurs, the power can cause the trust to be taxed as a grantor trust unless the power is relinquished.

Example 7. John Silver created an irrevocable trust for the benefit of his brother, Allen Wright. Under the trust's terms, John has no powers that cause him to be treated as the asset owner in the trust as long as Allen is alive. While Allen is alive, the trust is **not** treated as a revocable grantor trust. However, if Allen dies while John is still living, John has the option to revest the assets for his own benefit. After Allen passes away, John's power to revest causes the trust to be treated as if John were the assets' owner.

Beneficial Enjoyment[30]

In general, a person who has the power to acquire beneficial enjoyment of a trust's assets is considered the assets' owner for income tax purposes. Therefore, to the extent that someone can use their powers for their own benefit, a trust is treated as a grantor trust.

However, the concept of benefiting oneself is so nebulous that Congress had to specify a number of circumstances that are exceptions to the general rule and a number of exceptions to the exceptions. The material in this section is not intended to provide comprehensive explanations of all the exceptions.

Although the term **beneficial enjoyment** is used throughout the Code, regulations, IRS pronouncements, and related court cases, it is not defined in the Code. The term comes from the English courts of chancery.[31] The word **beneficial** derives from the concept of beneficiary — the one who realizes gains from the trust's existence. The term **enjoyment** relates to use — a person enjoys the right to use the asset. Both beneficial and enjoyment rights can exist without title in the underlying assets.

The general rule of beneficial enjoyment is that a trust is treated as a grantor trust for income tax purposes when the beneficial enjoyment of the corpus or the trust income:

- Is subject to a power that is exercisable by the grantor or a nonadverse party, or both; and
- Without the approval or consent of any adverse party.

---

29. Treas. Reg. §1.676(a)-1.

30. IRC §674.

31. *The Nature of the Beneficial Interest – Historical and Economic Perspectives.* Lau, M.W. Feb. 22, 2013. Bauhinia Foundation Research Centre. [papers.ssrn.com/sol3/papers.cfm?abstract_id=2213055] Accessed on Jul. 5, 2016; *Symposium: Beneficial Ownership and the Income Tax Act.* Brown, C. [www.ctf.ca/ctfweb/Documents/PDF/2003ctj/2003ctj1_brown-e.pdf] Accessed on Jul. 18, 2016.

There are **two exceptions to the general rule requiring the approval of an adverse party in order for a trust to be exempt from revocable grantor status.**

The **first exception** is applied generally to all the powers related to beneficial enjoyment. To meet this exception, the following conditions must be present with respect to the power in question.

- The trustee's power is limited by a reasonably definite external standard that is set forth in the trust instrument.
- The trustee's powers are solely exercisable without the approval or consent of any other person.
- None of the trustees is the grantor or spouse living with the grantor.

The **second exception** applies only to the following **two powers.**

1. To distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries
2. To pay out corpus to or for a beneficiary(ies), or to or for a class of beneficiaries (whether or not they are income beneficiaries)

This second exception applies only if the following conditions are met.

- Those powers are solely exercisable (without the approval or consent of any other person) by the trustee(s).
- The grantor is not a trustee.
- **No more than half** of the trustees are either related parties or subordinate parties who are subservient to the grantor's wishes.

Retained Powers[32]

The following powers retained by the grantor (or given to a nonadverse party) cause the trust to be treated as a grantor trust for income tax purposes if the power is **not** subject to the approval or consent of any adverse party.

> **Note.** The trust is also treated as a revocable grantor trust when a person who is a related party or subordinate party to the grantor has grantor-type **retained** powers. However, this does not apply if the person has an adverse interest or if they can prove they are not subservient to the grantor.[33]

1. The power to purchase, exchange, or otherwise deal with or dispose of the corpus or the income from the corpus for less than adequate consideration
2. The power to borrow without adequate interest or security (unless the trustee is someone other than the grantor and is authorized under a general lending power to make loans to any person without regard to interest or security)
3. Powers of administration, including the following
   - A power to vote or direct the voting of stock or other securities of a corporation in which the grantor's holdings and the trust are significant for purposes of voting control
   - A power to control investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the grantor's holdings and the trust are significant for purposes of voting control
   - A power to reacquire the trust corpus by substituting other property of an equivalent value

32. IRC §675.

33. IRC §672(c).

> **Note.** The power to reacquire trust corpus by substituting other property of equivalent value under IRC §675(4)(c) is often used to achieve the goals of an intentionally defective grantor trust. In Rev. Rul. 2008-22, the IRS confirmed the grantor's retention of this power would qualify the trust as a grantor trust for income tax purposes but would **not** require inclusion of the trust assets in the grantor's taxable estate.[34]

Power Over Income[35]

If the trust income can be used without the approval or consent of any adverse party in the following ways, the trust is treated as a grantor trust for income tax purposes. This also applies if the income can be used in these ways at the discretion of a grantor, a nonadverse party, or both.

1. Distributed to the grantor or the grantor's spouse
2. Held or accumulated for future distribution to the grantor or the grantor's spouse
3. Applied to the payment of premiums on life insurance policies on the grantor's life or the grantor's spouse (This does not apply if the insurance policies are irrevocably payable for qualified charitable purposes.)

Even if the income can be used at the discretion of the grantor, a nonadverse party, or both, the trust is not taxed as a grantor trust when the powers listed above can only be exercised after the occurrence of a specific event. Once the event occurs, the power can cause the trust's income to be taxed as a grantor trust unless the power is relinquished.

A trust may have a provision that allows someone acting as a trustee to apply or distribute the income for the support or maintenance of a beneficiary that the grantor is legally obligated to support. If the trust **actually** distributes funds to support such a beneficiary, the trust income is taxed to the grantor. Even if the distribution is paid out of the corpus or capital gains, the distribution is treated as a required distribution of distributable net income (DNI) to the grantor. However, if the trust does **not** actually distribute the funds, the provision does not cause the income to be taxed to the grantor unless the beneficiary is the grantor's spouse. If the spouse is the beneficiary, the income is always treated as income from a grantor trust.

> **Note.** For more information about DNI, see the 2015 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Trust Accounting and Taxation.

Other People Treated as Grantors[36]

In general, a person who has the power to acquire the corpus or the trust's income can be treated as the owner of the portion of the trust they control, even though they are not the grantor. This applies even if the person has previously partially released or otherwise modified such a power when, after the release or modification, they retain grantor-type powers. (Nonetheless, if the trust income is already taxed as if it were a revocable grantor trust, only the grantor must report the income.) However, this does not apply if the person disclaims the power within a reasonable time after becoming aware of its existence.

---

34. Rev. Rul. 2008-22, 2008-16 IRB 796.

35. IRC §677.

36. IRC §678.

If the power relates to the ability to make distributions for the benefit of someone whom the person is legally obligated to support, the distribution is taxed under the same rules as when the beneficiary is someone the grantor is legally obligated to support. In essence, the person with the power to make a distribution for their own benefit may be taxed on the distributions if the power is not suitably restricted.

Note. These rules are also applicable to any person other than the grantor who holds rights or powers that in effect give them ownership in the assets or income of the trust. Thus, a trust may be sufficiently controlled by a beneficiary such that the beneficiary is considered the trust property owner. This type of beneficiary-controlled trust is a **deemed grantor trust**.

DEATH OF REVOCABLE TRUST GRANTOR

The purpose of many revocable grantor trusts is to handle the disposition of the taxpayer's assets after they die. Assets held by a trust are not required to be probated; this can save court costs and keeps the assets' disposition private. When the grantor dies, the assets held by the trust are gathered, maintained, and/or distributed according to the trust's terms by the successor trustee. The revocable grantor trust becomes an irrevocable trust upon the grantor's death.

After a grantor dies, the trust must obtain an employer identification number (EIN).[37] It is also important that the tax practitioner obtain a copy of the trust document prior to completing a tax return for the trust.

Example 8. Peg Jazuss established The Jazuss Revocable Family Trust on January 2, 2012. Under the trust's terms, she retained control over all assets and rights of the trust. When she established the trust, she obtained an EIN and opened a bank account at 1st Hometown Bank in the trust's name. After she died on July 1, 2015, the trust was required to obtain a new EIN.

Note. For more information about when to apply for a new EIN, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues.

INCOME FOLLOWS TITLE

One of the most difficult aspects of preparing the trust return after the grantor's death is identifying the assets and related income that belong to the trust. Intentionally or not, many individuals do not title all their assets in the trust's name. The practitioner must understand the flow of the assets from the deceased person to the ultimate beneficiaries in order to properly report the taxable events.

Taxable income received by a cash-basis taxpayer prior to death is reported on Form 1040, *U.S. Individual Income Tax Return*. Depending on the titling of the assets in the decedent's estate, any income received after death may be reported by one of the following.

1. A trust on Form 1041, *Income Tax Return for Estates and Trusts*
2. An estate on Form 1041
3. The beneficiaries on their income tax returns
4. The deceased on the final Form 1040 if an election is made to report accrued interest on U.S. savings bonds under the IRC §454(a) election

37. Instructions for Form 1041.

The following table may be helpful to understanding this concept.

Type of Holding	Income After Death Reported by…
Accounts with designated beneficiaries (including POD and TOD) [a]	Beneficiaries directly
Assets owned by trusts	Trusts on Form 1041
Assets passing through probate estates	Estates on Form 1041
Assets owned jointly with the right of survivorship	Survivors directly
Assets owned under tenancy by the entirety	Surviving spouse
Assets owned by the deceased as tenants in common with another person	Estates on Form 1041
Assets owned by trusts and held as tenants in common with another person or entity	Trusts on Form 1041
Assets titled to the deceased alone with no beneficiaries or joint tenancy	Estates on Form 1041

[a] POD = Payable on death; TOD = Transfer on death.

To "catch" the assets not titled to the trust, many individuals also include a **"pour-over"** or **"spill-over"** provision in their wills stating that any assets not already in the trust will be transferred to the trust after their deaths.

> **Example 9.** Peg, from **Example 8,** bought a new home when she left her spouse in 2013. She was so excited to have her own place that she forgot to have the house titled in the name of her trust. Peg's will includes the following pour-over provision.
>
> *I give the rest and residue of my property to the successor trustee of The Jazuss Revocable Family Trust dated January 2, 2012.*
>
> Peg's executor hired an attorney to probate her will. Because of the pour-over will provision, the house was transferred to the trust through probate administration.

Even though a taxpayer has a pour-over will, **not all assets are subject to estate administration.** Assets that do not pass upon death through the estate or trust include the following.

1. **Assets held jointly with rights of survivorship** — These assets and the related income pass directly to the other owner(s).[38]

2. **Accounts with designated beneficiaries —** These assets are distributed by the institution directly to the designated beneficiaries.[39]

38. *Avoiding Probate with Joint Tenancy.* Randolph, Mary. Nolo. [www.nolo.com/legal-encyclopedia/free-books/avoid-probate-book/chapter6-3.html] Accessed on Jul. 6, 2016.

39. *Payable-on-Death (POD) Accounts: The Basics*. Randolph, Mary. Nolo. [www.nolo.com/legal-encyclopedia/free-books/avoid-probate-book/chapter1-1.html] Accessed on Jul. 6, 2016.

Example 10. Peg, from **Example 8,** had three other accounts at the bank where she maintained her trust savings account.

1. Peg's primary checking account was in her name alone with no other owners or beneficiaries specified. This account did not receive any interest income. This account became part of her estate, because there were no other owners and no designated beneficiaries. Under the terms of her will, the balance of the checking account was distributed to the trust.

2. Her interest-bearing checking account was held jointly with rights of survivorship with her niece, Kyrie Morgan. This account did not become part of the estate or the trust. The balance of this account went directly to Kyrie.

3. Peg had a money market account with her ex-husband, Terrence Rock, listed as the beneficiary. This account did not become part of either the estate or the trust. The account's balance passed directly to Terrence.

The savings account under the trust's original EIN belonged to the trust and stayed with the trust.

REPORTING INCOME EARNED FROM THE DECEASED'S ASSETS

Nominee Forms

The Forms 1099 issued to a deceased person often report income that was paid after death. The deceased person in this case is treated as a nominee. The IRS requires that a nominee file the appropriate Forms 1099 to report the income attributable to the actual recipients.[40]

Copy A of the applicable Form 1099 must be filed with a Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, to the appropriate IRS service center by the last day of February following the calendar year for which the income is reported (the due date is March 31 if the nominee form is filed electronically).[41]

> **Note.** The due date for filing Forms 1099-MISC, *Miscellaneous Income,* with the IRS is January 31 for returns relating to calendar years beginning in 2016 (and filed in 2017). For more information, see the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 6: New Developments.

The income recipient(s) must be given Copy B of the Form 1099 by the last day of January following the calendar year for which the income is reported. On the Form 1099, the nominee should be listed as the "payer." The actual recipients are listed as the "recipient" on each Form 1099 issued by the nominee.[42]

On the decedent's final Form 1040, all income reported under the decedent's social security number should be shown on the return. Adjustments for amounts actually received by other people should be subtracted on the appropriate form.

Example 11. Use the facts from **Example 8** and **Example 10.** While preparing Peg's 2015 tax return, Carl, her longtime tax accountant, noted that the bank accounts were not closed until December 2015. There were two Forms 1099-INT, *Interest Income,* received from 1st Hometown Bank. One included the savings account interest reported under the trust's original EIN. The other included the interest-bearing checking account and the money market account reported under Peg's social security number. To report the income properly, Carl must obtain the applicable account statements for each of the interest-bearing accounts and determine the interest received from January 1, 2015, through July 1, 2015, Peg's date of death.

---

40. IRS Pub. 550, *Investment Income and Expenses.*

41. 2016 General Instructions for Certain Information Returns.

42. Ibid.

Carl then issued the following nominee Forms 1099-INT for the interest received between July 2, 2015, and December 31, 2015, to the beneficial recipients of the income.

1. Kyrie Morgan received a Form 1099-INT for the income earned by the interest-bearing checking account after Peg's death.
2. Terrence Rock received a Form 1099-INT for the income earned by the money market account after Peg's death.
3. The trust, under the new EIN (issued after Peg's death), received a Form 1099-INT issued by the trust under the old EIN (used before Peg's death).

Carl plans to file three tax returns.

1. A Form 1040 for Peg up to the point of her demise—Her Schedule B, *Interest and Ordinary Dividends,* includes all the interest income reported under her social security number. The total of the nominee interest is subtracted on Schedule B.
2. A Form 1041 for the trust under the old EIN—This is filed by attaching a list of reportable items to Form 1041, instead of showing dollar amounts on the form.[43] A declaration on the front of the form indicates that the trust is a grantor trust under IRC §§671–677.
3. A Form 1041 for the trust under the new EIN

The 1099-INT issued to Kyrie follows.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. **Peg Jazuss, Deceased, Nominee** **1 Practitioner Way** **Hometown, IL 61554**	Payer's RTN (optional) 1 Interest income $ **1000.00**	OMB No. 1545-0112 2015 Form **1099-INT**	**Interest Income**
	2 Early withdrawal penalty $		**Copy B** **For Recipient**
PAYER'S federal identification number: **123-45-6789** RECIPIENT'S identification number: **987-65-4321**	3 Interest on U.S. Savings Bonds and Treas. obligations $		
RECIPIENT'S name **Kyrie Morgan**	4 Federal income tax withheld $	5 Investment expenses $	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.
Street address (including apt. no.) **331 Willow St.**	6 Foreign tax paid $	7 Foreign country or U.S. possession	
	8 Tax-exempt interest $	9 Specified private activity bond interest $	
City or town, state or province, country, and ZIP or foreign postal code **Hometown, IL 61554**	10 Market discount $	11 Bond premium $	
FATCA filing requirement ☐	12	13 Bond premium on tax-exempt bond $	
Account number (see instructions)	14 Tax-exempt and tax credit bond CUSIP no.	15 State / 16 State identification no.	17 State tax withheld $ $

Form **1099-INT** (keep for your records) www.irs.gov/form1099int Department of the Treasury - Internal Revenue Service

43. Instructions for Form 1041; Treas. Reg. §1.671-4(b).

IRC §645 ELECTION[44]

Under IRC §645, a qualified revocable trust (QRT)[45] can be treated and taxed for income tax purposes as part of an estate (rather than as a separate trust) if both the estate's executor and the trustee agree to this treatment. If the election is made, only one tax return has to be filed for each tax year, and the **trust income** is reported using the **estate's fiscal yearend**. If the election is not made, it may be necessary to file two tax returns, and the trust must use a calendar yearend.[46] The IRC §645 election is irrevocable.[47]

A QRT is any trust that, on the day the decedent died, was treated as owned by the decedent because the decedent (or a nonadverse party, or both) held the power to revoke the trust under IRC §676. As discussed previously, the power to revoke includes the power to revest in the grantor title to any portion of a trust without the approval or consent of an adverse party.[48]

The election is made by filing Form 8855, *Election to Treat a Qualified Revocable Trust as Part of an Estate*. The election must be made by the due date (including extensions) of Form 1041 for the first tax year of the estate (or the filing trust). This due date is generally the 15th day of the 4th month after the close of the first tax year of the estate. The due date applies even if the combined related estate and electing trust do not have sufficient income to require filing a Form 1041.

Example 12. Use the same facts as **Example 9.** To transfer the house to the trust, the house had to pass through probate. To handle this transaction, the court appointed an executor. Despite the fact that the estate had no income to report, the estate was required to obtain an EIN.

The executor elected June 30 as the fiscal yearend. To treat the QRT as part of the estate, the executor was required to file Form 8855 prior to October 15, 2016.

Both the estate's executor and the trust's trustee agreed that it would be better to treat the trust as part of the estate for income tax purposes. They each signed Form 8855, and they filed it on October 15, 2016. The combined income and expenses of the trust and the estate were reported on one Form 1041.

Note. If the executor or trustee had not wanted to treat the trust as part of the estate, either of them could decline to make the election. In that case, Form 8855 is not filed and each entity files its own Form 1041. The trust's fiscal year ends on December 31. The estate's executor may elect any fiscal yearend.

Procedures When There is No Probate Estate[49]

If there is **no probate estate** (no executor), the trustee may elect for the trust to be taxed as an estate. If there is more than one QRT, each trust may join in the election at the trustees' discretion. Each trust that participates in the election is referred to as an **electing trust.** A **filing trust** is an electing trust whose trustee was appointed as the filing trustee by all electing trusts. If only one QRT makes the election, that QRT is the filing trust.

---

44. Instructions for Form 8855.
45. Treas. Reg. § 1.645-1(b)(1).
46. IRC §644.
47. Treas. Reg. §1.645-1(e)(1).
48. Treas. Reg. §1.676(a)-1.
49. Treas. Reg. §1.645-1.

If there is no probate estate, the trustee treats the electing trust, during the election period, as an estate for all purposes of subtitle A (income taxes) of the Code.[50] Thus, for example, an electing trust is treated as an estate for the following purposes.

1. The adoption of a tax year
2. The determination of whether estimated tax payments are required
3. The charitable set-aside deduction under IRC §642(c)(2)
4. The S corporation shareholder requirements of IRC §1361(b)(1)
5. The special allowance for the $25,000 rental real estate exception under IRC §469(i)(4)

Note. If there is no probate estate, then it is not necessary to obtain an **estate** EIN.[51] The trust that is treated as the electing trust must obtain a new EIN that will be used during the period of trust settlement. If the assets are distributed to a successor trust at the completion of trust settlement, then the successor trust is required to obtain a new EIN.

Procedures When There is a Probate Estate[52]

If an executor was appointed **after** a trustee made the election, the executor must reaffirm the election by filing an amended Form 8855. The amended Form 8855 must be filed within 90 days of the executor's appointment. If the **amended** election is **not** made, the election period terminates the day before the executor is appointed.

Election Period

The election period begins on the date of the decedent's death and terminates on the earlier of:

1. The day on which each electing trust(s) and the related estate, if any, have distributed all their assets; or
2. The day before the "applicable date."

The **applicable date** is based on whether a Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, is **required** to be filed as a result of the decedent's death.

If Form 706 is **not required**, the applicable date is **two years** after the date of the decedent's death. If Form 706 **is required**, the applicable date is the **later** of:

1. Two years after the date of the decedent's death, or
2. Six months after the final determination of liability for estate tax.

If the trust's EIN was used to file the income tax returns during the election period and the applicable period expires before all the trust's assets were distributed, an electing trust must obtain a new EIN.[53] The electing trust's taxable income and expenses are included on the estate return up until the applicable date. For activity that occurs after the applicable date, the trust must file its own Form 1041 and must use a calendar year. This is true even if no executor was appointed and only one trust made the election to be taxed as an estate.

---

50. Treas. Reg. §1.645-1(e)(2)(i).
51. Treas. Reg. §1.645-1(e)(3)(ii).
52. Instructions for Form 8855.
53. Treas. Reg. §1.645-1(h); Treas. Reg. §301.6109-1(a)(4).

Example 13. Use the facts from **Example 8** through **Example 12.**

When Peg established her QRT, she obtained an EIN. When she died on July 1, 2015, the QRT was required to obtain a new EIN.

Two years after she died, the trustee continues to manage her assets under the trust's terms. Prior to July 1, 2017, the trustee must request a new EIN to report the ongoing trust activities. The trust's activities are reported in the following manner.

1. January 1, 2015 through June 30, 2015 — The trust is a grantor trust and the activities are reported as an attachment to Form 1041 under the original EIN using the declaration method, whereby a list of reportable items is attached to Form 1041 instead of showing dollar amounts on the form. A declaration on the front of the form should indicate that the trust is a grantor trust under IRC §§671–677.
2. July 1, 2015 through June 30, 2016 — The trust's activities are reported as part of the estate's Form 1041 under the EIN obtained by the estate.
3. July 1, 2016 through June 30, 2017 — The trust's activities are reported as part of the estate's Form 1041 under the EIN obtained by the estate.
4. July 1, 2017 through December 31, 2017 — The trust's activities are reported as a stand-alone entity using the new EIN on Form 1041.

Note. For an example with a completed Form 8855, see the 2015 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Trust Accounting and Taxation. **In addition to filing Form 8855, line G of Form 1041 should be checked to indicate that the trust made a §645 election.**

Application of the Separate-Share Rules[54]

When calculating DNI and the taxable amounts that flow to each beneficiary, the trust's net income and the estate must be calculated separately. This is true of sub-trusts and assets tracked separately within the trusts and the estate.

If a distribution were made by the estate to the trust, the estate's DNI is reduced and the trust's DNI is increased, solely for these purposes. The distribution has the same character in the hands of the trust as it had in the estate.

Example 14. Use the facts from **Example 8** through **Example 13.** Peg's estate was the recipient of one noninterest bearing checking account and one house. In addition, Peg had a small IRA that became part of the estate because she did not name a beneficiary on the account. (Her other IRAs named the trust as the beneficiary and therefore were not part of the estate.) She had no basis in the IRA, so 100% of the $4,000 distribution was income in respect of a decedent (IRD). The estate's DNI is calculated as follows.

Income	$4,000
Attorney fees and court costs	(1,500)
DNI before transfer to the trust	$2,500
Transferred to the trust	(2,500)
Net DNI of the estate after transfer	$ 0

Note. IRD is covered later in this chapter.

54. Treas. Reg. §1.645-1(e)(2)(iii).

Under the terms of Peg's trust:

1. The proceeds from the sale of real estate went to one beneficiary, Maureen.
2. All of the traditional IRA distributions received by the trust went to another beneficiary, Michael.
3. The remaining assets and income were transferred to a special needs trust (SNT), for the benefit of a disabled friend.

Final distributions from the trust were made on December 25, 2017. The trust files a first and final tax return under the newest EIN covering the period July 1, 2017, through December 25, 2017.

Because the distributions were tied to specific assets, the DNI for the trust and the deductions are calculated in shares based on the asset distributions.

	Maureen	Michael	SNT
Interest income			$10,000
Traditional IRAs received by the trust directly		$60,000	
Traditional IRA received from the estate (net of estate costs)		2,500	
Capital loss from sales of real estate	($8,000)		
Administration costs (directly allocated)	(1,000)	(5,000)	(9,000)
DNI by beneficiaries' shares	($9,000)	$57,500	$ 1,000

Accordingly, Maureen's Schedule K-1, *Beneficiary's Share of Income, Deductions, Credits, etc.,* reflects the $8,000 capital loss and the $1,000 of administration costs. Michael's Schedule K-1 reflects $57,500 of "other portfolio and nonbusiness income," and the Schedule K-1 for the SNT shows $1,000 of interest income.

Note. In **Example 14,** the deductions allocated to Maureen are divided between excess deductions and capital loss deductions because these are treated differently on her Form 1040. For Michael and the SNT, the administrative costs are absorbed by the income distributed to them, so only the net income is reported on their Schedules K-1. For more information, see the instructions for Form 1041.

Note. The state of Illinois does not tax traditional IRA distributions.[55] Practitioners must indicate on the Illinois Schedule K-1-T, *Beneficiary's Share of Income and Deductions,*[56] the amount of income from qualified retirement plans for the beneficiary to be able to exclude that amount from their Illinois income.

55. Instructions for Form IL-1041.

56. Instructions for IL Schedule K-1-T(1).

PROBATE ESTATE[57]

A **probate estate** includes only the assets that are subject to probate under applicable state law. Although these laws vary by jurisdiction, in general, the following assets are probated.

1. Assets held by the decedent in their name only with no beneficiary designated
2. Property held as tenants in common

The following assets are typically **not** probated.

1. Assets held in the name of a trust
2. Assets held jointly with right of survivorship
3. Accounts with designated beneficiaries (Also referred to as payable on death (POD) or transfer on death (TOD) designations)
4. Real estate held with a "transfer-on-death deed"

Note. Many states now allow a person to create a TOD deed, commonly referred to as a beneficiary deed, for certain types of real estate. These deeds allow the title of real estate to transfer directly to the person named on the deed after the owner's death. For more information, see **uofi.tax/16b3x1** [www.nolo.com/legal-encyclopedia/free-books/avoid-probate-book/chapter5-1.html].

Some states allow the executor to use a small estate affidavit in lieu of probating the estate through the courts. Only estates with values below the particular threshold set by the state are allowed to use this method.

57. *How to Avoid Probate*. Nolo. [www.nolo.com/legal-encyclopedia/avoid-probate-how-to-30235.html] Accessed on Jul. 7, 2016.

THE GROSS ESTATE

At the time a person dies, all of their assets are considered for purposes of determining if tax is due on the value of their estate. The tax imposed on the value of assets is often called the estate tax (or "death tax"). The **estate tax** should not be confused with the **estate income tax,** which is paid on income received by the estate after the person dies. Although all of a person's assets are included in their estate for estate tax purposes, not all income received after death is subject to the estate income tax.

In general, the decedent's gross estate for estate tax purposes includes all assets held by the decedent and under the decedent's control. Examples include the following.[58]

1. Assets held in the decedent's name
2. Assets held in **revocable grantor** trusts created by the decedent
3. Certain assets held in **irrevocable** trusts created by the decedent
4. Certain assets transferred during the decedent's life without an adequate and full consideration
5. Annuities
6. The portion of the value of nonspousal joint property paid for by the decedent
7. Half the value of property held by spouses as joint tenants or tenants by the entirety
8. Life insurance policies owned by the decedent (even though payable to beneficiaries other than the estate)
9. Property over which the decedent possessed a general power of appointment
10. Community property to the extent of the decedent's interest as defined by applicable law

Charitable bequests are deducted from the taxable estate.[59] However, if the bequest was of a specific dollar amount, there is no correlating deduction from estate income for income tax purposes.[60]

> **Note.** For information about the IRS's position on deducting charitable IRD distributions, see CCA 200848020.

Burial and medical expenses of the decedent are deducted from the value of the taxable estate.[61] Neither of these is deductible from the estate's income.[62] However, if the medical expenses are not used as an estate tax deduction, medical expenses paid within one year of the decedent's death may be included on the decedent's final income tax return.[63]

Administrative expenses may be claimed as a deduction for **either** estate tax or estate income tax purposes. To claim these expenses on the estate income tax return, the executor must attach a statement to the return explaining that the expenses were not used as deductions for estate tax purposes and a waiver of the right to use the deductions for estate tax purposes in the future.[64]

> **Note.** The Code specifically requires that the executor file the statement and waiver in order to deduct the administrative expenses on the estate's income tax return. However, neither the Code nor the regulations state whether these are still necessary when the estate is not required to file Form 706. Some practitioners file the statement and waiver with every estate income tax return; others only file them when Form 706 is required.

---

58. Instructions for Form 706.
59. IRC §2055(a).
60. Rev. Rul. 2003-123, 2003-2 CB 1200.
61. IRC §2053(a); Treas. Reg. §1.213-1(d)(2).
62. IRS Pub. 559, *Survivors, Executors, and Administrators.*
63. Treas. Reg. §1.213-1(d).
64. IRC §642(g).

FORM 706[65]

The executor of a decedent's estate uses Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, to report the estate's fair market value (FMV) and calculate the estate tax as imposed by Chapter 11 of the Code. For decedents who died in 2016, Form 706 must be filed by the estate's executor for any U.S. citizen or resident whose gross estate, plus adjusted taxable gifts and specific exemptions, is more than $5.45 million.[66]

Executors may **elect** to file Form 706 even when it is not required in order to make:

- A generation-skipping transfer tax exemption allocation or election,
- The portability election under IRC §2010(c)(5), or
- A protective filing to avoid any penalty if the estate value is later determined to be above the filing threshold.

Valuation Date[67]

The executor of an estate may choose to use the FMV on the date of death or on the alternate valuation date. The **alternate valuation date** is the date that is exactly six months after the date of death. The alternate valuation election may **only** be made if it lowers the estates' overall value and **lowers the estate tax liability.** The election must be used to value all assets in the estate.

Effect of Filing Form 706.[68] If a Form 706 was not filed, the beneficiary's basis is the FMV at the time of death as determined by the best information obtainable. If a Form 706 is filed, the beneficiary's basis is the FMV used to determine the amount of estate tax.

STATUTE OF LIMITATIONS

In general, the statute of limitations for the IRS to assess additional estate tax liability is three years after the filing date (or due date, if later) of the estate tax return.[69] The statute is extended to six years if the value of items omitted from the return exceeds 25% of the total gross estate reported on the estate tax return.[70]

The IRS may assess additional tax at any time if a false or fraudulent return was filed with the intent to evade tax. The unlimited assessment period also applies if no return is filed.[71]

> **Note.** The statute of limitations on the assessment of estate tax cannot be extended, even by taxpayer consent.[72]

65. Instructions for Form 706.
66. Rev. Proc. 2015-53, 2015-44 IRB 615.
67. IRC §2032.
68. Prop. Treas. Reg. §1.1014-10.
69. IRC §6501.
70. IRC §6501(e)(2).
71. IRC §6501(c).
72. IRC §6501(c)(4).

BASIS OF ASSETS IN ESTATES

3

Generally, the basis of an inherited asset is the asset's FMV on the decedent's date of death. There are a number of exceptions to this general rule, including IRD and appreciated property acquired by the decedent by gift within one year of death that is then inherited by the person who made the gift.[73]

> **Note.** For an extensive discussion regarding basis for inherited assets, see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Advanced Individual Issues. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

As mentioned earlier, the executor of an estate may choose to use the FMV on the date of death **or** on the **alternate valuation date** when filing Form 706.[74] If the executor makes an alternate valuation date election, the beneficiary's basis is equal to the property's FMV as of the alternate valuation date or when sold or disposed of.

BASIS MUST BE CONSISTENT WITH ESTATE TAX RETURN

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 added IRC §1014(f), which requires that the beneficiary's basis of inherited property must not exceed the final value used to determine the amount of estate tax due. This requirement may be referred to as the consistency requirement, or the consistent basis requirement.

If the final value was not yet determined for estate tax purposes, IRC §1014(f) requires that the beneficiary's basis must not exceed the value reported on Form 8971, *Information Regarding Beneficiaries Acquiring Property from a Decedent,* and Schedule A of that form (discussed later in the chapter). The new law is effective for property included on an estate tax return **filed** after July 31, 2015.

This Code section only applies to property whose inclusion in the decedent's estate increased the estate tax liability. The final value of the property is determined when **one** of the following events occurs.[75]

- The value of such property is shown on Form 706 **and** the value is not contested by the IRS before the statute of limitations expires.
- If the IRS determines that the value is different than the reported value, the basis is determined when the time for the executor to contest the IRS determination has expired.
- The value is determined by a court or pursuant to a settlement agreement with the IRS.

If none of these rules apply, then the value reported on Form 8971 is used. If one of the rules above subsequently changes the value, then a supplement to Form 8971 must be filed.

On March 4, 2016, the IRS published Prop. Treas. Reg. §1.1014-10 to provide guidance for complying with the new requirement. Proposed regulations may be relied upon until final regulations are adopted.

Under Prop. Treas. Reg. §1.1014-10, **if no estate tax is due, the entire gross estate is excluded from the application of the consistent basis requirement.** However, if an estate tax is due after the application of all available credits (other than a credit for a prepayment of estate tax), the consistency requirement applies to the **entire** gross estate, because all such property contributes to the liability. Nonetheless, because marital property, charitable property, and certain household and personal effects are not included in the taxable gross estate, these properties are exempt from the consistency requirement. Household and personal effects are excluded from the consistency requirement if the property was not subject to the appraisal requirement under Treas. Reg. §20.2031-6(b).

---

73. IRC §1014.

74. IRC §2032.

75. IRC §1014(f).

The **consistent basis requirement** applies whenever the taxpayer reports a taxable event to the IRS related to the property, such as depreciation or amortization. The requirement continues to apply until the property is sold, exchanged, or otherwise disposed of in one or more transactions that result in the recognition of gain or loss for income tax purposes. The requirement also continues to apply regardless of whether the owner on the date of the sale, exchange, or disposition is the same taxpayer who acquired the property from the decedent.

The final value for estate tax purposes is the taxpayer's **initial** basis in the property. Adjustments to basis can occur after the property is acquired. Examples of such adjustments include the following.

- Gain recognized by the decedent's estate or trust upon distribution of the property
- Post-death capital improvements and depreciation
- Post-death adjustments to the basis of an interest in a partnership or S corporation

Note. The existence of recourse or nonrecourse debt secured by property at the time of the decedent's death does not affect the property's basis. Therefore, post-death payments on such debt do not result in an adjustment to the property's basis.

The consistency requirement applies to property included in the decedent's gross estate and any other property for which the basis is determined in whole or in part by reference to the inherited property's basis. For example, when the inherited property is traded in a like-kind exchange, the **acquired property's basis** is determined by reference to **the basis of the traded property**. Likewise, the basis of property acquired as a result of the involuntary conversion of the inherited property is determined by reference to the inherited property's basis.

Prior to determining the final value of inherited property, the recipient of that property may not claim an initial basis in that property in excess of the value reported on Form 8971, Schedule A. If the property's final value is subsequently determined to be different from the reported value, then the taxpayer may **not** rely on the initial reporting of the property's value. The taxpayer may have a deficiency and underpayment resulting from this difference.

Example 15. Popeye inherited rental property from his uncle Chic, who died on April 15, 2015. The estate tax return was due January 15, 2016; the return was extended until July 15, 2016.

On August 1, 2016, the executor provided Popeye with a Form 8971, Schedule A, which reported that the property value used for estate tax purposes was $500,000. Popeye used this value to calculate the depreciation deduction for the property on his personal return.

The estate's Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return,* is audited by the IRS, and the IRS determines that the property's value was only $400,000. Popeye has a tax deficiency related to any returns he filed using the originally reported basis to determine his depreciation deduction.

If property was omitted from the estate tax return and it would have generated an estate tax liability if it were included on the return, the final value of that property depends on whether a corrected Form 706 is filed **prior** to the expiration of the period of limitation on assessment. If the executor files a Form 706 to properly include the property in the estate, the omitted property's final value is based on the final value determined after filing Form 706. If the executor does **not** report the omitted property before the expiration of the statute of limitations, the final value of that unreported property is **zero.**

Example 16. Roxie passed away on May 3, 2015. Her executor, Ming, determined that the value of Roxie's estate was $6.9 million. She filed Form 706 to report Roxie's estate's tax liability in December 2015. The deadline for filing was February 3, 2016. The statute of limitations expires on February 3, 2019.

In 2020, Ming is informed that Roxie's son found some stock certificates under her bed. The stock was worth $2 million when she died. The inherited stock's basis is zero because a corrected return was not filed prior to the expiration of the statute of limitations.

If no Form 706 was filed and if the inclusion in the decedent's gross estate of the omitted property would have generated or increased the estate's tax liability, the final value of **all covered property is zero** until the final value is determined.

Example 17. Use the same facts as **Example 16,** except Ming determined that the value of Roxie's estate was $3.9 million, and she did not file an estate tax return. Because no return was filed, the statute of limitations is still open with respect to the estate tax. If Ming does not file Form 706, the beneficiaries' basis in **both** the stock and the $3.9 million of assets previously identified is zero.

The following examples are adapted from Prop. Treas. Reg. §1.1014-10.

Example 18. At Duncan's death, he owned 50% of Duncan's Dives, a closely held partnership. The partnership owned a rental building with an FMV of $10 million subject to nonrecourse debt of $2 million at the time Duncan died.

Duncan's sole beneficiary is Caroline, his daughter. The partnership was valued at $8 million.

Duncan's 50% interest was reported on Form 706 as $4 million. The IRS accepted the return as filed, and the time for assessing the additional tax expires. Caroline sells her inherited share of the partnership for $6 million in cash shortly thereafter.

The final value of Duncan's interest was $4 million. Caroline's basis in the partnership interest at the time of its sale is $5 million, calculated as follows.[76]

Final value of Duncan's interest	$4 million
50% of the $2 million nonrecourse debt	1 million
Total	$5 million

Following the sale of the interest, Caroline reports a taxable gain of $1 million ($6 million sales price − $5 million basis). Caroline complied with the consistency requirement.

Note. The example in Prop. Treas. Reg. §1.1014-10 did not address the changes to Caroline's basis in the partnership interest that would have occurred during her time as an owner as a result of the taxable items passed through to her. In real life, her basis would be adjusted for the activity reported from the time of Duncan's death to the time of the sale.

Example 19. Use the same facts as **Example 18,** except the IRS adjusted the value of the interest in the partnership to $4.5 million, and that value was not contested before the expiration of the statute of limitations. Therefore, the final value of Duncan's interest in the partnership is $4.5 million.

Caroline claims a basis of $5.5 million ($4.5 million final value + $1 million nonrecourse debt) at the time of sale and reports gain on the sale of $500,000 ($6 million sale price − $5.5 million basis). Caroline complied with the consistency requirement.

Example 20. When Les Buck died, he owned (among other assets) a private residence that was not encumbered. His sole beneficiary was Charlene. Les's executor reports the residence's value on Form 706 as $600,000 and pays the estate tax liability. The IRS timely contests the reported value and determines that the

76. Under IRC §742 and Treas. Reg. §1.742-1.

residence's value is $725,000. The parties enter into a settlement agreement that provides that the residence's value is $650,000. Therefore, the final inherited value of the residence is $650,000.

Several years later, Charlene adds a master suite to the residence at a cost of $45,000. Her basis in the residence is increased by $45,000, to $695,000 ($650,000 inherited basis + $45,000 addition).[77]

Subsequently, Charlene sells the residence to an unrelated third party for $900,000. Charlene does not meet the requirements to treat the house as her primary residence; therefore, she cannot exclude the gain under IRC §121. Charlene claims a basis in the residence of $695,000 and reports a gain of $205,000 ($900,000 − $695,000). Charlene complied with the consistency requirement.

Example 21. When Jack died, his gross estate included a residence valued at $300,000 encumbered by a $100,000 nonrecourse debt. Title to the residence was held jointly by Jack and Jillian, his daughter, with rights of survivorship.

Jack provided all the consideration for the residence, and the residence's entire value was included in his gross estate. The executor reports the residence's value as $200,000 on Form 706 and claims no other deduction for the debt. Schedule A of Form 8971 reports the residence's value as $300,000. Jillian sells the residence for $375,000 before the final value is determined and claims a gain of $75,000 on her federal income tax return ($375,000 sales price − $300,000 basis reported on Schedule A).

A court subsequently determines that the residence's value was $290,000. The time for contesting this value in any court expires **before** the expiration of the period for assessing Jillian's income tax for the year of the sale of the residence.

The final value of the residence is $290,000. Because Jillian claimed a basis in the residence that exceeds the final value, she may have a tax deficiency and underpayment.

77. Under IRC §1016(a).

NEW FORM 8971[78]

For estate returns **required** to be filed under IRC §6018 after July 31, 2015, the executor must report the final estate tax value of property distributed (or to be distributed) from the estate to the beneficiaries.[79] **Form 8971,** ***Information Regarding Beneficiaries Acquiring Property from a Decedent,*** is used to summarize the beneficiary information **for the IRS.** Form 8971 is not given to any beneficiary. **It is only required if the estate's executor must file an estate tax return.** The form is **not** required if the executor files Form 706 for purposes other than because the gross estate exceeds the applicable exemption amount.

Other such purposes include making the following.[80]

- A generation-skipping transfer tax exemption allocation or election
- A portability election under §2010(c)(5)
- A protective filing to avoid any penalty if an asset value is later determined to cause a return to be required

Schedule A of Form 8971 is used to inform each beneficiary of the value used for estate tax purposes. The stated value generally must be reported by the recipient as their basis in the property. A separate Schedule A is filed for each beneficiary who received or will receive property that was included on Form 706, whether the property was received from the decedent or by reason of the decedent's death.

Due Date of Form 8971[81]

Form 8971 and each Schedule A are required to be filed and furnished on or before the **earlier** of:

1. The date that is 30 days after the due date of Form 706 (including extensions, if any), or
2. The date that is 30 days after the date on which Form 706 is filed with the IRS.

If the executor is not certain which property is to be distributed to which beneficiaries at the time the executor is required to file Form 8971 and the Schedules A, they must report all the potential assets available to each beneficiary. Once the exact distribution is determined, the executor may, but is not required to, file and furnish supplemental statements.

Property for Which Reporting is Required

In general, all property reported on Form 706 that is distributed to beneficiaries must be reported via Form 8971. This includes, for example, any other property whose basis is determined in whole or in part by reference to inherited property (e.g., as the result of a like-kind exchange or involuntary conversion). Nevertheless, the reporting requirements do not apply to the following types of property.

1. Cash (other than a coin collection or other coins or bills with numismatic value)
2. IRD (discussed later in this chapter)
3. Tangible personal property for which an appraisal is not required
4. Property sold, exchanged, or otherwise disposed of (and therefore not distributed to a beneficiary) by the estate in a transaction in which capital gain or loss is recognized

Example 22. Berger King passed away on August 1, 2015. His estate was valued at over $6 million, so Form 706 was required. His entire estate was liquidated except for Berger's brand-new Napoleon grill, which was left to his daughter, Frenchie. The grill was appraised at $3,500.

After Form 706 was filed, his executor provided the following Form 8971 to the IRS. The Schedule A was provided to Frenchie on June 30, 2016.

---

78. Prop. Treas. Reg. §1.6035-1.
79. IRC §6035.
80. Prop. Treas. Reg. §1.6035-1(a)(2).
81. Instructions for Form 8971.

For Example 22

Form **8971**
(January 2016)
Department of the Treasury
Internal Revenue Service

Information Regarding Beneficiaries Acquiring Property From a Decedent

▶ Information about Form 8971 and its separate instructions is at *www.irs.gov/form8971*.

OMB No. 1545-2264

Check box if this is a supplemental filing ☐

Part I Decedent and Executor Information

1 Decedent's name	2 Decedent's date of death	3 Decedent's SSN
Berger King	August 1, 2015	333 33 3333
4 Executor's name (see instructions)	5 Executor's phone no.	6 Executor's TIN
Lance Palatine	555-321-6354	333-44-5555

7 Executor's address (number and street including apartment or suite no.; city, town, or post office; state or province; country; and ZIP or foreign postal code)

123 Bun Drive, Hamburg, CT 06074

8 If there are multiple executors, check here ☐ and attach a statement showing the names, addresses, telephone numbers, and TINs of the additional executors.

9 If the estate elected alternate valuation, indicate the alternate valuation date: ____________

Part II Beneficiary Information

How many beneficiaries received (or are expected to receive) property from the estate? 1 For each beneficiary, provide the information requested below. If more space is needed, attach a statement showing the requested information for the additional beneficiaries.

A Name of Beneficiary	B TIN	C Address, City, State, ZIP	D Date Provided
Frenchie King	333-33-9999	369 Ketchup Lane Hamburg, CT 06074	June 30, 2016

Notice to Executors:

Submit Form 8971 with a copy of each completed Schedule A to the IRS. To protect privacy, Form 8971 should not be provided to any beneficiary. Only Schedule A of Form 8971 should be provided to the beneficiary. Retain copies of all forms for the estate's records.

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, all information reported herein is true, correct, and complete.

▶ Signature of executor Date

May the IRS discuss this return with the preparer shown below? See instructions . . . . ☐ Yes ☐ No

Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	Firm's name ▶			Firm's EIN ▶	
	Firm's address ▶			Phone no.	

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 37794V Form **8971** (1-2016)

For Example 22

Form 8971 (1-2016)

SCHEDULE A—Information Regarding Beneficiaries Acquiring Property From a Decedent

▶ Information about Form 8971 (including Schedule A) and its separate instructions is at *www.irs.gov/form8971*.

Check box if this is a supplemental filing ☐

Part 1. General Information

1 Decedent's name	2 Decedent's SSN	3 Beneficiary's name	4 Beneficiary's TIN
Berger King	333 33 3333	Frenchie King	333-33-9999

5 Executor's name	6 Executor's phone no.
Lance Palatine	555-321-6354

7 Executor's address

123 Bun Drive, Hamburg, CT 06074

Part 2. Information on Property Acquired

A Item No.	B Description of property acquired from the decedent and the Schedule and item number where reported on the decedent's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. If the beneficiary acquired a partial interest in the property, indicate the interest acquired here.	C Did this asset increase estate tax liability? *(Y/N)*	D Valuation Date	E Estate Tax Value *(in U.S. dollars)*
1	Form 706, Schedule F, Item 1 Description — 2016 Napoleon Prestige Pro 825 grill with dual heads, infrared rear & side burners, bottom burners	Y	08/01/2015	$3,500

Notice to Beneficiaries:

You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

Page A-1

Subsequent Reporting. After Form 8971 and the Schedules A are filed and furnished, there may be changes in the final values and/or the recipients of property. If so, the executor must file a supplemental Form 8971 with the IRS and furnish supplemental Schedules A to the beneficiaries.

Changes that require the executor to file supplemental reports include the following.

1. The discovery of property that should have been (but was not) reported on the estate tax return
2. A change in the value of property in accordance with an examination or litigation
3. A change in the identity of the beneficiary to whom the property is to be distributed (because of a death, disclaimer, bankruptcy, or otherwise)
4. The executor's disposition of property in a transaction in which the basis of new property received by the estate is determined in whole or in part by reference to the property acquired from the decedent or as a result of the decedent's death (e.g., as the result of a like-kind exchange or involuntary conversion)

The executor is **not** required to file supplemental reports in the case of inconsequential errors or omissions. However, any errors in the dollar amounts or any errors that would keep the beneficiary from receiving the original statement are considered consequential.[82]

Example 23. Dan is the executor for the estate of Uma. At the time Form 8971 was due, Dan was not sure which properties would be distributed to which beneficiaries. Therefore, he included all of the assets on the Schedules A for each beneficiary.

Prior to making the final distributions from the estate, one of the beneficiaries, Harmon, died. Dan must file a supplemental Form 8971 to identify Harmon's heirs as beneficiaries of Uma's estate. He must also provide each of Harmon's heirs with a Schedule A identifying the property that they might receive.

> **Note.** There are boxes at the top of Form 8971 and Schedule A to indicate that the form contains supplemental information.

Due Date for Supplemental Reporting. The supplemental statements must be filed and a supplemental statement must be furnished to each beneficiary on or before 30 days after:

1. The final value is determined,[83]
2. The executor discovers that the information reported is incorrect or incomplete, or
3. A supplemental Form 706 is filed that reports property not reported on a previously filed estate tax return.

Probate Property or Property from the Decedent's Revocable Trust. In certain circumstances, Form 706 may be filed before the property is distributed to the ultimate beneficiaries. If a situation occurs that causes the executor to be required to file supplemental statements and the property is still being held by the probate estate or by the decedent's revocable trust, the due date for the supplemental statements is 30 days after the date the property is distributed to the beneficiary.

If the executor chooses to include information regarding any changes to the basis of the reported property[84] that occurred after the date of death but before or on the date of distribution, that basis adjustment information must be shown separately from the final value required to be reported on that statement.

---

82. See Treas. Reg. §301.6722-1(b) for definition of inconsequential.

83. Within the meaning of Prop. Treas. Reg. §1.1014-10(c)(1).

84. As described in Prop. Treas. Reg. §1.1014-10(a)(2).

Transfers by Beneficiaries Requiring Supplemental Reporting. If a beneficiary subsequently passes property to a **related party** in a manner that requires the new owner's basis to be determined by the transferor's basis (e.g., a gift), the **beneficiary must report** the basis information to the IRS and the new owner using Form 8971 and Schedule A. These forms must be filed by the beneficiary-transferor no later than 30 days after the date of the distribution or other transfer.

This requirement also applies to the distribution or transfer of any **other** property when the transferred property's basis was determined in whole or in part by reference to the originally distributed property (e.g., as the result of a like-kind exchange or involuntary conversion).

Example 24. Use the same facts as **Example 22.** On January 1, 2017, Frenchie King, who had been using the inherited grill in her food cart, trades the grill to her neighbor Frank for a slightly smaller but newer version of the same grill. Frenchie's basis in the new grill is the same as her basis in the inherited grill after this like-kind exchange.

On January 3, 2017, Frenchie gives the grill to her daughter, Pickles. Frenchie must file Form 8971 with Schedule A and give a copy of the Schedule A to Pickles.

If the beneficiary-transferor is required to file a supplemental Schedule A before they receive their Schedule A from the executor, the supplemental schedule will only report the change in the property's ownership. In this case, the supplemental schedule does not need to provide the value information that would otherwise be required. If the transfer occurs before the final value is determined, the transferor **must also provide the executor** with a copy of the information filed with the IRS. When the executor subsequently files Form 8971 and the Schedules A, the executor must provide a Schedule A to the property's new owner.

For purposes of this provision, a related party includes the following.

1. Any transferor's family member as defined in IRC §2704(c)(2)
2. Any controlled entity (a corporation or any other entity in which the transferor and members of the transferor's family, whether directly or indirectly, have control within the meaning of IRC §2701(b)(2)(A) or (B))
3. Any trust of which the transferor is a deemed owner for income tax purposes

If the transferor chooses to include information on the supplemental statement regarding any changes to the basis of the reported property that occurred during the transferor's ownership of the property,[85] that basis adjustment information must be shown separately from the final value reported on Form 706.

Obligations of Beneficiaries. All beneficiaries who receive property that was reported on Form 706 must be given a Form 8971, Schedule A, showing the description and value of the property that they received. Beneficiaries include the following.

1. The executor
2. The recipient of a life estate
3. A person acquiring a remainder interest
4. The beneficiary of a contingent interest, unless the contingency occurred prior to the filing of Form 8971 (If the contingency subsequently negates the beneficiary's inheritance, the executor must complete a supplemental report regarding the change of beneficiary.)

If the beneficiary is a trust or another estate, the executor must furnish the beneficiary's Schedule A to the trustee or executor of the trust or estate, rather than directly to the beneficiaries of **that** trust or estate. If the beneficiary is a business entity, the executor must furnish the information to the entity. Transfers by these entities may require supplemental reporting as described previously.

---

85. Ibid.

An executor must use reasonable due diligence to identify and locate all beneficiaries. If the executor is unable to locate a beneficiary by the due date, the executor must report that on Form 8971. The executor must also include an explanation that describes their efforts to locate the beneficiary that shows they exercised reasonable due diligence.

If the executor subsequently locates the beneficiary, the executor must furnish a Schedule A to the beneficiary and file a supplemental Form 8971 with the IRS within 30 days of locating the beneficiary. A copy of the beneficiary's Schedule A must be attached to the supplemental Form 8971.

If the executor is unable to locate a beneficiary and distributes the property to a different beneficiary who was not identified on Form 8971 as the recipient of that property, the executor must file a supplemental return with the IRS and furnish a Schedule A to the substitute beneficiary. The supplemental filing is due within 30 days after the property is distributed. A copy of the beneficiary's Schedule A must be attached to the supplemental Form 8971.

Penalties[86]

Penalties apply if the Form 8971 and the related Schedules A are filed late or do not report accurate information. However, the penalties may be waived if the executor can show reasonable cause.

> **Note.** See IRC §6724 and the regulations thereunder for rules relating to waivers of penalties for certain failures due to reasonable cause.

The following penalties apply to both the Form 8971 and the required Schedules A that are to be included with the form.

1. Failure to timely file
2. Failure to include all information required to be shown on the form or schedule
3. Failure to include correct information on the form or schedule
4. Failure to file correct supplemental statements by the due date

Only one penalty applies for all failures relating to a single filing of a Form 8971 and required attachments. Each filing of a Form 8971 is a separate filing, regardless of whether the filing is the initial form or a supplemental form.

The amount of the penalty depends on when the correct Form 8971 with Schedules A is filed. The penalty is as follows. All penalty amounts shown are subject to adjustments for inflation.

	Penalty Per Form 8971	Maximum Penalty
Form 8971 and Schedules A filed within 30 days after due date	$50	$532,000 per year (or $186,000 if the taxpayer qualifies for lower maximum penalties[a])
Form 8971 and Schedules A filed more than 30 days after due date or never filed	$260	$3.193 million per year (or $1.064 million if the taxpayer qualifies for lower maximum penalties[a])
Failure to file correct Form 8971 or Schedule A due to intentional disregard of requirements	At least $530	No maximum

[a] Taxpayer qualifies for lower maximum penalties if their average annual gross receipts do not exceed $5 million for the three most recent tax years ending before the calendar year in which the returns were due.

86. Draft Instructions for Form 8971.

SELECT ISSUES FOR INHERITED ASSETS

INCOME IN RESPECT OF A DECEDENT

Income in respect of a decedent (IRD) is taxable income the taxpayer earned before death that is received after they die. IRD is not included on the decedent's final income tax return because the taxpayer did not collect the income before death. Unfortunately, IRD property does not receive a stepped-up basis.[87] It is, however, included as an asset on Form 706. The IRD is also reported as income by the beneficiary.

Because of the dual status of the income, the IRD recipient is entitled to a deduction for the federal estate tax that is attributable to the IRD. The deduction is allowable in the year the income from the IRD property is recognized. The deduction is calculated as the difference between the estate tax with and without the items that generated the IRD.[88]

The following are some examples of IRD for decedents who reported their income using the cash method.[89]

1. Unpaid wages that are payable to the decedent's estate
2. Uncollected interest on U.S. savings bonds
3. Income from installment agreements
4. Annuities, retirement plans, and IRAs

The IRD has the same character it would have had if the decedent had lived and received the income. For example, if the IRD would have been a short-term capital gain if the decedent had lived, it is also included in the beneficiary's income as a short-term capital gain.

> **Note.** For more information and examples specific to the four types of IRD (listed above), see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Advanced Individual Issues. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive]. For information and examples specific to farming, see the 2015 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 4: Agricultural Issues and Rural Investments.

Annuities[90]

The income portion of an annuity is IRD to the beneficiaries. The annuity's entire value is included in the gross estate. For this purpose, the term **annuity** includes any payment due to a beneficiary under a contract that is payable because the beneficiary outlived the decedent under one of the following conditions.

1. The annuity was payable to the decedent.
2. The decedent possessed the right to receive the annuity during **any** of the following periods.
   a. For their life
   b. For any period not ascertainable without reference to their death
   c. For any period that did not in fact end before their death

87. IRC §691.
88. IRC §691(c).
89. IRS Pub. 559, *Survivors, Executors, and Administrators*.
90. IRC §2039.

JOINTLY HELD PROPERTY WITH RIGHTS OF SURVIVORSHIP[91]

A decedent's gross estate may include at least a portion of the value of property held jointly with rights of survivorship. The following types of joint ownership involve survivorship issues.

1. Joint tenants with right of survivorship held by the decedent and any other person
2. Tenants by the entirety held by the decedent and spouse
3. Funds deposited with a banking institution in joint names and payable to either party or the survivor

The portion included in the gross estate depends on the property's original source and the property's beneficial enjoyment during the decedent's life. The Code contains the following descriptions of **jointly held property** that can be **excluded** from the estate.

1. The portion that can be shown to have originally belonged to the other person can be excluded. The property must not have been received or acquired by the other person from the decedent for less than adequate consideration.

Example 25. When Carl Harley, Jr. passed away, he and his mother jointly owned 100 shares of stock in Mom's Kitchen, Inc., a publicly traded corporation. His mother purchased the shares with her own money and received all the dividends from the stock. Carl's ownership interest in the stock may be excluded from his estate.

2. When a portion of the property (or part of the consideration with which such property was acquired) was acquired by the other person from the decedent for less than an adequate and full consideration, only the part of the value proportional to the consideration furnished by the other person in acquiring the property is excluded from the estate.

Example 26. Use the same facts as **Example 25,** except Carl gave his mother the money to purchase the stock. In this case, 100% of the shares' value is included in his estate.

3. If any property was acquired by gift, bequest, devise, or inheritance, as a tenancy by the entirety by the decedent and spouse, then half of the value is excluded from the estate.
4. If any property was acquired by gift, bequest, devise, or inheritance by the decedent and any other person as joint tenants with right of survivorship, then the portion of the value attributable to the other tenants is excluded from the estate.

Example 27. Karla Hardy and her three sisters inherited 100 acres of farmland from their father. The farmland is held jointly with rights of survivorship. When Karla died, three-quarters of the farm's value was excluded from her estate.

Only the portions of the assets included in the estate receive a stepped-up basis.

Example 28. Use the same facts as **Example 25.** The 100 shares of stock receive no stepped-up basis. Carl's mother must use her original basis to calculate her gain or loss if she sells the stock.

Example 29. Use the same facts as **Example 26.** All shares receive a stepped-up basis. Carl's mother must use the value reported on Carl's date of death as her basis, even if the value is lower than the original purchase price.

Example 30. Use the same facts as **Example 27.** Karla's sisters receive a stepped-up basis for the portion of the farm included in her estate. Each remaining sister's basis is composed of one-fourth of the farmland's value when their father died plus one-third of the quarter they inherited from Karla.

[91] IRC §2040.

> **Note.** To avoid probate, parents sometimes retitle their residence or other assets as joint tenants with right of survivorship with their adult children. Because the parent generally has paid for the residence, its entire value is included in the parent's gross estate under §2040(a) and therefore receives an FMV basis under §1014. This is true regardless of whether an estate tax return is required to be filed. The same is generally true with investments and other assets paid for by the parent but titled jointly with children.

Specific rules apply to certain joint interests of a married couple. In the case of any **qualified joint interest,** the value included in the gross estate is **half** of the value of the qualified joint interest.

The term **qualified joint interest** means any interest in property created after 1976 and held by the decedent and the decedent's spouse as tenants by the entirety or joint tenants with right of survivorship, but only if the decedent and the decedent's spouse are the only joint tenants.

Joint interests between spouses created prior to 1977 are not treated as qualified joint interests. Instead, the same rules that apply to nonspousal joint interests are used to determine what portion of the joint property is includable in the estate of the first spouse to die.[92] Although the passage of time means there are fewer pre-1977 joint interests today, in some cases it may be possible to achieve a 100% FMV basis when the first spouse dies, rather than the 50% available for a qualified joint interest. This occurs when the deceased spouse provided all the consideration to acquire the joint property. The following principles for determining who provided how much of the consideration are derived from relevant court cases.

- If the consideration came from a gift made by the decedent, it does not count; only income or profits in excess of the gift that go back into the property are taken into account.
- If jointly owned property is acquired through a mortgage, income derived from the property is presumed to have helped pay for it, meaning each spouse is presumed to have contributed.
- If it appears that each spouse had separate assets available at the time the joint property was purchased, there may be a presumption that they contributed from their separate assets in the absence of evidence to the contrary.
- If both spouses were working at the time the property was acquired or its mortgage was paid off, there is a presumption of contribution in proportion to their incomes. "Sweat equity" also counts, such as a spouse helping the other spouse in operating a sole proprietorship.
- Property inherited by a spouse is deemed paid for entirely by that spouse.

> **Note.** If there has been **any change** in the title of the property after 1976, **the pre-1977 rules no longer apply** and the qualified joint interest rules apply instead. This includes conveying spousal joint property into a couple's joint revocable trust.

This is purely an **income tax issue,** because the unlimited marital deduction ensures that there is **no estate tax** as a result of inclusion of the entire property in the first spouse's estate. When spousal contributions cannot be determined, treating the joint interest in the same manner as a qualified joint interest is appropriate.

If the surviving spouse is **not** a U.S. citizen (or treated as a U.S. citizen) at the time of the decedent's death, the qualified joint interest provisions do not apply. In this case, jointly held property is included in the decedent's estate to the extent the decedent provided the consideration to acquire the asset.[93]

---

92. In AOD 2001-006, 2001-42 IRB, the IRS acquiesced to the Tax Court's ruling in *Hahn v. Comm'r,* 110 TC 140 (1998). Consequently, the pre-1977 rules apply to spousal joint tenancies created prior to 1977 despite subsequent tax law changes. The first court case establishing this treatment was *Gallenstein v. U.S.,* 975 F.2d 286 (6th Cir. 1992).

93. Treas. Reg. §20.2056A-8.

PROPERTY HELD AS TENANTS IN COMMON

If property is held as tenants in common, there is no right of survivorship. Each owner has the right to transfer their share of the asset without the consent of the others either during their life or by appointing someone who will inherit the property when they die.[94] State law determines the default ownership form that is presumed to be taken in the absence of specific language that states that title ownership is taken with rights of survivorship. Often, the default is tenants-in-common ownership.

Unlike joint tenancies, the ownership interests in property held in common are not necessarily evenly divided by the number of owners. Only the portion of the asset held by the decedent is included in the decedent's estate.

If a person gives someone else a portion of their asset as a tenant in common, they have given up their power to control that portion of the asset's disposition, whether for their own benefit or for the benefit of another.[95]

BASIS OF INHERITED PARTNERSHIP INTERESTS

The basis of an inherited partnership interest consists of the FMV of the interest at the date of death (or at the alternate valuation date):

- Increased by the estate's or other successor's share of partnership liabilities, if any, on that date; and
- Reduced to the extent that such value is attributable to items constituting IRD.[96]

> **Note.** For more information about basis of inherited partnership interests and related examples, see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Advanced Individual Issues. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

Effect of Partnership IRD

If a partnership interest is inherited from a decedent and is includable in the decedent's gross estate, it receives a basis equal to its FMV on the decedent's date of death. The FMV basis is then reduced by the deceased partner's share of any items of the partnership that, had the deceased partner held them directly, would have been IRD in the hands of the deceased partner.

It is therefore necessary to know, as of the decedent's date of death, all items of the partnership that are treated as IRD. These items include such things as:

- Cash basis accounts receivable of the partnership;
- Rental crop shares; and
- Gain on the disposition of any asset which, on the decedent's date of death, the partnership had contracted to sell, and with respect to which sale there were no material contingencies remaining unsatisfied at the time of the decedent's death.

This information should be reported by the partnership on the deceased partner's Schedule K-1 as supplemental information.

---

94. *Tenancy in Common.* Cornell University Law School. Legal Information Institute. [www.law.cornell.edu/wex/tenancy_in_common] Accessed on May 14, 2016.

95. Treas. Reg. §25.2511-2(b).

96. Treas. Reg. §1.742-1.

Example 31. Roy, a 50% partner in a cash basis partnership dies. The FMV of the partnership interest is $50. The partnership assets include a $20 account receivable, of which $10 is Roy's share. Because the $10 would have constituted IRD if held directly by Roy, the outside partnership basis must be reduced by $10, from $50 to $40. When the receivable is actually collected and passed through to the successor to be taxed, the outside partnership basis increases from $40 to $50. A liquidation of Roy's interest for $50 therefore results in no gain or loss.

Without the outside basis reduction, collection of the receivable increases Roy's basis from $50 to $60. Redeeming the partnership interest for its $50 FMV results in a $10 loss, offsetting the effect of the $10 of IRD (although the loss is a capital loss and the IRD is ordinary income).

Inside Basis Adjustment (IRC §754 Election)

The purpose of the IRC §754 election is to allow a partnership to adjust the inside basis of partnership assets to equal the outside basis of the partnership interest. This issue commonly occurs when a partnership interest is purchased, the death of a partner occurs, or there is a distribution of partnership assets.

IRC §754 states:

> *If a partnership files an election, in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734 and, in the case of a transfer of a partnership interest, in the manner provided in section 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent taxable years. Such election may be revoked by the partnership, subject to such limitations as may be provided by regulations prescribed by the Secretary.*

In essence, the partnership can step up the basis of the assets it holds to equal the value of the partnership interest included in the deceased partner's estate tax return. This election is made by the surviving members of the partnership, not by the estate's executor.

> **Note.** For more information, see the 2011 *University of Illinois Federal Tax Workbook*, Chapter 4: Partnerships. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

BASIS OF INHERITED S CORPORATION SHARES

When a shareholder dies, the value of their S corporation shares is included in their estate. The FMV included in the estate may be determined using the following steps.

1. Calculate the corporation's FMV, which is the FMV of the corporate assets minus any corporate liabilities.
2. Reduce the corporation's FMV by any minority or marketability discounts.
3. Multiply the discounted value by the deceased shareholder's percentage ownership of the S corporation.
4. Reduce the result of steps 1 through 3 by the IRD.[97]

The beneficiary of S corporation stock must report IRD for any item of income in the same manner as if the decedent had directly held their pro-rata share of such item.[98] By default, the income before and after the decedent's death is calculated on a per-day, per-share basis.[99] Under this method, the items reported on Schedule K-1 are prorated over the year based on the average ownership interest.

97. IRC §1367(b)(4)(B).
98. IRC §1367(b)(4)(A).
99. IRC §1377(a)(1).

Shareholders may elect to use an interim closing method instead of using the per-share, per-day method of allocation when a shareholder dies. Under the interim closing method, the S corporation's activity for the year may be separated into two periods: before and after the deceased shareholder's death. Then the income or loss for each period is allocated on the per-share, per-day basis to the taxpayers who were shareholders during that period.[100] This method is also called a **terminating election**. This special election under Treas. Reg. §1.1377-1 is made by the S corporation only with the consent of all affected shareholders.

> **Note.** For more information on terminating elections and related examples, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: S Corporation Entity Issues.

No Inside Basis Adjustment

There is no provision under the S corporation rules to adjust the inside basis of a corporation's assets in a manner similar to an IRC §754 election for partnership assets. Accordingly, if an S corporation disposes of an asset shortly after a shareholder's death, the successor in interest must report on their tax return their pro-rata share of gain or loss just as any other shareholder would.

FIDUCIARY ACCOUNTING INCOME

IRC §643(b) provides that:

> *[T]he term 'income', when not preceded by the words 'taxable,' 'distributable net,' 'undistributed net,' or 'gross,' means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.*

This is commonly referred to as **fiduciary accounting income** (FAI). Thus, if a trust requires all income to be distributed currently, it is the FAI of the trust that must be distributed.

A very common error made by trustees and return preparers is confusing taxable income and FAI. For example, if a trust is a beneficiary of an IRA and receives a $10,000 required minimum distribution (RMD), it has $10,000 of taxable income (ignoring expenses and assuming no basis in the IRA). In the absence of a specific provision in the trust providing otherwise, the $10,000 may not be treated as FAI under state law. In many states, the Uniform Principal and Income Act treats 10% of any RMD as FAI and the remaining 90% as corpus. Consequently, in these states, only $1,000 of a $10,000 RMD is FAI.

There is a similar disparity between taxable income and FAI for income from S corporations and partnerships. For income tax purposes the distributive share of a passthrough entity's income on a Schedule K-1 is includable in gross income. However, for trust accounting purposes, usually only **cash distributions** are considered income.

100. IRC §1377(a).

ESTATES AND TRUSTS AS S CORPORATION SHAREHOLDERS

Under subchapter S of the Code, only certain types of individuals and entities are permitted to hold shares in the S corporation. A **decedent's estate** can hold S corporation shares without any time limit.[101] The transfer of shares to the decedent's estate does not cause termination of the S election.[102] This is true even if an individual who is an estate beneficiary is not eligible to hold S corporation shares. However, if the administration of the estate is unduly prolonged, the estate may be treated as closed for income tax purposes.[103]

Only certain types of trusts are permitted to be shareholders of an S corporation.[104] For the first two years after the shareholder's death, the estate will report the S corporation income and expense on the estate's Form 1041. Thereafter, trusts must elect a status as either a qualified subchapter S trust (QSST) or an electing small business trust (ESBT) in order to be eligible shareholders. Electing trusts must also meet other qualifying conditions to be eligible to make one of these elections.

With **grantor** and **deemed grantor trusts**, the trusts are eligible to hold S corporation shares as long as the grantors or controlling beneficiaries are U.S. citizens or U.S. residents who are directly eligible to hold S corporation shares as individuals.[105]

After the grantor's or controlling beneficiary's death, the grantor trust can generally continue to hold the S corporation shares for the 2-year period that begins on the date of death.[106]

A **testamentary trust[107]** is created by the decedent's will and comes into existence at death. A testamentary trust may hold S corporation shares for a period of two years beginning on the date the trust receives the S corporation shares from the estate.[108] With this type of trust, the S corporation shares first pass to the estate, then the estate transfers the shares to the trust. Consequently, the 2-year period starts after the estate administration of the shares is finished.

Before the expiration of the 2-year post-death period, stock held by a testamentary trust **must be transferred** to a qualified shareholder, a **QSST,** or an **ESBT.[109]** If the stock is not transferred, the S corporation could lose its S status. However, the IRS issued a number of letter rulings in which it allowed trusts to take corrective actions instead of terminating the corporation's S status.[110]

QSSTs and **ESBTs** are allowed to hold S corporation stock indefinitely without jeopardizing the corporation's S status as long as the trusts are operated within the allowed parameters. Generally speaking, a **QSST** is a trust with one current income beneficiary who receives all income each year. The QSST cannot accumulate income.[111] An **ESBT** is a trust with one or more current income beneficiaries. The trust is allowed to accumulate income, but must pay taxes at a higher rate.[112]

---

101. IRC §1361(b)(1)(B).

102. Ibid.

103. *Old Virginia Brick Company, Inc. v. Comm'r,* 367 F.2d 276 (4th Cir. 1966). (The shareholder was an ineligible shareholder because part of his shares were held by an estate that was a testamentary trust at the time of election; the estate was administered for approximately 23 years).

104. IRC §1361(c)(2).

105. IRC §1361(c)(2)(A)(i).

106. IRC §1361(c)(2)(A)(ii).

107. *Testamentary trust*. The Free Dictionary by Farlex. Inc. [legal-dictionary.thefreedictionary.com/testamentary+trust] Accessed on Jul. 7, 2016.

108. IRC §1361(c)(2)(A)(iii).

109. IRC §1361(b)(1).

110. Ltr. Ruls. 200703023 (Oct. 16, 2006); 200934007 (May 15, 2009); 200932031 (Apr. 29, 2009); 200934003 (May 15, 2009); 200927012 (Mar. 9, 2009).

111. IRC §1361(d); Treas. Reg. §1.1361-1(j).

112. IRC §1361(e); Treas. Reg. §1.1361-1(m).

RELIEF FOR LATE ELECTIONS

The IRS has authority under IRC §1362(f) to grant relief in situations in which a corporation failed to file a timely subchapter S or other election for a year, or the corporation's S status was inadvertently terminated, such as by failure of a trust beneficiary to make a timely QSST or ESBT election. A private ruling request is generally necessary to obtain relief. This involves payment of a significant user fee to the IRS as well as professional fees. The IRS will, in certain circumstances, grant relief without the need to submit a private ruling request. Although affirmative application for relief must be made, no user fee is required.

Relief for late QSST and ESBT elections is available under Rev. Proc. 2013-30.[113] This revenue procedure includes flowcharts that can be used to determine eligibility for relief.

THE QUALIFIED SUBCHAPTER S TRUST[114]

The QSST allows the grantor to designate who benefits after their death from the S corporation income while designating a different person to receive the stock after the death of the income beneficiary. In addition, the QSST's trustee is responsible for voting the corporation stock, a duty that the grantor may not wish to confer upon the income beneficiary. However, if the QSST is terminated while the income beneficiary is living, the corpus must be distributed to the income beneficiary.

Before the QSST election is made, the trust holding S corporation stock is taxed on the corporation's distributive shares of income and loss. Once the election is made, the beneficiary is taxed on the S corporation's income under the grantor trust rules as long as the QSST holds the S corporation stock. Therefore, the beneficiary must be the one who makes the QSST election.[115] The beneficiary makes the election by filing a declaration with the IRS service center where the corporation's income tax return is filed. The declaration must contain the following information.

1. The name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation
2. The indication that the election is being made under IRC §1361(d)(2)
3. The date on which the election is to become effective (no earlier than two months and 15 days before the date on which the election is filed)
4. The date (or dates) on which the corporation's stock was transferred to the trust

Along with the statement, the election must include enough documentation to prove the following.

1. The following requirements apply under the trust's terms and applicable local law.
   a. During the current income beneficiary's life, there is only one income beneficiary of the trust. (A married couple is counted as one beneficiary as long as they file joint returns and both are U.S. residents or citizens.)
   b. Any corpus distributed during the current income beneficiary's life may be distributed only to that beneficiary.
   c. The current beneficiary's income interest in the trust terminates on the earlier of the beneficiary's death or upon the trust's termination.
   d. Upon the trust's termination during the income beneficiary's life, the trust will distribute all its assets to such beneficiary.
2. **The trust is required to distribute all of its income currently**, **or** the **trustee distributes** all of its income currently if not so required by the trust's terms.
3. No distribution of income or corpus by the trust satisfies the grantor's legal obligation to support or maintain the income beneficiary.

---

113. Rev. Proc. 2013-30, 2013-36 IRB 173.

114. Robert Jamison, *S Corporation Taxation,* ¶1906, pp. 1588-1606 (CCH, 2016).

115. IRC §1361(d)(2)(A).

> **Note.** The attributes that must be documented along with the QSST election are the same conditions that the trust must possess in order to be eligible to make the election.

As long as the grantor is qualified to be an S corporation shareholder, the grantor of a revocable trust who is also the income beneficiary may make a protective QSST election despite the general rule that a revocable grantor trust is disregarded as a separate entity for income tax purposes.[116] However, after the grantor's death, the income beneficiary has the option to refuse to consent to the QSST election. Subsequent income beneficiaries also have the option to refuse to consent to the QSST election.[117]

When to File the QSST Election[118]

In general, the QSST election must be made within a period of two months and 16 days that begins:

- **On the day** that the stock is transferred to the trust, or
- On the **applicable date** specified in the regulations for events that necessitate an election by the trust. The applicable date that starts the election window varies according to:
  - The event that triggers the need for an election, and
  - The timing of that event compared to the S election's effective date.

> **Note.** For information about the applicable date for the following events, see Treas. Reg. §1.1361-1(j)(6)(iii).
>
> - The shareholders of a C corporation elect to become an S corporation.
> - The 2-year period for testamentary trusts expires.
> - An estate ceases to be a shareholder and the trust becomes the shareholder.
> - The trust ceases to be a grantor trust.

If a corporation's S election terminates because of a late QSST election, the corporation may request inadvertent termination relief. See Treas. Reg. §1.1362-4 for rules concerning inadvertent terminations.

Number of Income Beneficiaries

Despite the requirement that the trust can have only one income beneficiary, the regulations allow a trust with more than one beneficiary to be a QSST. To qualify for this exception, the interests of each beneficiary must qualify as a separate share by the separate-share rule. In this case, the beneficiary of each share of the trust may make the QSST election for their share of the trust without regard to the elections made by the other beneficiaries.[119]

Each beneficiary must have the lifetime right to receive all the income from their share of the trust. In addition, each beneficiary must receive any corpus distributed from their share of the trust.[120]

---

116. Treas. Reg. §1.1361-1(j)(6)(iv).
117. Treas. Reg. §1.1361-1(j)(9).
118. Treas. Reg. §1.1361-1(j)(6)(iii).
119. Treas. Reg. §1.1361-1(j)(3); IRC §663(c).
120. Treas. Reg. §1.1361-1(j)(3).

Income Distributions

The QSST must **either** distribute all income at least annually **or** the trust instrument must require all income to be distributed currently.[121] Distributions made under the 65-day rule of IRC §663(b) meet the current distribution rules for QSSTs.[122] The 65-day rule allows a trustee or executor to elect to treat distributions made within 65 days after yearend as if they were paid on the last day of the preceding tax year.

Example 32. QWRTY (a QSST) made no distributions to its beneficiary between January 1, 2016, and December 31, 2016. On February 28, 2017, the trustee determines that the trust's 2016 income was $50,000. The trustee must distribute $50,000 to the beneficiary prior to March 6, 2017, to make the election to treat the distribution as if it were made in 2016. This election allows the trust to stay compliant with the QSST requirement that all income be distributed currently.

Note. If the trust's terms require that all income be distributed currently, the trust must treat all income as if it had been distributed even if it was not distributed.[123]

The amount of income that must be distributed is determined by trust accounting rules, **not** by the amount of taxable income.[124] Based on the state laws under which the trust is established, FAI may only include the distributions received from the S corporation.[125] Consequently, the amount of taxable income passed through from the S corporation to the beneficiary may not necessarily equal the amount of distributions passed from the trust to the beneficiary.

Example 33. Blossom is the sole beneficiary of the Peachbee Children's Trust. The trust owns 10% of the stock of Peachbee Family Enterprises, Inc. (PFE). PFE is taxed as an S corporation. The trust does not hold any other investments.

Blossom made a QSST election effective January 1, 2015. The trust then received a Schedule K-1 from the S corporation for 2015 that reported $100,000 of ordinary income. However, the S corporation did not make any distributions in 2015.

Because Blossom's QSST election was in effect for 2015, she must report the entire $100,000 of income on her 2015 personal income tax return. Because the S corporation did not make any distributions, the trust's FAI was zero and there was no FAI to distribute to Blossom. Assuming Blossom was single with no other income, her 2015 federal income taxes would be just over $18,000.

Example 34. Use the same facts as **Example 33.** On April 1, 2016, the trust received $80,000 in distributions from the S corporation. The 2016 Schedule K-1 from PFE shows ordinary income of $2,000.

The $80,000 is the trust's FAI, which it must distribute to Blossom. The $2,000 of ordinary income flows through to Blossom's personal return.

IRC §661 limits the distribution deduction for complex trusts to the lesser of DNI or FAI distributed.[126] Consequently, without the QSST election, a trust holding S corporation stock may pay significantly higher taxes than it would with the QSST election in place.

---

121. IRC §1361(d)(3)(B).

122. Ltr. Rul. 8717024 (Jan. 17, 1987).

123. Treas. Reg. §1.661(a)-2(a)(1).

124. IRC §643(b).

125. Robert Jamison, *S Corporation Taxation,* ¶1906.09, p. 1596 (CCH, 2016).

126. However, if the FAI required to be distributed is greater than the actual amount distributed, the required distribution is used to determine the distribution deduction.

Example 35. Use the same facts as **Example 33** and **Example 34** except:

- The trust was a testamentary trust that acquired the shares in PFE on January 1, 2015, and
- Blossom did not make a QSST election.

On its 2015 Form 1041, the trust declared $100,000 of pass-through income from PFE. Although the trust's DNI was $100,000, its FAI was zero. Therefore, its distribution deduction was zero. The trust's 2015 federal income taxes were just over $41,000, including the net investment income tax.

On its 2016 Form 1041, the trust declares $2,000 of pass-through income from PFE. The trust's 2016 DNI is $2,000, and its 2016 FAI is $80,000. Therefore, its 2016 distribution deduction is limited to $2,000.

Note. If the QSST disposes of any portion of the S corporation stock, the QSST bears the income tax consequences of the sale, rather than the beneficiary.[127]

If the current beneficiary is a minor child, the distribution does not need to be made directly to the beneficiary. The distribution may go to a parent or to an account for the benefit of the minor, such as one established under the Uniform Transfers to Minors Act.[128]

Additionally, the IRS ruled that a trust could make the distribution to a special needs trust (SNT) instead of directly to the beneficiary. Because the disability trust was used solely for the health, support, and best interests of the QSST beneficiary, the IRS determined that distributing the income to the SNT was the same as making distributions directly to the beneficiary.[129]

THE ELECTING SMALL BUSINESS TRUST[130]

An ESBT has much more flexibility than a QSST. One drawback is that the trust itself must pay the taxes on the S corporation income at the **highest marginal income tax rate.** In addition, the trust cannot shift the income to the beneficiaries. However, the beneficiaries can treat all distributions as nontaxable. This may be beneficial in certain circumstances, but the trust may pay significantly more taxes than the beneficiaries would on the same income if the trust were a QSST.

ESBTs differ from QSSTs in three significant ways.

1. The ESBT may have multiple income beneficiaries.
2. There is no requirement to distribute any income.
3. The ESBT election is made by the trust not the beneficiaries.

127. Treas. Reg. §1.1361-1(j)(8).
128. Ltr. Rul. 9808020 (Nov. 19, 1997).
129. Ltr. Rul. 9444059 (Aug. 3, 1994).
130. Robert Jamison, *S Corporation Taxation,* ¶1907, pp. 1606-1624 (CCH, 2016).

Permitted Beneficiaries

ESBTs may have both current beneficiaries and additional **potential current beneficiaries (PCB).** A PCB includes **both** the **current beneficiaries** who are entitled to receive distributions under the terms of the trust document document and **any beneficiary who may currently receive distributions** from the trust **at the discretion of the trustee.**[131] PCBs include any person who is treated as the owner of any of the S corporation stock under the grantor trust rules, even if that person is not otherwise treated as a beneficiary.[132] PCBs do **not** include those whose only interests are a future interest in the trust.[133]

The primary qualification to elect ESBT status relates to the nature of the beneficiaries. Some of the qualifications apply to only current beneficiaries and others apply to all PCBs.

An ESBT may **only** have the following types of PCBs.[134]

- Individuals
- Estates
- Charitable organizations
- Distributee trusts[135]

In addition, none of the beneficiaries may have purchased their interest in the trust.[136] A purchase includes any transaction for which the basis of the acquired interest is the cost, including gifts when the recipient pays the gift tax on the transfer.[137]

S Corporation Limitations

Each PCB is counted as an S corporation shareholder.[138] As a result, all PCBs are counted for purposes of determining if the S corporation meets the 100-shareholder limitation.

> **Note.** See Treas. Reg. §1.1361-1(e) for more information concerning which groups of shareholders are counted as only one shareholder for purposes of the 100-shareholder limitation.

In addition, each PCB must be an eligible shareholder.[139] For example, if a PCB is a nonresident alien, the corporation no longer qualifies as an S corporation.[140] However, if a nonresident alien is a named beneficiary only if certain events occur, the beneficiary is not a PCB until after the events occur.[141] Thus, the corporation is eligible to be an S corporation until the triggering events occur.

---

131. IRC §1361(e)(2).
132. Treas. Reg. §1.1361-1(m)(4)(ii).
133. Treas. Reg. §1.1361-1(m)(4)(i).
134. Treas. Reg. §1.1361-1(m)(1).
135. Treas. Reg. §§1.1361-1(m)(1)(ii)(B) and 1.1361-1(m)(8), Example 7.
136. IRC §1361(e)(1)(A)(ii).
137. Treas. Reg. §1.1361-1(m)(1)(iii).
138. Treas. Reg. §1.1361-1(m)(4)(i).
139. Treas. Reg. §1.1361-1(m)(1).
140. IRC §1361(b)(1)(C).
141. Ltr. Ruls. 200522003 (Feb. 17, 2005); 200522004 (Feb. 17, 2005); 200522005 (Feb. 17, 2005).

If a PCB is not an eligible shareholder, the S corporation election terminates on the date that the PCB becomes a beneficiary.[142] However, the trust has one year from the date the ineligible shareholder became a PCB to dispose of all the S corporation stock, in which case the S corporation election is not terminated.[143] If the S corporation election terminates, relief may be available under IRC §1362(f).

Income Tax Treatment[144]

For income tax purposes, the portion of any ESBT that consists of S corporation stock is treated as a separate trust when calculating the tax due. This tax is calculated using rules only applicable to an ESBT.

- Ordinary income is taxed at the highest rate applicable to trusts (currently 39.6%).[145]
- Capital gains are taxed at the applicable rate.
- The exemption amount is zero.

The only items of income, loss, deduction, or credit to be taken into account in determining the tax due under these rules are the following.[146]

1. The pass-through items from the S corporation
2. Gains or losses from the disposition of S corporation stock
3. Deductions of state or local income taxes paid on S corporation income or disposition of the S corporation stock
4. Deductions of administrative expenses incurred from owning or disposing of the S corporation stock
5. Deductions of any interest expense paid or accrued on indebtedness incurred to acquire stock in the S corporation

A portion of the ESBT may be taxable to the grantor under the grantor tax rules. If the ESBT has investments in addition to the S corporation stock, the income and expenses related to the other investments are taxed under the usual rules.[147] Consequently, it may be necessary to track the trust's activity as if it were three separate trusts.

- The portion taxable under the grantor tax rules because of retained powers over certain investments
- The portion taxable under ESBT rules based on the S corporation's related activities
- The portion taxable under irrevocable trust rules related to all of the other investments

The mechanics of the tax calculation are beyond the scope of this chapter.

142. Treas. Reg. §1.1361-1(m)(5)(iii).

143. Treas. Reg. §1.1361-1(m)(4)(iii).

144. IRC §641(c)(1).

145. IRC §1(e).

146. IRC §641(c)(2).

147. IRC §641(c)(3).

Making the ESBT Election[148]

The trustee makes the election to be an ESBT by signing and filing a statement with the IRS service center where the S corporation files its income tax return. The election statement must include the following information.

1. A declaration that the trust is making an ESBT election under IRC §1361(e)(3)
2. The name, address, and taxpayer identification number of the electing trust
3. The names, addresses, and taxpayer identification numbers of the potential current beneficiaries
4. The name, address, and taxpayer identification number of the S corporation in which the trust currently holds stock
5. The first date on which the trust owned the stock in the S corporation
6. For a trust with a power to distribute (described in Treas. Reg. §1.1361-1(m)(4)(vi)(B)), a statement that such a power is included in the instrument (It is not necessary to include the name, address, or taxpayer identification number of any particular charity or any other information regarding the power.)
7. The date on which the election becomes effective (not earlier than two months and 15 days before the date on which the election is filed)
8. A representation signed by the trustee stating that the trust meets the definitional requirements of IRC §1361(e)(1) **and** that all potential current beneficiaries of the trust meet the shareholder requirements of IRC §1361(b)(1)

A trust that is a qualified S corporation shareholder because it is either a testamentary trust or a former grantor trust may elect ESBT treatment at any time during the 2-year period in which it is a qualified shareholder.[149] The deadline for electing ESBT status is two months and 16 days after the end of the 2-year period. If the trust makes an ineffective ESBT election within the 2-year period, the trust continues to qualify as an eligible S corporation shareholder until the expiration of the 2-year period.

> **Note.** For additional ESBT election deadlines related to other triggering events, see the "When to File the QSST Election" section earlier in this chapter.

A trust that qualifies as an eligible S corporation shareholder **cannot** make a conditional ESBT election that would only be effective in the event the trust fails to meet the requirements for an eligible trust under other provisions. However, a revocable grantor trust that qualifies as an ESBT may make an ESBT election.[150]

SWITCHING BETWEEN QSST AND ESBT ELECTIONS

A trust may qualify for both the QSST election and the ESBT election. In general, **both elections are irrevocable** without the consent of the IRS; however, the regulations permit a trust to elect to change statuses if all applicable conditions are met.[151] The date on which the change in election is effective cannot be more than two months and 15 days **prior** to the date on which the election is filed and cannot be more than 12 months **after** the date on which the election is filed.[152]

148. Treas. Reg. §1.1361-1(m)(2).
149. Treas. Reg. §1.1361-1(m)(2)(iv).
150. Treas. Reg. §1.1361-1(m)(2)(v).
151. Treas. Reg. §§1.1361-1(j)(11) and (m)(6).
152. Treas. Reg. §1.1361-1(j)(12)(iv).

The IRS permits a trust to change its status **from a QSST to an ESBT** if **all** the following conditions are met.[153]

- The trust meets all the requirements to be an ESBT.
- The trustee and the trust's current income beneficiary sign the ESBT election. This ESBT election must state at the top of the document "ATTENTION ENTITY CONTROL—CONVERSION OF A QSST TO AN ESBT PURSUANT TO SECTION 1.1361-1(j)" and include all information otherwise required for an ESBT election. A separate election must be made regarding the stock of each S corporation held by the trust.
- The trust does not convert from an ESBT to a QSST within the 36-month period preceding the effective date of the new ESBT election.

The IRS permits a trust to change its status **from an ESBT to a QSST** if **all** the following conditions are met.[154]

- The trust meets all of the requirements to be a QSST.
- The trustee and the trust's current income beneficiary sign the QSST election. This QSST election must state at the top of the document "ATTENTION ENTITY CONTROL—CONVERSION OF AN ESBT TO A QSST PURSUANT TO SECTION 1.1361-1(m)" and include all information otherwise required for a QSST election. A separate QSST election must be made regarding the stock of each S corporation held by the trust.
- The trust does not convert from a QSST to an ESBT within the 36-month period preceding the effective date of the new QSST election.

PORTABILITY AND BYPASS TRUSTS[155]

Note. For more information about portability, see the 2015 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Individual Taxpayer Issues.

The portability election for estate and gift taxes first became available on January 1, 2011.[156] The portability election allows a surviving spouse to use the deceased spouse's unused exclusion (DSUE) in the event that the deceased's taxable estate is less than the exclusion applicable for the year of death. The 2016 estate exclusion amount is $5.45 million.[157]

Once made, the portability election is irrevocable unless an adjustment or amendment to the election is made on a subsequent Form 706 that is filed on or before the due date (including extensions).[158]

Property passing to the decedent's spouse is not included in the deceased's taxable estate.[159] Prior to the availability of the portability election, many wealthy taxpayers included provisions in their estate plans to pass a certain amount of property into an irrevocable trust for the benefit of their surviving spouse in order to keep the benefit of the exclusion. The trust created by this mechanism is often called a bypass trust, family trust, credit shelter trust, or an AB trust.

If the deceased taxpayer did not update their estate plan prior to their death or if they had other reasons to establish a bypass trust, the provision to transfer a portion of their estate into a bypass trust may still apply when they die. The exact wording of the provision is important. The following series of examples is intended to illustrate this point and demonstrate the tax consequences of the various options.

153. Treas. Reg. §1.1361-1(j)(12).
154. Treas. Reg. §1.1361-1(m)(7).
155. IRC §2010(c)(5).
156. PL 111-312, Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.
157. Rev. Proc. 2015–53, 2015-44 IRB 615.
158. IRC §2010(c)(5)(A).
159. IRC §2056.

Following are the facts for **Example 36** through **Example 38.**

1. Ben and Jeri Lynn were a married couple. Ben passed away on September 9, 2016.
2. Ben had two children from a previous marriage. Jeri Lynn has one child from a previous marriage.

Note. The income earned on assets that are transferred after death is often reported from the time of the taxpayer's death until the transfer is complete using the deceased's tax identification number. In situations like the following examples, the tax practitioner should prepare nominee forms to notify the IRS of the taxpayer who is responsible for reporting the income.

Example 36. Ben and Jeri Lynn held all of their assets in a joint revocable grantor trust (Trust A). They did not obtain an EIN for this grantor trust. Trust A provides that, upon the death of the first to die, assets valued at the amount of the estate exclusion are transferred to Trust B, an irrevocable trust. The income earned on the assets in Trust B are distributed at least annually to the surviving spouse. Under the terms of Trust B, the corpus may not be invaded until the death of the surviving spouse. The assets in both trusts are passed to the three children, per stirpes (in equal shares), after the surviving spouse's death.

The total assets in Trust A are valued at $6 million on Ben's date of death. Stocks and bonds valued at $5.45 million (the estate exclusion amount) were transferred to Trust B over the course of the next few months. The remaining $550,000 of assets is left in Trust A under Jeri Lynn's control.

Because the assets were owned in a joint grantor trust, only $3 million (half of $6 million) of the assets actually belonged to Ben. His executor filed Form 706, showing the $3 million as the value of his estate. The executor also made the portability election to transfer the $2.45 million ($5.45 million − $3 million) DSUE to Jeri Lynn.

Jeri Lynn filed a Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, to report that she gave $2.45 million ($5.45 million − $3 million) to Trust B. Because this transfer did not constitute a gift of a present interest, the **annual gift exclusion** did **not** apply[160] and the entire gift was added to her lifetime gifts. The DSUE she received from Ben's estate increased the amount of her lifetime exclusion for gift tax purposes as well as for estate tax purposes.[161]

Income earned by the assets in Trust A from January 1 to September 9 is reported on the couple's joint personal tax return for 2016. Income on the assets that remained in Trust A after Ben's death is also reported on the joint return.

The income earned on the assets in Trust B is reported on Form 1041. Because Trust B requires the income to be distributed annually, most of the income is passed through to Jeri Lynn. However, capital gains belong to the corpus and therefore are taxable to Trust B.

Example 37. Ben and Jeri Lynn held all their assets in a joint revocable grantor trust (Trust A). They did not obtain an EIN for this grantor trust. Trust A provides that upon the death of the first to die, the surviving spouse may disclaim any asset to a bypass trust (Trust B, which is an irrevocable trust). The income earned on the assets in Trust B is distributed at least annually to the surviving spouse. Under the terms of Trust B, the corpus may not be invaded until the surviving spouse's death. The assets in both trusts are passed to the three children, per stirpes, after the surviving spouse's death.

The total assets in Trust A are valued at $6 million on Ben's date of death. Jeri Lynn disclaimed assets valued at $2.5 million to Trust B. The remaining $3.5 million of assets is left in Trust A under Jeri Lynn's control.

---

160. IRC §2503(b)(1).

161. Treas. Reg. §25.2505-2.

Because the assets were owned in a joint grantor trust, only $3 million (half of $6 million) of the assets actually belonged to Ben. His executor filed Form 706, showing the $3 million as the value of his estate and $500,000 as the amount of his estate that transferred to his spouse. The portion of his estate subject to tax was $2.5 million ($3 million – $500,000). The executor also made the portability election to transfer the $2.95 million ($5.45 million − $2.5 million) DSUE to Jeri Lynn.

Jeri Lynn did not file Form 709. She did not give any of her portion of the Trust A assets to Trust B. She simply abdicated her right to receive a portion of Ben's estate (the $2.5 million in Trust B).

Income earned by the assets in Trust A from January 1 to September 9 is reported on the couple's joint personal tax return for 2016. Income on the assets that remained in Trust A after Ben's death is also reported on the joint return.

The income earned on the assets in Trust B is reported on Form 1041. Because Trust B requires the income to be distributed annually, most of the income is passed through to Jeri Lynn. However, capital gains belong to the corpus and therefore are taxable to Trust B.

Example 38. Ben and Jeri Lynn held all their assets in two separate revocable grantor trusts. Ben's Trust held farm ground that he inherited from his father and various bank accounts. Income earned on the assets in Ben's Trust from January 1 to September 9, 2016, is reported on Ben and Jeri Lynn's 2016 joint Form 1040. Ben's Trust provides that two irrevocable trusts are created upon his death: the B&JL Family Trust and the Ben's Spousal Trust.

1. **The B&JL Family Trust.** The farmland worth $4.45 million was transferred to the B&JL Family Trust. Under the family trust's terms, the net income each year **may** be distributed to Jeri Lynn at her request. After her demise, Ben's children become the income beneficiaries. The family trust terminates 25 years after the death of the last to die of Ben's children or the farmland's sale, whichever occurs first.

   The income earned from September 9 to December 31, 2016, is reported on the family trust's Form 1041. Jeri Lynn did not request any of the income. The family trust must pay the income tax due on the farm income.

2. **Ben's Spousal Trust.** Ben's bank accounts worth $100,000 were transferred to Ben's Spousal Trust. Under the terms of the spousal trust, the net income each year **must** be distributed to Ben's surviving spouse. After her demise, the trust is terminated and the assets are distributed to both Ben and Jeri Lynn's children, per stirpes.

   The trustee of the spousal trust may distribute the corpus of the trust to Jeri Lynn under certain circumstances. The provisions regarding corpus distribution are designed to allow the trustee to provide for Jeri Lynn's needs without the corpus being subject to invasion if Jeri Lynn is eligible for public aid.

   The income earned from September 9 to December 31 is reported on the spousal trust's 2016 Form 1041. At her request, Jeri Lynn did **not** receive any of the income. Nonetheless, the income passed through to her and is taxable on her 2016 personal return. The income she did not take is considered a gift to the spousal trust. Depending on the amount of the income, she may need to file Form 709 to report the gift.